CHAPTER 5

THE COMMONWEALTH OF INDEPENDENT STATES

5.1 The policy agenda

In 2003 and 2004, the CIS emerged as one of the fastest growing regions in the world economy, all 12 members posting solid, albeit varying, rates of GDP growth. This outcome followed more than a decade of uneven economic performance and setbacks that accompanied the difficult economic and political transformation in the region. The current economic boom is all the more welcome as it has contributed to a recovery of living standards in these countries. It also reflects the progress made in some of the CIS economies with the market reforms introduced some years previously.

The rapid rates of economic growth in the region, especially in the commodity exporting countries, owe much to a favourable external environment characterized by rising prices and robust demand for most basic commodities. High commodity prices have also boosted fiscal revenues in the commodity exporting CIS economies, and the generally high rates of GDP growth have contributed to more balanced fiscal positions throughout the region (table 5.1.1). Resources channelled into the recently established stabilization funds in Azerbaijan, Kazakhstan and Russia have grown rapidly, creating a cushion in the event of negative external shocks. Nevertheless, in 2004 there has been a general pattern of procyclical fiscal loosening in many of the CIS economies, in some cases (such as Kazakhstan and Ukraine) reflecting an increase in pre-electoral spending. Monetary policy was generally accommodative in 2004. Rates of inflation continued to fall in most of the CIS economies in 2004 but inflationary pressures re-emerged in the course of the year due to higher energy prices and expansionary fiscal policies. In many countries the year-end inflation targets announced at the beginning of 2004 are unlikely to be met. Rapid economic growth, however, has had relatively limited impact on employment, with Azerbaijan, Georgia, Kyrgyzstan, Russia and especially Kazakhstan being the only countries where new jobs were created in 2004.

In some countries, particularly Russia, the persistently large current account surplus associated with growing oil exports (chart 5.1.1) has created dilemmas for macroeconomic policies. An outflow of private capital (box 5.1.1) has only partly offset the macroeconomic effect of this surplus, which has put a strong upward pressure on the exchange rate. The Russian monetary authorities have tried to prevent an excessive appreciation of the rouble, and so reduce the pernicious effects of the so-called "Dutch Disease",,[141] while at the same time preserving control over the rate of inflation.[142] Despite the central bank's massive interventions, the real appreciation of the rouble continued in 2004, especially when measured on the basis of international differences on producer prices (chart 5.1.2).

The Russian experience clearly shows that monetary policy alone is incapable of dealing with the negative implications of the "Dutch Disease" for competitiveness. Given their considerable dependence on commodity exports, other CIS economies also face similar problems. The focus of their policy approach therefore needs to be considerably broadened in order to encompass a wider set of factors that have an effect on competitiveness. Public policy should aim to establish well-functioning product, labour and financial markets, in order to create an environment that encourages firms to increase efficiency through active restructuring (which is key for preserving and raising competitiveness in the face of real exchange rate appreciation). More generally, policy makers in these economies will have to continue to progress with key systemic institutional and structural reforms.

Compared with eastern Europe, market reforms in the CIS have been complicated by the legacy of a greatly distorted economic structure, the lack of unequivocal political and popular support for reform, and the absence of an external anchor for the reform process, such as a realistic expectation of EU membership. Nor are the CIS countries close to the large west European markets. Despite these disadvantages, reforms in the CIS have nevertheless advanced, although at a slower pace and with significant differences across countries.[143]

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[141] The term "Dutch Disease" denotes the real appreciation of the exchange rate and its negative repercussions on the tradeable sector as a result of resource windfalls. In Russia, during the last several years there have been a series of shifts in the current account position due to increasing shipments and rising prices of oil. As can be seen in chart 5.1.2, these have led to a considerable cumulative real appreciation of the rouble.

[142] As discussed in section 5.2(i), this inconsistent policy led to conflicting objectives in monetary management.

[143] For an overview of the reform process in the CIS, see UNECE, "Progress in systemic reforms in the CIS", *Economic Survey of Europe, 2003 No. 1*, chap. 5, pp. 123-147.

TABLE 5.1.1

Fiscal deficits and public debt in the CIS economies, 2000-2005
(Per cent of GDP)

	Consolidated general government deficit (-) / surplus (+)						*Public debt* [a]				
	2000	*2001*	*2002*	*2003*	*2004* [b]	*2005 target*	*2000*	*2001*	*2002*	*2003*	*2004* [c]
Armenia	-6.4	-3.7	-0.3	-1.1	-1.3	..	..	45.3	46.6	40.9	..
Azerbaijan	-1.3	1.2	-0.4	-2.0	-1.2	..	..	..	..	..	..
Belarus	-0.2	-1.9	-1.8	-1.0	-1.5	-1.5	15.0	..	13.1	10.6	9.4
Georgia	-4.7	-2.0	-2.2	-1.3	-1.2	-0.5	60.3	57.7	55.0	54.3	..
Kazakhstan	-0.8	2.7	1.4	3.0	2.3	1.6	25.5	20.4	17.7	15.5	14.4
Kyrgyzstan	-9.9	-5.5	-6.3	-5.5	-4.7	-4.5	112.4	100.4	103.0	101.6	..
Republic of Moldova	-2.8	-0.5	-2.0	0.2	-0.7	-0.5	73.2	60.7	56.9	47.1	39.1
Russian Federation	3.1	2.7	0.6	1.1	3.2	1.5	63.3	50.8	43.2	32.1	28.1
Tajikistan	-0.6	-3.2	-2.4	-1.8	-3.5	..	..	..	..	..	..
Turkmenistan	..	-1.1	-0.7	-0.9	–	–	..	..	..	..	..
Ukraine	-1.3	-1.6	0.5	-0.7	-4.3	-1.3	..	31.0	29.2	25.0	23.1
Uzbekistan	..	-1.3	-3.0	-2.2	-1.1	-1.0	..	..	..	..	..

Source: UNECE secretariat estimates and calculations, based on direct communications from national ministries of finance, central banks and national statistical offices; IMF, *International Financial Statistics* (Washington, D.C.), various issues and country studies; TACIS publications.

Note: The consolidated general government deficit, or financing requirement, is reported in accordance with the IMF GFS method. National reporting practices may, in some cases, differ from this methodology. The 2005 targets are official budget deficits, forecast in the initial budget proposals, necessarily involving GDP and inflation projections as well as fiscal data. The definitions of the target deficits as well as some of the preliminary estimates of the deficits in 2004 may differ from the above definition. Definition of public debt: central government debt for Belarus, Kyrgyzstan and the Russian Federation; central government and government guaranteed for Armenia; consolidated general government debt for Georgia, Kazakhstan, Republic of Moldova and Ukraine.

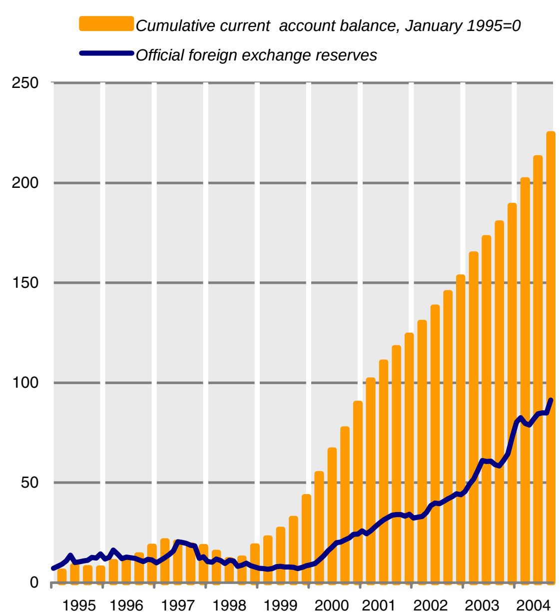
a End of period values.

b Forecast.

c June.

CHART 5.1.1

Russia's current account balance and official foreign exchange reserves, 1995-2004QIII
(Billion dollars)



Source: UNECE secretariat calculations, based on national statistics.

Most of the progress has been concentrated in basic market reforms, such as price and trade liberalization and small-scale privatization. Structural and institutional reforms – for example, of major institutions (the judiciary, public administration, health care, the pension system), labour markets, the banking system, competition policy, the establishment of effective bankruptcy procedures, etc. – have been much patchier. Compared with the basic reforms, the latter are more complicated as they require the creation and development of the structures and institutions that govern a market economy. In other words, they involve a transformation of the role of the state from direct participant in economic activity to regulator and institution-builder in a market context. The new institutional structures are required to define and implement policy, without directly interfering in the functioning of markets, and to enable these functions to be performed in an efficient, transparent and predictable manner.

In general, the pace of institutional and structural reforms in the CIS has slowed down in recent years, including 2004. In effect, policy makers have failed to take full advantage of the favourable economic circumstances during this period to accelerate the pace of systemic change. Electoral cycles may have affected the pace of reform in a number of countries that until recently had led the reform process in the region, such as Kazakhstan, Russia and Ukraine. Weak "state capacity" (the capacity of the public administration to initiate and implement reforms) appears to be an important constraint on structural and institutional reforms in the low-income CIS countries.

The loss of momentum in the reform process in the CIS is regrettable, given the daunting challenges that these economies face. Despite their strong economic performance

BOX 5.1.1

Capital outflows from the Russian Federation

Large capital outflows historically have had a weakening effect on Russia's balance of payments. In the immediate pre-devaluation period, substantial external financing was required to offset these outflows, as the current account balance did not provide the necessary funds.[1] Since then, the economic and political situation has changed radically, resulting in a much stronger balance of payments position. However, capital flight remains a significant problem.

There is no agreement on the definition of capital flight in the economic literature; different studies use diverse definitions. Moreover, conceptual differences may not yield operational indicators because of measurement problems. Thus, the definition of capital flight as outflows that exceed the amounts that could be explained by legitimate portfolio diversification is appealing but not easy to apply in practice. Broader definitions have the merit of avoiding difficult-to-make distinctions while capturing the overall impact on financing and foreign exchange supply.

The Central Bank of Russia (CBR) regularly presents figures on net private capital outflows, which include transactions by banks, non-financial companies and households (i.e. the non-financial private sector). Net errors and omissions in the balance of payments are included in their entirety and attributed to this latter sector. However, it is conceivable that this partly reflects unrecorded imports, which would have the effect of overstating both the reported current account surplus and capital outflows. Overall, net private capital outflows represent a broad measure of capital flight. Only public sector transactions are excluded, which comprise public debt transactions, foreign currency reserves and, since 2004, resources channelled into the Stabilization Fund.

It is possible to distinguish three periods in the overall dynamics of net private capital flows in Russia. The most critical phase was during the period 1997-1998, when large outflows were accompanied by a current account that was roughly in balance. In the subsequent two years (1999-2000), net outflows increased slightly, but they were accompanied by large current account surpluses, with the coverage ratio improving dramatically. In 2001-2003 there was a steady decline in net outflows, while the current account surplus remained large. As a result, these outflows represented only 6 per cent of the surplus in 2003. This evolution is consistent with the reduction of macroeconomic and political instability during this period. Empirical studies show that variables which measure instability, including expectations of a devaluation and the state of public finances, appear to have been the main determinants of capital flight.[2] In addition, there was less uncertainty over public policy, once the policy framework became easier to predict.

While the Russian Federation's current account remains healthy, estimates for the first three quarters of 2004 indicate that net capital outflows picked up again, with an increase of more than $7 billion from the same period in 2003. However, changing perceptions regarding the policy environment may now be exerting a negative influence.

As a net measure, net private capital outflows – the indicator of capital flight referred to so far – reflect transactions related to various types of assets held by both Russians and non-Russians. While from a macroeconomic point of view it is the aggregate result that matters, the implications of the dynamics of the various components are different, and should therefore be considered separately. Three main trends have emerged in recent years, each exerting a significant influence on overall net outflows: the growth of Russian foreign direct investment abroad, renewed confidence in the rouble, and increased access by Russian corporations to foreign financing.

Balance of payment figures show that net FDI inflows were negative since 2002, turning positive in the first nine months of 2004. The expansion of Russian corporations abroad has mainly involved the purchase of assets by natural resource companies as part of their efforts towards the global integration of their production networks or to secure market access. More recently, companies in other sectors, such as automotive, telecoms and information and communication technologies (ICT), have also sought to establish a direct presence abroad.[3] Outward FDI is not necessarily a reflection of the lack of domestic opportunities; rather, it is a sign of the strength of emerging Russian companies. On the other hand, the real appreciation of the rouble since 1999 (following its devaluation in 1998) has suppressed domestic demand for foreign exchange, as reflected in the balance of payments figures that indicate a fall in foreign cash assets since 2003.

Rating upgrades and favourable financing conditions for emerging markets have allowed Russian non-bank corporations to raise a significant amount of funds abroad since late 2001, with borrowing by the banking sector taking off somewhat later.[4] Access to international capital markets has allowed them to bypass the still inefficient domestic financial system, although at the cost of increasing foreign exchange risk. Massive borrowing caused recorded net private capital outflows to reach their lowest level in 2003. This was the result of a large increase in the liabilities (which appear in the balance of payments as a positive entry) of the banking and non-banking sectors by $33.3 billion. In contrast, the pace of accumulation of assets abroad by non-bank corporations slowed somewhat in the first nine months of 2004 ($1.7 billion less than in the same period of the preceding year, including errors and omissions, according to CBR estimates), and the increase in net outflows can be explained mainly by the decrease in liabilities and the accumulation of further assets by the banking sector. Driven by the rise in interest rates and the financial turmoil in mid-2004, movements in interest-sensitive flows appear to have been the main factor contributing to the increase in net capital outflows, in what seems to have been a reversal of the borrowing which took place in 2003. Despite some emerging concerns regarding the direction of economic policy and the protection of property rights in the Russian Federation, evidence of any significant impact on net private capital outflows is so far limited.

BOX 5.1.1 (concluded)

Capital outflows from the Russian Federation

On the basis of CBR data, it is possible to construct a narrower measure of capital flight (chart 5.1.3), which includes estimates of non-repatriated export revenues, fictitious import contracts, and errors and omissions in the balance of payments. In absolute terms, the ratio of this measure to the current account surplus declined sharply after the devaluation of the rouble; it then drifted upwards after 2001 only to fall again in 2004. A broader coverage along with measurement difficulties may partially explain these movements.

As argued earlier, the distinction between unrecorded capital outflows and broader measures has little significance from the point of view of the overall financing available to the economy. The new currency control law, which was enacted in June 2004, envisages a gradual elimination of most capital controls by 2007, which would make this difference even less meaningful.

Given the net private capital outflows, averaging almost $17 billion annually during the period 1996-2003, Russian residents may have accumulated a large stock of capital abroad, even allowing for some consumption and possible capital losses. This represents a significant pool of foreign assets from which reversals of previous outflows could take place. However, since some of these capital outflows reflect portfolio diversification, part of the cumulated stock is likely to remain abroad, even if adverse incentives for domestic investment are removed. The origin of some of the capital flowing into the Russian Federation suggests that some reversal has already been taking place. Insofar as Russian investors may display a superior knowledge of the domestic situation, such a reversal could imply a greater endorsement of national policies. However, it is arguable whether policy should specifically aim to reverse the flow of capital. A more appropriate stance would be to establish a favourable investment climate for foreign and domestic investors alike.[5] This would require mainly an effective protection of property rights, predictability of relations with the administration and further development of the financial system. However, institutional upgrading is a lengthy process that requires consistent actions over a long period of time.[6]

Moreover, a sharper than observed reduction in net capital outflows in recent years would have created even more problems for monetary management through increased upward pressure on the rouble. Successful economic restructuring requires sustained investment, which, apart from the evolution of oil prices, should erode the current account surplus. Declining net capital outflows are required as a counterpart to this desirable development.

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1 The balance of payments identity implies that a surplus in the current account must be accompanied by a net accumulation of foreign assets. This is reflected in an aggregate deficit of the capital and financial accounts, including the accumulation of foreign reserves, which appear with a negative sign in the balance of payments. Capital outflows that exceed the financing possibilities of the current account surplus (or which add to the financing requirements of the current account deficit) must be offset by capital inflows, including a loss of reserves, which enter the balance of payments with a positive sign.

2 A useful review of empirical studies on the determinants of capital flight is given in N. Hermes, R. Lensik and V. Murinde, *Flight Capital and its Reversal for Development Financing*, United Nations University/World Institute for Development Economics Research, Discussion Paper No. 2002/99 (Helsinki), 2002. This confirms that the broad definitions are the most commonly used.

3 UNCTAD, *World Investment Report 2004: The Shift Towards Services* (United Nations publication, Sales No. E.04.II.D.36), pp. 72-73. Low inward FDI figures partly reflect the fact that some transactions have been conducted offshore.

4 However, this does not appear excessive when compared with the overall increase in borrowing and equity issuance by emerging markets. International Monetary Fund, *Russian Federation: Selected Issues*, IMF Country Report No. 04/316 (Washington, D.C.), 2004.

5 In the recent past, some countries, such as Italy and South Africa, have declared an amnesty with the aim of recovering past tax losses due to the outflows. This, however, requires strong government credibility and avoidance of moral hazard problems. W. Buiter and I. Szegvari, *Capital Flight and Capital Outflows from Russia: Symptom, Cause and Cure,* European Bank for Reconstruction and Development Working Paper, No. 73 (London), 2002.

6 There is a difference between the announcement effect of changes and the actual consequences of their implementation, which are only likely to appear after a certain time lag. P. Hanson, "Putin and Russia's economic transformation", *Eurasian Geography and Economics*, Vol. 45, No. 6, 2004.

in recent years, the CIS economies still lag behind eastern Europe in terms of the recovery of output to its pre-transition level.[144] Overall, compared with eastern Europe, there has also been less progress in transforming the economic structures of the CIS countries. Much of the new investment in the CIS has been in the extractive industries, while relatively little has gone to other sectors of economic activity. And probably most important, the current pattern of economic growth in the CIS, heavily reliant on rising commodity exports, is not sustainable in the medium and long run. A failure to respond adequately to such problems will only make them more acute. They require instead a widening, deepening and acceleration of the reform process.

Economic diversification, which in the smaller commodity exporting CIS economies is closely linked to their efforts to reduce the incidence of poverty, constitutes an important policy challenge for most countries in this region. While large windfall revenues may tempt policy makers to engage in activist fiscal intervention (in the form of industrial policies involving increasing amounts of public funds), such a strategy runs a significant risk of introducing distortions. The case for intervention may be stronger in the provision of basic infrastructure services or improving education, as opposed to favouring specific sectors or activities. Plans

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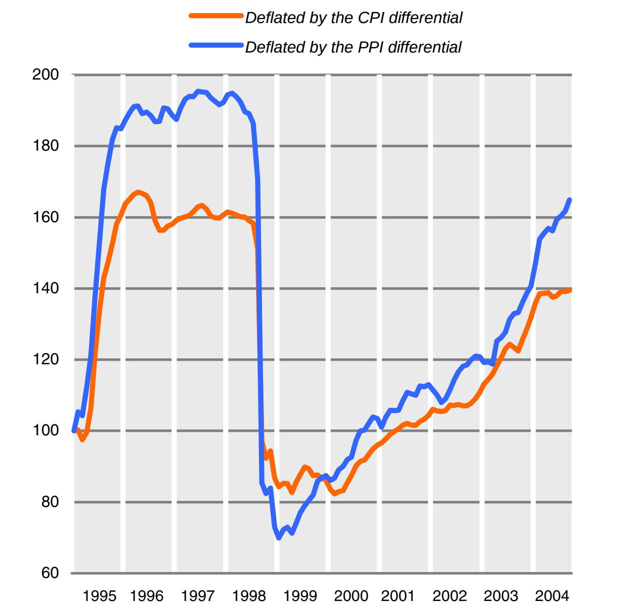
144 While aggregate GDP in eastern Europe as a whole had surpassed its 1989 level by 2001, in the CIS in 2003 it was still some 75 per cent of its 1989 level.

CHART 5.1.2

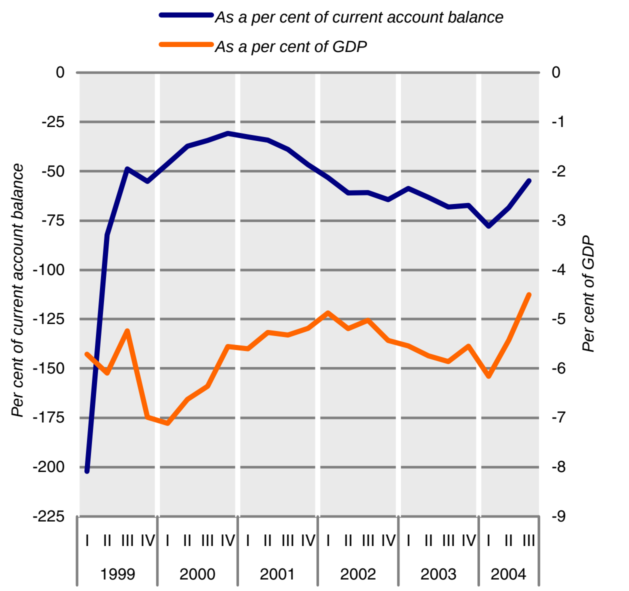
The rouble's real exchange rate against the dollar, January 1995-September 2004
(Indices, January 1995=100, per cent)



Source: UNECE secretariat calculations, based on national statistics.

CHART 5.1.3

Capital flight in Russia, narrow definition,[a] 1999-2004QIII
(Percentages)



Source: Central Bank of Russia; UNECE Common Database.

[a] The narrow definition includes non-repatriated export revenues, fictitious import contracts and errors and omissions. The values in the chart refer to rolling, cumulative four quarter indicators. The values for 2004QIII are Central Bank of Russia estimates.

in these areas will require a realistic assessment of the absorptive capacity of the economy and the ability of the institutional structures to implement them. Reforming the so-called "natural monopolies" (in particular, the electricity sector) remains a challenge in many countries including Russia. An important objective is to ensure the reduction of waste by means of an appropriate price structure and to provide the industry with the necessary funds for its long-term investment needs.

Labour market reforms are another key ingredient of the broad reform agenda of the CIS economies, and should be assigned high priority. Moreover, compared with eastern Europe, the CIS economies have made less progress in reforming their labour markets. Unfinished restructuring, as gauged by the share of loss-making enterprises in many countries and incomplete privatization, indicate the potential for further labour shedding. Policies fostering labour mobility, including the removal of bottlenecks in the housing market and of obstacles to the creation of new companies, are required to absorb the excess labour released from particular activities and companies. Unemployment benefit systems in the CIS (which appear to be rather inefficient in stimulating labour adjustment and active job search)[145] also require a radical overhaul. But most importantly, in order to lay the foundations for sustained and high rates of growth, these economies need to foster job creation in modern, high value added manufacturing and market services.

Financial reforms are another key component of the reform agenda as financial development can foster the growth of investment and promote the desired economic diversification. There are substantial differences in the depth of CIS financial sectors (table 5.1.2) but even in the countries with more sophisticated financial sectors, comparative indicators highlight the need for further progress. The prevalent large spreads on domestic interest rates indicate high levels of risk and widespread inefficiencies in the banking sectors. Improvements in the business environment and increased competition should be encouraged in order to address these deficiencies. Difficult access to credit is often quoted as a constraint on the development of small and medium enterprises (SME), which are expected to play a significant role in the development of activities outside the commodities sector. Poor corporate governance and outdated accounting practices, as well as weak banking supervision add to the underlying vulnerabilities of the region's financial systems, as evidenced by the recent turmoil in Russia's banking sector.

Financial development needs to start with the creation of a modern and efficient banking system but the importance of other non-banking financial intermediaries, such as insurance companies, pension funds and the organization of capital markets, should not be neglected. To some extent, the roots of the underdevelopment of the financial system are related to the ineffectual protection

[145] For details see UNECE, "Changes in unemployment benefit systems in eastern Europe and the CIS", *Economic Survey of Europe, 2003 No. 1*, chap. 7.1, pp. 191-198.

TABLE 5.1.2

Short-term interest rates and credit to the non-government sector in selected CIS economies, 2002-2004

(Per cent per annum, per cent of GDP)

	Interest rates on short-term credits (per cent)						*Interest rates on short-term deposits (per cent)*						*Total credit [a] (per cent of GDP)*		
	Nominal			*Real*			*Nominal*			*Real*					
	2002	*2003*	*2004 [b]*	*2002*	*2003*	*2004 [b]*	*2002*	*2003*	*2004 [b]*	*2002*	*2003*	*2004 [b]*	*2002*	*2003*	*2004 [c]*
Armenia	21.1	20.8	18.6	18.1	10.9	-2.0	9.6	6.9	5.0	8.5	2.1	-2.6	6.7	5.4	5.6
Azerbaijan	17.4	15.4	15.2	20.2	-0.6	10.1	8.7	11.5	9.3	5.7	9.2	3.5	6.4	7.2	8.6
Belarus	37.3	24.0	17.7	-2.2	-9.9	-6.4	27.2	17.4	13.0	-10.9	-8.6	-5.5	12.2	14.3	15.7
Georgia	31.8	32.3	34.5	24.4	29.3	29.8	9.8	9.3	7.8	3.9	4.2	2.4	9.1	9.9	9.2
Kazakhstan	15.6	15.5	14.6	15.2	5.7	0.9	11.3	10.6	9.5	5.0	3.7	2.2	16.4	19.3	22.1
Kyrgyzstan	36.2	24.3	21.5	29.1	15.7	10.2	7.9	5.5	5.3	5.7	2.3	0.8	3.8	4.1	4.7
Republic of Moldova	23.5	19.3	20.9	18.0	10.7	14.6	14.2	12.6	15.0	8.5	0.7	1.9	15.8	18.7	19.2
Russian Federation	15.7	13.0	11.7	-1.2	-0.1	-9.2	5.0	4.5	3.8	-9.5	-8.0	-6.3	16.0	18.6	21.9
Tajikistan	14.2	16.6	20.9	4.5	1.4	4.1	9.2	9.7	9.9	-2.7	-5.7	2.3	18.6	15.9	14.9
Ukraine	25.4	17.9	17.4	21.7	9.6	-1.3	7.9	7.0	8.1	7.1	1.7	–	14.3	21.1	25.3

Source: National statistics and direct communications from national statistical offices to the UNECE secretariat; IMF, *International Financial Statistics* (Washington, D.C.), various issues.

Note: Definition of interest rates:

Credits – Armenia: weighted average rate charged by commercial banks on new loans in domestic currency with maturities of 15 days to less than a year; Azerbaijan: weighted average rate charged by commercial banks on 12-month loans in national currency; Belarus: weighted average rate on short-term loans; Georgia: weighted average rate charged by commercial banks on three-month loans in national currency; Kazakhstan: weighted average interest rates for new credits; Kyrgyzstan: weighted average rate on loans in soms for one- to three-month maturities; Russian Federation: weighted average rate on loans of up to one-year maturity; Tajikistan: weighted average rate charged by commercial banks on loans of all types and maturities in national currency to non-bank sectors; Ukraine: weighted average rate on short-term loans. The real lending rates are the nominal rates discounted by the average rate of increase in the PPI for the corresponding period.

Deposits – Armenia: weighted average rate charged by commercial banks on new deposits in domestic currency with maturities of 15 days to less than a year; Azerbaijan: weighted average rate offered by commercial banks on 12-month deposits in national currency; Belarus: weighted average rate on short-term deposits; Georgia: weighted average rate offered by commercial banks on three-month deposits in national currency; Kazakhstan: weighted average interest rate (for new deposits); Kyrgyzstan: weighted average rate offered on time deposits of three-month maturities; Russian Federation: prevailing rate for time deposits with maturity of less than one year; Tajikistan: weighted average rate offered by commercial banks on time and savings deposits of various maturities in national currency; Ukraine: weighted average rate on short-term deposits. The real deposit rates are the nominal rates discounted by the average rate of increase in the CPI for the corresponding period.

a Total outstanding claims of commercial banks on the non-government sector. GDP data for 2004 are preliminary estimates.

b January-September; for Georgia, Kyrgyzstan and Tajikistan: January-August.

c January-September; for Armenia, Kazakhstan, Kyrgyzstan and Tajikistan: January-June.

of property rights, the absence of an efficient and impartial judicial system, weaknesses in the legal framework and the lack of transparency in corporate accounts. Ultimately, an underdeveloped financial system – which is a drag on economic growth – is a mirror of the overall economic and institutional conditions in a country. Financial reforms should thus be regarded as an integral part of a broader and more comprehensive programme of institutional and structural reform.

5.2 Recent macroeconomic developments

(i) Russia and other European CIS countries

(a) Macroeconomic performance

Growth remained vigorous in Russia for a second consecutive year…

Russia's economy continued to grow strongly in 2004, reaping windfall gains from the high world market prices of oil (table 5.2.1). However, economic activity started to lose some momentum in the third quarter, suggesting that the annual increase in GDP might be less than in 2003.[146] This deceleration reflects a combination of factors, including the real appreciation of the rouble, rising production costs and the negative impact of the turmoil in the banking system on access to credit.[147] In particular, a number of leading manufacturing branches seem to have suffered losses in competitiveness as a result of the rising real exchange rate. Construction activity also slowed down, most likely as a result of the banking crisis. In contrast, the growth of services has remained robust, particularly in communications.

While the average profitability of the corporate sector in Russia has been improving in recent years, there is still a large, albeit declining, group of loss-making companies.[148] This indicates the persistence of a segmented economic structure, partly the result of significant barriers to exit, characterized by costly allocative inefficiencies. Aggregate industrial performance figures (including

[146] Quarterly industrial output grew by 4.9 per cent, year-on-year, in the third quarter, down from 7.6 per cent in the first quarter and 7.1 per cent in the second.

[147] In the summer of 2004, Russia's central bank withdrew the banking licences of several banks, which caused a temporary havoc and withdrawals of deposits from the banking system. However, with most banks in a relatively sound financial position, the turmoil did not escalate into a full-blown banking crisis.

[148] While net aggregate corporate profits (excluding agricultural and financial companies) rose by 52.2 per cent, year-on-year, in the first nine months of 2004, 37.5 per cent of companies reported losses. Ministry of Economy of the Russian Federation, *Monitoring za yanvar'-oktyabr' 2004* (Moscow), 2004.

TABLE 5.2.1

Changes in real GDP in the CIS, 2003-2004
(Percentage change over the same period of the preceding year)

	2003	2004 [a]	2003 QI	2003 QII	2003 QIII	2003 QIV	2004 QI	2004 QII	2004 QIII
CIS	7.7	7.9	7.5	8.1	6.7	8.5	8.2	8.5	8.1
Armenia	13.9	10.0	11.8	16.7	15.9	11.3	7.5	10.2	11.2
Azerbaijan	11.2	9.5	7.9	12.2	11.3	13.2	10.6	10.6	8.6
Belarus	6.8	10.0	5.6	4.7	7.3	8.9	9.3	11.0	11.7
Georgia	11.1	6.0	6.5	12.3	10.2	14.8	9.2	9.2	1.7
Kazakhstan	9.3	9.3	10.5	9.6	7.7	9.2	9.0	9.2	9.1
Kyrgyzstan	6.7	6.5	4.6	0.8	7.8	10.8	5.7	12.2	4.8
Republic of Moldova	6.3	8.0	5.4	7.3	5.9	6.5	6.1	6.8	7.7
Russian Federation	7.3	6.8	7.5	7.9	6.5	7.6	7.5	7.4	6.4
Tajikistan	10.2	11.0	12.1	5.2	6.6	16.8	9.1	13.2	15.5
Turkmenistan [b]	6.8	6.0	..	..	..	..	..	..	..
Ukraine	9.4	12.4	8.4	10.0	6.8	12.1	12.3	13.2	14.3
Uzbekistan	4.4	7.6	2.2	5.4	4.4	5.9	4.8	7.5	14.2
Memorandum items:									
CIS without Russian Federation	8.5	10.1	7.5	8.5	7.3	10.2	9.6	10.8	11.6
Caucasian CIS countries	11.7	8.6	8.3	13.2	12.0	13.2	9.5	10.1	7.1
Central Asian CIS countries	7.5	8.4	7.4	7.3	6.6	8.4	7.3	8.7	10.2
Three European CIS countries	8.6	11.6	7.5	8.4	6.9	11.0	11.3	12.4	13.4
Low-income CIS countries	7.7	8.1	5.4	7.9	7.7	9.7	7.0	9.2	10.4

Source: National statistics; CIS Statistical Committee; direct communications from national statistical offices to UNECE secretariat.

Note: The CIS countries defined by the IFIs as low-income countries are: Armenia, Azerbaijan, Georgia, Kyrgyzstan, Republic of Moldova, Tajikistan and Uzbekistan. The aggregates are computed by the UNECE secretariat using weights based on purchasing power parities.

a Preliminary estimate.

b The annual changes of real GDP in Turkmenistan are UNECE secretariat estimates. On the methodology used, see box 5.2.1. These annual GDP growth rates were also used in computing the corresponding quarterly regional aggregates.

industrial productivity) thus mask large differences among firms and industries, underlining the need for further restructuring.

On the demand side, private consumption was the main source of growth, with the national accounts showing a significant acceleration in the first half of the year (tables 5.2.2 and 5.2.3). Retail trade figures suggest that this continued into the third quarter (table 5.2.4). Strong wage growth, new job creation and an improved terms of trade on households' income have supported buoyant consumption. Although gross fixed investment also rose strongly in the first half of the year, the latest figures indicate a certain loss of momentum, possibly related to the financial turmoil in the summer, which is likely to result in an overall deceleration for the year as a whole. There were also signs of diversification in fixed investment,[149] an acceleration of which would be welcome as it could bring about the productivity increases required to accommodate a stronger rouble.

Import growth continued to accelerate in 2004, bolstered by the strong domestic demand increasing the share of imports in domestic markets. The rapid rise in imports of 2004 was also driven by an increased demand for investment equipment.[150] In contrast, export volumes trailed behind and were losing some steam in the course of the year. The poor performance of industries that rely on the domestic market, against the background of rapid import growth, is yet another sign of the loss of competitiveness by domestic producers, implying a diminishing impact of final demand on domestic economic activity.[151] Income effects and supply constraints may have also played a role, as the increasing wealth of middle and upper class Russian consumers is shifting their preferences towards high-quality goods that are not always supplied by local producers.

…and accelerated in Belarus and Ukraine

A favourable external environment, coupled with solid domestic demand, fuelled a marked acceleration in Ukraine's GDP growth in 2004. In particular, the strong demand for Ukraine's key exports (chemicals, metals and some engineering products) boosted exporters' earnings, especially in the first half of the year, with positive spillovers

[149] There was a sharp drop in the share of investment going to the fuel-related industries (which, however, still remain the dominant sectors), with gains in communications, transport, agriculture and ferrous metallurgy.

[150] In the first nine months of 2004, the share of machinery, equipment and motor vehicles in total imports from non-CIS countries increased by 5.2 percentage points to 45.3 per cent. Ministry of Economy of the Russian Federation, op. cit.

[151] Output in light industry fell by 6.7 per cent, year-on-year, in the first 10 months of 2004, while in the food industry it grew by 3.8 per cent. In contrast, machine-building, with a 12 per cent increase in the same period, seems to be benefiting from the strength of investment.

TABLE 5.2.2

Components of real final demand in selected CIS countries, 2002-2004QII

(Percentage change over the same period of the preceding year)

	Private consumption expenditure [a]			*Government consumption expenditure [b]*			*Gross fixed capital formation*			*Exports of goods and services*			*Imports of goods and services*		
	2002	*2003*	*2004 QI-QII*	*2002*	*2003*	*2004 QI-QII*	*2002*	*2003*	*2004 QI-QII*	*2002*	*2003*	*2004 QI-QII*	*2002*	*2003*	*2004 QI-QII*
CIS	9.0	9.5	12.1	1.0	4.2	1.8	5.7	14.2	15.0	10.1	12.3	11.1	10.7	16.6	17.0
Armenia	8.9	8.4	9.6	2.2	14.0	13.6	33.1	33.7	9.2	35.8	29.0	1.3	18.9	27.0	-2.4
Azerbaijan	8.0	9.7	..	14.5	22.1	..	84.0	61.5	..	-6.3	19.6	..	16.4	57.6	..
Belarus	10.9	7.0	10.4	0.4	0.6	0.7	6.7	17.7	22.5	10.1	9.4	11.7	9.1	10.4	15.6
Kazakhstan	12.2	22.2	..	-4.3	7.5	..	10.2	8.9	..	22.6	5.5	..	4.3	-4.1	..
Kyrgyzstan	4.7	11.2	9.3	-0.2	-1.2	2.1	-7.4	-1.4	29.0	8.1	2.5	23.2	13.1	1.8	28.8
Republic of Moldova	6.3	16.7	8.4	30.3	-0.5	-15.4	5.7	13.3	15.9	19.0	18.9	10.4	15.7	25.0	7.5
Russian Federation	8.7	7.8	12.1	2.6	2.2	2.5	3.5	12.2	13.2	9.6	13.7	10.5	14.6	19.5	21.9
Ukraine	9.0	12.1	15.1	-6.7	14.8	-2.7	3.4	15.8	12.1	7.4	10.3	15.8	3.3	16.4	10.5

Source: National statistics; CIS Statistical Committee; direct communications from national statistical offices to UNECE secretariat.

Note: The aggregates are computed by the UNECE secretariat using weights based on purchasing power parities.

a Expenditures incurred by households and non-profit institutions serving households.

b Expenditures incurred by the general government on both individual consumption of goods and services and collective consumption of services.

TABLE 5.2.3

Contributions of the major components of final demand to changes in real GDP in selected CIS economies, 2002-2004QII

(Percentage points)

	Final consumption expenditure			*Gross fixed capital formation*			*Changes in stocks*			*Total domestic expenditure [a]*			*Net exports*		
	2002	*2003*	*2004 [b] QI-QII*	*2002*	*2003*	*2004 [b] QI-QII*	*2002*	*2003*	*2004 [b] QI-QII*	*2002*	*2003*	*2004 [b] QI-QII*	*2002*	*2003*	*2004 [b] QI-QII*
Armenia	8.6	8.9	10.5	5.9	7.1	2.0	-1.4	–	–	13.0	16.0	12.6	0.4	-4.1	2.3
Azerbaijan	6.9	8.8	..	19.2	21.0	..	-1.9	0.3	..	24.3	30.1	..	-8.7	-20.4	..
Belarus	6.4	4.3	7.4	1.5	3.9	5.4	-0.9	0.3	0.6	7.0	8.5	13.4	0.4	-1.0	-4.6
Kazakhstan	6.5	13.9	..	2.4	2.1	..	0.6	-0.2	..	9.5	15.8	..	8.4	4.5	..
Kyrgyzstan	3.0	7.4	7.3	-1.2	-0.2	2.9	0.1	-0.1	0.2	1.9	7.0	10.4	-1.9	0.2	-4.2
Republic of Moldova	9.8	13.8	3.9	1.0	2.2	2.5	-0.7	-0.3	0.7	10.0	15.7	7.1	-2.2	-9.4	-0.6
Russian Federation	4.8	4.5	6.5	0.7	2.2	2.0	-1.1	0.5	0.4	4.3	7.2	8.9	–	–	-1.7
Ukraine	3.8	9.6	8.2	0.7	3.0	2.3	-1.0	-0.4	-1.5	3.5	12.2	9.0	2.3	-2.6	3.9

Source: National and CIS Statistical Committee data; direct communications from national statistical offices to UNECE secretariat.

Note: The sum of the component changes does not add up to the GDP change for some CIS economies because of a reported statistical discrepancy, which appears on the expenditure side because the statistical offices base total GDP on the production side rather than the components of expenditure.

a Total consumption expenditure plus gross capital formation.

b Over the same period of 2003.

to other activities. However, the dynamics of industrial output suggest a certain moderation in the third quarter (chart 5.2.1), possibly indicating a weakening of demand. Agricultural output, which was badly affected by poor weather in 2003, recovered strongly in 2004 (thanks, in particular, to a record grain harvest), and made an important contribution to GDP growth. Construction activity was also on the rise, reflecting increasing incomes and a high level of fixed investment. Both domestic and external demand contributed to the high rate of GDP growth in the first half of 2004, Ukraine being one of the few CIS economies where net exports made a positive contribution to the increase in GDP (table 5.2.3). Real private consumption expenditure increased at a double-digit rate (table 5.2.2), fuelled by large wage increases. Quarterly figures for retail trade suggest that consumer demand remained strong in the third quarter as well (table 5.2.4). Gross fixed capital formation also continued to grow very rapidly.

While the recent economic performance in Ukraine has been impressive, the strong export-led growth is very narrowly based and vulnerable to a worsening of the external environment. The existence of a large current account surplus, despite the obvious investment needs of the country, suggests the presence of significant barriers to investment that need to be removed by further progress in structural reforms.

In 2004, economic growth also accelerated in Belarus. While the upturn was broadly based, the main supply-side impetus came from manufacturing, with industrial production accelerating in the course of the

TABLE 5.2.4

Volume of retail trade and real investment outlays in selected CIS economies, 2001-2004
(Percentage change over the same period of the preceding year)

	Volume of retail trade				Real investment outlays			
	2001	2002	2003	2004 [a]	2001	2002	2003	2004 [a]
Armenia	15.5	15.6	14.5	9.4	6.0	45.0	41.0	16.0
Azerbaijan	9.9	9.6	10.9	12.5	21.0	84.2	73.5	45.3
Belarus	28.2	11.5	9.9	11.3	-3.0	6.0	21.0	20.0
Georgia	7.3	3.7	8.8	6.3	11.0	18.0	68.0	22.0
Kazakhstan	15.7	8.2	10.0	10.0	44.7	10.6	10.6	10.0
Kyrgyzstan	6.2	8.2	13.5	18.7	-14.5	-9.6	-6.6	9.0
Republic of Moldova	14.8	34.2	18.2	9.7	11.0	11.0	16.0	12.0
Russian Federation	10.7	9.2	8.0	11.5	8.7	2.6	12.5	11.6
Tajikistan	1.6	17.5	24.5	21.9	..	..	..	..
Ukraine	11.6	16.2	21.0	18.7	20.8	8.9	31.3	34.5
Uzbekistan	9.6	1.7	5.1	3.1	3.7	3.8	4.5	3.0

Source: National statistics; CIS Statistical Committee; direct communications from national statistical offices to UNECE secretariat.

Note: Retail trade covers mainly goods in Kazakhstan and the Russian Federation; it comprises goods and catering in other CIS countries. The coverage in 2004, based on current monthly statistics, may differ from the coverage of annual statistics. Investment outlays mainly refer to expenditure on construction and installation works, machinery and equipment. Gross fixed capital formation is usually estimated by adding the following components to "capital investment": net changes in productive livestock, computer software, original art, the cost of mineral exploration and the value of major renovations and enlargements of buildings and machinery and equipment (which increase productive capacity or extend the service life of existing fixed assets).

a January-September.

year (chart 5.2.1). On the demand side, growth was predominantly driven by the continuing recovery of domestic absorption (particularly of fixed investment – table 5.2.2). With imports outpacing exports, net exports contributed negatively to GDP growth (table 5.2.3), despite the strong growth in exports, especially to Russia. In the Republic of Moldova, economic growth remained relatively strong in 2004. Good harvests contributed to a notable upturn in the important sector of agriculture and the related food-processing industry. Private consumption continued to rise strongly, partly driven by remittances from abroad.

Inflationary pressures are re-emerging in the large economies

During the course of the year, inflationary pressures were rising in both Russia and especially Ukraine, largely a consequence of the loosening of macroeconomic policy. In Russia, the cumulative inflation rate in January-September 2004 was 8.1 per cent, only a fraction lower than in the same period of 2003. The official target of 8 to 10 per cent for the cumulative year-end inflation rate (it was 12 per cent in 2003) appears unlikely to be achieved. The persistence of a relatively high rate of consumer price inflation reflects the effect of a highly expansionary monetary policy (see below) against a background of buoyant consumer demand. In Ukraine, the resurgence of inflationary pressure was even more pronounced, consumer prices rising faster than in the same period of 2003 (table 5.2.5). This largely reflects the effect of the pre-election loosening of fiscal policy (discussed below), which is likely to carry over into 2005. The hryvnia depreciated rather strongly in nominal effective terms and this added further upward pressure on prices. In both Russia and Ukraine, industrial producer prices rose even faster than consumer prices in the period January-September 2004 (chart 5.2.2), suggesting the likelihood of a further inflationary boost if the price rises incurred by producers are passed onto consumers.

In contrast, inflation rates continued to fall in Belarus and the Republic of Moldova in 2004, and the downtrend was more pronounced for producer than for consumer prices (chart 5.2.2). Despite the improvement, however, the average annual rate of consumer price inflation in Belarus remained the highest in the CIS, reflecting a highly accommodating monetary stance.[152] The fact that the rise in consumer prices in 2004 lagged behind that of producer prices probably reflects the influence of administrative price controls, which are still extensive at the retail level. In the Republic of Moldova, food prices rose more slowly than in 2003 (due to better harvests) and a significant appreciation of the nominal effective exchange rate helped to keep imported inflation to relatively modest levels.

Labour market performance lags behind the economic upturn

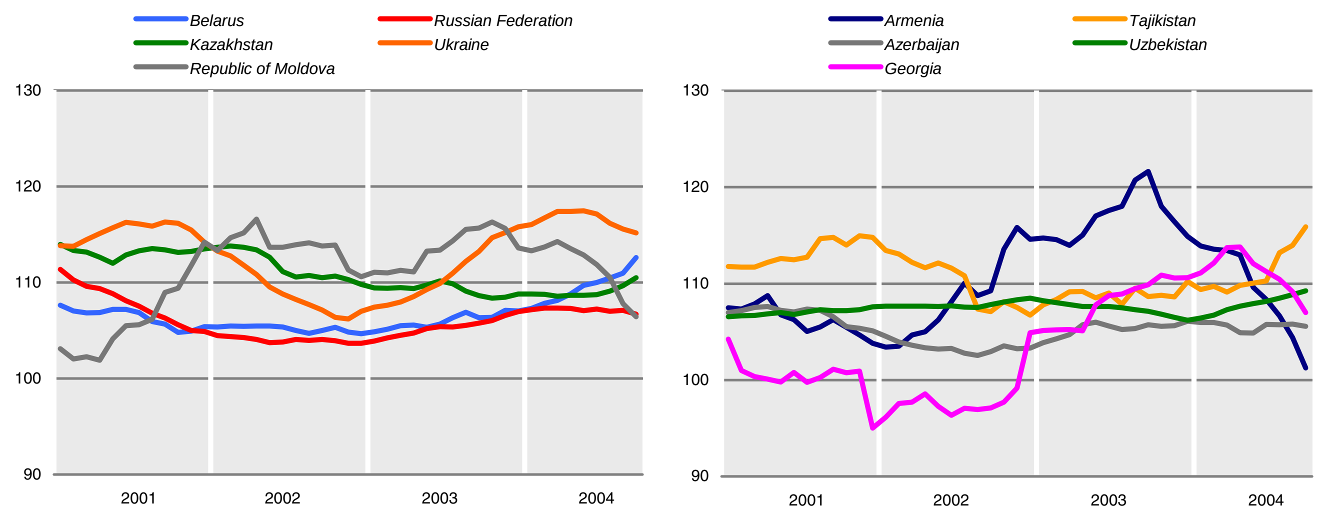
In Russia, total employment, as measured by the labour force survey (LFS) has been rising since the final quarter of 2003, and the unemployment rate had fallen to 7.4 per cent by the third quarter of 2004 (tables 5.2.6 and 5.2.7).

[152] The main instrument of monetary expansion in Belarus is directed soft lending by state-owned banks to state-owned firms. This is equivalent to hidden subsidies and is a form of quasi-fiscal activity in support of the government's industrial policy. Despite some recent reduction, the flow of such credits still remained significant in 2004.

CHART 5.2.1

Real industrial output in selected CIS economies, January 2001-September 2004

(Indices of 12-month output, same period of the preceding year=100)



Source: UNECE secretariat calculations, based on national statistics.

TABLE 5.2.5

Consumer prices in the CIS, 2002-2004

(Percentage change)

	Consumer prices, total								Food	Non-food	Services
	Over preceding year			2004, year on year			September over previous December				
	2002	2003	2004 [a]	QI	QII	QIII	2003	2004			
CIS	15.0	13.3	11.4	11.2	10.6	1.2	8.4	7.4	..	..	..
Armenia	1.0	4.7	7.7	7.8	7.3	8.3	1.1	-1.3	-2.1	-0.3	0.9
Azerbaijan	2.8	2.1	5.0	5.5	6.3	5.2	0.2	1.7	2.6	-0.1	-0.2
Belarus	42.8	28.5	21.3	22.4	19.7	17.0	18.5	9.1	9.5	5.7	11.0
Georgia	5.7	4.9	5.7	5.9	4.8	5.4	1.9	0.9	0.6	2.0	0.7
Kazakhstan	6.0	6.6	7.1	6.7	6.9	7.6	3.0	4.0	4.0	4.3	2.9
Kyrgyzstan	2.1	3.1	4.7	5.3	2.9	5.6	-0.1	0.3	-0.9	0.8	1.2
Republic of Moldova	5.3	11.7	13.8	14.6	13.0	11.1	11.4	6.5	4.0	8.0	9.1
Russian Federation	16.0	13.6	11.1	10.8	10.3	11.1	8.6	8.1	7.1	5.5	14.3
Tajikistan	12.2	16.3	9.5	8.5	5.7	8.7	8.5	4.6	4.8	5.5	0.3
Turkmenistan	..	..	..	..	..	..	..	..	..	..	..
Ukraine	0.8	5.2	8.0	7.4	7.4	9.6	3.3	5.6	6.5	3.8	4.5
Uzbekistan	..	..	..	..	..	..	..	..	..	..	..
Memorandum items:											
CIS excluding Russian Federation	13.1	12.6	12.1	12.2	11.3	11.4	8.1	5.9	..	..	..
Caucasian CIS countries	3.4	3.8	5.9	6.2	6.0	6.0	1.1	0.6	..	..	..
Central Asian CIS countries	..	..	..	..	..	..	..	..	..	..	..
Three European CIS countries	16.4	16.0	14.7	14.9	13.7	13.4	10.8	7.5	..	..	..

Source: UNECE secretariat estimates, based on national statistics.

[a] For the 12 months ending September 2004 over the preceding 12 months.

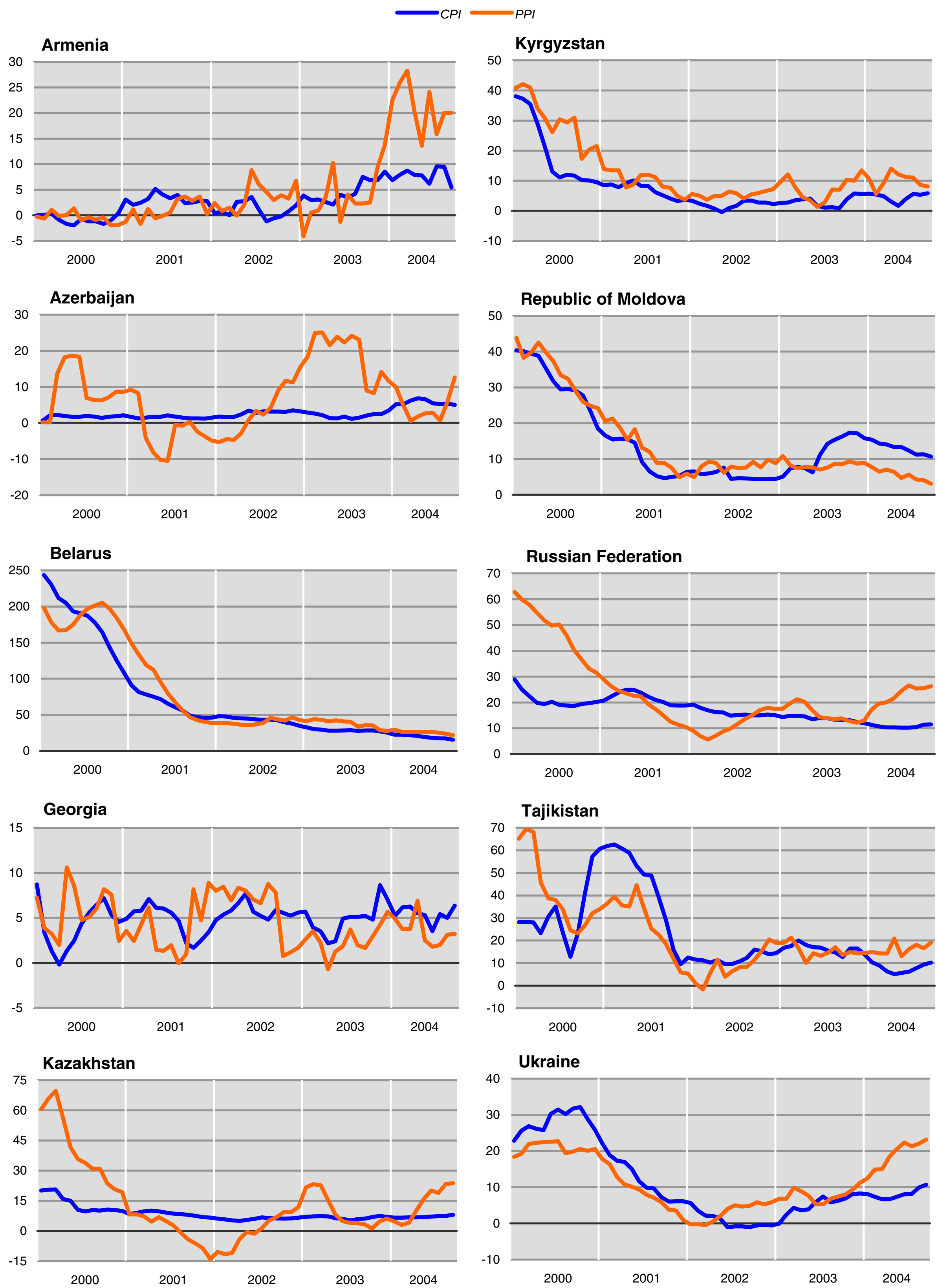
Payroll employment in industry increased significantly in the second quarter of 2004 after a two-year period of relatively aggressive restructuring.[153] The state sector's share in total employment has fallen slowly over the last few years, as in other CIS economies (chart 5.2.3). The cuts in payroll tax envisaged for 2005 should boost employment by reducing non-wage labour costs, although at the same time it may have an adverse effect on the public pension system.[154] The authorities contemplate a 20

[153] For an analysis of the underlying issues of industrial competitiveness, see OECD, *Economic Surveys: Russian Federation* (Paris), 2004, chap. 2.

[154] The government aims to offset the revenue losses associated with the reduction of the Unified Social Tax rate with the aid of new measures which, however, will have repercussions for the ongoing pension reform. While it is practically impossible to project precisely the overall effect of the payrolls tax cut, the estimates of the Russian authorities tend to be more optimistic than those of outside observers. OECD, op. cit., pp. 118-119.

CHART 5.2.2

Consumer and industrial producer prices in selected CIS economies, January 2000-September 2004
(Year-on-year, monthly percentage change)



Source: National statistics.

per cent increase in the minimum wage in 2005; this could reduce the demand for low-skilled workers and induce a strong wage inflation through a subsequent realignment of relative wages, unless some offsetting measures are implemented.

In Ukraine, total employment appears to have declined in the first half of 2004 despite a significant acceleration of output growth. Payroll employment in industry also fell (table 5.2.6). At the same time, involuntary unemployment, estimated on the basis of labour force surveys, declined in the second quarter of 2004, implying a drop in the participation rate. However, changes in the frequency of the labour force surveys and incomplete reconciliation of labour force statistics with the population census mean that the actual employment, unemployment and participation trends may differ from those shown in the available data.[155]

In Belarus, total payroll employment fell slowly in the first half of 2004 and more rapidly in industry. The fall in the number of registered unemployed over the same time period implies either increasing inactivity or some growth of employment in the small business sector that has not been captured by the official statistics.[156] However, the relatively large number of workers on long-term leave and the rather cumbersome registration rules for obtaining unemployment benefit imply that involuntary unemployment may be much higher than registered unemployment.[157] In the Republic of Moldova, there were large falls in employment in 2003 and the first half of 2004, and the unemployment rate, based on the quarterly labour force survey, was increasing through 2004. However, the postponement of the planned population census means that the reported unemployment rates are increasingly unreliable.

The combination of a rapid output growth and relatively stable levels of employment suggests large gains in industrial labour productivity, and the available statistics confirm this for most of the CIS economies. However, with wages often growing even more rapidly, there were no major improvements in cost competitiveness, as measured by unit labour costs (chart 5.2.4). Given the prevailing pressures for real exchange rate appreciation, this makes life very difficult for local producers who need to achieve still larger gains in efficiency if they are to preserve or improve their competitiveness. This points yet again to the need to accelerate and deepen major structural reforms in the domestic product, labour and financial markets.

(b) Selected macroeconomic policy issues

In Russia, monetary management is under strain…

The persistent rise in its current account surplus has put monetary management in Russia under considerable strain. The Central Bank of Russia (CBR) has in fact been targeting simultaneously two monetary goals – inflation (in the pursuit of its main objective, price stability) and the exchange rate (in an effort to prevent excessive real appreciation) – with only one instrument: intervention in the foreign exchange market.[158] However, this policy arrangement cannot guarantee success in meeting the two targets, given that the dynamics of the current account (which is a key driver of domestic monetary developments) is beyond the control of the monetary authorities. Day-to-day monetary management is likely to encounter consistency problems due to the possible emergence of conflicting objectives, forcing the monetary authorities to abandon one target at the expense of the other.[159] In addition, the current policy framework may have a destabilizing effect through its impact on the expectations of market participants. The CBR's revealed policy preference in 2004 appears to have been to prevent an excessive real appreciation of the rouble. However, if perceptions of a shift towards renewed importance of the inflation target emerge among market participants, even larger capital inflows could result as speculators seek to benefit from an expected appreciation of the rouble.[160]

One of the principal flaws in the present system of monetary management is that its success hinges on external factors, such as the price of crude oil, which largely determines Russia's current account position. Ultimately, monetary policy cannot successfully target the real exchange rate; at best, it can only have a temporary influence on the speed at which the real exchange rate changes.[161] Despite its shortcomings, the

[155] The annual LFS data for 2003 have been revised according to the 2001 population census. However, no revised data for the preceding period or for the individual quarters of 2004 have yet been published. Furthermore, beginning in 2004, the samples are taken on a monthly rather than a quarterly basis, and the two may not be fully comparable.

[156] The official monthly data for total and industrial employment exclude employment in small firms and self-employment.

[157] Economist Intelligence Unit, *Country Report. Belarus* (London), September 2004.

[158] The scope for using the central bank's policy rate in monetary management has been limited by the large amount of excess liquidity in the banking system. UNECE, *Economic Survey of Europe, 2004 No. 2*, chap. 1, p. 43.

[159] Consistency problems were obvious in 2004 due to the continued rise in Russia's current account surplus. The ensuing upward pressure on the exchange rate effectively precluded the CBR from meeting its targets of year-end inflation of between 8 per cent and 10 per cent, and a real effective exchange rate appreciation of between 5 and 7 per cent. Although the control of inflation has been declared the main goal of monetary policy, in 2004 the CBR de facto abandoned the inflation target as its main goal (which is likely to be missed for the year as a whole) at the expense of the real exchange rate target (which is likely to be achieved).

[160] The recent volatility of capital flows to Russia partly reflects the effect of this inconsistency on financial markets. Thus, capital outflows in early 2004 (box 5.1.1) followed a perceived shift in the CBR's policy towards a reduced emphasis on inflation; in turn, this was partly a reversal of previous inflows that had been generated by earlier expectations of rouble appreciation. There are indications that perception of increased tolerance of rouble appreciation may have been encouraging capital inflows in the closing months of 2004.

[161] The scope for sterilization operations, which offset the liquidity creation impact of foreign exchange purchases, has increased since the CBR started to issue its own bonds. This, however, may prove to be insufficient.

TABLE 5.2.6

Total and industrial employment in selected CIS economies, 2003-2004QII

(Percentage change over the same period of preceding year)

	Total employment [a]						Employment in industry [a]					
	2003				2004		2003				2004	
	QI	QII	QIII	QIV	QI	QII	QI	QII	QIII	QIV	QI	QII
CIS	-0.7	-0.1	-0.9	1.1	0.2	1.4	-1.8	-5.1	-1.8	-0.6	-1.5	2.2
Armenia	0.2	1.1	1.1	-0.5	0.7	-1.6	..	..	..	..	..	..
Azerbaijan	0.5	0.5	0.6	0.4	0.3	0.3	–	1.6	0.8	-2.0	0.1	0.2
Belarus	-1.1	-1.4	-0.9	-0.3	-1.2	-0.6	-5.4	-3.3	-2.5	-2.0	-1.0	-1.4
Georgia	1.2	3.6	7.3	9.6	4.0	0.2	..	..	..	..	..	..
Kazakhstan	2.2	4.0	4.0	5.2	7.0	1.8	6.7	8.2	7.7	5.8	4.3	2.5
Kyrgyzstan	1.3	1.3	1.3	1.3	1.0	1.0	-2.5	-2.8	-2.7	-2.7	0.8	1.2
Republic of Moldova	-11.4	-7.8	-8.8	-11.7	-6.7	-3.7	–	1.8	-3.6	-14.0	-9.2	-3.5
Russian Federation	-1.4	-0.7	-1.2	1.1	1.3	2.7	-1.7	-6.7	-2.2	-0.5	-1.8	3.5
Tajikistan	2.6	1.6	1.2	0.6	-1.0	-1.4	-6.6	-7.4	-5.7	-5.7	2.7	–
Turkmenistan	..	..	..	2.2[b]	..	..	..	..	..	2.4[b]	..	..
Ukraine	0.7	0.8	-1.6	1.4	-4.3	-1.2	-2.7	-2.1	-1.5	-0.8	-1.6	-1.4

Source: National statistics; TACIS; direct communications from national statistical offices to UNECE secretariat.

[a] Regional quarterly aggregate of total employment excludes Turkmenistan and Uzbekistan for which data are not available; that of industrial employment excludes Armenia and Georgia.

[b] Annual average.

TABLE 5.2.7

Registered and labour force survey unemployment in the CIS economies, 2003-2004

(Per cent of labour force)

	Registered unemployment					Labour force survey unemployment						
	2003		2004			2003				2004		
	Sep.	Dec.	Mar.	Jun.	Sep.	QI	QII	QIII	QIV	QI	QII	QIII
CIS	2.4	2.4	2.7	2.6	2.4	..	..	..	..	..	..	..
Armenia	9.8	9.8	9.8	9.3	9.1	..	..	..	..	..	..	..
Azerbaijan	1.4	1.4	1.4	1.4	1.4	..	..	..	..	..	..	..
Belarus	3.2	3.1	3.0	2.4	2.2	..	..	..	..	..	..	..
Georgia	..	2.5	..	..	..	13.5	11.4	10.5	10.7	13.0	11.9	..
Kazakhstan	2.0	1.8	1.9	1.9	1.6	9.3	8.3	7.9	9.1	8.9	7.8	7.9
Kyrgyzstan	3.0	3.0	3.0	2.9	3.0	13.7	8.3	7.1	10.7	..	..	..
Republic of Moldova	1.5	1.2	2.0	1.5	1.6	9.8	6.9	6.6	8.7	11.3	7.2	7.4
Russian Federation	2.1	2.3	2.3	2.2	2.2	8.9	8.0	7.9	8.2	8.9	7.5	7.4
Tajikistan	2.5	2.4	2.3	2.2	2.2	..	..	..	..	..	..	..
Ukraine	3.5	3.6	3.9	3.5	3.3	9.4	8.8	9.2	9.0	9.6	7.8	..

Source: National statistics; TACIS; direct communications from national statistical offices to UNECE secretariat.

current regime is unlikely to be abandoned as long as preventing an excessive appreciation of the exchange rate remains a significant policy concern. An eventual switch towards inflation targeting, as announced in Kazakhstan, would also raise difficult issues (section 5.2(iii)) and would require the development of a wider range of instruments of monetary management in line with an increased role of interest rates.

…while fiscal policy is squeezed between efficiency concerns and pressures for relaxation

Given the current strains in monetary management, fiscal policy in Russia can play a significant role in addressing competitiveness concerns. The launch in 2004 of a Stabilization Fund to accumulate the excess fiscal revenues arising from high oil prices has emerged as a powerful tool to reduce the pressure for rouble appreciation.[162] Unlike the foreign exchange interventions of the CBR, there are no domestic monetary implications (such as liquidity creation) associated with its operation, as the resources placed in the Stabilization Fund are to be invested abroad.

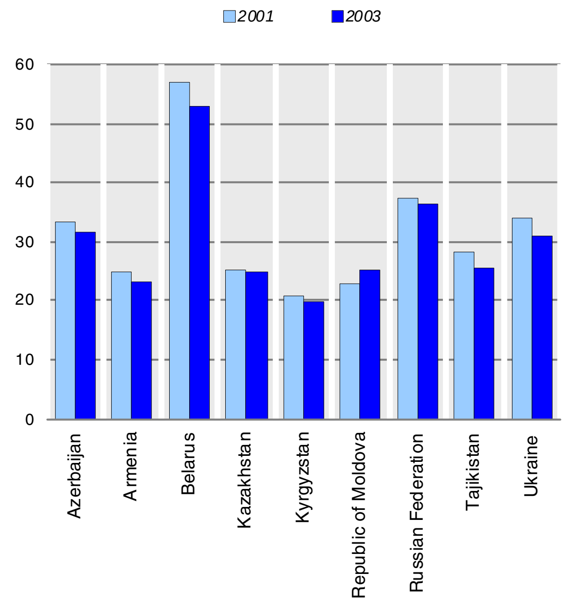
High commodity prices and strong economic growth resulted in a sizeable fiscal surplus in 2004, which was partly channelled into the Stabilization Fund.[163] In

[162] A credible fiscal rule governing the functioning of the stabilization fund would be an important component of the overall framework for macroeconomic policy, facilitating an eventual shift towards a regime of formal inflation targeting. However, this component is still missing.

[163] The growth of official foreign exchange reserves picked up strongly in the fourth quarter, partly as a result of the introduction of higher oil export tariffs (leading to increased repatriation of earnings

CHART 5.2.3

Share of total employment in the state sector in selected CIS economies, 2001 and 2003



Source: Statistical Committee of the CIS.

fact the fund is likely to have reached its statutory ceiling already by the end of its first year of existence.[164] With the rapid accumulation of fiscal reserves in the Fund, a political debate has intensified about the rules that govern its functioning and the use of its resources, and political pressures to use the Fund's resources to finance various items of current expenditure have been increasing. However, policy makers will need to resist the temptation of using this resource in response to populist demands, if the role of the Stabilization Fund as an instrument of macroeconomic management is not to be compromised. Moreover, the current rule that excess resources in the Fund can be spent once the ceiling has been reached, without reference to the current oil price, creates the risk of procyclical spending.[165]

In fact, there are already signs that the significant cyclical improvement in Russia's cash fiscal balance is prompting a procyclical relaxation of fiscal policy. Thus the draft budget for 2005 contains a number of policy measures with a possible procyclical effect. In particular, it is envisaged that the revenue loss associated with the planned reductions in payroll tax rates will only be partly offset by higher oil taxes.[166] The budget also envisages the expansion of a number of government financed programmes. The planned rise in public spending appears to be procyclical given the current strength of the Russian economy and the windfall revenue from the high oil price. At the same time, the envisaged policy changes are likely to increase the vulnerability of the budget to sudden falls in the price of oil.

Macroeconomic policy in Ukraine stumbled prior to the elections…

The political cycle in Ukraine led to a significant relaxation of fiscal policy as the presidential elections drew closer. Although this is a widespread phenomenon, some of the populist pre-election moves (such as the large increases in pensions in September and the planned rise in public sector wages) will have lasting negative fiscal implications as they are equivalent to a general increase in government spending. As a result, the underlying structural fiscal balance is likely to have deteriorated significantly in 2004. As shown by the experience of some east European countries (for example, Hungary) this type of fiscal loosening (involving notable wage increases) can have a lasting and damaging effect on macroeconomic stability. Furthermore, the negative fiscal implications of such moves are very difficult to reverse or offset, especially during a downturn in the growth cycle.

Ukraine's recent macroeconomic performance actually provides some early evidence of the potentially destabilizing effect of the fiscal loosening. Already in October, the sharp rise in aggregate incomes boosted the demand for foreign currency (still preferred as the vehicle for saving). At the same time, concerns about the course of policy after the election triggered increasing outflows of capital. The mounting pressure on the exchange rate soon gave rise to liquidity problems in the banking sector. The National Bank of Ukraine (NBU) was forced to intervene on both the interbank and the foreign exchange markets to prevent a banking crisis and a collapse of the exchange rate.[167] However, inflationary pressures were also mounting as a result of the excessive liquidity injected into the economy. Concerns about rising inflation forced another intervention by the monetary authorities who raised the central bank's interest rates in

by oil exporters). The resulting increase in fiscal revenues were diverted to the Stabilization Fund without affecting the money supply.

[164] In accordance with its statutory operating rules, excess fiscal revenues arising from a price for Urals oil blend above $20 per barrel are channelled to the Stabilization Fund. (A recent proposal has been to raise the oil price threshold.) Once the fund amounts to 500 billion roubles any excess can be used for other purposes, such as the repayment of public foreign debt. The rules for allocating such surpluses, however, are not clearly spelled out. The 500 billion rouble ceiling is expected to be reached (and even exceeded) by the end of 2004.

[165] Thus, if the accumulated funds were used to finance domestic public expenditure, the Stabilization Fund would fail to perform its role of sterilizing part of the foreign exchange inflows associated with the current account surplus, while the increase in expenditure would increase the pressure of domestic demand.

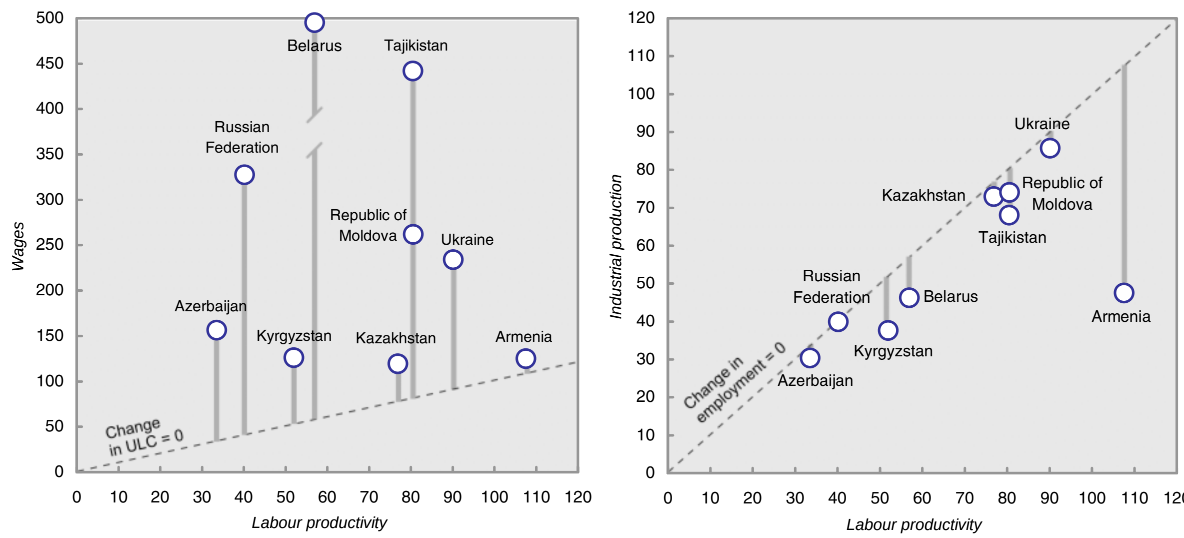
[166] The negative net fiscal impact of the reduction in payroll taxes is estimated at around 1 per cent of GDP, even in an environment of high oil prices. International Monetary Fund, *Russian Federation: Selected Issues,* Country Report No. 04/316 (Washington, D. C.), September 2004. Lower payroll taxes can have a positive impact on job creation in the longer run.

[167] As a result of these interventions, during the month of October alone Ukraine's official foreign exchange reserves dropped by 13 per cent, to $9.15 billion.

CHART 5.2.4

Industrial productivity and the dynamics of labour cost pressures in selected CIS economies, 2000-2004QII

(Cumulative percentage change, 1999=100)



Source: UNECE secretariat estimates and national sources.

Note: Industry=mining+manufacturing+utilities; wages: average nominal gross wages in industry; labour productivity: gross industrial production per worker; unit labour costs (ULC): average gross wages in industry deflated by labour productivity. The data for Armenia are for the period 2000-2003. Belarus: cumulative wage growth in 2000-2004 was 1,080 per cent. The distance (perpendicular line) between the country-value and the dotted line measures the cumulative increase in unit labour costs on the left-hand chart and the cumulative fall in employment on the right-hand chart.

November. At that point the NBU was confronted with conflicting objectives, as the tightening of policy could have an adverse effect on the banks' liquidity position, something that it had sought to prevent with its previous interventions. This episode highlights the risks associated with an excessive relaxation of fiscal policy in an environment of immature and volatile financial markets. Maintaining macroeconomic and financial stability in this environment requires a high degree of coordination between monetary and fiscal policy.

…and the macroeconomic situation deteriorated in their aftermath

While policy makers in Ukraine managed to prevent an outbreak of financial turmoil in the run-up to the elections – by sacrificing some of the relatively large foreign exchange reserves – there has since been a considerable deterioration in the general economic situation. The major uncertainties regarding the resolution of the ensuing political crisis constituted a major shock to investor confidence, causing turmoil in the financial markets. It is likely that political uncertainty and disruption in the financial system will have negative implications for economic activity in the short run.

(ii) The Caucasian Rim

Robust growth continued in 2004…

Economic growth in Azerbaijan continued to be fuelled by large inflows of FDI in the oil and gas sectors. The growth of fixed investment remained considerable (real investment outlays rising by 45 per cent, year-on-year, in the period January-September – table 5.2.4) but nevertheless was lower than in 2002-2003. The expansion in the construction and service sectors reflected positive spillovers from the oil and gas sectors. Real money incomes grew at double-digit rates, supporting an acceleration in the volume of retail trade (table 5.2.4). However, there is a growing divide between the oil and gas industry and the rest of the economy. The relatively small and underdeveloped agricultural sector remains the main source of employment and therefore its evolution has a major impact on welfare. As elsewhere in the region, agriculture has the potential to make a significant contribution to the diversification of exports and the improvement of living standards, but in order to do so the sector needs a major restructuring and investment to produce the needed gains in efficiency.

In Georgia, the economy has benefited greatly from its role as a transit corridor for oil and natural gas. In 2004, the construction sector was boosted by the ongoing work on the Baku-Tbilisi-Ceyhan oil pipeline and the Shah-Deniz gas pipeline, which have provided employment and generated demand for business services.[168] Industrial output, particularly manufacturing,

[168] These projects accounted for 69.3 per cent of construction output in the first half of the year. Housing construction also grew strongly. Georgian-European Policy and Legal Advice Centre, *Georgian Economic Trends*, No. 3 (Tbilisi), 2004.

grew strongly in the first half of the year, but more recent figures indicate a slowdown in the second half. Expansion in the services sector contributed most to the increase in GDP in the first three quarters of 2004. In contrast, output in agriculture, which remains the second largest sector after services, was sluggish although this was partly due to a base-period effect reflecting the strong rate of growth in 2003.

Armenia, which is bypassed by the two pipelines, has not benefited from the FDI-driven boom in neighbouring countries. In 2004 there was a marked slowdown of industrial output (after two years of very strong growth - chart 5.2.1) due to temporary disruptions in the diamond industry (which accounts for the bulk of its exports). There was also less dynamism in the construction sector reflecting a decline in foreign grant financing for local construction. At the same time, agricultural output recovered following improvements in infrastructure and a good harvest. Strong consumer demand (supported by wage increases and large remittances from abroad, which appear to have reached record levels in 2004) supported an expansion in trade and other business services, which partly offset the deceleration in construction and industry. Overall, the growth of GDP remained strong in 2004 and for the year as a whole is likely to exceed earlier expectations.

…and there was some increase in employment

The available labour market information indicates some increase in aggregate employment in the Caucasian region, although not in all the individual countries. In Armenia, total employment started to fall in the second quarter of 2004 while at the same time registered unemployment continued its slow decline (tables 5.2.6 and 5.2.7). It remains unclear whether these trends reflect a declining participation rate or rising activity in the informal sector. Total and industrial employment increased slightly in Azerbaijan, reflecting job creation as a result of the large energy infrastructure projects. Employment in Georgia has risen steadily since the second quarter of 2003, stimulated in part by the same infrastructure projects. Nevertheless, weak employment growth in the official sector has to be seen against a background of extensive self-employment that accounts for about two thirds of total employment in Georgia. Involuntary part-time employment remains widespread.[169]

Inflation remains low

In the three Caucasian rim economies consumer price inflation remained low in the first three quarters of 2004. Over January-September, consumer prices actually fell in Armenia and rose less than 2 per cent in both Azerbaijan and Georgia. As in 2003, these were among the lowest nine-month cumulative rates of consumer price inflation in the CIS. Food prices weakened over the summer and had a dampening effect on the overall level of consumer prices. In Armenia and Georgia, imported inflation also moderated, thanks to the appreciation of their currencies in nominal effective terms. Furthermore, consumer demand probably moderated in Georgia due to the slow growth of real household disposable incomes. In Azerbaijan, strong consumer demand does not seem to have put any upward pressure on the overall level of consumer prices.

In contrast, producer price inflation accelerated, especially in Armenia and Azerbaijan, reflecting to a large extent an intensification of cost pressures. In all three economies such cost pressures appear to be strong. These may eventually put pressure on consumer prices, especially if employment recovers and if the growth in real wages (and hence real disposable incomes) is decoupled from productivity growth. In Azerbaijan, the continuing surge in capital inflows could trigger inflationary pressure (as in Russia), unless they can be sterilized by government intervention through the State Oil Fund.

Seeking more flexibility in fiscal policy

The recent boom in the oil and gas sectors of Azerbaijan has given a strong boost to public revenue, not only in absolute terms but also as a share of GDP. The resulting improvement in the fiscal position has provided the government with more flexibility to pursue its agenda and allowed it to increase spending on social and developmental needs. Thus the 2004 budget envisaged a substantial increase in expenditure on health and education. Nurturing the development of the non-oil sectors, which is a key strategic policy, may eventually result in tax cuts that can be accommodated by projected increases in revenue. In contrast to Azerbaijan, Armenia and, particularly, Georgia, face the immediate challenge of raising public revenue and widening the tax base, while at the same time improving the structure of taxation.

Following the political change in November 2003, the government of Georgia embarked on a major effort to improve the efficiency of tax collection and of the customs administration.[170] The new strategy combines measures to strengthen enforcement with a tax reform, to be enacted in 2005, that will reduce both the rates and the number of taxes. These changes will be grounded in a general overhaul of the administration that will address governance issues in the public sector and seek to increase the efficiency of policy interventions. Economic performance in 2004 was satisfactory as progress in clearing arrears increased the credibility of the new

[169] Georgian-European Policy and Legal Advice Centre, op. cit., pp. 42-48.

[170] Public revenue as a proportion of GDP in Georgia is well below the average for countries with similar levels of GDP per capita. H. Lorie, *Priorities for Further Fiscal Reforms in the Commonwealth of Independent States*, IMF Working Paper, No. WP/03/209 (Washington, D.C.), October 2003.

measures. A significant increase (by 20 per cent) in tax revenue is expected already in 2005, the first year of the tax reform.[171] At the same time Georgia is faced with the need for fiscal consolidation due to the precarious state of its external finances.

In Armenia, a sharp fall in foreign grants weakened the overall budgetary position in 2004 but this was partly offset by improvements in tax collection, which have served to cushion the impact on spending.[172] Despite further projected increases in tax revenues (resulting from measures intended to strengthen the tax and customs administrations), the large increases in social expenditures may lead to a deterioration of the structural fiscal balance. As in Georgia, however, continued progress with reform may serve to mobilize external financial support.

Capacity constraints in public administration are a recurrent problem throughout the region, and these help to explain the low levels of efficiency in collecting public revenue. However, this is just one aspect of a vicious cycle, as improving this capacity requires public spending. Azerbaijan may be closer to escaping from this vicious cycle, as the oil-related rise in public revenue will provide the government with the opportunity to invest more resources in public administration.

At the same time, the scope for increased public spending on infrastructure and human capital needs is constrained by the absorptive capacity of these economies. Increasing that capacity requires major improvements in the legal and administrative environment in which public projects are undertaken. In any case, the proper management of public expenditure and continued efforts to reduce non-transparent, quasi-fiscal activities, particularly in the energy sector, remain important policy challenges.

Exchange rates face upward pressures

Upward pressures on exchange rates continued to mount in 2004. Appreciation vis-à-vis the dollar reflected the latter's weakness, but gains also occurred in relation to the euro and the Russian rouble. In Azerbaijan, the increased demand for the national currency is connected to the considerable oil-related capital inflows. The traditional response has been to maintain a relatively loose monetary policy, with foreign exchange intervention being the main instrument to contain upward pressures. However, this strategy will come under increasing strain as exports take off, following the completion of the infrastructure projects, while the scope for rapid increases in money demand narrows.[173] In Georgia, improved tax collection increased the demand for the domestic currency; this also had a dampening effect on inflation.[174] The strengthening of the balance of payments position led to the appreciation of the Armenian dram. This development was not resisted by the Central Bank of Armenia, as it remains more concerned with the control of inflation, which accelerated in 2003, and has refrained from targeting the exchange rate.

(iii) The central Asian CIS economies

Commodity exports continued to drive growth

Booming world commodity markets and strong import demand in its main export markets continued to underpin economic growth in the region in 2004. The continuing expansion of the oil and gas sectors, coupled with robust domestic demand, continued to drive economic growth in Kazakhstan. The strategic character of investments in this sector (supported by a steady inflow of FDI) suggests that these sectors will continue to expand even in the face of less favourable prices. The non-oil sectors also benefited from spillovers from the oil sector through income effects and increased demand for local inputs. The share of services in total GDP continued to increase, with transport and communications services benefiting from strong demand in the oil and gas industries. The growth of industrial output accelerated (chart 5.2.1), mainly due to the extractive industries, but manufacturing also performed well, with chemicals, plastics and engineering providing evidence of diversification.

Kyrgyzstan's industrial base is still rather narrow, dominated by gold extraction. The resumption of full-scale production in the Kumtor mine played a large role in the recovery of total industrial output early in the year but this one-off base effect eventually faded away. Similarly, soaring industrial output in Tajikistan largely reflected the export-driven expansion of aluminium production. A relatively strong recovery also continued in Turkmenistan, underpinned by growing output of natural gas and a good grain harvest; nevertheless, the actual rate of GDP is likely to have been well below the officially reported figures (box 5.2.1).

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[171] *BBC Monitoring Former Soviet Union*, 1 October 2004. On the basis of a stronger than projected revenue performance and increased grants, the government expects the ratio of total expenditures (including net lending) to GDP to grow by 4.6 percentage points to 25 per cent of GDP in 2005-2008. Government of Georgia, *The Government's Strategic Vision and Urgent Financing Priorities*, Donor's Conference (Brussels), 16-17 June 2004.

[172] In 2002-2003, grants accounted for around one fifth of total public revenue. However, the tax base did not grow in line with GDP, as grant-financed construction and diamond polishing are tax exempt. Tax revenue has been boosted by the introduction of a minimum corporate tax of 1 per cent of total sales.

[173] A more efficient policy may be the introduction of suitable sterilization instruments and increasing the rate of accumulation in the State Oil Fund.

[174] The National Bank of Georgia accommodated the increased demand for lari through a reduction of commercial banks' minimum reserve requirements in June 2004.

Box 5.2.1

Alternative estimates of real GDP growth in Turkmenistan

The official statistics produced since 2000 by the National Institute of Statistics and Forecasting (NISF) of Turkmenistan raise a number of questions. The officially reported rates of real GDP growth (an annual average rate of 19 per cent for the period 2000-2003, table 5.2.8) suggest that in this period Turkmenistan has been the fastest growing economy in the world. These rates diverge considerably, however, from the reported changes in the physical volume of output of the country's key commodities.[1] The implicit GDP deflators in the official statistics (an annual average of 8.4 per cent for 2000-2003) also appear to be inconsistent with the reported growth in the average nominal wage in the economy (an annual average increase of 52 per cent for the same period – table 5.2.8). Moreover, in 2002 the NISF stopped publishing GDP statistics reflecting valued added, and started reporting figures for aggregate gross output instead. The reporting of demographic statistics has been modified: the NISF replaced the previously published time series on the "resident" population with the number of persons "actually living" in the country. The latter implies a 4-5 per cent increase in the population per annum since 2000. The reported actual population for 2004 exceeded the resident population by about 20 per cent or 1 million people (table 5.2.8).

The UNECE secretariat has produced alternative estimates of real GDP growth for Turkmenistan. These were derived from output data in volume for some of the main products that shape the performance of Turkmenistan's resource-based economy. As most of these products are basic commodities, their weighted output growth, calculated from data in physical units, should be a good proxy for real output growth in the main economic sectors. The real change in total output (a proxy for GDP) is then calculated as a weighted average of output growth in these sectors.

More specifically, the changes in real agricultural output have been estimated on the basis of the reported production of grain, cotton, meat (slaughter weight), milk and vegetables. The production volumes of electricity, natural gas, oil, cotton yarn, flour, fertilizers, copper cable, wire, meat products and milk products were used to compute a proxy for industrial output; the volumes of cement, iron-reinforced structures and bricks – for construction; and the freight and passenger turnover – for transport and communication. Public sector employment served as a proxy for estimating the changes to the real output of the public sector. The rates of real output growth by main economic sectors (agriculture, industry, construction, transport and communication, trade and others) were then weighted by their shares in GDP to compute the rates of change of real aggregate output (GDP). The corresponding sectoral data for the years through 2001 are the officially reported statistics; for subsequent years the 2001 fixed weights were used. Within industry and agriculture, the weights of individual products were estimated on the basis of the previous year's structure of gross output.

The resulting estimates of the changes in real GDP for Turkmenistan are reported in table 5.2.8. A comparison with the corresponding official statistics for the years before the reporting methodology was changed suggest that the alternative measure of total output is reasonably reliable: although the latter differ somewhat from the official figures for 1997, 1998 and 1999, both series yield similar growth rates of real GDP in this period. Notably, the alternative estimates capture the dependence of Turkmenistan's economy on the output of a few key commodities (such as natural gas and cotton and, to a lesser extent, oil, grain and textiles). Thus, the 50 per cent fall in the output of natural gas in 1997, when Turkmenistan suspended gas exports to Ukraine because of the latter's non-payment, was the main factor behind the drop in real GDP in that year. Conversely, the rapid GDP growth in 1999 was the result of a combination of large increases in the production of natural gas, oil and oil products, cotton and textiles. Both the official figures for real GDP in these years and the alternative estimates reflect these fluctuations.

In contrast, from 2000 the alternative measure suggests much lower rates of real GDP growth than the official figures. During this period, there have been major fluctuations in the output of some key products (equivalent to shocks to the economy), which do not appear to have been captured in the official statistics. Thus, whereas the output of natural gas, after doubling in 2000 remained stable through 2004 (to meet demand from Russia and Ukraine), grain and cotton harvests were uneven and indeed poor in some years. The alternative estimates in table 5.2.8 reflect the impact of volatile commodity output on the rate of growth of real GDP. In addition, the implicit GDP deflators used in the alternative estimates for 2000-2003 are more plausible than the implicit deflators derived from the official statistics and are more closely in line with the reported changes in the average nominal wage. Finally, the alternative estimates of the changes in real GDP in Turkmenistan look more realistic when compared with the rates of real GDP growth in neighbouring countries with similar economic structures, such as Azerbaijan, Kazakhstan and Uzbekistan.

The alternative UNECE estimates of real GDP growth in Turkmenistan have been used in the relevant statistical tables of this *Survey*.

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[1] The official statistics seems to follow the overambitious long-term economic targets set in the recently adopted political document: "Strategia ekonomicheskogo, politicheskogo i kul'turnogo razvitiya Turkmenistana na period do 2020" [www.turkmenistan.gov.tm/countri/gos&prog.html]. Using 2000 as the base year, this strategy envisages a 28-fold increase of aggregate gross output, a 26-fold increase for industrial output and an 18-fold increase of agricultural output by 2020.

TABLE 5.2.8

Selected economic indicators for Turkmenistan (officially reported and estimated), 1997-2004

	1997	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004* [a]
Officially reported statistics								
Nominal GDP (billion manats)	11 109.0	13 995.0	20 056.0	25 648.0	35 119.0	45 240.0	55 709.0	..
Real GDP, rate of change (per cent per annum)	-11.4	7.1	16.5	18.6	20.4	20.5	17.1	..
Implicit GDP deflator (per cent per annum)	61.7	17.6	23.0	7.8	13.7	6.9	5.2	..
Average nominal wages, rate of change (per cent per annum)	156.9	46.3	21.8	80.5	47.1	42.4	40.0	..
Actual population (thousand persons)	4 710.4	4 846.8	4 993.5	5 200.0	5 369.4	5 640.0	5 893.8	..
Total employment (thousand persons)	1 815.9	1 838.7	1 851.9	1 908.3	1 947.3	1 996.1	2 039.7	..
Public sector employment (per cent of total employment)	53.5	46.4	42.8	35.5	31.0	27.9	26.5	..
Production of main commodities								
Electricity (million kwh)	9 498.0	9 416.0	8 860.0	9 943.0	10 615.0	10 700.0	10 900.0	11 000.0
Gas (billion cubic metres)	17.3	13.3	22.9	47.2	51.3	53.5	59.1	62.0
Oil and refinery products (million tonnes)	8.6	10.9	11.8	12.2	13.0	14.7	17.2	18.1
Cotton (thousand tonnes)	635.0	705.0	1 304.0	1 031.0	1 137.0	489.0	714.0	750.0
Grain (thousand tonnes)	760.0	1 290.0	1 544.0	1 091.0	1 238.0	1 287.0	1 310.0	2 130.0
GDP by main sectors of economic activity [b]								
Agriculture (per cent of total)	20.0	25.2	24.8	22.9	24.7	24.0	24.0	24.0
Industry (per cent of total)	32.9	27.5	31.4	35.0	36.6	37.0	37.0	37.0
Construction (per cent of total)	11.3	13.1	12.2	6.8	5.7	9.0	9.0	9.0
Transport and communication (per cent of total)	10.3	7.8	6.7	6.6	5.4	6.0	6.0	6.0
Trade (per cent of total)	3.6	3.6	4.1	3.5	4.2	4.0	4.0	4.0
Other (per cent of total)	21.8	22.8	20.8	25.1	23.5	20.0	20.0	20.0
Estimates by the UNECE secretariat								
Rates of change of real output								
Aggregate output (proxy for GDP, per cent per annum)	-11.6	5.1	13.8	6.1	4.1	1.8	6.8	6.0
Agriculture (per cent per annum)	16.4	22.3	24.6	-6.8	4.1	-8.5	8.2	10.6
Industry (per cent per annum)	-21.2	7.6	23.4	26.6	9.0	5.1	8.1	4.6
Construction (per cent per annum)	-4.6	1.3	2.1	-15.3	-3.4	12.9	12.0	10.0
Services (per cent per annum)	-7.2	-5.5	2.6	4.1	0.6	4.0	2.4	3.1
Implicit GDP deflator (per cent per annum)	61.7	17.6	23.0	20.6	31.6	26.5	15.3	10.0
Resident population (thousand persons)	4 605.5	4 681.3	4 738.2	4 790.4	4 845.3	4 900.8	4 957.0	5 013.8

Source: National Institute of Statistics and Forecasting of Turkmenistan; UNECE secretariat estimates.

a Preliminary estimates.

b Officially reported through 2001, UNECE secretariat estimates thereafter. See box 5.2.1 in this *Survey*.

Domestic demand remained buoyant in most of the central Asian economies with the possible exception of Uzbekistan (table 5.2.4). Consumption, boosted by large increases in real wages, continued to be a key support of economic growth. In Kyrgyzstan and, particularly, Kazakhstan, increased employment provided additional support for consumption. In Kazakhstan, wage rises were relatively large in low pay sectors, such as public health care and education, enhancing the impact on consumption. In addition, worker remittances from abroad have been rising in Kyrgyzstan and Tajikistan, underpinning consumption and the growth of domestic demand.

In Kazakhstan, total investment remained strong and there were signs of diversification: large increases in metallurgy and services (especially real estate) more than offset weaker investment in the extractive industries.[175] Investment accelerated sharply in Kyrgyzstan, partly reflecting the low base period following three years of contraction. In contrast, investment appears to have been sluggish in Uzbekistan.[176]

Strong domestic demand throughout the region has led to large increases in imports, which have exceeded the growth of exports.

Risks of overheating in Kazakhstan

In Kazakhstan, an expansionary fiscal policy, matched during most of the year by an accommodative monetary stance, prevented any further decline in the rate of inflation in 2004. The continuing strong growth of real household incomes and the steep rise in labour costs and material input prices added to the inflationary pressures. In September, the nine-month cumulative rate

[175] Despite a 7 per cent year-on-year fall during the first three quarters of 2004, investment in the extractive industries still accounted for 40 per cent of the total.

[176] While official data indicates a strong pick-up in GDP growth in Uzbekistan in 2004 (8.9 per cent in the first three quarters against 4 per cent in the same period of 2003), these figures have been questioned by some observers. Stagnation in the hydrocarbons sector and electricity consumption suggest a lower figure. Economist Intelligence Unit, *Country Report. Uzbekistan* (London), September 2004. The situation is similar in Turkmenistan, where the reported growth of oil and gas output (the country's key industry) is not consistent with the official figures for the growth of total industrial output (box 5.2.1).

of change of consumer prices reached 4 per cent and the year-end CPI target band of 5-7 per cent looked increasingly difficult to reach. This prompted the National Bank of Kazakhstan to signal in October its intention to tighten its policy stance by reducing its intervention in the foreign exchange market.[177] At present Kazakhstan's booming economy shows signs of overheating; the prevention of a further increase of inflationary pressures will ultimately depend on a tightening of fiscal policy.

In Kyrgyzstan, there was virtual price stability in terms of consumer and producer prices in 2004. Unit labour costs declined thanks to soaring productivity gains and moderate wage growth in industry, while the exchange rate remained relatively stable. In Tajikistan, inflation continued to fall throughout the first three quarters as a result of tighter monetary policy. The strong recovery of labour productivity largely offset the continued rise in wages (those in industry rose some 40 per cent, year-on-year, during the first three quarters).

Labour market performance remained uneven

In Kazakhstan, the labour markets continued to improve, employment growth being by far the most dynamic in the CIS. However, the government sector continues to account for one quarter of total employment and two fifths of dependent employment.[178] This suggests structural weakness in the private business sector that prevents it from increasing its share of total employment. The prospects for employment growth are good, provided that the government implements its ambitious plans for economic diversification without unduly restricting the development of product markets. Total employment increased in Kyrgyzstan in the first half of 2004. In contrast, it fell in Tajikistan, although industrial employment started to recover slowly. No labour market data for 2004 are available for Turkmenistan and Uzbekistan. The latest available labour market statistics for Turkmenistan show that in the early 2000s the growth of total and industrial employment was slowing down.

Fiscal revenues are highly dependent on commodity prices

High oil and gas prices, robust economic growth, and, in some cases, improvements in tax collection, boosted fiscal revenues in a number of central Asian economies in 2004. Revenues rose sharply in Kazakhstan, despite a number of tax cuts at the beginning of the year. However, the windfall from higher than projected oil prices was absorbed by increased expenditures. The relaxation of fiscal policy reflected increased spending on health and education (with sharp wage increases in both sectors), larger social outlays and an extensive housing programme. Nevertheless, the consolidated general budget remained in surplus and the reserves in the National Fund continued to grow.

The fiscal loosening reflects a policy choice to share the oil and gas windfall more widely, a preference that could strengthen social cohesion. While the expansion of the oil and gas sectors has helped to strengthen the public finances, financing extensive redistribution policies from temporary sources carries important risks. In particular, considerable fiscal prudence is needed with regard to programmes involving recurrent, non-discretionary spending as their unbalanced expansion may lead to a chronic deterioration in the structural fiscal balance.

The government of Kazakhstan has announced its intention to introduce tax incentives to promote high-technology and export-oriented industries as part of a broader strategy to encourage economic diversification.[179] In addition, specialized financial institutions have been set up to sustain this effort. The identification of favoured industries and their support with public funds carries a potential risk of wasteful use of public resources and the emergence of activities that are unable to survive under normal competitive conditions. An effective institutional framework for economic diversification can involve strategic partnerships between the government and the private sector, that associate closely the private sector to public goals, ensuring transparency in the provision of public support and promoting competition as the ultimate guarantor of sustained gains in productivity.[180] In any case, a careful review of the efficiency of budgetary spending in Kazakhstan should accompany the plans for its expansion.

Economic diversification is an even more pressing challenge in Kyrgyzstan, where, in the absence of new discoveries, the projected phasing out of gold production

[177] As in Russia, the large commodity-related export revenues have prompted massive purchases of foreign exchange by Kazakhstan's central bank and, at present, this is one of its key policy instruments.

[178] Kazakh Statistical Agency, *Ekonomicheskaya aktivnost' naseleniya Kazakhstana* (Almaty), 2004.

[179] Further tax reforms are scheduled for 2005, including changes in the amortization schedule of fixed assets with a fiscal cost equivalent to 0.4 per cent of officially projected GDP. Diversification is also expected to reduce the reliance of the budget on oil and gas revenues. Official projections indicate that in 2007, oil and gas revenues will account for 17.6 per cent of total revenues (national definition), down from 22.2 per cent in 2005. Government of the Republic of Kazakhstan, *Srednesrochnaya fiskal'naya politika Pravitel'stva Respubliki Kazakhstan na 2005-2007 gody*, Postanovlenie No. 918, 31 August 2004 [www.government.kz]. However, changes in the taxation of oil and mining revenues imply an increase in the government share of new contracts.

[180] Competition appears as a more important factor than infrastructure provision or administrative interference in explaining differences in productivity at the firm level in a recent sectoral survey of the investment climate in a number of eastern European and central Asian countries. F. Bastos and J. Nasir, *Productivity and the Investment Climate: What Matters Most?,* World Bank Policy Research Working Paper, No. 3335 (Washington, D.C.), June 2004.

will greatly reduce export capacity over the medium term. The envisaged tax reforms are intended to create better conditions for the development of small and medium enterprises and provide support for the development of alternative activities.[181] However, the precarious state of the public finances greatly reduces government's ability to implement these policies. Early figures suggest that there was some modest progress in fiscal consolidation in 2004 but this effort needs to be sustained.[182] Plans to increase development spending depend crucially on the ability to raise public revenue, including through a number of recent tax innovations where implementation has been lagging. Mobilizing additional external financial support, including through a possible debt rescheduling agreement with the Paris Club of creditors in 2005, could be vital for the success of Kyrgyzstan's development effort, given its large foreign debt burden.

The sharp fall of cotton prices from their high level at the beginning of 2004 has had a negative impact on public sector revenue in the other countries of the region. Despite the fall, average cotton prices for the year were roughly unchanged from 2003 and public sector revenue benefited from the exports of other commodities. In Tajikistan, an important challenge is to broaden the tax base in the emerging private sector in order to reduce the impact of volatile commodity prices on fiscal revenues. A more general policy issue for Tajikistan (as well as for other central Asian economies) is to sustain the effort to reform and streamline government administration and to create the right incentives for efficient governance through extensive civil service reform. These changes are necessary conditions for improving the efficiency of tax collection and public spending. Lack of timely data and extensive quasi-fiscal operations make it difficult to assess the position of public finances in Turkmenistan and Uzbekistan.

Monetary policy remained accommodative

Strong inflows of foreign capital have continued to pose problems for the conduct of monetary policy in Kazakhstan, which have been compounded by the procyclical loosening of fiscal policy. Although the main policy goal is the control of inflation, the monetary authorities (as in Russia) have intervened heavily in the foreign exchange market in order to avoid an excessive appreciation of the exchange rate.[183] In addition, the growth of foreign borrowing by Kazakh banks and corporations has further increased the pressure on the exchange rate.[184] The intended gradual liberalization of the capital account may help to ease the upward pressure on the exchange rate, as investing abroad will become easier for residents.[185] At the same time, it will increase the vulnerability of the economy to sudden capital outflows.

The intended policy shift towards inflation targeting raises further problems for policy makers in Kazakhstan. Such a regime of monetary management will require a greater degree of exchange rate flexibility, particularly in view of the intention to pursue a more activist fiscal policy. Inflation targeting will also require a wider range of policy tools for intervention on the domestic money markets in order to increase the role of interest rates in monetary management.[186] The extent of monetization has increased but it still remains low (table 5.1.2), which makes money demand difficult to predict, while the responsiveness of the economy to changes in interest rates may be limited.

In Kyrgyzstan, monetary policy has been conducted in an environment characterized by low inflation and a reduction in the cash fiscal deficit. Thanks to rising money demand, a rapid expansion of the money supply was absorbed without putting undue pressure on prices. In Tajikistan, monetary policy was tightened in order to

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[181] Interfax Central Asian News, 13 September 2004. Turkmenistan has also announced a programme of tax cuts, including the reduction of the VAT rate, BBC Monitoring Central Asia, 23 October 2004.

[182] The sale in 2004 of a part of the government's stake in the Kumtor gold mine on the Toronto stock exchange raised a total of $252.6 million, which helped to ease the public sector's financing constraints. However, in addition to the reported cash fiscal deficit, the public sector continues to incur a large quasi-fiscal deficit through extensive quasi-subsidies (implied levels of electricity tariffs that are well below cost recovery prices). In 2003, this was equivalent to 10.4 per cent of GDP and in 2004 it is expected to amount to 9.2 per cent of GDP. The government intends to reduce such quasi-subsidies to 4.8 per cent by 2007. Ministry of Finance of the Kyrgyz Republic, *Srednesrochnyi Prognoz Byudzheta Kyrgyzskoi Respubliki na 2005-2007 gody* (Bishkek), 2004.

[183] The purchases of foreign exchange have been partially sterilized through the sale of central bank notes but, in general, monetary policy has remained expansionary. The operations of the National Oil Fund (which has accumulated part of the windfall due to oil exports) are also equivalent to partial sterilization. However, the expansionary fiscal policy reduced to some extent the impact of this sterilization.

[184] Public external debt expressed in dollars has remained roughly unchanged but non-guaranteed private debt rose by 34.4 per cent in the year to the end of the second quarter of 2004. Commercial banks have raised long-term funding through syndicated loans, which has facilitated the lengthening of maturities in domestic lending. The access of banks and corporations to international capital markets is a reflection of good credit ratings, but it also indicates the limitations of the domestic banking system, which is nevertheless one of the most developed in the CIS.

[185] Other policy options being discussed are the introduction of higher minimum reserve requirements on commercial banks and compulsory deposits on foreign borrowing. *Dow Jones International News*, 22 October 2004.

[186] A conventional policy step would be to strengthen the central bank's portfolio of government securities in order to increase the scope of open market operations. In the case of Kazakhstan, however, this is complicated by the solid fiscal position and the reluctance of current holders to dispose of these assets. National Bank of the Republic of Kazakhstan, *Obzor inflyatsii 2 kvartala 2004 goda* (Almaty), 2004.

reduce inflation and correct previous policy slippages. Despite a sharp deceleration in the growth of monetary aggregates, the somoni resumed its slide in relation to the dollar in the second quarter, following some recovery early in the year.

The absence of monetary statistics prevents any comprehensive assessment of the situation in the other countries in the region. In Uzbekistan, the refinancing rate was lowered in July from 20 per cent to 18 per cent on the basis of a reported low rate of inflation. However, administrative credit constraints rather than cost are the main determinants of the access to finance. Support for the official exchange rate, which was unified in October 2003, is likely to have required continued restrictions and a de facto tight monetary stance.[187] In Turkmenistan, there is evidence of increasing spreads between official and black market rates, which are indicative of growing macroeconomic imbalances.

5.3 The short-term outlook

Growth may lose some momentum in 2005

Economic activity in the CIS as a whole is expected to lose some momentum in 2005 but will nevertheless remain quite strong. The major external factors that affect the short-term growth prospects of the CIS economies – the evolution of world commodity prices and demand in their main regional markets – point to some slowdown in the rate of growth. However, while commodity prices are expected to soften somewhat, they are still likely to be relatively high by historical standards. Domestic demand in the CIS should generally remain buoyant but its effect on domestic economic activity will depend on the extent to which local producers improve their responsiveness to demand. Macroeconomic policy will continue to be generally supportive, with an increasing risk of procyclical fiscal loosening in a number of countries.

GDP growth in Russia is set to weaken again in 2005, as a result of the combined effect of softer commodity prices and a strong rouble. Both the output and exports of oil are likely to slow down after several years of very strong growth. The influence of the planned fiscal expansion in supporting economic activity will probably be limited in view of the weak responsiveness of supply to rising domestic demand (partly a consequence of declining competitiveness). Nevertheless, GDP growth in Russia will still remain relatively high at around 6 per cent in 2005.

Output growth is also expected to decelerate in neighbouring Belarus and Ukraine, partly reflecting weaker Russian demand for their exports. In Ukraine, the political crisis following the 2004 election increases the risk of financial and macroeconomic destabilization and this is likely to have a negative effect on economic activity. GDP growth in Kazakhstan is expected to decelerate by around 1 percentage point to some 8 per cent in 2005, in line with the output targets for oil and natural gas production, and also influenced by somewhat weaker import demand in its main markets (Russia and China). While monetary policy may tighten in response to emerging inflationary pressures, the procyclical bias in fiscal policy is set to be carried forward into 2005.[188]

The Caucasian region is on the brink of a major transformation, with economic growth being driven by a major expansion of the regional pipeline system transporting Azeri oil.[189] This is expected to produce a sharp acceleration of GDP growth (to two-digit rates in 2005), with the main source of growth shifting from massive FDI (which will remain large), to growing exports, resulting in a reduction of external imbalances.[190] Macroeconomic policy, however, will have to cope with even greater pressures from strong capital inflows. Developments in Azerbaijan are expected to feed into the Georgian economy, through the impact of pipeline construction, growing transit fees and enhanced opportunities for trade. Georgia's new government has launched a new reform programme that has managed to attract considerable donor support.[191] Armenia is unlikely to benefit from the oil boom, as it is bypassed by the pipeline routes. GDP growth is expected to decelerate somewhat in 2005, as the momentum of grant-financed construction projects fades away.

GDP growth in Kyrgyzstan is likely to moderate in 2005, the result of a less favourable external environment and the fading of the base period effect associated with the recovery of output in the Kumtor gold mine. Macroeconomic policy will have to be more cautious in view of the need for fiscal consolidation, which is a condition for obtaining vital debt relief from the Paris Club of creditors. After several years of strong

[187] Public access to cash remains restricted, resulting in significant discounts on cash transactions. Asian Development Bank, *Asian Development 2004 Update* (Manila), 2004.

[188] The new parliament, elected in September-October 2004, adopted an amendment to the draft budget, agreed by the outgoing parliament, which increases the planned expenditure for 2005 by 101.4 billion tenge (or 0.2 per cent of GDP).

[189] The expected completion of the Baku-Tbilisi-Ceyhan oil pipeline in 2005 will allow Azerbaijan to greatly increase its exports. Pipeline construction will continue to boost economic activity in the region. The South Caucasus Gas Pipeline is expected to be finished in time to deliver the first contracted exports to Turkey in 2006.

[190] Azerbaijan's GDP is projected to double in dollar terms in the next four years, increasing its lead as the largest economy in the region. IMF, *Azerbaijan Republic: Third Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility-Staff Report*, Country Report No. 04/9 (Washington, D.C.), January 2004.

[191] In June 2004, a donor conference pledged $1 billion. However, further reforms will be needed to improve the absorptive capacity of the economy and to boost consumer and investor confidence.

growth, partly reflecting the impetus of post-conflict recovery, a more moderate but still robust pace of expansion is expected in Tajikistan in 2005. The conclusion of a debt-for-equity swap agreement with Russia may encourage further foreign direct investment. As in Kyrgyzstan, remittances will remain a significant support to domestic demand. In the remaining CIS countries, GDP is expected to continue to grow at rates similar to those in 2004, provided there are no negative external shocks.

Risks to the outlook: high vulnerability to external shocks and competitiveness losses

Whereas GDP throughout the CIS, and especially in the resource-rich CIS economies, has been growing at remarkably high rates during the last couple of years, economic growth in the region is not soundly based. The current boom in world commodity markets has greatly benefited the resource-abundant economies but it has also increased their exposure to external shocks caused by possible reversals in prices and/or world demand. The main vulnerability of these economies is their high degree of dependence on the exports of natural resources and low value added manufactured products. Besides, the current rate of export growth is clearly not sustainable for most of the CIS commodity exporters and even if external conditions remain favourable, the sources of this resource-based growth are likely to be exhausted in the not-too distant future.

While generating unusually large windfall revenue gains, high commodity prices have in some cases led to potentially damaging macroeconomic side effects, in particular the so-called "Dutch Disease". There are already signs, especially in Russia, that the loss of competitiveness due to real exchange rate appreciation, is an increasing burden on local producers and is choking off aggregate domestic economic activity. The capacity of macroeconomic policy to address these negative implications is fairly limited, moreover, given the relatively narrow set of instruments at the disposal of policy makers. Unless local producers are able to respond at the micro level through further restructuring, negative repercussions on output growth are likely in the affected countries, especially in their manufacturing industries.

Long-term prospects depend on diversification and economic reform

The current sources of rapid economic growth in the CIS region (rising volumes of exports of natural resources and favourable world commodity prices) could soon evaporate.[192] The recent rates of rapid GDP growth were possible because of increased utilization of existing productive capacity and largely reflect a recovery from the deep transformational recession in these economies. None of these factors is likely to continue for very long. Sustaining high rates of economic growth will therefore call for major changes in its composition and direction.

At the same time, current policies which are seeking to contain real exchange rate appreciation in order to preserve the competitiveness of local producers (as is the case in Russia) have obvious limitations. This is not a sustainable direction for policy and may prove a distraction from the necessary efforts to accelerate the pace of structural reforms in the resource-rich CIS economies. Ultimately, through diversification and modernization, these economies (Russia, in particular) will need to achieve significant productivity gains. Increased productivity will not only allow some of the negative implications of the real exchange rate appreciation to be offset, but it will also set the stage for sustainable high rates of economic growth and consequent increases in living standards.

The economic diversification and modernization of these economies is a long-term process that is likely to take years to materialize even under favourable circumstances and in a supportive policy environment. In order to restructure and develop, the CIS economies will have to be capable of attracting and absorbing vast amounts of private fixed investment, including FDI. That is, their economic environment should not only offer direct investors attractive and attainable future returns but should also facilitate the implementation of investment projects.

Public policy can play an important role in the successful restructuring of these economies. An important condition for this to materialize is the development of human capital, which is a key factor in long-term growth. Public policy can also play a leading role in the development of infrastructure. A crucial requirement, however, is to improve the quality and capacity of public administration and other institutions in order to enhance the impact of public intervention and limit distortions. Broadly speaking, public policy should target the removal of existing obstacles to the development of the private sector. In turn, this implies further deepening and broadening of key reforms in product and financial markets. In any case, a strategy of economic diversification relying on the mobilization of fixed investment calls for credible long-term policy commitments on the part of governments that will improve and then stabilize investors' long-term expectations.

[192] Thus according to medium- and long-term forecasts of the International Energy Agency, Russia's share in the global supply of oil is likely to fall after 2010. IEA, *World Energy Outlook 2004* (Paris), 2004, chap. 9.