3. Caucasus and Central Asia: Boosting Competitiveness for Higher and More Inclusive Growth

Global trade tensions and slowing growth in key trading partners are affecting the Caucasus and Central Asia (CCA) region. However, despite a decline in export growth, growth will remain broadly stable in 2019–20, supported by a looser fiscal stance and private sector credit growth. Nevertheless, a slowdown in total factor productivity—especially in the region's oil and gas exporters—points to lower potential growth and underscores the challenge of creating enough jobs for new workers. To foster higher and more inclusive growth and raise living standards, CCA policymakers should strengthen competitiveness, leverage comparative advantages, and foster diverse sources of growth to reap the gains from trade and integration into global value chains. This will include promoting private-sector-led growth, improving the efficiency of state-owned enterprises, and ensuring a well-functioning labor market. Macroeconomic policies should focus on addressing weak banking sectors, strengthening fiscal institutions, investing in infrastructure and human capital, and upgrading monetary policy frameworks to sustain stable and low inflation and support greater exchange rate flexibility.

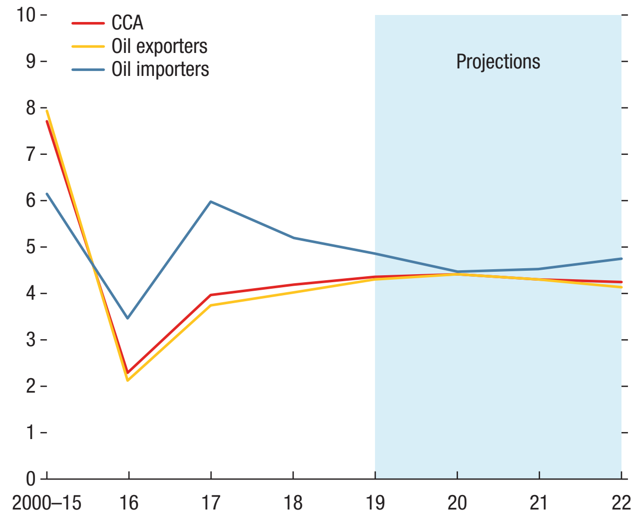
Global Trade Tensions Weigh on the Outlook

The CCA region faces a less-favorable global environment, including from trade tensions and slowing growth in key trading partners. Despite weaker trade, overall growth for the CCA region is expected to remain about 4½ percent in 2019–20 (Figure 3.1), largely owing to a looser fiscal stance.

Growth in the region's major trading partners, including China, Russia, and major euro area economies, is projected to fall from 3.2 percent in 2018 to 2.3 percent in 2019, while import growth is projected to decline from 11.4 percent in 2018 to –1.4 percent in 2019 (see Global Developments).

Prepared by Dalmacio F. Benicio and Lawrence Dwight, with research assistance of Oluremi Akin-Olugbade and Jorge de Leon Miranda.

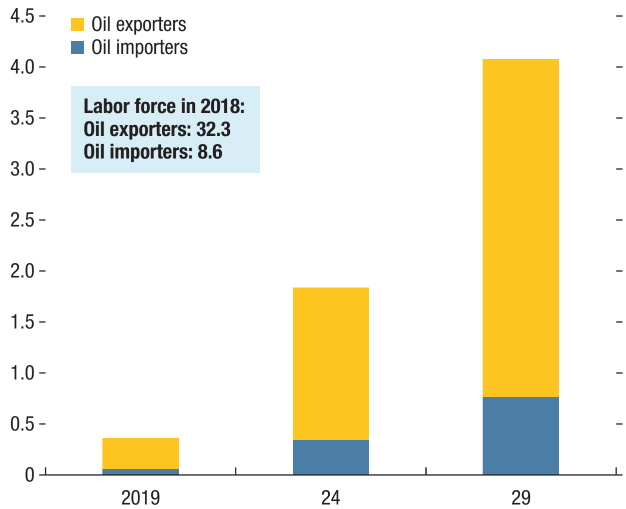
Figure 3.1. CCA Real GDP Growth
(Percent)



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

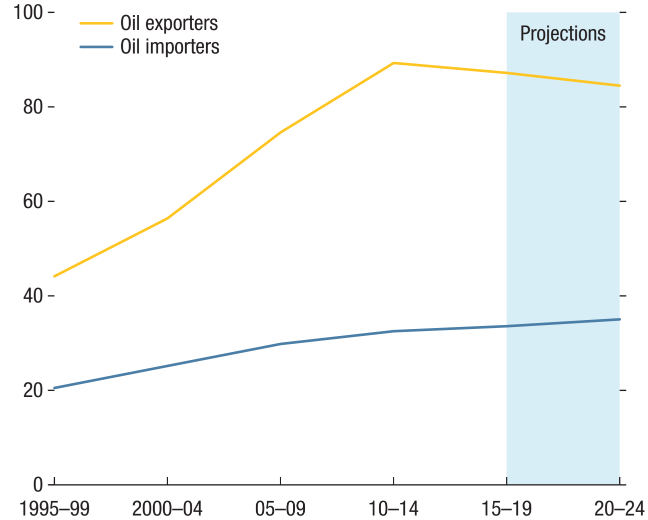
These developments are contributing to a sharper projected slowdown in trade in the CCA region in 2019. Growth in exports of goods and services of oil and gas exporters is projected to drop from 23 percent in 2017–18 to about –1.7 percent in 2019–20. The drop in the growth of exports of oil and gas importers is projected to be noticeable yet less dramatic. Import growth in oil and gas exporters is projected to decelerate from 10 percent in 2017–18 to 5.6 percent in 2019–20, owing to restrained domestic demand in some countries. Consequently, current account balances for oil and gas exporters are projected to deteriorate, while the sizable current account deficits of oil importers are projected to improve slightly. Overall, the CCA region's current account balance is projected to decline from a surplus of 0.3 percent of GDP in 2018 to a deficit of 1.5 percent of GDP in 2019–20.

Figure 3.2. Projected Cumulative Labor Force Increase Relative to 2018
(Millions)



Sources: International Labour Organization estimates; and IMF staff calculations.

Figure 3.3. Per Capita GDP Convergence
(Percent of EMEU per capita GDP, in PPP dollars)



Sources: National authorities; and IMF staff calculations.
Note: EMEU = emerging Europe; PPP = purchasing power parity.

Fiscal Expansion Will Offset External Shocks

Nonetheless, growth will be supported by a looser fiscal stance, with the CCA region's general government fiscal balance declining by 1.5 percent of GDP from 2018 to 2019 to 0.6 percent. In oil and gas importers, GDP growth is projected to decelerate modestly from 5.2 percent in 2018 to 4.7 percent in 2019–20. Besides fiscal support, oil and gas exporters will benefit from a pickup in consumer lending coupled with firmer construction, manufacturing, and services demand in Kazakhstan, Turkmenistan, and Uzbekistan. This will boost non-oil GDP growth from 3 percent in 2018 to 4.9 percent in 2019–20.

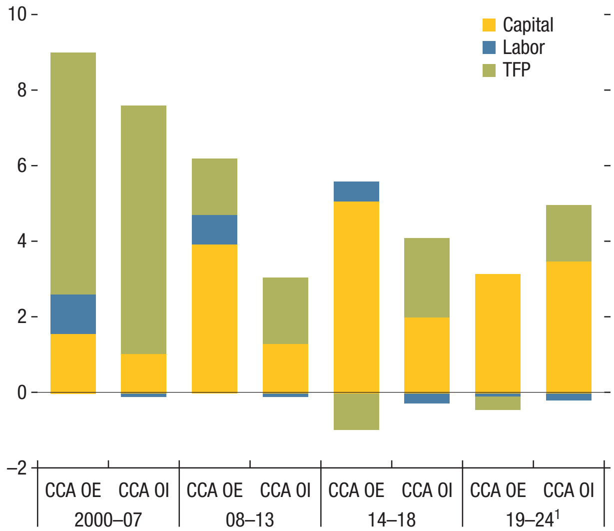
Given the stable growth outlook and lower global energy prices (see Global Developments), inflation expectations are generally well-anchored, though inflation remains in the double digits in Turkmenistan and Uzbekistan (13.4 and 14.7 percent, respectively) mainly owing to high credit growth and increases in utility tariffs.

The region's medium-term growth is projected to remain about 4½ percent, assuming a resumption in trading partner growth and a recovery in oil and gas production. Government debt levels are projected to remain stable at about 23 percent of GDP for oil and gas exporters and 49.8 percent of GDP for oil and gas importers this year. However, growth will not be sufficient to lift per capita incomes to emerging Europe levels (see April 2019 *Regional Economic Outlook Update: Middle East and Central Asia*) or reduce unemployment given 4 million new entrants (12 percent of the labor force) over the next 10 years (Figures 3.2 and 3.3). Currently, Armenia and Georgia have the highest unemployment rates, while Kazakhstan and Uzbekistan—with the largest populations in the CCA region—will have to absorb the greatest number of new workers.

Moreover, the growth in total factor productivity (TFP) in the CCA region has slowed considerably, driven by lower global growth following the global financial crisis, and for oil and gas exporting countries, by lower energy prices since 2014.[1] A slower catch-up effect following the economic

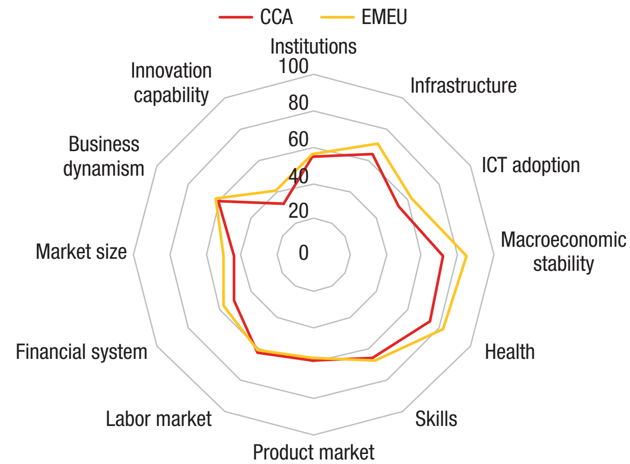
[1]For example, TFP for oil exporters was positive in 2008–13 when average global oil prices rose 6 percent a year but became negative in 2014–18 when average prices fell 8 percent a year.

Figure 3.4. Growth Accounting, CCA Oil Exporters vs. Oil Importers, 2000–24
(Percent)



Sources: International Labour Organization; national authorities; World Economic Outlook database; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; CCA OE = CCA oil exporters; CCA OI = CCA oil importers; TFP = total factor productivity.
[1]CCA OE does not include Turkmenistan for the period 2019–24.

Figure 3.5. Global Competitiveness Index
(0–100, where 100 is best)



Source: *World Economic Forum Global Competitiveness Report*, 2018.
Note: CCA = Caucasus and Central Asia; EMEU = emerging Europe; ICT = information and communication technology.

transition in the 1990s may also have played a role (Fayad and others 2019; OECD 2018a; Figure 3.4).

Downside risks cloud the region's outlook. External risks include intensified trade tensions, slower global growth, lower commodity prices, and rising geopolitical risks. Domestic risks include slowing reform momentum. A possible upside is higher growth from accelerated reforms in Kazakhstan and Uzbekistan.

How Competitive Are CCA Countries?

Global trade uncertainties and weak export performance in the CCA region underscore the need to strengthen competitiveness, leverage comparative advantages, and foster diverse sources of growth. While global trade has slowed, it will likely outpace medium-term global growth. As CCA countries are relatively closed, increased openness and trade could boost growth and efficiency.

Competitiveness is a multidimensional concept. Thus, several indicators are used to compare competitiveness with emerging Europe and Asia.

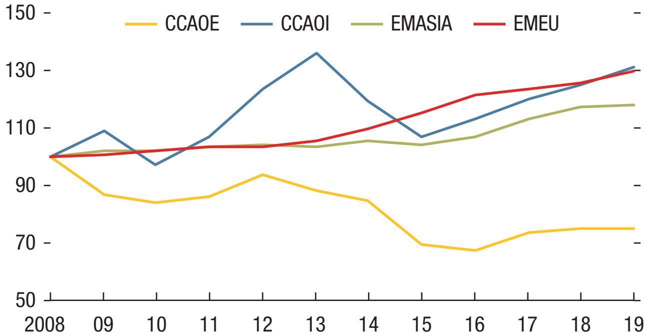
The CCA region scores favorably on several measures. The IMF assesses *exchange rates* to be in line with fundamentals for most countries following devaluations across the region after the large external shocks in 2014–16. Moreover, CCA countries compare well with peers on perceptions of *non–price competitiveness* (Figure 3.5). And CCA countries rate higher than emerging Asia on measures of *human* capital, though lower than emerging Europe.

Nonetheless, several impediments prevent the region from leveraging these advantages to more fully integrate into global markets and raise productivity and potential growth. First, CCA countries rate lower than their peers on access to finance, the tax burden on the formal economy, and the cost of regulation.

Second, trade costs and transport times are high. The average cost to ship a container to Shanghai or Rotterdam is more than five times higher for most

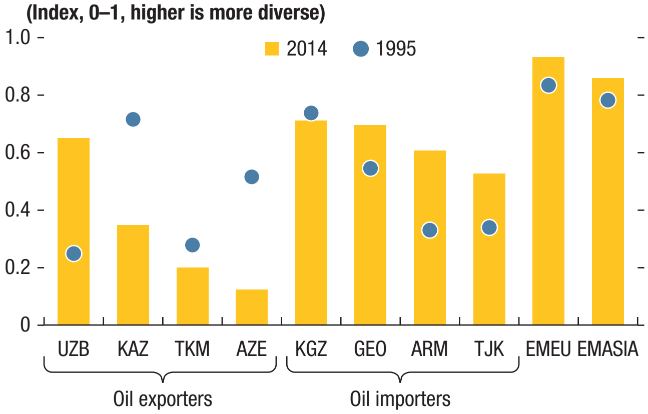
Figure 3.6. Characteristics of Exports

1. Share of Noncommodity Exports in Global Exports
(Index 2008 = 100, share of volume of world exports)



Sources: National authorities; and IMF staff calculations.
Note: CCAOE = CCA oil exporters; CCAOI = CCA oil importers; EMASIA = emerging Asia; EMEU = emerging Europe. EMASIA comprises Bangladesh, Cambodia, Indonesia, Lao P.D.R., Malaysia, Philippines, Thailand, and Vietnam. EMEU comprises Bulgaria, Czech Republic, Hungary, North Macedonia, Poland, Romania, Slovak Republic, and Slovenia.

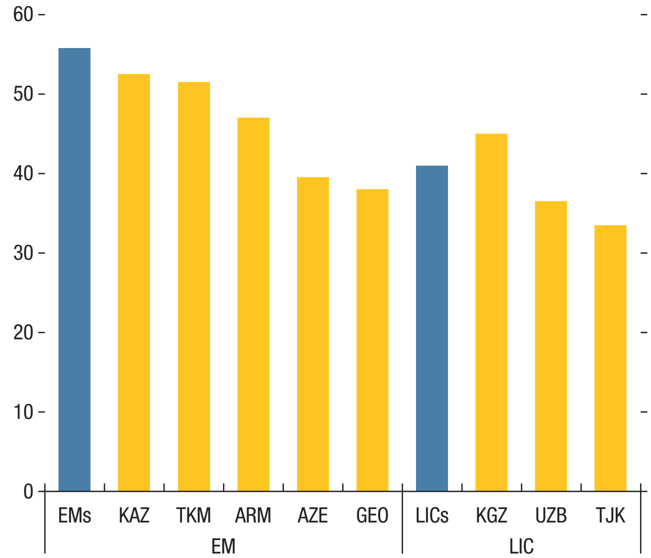
2. Export Quality[1]
(Index, 0–1, higher is more diverse)



Sources: IMF Diversification database; and IMF staff calculations.
Note: EMASIA = emerging Asia; EMEU = emerging Europe. Country abbreviations are International Organization for Standardization (ISO) country codes. Export Quality index rebased to be from 0 to 1, and is equal to a Theil index of export concentration.
[1]2014 is latest available year for the quality index.

Figure 3.7. Global Value Chain Participation Rate

(Percent)



Source: United Nations Conference on Trade and Development (UNCTAD)–Eora Global Value Chain (GVC) database.
Note: EM = emerging market economies; and LIC = low-income countries. Country abbreviations are International Organization for Standardization (ISO) country codes. Global value chain participation rate is calculated as the sum of foreign and domestic value added as a share of a country's gross exports. The larger the rate the higher the intensity of a country's involvement in global value chains.

CCA countries compared with those in emerging Europe (World Bank 2019b). Although high costs reflect geographic disadvantages (for example, landlocked economies, harsh climates, and low population density), they also reflect restrictions on trade and foreign direct investment (FDI), weak border management, and underdeveloped transportation and logistics infrastructure.

Third, the region's oil and gas exporters' share of the world's noncommodity export volumes has not kept pace with emerging market peers. The quality of exports has also fallen since 1995, implying the need to diversify and upgrade product quality (Figure 3.6). Moreover, FDI inflows are relatively small (see Chapter 4), and participation in global value chains (GVCs) is lower than in similar economies (Figure 3.7).[2]

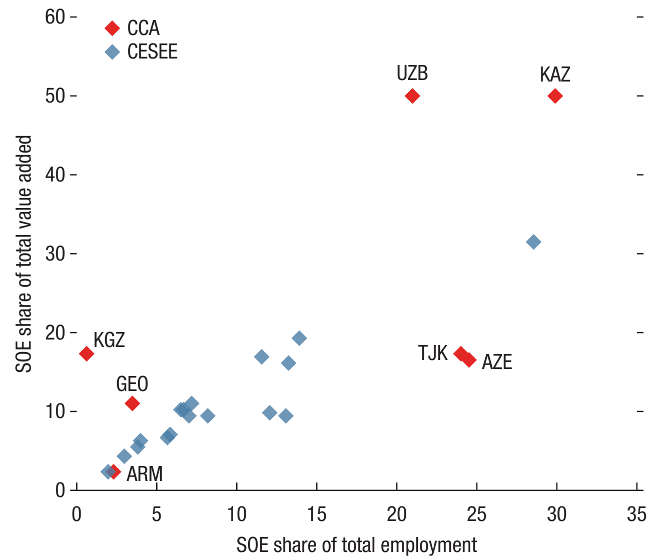
Fourth, government's large role in the economy, reflected in the dominance of state-owned enterprises (SOEs) in local markets, impedes efficiency and entrepreneurship. For example, in Kazakhstan SOEs account for about half of total value added, one-third of employment, and hold assets equal to nearly one-half of GDP (World Bank 2018; OECD 2018b; Figure 3.8). Yet some

[2]The GVC participation rate is measured as the sum of value added of intermediate imports and exports as a share of gross exports.

SOEs have weak operations, lose money, require subsidies, or lack transparency and effective oversight. Moreover, implicit guarantees on SOE liabilities are a growing concern and if they require fiscal support could have a significant impact on governments' fiscal positions (IMF 2019d).

Aside from competitiveness, oil and gas exporters are highly vulnerable to shocks in global commodity markets. CCA oil and gas importers are more diversified, but still have significant exposure to commodity cycles, including directly through exports of minerals and metals and indirectly through remittances from oil exporters, especially Russia. This underscores the region's vulnerability to the subdued outlook for commodity prices and global trade.

Figure 3.8. Value Added vs. Employment
(Percent)



Sources: National authorities; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; CESEE = Central, Eastern, and Southeastern Europe; SOE = state-owned enterprises. Country abbreviations are International Organization for Standardization (ISO) country codes. Turkmenistan is excluded due to data availability.

Promoting Competitiveness and Inclusive Growth

Although CCA countries have recently taken steps to sustain or enhance competitiveness, such as greater exchange rate flexibility, further efforts are needed to foster higher and more inclusive growth, generate jobs, raise living standards, build resilience, and reduce exposure to external shocks.

Policymakers should also continue to address legacy challenges from external shocks in 2014–16. This means addressing weaknesses in banking systems (Azerbaijan, Kazakhstan, Tajikistan) while modernizing monetary policy frameworks to support greater exchange rate flexibility (Azerbaijan, Kyrgyz Republic, Tajikistan, Turkmenistan, Uzbekistan). It also means strengthening fiscal institutions to support fiscal consolidation, rebuild buffers where needed (Armenia, Azerbaijan, Kazakhstan, Tajikistan), and create space for more productive investment in infrastructure and human capital (see April 2019 *Regional Economic Outlook Update: Middle East and Central Asia*). Improvements to fiscal institutions could include strengthening fiscal rules, fiscal transparency, and the efficiency of tax regimes and revenue administration.

In addition, CCA countries need to boost external competitiveness, FDI, and infrastructure investment, while guarding against risks such as global trade tensions (IMF 2018). Thus, governments should create an enabling environment for the private sector, including by fostering competition and implementing sound industrial policy.

Policymakers should also focus on reforms to achieve greater integration, higher growth, and more jobs. These reforms should reduce trade costs and help companies participate in GVCs, exploit comparative advantages, reform SOEs, nurture entrepreneurship, and ensure well-functioning labor markets. Taken together, these policies would help raise potential output, reinvigorate convergence in living standards, and help address unemployment.

Policies to Promote Participation in GVCs

Policies to promote inclusive growth and participation in GVCs include overcoming geographic remoteness by improving connectivity and lowering trade costs, liberalizing trade, promoting foreign investment, and improving the rule of law and contract enforcement (World Bank 2019a).

First, transport infrastructure could improve connectivity, lower trade costs, and boost FDI. Estimates suggest reduced trade costs could help CCA countries unlock trade and investment opportunities. For example, Belt and Road Initiative (BRI) transport projects could increase trade by 9.7 percent and reduce transport time by more than one-third. In turn, a 10 percent decrease in trade time is associated with a 12 percent increase in FDI (World Bank 2019b). Of course, countries need to ensure that the benefits of infrastructure projects outweigh their costs, including the costs of higher debt.

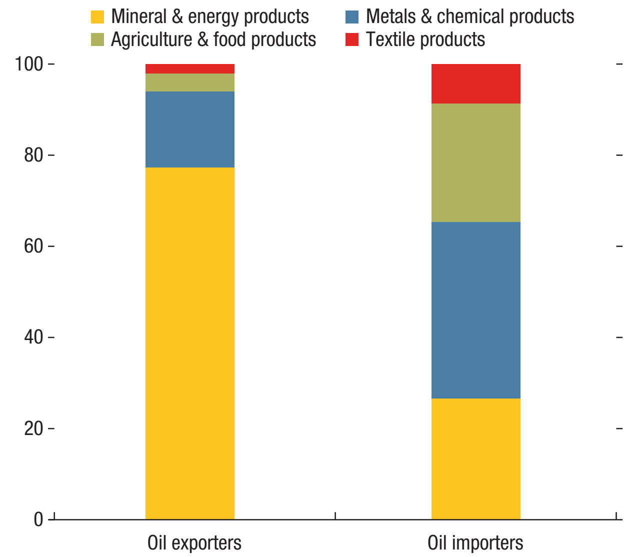
Second, reducing impediments to trade could increase integration into GVCs. Trade liberalization could expand trade in intermediate goods and facilitate downstream diversification. Greater trade could also encourage the adoption of productivity-enhancing technologies, improving the environment for e-commerce and telecommunications.

Third, policies to attract foreign investment—such as those that reduce expropriation risks and streamline entry procedures—are critical to develop the capital, technology, and managerial know-how to integrate into GVCs. Rule of law and contract enforcement would also promote integration into GVCs by fostering innovation and protecting intellectual property rights (World Bank 2019a).

Comparative Advantage

CCA countries need to develop and exploit new sources of comparative advantage, foster diversification, promote more inclusive growth, and accelerate income convergence. This means allocating resources toward more dynamic and productive sectors to diversify exports. Given limits to upgrading the quality of commodities, CCA countries could consider developing manufacturing and agribusiness where quality increases more rapidly (Henn, Papageorgiou, and Spatafora 2015). Revealed comparative advantage (RCA) analysis suggests sectors in which CCA countries have advantages (Figure 3.9).[3] These include mineral, metal, and chemical products for oil and gas exporters and agricultural products and textiles for oil and gas importers. There is the potential for further exports from sectors with high RCAs. Removing impediments to growth

Figure 3.9. Sector Concentration of Exports
(Percent, as a share of goods with RCA > 1)



Sources: United Nations Comtrade; and IMF staff calculations.
Note: RCA = revealed comparative advantage. Minerals and energy products include mineral fuels, oils, ores, and slag ash. Metals and chemical products include metals such as copper, zinc, aluminum, iron, steel, precious metals, and chemicals, including fertilizers and inorganic chemicals. Agriculture and food products include animal and plant products and produce, such as cereals, beverages, tobacco, vegetables, trees, edible fruits, and products of the milling industry; starch, and malt. Textiles include cotton, silk, apparel, and clothing.

[3]RCA measures the extent to which a given category of exports makes up a larger share of a country's exports relative to world exports. Specifically: Country c' s RCA in product i = $\frac{X_i^c / \sum_i X_i^c}{X_i^W / \sum_i X_i^W}$ in which: x_i^c = exports of product i by country c, and W denotes similar values for the world. RCA >1 suggests a comparative advantage in product i.

and boosting the quality of human capital would support greater inclusivity, diversification of production, and higher-value-added exports.

Reforming SOEs and Promoting Private Sector Jobs

State-owned enterprises in the CCA region share many of the problems of SOEs elsewhere, including requirements to provide public services, overstaffing, insufficient oversight, loss-making, and potential fiscal costs. Compared to other regions, SOEs in the CCA tend to be involved in a broader range of quasi-fiscal activities, including noncore activities such as hospitals, tourism, and schools, and have weaker financial reporting.

State-owned enterprises can provide public goods and effectively manage public assets given transparent and sound corporate governance. But SOEs can be inefficient or make losses if they lack proper incentives, good governance, or hard budget constraints. Research suggests that price and governance reforms can improve SOE financial performance as measured by return on equity (Baum and others, forthcoming).

Governments should reform SOEs that create fiscal risks, lack profitability or financial stability, or rely heavily on government subsidies or guarantees. This should be done by strengthening corporate governance, improving management, hardening budget constraints, improving incentives (for example, pricing and accountability), and reducing subsidies. To mitigate risks and improve transparency and oversight, policymakers should separate SOE ownership from supervisory functions, compensate SOEs for service mandates, create independent boards, hire professional managers and hold them accountable for financial and operational plans (including by fixing annual and midterm objectives), implement international accounting standards, and regularly publish reports on financial and operational performance, including financial and fiscal risk statements. Where SOEs operate in commercial markets, policymakers should make them compete with private firms and consider privatization (IMF 2016b).

To absorb new workers and boost inclusive growth, countries should pursue policies that promote efficient operation of labor markets, provide appropriate protection to workers, and remove impediments to job creation. On the supply side, this means boosting the quality of education and ensuring that workers have the right skills, especially for sectors that are growing and adapting to new technologies. On the demand side, taxes and regulations should not make hiring too costly. Structural measures should focus on policies, such as employment or social insurance and active labor market policies, that protect workers while promoting flexible labor markets (IMF 2019c).

To promote private sector development, governments should remove excessive regulation and give attention to areas identified as constraints to doing business. These include access to finance, taxes and regulation, inflation, and weak governance.

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CCA Region: Selected Economic Indicators, 2000–20

(Percent of GDP, unless otherwise indicated)

	Average 2000–15	2016	2017	Projections 2018	2019	2020
CCA						
Real GDP (annual growth)	7.8	2.3	4.0	4.2	4.4	4.4
Current Account Balance	0.6	−5.9	−2.3	0.3	−1.3	−1.7
Overall Fiscal Balance	1.9	−2.5	−2.8	2.1	0.6	0.1
Inflation (year average; percent)	8.9	10.5	9.4	8.3	7.6	7.6
CCA oil and gas exporters						
Real GDP (annual growth)	8.0	2.1	3.8	4.1	4.3	4.4
of which non-oil growth	8.3	1.5	3.4	3.0	5.1	4.6
Current Account Balance	1.9	−5.6	−1.9	1.5	−0.5	−1.0
Overall Fiscal Balance	2.7	−2.1	−2.6	2.6	1.0	0.5
Inflation (year average; percent)	9.2	11.6	10.0	9.0	8.1	7.9
CCA oil and gas importers						
Real GDP (annual growth)	6.2	3.5	6.0	5.2	4.9	4.5
Current Account Balance	−9.0	−8.3	−4.7	−7.9	−7.1	−6.7
Overall Fiscal Balance	−2.9	−5.4	−4.3	−2.1	−2.6	−2.6
Inflation (year average; percent)	7.0	1.8	4.6	2.7	3.8	4.5

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

CCA oil and gas exporters: Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan.

CCA oil and gas importers: Armenia, Georgia, the Kyrgyz Republic, and Tajikistan.