Increasing Regional Risks Call for Intensified Economic Reforms in the Caucasus and Central Asia

By Juha Kähkönen, Deputy Director, Middle East and Central Asia Department, International Monetary Fund, and Azim Sadikov, IMF Resident Representative to Georgia

The policymakers who met during the recent Annual Meetings of the International Monetary Fund faced some somber news regarding prospects for the global economy. Although global recovery continues, it remains uneven in advanced economies, and emerging economies are adjusting to rates of economic growth lower than those reached in the pre-crisis boom and post-crisis recovery. For the countries in the Caucasus and Central Asia (CCA), increased geopolitical tensions and the related slowdown in Russia's economy are of a particular concern. With weaker economic prospects and long-standing vulnerabilities, it is becoming more urgent to implement reforms to increase competitiveness, reduce unemployment, and improve living standards.

GDP growth in 2014–15 for this region is projected to decline from about 7 percent in 2013 to 5½. The decline might not seem large while many other regions of the world are growing at much lower rates. However, this is a region accustomed to high rates of growth, witnessing nearly 7½ percent growth during 2007-11, including during the global financial crisis.

GDP growth in Georgia is expected to reach 5 percent in 2014 and 2015 as the economy recovers from the slowdown in 2013. The Russia-Ukraine crisis has had limited economic impact so far given Georgia's limited (but growing) trade links with Russia and increasing remittances from Southern Europe. Inflation should approach 4 percent by end-2014, but the recent strengthening of the Lari will continue to weigh down on prices. Developing capital markets, introducing a new pension system, and improving education quality would allow Georgia to benefit fully from trade and investment opportunities created by the Deep and Comprehensive Free Trade Area Agreement with the EU, and boost medium-term growth. The recent decline in oil prices, if sustained, should translate into higher growth and a lower current account deficit.

The decline in oil prices adds uncertainty to the economic outlook. The region's oil exporters are vulnerable to a prolonged period of low oil prices. Growth in these economies may slow further as oil revenues fall, and unless their governments cut spending, their fiscal and external surpluses would also deteriorate. Although CCA oil importers would benefit from lower oil import bills at first, they are exposed to negative spillovers from Russia, an economy that itself depends heavily on oil.

The oil price shock is taking place against the backdrop of rising global risks. A further deepening of geopolitical tensions surrounding the situation in Ukraine could significantly impact the CCA economic outlook further, given the region's close links with Russia through trade, remittances, and investment. Our estimates suggest that a temporary fall of 1 percentage point in Russia's GDP growth in a given year would lower that year's growth in the CCA oil exporters by about 0.3 percentage points and in the oil importers by about 0.7 percentage points. Moreover, a longer period of slower growth in other economic partners, particularly Europe or China, would also affect growth in the CCA through weaker external demand and investment.

What should governments and central banks in the region do in response to the rising risks? First and foremost, they need to focus on maintaining economic and financial stability and, where possible, providing short-term support to economic growth. In this sense, given heightened risks, a pause in fiscal consolidation is justifiable in the countries that have buffers, such as Kazakhstan. In Georgia, after a temporary loosening in 2014, fiscal policy in 2015 is embarking on fiscal consolidation as conditions improve, to rebuild buffers and place public debt on a declining path. In oil and gas exporters, attention should be paid to ensure intergenerational equity and adequate precautionary balances to protect against commodity price uncertainty. And, where inflation is creeping up, monetary tightening may be needed.

However, these immediate steps are unlikely to break the trend of slower economic growth over the medium term. A recent IMF study shows that the decline in potential economic growth in the CCA region has been sharper than in other regions of the world. The region's productivity has declined and reform has slowed down, reinforcing the longstanding problems of unemployment, emigration, and inequality in the region.

Comprehensive reforms of governance, regulatory quality, and the rule of law are needed to create an environment conducive to increased productivity, investments, jobs, and growth. Priorities should be given to further diversifying commodity-based economies, improving access of firms and households to finance, strengthening the business climate, and pursuing balanced regional and multilateral trade integration. For its part, the IMF is working with the countries in the region to help them respond to these challenges. Depending on country circumstances, this help can include policy advice, technical assistance, and financial support

The recent global uncertainties only highlight further the need for a new economic model, less dependent on commodities, more integrated and diversified. This would help to propel the CCA countries permanently into the rank of fast paced emerging economies, allowing them to fully take advantage of their key geographic position and population dividend.