VI External Sector Policies

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Under the centralized planning system, the Central Asian states developed highly specialized and closely integrated economic relationships with the rest of the Soviet Union, notably characterized by a strong dependency on imports of energy, food, and consumer goods. During 1987–89, the region incurred trade deficits with the rest of the Soviet Union, averaging about 12 percent of GDP annually. The region's production structure was heavily oriented toward agriculture and mineral extraction, which left little room for growth of import-substituting industries. The export bases of the Central Asian states, therefore, lacked diversification, and import dependency was high, making these countries particularly vulnerable to adverse trade shocks. During the Soviet era, prices for energy and raw materials were far below world prices, so that the net importer countries in the region benefited from sizable trade subsidies. Turkmenistan—the only net exporter, whose primary export is natural gas—was an exception. Following independence, the Central Asian states (with the exception of Turkmenistan until 1997) continued to incur sizable and persistent external current account deficits (Table 6.1). Three main factors accounted for this. First, the agricultural, industrial, and household sectors inherited from the Soviet era were highly energy intensive. Second, the demand for investment goods to replace obsolete capital was high. Third, after years of repressed consumption, import demand for western consumer goods surged. Hence, imports from nontraditional markets grew rapidly, despite strenuous attempts (notably by Turkmenistan and Uzbekistan) to restrain imports, mostly through foreign exchange restrictions.

The newly independent Central Asian economies inherited state-controlled foreign trade systems from the Soviet era. Previously, foreign trade was subordinated to the requirements of the central plan, with price signals playing little role in the allocation of resources. State enterprises involved in foreign trade were confronted by a complex system of cross subsidies to offset the profits and losses arising from differences between foreign currency and domestic wholesale prices.[1] Exchange rates were administratively determined under a complex system of multiple currency practices. Export quotas were used to ensure compliance with bilateral trade agreements with countries outside of the Soviet Union. The management of foreign economic relations lacked transparency, with responsibility shared among several organizations, including the planning agency (Gosplan), the state foreign economic commission, the ministry of foreign economic relations, and a number of specialized foreign trade organizations. There was little opportunity or incentive for individual enterprises to engage in foreign trade.

Progress toward trade liberalization has varied across the Central Asian states. While the role of the state in foreign trade throughout the region has been significantly reduced, progress has been more pronounced in Kazakhstan, the Kyrgyz Republic, and Tajikistan, where highly restrictive state monopolies on foreign trade have been eliminated, licensing requirements relaxed, and significant tariff reforms initiated. Progress toward trade liberalization has been more gradual in Turkmenistan and Uzbekistan, where the state continues to play a dominant role, particularly in the foreign exchange market. The Central Asian states have benefited from the move to world trade. Exports have grown significantly, and the region has been broadly successful in diversifying markets. The movement toward world prices has, on the whole, benefited the region. A problem, however, has been the lack of an adequate payments system within the region, and with the region's traditional trading partners. Also, limited contract enforceability, continued reliance on barter trade (in some instances to settle debts), and limited currency convertibility have seriously inhibited the growth of intraregional trade.

External Sector Reforms

External sector reforms in the Central Asian states have covered five key areas: liberalization of foreign

[1] This system—known as the price equalization system—effectively isolated domestic prices from the effects of changes in world prices. For details see Wolf (1990).

Table 6.1. Current Account Balances

	1992	1993	1994	1995	1996	1997	1998 Prov.
	(In millions of U.S. dollars)						
Kazakhstan	−1,479	−438	−905	−516	−752	−912	−1,451
Kyrgyz Republic[1]	−98	−162	−124	−243	−425	−139	−285
Tajikistan	−53	−208	−170	−89	−76	−60	−133
Turkmenistan[2]	926	776	84	23	43	−580	−935
Uzbekistan	−236	−430	119	−21	−980	−584	−256
	(In percent of GDP)						
Kazakhstan	−51.4	−9.4	−8.6	−3.1	−3.6	−4.1	−5.6
Kyrgyz Republic[1]	−10.6	−16.4	−11.2	−16.3	−23.5	−7.9	−16.7
Tajikistan	−18.0	−30.7	−20.5	−14.6	−7.4	−5.5	−10.3
Turkmenistan[2]	54.7	20.1	1.8	1.3	2.1	−27.3	−36.2
Uzbekistan	−11.7	−7.8	2.1	−0.2	−7.2	−4.0	−1.8

Sources: IMF Staff Country Reports.
[1]Includes official and private transfers.
[2]Gas exports are recorded on an accrual basis. Nonpayment for gas exports are recorded as arrears in the capital account.

trade prices, reform of the trade system, market diversification, phasing out of barter trade, and currency reform.

Liberalization of Foreign Trade Prices

The Central Asian states followed Russia's lead in liberalizing foreign trade prices. The move to world prices in foreign trade had a mixed effect on the region. In the early years of independence, Turkmenistan and Uzbekistan enjoyed significant improvements in their terms of trade.[2] It proved relatively easy for Uzbekistan to shift exports of cotton and gold—traditionally supplied to the Soviet Union—to western markets. The move to world prices for energy within the BRO countries helped protect Turkmenistan's external position in the face of sharp output declines, including cutbacks in gas production. Diversifying gas export markets proved difficult, though. As of 1993, Turkmenistan was denied access to European markets through the regional gas pipeline network, so that its gas exports were confined to Ukraine and countries of the Caucuses. Hence, the benefits of the terms of trade improvement were substantially negated by sizable payments arrears by these trading partners for gas imports from Turkmenistan. By contrast, Kazakhstan and the Kyrgyz Republic experienced deteriorations in their terms of trade, while Tajikistan encountered wide swings. As trade shifted to world prices, export and import prices surged at different intervals, generating sharp year-to-year fluctuations.

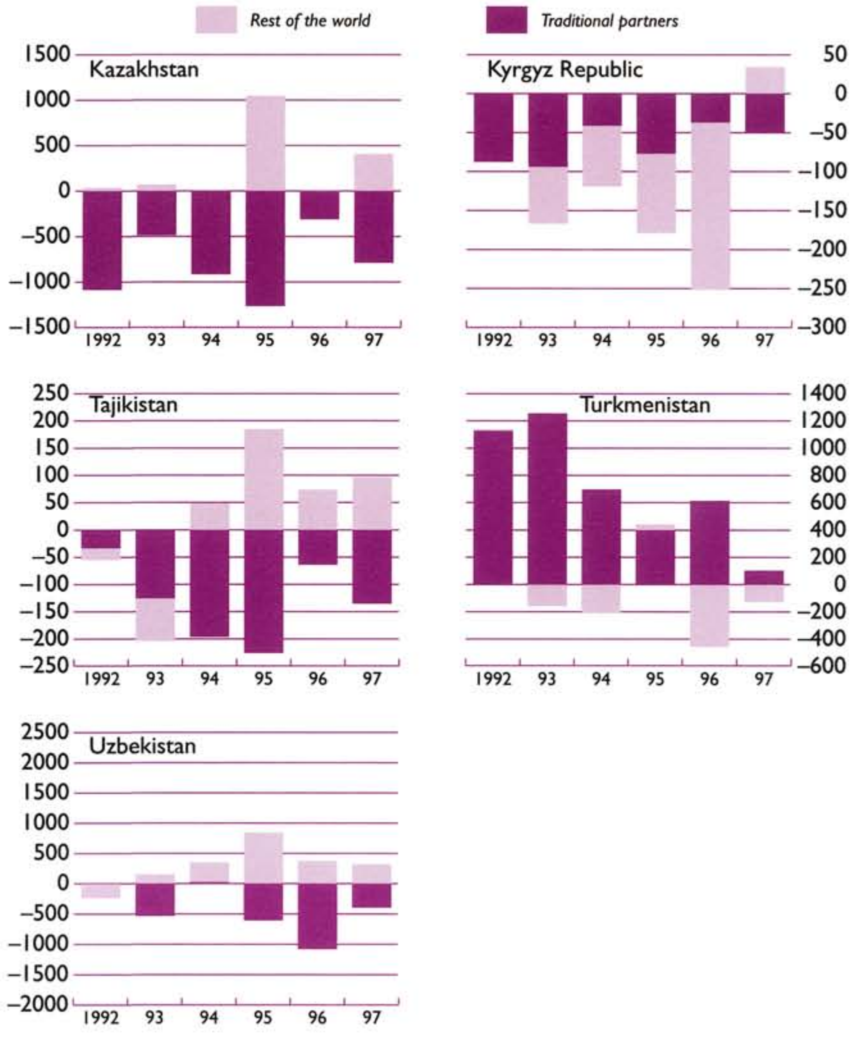
In 1993, exports of the Central Asian states to traditional markets—which at the time comprised two-thirds of exports—grew by 43 percent, largely reflecting the move toward world prices. While output declines that characterized the early years of transition were generally more muted in the Central Asian states, the effects of large output contractions in the BRO countries and disruptions to the payments system—coupled with the continued shift of trade to new markets—reduced the region's exports to traditional markets by 24 percent in 1994. Despite some subsequent recovery, the share of exports to traditional markets declined steadily during 1994–97. Kazakhstan, the Kyrgyz Republic, Tajikistan, and Uzbekistan continued to incur considerable trade deficits with the BRO countries (Figure 6.1). While Turkmenistan consistently recorded trade surpluses (on an accrual basis) until 1997, it accumulated claims of over $1.5 billion in unpaid exports against its traditional trading partners. As of 1997, the discontinuation of gas exports reversed Turkmenistan's trade balance with the BRO countries.

Reform of the Trade System

The Central Asian states inherited a foreign trade system that had partially undergone reform in the final years of the Soviet Union. After 1989, enter-

[2]This discussion is based on terms of trade data generated in the context of the IMF's World Economic Outlook exercise and suffers from certain weaknesses, as well as possible lack of comparability across countries.

Figure 6.1. Trade Balances
(In millions of U.S. dollars)



Sources: IMF Staff Country Reports.

prises could engage directly in foreign trade, rather than deal with state trading corporations. Also, enterprises were allowed to sell residual output after meeting production requirements of the state plan. To fulfill the production requirements, compulsory state orders and domestic price controls were initially maintained, triggering domestic shortages of some goods. To divert goods from export to domestic markets, explicit export taxes were levied in some instances and quantitative restrictions were applied.

The breakup of the Soviet Union accelerated the decentralization of foreign trade. The authority for trade relations was assumed by the ministries of foreign economic relations. The newly created state trading organizations quickly inherited many of the monopoly privileges enjoyed by their Soviet ancestors. Moreover, the legal framework inherited from the Soviet Union discouraged participation of the private sector in foreign trade. The absence of clearly defined property rights and the lack of legal means to enforce contracts made foreign trade

Box 6.1. Regional and International Trade Initiatives

The Central Asian states have taken a wide range of regional and international trade initiatives. All five have joined the Economic Cooperation Organization, which also includes Azerbaijan, Afghanistan, Pakistan, the Islamic Republic of Iran, and Turkey. The organization was set up to develop and improve the region's economic infrastructure and transportation system. Kazakhstan and the Kyrgyz Republic have joined a customs union with Belarus and the Russian Federation. Kazakhstan, the Kyrgyz Republic, Uzbekistan, and Tajikistan have formed the Central Asian Union (a single economic region) with the aim of improving payments arrangements and reducing import tariffs among member countries. All countries in the region have shown interest in becoming members of the World Trade Organization. In the case of Kazakhstan, the application to join the organization is at an advanced stage, while the Kyrgyz Republic signed a membership agreement in October 1998.

The European Union has granted all countries in the region access to the Generalized System of Preferences (GSP), which allows tariff reductions on manufactured goods and certain agricultural products and, in some cases, duty-free access to European Union markets. Most Favored Nation status was granted by the European Union under an agreement signed with the Soviet Union in 1989—the Trade and Commercial Economic Cooperation Agreement, which remains in force in the BRO countries. All countries of the region have gained MFN status with the United States and Japan. The U.S. has also granted GSP Status to Kazakhstan, the Kyrgyz Republic, and Uzbekistan. Japan is in the process of offering GSP status to all countries in the region.

highly risky. Excessive licensing regulations and heavy actual taxation of exports, through complex systems of multiple currency practices and foreign exchange surrender requirements, impeded the growth of trade.

Progress with trade reforms among the Central Asian states varied considerably.[3] Kazakhstan and the Kyrgyz Republic quickly moved to abolish state monopoly privileges, unify exchange rates, and simplify the regulatory and fiscal frameworks governing international trade. During 1994–95, the Kyrgyz Republic dismantled the centralized system of trade arrangements. During 1995–96, Kazakhstan followed suit, by canceling monopoly rights of state trading organizations, eliminating nontariff trade restrictions, abolishing export surrenders, and terminating the requirement to register export contracts at the commodity exchange, although registration requirements were reintroduced for certain agricultural products in 1997. Tajikistan initially adopted a highly restrictive trade regime, although these restrictions were never fully enforced. During 1997–98, it introduced a wide-reaching program of reforms, establishing an open and liberal trade regime. Thus, the state order system, state monopoly rights, export licensing requirements, surrender requirements, and export duties were abolished. Nontariff restrictions on imports were also eliminated, and a low uniform import tariff was introduced.

Progress with trade reforms has been slower in Turkmenistan and Uzbekistan. In both countries, the state still exercises considerable influence over trade. Export surrenders and taxes are maintained. In Turkmenistan, all foreign trade—with the exception of gas, which is the responsibility of the ministry of oil and gas—is channeled through the state commodity exchange. In Uzbekistan, cotton, grain, and gold exports are channeled through the state sector, and the ministry of foreign economic relations continues to play an important role in trade agreements with nontraditional trading partners. Uzbekistan has made progress in shifting the burden of taxation away from exports toward imports by simplifying and lowering export taxes and introducing import tariffs. Both countries also engage in import substitution. Uzbekistan is aiming to become self-sufficient in energy and food. Thus, oil imports are discouraged, while exports of certain agricultural products—notably cereals, dairy products, and meat—are forbidden. Similarly, Turkmenistan is striving for self-sufficiency in wheat.

Market Diversification

As a whole, the Central Asian states succeeded in diversifying export markets. For the region, the share of exports to the BRO countries declined to 41 percent in 1997 from 68 percent in 1992 (see Table 6.2 and Figure 6.2). Similarly, the combined share of imports from traditional trading partners fell to 50 percent from 66 percent during the same period (Table 6.3 and Figure 6.2). The individual country experiences were varied; Uzbekistan and Turkmenistan experienced dramatic shifts in trade flows, while progress was less pronounced in Kazakhstan and the Kyrgyz Republic, and Tajikistan registered a rising share of trade (notably imports) with traditional partners.

Export growth to nontraditional markets has been impressive, with exports from Central Asian states to nontraditional markets more than doubling to $7.4 billion in 1997 from $2.4 billion in 1992. At

[3]Regional and international trade initiatives by these countries are summarized in Box 6.1.

Table 6.2. Exports[1]
(In millions of U.S. dollars)

	1992	1993	1994	1995	1996	1997	1998 Prov.
Kazakhstan	3,562	4,769	3,285	5,164	6,292	6,769	5,748
Traditional partners	2,073	3,190	1,935	2,912	3,708	3,145	. . .
In percent	58.2	66.9	58.9	56.4	58.9	46.5	. . .
Rest of the world	1,489	1,579	1,350	2,252	2,584	3,624	. . .
In percent	41.8	33.1	41.1	43.6	41.1	53.5	. . .
Kyrgyz Republic	289	335	340	409	531	631	554
Traditional partners	216	223	223	269	394	346	272
In percent	74.9	66.5	65.5	65.8	74.2	54.9	49.1
Rest of the world	73	112	117	140	137	285	282
In percent	25.1	33.5	34.5	34.2	25.8	45.1	50.9
Tajikistan	185	456	559	839	770	746	651
Traditional partners	74	173	143	252	331	328	. . .
In percent	40.0	37.9	25.5	30.0	43.0	44.0	. . .
Rest of the world	111	283	417	587	439	418	. . .
In percent	60.0	62.1	74.5	70.0	57.0	56.0	. . .
Turkmenistan[2]	2,149	2,693	2,176	2,084	1,691	774	614
Traditional partners	1,934	2,370	1,669	1,422	1,142	397	. . .
In percent	90.0	88.0	76.7	68.2	67.5	51.3	. . .
Rest of the world	215	323	507	662	549	377	. . .
In percent	10.0	12.0	23.3	31.8	32.5	48.7	. . .
Uzbekistan	1,424	2,877	3,073	3,475	3,534	3,695	2,869
Traditional partners	869	1,440	1,684	1,186	643	961	. . .
In percent	61.0	50.1	54.8	34.1	18.2	26.0	. . .
Rest of the world	555	1,437	1,389	2,289	2,891	2,734	. . .
In percent	39.0	49.9	45.2	65.9	81.8	74.0	. . .
Total	7,608	11,130	9,432	11,971	12,818	12,615	10,433
Traditional partners	5,166	7,395	5,653	6,042	6,218	5,177	. . .
In percent	67.9	66.4	59.9	50.5	48.5	41.0	. . .
Rest of the world	2,441.9	3,734.7	3,779.7	5,929.2	6,600.2	7,437.6	. . .
In percent	32.1	33.6	40.1	49.5	51.5	59.0	. . .

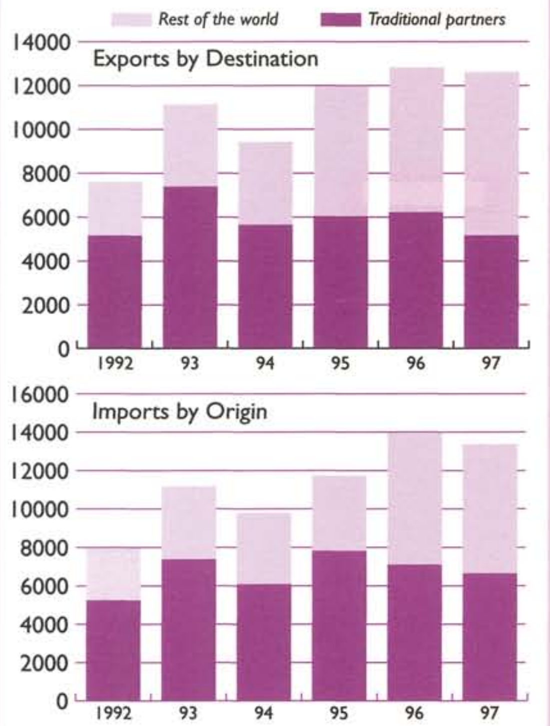
Source: International Monetary Fund.
[1]Traditional markets refer to the BRO countries.
[2]Gas exports are presented on an accrual basis. Nonpayments for gas exports are recorded as arrears in the capital account. Transit charges are included in gas exports through 1995. As of 1996, all gas is exported f.o.b. at the Turkmenistan border.

the same time, export growth to traditional markets has stagnated, reflecting disruptions to the payments system, lack of convertibility of the new currencies coupled with significant foreign exchange shortages within the region, and depressed import demand for Central Asian products during a period of sharp output contraction in traditional trading partners.

Among the countries of the region, Uzbekistan made the most progress in diversifying export markets. The share of exports to the BRO countries declined to 26 percent in 1997 from 61 percent in 1992. Two main developments explained the shift. First, major Uzbek exports (cotton and gold) fetched higher prices in non-BRO countries markets. Second, neighboring countries were unable to pay for Uzbek exports.[4] Meanwhile, imports from the BRO countries fell due to the government's policy of import substitution—notably the substitution of domestically produced gas for imported oil. Trading patterns changed more gradually in Kazakhstan, the Kyrgyz Republic, and Tajikistan. In Kazakhstan, the share of exports to the BRO countries declined steadily, to almost one-half in 1997 from close to two-thirds of total exports in 1992. This shift was partly accounted for

[4]The volume of gas exports in 1996 was one-half its level in 1995. Over the same period, cotton exports to BRO countries markets fell by two-thirds.

Figure 6.2. Direction of Trade
(In millions of U.S. dollars)



Sources: IMF Staff Country Reports.

by greater access to trade finance that opened up new export markets, particularly in the European Union. The share of imports from the BRO countries declined by a similar amount. Trade between the Kyrgyz Republic and its traditional trading partners recovered, after five years of decline, mainly in response to a recovery in economic activity in the BRO countries. Despite some fluctuations, Tajikistan generally showed a more steady trade pattern, with traditional partners still accounting for over 40 percent of exports and about 60 percent of imports in 1997. Turkmenistan's gas exports were channeled entirely to BRO countries markets, as of 1993, while a significant portion of cotton and oil product exports were shifted to new markets,[5] raising the export share of the latter to almost 50 percent by 1997. In the same year, nontraditional markets were the source of about half of Turkmenistan's imports.

Phasing Out of Barter Trade

In order to resolve payments difficulties, the Central Asian states resorted to barter trade, primarily through interstate bilateral trade agreements. Available information suggests that barter trade is important, particularly in Turkmenistan,[6] where large quantities of gas are exported through such arrangements, and in Tajikistan, where aluminum is also exported through similar arrangements. While barter has helped to maintain trade volumes, the goods traded have often been overvalued, of poor quality, and not necessarily in demand in the recipient country. Within the domestic economies, barter has created a noncash parallel market for goods. Moreover, enterprises receiving payments in the form of barter goods have often used surplus supplies to make payments on their outstanding debts. Barter trade may also have impeded the restructuring of domestic economies, since it is generally the older, less efficient industries that have been heavily involved in barter. In many cases, barter trade has permitted the production of goods that otherwise would not find a market. Valuation problems in barter trade have presented serious problems. The overvaluation of barter trade has distorted balance of payments statistics.

In recognition of these drawbacks, the Central Asian states have taken steps to discourage barter trade. Kazakhstan has passed legislation to prohibit barter trade, while Uzbekistan has issued a list of exports excluded from such trade. Turkmenistan has had some success in reducing the barter component on non-gas exports; since 1996, cotton, oil, and oil derivatives have been increasingly traded on a cash basis. Despite these initiatives, however, barter continues to be an important component of regional trade.

Currency Reform and Exchange Regimes

Initially the Central Asian states adopted the Russian ruble as their domestic currency, with each central bank maintaining a correspondent account in Moscow for interstate settlements. Monetary union was expected to minimize the disruption to foreign trade with traditional partners. However, the lack of convertibility of the ruble proved problematic and a

[5]While the region's export markets have shifted, the composition of exports continues to be heavily dominated by those industries developed under centralized planning. Exports from the region continue to be concentrated in fuels, metals, and agricultural products, particularly cotton.

[6]Trade data by type of payment indicate that in 1996, 24 percent of Turkmenistan's exports were paid for in cash, 54 percent in barter goods and construction services, and the remainder was accounted for by the accumulation of arrears. In subsequent years, the cash component rose, as oil and cotton exports were increasingly paid for in cash.

Table 6.3. Imports[1]
(In millions of U.S. dollars)

	1992	1993	1994	1995	1996	1997	1998 Prov.
Kazakhstan	4,683	5,183	4,205	5,387	6,618	7,154	6,949
Traditional partners	3,160	3,675	2,851	4,181	4,018	3,935	...
In percent	67.5	70.9	67.8	77.6	60.7	55.0	...
Rest of the world	1,523	1,508	1,354	1,206	2,600	3,219	...
In percent	32.5	29.1	32.2	22.4	39.3	45.0	...
Kyrgyz Republic	377	501	459	588	783	646	705
Traditional partners	304	317	264	346	431	396	365
In percent	80.5	63.2	57.5	58.9	55.0	61.3	51.8
Rest of the world	73	185	195	242	352	250	340
In percent	19.5	36.8	42.5	41.1	45.0	38.7	48.2
Tajikistan	240	660	707	880	761	785	780
Traditional partners	107	298	339	478	395	463	...
In percent	44.8	45.2	47.9	54.3	51.9	59.0	...
Rest of the world	132	362	368	402	366	322	...
In percent	55.2	54.8	52.1	45.7	48.1	41.0	...
Turkmenistan	1,009	1,593	1,690	1,644	1,532	1,005	1,137
Traditional partners	807	1,115	973	1,023	528	500	...
In percent	80.0	70.0	57.6	62.2	34.5	49.7	...
Rest of the world	202	478	717	621	1,004	505	...
In percent	20.0	30.0	42.4	37.8	65.5	50.3	...
Uzbekistan	1,660	3,255	2,727	3,238	4,240	3,767	2,812
Traditional partners	869	1,975	1,657	1,794	1,723	1,356	...
In percent	52.4	60.7	60.8	55.4	40.6	36.0	...
Rest of the world	791	1,280	1,070	1,444	2,517	2,411	...
In percent	47.6	39.3	39.2	44.6	59.4	64.0	...
Total	7,969	11,192	9,788	11,737	13,934	13,357	12,488
Traditional partners	5,248	7,380	6,084	7,822	7,095	6,650	...
In percent	65.9	65.9	62.2	66.6	50.9	49.8	...
Rest of the world	2,721	3,813	3,704	3,915	6,839	6,707	...
In percent	34.1	34.1	37.8	33.4	49.1	50.2	...

Source: International Monetary Fund.
[1]Traditional markets refer to the BRO countries.

segmented system of payments developed, with trade being conducted in both rubles and hard currency. The ruble zone, moreover, precluded the pursuit of independent financial policies aimed at reducing domestic inflation. As discussed in Section V, the Central Asian states introduced their own currencies in succession during 1993–95. However, in many respects, the early experience with domestic currencies was disappointing. Inflation persisted, necessitating periodic nominal devaluation of exchange rates for considerable periods after currency reform. Highly distortionary multiple currency practices mostly remained in place (Box 6.2) and dollarization was prevalent. Moreover, the new currencies failed to strengthen the interstate payments system. Only more recently are these trends being checked and reversed.

As part of the move toward more flexible exchange rate arrangements, all Central Asian states introduced foreign exchange auctions. Some states progressed within a fairly short time from central bank to interbank auctions. Presently, in Kazakhstan, interbank auctions take place daily and foreign exchange futures are sold at the stock market. In the Kyrgyz Republic, foreign exchange auctions were abolished in mid-1998, shifting foreign exchange transactions and the determination of the official exchange rate to the interbank market. Trading of foreign exchange takes place in the interbank market, where the central bank intervenes as needed. In Turkmenistan, a preauction screening process still limits the availability of foreign exchange to importers, and the central bank essentially determines the exchange rate. Commercial banks participate in the auctions only on behalf of

Box 6.2. Multiple Exchange Rate Practices

Following the introduction of domestic currencies, the Central Asian states maintained complex multiple exchange rate systems, complemented by legislation that required exporters to repatriate export earnings and surrender a portion to either the government or the central bank. The ensuing multiple currency practices imposed an implicit tax on exports, while subsidizing imports, which benefited from a more appreciated exchange rate. The central banks, moreover, used the foreign exchange obtained from exporters to purchase domestic currency at a more depreciated rate, with the associated profits not always transferred to the government.

Multiple exchange rate practices also contributed to foreign exchange shortages by encouraging the undervaluation of exports and diverting proceeds away from official channels of conversion. This promoted the rationing of foreign exchange by central banks, which, in turn, fueled parallel market activity. The channeling of economic activity to the informal sector added to tax collection problems and left some transactions entirely outside the tax base. Overall, multiple exchange rate arrangements lacked transparency, distorted resource allocation, and eroded budgetary tax revenue.

More recently, most Central Asian states have moved toward more flexible, unified, and market-oriented exchange rate regimes. Kazakhstan and the Kyrgyz Republic have eliminated multiple currency practices and accepted Article VIII status in the IMF. In 1996, Tajikistan unified its exchange rate and abolished surrender requirements. Following earlier failed attempts, Turkmenistan unified its exchange rate in April 1998, although it continued to restrict access to foreign exchange and sustained surrender requirements. Moreover, a tightening of exchange controls as of end-1998 has once again resulted in divergent exchange rates. Uzbekistan continues to maintain multiple exchange rates and surrender requirements.

their (enterprise) customers. With the unification of the official (auction) and commercial bank rates in April 1998 at the level of the latter, the commercial bank and exchange bureaus rates became effectively tied to the auction rate, as they were not allowed to deviate by more than 3 percent from the auction rate. In late 1998, a shortage of foreign exchange, coupled with lax financial policies, resulted in the reemergence of a growing spread between the official and parallel markets rates, with the latter rising to more than twice the official rate. In Uzbekistan, the central bank also effectively controls supply and demand in the foreign exchange auctions, and hence the official exchange rate. In January 1997, the commercial bank market was formally split off with a separate exchange rate, which, until July 1998, was not allowed to deviate by more than 12 percent from the auction rate. The elimination of this requirement in July 1998 did not immediately result in a widening of the spread between the two rates, suggesting continued government interference through rationing and screening. Meanwhile, the widely used parallel market rate was almost four times as high as the official rate in late 1998.

As noted in Section V, in pursuing macroeconomic stabilization, the Central Asian states were confronted with the choice between fixing their exchange rates to serve as a nominal anchor or adopting a money-based stabilization program, which required observing monetary targets while maintaining exchange rate flexibility. Both options had benefits and costs. An exchange rate anchor would afford greater policy discipline, stabilize traded goods prices, and offer a more transparent signal of a counterinflationary commitment, enhancing credibility. However, real shocks—such as terms of trade shocks—could not be effectively absorbed. Failure to defend the exchange rate peg could carry significant costs in terms of lost international reserves and a weakening of counterinflationary credibility. A money-based approach would offer a remedy to real shocks through exchange rate adjustments, but monetary targeting could be difficult in the absence of stability in the demand for money. Under this approach, real shocks could lead to excessive volatility in both the exchange rate and domestic interest rates, with adverse consequences for output growth.

Reflecting these structural changes and uncertainty, following independence, the Central Asian states adopted, more or less, discretionary monetary frameworks that were, in essence, informal inflation targeting regimes. All countries adopted floating exchange rates, although the central banks frequently intervened to limit movements in the exchange rate (managed float), and some even, at times, adopted an informal peg. While all countries closely monitored the exchange rate, disinflation was ultimately achieved by bringing monetary expansion under control.

Currency Substitution

Anecdotal evidence throughout the region suggests that the introduction of domestic currencies was accompanied by widespread currency substitution, mainly as a hedge against inflation and exchange rate depreciation.[7] Distrust of the domestic

[7]For an econometric analysis of currency substitution in the Kyrgyz Republic, see Appendix I in Catsambas (1999). The

Table 6.4. Exchange Rates

	1993	1994	1995	1996	1997	1998 Prov.
	(Domestic currency per U.S. dollar; end-of-period)					
Kazakhstan	6	54	64	74	76	85
Kyrgyz Republic	8	11	11	17	17	29
Tajikistan[1]	1,247	3,550	294	328	748	977
Turkmenistan[2]	2	75	200	4,070	4,165	5,200
Uzbekistan[2]	1	25	36	55	80	110
	(Domestic currency per U.S. dollar; period average)					
Kazakhstan	3	38	61	68	76	79
Kyrgyz Republic	4	11	11	13	17	21
Tajikistan[1]	...	...	123	296	581	786
Turkmenistan[2]	2	36	1,402	3,258	4,143	4,890
Uzbekistan[2]	1	11	30	40	66	95

Sources: National authorities; and IMF staff estimates.
[1]Until 1994, Russian rubles; as of 1995, Tajik rubles.
[2]Official rate.

banking systems (because of restrictions on cash withdrawals and, more recently, episodes of banking crises), access of tax authorities to bank accounts, and foreign exchange controls also encouraged currency substitution. The latter contributed to macroeconomic difficulties by weakening monetary control, reducing tax revenue, and, more generally, complicating policy formulation. For example, where there was significant currency substitution, the expenditure-switching effects of a devaluation were limited because relative prices were determined mostly in the parallel market, where the exchange rate was already more depreciated. By reducing the parallel market spread, a devaluation acted as a powerful signaling device, indicating a possible shift in policies. Also, reductions in parallel market spreads encouraged reverse currency substitution.

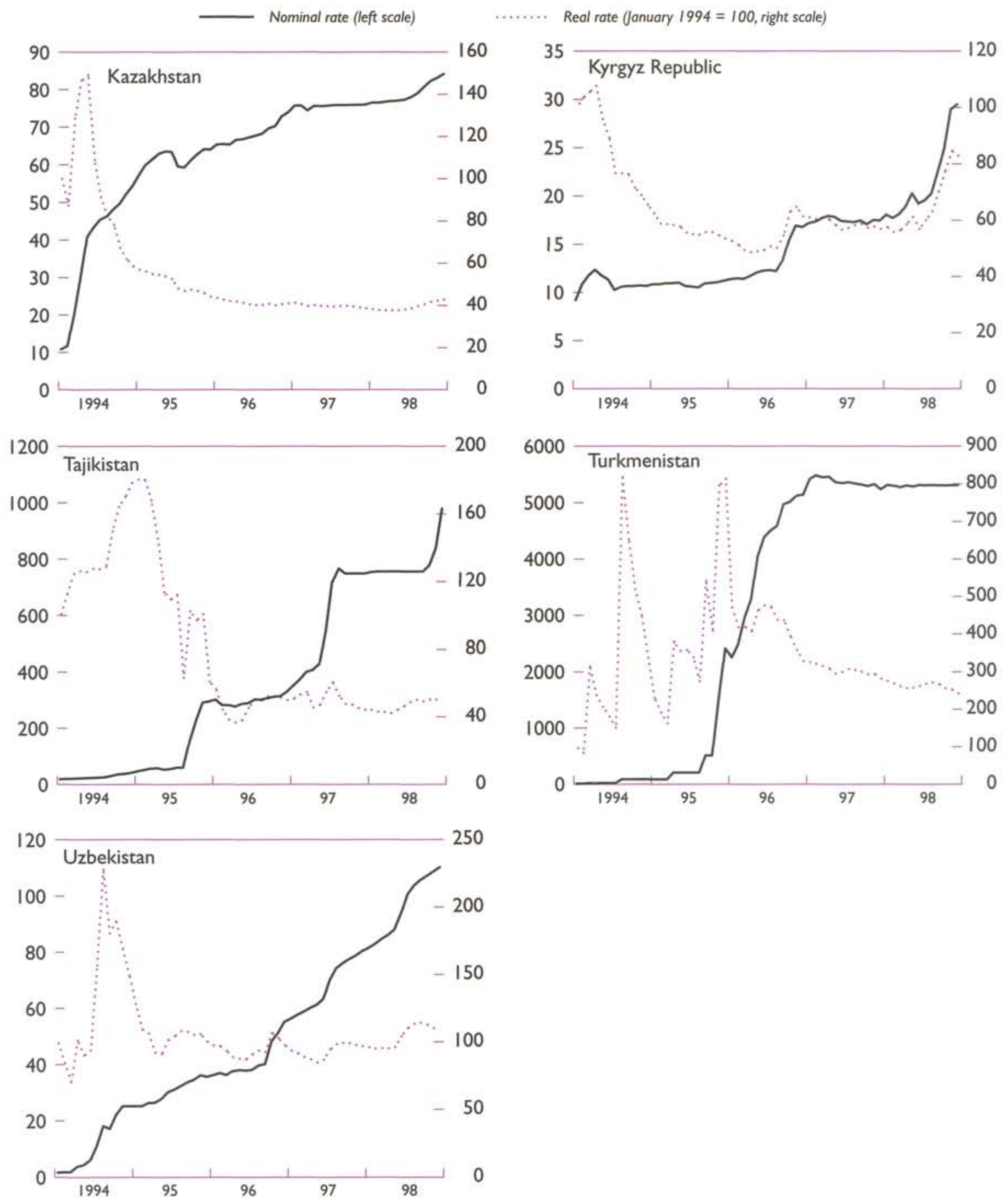
The Central Asian states responded to currency substitution by legalizing foreign currency deposits, thereby reducing incentives for capital flight and channeling a large quantity of foreign exchange away from the informal economy. The simplification of exchange systems through the phasing out of multiple currency practices also helped reduce currency substitution by removing, or at least narrowing, the spreads between the parallel market and official exchange rates. International experience shows that only a credible and sustained counterinflationary stabilization program can effectively eliminate the incentives for holding foreign currency. As the stabilization programs under way in these countries firmly take hold, the conditions that breed currency substitution can be expected to disappear over time.

analysis indicates that the interest rate differential and the depreciation of the exchange rate are significant determinants of currency substitution in the Kyrgyz Republic, and that policy measures—provided that they are sufficiently strong and implemented over an extended period—may have an important impact on the portfolio decisions of the private sector.

International Competitiveness

The broadest conventional measure of international competitiveness is the real exchange rate, which adjusts the nominal exchange rate by the ratio of domestic to foreign prices. A recent study by Halpern and Wyplosz (1996) points out that the real exchange rate in transition economies tends to follow a similar pattern. During the initial move to a market economy, the real exchange rate depreciates significantly; as market reforms are consolidated, it gradually appreciates. Possible explanatory factors are cited: economic restructuring, which leads to rapid productivity growth; abolition of price controls on nontradables, which raises the domestic price level and the real exchange rate; improvements in the quality of goods, which improves the terms of trade; widespread public sector reform, which shifts relative prices; and unsterilized capital inflows, which trigger nominal appreciations of the exchange rate. Thus, the real exchange rate appreciations observed may indicate an equilibrium adjustment to the process of transition, without necessarily having a negative impact on external competitiveness. Also,

Figure 6.3. Nominal and Real Exchange Rates[1]



Source: International Monetary Fund.

[1]The nominal rate is expressed in domestic currency units per U.S. dollar; an increase indicates a depreciation. The real exchange rate index is calculated by adjusting the nominal exchange rate, expressed in domestic currency units per U.S. dollar, for the differential between domestic and U.S. inflation (CPI); an increase indicates a real depreciation.

Table 6.5. Gross Official Reserves

	1992	1993	1994	1995	1996	1997	1998 Prov.
			(In millions of U.S. dollars; end-of-period)				
Kazakhstan	83	541	907	1,194	1,980	2,244	1,967
Kyrgyz Republic	24	63	98	115	118	200	189
Tajikistan	0	2	1	4	14	30	65
Turkmenistan	0	818	927	1,170	1,172	1,285	1,379
Uzbekistan	82	1,031	1,341	1,867	1,901	1,167	1,168
			(In months of imports)				
Kazakhstan	0.2	1.3	2.6	2.7	3.1	3.2	3.0
Kyrgyz Republic	0.8	1.5	2.6	2.5	1.6	3.0	2.6
Tajikistan	0.0	0.0	0.0	0.1	0.2	0.6	1.3
Turkmenistan	0.0	6.2	6.6	8.5	9.2	15.3	14.6
Uzbekistan	0.6	3.8	5.9	6.9	5.4	3.7	5.0

Source: International Monetary Fund.

a strengthening of confidence in domestic currencies as reforms take hold encourages residents to keep a greater proportion of their wealth in domestic currency, further contributing to a real appreciation of the exchange rate.

Table 6.4 (see page 43) and Figure 6.3 (see page 44) give details of real and nominal exchange rate developments in the Central Asian states. The most notable feature is that the real exchange rate has exhibited a great deal of variability in these countries. This is largely explained by the high levels of inflation, both domestically and in the region's traditional trading partners. Moreover, the countries in the group appear to have generally followed the widespread transition experience of real exchange rate appreciations, following initial steep real depreciations, although the timing of the turning points has varied among countries. Considerable care needs to be taken in interpreting this data. First, barter trade—which is still prevalent in a number of these countries—is not directly affected by changes in the real exchange rate.[8] Second, the existence of multiple currency practices distorts the impact of changes in the real exchange rate. Third, average wages expressed in U.S. dollar terms are still low relative to wages outside of the region.

[8]Typically, barter trade is conducted through a series of bilateral agreements in which the goods are notionally priced in U.S. dollar terms. If the exchange rate vis-à-vis the U.S. dollar changes, barter imports and exports are revalued in domestic currency, while the dollar values of barter exports and imports are unaffected.

Management of International Reserves

At the outset of transition, the Central Asian states had negligible foreign exchange reserves, and the rapid accumulation of reserves became one of their primary objectives. Table 6.5 and Figure 6.4 provide details of movements in international reserves of the Central Asian states since independence. All countries have made considerable progress in accumulating reserves, although the level remains low in Tajikistan. Turkmenistan—given its particular vulnerability to external shocks because of the volatility of gas exports—has continued to maintain presidential control over international reserves, while all other countries in the group have placed reserves under central bank management. More work remains to be undertaken in the Central Asian states to further strengthen the management of foreign exchange reserves, notably to clearly elaborate guidelines and reporting procedures, diversify reserve asset holdings, and improve risk management.

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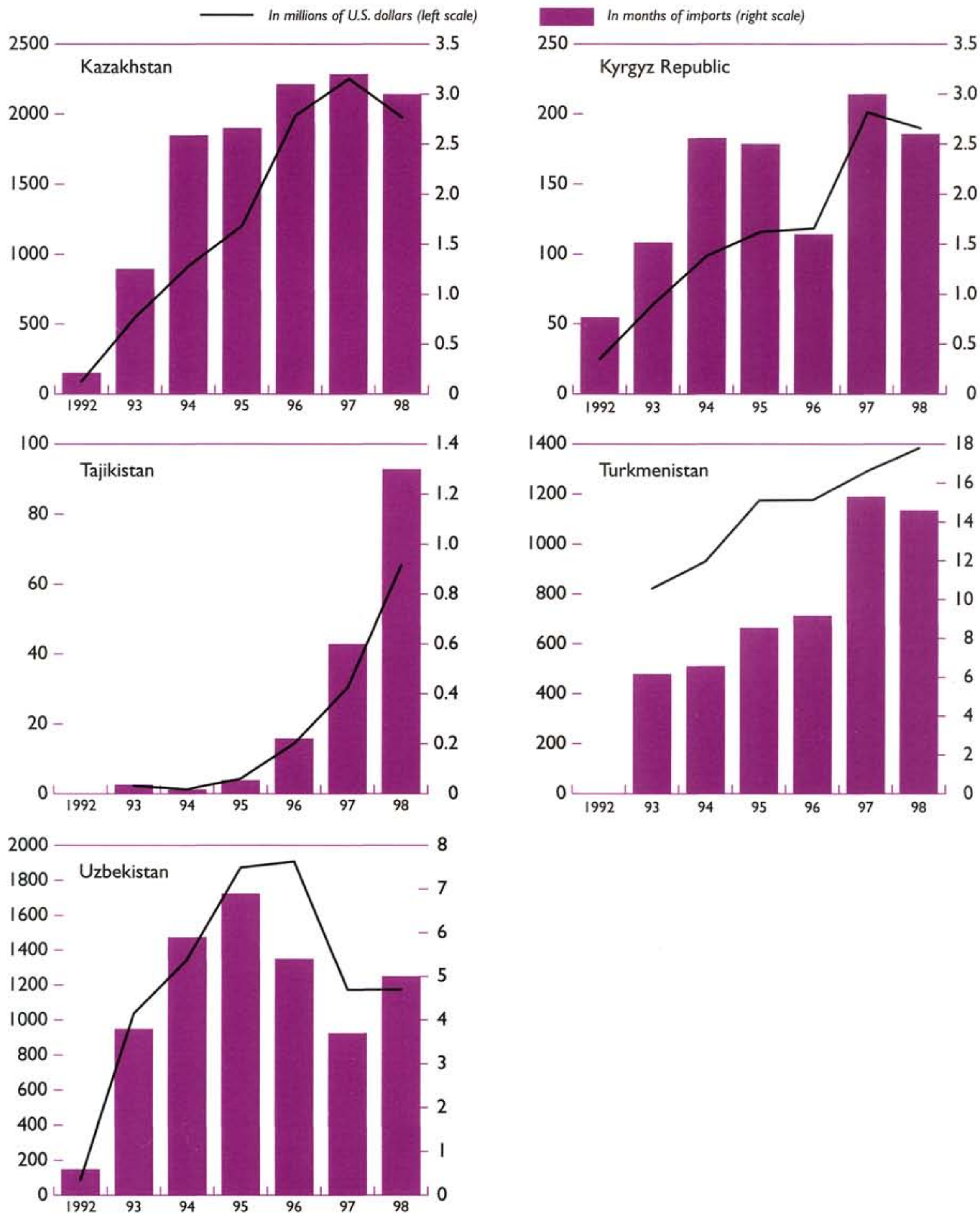
Figure 6.4. Gross Official Reserves



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