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Middle East and Central Asia Department

Opening Up in the Caucasus and Central Asia

Policy Frameworks to Support Regional and Global Integration

IMF staff team led by
Peter Kunzel with Phil de Imus,
Edward Gemayel, Risto Herrala,
Alexei Kireyev, and Farid Talishli

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Caucasus and Central Asia Department

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Executive Summary

The Caucasus and Central Asia (CCA) countries are at an important juncture in their economic transition. Following significant economic progress during the 2000s, recent external shocks have revealed the underlying vulnerabilities of the current growth model. Lower commodity prices, weaker remittances, and slower growth in key trading partners have reduced CCA growth, weakened external and fiscal balances, and raised public debt. The financial sector was also hit hard by large foreign exchange losses. While commodity prices have recovered somewhat since late 2014, the region needs to find new growth drivers to boost its economic potential; diversify away from natural resources, remittances, and public spending; and generate much stronger private sector–led activity.

Greater regional and global economic integration would create favorable dynamics to transition to higher sustainable growth. Opening the region up to more trade and investment would increase access to goods and services at lower prices, spur competition, promote innovation and diversification, increase transparency, reduce rents, and ultimately increase productivity and growth.

Recognizing the benefits of greater economic integration, countries in the region are taking some steps in that direction. CCA countries have pursued various regional and bilateral economic integration initiatives and most are members of the World Trade Organization (WTO). They have also made

[1]The CCA countries are Armenia, Azerbaijan, Georgia, Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan.

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some progress in diversifying their economies and have adopted more flexible exchange rate regimes following recent episodes of global volatility.

However, greater efforts are needed to open the CCA economies up to international trade and investment. CCA countries should seize the opportunity afforded by the current global upswing and various economic cooperation initiatives to further develop their infrastructure and integrate into the global value chain. Increased exports of non-commodity goods and services provide a clear opportunity for higher, sustainable, and inclusive growth, and intraregional trade should also be exploited. CCA countries should reduce tariff and nontariff barriers and strengthen their participation in multilateral trade initiatives led by the WTO. Greater capital account liberalization would help with financial sector development and growth, but the countries will need to ensure that banks are well equipped to deal with larger and potentially more volatile capital flows. The China-backed Belt and Road Initiative (BRI) may bring massive investment flows to the region over the next decade.

For CCA countries to reap the full economic benefits of integration and mitigate potential risks, economic frameworks and institutions will need to be strengthened. Robust economic frameworks and institutions will help the countries manage larger trade and capital flows associated with greater economic integration and will help ensure macroeconomic stability. This, in turn, will generate a more favorable investment climate and positive growth dynamics. The following areas deserve particular attention:

- ***Fiscal reforms.*** While CCA countries are aiming to improve their fiscal balances after recent shocks, fiscal adjustment should be more ambitious: rebuilding buffers and dealing with future shocks while facilitating economic integration. This would send a clear signal of fiscal responsibility and strong macroeconomic management to foreign investors. Fiscal policies should also promote growth and equity and ensure that strong social safety nets are available to support the transition to greater economic openness. Immediate priorities include mobilizing revenues and rationalizing non-priority expenditures to free resources for pro-growth and pro-integration spending, improving the fairness of the tax system and the efficiency of public spending, and safeguarding social spending. Fiscal frameworks will also need to be improved to help ensure that public investment projects, such as those presented by the BRI, are implemented effectively and that fiscal sustainability is maintained. These improvements will require building more robust budgetary institutions, fiscal rules, and risk management capacity.

- ***Monetary reforms.*** Monetary policy frameworks will need to be further strengthened to support economic integration. The move toward greater exchange rate flexibility in the region is a positive development that will

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help CCA countries weather future external shocks. While the choice of an alternative nominal anchor should reflect country-specific circumstances, inflation targeting has been gaining ground in the region. To successfully transition to inflation targeting, countries will need strong political commitment, greater institutional capacity, and effective communications, and they will have to address lingering financial stability concerns, including restoring the health and viability of the banking sector. Actions to reduce dollarization should be stepped up to strengthen monetary policy transmission and ensure low and stable inflation.

- ***Financial sector reforms.*** Effective financial intermediation is essential as CCA countries look to benefit from trade and investment opportunities. Banking sectors in the region were hit hard by recent external shocks and have not fully recovered, hampering their intermediation role. While efforts have been made, more are needed to strengthen the banking sector, including proper identification and recognition of nonperforming loans as well as timely intervention for troubled banks and stronger resolution frameworks. Improving bank governance and prudential regulation and supervision will be essential to avoid additional losses, and more efforts are needed to improve correspondent banking relationships and bring the unbanked into the financial system to channel savings into investment. Capital markets also need to be modernized and deepened to diversify financing sources, facilitate project financing, and help conduct effective monetary policy.

- ***Structural reforms.*** Ambitious structural reforms will support successful economic integration. The CCA region has considerable potential to diversify and to open its economies up to foreign trade and investment, which would boost growth. Reforms should focus on strengthening infrastructure, the business environment, governance, and labor skills, not only because gaps exist in these areas but also because progress on these fronts would make countries more competitive and attractive to outside investors, thereby supporting regional and global integration.

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CHAPTER

1 Background

The eight Caucasus and Central Asia (CCA) countries made significant economic progress during the 2000s. Growth was robust, inflation declined, and gains were achieved in building institutions and policy buffers and reducing poverty (Figure 1). However, growth was not broad-based. On the supply side, it was driven largely by oil and gas, mining, remittances, and construction, while on the demand side private consumption and public spending accounted for the bulk of growth.

External shocks that have affected the CCA region since 2014 have placed pressure on macroeconomic balances and the current growth model (Figure 2). As a result of lower commodity prices, weaker remittances, and slower growth in key trading partners (Russia and China), growth and current account balances weakened and public debt has risen. With these conditions and pressures likely to persist, growth will remain subdued unless the region can find new growth drivers; diversify away from natural resources, remittances, and public spending; and generate much stronger private sector–led activity. Increased exports of non-commodity goods and services is a clear area of opportunity. If it is well managed, the Belt and Road Initiative (BRI) could boost investment, trade, and economic prospects considerably for the region.

Increasing trade and investment will require much greater regional and global cooperation and integration. The CCA region remains fragmented and faces a common set of challenges, including intraregional tensions; a largely landlocked and difficult terrain; and underdeveloped, outdated, or outmoded infrastructure.[1] Several regional cooperation initiatives have been pursued—including the Eurasian Economic Union (EEU), the Central Asia

[1]The CCA has extremely varied geography, including vast mountain ranges such as the Tian Shan, the Hindu Kush, the Pamirs, and the Caucasus Mountains. Central Asia is largely landlocked and is also home to the

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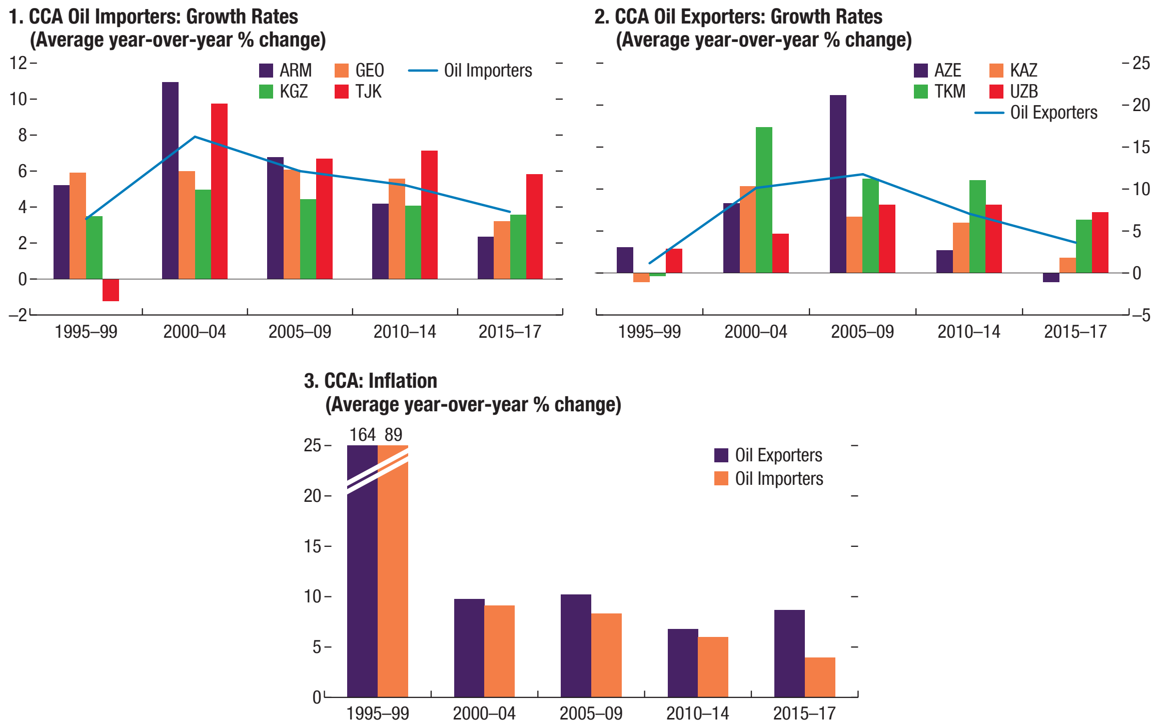
Figure 1. Growth Rates and Inflation



Source: IMF, *World Economic Outlook*.

Regional Economic Cooperation (CAREC) program, the Shanghai Cooperation Organization (SCO), and China's BRI—with varying degrees of success. Most CCA countries are now members of the World Trade Organization (WTO), and some have signed partnership and cooperation agreements with the European Union.

As CCA countries pursue diversification and integration efforts, they will need to strengthen their economic frameworks and institutions to fully reap the benefits and mitigate potential risks. This effort will require, for example, fiscal policy reforms that support efficient investment that can facilitate greater integration while ensuring public debt sustainability, monetary and financial sector frameworks that promote repair and recovery of banking systems, clear identification and management of vulnerabilities and risks, and structural reforms that promote better business and investment climates suited to greater cross-border cooperation.

vast Kara Kum and Kyzyl Kum deserts, which dominate the interior. These features hamper transportation and trade and increase infrastructure costs.

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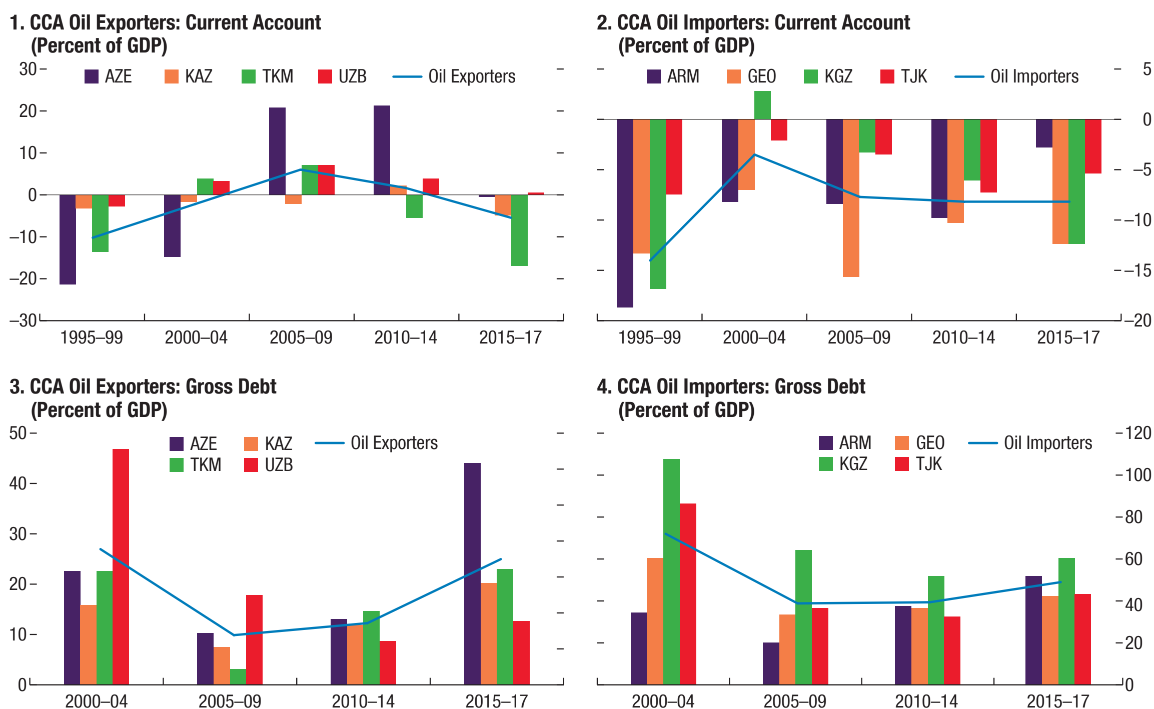
Figure 2. Current Account Balances and Debt



Source: IMF, *World Economic Outlook*.

This paper looks at how the CCA countries can strengthen their economic frameworks and institutions to maximize the benefits of greater openness for their economies. Specifically, it discusses the following issues:

- What the move toward greater integration implies for the scope, pace, and sequencing of trade and capital account liberalization
- What this more open trade environment means for public investment, debt sustainability, and fiscal risks, and how these risks can be managed
- How monetary and exchange rate policy frameworks can be further modernized to mitigate potential risks from greater capital flows
- How current financial sector weaknesses can be repaired and vulnerabilities addressed, and what is needed to prepare the financial sector for greater integration in terms of development, deepening, and inclusion
- The structural reforms needed to foster efficient trade and investment and ensure successful economic integration

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CHAPTER

2 Trade and Capital Account Liberalization

Trade

Increased trade openness would yield significant economic benefits to the region. Despite some recent progress toward trade diversification, CCA countries remain weakly integrated with the global economy, and intra-regional trade is low. The BRI offers opportunities to strengthen trade integration by using new infrastructure networks and transitioning toward more non-commodity and services exports. Additional trade liberalization—including through various trade arrangements—and intraregional trade are also needed.

Benefits of Trade Integration

Greater trade integration would yield significant benefits for CCA countries. The benefits of open trade are well known: it offers consumers and businesses more choices at lower prices, promotes innovation and productivity, and supports growth and overall welfare. At the same time, countries need to adjust to greater competition as they liberalize trade, and they may face disruptions in the short term, including a potential loss of jobs and revenues. Over the medium term, the benefits of enhanced trade integration are considerable for economies in the CCA region, and the global recovery provides an opportune time to boost exports and growth. Illustrative estimations suggest that trade integration measures—trade openness, global value chain (GVC) participation, export diversification, and product quality upgrade—could raise CCA countries' income levels by 5 to 10 percentage points within 5 to 10 years (Figure 3, Kireyev and others 2017). This estimation assumes that trade measures show the best year-on-year increase over the past 20 years. Thus, for example, growth rates could be 1 percentage point higher on average in 2019–23 if countries take steps to improve openness, 0.7 percentage point

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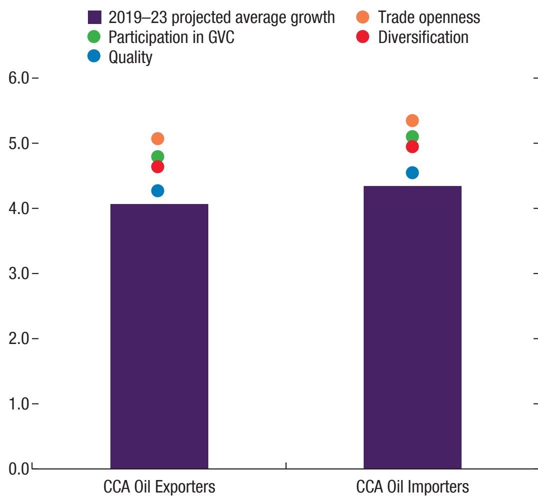
Figure 3. Estimated Contributions of Trade Measures to Growth
(Percent)



Source: IMF staff calculations.
Note: The growth increase is conditional on an increase in the given trade measure equal to the best historical period-over-period improvement observed in region in the last 20 years: 7.7 percentage points (pp) for trade openness; 4 pp for global value chains; 2.4 pp for diversification; 1.5 pp for quality.

higher if they enhance their participation in GVCs, 0.6 percentage point higher if they diversify their economies, and 0.2 percentage point higher if they improve their product quality. These effects would compound if the trade measures were taken in parallel but they might not be the same for CCA oil exporters and importers, given their different economic structures and degrees of trade openness.

Strengthening Trade Integration

The CCA region faces challenges in deepening trade integration despite its considerable potential. The region is at the crossroads of Asia, the Middle East, and Europe, and the BRI presents tremendous opportunities for deepening economic integration and joining GVCs. At the same time, trade openness has been declining and the CCA's trade remains concentrated in a few products. Regional trade initiatives have yet to yield significant results.

Trade openness across the CCA has been declining since 2008. This trend is in line with international developments, reflecting subdued international economic activity until 2017, including lower investment, slower trade liberalization, a decline in commodity prices, and slower growth of GVCs (IMF 2016a). CCA oil importers have been relatively more open than other emerging market and developing economies (EMDEs) and CCA commodity exporters, but lower remittances in recent years have compressed imports and contributed to an overall decline in openness (Figure 4). Among CCA commodity exporters, lower oil prices have driven the decline in trade openness. Excluding oil, trade openness of CCA commodity exporters has remained broadly stable

Some progress toward economic diversification is being made. While CCA exports are generally less diversified than EMDE exports, real export growth among CCA oil importers has been substantial and has outpaced that of CCA oil exporters and other EMDEs, suggesting some progress toward diversification. Recent data on the composition of trade seem to confirm that exports are becoming more diversified, notably in Kazakhstan, Azerbaijan, and Tajikistan. The United Nations Conference on Trade and Development (UNCTAD) concentration index was 0.57 for CCA oil exporters in 2016

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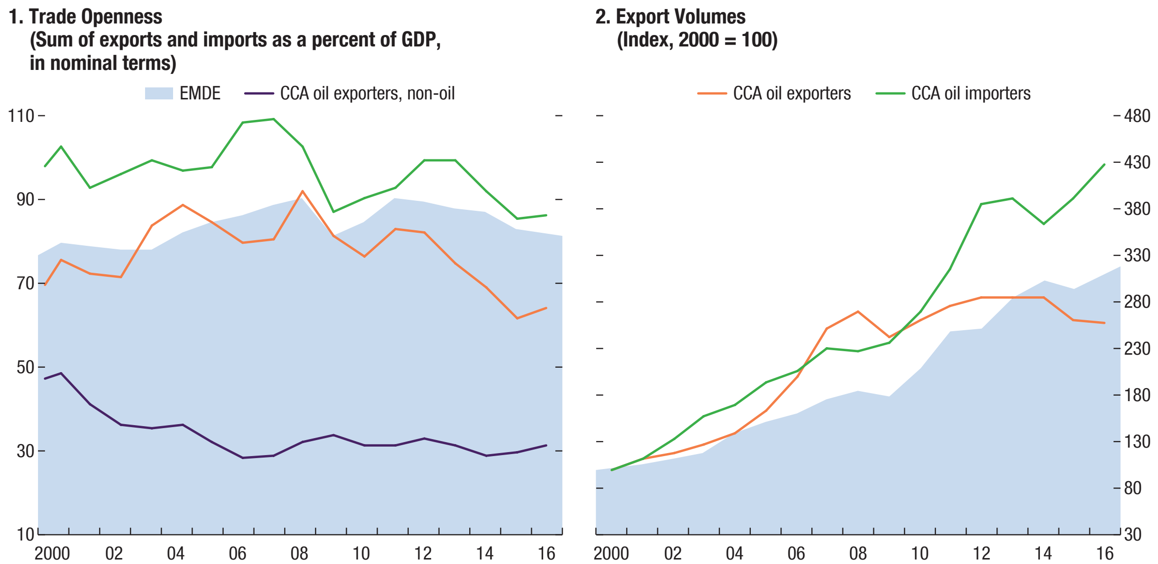
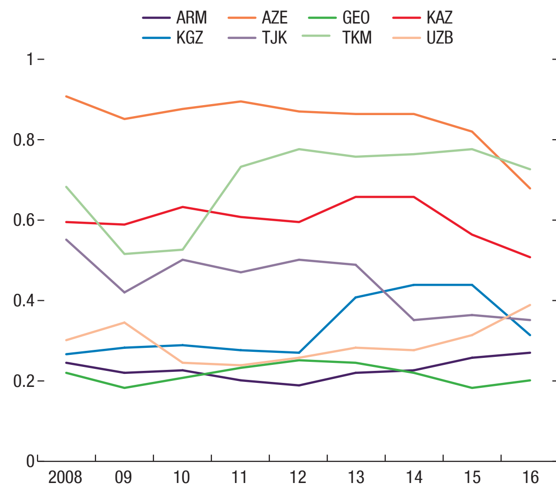
Figure 4. CCA: Trade Openness and Real Exports, 2000–16



Source: IMF October 2017 *World Economic Outlook* database; and staff calculations.
Note: CCA = Caucasus and Central Asia; EMDE = emerging and developing economies.

(down from 0.62 in 2008) and 0.28 for oil importers in 2016 (down from 0.32 in 2008) (Figure 5).[1] However, there is still a considerable way to go to diversify exports in these economies.

Figure 5. Concentration Index
(1 = exports/imports highly concentrated on few products)



Source: United Nations Conference on Trade and Development.

The CCA region remains weakly integrated into the global trade network. The region has made some progress integrating with the rest of the world (including through the promotion of special economic zones), and its share in world trade,

[1]The UNCTAD concentration index, also called the Herfindahl-Hirschmann Index, is a measure of the degree of product concentration. A value closer to 1 indicates that a country's exports are highly concentrated on a few products, while a value closer to 0 reflects exports that are more homogeneously distributed among a variety of products. Middle-income developing economies had a concentration index of 0.07 and oil exporters an index of 0.46 in 2016.

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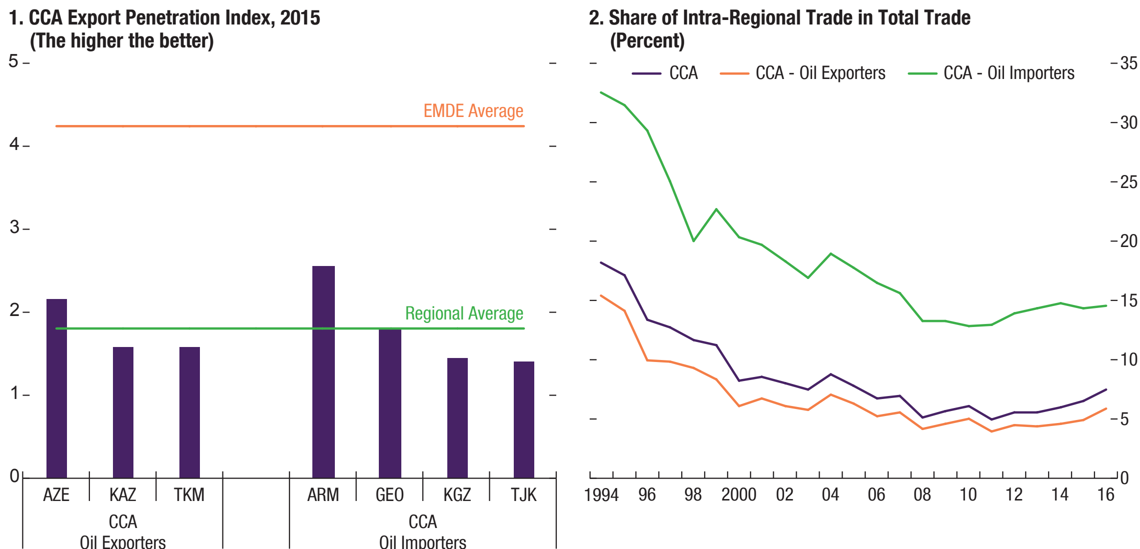
Figure 6. CCA: Trade Penetration and Intraregional Trade



Sources: WITS database; and IMF staff calculations.
Note: This indicator measures the extent to which a country's exports reach already proven markets, calculated as number of countries to which reporter exports a particular product divided by number of countries reporting importing the product that year. EMDE = emerging and developing economies.

although still relatively low (0.5 percent of global trade), has grown. Still, non-oil exports by CCA countries were about $500 on a per capita basis in 2017, roughly half the average of EMDEs. Both oil exporters and importers export to only 50 percent of potential markets, suggesting considerable scope for increase. Trade penetration, measured on the basis of export value per trading partner, is also relatively weak (Figure 6).

Intra-CCA regional trade is low. The aggregate GDP of the eight CCA countries in 2017 was about $350 billion (0.5 percent of world GDP). A common market of this size would rank the region among the largest 30 countries of the world and represents an opportunity for trade expansion. However, over the past few decades, intra-CCA trade has fallen considerably, reflecting regional tensions and the impact of the global financial crisis. Only in recent years has intraregional trade started to recover, albeit slowly, reflecting trade arrangements as well as diversification efforts among some countries in the region. But at 5 percent of total trade for oil exporters and 15 percent for oil importers, intraregional trade remains low by international standards—a clearly underexploited potential for the region.

Several factors explain the relatively low level of regional and global trade integration. In addition to difficult terrain and product concentration, problems related to the business climate and foreign exchange restrictions have impeded trade. Although the overall trading environment for CCA coun-

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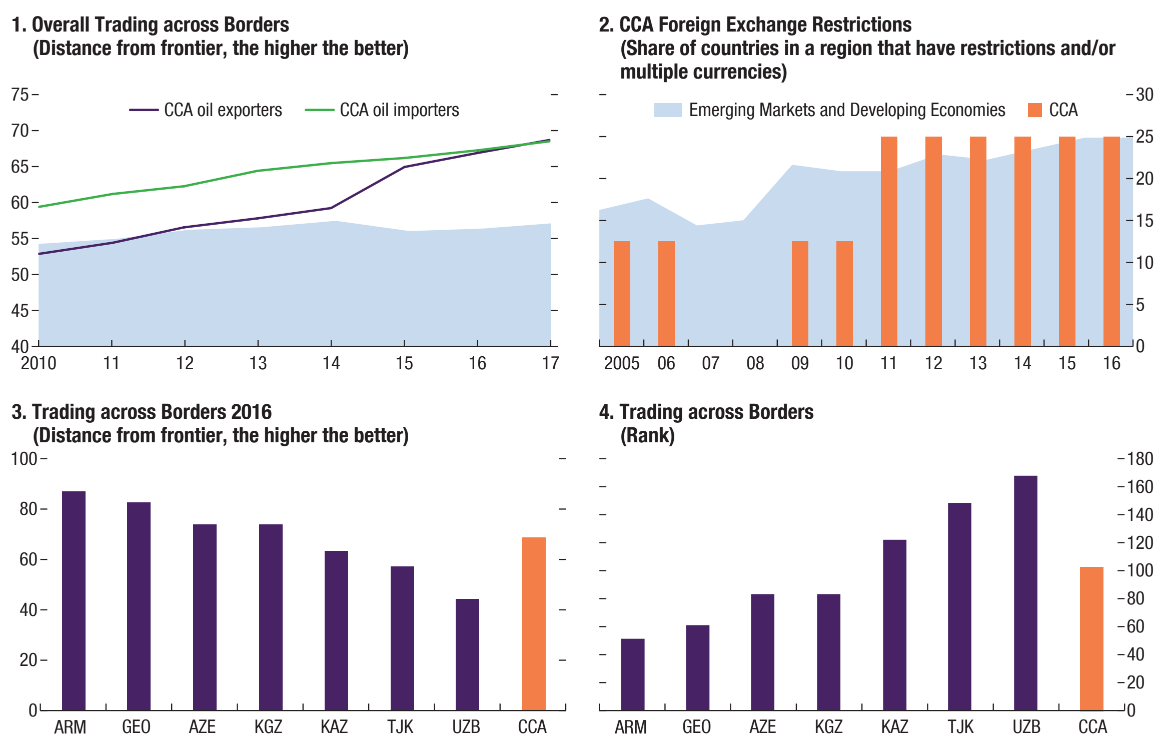
Figure 7. CCA: Trade Environment
(Percent)



Source: World Bank, Doing Business 2017.
Note: CCA = Caucasus and Central Asia; EMDE = emerging and developing economies.

tries has been improving in recent years and these countries rank favorably in World Bank cross-country comparisons, on average, relative to EMDEs (Figure 7), individual components of trading efficiency across borders could be improved. For instance, cumbersome administrative procedures related to the processing of export and import documents lead to high transit costs and long delivery times in many countries. At the same time, there is considerable dispersion across CCA countries in the ease of trading across borders, with Armenia and Georgia ranking among the top-tier countries and Tajikistan and Uzbekistan ranking in the lower tier. Foreign exchange restrictions in some CCA countries have further hampered trade.

Tariff and nontariff barriers also constrain trade. CCA countries have complex tariff schedules; apply tariffs on a wide range of products (including machinery, chemical products, foodstuffs, energy, and metals); and have different trade policies as reflected in their tariff rates, which range from relatively liberal (especially Georgia) to more restrictive (Tajikistan and, until recently, Uzbekistan). The average tariff rate for the region was 4.5 percent in 2015, although that average has increased since Armenia and the Kyrgyz

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Table 1. Weighted Average Tariff Rate

	2012	2015
Armenia	2.4	2.5
Azerbaijan	4.1	5.3
Georgia	0.7	0.3
Kazakhstan	3.7	4.7
Kyrgyz Republic	2.5	2.7
Tajikistan	5.2	7.2
Turkmenistan[1]	2.9	…
Uzbekistan	7.2	8.7
CCA[2]	3.7	4.5
China	3.6	3.4
Germany	1.0	1.6
Japan	1.2	1.4
Russia	6.3	2.8

Source: World Bank.
[1]Latest available data are for 2002.
[2]Excludes Turkmenistan.

Republic joined the EEU, whose common tariffs are higher (Table 1). By comparison, very open economies, such as Japan and Germany, have an average tariff rate of 1.5 percent. CCA countries also maintain considerable nontariff barriers that impede trade. These include regulations; quotas and bans on certain goods and raw materials (for example, carpets and chicken) in Kazakhstan, Turkmenistan, and Uzbekistan; poor customs infrastructure and high logistics costs (Kazakhstan and Tajikistan); unpredictable changes in tariff schedules (Turkmenistan and Uzbekistan); and weak administrative and legal regimes (Armenia and Azerbaijan) (Overland 2017).

Strengthening trade integration will require a multipronged approach. Priorities include the following:

- Using the BRI and other economic cooperation initiatives to develop infrastructure and facilitate trade integration. The BRI has already yielded over $10 billion in Chinese investments in the region (Box 1), and CCA countries should take advantage of their strategic position at the crossroads of Asia, Europe, and the Middle East to build and integrate infrastructure into the global network while mitigating potential fiscal risks. For instance, the development of road and rail corridors in Kazakhstan under the very sizable 2014–17 Nurly Zhol economic stimulus plan complements and extends international integration efforts.
- Increasing exports of non-commodity goods and services represents another area of opportunity. Greater specialization in manufactured goods and services would help diversify exports and boost competitiveness and growth. Again, the strategic position between East and West should be exploited. For example, trade between China and Europe that transits through the CCA could be tapped to integrate those countries into GVCs. With trade between China and Europe averaging over $1 billion a day, important opportunities exist in industrial and consumer goods, textiles, and machinery and equipment.[2]
- There is scope for greater intraregional trade as well. Revealed comparative advantage analysis suggests that the immediate potential for strengthening

[2]Some countries in the region, especially the Kyrgyz Republic, are already benefiting considerably from reexports, particularly in the manufacture of textile goods from China. In the Kyrgyz Republic, reexports accounted for about 13 percent of GDP in 2010 (Mogilevski 2012).

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trade ties lies in primary commodities, food, and metals (Box 2). In the long term, however, the CCA countries would benefit from greater specialization and from integrating into GVCs.

- Countries in the region should reduce tariff and nontariff barriers, including high customs costs, and strengthen administrative procedures to facilitate trade.

Opportunities to Leverage Trade Initiatives

CCA countries have pursued various economic integration initiatives, usually involving larger regional economies. Initiatives include the EEU, the CAREC, the SCO, and China's BRI. While the number of initiatives that include CCA countries has expanded, most of them have met with limited success thus far (Box 3).

CCA participation in multilateral trade agreements led by the WTO can stimulate more open trade and reforms. WTO membership is important as members participate in the development of new trade rules in multilateral negotiations, have their interests defended against unlawful trade practices through the WTO dispute-settlement mechanism, and receive extensive trade-related technical assistance. WTO membership is therefore a powerful instrument for unlocking trade in a transparent, multilateral framework and for stimulating domestic reform as well. Countries in the region should take advantage of this opportunity, particularly given the somewhat limited success of other regional initiatives.[3] While Armenia, Georgia, and the Kyrgyz Republic have been members of the WTO for over a decade, Kazakhstan and Tajikistan joined more recently (in 2013 and 2015, respectively) and Azerbaijan, Uzbekistan, and Turkmenistan are not yet members.[4]

Recent WTO trade liberalization efforts could be particularly beneficial for CCA countries. CCA countries should consider implementing the Trade Facilitation Agreement (TFA) established in early 2017. The WTO estimates that implementation of the TFA will cut customs-related costs of merchandise trade by 10 percent to 25 percent and could lead to a $1 trillion annual increase in global trade (WTO 2018). For the landlocked CCA countries, the TFA could serve as a unique multilateral platform to address connectivity challenges and improve trade flows within the region. CCA countries could also benefit from WTO's other initiatives. For instance, in December 2017, more than 80 like-minded WTO members launched exploratory work on

[3]A recent study finds that countries that recently joined the WTO and implemented the required trade reforms outperformed the original WTO members that did not have to undertake reforms (Kireyev 2016).

[4]Armenia, Georgia, and the Kyrgyz Republic joined the WTO in 2003, 2000, and 1998, respectively. Azerbaijan has been negotiating WTO accession since 1997 and Uzbekistan since 1994, but they are not yet members. Turkmenistan has been weighing WTO accession since 2013 but has not yet applied for membership.

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future WTO negotiations on electronic commerce, facilitating investment, and small- and medium-size enterprise (SME) trade.

Regional integration initiatives should be pursued to boost growth prospects. For instance, the EEU has provided benefits to its membership, notably through a new customs code and a common labor market, boosting remittances and expanding trade. More effort is needed, however, to achieve regional economic integration, including eliminating nontariff barriers and exemptions and moving ahead with EEU plans to forge other economic cooperation agreements, including with the European Union and China.

CCA countries could better leverage bilateral trade agreements to gain broader access to markets. While some CCA countries have negotiated bilateral trade agreements, their number is substantially lower than the EMDE average. Georgia concluded association agreements with the EU in 2014 that reduced or removed tariffs in bilateral trade. Armenia and Azerbaijan have signed cooperation and partnership agreements with the EU as well. There is scope for countries to do more on a bilateral basis, even as they pursue the multilateral approach to trade liberalization.

Capital

While capital flows have been relatively low and many CCA countries retain restrictions on capital account transactions, change is underway as countries seek to benefit from greater economic integration. However, when a country liberalizes capital accounts, it should take care to ensure that banks and government are able to manage the risks associated with greater—and potentially more volatile—capital flows. Specific near-term actions should include cleaning up bank balance sheets, improving the regulatory and supervisory framework, and addressing other risks, including those related to dollarization.

CCA capital flows are relatively low and have not grown significantly since the global financial crisis. Capital inflows to the region are primarily foreign direct investment (FDI) (Figure 8). Kazakhstan is the largest beneficiary of these inflows, followed by Azerbaijan. Kazakhstan and Azerbaijan—the two largest oil exporters in the region—are also the primary source of CCA investment abroad, both FDI and portfolio investment. Within the region, CCA oil importers invest primarily in Azerbaijan and Kazakhstan, whereas Georgia and, to a lesser extent, the Kyrgyz Republic have benefited most from FDI from CCA oil exporters.[5]

[5]Azerbaijan has been the largest single investor in Georgia in recent years, investing over $0.5 billion in 2015 in energy, infrastructure, and transportation. The two countries are connected by several important regional projects, including oil and gas pipelines, and the Baku-Tbilisi-Kars railway.

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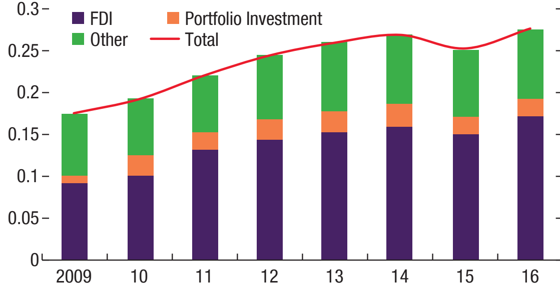
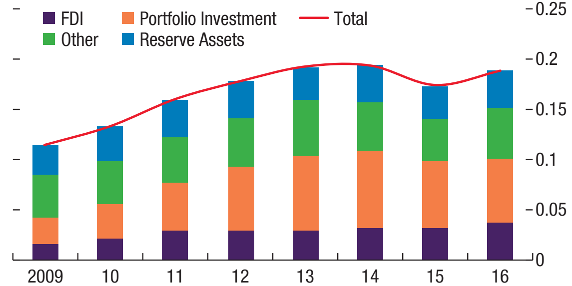
Figure 8. Capital Flows

1. CCA Capital Inflows
(Billions of US dollars)



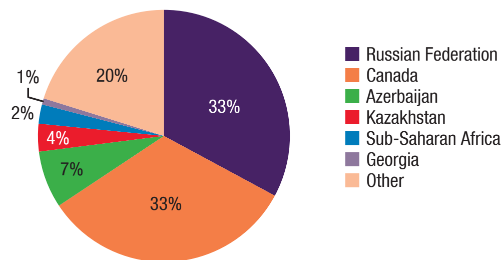
Source: IMF, *World Economic Outlook.*
Note: Data exclude Azerbaijan, Turkmenistan, and Uzbekistan.

2. CCA Capital Outflows
(Billions of US dollars)



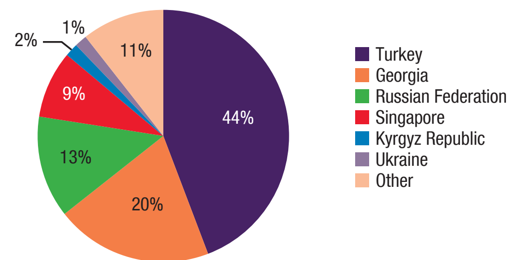
Source: IMF, *World Economic Outlook.*
Note: Data exclude Azerbaijan, Turkmenistan, and Uzbekistan.

3. Oil Importers: Destinations of FDI Outflows



Source: IMF, Coordinated Direct Investment Survey.

4. Oil Exporters: Destinations of FDI Outflows



Source: IMF, Coordinated Direct Investment Survey.

The degree of capital account openness varies considerably across the region. Armenia and Georgia have the most open financial systems as measured by the Chinn-Ito financial openness index (Figure 9).[6] Both countries maintain relatively few controls on cross-border capital flows. However, there are some restrictions, such as on the investment of insurance companies and pension funds abroad (on prudential grounds) and on land purchases by nonresidents. Most other CCA countries have intervened more in the financial system in the past (for example, interest rate caps and directed lending) and retain restrictions on cross-border flows as well as controls on the domestic financial system. Capital account restrictions include restrictions on FDI, domestic security purchases by nonresidents and foreign securities by residents, real estate purchases by nonresidents, repatriation requirements, and foreign exchange surrender requirements (Turkmenistan and, until recently, Uzbekistan).

[6] The Chinn-Ito financial openness index measures a country's degree of capital account openness (*Journal of Development Economics* 2006).

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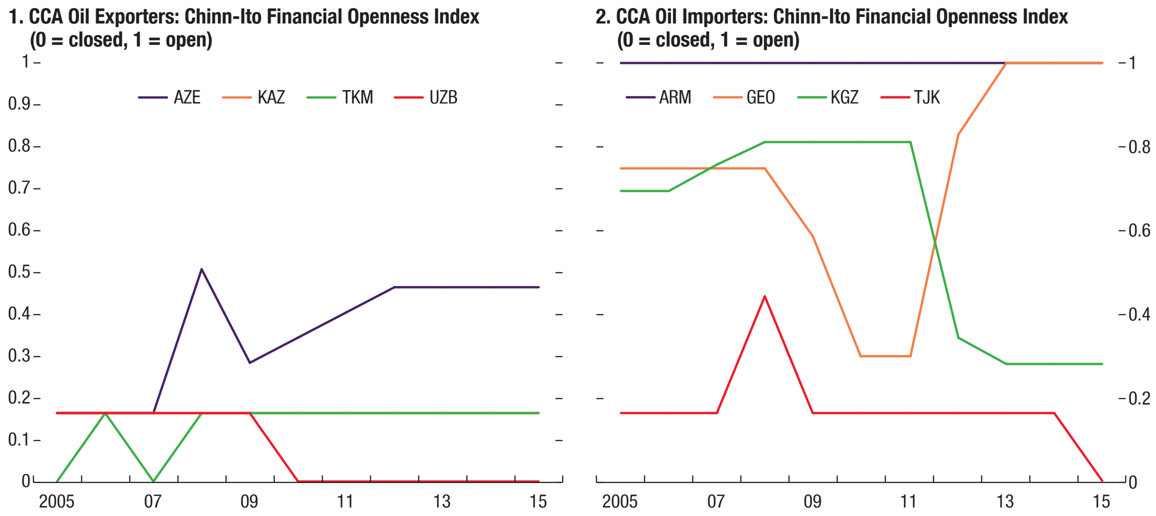
Figure 9. Financial Openness



Source: Chinn and Ito 2015.

There is no clear consensus on the pace and sequencing of capital account liberalization. While capital account liberalization can provide benefits to an economy (including fostering financial sector development and growth) if it is well sequenced and executed, it can be disruptive if the country is not prepared to manage the associated risks. In some cases, countries have opted to reimpose capital controls following capital account liberalization in the face of exchange rate pressures (for example, Belarus and Ukraine in 2014 and China in 2015). These reversals point to the need to be well prepared to deal with greater openness. Capital account liberalization should be well planned, well timed, and well sequenced to ensure that benefits outweigh costs.

The pace and sequencing of capital account liberalization for CCA countries should take into account their ability to manage the associated risks. Armenia, for example, achieved financial opening in a relatively short time in the 1990s, completing the process well before it lifted the foreign exchange anchor and moved to inflation targeting. Georgia started financial opening at about the same time as Armenia but arrived at its present high level of openness only in 2013, after moving to inflation targeting in 2009. Because many CCA countries still have fairly closed financial systems and are in need of bank balance sheet repair, they may not be well equipped to remove capital controls quickly. Rather, capital account liberalization should focus in the short term on strengthening the health of the banking sector, improving the regulatory and supervisory framework, and addressing other risks, including those related to dollarization (described in later sections).

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Chapter

3 Economic Frameworks and Institutions

Robust economic frameworks and institutions will be essential to help CCA countries integrate regionally and globally. Strong frameworks and institutions will be needed to manage larger trade and capital flows associated with greater economic integration and to help ensure macroeconomic stability. This stability, in turn, will generate a more favorable investment climate and positive growth dynamics.

Fiscal Policy and Frameworks[1]

CCA countries are trying to improve fiscal balances following recent shocks, but a more ambitious fiscal adjustment would be preferable to rebuild buffers and deal with possible future shocks and greater economic integration. Policy efforts should focus on revenue mobilization, rationalizing nonpriority expenditures, strong social safety nets, and improving public spending, as investment opportunities—including public-private partnerships (PPPs)—are expected to grow in the context of various integration initiatives. Such efforts would support fiscal consolidation while allowing for more pro-growth spending. Fiscal risks will require scrutiny as more public investment and infrastructure projects get underway. This scrutiny will require more robust budgetary institutions, fiscal rules, and risk management capacity.

Current Fiscal Situation and Plans

Fiscal deficits and public debt levels in both oil exporters and importers have increased considerably as a result of the 2014–15 external shocks. In oil importers, weaker revenues and higher public spending to support eco-

[1]This section draws on Gemayel and others (2018).

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nomic activity increased fiscal deficits by about 4 percentage points of GDP on average between 2013 and 2016 to 6.1 percent of GDP, and public debt increased to 49 percent of GDP. In oil exporters (Azerbaijan and Kazakhstan), fiscal balances deteriorated by about 7 percentage points of GDP on average over the same period, and fiscal deficits reached 3.3 percent of GDP by 2016. Net foreign assets—the difference between the government's gross assets and debt—in oil exporters actually improved by about 7 percent of GDP over this period, reflecting the positive impact of exchange rate depreciation on net foreign assets.[2]

Countries in the region are planning to undertake fiscal adjustment over the medium term. Adjustment plans for 2017–22 vary by country. Those with higher deficits (such as Azerbaijan, Kazakhstan, and Tajikistan) have generally initiated larger adjustment plans, reflecting the magnitude of the shock they faced and the completion of the countercyclical policies they pursued. Others (such as Armenia, Georgia, and the Kyrgyz Republic) have more moderate adjustment plans.

- For CCA oil exporters, overall fiscal deficits are projected to improve by over 2 percentage points of GDP (from 2016) to an average of about 1.1 percent of GDP in 2022. Despite the improvement in the fiscal position, the overall deficit and lower projected oil prices over the medium term will cause net financial assets to fall from 26 percent of GDP in 2016 to about 10 percent of GDP by 2022, which will reduce fiscal buffers (Figure 10, green line).
- CCA oil importers' fiscal adjustment will stabilize public debt above precrisis levels. The fiscal deficit is expected to improve on average by over 4 percentage points of GDP (from 2016) to about 1.9 percent of GDP in 2022. Under these adjustment plans, public debt is projected to stabilize at about 50 percent of GDP by 2022, a level comparable to that in 2016 but considerably higher than the 37 percent of GDP average at the end of 2013.

Suggested Fiscal Adjustment

Given the persistent nature of the shocks and to facilitate greater economic integration, CCA countries should pursue more ambitious consolidation efforts. Consolidation would allow fiscal buffers to be rebuilt and would create room for countercyclical policies in case of future shocks.[3] It would also

[2]The positive exchange rate effect on net foreign assets reflects the higher dollar-denominated share of assets compared with liabilities. In addition, the conversion of net foreign assets into local currency has contributed to the increase of net foreign assets relative to GDP.

[3]Shocks could include a decline in remittances and a contraction of economic activity in key trading partners in the case of oil importers, and lower commodity prices and a decline in sovereign wealth funds' assets in the case of oil exporters. A more open economy also argues for greater fiscal buffers to deal with larger and

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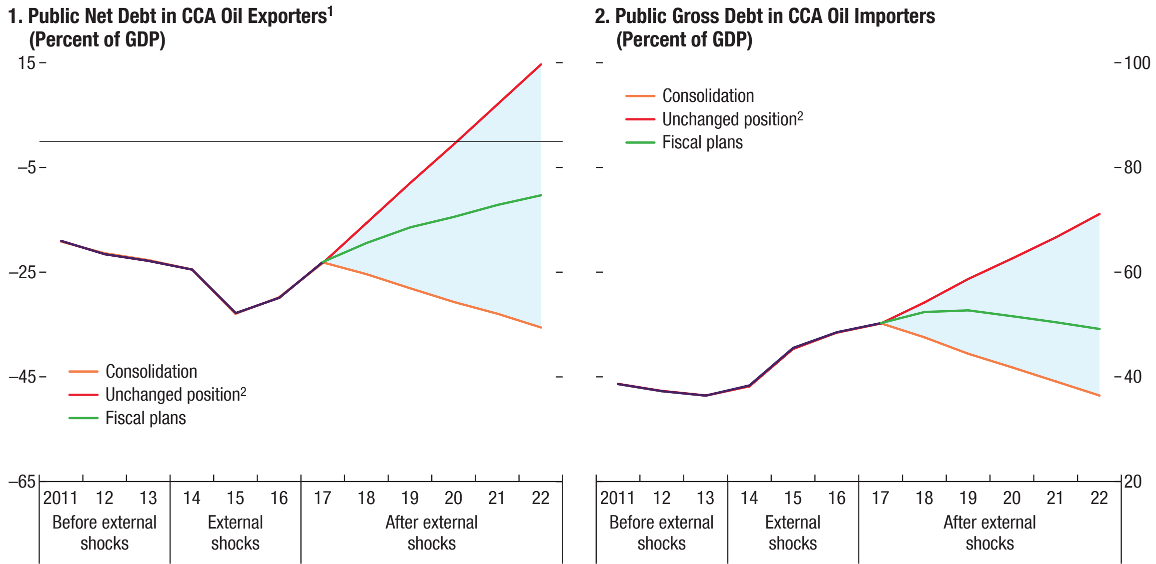
Figure 10. Public Debt Options for the CCA



Source: IMF REO October 2017; and IMF staff calculations.
Note: Turkmenistan and Uzbekistan omitted for lack of data.
[1]Public debt for oil exporters is measured on a net debt basis, taking into account foreign assets of country oil funds.
[2]Unchanged position refers to a scenario in which the end-2017 fiscal balance is added to the stock of debt in each forecast year.

send a clear signal of fiscal responsibility and strong macroeconomic management to domestic and foreign investors, which is needed if the region wishes to increase investment and integrate successfully into the global economy. The adjustment should be done in a growth-friendly manner by preserving much-needed infrastructure investments while reducing expenditure inefficiencies and increasing revenues. To be successful, policymakers will have to ensure that the needed reforms, including their distributional consequences, are well designed and effectively communicated to the population.

More ambitious consolidation could bring debt to preshock levels (orange line in figure 10). This would provide policy buffers in the event of renewed external shocks, including through countercyclical policies. Oil importers could target a preshock level of gross public debt, 37 percent of GDP on average, that would require an average reduction in gross debt of about 12 percentage points of GDP from levels at the end of 2016. Oil exporters would target a precrisis net asset-to-GDP ratio, 26 percent on average, that would require an average consolidation effort of about 11 percentage points of GDP from levels at the end of 2016. This would help preserve the stock of sovereign assets for future generations.

potentially more volatile capital flows, particularly as the region transitions to greater openness and given the sensitivity of debt dynamics to exchange rate volatility.

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The size, timing, and speed of consolidation should be country-specific. While average CCA debt levels may seem relatively low, their sensitivity to shocks (for example, a growth or commodity price shock) reinforces the need to rebuild fiscal buffers beyond current adjustment plans. Countries with higher debt levels, limited buffers, and weaker debt dynamics should front-load consolidation. Countries with more manageable debt levels could pursue more gradual consolidation.

Fiscal Adjustment Composition

To support pro-growth fiscal policies, CCA countries should enhance revenue mobilization and increase productive spending and efficiency. Higher tax revenues (for instance, by broadening the tax base and strengthening tax administration) would support consolidation efforts while allowing for more pro-growth expenditures. Efforts are also needed to make income taxes more progressive, through adjustments in income tax rates and value-added taxes, and to promote equity by reducing regressive and distortive exemptions and closing tax loopholes. On the spending side, current expenditure needs to be prioritized, capital spending made more efficient, and social spending improved, including through better targeted programs. Consideration should also be given to rationalizing government wage bills, especially where public sector wages and employment are high relative to the private sector (see Tamirisa and others 2018); reducing generalized energy subsidies using mechanisms to protect the most vulnerable segments of the population; and improving public services (for example, access to electricity). Such reforms would help generate savings, raise income equality, and improve productivity and growth. They would also facilitate economic integration and diversification as the CCA economies become more competitive and attractive to domestic and foreign investors.

The efficiency and productivity of public investment needs to be improved. This is particularly important in the context of the BRI, where considerable opportunities for investment are expected, including through PPPs. The average efficiency of investment in the CCA region, measured using a frontier approach, is below the average of the EMDEs (Table 2).[4] In relatively high-efficiency countries such as Armenia, Azerbaijan, and Georgia, an increase in public investment represents an opportunity to close infrastructure gaps and boost short- and medium-term growth. In lower-efficiency countries (for example, Kazakhstan, the Kyrgyz Republic, and Tajikistan), structural

[4]The score ranges between 0 and 1, where 1 represents perfect efficiency and 0 perfect inefficiency. The frontier is made up of efficient combinations of infrastructure quality as measured in the World Economic Forum's Global Competitiveness Index and public capital stock per capita in 2014. See IMF (2015c) for a detailed explanation of the methodology.

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reforms that strengthen public management should be considered before the government embarks on large public investment projects that may create fiscal sustainability concerns (see IMF 2015b, 2016a).

Table 2. Public Investment Efficiency
(Distance to Frontier)

CCA commodity exporters	**0.79**
Azerbaijan	0.94
Kazakhstan	0.65
Turkmenistan	...
Uzbekistan	...
CCA commodity importers	**0.71**
Armenia	0.79
Georgia	0.86
Kyrgyz Republic	0.57
Tajikistan	0.61
Emerging market economies	**0.78**
Low-income developing economies	**0.77**
Advanced economies	**0.89**

Source: IMF 2015b

Strengthening Fiscal Policy Frameworks

Stronger fiscal frameworks will be required as CCA countries seek to benefit from greater economic integration. These frameworks will help ensure that investment projects such as those presented by the BRI are implemented effectively, while fiscal positions are maintained. Robust fiscal frameworks will also improve transparency and governance and contribute to a better investment climate. Three elements are particularly important for a fiscal framework: (1) robust budgetary institutions and medium-term budgeting, (2) fiscal rules, and (3) fiscal risk management.

Robust Budgetary Institutions and Medium-Term Budgeting

Many CCA countries do not have comprehensive and unified medium-term budgeting. For instance, capital and recurrent budgets are prepared by separate ministries without using program classification or accounts do not adequately distinguish between recurrent and capital spending, leading to possible underestimation of costs. At the same time, capital spending is often not projected beyond the budget year, making it difficult to assess whether investment projects are sustainable. Even when projections are available, they are not necessarily published or integrated into a medium-term budget framework. As a result, many CCA countries exhibit large deviations between budgets and outturns.

Stronger budgetary institutions and medium-term budgeting would foster credibility and efficiency in public spending and would promote fiscal sustainability. Governments should have a holistic view of their expenditures, meaning that all expenditure decisions (including public investment) are considered together, leading to better prioritization among competing items. All public investments, including PPPs, should be fully integrated into spending plans, authorized by the legislature, and disclosed in budget documentation to ensure adequate oversight and transparency. In addition, public investment

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should take into account immediate capital outlays and future operating and maintenance costs, and should be set in a multiyear budgeting framework, so that expenditures are fully aligned and compatible with projected resource envelopes over the medium term.

Fiscal Rules

CCA countries typically do not have robust fiscal rules. Countries do not have specific rules, the rules are not well calibrated to achieve their objectives, or the rules do not take into account macroeconomic shocks. Furthermore, some practices on budget amendments have reduced compliance with fiscal rules. Without credible fiscal rules, countries are more vulnerable to overspending in good times (with the risk that spending quality suffers) or to cutting spending abruptly when times are bad.

Credible fiscal rules would anchor sustainability and facilitate public investment. Credible rules impose durable constraints on fiscal policy, ensure transparent budget processes, and create space for sustainable investment (Schaechter and others 2012) by limiting discretion and anchoring expectations. If they are properly calibrated and implemented, fiscal rules can help correct the deficit bias prevailing in many CCA countries and ensure fiscal sustainability. However, fiscal rules are not a panacea—especially for oil exporters (where revenue volatility can be large) or in the presence of significant public financial management weaknesses. Best practices in designing and implementing fiscal rules include the following: (1) clearly defined objectives linked to numerical targets, (2) incentives to build buffers in good times and allow for adequate fiscal support in downturns, (3) calibration that ensures fiscal sustainability in the face of shocks, (4) escape clauses to deal with tail events, (5) effective monitoring, and (6) broad institutional and economic coverage, including at the subnational level (IMF 2018c).

Fiscal Risk Management

Sound risk management practices can reduce fiscal risks associated with investments or broader shocks, helping to safeguard macroeconomic stability. A better understanding of risks allows governments to reduce exposures and take mitigating measures. Moreover, greater transparency and effective risk management practices can help underpin credibility and market confidence, which in turn can attract more trade and investment.

CCA countries have room to improve fiscal risk management. While some analysis of fiscal risks in CCA countries exists, it tends to focus on the static sensitivity of primary fiscal aggregates to macroeconomic shocks (for example, commodity prices and exchange rates) without looking at the correlation

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of shocks or the impacts on asset and liability values, or analyzing the risks within a macroeconomic modeling framework. Analysis also does not generally capture the impact of spending in the broader public sector (such as subnational governments or state-owned enterprises) that could give rise to contingent liabilities. Capturing such potential risks is particularly important in the context of the BRI, as foreign investments may involve a ramping up of PPPs, including at the subnational level. Countries should therefore aim to improve the coverage and timeliness of data for the sovereign balance sheet and the analytical framework for assessing fiscal risks. It will also be necessary to expand the capacity to manage and mitigate risk, either through direct controls over exposures or through risk provisions.

Monetary Frameworks[5]

Monetary policy frameworks across the CCA need to be further strengthened to support economic integration. The move toward greater exchange rate flexibility in the region is a positive development and will help CCA countries weather future external shocks. While the choice of an alternative nominal anchor should reflect country-specific circumstances, inflation targeting has been gaining ground in the region. By promoting price stability, inflation targeting can play a role in financial sector reforms and market development as well as stimulating investment, economic integration, and growth. To successfully transition to inflation targeting, countries will need strong political commitment, ongoing development of institutional capacity, and efforts to address lingering financial stability concerns, including restoring the health of bank balance sheets. Adopting similar inflation targets would promote greater exchange rate stability and trade and financial links among CCA countries.

Toward More Flexible Exchange Rates

Countries in the CCA region are moving away from managed exchange rates. Many abandoned FX anchors and other managed monetary policy regimes over the past decade (Table 3).

Inflation targeting coupled with more flexible exchange rates has been gaining ground. No country in the region targeted inflation in 2005, but since then Armenia, Georgia, and Kazakhstan have all transitioned to inflation targeting. This shift mirrors global trends and is set to continue: the Kyrgyz Republic recently announced an inflation target, and Azerbaijan, Tajikistan, and Uzbekistan have announced their intention to move to inflation

[5]See Horton and others (2016) for a comprehensive treatment of monetary and exchange rate policies in the CCA.

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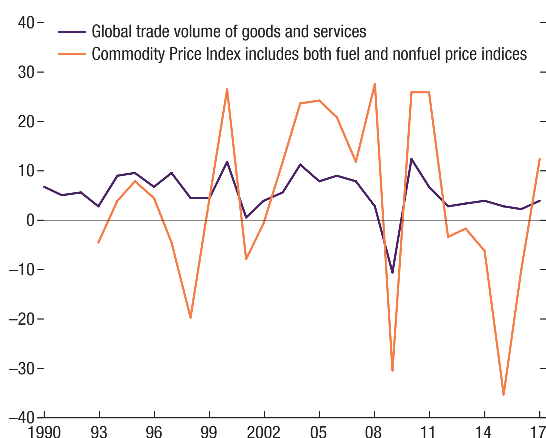
Table 3. Monetary and Exchange Rate Policies, and Financial Openness in CCA Countries

	Monetary Policy Regime		Exchange Rate Arrangement		Financial Openness (0 = closed; 1 = open)	
	2005	2015	2005	2015	2005	2015
Armenia	Other	Inflation target	independent float	float	1	1
Azerbaijan	Other	Other	conventional peg	other managed	0.2	0.5
Georgia	Other	Inflation target	managed float	float	0.75	1
Kazakhstan	Other	Inflation target	managed float	float	0.2	0.2
Kyrgyz Republic	Other	Other	managed float	other managed	0.7	0.3
Tajikistan	Monetary target	Monetary target	conventional peg	other managed	0.2	0
Turkmenistan	FX anchor	FX anchor	managed float	conventional peg	0	0.2
Uzbekistan	Other	Monetary target	managed float	crawl	0.2	0

Source: Annual Report on Exchange Arrangements and Exchange Restrictions database, M Chinn and H Ito (2006).

Figure 11. Global Shocks



Source: IMF, *World Economic Outlook*.

targeting over the medium term. Turkmenistan continues to peg its currency to the U.S. dollar.

Greater exchange rate flexibility is playing an important stabilizing role. The move in the region from pegged or managed exchange rates toward more flexible ones has been driven by volatility in the global economy (Figure 11). In late 2014, CCA currencies came under pressure and foreign exchange reserves were drawn down. CCA countries recognized the need to adjust to the new environment and the useful shock-absorbing role that greater exchange rate flexibility can play (Horton and others 2016). Accordingly, all countries in the region allowed for some degree of exchange rate flexibility, with some (for example, Azerbaijan and Turkmenistan) pursuing step devaluations. Uzbekistan has recently made the sum fully convertible as part of a broader economic liberalization strategy (Box 4). The move toward greater exchange rate flexibility helped countries weather the external shock and has facilitated the further integration of CCA countries into the global economy.

Ensuring a Credible Nominal Anchor to Support Macroeconomic Stability and Openness

Inflation targeting can bring significant economic benefits and support global integration. While the choice of the nominal anchor should reflect country-specific circumstances, empirical evidence for emerging economies suggests that inflation-targeting regimes outperform others as measured by

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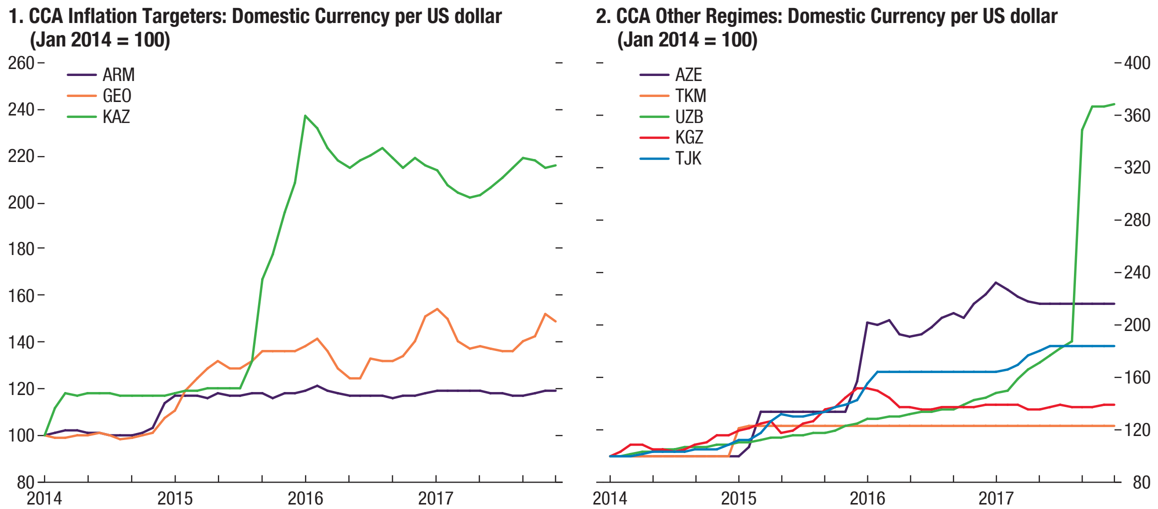
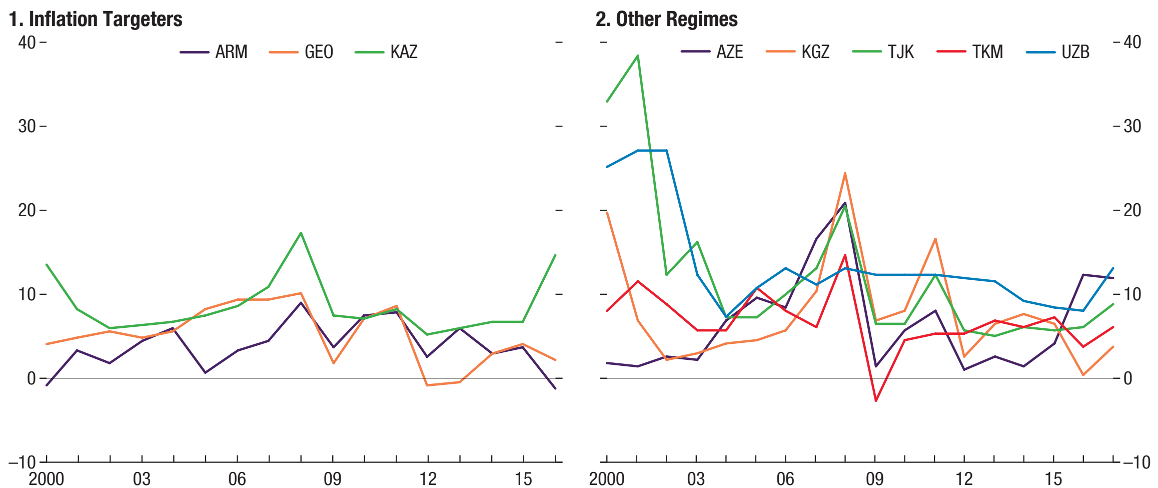
Figure 12. Exchange Rates



Source: IMF, International Financial Statistics.

Figure 13. Inflation, 2000–17
(In percent)



Source: IMF, *World Economic Outlook.*

inflation, inflation expectations, volatility of the output gap, interest rates, exchange rates, and international reserves (Batini and Laxton 2005).[6] The recent experience of CCA countries corroborates these findings: the countries

[6]Monetary aggregate targeting may be simpler to implement than inflation targeting and has met with some success, though the link between monetary aggregates and inflation can be weak. The increase in the amount of money in circulation can also be hard to predict and control with traditional monetary policy instruments.

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in the region with the longest experience with inflation targeting (Armenia and Georgia) have enjoyed lower inflation and exchange rate volatility over the past decade (Figures 12 and 13). By fostering greater macroeconomic stability, an effective inflation-targeting regime provides an environment conducive to domestic and foreign investment and growth, thereby facilitating greater integration into the global economy.

Under inflation targeting, the standard approach is to set the monetary policy stance so that inflation reaches the target in the medium term. The time horizon is typically left purposefully vague to allow room for monetary policy to address other objectives, such as smoothing temporary disturbances in GDP growth and exchange rates. Inflation-targeting countries in the CCA region also have employed annual inflation targets that have shifted over time. While this practice may demonstrate commitment to control inflation, it potentially exposes the economies to greater output volatility and risks loss of credibility if the target is missed. For inflation-targeting central banks, managing the path of inflation too narrowly is usually not optimal.

The choice of the inflation target is important for exchange rate stability and can promote greater openness. Economies at similar levels of development and openness can promote exchange rate stability by selecting similar inflation targets. In developed countries, inflation targets tend to cluster around 2 percent; in emerging economies, around 4 percent. In Armenia, Georgia, and Kazakhstan, the 2018 target levels for inflation are 4 percent, 3 percent, and 5 percent to 7 percent, respectively. By selecting similar inflation targets, CCA countries could reduce the cost of hedging against FX risks and promote trade and financial links (including within the region) without imposing the more arduous constraints on policy, such as fiscal policy, that are typical of trade and monetary unions.

Strong political commitment is needed to successfully transition to inflation targeting. To successfully anchor expectations, the central bank needs to be assigned a clear inflation targeting mandate and granted strong de facto operational independence. Government interference in the central bank's operations (for instance, through fiscal dominance or directed lending) must be discontinued. This is a tall order in some emerging and developing countries that are used to tightly controlling financial systems and allocating financial flows on the basis of other policy objectives. While CCA central banks appear to be relatively independent and transparent based on the letter of the law (Dincer and Eichengreen 2014), this does not always ensure adequate independence in practice.

Modern monetary policy frameworks and strong institutional capacity support inflation targeting. Given the time it takes to set up modern inflation targeting frameworks, CCA countries should continue to build their mone-

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tary policy frameworks and institutional capacity. Key elements of a modern inflation targeting framework include declaring a medium-term inflation objective; selecting a suitable operational target; building analytical capacity, particularly with regard to inflation forecasting; having deep and liquid money and foreign exchange markets; and ensuring clear, open, and timely communications (Horton and others 2016).

Addressing financial stability concerns arising from flexible exchange rates is essential, especially in the transition phase. Efforts to improve the health of bank balance sheets is a key step to allow banks to effectively manage large capital inflows and exchange rate swings. The high level of dollarization in the balance sheets of CCA banks, nonfinancial corporations, and households represents a considerable risk, particularly given the large net open FX positions (described in later sections) and can impede monetary policy effectiveness. Incentives to reduce dollarization can be helpful to mitigate FX risks; these incentives include achieving low and stable inflation, removing regulations that discourage local currency use, and instituting prudential measures to encourage more local currency use (for example, lower local currency reserve requirements and higher provisions on FX lending). Some CCA countries are already pursuing de-dollarization strategies; for example, Armenia, Georgia, and the Kyrgyz Republic have put in place a wide range of actions, from restrictions on some FX transactions to prudential, supervisory, and crisis management measures.

Financial Sector Policies[7]

Healthier banking systems and deeper capital markets in CCA countries would support regional and global integration by promoting more efficient intermediation, financial inclusion, larger capital flows, infrastructure investment, and economic diversification. To facilitate this transformation, bank balance sheets need to be strengthened, intermediation enhanced, transparency improved, financial inclusion encouraged, and correspondent banking relationships (CBRs) promoted. Companies could diversify their financing sources and promote investment opportunities by developing capital markets.

The State of Play

Since 2014, CCA financial systems have been affected by external shocks, with the impact differing across the region. Reflecting the low global interest rate environment, banks in the region had borrowed heavily in foreign cur-

[7]This section draws from the forthcoming IMF Departmental Paper “Building Resilient Banking Sectors in the Caucasus and Central Asia.”

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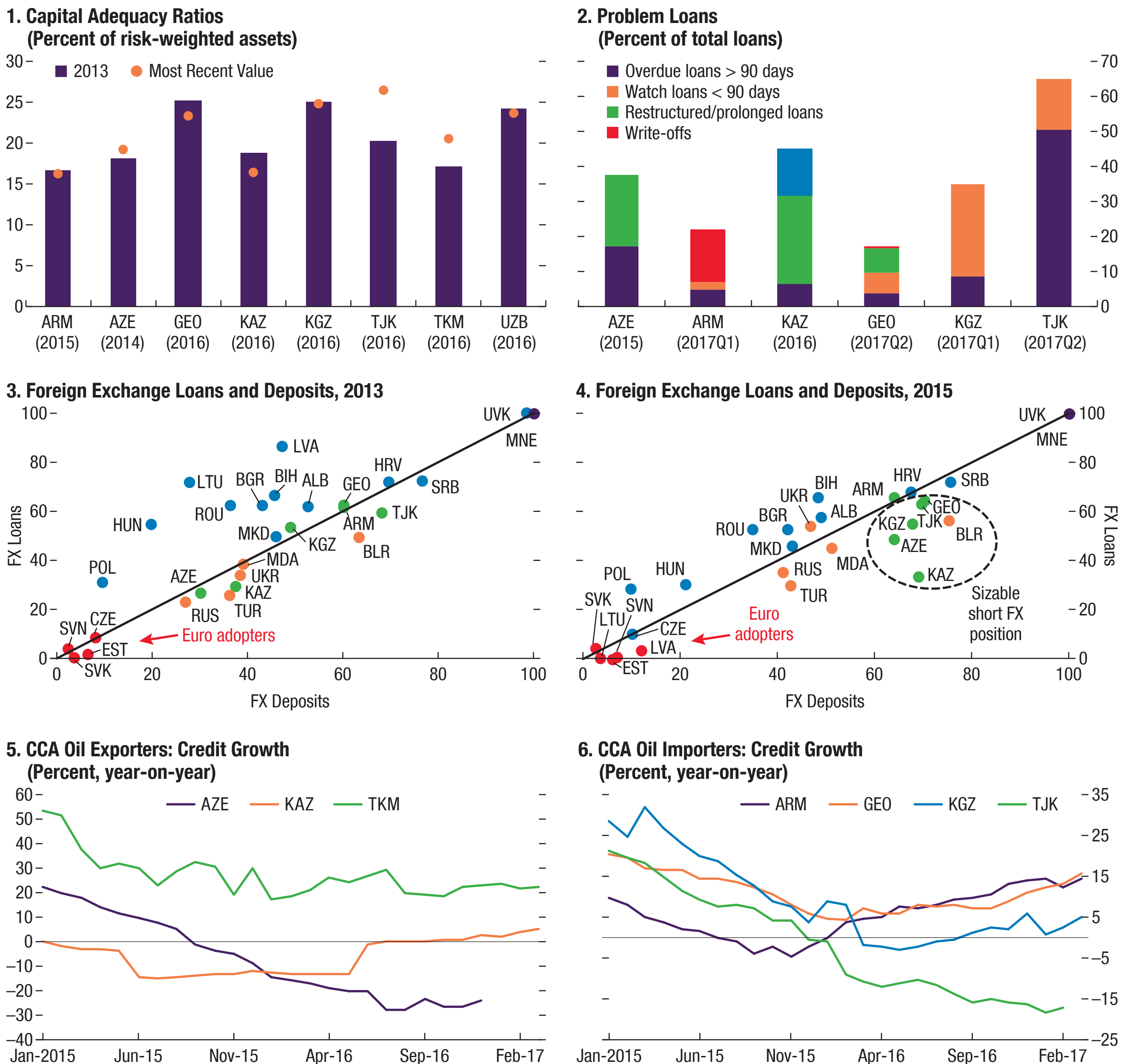
Figure 14. CCA Countries: Selected Financial Indicators



Source: National authorities; and IMF staff calculations.

rency on an unhedged basis to finance lending. With significant net open FX positions, banks suffered large losses when domestic currencies depreciated beginning in late 2014. Banking sectors in Armenia, Georgia, and the Kyrgyz Republic have proven to be fairly resilient, reflecting a lower initial level of nonperforming loans (NPLs) and improved regulation and supervision. The impact of shocks was more pronounced in CCA countries that are more

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dependent on oil (Azerbaijan and Kazakhstan) and remittances (Tajikistan). Strains in CCA banking sectors intensified as liquidity tightened, asset quality deteriorated, and banks became undercapitalized.

Even before the latest shock, CCA banking sectors were not at full strength. Asset quality was generally weak, owing in part to shortcomings in regulation, supervision, and governance (Figure 14). The sector lacked competition, and in most countries related-party lending was a regular business practice. These issues translated into excessive risk taking, which was exacerbated in highly dollarized economies.

Efforts have been made to strengthen bank balance sheets. These efforts include liquidity support, capital injections, bank restructurings, mergers, and liquidations. For example, in Azerbaijan, the largest state-owned bank is in the process of a voluntary debt restructuring worth some 9 percent of GDP. In Kazakhstan, the two largest banks have merged, with the authorities providing about 4 percent of GDP in capital support in 2017. In Tajikistan, the government also intervened, providing assistance equivalent to 6 percent of GDP to the two largest banks. Some countries have also taken measures to reduce dollarization and to strengthen prudential requirements related to foreign exchange rate risk.

Still, financial sector vulnerabilities remain high. While the asset quality of CCA commercial banks has deteriorated, the overall magnitude of the situation is difficult to assess, and bank balance sheets remain exposed to FX risk. Official data show significant NPLs, ranging from 4 percent to 5 percent in Georgia and Armenia to 50 percent in Tajikistan. However, a broader definition of problem loans—including watch loans, restructured loans, write-offs, and transfers to special-purpose vehicles—reveals weaker asset quality. Regulatory shortcomings also may have created incentives to mask deteriorating asset quality.[8]

Financial inclusion is limited. While the level differs among CCA countries, financial inclusion is, on average, lower than the EMDE average. For example, outstanding deposits with CCA commercial banks averaged about 30 percent of GDP in 2016, compared with about a 62 percent average for non-CCA EMDEs. Within the CCA region, this figure ranges from 40 percent in Georgia to 22 percent in Uzbekistan. According to surveys, households cite insufficient savings, expenses associated with holding a bank account, inadequate documentation, distance, and lack of trust in banks as reasons for the low use of financial services. Firms said they do not apply for loans because of unfavorable interest rates, complex application proce-

[8]For example, official regulatory ceilings on NPLs (in Kazakhstan, for instance, NPL ratios could not exceed 10 percent) have likely encouraged banks to underreport these loans, leading to under-provisioning.

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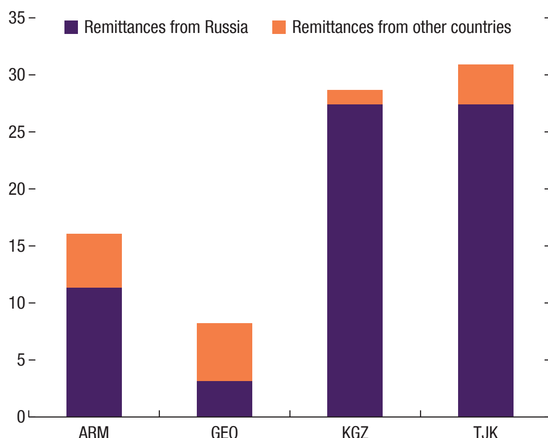
Figure 15. CCA Oil Importers: Remittances, 2014–16 Average
(Percent of GDP)



Source: Bloomberg.

dures, or insufficient collateral requirements, or because they do not need financing (Ayyagari, 2015).

Under these conditions, CCA banking sectors are not in strong shape to support integration, diversification, and more inclusive and sustainable growth. Credit growth (at constant exchange rates) declined by 30 to 40 percentage points in Azerbaijan and Tajikistan during 2015–16. The fall was less pronounced in Armenia, Georgia, Kazakhstan, and the Kyrgyz Republic. While there has been some recovery in credit growth in Armenia and Georgia, weak balance sheets and legacy impairments have had a negative effect on confidence in general and have weakened banks' lending ability.

Correspondent Banking Relationships

Greater access to CBRs would stimulate greater economic ties and opportunities for the region. Banks that can maintain or increase their CBRs—related to trade finance, remittances, and any transactions that require settlement in foreign currency—are able to process higher dollar-volume amounts and stimulate cross-border financial flows (IFC 2017a). By the same token, a decline in the number of CBRs is a concern, because it can affect the ability to send and receive international payments or may drive payments underground, with potentially adverse impacts for trade, financial stability, and growth.

Unfortunately, CBRs are under pressure in several CCA countries. A recent IMF survey on CBRs in the region found that 39 percent of banks had experienced a slight decline in the number of CBR accounts, while 13 percent had experienced a significant decline over the past three years (IMF 2018d). For example, one of the last major US-domiciled banks has recently withdrawn from the Kyrgyz banking system, compelling banks to carry out dollar-denominated transactions (such as those related to remittances) with a small number of Russian and Kazakh banks (Figure 15). Transactions in dollars are becoming increasingly difficult and costly, impeding the efficacy and profitability of the banking sector. The main reasons given by survey respondents for the decline in CBR accounts included changes in the business strategy and insufficient business to justify the cost of customer due diligence. Other factors—such as reorganization of business portfolios and enforcement

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actions by the domestic authority on relevant foreign financial institutions—were reported to play a smaller but still significant role.

Capital Markets

CCA capital markets are relatively underdeveloped, impeding regional integration. While there are differences within the region, the nonbank share of financial system assets is generally small, private equity markets are underdeveloped, and the insurance business is picking up very slowly (IMF 2014). Local debt markets are small to nonexistent. Some firms have been able to issue debt instruments domestically, but trading is thin. Interbank markets (such as a repurchase market in Kazakhstan) help with bank liquidity, and foreign exchange swap markets are becoming more active.

Kazakhstan has ambitions to develop a regional financial center in Astana. The Astana International Financial Centre (AIFC) opened in 2018 with the aim of establishing a financial hub to attract investments from Central Asia, China, and the Middle East. The Astana International Exchange has partnered with NASDAQ and the Shanghai Stock Exchange, which is a part owner. The AIFC is in a special economic zone offering tax incentives, easier procedures for foreigners to acquire work permits, and use of English as its official language, and it is regulated by a court and international arbitration center based on English law. The AIFC's development will require further development of capital markets and addressing governance issues in Kazakhstan and the region (see later sections). The financial center will have to compete with other regional financial hubs in China and the Middle East. International investors will be watching the progress of Kazakhstan's privatization program and Sukuk issuance.

Toward a New Business Model

A new business model for the financial system is needed in the region. This model should provide a more transparent environment for domestic finance, promote and efficiently channel savings to productive investment, and increase foreign participation. Reforms should start with fostering a stronger and more competitive banking system to enhance trust in the system and give it the ability to adapt products and services to the changing environment for investment and economic diversification. Without change, the region risks missing out on considerable opportunities for economic growth and prosperity.

No single strategy can be applied to strengthen financial resilience and efficiency—decisive action is needed simultaneously on various fronts.

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The actions depend on country-specific circumstances. Country strategies should have the broad goals of (1) strengthening financial stability, bank lending, and financial inclusion; (2) developing CBRs; and (3) developing capital markets.

Reforms are needed to enhance financial stability and facilitate bank intermediation to support economic activity and regional integration. Some comprehensive programs for enhancing financial stability and intermediation for countries in the region have been announced recently, including to improve regulatory and supervisory frameworks in Armenia, Georgia Kazakhstan, and the Kyrgyz Republic. The immediate priorities include the following:

- *Accurately assessing banking health in CCA countries.* Uncertainty about the size of problems on banks' balance sheets is hindering timely intervention. Early intervention would limit potential fiscal costs and support a speedier recovery. NPL reporting, including off-balance-sheet items, should be brought in line with international best practice, and independent asset quality reviews are needed to accurately assess the viability of banks.
- *Further strengthening prudential regulation and supervision.* Strengthening consolidated supervision and macroprudential frameworks is essential. For instance, stricter rules on banks' open positions in foreign currency and foreign-currency-denominated lending would reduce dollarization, strengthen monetary policy transmission, and facilitate economic integration. Financial supervision should also move toward a risk-based approach, and CCA banks should be encouraged to strengthen credit risk assessment to prevent further accumulation of impaired assets.
- *Improving bank governance.* In many CCA countries, weak bank governance, exacerbated by political interference and corruption, has encouraged related-party lending and excessive risk taking. Governance problems can seriously undermine credit support to the economy and growth, and efforts should be made to strengthen transparency (including establishing clear responsibility at the executive and board levels); limit public sector influence on banks; and establish independent risk management, compliance, and internal control units.
- *Strengthening bank resolution frameworks.* CCA countries need to enhance the effectiveness of their resolution frameworks, including strengthening the independence and governance of the resolution authority. State support should only be provided for viable banks under strict conditions, such as time-bound recapitalizations with clear restructuring plans. For insolvent institutions, liquidation options should provide for orderly closure while protecting retail customers through deposit insurance.
- *Promoting savings and financial inclusion.* This means developing and marketing savings products and undertaking a financial literacy campaign.

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Modern mobile banking products and payment systems should be promoted to reach the large unbanked segments of the population. Bringing the unbanked into the financial system will help channel savings into investments and contribute to a more vibrant and inclusive economy.

Efforts are needed to address issues related to CBRs, given their importance for the banking sector and the potential to improve integration and economic prospects for the region more broadly. Measures should be taken to enhance respondent banks' capacity to manage risks, improve communications between correspondent and respondent banks, remove impediments to information sharing, and strengthen and effectively implement regulatory and supervisory frameworks in line with international standards, especially those for combatting money laundering and the financing of terrorism.

Capital market development should be a part of broader financial reforms and economic integration. Efficient foreign exchange and money markets, as well as hedging instruments, are needed. The development of the corporate bond and equity markets can also be useful to channel savings for project financing and infrastructure investment and to strengthen partnerships with foreign investors. The increase in trade, investment, and infrastructure projects connected to the BRI also has the potential to increase ancillary products and services, such as insurance. Efforts to develop capital markets should be pursued on several fronts, including the following:

- *Modernizing infrastructure.* Modernizing financial sector infrastructure can expand and deepen capital markets. Modernization programs should include reviewing and updating securities and capital markets laws to ensure transparent rules for issuers and investor protection; creating appropriate regulations and robust supervisory arrangements; and upgrading settlement, clearing, and payment infrastructure and operations to international standards (IFC 2017b).
- *Money and foreign exchange markets.* In the money and foreign exchange markets, the central bank can play a role in monitoring market developments and behavior, and can act as a safety valve in emergency situations. Developing the Treasury bill market would help support money market development and cash management.
- *Equities.* The NASDAQ exchange in Armenia and cooperation between Kazakhstan and Euroclear to open the domestic bond market are good examples of regional initiatives to develop markets and infrastructure and to adopt international standards. Countries should ensure that regulations and taxes do not unduly constrain market development.
- *Debt markets.* Governments should develop medium-term debt management strategies that integrate market development objectives. As part of such a strategy, it is important to establish a sovereign benchmark yield

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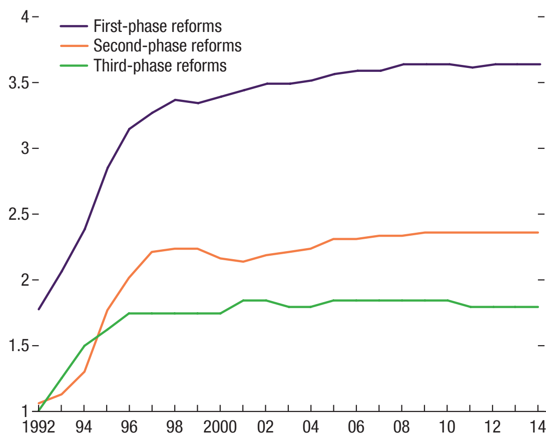
Figure 16. Three Stages of Reform in the CCA
(Average Transition Indicators)



Source: European Bank for Reconstruction and Development.

curve for the pricing of corporate debt; an issuance strategy; an effective auction and primary dealer system; market support mechanisms, including buy-back operations to establish benchmarks and trading; and incentives to grow the investor base. Governments could also consider using capital markets to help finance infrastructure projects.

Structural Reforms

Ambitious structural reforms will be needed to support successful economic integration. The current growth model—heavily reliant on commodities, remittances, and public spending— is susceptible to shocks and will not generate sufficient growth and jobs needed to reduce poverty. The region has considerable potential and opportunities to diversify, open economies up to foreign trade and investment, and boost growth. To support these objectives, reforms will need to address impediments to private sector activity, productivity, and growth. Efforts to strengthen infrastructure, the business environment, governance, and labor skills will be particularly important, because gaps in the region remain considerable in these areas and because progress on these fronts would make countries more attractive to outside investors and support regional and global integration.

Opportunities for Greater Integration and Private Sector Activity

Reforms in the region should aim to raise productivity growth and facilitate deeper economic integration. Empirical analysis (Dabla-Norris, Ho, and Kyobe 2016) suggests that the effectiveness of structural reforms to raise productivity depends on a country's income level and its distance to the technology frontier. Thus, for instance, to maximize productivity gains, low-income countries may benefit more from removing price controls and liberalizing trade, whereas emerging markets can benefit more from enhancing the efficiency of banking systems, developing capital markets, and strengthening the business environment. CCA countries have already completed many of the stage 1 or "market-enabling" reforms: price liberalization, privatization of small firms, and exchange rate unification as defined by the European Bank for Reconstruction and Development's framework for transition economies (Figure 16). Progress on market-deepening and market-sustaining reforms

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Table 4. Transition Indicators[1]

	Corporate Sector				Energy		Infrastructure				Financial Sector			
	Agribusiness	Industry	Real Estate	ICT	Natural Resources	Electric Power	Water	Urban Transport	Roads	Railways	Banking	Insurance	Private Equity	Capital Markets
Armenia	32	3	32	3	21	31	32	21	32	21	21	2	1	2
Azerbaijan	21	2	2	22	21	21	22	2	21	21	2	2	1	22
Georgia	32	32	32	32	2	31	2	21	21	3	32	2	1	22
Kazakhstan	32	2	3	3	22	3	21	21	32	3	21	21	22	2
Kyrgyz Republic	21	2	21	3	22	21	2	2	22	1	2	22	1	22
Tajikistan	2	22	22	21	1	2	2	2	22	1	2	22	1	1
Turkmenistan	1	1	1	22	1	1	1	1	1	1	1	22	1	1
Uzbekistan	2	1	2	2	1	21	22	2	1	32	1	2	1	1
CCA	21	2	21	21	22	21	2	2	2	2	2	2	1	22

Source: EBRD Transition Report 2016-17.
[1]Transition Indicators range from 1 to 4+, with 1 representing little or no change relative to a rigid, centrally planned economy and 4+ representing the standards of an industrialized market economy.

(stages 2 and 3)—which include governance reforms, financial deepening, privatization of larger firms, commercialization of infrastructure, and other elements to strengthen the business environment (for example, contract enforcement and property rights)—are not as well advanced. A recent study by Funke, Isakova, and Ivanya (2017) suggests that improvements to strengthen institutions, develop infrastructure, enhance financial market development, and improve labor market efficiency could have high payoffs for growth in the region.

Inadequate infrastructure is a key impediment to growth and integration. EBRD transition indicators show that Kazakhstan and countries in the Caucasus have made more inroads in developing infrastructure—including roads, railways, water, electric grids, and information and communications technology—than other CCA economies (Table 4). Infrastructure investments in countries like Kazakhstan and Georgia are central to their development plans and have gathered support from international partners.[9] Reforms in Tajikistan, Turkmenistan, and Uzbekistan are less advanced.

A strong business environment is key to fostering innovation, productivity, and growth. The World Bank's Doing Business Indicators, which measure the quality and effectiveness of business regulation, show considerable dispersion across CCA countries (Table 5). Georgia, with an overall ranking of 9 out of 190 countries, has implemented the highest number of business regulation reforms (47) since the launch of the report in 2003. Other countries in the region—with the exception of Tajikistan and Turkmenistan, which

[9]Georgia's ambitious public investment plans include the development of an east-west highway and a north-south corridor by 2020, with support from international partners. In Kazakhstan, the development of road and rail corridors complements international integration via the BRI.

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Table 5. Doing Business Indicators[1]

	DTF	Ranking								
	Distance to Frontier	Overall Rank	Starting a Business	Construction Permit	Get Electricity	Property Registr.	Paying Taxes	Border Trading	Contract enforce	Resolve Insolvency
Armenia	72.5	47	15	89	66	13	87	52	47	97
Azerbaijan	70.2	57	18	161	102	21	35	83	38	47
Georgia	82.1	9	4	29	30	4	22	62	7	57
Kazakhstan	75.4	36	41	52	70	17	50	123	6	39
Kyrgyz Republic	65.7	77	29	31	164	8	151	84	139	119
Tajikistan	58.8	123	57	136	171	90	132	149	54	148
Turkmenistan	…	…	…	…	…	…	…	…	…	…
Uzbekistan	66.3	74	11	135	27	73	78	168	39	87
CCA	70.1	60.4	25.0	90.4	90.0	32.3	79.3	103.0	47.1	84.9

Source: World Bank Doing Business Report 2018.
[1]Doing Business Distance to Frontier (DTF) is measured on a scale of 0 to 100, where 100 represents the frontier, whereas a rank closer to 1 represents a more friendly business environment.

are not ranked—rank in the top half of countries overall, but there is scope for improvement, notably in access to electricity, construction permitting, paying taxes, strengthening insolvency procedures, and enhancing customs procedures.

Governance needs to be improved. The CCA region continues to lag behind on most governance indicators (Box 5). Tackling corruption, increasing voice and accountability, and strengthening the rule of law would encourage investment and strengthen the region's growth potential. While specific measures differ from country to country, efforts to strengthen governance and weed out corruption will require political leadership and greater voice, efforts to address money laundering, and improved procurement and fiscal transparency. More effort is also needed to strengthen the rule of law, including the judicial framework, property rights, and contract enforcement.

Strengthening labor markets and skills would yield significant benefits as the region opens up. The region needs to prepare its labor force, and particularly its youth, for the business and labor market opportunities that will present themselves with the opening up of markets to foreign trade and investment. The unemployment rate remains relatively high in Armenia, Georgia, and Tajikistan, and youth unemployment throughout the region is typically twice as high as overall unemployment (Figure 17). While the education system is generally strong, school-to-work transition is weak, and vocational education and job-related training are not adequate. This is reflected in large labor market and business skill gap indicators (Table 6). With youth and rural unemployment high and employment concentrated in the low-productivity agricultural sector, it will be important for countries to develop the skills that are increasingly in demand in the global labor market (for example, skills in

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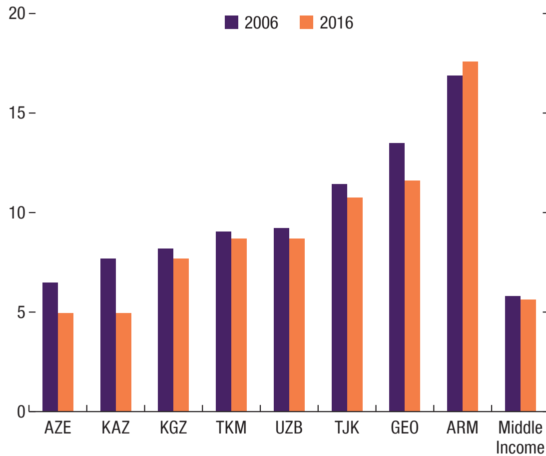
Figure 17. Unemployment Rate
(Percent of labor force)



Source: World Bank, World Development Indicators.

Table 6. Development and Inclusion Gaps[1]

	Ranking		
	Education	Labor Markets	Buisness Skills
Armenia	Medium	Medium	Large
Azerbaijan	Small	Large	Large
Georgia	Small	Medium	Large
Kazakhstan	Medium	Small	Large
Kyrgyz Republic	Small	Large	Large
Tajikistan	Small	Large	Large
Turkmenistan	N/A	N/A	Large
Uzbekistan	Medium	Small	Large

Source: EBRD Transition Report 2016–17.
[1]"Small" represents a better country rank

information technology and critical thinking) and that will facilitate integration into GVCs. Labor market regulation—including hiring and redundancy rules, employee protection, and wage regulations—could be improved in a number of countries in the region to ensure adequate flexibility and protection. For example, more flexible employment contracts in countries such as Armenia, the Kyrgyz Republic, Tajikistan, and Uzbekistan would generate employment while facilitating labor market flexibility.[10]

[10]For example, these countries do not allow fixed-term contracts for permanent tasks, which is the practice in most countries.

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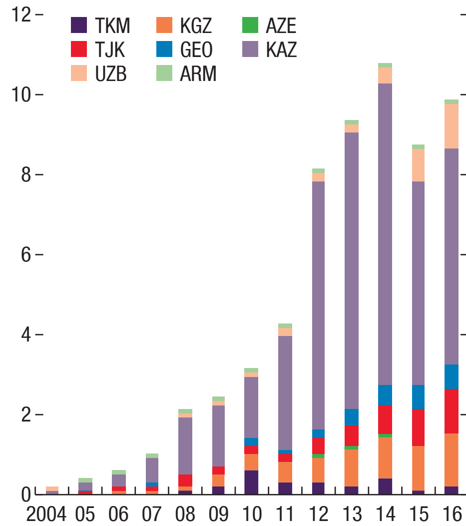
Box 1. The CCA and the BRI

China's Belt and Road Initiative (BRI), unveiled by President Xi Jinping in 2013, involves all Caucasus and Central Asia (CCA) countries. The initiative focuses on strengthening economic ties and cooperation along the Silk Road connecting China to Europe via Central Asia (Silk Road Economic Belt) and the Indian Ocean (Maritime Silk Road). While the focus has been on infrastructure investment—including roads, railways, and power grids—the initiative covers broader cooperation, including trade facilitation and technical assistance. The BRI is one of the largest and most complex investment projects in history, covering more than 65 countries—the equivalent of 65 percent of the world's population and 40 percent of global GDP as of 2017.

The BRI presents considerable investment and trade opportunities for the CCA. China's outward direct investment (ODI) to the region through the end of 2016 amounted to nearly $10 billion (Figure 1.1). Kazakhstan has been the primary beneficiary, with over $5 billion in investment (4 percent of GDP). For the Kyrgyz Republic and Tajikistan, investments have been significant (in excess of $1 billion each), representing nearly 17 percent and 19 percent of their countries' GDP, respectively (Figure 1.2).

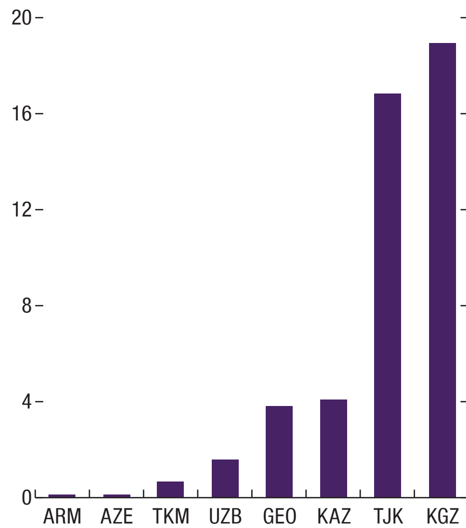
While economic opportunities under the BRI are considerable and expected to grow, the initiative also entails risks that need to be managed. Specifically, fiscal risks associated with public investment and infrastructure spending need to be mitigated and public debt sustainability maintained (see main text section on fiscal policy and frameworks). In addition, higher investment and growth could lead to a deterioration in the current account, which could be only partially offset by higher capital inflows. Greater exchange rate flexibility should help mitigate such risks (see section on monetary frameworks in the main text).

Figure 1.1. China's ODI Stock in CCA, 2016
(Billions of US dollars)



Source: CEIC database.

Figure 1.2. China's ODI Stock in CCA, 2016
(Percent of GDP)



Source: CEIC database.

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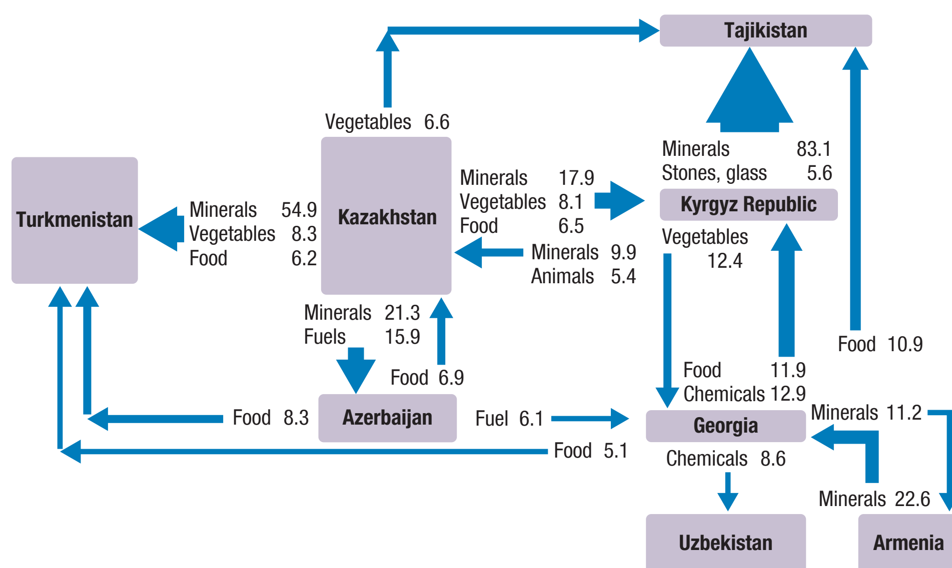
Box 2. Potential to Enhance Regional Trade

The potential to increase regional trade among the Caucasus and Central Asia (CCA) countries can be assessed by the revealed comparative advantage (RCA) index.[1] The RCA index has been estimated for each CCA country relative to each of its regional trading partners in 16 broad sectors. Data limitations precluded the calculation of the RCA for Tajikistan, Turkmenistan, and Uzbekistan relative to other CCA countries. However, bilateral export flows of Armenia, Azerbaijan, Georgia, Kazakhstan, and the Kyrgyz Republic allow the identification of some underused potential for regional integration within these CCA countries (Figure 2.1). Given their level of development, the largest potential to enhance trade integration among CCA countries in the near term exists mainly in the trade in primary commodities, foods, and metals. While there is no visible RCA for CCA countries relative to each other in machinery, transportation equipment, and other manufactured products, opportunities should be explored (also in

Figure 2.1. Revealed Comparative Advantage
(Pairwise indices)



Source: IMF staff calculations.

[1]RCA is a measure of a country's relative advantage in a specific sector as evidenced by trade flows. If the index is higher than 1 in a sector, a country's share of exports in that sector exceeds the global export share of the same sector. In this case, the country has a relative advantage in that sector. The RCA index can also be interpreted as an indicator of direction and broad sectors for potential additional export flows between two countries.

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Box 2. Potential to Enhance Regional Trade *(continued)*

the context of global integration), as greater specialization would provide opportunities for entering global value chains and boost competitiveness and growth.

Kazakhstan has the largest potential for additional exports, though RCA exists for most countries in the region. In particular, Kazakhstan has an RCA in minerals compared with Turkmenistan, the Kyrgyz Republic, and Azerbaijan. Substantial additional exports of vegetables and foods are also possible from Kazakhstan to Tajikistan, Turkmenistan, and the Kyrgyz Republic. Additional large trade potential seems to exist between the Kyrgyz Republic, which has an RCA over Tajikistan in minerals exports, and between Georgia and Armenia in different types of minerals. Georgia could sell more chemicals to the Kyrgyz Republic and Uzbekistan.

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Box 3. Limited Success of Integration Initiatives in the CCA

Greater economic integration has been a consideration for the Caucasus and Central Asia (CCA) countries practically since the breakup of the Soviet Union in 1991. As early as December 1991, the Commonwealth of Independent States (CIS) was founded among the eight CCA countries plus Belarus, Moldova, Russia, and Ukraine. In 1994, 11 CIS countries (all but Turkmenistan) agreed to create a CIS-wide free trade area, but agreements were not signed or ratified by the full group. A customs union among Belarus, Kazakhstan, and Russia was established in 1996 and was extended as the Eurasian Economic Community (EAEC) in 2000 to the Kyrgyz Republic and Tajikistan. The Eurasian Economic Union succeeded the EAEC in 2014–15, comprising Belarus, Kazakhstan, and Russia, and later Armenia and the Kyrgyz Republic. Other groupings and affiliations have included the following:

- Membership of seven CCA countries (excluding Armenia) in the Central Asia Regional Economic Cooperation program, focused on transportation, trade, and energy/utility projects, which have totaled $31.5 billion in investments since 2001.
- Membership in the Shanghai Cooperation Organization (SCO), formed in 2001–03 to foster policy dialogue among Kazakhstan, the Kyrgyz Republic, Tajikistan, and Uzbekistan, along with China and Russia, and later India and Pakistan. Armenia and Azerbaijan are SCO "dialogue partners."
- China's Belt and Road Initiative, which covers more than 65 countries, including all CCA countries (see Box 1).
- Partnership and free trade agreements between Caucasus countries and the European Union.
- Membership of several CCA countries in the World Trade Organization.

While progress has been made in building capacity and institutions and upgrading infrastructure and connectivity, integration has not proceeded as strongly as suggested by these initiatives. Slow progress reflects a range of factors:

- Structural factors. One restraining factor has been the importance in most CCA countries of primary commodity production and export, including hydrocarbons, minerals, metals, grain, cotton.
- Macroeconomic factors. Volatility of growth and inflation in the CCA is among the world's highest, in part reflecting volatile prices and the importance of natural resources. Recessions in 1998 (Russian crisis), 2008–09 (global financial crisis), and 2014–15 (oil price shocks) were setbacks.
- Institutional and policy variation. The years since independence have been marked by an extended period of building national institutions and policy frameworks, including those related to fiscal policy, business environments, and the rule of law. Convergence of policy frameworks (tax bases and rates, regulations) has not been a central objective.

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Box 3. Limited Success of Integration Initiatives in the CCA *(continued)*

- Political-economic and governance challenges. These challenges have limited domestic and foreign investor (including those from other CCA countries) interest in many CCA countries. Business openings have often gone to nationals, especially political elites.
- Geopolitical challenges. These challenges have included tensions in the Caucasus and Central Asia, and dislocations linked to sanctions against Iran and Russia.

It will be important to overcome these challenges in the future, including with a strong spirit of openness and commitment to ensuring that integration extends beyond membership in regional groups to meaningful support from the highest levels for real integration—at borders, at grassroots levels, and among national institutions and agencies that are critical for facilitating trade and exchange, coordination, monitoring, and enforcement. The change in policy direction in Uzbekistan and the opening of trade, transport, energy, and visa links and other contacts with regional neighbors is encouraging, and should be emulated by the rest of the CCA countries.

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Box 4. Uzbekistan's Liberalization Strategy

In February 2017, the government of Uzbekistan introduced a broad-based program to develop the Uzbek economy; this program is being rapidly implemented and has the potential to markedly strengthen Uzbekistan's growth prospects and improve living standards. The program also presents an opportunity for enhanced economic cooperation among Caucasus and Central Asia countries, with significant positive economic benefits for the region. The following are some of the principal elements of the program:

- *Foreign exchange liberalization.* The Uzbek sum has been floated, and restrictions on the purchase and sale of foreign exchange (including repatriation requirements) have been lifted. Preparations are underway to move to inflation targeting in the medium term.
- *Trade liberalization.* Licensing requirements for foreign trade are being simplified, and previous monopolies (such as those related to the import and export of agricultural products) are being opened to competition. Customs procedures for transit of goods through Uzbekistan are being simplified.
- *Strengthening of transportation and utility networks.* Rail and road connections are being actively promoted, including the recent openings of the Angren-Pap railway line linking China and Central Asia, and the Turkmenabad-Farab road and railway bridge. Significant efforts are also underway to boost energy production and exports, with support from the World Bank and the Asian Development Bank.
- *Travel.* Visa requirements are being lifted for a growing number of countries, and the exit visa system is being abolished. Regulations and processes for border crossing have been simplified and new crossing points opened with Kazakhstan, the Kyrgyz Republic, and Tajikistan.
- *Migration.* The framework regulating Uzbek labor in Russia has been improved to provide workers with more rights and security.

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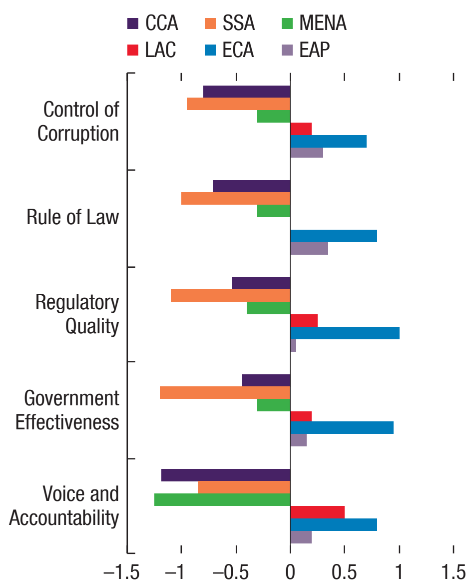
Box 5. Governance

Governance is a broad concept covering all aspects of how a country is governed, including its economic policies, regulatory framework, and adherence to the rule of law. Poor governance offers incentives and opportunities for corruption (the abuse of public office for private gain), which undermines public trust, threatens market integrity, distorts competition, and endangers economic development.

Good governance thus matters for economic development and growth. Well-functioning political institutions maintain good policies even through changes in governments and protect investors from arbitrary government decisions and expropriation (Acemoglu and others, 2008; IMF 2015b, 2018b). Political stability, robust and business-friendly regulations, and legal certainty also improve the investment climate, which is conducive to growth.

Governance challenges vary across the Caucasus and Central Asia (CCA). The Worldwide Governance Indicators suggest that CCA countries lag behind other regions, particularly in controlling corruption, enforcing the rule of law, and strengthening voice and accountability.[1] Among the CCA countries, Georgia stands out as having better scorecards in most dimensions of governance, particularly in government effectiveness, regulatory quality, and controlling corruption.

Figure 5.1. Governance Indicators, 2016



Source: World Bank, Worldwide Governance Indicators.
Note: CCA = Caucasus and Central Asia, SSA = Sub-Saharan Africa, MENA = Middle East and North Africa, LAC = Latin American and Caribbean, ECA = Eastern Europe, EAP = East Asia and Pacific.

CCA countries need to tackle governance issues more forcefully. Weeding out corruption will be key to improving the investment climate. While specific anticorruption measures differ from country to country, strong vested interests and ties make monopolistic economic structures, rent seeking, and corruption difficult to overcome. Change will need to come from government leadership. Specific areas where more could be done to enhance transparency and boost anticorruption efforts include strengthening Anti-Money Launder-

[1]The World Bank's Worldwide Governance Indicators combine the views of a large number of enterprise, citizen, and expert survey respondents in industrial and developing countries. While useful as a tool for broad cross-country comparisons and for evaluating broad trends over time, they are often too blunt for formulating specific governance reforms and do not represent the IMF's assessment of the level of governance in a particular country.

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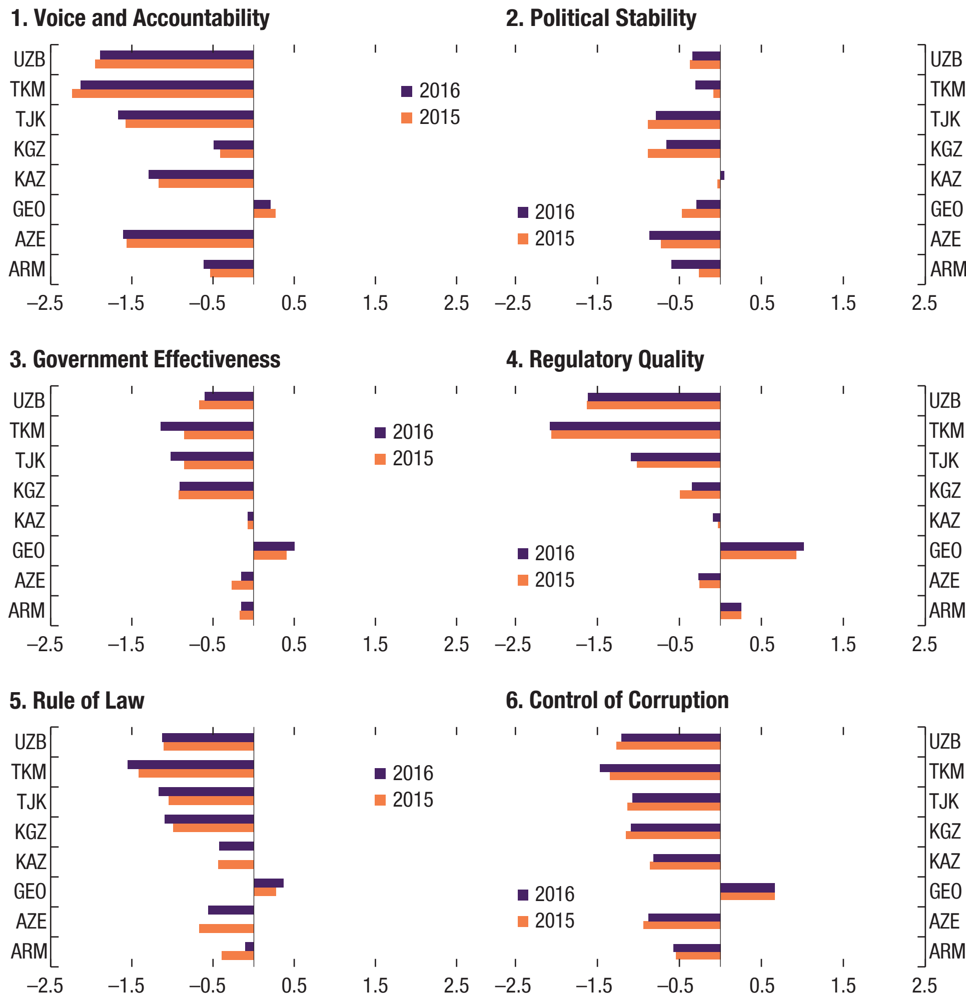
Box 5. Governance *(continued)*

Figure 5.2. Governance Indicators in CCA Countries, 2015 and 2016



Source: World Bank, Worldwide Governance Indicators.
Note: Ranges from approximately –2.5 (weak) to 2.5 (strong) governance performance.

ing/Combating the Financing of Terrorism in line with the Financial Action Task Force (FATF) standards, establishing procurement laws, and improving fiscal reporting.

Efforts are also needed to strengthen the rule of law, including the judicial framework, to improve property rights, contract enforcement, and insolvency procedures. Improving the quality of the judiciary—in terms of both its technical capacity and its independence from private influence and public interference—is key to ensuring predictability and the enforcement of economic rights, and promoting investment.

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