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034519/EU XXIII.GP
Eingelangt am 07/04/08

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COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 7.4.2008
SEC(2008) 417

COMMISSION STAFF WORKING PAPER

ANNEX TO THE

PROPOSAL FOR A COUNCIL DECISION

**on the eligibility of Central Asian countries under Council Decision 2006/1016/EC
granting a Community guarantee to the European Investment Bank against losses
under loans and loan guarantees for projects outside the Community**

**Background information on five Central Asian countries: Kazakhstan, Kyrgyzstan,
Tajikistan, Turkmenistan and Uzbekistan**

{COM(2008) 172}

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1. INTRODUCTION

This Commission Staff Working Paper (the "Paper") is an annex to the proposal for a Council Decision on the eligibility of Central Asian countries under Council Decision 2006/1016/EC granting a Community guarantee to the European Investment Bank against losses under loans and loan guarantees for projects outside the Community {COM (2008) xx}.

The Paper provides background information on the economic situation of five Central Asian countries, namely Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan, thus supporting the Commission's proposal for the establishment of the eligibility for European Investment Bank ("EIB") financing under Community guarantee in accordance with Council Decision 2006/1016/EC.

2. ECONOMIC DEVELOPMENTS IN CENTRAL ASIA

2.1. Current situation

Growth in the Central Asia region has been strong in recent years, fuelled by gas and oil production and exports in Kazakhstan and Turkmenistan, gold in Kyrgyzstan and cotton in Uzbekistan. Growth in the five countries of the region was 7.3% in 2006 and is estimated at around 8.3% in 2007, with particularly strong performance in Kazakhstan and Turkmenistan. This was the eighth year in a row of growth at this pace or higher, a sustained strong performance that has nearly doubled the region's GDP in real terms over the past decade.

Despite this strong performance, unemployment rates remain in double digits throughout much of the region, largely reflecting a rapidly growing labour force. Strong external inflows resulting from high oil and non-oil commodity prices, foreign investments and remittances are fuelling credit growth, and inflation continues to edge up, though it remains moderate in most countries with average consumer price inflation in the region at around 10%. The large external inflows to the region have led to rising foreign reserves in all countries. The region's fiscal and external surpluses are still rising, but at a slower pace than in recent years. Progress in reducing debt and building official reserves has put the region in a better position to absorb shocks and address development needs.

The current account deficits of the low income countries in the region (Kyrgyzstan and Tajikistan) widened mainly due to accelerated import growth mirroring higher oil prices. Regional export performance was strong mainly due to oil receipts in Kazakhstan and Turkmenistan. Kazakhstan holds 0.6 percent of the world proven oil reserves. Turkmenistan has less oil (about 0.3 percent of world reserves in 2004), but in addition accounts for about 2.1 percent of global natural gas production.

Remittances have developed into an important source of foreign exchange for Central Asia. They have contributed to growth and poverty reduction. As percentage of GDP, remittances are particularly significant in Kyrgyzstan and Tajikistan. The booming Russian economy accounts for 50 to 80 percent of remittance inflows. The remainder comes largely from Western Europe, the United States, Turkey and Kazakhstan. The majority of migrant workers in Russia are employed in construction, trade-related services, oil and gas, and agriculture. Monthly dollar wages in Russia have approximately tripled since 2001. The growth of remittances is projected to continue as long as high energy prices keep fuelling the Russian

economy. Economic growth has benefited from the rise of remittances through their impact on consumption. Also remittances have been important for alleviating poverty especially in Tajikistan. Moreover, remittances are a crucial source of external current account financing in Kyrgyzstan and Tajikistan, thus contributing to macroeconomic stability.

Yet, Central Asia remains poor and a gap is opening up between those countries with oil and gas, and those without. Agriculture accounted for about 50 percent of the Kyrgyz economy in 2006, but for just 6.3 percent of Kazakhstan's. Per capita incomes in the oil producers in 2006 were more than eight times higher than those in Kyrgyzstan, Tajikistan and Uzbekistan. In 2007, the per capita GDP in Kazakhstan was \$6,314, while in Tajikistan it was \$449.

2.2. Outlook

Macroeconomic performance prospects in the Central Asia region remain very good for the near future. Growth is expected to remain high in 2008, at 7-8 percent on average, but inflation has picked up considerably towards the end of the last year. There are however some risks to growth. The region remains heavily dependent on volatile oil and non-oil commodity prices. Moreover, performance could be significantly affected if global growth were to slow or global financial market conditions were to tighten, which could significantly reduce external inflows to the region.

While progress in building reserves and reducing debt has put the region in a better position, policies should continue to aim at strengthening the region's resilience to such developments. In particular:

- (1) The authorities in all five countries could limit inflationary pressure by tightening monetary policies and allowing more nominal exchange rate appreciation in response to continued foreign exchange inflows.
- (2) Governments should be vigilant to the risks of a new cycle of excessive external borrowing, whether public or private. In Kazakhstan, tighter prudential measures may be needed to limit the external borrowing by banks which is financing the rapid credit growth. Kyrgyzstan and Tajikistan need to avoid excessive debt accumulation while investing to improve infrastructure.
- (3) Adjustment to higher oil prices remains a challenge. Both oil producers and consumers should ensure that changes in world oil prices are passed through quickly to domestic product prices, while strengthening compensation mechanisms for the poor.

In addition to strengthening macroeconomic management, the region's resilience to shocks will be boosted by structural and institutional reforms that should continue. These reforms are expected to foster private sector development, increase productivity and ultimately improve the business climate and make these countries more attractive for investments. Also, increased regional cooperation would promote trade and investment, and improve prospects for long-term growth and poverty reduction. In this context, lending by the EIB will play a catalytic role in attracting private investments. Energy and transport infrastructure are expected to benefit most from the EIB operations.

3. COUNTRY ECONOMIES IN A NUTSHELL

3.1. Kazakhstan

Real economy

The Kazakh economy is increasingly driven by the hydrocarbon sector. In 2006, hydrocarbon activity (including transport and other related sectors) accounted for more than 30% of nominal GDP. About 30% of total government revenues were derived from the hydrocarbon sector, compared to 6% in 1999. The share of crude oil and natural gas output in industrial production has almost tripled since 1998, reaching 45%. Oil and gas exports accounted for over 55% of total export earnings. Investment in the hydrocarbon sector constituted about a third of total investment and one half of FDI.

However, output has also risen in other sectors, reflected by strong expansion in industry, construction and services. Kazakhstan's rapid economic growth continues. A favourable external environment and sound economic management set the stage for the eighth consecutive year of impressive performance in 2007, with a strong GDP growth estimated at 8.7% (after 10.7% in 2006). Like many oil-dependent countries, Kazakhstan is prone to the so-called Dutch Disease, an economic condition where sharp currency appreciation, fuelled by revenues from natural resources, makes a country's (non-oil) economy less competitive. The authorities have been able to limit the effects, thanks to the stabilisation function of the oil fund and through significant forex interventions.

Fiscal policy

The government is committed to further public sector wage increases, the budgetary impact of these measures being offset by growing oil revenues and strengthening tax administration. The budget surplus has remained high over the last years, 5.8% of GDP in 2005 (including inflows to the National Fund) and 7.8% in 2006; it was projected at 4.8% in 2007.

Investment climate

Kazakhstan's investment climate is showing a very mixed picture. The country has made significant progress toward creating a market economy since its independence in 1991. The EU in 2000 recognized the success of Kazakhstan's reforms by granting it quasi-market economy status (for the purpose of EU trade defence instruments). The OECD has recently upgraded its rating of Kazakhstan's export risk and shifted the country from its fifth risk group to the fourth.

However, outside the petroleum sector, the business climate remains difficult, notably for small and medium-scale enterprises and foreign investors. A major impediment to private sector development is lack of transparency in law enforcement, customs and tax levy. Some business climate surveys suggest mixed progress on structural reforms.

3.2. Kyrgyzstan

Real economy

Following strong real GDP growth in 2004 the new government that has been in office since the March 2005 "Tulip Revolution" has broadly maintained political stability. Economic activity in 2005 however slowed down following the political upheaval and output growth fell short of expectations. Real GDP in 2005 contracted slightly by 0.2%. In 2006, notwithstanding a serious accident in the Kumtor gold mine which limited its output by an

estimated 40%, real economy still rebounded with a GDP growth of 2.7%, mainly due to a recovery in agricultural output and manufacturing. For the year 2007 growth estimate is much higher, at 7.5%.

The 2006 accident stresses once again the economy's reliance on the Kumtor mine, accountable for about 45% of the country's industrial output and 50% of export revenue. This remains a serious concern because of the volatility of world gold prices and the risk of renewed supply-side shocks. It is also problematic over the longer term in view of the gradual depletion of Kumtor's reserves. The mine is expected to halve its output by 2009 and to contribute very little from 2015 onwards. To compensate for this loss, further development at some of the country's other gold sites is required and this has only recently begun to pick up. The economy also needs faster development in other sectors, including agriculture, tourism and financial services. Progress is lagging in a number of areas. In particular, slow improvements in the business environment, insufficient regulatory and tax reform, and the still limited size of the financial sector continue to hamper entrepreneurship and investment.

Fiscal policy

Fiscal consolidation continued in 2006. The general government deficit narrowed from 3.7% of GDP in 2005 to 2.3% in 2006, partly through improved tax collection and restraint on current expenditures. Kyrgyzstan remains dependent on financing provided by external donors, such as the IMF, the World Bank and the Asian Development Bank. General government tax receipts in 2005 recorded a revenue loss due to a reduction in the payroll tax rate introduced in January that year, while other changes in tax rates were broadly revenue neutral. In 2006, total expenditure was 27.5 % of GDP as compared to 28.3% in 2005. Social spending increased slightly in 2006. For 2007 a deficit of 3.1% of GDP was projected.

External debt

The external debt burden is large but receding. In 2005, the Government completed bilateral negotiations with all Paris Club creditors, except Turkey where an agreement was reached in March 2006, and signed debt relief agreements with Japan and the Russian Federation. These agreements follow the IMF's approval of a new arrangement under the Poverty Reduction and Growth Facility (PRGF) on 23rd February 2005. Total external debt in 2005 was slightly more than \$2 billion, or 85.1% of GDP, representing a substantial fall from recent levels. By the end of 2006 it had further decreased to 74.7% of GDP, followed by an estimated 59.1% of GDP in 2007. The bulk of external debt (about 94%) is public, and hence the debt situation is an important determinant of fiscal sustainability. Following a nation-wide heated political debate, the Kyrgyz parliament voted in early 2007 against entrance in the HIPC programme for debt relief.

Investment climate

Key challenges are to improve tax administration, adopt concrete measures against corruption, enhance effectiveness of courts and reduce bureaucracy. Infrastructure is characterised by a generally low quality of services and inefficiency, requiring extensive investment which the public sector has been unable to upgrade due to fiscal constraints. The tax levels for companies are high and related procedures are burdensome.

3.3. Tajikistan

Real economy

Tajikistan's GDP growth accelerated from 6.7% in 2005 to 7.0% in 2006, and to an estimated 7.5% in 2007, mainly due to major foreign-investment projects and strong domestic demand. Cotton and aluminium remain the traditional pillars of the economy. However diversification of the economy continued (though slowly), enlarging the share of the services sector, with trade, construction, communications and financial activities being the fastest growing sectors. The share of agriculture has declined between 1991 and 2005 from 36% of GDP to 22%. Domestic demand is driven essentially by higher private consumption spending, in turn mainly financed by strong growth in workers' remittances and, to a lesser degree, by public sector wage rises. Remittances are estimated in the 2006 balance of payments to have increased to about \$900 million, or about one-third of GDP. The remittances include small-scale export receipts, which are usually 30% of transfers. This amount is likely to double, if unofficial inflows are counted. These funds, largely from workers in Russia, have buoyed growth in services activities, such as retail trade and light manufacturing. They have also financed some investments in small enterprises.

Fiscal policy

Tax collection as a ratio to GDP has continued to increase from 15.2% in 2004 to 16.0% in 2005 and 16.4% for 2006. The government budget improved from a deficit of 2.9% of GDP in 2005 to a surplus of 1.7% of GDP in 2006 in spite of increased public sector wages. Good progress was made in reprioritizing expenditures towards social sectors such as education and health care, in line with the government's commitment under the Poverty Reduction Strategy Paper (PRSP). For 2007 a deficit of 14.1% of GDP is expected due to heavy public investments (18.8 % of GDP) which will be mostly financed by official loans from China.

External debt

Thanks to debt relief complemented with similar bilateral debt agreements with other creditors (e.g. Pakistan), external debt has fallen from 64.8% of GDP in 2003 down to 33.6% in 2006. Recently however the authorities stated that their development strategy involves a very rapid accumulation of external debt, on concessional terms, over the next three years. They intend to be constrained by a foreign debt ceiling of 60% of GDP in the medium-term future.

A new development in 2006 was related to the discussion on three new loans from China amounting to about US\$ 600 million in total, to finance projects in the infrastructure and energy sectors. It is worth stressing that the size of this new debt is roughly equal to two third of Tajikistan's previous total foreign indebtedness. Moreover, there may be further future lending from China. In addition, the government of Tajikistan intends to contract \$400 million of debt from China to build new hydroelectric power stations. Therefore, despite relief provided by the MDRI (Multilateral Debt Relief Initiative), debt distress risk has increased significantly. Also an issue has arisen concerning the amount debt of cotton farms for inputs (the so-called cotton debt) that may have to be allocated to the total public debt, following guarantees given by the authorities. The IMF is currently mapping this debt that could potentially substantially increase the (public) Debt to GDP ratio.

Investment climate

Tajikistan's business climate continues to be difficult. Tajikistan ranks 158 out of 178 countries in the World Bank's Doing Business Report for 2008 and corruption remains an important obstacle, both to business and reform. Weak governance, barriers to entry and the cost of dealing with the government are the other main constraints on businesses. The private sector in Tajikistan remains underdeveloped with a share of GDP at around 55% and private

investment at about 5% of GDP. Some progress may come however after the adoption last year of the Private Sector Development Strategy, with a new law on licensing aimed at reducing the number of business inspections and extending the duration of permits.

3.4. Turkmenistan

Real economy

With large gas reserves and a small population, Turkmenistan's export potential is huge, though substantial investments are needed to increase production. Although its 4.5 million people receive free gas, electricity and water, incomes are among the lowest in Central Asia and health and education services are declining. The Government's economic policy is still determined by central planning. It continues to rely on production targets, mandatory state procurement, directed bank credits and foreign exchange restrictions. Key sectors of the economy, including the energy sector and the banking system, remain in state hands. As public enterprises continue to operate under soft budget constraints, the Government relies on price controls and restrictions on cash withdrawals from banks to contain inflation in the consumer goods market. The Turkmen authorities have recently expressed willingness to engage more actively with international donors such as the World Bank (WB), and they have taken positive steps to address long-standing issues that hindered development of a WB program in Turkmenistan. Thus, the WB, at the request of the Government of Turkmenistan, is currently exploring ways of supporting Turkmenistan in selected areas through a small and focused technical assistance program.

The availability and accuracy of data and information continue to be major constraints in the analysis of economic developments in Turkmenistan. According to official statistics, real GDP growth in the last years was about 20%. However, it is generally accepted that the official figures are significantly overstated. The IMF estimates the real GDP growth rate over the period 2005-2007 at 9-10%. The strong expansion is supported by higher hydrocarbon prices and public investment programmes.

Fiscal policy

Fiscal policy remained tight during the past years. However, the government continues to conduct fiscal operations in a non-transparent manner and with large off-balance sheet activities. For 2007 a planned midyear budget adjustment increased spending by an additional 1% of GDP to cover new programs in education, health, and social security. Nevertheless, the overall fiscal balance is expected to remain in a small surplus of 0.4% of GDP as hydrocarbon revenue is likely to be significantly higher than budgeted.

Investment climate

Turkmenistan's economic strategy for the period until 2020 - adopted in August 2003 - differs little from previous strategies, meaning that it still sets ambitious production targets for all sectors, to be supported by extensive state-led investment. The sustainability of the government's economic policies will depend mainly on its ability to earn hard currency from commodity exports. In view of the current development of the oil-refining, gas and cotton-processing sectors, it seems likely that export revenue will hold up sufficiently to preclude the need for the government to make any progress towards introducing economic reform. The restrictive business environment will continue to deter most western foreign investors, dampening inflows of FDI.

3.5. Uzbekistan

Real economy

Developments strongly suggest that the economy, despite the above-trend growth of the last three years, is underperforming relative to its potential, largely because of the reform backlog in structural policies. GDP grew by an average of 7.4% in 2005-2007, as compared to an average of 4.2% in 1999-2003. Agriculture's contribution was helped by a record cotton crop in 2005. Industrial performance has improved over the last, with significant contributions from machinery, chemicals, and metals, in good part based on larger export sales. Also non-commodity export recorded strong growth. In 2006 on the demand side, net exports have made a positive contribution to GDP growth as the external environment remained favourable, but on the other side imports were up. In September 2007, the Government of Uzbekistan formally adopted its first Welfare Improvement Strategy (WIS), covering the period 2008-10, and transmitted the document to the World Bank (International Development Association – IDA) and the International Monetary Fund (IMF). The strategy accords a somewhat greater role to market principles and describes measures to undertake structural reforms. There is a particular emphasis on improving the business environment; it also provides a more candid assessment of economic and social challenges facing the country.

Fiscal policy

In 2005 a number of changes in tax policy were introduced, most notably further reduction in the corporate income tax from 18 to 15 % and a reduction in the sales tax levied on small enterprises. At the same time, a number of tax rate increases have been introduced, including on the use of water and land. The resulting fiscal revenue outperformed the projected budget for the period 2005-2006. On the expenditure side public wages and benefits increased but this motion was more than offset by decreasing capital expenditure. 2005 and 2006 recorded fiscal surpluses of respectively 1.3% of GDP and 3.6% of GDP. For 2007 a deficit of 2.9% is estimated.

Investment climate

Trade policy remains restrictive. Effective rates of protection against consumer imports are significant and excise tax rates on a wide range of consumer imports are higher than on domestic goods. Other regulatory “behind-the-border” barriers to trade include the regulation of wholesale and retail trade affecting the domestic marketing of imports. This regime imposes a heavy regulatory burden on individual entrepreneurs, in particular cross-border shuttle traders, who are an important source of supply for the private sector and contributes to the adverse investment environment. The poor business climate is reflected by the limited amount of FDI inflows estimated at \$ 200 million in 2005 (1.5% of GDP). Future FDI inflows however will be buoyed through hydrocarbons investments from the People's Republic of China and the Russian Federation.

4. SELECTED KEY INDICATORS

	2003	2004	2005	2006	2007 est.
Real GDP growth (% change)					
Kazakhstan	9.3	9.6	9.7	10.7	8.7
Kyrgyzstan	7.0	7.0	-0.2	2.7	7.5
Tajikistan	10.2	10.6	6.7	7.0	7.5
Turkmenistan	17.1	14.7	9.0	9.0	10.0
Uzbekistan	4.2	7.7	7.0	7.2	7.7
Nominal GDP (in USD billions)					
Kazakhstan	30.9	43.2	57.1	81.0	95.5
Kyrgyzstan	1.9	2.2	2.4	2.8	3.5
Tajikistan	1.6	2.2	2.5	2.8	3.3
Turkmenistan	11.4	14.2	17.2	21.8	26.2
Uzbekistan	10.1	12.0	13.7	16.1	18.8
GDP per capita (in USD)					
Kazakhstan	2,064	2,863	3,785	5,363	6,314
Kyrgyzstan	380	434	473	542	662
Tajikistan	248	329	364	411	449
Turkmenistan	2,347	2,871	3,418	4,280	5,055
Uzbekistan	396	463	520	605	699
Inflation (% change)					
Kazakhstan	6.4	6.9	7.6	8.6	8.8
Kyrgyzstan	3.1	4.1	4.3	5.6	12.6
Tajikistan	16.4	7.2	7.3	10.0	11.4
Turkmenistan	5.6	5.9	10.7	8.2	6.5
Uzbekistan	14.8	8.8	21.0	19.5	10.4
Unemployment rate (%)					
Kazakhstan	8.8	8.4	8.1	7.8	7.6
Kyrgyzstan	8.9	9.0	9.7	10.0	10.4
Tajikistan	2.4	2.0	2.1	2.3	2.5
Turkmenistan	n.a.	n.a.	n.a.	n.a.	n.a.
Uzbekistan	n.a.	n.a.	n.a.	n.a.	n.a.
General Government Budget balance (% of GDP)					
Kazakhstan	2.7	2.5	5.8	7.8	4.8
Kyrgyzstan	-4.7	-4.4	-3.7	-2.3	-3.1
Tajikistan	-1.8	-2.4	-2.9	-3.4	-14.1
Turkmenistan	-1.3	0.4	0.8	5.1	0.4
Uzbekistan	0.1	0.6	1.3	3.6	2.9
Total Gross Public Debt (% of GDP)					
Kazakhstan	14.9	11.4	8.1	6.8	5.6
Kyrgyzstan	106.9	92.7	85.1	74.7	59.1
Tajikistan	64.8	43.1	41.9	33.6	41.9
Turkmenistan	13.6	9.2	5.4	3.3	2.0
Uzbekistan	41.6	35.1	29.5	22.6	18.6
Current Account Balance (% of GDP)					
Kazakhstan	-0.9	0.8	-1.8	-2.2	-2.2
Kyrgyzstan	-4.4	-3.5	-2.3	-16.8	-17.9
Tajikistan	-1.3	-3.9	-2.5	-2.9	-11.6
Turkmenistan	2.7	0.6	5.1	15.3	11.7
Uzbekistan	8.7	10.1	14.3	19.4	19.7