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Challenges of economic development in Azerbaijan

Namig Tagiyev and Elvin Afandi

The economic performance of Azerbaijan is analyzed by separating three major economic development stages of the country but giving priority to the current period and its main principals. Besides, some important economic policy objectives of the government are listed too.

After retrieving the independence of Azerbaijan, the transformation of political and socio-economic system - establishing an independent national economy that is based on democratic institutions and functioning market economy - became of a pivotal importance. Since then, the government has faced several important challenges such as the consolidation of independence; the establishment of a democratic, legal and secular state; the transition to market economy; the maintenance of territorial integrity of the country; the improvement of the population's safety welfare.

The economic development from the date of regaining independence until present days can be divided into three major stages. The first stage is the period of economic decline in 1991-1995. The second stage is the period of macroeconomic stabilization and dynamic growth in 1996-2004. The third, current stage has been characterized by significant socio-economic development since 2005.

Economic decline

In course of the first stage, negative tendencies were observed in case of all economic indicators. Among these, the decline of real GDP has to be strongly underlined, which was a result of the dramatic decrease of production volume in the country. In general, the collapse of the Soviet markets and unsystematic economic reforms implemented during 1991-1995 caused serious problems. The financial and banking system experienced paralysis. The budget deficit went up to 13% of GDP in 1994, and the whole deficit was financed by the National Bank through excessive increase of money supply. In 1992-1994, the emissions comprised 40-45% of money incomes of the population. In 1992-1994, the ratio of credit volume to GDP equaled to 55-60%. In 1994, interest rate of the National Bank amounted to 250%. The national currency which was introduced in 1992, started to depreciate soon and by 1995, the exchange rate depreciated 245 times against the US dollar. The inflation in the country reached its peak during that period. In 1992-1994, the foreign trade turnover volume decreased by 42%. Up to 1994, there were no foreign investments in the country. During this period, the real money incomes of the population decreased drastically and the poverty level dramatically increased.

Macroeconomic stability and dynamic growth

Since 1995, Azerbaijan has obtained a number of achievements in socio-economic development and integration to world economy. However, the greatest achievement is the new Azerbaijani model that has been launched during the establishment of the independent state, in terms of economic reforms and development.

During the second stage, as an official base for realizing the mentioned model, several large-scale policy documents (conception, strategy and programs) were adopted. Furthermore, the economic reforms with the frame of support from several financial institutions (especially the International Monetary Fund) were conducted through various programs.

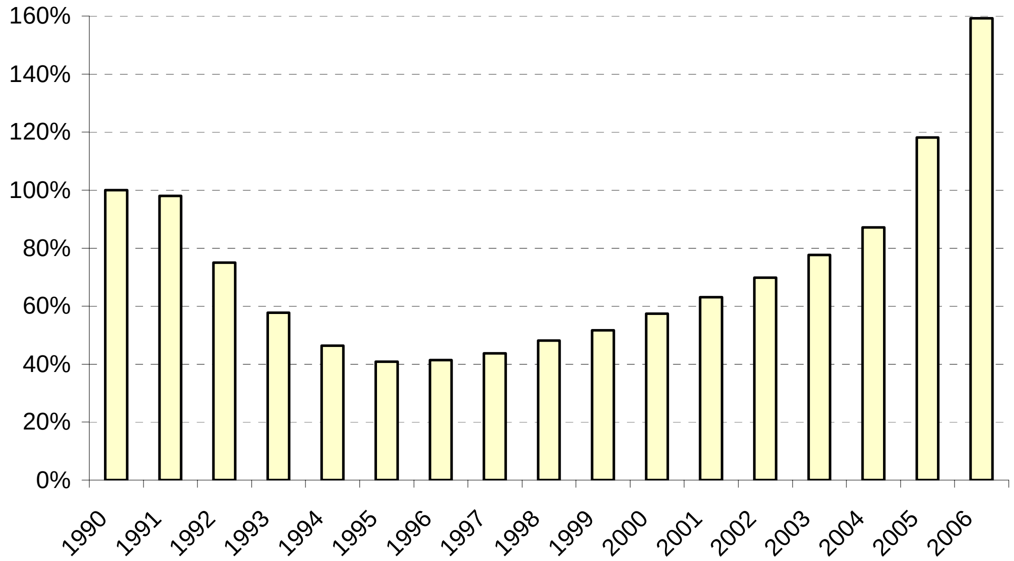
Here we should note that the strategic directions of the Azerbaijan model are built upon sustainable and dynamic development logics. This model's main objectives are to form single socio-oriented economic system – independent national economy that is built upon functioning market economy and self-development potential. It actively involves natural-economic, technical-production and scientific–technical potential, ensures efficient integration of national economy into world economy as well as the country's accession to WTO. It maintains dynamic development and puts into practice the sustainable development model.

The most illustrative proof of the viability and efficiency of the economic reforms were the achievements obtained in the socio-economic sphere in recent years. The inflation was restrained, as the inflation level in Azerbaijan has never exceeded 2-3% since 1996, only in 2004, when it equaled to 6.7%. The practice of funding the budget deficit by the National Bank was dropped, and the budget deficit decreased to 1-2% of GDP. Thanks to these changes, the macroeconomic stability was achieved in 1996, and since 1997, it has become possible to ensure dynamic economic development, as after 1.3% real GDP growth rate in 1996 it reached 5.8% in 1997, and averaged around 10% between 1998 and 2004.

Current development trajectory

Most economists do not agree with that the independent Azerbaijan stepped into its third economic development phase in 2005. To prove this it is sufficient to provide the analysis of some macroeconomic indicators.

Chart 1. Development of real GDP in 1990-2006 (at 1990 prices, %)



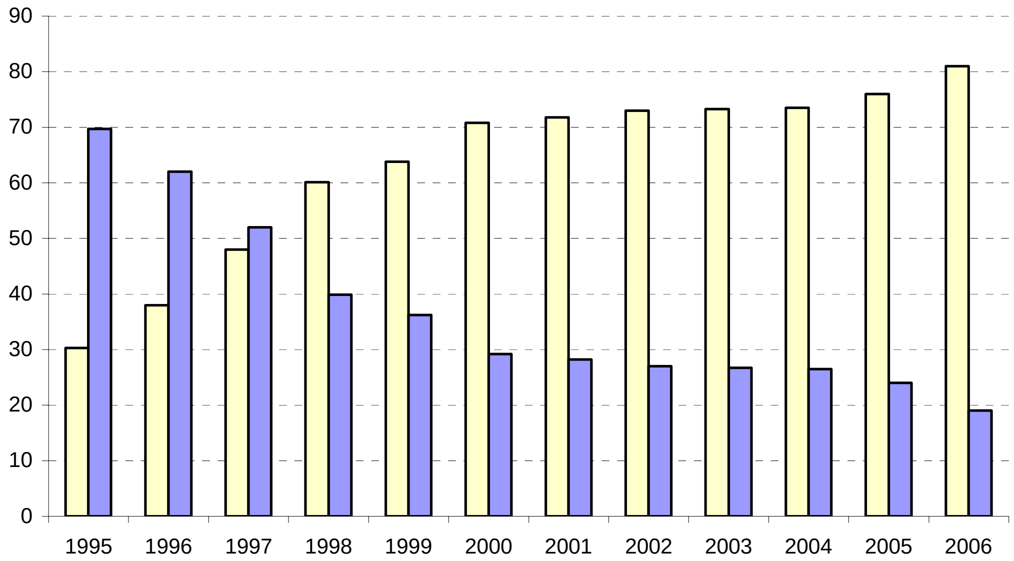
Source: State Statistics Committee of the Republic of Azerbaijan, own calculations

Having a look on *Chart 1,* real GDP growth has been negative in course of 1991-1995, and the economy has recovered in 1996. The volume of the real GDP produced in Azerbaijan reached the level of 1990 only in 2005. The volume of real GDP in 2005 and 2006 exceeded the volume of the GDP produced in 1990 by 18.2% and 59.3% respectively.

One of the major reasons why the mentioned extreme growth in real GDP was achieved in 2005 and 2006 is related to the data of National Bank of Azerbaijan. The country realized annual real GDP growth of 26.4% and 34.5% respectively, which is considered as a world record that occurred thanks to the large-scale oil export to world market via Baku-Tbilisi-Ceyhan oil pipeline. However, many experts are not in favor for such growth, reasoning their concerns by Dutch Disease, as a negative economic ailment caused by natural resource price increase and its negative effect on industrial and particularly on manufacturing development.

It is quite clear that in the recent period one of the main factors that speed up the economic growth in countries all over the world is the development of private sectors. This is the case in Azerbaijan, especially in connection with the third stage.

Chart 2. Contribution of public and private sectors to GDP production 1995-2006 (% of GDP)



Source: State Statistics Committee of the Republic of Azerbaijan 2006: Azerbaijan in figures

Chart 2 shows that the share of private sector in GDP production increased up to 76% in 2005 and it reached the record level, namely 81% in 2006. During the current stage, public property privatization and start of the implementation of the second privatization program launched at the end of the first stage, which allowed the privatization of enterprises of communication, transport, chemical industry, machine-building, fuel-energy complexes, also stimulated economic performance.

On the other hand, we should mention the role of the National Fund on Support of Entrepreneurship that functions to realize the government's support activity (support to private sector, production of import substitution products, manufacture of the products with export potential, innovation activity etc.).

The role of huge oil revenues was important in achieving the record level of economic growth in recent years. The oil sector has started to experience a strong development period as a sub-sector of the industry. It is possible to recognize on *Chart 3* that in 2005 and 2006 the share of industry sector together with the oil sector in nominal GDP was very high and ran up to 47.5% and 58.3% respectively.

All the mentioned facts show that the economic development of the country has already entered into a new stage of quality. The major objective of the current stage is to ensure the sustainability of dynamic socio-economic development in the country in the long-term by achieving the improved competitiveness of the national economy and efficient integration to the world economy by shifting from a particularly oil sector driven growth to a manufacturing and services driven one.

However, even at present, to achieve certain objectives ensuring and maintaining economic development sustainability in the Republic of Azerbaijan, the following necessary points has to be achieved with active participation of economic policy.

The economic potential has to be defined and it should be realized in an integrated way. Priority has to be given to develop non-oil sectors such as manufacturing industry and services in order to strengthen sustainability and economic diversification leaning on the opportunities coming from oil sector generated capital and development resources.

Chart 3. Development of nominal GDP by sectors contribution 2000-2006 (%)

Source: State Statistics Committee of the Republic of Azerbaijan 2006: Azerbaijan in figures

The conditions of business climate, the operating environment of entrepreneurship has to be improved by appropriate measures, which can have positive impact on employment and economic growth as well. The volume, the quality and the targeting of social services with the main objective of poverty reduction has to be achieved. Considerable efforts have to be made in order to improve the education level, especially concerning secondary and higher education. Finally yet importantly, the ecological balance and the environmental sustainability have to be seriously taken into consideration too.

Financial sector in Kyrgyzstan: heading toward banking sector penetration

Samagan Aitymbetov

At the early stage of transition, the acceleration of an economy is usually driven by robust real sector growth, which is generally financed by the informal financial sector. However, when the real sector reaches a certain point, the informal approach cannot continue to support further sustainable development. Private sector development needs formal financing channels and tools through banking sector or capital markets. For a relatively small economy like Kyrgyzstan, the banking sector is usually the first to drive this stage of growth. The next challenges for young financial sector of the republic are active banking sector penetration and facilitating financial access to small and medium enterprises.

Investment Climate Statement of the Kyrgyz Republic, made by US State Department, describes Kyrgyzstan as largely a cash society, where outside investors have rarely sought financing from domestic banks. Bank lending is heavily biased towards short-term loans and traditionally does not favor the usage of physical assets as collateral. Some banks ignore retail banking, focusing rather on government bonds".[1] Nevertheless, EBRD Transition Reports 2006 shows that there has been appreciable progress in banking sector reform in Kyrgyzstan evidenced by increased level of banking intermediation, albeit from very low level. Despite political uncertainty observable since March 2005, the banking sector grew rapidly, with total customer loans up around 60% per annum in real terms, in the last three years. Customer loans to GDP increased from 3% in 2003 to 10% in 2006.[2] In recent years there has been a strong increase in foreign bank control as a number of Kazakh banks have established subsidiaries, bringing new technologies and enhancing competition. Furthermore, remittances have been identified as a potential catalyst for the financial deepening of Kyrgyzstan, as a recipient country through higher access to banking services by migrants' families.

Contradictory deepening of the financial sector in Kyrgyzstan

Recent data suggests that the macroeconomic and structural reforms pursued by transition countries have been successful in fostering financial sector development. Banking sector prevails in the financial system of the Kyrgyz Republic: 21 commercial banks operated in the Kyrgyz Republic as of 1 July 2007. The sector of non-banking institutions and micro crediting organizations - focusing mainly on agriculture and small businesses - is relatively developed compared to other CIS countries. Securities market and insurance business are at their primary development stage.

The financial intermediation defined as the ratio of aggregate credit portfolio to gross domestic product (GDP) increased in comparison with similar period of the last year and was 15.1%. The marked growth in financial intermediation level is connected particularly with the growth in the loan portfolio of banking institutions in Kyrgyzstan. The growth rates of loans of the banking system and non-banking financial institutions were 21.5% and 10.3% respectively, which are still among the lowest ratios in Europe and Central Asia region.

According to a study of the Swiss National Bank, between 1998 and 2005, the ratio of private credit to GDP increased from 31% to 46% in Central and Eastern Europe, from 18% to 28% in Southeast Europe and from 8% to 19% in CIS countries. This substantial deepening of financial sectors in transition countries has been

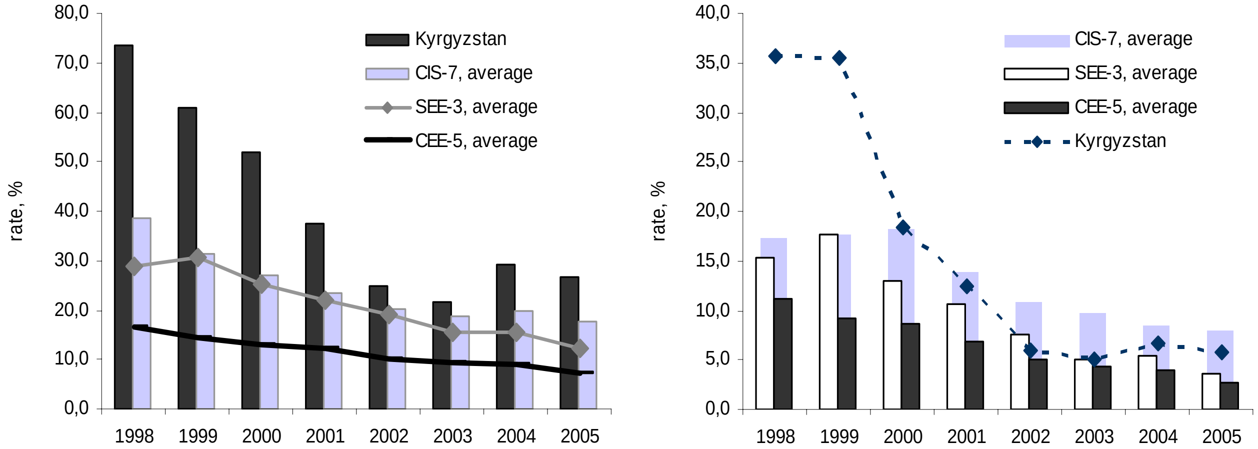
1 2007 Investment Climate Statement – Kyrgyz Republic. http://www.state.gov/e/eeb/ifd/2007/80715.htm

2 EBRD Strategy For The Kyrgyz Republic. Approved by 12 June 2007

accompanied by marked reductions in banks' interest rates. Between 1998 and 2005, average nominal lending rates for all countries fell from 32.9% to 12.9%, while deposit rates dropped from 16.4% to 5.4%. The intermediation spread of banks (lending rate minus deposit rate) has been more than halved from 16.5% to 7.5% on average.

In Kyrgyzstan, the average lending rate in local currency has been halved from 54% at the beginning of 1998 to 25.5% at the end of 2006 (the highest level among CIS states), while the deposit rate fell from 37% to 9.5%. Comparing lending and deposit rates shows however that the intermediation spread on local currency funds has remained constant at 17-18%. Some analysts suppose that intermediation spreads are closely linked to the low competition in the Kyrgyz banking sector and regulatory requirements. In spite of considerable expansion in the range of services rendered by finance and credit institutions, credits are the main component of their performing assets.

Chart 4. Lending (left) and deposit rates (right) in Kyrgyzstan, CIS-7, SEE-3 and CEE-5



Note: CIS-7 includes Armenia, Azerbaijan, Georgia, Kyrgyzstan, Moldova, Tajikistan, Uzbekistan; SEE-3 includes Southeast European countries: Bulgaria, Croatia, Romania and CEE-5 includes Central and East European countries: Czech Republic, Hungary, Poland, Slovak Republic, and Slovenia

Source: Author's calculations, European Bank of Reconstruction and Development

Consequently, it is critical to examine the Kyrgyz financial sector and address the obstacles of its development that is crucial from the point of view of sustainability of Kyrgyz economic growth.

Access to medium and long-term finance continues to be severely limited. Deposits in the banking system grew from 3.5% of GDP at the end of 2001 to 15% at the end of 2006, reflecting increasing confidence, but are still too low to support an expanding private sector. Total loans by commercial banks reached around 10% of GDP, with 27% over 1 year maturity. Interest rates on loans have gradually been declining, but average interest rates as reported by the National Bank of the Kyrgyz Republic (NBKR) are at relatively high rates (24% in local and 17.5% in foreign currency).

New empirical analysis suggests that the liberalization of the Kyrgyz financial sector seems to have been beneficial to both depositors and borrowers. The presence of foreign controlled banks (the share of foreign participation in the authorized capital of commercial banks reached 62.4%) has boosted confidence in the banking sector, and therefore, has reduced deposit rates. Moreover, foreign banks charge significantly lower lending rates than domestic banks. However, Kyrgyz lending and deposit markets are far from competitive, despite the recent restructuring of the sector.

Table 1. Summary data on the Kyrgyz banking sector, 2001-2006 (KGS million)[3]

	2001	2002	2003	2004	2005	2006
Total assets	5 029	7 860	11 385	17 703	21 904	28 318
Total credit	1 557	2 010	2 893	5 801	7 645	11 300
Total deposits	2 540	3 529	4 781	7 976	12 091	14 976
GDP	73 883	75 367	83 872	94 351	100 900	113 176
Credit-deposit ratio (%)	61.3	57.0	60.5	73.3	63.4	75.5
Share in GDP (%)						
Total assets	6.8	10.4	13.6	18.8	21.7	25.0
Total credit	2.1	2.7	3.4	6.1	7.6	10.0
Total deposits	3.4	4.7	5.7	8.5	12.0	13.2
Yield (%)						
Return on Assets (ROA)	5.1	5.1	8.8	17.5	17.6	22.4
Return on Equity (ROE)	1.4	1.1	1.6	2.5	2.3	3.3
Exchange Rate (Soms/USD)	48.45	46.94	43.72	42.67	41.01	40.16

Source: National Bank of The Kyrgyz Republic

From a private sector perspective, increase in competition among financial institutions should increase lending volume, reduce interest rates and lengthen tenors for borrowers. Unfortunately, the recent reduction in banking sector concentration does not seem to have increased competition at all.[4] The administrative and regulatory barriers, high market entry costs reasoned by low confidence and overly segmented banking sector are major obstacles for improvement of competition.

The analysis of banking system structure (market segment occupied by groups of large, medium and small banks) shows the reduction of concentration in market shares. Large banks experienced lost of market share by 14.7 percentage points to 58.5% from 2004 to 2006 ("large banks" refers to banks, whose share in total assets, loans, deposits and capital exceeds 10%, medium banks - from 5% to 10%, and for small banks less than 5%). Thus, banks' interest rates have not fully responded to lower market rates, which have been brought about by macroeconomic stabilization.

Non-bank financial organizations, dominated by microfinance institutions and credit unions regulated by the NBKR, remain small. Most of them do not have a deposit license and rely on external financing (primarily from donors). Credits extended by these institutions amounted to 4-5% of GDP in 2006.

The need for further banking sector penetration

The key challenge of developing Kyrgyz financial system is further strengthening of the access to financial services which is not only a natural outcome of financial deepening, but also a precondition for economic growth. Further development of the financial sector should increase its openness and competitiveness, attracting more savings and facilitating investments from both domestic and foreign sources, and easing investors' access to financial resources. There are two main directions of the reforms: recovering public confidence in financial intermediaries and improving the quality and efficiency of day-to-day service delivery.

With the goal of increasing the reliability and stability of the banking system, the NBKR announced that it would continue a consistent policy of increasing its capital base, and by the end of 2007, the NBKR requirement for banks with respect to the minimum amount of equity capital would be raised to KGS 100 million. Beginning in 2008, NBKR will begin the placement in operation of supervisory bases for controlling

3 KGS – Som, the national currency of the Kyrgyz Republic

4 M. Brown, M. Rueda Maurer, T. Pak, N. Tynaev. Banking Sector Reform and Interest Rates in Transition Economies: Bank-Level Evidence from Kyrgyzstan. Swiss National Bank Working Papers. February 2007

market, transaction, country, and transfer risk. The introduction of a deposit protection system will promote a rise of banking penetration that on the one hand will increase the attractiveness of bank deposits for the population through their insurance and on the other hand will increase the volume of lending to the population through an expansion of commercial banks' deposit base. The National Bank has developed a draft Law of the Kyrgyz Republic "On Protection of Deposits" and an Action Plan for the Introduction of a Deposit Protection System, which were proposed for review of the Kyrgyz Parliament in 2007.

The introduction of this system will depend on its approval by legislative and executive branches of state authority. In case of a positive resolution at the end of 2007 and with the start of the formation of the Social Fund in 2007-2008, one may project a rise of the receipt of deposits in the banking system from the population as early as in this period.

In view of the importance of agriculture in the Kyrgyz Republic and the relatively high poverty rates in rural areas, reforms should emphasize the importance of rural finance development. According to some estimates, the current demand for loans is at least USD 300 million, against the delivered USD 54 million. One of the steps here is the privatization of the two state-owned banks Aiyl Bank and the Savings and Settlement Company, which have the largest branch networks in Kyrgyzstan.

To mitigate systemic risk to the financial system, especially in light of recent rapid credit growth, policies and procedures for risk management process have to be in place. However, risk management in the Kyrgyz banking system is almost nonexistent. While many banks have started to enter into new businesses, most banks have neither adequate understanding nor capacity to manage risks associated with lending and other banking activities, which poses significant risk to the financial system.

According to the estimations of NBKR, correlation of assets, loans and deposits to GDP in 2010 will exceed the levels of 30%, 15% and 20% respectively. It will be higher and better than now but Kyrgyz banking sector productivity will remain low in comparison with international standards, and this indicates that there is still room for consolidation, cost rationalization and technological progress. In this respect, competition policy that fosters bank growth and cost rationalization, for example through mergers and acquisitions and/or the entry of first-tier international banks, can help in reducing lending rates and spreads.

The central bank should undertake active promotional activities that would catalyze the finance sector. There is arguably a role for central banks in undertaking short-term activities to promote financial systems able to provide households with access to sustainable savings and credit services. These so-called "promotional activities" are intended to be a catalyst for private sector activity. They may include support for pilot projects using innovative approaches, as well as research, collection and publication of data, advocacy, and training.

Factors of economic growth in Georgia

Nodar Khaduri[5]

After a deep recession in the 1990s, the Georgian economy is overcoming its main problems systematically. Georgia has performed double-digit growth rates in recent years and has become attractive for foreign investors, even if there are still heavy measures needed in order to ensure further development.

In the process of transition, Georgia is recently realizing significant achievements in economic development. The country has slowly but irreversibly left behind the economic recession after the dissolution of the Soviet Union, that was accompanied by internal civil and military opposition unprecedented in former Soviet Republics and other post communist countries.

In comparison with other former planned economies, the first years were extremely difficult for the economy. Georgia had to face a number of acute internal problems caused by the separatist movement, civil war and the emergence of criminal organizations. Common challenges of other post-communist countries – the breakdown of traditional links and relations, absence of own currency and monetary system, governance problems, territorial arrangement and defense, among others – exacerbated the situation.

Brief macroeconomic overview

Georgia was in chaos in 1991-1993, with all the industry inhibited and other fields of national economy coming to a standstill. Crime, military hostilities in Abkhazia, the transport blockade, uncontrolled emission of temporary coupons, hyperinflation were the key issues. Because of these, in 1994 the GDP was only quarter of its 1989 level.

That time, Georgia had lived in absence of any far-sighted macroeconomic policy, which was reflected in macroeconomic indicators of 1994. According to official statistics, inflation topped 7840% in 1994, real GDP decreased by 10.4% in 1994. Around 1.7 million people were employed in the national economy in 1994 that is only 56% of labor resources. Besides, the majority of the employed was on unpaid vacations for months. These people increased the number of non-visible unemployed.[6] Meanwhile, every 'real' employed earned 6.3 million coupons monthly equal to 5 USD, while those employed in the government sector earned 1 USD. That practically meant that the Georgian population was doomed to hunger.

Thanks to the government's anti-crisis program, economic recession was stopped in 1995 and even a modest, 2.6 % growth was achieved. Inflation dropped to 157.4%, from of 7841% in 1994. The country gradually started to leave hard times behind. These anti-crisis measures were based on the macroeconomic stabilization and sub-system reforms.

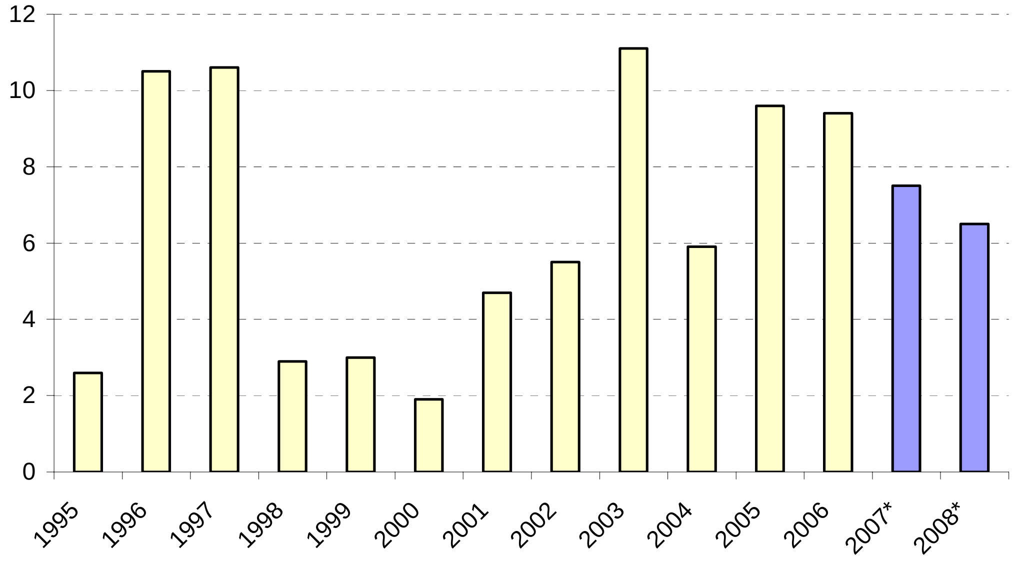
The legal framework of the country's financial system regulating market-based budgetary and monetary processes has been developed and adopted. Due to strict monetary policy enforced partly by first financial help and conditionality of World Bank and International Monetary Fund[7], the National Bank of Georgia managed to curb the hyperinflation, which made possible the currency reform (the Russian ruble and USD were removed from circulation and a new stable national currency, the Georgian lari was introduced). The process of liberalization of prices has practically been completed (the hardest part of which was a release of bread prices).

5 Ph.D. in Economics, Professor

6 These are people who "work", but they had no salary as they were in non-profit vacations for months

7 World Bank and the IMF granted USD 206 million credit to Georgia in 1995

Chart 5. Development of real GDP in its growth period 1995-2008 (%)



**IMF forecast*

Source: International Monetary Fund

A two-tier banking system was formed by delineation of the central banking and commercial banking functions. The process of privatization of all former government-owned banks has been completed.

Full liberalization of external trade has been achieved. Foreign debts and conditions for the servicing were rescheduled. Georgia acquired the image of a country that is able to pay back its debts.

Economic growth reached 10.5% and 10.6%, respectively in 1996 and 1997. The pace of GDP growth slowed down in 1998-2000 and reached 2-3%. The decelerating growth caused fiscal mismatch, as the growth of budgetary revenues slowed down, while the government was biased to enlarge expenditures in a paces of previous years. The possibility to overcome the fiscal imbalance appeared only after the “Rose Revolution”.

Reasons of economic growth

The record in economic growth was achieved in 2003, when despite the difficult socio-economic situation, the economic growth reached almost 11%. In fact, this happened due to one considerable foreign investment project – the Baku-Tbilisi-Ceyhan pipeline construction and investments in Georgian territory.

The recent general economic revival started after the “Rose Revolution”. Georgia has become the ground for economic reforms after the new government embraced liberal values. The governance became more correct, transparent and efficient. The state took active measures to create the necessary environment for business development. The privatization process accelerated and the licensing and authorizing procedures were simplified. The government also took steps in order to reform taxation and customs.

Privatization of large establishments has started and the majority of state enterprises turned to private property. Their selling prices have sharply increased when foreign investors have become active. It is not surprising that Russian and Kazakh investors were the most active actors. Unfortunately, industry has received only a little part of the investments. Most of them were made in construction-rehabilitation of travel establishments.

Free trade is one of the major achievements of the government. The senseless protectionism and introverted economic policy became unacceptable. Georgia has become one of the first among post-Soviet countries getting the membership of the World Trade Organization (WTO). Regarding the terms taken, the country took the responsibility for abolishing customs duties by the year of 2025. However, it has been executed since 2006.

Theoreticians and practical economists consider that the most important hindrance to economic development is the government regulation of businesses. The current government is actively implementing the policy of “minor governance”. Besides turning away from protectionism and privileges, it gives priority to private ownership, restricts the competence of government institutions to those activities, which could not be provided by the private sector, and minimizes administrative interference in the economy.

A tax code was created, according to which the amount of taxes was narrowed (for example motor-road benefit taxes, which in its essence were identical to VAT). Revenue and social tax rates were reduced (firstly the country transferred from the progressive taxation onto flat income tax rate of 12% from 2004), VAT was also moderated (from 20% to 18%). Simultaneously, tax administration and collection strengthened. Because of these efforts, tax receipts in the state budget that never exceeded 7% of GDP at previous years, currently stand at 20% to GDP. This increase was accompanied with a notable expansion of nominal GDP.

Unfortunately, there are still difficulties that hinder economic growth. There are external concerns, especially from the Russian side. Russia declared economic war against Georgia. Currently there is no transport and communications between the countries; even post deliveries are complicated. As for trade, Russia banned wine, mineral water, agricultural product imports from Georgia in 2006. Russia also restricted visa issuing, ousting thousands of Georgian citizens.

Additionally, internal problems persist, as private rights are still not sufficiently protected. The government and the bureaucracy frequently interfere with business activities, Inflation and unemployment remain severe problems: 13% of active population in Georgia is still unemployed, while inflation was close to 10% in 2006.

Table 2. Development of main macroeconomic aggregates, 2003-2007

	2003	2004	2005	2006	2007 Jan-May
GDP in market prices (USD mln)	3994.7	5166.3	6415.8	7849.3	-
GDP per capita (USD)	922.6	1 196.6	1 479.4	1 779.2	-
Real GDP growth	11.1	5.9	9.6	9.4	11.4
Consumer price index (%)	*7.0*	*7.5*	*6.2*	*8.8*	*4.3*
Employment (thousand)	1814.5	1783.3	1744.6	-	-
Unemployment rate (%)	11.5	12.6	13.8	-	-
Growth of nominal wages (%)	110.9	124.4	130.4	-	-
Growth of real wages (%)	105.8	117.7	120.5	-	-
Exports (FOB) (USD mln)	465.3	646.9	866.7	992.5	437.8
Imports (CIF) (USD mln)	1141.1	1847.9	2490.9	3677.8	1852.1
Trade balance (USD mln)	-675.8	-1201.0	-1624.2	-2685.2	-1414.3
Trade balance to GDP (%)	-16.9	-23.4	-25.3	-34.6	-
Export / import ratio (%)	40.8	35.0	34.8	27.0	23.6
Official exchange rate (USD/GEL, end of period)	2.0750	1.8250	1.7925	1.7135	1.6780
Official exchange rate (USD/GEL, period average)	2.1459	1.9168	1.8126	1.7764	1.7025

Source: National Bank of Georgia, Statistics Georgia

Economic growth forecast

It will certainly be hard to maintain a high rate of GDP growth, but in case of an appropriate economic policy, it is likely to remain around 5-7%. The government decided to take measures to curb inflation and overcome the unemployment.

It has to be noted that it is necessary to ensure property rights, prepare and implement the optimal policy and more importantly implement optimal monetary and fiscal policy in order to realize optimistic forecast. It has to be added that without resuming trade and economic relations with Russia it will be difficult to solve economic problems, though the integration line to EU and NATO requires important economic progress.

Taking into account all the elaborated aspects, nominal GDP will reach GEL 20-22 billion (approximately USD 14-15 billion) by 2010. Inflation could be squeezed to 5%, parallel with stable exchange rates. The improvement of external economic activity of Georgian enterprises is vital through developed export potential.

Overall development and the role of competitiveness in Caucasian and Central Asian countries

Tamás Borkó

Countries of Caucasus and Central Asia used to be treated as economies of similar development level. However, their main economic and human development indicators show that all of them are in special situation and in unique initial position. This analysis reviews the countries relative position within the region using main aggregates of development. Finally, the competitiveness and its main factors are investigated.

Starting with short historical commemoration, the collapse of the former Soviet Union brought for both regions sharp economic decline. During the first five years of transition in the period 1991-1995, all eight countries experienced extreme drop in gross domestic product. Only the second half of the nineties could show the signs of economic stabilization and revival, seemingly more sustainable paces of growth.

Achievements of seventeen consecutive years

However, there is some difference in terms of the setback's magnitude if comparing Caucasus economies with the Central Asian ones. (*See Table 3*) According to UNECE data, the Caucasian states experienced more serious decline. Only in the year 1992, Armenia and Georgia lost more than 40% of its GDP. Investigating the data, there are some more conclusions. The economic growth of both regions has started in 1995-1996, following considerable efforts done in order to establish minimum of operating political and economic institutions.

Table 3. GDP growth in Caucasus and Central Asia, 1991-2006 (%, GDP at prices and PPPs of 2000)

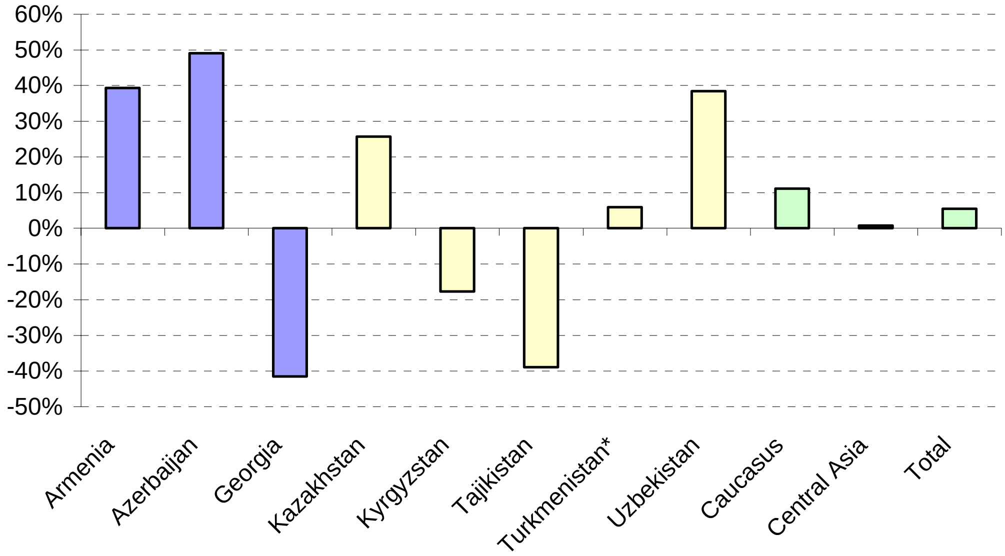
	AM	AZ	GE	KZ	KG	TJ	TM	UZ	*Caucasus**	*Central Asia**	TOTAL*
1991	-11.7	-0.7	-21.1	-11.0	-7.9	-8.2	-4.7	-0.5	*-11.2*	*-6.5*	**-8.2**
1992	-41.8	-22.6	-44.9	-5.3	-13.8	-32.1	-15.0	-11.1	*-36.4*	*-15.5*	**-23.3**
1993	-8.8	-23.1	-29.3	-9.2	-15.5	-16.3	1.5	-2.3	*-20.4*	*-8.4*	**-12.9**
1994	5.4	-19.7	-10.4	-12.6	-20.1	-21.3	-17.3	-5.2	*-8.2*	*-15.3*	**-12.7**
1995	6.9	-11.8	2.6	-8.2	-5.4	-6.0	-7.2	-0.9	*-0.8*	*-5.5*	**-3.8**
1996	5.9	1.3	11.2	0.5	7.1	-22.5	6.7	1.7	*6.1*	*-1.3*	**1.5**
1997	3.3	5.8	10.5	1.7	9.9	1.7	-11.4	5.2	*6.5*	*1.4*	**3.3**
1998	7.3	10.0	3.1	-1.9	2.1	5.3	7.1	4.4	*6.8*	*3.4*	**4.7**
1999	3.3	7.4	2.9	2.7	3.7	3.7	16.5	4.4	*4.5*	*6.2*	**5.6**
2000	5.9	11.1	1.8	9.8	5.4	8.3	5.5	4.0	*6.3*	*6.6*	**6.5**
2001	9.6	9.9	4.8	13.5	5.3	9.6	4.3	4.5	*8.1*	*7.4*	**7.7**
2002	15.1	10.6	5.5	9.8	0.0	10.8	0.3	4.2	*10.4*	*5.0*	**7.0**
2003	14.0	11.2	11.1	9.3	7.0	11.1	3.3	4.4	*12.1*	*7.0*	**8.9**
2004	10.5	10.2	5.9	9.6	7.0	10.3	4.5	7.7	*8.9*	*7.8*	**8.2**
2005	14.0	26.4	9.6	9.7	-0.2	6.7	9.6	7.0	*16.7*	*6.6*	**10.4**
2006	13.4	34.5	9.4	10.6	2.7	7.0	9,0**	7.3	*19.1*	*6.9*	**10.6**

**arithmetical average **IMF estimate*

Source: UNECE Statistical Division Database

These disperse performances mean that in 2006 not all of the eight countries were able to reach its GDP level of 1990. Armenia, Azerbaijan, Kazakhstan, Turkmenistan and Uzbekistan are over its 1990's GDP level, while Georgia, Kyrgyzstan, Tajikistan are below. (*See Chart 6*)

Chart 6. Caucasian and Central Asian countries' GDP in 2006 over 1990 (%)



**In calculations 2006 real GDP growth of Turkmenistan is by IMF estimation*

Source: UNECE Statistical Division Database, own calculations

If analyzing the regional aggregates, both regions and their aggregated total show, that this area has reached its economic performance level observed in 1990. However, it is clear that some of the countries are still well below the GDP level of the beginning of transition.

Current relative positions of countries

By size of economy measured by nominal GDP in current prices according to latest available comparable 2005 data, one can see that Kazakhstan is the biggest economy in the region, following by Uzbekistan, Azerbaijan and Turkmenistan. The second group consists of Georgia, Armenia, Kyrgyzstan and Tajikistan. Nevertheless, it is clear that all of the mentioned economies are small economies. (*See Table 4.*)

As for more realistic development level, measured by GDP per capita, Kazakhstan and Turkmenistan are the leading group, followed by the Caucasian states. The team of Kyrgyzstan, Tajikistan and Uzbekistan lags behind.

Indeed, it is fair to have a look on the positions of countries on the Human Development Ranking (UNDP) defined by calculated development indices (HDI). By its latest available 2004 data and ranking, Armenia and Kazakhstan take the best places, outpacing the remaining two Caucasian countries. The four not mentioned Central Asian states are in the worst position by human development level.

If comparing the regions, Caucasus produces 44% of Central Asia's GDP. It is not so bad performance if taking into consideration that the population the Caucasus is 27% of Central Asia . Of course, this is reflected in GDP per capita data, and additionally in the HDI and its ranking.

Having a look on some control data, Hungary, as the new member of European Union with around 10 million inhabitants produced USD 155.4 billion at internationally comparable prices in 2005, that means USD 15405 GDP per capita. Ukraine, as also CIS economy, with closed to 47 million population produced USD 290.6 billion, that corresponds to USD 6193 GDP per capita. This is less than Kazakhstan's similar per capita indicator.

Table 4. The main development indicators

Country	GDP (at prices and PPPs of 2000, USD millions)	Population (thousands)	GDP per capita (at prices and PPPs of 2000, USD)	Human Development Index (HDI)	HDI Ranking
	2005	2005	2005	2004	2004
Armenia	13 356	3 016	4 428	0.768	80
Azerbaijan	36 702	8 392	4 374	0.736	99
Georgia	14 661	4 361	3 362	0.743	97
Kazakhstan	104 925	15 147	6 927	0.774	79
Kyrgyzstan	8 672	5 116	1 695	0.705	110
Tajikistan	7 765	6 850	1 134	0.652	122
Turkmenistan	24 492	4 833	5 067	0.724	105
Uzbekistan	49 000*	26 593	1870*	0.696	113
Caucasus	***64 719***	***15 769***	***4104***	***0.749***	***92***
Central Asia	***145 854***	***58 539***	***2492***	***0.710***	***106***
TOTAL	**210 573**	**74 308**	**2834**	**0.725**	**101**

**2004 data, own calculation based on estimation of UNDP*

Source: UNECE Statistical Division Database, UNDP

There is one more interesting momentum concerning economic and human development in the given regions, as by available UNDP data Armenia, Georgia, Kyrgyzstan, Tajikistan and Uzbekistan do better in turning income into education and health opportunities (higher human development), while Azerbaijan, Kazakhstan and Turkmenistan do worse. All countries inherited close to similar conditions from the Soviet era.

Consequently, Black Sea area and its eight economies mean considerable potential, as its population reaches almost 75 million people. This is very similar to Central and Eastern Europe’s 73 million, that produced in 2005 USD 2257 billion GDP at comparable prices that is ten times higher. The initial and the current conditions are very different, however there can be found good lessons out of experiences of the already EU member states.

Competitiveness, as a key factor of development

One of the key factors of development is the ability of countries to be competitive, attracting foreign direct investments and entering the world economy and its globalization processes. For measuring the performance of the investigated countries, the competitiveness indicator of World Economic Forum, the Global Competitiveness Index and its main sub-indices are considered.

According to available data (*Table 5*), Kazakhstan and Azerbaijan have good overall competitiveness ranking, even if we know that the performance of these economies is based particularly on fossil fuels. As before, Armenia and Georgia represents similar characteristics. Tajikistan and Uzbekistan lags behind, and by common sense possibly Turkmenistan and Uzbekistan as well. The given indicators reflect however, the possible reasons of differences in performances.

Kazakhstan and Azerbaijan differ from others considerably in macroeconomic stability (public balance and debt, savings, inflation, interest rate spread, real effective exchange rate), infrastructure, business sophistication and innovation factors, and in some factors of efficiency enhancers.

Table 5. Global Competitiveness Index (GCI) and its ranking

		Kazakhstan	Azerbaijan	Armenia	Georgia	Tajikistan	Kyrgyzstan
Global Competitiveness Index	*Rank*	*56*	*64*	*82*	*85*	*96*	*107*
	Score	**4,19**	**4,06**	**3,75**	**3,73**	**3,5**	**3,31**
I. Basic requirements	*Rank*	*51*	*56*	*81*	*82*	*94*	*109*
	Score	**4,64**	**4,59**	**4,21**	**4,2**	**3,94**	**3,56**
1. Institutions	*Rank*	*75*	*72*	*84*	*78*	*77*	*123*
	Score	**3,59**	**3,63**	**3,44**	**3,51**	**3,53**	**2,66**
2. Infrastructure	*Rank*	*68*	*56*	*92*	*79*	*108*	*103*
	Score	**3,33**	**3,67**	**2,66**	**2,87**	**2,2**	**2,3**
3. Macroeconomy	*Rank*	*10*	*17*	*71*	*93*	*96*	*117*
	Score	**5,57**	**5,3**	**4,33**	**4,02**	**3,94**	**3,27**
4. Health and primary education	*Rank*	*86*	*96*	*62*	*61*	*85*	*91*
	Score	**6,08**	**5,76**	**6,4**	**6,4**	**6,09**	**6,02**
II. Efficiency enhancers	*Rank*	*56*	*78*	*88*	*87*	*103*	*102*
	Score	**3,97**	**3,52**	**3,33**	**3,36**	**3,07**	**3,08**
5. Higher education and training	*Rank*	*51*	*82*	*80*	*76*	*98*	*79*
	Score	**4,28**	**3,56**	**3,58**	**3,69**	**3,09**	**3,6**
6. Market efficiency	*Rank*	*44*	*81*	*104*	*86*	*108*	*114*
	Score	**4,39**	**3,96**	**3,6**	**3,86**	**3,56**	**3,48**
7. Technological readiness	*Rank*	*66*	*76*	*86*	*106*	*102*	*122*
	Score	**3,23**	**3,03**	**2,81**	**2,54**	**2,57**	**2,16**
III. Innovation factors	*Rank*	*74*	*70*	*93*	*113*	*103*	*108*
	Score	**3,51**	**3,59**	**3,17**	**2,86**	**3,02**	**2,93**
8. Business sophistication	*Rank*	*72*	*70*	*104*	*116*	*110*	*105*
	Score	**3,9**	**3,92**	**3,34**	**3,02**	**3,19**	**3,31**
9. Innovation	*Rank*	*70*	*63*	*84*	*102*	*95*	*111*
	Score	**3,13**	**3,26**	**3**	**2,71**	**2,85**	**2,55**

**data for Turkmenistan and Uzbekistan are not available*

Source: World Economic Forum, Global Competitiveness Report 2006-2007

Tools of development

Thus, countries lagging behind can step forward in economic and human development by improving their transport and telecommunications infrastructure, concentrating on prerequisites of macroeconomic stability, ensuring competitive and innovative business environment and legislation.

For both regions, either for the Caucasus or for Central Asia it is inevitable to invest more into health, primary and higher education. The operation and quality of public and private institutions have to get emphasis. There is still considerable room for measures in terms of improving innovation potential and market efficiency, especially in legislation.