areas has begun to rise, but major initiatives are needed in the short term.

For Hong Kong, China, several policy issues seem to be gaining importance. Maintaining investor confidence is the key as the economy is the premier financial centre in the region and its prosperity is strongly linked to how investors and users of its services perceive policy changes and the functioning of the Government, particularly moves towards greater democratization and popular participation in decision-making. The fiscal deficit and the accumulation of public debt need attention as they conflict with the low tax regime that Hong Kong, China, has traditionally enjoyed. The Hong Kong, China, government expects to restore fiscal balance in 2008-2009.

Another issue concerns administrative changes and policy continuity. Under the "Strong governance for the people" policy, the Chief Executive announced several administrative changes on 12 October 2005, including the reorganization of the Chief Executive's Office to increase its effectiveness. The size of the civil service would continue to be reduced in order to maintain a small government. Plans have been announced to recruit more talented professionals from the mainland and abroad. Professionals would be allowed to stay in Hong Kong, China, without having to have a prior job offer. The Hong Kong, China authorities expect to sustain the pre-eminent position of the economy as a regional financial and commercial centre through these means.

Significant challenges faced by Mongolia are to increase the value added in its mining sector and to diversify into new export areas. Greater value added domestically in mining would provide increased employment opportunities. Moving up the value chain from raw material exports, such as through the establishment of smelters and refineries, would require investment in capital and technology. This may be achieved by greater foreign investment in the sector. The country relies on a narrow range of export products, with minerals, cashmere and textiles accounting for more than 80 per cent of exports. Further development of tourism services could diversify foreign earnings. There has been growth in the sector over the past few years, although visitor numbers are still low. The country possesses attractive adventure and cultural opportunities. To fully benefit from these advantages, the general tourism infrastructure needs improvement.

Oil prices and appreciation of the won are the main policy issues

After successfully negotiating post-Asian financial crisis-related challenges and regaining strong growth momentum in the last two to three years, the economy of the Republic of Korea is expected to face two broad policy issues as it enters 2006. First, as an energy importer, high and volatile global oil prices pose considerable risks for the economy. High oil prices could cause aggregate demand in the economy to contract, with possibly severe implications for GDP growth. High oil prices could also affect global demand for exports from the country, adversely affecting its growth prospects. Second, dollar interest rates are on the rise; this could put upward pressure on Korean interest rates, putting downward pressure on housing prices. Higher interest rates could lead to a sharp contraction in new construction activity, with significant downstream effects. The large current account imbalances in the global economy suggest that significant exchange realignments should take place over the medium term. The won already appreciated by nearly 5 per cent against the dollar in 2005. Any further appreciation could undermine export competitiveness, particularly in the information and communication technology industry.

North and Central Asia

Overview

The subregion enjoyed the seventh successive year of GDP growth

The countries of North and Central Asia experienced the seventh successive year of GDP growth in 2005, the longest sustained expansion since the beginning of their transition to a market-based system in 1992. Positive GDP growth was recorded virtually across the subregion in 2005. The growth performance of the countries, with the exception of Kyrgyzstan, remained strong as a result of high export commodity prices. Domestic demand also played an important role, with retail turnover growing at double digit rates in most of the economies. However, increases in the prices of fuel and food products, and higher domestic utility tariffs, pushed up consumer price inflation in virtually all the countries of North and Central Asia.

The strong economic expansion over much of the subregion in 2005 was underpinned by the continuing growth in external trade and foreign investment. Owing to favourable international conditions for the principal exports of Kazakhstan and the Russian Federation and increased global oil and gas prices, those countries increased their trade surpluses in the first 11 months of 2005. However, the other economies were expected to experience wider trade deficits owing to the strong growth in imports, primarily of intermediate and capital goods, food and raw material.

GDP growth performance

High international prices of natural resources provided robust growth in 2005

Robust growth in the subregion in 2005 was driven largely by the high international prices of oil, gas and other natural resources. Proportionately, the energy sector and net exports contributed more to economic growth in most of the countries of the subregion than in previous years. On the demand side, private consumption remained the main source of economic growth, and growth of domestic demand was driven by rising household incomes and large inflows of foreign remittances.

In individual economies, Azerbaijan registered a remarkable 26.4 per cent growth in GDP in 2005, a result of high capital investment in oil and gas and strong overall industrial performance (see figure II.9). The industrial sector benefited from the construction of the Baku-Tbilisi-Ceyhan oil pipeline completed in May 2005 and from new investment in the South Caucasus gas pipeline project. Industrial output grew by 33.5 per cent in 2005. The mining sector accounted for more than 50 per cent of total industrial production and was one of the main drivers of economic growth. The agricultural sector grew by 7.5 per cent in 2005 and remained the largest employer in the country.

Armenia continued its high rate of GDP growth and maintained progress in macroeconomic reform in 2005. GDP growth averaged

Figure II.9. GDP and sectoral growth in North and Central Asian economies, 2003-2005

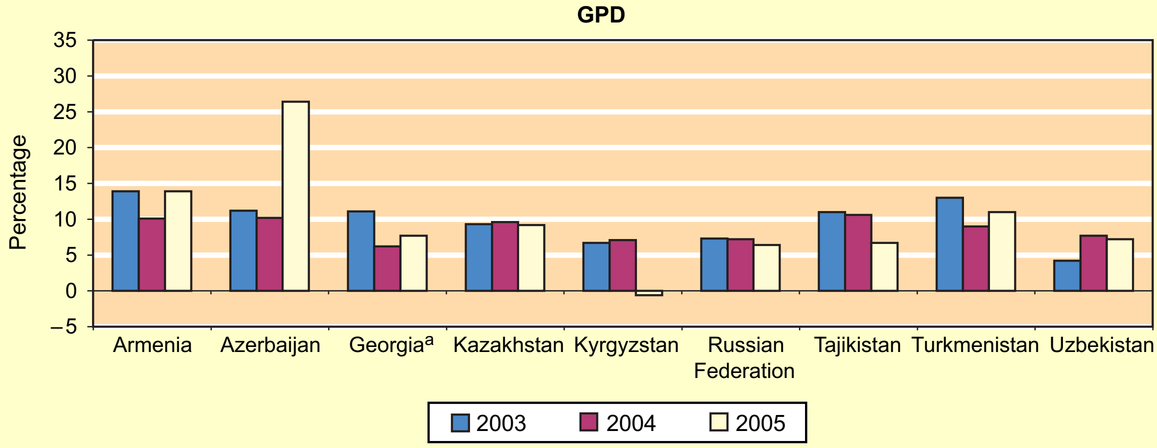

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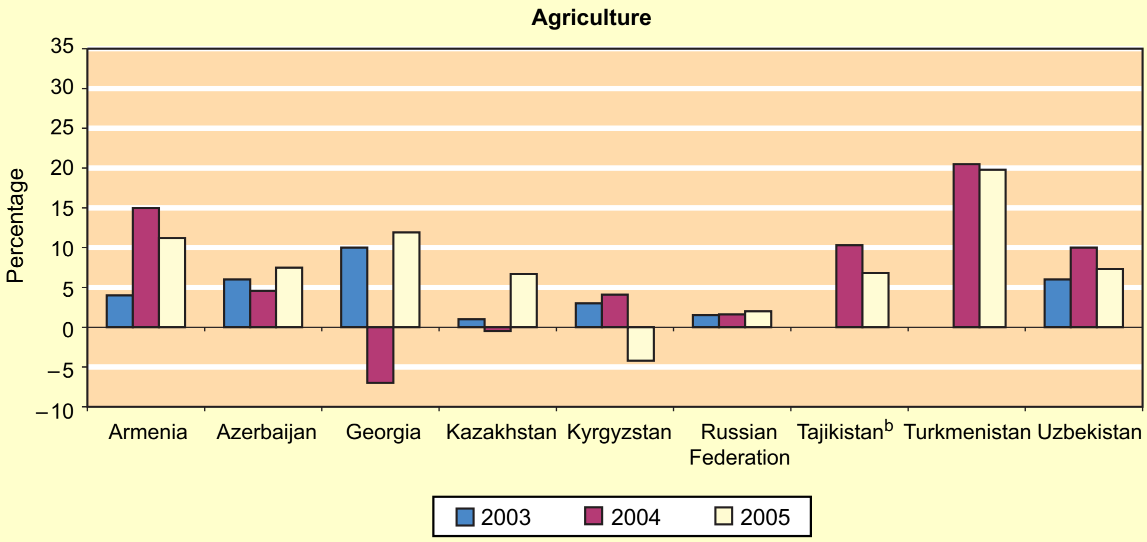
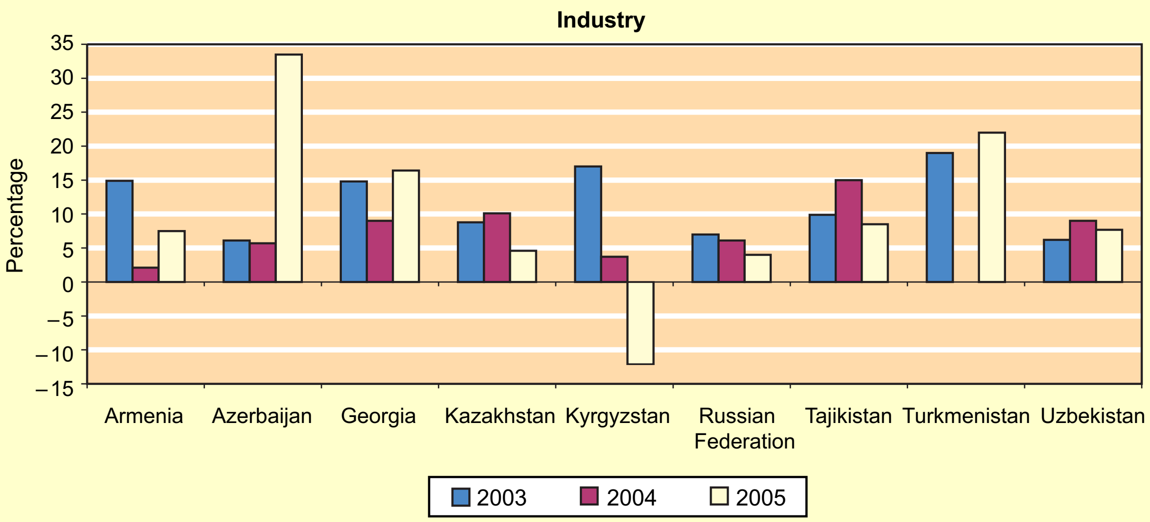
Figure II.9 *(continued)*





Sources: United Nations Economic and Social Commission for Asia and the Pacific, based on United Nations Economic Commission for Europe, *Economic Survey of Europe 2005,* No. 1 (United Nations publication, Sales No. E.05.II.E.7); website of the Commonwealth of Independent States Inter-state Statistical Committee, <www.cisstat.com>, accessed on 6 January 2006 and 10 February 2006; and Economist Intelligence Unit, *Country Reports* (London, EIU, 2006), various issues; and national sources.

[a] Growth rate for 2005 refers to January-September.

[b] Growth rate for 2005 refers to January-August.

more than 11 per cent annually in the period 2000-2004 and was 13.9 per cent in 2005. Construction and agriculture were the fastest growing sectors. Owing to a good fruit harvest, agricultural output grew by 11.2 per cent in 2005. A growth rate of 7.5 per cent in industry in the same year was boosted by FDI and inflows of remittances. These capital flows were used to renovate public infrastructure and build new productive capacity in the trade and service sectors. These sectors also supported growth in domestic demand, reflected in the 9.3 per cent growth in retail turnover in 2005. Remittances helped to increase personal incomes, which rose almost 9 per cent in the first five months of 2005.

Kazakhstan, a principal energy producer in the subregion, achieved rapid growth of more than 9 per cent annually in the period 2002-2004. GDP grew by 9.2 per cent in 2005 owing to new investment, particularly FDI, and expansion in domestic demand. Broad-based growth was recorded in all sectors: industrial production grew by 4.6 per cent and agricultural output grew by 6.7 per cent in 2005. The construction sector grew strongly, owing to rapidly rising investment in new pipelines and residential construction. Despite bad weather, the grain harvest amounted to 13.8 million tons for 2005, an increase of 11.4 per cent.

The rapid GDP growth that Georgia achieved in the period 2002-2004 continued in 2005, with a 7.7 per cent increase in the first nine months of 2005. The fastest growing sectors were industry, construction and agriculture. Industrial output grew by 16.4 per cent in 2005, owing to hydrocarbon development in the Caucasus area. The completion of the oil pipeline from Azerbaijan to Turkey through Georgia and the beginning of a new gas pipeline in the South Caucasus became an increasingly important source of economic growth in Georgia. In addition, construction of new oil and gas pipelines promoted the development of other sectors such as telecommunications, hotels and catering. Agricultural production increased by about 12 per cent in 2005, accounting for one fifth of GDP in the same year. Additional land reforms, including privatization, were planned for 2005-2006 to improve agricultural production.

Economic growth in the Russian Federation, the largest economy in the subregion, was expected to slow to 6.4 per cent in 2005 compared with 7.2 per cent in 2004 and 7.3 per cent in 2003. The growth rates of industrial output were also below the rates recorded in 2004. The slowdown was essentially the result of the slow pace of industrial restructuring. The main sources of growth in industry are manufacturing, mining and extraction, led by oil and gas. Oil and gas were particularly buoyant in 2005. Agriculture continued to be a weak performer in the economy, growing by 2.0 per cent in 2005 due to problems in the livestock sector. The grain harvest, at 78-79 million tons, was expected to be the same as in 2004. The main drivers of economic growth in the Russian Federation in 2005 were domestic demand, net exports and investment. Domestic demand was met mainly by domestic output and its growth was reflected in strong retail sales, which rose by 12.0 per cent in 2005. Net exports and investment were stimulated by the strong performance of the energy sector.

Economic growth in Tajikistan was also expected to decelerate in 2005 owing to the slow progress achieved in agricultural reform and industrial restructuring. GDP rose by 6.7 per cent in 2005 compared with more than the 10 per cent growth recorded annually in the period 2002-2004. Industry continued to be the fastest growing sector, increasing by 8.5 per cent in 2005. There was also a considerable increase in the production of consumer goods, which resulted in a growth rate of 9.6 per cent in retail trade turnover in 2005. Rising wages in Tajikistan and continued inflows of worker remittances boosted domestic demand and private consumption. The service sector became an increasingly important source of growth in the country. Growth in agricultural production decelerated from 10.3 per cent in 2004 to 6.8 per cent in the first eight months of 2005 owing to unfavourable weather conditions and floods.

With high capital investment in the gas and oil sectors and strong industrial performance, overall economic growth of 11 per cent was expected in Turkmenistan in 2005. Hydrocarbons remain the main contributor to the growth of industrial output, which rose by 22.0 per cent in 2005. Cotton and wheat also played a significant role in boosting economic growth. However, the cotton harvest was expected to be below the 2005 target, which could have negative implications for the textile sector and the trade balance.

Hydrocarbons and agriculture remained the leading sectors for economic growth in Uzbekistan in 2005. New investment from the Russian Federation and China in oil and gas production and recovery in the manufacturing sector contributed to the 7.7 per cent growth rate in industrial production in 2005. Agricultural production increased by 7.3 per cent in the same year owing to an improved harvest of the main export earner and the largest source of employment in the country, the cotton sector. Also contributing to strong expansion of both industry and agriculture was the introduction of convertibility to the som currency, which boosted exports and improved the competitiveness of local manufacturing of consumer goods. GDP growth in Uzbekistan was expected to be 7.2 per cent in 2005.

Total output, after rising by 7.1 per cent in 2004, decelerated to 0.6 per cent in 2005 in Kyrgyzstan. A marked slowdown in the production of gold, which accounts for more than 40 per cent of the country's industrial production, resulted in a 12.1 per cent decline in industrial output in 2005. The agricultural sector also posted a 4.2 per cent drop in the same year. However, private consumption was strong owing to rising wages and large inflows of remittances from abroad.

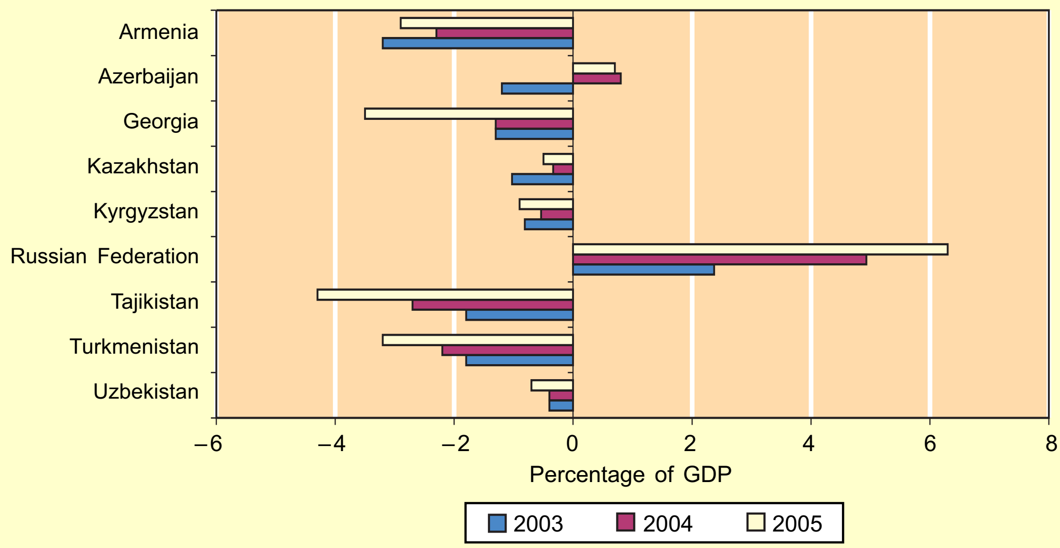
Key macroeconomic policy developments

Fiscal policy developments

The reform process continues but the pace slackens

In 2005, much of the subregion continued to make progress in strengthening revenue collection and fiscal consolidation and improving public expenditure policy, although in comparison with previous years the pace appears to have slackened somewhat (see figure II.10).

Figure II.10. Budget balance in North and Central Asian economies, 2003-2005[a]



Sources: United Nations Economic and Social Commission for Asia and the Pacific, based on International Monetary Fund, *International Financial Statistics* (CD-ROM) (Washington, D.C., IMF, 2005), and *World Economic Outlook databases* (Washington, D.C., IMF, 2005); and Economist Intelligence Unit, *Country Reports* (London, EIU, 2005 and 2006), various issues.

[a] Data for 2005 are estimates.

During 2005 the Government of the Russian Federation revised the federal budget to reflect the improved revenue position as a result of higher than expected oil and natural gas prices and better tax collection. Taxes on fossil fuel extraction, on profits and on value added made up the bulk of tax collections. In addition, tax collection improved as a result of greater efficiency by the tax authorities, reflected especially in the payment of substantial tax arrears by some large oil companies. Federal budget revenues exceeded the Government target for 2005 and should provide a budget surplus of 6.3 per cent of GDP by the end of the year. On the spending side, three fourths of the excess revenue was earmarked for social welfare, including increasing the salaries of public sector workers and for investment promotion. To further improve tax collection, the Government planned to implement an amnesty on the repatriation of capital flight allowing individuals to transfer money from foreign to domestic banks with a proposed payment of 13 per cent or even 7 per cent income tax on the amount being transferred. It was expected that this amnesty would have a positive effect on business confidence.

High oil and gas prices also supported budget revenues in Azerbaijan in 2005. Higher than expected revenue should provide the State budget with a surplus of 0.7 per cent of GDP in 2005. The main sources of revenue were the taxes on value added, corporate profits and income, while major budget outlays were for education, social security and infrastructure development.

Owing to high commodity prices, especially for oil and gas, budget performance in Kazakhstan was strong in the first half of 2005, with a surplus of 3.1 per cent of GDP. However, the budget was expected to have reverted to a small deficit of 0.5 per cent of GDP by the end of 2005.

In 2005, Armenia increased its tax collection owing to improved tax and customs administration and a crackdown on endemic tax evasion. Overall, tax collection increased by nearly 25 per cent in the first five months of 2005, which enabled the Government to meet increased expenditure targets. Excise and value added taxes accounted for almost 60 per cent of total tax revenues and they remained the principal source of budget revenues. However, underreporting of corporate taxes was a serious problem, at about 17 per cent of tax proceeds. A 1 per cent minimum turnover tax was introduced in 2004 to increase corporate taxes, thus ensuring greater compliance with tax laws by the country's largest taxpayers. Social spending increased significantly in 2005 owing to increases in public sector wages, pensions and poverty-related benefits. The Government budget deficit target for 2005 was 2.9 per cent of GDP.

In Georgia, the likely budget deficit of 3.5 per cent of GDP in 2005 was expected to be covered mainly by inflows from foreign multilateral organizations. Some additional revenue was also expected from the privatization of State property. Among the main budget priorities in 2005 were paying off pension arrears and reducing poverty. The budget provided for raising the minimum monthly wage of State sector employees to $65 and the minimum monthly pension to $15 in 2005. The Government also introduced a financial amnesty on undeclared assets and a new tax code to strengthen revenue performance in 2005. The tax code reduced the number of taxes from 21 to 7 and the rates of the social, income and value-added taxes.

In 2005, Tajikistan introduced a new tax code that established a two-tier income tax system, a minimum tax on corporate turnover and removed several exemptions. The new code was expected to improve compliance in the payment of taxes and bring in more revenues from the country's shadow economy. However, the budget deficit target for 2005 was revised upwards from 0.5 to 4.3 per cent of GDP.

Uzbekistan was expected to have a lower deficit of 0.7 per cent of GDP in 2005. Budget performance was solid in the first half of 2005, with a surplus of 1.2 per cent of GDP and budget revenues boosted by the effects of high gold prices and delays in expenditure. In October 2005, the Government increased by 20 per cent minimum State sector wages, pensions, stipends and other social benefit payments. The expanded State spending put the budget back into deficit by the end of the year.

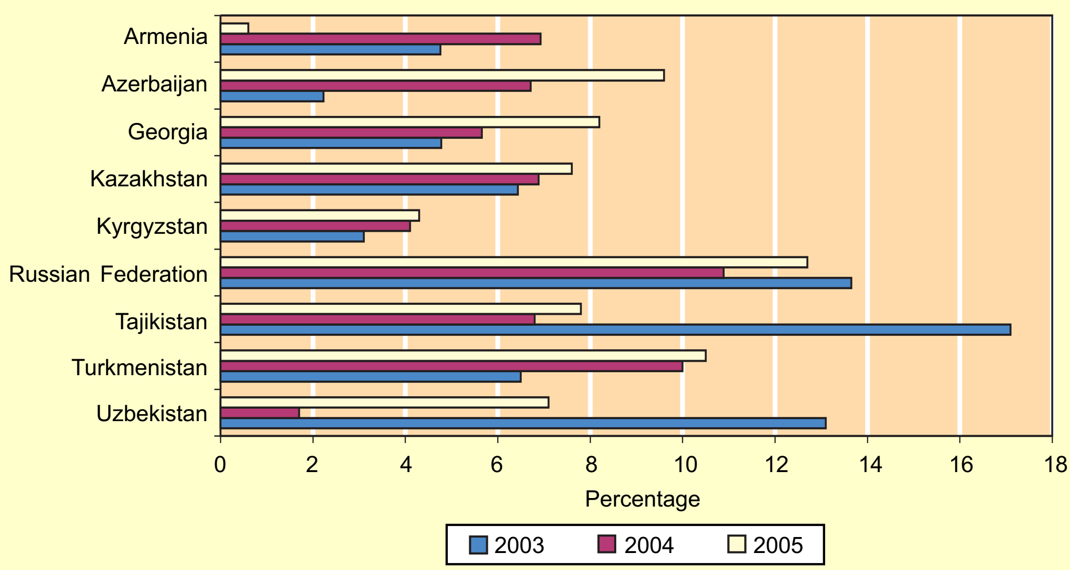
Monetary policy developments

The subregion had two key policy targets in monetary policy in 2005: preventing excessive real exchange rate appreciation, the so-called Dutch disease (the tendency of the exchange rates to appreciate in price-inelastic natural resource-producing economies) and curbing inflation. The loosening of monetary policy in the subregional economies was attributed to the clearance of wage and pension arrears and growth in net foreign assets. A further indication of the gradual loosening of monetary policy was the periodic cuts in benchmark interest rates, the refinancing rates of the central banks. This policy approach created a dilemma for the authorities, as it tended to undermine the fight against inflation (see figure II.11).

In the Russian Federation the monetary policy in 2005 was aimed at reducing inflation to a target of 11 per cent and preventing excessive real appreciation of the ruble, which would reduce competitiveness. However, high oil prices led to an increase in the money supply and in inflation. High inflation of 12.7 per cent in 2005 was driven primarily by increases in the costs of food products, housing and communal services. This level of inflation is regarded as being very high for country attempting to attain sustained economic growth. Therefore, one of the key goals of the Russian Federation in 2006 was expected to be a gradual decrease in inflation to 7-8.5 per cent and management of money supply growth consistent with the inflation target; money supply growth is a problem created by an enormous trade surplus of close to $143 billion in 2005. Monetary policy was expected also to be consistent with efforts to prevent real appreciation of the ruble. In 2005, the central bank succeeded in preventing the ruble from strengthening. The inflation target was also met, but only just, and reserves rose to $165 billion by November 2005.

Robust economic expansion and surging hard currency inflows in Azerbaijan resulted in strong growth in the money supply, which accelerated consumer price inflation. Consumer price inflation stood at 9.6 per cent in 2005. The high level of inflation forced the National Bank of Azerbaijan to tighten monetary policy. The bank

Figure II.11. Inflation[a] in North and Central Asian economies, 2003-2005[b]



Sources: United Nations Economic and Social Commission for Asia and the Pacific, based on the website of the Commonwealth of Independent States Inter-state Statistical Committee, <www.cisstat.com>, accessed on 6 January 2006 and 10 February 2006; and Economist Intelligence Unit, *Country Reports* (London, EIU, 2006), various issues.

[a] Inflation rates refer to percentage changes in the consumer price index.
[b] Data for 2005 are estimates.

raised its benchmark interest rate, the refinancing rate, from 7 to 8 per cent in 2005, making the refinancing rate positive in real terms. The higher interest rates and appreciation of the exchange rate were expected to rein in inflation in 2005 and 2006, causing the average annual consumer price index to fall substantially in 2006.

Tajikistan, too, maintained a relatively tight monetary policy in 2005 to curb inflation and ensure currency stability. However, a sudden jump in gas and oil prices led to a 10 per cent increase in the price of basic food products in the country in September 2005. In 2005, consumer price inflation was 7.8 per cent compared with 6.8 per cent in 2004. Other factors contributing to the increase in the overall price level were rises in domestic utility tariffs, public sector salaries, pensions and the minimum wage. In addition, robust inflows of workers' remittances contributed to growth in domestic demand, pushing up prices. Average annual inflation in 2005 was higher than the central bank's 7 per cent target. In response, the national currency, the Tajikistan somoni was expected to depreciate by 5 per cent in 2005.

Massive foreign exchange inflows caused rapid growth in all monetary aggregates in Kazakhstan, and this had an inflationary effect. Large hard currency inflows resulting from the oil boom caused consumer price inflation to accelerate from 6.9 per cent in 2004 to 7.6 per cent in 2005. Additional inflationary pressure came from wage growth and producer prices, which rose at double-digit rates. The inflation rate exceeded the annual consumer price inflation target of 5.7 per cent. Accelerating consumer price inflation forced the National Bank of Kazakhstan to raise its benchmark interest rate, the refinancing rate, from 7 to 8 per cent, but that did not prevent a real appreciation of the tenge in 2005.

Georgia's monetary policy in 2005 was also aimed at curbing inflation and ensuring the stability of the national currency. However, consumer price inflation was 8.2 per cent in 2005. High oil prices, rising food prices, increasing household energy consumption and a rise in excise taxes on some leading commodities exerted greater upward price pressure than expected. Strong capital inflows and increased budget and export earnings strengthened the lari against the dollar in 2005 and thus mitigated the upward pressure to some extent.

Price stability also continued as the focus of monetary policy in Armenia in 2005. Following inflation of 6.9 per cent in 2004, which reflected robust expansion in the demand for money, inflation decelerated sharply to 0.6 per cent in 2005. To reduce inflationary pressure, the central bank refrained from intervening in the currency markets and broadened its policy tools to keep the national currency stable. However, in the first half of 2005, the Armenian dram appreciated by almost 20 per cent against the United States dollar.

In Uzbekistan, inflation was expected to accelerate from 1.7 per cent in 2004 to 7.1 per cent in 2005 because of money supply growth, increases in utility tariffs and payment of wage and pension arrears. The introduction of currency convertibility in 2003 and the removal of restrictions on the purchase of hard currency allowed the Uzbekistan som to depreciate against the United States dollar by about 1 per cent per month during 2005.

To lessen the impact of the Turkmenistan manat's depreciation, the Government of Turkmenistan continued to pursue a tight monetary policy and maintained extensive price controls and subsidies on basic goods, as well as the free provision of utilities in 2005. Nevertheless, annual consumer price inflation was expected to be 10.5 per cent in 2005, owing to rises in public sector wages, pensions and various household benefits.

Financial sector policies

Ongoing financial sector reforms in the Russian Federation in 2005 included conversion of in-kind social benefits to cash payments and an amnesty for the repatriation of the outfow of money in capital flight that occurred in recent years. Anyone repatriating such capital would pay a flat 13 per cent or even 7 per cent of the amount concerned. The funds would be deposited in a bank in the country and invested in the national economy. The amnesty could be offered for a six-month period in 2006. Proposals for simplifying legalization of undeclared domestic income were also under preparation.

Tajikistan continued banking sector reforms aimed at increasing competition, improving access to credit and promoting microcredit and small enterprises. All limits on foreign bank activities in the country were abolished and banking laws were amended, as needed. The reforms enabled Tajikistan to improve operational efficiency and increase public confidence in the sector. However, further efforts are needed to improve financial discipline in large industrial enterprises and to streamline business regulations in order to encourage private sector development.

Despite improvements in banking sector supervision in Kyrgyzstan in recent years, greater consolidation and a higher level of financial intermediation are still needed. Industrial enterprises, for example, still have limited access to commercial bank financing, and only a small percentage of bank credit is provided on a long-term basis.

In contrast, growing confidence in the banking system of Armenia contributed to a higher demand for money and greater financial intermediation. A strengthened banking system improved the business environment in 2005, and there was a 30 per cent increase in domestic credit from commercial banks to companies. Financial intermediation by the banking sector was also increasing more generally in the economy, with the introduction of new services and savings media.

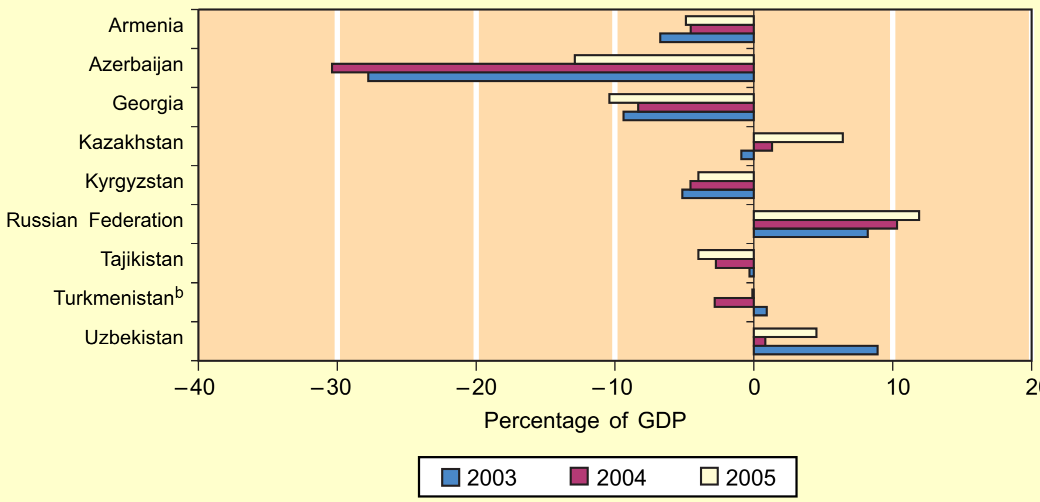
Developments in the external sector

Current account, exports and imports

External balance improves but not in all economies

The Russian Federation, Kazakhstan and Uzbekistan recorded substantial current account surpluses in 2005 (see figure II.12) owing to growing trade surpluses (see figure II.13). In the process these economies built up their international reserves and repaid a part of their foreign debt. Other subregional economies continued to have current account deficits that deteriorated slightly.

Figure II.12. Current account balance in North and Central Asian economies, 2003-2005[a]

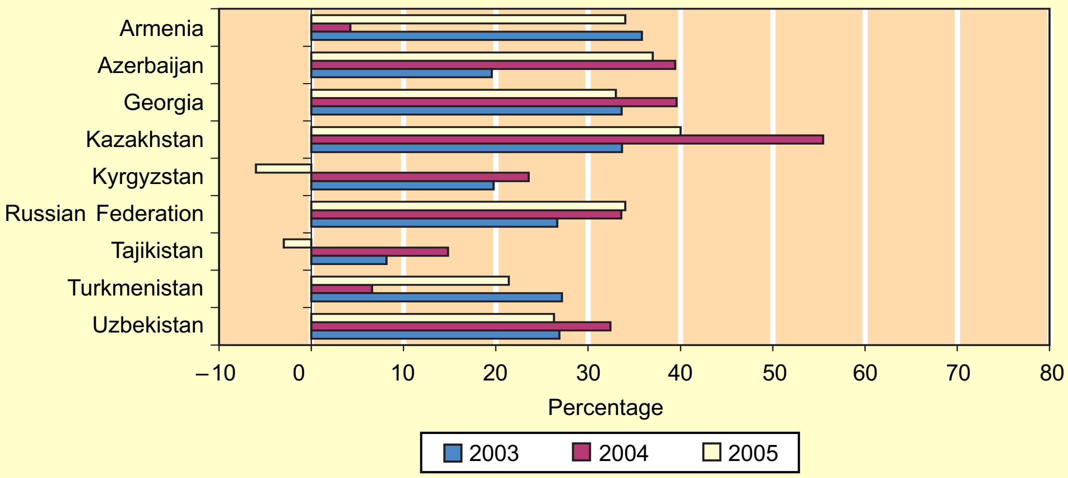


Sources: United Nations Economic and Social Commission for Asia and the Pacific, based on International Monetary Fund, *International Financial Statistics* (CD-ROM) (Washington, D.C., 2005), and *World Economic Outlook databases* (Washington, D.C., IMF, 2005); and Economist Intelligence Unit, *Country Reports* (London, EIU, 2005), various issues.

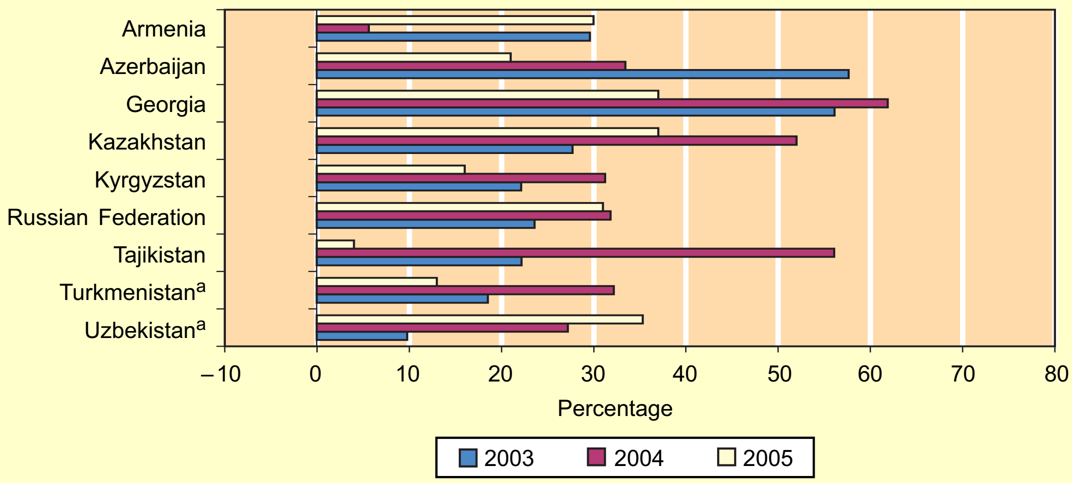
[a] Data for 2005 are estimates.
[b] Current account balance is calculated using official exchange rates.

Figure II.13. Growth rates in merchandise export earnings and import spending in North and Central Asian economies, 2003-2005

Export



Import



Sources: Website of Commonwealth of Independent States Inter-State Statistical Committee, <www.cisstat.com>, accessed on 22 February 2006 and Economist Intelligence Unit, *Country Reports* (London, EIU, 2005), various issues.

Note: Growth rates for 2005 are estimates for Turkmenistan and Uzbekistan.

[a] Valued free on board (f.o.b.).

The Russian Federation enjoyed higher current account and trade surpluses in 2005. Its trade surplus increased from $106 billion in 2004 to more than $140 billion in 2005, while the current account surplus topped $100 billion in the same year. This outcome was the result almost entirely of the high prices and general buoyancy of energy exports. The Russian Federation became a major supplier of energy to the major energy consumers in the region, including China, India, Japan and the Republic of Korea in 2005. The volume of exports rose by 37.2 per cent in 2005 to countries outside the Commonwealth of Independent States (CIS) compared with 10.6 per cent to CIS countries. Imports from non-CIS countries rose by 37.5 per cent and from CIS countries by 6.8 per cent in 2005.

Rising world oil prices increased the merchandise trade surplus of Kazakhstan from $7.3 billion in 2004 to $9.4 billion in the first 11 months of 2005. As a result, the current account was expected to record a surplus of 6.4 per cent of GDP in 2005 following strong growth in oil and gas exports. In the first 11 months of 2005, oil and gas contributed more than three fifths of merchandise export earnings, which grew by 40.0 per cent and reached $25 billion. Merchandise imports grew by 37.0 per cent to $15.8 billion in the same period. The growth in import spending remained high owing to larger imports of capital goods, machinery and equipment needed to implement the Government's import-substitution policy.

Owing to high prices of the main export commodities, cotton and gold, Uzbekistan was expected to record a trade surplus of $1.2 billion and a surplus of 4.5 per cent of GDP in its current account in 2005. Export earnings were estimated to have grown by 26.3 per cent for a total of $5.4 billion, while merchandise imports were expected to grow by 35.3 per cent, to $4.1 billion in 2005. The Government of Uzbekistan continued to exercise control over the import of consumer goods in order to protect domestic industries and to keep trade and current account balances in surplus.

FDI inflows into hydrocarbon projects were expected to reduce the current account deficit of Azerbaijan from 30.4 per cent of GDP in 2004 to 12.9 per cent in 2005. The economy ran a trade surplus of $338 million in the first 11 months of 2005, compared with $110 million in 2004. Imports rose by 21.0 per cent to $3.8 billion in the first 11 months of 2005. Among the largest imports were energy, capital goods (primarily machinery and equipment) and foodstuffs. Oil and refined petroleum products accounted for the largest share of export earnings, which increased by 37.0 per cent in the first 11 months of 2005.

The growing trade imbalance of Tajikistan widened its current account deficit from 2.7 per cent of GDP in 2004 to 4.0 per cent in 2005. The trade deficit exceeded $330 million in the first 11 months of 2005 compared with $460 million in 2004, a result of unfavourable trends in global commodity prices. Export revenue fell 3.0 per cent to $823 million in the first 11 months of 2005 as a result of a decline in the price of cotton. Cotton remained the country's second largest export commodity, while aluminium provided the bulk of total earnings. Import expenditures rose 4.0 per cent to $1.2 billion in the same period owing largely to higher fuel prices. Imports of consumer goods continued to increase, in line with rising foreign remittances and higher wages, which boosted the purchasing power of domestic households.

The current account of Kyrgyzstan was expected to remain in deficit at 4.0 per cent of GDP in 2005 owing to rapidly rising imports and falling exports. Imports grew by 16.0 per cent to $979 million and exports fell by 6.0 per cent to $618 million in the first 11 months of 2005. The trade deficit increased from $222 million in 2004 to more than $360 million in the first 11 months of 2005. The growing trade imbalance was the result of the country's narrow export base, strong domestic demand and considerable energy requirements.

The current account deficit of Georgia deteriorated in 2005 as a result of a worsening of the trade balance. The trade deficit rose from $1.2 billion in 2004 to more than $1.4 billion in the first 11 months of 2005. Merchandise imports grew by 37.0 per cent and reached $2.2 billion in the first 11 months of 2005 as a result of a rise in capital imports related to pipeline construction and increased spending on consumer goods. Export revenue grew strongly by 33.0 per cent in the first 11 months of 2005 to $785 million owing to buoyant global prices for the main export item, metals, and to an increase in the trade in wine and mineral water. However, the country remained vulnerable to changes in the external economic environment because of its narrow export base.

Despite a substantial increase in the merchandise exports of Armenia, its trade deficit widened from $628 million in 2004 to $715 million in the first 11 months of 2005. Export earnings rose more than 30 per cent to $867 million in the first 11 months of 2005, owing to favourable prices for base metals and investment-related growth in the main export-producing sectors of the country. However, high global prices for the main import commodities raised import costs by 30.0 per cent to $1.6 billion in the first 11 months of 2005. The growing trade deficit was expected to widen the current account deficit from 4.5 per cent of GDP in 2004 to 4.9 per cent in 2005.

Capital inflows

Armenia was expected to approve a new law by the end of 2005 to promote greater foreign investment by easing restrictions on access to the country's market. FDI in Armenia increased from $121 million in 2003 to $218 million in 2004 and by more than 11 per cent to almost $140 million in the first six months of 2005. The bulk of the foreign investment from more than 30 countries was concentrated in metallurgy, food services, telecommunications and energy. Among the main foreign investors were Argentina, France, Germany, Greece, the Russian Federation and the United States.

The Russian Federation and the United States were also among the largest investors in Georgia in 2005. Inflows of FDI declined slightly, however, from $172 million in 2003 to $169 million in 2004. The service sector was the main recipient of FDI. In addition to FDI, Georgia was expected to receive a new $300 million aid package from the United States Millennium Challenge Account over the next five years. The aid package is aimed at developing and modernizing the infrastructure of the poorest and remotest regions of the country.

Foreign investment in the Russian Federation reached $11.6 billion in 2004, up from $8 billion in 2003 thanks to an improved investment climate and the removal of cumbersome restrictions on capital repatriation. FDI was expected to increase by a further 60 per cent in 2005, driven by high energy prices and the country's huge untapped potential in this area. In 2005, interest in the Russian Federation in new investment in the energy field was extended to Asian countries such as China, India, Japan and the Republic of Korea to construct and modernize the country's energy infrastructure. China, for example, was evaluating an investment in a new strategic oil pipeline from the far eastern area of the Russian Federation to the Chinese border, with a total throughput of 30 million tons of oil annually. The Russian Federation was also expected to participate in a new consortium of companies from China, Malaysia, the Republic of Korea and Uzbekistan to develop gas fields in the Aral Sea area.

FDI inflows in Kazakhstan reached $4.3 billion in 2004, double the $2.1 billion received in 2003. More than 40 per cent of FDI inflows went into the oil and gas sector.

FDI inflows in Azerbaijan, another oil-producing country, exceeded $3 billion in both 2003 and 2004. However, the level of FDI was low compared with that to other hydrocarbon-producing countries in the subregion. One third of FDI was allocated to the transport and communication sector, about 20 per cent to light industry and 13 per cent to the oil and energy sector.

Foreign debt

High oil and gas prices enabled the energy-producing countries of the subregion to accelerate repayment of external debt and to replenish and enlarge their foreign exchange reserves. In 2005, the hard currency reserves in the Russian Federation exceeded total foreign debt, enabling the country to pursue an active policy of debt reduction, repaying about one third of outstanding debt to the Paris Club of leading creditor countries on an accelerated schedule. The repayment was expected to save about $6 billion in interest annually. This repayment is considered to be the largest early repayment in the Paris Club's history. Even after this repayment, the country's foreign debt still amounted to about $80 billion at the end of the year. The stabilization fund of the Russian Federation was expected to reach $30 billion in 2005, while foreign exchange reserves were nearly $165 billion in November 2005.

The gross foreign debt of Kazakhstan rose from $22.8 billion in 2004 to about $35 billion in the first half of 2005. Sovereign foreign debt accounted for 10 per cent of the total and private sector debt for 90 per cent. The foreign debt was the equivalent of 78.6 per cent of the country's GDP in 2005.

Tajikistan's foreign debt was expected to be reduced from 70 per cent of GDP in 2000 to 40 per cent in 2005, owing to the conclusion of several debt-rescheduling and write-off agreements. The country, for example, concluded a debt-for-equity swap with the Russian Federation in October 2004. The direct government debt accounted for almost 80 per cent of the total of $905 million debt in 2005. Among the main creditors were the World Bank, the Asian Development Bank, the Islamic Development Bank, the European Commission and the OPEC Fund for International Development.

Kyrgyzstan reduced its external debt from more than $2 billion in 2004 to $1.93 billion in the first three months of 2005 through a restructuring deal reached with the Paris Club.

Armenia also improved its prospects for external debt sustainability through a debt-for-equity swap agreement concluded with the Russian Federation, which reduced its bilateral debt by about $100 million. Debt rescheduling agreements were also concluded with the country's other main creditors. Since the bulk of the external debt that Armenia owed to multilateral creditors was provided on concessional terms, the debt service burden has not been onerous. Total external debt amounted to $1.18 billion, or 33 per cent of GDP in 2004 compared with 39 per cent of GDP in 2003.

Medium-term prospects and key policy issues

Integration into the global and regional economies is an important challenge for the subregion

At the macro level the subregion has to address five basic sets of policy issues. First, integration of the countries into the global economy will provide new opportunities to maintain growth momentum. Accession to WTO is one of the main medium-term goals to that end. Armenia, Georgia and Kyrgyzstan are full members of WTO. The other economies, except Turkmenistan, have observer status at WTO and are at different stages in accession negotiations. In 2005, Kazakhstan and the Russian Federation made encouraging progress in negotiations and were expected to become WTO members in the near future. WTO membership could help the countries in North and Central Asia to establish legal frameworks and market-based institutions supportive of international trade and widen access to markets and investment inflows through the provision of unconditional most-favoured-nation status. However, since most of the subregional economies are still in transition to a market-oriented system it is important for them to assess the costs and benefits of WTO membership before making commitments that may not be in their best interests.

Second, participation of the countries of North and Central Asia in regional economic cooperation in Asia could facilitate their integration into the global economy. Currently, these countries participate mainly in two regional trading arrangements: Commonwealth of Independent States and the Economic Cooperation Organization. Little progress has been made in reintegrating the economies of the former Union of Soviet Socialist Republics, despite the numerous agreements adopted and the institutions created under CIS auspices. The achievements of the Economic Cooperation Organization have also been limited by the failure of members to comply with commitments and regulations.

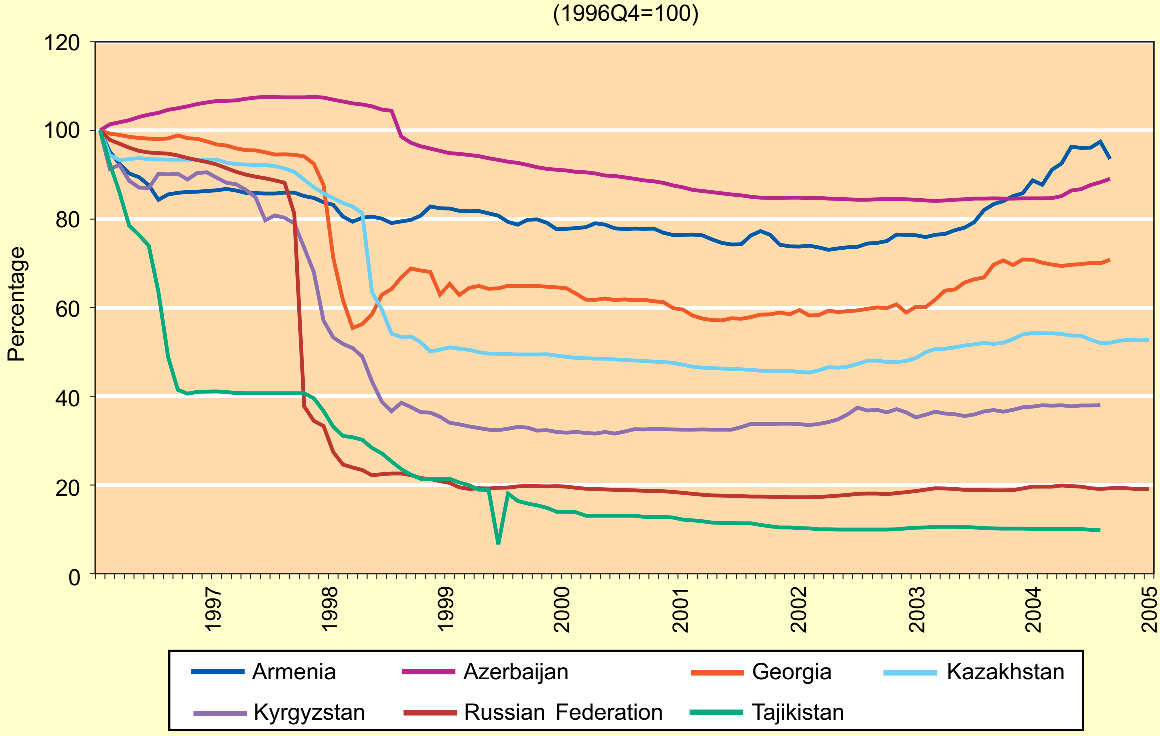
The Eurasian Economic Community (EurAsEC), created by Belarus, Kazakhstan, Kyrgyzstan, the Russian Federation and Tajikistan in 2000 as a customs union, has had a more constructive role in promoting regional economic cooperation. In 2005, Uzbekistan joined EurAsEC after the Organization of Central Asian Cooperation merged with EurAsEC. The North and Central Asian countries are expected to promote their economic integration into a single, free-trade, economic zone within EurAsEC. The economic dynamism of Asia, particularly China, could provide significant new economic opportunities for the economies of North and Central Asia, enhancing trade and financial links with the rest of Asia. New growth hubs centring on East, South and South-East Asia are emerging in the broader Asian and Pacific region where growth has outpaced that of the rest of the world over the past decade; these trends are likely to continue at least over the medium term.

Third, sustaining a high rate of growth in the countries of North and Central Asia requires diversification of production and exports and of export markets. Many economies in the subregion continue to have a high degree of concentration in domestic production and external trade. This concentration makes them more vulnerable to external shocks, as was demonstrated in the Russian Federation in 1998. Promoting diversification requires sustained, high-quality investment in both hard and soft public goods, well-maintained physical infrastructure and reliable public services, including legal and regulatory systems, and the development of new technologies and products, since most private sector enterprises still lack the resources to conduct such activities. Above all, diversification requires realistic exchange rates that do not undermine international competitiveness (see figure II.14). Virtually all countries in the subregion produce primarily natural resources, the demand for which is relatively price inelastic. In such economies, an overvalued exchange rate could gravely undermine diversification.

Fourth, economic diversification and cooperation of the North and Central Asian countries require an unwavering commitment to reform and to building on the gains already achieved. The essential components of reform are a commitment to macroeconomic stability and prudence, keeping inflation low and maintaining exchange rate stability. Higher energy and commodity prices might not be a blessing in disguise, however, because in the current phase they appear to dilute the reform effort. They could also be masking still unaddressed structural weaknesses

Figure II.14. Index of exchange rates against the United States dollar in selected North and Central Asian economies, 1996-2005[a]

(1996Q4=100)



Sources: International Monetary Fund, *International Financial Statistics* (CD-ROM) (Washington, D.C., IMF, 2005); and *The Economist,* various issues.

[a] Data for 2005 are estimates.

in the economies of the subregion. The current phase should therefore be a spur to further reform. Further financial sector reforms are needed for the development of a forward-looking, more harmonized subregional tax policy framework and an integrated economic space for cross-border trade and investment. In this area the subregion could follow the example of the various areas of cooperation agreed by the Association of Southeast Asian Nations (ASEAN) and the ASEAN Free Trade Area.

Fifth, while regional and bilateral trade preference schemes can play a useful role in promoting subregional trade in North and Central Asia, closer economic cooperation in the future needs to extend beyond trade. The construction of regional infrastructure is necessary for meaningful economic cooperation, expansion of exports and greater inflows of FDI. Improvement in transport could enable people and goods to move more easily and rapidly among countries, reduce the cost of trade and enhance the value of business. The subregion's transportation infrastructure is adequate for supporting the needs of the economies and for facilitating their trade and development interests in the former Union of Soviet Socialist Republics. However, that aspect of the infrastructure should be reoriented and improved to meet the goals of expanded trade and closer economic cooperation among countries in the subregion and with other countries. The most important problem facing the transportation sector in North and Central Asia is the rapid deterioration of physical infrastructure as a result of inadequate investment in maintenance, repair and rehabilitation.

Growth will continue in the subregion in 2006 and unemployment will decline

GDP growth in the Russian Federation is forecast to be 5.6-5.8 per cent in 2006; it will be driven by buoyant private consumption and strong investment spending. The budget plan of the country for 2006-2008 reflects significant spending in order to double public sector wages by 2008 and to improve transport infrastructure. The plan also calls for the creation of a 700 billion ruble ($25 billion) investment fund to finance large-scale infrastructure projects. The fund was to be financed with surplus budget revenues stemming from high oil prices and from cost savings arising from early repayment of a portion of the external debt of the country. Based on current trends, the budget surplus should continue for the next three years.

The economy of Kazakhstan is expected to expand by more than 9 per cent annually for the next five years, transforming it into a dynamic developing country with a high standard of living. During this period, GDP per capita could reach $8,000-$9,000 a year, bringing the average monthly salary to 70,000 Kazakhstan tenges (about $500). By 2012, oil production and industrial production are expected to double. Through the higher household incomes that growth will bring in its wake, small and medium-sized businesses should form the basis of the economy, generating up to 40 per cent of GDP. Among other mid-term goals of the economy are ensuring greater cooperation and dialogue between State and private sector businesses, promoting and protecting private property, orienting the economy towards exports and improving the business climate.

Economic growth in Armenia in 2006 is expected to subside from the double digit growth of the period 2002-2005 to 7.5 per cent in 2006.

Azerbaijan is likely to continue investing in the energy sector and raising energy production. GDP growth is forecast to reach an extraordinary 25 per cent in 2006 owing mainly to a substantial increase in oil and gas output. Maintaining macroeconomic stability during a period of rapid economic growth has increasingly appeared as a key policy issue. Over-reliance on hydrocarbons could have an adverse affect on the economic structure and on the development of the oil and non-oil sectors alike in the long term.

Tajikistan's new country assistance strategy for the period 2006-2009 envisages strengthening the financial sector to improve the business environment, targeting more financial resources at the health and education sectors and increasing the efficiency of the domestic energy sector through greater exploitation of the country's hydropower potential.

Georgia is expected to attain 9 per cent GDP growth in 2006 owing to a rapid rise in investment linked to the construction of pipelines. Inflation could be reduced from 8.2 per cent in 2005 to 3 per cent GDP in 2006 and remain within the Government's target rate of 3 per cent of GDP. The Government is expected to implement further reforms of the tax and customs administration in order to mobilize greater tax revenues, enhance fiscal transparency and strengthen the financial sector.

The GDP of Turkmenistan is expected to grow by 8-9 per cent in 2006-2007, assuming that the high international prices of hydrocarbons persist. The hydrocarbon sector and construction should be the main contributors to economic growth. Strong export revenue from the sale of gas would keep the current account in surplus in 2006.

The growing investment of China and the Russian Federation in the oil and gas sector of Uzbekistan could provide a major impetus to economic growth in that country, which could average 5.6 per cent annually in 2006-2007. High gold prices would enable the economy to maintain surpluses in its trade and current accounts and allow greater freedom in domestic policies. The textile sector's contribution to economic expansion should increase with a more competitive exchange rate for the national currency.

High GDP growth will expand employment opportunities in most of the subregion

Owing to high rates of growth, employment opportunities are expected to expand in most of the economies of North and Central Asia in 2006. The Russian Federation, for example, improved its labour-market conditions considerably in 2004-2005. Employment rose 2 per cent in 2004, owing to restructuring of industry and expansion of the service sector. In the first nine months of 2005, 2.4 million jobs were created and the unemployment rate fell by 1.7 per cent.

The unemployment rate in Kazakhstan declined steadily as a result of continuing economic growth and stood at an average of 7.8 per cent of the economically active population of just over 8 million in the first eight months of 2005. At this level, however, the country had the highest reported unemployment rate in the subregion, but other countries in the subregion report only registered unemployment, which is not comparable and may not measure unemployment accurately. The high rate also indicates that there was a greater measure of structural reform in Kazakhstan than elsewhere in the subregion.

The labour market of Armenia developed favourably in 2004, and wages and incomes rose. However, progress in job creation slowed in 2005. The unemployment rate hardly changed, falling from 9.0 per cent in 2004 to 8.9 per cent in the second quarter of 2005 despite a high rate of emigration.

Output growth in Georgia in recent years has resulted in slow job creation, and the overall labour-market situation remains unfavourable. The unemployment rate rose from 10.7 per cent in 2003 to 12.5 per cent in 2004 due to large-scale cuts in public sector employment. The unemployment rate was much lower in rural areas than in urban areas owing to family, largely subsistence, farming although there was some seasonal work for the rural population.

The rate of labour migration from Tajikistan to neighbouring countries declined from more than 420,000 people in the first quarter of 2004 to 320,000 in the first quarter of 2005. Although the Russian Federation continued as the destination for roughly 90 per cent of this labour outflow from Tajikistan, the decline was due to greater job opportunities in Tajikistan, including new jobs related to the construction of hydroelectric power plants.

The slow pace of structural reform continues to dampen job creation in Kyrgyzstan. As a result, unemployment was higher than 4 per cent in the first four months of 2005. It is worth mentioning, however, that the actual number of people unemployed was much higher, possibly by one third more than the officially reported unemployment numbers.

Pacific island economies

Overview

Modest growth continues

Pacific island countries face many daunting problems in their quest for economic growth and sustainable development. These include the physical disadvantages of remoteness, smallness and dispersion, significantly raising transport and