

ECONOMIC AND SOCIAL COMMISSION FOR ASIA AND THE PACIFIC

**MANAGING GLOBALIZATION
IN SELECTED COUNTRIES
WITH ECONOMIES
IN TRANSITION**



UNITED NATIONS

**ESCAP WORKS TOWARDS REDUCING POVERTY
AND MANAGING GLOBALIZATION**

Economic and Social Commission for Asia and the Pacific

**MANAGING GLOBALIZATION IN
SELECTED COUNTRIES WITH ECONOMIES
IN TRANSITION**



UNITED NATIONS

New York, 2003

ST/ESCAP/2274

UNITED NATIONS PUBLICATION

Sales No. E.03.II.F.58

Copyright © United Nations 2003

ISBN: 92-1-120332-5

This document has been issued without formal editing.

The designations employed and the presentation of the material in this publication do not imply the expression of any opinion whatsoever on the part of the Secretariat of the United Nations concerning the legal status of any country, territory, city or area, or of its authorities, or concerning the delimitation of its frontiers or boundaries.

The views expressed in this publication are those of the authors and do not necessarily reflect the views of the United Nations Secretariat.

Mention of firm names and commercial products does not imply the endorsement of the United Nations.

PREFACE

This publication is based on country assessment studies carried out under the Development Account project on “Capacity-building of ESCAP member States for managing globalization”. Country studies on Armenia, Azerbaijan, Kazakhstan, Kyrgyzstan, Tajikistan and Uzbekistan brought out the salient features, issues and problems of the globalization process emerging in economies in market-based transition in the ESCAP region. They also contain various proposals for the promotion of further economic restructuring and policy reforms – including a detailed assessment on a number of core areas of reform that are essential for the efficient and effective operation of a market economy, namely, markets and trade, investments, financial institutions and human resources development. In addition, the studies reviewed at length the country-specific conditions and circumstances, the progress in market-based economic transformation as well as the remaining agenda of policy reform and capacity-building to better manage the challenges and opportunities of economic growth, structural diversification and competitive globalization.

The publication was undertaken by the Socio-economic Analysis Section of the Poverty and Development Division, ESCAP. Mr. Eugene I. Gherman, Economic Affairs Officer, prepared the overview paper. Substantive editing of the publication was provided by Ms. Fareeda Maroof Hla, a consultant to ESCAP. Acknowledgements are due to the national experts from Central Asian economies who prepared assessment country studies on managing globalization in their respective countries, namely, Ms. Anahit Petrosyan, Head, Macroeconomic Research and Analysis Department, Ministry of Finance and Economy, Mr. Gnel Mayilyan, Head, Investment Policy Department, Ministry of Trade and Economic Development, and Mr. Paruyr Hovhannisyan, Head, International Economic Cooperation Department, Ministry of Foreign Affairs, Armenia (chapter II); Mr. Adalat Muradov, Professor, Academy of Public Administration under the President, and Mr. Altai Efendiev, Head, Department of Economic Cooperation and Development, Ministry of Foreign Affairs, Azerbaijan (chapter III); Mr. Sh. A. Dauranov, Director, Department of Economic Policy and Indicative Planning, Ministry of Economics and Budgeting Planning and Mr. A. F. Deberdeev, Deputy Director General, Economic Research Institute, Ministry of Economics and Budgeting Planning, Kazakhstan (chapter IV); Ms. Anarkan Rahmanova, Chief, Main Department of External Economic Relations, Trade and Work with WTO, Ministry of External Trade

and Industry, Kyrgyzstan (chapter V); Mr. Isroil I. Mahmudov, Deputy Minister, Ministry of Economy and Trade, and the staff members of the Institute of Economic Research, Ministry of Economy and Trade, Mr. Nuriddin K. Kayumov, Professor and Director, Academician of the Academy of Sciences, Mr. Rashid K. Rahimov, Professor and Head of Department, Academician of the Academy of Sciences, and Mr. Khojamahmad U. Umarov, Professor, Head of Department of the Institute, Tajikistan (chapter VI); and to the staff members of the Center for Economic Research of Uzbekistan (chapter VII).

CONTENTS

	<i>Page</i>
PREFACE	iii
I. MANAGING GLOBALIZATION IN SELECTED COUNTRIES OF CENTRAL ASIA	1
Introduction	1
A. Globalization and regional integration	2
B. Transition assessment.....	6
C. International trade	8
D. Foreign direct investment	11
E. Emerging social issues during transition	13
F. The challenges ahead	15
II. MANAGING GLOBALIZATION IN ARMENIA	17
Introduction	17
A. Globalization and regional integration	17
B. Transition assessment.....	22
C. Markets and trade	29
D. Investment liberalization policies	30
E. Impact of globalization on social and human resources development	33
F. Key challenges ahead.....	40
G. Conclusions	44
III. MANAGING GLOBALIZATION IN AZERBAIJAN	47
Introduction	47
A. Globalization and regional integration	48
B. Transition assessment.....	50
C. Markets and trade	54

CONTENTS *(continued)*

	<i>Page</i>
D. Investment liberalization policies	56
E. Impact of globalization on social and human resources development	58
F. Key challenges ahead	60
G. Conclusions	63
IV. MANAGING GLOBALIZATION IN KAZAKHSTAN	65
Introduction	65
A. Globalization and regional integration	66
B. Transition assessment.....	68
C. Markets and trade	74
D. Investment liberalization policies	76
E. Impact of globalization on social and human resources development	77
F. Key challenges ahead.....	81
G. Conclusions	85
V. MANAGING GLOBALIZATION IN KYRGYZSTAN	87
Introduction	87
A. Globalization and regional integration	88
B. Transition assessment.....	91
C. Markets and trade	98
D. Investment liberalization policies	99
E. Impact of globalization on social and human resources development	101
F. Key challenges ahead.....	106
G. Conclusions	109

CONTENTS *(continued)*

	<i>Page</i>
VI. MANAGING GLOBALIZATION IN TAJIKISTAN	111
Introduction	111
A. Globalization and regional integration	112
B. Transition assessment	114
C. Markets and trade	121
D. Impact of globalization on social and human resources development	122
E. Key challenges ahead	124
F. Conclusions	127
VII. MANAGING GLOBALIZATION IN UZBEKISTAN	129
Introduction	129
A. Globalization and regional integration	129
B. Transition assessment	131
C. Markets and trade	141
D. Investment liberalization policies	142
E. Impact of globalization on social and human resources development	145
F. Key challenges ahead	148
G. Conclusions	152

TABLES

	<i>Page</i>
I.1. Area and population of selected countries in Central Asia, 2002	3
I.2. Merchandise exports and imports of the Central Asian countries, 1995-2002	9
I.3. Foreign direct investment in selected Central Asian economies, 1997-2001	12
II.1. Foreign investment incentives	32
IV.1. Distribution of imports by rates of customs duty, 1995 and 2001	75
IV.2. Indicators of living standards in Kazakhstan, 1995-2001	79
IV.3. Selected consumption indicators in Kazakhstan	80
V.1. Indicators of living standards in Kyrgyzstan, 1996-2001	103
VII.1. Development of the private sector in Uzbekistan	136
VII.2. Indicators of FDI in Uzbekistan, 1994-2001	144

ABBREVIATIONS

ADB	Asian Development Bank
BSEC	Black Sea Economic Cooperation Organization
CACO	Central Asian Cooperation Organization
CAEC	Central Asian Economic Community
c.i.f.	cost, insurance, freight
CIS	Commonwealth of Independent States
EBRD	European Bank for Reconstruction and Development
ECO	Economic Cooperation Organization
ESCAP	Economic and Social Commission for Asia and the Pacific
EU	European Union
EurAsEC	Eurasian Economic Community
FDI	foreign direct investment
f.o.b.	free on board
FTA	free trade agreement
GDP	gross domestic product
GUUAM	transport and economic block of Georgia, Ukraine, Uzbekistan, Azerbaijan and Moldova
HGA	host government agreement
ICOR	incremental capital output ratio
ICT	information and communication technology
IMF	International Monetary Fund
MFN	most-favoured nation
PRSP	Poverty Reduction Strategy Paper

ABBREVIATIONS *(continued)*

PSA	production-sharing agreements
SCO	Shanghai Cooperation Organization
SMEs	small and medium-sized enterprises
TRACECA	Transport Corridor Europe-Caucasus-Asia
UNDP	United Nations Development Programme
VAT	value added tax
WTO	World Trade Organization

I **MANAGING GLOBALIZATION IN SELECTED COUNTRIES OF CENTRAL ASIA¹**

Introduction

Globalization signifies an increase in interaction across borders in areas such as economic cooperation, technology, personal contacts and political engagement. The process is fostered and coordinated by a number of international institutions and organizations, many of whom are outgrowths of globalization itself. These bodies seek to maintain systemic stability and transparency in diverse and segmented markets across countries and regions and to promote equitable ownership and participation among partner economies over time. They also aim to ensure intergenerational sustainability of global and regional common resources. Thus, economic integration among interdependent countries has become multifaceted, involving economic production but also transnational resource mobilization, allocative decisions and intermediation.

The benefits of globalization are related to the availability of newer, cheaper, faster and more diversified and expanded flows of resources, goods, services, facilities, ideas and knowledge, as well as to higher living standards on a global basis. However, these benefits are not equally distributed among all participating countries. While developed countries, seem to enjoy the immediate benefits of the process of globalization disproportionately, the developing and least developed countries have to make painful readjustments to their economic and social policies. Global integration has also made many nations more vulnerable to exogenous shocks, leading to internal crises that sometimes become international. The principal issue at stake is how best to carry out the globalization process in a sustainable manner that is consonant with the inevitable diversity of local conditions and circumstances, both within and across interdependent countries and also through time.

The Central Asian economies have been involved in the globalization process since the beginning of their economic transition to a market-oriented system in 1992. Macroeconomic reforms initiated in these countries have

¹ The countries included within the scope of this analysis are Armenia, Azerbaijan, Kazakhstan, Kyrgyzstan, Tajikistan and Uzbekistan.

included the introduction of prudent macroeconomic management, financial sector reform, tax reform, exchange rate management, legislative reform, better public administration and participation of the private sector in economic development. Considerable progress was made towards trade liberalization through the elimination of State monopolies in foreign trade, relaxation of licensing requirements and implementation of significant tariff reforms. The ongoing reforms of policies and structures have enabled Central Asian countries to move towards more open economies capable of benefiting from the globalization process.

A. Globalization and regional integration

The Central Asian countries consider globalization to be a means for improving national competitiveness as well as the living standards and welfare of their people. The first step undertaken by these countries to further the process was the development of regional economic cooperation within the Commonwealth of Independent States (CIS). Economic cooperation among Central Asian countries can be viewed both as a natural outcome of, as well as a prerequisite to, their economic and social development. It is also a natural outcome of their geographic proximity. More importantly, the countries of the subregion were part of the former Soviet Union and were firmly integrated into the inter-State division of labour. In the immediate aftermath of the break-up of the former Soviet Union, some of the links between Central Asian nations were severed. More recently, efforts have been made to restore and revitalize these links. Regional economic cooperation is also a necessity as each of the Central Asian republics individually has a rather small market (table I.1). However, the many historical and geographical characteristics common to these countries, as well as areas of economic complementarity between them, suggest that there is considerable potential for the countries of Central Asia to face global challenges collectively.

The process of economic integration in CIS was initiated in 1993 with the signing of an agreement by all 12 members on the creation of an economic union to form a common economic space.² In addition, an agreement on the creation of a free trade zone was signed in 1994. A schedule for the implementation of proposals on the establishment and functioning of the free trade zone were adopted by the Council of Heads of State of CIS in June 2000. In the same

² Apart from the Central Asian republics included in this study, the other members of CIS are Belarus, Georgia, Republic of Moldova, Russian Federation, Turkmenistan and Ukraine.

Table I.1. Area and population of selected countries in Central Asia, 2002

	<i>Area (thousand square kilometres)</i>	<i>Population (millions)</i>
Armenia	29.8	3.2
Azerbaijan	86.6	8.2
Kazakhstan	2 724.9	14.8
Kyrgyzstan	199.9	5.0
Tajikistan	143.1	6.5
Uzbekistan	448.9	25.1

Source: Interstate Statistical Committee of the CIS, February 2003.

month, the Council of Heads of Government of CIS adopted a plan of measures for realizing the programme of action for the development of CIS in the period to 2005. However, progress has been slow, as such close integration requires macroeconomic convergence as well as a series of complex negotiations involving decisions on all aspects of an economic union. These include the establishment of a common central bank and a single supranational currency; common monetary and fiscal positions in support of an agreed inflation target; a common foreign economic policy and agreements regarding the unimpeded internal movement of goods and services, as well as factors of production; and a joint budget to address common needs, preferably financed through a single taxation system. The formation of an economic union inevitably presupposes the renunciation of a certain degree of economic sovereignty and the transfer of some significant economic management functions to supranational institutions.

In February 2003, four members of CIS, namely Kazakhstan, Russian Federation, Ukraine and Belarus, took the initiative in establishing an economic union and signed an agreement for the creation of a single economic space. The countries agreed to establish an Organization of Regional Integration with a supranational commission on trade and tariffs. The single economic space is a new form of integration within CIS, requiring synchronization in the customs, currency, legislative and budgetary spheres. Kazakhstan, Russian Federation and Belarus are also members of the Eurasian Economic Community (EurAsEC), which includes Kyrgyzstan and Tajikistan. A free trade zone with a common external tariff, customs and tax policy is to be established within the Community. Furthermore, the EurAsEC will introduce a common currency and broader cooperation among member countries, including in such areas as economic

restructuring, the promotion of macroeconomic stabilization policies, improvements in the investment climate and adequate food supplies for the public. The countries of EurAsEC will also develop a joint position for negotiations on accession to the World Trade Organization (WTO).

In 1994, Kazakhstan, Kyrgyzstan and Uzbekistan signed an agreement on establishing a common economic space. Tajikistan joined the agreement in March 1998, leading to the creation of the Central Asian Economic Community (CAEC) by the four Central Asian republics. In February 2002, the Community was replaced by the Central Asian Cooperation Organization (CACO) aimed at improving the forms and mechanisms of regional economic collaboration. Among the measures contemplated are the gradual establishment of a free trade area; coordination in regional transport and energy systems; the sharing of water resources; reinforcement of industrial cooperation; development of direct economic ties; and coordination of efforts to improve the regional environment. Mutually beneficial economic cooperation is the main priority of the CACO.

In order to increase the size of the markets and resources available to them, so as to diversify production and create a competitive economic environment in the subregion, the republics of Central Asia have broadened economic cooperation to include other countries within and outside the ESCAP region. In 1992, for example, Azerbaijan, Kazakhstan, Kyrgyzstan, Tajikistan and Uzbekistan joined the Economic Cooperation Organization (ECO), which was originally founded by Iran, Pakistan and Turkey. The major activities of ECO include the development of transport and telecommunications infrastructure, the attraction of foreign direct investment (FDI) to the subregion and cooperation in cultural activities and scientific research. However, the achievements of ECO have been limited by the non-compliance of members regarding the necessary commitments and regulations. Armenia and Azerbaijan are members of the Black Sea Economic Cooperation Organization (BSEC) created in 1992.³ BSEC focuses its activities on the promotion of economic partnership in the sphere of industry, trade, transportation, agriculture, environment and energy with the main objective being to integrate member states into European and Asian structures. Other objectives are to reduce tariff and non-tariff barriers between regions and to create a more favourable environment for exchange of the country experiences and ideas on the implementation of macroeconomic and social policies.

³ Other members of the organization include Albania, Bulgaria, Georgia, Greece, Moldova, Romania, Russian Federation, Turkey and Ukraine.

During the last six years, economic cooperation in Central Asia has been extended both east and west. Azerbaijan, Georgia and Uzbekistan formed an economic block focused on transport with two other CIS countries, Ukraine and Republic of Moldova, in 1997. The organization, referred to by the initials of member countries as GUUAM, is to be transformed into a subregional integrated association to serve as a transportation link between Europe and the Asia-Pacific region. Central Asian countries have also increased economic cooperation with China, particularly within the Shanghai Cooperation Organization (SCO) established in 1996.⁴ One of the main objectives of the organization, which is expected to function as a fully-fledged international organization in 2004, is to promote economic cooperation through building trade links and developing energy resources.

The integration of the Central Asian countries with the rest of the international community provides an opportunity to improve socio-economic conditions within the subregion. These countries participate actively in the process of globalization through membership of different intergovernmental organizations, such as the International Monetary Fund (IMF), the World Bank, the Asian Development Bank (ADB) and the European Bank for Reconstruction and Development (EBRD), from whom assistance in undertaking large-scale structural changes and implementing macroeconomic reforms has been received. However, the main long-standing policy goal of the Central Asian countries for further integration into the global economy is accession to WTO. At present, only three countries in the subregion, namely Armenia, Georgia and Kyrgyzstan, are full members of WTO. The other countries are at different stages in the accession negotiations. Kyrgyzstan, which was the first CIS country to join WTO in 1998, has developed trade and economic relations with more than 100 States and has increased its external trade turnover from US\$ 537 million in 1998 to US\$ 970 million in 2002. Armenia completed the process of accession to WTO in December 2002 and the Protocol of Accession is now awaiting ratification by that country's parliament. The membership of a country in WTO promotes the establishment of a legal framework and market-based institutions supportive of international trade and widens access to markets and investment inflows through the provision of unconditional most-favoured nation (MFN) status. Azerbaijan, Kazakhstan, Tajikistan and Uzbekistan currently have observer status at WTO and are engaged in intensive accession negotiations. The

⁴ The founder members were China, Kazakhstan, Kyrgyzstan, Russian Federation and Tajikistan. Uzbekistan joined the SCO in 2001.

negotiation process focuses mainly on so-called systemic issues, including the harmonization of national trade standards with global norms.

B. Transition assessment

More than a decade has passed since the countries of Central Asia launched major macroeconomic reforms with the objective of transforming their economic systems. Macroeconomic reforms initiated in those economies have many common features. The most important aspects of these reforms relate to macroeconomic stabilization, financial sector reform, fiscal reform, exchange rate management, legislative reform and improved public administration. Key issues in macroeconomic policy facing all countries were creating market-based economic systems and becoming more competitive on global markets through liberalization, privatization and the participation of the private sector in the development process.

Armenia, Azerbaijan, Kazakhstan and Kyrgyzstan have been more successful than other Central Asian republics in implementing price and trade liberalization policies, as well as in reforming monetary and fiscal policies. Improvements in those areas were followed by banking, tax and budgetary reforms, which resulted in arresting the hyperinflation experienced by all these countries in 1993-1995. Prudent fiscal and monetary policies and appreciation of national currencies were the two main factors in the considerable success achieved in macroeconomic stabilization in those countries. However, the progress of Uzbekistan in implementing macroeconomic reforms has been slow, as the Government has followed a more gradual approach in the transition to a market-oriented economy. The reform process in Tajikistan was hampered by many internal and external factors. Among them was the lack of financial resources and experience to implement macroeconomic transformation and to speed up economic recovery. An environment unfavourable to competition both in the country and in the subregion and an inappropriate legal framework for the creation of institutions needed for the functioning of a market economy were other handicaps. However, the country managed to pull through these difficulties with remarkable success. In 2000-2002, annual growth rates of GDP and of industrial production exceeded 8 per cent and 10 per cent respectively.

Over the past decade, Central Asian economies have undertaken substantial financial sector reforms, as well reforming tax policy and tax administration, so as to fight hyperinflation, improve their fiscal positions and remove interest rate controls, thereby bringing these rates closer to their market values. The

liberalization of the external account, more flexible exchange rates and the establishment of foreign financial companies in the domestic market have accompanied the reform measures.

The reform of the financial sector in Armenia has been aimed at increasing tax revenues and reducing inefficient public expenditure to curb enormous budget deficits. Since 1995, the Central Bank has gradually moved to the use of market-based instruments for better coordination of monetary and fiscal policies. As a result, bank capitalization increased and banking supervision was enhanced. The approval of a law relating to the Central Bank of Armenia in 1993 improved the legal environment for the functioning of the banking system. Azerbaijan reformed its tax system through adoption of a tax code, established a currency market and stabilized the exchange rate to maintain convertibility and reduce the inflation rate. In Kazakhstan considerable improvement was made in tax administration and the budget process, as well as in the banking system. The Central Bank formulated measures to maintain price stability, created a fund to provide deposit insurance and introduced further exchange rate liberalization. The reform of the fiscal system has been aimed at increasing the efficiency of budget performance, expanding the tax base to increase revenues and modernizing the Treasury. Kazakhstan's reform efforts were recognized in March 2002 when the United States of America accorded the country market economy status.

In the course of macroeconomic reforms, the Central Asian economies have moved from multiple exchange rate practices towards more flexible, unified and market-based exchange rate regimes. Kazakhstan, Kyrgyzstan and Tajikistan have eliminated multiple rates, abolished surrender requirements and accepted Article VIII status in IMF. Uzbekistan introduced a number of policy measures to relax currency controls for both foreign investors and national businesses in 2001-2002 as part of the gradual liberalization of the foreign currency market. Among these measures were the introduction of a new exchange rate for exporters and foreign investors, the abolition of the tax on repatriated hard-currency earnings and the exemption of small and medium-sized enterprises (SMEs) from the surrender rate. The som was also depreciated in order to bring the official rate closer to the parallel market rate but the currency has yet to become fully convertible as planned.

In order to mobilize more resources for investment, reduce uncertainty and transaction costs and pool risks, Kazakhstan, Kyrgyzstan and Uzbekistan established stock exchanges in 1997, 1998 and 1994 respectively. The exchanges have infrastructure, regulatory frameworks and listing requirements that conform

to relatively high standards. However, trading levels remain low, reflecting the small size of these economies.

Central Asian republics also began the process of privatization as part of the structural reforms implemented during the past decade. Privatization in all these countries has been implemented in stages, starting with privatization of SMEs and moving on to large State-owned enterprises. However, the results and consequences of these reforms differ from country to country. The key issues affecting privatization in all these countries, however, are the ability of privatized enterprises to attract qualified management and advanced technology, as well as the restoration of confidence in financial systems so that the savings and investment needed for development will be stimulated.

Armenia initially privatized more than half of its agricultural land, resulting in an increase in the number of farms as well as in agricultural production. Then, during the period of mass privatization, ownership of more than 1,500 medium- and large-scale enterprises and 6,000 small businesses was transferred. In the last stage of the privatization process, referred to as cash privatization, many joint ventures were created, which attracted additional investment inflows into the economy to some extent. In Azerbaijan, the process of privatization also started with land reforms and privatization of medium-sized enterprises, which increased the share of the private sector in agriculture and industry.

Kazakhstan focused its privatization programme on post-privatization policy, including the bankruptcy process for insolvent enterprises, creating conditions for faster recovery of industry and legalization of private sector activities. The privatization of large enterprises in the mining, chemical, oil and oil-processing industries was made on a case-by-case basis and those enterprises were sold mainly to foreign investors. During the privatization process, the Government also worked out a policy to improve the structure and management of remaining State enterprises. The privatization programme in Uzbekistan is more modest. The first stage was directed at companies in the trade and consumer services sectors. It was followed by the sale of larger companies in industry.

C. International trade

The Central Asian countries have made considerable progress towards trade liberalization through the elimination of state monopolies in foreign trade, relaxation of licensing requirements and implementation of significant tariff reforms. Most countries have established relatively open and liberal regimes and have undertaken measures to abolish state monopoly privileges, unify

exchange rates and simplify the regulatory and fiscal frameworks governing foreign trade. The efforts to liberalize trade also included elimination of non-tariff trade restrictions and export duties, surrender of earnings from exports and registration requirements for export contracts.

The Central Asian economies have benefited from trade liberalization and the move towards world prices. In 1995-2002, exports grew significantly and countries were also able to diversify their markets (table I.2). During this period, export earnings rose from US\$ 637 million to US\$ 2,167 million in Azerbaijan and from US\$ 271 million to US\$ 508 million in Armenia. Despite a narrow export base and lower oil prices, export earnings in Kazakhstan rose from US\$ 5.25 billion in 1995 to US\$ 9.67 billion in 2002. Imports continued to be dominated by technological goods and the value of import spending

Table I.2. Merchandise exports and imports of the Central Asian countries, 1995-2002

(Millions of US dollars)

	1995			2001			2002		
	Total	CIS	Other	Total	CIS	Other	Total	CIS	Other
Exports (f.o.b.)									
Armenia	271	170	101	342	89	253	508	98	410
Azerbaijan	637	285	352	2 314	223	2 091	2 167	243	1 924
Kazakhstan	5 250	2 883	2 367	8 647	2 632	6 015	9 670	2 211	7 459
Kyrgyzstan	409	269	140	476	168	308	487	170	317
Tajikistan	749	252	497	652	212	440	739	189	550
Uzbekistan	2 821	1 109	1 712	2 025	n.a.	n.a.	1 370 ^a	n.a.	n.a.
Imports (c.i.f.)									
Armenia	674	334	340	877	218	659	990	305	685
Azerbaijan	667	228	439	1 431	445	986	1 666	650	1 016
Kazakhstan	3 807	2 653	1 154	6 363	3 306	3 057	6 496	3 042	3 454
Kyrgyzstan	522	353	169	467	257	210	589	324	265
Tajikistan	810	478	332	688	538	150	715	543	172
Uzbekistan	2 748	1 118	1 630	2 341	n.a.	n.a.	1 350 ^a	n.a.	n.a.

Source: Interstate Statistical Committee of the CIS web site <<http://www.cisstat.com/eng/mac-08.htm>> (21 July 2003).

Notes: n.a. = not available.

^a January-June 2002.

increased from US\$ 3.8 billion in 1995 to US\$ 6.5 billion in 2002. Tajikistan ran a trade surplus of US\$ 24 million in 2002 compared with a trade deficit of US\$ 61 million recorded in 1995 as import spending fell by US\$ 95 million. During the first half of 2002, import spending rose by 11 per cent in Uzbekistan owing mainly to an increase in imported machinery and equipment, which accounted for 44 per cent of all imports of goods and services. Export earnings declined from US\$ 1.58 billion in the first half of 2001 to US\$1.37 billion in the corresponding period of 2002, mainly owing to a decline in the value of cotton, food and energy exports. The CIS countries, in particular Russian Federation, remained the main trading partners for most countries in Central Asia. The CIS countries accounted for 26 per cent of total export earnings and 76 per cent of the total import expenditures of Tajikistan in 2002. In 2002, exports to other CIS countries rose by about 20 per cent in Kyrgyzstan, while the share of CIS countries in that country's imports increased by 26 per cent.

In the 1990s, the Central Asian countries redirected their trade to some extent away from traditional partners of the former Soviet Union to non-CIS countries. Although Russian Federation remains one of the main trade partners of all the countries in the subregion, more than 60 per cent of exports from these countries is now directed to non-CIS destinations. Germany, Italy, China and the United States are among the new trade partners of the Central Asian countries. Improved international market conditions increased the value of exports of the Central Asian countries to the non-CIS area. For example, non-CIS economies accounted for about 78 per cent of Kazakhstan's exports in 2002, compared with 45 per cent in 1995, reflecting increased sales of electricity and agricultural commodities. Exports from Tajikistan to countries outside CIS also increased in the same period on the strength of higher aluminum sales.

Primary commodities dominate the exports of Central Asian countries making their export revenues highly sensitive to changes in world commodity prices. Kazakhstan and Azerbaijan depend significantly on foreign sales of crude oil, natural gas and oil products. Exports of base and ferrous metals are important to Kazakhstan, Kyrgyzstan and Tajikistan, while cotton and light industrial products are important to Uzbekistan. The countries of the subregion export similar products to third markets where they are in competition with each other. At the same time, the trade regimes of these economies are still characterized by a complex set of non-transparent, non-tariff barriers, in addition to a wide-ranging and changeable tariff structure. For example, Kazakhstan imposed a tariff of 200 per cent on goods imported from Uzbekistan and Kyrgyzstan in February 1999. As a retaliatory measure, Uzbekistan introduced

US\$ 300 transit fees on lorries from Kazakhstan, to which Kazakhstan responded by removing the tariff but imposing a value added tax of 20 per cent on imports from Uzbekistan.

Trade facilitation measures are a necessary accompaniment to trade liberalization at the subregional level. Harmonizing and simplifying administrative aspects of individual trade transactions are essential because if traders continue to face a multitude of procedural obstacles to trade, liberalization efforts may not yield the anticipated results. There are a number of ways in which trade facilitation measures can help Central Asian countries integrate into regional and global economic systems. Obstacles to trade at the border, in the form of trans-shipment delays at points of entry and exit, complex customs procedures, unfair customs valuations or unnecessary inspections, are commonly found among Central Asian countries. Simplification, automation, harmonization and greater transparency in customs procedures could significantly lower the costs of doing business and engaging in trade.

In order to reduce trade barriers, Central Asian republics have undertaken several bilateral initiatives towards closer economic cooperation. Kazakhstan and Kyrgyzstan reached an agreement on free trade in 1996, with the aim of creating favourable conditions for the free movement of goods, capital and labour. In 2002, the two countries signed a programme of economic cooperation for the period to 2005, including agreements on labour migration and the equitable use of water resources. Kyrgyzstan and Tajikistan also signed agreements on free trade and on the mutual protection of investments. The two countries agreed to establish a bilateral commission to resolve border issues, noting the desire of both sides to develop coal, gas and mineral resources located in the immediate vicinity of their common border. In February 2001, Tajikistan and Uzbekistan expanded their mutually beneficial economic cooperation through signing two agreements on mutual payments for goods transport and on cooperation in the use of water resources. In addition, the two countries signed agreements in March 2003 on transit, water and energy, which strengthen bilateral trade and economic cooperation between them.

D. Foreign direct investment

FDI plays an important role in the economic development of countries in Central Asia. FDI provides the subregion with an additional source of capital and enhances market access through the distribution systems of transnational corporations. FDI serves as a vehicle for technology transfer and plays a major

instrument in enhancing the efficiency of trade in services, such as banking, insurance and telecommunications. Central Asian countries have individually taken steps to liberalize their investment regimes to attract FDI. In combination with macroeconomic stabilization, this has led to an increase in FDI inflows to those countries (table I.3).

Table I.3. Foreign direct investment in selected Central Asian economies, 1997-2001

(Millions of US dollars)

	1997	1998	1999	2000	2001	Total 1992-2001
Armenia	52	221	122	104	70	569
Azerbaijan	1 125	1 023	510	129	227	3 014
Kazakhstan	1 321	1 151	1 468	1 278	2 760	11 042
Kyrgyzstan	83	109	44	-2	25	450
Tajikistan	30	40 ^a	6 ^a	23 ^a	8 ^a	182 ^a
Uzbekistan	167	140	121	75	70	769

Source: Economic Commission for Europe, *Economic Survey of Europe 2002* (United Nations publication, Sales No. E.02.II.E.7).

^a Data from the State Statistical Committee of the Republic of Tajikistan.

Kazakhstan attracted more than 80 per cent of all FDI in Central Asia in 1992-2001. The country's natural resources are the main focus of interest for foreign investors, with 50 per cent of FDI during this period going to the oil and gas sector and a further 27 per cent to the metals sector. Total FDI in Azerbaijan in 1992-2001 amounted to just over US\$ 3 billion or less than 30 per cent of the total invested in Kazakhstan. Here, too, the bulk of FDI has gone to the oil sector. Uzbekistan has the lowest average ratio of FDI to GDP in Central Asia. Total net FDI in 1992-2001 was about US\$ 770 million, equivalent to US\$ 30 per head or 1.2 per cent of GDP. In comparison, Kazakhstan attracted FDI inflows of 6.8 per cent of GDP in 2000. Among other Central Asian economies, FDI flows to Kyrgyzstan rank above Tajikistan, which receives the lowest level of FDI in the subregion. To encourage foreign investment, the Government has made some legislative changes. In particular, the Laws on Foreign Investment and on Customs Tariffs, as well as the Tax Code were amended in 2002. In 2000, FDI accounted for 2.2 per cent of GDP

in Kyrgyzstan. The United Kingdom of Great Britain and Northern Ireland, the United States, Turkey, Italy and Russian Federation are the main foreign investors in that country.

All Central Asian countries view FDI as a critical factor in making the transition from centrally planned to market-driven economies. All of them have adopted foreign investment codes intended to open up their economies to foreign participation. However, there are considerable differences among countries with respect to the conditions influencing FDI. The attraction of FDI flows depends not only upon the legal framework and available incentives but also on political stability, the general business climate, availability of indigenous resources including skilled labour and various other determinants in the host country. More effective cooperation between Central Asian republics would enable them to attract greater inflows of FDI and maximize its benefits in the subregion. In view of the small sizes of national markets, progress in cooperation that would guarantee access to the whole subregional market to potential foreign investors represents an essential precondition for promoting investment in manufacturing and redressing the present excessive concentration of FDI in primary industries.

E. Emerging social issues during transition

The transition to a market-based system in Central Asian countries over the past decade has been much more difficult than originally expected. Economic contraction and the related growth in poverty and unemployment in those countries were much greater and of longer duration than initially expected, while rapid growth in external indebtedness in some countries threatened to undermine the economic recovery once it was finally under way. In 1990-1995, real GDP of Central Asian countries fell by more than 50 per cent and poverty and inequality increased substantially. Since 1995, growth has resumed and important gains have been made, as mentioned earlier, in macroeconomic stability, fiscal consolidation, privatization and liberalization of economic activity and development of the basic institutions required for the efficient functioning of market economies. However, output of most subregional economies in Central Asia in 2002 remained around 25-30 per cent below the 1989 level and financial and physical indicators of living standards remain depressed and may have deteriorated in some countries. Uzbekistan was the only country where GDP had recovered to the level of 1989 by 2001.

During the transition period, poverty and income inequality increased to very high levels in Central Asian republics and poverty alleviation and unemployment appear to be the main challenges now facing these countries. A sizeable proportion of the population in the subregion lives in poverty. Physical indicators of poverty have steadily worsened and social safety nets have deteriorated greatly, mainly owing to the limited resources available for poverty reduction and to the absence of income and employment generation programmes in many Central Asian countries. For example, about 50 per cent of the population in Kyrgyzstan lived below the poverty line in 2002. The number of registered unemployed in the country increased from 2.9 per cent in 1999 to 3.3 per cent in 2002. Half of those unemployed were women and average unemployment benefits were around US\$ 9.5 per month, a little over one third of the minimum subsistence level of US\$ 32. In the last decade, the population of Tajikistan increased by 14 per cent, reaching 6.5 million in 2002, while GDP fell by 64 per cent, resulting in soaring unemployment and poverty. The minimum wage in Tajikistan at the beginning of 2002 was one of the lowest in the CIS countries. Official unemployment in the country was at the relatively low level of 4.2 per cent of the workforce in 2002. However, unemployment was on an upward trend owing to the slow speed of restructuring in the industrial sector and the lack of reform in the agricultural sector. Of the total number of women and young people aged 15-29 years in the labour force in 2002, some 53 per cent and 66 per cent respectively were unemployed.

Among the measures undertaken by the Central Asian countries to reform labour markets were improvements in labour legislation and the creation of new employment opportunities. As a result, the official unemployment rate fell from 11.5 to 9.8 per cent in Armenia and from 3.9 to 2.8 per cent in Kazakhstan between 1999 and 2001. Official unemployment rates remained largely unchanged at relatively low levels of around 0.5-1.5 per cent in Azerbaijan and Uzbekistan. Azerbaijan adopted an employment generation programme based on the new business environment and self-employment opportunities created during the economic transition. The programme focused on training and retraining employees and on the establishment of an information system on labour markets. A similar information system was developed in Tajikistan to monitor labour markets and to improve systems for job search, particularly in the private sector. New economic conditions in labour markets in Kazakhstan have enabled unemployment rates to be reduced with a high level of self-employment and increased labour mobility. Nevertheless, total employment in Central Asia in 2001 was still some 15-25 per cent below the 1989 level.

The Governments of Central Asian countries have also proceeded with reforms of income generation policies aimed at increasing the general wage level as well as improving payment systems to stimulate employment. Azerbaijan adopted a law on the minimum budget needed by consumers, which identified the subsistence consumption basket for the population based on the minimum wage and the most important goods and services needed by households. The tight monetary and budget policies that were introduced by the Government of Uzbekistan in 1995 resulted in falling levels of real income and wages in the population that created considerable economic and social disruption and dislocation, particularly in rural areas where the poorest segment of the population lives. The social support system for the most vulnerable groups of the population has now been reformed. The main reform measures included direct social transfers to poor families, targeted social benefits and privileges, as well as other incentives and payments. A programme of targeted support to socially vulnerable groups for the period of 2002-2003 introduced by the Government of Uzbekistan in 2001 was expected to have a positive impact on the social and human welfare of the rural population.

The issues of poverty, unemployment and income distribution in Central Asian countries are among major policy concerns in those economies. In order to make better progress in poverty reduction, countries in the subregion need to tackle a broad agenda of fiscal, structural, social and institutional reforms. It goes without saying that sustained, rapid economic growth is the basic requirement for poverty reduction. However, further action to implement social reforms is also needed.

F. The challenges ahead

A sustainable rate of economic growth and integration into the global economy are two factors for successful development of any country. The countries of Central Asia are fortunate in having a good foundation on which to base their economic growth. They are rich in natural resources, which constitute their principal export prospects in the global economy. The subregion has a comparative advantage in agriculture and can be self-sufficient in food. Additional advantages of the region are human resources with a high level of education and scientific and technical potential. The countries of Central Asia have initiated cooperative efforts in their integration into the regional and global economies. However, full benefits of such cooperation are yet to be realized because of many factors such as completion of ongoing reforms, achievement of

macroeconomic stability, improvement of fiscal positions, promotion of sub-regional economic cooperation in trade. Attracting increased FDI, infrastructure and human resources development and accession to WTO are other outstanding issues.

In addition to a number of common challenges faced by Central Asian countries in transition to a market economy, each country has its own key policy imperatives. Important areas that require the continued attention of the Government of Armenia are completion of financial sector reforms, modernization of industrial enterprises and market infrastructure and implementation of the Interim Poverty Reduction Strategy. Azerbaijan and Kazakhstan intend to develop non-oil sectors in order to diversify economic production and enhance their competitiveness in international trade and investment. Other challenges faced by these countries range from energy sector reform, banking modernization, strengthening of corporate governance to poverty alleviation. Kazakhstan is expected to reduce the percentage of the population lining below the poverty line by one third over the period 2002-2005. This goal is one of the main objectives of the economic development strategy of the country aimed at building a competitive economy and doubling its GDP by 2010.

The reform agenda in Tajikistan includes completing the creation of market structures, developing the private sector, restructuring industries and SMEs to increase job opportunities for the population and to accelerate output growth, which should lead to improved living standards and poverty reduction. Among the main challenges facing Uzbekistan are liberalization of the foreign exchange regime, full convertibility of the national currency, banking sector reform, tax policy reforms and promotion of privatization with the involvement of foreign investors. For Kyrgyzstan, the main priorities in the medium and long terms are opening new export markets as a new member country of WTO, strengthening economic cooperation with traditional trade partners, mobilization of domestic resources and attracting FDI.

Finally, attention should also be paid to the agricultural sector, which is a very important pillar supporting economic development in Central Asia. In Tajikistan, for example, the agricultural sector faces a variety of constraints and bottlenecks, such as chronic shortages of credit and new investment in modern agricultural machinery and high-quality inputs. Higher agricultural output and productivity could be attained through the introduction of a system of long-term leasing of agricultural land, efforts to improve yields, more stable fuel supplies and greater financial and market-based incentives for agricultural workers.



MANAGING GLOBALIZATION IN ARMENIA

Introduction

Globalization is creating opportunities for millions of people around the world. In general terms, globalization describes the process of increasing economic integration among nations through cross-border flows of goods and resources, together with the development of a complementary set of organizational structures to manage the network of economic activities. In recent years, new information and communication techniques and the growing reach of transnational corporations have added fresh impetus to this process. Emphasis has been placed on private initiative, market incentives and competition as the forces to get the most from existing resources, accelerate growth and raise living standards. With the economic failures of central planning exposed after the collapse of the Berlin Wall, globalization has been seen as the one model to fit all economic circumstances.

The multifaceted processes of globalization are not devoid of negative aspects, many of which have emerged during abrupt transitions from closed to open systems. A number of societies that are still traditional or in early stages of industrialization have merely become sources of cheap labour and raw materials. At the same time, globalization should not lead to needless homogeneity, since every society is free to adopt from among the assortment of universal values those that it needs and is able to accept. The process of globalization is seen as a challenge to preserve identity and maintain individuality, as distinct from uniformity, in the perception of groups of people and communities with different cultures, beliefs and value systems. In this context, the current challenge is to find rules and institutions that strengthen global governance while preserving the advantages of global markets. This study takes as its focus the features specific to Armenia's transition to a free market and to its integration into the world economy.

A. Globalization and regional integration

1. Integration into the multilateral trading system

Trade is one of the most important means whereby countries can link themselves to the world economy as part of ongoing process of globalization.

In recent years, new trade agreements have often been promoted on the basis of their potential benefit to developing countries and countries in transition. In this regard, membership of WTO is of paramount importance and the sooner countries implement market-oriented reforms and liberalize trade, the closer they are to membership of WTO.

The process of Armenia's accession to WTO was complex, prolonged and difficult, involving much more than a simple political decision. New laws and legislative acts had to be introduced by the Government to comply with the requirements of WTO, including in the areas of competition policy, encouragement of small and medium-sized enterprises, protection of the internal market, and anti-dumping. Existing laws relating to the customs code and to protection of intellectual property rights also had to be amended and changed. Among the obstacles in this process was some opposition on the part of some members of the public and certain parliamentary factions. However, the accession procedure was completed in November 2002 and officially approved on 10 December 2002 during the meeting of the WTO General Council in Geneva. The Protocol of Accession is now subject to the ratification by Parliament. Thirty days after the WTO Secretariat receives official notification of this ratification, the country will finally become the 145th member of WTO.

The benefits of WTO membership are well known. First, membership promotes the establishment of a legal framework and market-based institutions in support of international trade. Second, membership provides better guarantees for market access through the provision of unconditional most-favoured nation status, of particular importance to economies in transition. There is now an expectation that exports from Armenia to WTO member countries will grow rapidly as a result of falling trade barriers. Third, there is an established, binding dispute settlement mechanism, which has so far proved to be effective in adjudicating trade disputes. Finally, and very importantly, membership of WTO will reassure potential investors about the predictability and benevolence of the investment climate in Armenia.

Armenia's membership of relevant international organizations, such as the United Nations and its specialized agencies, and its acceptance of international laws are essential for its participation in the globalization process. Thus, under globalization, when state mechanisms are insufficient, international norms can come into play. This is a new dimension in the harmonization of relationships between international standards and local norms, as well as between international organizations and the State. Formerly undisturbed principles of sovereignty and non-intervention, particularly in the area of human rights, are now subject to restriction, within limits.

Armenia has always been a strong advocate of regional cooperation. By transforming differences in national points of view into a unified vision through dialogue, mutual respect, confidence and conciliation, regional economic cooperation contributes significantly to joint efforts aimed at market-based transition and should ultimately consolidate mutually beneficial partnerships in all fields of common interest. The Government of Armenia attaches great importance to regional cooperation initiatives, such as the Transport Corridor Europe-Caucasus-Asia of the European Union (EU) and Interstate Oil and Gas Transport to Europe, as well as Armenia-Greece-Iran trilateral cooperation.

2. Regional trading arrangements and partnerships

At present, Armenia participates in two regional trading arrangements, BSEC and CIS. While cooperation within CIS has made some progress mainly in the political and military areas, BSEC has elaborated quite a solid economic agenda for joint action.

(a) Black Sea Economic Cooperation

In 1992, eleven States in the Black Sea area, Albania, Armenia, Azerbaijan, Bulgaria, Georgia, Greece, Moldova, Romania, Russian Federation, Turkey and Ukraine, initiated BSEC with the goal of promoting economic partnership and assisting member states in integrating themselves into Europe and the world economy. The major sectors covered by BSEC are: industry, trade, transportation, agriculture, environment, research and technology, tourism, energy, SMEs and health. A solid basis has been created for facilitating the reduction of intraregional tariffs and non-tariff barriers and creating an environment in which member states can learn from each other about prioritizing, planning and implementing economic and social policies. The “Declaration of Intent for Establishment of the BSEC Free Trade Area” was adopted in Istanbul in 1997 and Armenia has participated actively in the process of elaborating a plan of action for its creation. The following actions are to be undertaken in the short, medium and long terms to realize the measures envisaged in the plan:

- A review of the foreign trade legislation of member states related to manufactured products, with a view to identifying existing tariff and non-tariff barriers and to recommending measures to overcome them progressively.

- The creation of a legal framework for establishing the BSEC free trade area and, to ensure progress on this score, the promotion of bilateral free trade agreements between member states consistent with the membership of some countries of the EU and WTO.
- Maintenance of traditional trade flows in agriculture together with a review of trade in other agricultural products, with a view to expanding such trade further by way of progressive preferential treatment on a mutually beneficial basis.
- Provision of assistance to those member states in the process of accession to WTO through sharing available experience and information and, subsequently, ensuring conformity of national legislation with the General Agreement on Tariffs and Trade (1994) and the General Agreement on Trade in Services.
- Gradual harmonization of customs, foreign trade and competition legislation in member states, as well as elaboration of the rules of origin in the framework of the free trade area.
- Improvement of certification procedures in order to facilitate mutual recognition of certificates of conformity and, in the longer term, harmonization of standards.
- Reformation and modernization of economic and social structures, giving priority to the adoption and implementation of technical support programmes for SMEs, and creation of an appropriate institutional and regulatory framework for the development of a market economy.
- Establishing close cooperation among statistics institutions in member states and developing statistics on harmonized basis.
- Improvement of border crossings and facilitation of the movement of commercial goods and services across borders, including transit traffic.
- Promotion and conclusion of bilateral agreements between member states on encouraging and protecting foreign investments and avoiding double taxation.

However, there is at present a move to reshape this initiative to focus initially on trade liberalization in the BSEC region, rather than proceeding directly to the establishment of a FTA.

Eight members of BSEC (Albania, Armenia, Bulgaria, Greece, Georgia, Moldova, Romania and Turkey) enjoy the full benefits of WTO membership. The other three countries (Azerbaijan, Russian Federation and Ukraine) are at

different stages of accession to WTO. The prevailing opinion on cooperation within BSEC is that only after all member states have acceded to WTO and brought their policy and regulatory frameworks into conformity with WTO Agreements, will negotiations on establishing a BSEC FTA be fully productive.

(b) Commonwealth of Independent States

The CIS, which was established in 1991, was conceived as a successor organization to the former Soviet Union in its role of coordinating the foreign and economic policies of member nations but without supranational powers. By 1993, all the former republics of the union were members of CIS, with the exception of the Baltic States. By recognizing current borders and the independence, sovereignty and equality of each republic, CIS created a qualitatively new system of interstate relations between members, including in the sphere of external trade.¹ However, the bilateral intergovernmental agreements on free trade signed in 1991-1993 that provided the basis for the development of foreign trade reflected the peculiarities of the Soviet system.

In September 1993, the heads of the CIS States signed an agreement on creating an economic union to form a common economic space, with free movement of goods and services, as well as labour and capital, and with wide-ranging coordination of economic policies so as to foster conditions favourable to the development of direct production links. In April 1994, another agreement was signed, establishing a free trade zone to be created by 2005. This was supplemented by a protocol in 1999, dealing primarily with the modalities of amending the original agreement and temporary exits from the free trade zone. Together, the agreement and the protocol replace the existing bilateral free trade zone regimes with a multilateral one. Parties to the agreement will face unified customs rules, creating favourable conditions for the free movement of commodities and the growth of trade. The prospects of establishing the CIS common market appear to be closer.

A free trade zone is, however, only the first stage in creating an economic union. Apart from eliminating tariff and non-tariff barriers to trade, several measures to facilitate trade need to be taken. A common accounting system for trade and payments will also be required, as well as coordination in the conduct

¹ The following discussion draws extensively on the web sites of the Commonwealth of Independent States, specifically <http://www.cis.minsk.by/english/engl_cis.htm> and <<http://www.cis.minsk.by/english/eng-zona.htm>>.

of trade and other economic policies, including competition policy, as well as in the areas of finance and investment and in the social sphere. Realization of economies of scale, through specialization and trade, and the creation of production networks within the CIS will require greater collaboration both between and within sectors, as well as scientific and technical cooperation to improve competitiveness. Finally, harmonization and unification of legislation in countries that are party to the agreement will be necessary for the proper and effective functioning of the free trade zone. The CIS Council of Heads of State reaffirmed its support for the creation of a FTA in June 2000, when a schedule for the implementation of proposals for its establishment and functioning was adopted.

At the same meeting, the Councils of Heads of State and Heads of Government adopted a programme of action for the development of the CIS over a five-year period to 2005, aimed at bringing an economic union closer. Differences in levels of development, economic potential and the extent of economic reform undertaken so far imply that the speed with which each member country can move to implement a FTA is likely to differ. Therefore, there is to be a specific timetable for each of the CIS countries, although all countries will be proceeding to the same goal. However, public opinion in support of a FTA is still muted and progress has been slow. Agreement has not yet been reached on a common customs policy, even though the most recent meeting of the Council of Heads of State declared its intention to make the CIS free trade zone functional starting from March-April 2003.

B. Transition assessment

1. Progress in transition and its indicators

The Armenian economy has been subjected to a series of major shocks in recent years. First, there was a massive earthquake in December 1988 that affected around 40 per cent of the nation's territory and severely damaged infrastructure; almost 25,000 people died and 500,000 people were left homeless. Second, political independence in the aftermath of the collapse of the Soviet Union was accompanied by a sharp deterioration in the terms of trade, owing to the increased prices of imported energy and the loss of export markets. Third, there was a conflict with neighbouring Azerbaijan over the enclave of Nagorno-Karabakh. As a result, the economy declined during 1991-1993 and, by the end of the period, aggregate output amounted to only 46.8 per cent of the 1990 level. The economic decline was accompanied by very high inflation, which peaked in 1993 when the average increase in the Consumer Price Index reached 4,962 per cent.

In 1994, with the support of the international community, the Government of Armenia started the implementation of a comprehensive stabilization programme to correct large macroeconomic imbalances as well as carry out economic and structural reforms. Major economic reform measures were introduced. The reforms included: comprehensive price liberalization; transfer to the private sector of State-owned agricultural land, housing and enterprises; changing the role of State and introduction of public finance and tax reforms; monetary discipline to control changes in the price level and the introduction of a market-based financial system; adoption of a free trade policy with low tariffs and elimination of non-tariffs barriers to trade; removal of controls over capital movements; and, finally, the adoption of currency convertibility and a floating exchange rate. The goals of the reforms were to achieve macroeconomic stability, to accelerate the rate of economic growth, and to increase efficiency in the allocation of resources.

The stabilization period consisted of two major stages. The first consisted of a fundamental shift towards more restrained monetary and fiscal policies. Fiscal tightening created the conditions for monetary contraction by reducing the need for Central Bank financing of the public sector deficit, thus leading to lower inflation. The second stage increased emphasis on structural reforms, including liberalization of the trade and exchange rate systems; a strengthening of the financial sector; restructuring of enterprises, primarily through privatization; institution building and legislative reforms. As a result of the measures adopted, the economy stabilized and growth resumed in 1994. The average growth rate in 1994-2001 was 6 per cent, with a significant acceleration to 9.6 per cent in 2001. The forecast for real GDP growth in 2002 was 11 per cent but this high rate may not be sustainable and the forecast for 2003-2005 is for a slowdown to around 6 per cent per year. Inflation has not exceeded 3 per cent per year since 1998.

After the break up of the Soviet Union, a change in the composition of output took place in Armenia. Heavy industry declined as a result of unfavourable price movements and the collapse of traditional markets, while agricultural production and light manufacturing increased in importance. The most dynamic sectors in the economy during recent years have been food processing, non-metallic minerals, jewellery and construction. Other sectors with considerable potential, including in terms of spillover effects on the rest of the economy, are software and tourism and their development is among the top priorities of the Government.

2. Lessons from privatization

Privatization has been underway in Armenia since independence. The privatization process over the past ten years can be divided into three stages. The first stage covers 1991-1993 and included the privatization of land and apartments in residential apartment buildings. The second stage covers 1994-1998 and was distinguished by mass privatization through the issuance of certificates or vouchers. The third stage covers 1998-2001, when privatization proceeded on a “case-by-case” basis.

Armenia became the first post-Soviet State to privatize agricultural land, which was very quickly carried out between 1991 and 1993 when nearly all such land passed into private hands. Livestock and other means of production were also privatized. As a result, old agricultural enterprises were closed down and by January 1999 more than 330,000 private farms were created, in fact hampering economies of scale. The privatization programme resulted in a very fragmented land structure, and the average size of farms is now only 1.2 hectares, normally divided into three or four separately located parcels. Nevertheless, privatization has resulted in an increase in agricultural production, with greater self-sufficiency and food security for Armenia and more agricultural exports. The variety of local products available on domestic markets has also increased. Since 1995, agriculture has had stable growth, averaging 4.5 per cent annually in 1995-2001, even though its share in GDP has declined, from 43.8 per cent in 1994 to 25 per cent in 2001, as sectors such as construction and services have grown faster.

In August 1992, the parliament of Armenia passed a Law on Privatization and Demonopolization of State Owned Enterprises and Unfinished Construction Projects that became the cornerstone of the whole process. By the end of 1997, ownership of around 60 per cent of all medium-sized and large enterprises as well as around 60 per cent of all small enterprises was transferred to private hands. Vouchers were the principal means of payment for the purchase of these enterprises until the programme ended in 1998. Vouchers were traded freely on the open market at approximately 30-40 per cent of the nominal value. Thus, the effective values at which enterprises were privatized were well below declared asset values, leading to a substantial reduction in privatization revenues. In the vast majority of cases, ownership was transferred either to managers or employees, leading to an accumulation of assets principally in the hands of the managers.

The new Law on Privatization, approved in January 1998, provided the general framework for further privatization, including the methods to be used and the procedures to be followed in preparing companies for privatization. According to the Law, the main methods of privatization included tenders, auctions, share subscriptions, direct sales, and sales through the capital markets. Currently, cash privatization and privatization with the help of strategic investors by means of international tenders are the preferred means by which the Government hopes to create a competitive privatization process and to attract quality investors. Several major enterprises have already been sold to foreign investors, including majority stakes in the national telecommunications company, ArmenTel, the Yerevan Brandy Factory, Hotel Yerevan and others.

The privatization programme has been making slow progress since 1998. Implementation has been hampered by a number of problems such as the lack of efficient markets and institutional infrastructure and a weak and underdeveloped banking system, among others. However, by August 2000, 83 per cent of the 1533 medium-sized and large enterprises and 90 per cent of the 6,829 small enterprises had been privatized and a new class of entrepreneurs, much needed for sustainable growth, had been created.

3. Reform of fiscal and monetary policies

Before embarking on its stabilization programme, Armenia's fiscal policy was characterized by extremely high budget deficits financed largely by loans from the Central Bank. According to some sources, the consolidated public sector budget deficit was equal to 54.3 per cent of GDP on a cash basis in 1993. To correct this major imbalance, reforms were implemented on the revenue as well as the expenditure side.

Tax reform was undertaken in Armenia during 1992-1996 but a turning point was reached in 1997 with the passage of a tax law that established the basis of a modern tax system. Subsequently, new laws based predominantly on international standards were adopted. These measures broadened the tax base and resulted in increased tax revenues. The ratio of tax revenues to GDP reached 14.4 per cent in 2001 compared with 10.9 per cent in 1994. A substantial shift occurred in the same period towards indirect taxes, particularly VAT, and away from direct taxes, which used to be the primary source of revenue in the early 1990s. This suggests that, in coming years, further increases in tax effort in support of development may require an increase in direct taxes.

Changes on the expenditure side have also been dramatic, with a massive reduction in spending. Expenditure fell sharply as current spending was drastically reduced. Spending on subsidies, in particular, fell sharply as targeting of social safety net payments improved. Part of the adjustment in expenditure, however, came from a reduction in capital spending. As a result, total expenditure as a share of GDP decreased from 43 per cent in 1994 to almost 21 per cent in 2001. The budget deficit has been decreasing steadily as a result of the combined effects of these measures, reaching 4.3 per cent of GDP on a cash basis in 2001.

One of the main features of Armenia during 1994-2001 was its relatively high degree of dependence on foreign financing. In 2001, for example, foreign loans financed close to 65 per cent of the budget deficit. The large external current account deficit during the 1990s was also mainly financed by the accumulation of external debt; by the end of 2001, external debt amounted to US\$ 905.4 million, or nearly 43 per cent of GDP. Multilateral creditors accounted for 75.4 per cent of this debt, with the rest coming from bilateral creditors. However, over 78 per cent of the debt is on concessional terms, which eases the debt-service burden considerably. The loans have primarily been used to finance structural reforms at the macroeconomic level, as well as investment projects and sectoral reforms in energy, agriculture, construction and transport, and also in the social sectors.

Armenia started conducting an independent monetary policy after the introduction of a national currency, the dram, in November 1993. At that time, the Central Bank was not strong institution and, moreover, there was a lack of foreign exchange reserves to ensure currency stability. The macroeconomic situation was also very difficult, as the economy was experiencing hyperinflation. However, in less than two years, the Central Bank managed to bring inflation under control and stabilize the exchange rate. Since that time, Armenia has continued to enjoy macroeconomic stability. This remarkable achievement was obtained through the gradual introduction of market-based instruments, such as open market operations, for implementing monetary policy and the establishment of a mechanism to coordinate monetary and fiscal policies.

In the initial stages of conducting an independent monetary policy, the Central Bank had a limited set of instruments for liquidity management. The main instruments involved operations on the foreign exchange market and, later, credit auctions. The gradual shift to market-based instruments began after September 1995, when the treasury bills market started functioning with the auction of one-month treasury bills. In May 1996, the Government began issuing three-month and six-month treasury bills, and, in late 1996, the range of

maturities was expanded to 9 and 12 months. The development of the treasury bills market created an environment for conducting open market operations in the form of repurchase and reverse repurchase agreements for liquidity management purposes.

The introduction of market-based instruments and better coordination of monetary and fiscal policies has had a positive impact on interest rates. Interest rates in the government securities market were substantially reduced and, consequently, deposit and loan interest rates also fell. By the end of 2001, the annual weighted average interest rate on government securities was 18.7 per cent compared to 56.1 per cent at the end 1996. Over the same period, the annual average interest rate for three-month loans and deposits in dram had fallen to 27.7 per cent from 65.1 per cent and to 14.7 per cent from 21.6 per cent respectively.

After the introduction of the national currency, the authorities did not make a formal commitment to a fixed exchange rate system. However, the exchange rate vis-à-vis the United States dollar remained more or less stable, without extensive intervention by the Central Bank, for almost two years until mid-1996, facilitated by the dram's initial undervaluation in early 1994. Negative real domestic interest rates, coupled with the limited range of available savings instruments that were also perceived to be highly risky, fuelled strong demand for foreign exchange that led to the dram depreciating in the first few months after its introduction. The resulting de facto nominal exchange rate anchor played an important role in lowering and stabilizing the rate of inflation by containing price increases of imported goods. Exchange rate stability also provided a general signal of the appropriateness of financial policies, thus helping to form expectations of low inflation equilibrium. Currently, a floating exchange rate regime is in place, with the Central Bank intervening in the market primarily to smooth seasonal fluctuations in liquidity.

Economic reforms cannot be considered successful without an efficiently functioning financial sector. Among the reforms carried out in Armenia, that of the financial system stands out. Major reforms in the financial sector began in 1994 following the economic collapse and hyperinflation of 1991-1993 as a result of which the banking system ceased to exercise its financial intermediation function and lost its ability to make payments and settlements. The reforms aimed at consolidation and restructuring of the banking system, increasing bank capitalization and enhancing banking supervision, as well at improving the legal environment. Key reforms were the introduction of fundamental laws regulating banking activity, including supervision by the Central Bank, and the adoption of capital adequacy guidelines based on the Basel Accord and best international

practices. Minimum capital requirements for existing banks were increased and by 1 July 2005 should be equal to US\$ 5 million. In the area of banking supervision, a new loan classification system and the subjective assessment method were introduced. New provisioning rules for loan-loss reserves were also adopted. The Central Bank now has the legal authority to act more quickly in dealing with problem banks, without making an initial application to the courts as used to be the case. Measures were also adopted that allowed commercial bank restructuring and consolidation and liberalized banking services, permitting foreign banks to enter the domestic market. The Central Bank is preparing to introduce a deposit insurance scheme that will begin collecting premiums from banks in mid-2003. The effect of the reforms so far has been to increase public confidence in the reliability of the banking system.

At present, there are 28 private banks in Armenia, the last State-owned bank having been privatized in 2001. Despite the continued high rate of growth in real GDP in recent years and the notable development of the banking system, it still remains relatively small. At the end of 2001, total banks assets were equal to 17.5 per cent of GDP, the ratio of private sector credit to GDP was 8 per cent, and the monetization ratio, measured as the ratio of broad money to GDP, was 14.5 per cent only. These relatively low figures reflect a number of factors, including inadequate bank capitalization, lack of progress on legal reforms, particularly on administrative procedures for enforcement of collateral, and inadequate credit evaluation methods.

In developed countries, the financial system generally includes a capital market, which is a very important component. An established, well functioning capital market is important for channelling savings into profitable investments. However, the capital market in Armenia is rudimentary. A Securities Commission and the Armenian Stock Exchange have been established and a law regulating the securities market was adopted in August 2000, but trading volumes remain very small. The rudimentary nature of the Armenian capital market is also explained by the underdeveloped nature and, in some cases, absence of necessary infrastructure such as investment funds and companies.

The volume of business conducted by non-bank financial institutions is also insignificant. Some measures have been taken to enhance the creation and operation of these institutions, including the passage of appropriate legislation, but their capacity to mobilize resources and participate in the financial market remains negligible. The most developed and most regulated non-bank financial institutions are the insurance companies, but their role and place in economy is still insignificant.

C. Markets and trade

1. Extent and sequencing of trade liberalization

With an economy that is heavily dependent on foreign trade, the Armenian Government has a strong outward orientation and makes every effort to attract foreign investments that boost export production capacity. Steps have been taken to enhance the legal basis regulating trade regimes with major trading partners. Armenia has a free trade regime with Georgia, Kyrgyzstan, Moldova, Russian Federation, Tajikistan, Turkmenistan and Ukraine. Armenia also has most-favoured nation trade relations with several other countries as a member of WTO. Liberalization of the foreign trade regime, with no restrictions on the use of foreign currency for purposes of trade, and adoption of a floating exchange rate have allowed Armenia to accept Article VIII of the IMF Articles of Agreement.

The import tariff regime in Armenia is unified and relatively simple, with quantitative restrictions to limit imports largely avoided. Some import restrictions have been imposed for health, security and environmental reasons, the products affected being weapons, drugs, nuclear materials and so on. There are only two tariff rates, 0 and 10 per cent. Armenia does not tax exports, or attempt to restrict them, with the exception of some sensitive products, such as explosives and nuclear materials considered to be part of the national patrimony. However, in line with an agreement between the two parties, textile exports from Armenia to the EU are licensed.

2. Export promotion

With its limited internal market, production for export is the key to sustained growth in Armenia. Measures to stimulate and promote exports are very important for the future development of the economy, but so far problems in these areas to the large extent have not been satisfactorily solved.

In recent year, exports have grown faster than imports, leading to a significant narrowing of the trade and current account deficits. In 1998-2001, the average growth rate of exports was 11.3 per cent and of imports 0.4 per cent. By the end of the period, the current account deficit, including official transfers, as a percentage of GDP equalled 9.5 per cent. Continued rapid growth in exports coupled with slower growth in imports in 2002 was expected to lead to a further narrowing of the current account deficit in 2002 to less than 8 per cent of GDP.

The structure of exports changed substantially during the transition period, in line with increased access to new markets outside the former Soviet Union. Currently, major export items from Armenia are diamonds and other gems and products from agriculture, food processing, energy and metallurgy. In 2001, the share of diamonds and other gems in total merchandise exports was 35.8 per cent, while the share of agricultural and food-processing products was 14 per cent and of energy and metallurgy products was 11.2 per cent.

For its future development, Armenia needs to identify products with growth potential in foreign markets. Technical assistance may be required in developing the institutional framework needed for trade facilitation and export promotion including eliminating legal, technical and other administrative restrictions to exports, market research, trade finance and insurance and so on.

D. Investment liberalization policies

The Government of Armenia has attached the highest priority to encouraging private investment as part of its overall strategy for economic development. To this end, fiscal and other regulatory and administrative constraints have been removed to decrease risk for investors. Incentives have been provided in all sectors of the economy to encourage investment that will create jobs, utilize domestic resources, develop infrastructure and generate exports. The privatization of State enterprises and services is another measure designed to encourage domestic and foreign investment.

1. FDI flows in Armenia

The inflow of FDI has accelerated since 1994 and the dynamics of FDI growth are encouraging. According to official statistics, foreign capital was invested in 2,175 companies established in 1991-2001, with the largest number registered in recent years. Foreign investment has come mainly from the Russian Federation, several countries in the EU, Canada, the United States of America, Iran, Lebanon and Syria. Typically, there is a large community of Armenian origin in the countries that are the sources of this investment. In total, during 1991-2001, FDI in Armenia was about US\$ 900 million.

In the past three years, the majority of joint ventures and private foreign companies were involved primarily in foreign trade, but more recently there has been a shift towards industry and services. In 2001, the share of FDI going to industry was 51.6 per cent, to services 40.1 per cent and to trade 8.3 per cent.

Mining has also attracted increased interest from foreign investors, and these foreign firms plan to invest US\$ 200 million over 10 years to upgrade two gold mines and construct a tailings processing plant. Investors have also expressed an interest in the diamond cutting industry and privatization via international tender has begun.

2. Regulatory framework for foreign investment

With the passage of the Foreign Investment Law in 1994, Armenia declared an “open door” policy to FDI. The passage of the law highlights the catalytic role of FDI in generating economic growth and employment in the view of the Government, which has taken steps to realize its potential economic benefits while recognizing the importance of protecting investments and investors. Further investment liberalization has come with subsequent legislation and other relevant provisions in commercial laws. In 2003, the Wall Street Journal and Heritage Foundation ranked Armenia joint 44th in the Index of Economic Freedom, above other CIS countries.²

At present, Armenian investment policy is quite liberal and according to an assessment done by the University of Maryland’s Center for International Reform and the Informal Sector,³ the Foreign Investment Law appears to be among the most progressive and liberal laws regulating foreign direct investment in force among transitional economies. Foreign companies are welcome to invest in any sector, although a license may be needed for investments in certain sectors. These companies are also entitled under the law to the same treatment as local companies (national treatment). Laws and regulations that affect direct investment, such as environmental rules, health and safety regulations, employment regulations, among others, are non-discriminatory and apply to both foreign and domestic firms.

Property rights are secured under the Constitution and the Foreign Investment Law, which requires full compensation in the unlikely event of a Government seizure of property. There are no restrictions on the conversion or

² From the web site of the Heritage Foundation, <<http://cf.heritage.org/index/country.cfm?ID=5.0>> (27 March 2003).

³ “Investigation of factors inhibiting foreign direct investment in Armenia”, report prepared for the United Nations Development Programme (UNDP) and the Ministry of Industry and Trade, Armenia, 1999.

repatriation of earnings and capital, including branch profits, dividends, interest, royalties or management and technical service fees. A variety of legal forms are permitted for companies in which foreign investors have a stake and investments are insulated for a period of five years from adverse legislative changes. Provision has been made for access to the Armenian and international courts to resolve disputes. Intellectual property has been protected and a host of other rights and privileges that are regarded as important, if not essential, by foreign investors have been provided.

Currently Armenia has no generalized investment incentive schemes in place other than those indicated in the table II.1 below. However, Armenian legislation stipulates that additional privileges may be granted for the purpose of encouraging foreign investments in priority areas for social and economic development. Several ad hoc incentives can normally be negotiated on a case-by-case basis for this type of strategic investment.

Table II.1. Foreign investment incentives

Ownership	Full ownership (100 per cent) permitted
Admission	No screening and/or specific approval/authorization for entry of the investment
Land access	Lease up to 99 years freely permitted
Tax holiday	Available for foreign investments above US\$ 1 million
Import duty	No duties on most of the statutory capital and on raw materials
Export duty	None
VAT on export	Refund provided
Income tax	No special incentives or exemptions
Corporate tax	Tax holiday for investments above US\$ 1 million
Losses carried forward	Losses may be carried forward indefinitely
Exchange control	Free operation of foreign currency account
Remittance	No restriction on remittances
Staff recruitment	No restriction
Location incentives	No sectoral or geographical restrictions on investment. Certain incentives for earthquake zones, mountainous rural areas, and rural areas located along the borderline
Sectoral incentives	Negotiated
Investment guarantees	Five years protection clause, 30 bilateral treaties and membership in the Multilateral Investment Guarantee Agency
Dispute resolution	International Convention on Investment Disputes signatory; membership in the International Center for the Settlement of Investment Disputes

3. Taxation of enterprise profits

Armenian nationals are taxed on their profits worldwide, while foreign entities are taxed only on the share of taxable profits received from Armenian sources. According to the Foreign Investment Law, companies with foreign participation are entitled to substantial deductions of annual profit tax for a specified number of years, when the share of the foreign partner exceeds 500 million dram. In the event of liquidation of the taxpayer within the specified period, however, the amount of the profit tax will be calculated in full for the entire period of operation.

As a complement to its own legislation, Armenia has signed bilateral treaties on reciprocal promotion and protection of investments with 30 countries and has pre-signed agreements with two others. Another 25 treaties are under negotiation. Armenia is also a signatory to the International Convention on Investment Disputes and a member of the International Center for the Settlement of Investment Disputes.

E. Impact of globalization on social and human resources development

Transition to a market economy in Armenia in the context of globalization inevitably necessitates the implementation of reforms in all economic spheres so as to increase the living standards of the people and to protect their rights and freedoms. State policy in social spheres has a pivotal role in the achievement of this objective. It should not only secure social guarantees but also serve as a key factor in stimulating the development of the market economy. Democracy and rising living standards should serve to enhance the level of freedom all citizens, protect health, facilitate adaptation to changes in working conditions, guarantee freedom of movement and access to education, which will go a long way in promoting sustainable reforms.

The transition to a new economic system hits the social sphere hardest. Though some political stability has been achieved owing to the economic reforms carried out so far, the social situation still remains strained mainly as a result of the passivity of State social policy. Living standards of large groups of the population have declined drastically and poverty, which until recently was relatively rare in the former Soviet era, has become widespread. An overwhelming majority of the population anticipated some social support from the

State but these expectations were impossible to meet since resources were very limited. Nevertheless, the Human Development Index for Armenia reveals some positive trends. From ranking 103rd among 174 countries in 1995, Armenia advanced to 87th place in 1999 and to 76th (out of 173 countries) in 2002, an improvement partly explained by the notable economic recovery.

1. Changes in employment during the transitional process⁴

The radical institutional and structural reforms initiated in Armenia with the introduction of the market economy have resulted in substantial changes in the rates of growth and the structure of employment. The initial economic decline resulted in a reduction in the numbers employed, a trend which has, however, persisted even during the subsequent period of economic growth. The gap between supply and demand in the labour market in Armenia appears to be widening. Insufficient economic growth, slow restructuring of industries, low levels of capacity utilization in industry and inadequate job creation have all lead to declining employment. Official statistical data on the labour force do not fully reflect the actual situation owing to incomplete coverage of employment in the formal sector and to widespread hidden employment and unemployment. The figures are also somewhat distorted by the introduction of the family benefits scheme in January 1999.

With these caveats, labour force indicators for Armenia at the end of December 2001 indicate that the overall unemployment rate in the country was approximately 10.7 per cent, with considerable regional variation. The effect of the introduction of the family benefits scheme was to increase measured unemployment until April 2000. Field office studies show that, following the introduction of the scheme, approximately 80 per cent of those unable to find work as well as those with unregistered employment reported to employment centres. Several people ostensibly employed on a voluntary basis were more concerned about getting a statement certifying their unemployed status, rather than getting a job. Furthermore, unemployment fluctuated the most when documents to register or re-register for the family benefits scheme had to be updated. The employment department plans to introduce a number of measures to prevent these sharp, artificial increases in unemployment.

⁴ This section draws extensively on the web site of the Government of Armenia, available at <http://www.gov.am/en/gov/iprsp/3.6.html> (31 March 2003).

Turning to the composition of the unemployed, the share of women in the total number was high, at around 64.6 per cent in December 2001, although the percentage declined somewhat during the year. However, the decline was largely due to an increase in the number of men reported as being unemployed during the period, who were either previously working without registration or had been laid off by enterprises. The overwhelming majority of the unemployed appear to be concentrated in urban areas, particularly Yerevan, Gyumri and Vanadzor; the percentage of the urban population in the total unemployed was nearly 95 per cent. The educational distribution of the unemployed has been relatively stable, with approximately 12 per cent holding university degrees, 24 per cent with secondary vocational diplomas, 57.3 per cent with high school diplomas, and 6.8 per cent having completed middle school in December 2001. Over 18 per cent of the unemployed had been laid off, 78 per cent quit their jobs, 1.3 per cent had lost their jobs for disciplinary reasons and 2.2 per cent were first-time job seekers. The age structure of the unemployed shows that a substantial majority were in the 30-50 years age bracket (61.5 per cent), while 21.3 per cent were aged 22-30 years. A relatively small percentage of the unemployed were under the age of 18 (0.8 per cent), while 7.5 per cent were aged 18-22 and 8.9 per cent older than 50 years.

Unemployment appears to have increased in recent years for people 30-50 years old, while remaining relatively stable for workers above the age of 50 who face particular difficulties in finding jobs. Employers prefer younger workers in the 18-30 age range. Older workers cannot easily adjust to the new economic realities, which require them to change their career profiles and start on new jobs. Frequently, they are not competitive in the labour market because of a structural mismatch between the skills and qualifications they possess and those that are required. A similar challenge is faced by first-time job seekers; the newer jobs available need highly qualified experts and employers will not consider first-timers lacking experience and skills.

Moreover, there is virtually no demand for certain professions in the country (engineering, culture, geology), whereas many of the unemployed have degrees in these fields. In contrast, there is a high demand for qualified software experts, secretaries, translators (especially for English), insurance agents, brokers, teachers, physicians, and service personnel in the labour market. Nevertheless, job vacancies in these professions are sometimes not filled, mostly due to the low salaries offered.

These structural problems in the labour market reflect delayed reforms in university and secondary vocational education that have led to the inability of the educational system to produce highly qualified experts for the market economy, while still churning out specialists in some other less-needed areas. While educating fully qualified experts to university degree standard is one way out of the problem, another possibility is additional training to help people in changing specializations or enhancing qualifications so as to bring the skills of the existing labour force into line with market demand for human resources.

The break-up of the previous system of economic governance and the development of a market economy have inevitably brought about changes and shifts in all areas of public life. The pace of market economic development in the country, the emergence of alternative ownership types, increasing income inequality between different segments of the population, growing unemployment and other negative consequences have raised the need for developing and introducing conceptually new approaches and tools for short-term and strategic management in the social sector. In particular, short-term management requires a concentration of information flows and the introduction of state-of-the-art methods for information collection and streamlining of statistics. Moreover, strategic management requires that analyses and projections based on accurate information and state-of-the-art technology should be applied in order to justify the legislation and to explore internal inconsistencies in sector legislation. In this process of reform, one should focus on the creation of a social security structure that will accurately manage information and operate databases in order to allow the different units to enforce the legislation and to create a favourable climate for its optimization. The creation of the Nemrut Information and Analysis Center in November 2000 was indicative of the Government's efforts to improve social protection. The Center operates information systems designed to handle sector-specific matters and to present an aggregate picture of the social situation in support of the national programmes on battling poverty.

The introduction of a market economy opens up the prospect of promoting self-employment. Employment services can provide some financial assistance to those unemployed wishing to start a private business. Undoubtedly, these actions can play only a limited role but they are essential prerequisites for solving the social problems of the unemployed, as at present, the possibilities for new job creation in the economy are somewhat limited.

The movement of labour is one of the most visible aspects of globalization and migration from Armenia has been an indication of the poor social conditions in the country. It has been estimated that at least 800,000 persons left the

country during 1991-2000, with most migrants being working-age men from urban areas with a high level of education. The establishment of the Department of Refugees and Migration is one of the steps undertaken in Armenia to regulate migration.

2. Poverty and social safety nets

The use of family income, an indicator that is accepted worldwide, for estimating vulnerability is problematic in Armenia, given the extent of the informal sector that has blossomed and deepened together with the development of the formal economy, thus posing new problems relating to income calculation. Without a means to calculate income accurately, the right to a family allowance is determined using indirect indicators, which in turn has raised questions as to their choice. One of the consequences of the overall decline in living standards in the transition to a market economy is increased social stratification, as evidenced by deepening income inequality and polarization. For example, surveys have shown that the expenditure of those in the top 10 per cent income bracket was 18 times that of those in the lowest 10 per cent; expenditure on food constituted 69 per cent of total expenditure for those in the lowest income group and only 38 per cent for the top 10 per cent of income earners.

Official data from 1988 indicate that only one fifth of the population of Armenia was considered to be below the poverty line, defined as a minimum income per family equivalent to US\$ 87 at that time.⁵ Household income was derived principally from wages, which accounted for 76 per cent of the total. Pensions, stipends and social benefits accounted for a further 11 per cent, and proceeds from the sale of agricultural production, as well as income from other sources, accounted for 13 per cent. The average household's expenditure was primarily on food (41 per cent), industrial goods (28 per cent) and services (9 per cent).

Following the socio-economic crisis of the early 1990s, the contribution of wages to household income more than halved between 1991, when it was 54 per cent, and 1994, when the contribution was only 25 per cent. The share of income from other sources, such as workers' remittances, humanitarian

⁵ This discussion draws extensively on the Republic of Armenia's Interim Poverty Reduction Strategy Paper, available at <<http://www.imf.org/external/NP/prsp/2001/am/01/INDEX.HTM>> (31 March 2003).

assistance and charity, in total household income nearly quadrupled, from 15 to 56 per cent over the same period. Spending on food increased significantly, from 54 to 65 per cent, and there are indications that the food consumed was also of poorer quality in terms of calories produced. Expenditures on industrial commodities declined from 27 to 21 per cent. Although economic growth has recovered subsequently, this picture has remained substantially unchanged.

Integrated Household Surveys conducted in 1996 and 1998-1999 by the Ministry of Statistics in cooperation with the World Bank show that the number of households below the poverty line⁶ was approximately 55 per cent of the total population, with little change over the period. However, households defined as extremely poor⁷ decreased significantly over the same period, from 28 per cent of the total population in 1996 to 23 per cent in 1998-1999. The introduction of the system of family allowances targeted at the very poorest groups in the population is thought to be the principal factor behind the decline. Vulnerability is also high, and it has been estimated that two thirds of the population in total is likely to require social assistance, more than double the average proportion requiring such assistance in economies in transition.

There are also regional variations in the level of poverty in Armenia. Just under half the population of the Shirak region is below the poverty line, while in Lori and Tavush the figure is over one third. Rural poverty is highest in Syunik, Lori and Tavush. Poverty is also likely to be concentrated among the elderly. The number of persons above the age of 60 comprises around 20 per cent of the total population and, of these, 10 per cent live alone and are in need of social assistance and services. The increased proportion of the elderly reflects the emigration of younger people of working age, mentioned earlier.

Finally, World Bank estimates indicate that income inequality has been rising in Armenia. The income-based Gini coefficient was estimated to be 0.27 prior to transition but 1998-1999 estimates put it at 0.538, above the average 0.34 for all economies in transition. There is an obvious need for strong State policy in the sphere of social support and security. Armenia has completed an Interim Poverty Reduction Strategy Paper (PRSP) in 2001, and the final PRSP is currently being drafted. The strategy, discussed in greater detail below,

⁶ Measured by a food poverty line equal to 11,735 drams per month.

⁷ Those with income below the value of a minimum food consumption basket equal to 7,194 drams per month.

focuses on addressing socio-economic problems, in particular poverty reduction, in parallel with measures to foster sustained economic growth and structural reform.

3. The family benefit scheme⁸

Prior to the introduction of the family benefit scheme in 1999, social assistance in Armenia consisted of 26 small, uncoordinated cash benefits paid to individuals from certain eligible categories associated with the pre-transition definition of “social risk groups”. The most important categories were orphans, single mothers, disabled individuals, families with four or more children and pensioners living alone or not working. Other groups receiving benefits were identified by a broad range of indicators such as area of residence or merits before the State. In December 1998, nearly half a million individuals were covered by the assistance scheme, but benefits were low, ranging from 1,000 to 4,000 dram per individual per month.

A targeted cash poverty family benefit awarded to eligible households (not individuals) was introduced in January 1999, replacing the old system. Currently averaging 8,000 dram per recipient family, the benefit is significantly higher than any other cash transfer in Armenia. Given the largely informal nature of much of the economy, targeting is achieved on the basis of a single-index formula derived from individual and household indicators that approximates means-tested eligibility. Some of the indicators are similar to those used in the past, such as disability or orphanhood, but additional indicators at the household level that correlate strongly with poverty, such as car ownership and housing characteristics, are also included. Additional filters, such as telephone bills, property transactions, customs transactions and private entrepreneurship are also used.

Initially, more than 230,000 families were receiving the benefit, approximately 28 per cent of all families, roughly equal to the incidence of extreme poverty calculated using the 1996 Household Survey. However, the number has been coming down gradually, as a result of better screening and improved benefit administration, as well as resource constraints. In May 2002, only 150,000 families were receiving assistance. The budget allocated to social

⁸ Based on Anton Dobronogov, “Social protection in low income CIS countries” unpublished paper presented at the Lucerne Conference of the CIS-7 Initiative, 20-22 January 2003.

assistance, which was increased from 13.4 to 21.1 billion drams in 1999, decreased subsequently, reflecting the reduced number of beneficiaries and severely constrained public resources; in 2002 the budget allocation was 14.8 billion drams.

A comparison between the old and new systems is difficult as administrative data are available only either at the individual (old system) or at the household level (new system). From administrative data, it appears that the 57 per cent increase in the social assistance budget in 1999 was not accompanied by a similar increase in the average benefit per individual. The 1998-1999 Household Survey, however, indicates that the average household benefit among recipients increased by an average 41 per cent. It should be noted that the fraction of the population receiving social assistance remained substantially unchanged, falling by only 1 percentage point. This was intentional, as the Government did not want any social upheaval or popular dissatisfaction to compromise the reform process, so sufficient resources were allocated and eligibility criteria for the new family benefit scheme included most of the indicators used for the previous individual benefits.

F. Key challenges ahead

The immediate challenges for the Armenian Government are to keep up the pace of privatization, continue attracting foreign investment and complete the regulatory and legal framework for capital markets, thus improving the private sector's access to finance.

Social and human development remains one of the fields that require particular attention in Armenia in the process of adapting to an increasingly globalized environment. Investment in human capital is one of the crucial preconditions for achieving and sustaining economic growth and development in Armenia. To reach this objective, it is necessary to increase public spending on education to ensure its quality. It is also necessary to increase public spending on health, while continuing health sector reform and, in particular, streamlining its management and financing. In the short and medium terms, public spending should be focused on preventive and primary health care programmes and services and should target the poor more effectively.

The areas that require particular attention from the Government of Armenia in the country's progress along the path of reforms are poverty alleviation, unemployment, and corruption.

1. Poverty alleviation

As mentioned earlier, the Government of Armenia adopted an interim PRSP in March 2001, thus establishing a three-year framework for action to reduce poverty. The major pillars of its poverty reduction strategy include:

- Faster, broad-based, sustainable and equitable growth as the main instrument for reducing poverty. To achieve this goal, the Government intends to maintain a stable macroeconomic environment supportive of high economic growth and focus on the fair distribution of the benefits of that growth for the entire population. It intends to undertake major improvements in the business and investment climate so as to create employment opportunities. In particular, it will privatize public enterprises in an open and transparent manner in order to increase effective employment, thereby alleviating social problems, and also to attract foreign direct investment. The development of small and medium-sized enterprises will be supported, so as to foster a competitive environment. Reform of the financial sector will be pursued to improve the intermediation process and increase efficiency in the allocation of financial resources and so promote growth. Further development of the agricultural sector will also be an important element in the strategy, as agriculture is the main source of employment in rural areas and fundamental to poverty reduction.
- Establishment of an efficient system of governance, focused on developing a transparent and efficient civil service system and strengthening civil society participation and media oversight. A favourable environment for a competitive and growing private sector will be fostered and management in the public sector reformed, while a sound and efficient judicial system, crucial for the operations of the private sector and the protection of human and property rights, will also be developed.
- Sustainable human development that includes preparation and implementation of a comprehensive and targeted strategy in the areas of health, education and social security. The government programme on health will include publicly financed medical services and the creation of a new health system that combines both market mechanisms and social guarantees. Public health services will be more targeted, affordable to the poor, efficient, and modern. Priority will be given to the development of basic medical care. In education, the Government is committed to a sustained effort to improve educational standards. The education policy aims to improve the efficiency of the educational

system while maintaining fiscal sustainability. The main priorities of pre-school, school, special and vocational education include maintenance and improvement of the existing system, ensuring affordability and maximum enrolment, modernization of teaching methods and curricula, and improvement of the legislative framework. The Government's reform efforts in the education sector will include regulating the legal status of educational institutes and improving the system of management and financing through the introduction of per-student financing. A differentiated approach towards schools in frontier, remote, and isolated regions will also be developed to make education available to children in those regions as well. The quality of education will be improved by increasing the salaries of teachers and school administrators and additional teacher training. Textbooks will be provided free of charge to first-grade students, as well as to needy students in primary schools. In the area of social protection, the Government views job creation as the cornerstone for addressing social issues, which in turn will help to reduce poverty. Understanding that flexible labour markets play an important role in job creation, the Government will revise and, when necessary, change the legislation regulating labour markets, as well as institutions and policies in this area. The Government will rationalize public protection against unemployment and focus on policies that assist people in finding jobs, such as job-search assistance and career counselling. The Government will continue to pay special attention to social assistance programmes. The family benefit scheme will continue to be a priority. The Government will continue to improve targeting of the benefit to ensure that the most vulnerable groups of the population receive it. The development of the social insurance system will focus on further reform of the State social insurance system and the improvement of its administration, management and financing.

2. Unemployment

Armenia has to focus on generating more job opportunities by creating a favourable environment for private sector development, which will then provide more opportunities for the population to participate in the labour market. To solve the unemployment problem and to find work for the economically active population, the Government is considering adopting a more active and effective policy, particularly by undertaking the following:

- professional and vocational training and re-education for the unemployed;
- promotion of small business and entrepreneurship;
- financial support of unemployed persons wishing to set up their own businesses;
- organization of social works projects;
- development of programmes at the national and regional levels; and
- provision of employment for uncompetitive groups on the labour market.

3. Corruption

The Government of Armenia has recognized the negative impact of bad governance and corruption on economic development and an Anti-Corruption Strategy Programme is being finalized. The programme will consider corruption in different fields and address measures to overcome the problem. Thus, the programme will include such areas as improvement of tax and customs policy and administration, protection of property rights, reform of the system of law enforcement, promotion of competition, and development of best practices for budgetary procedures and procurement. One of the crucial tasks is creating a sound judicial system and establishing a favourable legislative and regulatory environment.

Improving access to information, in order to increase the degree of public awareness and public participation in policy-making, will be an important part of the programme. Although indirect, the role of political institutions in the struggle against corruption is very important. In countries in transition like Armenia, the negative impact of political corruption is especially serious because, in such countries, many political institutions such as elections and political parties are newly established. The perception about their corruptness undermines both public trust towards these institutions and the legitimacy of the democratic regime in the country. The measures suggested in the Anti-Corruption Strategy Programme are directed at restoring integrity to the political system and several laws and regulations are to be adopted or amended to regulate lobbying and control the formation of parties, especially the section regulating party financing. The public ethics code and the standing order regulating inter-faction, inter-party movement inside the parliament are also to be revised.

The parliament of Armenia, in recognition of the role of local authorities in strengthening democracy, recently adopted a new Law on Local Self-Governance, which defines the rights and responsibilities of these authorities. In this regard, it should also be mentioned that the Government of Armenia has started reforming public sector governance as a whole. Laws relating to the civil service and to the income and assets of high-level officials have already been adopted.

G. Conclusions

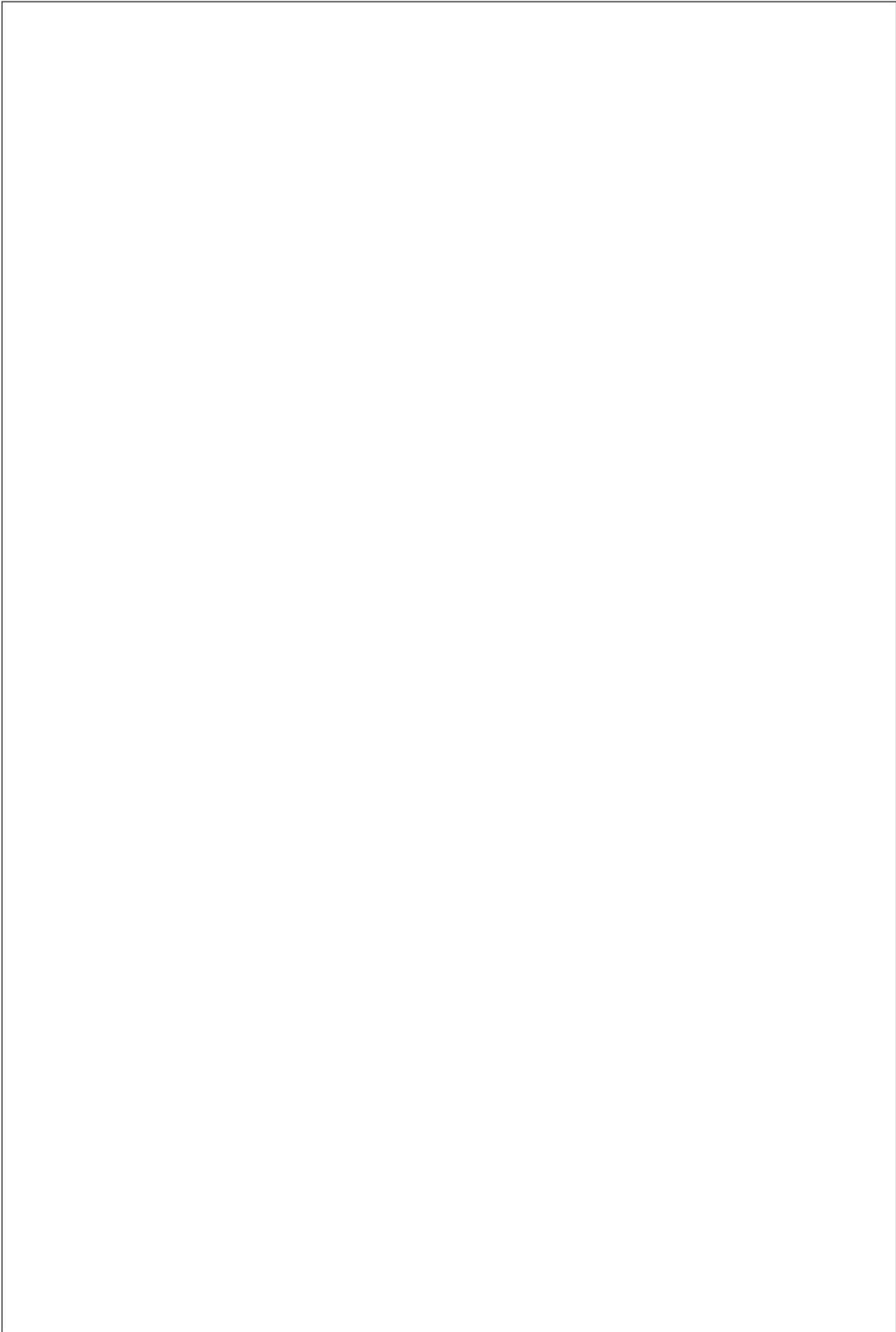
At the conclusion of the last millennium, the people of Armenia made a choice to build a sovereign and democratic state, thus taking on the considerable responsibility of overcoming numerous and complex challenges in the transition to a market economy, accompanied by human and social development. Adjustment to the global process of integration currently underway should be taken as a requirement for Armenia to ensure sustainable development, and improved living standards for its people.

In the transition to a market economy, Armenia has undertaken important steps in implementing radical reforms and fostering integration into the world economy. These included, most importantly, trade liberalization including a reduction in administrative barriers regulating foreign trade and increased reliance on more transparent measures such as tariffs. Establishing a national currency with a functioning exchange market are other important achievements. Development of the private sector, including measures to reduce administrative controls over prices, has encouraged greater participation in the Armenian economy on the part of foreign investors. Beginning in 1993, work also began on creating a legislative foundation, drawing on international norms, for securing a market regime.

On the way to implementing radical reforms, Armenia has had some notable achievements. The country's economy is enjoying slow but sustained growth, low inflation and relatively stable currency. The financial sector has made rapid progress in the past few years. Although small, the banking sector is relatively efficient. As part of its policy of integrating into the world trade system, Armenia has completed the process of accession to WTO and is to become its 145th member. Armenia is also participating actively in regional cooperation programmes within the BSEC, CIS and other regional initiatives. Armenia's investment and trade policies are among the most open in the CIS.

Ongoing large-scale privatization and consistent improvements in the investment climate offer attractive opportunities for FDI. Armenia economy is now quite diversified, with a well-developed electronics sector, and the country has a competitive edge in diamond processing, pharmaceuticals and machinery.

Nevertheless, several concerns remain. A framework for a competitive environment and the creation of a level playing field for all businesses has yet to be established. Economic performance remains weak and the state apparatus dealing with the management of the economy is still faced with problems such as corruption and ineffectiveness. Major reasons given for emigration are the low levels of income and economic and social rights. Issues of economic and human development need to be considered together and integrated solutions sought, both from the point of view of global economic development and of domestic social interaction. The overhauling of the social safety net is an important step in this regard.





Introduction

Globalization, which began as an economic phenomenon, is increasingly a political and social process. The role and place of national governments and the relationship between the public and private sectors are under question in a rapidly globalizing world. New information and communications technologies lead to important structural and institutional changes in manufacturing and services. The export orientation, deregulation, liberalization and privatization that characterize the expansion and deepening of the globalization process are directly connected to external competitiveness but are simultaneously the sources of internal and external conflicts. The problem of harmonizing efforts aimed at achieving competitive advantage with those aimed at social development has become the key issue for all countries in the world without exception.

Although the gains and losses from the process of globalization are often distributed in a very uneven manner between participants, requiring interstate cooperation to resolve problems, national governments have the responsibility for adopting domestic policies that make it possible for countries to become members of the international commonwealth. This minimizes social losses connected with globalization and makes it more likely that the distribution of benefits from trade and foreign investments will become fairer.

The place of a country in the world today is defined more by the quality of its human capital and educational system and by technical progress in manufacturing. Comparative advantage and business success depend less on simply combining factors of production and more on knowledge and management skills. Increased labour mobility under globalization constrains government policy on, for example, taxation of incomes, while freedom of movement fosters democracy. Openness to foreign trade increases competition within a country and helps combat corruption, while leading to increased capital inflows. International capital mobility is guided by stability, transparency, predictability and adherence to internationally accepted rules and not simply by access to cheap labour and raw materials. Transnational corporations transfer not only technology and management skills but also labour standards closer to international norms. Legislative reform to make use of the huge potential of globalization and to reduce risks to a minimum is a necessary step. In Azerbaijan, some 250

laws and 700 normative legal acts have been adopted so far to regulate the process of reform in all spheres of economic and national life.

A. Globalization and regional integration

1. Integration into the multilateral trading system

In the process of globalization, countries in transition need to cooperate closely with IMF and other international organizations and this is a major factor in constructing a market economy in those countries. Since 1992, Azerbaijan has been a member of IMF and the World Bank. It is also a member of ADB and has received assistance from EBRD, the Islamic Development Bank and the Black Sea Trade and Development Bank.

Azerbaijan has had observer status in WTO since June 1997 and is currently in the process of accession to that organization, which will require reconsideration of its customs duties. At present, import duties contribute about 9 per cent of budget revenues and a uniform rate of 15 per cent is applied to most final goods imports. There are no taxes on exports. The first round of negotiations with WTO took place in June 2002 and the second round was held in early 2003. There is some concern within the country that a reduction in tariffs will undermine local manufacturers and Azerbaijan cannot also rule out subsidizing agriculture for some time, even after accession to WTO, as vulnerable population groups are engaged in this sector. At present, agriculture does not receive grants or other direct subsidies but indirect subsidies in the form of tax privileges and write-offs of debt owed to State-owned banks.

Membership of WTO will force Azerbaijan to adhere to international quality standards in the goods exported, to open its services sector to foreign competition and to protect intellectual property rights. Though the benefits of membership will dominate, it is necessary to take into account the costs that Azerbaijan may incur by acceding to WTO. These costs have both an economic and a social character, related to the process of adapting to greater international competition, and there are also material costs involved, for example, in bringing national laws into conformity with international norms.

2. Regional trading arrangements and partnerships

The fundamental organization for regional cooperation in Central Asia is CIS and Azerbaijan has been a member since its founding in 1992. However, little progress has been made in reintegrating the economies of the former

Soviet Union, in spite of the numerous agreements, resolutions and other documents that have been adopted and the proliferation of institutes and semi-governmental and non-governmental organizations created under its auspices. Economically and politically, the members of CIS are not at present ready for real economic integration on a market basis and the outlook is not very bright.

The agreement to form an economic union, signed by all 12 members of CIS, was supported by further agreements on the creation of a free trade zone, the establishment of an international economic committee, a payment union and so on. Most of these agreements appear to have been impractical. Even the most elementary step in integration, the creation of a free trade zone, has become an insuperable barrier and the agreement has not been ratified by all States so far. The Interstate Bank, founded in 1993, also does not function well. The lack of progress has encouraged countries to resolve their problems independently and the drifting apart of CIS members has created new economic and political realities. Azerbaijan has signed a number of bilateral free trade agreements with other countries in CIS but only the agreements with Georgia, Kazakhstan and Ukraine, under which imports are exempt from duties, are currently effective. Azerbaijan has also signed a trade agreement with the EU under which it receives MFN treatment. In addition, the trade regimes extended to the country by the EU, Japan and the United States under the generalized system of preferences (GSP) have created new opportunities for access to their markets but the quality of exports has to be brought into conformity with their standards.

In 1992 Azerbaijan became a member of ECO, founded by Iran, Pakistan and Turkey in 1964 and reorganized in 1985. Within this grouping, tariff reductions and other measures of trade liberalization are planned but little progress has been made in these areas. The main thrust of ECO is directed to the development of transport and telecommunications infrastructure, the creation of conditions for simplifying payments within the group, financial development and attraction of FDI.

Azerbaijan, Georgia, Ukraine and Moldova formed a transport and economic block in 1997 that was joined by Uzbekistan in 1999 and is known by the initials of its members as GUUAM. The share of this block in Azerbaijan's trade remains low, around 4 per cent in total imports and about 3 per cent in total exports at present. However, an agreement signed in Yalta in July 2002 on creating a free trade zone and on a project to create an oil transport corridor between Europe and Asia could transform GUUAM into a strong association for regional integration that serves as a link between Europe and the Asia-Pacific region. Azerbaijan is also a member of BSEC, which has had a share in its

imports of around 38 per cent and in exports of around 19 per cent in recent years. Although BSEC could potentially be a common market, it is premature to speak of this, as the grouping has no real organization as yet and its members appear to have different interests.

Azerbaijan's foreign trade doubled between 1993 and 2001, to reach US\$ 3.8 billion, but the commodity concentration worsened sharply. Over 90 per cent of exports consists of oil and oil products, while imports are principally of food. Trade between Azerbaijan and other CIS members decreased sharply after independence. In 1991, the share of the countries that became CIS in the exports of Azerbaijan was 92.8 per cent of the total but by 2001 this had fallen to 10.1 per cent. In particular, the share of Russian Federation in total exports from Azerbaijan fell from 53.0 per cent in 1991 to 3.4 per cent in 2001, while its share in imports fell from 45.6 to 10.2 per cent over the same period. The share of all CIS countries in total imports into Azerbaijan was only 30.8 per cent in 2001. There were also significant declines in the shares of Iran and Turkey in Azerbaijan's exports. Iran's share fell from around one third of total exports in 1994-1996 to a negligible 0.4 per cent in 2001 and Turkey's share halved, from approximately 6 per cent to nearly 3 per cent, over the same period.

B. Transition assessment

1. Progress in transition and its indicators

Although the level of GDP in Azerbaijan remains well below its value in 1989, it is nevertheless possible to speak about progress in transition in terms of achievements in privatization, liberalization and stabilization and a reduction in the degree of State intervention in the economy. In common with other formerly socialist economies, the first step in the creation of a market economy in Azerbaijan was the liberalization of prices and foreign trade. Price liberalization led to hyperinflation in 1991-1994 and occasionally to economic paralysis. The annual rate of inflation jumped from 206.6 per cent in 1991 to 1,012.3 per cent in 1992 and by 1994 it had reached 1,763 per cent. After 1995, however, inflation began to slow and prices are now essentially stable, with the increase in consumer prices limited to 1.5 per cent in 2001. Foreign trade has been considerably liberalized, leading to a substantial increase in total trade. More than 25 trade-related ministries, State concerns and associations have been liquidated, import quotas have been abolished and the tax on exports has been cancelled.

Between 1998 and 2002, real GDP growth averaged nearly 10 per cent annually. In 1995-2001, the annual budget deficit remained within 1-2 per cent of GDP and is no longer financed by the National Bank. The National Bank's interest rates have fallen from an average 25 per cent in 1994 to an average 10 per cent in 2002. However, the financial sector remains rather small and backward in Azerbaijan and is not able to carry out the basic functions of financial intermediation.

Privatization of large enterprises has made moderate progress so far but for small enterprises it has essentially been achieved. The share of the private sector in Azerbaijan in GDP is now approximately 71 per cent¹ and the private sector accounted for over 80 per cent of total investment in 2002. The ratio of the Government's budget to GDP has fallen from 41.2 per cent in 1993 to 16.2 per cent in 2000. However, Azerbaijan is still some way from being a market economy. The index of economic freedom calculated by the Heritage Foundation placed Azerbaijan 104th out of 156 countries in 2003² and competition remains weak, limited by problems related to the shadow economy and to corruption.

2. Progress in privatization

In the majority of countries in transition, price and trade liberalization are quickly followed by privatization. However, Azerbaijan began the process of privatization only in 1997, last among CIS countries. The participation of the majority of the population in privatization through the issuance of privatization shares has been largely symbolical, owing to manipulation of the market. By the end of 1998, over 21,000 entities were privatized but the public, as owners of privatization shares, has not participated in the incorporation of these enterprises. At the same time, the main purpose of privatization, namely, the creation of a competitive market environment has not been achieved. Finally, structural transformation of the economy through privatization has not so far been observed in Azerbaijan.

Starting in August 2000, the second stage of privatization covering medium and large enterprises began using auctions and investment competitions. The process is now supervised by the Ministry of Economic Development,

¹ The private sector accounts for nearly all of agricultural production, over two thirds of construction activity and nearly half of total industrial production.

² From the web site of the Heritage Foundation, <<http://cf.heritage.org/index/indexoffreedom.cfm>> (29 July 2003).

which was created in April 2001 by the merger of several other ministries and State committees. About 70 per cent of the income received from privatization goes to finance the budget deficit and the share of income from privatization in budget revenues reached a peak of 6 per cent in 1998 but has since fallen. In July 2002, an additional 26,779 small enterprises and over 1,424 medium and large enterprises were privatized.

Land reform has been carried out by the gratuitous distribution of over 1.3 million hectares of agricultural land among villagers, along with the right to purchase and sell the land. As a result, 40,000 individual farms and about 5,000 other village entities such as cooperatives and small enterprises have been established.

3. Fiscal reform

The share of budget revenues in GDP has fallen from 39.1 per cent in 1991 to 15.2 per cent in 2002. Fiscal reforms aim to increase tax collections through expanding the tax base and reducing tax privileges, tax avoidance and tax evasion. Charges for public services are forecast to increase 1.8 times in nominal terms in 2001-2005 and the share of those charges in public expenditure on social needs will increase from 48.7 per cent in 2001 to 55.9 per cent in 2005. The increases will affect public health services, education and social protection and social maintenance programmes, as well as housing services. The budget deficit as a percentage of GDP has fallen from 3.0 per cent in 1991 to 1.0 per cent in 2000; a budget surplus equivalent to 0.3 per cent GDP was recorded in 2001.

Tax administration is to be strengthened and the tax system is to be made more competitive in relation to other countries in Central Asia. In addition, a modern system of public expenditure administration has enabled all budget operations to be carried out only through a single account at the Treasury, greatly enhancing expenditure control. These administrative reforms are to be deepened in future. A common automated network will link the Ministry of Taxes and the Customs Committee and the ministry is to be completely computerized and reorganized. Electronic filing of income tax declarations will also be introduced.

A State Oil Fund was formed in December 1999, where all income relating to the oil and gas industry in Azerbaijan will be deposited. This includes income from the sale of crude oil and gas; bonuses received from foreign oil companies beginning in 2000; rental payments for the use of State property by foreign companies; income received from activities undertaken jointly with

foreign companies; income earned on investments made by the fund; and income from the sale of assets transferred to partners from Azerbaijan by foreign companies on the conclusion of their contracts. In July 2002, total assets of the fund amounted to US\$ 584 million.

4. Monetary policy and banking sector reforms

The banking system is relatively underdeveloped in Azerbaijan, where the ratios of deposits and loans to GDP are around 11-12 per cent. The need for reform of the system is indicated by the wide variation in loan interest rates that range from 10 to 20 per cent. In 1996, the law on the National Bank of Azerbaijan and the law on banks and banking activity were passed, as a result of which the National Bank was removed from the structure of Government and transferred to the control of the President of the Republic. Thus, the conduct of monetary policy was detached from overall economic policy and given a priority role in economic reform.

Following stabilization of the exchange rate in 1994, the National Bank of Azerbaijan followed a policy of strict control of the money supply, in close cooperation with IMF. As a result, price stability was achieved, with inflation beginning to slow in 1995 and price levels actually falling in 1998-1999. Monetary easing that began in the second half of 1999 permitted a low, positive rate of inflation in subsequent years. Real interest rates on loans and deposits were 32.5 and 22.3 per cent respectively in 1999 and these rates had fallen to 17 and 8 per cent respectively by 2001. Foreign currency reserves increased very substantially after 1995 and amount to approximately US\$ 1.2 billion. Convertibility of the domestic currency, the manat, has also been maintained. The monetization ratio fell from 23 per cent in 1994 to 7 per cent in 2000. However, the share of currency in circulation in the broad money supply (M2) has been rising steadily, from nearly 63 per cent in 1995 to over 81 per cent in 2000, indicating the existence of a significant shadow economy.

As a result of banking sector reforms, the number of banks has fallen sharply but there has been a considerable increase in total bank capital. Savings of the public have also increased substantially and 55 per cent of these savings are in commercial bank deposits. The share of commercial banks in total bank capital is around 65 per cent and in total lending it is approximately 45 per cent. Starting in January 2002, foreign investors are able to hold 50 per cent of the total authorized capital of a bank, up from 30 per cent. In practice, this share has not exceeded 20 per cent and was as low as 11 per cent in mid-2002. An electronic payments system has also been created.

The National Bank of Azerbaijan has adopted a reform strategy for the banking system for 2002-2005 according to which banking legislation will be brought into conformity with the international standards. Minimum authorized bank capital will be increased to US\$ 5 million, a doubling of the current figure, while consolidation of commercial banks and privatization of State-owned banks are to continue. Deposit insurance will be introduced and bank management and accounting practices raised to international standards. Monetary policy is expected to be more flexible in future, in line with the targeted annual rate of inflation of 2.5 per cent in 2001-2005. Management of the exchange rate is also more flexible, to preserve the competitiveness of the country's exports.

C. Markets and trade

Under the interstate division of labour in the former Soviet Union, Azerbaijan was predominantly a raw materials supplier and was heavily dependent on other republics for food, capital goods and intermediate products. However, beginning in the 1970s, new industries aimed at diversifying the economy were developed, with an emphasis on equipment and machinery for oil exploration, chemical and petrochemical production, metals and iron ore and durable consumer goods. After independence, economic policy was directed at reshaping Azerbaijan's economic structure to achieve greater economic independence and security by ensuring self-sufficiency in food and agricultural products, efficiency in the use of energy resources, economic diversification and greater integration in the region and the international economy. Foreign trade is instrumental in achieving these aims. However, although the trade ratio is currently above 60 per cent of GDP and is growing, oil and petroleum products constitute over 80 per cent of the country's exports so that the degree of dependence on and vulnerability to external conditions remain high.

Liberalization of foreign trade has been an important part of the reform agenda from the start. Trading activities were privatized and special arrangements and barter trade abolished. External trade is now conducted only on a monetary basis and the manat was made fully convertible for trade operations. Trade barriers are being gradually removed and tariff measures are becoming the principal instrument in trade regulation. Foreign trade has increased rapidly as a result of these measures, and the average annual growth rate has been in excess of 20-25 per cent. The share of the private sector in foreign trade increased from 73 per cent in 1991 to over 98 per cent in 2001. The number of Azerbaijan's trading partners nearly doubled between 1995 and 2002 and the trade dependence on CIS countries fell sharply in the same period; the share of

those countries in total trade of Azerbaijan amounted to just under one quarter in 2002. At the same time, the share of developed countries in Azerbaijan's exports has been increasing, from around 4 per cent in 1992-1993 to around 60 per cent in 2001-2002, and their share in imports is even higher, currently over 88 per cent.

Azerbaijan signed the Memorandum of Accession to WTO in 1997, after which a simplified schedule of import duties was introduced that has formed the basis for further simplification and reduction. Rates of import duties were fixed at 15, 10, 5, 0.5 and 0 per cent in 1999 and most imported final goods, including food, are subject to 15 per cent duty, except for capital goods. As a result of these measures, the degree of self-sufficiency in meat, milk and eggs has increased to very high levels and the share of food in total imports has fallen considerably. Goods and commodities imported under production sharing agreements for the development of oil fields and construction of the major oil export pipeline are exempt from duties, as are re-exports and intermediate goods. Recently, however, controversial temporary measures were introduced to protect the local metallurgy industry. These measures include prohibition of scrap and ferrous metals exports to provide raw material for the local industry as well as application of the highest tariff rate on imported metals.

Azerbaijan has other regulations concerning the export of locally produced strategic commodities, including oil and petroleum products, cotton, electric power, gas and non-ferrous metals. Domestic prices for socially sensitive products such as petrol, gas and electricity are subsidized and the Government controls the sale of these products. However, some measures have been introduced by the Government to stimulate exports, such as the elimination of export tariffs and import duties on products to be processed for export (except for scrap and ferrous metals), as well as the foreign currency surrender requirement for exporters. Simplified procedures for issuing of certificates of origin for exports, simplified licensing, subsidized credit and other financial support have also been introduced.

The development of foreign trade in Azerbaijan is now mainly responsive to market demand. However, institutional, regulatory and legislative weaknesses remain that hamper the sector's development. Poor transport, communications and energy infrastructure, particularly in rural areas, the absence of wholesale markets and storage facilities and underdeveloped financial and banking facilities are other factors constraining growth. Exports continue to be dominated by low value added items, while imports are largely high value added goods.

Apart from institutional development and capacity-building, other issues that remain to be addressed include closer congruence between trade policy and overall economic development policy in the context of integration into the world trading system. Further reduction in State control and interference is needed if the informal sector, estimated to be equal to 65 per cent of GDP, is to be brought into the mainstream. Measures to address the digital divide and develop e-commerce, such as the recently introduced national programme on information and communication technology (ICT) development, are also important for the further development of private sector activity in trade.

D. Investment liberalization policies

In the transition to a market economy, Azerbaijan has placed emphasis on the role of private initiative as the major driving force. In this context, the policy of openness to and attraction of foreign investments is one of the priorities in the reform strategy. It is hoped that FDI will bring much needed financial resources, technology and managerial expertise as well as access to international markets and it is viewed as being instrumental in reshaping the structure of the national economy and integrating it into the regional and global economy.

The parliament of Azerbaijan adopted a law on the protection of foreign investments in 1992, which is viewed as being one of the most progressive foreign investment laws in CIS. The law guarantees foreign investors rights to national treatment and, in some cases, preferential treatment. Profits after tax can be freely repatriated and adequate and unconditional compensation is payable in the event of expropriation or nationalization. A moratorium for ten years on possible adverse effects on investments following passage of new legislation is offered, as is unhindered access to international arbitration in the settlement of disputes. Various forms of foreign investment are permitted, including 100 per cent ownership, joint ventures, purchases of enterprises and assets such as property, buildings, financial securities, rights to use land and other natural resources, other proprietary rights and long-term management contracts. Although the law was a big step forward in opening the Azerbaijan economy to foreign investments, the environment was still not conducive to those investments, owing to high political risks and some administrative barriers.

In order to accelerate economic development and to ensure FDI inflows into oil exploration, a model for production-sharing agreements (PSA) was worked out by the Government in negotiations with foreign oil companies that envisaged special tax and customs regimes. This model is commonly considered

to be one of the most liberal in this field. This led to the signing of the first PSA in September 1994 with a consortium of 11 major oil companies to explore and develop the Azeri-Chirag-Guneshli oil field with a total investment commitment amounting to US\$ 8-10 billion. Subsequently, a further 19 PSAs for the exploration of offshore oilfields worth over US\$ 50 billion have been signed. As oilfield exploration has progressed, a Host Government Agreement (HGA) has been introduced to attract FDI to the development of the major pipelines infrastructure for the export of hydrocarbon resources. The tax and customs regimes governing investments under the PSA and HGA are very favourable. Additionally, Azerbaijan has signed bilateral investment promotion and protection agreements as well as double taxation treaties with all 27 countries from which most FDI originates.

The policies adopted for attracting investment to the oil and gas sectors have been extremely successful in doing so. As the estimated multiplier effects of FDI are thought to be three times the amount invested, this should auger well for future economic development. On a per capita basis, FDI in Azerbaijan is one of the highest in the CIS, exceeding US\$ 1,000. The ratio of FDI to GDP is also one of the highest among economies in transition, ranging from 20 to 25 per cent in 1995-2002. These trends are expected to continue and to strengthen in the future.

There is no doubt that FDI has been a major contributor to the economic development of Azerbaijan, accounting for over three quarters of the total amount invested in the economy. However, it remains concentrated in the oil and gas sectors and in related industries and services, which are governed by the special tax and customs regimes. Most FDI has occurred in an enclave around Baku with contracts and subcontracts awarded mainly to foreign contractors, so that the regional and sectoral spin-offs have been limited. Expectations of a greater contribution of FDI to economic diversification and development have also not been realized as revenues have so far been directed principally to cost recovery and the balance has not been reinvested into the economy. Although this may also be a reflection of the lack of integrated policies that could help to channel these revenues to the development of other industries, there is a danger that Azerbaijan may become a victim of the "Dutch disease".

The Government has recently approved a comprehensive, medium-term poverty reduction strategy with a total cost of US\$ 3 billion, elaborated together with the international donor community. Regional and structural tax incentives were introduced in 2003 to promote development, foster entrepreneurship and encourage investments in remote rural areas. Financial support and tax

incentives to boost the development of the non-oil sectors, particularly agriculture and food processing, in the economy and SMEs were introduced in 2002. In the same year, the Microcredit Bank of Azerbaijan was established and is to direct 70 per cent of its lending to financing trading operations and 30 per cent to SMEs. Licensing for business and commercial activities were simplified and public sector intervention in business was significantly reduced. A number of initiatives are currently being undertaken with the assistance of international institutions to assess and improve the investment climate and develop policies to attract greater FDI.

E. Impact of globalization on social and human resources development

The share of the public sector in total employment decreased from 71 per cent in 1990 to 33.4 per cent in 2001, illustrating the growth of the private sector. The structure of employment has also changed. The share of employment in industry and services has declined, from 12.7 per cent in 1990 to 6 per cent in 2001 in the case of the former and from 6.8 to 4 per cent in the same period in the case of the latter. In contrast, the share of employment in agriculture and forestry, which had remained stable at around 31 per cent until 1998, increased thereafter and is now around 43 per cent. Official unemployment rates are rather low in Azerbaijan. For example, in 2001, the unemployment rate was 1.3 per cent but the true figure is likely to be somewhat higher. Of the total unemployed, 6.4 per cent received unemployment benefits. A labour exchange was established in Baku in May 1999 and around 9,000 persons have registered with it since its inception, 4,000 of them being placed in temporary jobs. Some 8,000 persons have received training and retraining since 1997.

The Government of Azerbaijan is planning to undertake several measures to increase employment and develop the labour market in the next five years. These include targeting measures to create employment to those requiring social protection, developing SMEs and encouraging self-employment, including through microcredit, and increasing advisory services and labour exchanges. Information systems to facilitate job search as well as to aid employment forecasting are to be developed. Greater public intervention is foreseen in this area, with public works undertaken in the regions and an increase in the unemployment benefit. A system of unemployment insurance is also to be developed. The issue of labour emigration will be given greater attention to improve the protection of citizens working overseas.

Money incomes did not keep pace with the rate of inflation during 1994-2000 and income disparities widened. In comparison to neighbouring countries, Azerbaijan performs poorly in terms of the material well-being of its population. It also performs badly in terms of human development, only the primary school enrolment ratio, at 97 per cent, being at an acceptable level. In October 1992, the law on the minimal consumption budget was adopted in Azerbaijan. The budget includes expenditures on food sufficient to provide 2,468 calories per day as well as on other items such as transportation, utilities, entertainment and so on. In 2000, the State Statistics Committee estimated this budget to amount to 337,900 manat per month, equivalent to US\$ 76 dollars or US\$ 2.50 per day. In 1995, average nominal monthly wages amounted to 23.9 per cent of the minimal consumption basket and the figure had risen to only 64.1 per cent by 2000. However, the Government believes that the minimal consumption basket as currently defined is an overestimate and likely to overstate poverty levels.

In Azerbaijan, a wide range of grants are payable to pensioners, war veterans, the disabled and to the children of needy families. Each child receives a grant at birth. However, poverty remains high, particularly in rural areas. An estimated 1.7 million able-bodied persons live in villages, of whom 65 per cent are engaged in agriculture. Each of these persons needs an estimated 1 hectare for cultivation and can hope to earn around US\$ 156 annually, or US\$ 13 per month. This amounts to approximately US\$ 0.43 per day, well below the minimal consumption budget. Taking into account the number of dependents each able-bodied person has, the situation appears to be even more dire.

The funds allocated to health in the budget have decreased considerably. Work on immuno-preventive maintenance has been practically suspended, with adverse consequences for the health status of the population. The general system of health care, which is free of charge, has gradually broken up. Demographic parameters have worsened sharply. A programme to reform public health care services has been prepared and is being realized with the assistance of the World Bank. The purpose of this programme is to improve the quality of medical services and improve access, especially for the poorer sections of the population. As an estimated 70-75 per cent of the people are expected to rely on the State health care system in the near future, charges for the services provided are likely to increase. The present condition of municipal services is well below the minimum requirements of the population. Water and sewage networks are in a state of collapse where they do exist and in most of the inhabited areas in the regions, they do not. By some estimates, only 40-45 per cent of the costs of providing these services is covered by the charges imposed.

Azerbaijan's Poverty Reduction Strategy Programme (PRSP) envisages completion of reforms and structural adjustment. In the social sphere, significant improvements are to be made in the provision of public services such as electricity, gas and water supply, education, public health care services and environmental protection. Charges to cover social needs are, however, expected to rise from 48.7 per cent of costs to 55.9 per cent by 2005.

As part of the strategy, the system of social protection after retirement is to be improved. One of the greatest social problems during transition to a market economic system in Azerbaijan is the condition of the pension system. Although nominal pensions have been raised on several occasions in the past, pensions remain very low in comparison with average wages. In future, pensions will be raised and will no longer be linked to the minimum wage as at present. Instead, they will be increased in line with average wages.

Pension reform assumes transition to a system with three components. The first consists of labour pensions based on obligatory State social insurance and the size of the pension received will be determined by the amount of social insurance contributions paid. The second consists of pensions granted as social aid to persons not receiving labour pensions and the third consists of private pension plans.

F. Key challenges ahead

Azerbaijan expects rapid growth in the years ahead based on significant increases in the production and export of oil and gas, following major FDI inflows. Privatization and the development of SMEs will increasingly shape the economy, while the implementation of the PRSP will have a clear impact on the social sphere. The challenge for the Government in these circumstances is to maintain the momentum of growth, while continuing the reform, restructuring and diversification of the economy.

Against this background, the question whether the country has developed adequate institutional infrastructure and capacities to be able to manage all the challenges of development is becoming more and more topical. Recent experience shows that inadequate institutional infrastructure and poor governance carry with them high risks of unequal and unfair income distribution, thus jeopardizing democratic reforms. Officially, about half the population is living in poverty. This situation undoubtedly, complicates implementation of market reforms. The PRSP, which aims to cut poverty rates by 25 per cent by the year

2015, is therefore viewed as an important element of Azerbaijan's medium- to long-term development strategy and one of the most serious challenges facing the Government.

This issue is becoming more critical for the countries like Azerbaijan with economies in transition as they enter a decisive phase of their transformation from centrally-planned to market-oriented economies. Many of these countries do not have adequate resources and institutional capacities and lack knowledge and experience, thus they have to rely very much on international assistance to pursue unprecedented democratic changes.

The Government of Azerbaijan is pursuing administrative reforms aimed at enhancing efficiency through streamlining public administration, reducing the number of ministries and State agencies and the number of public sector employees and fighting bureaucracy and corruption. New institutions have, however, been established to enhance control over public spending and ensure more efficient utilization of financial resources.

Azerbaijan has several advantages that need to be kept in mind when formulating a development strategy for the country. Abundant natural resources, particularly of oil and gas, and its geographical location between Europe and Asia are among these. Development of the transit potential of the country as well as the promotion of Baku as a regional hub of the Caspian Sea region could be of great benefit to the economy. Azerbaijan is currently implementing several major regional projects to meet the challenges of globalization. Among these are the development of an east-west transport corridor (Transport Corridor Europe-Caucasus-Asia, or TRACECA); a fibre-optic communications link between Europe and Asia; the realization of regional pipeline infrastructures for oil and gas; and a north-south transport corridor.

Based on the discussion above, key reform challenges can be identified as follows:

- (a) Reform of public administration and development of an institutional framework and institutional capacities to ensure good governance. Introduction of new concepts such as e-governance to ensure transparency, accountability and efficiency. Strong Government is the backbone for the development of statehood in countries facing the challenges of globalization.
- (b) Reform of the oil and gas sector. The energy sector is the basis for the economic revival of Azerbaijan and is the engine driving development. It contributes 60 per cent of budget revenues and 70 per cent of

export revenues and is the destination of 65 per cent of FDI. Developments in this sector have repercussions for overall development in Central Asia, while the heavy dependence of the country on this sector has caused concerns about the “Dutch disease” syndrome. It is therefore crucial that serious reforms should start here.

It has been estimated that State-owned enterprises in this sector have accumulated large quasi-fiscal deficits, amounting to 20-25 per cent of GDP, owing to subsidies, payment arrears for public utilities, technical losses and theft. The elimination of this deficit is an urgent task. Oil constitutes about 80 per cent of the energy balance of the country, where energy consumption is marked by inefficiency. There needs to be a shift in emphasis from oil to natural gas in the domestic energy balance, as well as development of alternative and renewable sources of energy. This will reduce imports and free oil resources to be used more productively for developing value added industries and exports. The participation of the private sector, improved metering and management contracts awarded by tender for all distribution networks are planned so as to foster development along these lines.

- (c) Banking sector reforms. Despite the reduction in the number of banks, there are still too many commercial banks that are weak, undercapitalized and illiquid, with negligible shares of total deposits. Most commercial bank loans are directed to short-term trade transactions. Reforms are needed to ensure more vigorous private sector development in this sector. The two remaining State-owned banks are due to be privatized in 2003-2004.
- (d) Reform of the taxation and customs systems. Malpractice in both systems, such as favouritism and corruption, has been the object of criticism and they are considered to be one of the major obstacles to economic development, particularly of SMEs. Transparency, accountability and simplicity of these systems are crucial to securing the creation of national wealth as well as its fair distribution and redistribution.
- (e) Development of modern infrastructure in transport and communications. This is crucial for economic diversification and the elimination of regional disparities within the country, as well as for its greater international integration. It will also go some way towards capitalizing on Azerbaijan’s location and will help to develop Baku as a regional hub.

- (f) Development of agriculture. This sector has traditionally been the second largest in the economy and is a sector with great potential. The development of agriculture and food processing is crucial to the diversification of the economy, SME development and to meeting the Millennium Development Goals in poverty alleviation and food security. Although the Government introduced radical agrarian reforms, poor industrial and financial infrastructure have hampered the sector's development.
- (g) Reform of State-owned enterprises and their subsequent privatization. This will enhance FDI inflows and the diversification of the economy and its integration into the region and the international economy. It will also enhance competitiveness through the transfer of modern technology. However, the privatization process must be seen to be open, fair and transparent.
- (h) Reform of the social sector. With the development of the economy in Azerbaijan more attention should be given to reforms in areas such as pensions, poverty eradication, healthcare and education. In the context of globalization, education should be given the highest priority, as knowledge is becoming the principal resource for economic development.
- (i) Further regional and international integration. Deepening regional cooperation and bringing domestic legislation and regulatory standards into conformity with WTO will ensure the continuing smooth and balanced integration of Azerbaijan into the region and the international economy.
- (j) Accessing and utilizing international assistance. There is a need to enhance the country's ability to make better use of the opportunities provided by the international donor community, through aid and other assistance directed to countries with economies in transition, in addressing issues of poverty alleviation, governance, and environmental protection.

G. Conclusions

Since its independence, Azerbaijan embarked on a course of market-based reforms to ensure the democratic development of the country and to restructure the economy so as to make it more balanced, diversified and competitive and further its integration into the regional and wider international economy. Azerbaijan has made significant advances in market-oriented reforms, given difficult and complex

internal and external circumstances. Major achievements have been made in the development of its hydrocarbon reserves and in attracting FDI, as well as in attaining macroeconomic stability through the implementation of strict financial discipline in close cooperation with international financial institutions.

Macroeconomic stability provided favourable conditions for widening and deepening market reforms. Azerbaijan initiated economic restructuring through the liberalization of trade and economic activity, privatization and radical reforms in agriculture and services, including banking and finance. Reforms in the social sector and in public administration also commenced. As a result of these measures, Azerbaijan has diversified its international trade and its economic ties with the outside world. It is now a member of major international organizations and has joined and actively participates in almost all regional organizations, projects, programmes and initiatives.

The private sector now plays a leading role in shaping new economic structures. However, economic growth has been unbalanced between economic sectors and the regions of the country, with most activity concentrated in the energy sector and around the capital city of Baku. Poor public sector governance has affected the business environment adversely and fostered the development of a large shadow economy. The worsening income distribution has led to social polarization and the marginalization of large groups of people, with half of the population living in poverty.

As Azerbaijan enters a new phase in its development, these issues are now being addressed through various national programmes and strategies. However, to address the challenges facing the country and pursue policies in a comprehensive and integrated manner, the country's objectives and prospects need to be clarified. A vision for Azerbaijan's long-term development, in the light of its comparative advantage and the opportunities realistically provided by globalization, should be formulated and the future role of the State clearly indicated. On this basis, resources available internationally can be sought and efficiently mobilized to realize this vision.

One of the most evident manifestations of globalization today is that major players such as transnational corporations, large industrialized countries and international organizations increasingly define global economic development. Small economies like Azerbaijan remain extremely vulnerable to the external developments and have to cultivate the ability to react and adapt quickly to those changes. This ability will define to a large extent their competitiveness and, in this context, the role of governance and the management of external boundaries are becoming increasingly crucial.

IV **MANAGING GLOBALIZATION IN KAZAKHSTAN**

Introduction

Globalization provides great opportunities for steady economic growth. To take advantage of them, conditions that favour a modern economy such as production infrastructure and investment in education and science need to be created. Globalization can, however, also threaten stable economic development particularly in small countries with a narrow economic base such as Kazakhstan. This is especially true of financial markets, which are highly internationalized and characterized by instability and contagion.

Countries in regional groupings, such as the European Union, the North American Free Trade Area and the Association of South East Asian Nations, appear to have benefited the most from globalization. Countries like Kazakhstan, however, have had to face increased competition without the capital and technology to do so adequately. At the same time, globalization has positive effects that can be seen through trade. Imports create additional competition but increase the variety of goods available in domestic markets to the benefit of consumers, while producers gain from increased export demand. Trade facilitates restructuring by stimulating the redistribution of resources within a country. It also stimulates the relocation of some productive activities from industrialized to developing countries, which together with the progress in ICT that has led to a sharp increase in trade in services, creates additional opportunities for them.

In the last quarter of the twentieth century, the world entered a new phase of global integration. The process of economic and political integration intensified significantly and took a new direction. If globalization was defined earlier by the free movement of goods and financial capital, it is now dominated by intellectual and human capital, marking the transition to post-industrial development. Ideally, external trade, foreign investments and transfer of technology should be closely integrated in a globalizing world, although this does not happen in practice. Developed countries continue to be prime movers in the production of high technology goods but the inflow of foreign investment does not guarantee the inflow of knowledge.

Countries that have completed the process of modernization most successfully can hope to meet the challenges of globalization, although this is no longer enough. The new era requires taking every opportunity to break into the post-industrial, information society, which means investing in human capital, the main source of innovation. Globalization is an objective process. It is hardly possible to turn back the globalization wheel. The question is how to manage it so that as many people as possible can benefit.

A. Globalization and regional integration

1. Integration into the multilateral trading system

Trade integration is crucial to Kazakhstan, with its small internal market and high dependence on exports of raw materials that increases its vulnerability to fluctuations in world commodity prices. Globalization brings with it new possibilities for accessing world markets. Without joining WTO, Kazakhstan could suffer trade discrimination. Membership in WTO, however, would entitle the country to MFN treatment and enable it to become a participant with equal rights in the international division of labour. Membership would promote development of the legal basis and institutions of a market economy, stimulating the development of trade and increasing FDI. It would also provide a means for the resolution of trade disputes. The need for Kazakhstan to be able to enter markets overseas freely is being given additional impetus by increased oil revenues that could make it into a future exporter of capital.

Kazakhstan applied to join WTO in 1996 and has been engaged in the negotiation process since. A memorandum on the foreign trade regime in Kazakhstan has been presented to WTO and the country has been harmonizing its legislation with international norms and standards. Nine new laws and five amendments to existing laws were introduced in the areas of standardization, certification, subsidies, protection of domestic markets from imports, patent laws and so on. Training has also been provided to public sector personnel engaged in trade-related activities.

The question of entering the WTO is being widely discussed by the people of Kazakhstan at all levels, particularly between the Government and business representatives where potential negative consequences for the country post-entry are the subject of dispute. Most goods entering Kazakhstan at present face relatively low tariff rates and the average tariff rate is unlikely to fall after WTO entry. The only sector that must continue to be protected is agriculture but this is allowed under WTO and happens in many member countries. The extent of

the protection is still open to discussion but import duties on agricultural products are low in Kazakhstan. Membership in WTO will benefit labour-intensive exports from the country such as machinery, textiles and processed foods, as has happened, for example, in China. However, the overall impact of WTO entry is hard to quantify as it has many dimensions and will not occur in isolation. It remains true to say, however, that increased competition in domestic markets will force local producers to improve product quality and lower price with benefits for consumers and society.

2. Regional trading arrangements and partnerships

At present, Kazakhstan engages in trade with 183 countries and has trade agreements with 50, most of whom receive MFN treatment. The Government coordinates the activity of 48 bilateral intergovernmental commissions on trade and economic cooperation. In 2001 alone, 24 of these commissions met, which is a sign of the greater role of foreign trade in the development of the country. There was a qualitative improvement in the trade and economic relations between Kazakhstan and its most important trading partners and greater activity in the sphere of regional cooperation in the same year.

Kazakhstan is a member of several regional trade and economic integration groupings but there is little to show from this cooperation so far. The principal regional grouping is the CIS, which has not become a factor strengthening economic integration of countries that were members of the former Soviet Union. On the contrary, in response to increased friction between member States, trade and consular regimes have been tightened. Russian Federation has not been able to become the base around which the new economic community could be formed.

Other regional groupings are ECO, originally established by Iran, Pakistan and Turkey, which is mainly an advisory body, and CACO, which serves more as a tool for deciding interstate political questions, rather than for economic integration. In the CACO, there is no evident leader state that the rest could cluster around, which results in economic and political borders coinciding. A more constructive role is played by EurAsEC, which was created on the principles of a customs union. It provided for a uniform customs policy and the creation of the conditions for forming an internal market, as well as interstate cooperation for participating in world markets. Within the EurAsEC framework, a coordinated approach to entering WTO was proposed. Despite some progress in the development of EurAsEC, it has not become a regional market able to sustain economic development of its member States and will probably not do so for a long time. The situation could change if Russian Federation changed the

orientation of its external economic politics from Europe to Asia. Meetings of the recently formed SCO have been political rather than economic but the grouping has a large potential for economic integration. The presence of two of the largest regional economies, Russian Federation and China, among the members provides a basis for other countries to develop their economies.

B. Transition assessment

1. Stages in the reform process since independence

After independence, there was considerable deterioration in socio-economic conditions in Kazakhstan. Hyperinflation led to a collapse in real incomes and the accumulation of substantial arrears in wage and pension payments. Rising unemployment induced over a million people to seek work abroad. Social stratification became more acute, with widening income disparities between regions, social groups and men and women. Access to social services such as education and health care deteriorated.

During the first stages of reform after independence, in 1992-1994, economic policy in Kazakhstan was concerned with liberalization and the creation of the legislative and institutional base for a market economy. Prices were liberalized and, after a failed attempt at monetary compression, expansion of credit resumed. Countries that remained in the rouble zone like Kazakhstan experienced significant devaluation and hyperinflation, with prices of consumer goods and services rising as much as 20 times compared to pre-independence levels. Continued State control of prices in key industries, such as energy, metals and grains, and of socially sensitive goods and services led to distortions in relative prices. The agricultural sector, in particular, was adversely affected. The Government also engaged in significant external borrowing to finance imports of consumer goods, which quickly displaced domestic products.

State bodies with planning and distribution functions were abolished during this period and there was a reduction of State interference in the management of the economy. Restrictions on the movement of many goods were removed. Among the many institutions and bodies of State that had to be created at this time, the banking system and the customs department were organized and attempts were made to attract FDI for the production of consumer goods and services for the domestic market. Not least, a change in the worldview of all market participants had to be fostered, including by training management personnel, while social and political stability had to be preserved. Other achievements of the first stage of market reforms in Kazakhstan were the

introduction of the national currency and the country's entrance into the world community and international financial bodies.

Absence of skilled management and the lack of appropriate market-based legislation affected economic results negatively in the early stages of transition to a market economy in Kazakhstan. Gross national product fell by 40 per cent during 1992-1994 and real savings were greatly eroded. Attempts to control prices administratively added to inflationary pressures, with many goods being re-exported. Most businesses became insolvent and unemployment was high. Government attempts at the administrative allocation of credit to enterprises led to many loans becoming non-performing and increased public debt.

The second stage of market-based reforms in Kazakhstan, during 1995-1999, was more constructive. The main aim was the achievement of macroeconomic stabilization and the continuation and deepening of the reform process. Aspects of this included financial sector reforms, the abolition of State monopolies, privatization and restructuring of enterprises. Greater fiscal discipline, which reduced budget deficits and the resort to inflationary sources of financing, as well as tight monetary policies adopted by the National Bank of Kazakhstan led to price stability being essentially achieved by 1997 but at the cost of economic contraction and rising unemployment. Although unpopular, these measures did not result in social unrest, permitting the continuation of these policies until the qualitative changes they were designed to bring about in the economy became more visible.

During this stage of reforms in Kazakhstan, public expenditure and taxation reforms brought budgetary planning and administration to international standards. A pension system was introduced and pension funds began to participate in the market for government bonds. The people's trust in the banking system grew, significantly increasing savings mobilization and the availability of financing for investment.

During 1994-1997, important legislative documents were drawn up, which specified the relationship of the State with private agents and gave economic independence to enterprises along with responsibility for their performance. Laws passed during this period include laws on the National Bank, bankruptcy, the oil sector, taxes and levies, production cooperatives, privatization, State support for FDI and the stock market. Reforms of institutions in the public sector, both at the central and local levels, were also carried out and the structure of central and local administrative bodies was improved. Great attention was paid to developing human resources through training employees locally and management personnel abroad.

During the course of reforms in Kazakhstan, new problems emerged that required immediate attention and delayed a return to economic growth. Among these was a loss of State control over strategically important industries such as oil extraction, ferrous and non-ferrous metallurgy. The financial difficulty faced by many large enterprises, owing to high levels of debt, was another problem that was compounded by reduced bank lending and the underdeveloped stock market. Growth of the shadow economy leading to low levels of tax collection and of non-tax payments to the Government caused a shortfall in investment in agriculture, health and education. Nevertheless, the economy stabilized and economic performance improved during the second stage of the reform process, with GDP increasing by more than 3 per cent in 1995-1999.

From the second half of 1999 Kazakhstan was able to embark on a period of high economic growth initially helped by devaluation of the national currency, the tenge, and increased participation in world commodity markets for its natural resources. One of the main factors in the development of the Kazakhstan economy at this time was economic growth in Russian Federation, which boosted trade with Kazakhstan.

The third stage of reforms in Kazakhstan, from 2000 onwards, was a period of rapid economic growth. Among many important policy goals in 2000-2002 were the harmonization of economic and budgetary planning, supporting SMEs, developing State and private sector insurance, creating the National Fund of Kazakhstan and Development Bank of Kazakhstan and fighting corruption. A noticeable feature of the third stage of reforms was the high inflow of FDI in the oil and gas industries, which experienced very rapid rates of growth that were also helped by high world oil prices. High commodity prices also benefited the metals and grains sectors. Enterprises operating in the raw materials sector in Kazakhstan were able to raise the wages and salaries paid to employees and to increase investment in fixed assets. There were spillover benefits for industries supplying products to these industries, such as machinery and equipment and construction and building materials. In 2000-2002, average per capita real income in Kazakhstan increased nearly by 24 per cent.

Deepening structural and institutional reforms were also of considerable importance to enhanced economic growth during the third stage of reforms and in recognition of these efforts, Kazakhstan was granted market economy status by the United States in 2002. The reforms included further improvements in tax administration and budgetary control; strengthening of the banking system; further liberalization of the activity of banks and pension funds; the introduction of deposit insurance; and liberalization of the exchange rate regime. Some tax

rates and interest rates were reduced and increases in the tariffs of natural monopolies were restrained to protect those on low incomes. This helped to control inflation and prevent further erosion in the competitiveness of domestic goods. The Government also pursued an import-substitution policy after 2000, which boosted the output of several enterprises that had received subsidized credit.

As a whole, economic performance in Kazakhstan has been positive during the third reform stage, with broadly-based GDP growth averaging 10.8 per cent in 2000-2002. An increase in business incomes and savings during this period fostered something of an investment boom; there was a 60 per cent increase in fixed capital investment in 2000-2002 in which FDI, which had played the leading role in 1995-1999, had a somewhat smaller share as compared with domestic investment. The rate of inflation slowed and was down to just under 6 per cent in 2002. In the same year, real wages increased by 8 per cent and the contribution of consumption expenditures to GDP has also increased.

The economy of Kazakhstan has gone through a structural transformation since independence. Agriculture, which accounted for just over one third of GDP in 1990, has seen its share fall to little over 8 per cent in 2000-2002. The share of construction fell from just over 12 per cent to approximately 5 per cent over the same period. There has been a significant increase in the share of output contributed by industry, from 20.5 per cent in 1990 to 31.3 per cent in 2000-2002. The most noticeable change has been the large increase in the share of services, from around one third of total output at the time of independence to nearly half of output in 2000-2002. Nevertheless, the reliance of Kazakhstan on raw materials remains.

2. Lessons from privatization

Privatization of State-owned enterprises in Kazakhstan took place during 1994-1997 and three modalities were used, depending on the size of the enterprise concerned. Small businesses were sold for cash, usually to their employees, while sales of large enterprises took place on the basis of individual tenders. The large enterprises were mainly in industries based on natural resources, such as metallurgy, chemicals, oil and oil processing. As there were neither domestic buyers able to purchase these enterprises nor qualified managers to run them, the purchasers were largely foreign investors. Owing to the inexperience of local officials handling the sales, the legal terms did not fully conform to the wishes of Kazakhstan authorities. However, the Government has no plans to reconsider these contracts.

Medium-sized businesses were included in a mass privatization in which they were sold to investment privatization funds in exchange for shares that were distributed to the public. It was hoped that these shares would become central to the development of the stock market with widespread public participation but the poor outlook for most of these enterprises rendered the shares of little value, preventing their sale. The investment funds themselves were not in a position to inject capital into these businesses to aid their restructuring. Some steps were taken in 1995-1997 to restore the financial viability of the enterprises but owing to insufficient financial resources the attempts were not successful and the bank set up to undertake their rehabilitation itself became bankrupt. Following the introduction of the bankruptcy law, most businesses that had been part of the mass privatization declared bankruptcy and were sold to private citizens.

The outcome of the privatization efforts appears to have been favourable for the economy of Kazakhstan, owing to large inflows of FDI and increased government revenues. The large enterprises that were purchased by foreign investors have benefited from better management and have generated increased demand for local goods and services, which has helped small and medium-sized businesses. According to the Statistical Agency of Kazakhstan, only 15.5 per cent of GDP came from the State-owned sector in 2001.

In 2003-2005, the focus of policy will shift from the privatization of remaining State-owned property to improving its management and utilization, with the aim of conserving and regulating the development of the most important sectors of the economy. Improving the system of accounts for this property will be another goal. Other government priorities in this regard include increasing central and local government revenues from the use of public property, optimizing the structure of State-owned property and improving the financial health of State-owned enterprises.

3. Fiscal policy reform

During 1995-1996, extensive improvements were made to the budget system in Kazakhstan owing to a sharp reduction in government revenues without a corresponding fall in public expenditure needs. The transition to budget programming began and the structure of budgeted outlays became comparable with international standards. A great deal of attention was paid to finding anti-inflationary sources of financing for budget deficits and gradually less reliance was placed on bank lending. It was replaced by public sector borrowing, either through domestic sales of government securities or external sales of bonds on world markets, as well as loans from IMF and the World Bank.

From the second half of 1995, new regulations were introduced regarding tax and non-tax payments in Kazakhstan. New tax codes were introduced in 2002 to regulate the tax system and improve equity, while also expanding the tax base. At present, the annual budget, which has current and development components, is formulated on the basis of economic policy and macroeconomic forecasts that are in accordance with the three-year rolling socio-economic development plan. Further reforms and improvements are planned for 2003-2005 focusing on greater efficiency and control of budget planning and performance. The tax base is to be widened and tax and customs administration and the Treasury are to be modernized and upgraded through adoption of new technologies. A register of taxpayers is to be introduced and a system for the automated payment of taxes and duties completed. Keeping public sector borrowing within agreed limits that safeguard economic stability is another important aim.

4. Monetary policy reform and financial sector development

Macroeconomic stabilization in Kazakhstan in 1994-1999 required a reduction in the level of monetization of the economy and in the monthly inflation rate to a level below 10 per cent. Bringing the balance of payments deficit down to an acceptable level and financing the budget deficit from non-inflationary sources were also necessary. As mentioned earlier, these steps resulted in the restoration of price stability. The exchange rate was also stabilized and auctions have been freely conducted on the exchange market since 1994. This has resulted in the disappearance of the black market in foreign exchange.

As part of its reform process, several regulations were introduced in Kazakhstan relating to the National Bank of Kazakhstan, the national currency, the banking system and financial and stock markets. The Central Bank and a number of commercial banks have also created a fund to insure bank deposits.

Reform is to continue in 2003-2005, when inflation targeting is to be adopted by the National Bank of Kazakhstan. The main instrument of monetary policy under this regime will be open market operations targeting the National Bank's repurchase rate. Work on reinforcing the role of the discount rate and other short-term rates will continue. The exchange rate regime is also to be liberalized further in Kazakhstan, which will affect currency and capital outflow controls. The National Bank is planning to float the tenge relatively freely, interfering only to counter speculative attacks, with the aim of preserving the

competitiveness of Kazakhstan goods on foreign markets. Forecast inflows of FDI are expected to be sufficient to cover current account deficits and permit reserves to be built up to a level covering three months of imports.

In the financial sector, the banking system is to be strengthened in 2003-2005 in Kazakhstan in line with Basel standards on capital adequacy, disclosure and banking supervision, while deposit insurance is to be improved. Microfinance and mortgage lending are other priority areas for development. The insurance industry is to be put on a firmer financial footing and professional standards are to be raised. Professional standards will also be raised among emitters of securities on the Kazakhstan stock exchange and supervision is to be strengthened. Increasing the participation of the public in the stock market, including through the development of mutual funds is another aim. Finally, the administration of the pension system is to be modernized through the use of ICT and greater diversification will be permitted in the allocation of pension fund investments.

C. Markets and trade

Raw materials dominate exports from Kazakhstan, accounting for over 80 per cent of total exports in recent years. Oil, ferrous and non-ferrous metals, grains, coal and ores are major exports. As a result, the country as a whole is very vulnerable to fluctuations in world commodity prices. In the long term, Kazakhstan hopes to move up the value-added scale in its exports as well as to diversify and expand export trade.

Machinery and equipment, vehicles and instruments have the largest share in imports in Kazakhstan. Other major import categories are chemical products, plastics and rubber, mineral and base metal products and food. The current tariff policy is to permit an import structure that enables diversification and modernization of the economy. The tariff regulations allow for zero or very low levels of custom duties on machinery and equipment, some raw materials and semi-processed goods, as production of these is either absent or insufficient in the country. Protection is currently given to the poultry, sausage, yeast, wallpaper, cement and rug industries. The evolution in the structure of customs duties between 1995 and 2001 is shown in table IV.1 and the tendency towards lower customs duties during this period is clear. The 40 and 50 per cent rates of duty have been cancelled, while the 100 per cent rate has been retained on ethyl alcohol. The average tariff rate on imports has fallen from 13 per cent in 1995 to 8.5 per cent in 2001.

Table IV.1. Distribution of imports by rates of customs duty, 1995 and 2001

Rate (per cent)	Number of items	
	1995	2001
0	833	3 342
5	2 594	3 175
10	3 040	1 018
15	1 683	785
20	1 458	745
25	271	124
30	198	109

Source: Unpublished data from the Economic Research Institute, Almaty.

Apart from customs duties, protective duties can be applied within the framework of the legal system in Kazakhstan for the protection of the domestic market from imported goods, for anti-dumping measures and for subsidies and compensation measures. MFN treatment is extended to countries that are members of EurAsEC and CACO, with which there are free trade agreements.

Kazakhstan has accepted export promotion as being more advantageous to future economic development than import substitution as it compels domestic manufacturers to increase efficiency, raise productivity and improve competitiveness. Export orientation is the best way forward for small countries with a limited domestic market like Kazakhstan, enabling it to reduce its reliance on exports of raw materials. However, it is important for the country to define those areas where its competitive advantage lies, enabling a more efficient integration into world markets than is the case at present.

The importance of countries outside CIS in the trade of Kazakhstan is increasing. In 2002, their share in the country's total exports was 77.1 per cent as compared with 69.6 per cent in 2001, while their share in total imports had grown to 53.2 per cent from 48 per cent in the same period. Major trade partners outside CIS are China, the United States and EU countries such as Germany, Italy and Great Britain. Within CIS, Russian Federation is the main trade partner, accounting for around one fourth of total trade turnover, and Kazakhstan has a negative trade balance with that country.

D. Investment liberalization policies

Kazakhstan enjoyed an investment boom in 2000-2002 in which domestic investors played a larger role than did foreign investors. Nevertheless, investment continued to be concentrated in industries based on the country's raw materials, with around 58 per cent of total investment during the period directed to those industries. A further 10 per cent of total investment was in transport, communications and processing, of which 6 per cent was in metallurgy, and 1.3 per cent in the production of foodstuffs. Economic diversification appears to be proceeding at a slow speed. Finance for investment continues to be difficult to obtain, as the stock market is not very active and bank lending is principally directed to short-term loans for the acquisition of current assets. The pension fund has not as yet been used to finance domestic investment and insurance funds are still in the process of being set up.

Economic liberalization in 1995-2000 allowed Kazakhstan to attract net FDI totalling US\$ 7.4 billion and the annual inflow of investment into the country has settled at around US\$ 2-2.5 billion at present. Most FDI goes into oil extraction and metallurgy and to the development of communications infrastructure; manufacturing and agriculture have so far remained unattractive to foreign investors.

Government policy towards investment in Kazakhstan continues to be directed to attempting to channel domestic and foreign investments to key economic sectors, which include industries in agriculture, textiles, food, machinery, metal processing, construction materials and chemical and petrochemical industries. The aim is to rationalize investments and to broaden economic development, as well as to optimize the use of public savings including the pension fund in financing investment. Work on improving existing legislation regulating the system of privileges and preferences granted to investors will continue.

During 2003-2005, measures that have been planned to enhance investment include the creation of a system of investment insurance and the introduction of an alternative form of investment cooperation based on the build-operate-transfer principle. Finance for investment is a major area of concern and improvements in the functioning of the stock market and in the methods of attracting savings to pension funds and postal savings accounts are planned. In addition, finance for SMEs and for mortgages for house building will be improved. Public sector investment will be concentrated on infrastruc-

ture development and on sectors that are unattractive to private investors but nevertheless have high priority and assistance will be sought from international financial organizations and donor countries in those areas. Around 53 per cent of public investment in 2003-2005 is expected to go to developing transport and communications infrastructure, which is a prerequisite for creating a favourable investment climate that will attract private investment in fixed assets and improve the mobility of the public. Social sectors will receive 7 per cent of total public investment and 10 per cent is to go to housing and municipal services. Agriculture and water supply will receive 12 per cent.

Under the tax laws of Kazakhstan, tax preferences that can be used against corporate income tax and property tax liabilities are available to investors. These preferences allow for additional deductions from the taxpayer's total annual income for fixed asset investments that create a new business. Exemptions from property tax are also available for investments in new business facilities or in expanding and developing existing business facilities.

E. Impact of globalization on social and human resources development

1. Changes in employment during the transition process

Potential labour resources in Kazakhstan, which include economically active as well as inactive persons, were estimated as 10.6 million people, or 71.6 per cent of the population, at the end of 2001. In recent years, although the total population of Kazakhstan has been declining, the share of the able-bodied in the population has increased, generating additional pressure on the labour market. The total labour force is estimated at around 7.4 million people, of whom around 90 per cent are currently employed.

During the period of falling output after independence and the commencement of market-based transition, unemployment rose sharply and continued to increase for several years, the unemployment rate reaching 13.5 per cent of the labour force at the end of 1999. Since then, some positive trends have been visible in the labour market. Steady and high rates of economic growth, the development of small enterprises and the emergence of self-employment have generated new job opportunities and increased labour absorption. Unemployment declined by 14 per cent between 2000 and 2001 and the unemployment rate at the end of 2001 was 10.4 per cent. Since that date, unemployment has continued to fall.

Self-employment is one of the characteristics of the modern labour market in Kazakhstan, where the share of the self-employed in total employment exceeded 42 per cent in 2001 reflecting dynamic growth in the private sector and in SMEs in particular. The private sector accounted for 67 per cent of total employment in 2001, while the share of large and medium-sized enterprises in the total number of hired workers was 59 per cent. New jobs created by those enterprises increased by 2 per cent in 2001 as compared with the previous year. Part-time workers accounted for a little over 29 per cent of total employment in 2001 and the ratio of unfilled vacancies to total employment remained steady at 0.4 per cent in the same year, reflecting a shortage of skilled labour.

2. Poverty and social safety nets

Unemployment was largely disguised in the years prior to independence. The capital-labour ratio and labour productivity were low and there was little correlation between qualifications and ability, on the one hand, and compensation on the other. Following independence, Kazakhstan found itself unable to compete against imports and in the initial years of the transition period resorted to import protection. This gave way in the mid-1990s to a policy of greater openness and export orientation in order to improve competitiveness and place development on a sustainable basis.

As a result of the social reforms in Kazakhstan, public attitudes towards labour and its remuneration were revised sharply. Two opposing trends were discernible: those who were in paid employment were given increased responsibility while others lost hope of finding work and a steady source of income. Large differences in income levels in the country emerged and the provision of public health, education and cultural activity was significantly reduced. The educational and cultural levels of the population fell noticeably. Consequently, the need to increase public financing of social sector development became apparent and there were reforms in the pension, education and public health systems.

Raising the quality of life became the most important task for social policy in Kazakhstan and the fall in living standards in the first half of the 1990s has been replaced by a gradual increase in per capita income (table IV.2). In 2001, average per capita income amounted to 7,363 tenge, equivalent to approximately US\$ 51, more than quadruple the 1995 level of 1,721 tenge and an increase of nearly 13 per cent over the previous year.

Table IV.2. Indicators of living standards in Kazakhstan, 1995-2001

<i>Indicator</i>	<i>1995</i>	<i>1996</i>	<i>1997</i>	<i>1998</i>	<i>1999</i>	<i>2000</i>	<i>2001</i>
Average per capita monthly income, tenge	1 721	2 371	2 849	3 020	5 539	6 499	7 363
Average monthly wage, tenge	4 786	6 841	8 541	9 683	11 864	14 374	17 364
Minimum monthly wage, tenge	262	1 550	2 129	2 395	2 605	2 680	3 484
Fixed monthly pension payment, tenge	1 876	3 120	3 336	4 213	4 270	4 462	4 947
Estimated monthly subsistence income level, tenge	1 923	2 821	3 120	3 336	3 394	4 007	4 596
Share of population with incomes below the subsistence level, per cent	n.a.	34.6	43.0	43.4	34.5	31.8	28.4
Share of population with incomes below the cost of the minimum food basket, per cent	n.a.	n.a.	14.3	18.0	14.5	11.7	11.3
Share of lowest income quintile in total income, per cent	n.a.	n.a.	6.5	6.1	6.2	6.1	7.2
Share of highest income quintile in total income, per cent	n.a.	n.a.	41.8	42.1	42.0	43.1	41.9

Source: Data provided by the Ministry of Labour and Social Protection of the Population in the Republic of Kazakhstan.

n.a. = not available.

The increases in the average monthly wage and in the minimum wage per month between 1995 and 2001 have been similarly impressive. Fixed pension payments have also gone up but remain close to the estimated monthly subsistence income level. In terms of both income and consumption, poverty levels have declined, particularly after 1999. Income inequality, as indicated by the shares of the highest and lowest income quintiles in total income, widened in 1997-2000 but diminished somewhat in 2001.

Rising disposable incomes and more stable prices, particularly of durable goods, have helped growth in household consumption, which increased from a total of 803.3 billion tenge in 1995 to 1,915.9 billion tenge in 2001. Housing quality, in terms of space per inhabitant, and ownership of many consumer durables and vehicles increased significantly after independence, particularly in 1995-2001 (table IV.3). For example, housing space per inhabitant increased from 15.1 square metres in 1995 to 16.8 square metres in 2001. The number of refrigerators and televisions per 1,000 persons increased from 31 and 289 respectively in 1995 to 62 and 373 respectively in 2001. Moreover, a steady growth in passenger car ownership has been reported after independence, from 50 per 1,000 persons in 1991 to 63 in 1995 and 68 in 2001.

Table IV.3. Selected consumption indicators in Kazakhstan

(Units per 1,000 persons)

<i>Indicator</i>	<i>1991</i>	<i>1995</i>	<i>2000</i>	<i>2001</i>
Housing ^a	14.4	15.1	16.5	16.8
Radios	61	84	97	101
Television sets	258	289	351	373
Tape recorders, video recorders	178	211	286	301
Refrigerators	24	31	56	62
Cameras	252	271	296	331
Washing machines	219	243	259	271
Vacuum cleaners	120	136	162	191
Motorcycles and motor scooters	30	45	52	54
Passenger cars	50	63	65	68

Source: Data provided by the Statistical Agency of Kazakhstan.

^a Square metres per inhabitant.

The human development index (HDI) declined from 0.768 in 1991 to 0.726 in 1995 in Kazakhstan but increased steadily thereafter to reach 0.773 in 2001. The improvement reflects not only the gains in per capita income mentioned earlier but also an improvement in the education level index, which had fallen from 0.919 in 1991 to 0.901 in 1995 before recovering to 0.937 in 2001. However, the health status of the population of Kazakhstan, as indicated

by life expectancy at birth, has not fully recovered to the level at the time of independence. In 1991, life expectancy at birth was 67.6 years but by 1995 this had fallen to 63.5 years, after which it began to rise and is now 65.6 years.

To help poorer families and improve the quality of life in Kazakhstan, the Government has designed schemes to develop education and public health and to alleviate poverty and unemployment.

F. Key challenges ahead

The Government's strategic goals in the economic development of Kazakhstan until 2010 are to build a long-term base for a competitive economy and to double GDP. Various problems will need to be solved in order to achieve these goals, related to continuation of structural and institutional reforms, creation of the conditions for a high rate of economic growth under globalization, increasing incomes and social protection of needy groups in the population. Because of the economy's high dependence on exporting raw materials, efforts will be concentrated on the development of domestic industries, which will increase economic security and raise the standard of living in the country.

In 2003-2005, the legislative, economic and administrative activity of the Government is to be directed to:

- the development of agriculture and improving the quality of rural life;
- the improvement of the health service and promoting a healthy lifestyle;
- the development of human resources through increasing the level of education and availability of professional training;
- the development of production and social infrastructure;
- the development of industries in raw materials processing, machinery, consumer goods and construction materials; and
- the development of Astana city.

The Government and the National Bank of Kazakhstan will also seek to create the economic, monetary, fiscal and legislative conditions to cater to the private enterprise sector and to facilitate increasing incomes. Work will also continue on poverty reduction and combating unemployment.

1. The processing industry

The post-communist Kazakh economy continues to function and develop in the presence of complex socio-economic, environmental and demographic problems, many of which were inherited from the era of central planning and were intensified by the transformation process. This is particularly evident in the processing industry, which has been less successful than the raw materials sector in financing its development. The effects of the devaluation of the tenge, which was the main factor stimulating recent growth in the industry, have now been exhausted and its competitive weakness is evident.

Kazakhstan has a technologically backward processing industry, as existing technologies were developed and introduced in the 1970s or, at best, the early-1980s. They were either Soviet technologies or imported from other socialist countries. New production technologies have not been introduced in the processing sector in Kazakhstan and installed capacity is worn out and outdated. The average age of equipment currently installed in the industry is 3 to 4 times the age of equipment in developed countries. There is no domestic production of a high technological or scientific standard in this sector, with the exception of ferrous metallurgy, which is closer to the raw materials sector than to processing.

This situation has been inherited from the Soviet era, when the industry developed as a complement to heavy industry that had priority in the primary conversion of mineral and raw material resources. In the reform years, Kazakhstan lost most of its research and highly qualified personnel in the processing sector as many institutes and agencies were closed, owing to steep falls in production and demand and the emigration of many Russian-speakers. Other scientists and engineers retired and were not replaced by younger qualified staff.

The low competitiveness of goods produced by the processing industry in Kazakhstan is a reflection of high production costs and low labour productivity. Subsidies as well as tax and tariff privileges do not encourage enterprises to improve efficiency. The unattractiveness of the processing industry for investors can be explained by these factors and by low profitability, with an average rate of return around 6-13 per cent compared with a cost of capital of around 14-18 per cent. In addition, the landlocked nature of Kazakhstan, its remote location and its comparatively high labour costs relative to other Central Asian republics are other factors deterring investors. In recent years, only 8-9 per cent of all fixed capital investment has been directed to the processing sector. Capital

inflows into processing from enterprises in raw materials industries such as oil have been limited and there is little bank lending to this sector. Given that much of the investment that does occur in the sector needs to be self-financed, the relatively high level of taxation of enterprise income in Kazakhstan may be a negative factor in its development.

A feature in the development and location of enterprises in processing industries is their tendency to territorial concentration driven by the availability of physical and social infrastructure, much of which deteriorated in the transition period after independence. On the one hand, large cities can offer few possibilities for further growth and development of these industries but, on the other, small and medium-sized cities do not have enough roads, electricity, gas, heat, water and so on. At present, a unified market and common economic space do not exist in the territory of Kazakhstan owing to the lack of adequate infrastructure. The territory is divided into five regions that are poorly connected by transport and energy networks, North, South, East, West and Central Kazakhstan, each with an autonomous economy. This limits competition and fragments an already narrow domestic market, aggravating the development of the processing sector, which is dependent on domestic demand as its current lack of competitiveness makes foreign markets inaccessible.

2. Demography and migration

The core of demographic and migration policies in Kazakhstan is to create the economic foundation for an increase in the population of the country, with an emphasis on family support and parenthood and the achievement of equality between the sexes. Therefore, a number of issues need to be addressed including improving the health status of the population by encouraging social and personal responsibility for health. Stabilizing the birth rate at a level that provides for continuing generations in future will be encouraged by the introduction of maternity allowances. Improving vital conditions for families and strengthening the family itself are important aspects of government policy in this regard. To address the problem of migration, a programme of migration policies in Kazakhstan to 2010 will be formulated.

For the social protection of those citizens occupied in the informal economy and to prevent illegal migration, there are plans to legalize labour relations in this sector. The priority question in the field of immigration is the migration of ethnic Kazakh people from war zones, internal disorder, systematic violations of human rights, areas of ecological disaster and from countries with a risk of invasion.

3. Employment and human resources development

Key priorities in employment and human resources development in Kazakhstan are to increase both the working population and the qualifications of workers. To achieve these desired goals will require increasing job opportunities through improvements in legislation facilitating employment growth, protecting the internal labour market and making efficient use of the country's labour resources. Setting up a system of information to monitor job creation, putting labour relations on a legal basis, creating new work places and raising the professional skills of people in the labour market are additional measures that need to be taken in Kazakhstan.

To regulate labour relations and improve labour protection, the introduction of a labour code needs to be considered. Further improvements in labour legislation will be directed to protecting workers' rights by improving the system for making individual and collective agreements, restricting short-term individual labour contracts and overtime hours and improving the conditions of employment. The role of social partnerships in regulating wage disputes will increase and its sphere will be enlarged, with greater use being made of arbitration. Discussions will be focused on preventing and solving labour disputes, as well as helping to decide on employment and social protection issues.

To develop sexual equality, special measures will be introduced that improve working conditions for women, including maternity rights. New measures that protect children and socially vulnerable population groups are planned.

4. Poverty reduction and social support

The principal ways in which poverty can be reduced and social protection improved is through economic growth, productive employment and increased wages, as well as through providing adequate public services in health and education. Improvements can also be made to social protection by increasing the effectiveness of management in public institutions in the social sector. From 2003, the Government's initiative on poverty reduction in the period to 2005 will come into force. Successful completion of the programme is expected to reduce the poverty level in 2005 by one third compared with 2002.

The following measures of social support for vulnerable groups in the population are proposed in the programme:

- an annual minimum increase in retirement pensions with timely payments;
- social support for those below the poverty line according to average family income;
- educational and work placements for orphaned or exiled children; and
- integration of the disabled into society and timely payment of disability allowances.

Social support financed from the public budget will be allocated to the most vulnerable groups in society. Others will be encouraged to take care of themselves by the introduction of compulsory social insurance. Thus, the social burden will be divided between the Government, employers and employees in the event of social risk. Systems for targeting social help as well as methods for estimating income need to be improved. The working population will also receive social help through the financing of public works, training programmes and assistance with job placements.

Further improvements in methods used to determine social standards are planned with regard to minimum living standards, minimum wages and minimum pension payments. The amount and growth of social payments will be calculated according to actual socio-economic conditions, which will form the basis for gradual increments in salaries and social benefits. Government regulation of the social security system will remain the main principle of social support policy in Kazakhstan. The State's role will be maintained even with significant development of the social insurance and pension systems. Before completion of the reforms, the public budget will remain the main source of social protection. The reduction of State involvement will occur only with the development of social insurance schemes.

G. Conclusions

In the years since independence, the worldview of the people of Kazakhstan has gone through a revolutionary change. The people have come to understand that they are the creators of their own welfare and the State can only provide minimum social support along with the conditions for acquiring professional skills. Enterprises have also ceased to demand subsidies and tax concessions and have started to seek to survive and grow in a competitive environment. Production without profits is no longer viable under globalization.

Successes in the transition to a market economic system have had a positive effect on the pace of economic development and growth in the welfare of the people of Kazakhstan. This was also helped by improved world economic prospects that favoured exports from Kazakhstan. Macroeconomic stability, large FDI inflows into the country and growing public revenues have created the conditions for accumulating financial capital in pension and insurance funds, as well as the National Fund of the Republic Kazakhstan and the Development Bank of Kazakhstan. The recognition of Kazakhstan as a country with a market economy had a positive effect on foreign trade and foreign investment. The improved outlook for the country is reflected in the raising of sovereign credit ratings for Kazakhstan to investment grade levels in September 2002, with a positive outlook. Kazakhstan is the first among CIS countries to have reached this rating.



Introduction

Countries in transition are faced with the necessity of transforming their economic systems in the context of rapid globalization that has been speeded up by increased economic liberalization and the development of modern transport and communications infrastructure and ICT. The benefits of globalization relate to increased opportunities to participate in the international division of labour by accessing world markets for goods, services and capital. Enhanced productivity, partly owing to improved access to modern technologies, and better product quality contribute to economic growth and rising employment and help to foster human resources development. In its transition to a market economy, Kyrgyzstan has chosen the model of a small, open economy for itself, joining international organizations such as WTO, IMF and the World Bank soon after independence.

Kyrgyzstan is a small, landlocked country in Central Asia but its location, which makes it a natural bridge between Europe and Asia, can be to its advantage. The republic has the potential to become an important transit country for road, rail and air transport and the development of the infrastructure for this will benefit its poorer and more remote regions.

Globalization is not, however, without risks. One of the main risks of the globalization process in the world economy is the rapid spread of financial crises globally, as happened with the Asian financial crisis, for example. Without appropriate policies in place, this can lead to economic instability but there are concerns about globalization other than purely economic considerations. Many of those who are against the integration process care about its influence on a wide range of issues, such as culture, the environment, public health, migration, crime and the loss of control over personal life. To neutralize some of these risks, it is necessary for countries to create new institutions and policies able to deal with them that are strengthened by participation in international markets, organizations and forums.

A. Globalization and regional integration

1. Integration into the multilateral trading system

After independence, Kyrgyzstan in common with other newly independent States that were members of the former Soviet Union experienced sharp decreases in production and trade. It lacked an effective trade and payments policy, a problem that was aggravated by the deep economic interdependence of the new States. Trade and economic cooperation agreements concluded with its partners in CIS in 1992-1994 did not generate sufficient trade for Kyrgyzstan and hindered the development of market forces in this area as the agreements institutionalized centrally regulated trade.

The Government considers that the long term success of economic reforms and economic development in Kyrgyzstan depend on full integration into the world trading system. As a small country with limited natural resources, Kyrgyzstan needs imports of raw materials and other goods and wide access to foreign suppliers. New foreign markets are also necessary for its exports so as to stabilize the balance of payments and to encourage domestic and foreign investment in sectors where its comparative advantage lies. Thus, membership of WTO is of considerable importance to Kyrgyzstan.

After an accession process that lasted three years, Kyrgyzstan became a member of WTO on 20 December 1998. The speed of the process reflected the country's strong desire to participate in a free and fair international trading system, the absence of major domestic obstacles to membership and the liberal trading regime already existing in Kyrgyzstan. The country now has a legal regime and external trade regulations that accord with WTO agreements. It has also accepted the principal obligations governing access to its goods and services markets. These include obligations on tariffs, which are to be contained in the 10-30 per cent range. Kyrgyzstan has agreed to open access to the services sector and to limit domestic subsidies and to eliminate export subsidies for agriculture.

The number of Kyrgyzstan's trading partners now exceeds 100, of whom 80 per cent are WTO members. External trade has been reoriented during the transition period from markets in CIS to WTO members. The share of CIS countries in total external trade was 80.1 per cent in 1992 but by 2002 this share had fallen to 45.7 per cent; the corresponding increase in the share of WTO members was from 19.9 to 52.9 per cent in the same period. Although there is no clear trend in the growth of external trade since joining WTO, merchandise exports from Kyrgyzstan have grown in 2000-2002. Turning to the services

sector, exports such as transport, construction and business services have increased fairly steadily since 1998 but imports of services such as transport and insurance have decreased. As a result, the deficit on the services account narrowed sharply.

A consequence of WTO membership is the declining contribution of tariff revenues to the public budget. Before joining WTO, the average tariff rate was 9.18 per cent; in 2000 it had fallen to 5.2 per cent and has continued falling in line with WTO obligations, reaching 5.07 per cent in 2002. Combined with the effects of declining imports, the share of customs revenues in total public revenues fell from 6.2 per cent in 1998 to 2.4 per cent in 2001 before increasing to 2.9 per cent in 2002 as imports revived.

Several problems continue to stand in the way of Kyrgyzstan fully benefiting from WTO membership. First among these are its geographical remoteness and high transport costs owing to underdeveloped transport infrastructure. A related problem is the need for trade destined to and from Kyrgyzstan to transit through countries that are not WTO members. The poor quality of domestic products is another problem, as well as difficulties in accessing markets in neighbouring countries. Some of these difficulties will be removed when fellow members of CIS accede to WTO. As an illustration, China's recent accession to WTO may prove very beneficial to Kyrgyzstan, although some time may elapse before the effects can be fully evaluated as the agreed transition period before China adheres fully to WTO obligations is rather long. Nevertheless, an indication can be had from 2001, when Kyrgyzstan's exports to and imports from China increased by 52.3 and 17.9 per cent respectively as compared with the previous year.

2. Regional trading arrangements and partnerships

Kyrgyzstan is currently a member of several regional trading arrangements. It joined ECO in November 1992, CIS in September 1993, CAEC (now CACO) in April 1994 and the EurAsEC in March 1996. However, the process of genuine integration in unions that have been formed among countries of the former Soviet Union is still handicapped by trade barriers, which decrease the mobility of goods, services, factors of production and technologies, as well as political limitations.

ECO seeks to develop regional economic cooperation subject to the needs of member countries and external economic and political circumstances. Under ECO, Kyrgyzstan is a signatory to a framework agreement on transit trade since

1995 and a framework agreement on trade cooperation since 2000. Access to the sea is a major problem in the ECO region and plans for improving transport and communications infrastructure and facilitating this access are well under way. Under the trade cooperation agreement, countries agreed to decrease tariffs and remove non-tariff barriers and to establish a WTO-compliant regime to regulate trade in the region. However, Kyrgyzstan's trade with ECO has been declining steadily, in part because many members are CIS countries and also because of unfavourable economic circumstances.

For CIS countries, integration was stimulated by their common history. Kyrgyzstan imported 33 per cent of its consumption needs from and exported 16 per cent of total production to the former Soviet Union. The collapse of that union had more serious consequences for it than for other States. Therefore, Kyrgyzstan joined in the agreement to form an economic union in CIS, with all that it entailed. Hundreds of agreements were signed with the aim of integrating CIS countries but not all of them were implemented and the economic union is far from being realized. In fact, it is true to say that whereas integration in CIS is proceeding slowly in some areas, in many others disagreements between members appear to have widened. Kyrgyzstan's total trade with CIS almost halved between 1996 and 2002 owing to the reorientation of its trade to WTO members and the weakening of economic links between CIS countries.

Without turning its back entirely on the idea of an economic union within CIS, Kyrgyzstan has been seeking greater cooperation with other Central Asian republics, particularly Kazakhstan and Uzbekistan and, more recently, Tajikistan, including in the context of existing regional trade and economic cooperation bodies such as CIS, CAEC and EurAsEC. However, coordination of national interests among those countries is proving to be difficult as the speed and nature of market-based transition differs between them.

At the end of December 2001, CAEC became CACO, which aims to further cooperation not only in the economic sphere but also in other areas such as regional security. At present, several bilateral agreements exist under CACO on free trade, mutual protection of investments, double taxation, taxation of foreign trade and the formation of stock markets. Customs services in CACO countries have agreed to further cooperation and mutual assistance. A programme of cooperation on migration has already begun and an agreement on the movement of people has been signed. Agreements on cooperation in the exploitation and use of hydropower resources and the financing and maintenance of State-owned projects in this field have also been reached. Despite these agreements, total trade between Kyrgyzstan and members of CACO has been

declining and, in 2002, it was only 30 per cent of its value in 1996. Exports to CACO countries, in particular, have fallen sharply, from nearly US\$ 588 million in 1996 to just under US\$ 75 million in 2002. Regional trading relationships are not as yet being accorded high priority.

In contrast to CACO, relations between members of EurAsEC are more complementary because of the participation of Russian Federation, with its well-developed industry and great technical resources. Participation of Russian Federation opens up remarkable opportunities for all members of EurAsEC to develop economic, scientific, industrial and other relations. Unfortunately, integration has proceeded slowly owing to the difficulties faced by post-Soviet economies and Kyrgyzstan's trade with other members of EurAsEC has declined, from approximately US\$ 585 million in 1996 to roughly US\$ 377 million in 2002. Whereas exports from Kyrgyzstan have fallen by 50 per cent in that time, imports have fallen more slowly, by only 25 per cent. If EurAsEC gains the status of an international organization the situation may improve, particularly when all its members are also members of WTO.

Kyrgyzstan is also a member of SCO, a grouping of large countries such as Russian Federation and China and small countries such as the Central Asian republics in which the interests of the smaller countries are not infringed upon. Cooperation in SCO extends from economic development and general prosperity to strengthening the position of the grouping and enhancing its role in the global economy.

B. Transition assessment

1. Stages in the reform process

At the time of the former Soviet Union, Kyrgyzstan had a broadly based manufacturing sector producing a variety of machinery and industrial and consumer goods, of which approximately 70 per cent were exported. The agricultural sector was specialized in cattle breeding and the production of wool, as well as cotton, tobacco, vegetables and fruits and the country was the largest producer of electric power and coal in the union. Kyrgyzstan also received direct and indirect grants, amounting to 13 per cent of GDP, from the Soviet Union's budget. These grants were either in the form of budgetary support or investments in large enterprises. Significant investment in social infrastructure led to the accumulation of considerable human capital, in terms of education and health, with levels of educational development rivalling those in developed countries.

The transition of Kyrgyzstan to a market economy with economic growth and stability can be divided into three periods. In 1991-1995, GDP was halved and living standards fell sharply as poverty increased by 50 per cent. The rate of inflation accelerated to reach 1,366 per cent in 1993 and hyperinflation led to the national currency, the som, introduced in May 1993, being devalued. Industrial decline was accompanied by an increase in the contribution of agriculture and services to GDP. Old economic institutions collapsed to be replaced by new market structures and mechanisms. Liberalization of the domestic market, privatization of State-owned enterprises, trade liberalization, agricultural reorganization, financial and credit reforms and social sector reforms accompanied this process.

The economy started to recover in 1996 principally owing to faster growth in agriculture but also in gold mining and energy. However, 1998-1999 was a period of financial crisis during which growth slowed, the som was devalued and the budget deficit was high. Finally, beginning in 2000, economic growth recovered but it has not been steady. The rate of inflation slowed, the budget deficit declined, the exchange rate stabilized and external debt was restructured. Real incomes, which had increased briefly in 1997, began to grow again in 2001. During this period, the following strategies were formulated and adopted to plan Kyrgyzstan's development and its economic management:

- The Comprehensive Development Framework (CDF), outlining development in 2001-2010 and the strategy to achieve it;
- The National Poverty Reduction Strategy (NPRS) for 2003-2005 formulated within the context of the CDF;
- The medium-term budget forecast, worked out within the context of the CDF and the NPRS, which will determine their financial base; and
- The Public Investment Programme (PIP), outlining plans for capital investment in line with the CDF and the NPRS.

2. Key reforms

In the transition to a market economy, macroeconomic stabilization has been the principal task for Kyrgyzstan, which was the first republic in Central Asia to introduce a national currency. The country embarked on a programme of stabilization and structural adjustment in 1993, under the aegis of IMF as a pre-condition for external financial inflows, both official and private. The programme was centered on tighter monetary and fiscal policies and trade liberalization.

The elimination of the post-independence hyperinflation in 1994-1995 was the first sign of stabilization. The exchange rate remained relatively stable after March 1995 when Kyrgyzstan accepted IMF Article VIII obligations and the som became freely convertible. External financial inflows increased but so did external indebtedness. However, high budget and current account deficits sometimes in excess of 20 per cent of GDP continued, leading to long-term macroeconomic instability and vulnerability to external shocks. One such shock was the financial crisis in Russian Federation in 1998-1999 as a result of which inflation increased and the exchange rate was sharply devalued.

The 2000-2003 period in Kyrgyzstan is characterized by more fundamental macroeconomic stabilization. Control over public expenditures led to a decrease in the budget deficit, which had peaked at 17.4 per cent of GDP in 1992, to 5.9 per cent in 2002. This facilitated tighter monetary control so that the rate of inflation level fell to the comparatively low level of 2.3 per cent in 2002. Stringent monetary and fiscal discipline was dictated in part by the high level of external debt as a result of borrowing by the Government to cover current and development expenditures. The devaluation of the som also increased the debt ratio, which amounted to 95 per cent of GDP in 2001.

Liberalization of the internal market in Kyrgyzstan had commenced in the Soviet era and by mid-1994 most price controls and production subsidies were removed. However, until the beginning of the third reform period, State-regulated monopolies continued to exist in public utilities and some municipal services. The reform of these enterprises commenced in 2000 and the domestic market in Kyrgyzstan is now completely liberalized with the exception of energy price controls that will be removed as soon as a mechanism to compensate the poor has been found.

Privatization and structural reorganization of the economy followed macroeconomic stabilization and economic liberalization. Beginning in 1997, legislative reforms secured property rights of juridical and natural persons in Kyrgyzstan and a referendum was held in 1998 to enshrine private property in the country's constitution. A vigorous programme of privatization led to over 70 per cent of State-owned establishments passing into private hands by January 2003. The level of privatization varies between sectors, with almost all enterprises in consumer services, 97.1 per cent in trade and catering and 88.6 per cent in industry being privately owned. Private ownership is somewhat lower in construction, transport and agriculture, where 58.8, 57 and 44.3 per cent respectively of enterprises are in private hands.

Privatization in Kyrgyzstan did not immediately lead to better economic and social performance of the enterprises concerned. On the contrary, output and productivity fell and working conditions in those enterprises deteriorated. The share of industry in GDP decreased from 27.5 per cent in 1991 to 20.3 per cent in 2002 and there was a change in the sectoral composition of industrial output, with a sharp decline in machinery and light industry and growth in the production of gold and power. Subsequently, it has been suggested that the initial privatization was carried out hastily and without adequate economic and financial analysis and this error was not repeated later. Privatization of sectors such as tourism and health resorts as well as basic sectors such as power, gas, telecommunications and mining is currently underway, with the assistance of the World Bank.

Agrarian reform is of great significance in Kyrgyzstan, where 60 per cent of the population lives in rural areas and 30 per cent of GDP is contributed by agriculture. Only 60 per cent of the country's land area can be utilized for agricultural activities and only 7 per cent is cultivable, the rest being used for hay and pasture. At the time of independence, nearly 94 per cent of land was under the control of the State and of farming collectives and just over 6 per cent was being used by small farmers.

As the result of fundamental land reform in Kyrgyzstan, State ownership of land gave way to a combination of collective, municipal, private and other forms of ownership. Currently about 42 per cent of the land is used by private farms, over 26 per cent by collective farms and nearly 15 per cent by State enterprises. Private citizens were allotted free use of land on an equal basis but without transfer and sale rights. Some collective farms were broken up and their land allotted to private farms, initially on 49-year leases that were later extended to 99 years. The allocation of land was in proportion to the sizes of the families involved and, in total, approximately 72 per cent of all agricultural land except pasture was distributed among 2.6 million persons. As a result, all rural residents have some land for their use although the sizes of individual plots differ because of the regional characteristics of the land. A law introduced in December 2000 on land use places restrictions on the concentration of land and, although restrictions on the sale and transfer of land were eased considerably the following year, some restrictions remain in rural areas.

The radical changes that have occurred in the agricultural sector have had an impact on the structure of agricultural output, with crops such as grains, potatoes and sugar beet gaining at the expense of others such as barley, corn and tobacco. The livestock sector, along with the production of meat and wool, has declined and productivity has fallen. However, the reforms, which were

rather painful from both the economic and social points of view, are incomplete as much work remains to be done to build capacity, develop human resources and improve production, processing and marketing in agriculture.

3. Fiscal policy reform

Reform of the financial system is an essential component of Kyrgyzstan's overall reform efforts, necessitating an examination of public finances because of the central role played by the annual State budget. At the time of independence, the financial system in the country was seriously distorted owing to large budget deficits caused by growing expenditures on subsidies and defense. From the beginning of the 1990s there was also a significant decline in tax revenues owing to weaknesses in the relevant legislation, poor tax administration and an absence of a tradition of voluntary tax payments. The problem was compounded by hyperinflation, the collapse in output, increased use of barter and tax evasion.

Tax reform began in 1992, when Kyrgyzstan, which had little experience in tax policy, decided to rely on indirect taxes such as VAT and excises as the main revenue sources. However, VAT was introduced at the relatively high rate of 28 per cent, resulting in problems of tax collection. The rate was lowered to 20 per cent in 1993 in common with other CIS countries and the structure of taxes and the level of taxation have been frequently adjusted since that time. Gradually, simplification of the taxation system leading up to the adoption of a tax code in 1996, the expansion of the tax base and abolition of tax privileges by the Government led to increased tax revenues. More recently, the Government's total consolidated budgetary income increased from 15.1 per cent of GDP in 2000 to 19.2 per cent of GDP in 2002; the increase in tax revenues as a percentage of GDP was from 11.7 to 13.9 per cent in the same period. However, budget deficits and public borrowing have continued.

Public expenditure reforms in Kyrgyzstan have focused on increasing the effectiveness of those expenditures and increasing transparency in planning and performance assessment. The introduction of programme budgeting based on a medium-term budget forecast, which began in 2002, will be completed by 2005 and should improve management of public expenditures. In recent years, public expenditure as a percentage of GDP has fallen from 26.1 per cent in 2000 to 22.1 per cent in 2001 before rising again to 25.6 per cent in 2002. The sharp fall in 2001 reflected reduced debt repayments as well as public expenditure cuts, including in the social sector, which were difficult to sustain the following year in light of Kyrgyzstan's poverty reduction goals. The scarcity of budget resources has brought the question of their effective utilization to the fore.

This is particularly true of the PIP, which was reduced by 2.4 per cent in 2000-2002 and led to an examination of the prioritization of projects, their inclusion in the PIP and their design and management. As the PIP is not fully integrated into the public budget, the desired level of transparency and effectiveness of expenditures are not always achieved.

4. Monetary policy reform

Monetary policy in Kyrgyzstan has been dominated by the need to control inflation and to further the reform process. The country was part of the rouble zone until 1993 when the national currency, the som, was introduced. A policy of strict control of the money supply, as part of a stabilization programme prescribed by IMF, commenced in 1994 and lending to State-owned enterprises was curbed. The rate of inflation slowed sharply, falling to 13 per cent in 1997. An important factor in this process was the relative stability of the som in 1995-1998, owing to IMF-financed intervention by the National Bank of Kyrgyzstan in the interbank currency market. However, continuing large budget and current account deficits undermined macroeconomic stability until they were reined in beginning in 1999. In 2000-2002, the macroeconomic situation improved considerably and the rate of inflation fell to 2.3 per cent in 2002, one of the lowest rates among CIS countries. Currency appreciation was an important factor in the achievement of price stability.

Unfortunately, the adoption of restrictive monetary policies by the National Bank has had some negative consequences as well. Credit growth has been insufficient to foster economic development and consumer demand, including for local goods and services, has remained depressed. High interest rates, which were initially justified by the high rates of inflation, have also impeded development of the banking sector and financial intermediation has been constrained by excessive caution on the part of both borrowers and lenders.

5. Development of the financial sector

In the early stages of transition to a market economy in 1992-1994, the National Bank of Kyrgyzstan and commercial banks were established, alongside State-owned banks. The poor financial condition of many banks subsequently led to the initiation of bank restructuring, with the assistance of the World Bank. Standards of bank supervision were raised and a Debt Resolution Agency established. The payments system was modernized and international accounting standards adopted by the National Bank and commercial banks. The financial

crisis in Russian Federation in 1998-1999 threatened bank stability in Kyrgyzstan but a systemic crisis was avoided through swift action on the part of the National Bank. A strategy of reconstruction and stabilization of the banking system as well as its medium-term development has now been worked out. In recent years, problem banks, with poor management and internal controls as well as those in violation of relevant laws, have been placed under special administration and liquidated.

As the result of the reforms, bank management has improved, which can be seen by a reduction in operational expenses and an increase in interest income from credit activity, despite some reduction in interest rates. In 2001, the combined banking system returned to profitability and total assets increased. The latter reflected increased requirements on capital adequacy and subscribed capital. However, the higher standards have not as yet led to bank consolidation.

In the non-bank sector, which is also regulated by the National Bank, the growth in the availability of microfinance and in the development of credit unions is of note. Access to financial services and small loans for individuals and entrepreneurs in the rural areas of Kyrgyzstan is an important prerequisite for increased employment and poverty reduction and microfinance has received strong donor support, particularly from the World Bank and the EBRD. The Kyrgyz Agrarian Financial Corporation is very active in the microfinance field, increasing the volume of its lending to producers of agricultural commodities by a factor of 18 between 1997 and 2001 to 587 million soms even though interest rates charged increased somewhat. Loan recovery rates have been in excess of 90 per cent.

The development of credit unions in Kyrgyzstan has been remarkable. Currently, there are over 300 credit unions in existence with total subscribed capital in excess of 120 million soms. Donors and the Asian Development Bank have supported their development so far but they are likely to become self-financing in future as the necessary legislation for them to do so is in place. However, the credit unions have not built up their institutional capital as yet, suggesting room for improvement in the quality of their growth.

The insurance sector and pension funds remain relatively underdeveloped in Kyrgyzstan. Although the insurance market has great potential, relevant infrastructure and a normative and legal framework for further growth are lacking. Nevertheless, the sector has seen some increase in premiums collected in recent years. Legislation is in place regulating non-State pension funds but there is only one such fund at present, indicating the lack of development in this area.

C. Markets and trade

Liberalization of external trade is an important indicator of economic reforms in Kyrgyzstan. From 1991 to 1994 control of external trade through tariff and non-tariff measures continued. High rates of customs duties were applied to a large number of export and import commodities and quotas and licenses were also widely used. External trade regulation was radically liberalized in a short space of time commencing in 1994. Export and import licensing was abolished in that year barring a few socially important items and State and private enterprises are now free to engage in foreign trade operations without any restriction, except for those products. Kyrgyzstan no longer has any quantitative restrictions on exports and imports and there are no export duties but import tariffs and quotas on alcohol and spirits remain. The foreign trade regime in Kyrgyzstan today is the most liberal among CIS countries and is also supported by complete convertibility of the national currency.

Before 1999 there was a fixed tariff in Kyrgyzstan, equal to 10 per cent of the declared customs value, applied to all kinds of goods. Since that date, customs duties on imported goods have been re-examined annually and import tariffs are currently in the 0-15 per cent range, with an average rate of 5.07 per cent in 2002. Trade liberalization has resulted in 45 per cent increase in total trade between 1992 and 2002, when total exports and imports amounted to US\$ 1,072.2 million. There has also been a change in the direction of trade flows away from CIS countries, as has been mentioned earlier. However, Russian Federation remains the second most important export market, after Switzerland, and the most important source of imports after Kazakhstan. Energy, machinery, equipment and consumer goods dominate imports, while exports are principally products from the mining and agricultural sectors as well as hydropower. The structure of foreign trade has yet to demonstrate fully the benefits of membership in WTO and the various regional trade arrangements.

In order to meet the growth target set out in the CDF, Kyrgyzstan needs to increase exports by at least 10 per cent annually. In the short term, exports will continue to be derived from the country's natural resources, which determine its comparative advantage. In the long term, however, Kyrgyzstan needs to diversify its export base to include high-value products such as power, precious metals, highly processed goods and goods that are capital- and technology-intensive. At present, export promotion efforts are confined to encouraging increased sales of goods that are currently produced. However, financial

assistance is the most effective means for stimulating exports and measures such as export credits, together with export credit insurance and State guarantees could be used in future to encourage development of high value added exports. The export potential of the four free economic zones existing in the country could also be increased.

D. Investment liberalization policies

Investment policy in Kyrgyzstan is conditioned by the view that without effective mobilization of internal resources, stable growth and development will not be possible. The major component of policy should be the mobilization of domestic savings, both public and private, and support for investment in industry. Foreign investment is an important addition to domestic efforts but economic liberalization and measures to attract FDI are not the only factors that attract foreign investors. The investment climate in a country is determined by a number of variables, including economic, social and political stability, the economic outlook, taxation, investment incentives, quality and availability of labour and infrastructure, bureaucracy, corruption and so on. During the period of reforms in Kyrgyzstan, steps were actively taken to eliminate factors adversely affecting investment but the most significant steps have only been taken recently.

In Kyrgyzstan, foreign investment is governed by the Law on Foreign Investments, passed in 1997, and the Law on Investment, passed in March 2003. There are no restrictions on the inflow of foreign investment in the republic and all sectors of the economy are open for the realization of investment projects. Foreign investors can also be the sole owners of property and other assets in Kyrgyzstan without entering into joint ventures. They are automatically entitled to visas that permit them to work and live in Kyrgyzstan and citizens of some countries that are members of WTO and the Schengen Agreement of the European Union are able to enter the country without visas.

National treatment is given to foreign investors in their business activity and the current tax code in Kyrgyzstan takes a common approach to both domestic and foreign investors. However, tax and customs privileges for foreign investors are considered to be ineffective in attracting FDI, discriminatory and expensive. Prompt payment and fair compensation is guaranteed in cases of expropriation and foreign investors are also guaranteed unrestricted repatriation of capital, dividends and profits. The national currency is fully convertible for this purpose and investors can choose to keep their earnings in foreign currency without having to convert it into soms.

Several new institutions have been created recently to stimulate investment, particularly FDI. An Implementation Council on Foreign Investments¹ was created in August 2001 to evaluate the business environment and to make it more investor-friendly. A Special Representative of the President on Foreign Investments coordinates the activity of ministries, departments and organs of local government on issues relating to foreign investment. An Investment Promotion Center has been set up to act as a one stop shop for both domestic and foreign investors with broad powers to act on their behalf and to facilitate partnerships, as well as to provide business services such as market research and consultation free of charge. It also assists in obtaining permits, licenses and visas. Finally, an Expert-Appellate Counsel has been formed to evaluate suggestions and resolve complaints from investors and entrepreneurs with regard to administrative and bureaucratic difficulties.

Taking into account the importance of SMEs for investment and growth in Kyrgyzstan, a great deal of attention has been given to their support. Two programmes of support have been realized in which the main problems facing SMEs were addressed, including improving tax legislation, simplifying registration and licensing, improving access to credit and reducing unnecessary controls. A network of public and private financial organizations has also been set up to support SMEs.

At present, four free economic zones have been established, in areas suitable for mass production, to attract investment in Kyrgyzstan. Businesses in these zones are exempt from all taxes, levies and customs duties on exports, imports and re-exports except for a 1-2 per cent charge on the income earned from the sale of the goods and services produced. Exports are free of quotas and licensing requirements.

In attracting FDI, Kyrgyzstan also attaches considerable importance to the development of human resources, to improve the quality of its already highly educated and qualified low-cost workforce. However, the country's remoteness and its landlocked character, which increase transport costs, can be a problem but its strategic location can counteract this to some extent.

¹ The Council has seven members, the President, Prime Minister, Special Representative of the President on Foreign Investments, the Ambassador of the United States of America, the Resident Representative of the World Bank and two representatives of major foreign investors serving on a rotational basis.

Since 2001, a document referred to as the Investment Matrix has been produced each year in which the main strategic directions for stimulating investment and attracting FDI are set out. Investment Matrix I was published in September 2001, Investment Matrix II in April 2002 and Investment Matrix III in January 2003. The most recent document focuses on deregulation and other measures to stimulate investment, including strengthening the banking system. Tax and tariff incentives will also be provided to encourage technological imports and the system of technical regulations will be reformed and State intervention reduced. Investment in the ICT industry is to be encouraged and Kyrgyzstan is to be developed as a transport and communications transit country.

E. Impact of globalization on social and human resources development

1. The labour market, employment and incomes

In the years since independence, some demographic changes can be observed in Kyrgyzstan. Families with many children have given way to single-child families and migration, both within the country as well as to foreign countries, has increased to the extent that the population of the country actually decreased in 1994 owing to large-scale emigration. Out of a total population of approximately 5 million people, nearly 52 per cent is of working age. However, continued emigration of people in this age group in search of better job opportunities overseas is a matter of some concern as it represents a drain on the country's human resources.

During the transition to a market economy, the changing forms of business ownership following privatization resulted in the creation of new enterprises and new work opportunities and a restructuring of employment. The share of the public sector in total employment fell from 60.2 per cent in 1992 to 22 per cent in 2001. Employment in industry declined while employment in the services sector, particularly financial services, and in agriculture increased. However, unemployment continues to be largely concentrated in rural areas. Informal work has grown in importance as the shadow economy has expanded. Individual entrepreneurship and self-employment have become more significant, noticeably among the indigenous Kyrgyz population, many of whom are now engaged in trade.

Growth in the labour force has outpaced the growth in available jobs and the unemployment rate, including those not officially registered as unemployed, is estimated to have increased from 4.1 per cent in 1994 to 8 per cent in 2002. The official unemployment rate increased from 0.7 to 3.3 per cent in the same

period, but declined to 3.1 per cent in 2003. However, these figures do not include large numbers of discouraged workers and disguised unemployment. Underemployment and part-time employment, including in jobs that have been administratively created, are also significant particularly in industry. A State employment service, together with a fund for employment assistance and a labour registry, has been introduced. However, the majority of the unemployed prefer to search independently for jobs, as they view public employment offices to be unsatisfactory. Of the people applying for jobs through those offices, 52 per cent were women.

Among strategic aims of labour market reform in Kyrgyzstan are increasing employment through the effective distribution and utilization of labour; strengthening labour protection and the rights of employees in a manner consistent with the interests of employers; and increasing labour remuneration. Professional training and retraining and SME development are important elements in employment policy.

Another aim of labour market reform in Kyrgyzstan is to increase the share of labour remuneration in total money incomes. That share decreased from 55.2 per cent in 1992 to 24.5 per cent in 2001 although it remains the main source of income of the majority of the population. The share of social transfers in total money incomes declined drastically, from 27.2 to 10.1 per cent in the same period, as a result of reduced public expenditure on social protection and improved targeting. Incomes from ownership and entrepreneurship have increased rapidly, from 12 to 50 per cent in 1992-2001.

Centralized regulation of labour remuneration, including the minimum wage, together with certain State guarantees affecting employment are elements that have been retained from the socialist era. The minimum wage, which has been reviewed seven times since independence, is determined on the basis of prevailing views on standards of living and it is used in establishing wage rates in the public sector, as well as the minimum pension and other social payments. The size of the minimal consumer budget (MCB) is an important consideration in setting the minimum wage.

In 2002, the average monthly wage was around 1,618 soms, an increase of nearly 11 per cent over the previous year. In this regard, a remarkable differentiation in the level of wages between economic sectors is becoming evident. The most highly paid employees are in finance and banking and State management, with wages 3 to 4 times higher than the average. At the same time, wages for employees in health care, education and other social services and in agriculture and forestry are almost half the average. However, it should be noted that in 2000, for the first time since reforms began, average monthly wages exceeded the MCB.

2. Poverty and living standards

The crises that affected the economy of Kyrgyzstan during its transition to a market economy led to a decrease in the standard of living among the population, particularly for vulnerable groups with low incomes, such as pensioners, invalids and households, generally in rural areas, with limited means and many children. During these years, the incidence of poverty increased, from approximately 44 per cent of the population in 1996 to a peak of 55 per cent in 1999 before declining to reach 48 per cent in 2001 as measured by the food poverty line (table V.1). The food poverty line in Kyrgyzstan is based on the physiological needs of persons and is defined in terms of the income needed to meet the minimal food needs of a household.

Table V.1. Indicators of living standards in Kyrgyzstan, 1996-2001

<i>Indicator</i>	1996	1997	1998	1999	2000	2001
Average monthly income per capita, som	244	332	411	575	709	831
Average monthly wage per employee, som	491	680	841	1 050	1 227	1 455
Minimum monthly wage, som	75	83	100	100	100	102
Average monthly pension, som	247	307	378	385	462	553
MCB per month, som	534	691	799	1 097	1 205	1 316
Per cent of the population below food poverty line	44	43	55	55	52	48
Gini coefficient	0.391	0.453	0.447	0.443	0.449	0.441

Source: Data obtained from the National Statistic Committee and the Center of Economic Research and Social Reform under the Ministry of Finance.

The MCB is the set of food and non-foods goods and services that provide a socially acceptable standard of living. The Government of Kyrgyzstan determines the MCB once a year, except in times of inflation when it is reviewed quarterly based on the increase in the consumer price index. The MCB is used in determining the national poverty line, as the criterion used to establish whether a household is living in poverty is the share of income the household spends on food. If the household spends more than half of its income on food, it is considered to be among the poor.

Another indicator of the decline in living standards in Kyrgyzstan is the minimum wage, which is supposed to be equal to roughly 20 per cent of the MCB. However, beginning in 1995, when the minimum wage was approximately 21 per cent of the MCB, its meaning has declined each year as prices have increased rapidly. In 1998-2000, the minimum wage was effectively frozen. As a percentage of the MCB, it has declined to approximately 8 per cent in 2001. In practice, the level of the minimum wage has little impact on wage rates in general, except in the public sector.

The average monthly pension more than doubled in 1996-2001 but it remains well below the MCB, being roughly half the amount needed to ensure a minimal consumption standard in 2001. Thus, one of the main social guarantees provided by the Government has lost its principal function of supporting an acceptable standard of living and cannot reduce poverty among the population. The difficult economic situation during the transition period led to deficits in social insurance programmes and declining social insurance payments. In 1990, there were four employees paying contributions for each pensioner but by 2001 the figure had fallen to 1.7 and it is no longer possible for the State to provide guaranteed social payments such as pensions and other allowances. Aggravating these problems is the increase in income inequality as indicated by the Gini coefficient, which rose from 0.391 in 1996 to 0.441 in 2001.

3. Social security and human development

The social aspect of national security in Kyrgyzstan has been adversely affected during the transition to a market economy as social transfers and benefits have been drastically cut back, adding to the dangers of social conflict. Nevertheless, human development in Kyrgyzstan has progressed. According to national estimates, average life expectancy at birth was 68.7 years in 2001, up from 66.6 years in 1996, although women continue to outlive men by 8-9 years. Adult literacy, already high in 1996, was 98.7 per cent in 2001, while the combined primary, secondary and tertiary enrolment ratio was 71 per cent. The human development index increased from 0.688 in 1996 to 0.723 in 2001.

Increased life expectancy will put pressure on the health care system in Kyrgyzstan in future but budget cuts have led to a decrease in the number of hospitals. Low wages in the sector have also caused an outflow of qualified staff and the overall quality of medical services has declined as a result. Insufficient access to medical services is a serious problem. Problems have also arisen in connection with decreased funding for education. Educational facilities have deteriorated, wages for teachers remain low and educational

quality has suffered. The importance of education to poverty reduction efforts cannot be overestimated. At present, education is not free of charge and families spend a large share of their incomes on educational expenses, which can affect enrolment ratios. By some estimates, even a decrease of 2-3 points in the combined enrolment ratio will set back educational progress by 30 years.

The Government of Kyrgyzstan provides social guarantees for all the population irrespective of socio-economic status. The system of social support is based on two principles: guaranteed State support for maintenance of a minimal consumption level and targeted support for the socially vulnerable strata of the population. In practice, targeting is done on the basis of verifiable income levels without a broader assessment of need. Pensions account for approximately 80 per cent of all social support, the balance going to finance allowances and social assistance, as well as scholarships.

At present, social protection in Kyrgyzstan is also implemented by a system of payments of common monthly grants to all poor households. Households where average monthly income per member is no more than 40 soms qualify for this assistance. The system has several limitations. First, the threshold amounts to only 22 per cent of the national poverty line in 2001, thus providing an insignificant level of protection from poverty. Second, targeting is weak and could be improved. One of the characteristics of poverty in Kyrgyzstan is its mobility and keeping track of all those entitled to benefits is expensive and difficult. Large numbers of households can and do fall through the social support net.

Currently, the system of direct transfers also includes the payment of grants to invalids, unwed mothers with ten or more children and orphans. There is also a system of subsidies for electricity and other public utilities for 36 different categories of population. It is impossible to determine the influence of these programmes on the well-being of the poor without clearer information relating to the actual size of the grants and the coverage achieved of the targeted groups. Additionally, there is a system of unemployment grants and old-age pensions in Kyrgyzstan but a very limited part of population currently has a right to them and they do not provide full protection from poverty. The level of grants is absurdly low, taking into consideration actual conditions, although they were increased by 20 per cent in April 2001 along with the income threshold to qualify for these grants. The main conclusions that can be reached is that the system of social assistance in Kyrgyzstan has not been able to play a major role in providing social support and that the level of transfers has been insufficient in mitigating the consequences of poverty.

F. Key challenges ahead

1. Constraints on future growth

The CDF envisages a reduction in the incidence of poverty from 52 per cent in 2000 to 26 per cent in 2010 in Kyrgyzstan. For this goal to be achieved, real GDP has to grow at an average annual rate of 5 per cent so that GDP per capita increases by 50 per cent in 2000-2010 and the high rates of savings and investment needed are realized. However, the natural resources that have fuelled the country's growth so far, in agriculture, gold mining and energy, are already exhausted so that diversification is necessary to sustain growth momentum. This requires an industrial policy that is less focused on individual sectors but more on creating an overall climate favourable to investment and private enterprise and on resolving existing economic problems.

One of these problems is the insufficient level of investment in Kyrgyzstan. In the past, the low level of private investment was offset by public investment in fixed assets but the rising level of external debt owed by the Government limits this option in future. Therefore, measures need to be taken to stimulate private domestic investment and to attract FDI, which needs to double to meet growth forecasts. At the same time, public investment will continue to be needed in developing economic and social infrastructure but will have to be financed through taxation rather than through borrowing, so that tax effort and tax administration will have to be improved.

The other important problem in meeting the economic growth target is increasing exports. Kyrgyzstan will be an attractive destination for FDI only if there are unrestricted opportunities for export as the domestic market is so limited. Export growth is also necessary for macroeconomic stability and for servicing external debt. A consistent policy of support, in the context of integration into regional and multinational trading systems, will be necessary if Kyrgyzstan is to take advantage of the opportunities that are becoming available, for example in trade with China, and exports are to increase. In the sphere of external trade policy, an important problem is the presence of regional limitations. As the member of WTO and CIS, Kyrgyzstan is planning to suggest concrete measures that can be taken with neighbouring countries to ease those limitations. For its part, Kyrgyzstan supports free trade and full currency convertibility and opposes measures such as temporary tariffs or non-tariff barriers. Greater regional trade and economic integration, including the creation

of an internal market, will help in attracting FDI to Central Asia. Kyrgyzstan would find it relatively easy to attract FDI in those areas where it has a comparative advantage, but protectionist policies of some neighbouring countries constitute a handicap.

Improving the competitiveness of goods and services produced in Kyrgyzstan will also be necessary if exports are to grow. Currency devaluation to increase price competitiveness is a poor solution as it increases the cost of debt service and provides only short-term benefits. For a solution that is sustainable in the long term, restraining inflation and increasing total factor productivity are required, along with improved product quality. These changes can be encouraged by making domestic markets function better through increased competition and by fostering more effective utilization of scientific and technical progress.

There is a need to increase the effectiveness of the financial system, an area in which Kyrgyzstan has some problems. Commercial banks suffer from poor management quality, weak internal controls and inadequate supervision. They are also hampered by inadequate domestic legislation regarding the protection of creditors and by low public trust. Non-bank financial institutions, such as credit unions and insurance companies, could play a greater role in financial intermediation. After appropriate financial strengthening, credit unions could be transformed into cooperative banks to serve the population in rural areas. The market for insurance services could be further developed and strengthened if relevant legislation and supervision are improved and institutions such as an institute of actuaries established.

Finally, the wide-ranging structural reforms envisaged in the CDF and the NPRS will not be realized without an improvement in public administration. Improvements to the budget process, a more efficient determination and differentiation of functions, greater transparency in the organs of State and a decrease in corruption are all necessary.

2. Income inequality and poverty reduction

In spite of progress achieved so far, particularly after 2000, poverty reduction is still a major problem facing Kyrgyzstan, which is the second poorest country in the former Soviet Union. Rising income inequality compounds the problem and the first task for the country in reducing poverty is to prevent further increases in income disparities. Social policy measures,

particularly income transfers, are the principal tool in this regard but economic policy also has a role to play. The reduction of poverty in 2000-2001 was achieved by falling rates of inflation during that period, which reduced the inflation tax and its deleterious effects on the living standards of the poor. To reduce income inequality and the incidence of poverty in Kyrgyzstan, it is necessary to take measures to increase employment, as well as productivity and incomes, particularly in rural areas, and to complete pension reform.

An important mechanism for transmitting the benefits of growth to the poor is through increasing employment, as labour is often the only resource of the poor. However, economic growth in Kyrgyzstan in 1996-2001 was not “pro-poor” in the sense that the employment elasticity of growth was quite low. In those six years, GDP increased by 38.4 per cent but the corresponding increase in employment was only 8.9 per cent. Most of the employment growth was in agriculture where, according to the National Statistics Committee, any person with land, irrespective of whether that person is working on it or not, is classified as employed. Growth without employment will have less impact on poverty reduction.

Nevertheless, GDP growth in 1998-2001 was led by agriculture and this appears to have reduced poverty as the majority of the poor in Kyrgyzstan live in rural areas. The incidence of poverty in those areas declined from 62.4 per cent in 1998 to 51.0 per cent in 2001. Agriculture merits greater attention as it supports a disproportionately high percentage of the population. To increase the incomes of the rural population, the strategy of village development should be directed to increasing the productivity of the land, which can be done through improved farming methods. The small plot sizes that are prevalent today do not permit crop rotation, adversely affecting yields. A cooperative and voluntary approach to pooling land resources would help in overcoming this problem.

Further poverty reduction in rural areas could be achieved by measures to assist more vulnerable households in their farming activity. Land redistribution was not accompanied by improved access to additional resources that are necessary to increase capacities among farmers and there is a danger that more efficient farmers will buy out weaker ones and landholdings will be concentrated again. Assistance with agricultural credit and marketing, as well as irrigation, may be needed to encourage individual farmers and cooperatives to take advantage of available services and the services themselves need to be provided more equitably.

During the off-season, many agricultural workers are disoccupied and without incomes, so that they are obliged to sell their assets, including cattle. Providing these workers with productive employment is a major task facing Kyrgyzstan. Encouraging the development of non-agricultural SMEs in rural areas, particularly in food processing, improving transport and marketing infrastructure and access to credit in those regions and removing barriers to trade are all steps that would assist in poverty reduction.

One of the priorities of social protection in Kyrgyzstan at all stages of economic reforms is strengthening the targeting of social support to the most vulnerable population groups. Grants to these groups should be close to the living wage and, budget permitting, protected from inflation. Pensions are an important part of the system of social transfers and are currently paid on the basis of age without regard to actual need. There is a need to distinguish between working pensioners, for whom pension payments are simply a source of additional income, and those who are too sick or old to work but are unable to meet their basic needs with the standard pension payment. A reconsideration of the pension system and the determination of unemployment benefits to help those truly in need is in order.

G. Conclusions

For a small country such as Kyrgyzstan, export-led growth is the only realistic option, obliging it to make every effort to access potential export markets. Liberalization of external trade has been of the principal components of the country's economic reforms. Attaining the CDF targets for growth and investment hinges on achieving sustained high rates of export growth. In the medium and long terms, important national priorities for Kyrgyzstan are greater integration into the regional and multilateral trading system to take full advantage of all available opportunities for expanding and diversifying trade and to increase reliance on private investment, both domestic and foreign. An important task for the country is to take advantage of its location to become a transit transport and communications bridge between Europe and Asia. The revival of the Great Silk Road in the current context takes on additional significance for trade promotion in Kyrgyzstan.

Macroeconomic stabilization has benefited economic growth in Kyrgyzstan but continuing budget and current account deficits undermine what has been achieved and increase vulnerability to external and internal shocks. Economic growth in recent years has been dependent on sectors such as agriculture, gold

mining and energy that are all affected by factors which cannot be easily controlled, such as the weather and global economic conditions, and that do not provide a sustainable basis for future growth. In addition, the financial system has not fully benefited from increased stability and real interest rates continue to be high and reforms are incomplete.

Poverty continues to be a problem, particularly in rural areas where families tend to be large. More attention needs to be given to raising incomes in those areas in order to reduce poverty further. Finally, cuts in social services for budgetary reasons necessitate a closer examination of existing social transfers to improve their effectiveness in helping vulnerable population groups and in reducing income inequality.

VI

MANAGING GLOBALIZATION IN TAJIKISTAN

Introduction

Globalization has spread to the remotest corners of the world including Tajikistan. The most tangible effects of the process of globalization on the country were those that occurred in the aftermath of the break-up of the former Soviet Union, when Tajikistan became independent. However, the first phase of the country's involvement in the larger world community did not result in unambiguously positive political and economic outcomes, on the contrary. Nevertheless, the people of Tajikistan have still been able to benefit from the extension of democratic freedoms, access to international mass media and the latest technologies including ICT. Consumers have had access to more and better quality goods.

Globalization is an objective process with a degree of inevitability in which countries such as Tajikistan should participate but in a manner consistent with their interests. Greater integration into the world economy can lead to greater susceptibility to trade and financial shocks, for example, stemming from fluctuations in commodity prices. However, if small countries that are among the least developed remain out of the globalization process, they face problems arising from limited resources and small domestic markets. Globalization brings access to foreign markets and the latest technologies and business methods through integration into global production networks, enabling countries like Tajikistan to improve the range and quality of their products. The removal of trade barriers, along with lower, simplified tax rates and a reduction in administrative interference, improves the business climate for both domestic and foreign producers.

However, the increased pressure of competition through greater imports and foreign investment, while forcing domestic producers to become more efficient and adapt quickly to the changing business environment, also endangers their survival by eroding profit margins. A low level of human development, poor infrastructure and a poor investment climate can limit the ability of countries like Tajikistan to take advantage of the opportunities that globalization makes available. However, the redistribution of resources and incomes following globalization appears to favour countries with higher levels

of income, so that global income inequality is widening at the expense of the poorer countries. Unlike international socialist economic integration, the current process of globalization does not seek to equalize levels of economic and social development between countries.

A loosening of the mechanisms of State regulation, built up over decades, brings with it the danger that nations will be less and less able to grapple with economic and social dislocations. Lower public revenues owing to tariff reductions compound the problem and force expenditure cuts in order to control budget deficits. Regional and multilateral economic integration also lead to a weakening of the economic functions of the State in favour of collective decisions, with an increased role for international organizations such as IMF, World Bank and WTO. For these reasons, Tajikistan like other countries in transition should join the process of globalization gradually, commencing with participation in the process of regional economic integration.

A. Globalization and regional integration

1. Integration into the multilateral trading system

International trade and economic organizations are concerned that regional trade agreements, which are becoming increasingly popular, may undermine the global trading system. Agreements on the creation of free trade zones or free economic zones as part of a process of regional integration can be assumed to lead to a lowering of tariffs and an elimination of non-tariff barriers. For globalization to bring about its desired effects conflicts between regional and global integration need to be resolved constructively and countries that stand to lose the benefits of regional preferences by their participation in multilateral integration need to be compensated. If those preferences cover a wider range of issues regarding cooperation, within the framework of regional unions, as compared with opportunities provided by participation in wider global integration processes, this can complicate multilateral negotiations. In this situation, the step by step cancellation of some parts of the regional preferential system over a period of time becomes important in the transition to a multilateral system.

Tajikistan needs free trade and intends to comply with the obligations of acceding to WTO, when that happens. However, the country will not become a WTO member ahead of those countries with which it has a permanent trade agreement and which, in other respects, continue to adopt protectionist policies. The decision concerning accession to WTO should be made only after Tajikistan

has successfully completed bilateral negotiations with those countries on issues related to their trade regimes. Otherwise, there is a danger that exports to WTO members will be insufficient to offset the loss of existing export markets, while domestic producers will be struggling to cope with the expected sharp increase in imports.

Although accession to WTO seems to be an inevitable step, the former Soviet republics need to make sure that it will increase their economic growth and social development, improve living standards for their people and increase trade. The members of regional groupings such as CIS and EurAsEC should coordinate among themselves and seek to obtain easier terms and conditions for countries in transition wishing to accede to WTO.

Membership of WTO implies elimination of any kind of discrimination in trade relations; full liberalization and expansion of foreign trade; attraction of foreign investment; and integration of national economies into the global economic area. Tajikistan could move to achieve these goals at different speeds. For example, it could move faster to attract foreign investment than to liberalize foreign trade fully but this is an approach that needs to be mutually agreed upon even in the preparatory phase to negotiations. Negotiating partners need to understand the problems and obstacles that Tajikistan faces on its path to socio-economic development, especially the problem of poverty.

2. Regional trading arrangements and partnerships

The creation of mechanisms of economic cooperation that work effectively among the countries in transition located in Central Asia will prepare and facilitate the full inclusion of those countries, including Tajikistan, in the globalization process. The point is that globalization should be anticipated by regionalization or, in other words, the integration of the economies of individual countries within larger regional groupings. In the case of Tajikistan, regionalization is the system of mutually beneficial cooperation between several countries illustrated by, for example, CACO or, more successfully, the EurAsEC. Those countries have declared that the creation of a common economic area, including a common customs area, is their key objective but many tariff and non-tariff barriers remain, preventing the realization of this goal.

At the same time, the advantages that Tajikistan could potentially obtain from EurAsEC are significantly degraded by the absence of Uzbekistan from the grouping. Tajikistan shares a common border with Uzbekistan in the plains to its north and west through which major road and rail transit transport links were

constructed in the Soviet era. With other countries with which it shares a common border, namely Afghanistan, China and Kyrgyzstan, transport links consist of minor roads that are little used. Uzbekistan is also the principal supplier of natural gas to Tajikistan and the economies of both countries are essentially dependent on one system for energy. Both Uzbekistan and Tajikistan are members of CACO but this organization has never regulated relations between its members on the basis of collective commitments, as they have never really been implemented. In addition, between January 1993 and August 2002 Uzbekistan and Tajikistan signed 42 agreements and protocols, of which 39 relate directly to trade and economic cooperation but, unfortunately, the majority of those agreements has not been implemented by both parties.

B. Transition assessment

1. Progress in transition and its indicators

Tajikistan developed very rapidly during the Soviet era, transforming itself from an agricultural province of the former Bukhara Emirate into an industrialized country with mid-level development. In 1960-1990 in particular, strongly capital-intensive development funded largely by the central budget of the former Soviet Union characterized industry and agriculture. The development of hydropower, aluminum and chemicals led to industry contributing 27.3 per cent of GDP in 1990. The mechanization and industrialization of agriculture, particularly in cattle breeding, poultry raising and the production of grains, fodder and irrigated cotton maintained the sector's share in GDP at 36.3 per cent in the same year. Transport infrastructure connecting all settlements in a single network developed quickly as urbanization increased.

Following independence in Tajikistan, economic growth collapsed and inflation accelerated as shortages of consumer goods developed. Bureaucracy and corruption increased, while falling living standards endangered social stability. The breakdown in the centralized system of economic administration made it more difficult for the country to extricate itself from an increasingly more complex situation. The ending of trade and economic links with Russian Federation and other former Soviet republics and free use of the former federal transport infrastructure accompanied the dissolution of the former USSR. Internal conflict and the weakening of the regulatory role of the State, together with the simultaneous implementation of measures to transform the centrally-planned economy to a market-based system, deepened the economic crisis and GDP fell by 58.1 per cent in 1991-1996. Economic recovery began in the

second half of 1997 as macroeconomic stabilization became more evident and GDP expanded by 24.5 per cent in 1997-2002. However, the level of GDP in 2002 was still only equal to 56.9 per cent of its level in 1991.

As a further sign of macroeconomic stabilization in Tajikistan, the rate of inflation fell from a peak of 7,343.1 per cent in 1993 to 3.2 per cent in 1998 although it accelerated again subsequently; it was 36.5 per cent in 2001. The current account and balance of payments deficits have improved, while budget deficits have been largely absent except in 2000, enabling monetary policy to be tightened. A budget surplus was recorded in 2002. However, macroeconomic stabilization cannot be taken for granted, as indicated by the high level of external debt, which amounted to 74.1 per cent of GDP in real terms in 2002, and an increase in the real exchange rate of the domestic currency, the somoni. Further increases in external debt will jeopardize Tajikistan's credit ratings, with negative consequences for the already low levels of FDI inflows.

The slow rate of Tajikistan's recovery from the transition recession reflects the inadequate development of market institutions in the country. Banking activity does not meet the requirements of a market economy and Tajikistan is one of a few former Soviet countries where a secondary securities market has not as yet been created and there is little portfolio investment. If credit could be made available on a competitive basis to all qualified borrowers, entrepreneurship would increase in a short space of time and growth would accelerate. However, the development of the secondary securities market is likely to lag behind owing to unsuccessful privatization, lack of post-privatization support from the State, low per capita incomes and the rent-seeking nature of economic development.

Inadequate economic growth in Tajikistan is also explained by the lack of a competitive environment in the economy. Although anti-monopoly legislation exists on the books, economic activity is divided into spheres of influence exercised by corrupt officials and criminals. Businesses and SMEs, in particular, are suffering and their number has declined from 3,390 in 1995 to 1,181 in 2001 while employment in those firms has fallen from 38,400 to 14,800 in the same period.¹ Restructuring aimed at adjusting to changing domestic and foreign demand patterns has been slow, hampering economic growth in Tajikistan. The main reasons for this are the lack of financial resources

¹ State Statistical Agency, *Statistical Yearbook of the Republic of Tajikistan*, Dushanbe, 2002, p. 180.

available to the incipient private sector, in part owing to the low credit ratings of the country, and the lack of post-privatization restructuring support. Restructuring in agriculture has made slow progress, especially in the development of private farms but here too, insufficient financial resources as well as the lack of law and order hamper it.

Economic liberalization has found its expression in openness of economy but after an increase in the volumes of exports and imports in the first half of the 1990s, exports have been quite volatile while imports have tended to follow trends in the domestic economy. Exports continue to be dominated by aluminum, cotton and electric power and imports by alumina, natural gas, oil products, electric power, grains and flour. However, there is almost no direct connection between the openness of economy and economic growth, partly owing to the fact that increased imports of alumina and exports of aluminum simply reflect the rehabilitation of the Tajik Aluminum Plant and not liberalization. Another reason for the lack of correlation is the existence of numerous obstacles to foreign trade in Tajikistan and export licensing is first among them. For example, 11 authorization documents, taking 3-5 months to obtain, are needed to export cotton and the bribes needed along the way add considerably to costs, to the extent of making exports unprofitable. The imposition of VAT, even on imports of technologically advanced capital goods, and tariffs at a 5 per cent rate also create financial problems for importers and hamper technical progress and economic growth in the country.

Tajikistan was one of the first among former Soviet countries to eliminate State regulation of prices, markets and foreign trade, a policy for which it has received high marks.² What is surprising is that, in contrast to the majority of liberalized economies, the formation of a favourable competitive environment has not occurred in Tajikistan so far. The reason is that from the beginning prices and markets in Tajikistan have been subject to several restrictions, such as licenses, authorizations, unofficial quotas and so on, as well as to restrictive behaviour on the part of law enforcement and local authorities. The authorization of local authorities is necessary even to cross district borders in order to sell foodstuffs, for example. In addition, there are numerous cases of extortion during the transport and sale of goods, so that, for many foodstuffs, transport beyond 200 kilometres becomes unprofitable. Recent presidential decrees have

² See, for example, EBRD, *Transition Report 2000: Employment, Skills and Transition*, 2000, p. 216.

sought to remove some of these unofficial restrictions on the movement of goods but they have been poorly enforced and inspections by tax, customs and other authorities have increased. Altogether, the problems prevent the potential benefits of liberalization from being realized.

2. Lessons from privatization

Measures to eliminate the monopoly of the State on ownership and the development of various ownership patterns, involving both public and private sectors, have been among the most important steps in the liberalization of Tajikistan's economy. Those measures were implemented within the framework of a programme of step by step decentralization and privatization in all sectors of economy during the course of which the share of the private sector in the total number of enterprises almost doubled, from 25.4 per cent in 1991 to 48.9 per cent in 2001.³ Privatization has been dominated by small firms, which account for nearly 94 per cent of all privately owned enterprises. Privatization of large firms has proceeded more slowly and the corporate form of ownership in privatization has been little used in Tajikistan, accounting for only 1.3 per cent of the total number of privatized enterprises in this period. The extent of privatization has been greatest in trade and consumer services, where in 2002 privatized enterprises were respectively 98 and 92.3 per cent of the total. In contrast, only 5.9 per cent of enterprises in industry and 6.4 per cent in agriculture were in private hands in the same year. The buyout of State-owned enterprises, or of property leased by them, by members of work collectives is uncommon.

The step by step approach to privatization, with immediate privatization of small enterprises and slower privatization of large enterprises, has been fairly successful in Tajikistan. The dominance of the private sector in small business activities is proving to be decisive in revitalizing SMEs. More complicated problems arise with the privatization of large State-owned enterprises, the main problem being the need to improve the economic efficiency of those enterprises prior to their sale.

Privatization has been considered essential for the creation of a market economy. In this regard, a quantitative indicator of the impact of privatization in Tajikistan is the share of the private sector in total employment, which increased

³ State Statistical Agency, *op. cit.*, p. 171.

from 19 per cent in 1991 to 42.8 per cent in 2002. Employment in the public sector declined from 59.7 to 28.4 per cent in the same period. However, privatization has not had a significant impact on economic growth and efficiency in Tajikistan as serious mistakes were made during its preparation and implementation. Recommendations of the international financial institutions regarding the methodology, scope and speed of privatization were damaging for a country in Tajikistan's situation and, moreover, those recommendations did not take into account the specific characteristics of the country, following textbook prescriptions instead. The recommendations erred in focusing on the financial aspects of privatization and in exalting private ownership without due regard to the possible benefits of State ownership.

Tajikistan's experience in this regard, along with that of other countries, illustrates the need for strong public and private institutions that can become the foundation for the successful implementation of the process of privatization. In this manner, vital interests of the nation are safeguarded and public control of the privatization process is assured. Lack of a strong institutional element was the reason why the results of privatization have not met the expectations of the general public in Tajikistan.

The lack of post-privatization support has been another factor in the disappointing results from privatization so far. A fund to support businesses after they had passed into private hands was not established in Tajikistan and many enterprises suffered from shortages of working capital in the aftermath of privatization as they had suspended their business activities for various reasons long before they were sold. The enterprises no longer received State subsidies but were unable to obtain bank loans as the financial system was in crisis.

3. Fiscal and monetary reforms

The financial system of Tajikistan is still in the initial stage of its development though institutional reforms in the most important areas of the system have been implemented. A legal framework for the functioning of the system has been created and considerable attention has been given to financial stabilization. However, limited development of the financial sector constrains the use of monetary policy. The absence of a secondary market in treasury bills and weak institutional capacity prevent open market operations being used. To improve the situation, the National Bank of Tajikistan is attempting to develop an interbank market for credit in which it could intervene as needed for the conduct of monetary operations.

In this regard, budgetary reforms are worth noting. Financing of budget deficits is no longer carried out through borrowing from the National Bank of Tajikistan, with adverse consequences for inflation, but by the sale of treasury bills and the efficiency of treasury operations has been improved. The relationship between the budgets of central and local governments has been clarified so that there is a clearer distinction between revenue sources and expenditures of each. Assets of the Social Protection Fund and the Highway Fund have been consolidated into the central budget and off-budget funds are gradually being liquidated.

The overall size of the central budget has been declining in Tajikistan for some years owing to the economic decline after independence as well as civil unrest and problems with reforms. Revenues remain low and despite an approximately five-fold increase in total public revenues per capita in 1995-2002, the ratios of tax and total revenues to GDP were 15.3 and 16.3 per cent respectively in 2002. Tax effort in Tajikistan is clearly poor, as the average ratio of tax revenues to GDP in other CIS countries is around 25 per cent. The reasons for the low level of tax collections include imperfections in tax and customs legislation, which the introduction of the new tax code and VAT reform in 1999 has gone some way to correcting. The poor state of the economy also contributed to the weak performance of businesses whose indebtedness and tax arrears have been rising. The growth of the shadow economy and corruption in tax and customs bodies are other factors keeping tax collections low.

The sale of treasury bills has also not met with much success in Tajikistan although the legal framework for the regulation of the primary market in these bills is in place and a securities commission has been established. Generally, no more than half the total asset value of the bills on sale is taken up by the public at auction, commercial banks having to purchase the remainder.

Low public revenues have resulted in budget constraints and public expenditure on education and health, as well as cultural activities has been inadequate to maintain, let alone improve, standards. Development expenditures have also been declining in recent years, from 17 per cent of GDP in 1997 to 14.8 per cent of GDP in 2002. Those expenditures have been mostly related to infrastructure development and resources have been insufficient to further economic reform and restructuring efforts.

Gradual implementation of measures to increase public revenues has become urgent. Reducing tax rates and customs duties, shifting to direct from indirect taxation and simplifying the tax system to make it understandable to all

may improve compliance, particularly if a system of mandatory tax declarations is introduced. Improving the financial health of enterprises, including through remonetization of economic activities, and bringing the informal economy out of the shadows by restricting cash transactions and “dollarization” are other steps to increase tax collections. Elimination of corruption in taxation and customs bodies and in law enforcement, accompanied by steps to combat smuggling will put a stop to large revenue losses. The granting of tax relief should be reviewed and the practice of unilateral exemption of some companies from taxes should be stopped.

4. Financial sector reform

Reform of the banking system in Tajikistan has not made much progress and the sector is unable to play the role expected of it in economic development and poverty reduction. Despite the reforms that have been implemented so far, the financial position of the banking system remains weak and vulnerable to external or internal shocks. The operational efficiency of banks is also low. The volume of credit extended by the banking sector is only around 5 per cent of GDP and the aggregate capital of the banking system is approximately US\$ 10 million, clearly inadequate to finance the large development projects that are needed in Tajikistan. The distribution of assets within the banking system also highlights its fragility, as the four largest banks possess nearly 85 per cent of all assets. Smaller and second-tier banks are not in a position to have much impact on the economy.

The main problem in the development of the banking system is the insufficient level of liquidity in the economy. This situation emerged after the implementation of monetary reforms in the mid-1990s that were only partially successful and resulted in the level of monetization of the economy, as measured by the ratio of the broad money supply to GDP, dropping sharply to 5 per cent. Currently, the ratio is around 6.5-7 per cent, resulting in insufficient liquidity in the real sector, a credit squeeze and a decline in effective demand.

There is an acute shortage of financial resources needed to increase the authorized capital of banks, which averaged US\$ 565,400 per bank at the beginning of 2002. In general, around 80 per cent of authorized capital consists of the initial equity capital and little has been built up through the accumulation of profits. Authorized capital requirements were increased to US\$ 1 million in January 2001 by the National Bank of Tajikistan and led to a reduction in the number of banks to 13 by the end of the year. Those requirements are to rise

further to US\$ 3 million by 2004 and the capital adequacy ratio has been raised from 9 to 12 per cent in January 2002. This is a very stringent requirement as even large banks in the country are not always able to reach this ratio.

Insufficiency of assets reflects the low level of deposits, which in turn reflect the growth of the shadow economy and its reliance on cash, as well as the use of non-bank channels by migrants to transfer money to Tajikistan. The share of all deposits in total liabilities in many banks is roughly in the 8-15 per cent range, interbank and central bank liabilities largely accounting for the remainder. The weak balance sheets of domestic banks in Tajikistan prevent them from entering into cooperative arrangements with foreign banks, limiting the development of credit lines and correspondent accounts. Foreign banks are also unable to confirm guarantees extended by banks in Tajikistan. The current situation requires radical change; otherwise it will be impossible to achieve the strategic socio-economic objectives of the country.

C. Markets and trade

1. Trade liberalization

Tajikistan differs from other members of EurAsEC in its liberal trade regime in which non-tariff barriers are completely absent. The weighted average tariff rate is currently around 8 per cent. Over the last decade, foreign trade turnover has increased by a factor of 11. In 1991, total exports amounted to 0.03 per cent of GDP but by 2002 they had increased to 60.8 per cent of GDP. The ratio of imports to GDP increased from 0.03 to 59.3 per cent in the same period. However, the share of raw materials in total exports from Tajikistan is high and aluminum, raw cotton and minerals account for approximately 80 per cent of export earnings. Although the country's power-generation potential is one of the highest among CIS countries, exports of energy as well as machinery and equipment remain insignificant. The share of food in total imports has increased rapidly and is now around 10 per cent.

2. Import substitution and export promotion

Tajikistan does not have an industrial policy providing post-privatization support to businesses producing goods for the domestic market. Consequently, many products are imported, even though most of them could be produced locally. For example, large quantities of poor quality spaghetti are imported from

Iran and Turkey, even though small, privatized enterprises with Italian machines for the production of pasta exist in Dushanbe and Khujand. However, those enterprises have insufficient financial resources either to operate at all or to operate at a high level of capacity utilization. Many other similar examples exist.

Tajikistan does not have a favourable balance of trade and the situation could be radically changed if the country was to follow an import-substitution policy. The first step in such a policy could be based on the implementation of an official post-privatization assistance programme together with financial assistance for SMEs. The second step could involve restructuring enterprises that prior to independence specialized in the production of goods for the entire USSR. The third and final step would involve construction and technical servicing of factories to process Tajikistan's natural resources or to manufacture items of mass consumption.

Developing export-oriented industries is a policy that Tajikistan does not have the resources to pursue in the short term, as it requires large, risky investments to produce goods that are competitive in world markets. A policy to promote exports should seek to expand the production and export of those goods in which Tajikistan has a comparative advantage, such as cotton filament, cotton and silk yarns and aluminum. In all those cases, steps to lower costs and improve capacity utilization will be needed.

D. Impact of globalization on social and human resources development

In the years preceding independence, legislation on mandatory work and employment guarantees were in place in Tajikistan and employment increased steadily. Nevertheless, the country suffered from surplus labour owing to demographic conditions, which kept productivity low, and to capital-intensive economic development. However, the majority of the population had income and consumption levels above minimal standards and household incomes were largely derived from the earnings of labour. Attention was paid to improving manpower quality through training of qualified workers and specialists and the provision of benefits such as education guarantees, health care, housing and paid leave. In terms of human development, illiteracy was completely eliminated in Tajikistan prior to independence, infectious diseases were eradicated, secondary education was made compulsory, health care was available to all at no charge and vocational and special education were provided. In other words, Tajikistan should have been in a favourable position to take full advantage of globalization but it did not happen.

The economic upheaval following the collapse of the former Soviet Union and during the transition to a market economy caused the social situation in Tajikistan to deteriorate, with adverse consequences for the development of human resources, increasing unemployment and lowered living standards. For a country like Tajikistan, with a high natural rate of population growth, low urbanization and a widespread traditional way of life, the consequences have been serious. During 1991-2002, the labour force increased by 15 per cent but employment decreased by 8.8 per cent. The number of people employed in industry more than halved in the same period, while the number employed in agriculture increased by 38.2 per cent. The number of employed women fell by 43.2 per cent.

Globalization led to de-industrialization in Tajikistan and an increase in the rural labour supply and agricultural productivity suffered. While the share of agriculture in total employment rose from 45 to 66.6 per cent in 1991-2002, real output in the sector fell by 29.2 per cent in the same period. De-industrialization led to a reduction in the employment of technical specialists and an increase in unemployment among people with higher education, causing large-scale emigration of qualified labour. Training of specialists has decreased and the number of graduates from the secondary professional training schools has fallen by 50.3 per cent. Vocational training has also declined and the use of manual, unqualified workers for heavy labour has expanded. Paradoxically, child labour appears to have increased. Working conditions and employees rights have received little protection.

The duration of job search has increased; in 1996, the average duration of job search for an unemployed person was 4.1 months but this had risen to 4.2 months in 2001. Only 4.6 per cent of the unemployed had searched for a job for more than one year in 1996 and in 2002 the figure had increased to 5.6 per cent. Disguised unemployment, part-time employment and underemployment are increasing, so that official data do not provide an accurate estimate of unemployment. To be included among the unemployed, workers have to be officially registered on the labour exchange and to receive unemployment benefits. The official unemployment rate is around 3-3.1 per cent of the labour force but the interim Poverty Reduction Strategy Paper (PRSP) estimates the true figure to be closer to 33 per cent.

There is no systematic attempt by the Government to increase employment in Tajikistan, as activities in this regard are not controlled. Incentives for private initiatives relating to employment have not been developed. The SME

sector receives little support from the Government and privatized small enterprises have been able to contribute little to employment growth. Unemployment in Tajikistan has become chronic causing many people to drop out of the labour force. Emigration to other countries in CIS is another option that has, by some estimates, been taken up by 800,000 to 1 million persons and remittances from migrant workers are now an important part of household income.

The problem of unemployment is made more acute by the low level of unemployment benefits and by poorly developed employment services. Information made available to job seekers, classified by profession, specialty and qualifications, is insufficient and a system to monitor labour market conditions is not operational. In seeking a solution to unemployment, professional and vocational training needs to be emphasized. Job opportunities in industry should be expanded at the expense of agriculture and an attempt should be made to identify future employment trends. Assistance with job placements and job search should be improved. Labour market flexibility should be encouraged, while protecting working conditions.

Other indicators of social and human development have also not benefited from the recent economic stabilization. The incidence of poverty in Tajikistan in 1999 was estimated to be equal to 83.5 per cent. The figure is likely to be much higher in rural areas, where nearly three quarters of the population live. Polarization of the population according to income is also increasing and official data indicate that the expenditures of the richest households are four times the expenditures of the poorest. Expenditure on food comprises 79 per cent of the family budget in the poorest households.

E. Key challenges ahead

Tajikistan has considerable economic potential that could be developed in the future to further social and human development in the country. The immediate task confronting it, however, is recovery from the post-independence decline and restoration of GDP per capita to the level of 1990, which could be achieved in the next 15 years. Reconstruction and restoration of Tajikistan's productive capacity do not mean returning to the former Soviet system of centralized control but should be carried out on the basis of the market structures adopted during the transition period. The new forms of business organization that have since emerged could have an explosive effect on growth, both in industry and agriculture, and lead to a closer match between market demand and output in Tajikistan.

In order for the new businesses in Tajikistan to remain profitable and competitive, they need to become part of the network of international specialization and cooperation. This will clearly depend on increasing the attractiveness of the country as a destination for FDI as significant investment will be needed for the technical rehabilitation, modernization and restructuring of enterprises. At present, the creation of new enterprises is likely to be confined to the SME sector as neither private nor public sectors have the resources to establish large firms.

In the present conditions of capital scarcity, it is important to focus on investments that are likely to have a significant effect on development even in the short term and that offer a rapid payback, without requiring large outlays of capital. One possibility is agricultural processing, which could be quickly and efficiently developed by SMEs. However, this will require improving the access of those firms to working capital of which they have been starved since the mid-1990s. Another priority area for investment is infrastructure construction, rehabilitation and maintenance. Extending the road transport network into rural areas, improving passenger and cargo services, repairing the power grid, telecommunications and water pipes would all be cost effective.

Restructuring of the larger industrial enterprises will require separating their productive activities from the provision of social services such as schools, clinics and so on and placing the latter under the management of appropriate public sector institutions. Some of those enterprises can then be privatized. This is likely to be more effective if centralized control within the enterprises is eliminated and management is decentralized and rationalized. Another aspect of restructuring refers to re-equipping enterprises with technologically advanced capital equipment so that they can switch to the production of goods that meet domestic and external demand. Carrying out the task of restructuring will, however, only be possible if financial resources are available. If they are not, the task will have to be postponed but the privatization of large enterprises could attract the necessary resources through FDI, which would also facilitate access to new technologies and management know-how.

Further development of the economy will subsequently be ensured through self-financing and mainly on the basis of internal capital formation. The restructuring and decentralization of large enterprises will also lead to a decrease in industrial concentration, fostering greater competition and efficiency, and will encourage diversification of output. Simultaneously with the process of rehabilitation of Tajikistan's economic potential, measures to build capacity and develop human resources need to be implemented.

In addition, to make better use of the country's rich natural resources, investment in developing hydropower will be needed. Increased availability of electric power will lead to a doubling of irrigated areas and the achievement of complete food security in Tajikistan. Export revenues will also rise as more electric power is exported. Hydropower development will not only ensure the financial rehabilitation of Tajikistan's economy but will also lead to the accumulation of resources for further investment.

The changes in Tajikistan's development mentioned above will necessarily lead to growth in per capita income and a reduction of poverty. However, the country will still need to take action to reduce income inequality. The aim of reforms is to eliminate deeply rooted phenomena of polarization of incomes and injustice in consumption. Tajikistan not only has an extremely low level of per capita income and consumption but also a very high Gini coefficient. The majority of the population lives below the poverty line, struggling to survive, while at the same time the gap between the incomes of the richest and the poorest families is very wide. The Government has been unable to lessen the shocking differences in living standards, which are largely the result of the unequal distribution of ownership of the country's resources. They also reflect other phenomena such as the non-payment of wages to workers in the cotton industry in 1992-1996, low cotton prices and the inability of all sections of the population to participate in privatization.

Without changes in the distribution of income and consumption, the impact of economic growth on key indicators of living standards will remain low. In Tajikistan today, establishing good governance and fighting corruption in an uncompromising manner are essential if the impact is to be raised to the level desired. In the interim, humanitarian aid and migrant workers' remittances have played a role in narrowing income disparities.

The flow of emigrants from Tajikistan is growing every month and their average earnings are increasing, enabling them to contribute more to their families. The conclusion of agreements between Tajikistan and host countries, based on ILO norms, concerning the terms, conditions and benefits of employment of emigrant workers will not only increase their incomes and protect their rights but also augment their role in financing investment in their home country. However, it does not reduce the responsibility of the Government and domestic employers with regard to increasing per capita income and consumption to socially acceptable levels and providing the population with social security.

In improving the process of reform and correcting its trajectory, the public sector has an important role to play. Unfortunately, the quality of public sector employees has declined significantly from the level of the Soviet era and they need to be re-educated about methods of governance and how to use them effectively. Public employees should have the educational background, experience and skills required of them in their areas of competence and selection processes should be competitive. Personnel training and re-training should also be provided and more posts in local government should be elected.

Serious mistakes were made during the implementation of monetary and banking reforms in Tajikistan and a significant correction is needed. The National Bank of Tajikistan should seek to re-monetize the economy without reigniting inflation. With regard to banking reforms, prudential standards need to be reviewed to be more in line with conditions in the country and the financial potential of companies and the public. It is necessary for the banking system to obtain the confidence and trust of the people so that increased deposits can become the basis for loan expansion. The level of “dollarization” and the use of cash transactions outside the banking system in the economy of Tajikistan also need to be reduced.

In the area of tax policy, further reforms are required to increase tax collections. The number of taxes and the level of taxes and customs duties should be reduced and a single land tax introduced. SMEs should also be subject to a single tax and VAT should be eliminated so that there is a preponderance of direct taxes in the tax system.

Finally, decisive steps should be taken as soon as possible to develop the infrastructure needed for markets to function properly. The lack of that infrastructure during the transition period has been a serious obstacle to the reform process and has prevented full advantage being taken of the opportunities presented by globalization.

F. Conclusions

At the start of the 21st century, globalization has become a universal process, affecting all of mankind. Tajikistan has become part of this process, particularly in the period following the collapse of the former Soviet Union. The economy of the country is now more vulnerable to trade and financial shocks, such as commodity price fluctuations. In other words, globalization can have both positive and negative consequences for Tajikistan.

As long as market institutions remain underdeveloped, the growth of basic economic sectors unbalanced, goods production uncompetitive and domestic firms without any protection, the hasty participation of Tajikistan in all the processes of globalization will lead to economic failure. Globalization should happen gradually, beginning with regional economic integration. Integration into the multilateral trading system will follow, in the case of Tajikistan after bilateral negotiations with the countries with which it has trade agreements.

After 1996, macroeconomic stabilization is becoming more of a reality but economic growth remains low. Inflation is not yet firmly under control and the high level of external debt, together with exchange rate weakness indicates that stabilization may not be sustainable. To a great extent, the slow economic growth in Tajikistan is connected with the insufficient development of market institutions. The banking sector, in particular, does not meet the requirements of a market economy. Inadequate economic growth in Tajikistan is also explained by the lack of a competitive environment in the country.

Nevertheless, the liberalization, privatization and other reform measures that have been taken so far have been of great importance to Tajikistan. The step by step approach to privatization, beginning with small businesses, has been successfully implemented. The financial system of Tajikistan is still in the initial phase of its development though institutional reforms in the most important areas have been implemented.

Fiscal and monetary reforms are continuing. Increasing budget revenues through reforming the tax system remains a challenge, as does the elimination of corruption to prevent budget resources from being embezzled. In the monetary sphere steps need to be taken to improve liquidity and access to credit. In its transition to a market economy, Tajikistan faces a number of obstacles to developing foreign trade. Among those are its landlocked situation and geographical remoteness, underdeveloped transport infrastructure, national security problems and the low purchasing power of its population.

Tajikistan has huge potential, which could be developed to promote acceleration of productivity and economic growth and so enable the country to resolve its complex social problems, particularly unemployment and poverty reduction. As a more modest task, achievable in the next 15 years, rehabilitation of the industrial and social potential built up in the past could restore GDP to its 1990 level.

Introduction

Globalization involves a combination of such processes as cross-border flows of goods, capital, technologies, information and people and the territorial and institutional integration of markets. There are also attendant problems such as environmental degradation, which require global cooperation. Globalization is necessary because of the uneven distribution of natural and human resources on the planet, which requires international cooperation for their most effective use. On the whole, the process of globalization has no real alternative but there are different approaches to the resolution of some of the problems provoked by it.

Pursuing globalization increases the mobility of factors of production, which should help reduce income disparities between different countries and equalize development levels. In reality, the reverse appears to be true, particularly as the gap in average income per capita between developed and developing countries is growing significantly. Nevertheless, these tendencies are not the inevitable consequences of globalization but, rather, emerge owing to the inadequacies in the development policies of both international organizations and States.

In many instances, both internal and external factors condition the difficult economic situation of a number of developing countries. As an illustration, the labour market for highly qualified workers, who form a professional elite, is becoming more and more integrated internationally while national barriers continue to limit the market for unqualified workers. Tariff increases and foreign trade barriers, erected by developed countries to protect their producers, are considerable impediments for realization of the export potential of developing countries. According to the World Bank, ending protectionist policies in developed countries could add US\$ 30 billion to the GDP of poor countries.

A. Globalization and regional integration

1. Integration into the multilateral trading system

In December 1994, Uzbekistan applied for WTO membership and the country is currently going through the accession process. The major principle underlying WTO is MFN treatment for all members. Membership in WTO

should bring about an increase in production efficiency and competitiveness, enhance integration into the global economy and provide more benefits from globalization in the long run. Membership in WTO also opens greater possibilities for settling trade disputes fairly and raises the confidence of trade partners and investors in a member country.

However, WTO membership places some restrictions on members that can create problems during the adjustment phase, especially in the short run. These include decreased government support for local producers, reductions in subsidies and restricted application of State instruments for regulation. In addition, the decline in tax revenues from foreign trade following the reduction of customs duties can have a negative impact on the budget. The risk of these adverse outcomes can, however, be minimized by the liberalization of foreign trade before entry into WTO.

2. Regional trading arrangements and partnerships

In the process of foreign trade liberalization and accelerated integration of Uzbekistan into the global economy, regional integration is of special importance. Regional integration restricts sovereignty in economic policy, but has a number of advantages, including:

- Increased specialization and realization of economies of scale through the pooling of resources and markets;
- Increased consumer choice through access to a wider range of markets;
- Increased competitiveness of goods and services in global markets following the development of intraregional competition;
- Better opportunities for wider scientific and engineering exchange and joint efforts to develop science and technology;
- Creation of better infrastructure in transport, finance and communications; and
- Greater ability to protect regional and national interests in relation to other countries, transnational companies and international economic organizations.

Currently, Uzbekistan is a member of several regional and subregional groupings and the country attaches a high priority to improving their functioning.

The fundamental regional grouping in Central Asia is the CIS, which seeks to preserve and deepen traditional economic relations. It has become a model of political integration and is divided into several integration zones. The most important multilateral agreements within its framework are the Treaty on Economic Union (1993) and the Agreement on a Free Trade Zone (1994). An agreement on creating a Common Agrarian Market in CIS was signed in 1997, to which Uzbekistan later subscribed.

In 1992, Uzbekistan, along with other countries in Central Asia, became a member of the ECO, a grouping originally founded in 1964 by Iran, Pakistan and Turkey to further economic, cultural, scientific and engineering cooperation. In 1994, the Union of Central Asia was formed, grouping Kazakhstan, Kyrgyzstan, Uzbekistan and Tajikistan. This became the Central Asian Economic Community (CAEC) in 1998. In February 2002 it was transformed into Central Asian Cooperation Organization (CACO). In 1999, Uzbekistan joined the regional economic union of GUUAM and, in 2001, the SCO.

The conditions exist for the further development of Central Asian countries on the basis of greater integration. However, the process of regional integration is currently being hindered by toughened customs barriers caused by the increased threat from international terrorism, differences in national interests, uncoordinated efforts in foreign currency reform, problems of water and energy supply and lack of coordination in the transport sphere. Possibly the situation will change in the future, but viable regional integration within Central Asia and within the CIS will require some time, as well as an understanding that economic development and integration into the world economic system need joint efforts and mutual concessions. However, WTO membership creates a conflict of interest between global trade liberalization and regional integration, particularly for those countries that are members of customs unions.

B. Transition assessment

1. Stages in the reform process since independence

Following the collapse of the former Soviet Union, Uzbekistan found itself with a structure of production highly specialized in supplying raw materials and intermediate goods, such as agricultural products, fuels and other mineral products. Most consumer and capital goods were imported. Specialization in the production and export of raw materials was especially important in the early years of transition, since these goods were very competitive on world markets.

Within a short period of time, Uzbekistan managed to redirect its foreign trade away from the markets of the former Soviet Union to overseas markets. As a result, economic collapse slowed down, in part owing to the low level of industrialization. However, specialization in raw materials led to a strong dependence on world commodity markets, leaving the country vulnerable to their notorious instability.

Uzbekistan also had one of the lowest standards of living among the republics of the former Soviet Union. Development was unbalanced, with industrial and commercial activity, often conducted by giant monopolies, concentrated in urban centres. Rural areas, where 60 per cent of the population lives, were industrially underdeveloped. Furthermore, scant regard was paid to the environment during the Soviet era. The policy of large-scale, irrigated agriculture pursued in Central Asia in the 1960s to the 1980s, particularly in Uzbekistan, was largely responsible for the death of the Aral Sea, one of the greatest environmental disasters in the world.

At independence, low productivity and poor management characterized industrial production. The rupture of economic links between enterprises located in different republics of the former Soviet Union, which occurred during the first years of independence, also aggravated the situation. In order to integrate with the world economy, Uzbekistan was faced with the challenge of radically reforming the structure of production and diversifying its economic base to correct the imbalance between raw material and process industries.

To add to its problems, Uzbekistan had rudimentary political and governance infrastructure. The republic lacked institutions and experienced staff in the area of domestic and foreign policy formulation and implementation, including economic policy. A reform programme was elaborated based on five principles:

- Priority of economic matters over politics and domestic and foreign economic relations divorced from ideology;
- Primary reliance on the State to initiate and undertake reforms during the transition;
- Primary reliance on the rule of law in all spheres of public life;
- A strong social policy, providing social security and support to vulnerable population groups during the transition period;
- Gradual transition to a market economy without the use of shock therapy.

In the initial stages of the reform process, from 1992 to early 1994, the country encountered difficulties related to the breakdown of economic relations between the former Soviet republics and the loss of subsidies, which resulted from the collapse of the Soviet Union.¹ It was impossible to conduct an independent monetary policy as the country was part of the rouble zone and there was a high rate of inflation. As a result of the liquidation of the State monopoly on foreign trade and foreign economic activity, competition from imports hurt local industry. The key objectives of social and economic policy during this period were the creation of the infrastructure of an independent state, introduction of the legislation needed for transition to a market economy, privatization, price liberalization and stabilization and the provision of social security for the population.

In an attempt to offset reduced domestic demand, production and consumption were subsidized, increasing budget and balance-of-payments deficits. Lax macroeconomic policies, macroeconomic imbalances and limited market reforms characterized these years. Since the Government supported key industries and foreign trade was reoriented to overseas markets, the economic recession was relatively insignificant during the early reform period. Real GDP had fallen by 17.7 per cent by 1993-1994 from its value in 1991, the smallest decline among all CIS countries.

The second phase of the reform process began in 1994 with the publication of a presidential decree aimed at deepening economic reforms, protecting private property and developing entrepreneurship and lasted until 1996. The second stage was characterized by a more rigid financial policy, accelerated reforms in many areas and, most importantly, a significantly improved macroeconomic situation. The Government cut subsidies to consumers and producers significantly and measures were undertaken to increase budget revenues and strengthen financial and budgetary management. As a result, the consolidated budget deficit was greatly reduced. Treasury bills were introduced in March 1996.

Monetary policy was also tightened, refinancing rates raised and subsidized credit to enterprises was cancelled. The financing of the budget deficit by the banking system was restricted to 1.4 per cent of the GDP in 1995. As a result,

¹ In 1991, subsidies to Uzbekistan from the budget of the former Soviet Union amounted to 18.5 per cent of GDP.

the annual inflation rate fell from 1,557 per cent in 1994 to 184.5 per cent in 1996. A national currency was introduced on 1 July 1994, following which consumer prices were further liberalized, rationing of staple foods was abandoned and restrictions on foreign exchange eased. State procurement was cancelled for all agricultural products, excluding cotton and grain where it was considerably reduced. The fall in real GDP was arrested, with real GDP growth achieved for the first time in 1996 after the initiation of reforms. During this period, social policy was radically reformed, shifting to targeted support for the most vulnerable population groups. More attention was paid to maternal and child health and to bringing up and educating the new generation through targeted government programmes.

From the end of 1996 to mid-1999, internal and external shocks led to increased public investment aimed at accelerating structural reforms. Monetary policy was eased and foreign currency rationing introduced. Trade restrictions were tightened and management of exports by the State increased. The difference between the official and unofficial exchange rates widened notably. Rapid inflation and falling world prices for key exports led to real exchange rate appreciation with a negative impact on exports, while foreign currency rationing hindered the inflow of foreign direct investment.

Liberalization recommenced in 1999 and government interference in the economy began to decrease. Increased guarantees and protection from the illegal interference of controlling agencies in the activities of economic entities were provided and economic policy shifted gradually from import substitution towards export orientation. Before 1999, the major instrument of structural reform was, to some extent, the creation of large enterprises supported by the Government through directed lending, subsidies and the sale of foreign currency at below market rates. Beginning in 1999, the main priorities for economic policy were structural reform through the development of SMEs, optimization of public expenditure, reduction of the tax burden, export promotion and achieving currency convertibility. A single tax on SMEs was introduced and measures were undertaken to reduce transaction costs for these firms by simplifying controls on them. Significant tax incentives were granted to exporters, the national currency was greatly devalued and measures undertaken to achieve foreign currency conversion on the current account. Privatization of strategic industries commenced in 2000 with the oil and gas sector and, in 2001, restructuring and privatization was extended to the power, municipal services, transport and communications sectors.

2. Lessons from privatization

A number of factors necessitated privatization in Uzbekistan as well as other economies in transition, mainly the weak capacity and low efficiency of State-owned enterprises and the low quality of their products. Privatization in Uzbekistan was undertaken by transferring State shares to investment companies. In this way, speculative and criminal activity was avoided.

The initial phase of privatization in 1992-1994 laid the basis for a mixed economy. Many ministries and departments were reorganized into concerns, associations and corporations that were originally formed as closed joint-stock companies. Small-scale privatization was undertaken of SMEs engaged in trade and services, as well as in local, light industries, construction and construction materials, and food industries. In total, 54,000 entities were privatized. At the same time, a programme on allocating land to the rural population was being implemented with the aim of enlarging the number of private plots. This strengthened the private sector in rural areas, increased production of food, increased employment and encouraged house building. Social stability was achieved as a result of the expanded private sector.

At the beginning of 1994, a real estate market was established in Uzbekistan and a real estate exchange started functioning. Closed joint-stock companies, principally medium- and large-sized enterprises in food and light industries, machinery, transport and other sectors of the economy, including those of a strategic nature, were transformed into open ones. Their shares were distributed between the State and labour collectives and were also sold to local and foreign investors, mainly on the local stock exchange. The second stage of privatization, between 1994 and 1998, also promoted the formation of a treasury bills market. To develop securities markets, appropriate regulatory and legislative frameworks were adopted and during this period the value of securities issued increased six-fold. In September 1996, the Program of Privatization of Investment Funds (PIF) was adopted. The programme aims at privatization through the attraction of a wide spectrum of the population, while seeking to protect the public's investments. The privatization effort resulted in the share of private enterprises in the total number of enterprises reaching 83.7 per cent by 1998.

Before 1998, the method of privatization widely adopted in the country was based on standardized privatization plans regardless of size, economic potential and sectoral affiliation of the enterprises to be privatized. Though it opened up new opportunities for increasing the tempo of the privatization

process, the method did not take into account the specific features of enterprises in designing privatization plans. This stage of privatization was aimed largely at promoting competition in the economy to enhance competitiveness.

Privatization from 1999 to the present is focused on large State-owned enterprises in basic industries, giving priority to the participation of foreign investors. An individual approach is applied in the privatization of those enterprises, which provides for participation of strategic investors. A distinctive feature of privatization based on an individual approach is thorough study of the enterprise to be privatized and the adoption of a strategy adapted to each enterprise, as well as the participation of experienced international financial consultants. From table VII.1, the success of the privatization effort can be seen in the greatly increased share of the private sector in economic activity. Furthermore, by 2001, over 74 per cent of property was in private hands.

Table VII.1. Development of the private sector in Uzbekistan

(Percentages)

<i>Share of the private sector in</i>	<i>1991</i>	<i>1992</i>	<i>1993</i>	<i>1994</i>	<i>1995</i>	<i>1996</i>	<i>1997</i>	<i>1998</i>	<i>1999</i>	<i>2000</i>	<i>2001</i>
GDP	n.a.	n.a.	n.a.	n.a.	56.0	54.7	63.5	64.4	69.9	72.6	74.1
Industrial production	10.0	11.9	15.9	46.3	50.2	53.5	59.0	60.2	61.4	63.0	70.8
Agriculture	64.7	68.5	86.6	96.7	97.6	97.8	98.6	98.7	98.7	98.7	99.0
Fixed capital investment	24.4	31.1	24.9	31.6	44.9	30.0	32.3	40.7	34.0	38.0	40.1
Subcontracted construction	7.6	8.4	7.3	23.0	62.1	64.2	71.9	77.1	77.7	78.0	83.9
Retail trade	52.5	53.5	72.0	90.6	91.7	94.5	95.3	95.5	96.0	96.5	97.2
Services	14.0	12.4	10.5	8.5	21.4	35.0	43.0	53.7	54.7	55.5	58.0

Source: Data obtained from the Ministry of Macroeconomics and Statistics.

Note: n.a. = not available.

A major constraint on private entrepreneurship development is the underdeveloped securities market. This is due to the lack of trust in the financial system, low profitability of enterprises and weak shareholder power. Macroeconomic stabilization and improvement in the financial situation of

enterprises through restructuring are also needed if investment activity and private entrepreneurship are to grow.

Limited internal resources and the need to keep external indebtedness within acceptable limits during the period of deepening economic reforms and integration into the global economy lead to the need for a selective approach by the Government to industrial policy. In the context of foreign trade liberalization, subsidizing financially troubled economic sectors could be a heavy burden on the State budget. Overall, public intervention in private sector activities needs to be reduced, with the State concentrating on formulating an effective economic policy and providing the legal basis for reforms.

From the perspective of increasing industrial capacity in Uzbekistan, the current stage in privatization is central to the integration of the country into the world economy. Large industrial enterprises in Uzbekistan can survive only if they are oriented to external markets but in these markets they are likely to encounter stiff competition from established producers. Given this fact, foreign investors need to identify potential niches in world markets that the privatized enterprises receiving their investments could potentially seize according to their competitive advantage.

3. Fiscal policy reform

During the first years of independence, Uzbekistan had to create independent budget and tax systems and learn how to formulate a fiscal policy suited to a market economy and to the challenges of the global economy. In the initial stages of the reform process, key priorities were ensuring the social security of the population and achieving a balanced budget. The budget deficit was large, as subsidies from the former Soviet Union had ended and the tax base was dramatically reduced owing to the fall in production. This, together with the narrowness of the tax base, explains the expediency of the introduction during 1992-1993 of an easily collected value added tax (VAT) at the very high rate of 30 per cent, an excise duty of 40 per cent on some commodities and a tax on exports. At the same time, income tax rates on enterprises were not high and ranged from 12 to 15 per cent.

In 1993, new taxes were introduced and the tax base was expanded for some types of tax payments. The income tax rate was raised and the scheme for calculating VAT was changed. However, opportunities for pursuing an independent fiscal policy were still constrained by Uzbekistan's membership of the rouble area. After the national currency was introduced, this constraint was

removed and the tax system was simplified and unified in 1995. Tax rates on natural resources and property were raised, a mining tax was imposed and a land tax was levied on agricultural enterprises.

After 1995, the public budget has been dominated by the Government's support of large investment projects related to structural adjustment. Since 1998, the Tax Code of the Republic of Uzbekistan has been in effect. The code comprises several laws on taxation and has made the taxation system more efficient, providing a unified legislative basis aimed at expanding revenues and allowing for the division of taxes between local and national authorities. Some of the key changes that took place in the taxation system between 1998 and 2002 include a reduction in the number of taxes, particularly for SMEs and agricultural enterprises, through unification and simplification; a reduction in profits tax; greater reliance on indirect taxes and resource levies; and tax incentives for exporters.

In spite of the measures undertaken to reform the taxation system, the tax burden remains rather heavy. In 2001, the share of budget revenues in GDP was 35.1 per cent, taking into account social transfers to off-budget funds. Though the tax burden is falling, it is still much higher than in other economies in transition, developing countries and even many developed countries with much higher incomes per capita. The situation becomes even more problematic when the number of tax incentives and the expansion of the shadow economy are taken into account, indicating that the effective tax burden is extremely high.

In the context of globalization, a heavy tax burden not only impedes competitiveness of domestically produced commodities and services, but also promotes tax evasion and the growth of a shadow economy, deters product and export diversification and leads to capital flight and skilled labour emigration. Given the socio-economic situation of the country, the need to lessen the tax burden call for an urgent review of existing tax and expenditure systems. At present, about 19 per cent of public expenditure is accounted for by central government investments that are not very effective. It would be more productive to use public funds to finance infrastructure development, including social infrastructure of public health and education, leaving commercial projects to the private sector.

The share of social sectors in total public expenditure in 2001 was 37 per cent. Given the special role played by science, education and public health in ensuring the country's competitiveness with respect to human capital in conditions of globalization, this large share is justified. However, planning of

education, health care and other social spending is based on the so-called baseline method that implies retaining given spending priorities with inflation-adjusted increases. As a result, non-priority spending is adequately funded, whereas new promising directions receive inadequate financial support. To optimize use of the State budget, greater reliance on a programme-based approach could be justified. Better control of public expenditures and additional privatization would go some way towards reducing public spending and making tax reduction possible.

4. Monetary policy reform

A high rate of inflation inherited from the former Soviet Union continued to accelerate during the early years after independence. In 1992, the GDP deflator increased by 711 per cent and by 1,079 per cent in 1993 and 1,239 per cent in 1994. One of the factors behind the hyperinflation was a huge budget deficit that amounted to 12.5 and 10.4 per cent of GDP in 1992 and 1993 respectively. After the introduction of the national currency in July 1994, an opportunity opened up to formulate an independent monetary policy and to implement a programme of stabilization, aimed at restraining inflation and preventing further declines in production. Tightened fiscal and monetary policies resulted in a decrease in the budget deficit to 6.1 and 4.1 per cent of GDP in 1994 and 1995 respectively. The annual rate of inflation estimated using a consumer price index dropped dramatically to 117 per cent in 1995. Macroeconomic stabilization was achieved by 1996, resulting in increased business activity, the growth of domestic savings and greater investment.

Subsequently, macroeconomic policy changed significantly. The most notable changes were new limits on the foreign exchange market and greater use of direct instruments for conducting monetary policy.² As a result, the monetization ratio, as measured by the ratio of the broad money supply to GDP, decreased continuously, falling from 14.9 per cent in 1996 to 10.4 per cent in 2001. Monetary reforms accelerated during 2001-2002 but absence of a stable money market has prevented the adoption of indirect instruments to regulate monetary policy. Such a situation hampers the ability of monetary policy to prevent and neutralize financial crises. Trust in the Central Bank may also be undermined by its apparent lack of independence. The creation and develop-

² These instruments include centralized credits, interest rate limitations and preferences, regulation of transactions related to funds on hand and so on.

ment of an integrated money market will help accelerate economic reforms, allowing commercial banks to reduce excess reserves and increase lending so preventing de-monetization. Monetary policy can then focus on targeting the inflation rate and maintaining the exchange rate after it has been unified and convertibility achieved, which will help in realizing the advantages of globalization and mitigate risks.

5. Financial sector reform

The formation and development of the financial sector in Uzbekistan is a reflection of overall developments in the economy during transition. At the initial stages of economic reform, economic recession and hyperinflation seriously damaged the sound functioning of the financial system and the efficiency of commercial banks. The financial sector in Uzbekistan is still characterized by segmentation and poorly developed institutions. The banking system³ accounts for most financial intermediation as the legislative base is not yet in place to regulate the activity of quasi-bank financial institutions. Money and interbank markets are not active and the market of securities is underdeveloped.

The segmented nature of financial markets in Uzbekistan is evident in many areas. For example, one of the fundamental sectors of economy, agriculture, permanently lacks financing owing to low profitability. This creates serious problems for the economy, impeding the smooth circulation of money between agriculture and other economic sectors. The system of multiple exchange rates, currently in existence in Uzbekistan, is also a source of price distortions and financial segmentation. In its attempts to eliminate price distortions, government policy aims at the liberalization of the currency market and unification of exchange rates by devaluing the official rate rapidly and liberalizing access to the interbank currency market.

The banking system in Uzbekistan is under-capitalized, the ratio of aggregate bank capital to GDP being just under 4.5 per cent in 1999, well below the average 12 per cent figure of other economies in transition in the same year. The development of the banking sector is also hampered by the absence of

³ At present, the banking system in Uzbekistan consists of 37 commercial banks, of which 6 banks have foreign capital participation, 17 are privately-owned and 3 State-owned. The remaining banks are joint-stock commercial banks.

market-determined interest rates. The refinancing rate of the Central Bank serves, to some extent, as the base interest rate, mainly because all existing restrictions on interest rates are linked to it and it is used by commercial banks in setting their own rates.

At the end of 2000, 93 per cent of credits granted by the banking sector were foreign currency credits guaranteed by the Government. In this situation, devaluation of the official rate automatically raises the cost of debt service and worsens bank credit portfolios. Considerable devaluation of the official rate in 2000-2001 led to a substantial increase in non-performing loans, increasing the risk of a crisis that could strike the entire bank system. Further liberalization of the currency market and unification of exchange rates envisages additional devaluation of the official exchange rate, which may increase the risk of a systemic crisis, a factor that needs to be taken into account in restructuring banks and their debts.

For deeper economic reforms and integration into the world financial system, inflation has to be brought down to single digits. Reducing concentration in the industry through further privatization of State-owned banks and the removal of restrictions on the access of foreign financial institutions to the internal financial market can foster competition in the banking system and increase efficiency. Increasing transparency and financial disclosure while strengthening the legislative base to ensure fulfilment of contractual obligations are vital matters requiring further attention. The Government must also encourage the independence of financial institutions in managing their affairs.

C. Markets and trade

The foreign trade policy of Uzbekistan can be divided into several phases. During the initial stages of reform, in 1991-1994, low tariff levels in the 5-10 per cent range and a lack of non-tariff barriers characterized import policy. At the same time, exports of food and industrial goods were subject to 40 per cent tariffs and most exports, especially those of State-owned enterprises, were subject to quotas and licenses. During 1994-1996, imports were further liberalized but the restraints on exports continued and tariff rates on exports were raised. However, in 1996-1998, the number of goods exported on the basis of quotas and licenses was greatly reduced. Quotas and licenses were retained for those goods where domestic and world prices differed significantly, such as cotton fibre, non-ferrous metals, energy and raw materials and exports were banned for another 13 goods. High export duties remained principally on raw

material exports. After 1998, export tariffs were reduced significantly and later abolished while protection against imports has increased.

Besides tariff and taxes, at present there are also de facto constraints on both exports and imports, which have the same effect as quotas. These include foreign currency rationing, which is still in use. The annual import forecast prepared by the Ministry of Macroeconomics and Statistics acts as an additional constraint. As for regulation of exports, only some commodities require licenses. However, the cabinet must approve the distribution of key industrial products on an annual basis and this is no less a constraint than the export ban on many commodities. Since import restrictions also lead to a decline in exports through their effects on the exchange rate and the prices of intermediate goods, further liberalization of exports and imports is a necessity. Foreign trade liberalization should be done gradually to avoid major dislocations in the economy but even temporary deviations from the liberalization course can lead to more radical and expensive measures being needed down the road.

The breakdown in economic links between enterprises located in different republics of the former Soviet Union, their insolvency and the collapse of the payments system were major problems that Uzbekistan faced in the years immediately following independence. Since then, it has reoriented its foreign trade away from the former Soviet area to overseas markets. The share of CIS countries in exports from Uzbekistan has fallen from two thirds of the total in 1994 to about one third in 2001, while their share in its imports has fallen more slowly, from just over 53 per cent to just over 37 per cent in the same period. The reorientation of foreign trade and trade liberalization have had beneficial effects on the volume of Uzbekistan's exports. However, the value of total exports has fluctuated somewhat, reflecting changes in its terms of trade. As these terms have improved recently, the value of exports has stabilized. The structure of Uzbekistan's exports has changed since independence. Along with traditional exports such as cotton yarn, fabrics and non-ferrous metals, exports of products of the chemical, oil and gas and machinery industries have increased. In spite of this, raw materials continue to account for about two thirds of total exports, which makes the country vulnerable to fluctuations in world commodity prices.

D. Investment liberalization policies

From the very beginning of the transition period, the Government of Uzbekistan placed particular emphasis on domestic and foreign investment. In the early stages of reforms, investment fell owing to various factors related to

the collapse of the former Soviet Union. During this period, investment policy was concerned primarily with preserving existing industrial capacity. Subsequently, investment grew very rapidly and investment policy shifted to directing domestic and foreign capital towards the structural reform of key sectors such as the oil and gas industry, as well as establishing industries to produce consumer goods, vehicles, raw materials and semi-finished goods.

More recently, investment policy has focused more on SME development. As part of the reprioritization effort, licensing, registration, accounting and taxation regulations for SMEs were simplified and the Council of Small and Medium-Size Enterprises Development was established. Several incentives were offered to SMEs, including a reduction in the income tax rate applicable to first and second year income of 75 and 50 per cent respectively. SMEs receive preferential credit and the income earned by commercial banks from SME lending is tax exempt.

Support for SMEs has become a fruitful arena for international cooperation and Uzbekistan has so far received some US\$ 455 millions to finance SME projects from international financial organizations. Despite these massive efforts, however, at present there are only approximately six SMEs for every thousand persons in the country, whereas the comparable figure in Western Europe is at least 30. The share of SMEs in foreign trade activity is less than 2 per cent, a comparatively low figure, as most small businesses are concentrated in trading and public catering where entrepreneurs need little capital and expect a short payback period.

The investment policy of the Government of Uzbekistan has enabled it to achieve self-sufficiency in energy and food. In 1990, Uzbekistan could meet only 28 per cent of its demand for oil, whereas by 1995 oil imports had practically ceased and oil exports had more than tripled. As early as at the mid-1990s, grain self-sufficiency was achieved and grain imports began declining gradually in 1995. Nevertheless, the investment policy has had some negative consequences for the competitiveness of some sectors and enterprises in the context of globalization and integration into the world economy.

As a result of an investment policy directed towards import substitution, a number of enterprises were established in Uzbekistan to exploit the short-term effects of import rationing. As a rule, those enterprises were also granted monopoly powers, which did not favour the development of a competitive environment or quality improvement. Many of the enterprises created and developed during this period are likely to become unprofitable after foreign trade and the currency market are liberalized.

The basis of investment policy of the Government of Uzbekistan is the annual investment programme, a component of the overall socio-economic development forecasts. The investment programme contains a list of priority investment projects, detailing customers, foreign partners and sources of financing. Those projects receive several incentives and privileges, the most important of which is access to foreign currency convertibility at an overvalued exchange rate at the Central Bank. This, along with support from the public budget and access to low-cost credit from the banking system, greatly increases economic rents for investors. However, approximately 60 per cent of all fixed investment is still undertaken by the State. Much of this investment is in heavily capital-intensive activities, stimulated by numerous preferences and privileges. Not surprisingly, much of it is inefficient. During 1998-2001, the ICOR averaged 6.5 whereas the comparative figure in countries with a strong export orientation is 3-4.

The share of foreign investment in total investment increased from 19 per cent in 1996 to 33.7 per cent in 2001. However, the overwhelming majority of foreign investment, around 85 per cent, was in the form of loans guaranteed by the Government, increasing external indebtedness and potentially posing debt service problems in future. FDI has been increasing (table VII.2) but remains low despite the fact that foreign investors are given legal guarantees and several privileges with respect to taxation and the foreign trade regime, such as the removal or reduction of customs and excise duties and other trade taxes.

Table VII.2. Indicators of FDI in Uzbekistan, 1994-2001

<i>Indicator</i>	<i>1994</i>	<i>1995</i>	<i>1996</i>	<i>1997</i>	<i>1998</i>	<i>1999</i>	<i>2000</i>	<i>2001</i>
Total FDI (million US dollars)	70	352	169	275	133	111	105	108
Number of registered enterprises with FDI	1 246	1 878	3 061	3 355	3 594	3 554	3 445	3 281
Number of employees in enterprises with FDI	–	28 929	55 145	79 613	86 322	86 281	91 100	90 400
Share of enterprises with FDI in GDP (per cent)	2.6	2.0	7.0	12.0	13.0	13.0	12.1	7.9
Share of enterprises with FDI in the total exports (per cent)	0.6	2.0	4.0	9.0	10.0	11.0	13.8	12.8
Share of enterprises with FDI in the total imports (per cent)	5.6	14.5	33.0	39.0	34.0	33.0	25.8	29.9

Source: Data obtained from the Ministry for Macroeconomics and Statistics.

E. Impact of globalization on social and human resources development

1. The labour market and employment

The collapse in production following independence was accompanied by a fall in employment. Since 1995, however, there has been an increase in the labour force owing to increased employment opportunities in the non-governmental sector and the growth of informal employment. As a result, the structure of employment has changed rapidly. In 1991, the public sector employed 60 per cent of the total number in employment but by 2001 this share had fallen to less than 30 per cent. The dynamics of the labour market are largely affected by demographic factors. High birth rates in the 1970s and 1980s led to an increase in the population in younger age brackets and there were more than 10 million children under the age of 15 at the beginning of 1998. In the short term, there is likely to be a surge in the number of young, unskilled workers entering the labour force whereas it is skilled professionals that are in demand. The official unemployment rate in 1993-1998 was 0.5 per cent or less but unofficial estimates put the true figure at approximately 5.7 per cent.

The apparent increase in unemployment as economic reforms were implemented is a reflection of several factors. First, there was the privatization of large, State-owned enterprises that released labour resources that have still to be absorbed fully by private enterprises. Second, the restructuring of agricultural enterprises speeded up the release of the labour surplus in agriculture, estimated at 100,000 workers per year. Even so, employment in agriculture remains excessive and according to some estimates, the total labour surplus in agriculture amounts to approximately 600,000 people. Finally, the demographic factors mentioned above are adding about 400,000 people to the labour force annually.

The Government's policy with regard to the labour market is to give priority to its regulation and implement measures to support employment in those areas and sectors where the situation is especially difficult. The creation of new jobs, improving professional training and retraining and organizing temporary public works to improve economic and social infrastructure are other aspects of this policy.

2. Professional training

According to many indicators, educational standards in Uzbekistan are among the highest in the world. The country managed to retain these high

standards during transition, without distinction according to gender, age, nationality and ethnic origin. This was possible owing to the passage of the Law on Education in 1997 that made free secondary and vocational education mandatory. Since then, several new school and pre-school facilities have been opened. Also in 1997, the Law on the National Professional Training Programme, which gives priority to ensuring continuity of education and professional training according to the requirements of the labour market, was adopted. The programme provides for:

- Professional training of specialists at all levels, according to the changing requirements of the country during development;
- Reform of educational institutions in the light of the country's transition to a market economy;
- Introduction of universal education for twelve years, comprising nine years of secondary education that are already mandatory plus three additional years of vocational education;
- Development of State standards for education in line with the new demand for specialists in the economy; and
- Certification of educational institutions at all levels.

3. Support for incomes during transition

In the period from 1991 to 1995, both money and real incomes declined in Uzbekistan. The Government sought to support income levels by pursuing an accommodative monetary policy and providing subsidies, social transfers and other benefits to almost all the population. Other measures included subsidizing local producers, as well as the prices of imported essential goods, limitations on exports and price controls for basic consumer goods, including medicines. Wage and income indexation was widespread and little attempt was made to control informal economic activities. This approach allowed incomes to be cushioned to some extent from the shock of price liberalization.

After the introduction of a national currency, in the second half of 1994 monetary and fiscal policies were tightened. In line with this, wage and income indexation became less widespread and, since 1995, index-linked increases in the minimum wage and related payments have been limited to twice a year. Consumer subsidies were reduced to a minimum, remaining only for some municipal services and a system of targeted social security benefits for vulnerable population groups was created, with non-targeted subsidies and privileges

being eliminated. Along with improved administration of social security funds, this enabled payments to vulnerable population groups to increase significantly while budget expenditures for these purposes were simultaneously reduced. By 1996, economic activity had recovered and income from entrepreneurship, property and farming increased.

4. Poverty and social safety nets

During most of the Soviet era, information related to poverty was classified as secret. Beginning in the late-1980s, the existence of poverty was recognized and a working definition of poverty was developed, with people having an income level below the minimum wage defined as being poor. According to this definition, 44 per cent of Uzbekistan's population were poor, mainly people living in rural areas, pensioners, widows, single mothers and disabled people. No effective independent system of social protection existed in Uzbekistan, which was included in the former Soviet Union's social protection system. Although this system had a comprehensive coverage, misallocation of funds and lack of targeted measures prevented effective poverty alleviation.

Poverty has many aspects so that general statements about it are difficult to make. In addition to this, the lack of reliable information complicates an in-depth analysis of the situation. Absolute and relative poverty levels are very difficult to identify in Uzbekistan. Some information can be obtained from the data submitted monthly by the system of local government institutions known as *mahallas*. These data suggest that currently some 500,000 families, around 12 per cent of all households and 13-15 per cent of the population, are extremely poor and there is a high concentration of poverty in rural areas. In addition, there are currently estimated to be about 1 million low-income families in Uzbekistan and a considerable number with incomes close to low levels.

Until 1994, social protection in Uzbekistan followed the Soviet model, seeking, where possible, to enhance it. One of the first national laws adopted, in 1991, was the Law on Social Protection of Disabled People that provided legal guarantees for this vulnerable group. In 1992, the Law on Employment of the Population was adopted to provide legal guarantees and social support to unemployed persons. Gradual reform of the system of social protection commenced in 1994. First, this system was reoriented to target subsidies to the neediest groups in the population. Second, social support was channelled largely to families and, third, indicators of family welfare, such as income, property ownership and paid employment, were taken into account in determining benefits.

The main feature of the mechanism of social protection was the delegation of the power to nominate beneficiaries and to distribute benefits to local government institutions or *mahallas*. This allowed the State to improve targeting and reduce administrative expenditures, while at the same time enhancing the role of local government institutions in social and economic life. In 1994, local government institutions distributed about 2 per cent of the budgeted expenditures to low-income families, a figure that had increased to 9 per cent by 1996.

At present, over 43 per cent of all families get direct State financial support, half of them receiving child benefits. Targeted social payments and privileges are provided for population groups such as pensioners, elderly persons ineligible for a pension, widows, orphans and children from low-income families. The assistance is largely to pay for municipal services and public transport, as well as to provide these groups with free food, medicines, winter clothes and school necessities and also to give them an opportunity to attend health centres and resorts. Compensatory benefits and payments are also made to war veterans and victims of natural disasters.

The right to social support in old age and in the case of disability or the loss of a breadwinner is enshrined in Article 39 of the Constitution of the Republic of Uzbekistan. The largest component of social security in Uzbekistan is the State pension system. It functions in accordance with the Law on State Pensions for Citizens, adopted in September 1993, that created a new pension system based on the pay-as-you-go principle.

Although the dependency ratio (i.e. the ratio of the retired to the employed) is comparatively low at 0.3, financial problems may appear in future. Actuarial estimates indicate that only 42 per cent of the employed contribute to the pension fund, the remainder being in arrears with pension fund payments. The greying of the population of Uzbekistan that is forecast to occur in the near future necessitates early pension reform.

F. Key challenges ahead

Globalization leads to an increase in the demand for highly skilled, well educated and well paid workers in developed countries and the movement of jobs requiring lower skill levels to developing countries where labour is relatively cheap. While this process will clearly help in absorbing surplus labour in developing countries in the short term, the effect in the long term may be negative if it leads to a slowdown in the qualitative improvement of the labour force. However, for a country like Uzbekistan, where 400,000 people

were unemployed at the end of 2001, increasing employment in the short term is of considerable importance. It should also be emphasized that the prerequisites and conditions exist in Uzbekistan to counteract the danger of an expansion of unskilled labour, or a slowdown or suspension of human resources development, in the form of the national training and retraining programme.

1. Job opportunities and emigration

Creating job opportunities for population groups most in need of employment would enhance the positive effects of globalization. The Bizintrud Programme, executed by the Employment Fund of Uzbekistan in cooperation with the Pfaff Singer Company provides an example of what can be done. The Company provides sewing equipment to unemployed women with low skill levels, mostly in rural areas where unemployment and underemployment are high. It also places orders for clothing and similar soft products that are distributed through a network of partnering trade companies. However, such programmes by themselves are obviously not enough to improve the labour market situation in Uzbekistan. Improving the investment climate in the country to attract FDI, for example to the food processing and other light industries, which can successfully be developed in rural areas, would have a more consistent effect on employment.

Economic restructuring driven by globalization can lead to unbalanced growth in national economies. In Uzbekistan, however, the need for economic restructuring did not emerge only as a result of globalization but as early as the 1980s, when it became clear that an economy based on cotton and mining would be unable to generate either accelerated economic growth or higher incomes for the population. However, it is necessary to ensure that economic restructuring caused by internal factors is not dissonant with global trends. For example, deindustrialization of the world economy is linked to rapid growth of the services sector, where employment has been growing rapidly. As a consequence, other sectors have been shedding jobs. This suggests that job-security programmes should seek to accelerate development of services through giving priority to investment in this sector.

The increased mobility of labour can also be a potential problem in an open economy. International migration has both positive and negative effects. It allows workers to upgrade professional skills and to acquire new skills and new ways of thinking. It also leads to increased remittance flows to the home country, which can be quite substantial. However, the most valuable domestic labour resources are highly skilled workers who are also the most mobile.

These workers are able to move to other countries, frequently in the developed world, in response to the widening wage gap between high- and low-skill jobs and, as many countries are interested in recruiting talented professionals, these workers can obtain entry visas relatively easily. It is very difficult to cope with this brain drain, in view of the constitutional guarantee on freedom of movement. However, market reforms in Uzbekistan are leading to the creation of new opportunities for well educated, skilled workers within the country, which should slow emigration.

Uzbekistan possesses about 40 per cent of the labour resources of Central Asia. Literacy, at 99.2 per cent, is almost universal. The average number of years spent in school is 11.4, ranging from 13.9 years in urban areas to 9.8 years in rural areas. Every fourth employed person has higher or vocational education. This has led to many workers seeking seasonal and short-term work in other CIS countries following the introduction of market reforms there. For example, during the summer of 2002, 150,000 persons sought work in neighbouring countries, 80 per cent of them in Russian Federation.

With limited official labour migration through the Ministry of Labour and Social Protection of Population, illegal migration has also become popular among the people of Uzbekistan. In Uzbekistan, there are no licensed private companies and agencies that can help people seek employment abroad. However, firms engage in this activity under the guise of tourism or other organizations licensed to operate in sending people abroad. Individuals pay for their services but have no guarantees as to social security once they have gone abroad. With time, many restrictions on emigration may be removed as globalization proceeds.

2. Income inequality and social stratification

Although real income has been growing moderately in Uzbekistan in recent years, much of this growth has gone to families in higher income brackets, indicating increased social stratification. The number of families on low incomes increased in the late-1990s as a result of economic restructuring and this process can be expected to continue with deeper integration and the demand for greater efficiency in the agricultural sector. Globalization will inevitably affect the social situation of the country. While in the early-1990s, poverty was the result of factors such as low skills, disability, widowhood and old age, now even skilled workers are in danger of joining the ranks of the poor if they are not retrained and professionally upgraded. Enhanced social protection is, therefore, advisable along with deepening economic liberalization.

Income inequality is not new to Uzbekistan, as incomes remained unequal during the socialist period.⁴ After independence, income inequality was estimated to be somewhat higher in Uzbekistan than, for example, in Russian Federation, owing to the large agricultural sector and rural population. By 1996, transition to a market economy is estimated to have increased measured income inequality in Uzbekistan by about one fifth. Another troubling feature of changes in the distribution of income in the country during the transition period is that there appears to have been little relation between educational attainment and increased income. This factor has triggered a revision of values and ideals among the younger generation, leading to substantial emigration and undermining human capital formation. There is also a visible gap between ethnic groups in terms of income. Whereas only 20 per cent of families of ethnic European origin are in the low-income brackets, 54 per cent of families of Uzbek origin are in these brackets. This is particularly true of women in rural areas, and the typical poor person in Uzbekistan is most likely to be an Uzbek countrywoman.

Major attempts at income redistribution would create a heavy burden on the public budget and affect labour and production incentives adversely. Although it is hoped that economic growth will eventually help the poorest groups in the population, the Government of Uzbekistan has attempted to support subsistence levels of income even at the cost of a comparatively slower transition to a market economy. Public expenditures have not been pared to the same extent as in other CIS countries and expenditures on education and healthcare have increased. These expenditures have also been redirected to meet the needs of the public. For example, spending on health care has focused on increasing the number of out-patient centres instead of increasing the number of beds, while medical training has concentrated on producing more general practitioners rather than specialists. An important thrust of social protection measures to prevent severe social stratification has been the recent adoption of programmes for raising living standards for vulnerable groups, including by fostering entrepreneurship and self-employment. In this regard, more attention is being given to coordinating microcredit programmes supported by donors.

⁴ This section draws on K. Malik, "Poverty and income in Uzbekistan and other Central Asian countries", *Ekonomicheskoye Obozrenie*, Centre for Economic Research, Tashkent, pp. 20-25, January 1998; and R. Pomfret, "A comparative study of national poverty reduction strategies: Uzbekistan, Kazakhstan, Kyrgyzstan", *Ekonomicheskoye Obozrenie*, Centre for Economic Research, Tashkent, pp. 30-32, January 1998.

G. Conclusions

In general, the impact of globalization on economic development in different countries is closely related to their competitiveness. Globalization has benefited those countries that have managed to create the most favourable conditions for entrepreneurial activity and the attraction of FDI through developing efficient financial systems and fostering economic development based on comparative advantage. Countries that have failed to create those conditions have lost out.

The unfavourable initial conditions that Uzbekistan inherited at independence, such as a heavy reliance on the production of primary commodities, lack of economic infrastructure, its doubly landlocked position and its demographic situation, continue to hinder the realization of its economic potential. There is also a predisposition to taking a relatively cautious approach to reform and economic openness, seen in the sharp increase in protectionism and financial regulation in the late-1990s following the Asian financial crisis and the deterioration in the country's terms of trade.

The need to ensure sustainable development and resolve a number of socio-economic problems demand attracting significant new investments embodying new technologies and mastering modern efficient forms for organizing production and labour and improving human resources. This is impossible without deep participation in the world economy. Developments in many spheres have not, however, been conducive to meeting these challenges. In particular, the present system of foreign exchange regulation distorts incentives for investment. Taxation is high and the tax system complex, increasing the danger of capital flight. Inadequate financial markets and a weak banking system do not encourage domestic and foreign investment and hinder the formation of large enterprises. Regulations governing FDI are bureaucratic and complex. The significant presence of the State in basic economic sectors as well as State regulation of economic activity through a cumbersome, non-transparent process hinders the development of the private sector.

Nevertheless, important measures were undertaken recently in liberalizing the financial sector and foreign trade in Uzbekistan and in the areas of fiscal reform, reduced State control of economic activity, privatization and foreign investment. Uzbekistan is planning to join WTO and is currently implementing a series of measures approved by international financial organizations that will, it is hoped, bring about rapid integration of the country in the world economy, enabling it to take advantage of the opportunities offered by globalization, for the sake of the people.

READERSHIP SURVEY

The Poverty and Development Division of ESCAP is undertaking an evaluation of the publication, *Managing Globalization in Selected Countries with Economies in Transition*, with a view to improving the usefulness of future publications to our readers. We would appreciate it if you could complete this questionnaire and return it, at your earliest convenience, to

Chief
Poverty and Development Division
ESCAP, United Nations Building
Rajadamnern Avenue
Bangkok 10200, THAILAND

QUESTIONNAIRE

Rating for quality and usefulness
(please circle)

Excellent Very good Average Poor

1. Please indicate your assessment of the quality of the publication on:

• Presentation/format	4	3	2	1
• Readability	4	3	2	1
• Timeliness of information	4	3	2	1
• Coverage of subject matter	4	3	2	1
• Analytical rigour	4	3	2	1
• Overall quality	4	3	2	1

2. How useful is the publication to your work?

• Provision of information	4	3	2	1
• Clarification of issues	4	3	2	1
• Its findings	4	3	2	1
• Policy suggestions	4	3	2	1
• Overall usefulness	4	3	2	1



3. Please give examples of how this publication has contributed to your work:

.....
.....
.....
.....

4. Suggestions for improvement of the publication:

.....
.....
.....
.....

5. Your background information, please:

Name:
Title/position:
Institution:
Office address:
.....

Please use additional sheets of paper if required to answer the questions. Thank you for your kind cooperation in completing this questionnaire.



This publication may be obtained from:

Chief
Poverty and Development Division
Economic and Social Commission for Asia and the Pacific
Rajadamnern Avenue
Bangkok 10200, Thailand

Tel: (662) 288-1610
Fax: (662) 288-1000, 288-3007
Telex: 82392 ESCAP TH, 82315 ESCAP TH
Cable: ESCAP BANGKOK

كيفية الحصول على منشورات الأمم المتحدة

يمكن الحصول على منشورات الأمم المتحدة من المكتبات ودور التوزيع في جميع أنحاء العالم. استعلم عنها من المكتبة التي تتعامل معها أو اكتب إلى : الأمم المتحدة، قسم البيع، نيويورك أو في جنيف .

如何购取联合国出版物

联合国出版物在全世界各地的书店和经售处均有发售。请向书店询问或写信到纽约或日内瓦的联合国销售组。

HOW TO OBTAIN UNITED NATIONS PUBLICATIONS

United Nations publications may be obtained from bookstores and distributors throughout the world. Consult your bookstore or write to: United Nations, Sales Section, New York or Geneva.

COMMENT SE PROCURER LES PUBLICATIONS DES NATIONS UNIES

Les publications des Nations Unies sont en vente dans les librairies et les agences dépositaires du monde entier. Informez-vous auprès de votre libraire ou adressez-vous à : Nations Unies, Section des ventes, New York ou Genève.

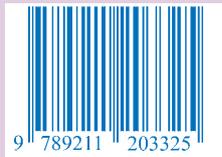
КАК ПОЛУЧИТЬ ИЗДАНИЯ ОРГАНИЗАЦИИ ОБЪЕДИНЕННЫХ НАЦИЙ

Издания Организации Объединенных Наций можно купить в книжных магазинах и агентствах во всех районах мира. Наводите справки об изданиях в вашем книжном магазине или пишите по адресу : Организация Объединенных Наций, Секция по продаже изданий, Нью-Йорк или Женева.

COMO CONSEGUIR PUBLICACIONES DE LAS NACIONES UNIDAS

Las publicaciones de las Naciones Unidas están en venta en librerías y casas distribuidoras en todas partes del mundo. Consulte a su librero o diríjase a: Naciones Unidas, Sección de Ventas, Nueva York o Ginebra.

Printed in Bangkok
November 2003 – 440



United Nations publication
Sales No. E.03.II.F.58
Copyright © United Nations 2003
ISBN: 92-1-120332-5
ST/ESCAP/2274