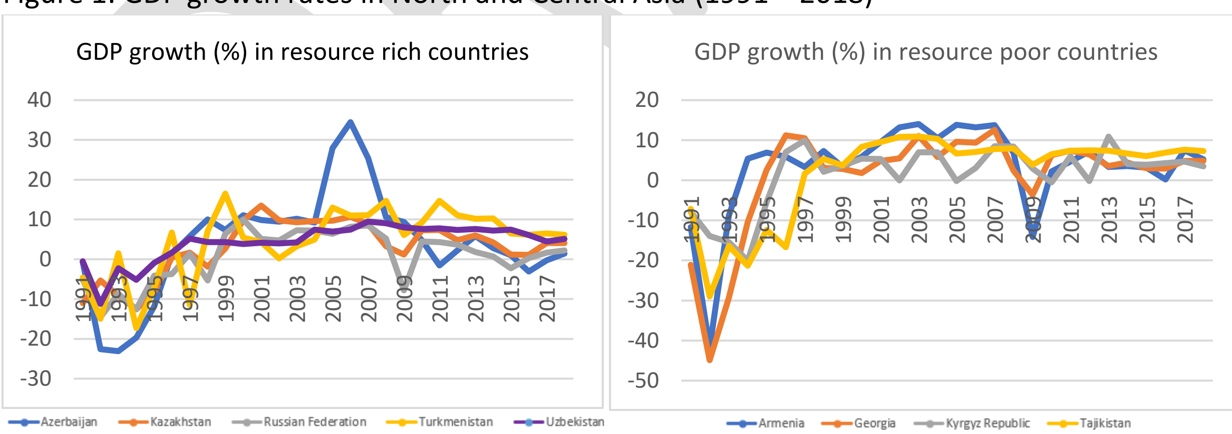
Preliminary paper: Structural Economic Transformation in NCA

Economic growth and development in North and Central Asia

Economic growth and development in North and Central Asia countries are heavily influenced by geopolitical factors and socioeconomic structure. Since the transition into a market-driven economy in 1991, the countries of North and Central Asia have recorded considerable economic growth. This growth was also driven mainly by the expansion of the extractive industry and spurred on by high prices in oil, gas and minerals. In most resource-rich countries, economic growth rates exceeded 7-8% for almost a decade, sometimes achieving up to 35% of annual economic growth (such as Azerbaijan in 2006). In contrast, countries that did not have the same scale of natural resources had to look for alternative means for growth. Kyrgyzstan evolved initially as a major hub for re-exporting goods from China, whereas other countries such as Tajikistan and Uzbekistan benefited from an increased flow of remittances.

Despite the recorded economic growth, the overall development model remained suboptimal in terms of efficiency of public investment, reducing informal employment, encouraging non-commodity export and promoting inclusive economic growth (ADB, 2019). As seen in Figure 1, the slump of the global economy and commodity prices in 2008 interrupted this resource-based growth, which in turn affected the development agenda in the region. Against the declining economic growth, the pace of poverty reduction has also slowed down in all the countries of the region while household incomes are growingly supported through consumer lending, pointing towards a worrying trend for the situation of household debt. Despite the initial positive contribution of household debt towards economic growth, continued increase in household debt may heighten the probability of a financial crisis.

Figure 1: GDP growth rates in North and Central Asia (1991 – 2018)



The decreasing growth rates in the North and Central Asia region might continue to have negative spillovers in the years to come. The World Bank estimates that growth rates in the region would remain slightly above 2% should it continue to be “business as usual”. Estimates based on the International Futures Model by The Frederick S. Pardee Center suggest that in the case that economic growth in the region does not exceed 2.2% per annum, setbacks from the

baseline level of 2015 would be observed in terms of health, education and manufacturing indicators. Hence, reviving economic growth in the short term could enable the implementation of development activities, but new growth models need to be identified to ensure the sustainability.

The decreasing growth rates drove countries in North and Central Asia to search for new developmental strategies. Among these strategies, structural transformation and connectivity as a means for integrating into broader value chains are identified as common priorities for countries in the region. This is in line with the Vienna Programme of Action (VPoA) calling to prioritize structural economic transformation for landlocked developing countries, as most countries in the North and Central Asia region are landlocked. Structural transformation is associated with reallocation of factors production to maximize productivity, product sophistication and diversification, as well as integration into broader value chains to generate higher value. Such transformation is aimed at reducing the negative impacts of geographical disadvantages and external shocks and is expected to create jobs and promote inclusive growth.

Structural transformation in North and Central Asia happened at markedly different paces. Comparing the employment share by sector, Russia and Kazakhstan had seen a significant decrease in employment in the agriculture sector between 1991 and 2019, implying that more labor is now being employed in the manufacturing and services sector. This is however not the case for countries such as Georgia and Tajikistan where the agriculture sector still employs a large share of the labor force. The manufacturing sector’s share of employment remains low in many of the North and Central Asian countries, indicating potential for further industrialization. The patterns of industrialization in North and Central Asia will be discussed in the next section.

Generally, a shift from agriculture to manufacturing has characterized successful transformation processes for several Asian countries such as Republic of Korea, Malaysia and Thailand. However, policies and efforts for structural transformation in North and Central Asia need to keep in mind the realities – comparative advantages and limitations – of the region. Instead of looking at labor movements from one sector to another, it might be more relevant to focus on measures to improve the productivity levels across all sectors in order to drive economic growth and development as it was found that labor productivity levels remain relatively low across most of North and Central Asia countries compared to other developing countries (ESCAP, 2019).

Structural transformation has the potential to positively contribute to achieving sustainable economic growth and development in North and Central Asia countries with concerted policies that consider the realities of each country. These policies need to be complemented by efforts to develop infrastructure, promote trade and investment opportunities and upgrade skills of workers in order to ensure inclusive growth.

Country specific developments

Armenia

Since 1991, Armenia experienced several economic and geopolitical challenges, among them the loss of market shares for many large enterprises, increase of energy prices (Armenia is an energy importer) and war over Nagorno-Karabakh which caused blockades and disruptions in trade. As a result, GDP growth rates during 1991-1993 was negative, with the lowest rate – 42% in 1992. The government of Armenia implemented strong monetary and fiscal policies, which resulted in hyperinflation recovery from 5000% in 1994 to less than 1% in 1999.

Armenia introduced several government development strategies in the past decade. In the development strategy for 2017-2022, the government focuses a lot on energy independency through the means of electricity market liberalization, development of long-term power system program and introducing the draft of the law on energy. The benefits to this strategy is yet to be observed, as historically, the development process in Armenia has been slow due to insufficient resources, especially in privatized state enterprises. As a result, the number of operating enterprises has decreased, which led to growth in unemployment rates. Despite development programs initiated by the government, the situation with poverty did not improve much, showing 32% of population below poverty line in 2019 compare to 35.8% in 2009 and 45% in 2000 (World Bank indicators).

Azerbaijan

Generally, all the state programs introduced by the Azerbaijan government recently aim at economic diversification and strengthening the non-oil sector. However, investments flow in the country help maintain the dominant position of oil and gas in the energy sector and the economy.

For the last decade petroleum products export in Azerbaijan has been the main driver of economic growth, but the main task at this stage is to achieve the rapid development of the non-oil sector, increase the economy effectiveness and competitiveness, and to ensure its progress on an innovative basis. According to OECD, petroleum products account for 90% of the country’s exports, and oil and gas industry forms from 33% to 50% of total GDP depending on oil prices. Due to higher exports in natural gas, the hydrocarbons sector growth amounted 1.1%. However, without introducing new reforms on private sector investment, human capital development, reducing government influence, and competitiveness increase, the economic growth of the country in medium term will be temporary, as the sector depends on rising gas exports.

Nevertheless, in recent years, Azerbaijan significantly improved its investment climate, by strengthening institutional, regulatory and operational conditions for the activities of companies in the country: in 2019 the country ranked 25th in the ranking of ease of doing business compared to 57th in 2018. The country proclaimed the goal of diversifying foreign direct investment and reorienting from coal, oil and natural gas to infrastructure and industry, towards achieving structural transformation.

Georgia

Georgia's economic development can be divided into four phases: (i) 1990-1994, when the GDP growth rate showed the worst decline in the region at -45% in 1992; (ii) 1994-2003, stabilization and early reform phase, with GDP growth rate on average 8.2%; (iii) 2003-2012, liberalization and premarket reforms, when GDP growth rate on average was 6.7%; (iv) 2012-2018, social reforms, GDP growth rate on average was at 4.3%. During the second phase, the country achieved macroeconomic stability and restored security. First steps in agricultural enterprises privatization, legal framework on financial services development and health and education sectors improvement were taken. Liberalization and premarket reforms were undertaken which focused on corruption reduction and helped simplify the process of starting business.

Georgia's GDP growth rate fluctuations were mainly a result of the country's economy vulnerability to external shocks (as an example, Russian crisis in 2009). Remittances from Georgian migrant workers, mainly from Russia, were until recently the most reliable and least volatile source of external monetary inflow that compensated inadequate employment opportunities at home. Stable economy development resulted in poverty reduction from 54% in 1999 to 9.2% in 2009 (Index Mundi). Growth has been driven mainly by services sector, the share in GDP of which accounted 68% in 2018. Agriculture (8% of GDP in 2018) has lagged in terms of productivity improvements and manufacturing sector (24% of GDP in 2018) was stagnating. Main industrial sectors of Georgia include mining sector (ores, slag, ash), beverages, vehicles, tobacco, pharmaceuticals, fruits and nuts, fertilizers, gems and precious metals and machinery including computers. These commodities account for 75.4% of the overall value of its global shipments.

Kazakhstan

Since its independence, Kazakhstan experienced three stages of development: (i) 1991-1996, this stage focused on strengthening and developing the political, economic systems and statehood of the republic. (ii) 1996-2012, this stage began with the adoption of Kazakhstan 2030 strategy which aimed at sustainable economic growth through diversification of production and FDI attraction. During this period, several specialized institutes were created – National Fund, Development bank of Kazakhstan, Investment fund of Kazakhstan and National Innovation Fund with the aim to stimulate entrepreneurship and create new industries as manufacturing. (iii) 2015 onwards, when the former President proposed Five institutional Reforms including State program for innovative and industrial development, which aimed at the stimulation of the manufacturing industry competitiveness, increase labor productivity and export of processed goods.

Despite these programs aimed at industrial development, industry value added as a percentage of GDP in Kazakhstan does not show any significant growth. It recorded a decrease in value added since year 2000 (38%), amounting 33% in 2018. According to EBRD transition reports, GDP growth in the country is primarily supported by recovery in oil exports and stronger activity in the construction, agriculture and transport sectors, amounting 4.1% in 2018.

Kyrgyzstan

Kyrgyzstan suffered the worst economic decline in the region after the Soviet Union collapse, followed by hyperinflation, high unemployment and impoverishment. Since independence, Kyrgyzstan has undertaken several reforms including land reforms, introduction of the national currency, privatization of state enterprises and reduction of import tariffs. However, the industrial base was almost abolished and contributed to the limited growth and development of the country. For the last five years, annual GDP growth was recorded at 4.2% on average and share of industry in GDP accounted for 27% in 2018, showing signs of economic stabilization.

The country's economy is heavily dependent on the exploitation of natural resources, similar to other countries in North and Central Asia. Kyrgyzstan's main source of income is gold mining, with the country being the fifth largest gold mine in the world. Remittances also account for a large part of the country' GDP at almost 25%, while foreign aid and loans are also a main contributor the economy. A significant share of the nation's remittances inflow is from labor migrants in Russia, Kazakhstan and the United States. As a result of the country's membership in the Eurasian European Union and Russia's economy growth, the inflow of remittances is increasing. Recent reports from the World Bank reclassified Kyrgyzstan from low-income to lower-middle income group.

Russian Federation

Like all other ex-Soviet Union countries, Russia has undergone several significant changes in its economic structure. In early 1990's, economic reforms included privatization of the industry, except for energy, transportation, banking and defense related sectors. The annual GDP growth graph shows that all post-Soviet Union countries' economies are highly influenced by world commodity price fluctuations. Russia is not an exception. After a recession in 2015 (oil price fall, international sanctions, and structural limitations), GDP started to recover in 2017 growing 1.5%, mainly driven by exports, private consumption, falling inflation,

The share of industry in GDP in Russia fell from 46% in 1991 to 34% in 2000 and 30% in 2010. Since 2010, there was no significant growth in the sector, comprising 32% in 2018. The industrial sector of Russia is diverse, covering complete range of mining and extractive industries, all forms of machines buildings, road and rail transportation equipment, communications equipment, agricultural machinery, construction equipment, electric power generating and transmitting equipment, medical and scientific instruments and consumer durables. Among the government's initiatives to facilitate economic growth and development include project financing, guarantees, industry support fund, industrial parks, government procurement and public-private partnerships. All these support measures are aimed at import substitution and export expansion of non-oil products. Russia is also a leading country in the region in the number of free economic zones. These economic zones are mainly targeted towards industrial sectors, with increasing focus on innovation and tourism sectors.

Tajikistan

Average GDP growth rate in Tajikistan for the last 10 years grew at an average of 7.5%, and in 2017 sector composition of GDP stood at 29% for agriculture, 46% for services and 26% for industry, showing the increasing prominence of the service sector. After the end of a civil war in 1997, main contributions to economic growth and stability were from remittance inflows and international prices for aluminum and cotton, which are the country’s dominant exports. The five-year civil war damaged most of the country’s infrastructure, as well as disrupted agricultural and industrial production. During the period of 1991-1997, GDP rate declined by 14.4% on average, and main reforms were focused on political stability. After the civil war, Tajikistan government aimed to achieve economic growth and initiated poverty reduction strategies, which resulted in a decrease of in the percentage of population below poverty line in Tajikistan from 46.7% in 2009 to 31.5% in 2019. However, development gaps still exist across the country and major transformation in the economic structure would be required to achieve sustainable economic growth.

Industrial sector strategies of Tajikistan mainly focus on aluminum, construction materials, cotton, minerals and precious stones production. However, main drivers of economic growth were agriculture and services, as industrial sector contributed at minimal level. This could signify opportunities to improve productivity of the industrial sector in order to promote industry-led growth. The contribution of services is mainly driven by remittances inflow, which makes the country’s economy vulnerable to external shocks such as the slowdown of Russia’s economy in 2015.

Turkmenistan

Turkmenistan is another resource dependent and resource rich country in North and Central Asia, with the world’s fourth largest confirmed natural gas reserves. An increase in world commodity price in 2008 significantly contributed to the share of industry value add in the economy of Turkmenistan. However, due to disputes on gas supplies between Russia and Turkmenistan (an explosion of Central Asia-Center gas pipeline system) in the following years, export of gas decreased. Since 2008, several projects on pipeline construction were initiated, one of which is Turkmenistan-Afghanistan-Pakistan-India (TAPI) gas line. The perspective project was launched in 2015 and it plans to provide India and Pakistan with fuel with a chance to expand the export geography to other growing markets of Asia Pacific.

The government of Turkmenistan adopted the national program for Socio-Development for 2011-2030 which comprises four guiding principles: high rates of growth, macroeconomic stability, improved living standards and quality of life, which will be achieved through diversification, innovation and infrastructure development. Initiatives such as providing financial support as subsidization of interest rates on loans, credit guarantees and organization of large-scale training programs and consulting services to small and medium sized enterprises indicates the government’s shift in focus towards an economy less reliant on natural resources.

Uzbekistan

Several reforms in Uzbekistan since 1991 resulted in three major structural changes.

i. A decrease in cotton production and export and an increase in food production which led to self-sufficiency;
ii. Attainment of energy self-sufficiency and an achievement or net fuel export;
iii. An increase in the share of GDP and the share of machinery and equipment in industrial output

Considering that the country is double land locked and not a major oil and gas exporter, Uzbekistan has been quite successful in promoting economic growth compared to other post-Soviet Union countries. There was stable GDP growth since 1994 but the level of per capita income remained low.

Recently, Uzbekistan introduced several reforms to transform the national economy that delivered improvements to the country's business and investment climate. The reforms include changes to the currency and tax systems, opening of the bank sector for foreign investors, lifting state monopolies in some sectors, opening borders with neighbor countries for transport links development and investment opportunities. Other reforms include trade liberalization and resuming efforts on WTO accession. Industrial economic zones has also been established to diversify its economy including special economic zones for fruits, vegetables, and other agricultural goods processing, packaging, and storage, textile, carpet, footwear and leather products, ecologic secure chemical, pharmaceutical, electrotechnical, machinery and automobile, construction materials industries.

Trade and investment

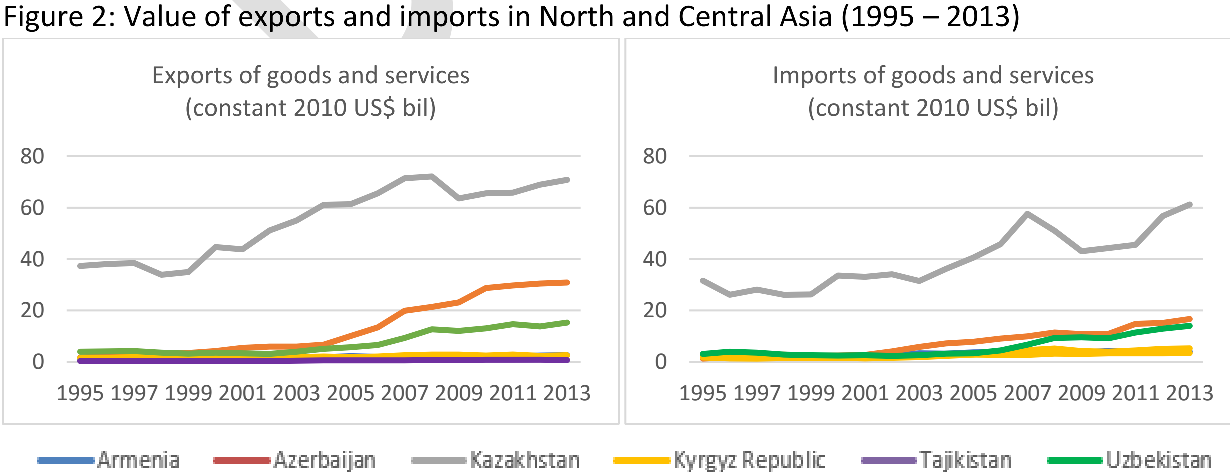
Trade and investment are major factors contributing to economic development and are correlated to patterns of structural transformation. The potential for trade and investment in North and Central Asian countries stems from their geographical location, bordering China and Russia while also being at the crossroads between Asia and Europe. However, limited infrastructure development and political challenges remain to be constraining factors that hinders trade and investment.

Trade and investment policies in the region vary despite the formation of common customs union, economic cooperation initiatives and trade and investment agreements coming into effect. It was stated that sometimes, these policies and agreements led to more conflicts and contradictions rather than promoting regional cooperation and integration (Mukhamediyev & Khitakhunov, 2017).

Compared to other economic blocs in Asia and the Pacific, intraregional trade among North and Central Asia countries is relatively small. The region also trades more with the rest of the world, with the European Union as a major trading partner, compared to the rest of Asia Pacific (ESCAP, 2018). This trade pattern implies a weaker economic integration of this region to the rest of Asia and shows potential for better intraregional trade connectivity through trade diversification and complementarities.

Trade data shows that Russian Federation greatly surpasses the other countries in North and Central Asia in terms of trade volume and hence is omitted from the graphs below. Among the other countries, Kazakhstan leads in terms of import and export value with rapid growth recorded between 2000 and 2008. Kazakhstan's higher value in trade could be contributed to its progressive policies initiated since its independence, which also contributed to economic growth and development. Though natural resources is still the main export commodity for North and Central Asia countries, service exports in the region has increased significantly, especially in travel and transport related services due to visa exemptions, improved rail and road connectivity as well as the establishment of oil and gas pipelines in the region.

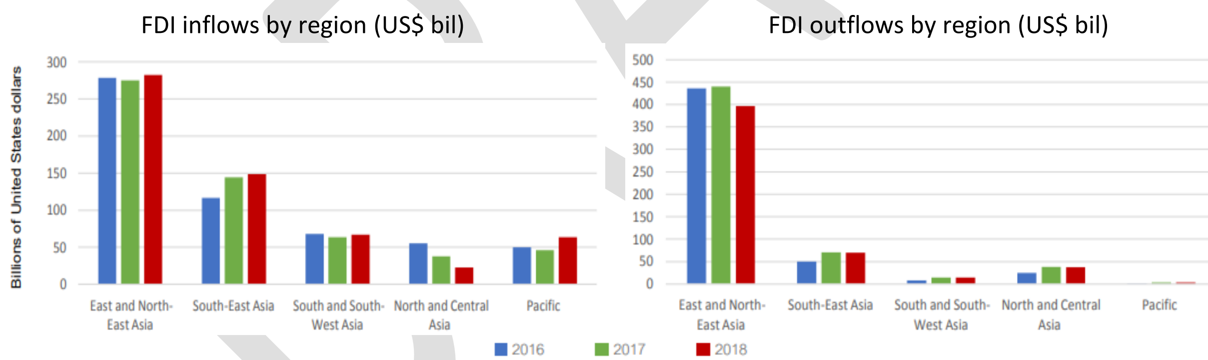
Figure 2: Value of exports and imports in North and Central Asia (1995 – 2013)



The import structure for most North and Central Asian countries did not changed much over the past couple decades, with machineries still dominating as the main imported good. However, there has been some geographical reorientation in terms of the country of origin of these imported goods. Although Russian Federation is still a main source for imports for many of the North and Central Asian countries due to economic and political ties inherited from Soviet Union times, in the recent decade, there has been a decrease in the share of imports from Russia which has been captured by China and to a lesser extent, other North and Central Asian countries. As with the case of exports, Kazakhstan leads in terms of import value and maintains a positive trade balance.

Based on the Asia-Pacific Trade and Investment Trends 2019/2020, North and Central Asia is the only region in Asia and the Pacific which recorded a decrease in foreign direct investment inflows in 2018, logging a steady decline in FDI inflows since 2015. Almost all countries in the region recorded double digit decline in FDI inflows, except Armenia, Tajikistan and Uzbekistan. Similar to its trade composition, investments in North and Central Asia countries are heavily focused on natural resources and commodities such as the oil and gas sector. Hence, unstable commodity prices in recent years had negatively impacted the inflow of investments and hampered economic growth. Among the countries with an increase in FDI inflow, Uzbekistan recorded remarkable growth of 322% at US$ 412 million. This could be contributed to the government's initiatives in liberalizing business and investment processes.

Figure 3: FDI inflows and outflows in Asia and the Pacific (2016 – 2018)



The integration of North and Central Asia countries through trade and investment has been limited due to the low degree of trade and investment complementarities as production and economic structure is highly similar in many countries in the region. Regional cooperation and integration need to be strengthened not just through harmonizing trade and investment policies but also in terms of the development of infrastructure in order to realize economic gains and facilitate structural transformation.

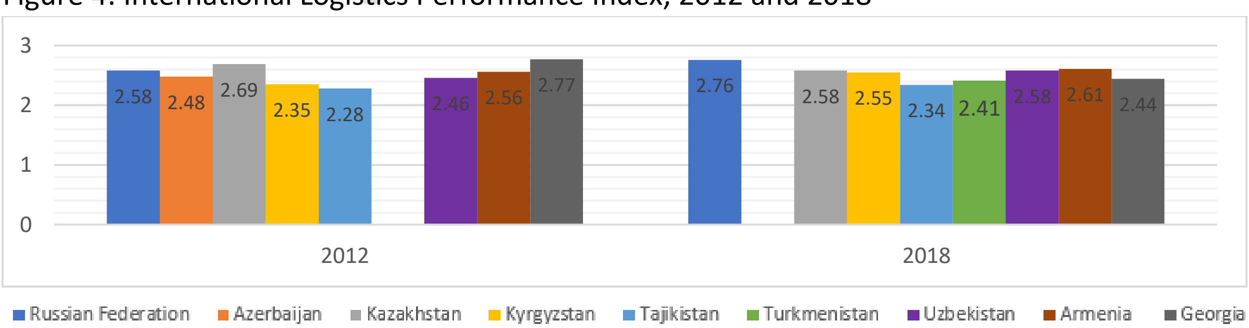
Infrastructure development and connectivity

Infrastructure development and connectivity are important factors to sustain economic growth and promote structural transformation, especially in North and Central Asian countries which are landlocked. Many studies have shown that infrastructure development positively contributes to structural transformation, especially when infrastructure projects are planned and designed as part of wider national or regional development strategies, as better infrastructure leads to increase in productivity and lowers the cost of doing business.

In North and Central Asia, governments are increasingly placing importance on development strategies with infrastructure connectivity as a main component, recognizing its strategic importance in modernizing their economies and in integrating the economies of North and Central Asia intra-regionally and with the rest of the world. It is important to recognize that infrastructure development and connectivity in the region is of a transboundary nature that needs to be addressed through regional cooperation and collaboration. However, structural factors such as weak regulatory frameworks, economic asymmetries and geopolitical conflicts had limited the cooperation process. In order to realize the envisioned provisions of roads and railways, water and power supplies, as well as telecommunications and digital infrastructure, countries in the region need to identify financing and development priorities and to overcome the various structural weaknesses present in the current systems.

Most North and Central Asia countries inherited extensive road and railway infrastructure from Soviet times. The strategic importance of these road and railway networks is shown by the fact that many have been identified in international frameworks and agreements such as the Intergovernmental Agreement on the Asian Highway Network, Transport Corridor Europe-Caucasus-Asia (TRACECA) and the Intergovernmental Agreement on the Trans-Asian Railway Network, as the region is situated at natural crossroads of North-South and East-West transport corridors. Despite progress in transport coordination in the region, transport and logistics costs remained high while implementation and enforcement of policy agreements remained lacking. In recent years, international initiatives such as the Belt and Road Initiative, Connecting Europe and Asia Strategy have increased investments on road and railway significantly. In line with new infrastructure investments, emphasis also needs to be placed upon the maintenance and upgrade for existing infrastructure in order to ensure consistency and uphold standards.

Figure 4: International Logistics Performance Index, 2012 and 2018



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