REGIONAL ECONOMIES

TURNING THE CORNER: THE ECONOMIC REVIVAL OF CENTRAL ASIA

Malcolm DOWLING

Visiting Professor at Singapore Management University (Singapore)

Ganeshan WIGNARAJA

Senior Economist, Asian Development Bank (Manila, Philippines)

1. Introduction

The Central Asian Republics (CARs) occupy a strategic position straddling East and West and have a significant development potential. In the aftermath of transition, however, the CARs witnessed a period of prolonged slow and negative growth and a rising incidence of poverty.[1] Many

The views expressed in the paper are solely the responsibility of the authors and cannot be attributed to the organizations to which they belong.

[1] A plethora of literature exists on the history, strategic significance, economic record and reform experience of Central Asia during the first decade of transition to a market economy. For a selection, see: S.F. Starr, "Making Eurasia Stable," *Foreign Affairs*, January-February 1996, pp. 80-92; idem, "Central Asia in the Global Economy", *Foreign Policy*, September-October 2004; E. Trushin, E. Trushin, "Basic Problems of Market Transition in Central Asia," in: *Central Asia and the New Global Economy*, ed. by B. Rumer, M.E. Sharpe, New York, 2000; R. Pomfret, K. Anderson, "Economic Development Strategies in Central Asia Since 1991," *Asian Studies Review*, Vol. 25, No. 2, 2001, pp. 185-200; N.F. Campos, F. Coricelli,

factors have been put forward to explain the difficult transition experience, including the disruption in production and economic relations existing in the former Soviet Union, the collapse of aid as it was in the former Soviet Union, the nascent private sector, the lack of capital markets, the limited number of institutions required for a market economy, and the gaps in infrastructure.

Nevertheless, Central Asia seems to have turned the corner during the last few years. Economic growth, which accelerated to historically unprecedented levels, has been driven by high commodity prices—particularly for oil and natural gas—and buyout demand, increasing inward investment, improved macroeconomic management, and development of infrastructure.[2] There are signs that oil-and-gas-sector-led growth has stimulated the development of the services sector (construction and banking), as well as some manufacturing activities. There are also indications that economic prosperity has been accompanied by job creation and some reduction in poverty. There is optimism in Central Asia's political circles with some even predicting that the region will join the ranks of middle income countries within a decade or so.

Against this backdrop, this paper reviews the characteristics of the boom that has evolved since 1997, with particular reference to macroeconomic developments and poverty. Distinctions are drawn between the economic structure and performance of resource-rich (oil and natural gas) economies and other CARs which have fewer resources. Drawing on this analysis, the outlook for the CARs for the next ten years is projected against a background of global prospects. The paper also seeks to guide CARs' policymakers by suggesting the direction of future economic performance, as well as indicating key policy issues. As long-run forecasts can change in response to external events, the risks for the CARs' outlook are also highlighted.

2. Accelerating Economic Performance

Growth and Inflation

After nearly a decade of dismal economic performance following the breakup of the Soviet Union, the Central Asian republics have been demonstrating booming economic performance since 1997. From 1997 to 2001, the GDP grew by nearly 6% per annum compared with the negative growth in the previous five years (see Table 1). In the next three years, growth accelerated to a spectacular 9.7%, the highest in the post-transition period for any group of countries in the Soviet expanse and a performance that compares favorably with the fastest-growing economies in Asia and the rest of the developing world.

The high energy prices and investments in the oil and gas sector, including petrochemicals, were the main growth drivers in the three oil-exporting economies of Azerbaijan, Kazakhstan, and Turkmenistan. In Azerbaijan, oilfield and pipeline investment, as well as natural gas development have

"Growth in Transition: What We Know, What We Don't and What We Should," *Journal of Economic Literature*, XL, September 2002, pp. 793-836; *Transition: The First Ten Years: Analysis and Lessons for Eastern Europe and the Former Soviet Union*, World Bank, 2002, Washington DC; S. Zhukov, "Central Asia: Development Under Conditions of Globalization," in: *Central Asia: A Gathering Storm*, ed. by B. Rumer, M.E. Sharpe, New York, 2002; E. Loukoianova, A. Unigovskaya, "Analysis of Recent Growth in Low-Income CIS Countries," *IMF Working Paper*/04/151, 2004.

[2] In its first regional economic outlook for the Middle East and Central Asia, the IMF notes that "a favorable external environment combined with generally sound economic policies to produce strong macroeconomic performance for the countries of the Middle East and Central Asia in 2003 and early 2004…Prospects are for continued strong performance through 2005" (*Middle East and Central Asia: Regional Economic Outlook*, International Monetary Fund, Washington DC, 2004, p. 2).

Table 1

Current Economic Performance in Central Asia

Country	Real GDP Growth % per year		Manufactured Exports per Capita, $	Per Capita Income, $	Poverty Incidence, % of Population (b)
	1997-2001	2002-2004	2003	2003	Latest
Oil Exporters					
Azerbaijan	9.5	10.6	16.4	865.0	49.6
Kazakhstan	5.2	9.5	142.1	1,995.0	27.9
Turkmenistan	10.2	21.3	46.9	1,236.0	29.9
Non-Oil Exporters					
Kyrgyz Republic	5.3	4.7	38.2	344.0	52.0
Tajikistan	5.9	9.9	39.7	207.0	56.6
Uzbekistan	4.4	5.3	30.7	389.0	27.5
CARs	6.1 (a)	9.7 (a)	57.1	839.3	40.6

Notes: (a) Weighted average, GDP weights.
(b) National poverty lines.

Sources: Calculated from ADB Asian Development Outlook, various; ADB, *Poverty in Asia*, Asian Development Bank, Manila, 2004; World Bank World Development Indicators 2005; national sources.

contributed to a strong growth environment. In Kazakhstan, oil and natural gas investments have been a source of rapid expansion. In addition, economic diversification has begun recently as food processing, machinery, oil refining and chemicals showed strong growth.

Among the non-oil economies, growth in the Kyrgyz Republic averaged around 5% beginning in 1997 and accelerated further to 7% in 2003 and 2004. A buoyant minerals sector led by gold exports expanded rapidly. Uzbekistan's economy grew steadily at just over 5%, beginning in 1997, as agricultural production benefited from restructuring and privatization, as well as from favorable cotton prices. Per capita income has also grown dramatically, since population growth remained low. By the end of 2003, per capita income increased to an average of $840.8.[3] In Tajikistan, the

[3] Despite these recent gains in income growth, per capita income in the CARs remains low by international standards as they are categorized as low income countries (with the exception of Kazakhstan, which is a middle income country).

end of civil war served as the main impetus for expansion as GDP growth averaged about 10% during 2002-2004.

Macroeconomic stability, empowered by inflation, has also improved. Inflation rates have fallen significantly throughout the region over the past few years, indicating improved macroeconomic stability. Average inflation for the CARs as a group declined from 20.4% to 6.9% between 1997-2001 and 2002-2004. Furthermore, both oil exporters and non-oil exporters were typically able to contain inflation in 2002-2004 at levels lower than in 1997-2001. This may be partly the result of greater fiscal and monetary discipline, as well as greater stability in the exchange rate and moderate inflation worldwide. The Kyrgyz Republic (3%) had the lowest inflation among the CARs in 2002-2004, while Tajikistan, with double-digit inflation, had the highest.

Structural Change

This boom has been driven by structural changes in the economies and has resulted in a shift toward the production of industrial goods and minerals and away from agriculture.[4] While oil and gas continued to drive the industrial sector, the rest of the industrial sectors and manufacturing also grew rapidly. The share of industry in the GDP and manufacturing value added increased. For example, manufacturing value added increased by over 25% per annum in Azerbaijan and 10% per annum in Kazakhstan between 1998 and 2003. Manufacturing value added per capita also increased. By 2003, Kazakhstan had the largest industrial base, while the Kyrgyz Republic had the smallest. The remaining CARs fall in between these extremes.

The recent industrial recovery in the CARs is closely linked to the performance of manufactured exports, which grew about 10% per annum for the region as a whole between 1998 and 2003. Both oil and non-oil exporters had respectable manufactured export growth, although the former (11.0%) was somewhat higher than the latter (7.8%). By 2003, manufactured exports per capita in Kazakhstan were more than three times higher than those of the other CARs (see Table 1). The structure of manufacturing and manufactured exports varies from country to country. Textiles and garments comprise over 80% of manufactured exports in Tajikistan and Turkmenistan (driven in part by foreign investors from Turkey and Korea) and about 37% of the Kyrgyz Republic's manufactured exports. Meanwhile, Kazakhstan's manufactured exports are dominated by iron and steel with some focus on chemicals and plastics, as well as on machinery and transport equipment. Azerbaijan also has a mix of iron and steel, chemicals, and machinery.

External Developments

External sector performance has generally improved compared with the past as exports have grown more rapidly. This improved trade performance, particularly since 1997, has been driven by developments in the minerals and metals sector in the oil-exporting countries and by prices for gold and cotton in the non-oil-exporting economies. Manufacturing has also been buoyant and the overall performance has improved dramatically compared with a decade ago. Between 1997 and 2004, overall export growth from the oil- exporting CARs was strong, averaging about 18% per annum. In the non-oil-

[4] Nevertheless, the pace of structural change in Central Asia has been slower than those witnessed in the high performing Asian economies such as South Korea, Malaysia and the Peoples Republic of China (see: G. Wignaraja, A. Taylor, "Benchmarking Competitiveness: A First Look at the Manufacturing Export Competitiveness Index," in: *Competitiveness Strategy in Developing Countries,* ed. by G. Wignaraja, Routledge, London, 2003).

exporting countries in the region, export performance accelerated after 2001. By 2004, export growth in the Kyrgyz Republic, Tajikistan, and Uzbekistan averaged over 20%. In the Kyrgyz Republic, export growth has fluctuated between negative and strong growth, primarily because of movements in gold prices and exports of gold and petroleum products. In Tajikistan, exports of cotton and aluminum steadily increased as the economy continued to recover. In Uzbekistan, export growth picked up dramatically in 2003 and 2004 on the back of higher prices for gold and cotton.

The boom has increased government revenue and has helped fiscal performance and reduced reliance on external borrowing. As a result the total debt for the CARs has typically fallen as a % of the GDP. In 2004, the total debt of the region (aside from Kazakhstan) was just over $8 billion, and it has not increased substantially since the late 1990s. In 2004, the debt service ratio was highest in Tajikistan and Kazakhstan at 49% and 26%, respectively, and less than 20% in the other countries. A worrisome development in Uzbekistan is that the debt service ratio has been increasing steadily.

There are also signs that foreign investors are beginning to take greater interest in the CARs. This is reflected by strong inflows into the oil rich exporters. This is a classic example of natural resource seeking FDI (mainly from the United States, EU, and Russia) and has brought with it capital, foreign technology, and western management expertise to facilitate the efficient development of oil and gas exports. Most of Central Asia's FDI since the mid-1990s has gone to Kazakhstan, which has by far the largest potential for further economic development. Such FDI is concentrated in the oil and gas industry, but has gradually spilt over into electricity, metals, manufacturing, and banking. In the last several years, however, there has also been a dramatic increase in FDI flows to Azerbaijan to the extent that by 2003 FDI of $2.3 billion slightly exceeded that in Kazakhstan ($2.2 billion).

It is striking that FDI in the three non-oil-exporting CARs is negligible, amounting to only $107.5 million in 2003. The lack of natural resources, high transaction costs due to landlocked terrains, vast distance from markets, and perceived political risk are among the explanations for the low FDI in non-oil-exporting CARs.

Per Capita Income and Poverty

Despite these recent gains in income growth, per capita income remains low by international standards. In current dollar terms, four out of the six CARs had a per capita income of $600 or less per year in 1997-2001, and these levels were lower than those achieved by China at the time. As Table 1 shows, by 2003 Kazakhstan and Turkmenistan were able to raise per capita income to over $1,200, and the other CARs were also able to make some progress. However, exchange rate movements negated some of these gains.

Growth in government revenue has enabled the governments in the CARs to increase spending on human resource programs. As a result, there has been a gradual improvement in social sector spending for health and education. These expenditures, along with more rapid economic growth, have resulted in an improvement in human resource development indicators and a reduction in poverty.

Poverty line estimates are useful for cross-country comparisons and reveal a variable pattern of poverty incidence in the CARs. Based on estimates made in the late 1990s and early years of the new millennium, national poverty line estimates show that between 25% and 30% of the population was living in poverty in the two oil-exporting CARs—Kazakhstan and Turkmenistan—and in Uzbekistan (see Table 1). In the remaining three CARs (Azerbaijan, the Kyrgyz Republic, and Tajikistan), the poverty estimates were nearly twice as high, ranging from around 50% to 56%. For the CARs as a whole, poverty averages around 41%. Poverty has fallen somewhat in Kazakhstan, where poverty estimates made in the late 1990s were in the range of 40%. It is difficult to determine trends in poverty in the other CARs based on national estimates due to the lack of data. It is worthwhile noting that international poverty line estimates made by the World Bank show somewhat lower levels of poverty and that poverty has been declining slowly.[5]

3. Future Outlook

The pressing question facing the CARs is whether the boom that started in the late 1990s will continue for the next decade. While this is impossible to predict with certainty, we are offering the outcome we believe most likely.

World Outlook

The projections for the CARs are made based on certain assumptions about the future direction of the world economy. The World Outlook is developed with the aid of a world econometric model developed by Oxford Economic Forecasting (OEF 2005). These can be summarized as follows.

- Robust world growth of about 3.3% and buoyant global demand;
- Favorable commodity prices, including oil prices of about $35 per barrel;
- The emergence of China and India as regional economic powerhouses;
- No wars or major disruptions in the region;
- Growing investor confidence (particularly with regard to foreign direct investment);
- Continued implementation of policy reforms at a moderate pace in the CARs.

These forecasts form a global macroeconomic background for analyzing the future prospects for the CARs. We derived our forecasts for the CARs based on initial conditions (e.g. resource endowments and human capital) and the expected pace of implementation of policy reforms. Where events seemed to be evolving smoothly, time trends were used for projections. In other cases, structural changes were incorporated to provide a more comprehensive framework.[6]

Growth

As Table 2 shows, GDP growth in the region is likely to be robust, averaging 7.2% per annum in all the CARs (2005-2015). This is quite high by the historical standards of developing and transition countries. As a group, the oil-rich economies will grow more rapidly than the non-oil economies. Azerbaijan is expected to grow the fastest at around 11% per annum and Uzbekistan the slowest (5%

[5] Although the data are very sketchy and there are issues of data consistency and reliability, the available international poverty line estimates suggest that poverty has declined in several CARs. It seems that greater economic prosperity in recent years has spilt over into employment creation and some reduction in poverty in the region. Furthermore, it seems that the oil exporters typically have a lower poverty incidence than the non-oil exporters (for detail, see: *Central Asia: Mapping Future Prospects*, Asian Development Bank, Manila, 2005).

[6] For more detail, see: Ibidem.

per annum). In between these, Kazakhstan is likely to grow at 7.4%, Tajikistan 6.1%, the Kyrgyz Republic 5.8%, and Turkmenistan 5.8%. This is a strong performance for developing countries in general and even compared with Asian transition economies such as Vietnam, Cambodia, and Laos. Robust growth combined with different endowments and development opportunities suggest that the CARs will emerge as one of world's most dynamically developing regions. There will be significant potential for structural changes and a number of opportunities for trade and international investment in manufacturing, as well as in the booming oil and gas industry.

Table 2

Future Prospects in Central Asia

Country	Real GDP Growth 2005-2015 % per year	Manu-factured Exports per Capita, $ 2015	Per Capita Income, $ 2015	Poverty Incidence 2015, % of Population (b)
Oil Exporters				
Azerbaijan	11.2	37.4	2,829	26.6
Kazakhstan	7.5	365.3	5,248	16.3
Turkmenistan	5.8	136.2	1,959	18.1
Non-Oil Exporters				
Kyrgyz Republic	5.8	57.4	593	32.9
Tajikistan	6.1	83.0	375	31.3
Uzbekistan	5.2	82.3	591	17.8
CARs	7.2 (a)	141	1,933	23.8

Notes: (a) Weighted average, GDP weights.
(b) National poverty lines

Source: Authors' estimates.

Structural Change

Structural changes will occur as a result of increased exploitation of the mineral resource base and industrialization, which is projected to continue. By 2015, total oil and gas exports from the oil-rich CARs will amount to about $32 billion, a nearly three-fold increase from the export value of about $12 billion today.[7]

[7] These projections were based on forecasts of oil prices, production capacity, proven reserves and anticipated developments in transportation (e.g. pipelines).

Oil and gas exports will continue to be the main drivers of economic growth and dynamism in the three oil-rich economies. The proven reserves of oil and natural gas should be sufficient to maintain current and projected future rates of extraction for the next 25 to 60 years in the three oil-exporting economies. Growth in oil and gas exports will be strongest in Azerbaijan following the opening of the Baku-Tbilisi-Ceyhan (BTC) pipeline. This pipeline opens up the European oil market to Azerbaijan and potentially also to Kazakhstan. The BTC pipeline will provide an alternative oil shipment route to Europe, avoiding the high transit charges levied by the Russian Federation. Oil sector growth will slow somewhat in the medium term as prices for oil and gas stabilize at around $35 per barrel and output growth slows as existing pipeline capacity is more fully utilized. Nevertheless, the oil and gas sector will grow faster than the GDP in all the oil-exporting countries.

Economic diversification will continue at a more rapid pace through the expansion of manufactured exports. As Tables 1 and 2 suggest, total manufactured exports per capita in the CARs are predicted to triple to $141 by 2015 (up from $57.1 in 2003). The region's manufactured export base will continue to be dominated by Kazakhstan ($4.8 billion) and Uzbekistan ($2.5 billion). Kazakhstan will continue to have the highest manufactured exports per capita. Turkmenistan comes next. Azerbaijan remains the smallest exporter in terms of manufactured exports per capita. Capital-intensive petroleum products like plastics and petrochemicals, metal products, engineering goods, and some textiles and garments are likely to underlie this manufactured export growth. There is also likely to be diversification of export markets away from Russia as the demand from China and India grows rapidly. Industrialization and structural change will result in a wider variety of products being produced for regional and international markets, help boost per capita income, and result in job creation.

External Sector

The external sector projections focus on the three non-oil-exporting countries (the Kyrgyz Republic, Tajikistan, and Uzbekistan). This is because the external sector accounts for the three oil-producing countries are dominated by oil and gas. As a result, these countries have high enough incomes and sufficient foreign direct investment to go to capital markets for additional resources. The current account deficit is predicted to increase in the Kyrgyz Republic and Tajikistan. These current account deficits will be modest in size, ranging from $200 million per annum in the Kyrgyz Republic to $70 million in Tajikistan for the period 2011—2015. This is because import demand growth to meet various infrastructure and manufacturing project requirements, as well as for some consumer goods is projected to be somewhat stronger than the expansion of exports proceeds. Growth in the current account deficit will be constrained by already high levels of external debt and limited sources of finance for the Kyrgyz Republic and Tajikistan. In Uzbekistan, the current account balance is predicted to remain in surplus over the forecast period as a result of stronger export growth to the Chinese market and continued slow growth in imports. Structural factors and a restrictive policy environment, which discourages trade liberalization, will also inhibit more rapid import growth.

Foreign direct investment (FDI) is expected to rise slowly as the external policy environment improves in the Kyrgyz Republic and (to a lesser extent) in Tajikistan. FDI inflows of $125 million per annum in the Kyrgyz Republic and $75 million in Tajikistan, while modest in size by international standards, will help to offset the rising current account deficit and should contribute to an increase in technology transfer and productivity gains in industry. The slower reforming policy environment in Uzbekistan is expected to keep inflows of FDI growth to around $120 million per annum.

Total outstanding debt as a % of the GDP is expected to decline slowly in the Kyrgyz Republic and Tajikistan and more rapidly in Uzbekistan. The stimulators of debt reduction are increased inflows of FDI in all three non-oil economies, debt restructuring in the Kyrgyz Republic and possibly Tajikistan, remittances in Tajikistan, and the use of some trade and current account surplus to reduce external debt in Uzbekistan.

Per Capita Income and Poverty

Average per capita income for the CARs of just under $2,000 in 2015 will place the region firmly within the ranks of today's middle-income economies.[8] However, there will be significant variation within the region among the oil-rich economies led by Kazakhstan, which have per capita incomes more than six times higher than those of the non-oil economies (see Table 2). With a per capita income of $5,248 by 2015, Kazakhstan will be firmly established as an upper middle-income country. The other two oil-rich economies' per capita income will be comparable to the current per capita income of Russia and Thailand. Tajikistan (per capita income of $375) will remain the poorest CAR and be among the ranks of today's low-income countries ($450 per capita). With just under $600 per capita, the Kyrgyz Republic and Uzbekistan will be somewhat higher and have graduated into the category of lower middle-income countries. Nevertheless, they will remain among the low-income countries in terms of per capita income levels. These forecasts highlight the impact of successful exploitation of oil and gas resources and indicate that there will be increased divergence in the economic prosperity of the oil- and non-oil-rich economies. They also underline the likely emergence of Kazakhstan as a regional growth pole with the potential to promote expanded trade and investment relations with other CARs. Kazakhstan and the two oil-rich economies will also increasingly become a magnet for labor migration from poorer CARs. For the non-oil economies of Tajikistan, Uzbekistan, and the Kyrgyz Republic there will be a continued need for external assistance to raise incomes and reduce the impact of poverty.

Rapid growth in income will facilitate a sustained reduction in poverty in the CARs during the forecast period. As a whole, the incidence of poverty will fall from 40.6% today to about 23.8% in 2015 (see Tables 1 and 2).[9] This means that around 12 million more people will leave the poverty ranks as a result of strong economic performance. While still high, this poverty rate is around the level of poverty in Poland today and slightly less than the current poverty rate in the Russian Federation. The poorest country in 2015 will be Tajikistan, with about a third of its population living below the poverty line. The Kyrgyz Republic will have a somewhat lower incidence of poverty, followed by several other CARs which will be able to bring poverty down to the range of 15-18%. In all the CARs, rural poverty will remain higher than urban poverty, while pockets of urban poverty are likely to persist. An analysis of future trends in poverty suggests that the high rates of rural

[8] S. Zhukov says that to restore income to 1990 levels, the CARs will have to grow at between 4.5 and 5% per annum until 2015 (see: S. Zhukov, "Central Asia: Midterm Economic Prospects," in: *Central Asia and the New Global Economy*, ed. by B. Rumer, M.E. Sharpe, New York, 2000, p. 254).

[9] A crucial aspect of the poverty projection for 2015 was the elasticity of poverty reduction with respect to GDP growth. The reported poverty estimates are somewhat conservative considering the development experience of other Asian economies. Oil-exporting countries were assumed to have somewhat lower poverty elasticities due to the capital-intensity of oil sector and industrial production. Remittance income from overseas workers in the non-oil economies are also taken into account in making poverty assessments for the future. These projections were based on historical information for the CARs, staff estimates of structural change in the poverty-income relationship over time and poverty elasticity's for other Asian countries. On other Asian countries and other developing countries in general see: J.M. Dowling, M.R. Valenzuela, *Economic Development in Asia*, Thomson Learning, Singapore, 2004.

poverty will continue to stimulate rural to urban migration and that international migration is likely to continue at a significant rate. Even though the reduction in poverty will be substantial, some of the poorer CARs will need to devote more resources to reducing poverty by expanding current programs to fight poverty and developing new programs to address the needs of specific target groups. The development of labor-intensive sectors, such as agriculture and tourism, will also contribute to poverty reduction.

4. Risks

There are two fundamental sources of risks associated with the forecasts contained in this paper. The first relates to prospects for the world economy, particularly in industrial countries. The second involves the CARs themselves.

Risks to the global economy

There are a number of risks associated with the forecast that could result in lower growth and poor economic performance of the world economy. Persistent higher oil prices are the most immediate threat. Higher oil prices will slow down growth in the United States and other industrial countries, which will have an adverse effect on the rest of the world through international trade. Another risk relates to future economic performance in China. Much of the income added to the world economy in the past few years was from China's rapid growth, a trend which is built into our forecast. If China is not able to slow its growth gradually, it could result in a sharp economic slowdown which could have serious repercussions on world growth and the rest of Asia.

Risks to the CARs

There are several risks associated with the outlook for the CARs. Some of these risks relate to the outlook for the world economy. These include sluggish growth or a collapse in energy prices and/or weakness in the major commodity exports of the CARs, including cotton, aluminum, and gold. Terrorism is a continuing potential threat to the region, particularly where ethnic tension could surface. Political instability and poor governance pose considerable risks to the CARs' outlook. Particularly relevant is the prospect of prolonged economic and political uncertainty in the Kyrgyz Republic following the sudden change of government, political protests in Azerbaijan, and escalating tensions in Uzbekistan in the wake of the Andijan crackdown.

At the policy level, the timing of structural and policy reforms envisaged in the outlook could be delayed or postponed. These include regional cooperation arrangements in the oil and natural gas sector, which would increase revenue and reduce transit taxes, as well as general regional cooperation measures to deal with trade and transit bottlenecks. Reforms in the non-oil economies which could lift productivity, contribute to diversification of the industrial base, and increase efficiency may also be delayed. Slower economic growth or slower implementation of initiatives to address social sector issues could also have an adverse impact on the anticipated reduction in poverty.

5. Summary and Policy Implications

The overall outlook for Central Asia up to 2015 is positive. The region seems set to join the ranks of middle-income countries driven by robust GDP growth in excess of 7% per annum in the CARs. Furthermore, poverty will fall dramatically to about 23% of the region's population. The oil and gas sector will underlie economic prosperity alongside an emerging private manufacturing sector. At the same time, some outstanding challenges will remain. In spite of rapid growth, poverty levels will be unacceptably high in several Central Asian republics. The nascent manufacturing sector and particularly private enterprises need to be supported by business-friendly policies. Slow population growth means that the domestic market and skill base might have to be enhanced by regional cooperation and labor migration.

The realization of this positive outlook will depend upon a number of factors. Some are promoted by external influences, while others are within the realm of policymakers. There are three principal policy priorities which require initiatives at the national level, as well as regional cooperation within the CARs.

Continued Development of the Region's Energy Resources while Further Diversifying the Economy. On the energy side, this will require a transparent, predictable policy environment to attract continued inward investment, rationalization of power prices to reflect cost consideration, development of pipelines featuring both national and regional priorities, judicious investment in energy resources, and environmental management to best international standards.[10] Key priorities for industrial diversification might include: small and medium enterprise development through financial and non-financial support, attraction of export-oriented foreign investment through competitive incentives and more aggressive promotion, streamlining of business procedures, and encouraging spillovers from oil and gas industries.

Development of Cost-Competitive Infrastructure including Regional Cooperation. Given the distance from international markets, it is critical to improve infrastructure. Some of the projects could include: improvement of the internal and external road network; expansion, harmonization, and modernization of the railway network; investment in ICT infrastructure; and ensuring free and flexible air transport. Small and segmented domestic markets, high infrastructure development costs, transit bottlenecks, and dispersed resource endowments make regional cooperation crucial to future prosperity. Some initiatives might include: reduction of barriers to regional trade and investment, harmonization of regional customs administration, resolution of disputes over the water-energy nexus, and further cooperation to resolve problems in the transportation of energy via pipelines.

Poverty Reduction. The persistence of poverty requires special attention in future economic strategy. Measures to reduce poverty further might include: providing targeted provision for groups at risk, expanding the provision of micro-financing, increased expenditure on social sectors targeting the poor, and education of women. The development of labor-intensive sectors, such as agriculture and tourism, would also contribute to poverty reduction.

[10] For an analysis of some of the policy issues in the oil and gas sector of Kazakhstan see: B. Khusainov, K. Berentaev, "Kazakhstan: Problems of Developing the Oil and Gas Sector and Improving the System for Taxing Subsurface Users," *Central Asia and the Caucasus*, No. 5 (29), 2004, pp. 70-81.