THE GLOBAL ECONOMIC CRISIS OF 2008—2009 IN THE CAUCASUS, CENTRAL ASIA AND MONGOLIA

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THE QUESTIONS

RECESSION

- What are the channels through which the global economic crisis of 2008—2009 was transmitted to the Caucasus, Central Asia and Mongolia?

RECOVERY

- What systemic issues are raised by the nature of the policy response?

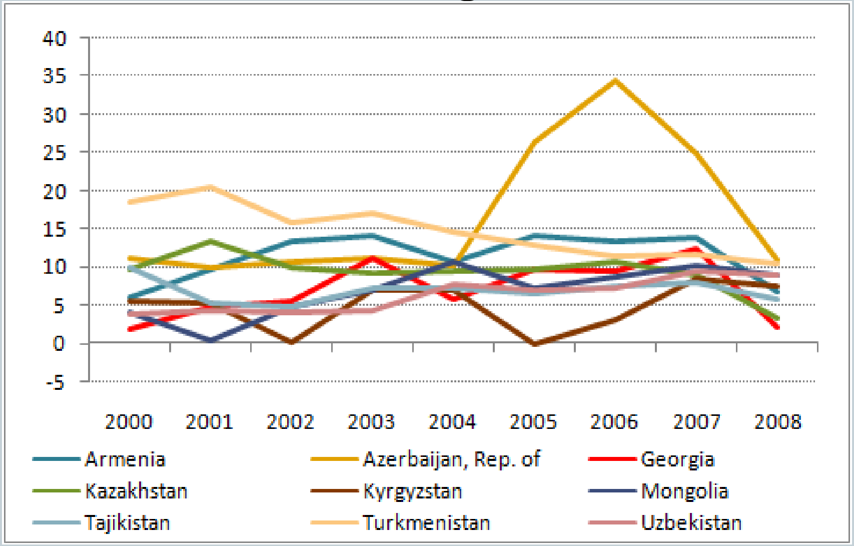
REFORM

- What are the most urgent structural reforms needed for countries to stay competitive in the post-crisis world?

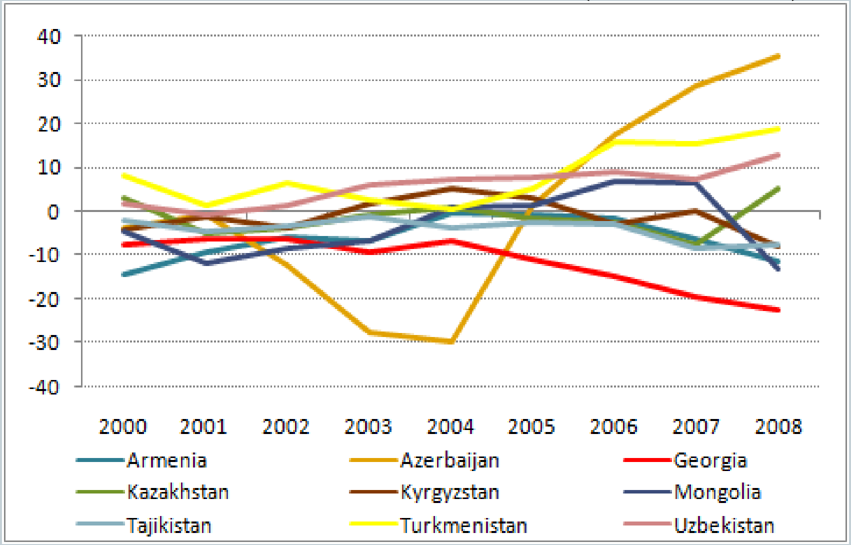
PRELUDE TO THE CRISIS

The Caucasus, Central Asia and Mongolia—a diverse group of countries with gross national incomes per capita in 2008 ranging from $600 to over $6,000—grew robustly since 2000, generally slowing in 2008 as the global crisis took hold. This was accompanied by an accumulation of (mostly) private sector-driven current account imbalances in Armenia, Georgia, Kazakhstan and Tajikistan after 2005, with the sudden stop in capital flows in Kazakhstan bringing about a reversal in 2008.

Real GDP growth



Current account balance (% of GDP)



Source: IMF World Economic Outlook, World Bank, World Development Indicators and author's calculations

CHANNELS OF TRANSMISSION

- Slowdown in the growth of export demand (in all countries)as a result of the contraction in GDP in 2009, mainly in the Russian Federation, Turkey and Ukraine in 2009
- Fall in remittances between one-third and one-half year-on-year in 2009 (Armenia, Azerbaijan, Georgia, the Kyrgyz Republic, Tajikistan, Uzbekistan), mostly due to the downturn in the Russian Federation
- Terms of trade losses for commodity exporters (oil in Azerbaijan, Kazakhstan, Turkmenistan; copper in Mongolia, aluminum and cotton in Tajikistan)
- Sudden stop in external capital flows (a “capital account crisis” in Kazakhstan, the country financially most integrated in world markets)

THE POLICY RESPONSE

Fiscal

- In general, expansionary fiscal policy in 2009 did not cut expenditure in the face of collapsing tax revenue, in order to support demand in a recession, with fiscal policy planned to be tightened in the future when the economy is stronger. This was financed by external official borrowing in energy importers (Armenia, Georgia, the Kyrgyz Republic, Mongolia, Tajikistan) and stabilization funds in energy exporters (Azerbaijan, Kazakhstan, Turkmenistan, Uzbekistan).
- But the extent of fiscal accommodation in energy importers is constrained by whether it leads to unsustainable public debt levels. While current strategies are viable, they could be derailed in the event of a weak global recovery, which is not unusual for a recession associated with a global financial crisis. In that event, more concessional official financing and grant financing will be required to moderate the tradeoff between fiscal accommodation and sustainable debt.

Financial Sector

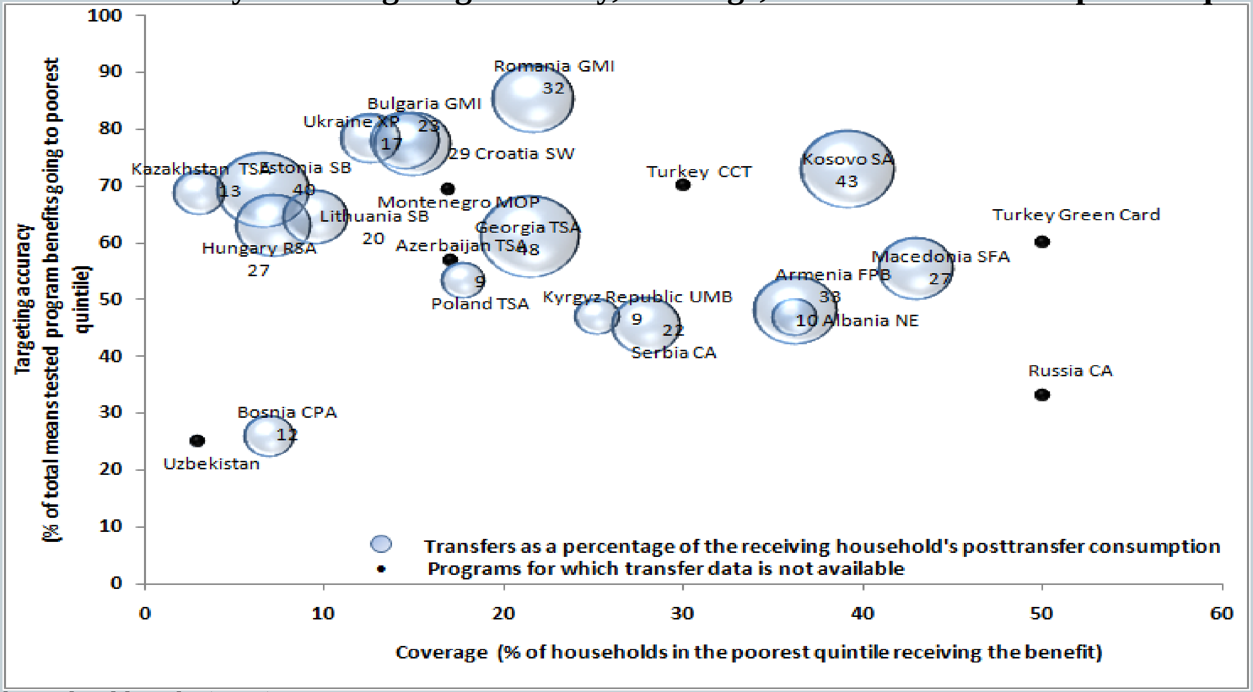
- *Containment* of actual or potential banking crises (mainly the liability side of bank balance sheets) caused by drying up of external wholesale funding ("sudden stop" in Kazakhstan in 2007, inability to rollover maturing external debt Georgia after 2008 conflict) and erosion of deposit bases has taken the form of liquidity support to viable banks, intervention in distressed banks and strengthened deposit insurance to boost confidence.
- *Resolution* of actual or potential banking crises (mainly the asset side of bank balance sheets) is work in progress. Deterioration of asset quality in all countries due to the recession is reflected in rising nonperforming loans and loan-loss provisions. This has resulted in credit contractions to the private sector despite looser monetary policy.
- Governments should avoid regulatory forbearance and enable banks and their (mainly) corporate borrowers to restructure debts even though private indebtedness is not high on average in these counties, so that problem loans do not impede financial intermediation and the economic recovery.

THE POLICY RESPONSE (continued)

Social Safety Nets

- Rising unemployment and poverty suggest that the crisis has the potential to exact a high humanitarian toll. Means-tested social safety nets in the Caucasus have high levels of targeting accuracy (50 to 60 percent of benefits reach the poorest quintile of households) and should be scaled up to cover a higher proportion of those households by enhancing outreach. This is generally less true in Central Asia and Mongolia, where governments should scale up means-tested programs where they exist and introduce poverty-focused programs where they do not by eliminating untargeted privileges and refocusing design and eligibility criteria.

Means-tested safety nets: targeting accuracy, coverage, and transfers to the poorest quintile



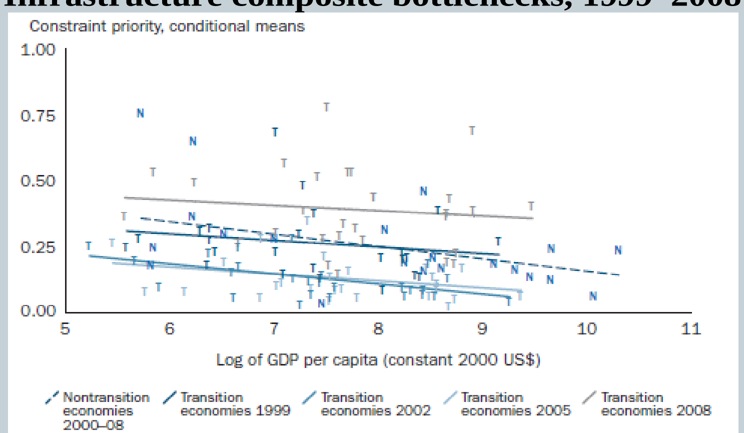
Source: Mitra, Selowsky and Zalduendo (2009)

Note: The figure shows the targeting accuracy and coverage of means-tested safety net programs. The size of the bubbles is a measure of their generosity—the transfer received by households in the poorest quintile as a share of the post-transfer consumption of all beneficiary households in that quintile.

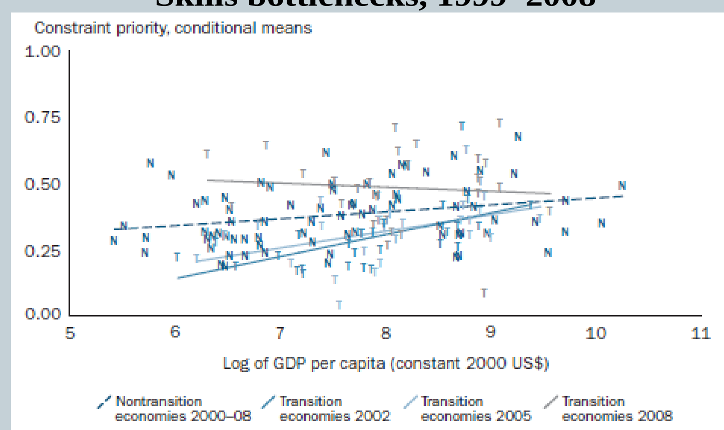
STRUCTURAL REFORM

- On the eve of the crisis, 10,000 firms in 28 transition economies (TEs) of Central and Eastern Europe and the former Soviet Union were asked (World Bank-EBRD Business Environment and Enterprise Performance Survey 2008) which elements of the business environment –taxation, labor regulation, customs administration, infrastructure, labor skills, licensing, the rule of law, finance—were the most problematic for the operation and growth of their businesses. Their responses were compared with those of 51,000 firms in 74 non-transition economies (NTEs) (World Bank Investment Climate Assessments).
- The superior infrastructure and labor skills with which countries started transition are gone. These are now not only the tightest constraints to growth but remarkably also more constraining than in NTEs at similar income levels. The figures below show that while infrastructure and labor skills constraints became tighter for TEs compared to NTEs in 2008, the lower and lower middle income TEs (which include the Caucasus and Central Asia except Turkmenistan) are relatively *less* constrained on infrastructure and relatively *more* constrained on labor skills compared to NTEs at similar income levels than the upper middle income TEs. While the recession has likely loosened these constraints, they can be expected to reemerge as binding constraints once economic growth takes hold, underscoring the urgent need for structural reform in infrastructure and education.

Infrastructure composite bottlenecks, 1999–2008



Skills bottlenecks, 1999–2008



Note: The vertical axis is a measure of the reported severity of the constraint
Source: Mitra, Selowsky and Zalduendo (2009)

CONCLUSIONS

- Countries have been able to draw on external official finance to postpone the fiscal adjustment which would have aggravated the recession had it been implemented in 2009. Its extent has been constrained either by excessive pro-cyclicality in fiscal policy during the boom years or by the need to avoid unsustainable debt levels rather than the availability of financing. Energy importing countries without stabilization funds (Armenia, Georgia, the Kyrgyz Republic, Mongolia, Tajikistan) have IMF-supported programs which have attracted financing from the Asian Development Bank, the World Bank and bilateral donors. However, a protracted weak recovery from the crisis could complicate this strategy and would call for additional concessional financing or grant financing.
- Dealing with the human dimension of the crisis requires importantly that means-tested safety net programs be scaled up in countries where they exist—generally more true in the Caucasus than in Central Asia and Mongolia—and that poverty-focused programs be introduced where they do not exist. This will require expenditure reallocation, together with elimination of untargeted privileges and refocusing of design and eligibility criteria.
- Infrastructure and labor skills have emerged as the tightest constraints to growth. These sectors need urgent reform if countries in the Caucasus and Central Asia are to stay competitive in a world where private capital flows to developing countries are likely to be considerably lower and official flows are performance-based.