Weathering Economic Storms in Central Asia

INITIAL IMPACTS OF THE WAR IN UKRAINE

OECD

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Foreword

Russia's full-scale invasion of Ukraine on 24 February has left the country devastated, while generating a global economic shock that has not spared Central Asia. Early forecasts anticipated significant disruptions to the region's post-pandemic recovery, given its close political and economic integration with Russia, especially in terms of trade, freight transit, investment, financial links and labour. The contraction of the Russian economy induced by international sanctions, trade disruptions, and commodity price spikes was expected to dent remittances and trade flows, magnify debt vulnerabilities and disrupt the region's financial sector. The depressed macroeconomic environment and increased international uncertainty were also seen as factors undermining Central Asia's attractiveness as an investment destination.

However, the economies of the region have so far shown surprising resilience to the headwinds caused by Russia's war on Ukraine, and China's economic slowdown. Notwithstanding high inflation, the five Central Asian states registered record-high remittances levels in the first half of 2022, national currencies quickly rebounded to pre-war levels after an initial drop, and an influx of skilled workers has boosted demand for services and hospitality. However, as the medium-term effects of the sanctions against Russia, the global cost-of-living crisis, and China's economic slowdown have started to unfold, Central Asia faces lingering uncertainty.

The current situation might therefore provide the opportunity for Central Asia to diversify trading partners, solidify the post-pandemic recovery and pursue its agenda of structural reforms to foster investment and private sector development. Russia's economic decline might accelerate the growth of China's economic presence in the region, but this will entail challenges, in particular in relation to debt sustainability and territorial integrity of certain Central Asian countries. Opening up new trade routes will prove essential for the region's economic diversification, given Central Asia's vulnerability to Russia's international agenda and zero-COVID policies in China that have strongly undermined export opportunities. The search for alternative trading routes has recently gathered momentum, as exemplified by the ratification or ongoing negotiations of preferential trade agreements with Pakistan and the pursuit of new trade routes through Iran, Afghanistan or the so-called trans-Caspian "Middle-Corridor".

This note explores the economic impacts of Russia's invasion of Ukraine and ensuing sanctions against Russia on Central Asia, looking in particular at the impact of these disruptions on inflation, migration, remittances, investment, and trade. It summarises initial policy responses across Central Asia and concludes with an overview of potential responses for policy-makers to consider in the short and medium terms to mitigate the shock and increase resilience going forward

Acknowledgments

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This report was prepared under the guidance of Mr Andreas Schaal, Director of the OECD Directorate for Global Relations and Co-operation, and Mr William Tompson, Head of the OECD Eurasia Division. The project was managed by Mr Grégory Lecomte, Head of the Central Asia Unit, and coordinated by Ms Amélie Schurich-Rey, Economist and Policy Analyst, OECD Eurasia Division.

The authors of this report are Ms Amélie Schurich-Rey and Ms Céleste Laporte-Talamon, Policy Analysts, OECD Eurasia Division, with significant contributions of Mr Dylan van de Ven, Junior Policy Analyst in the same Division. Valuable analytical support was provided by Mr Fikrat Valehli, Mr Hugo Brisebard, and Ms Shamima Oshurbekova, Junior Policy Analysts in the OECD Eurasia Division. Ms Anna Chahtahtinsky and Ms Elisa Larrakoetxea, Programme Administrators in the OECD Eurasia Division, provided unfailing administrative and logistical support.

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Preliminary findings were discussed, in June 2022 for Kyrgyzstan and October 2022 for Mongolia, with government and private sector representatives on the occasion of two webinars. The OECD would like to express its gratitude to the Ministry of Economy and Commerce of the Kyrgyz Republic and the Ministry of Economic Development of Mongolia for their support, and the European Bank for Reconstruction and Development (EBRD), the Asian Development Bank (ADB), the World Bank, and the United Nations International Fund for Agricultural Development (IFAD) for their participation in these event.

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Executive summary

Central Asia has so far withstood the shock created by the war in Ukraine

The effects of Russia's full-scale invasion of Ukraine were expected to have a rapid negative economic impact on Central Asia, whose economies remain closely integrated with its large neighbour. However, contrary to predictions, GDP has continued to grow across the region in the first half of 2022 as the main engines of growth, commodity export prices and labour remittances, have been on the rise. The rebound of national currencies to pre-war levels after an initial drop, and an influx of skilled workers have further supported consumption across the region. However, rising inflation is weighing negatively on businesses and households, further adding to supply chain disruptions and raising cost of living and food security concerns, in particular for non-commodity exporters, Kyrgyzstan and Tajikistan.

However, the region's medium-term outlook remains fragile

Central Asia's surprising resilience to the economic headwinds comes against the backdrop of a fragile post-COVID recovery that left growth subdued and fiscal margins reduced, leaving the region with an uncertain future. As the medium-term effects of the sanctions against Russia, the global cost-of-living crisis, and China's economic slowdown start to unfold, the impact on economies of Central Asia could be substantial and negative. In particular, if the trade channel has remained robust so far across the region, its close ties with Russia leaves it vulnerable to political and supply risks; increased uncertainty might reduce investment attractiveness, while financial market developments might weigh negatively on the sustainability of public finances.

Policy options for Central Asia to further advance their private sector development agenda in uncertain times

If growth patterns are more fragile than ever, the current situation also offers an opportunity to Central Asia to address long-term structural needs and redefine its economic relations with its two large neighbors. Doing so will require Central Asian countries to further reform their business environments, and mobilise investments for the green transition. In addition, diversifying trade away from Russia and China will not only require the opening up of new trade routes, but also, and more immediately, advancement of regional integration, both in terms of infrastructures and the harmonisation of legal and regulatory standards.

Introduction

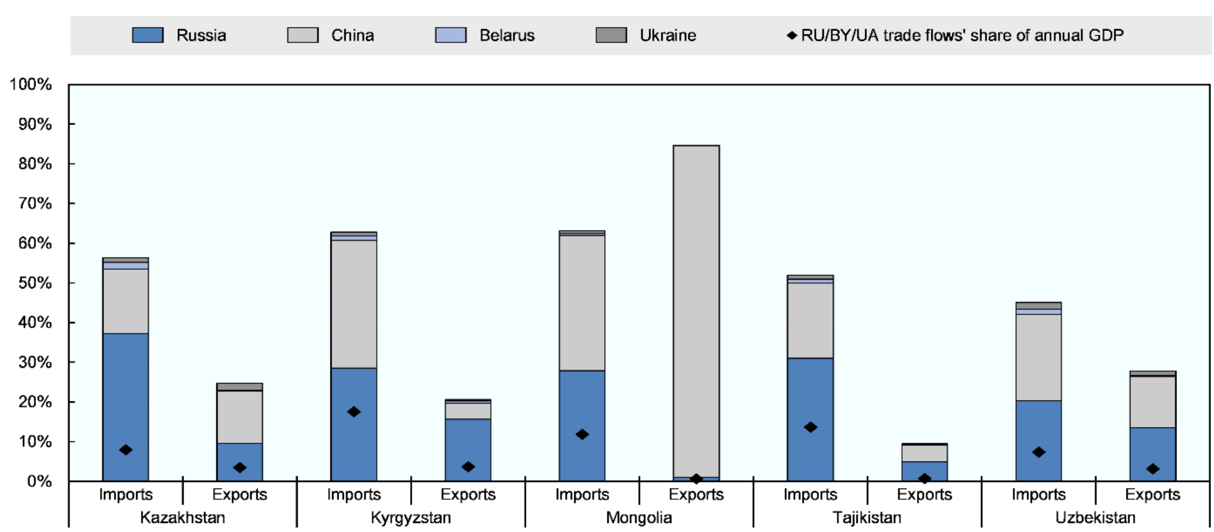
The spill-over effects of the war and sanctions have reverberated globally, through commodity price increases, trade disruptions, financial decoupling, migration, and humanitarian impacts. Central Asia's trade and remittance connections with Russia are particularly tight, which made it one of the regions likely to be most affected.

Central Asian economies are closely integrated with Russia

Trade linkages

The trade profile of most Central Asian countries remains concentrated on a small number of partners and products for both imports and exports. In particular, Russian imports greatly outweigh exports across all Central Asian countries, the country being the region's largest source of imports, except for Kyrgyzstan and Mongolia, where Russia ranks second behind China (Figure 1).

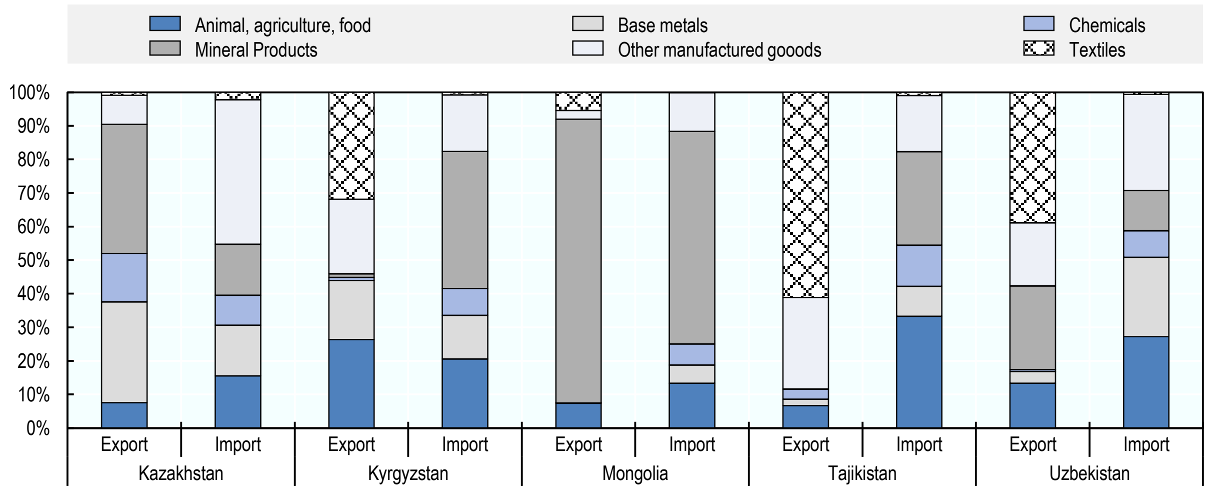
Figure 1. Share of trade flows from/to Russia, Belarus and Ukraine (average 2016-2021)



Note: Exports include both energy and non-energy goods. Belarus is responsible for 0% (Mongolia) to 0.5% (Kazakhstan) of Central Asia exports. Data for Turkmenistan has not been included due to reporting inconsistencies.
Source: (UNCTAD STAT, 2022[1])

Imports are predominantly composed of mineral products, base metals and chemicals as well as electric machinery and food. On the export side, Russia is the largest destination for Kyrgyzstan and second for Kazakhstan and Uzbekistan, buying mainly mineral products, textiles, base metals, and vegetables (Figure 2).

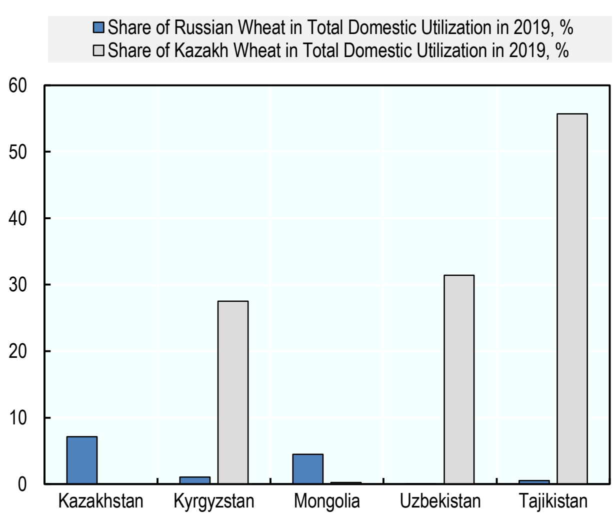
Figure 2. Sectoral composition of Russian imports and exports from/to Central Asia (2016-2020 average) and trade value (% of GDP, rhs)



Note: No data available for Turkmenistan. "Other manufactured goods" as defined by the European Commission includes Chemicals and Textiles. However, due to the importance of these two segments for the region, these two sectors are separated for visualisation purposes.
Source: (UN Comtrade, 2022[2]).

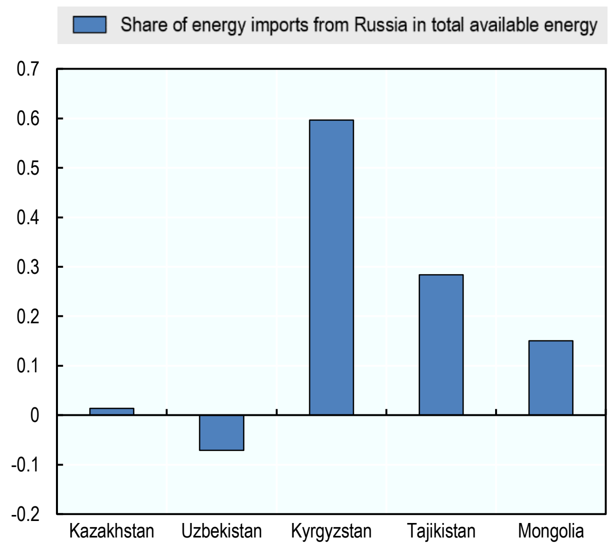
With the exception of Uzbekistan, Central Asian economies have become more dependent on wheat imports from Russia since 2020 (Figure 3). Tajikistan and Mongolia imported close to 100% of their wheat needs from Russia in 2020, while that figure reached close to 55% in the case of Kyrgyzstan in 2021. Energy dependence is also substantial for those three Central Asian economies: energy imports from Russia account for 60% of domestic utilisation in Kyrgyzstan, close to 30% in Tajikistan and 15% in Mongolia, Kazakhstan and Uzbekistan do not rely on Russian energy in 2022 (Figure 4)

Figure 3. Share of wheat imports from Russia and Kazakhstan in total domestic utilisation (%)



Note: No data available for Turkmenistan.
Source: OECD calculations based on (UNCTAD STAT, 2022[1]; FAO, 2022[3]).

Figure 4. Share of energy imports from Russia in total available energy in Central Asia



Note: No data available for Turkmenistan. Due to data limitations, gross available energy is calculated as primary production + imports – exports, without taking into account recovered and recycled products or stock variation.
Source: IEA (2022).

Financial sector

Financial systems in Central Asia have been relatively stable in recent years, but the region has a history of banking crises, most recently against the backdrop of global shocks in 2008-09 and 2014-15. The effects of COVID-19 have further exacerbated the existing vulnerabilities, as liquidity provision issues in 2020 were met with an easing of prudential regulation and non-performing loan ratios throughout the region went up (OECD, 2021[4]; IMF, 2022[5]). Overall, the weakness of banking sectors across much of the region has been a drag on the development of the private sector due to limited access to finance and an absence of deep, well-functioning capital markets.

However, Central Asia's banking sector exposure to soft currencies represented less than 15% of claims and liabilities in 2021, which indicates that banks' exposure to the ruble was most likely below this threshold before the war (BIS, 2022[6]). Nevertheless, Kazakhstan, Kyrgyzstan and Tajikistan had close banking ties with Russia, with all of their banks having Russian accounts among their top four correspondents[1], compared to 50% of banks in Mongolia and Uzbekistan, while Tajik financial credit institutions held three-quarters of their correspondent accounts with Russian banks at the onset of the war (EBRD, 2022[7]).

Foreign Direct Investment

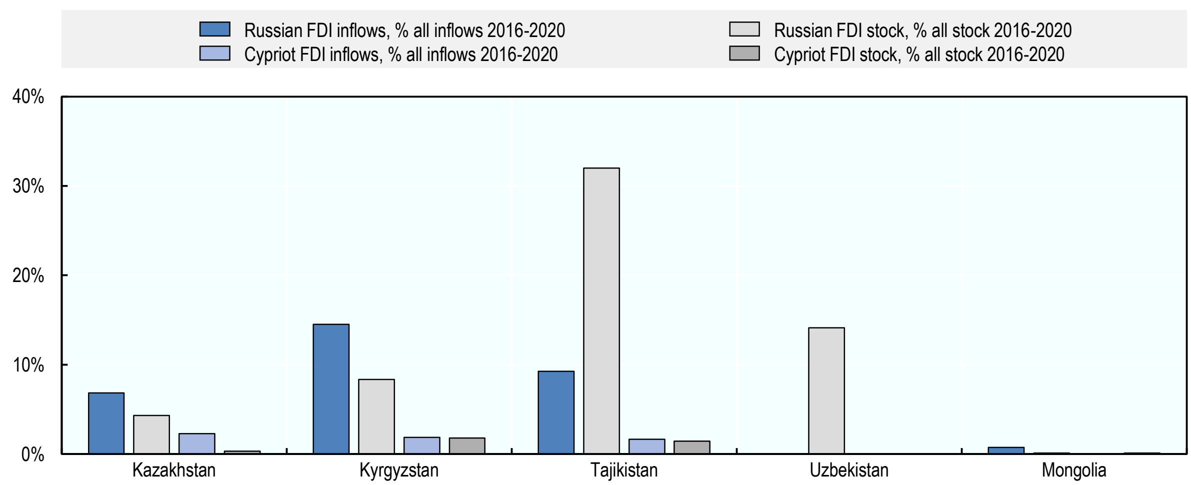
Although exact numbers may vary substantially between inward figures reported by the national statistical offices (NSOs) of Central Asian countries and outward data reported by the Central Bank of Russia (CBR)[2],

[1] A correspondent bank defines a financial institution providing and facilitating services to another financial institution, often in another country. Corresponding banks are mainly used by domestic banks to service transactions from or completed in foreign countries, allowing domestic banks to access foreign financial markets without having to open branches abroad.

[2] Differences in reported figures between both sources can be substantial in some cases. For instance, Kyrgyzstan reports Russian FDI inflows amounting to almost 15% of total FDI inflows to the country, while the CBR reports inflows

the stock of Russian FDI between 2016 and 2020 remained substantial in Tajikistan and Uzbekistan, where it averaged 32% and 14.1% of the total FDI stocks respectively. However, Russia's share of FDI stock might be overestimated in Uzbekistan, as data are lacking for some countries, including important players such as France and Japan. By contrast, actual stocks and inflows of Russian FDI might be slightly underestimated in Kyrgyzstan, Tajikistan, and Kazakhstan where FDI from Cyprus, a well-known offshore location amount to almost 2% of total stocks and inflows (Bulatov, 2017[8]). Russian net FDI inflows to Kyrgyzstan have been the highest in the region over the period, representing about 15% of total inflows (Figure 5). In Kazakhstan, a relatively low base of Russian FDI stock suggests that while FDI inflows are rising, the importance of Russian investment remains limited, except for large-scale mining projects. Mongolia is scarcely exposed to Russian investment, as Russian FDI stock amounts to just 0.1% of all stock, and its share of net inflows was negative over the period, indicating that Russia has been disinvesting over recent years.

Figure 5. Share of Russian investment in total FDI stock and inflows to Central Asia, 2016-2020



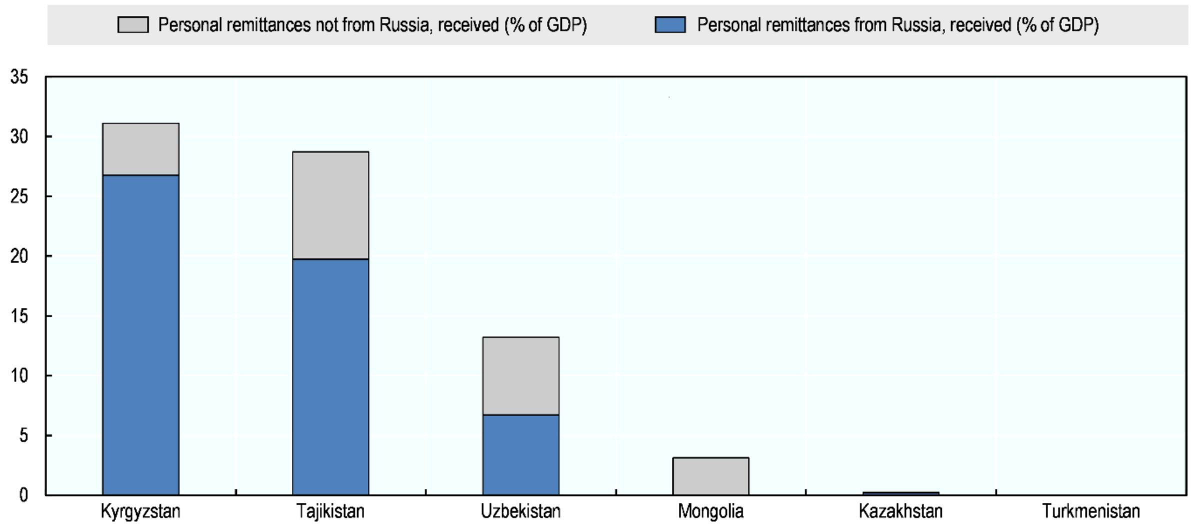
Notes: (1) For comparability purposes, stock data refers to direct investment positions as reported by the receiving economy, taken from the IMF CDIS database, since inflow data is taken from the National Statistical Offices of the displayed countries. (2) Uzbekistan FDI stock data refers to outward data reported by the counterpart economy. Russian share in FDI stock for Uzbekistan may be overestimated as some countries (including Cyprus, France and Japan) kept FDI outflows to Uzbekistan confidential. (3) No available data for Turkmenistan nor for FDI inflows to Uzbekistan. (4) Tajikistan FDI inflow data is only available for 2017-2019.
Source: (IMF, 2022[9]).

People: labour migration and remittances

Remittances remain a major source of income and foreign currency earnings for Central Asian economies, representing 32.7% of GDP in Kyrgyzstan, 33.4% in Tajikistan, and 13.3% in Uzbekistan in 2021 (Figure 6) (KNOMAD, 2022[10]). The bulk of these remittances stems from Russia, reaching, for instance, 26.9% of GDP in Kyrgyzstan, 19.5% of GDP in Tajikistan, and 7.4% in Uzbekistan in 2021, accounting for more than 50 per cent of the total remittances received that year (KNOMAD, 2022[10]; World Bank, 2022[11]; Central Bank of Russia, 2022[12]).

amounting to 55%. Except for that extreme case, differences between both datasets still reflect the same dynamics over the period we consider here (2016-2020). For data availability and comparability purposes, we chose to use FDI stock and inflow data as reported by NSOs.

Figure 6. Share of remittances from Russia to Central Asia as % of GDP in 2017-2021



Note: Share of remittances from Russia to Tajikistan is based on 2020 and 2021 data only.
Source: (KNOMAD, 2022[10]) (World Bank, 2022[11]) (Central Bank of Russia, 2022[12]).

The impact of international economic sanctions on the Russian economy has so far been less severe than initially anticipated

International sanctions led by the European Union and the United States aim at pressuring Russia to end the war

In response to Russia's decision to recognise as independent the non-government controlled areas of the Donetsk and Luhansk oblasts and its full-scale invasion of Ukraine on 24 February 2022, the United States, the European Union, the G7 and other Western and non-Western partners imposed sanctions on Russia in an effort to thwart the latter's ability to finance the war. Measures target both the internal real economy and external, macro-financial stability, and add to the more limited sanctions imposed in 2014 following Russia's annexation of Crimea.

Since February 2022, the EU has issued eight packages of sanctions or restrictive measures against Russia, some of which also target Belarus (European Commission, 2022[13]). Leading sanctions apply to the technology, financial and energy sectors and target a wide range of Russian entities and individuals such as state-owned media channels and agencies; high-ranking governmental officials, business people linked to the Russian regime, and other influential figures; government ministries, state-owned enterprises (SOEs), and private banks. In addition, sanctions apply to financial assets held in Western jurisdictions; transactions involving the Russian Central Bank, the export of arms, oil and gas machinery, luxury goods, and advanced technology items; and various import restrictions (Vienna Institute for International Economic Studies, 2022[14]). The latest sanctions package, in particular introduces a price cap on Russian oil imports, complementing the EU's plan to stop importing Russian oil as of 2023 by banning European companies from transporting Russian crude above a certain price to third countries (Economist Intelligence Unit, 2022[15]; European Council, 2022[16]).

The United States has also imposed wide ranging sanctions on Russia's largest financial institutions, banks, state-owned enterprises, elites, and family members, as well as prohibiting new investments in the country. US sanctions include a prohibition on the import of Russian oil, natural gas, and coal into the US, sanctions on more than 400 individuals and entities, and various financial restrictions on Sberbank, VTB, and Alfa Bank; and a ban on the export of US dollar banknotes and many US technologies to Russia (The White House, 2022[17]).The United States also issued secondary sanctions guidance, signalling its readiness to apply sanctions to organisations outside Russia which would trade with or provide financial, technological, or material support for its military or its annexation of Ukrainian sovereign territory (US Department of the Treasury, 2022[18]).

The co-ordinated and relatively swift adoption of comprehensive sanctions against Russia's financial system rendered Russian assets toxic for many foreign investors, triggering an asset sell-off that led to capital flight, an initial ruble depreciation by close to 60%, excess deposit outflows from the country, and stock market plunge (Interfax, 2022[19]; Central Bank of Russia, 2022[20]; Central Bank of Russia, 2022[21]). While European sanctions are particularly affecting the supply of consumer goods, as the EU is Russia's largest trading partner in goods (European Commission, 2022[13]), the complexity of navigating sanctions and negative perceptions of operating in Russia have led more than 1000 international firms to curtail operations on the Russian market since the beginning of the war, particularly in aviation, finance, software, and agriculture. This has added to supply-chain disruptions, while Russian traders have been facing barriers to continued operations, and will have to find substitutes for imports (IMF, 2022[22]). In turn these disruptions have led to delayed deliveries, shortages of goods, and higher prices, resulting in a supply-side crunch (Vienna Institute for International Economic Studies, 2022[14]).

The Russian economy is contracting, yet is proving more resilient than initially expected

Russia's economy was expected to contract sharply in 2022, with IMF April 2022 estimates predicting a "large contraction" of 8.5% in 2022 due to the impact of the sanctions on international trade, disrupted financial systems and a loss of confidence (IMF, 2022[22]; OECD, 2022[23]; Vienna Institute for International Economic Studies, 2022[14]). However, the latest projections upgraded the forecast for Russia's economic decline in 2022 by 5.1 percentage points to envisage a 3.4% decline (IMF, 2022[24]). The economy is proving more resilient so far than planned, due to i) soaring commodity prices: the energy market has indeed priced in the decrease in oil supply following the embargo announcement, although Europe has continued to buy oil, while Russia also found alternative buyers in China and India, which boosted fiscal revenue and offset European losses (Meduza, 2022[25]); ii) targeted monetary policy interventions from the Central Bank of Russia (CBR) preventing capital flight from banks, a wave of bankruptcies, and high inflation through a sharp increase in the key rate, iii) and a resilient labour market (IMF, 2022[24]).

However, several factors indicate a potentially more severe, longer-term decline. First among them is the shortage of technological inputs. An increasingly closed economy, subject to technological and other specialised import bans that are needed by Russian industry is likely to significantly alter technological advances, industrial production and long-term growth. The Russian automotive and aviation sectors have already shown signs of subsidence, with reports of Russian airlines having to strip airplanes to use spare parts they can no longer purchase abroad (Reuters, 2022[26]), and car production registering an 80% decrease year-on-year in August 2022 (EIU, 2022[27]).

EU sanctions targeting Russian oil coming into effect in 2023 as well as the gas supply cuts are expected to curb Russia's energy revenue. Whilst the oil price cap is unlikely to lead to a collapse of Russia's oil production and exports, it will deprive it of a significant source of revenue – the EU accounted for roughly 50% of oil sales before the war – and increase the risk for tier countries to trade with the former. The Russian government already expects export earnings to fall by almost 10% in 2023. As for gas, significant infrastructure investments will be needed to increase supplies to the East, as current infrastructure does not allow to redirect falling volumes from the European market to Asia (Energy Monitor, 2022[28]).

Last but not least, the transition to a war economy and the partial mobilisation announced on September 21st are expected to have a structural impact on GDP growth: a reduction of the available labour force, lower household spending, a drop in revenue collection, and significant human capital flight of highly-skilled workers from Russia are all likely to have a negative impact on growth (Meduza, 2022[25]). More than 250,000 people have reportedly fled the country since the mobilisation announcement (Novaya Gazeta Europe, 2022[29]); adding to the hundreds of thousands who already left following the beginning of hostilities in February (BBC, 2022[30]). The departure of young entrepreneurial talent in academic, finance, and tech and the reduction of the labour force will negatively impact the country's capacity to innovate, demographic trends and ultimately the economy's long-term trajectory.

Table 1. Overview of the main types of sanctions imposed on Russia as of October 2022

	TARGETED INSTITUTIONS, SECTORS, AND PERSONS					
	Technology sector	**Trade and energy sector**	**Central Bank**	**Financial institutions**	**SOEs**	**Oligarchs**
TYPES OF SANCTIONS	Export ban in the defence, aerospace, marine, oil refining, aviation, transportation equipment, luxury and electronics sectors Export controls on dual-use technologies (microchips, semiconductors, servers) products using Western-made or designed chips	Import ban on crude oil and refined petroleum products (with limited exceptions), coal and other solid fossil fuels, gold, steel, iron, wood, cement and certain fertilisers, seafood, liquor Price cap on Russian oil Ban on EU companies to provide shipping insurance, brokering services, or financing for oil exports from Russia to third countries Freeze of the Nordstream 2 gas pipeline project	No access to assets held at private institutions and central banks in the EU and US Ban on banks providing loans, services, or assistance to the government and CBR Ban of all transactions (asset transfers, foreign exchange transactions, etc.) with the CBR	Asset freeze and prohibition to make funds and economic resources available to entities and individuals on the sanctions list Decoupling of certain Russian banks from the SWIFT system (including Sberbank, Russia's largest bank) Prohibition of investments in projects of the Russian sovereign wealth fund (*Russian Direct Investment Fund*)	Prohibition of all transactions with certain Russian SOEs Prohibition of the listing and provision of services on trading venues Prohibition of new debt and equity provision	Asset freeze and prohibition to make funds and economic resources available to listed individuals Prohibition for banks to accept deposits exceeding €100,000 Travel bans and visa restrictions Seizure of luxury goods, property and asset management and service companies
EXPECTED IMPACT ON THE RUSSIAN ECONOMY	Limited equipment and technology procurement for the defence sector that can double for civilian use, impacting war industry and high-tech sectors Atrophied industrial development	Cut in Russia's oil revenue Containment of possible Russian oil price spike	Complication of international payments Ruble exchange rate volatility, increased inflation and reduced purchasing power Increased government borrowing costs No access to foreign assets stored in other central banks and private institutions	Complication of international payments Reduction of investments and economic activity Exclusion of Russia from global markets	Reduced revenue and tax sources Reduction of investments and economic activity Exclusion of Russia from global supply chains	Increase in the political cost of support to the Russian government More difficulty in attempts to evade sanctions

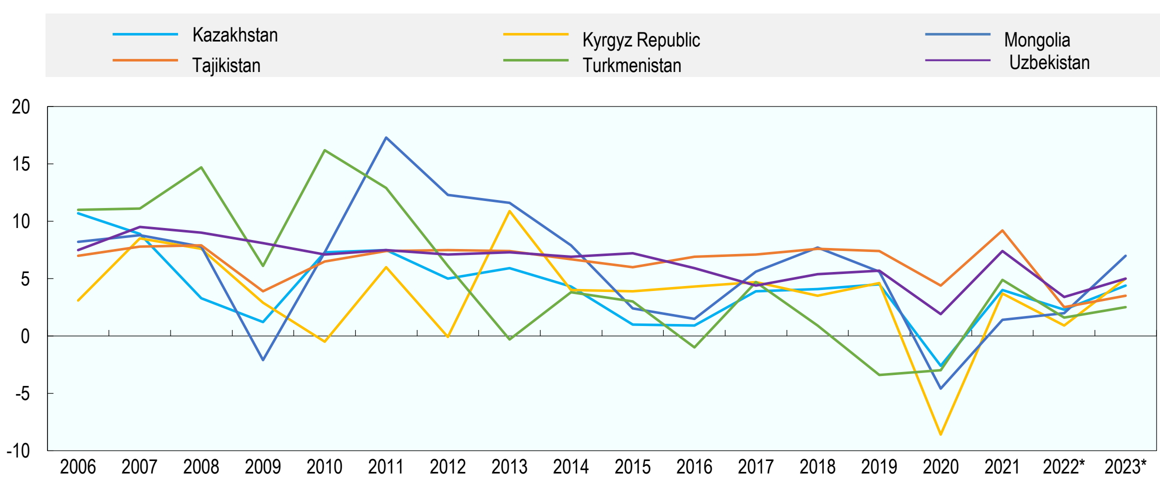
Source: (De Nederlandsche Bank, 2022[31]) (Central Bank of Ireland, 2022[32]) (European Commission, 2022[33]) (NPR, 2022[34]) (US Department of the Treasury, 2022[35]) (EUR-Lex, 2022[36]) (European Commission, 2022[37]) (Interfax, 2022[38]) (Office of Foreign Assets Control, 2022[39]) (European Council on Foreign Relations, 2022[40]).

Economies of Central Asia seem to have withstood the shock created by the sanctions

GDP continued to grow across Central Asia in the first half of the year

Given Central Asia's close economic relations with Russia and anticipations for a strong and immediate contraction of the latter's economy, many observers expected the cascading effects of international sanctions against Russia to derail the post-pandemic recovery trend that had emerged in 2021 in Central Asia (Figure 7) (OECD, 2021[4]).

Figure 7. Real GDP growth in Central Asia (%)



Source: (IMF, 2022[22]).

Compared to projections from autumn 2021, growth was forecasted to more than halve in 2022, except for Mongolia, and Turkmenistan (Table 1). The largest drop was anticipated in the region's most vulnerable and non-commodity exporting countries, especially Kyrgyzstan and Tajikistan, where the effects of the war in Ukraine were expected to exacerbate high debt distress risks (OECD, 2021[4]; IMF, 2022[22]).

Table 2. The 2021 post-pandemic recovery trend in Central Asia is likely to slow down

The deviation from the original forecasts underscores the depth of the estimated economic shock across the region

	GDP growth 2021	GDP growth forecast 2022			GDP growth forecast 2023	
		Estimates as of October 2021	**Estimates as of April 2022**	**Estimates as of October 2022**	Estimates as of April 2022	Estimates as of October 2022
Kazakhstan	4.0	**3.9**	**2.3**	**2.5**	4.4	4.4
Kyrgyzstan	3.7	**5.6**	**0.9**	**3.8**	5.0	3.2
Mongolia	1.4	**NA**	**2.0**	**2.5**	7.0	5.0
Tajikistan	9.2	**4.5**	**2.5**	**5.5**	3.5	4.0
Turkmenistan	4.9	**1.7**	**1.6**	**1.2**	2.5	2.3
Uzbekistan	7.4	**5.4**	**3.4**	**5.2**	5.0	4.7

Source: (IMF, 2021[41]; IMF, 2022[22]; IMF, 2022[24]).

Fears that the economic consequences of the war in Ukraine might derail the post-COVID recovery have not yet materialised. On the contrary, growth number projections have been revised upwards since for the economies of the region (Table 2). Revisions have been highest for Tajikistan (+3pp), Kyrgyzstan (+2.9pp) and Uzbekistan (+1.8pp), and more moderate for Mongolia (+0.5pp) and Kazakhstan (+0.2pp). Only Turkmenistan saw a downward revision for both 2022 and 2023 forecast. Growth in the first half of the year was supported by an important boost to consumption driven by public sector wage hikes, high remittance flows to Kyrgyzstan, Tajikistan and Uzbekistan, a sharp increase in trade flows, suggesting possible shadow trade with Russia, and important gains for commodity exporters Kazakhstan and Turkmenistan (EBRD).

However, downward revision for 2023 growth numbers, even if they remain strong in global comparison, remind of the fragility of post-COVID-19 recovery consolidation across the region. If the Russian economy is set to further contract, it is not to be excluded that the impact on economies of Central Asia might be negative and of a stronger magnitude. Unprecedented levels of political and economic uncertainty make growth patterns and predictions more fragile than ever, pointing to the need for Central Asia to address long-term structural needs and diversify its foreign trade and investment relationships to secure a strong and sustained growth trajectory.

Table 3. Overview of the expected and actual transmission channels to the economies of Central Asia

		Initial expectations Spring 2022	Observed impact September 2022
TRANSMISSION CHANNELS	MACROECONOMIC	**Drop in growth rates** across the region Significant **price increases, especially of basic food products** • In Kazakhstan, **NBK inflation expectations** increased to 11.4% • In Uzbekistan, **NBU inflation estimates** between 12% and 14% for 2022 **Higher energy costs** for Kyrgyzstan, Mongolia and Tajikistan due to high dependence on energy imports from Russia	**Strong upward revisions for 2022 growth rates** • Growth expected to moderate in 2023 • Consumption boost (high remittance flows in Kyrgyzstan and Uzbekistan, public sector wage hikes and a sharp increase in shadow trade with Russia) has supported growth **Record-high price increases** for food and energy products **High revenue gains for commodity exporters**, esp. Kazakhstan
	LABOUR	**Strong fall in labour remittances** across Central Asia, especially for Kyrgyzstan, Tajikistan and Uzbekistan **Increased strain on the lower-skilled segments of labour markets** due to returning migrants **Relocation of labour from Russia and Belarus**, especially in the IT sector	**Record high remittance inflows** to Kyrgyzstan and Uzbekistan • Relative strengthening of the ruble, which supported the value of remittances No **surge in the levels of returning migrants** **Relocation of highly skilled Russian speaking workers and businesses** to IT-parks and special economic zones across the region
	FINANCIAL SECTOR	**Operational difficulties** for Russian owned banks, or affiliates of Russian banks **Potential disruptions in the banking sector** as many banks have strong correspondent account ties with Russia • In Kazakhstan and Kyrgyzstan, all banks have a Russian account as a top 4 correspondent, 75% of banks in Tajikistan, and half of banks in Mongolia and Uzbekistan **Destabilisation of payment systems in Kazakhstan and Uzbekistan** if Mir system to be sanctioned by the US **Strong depreciation and volatility** of national currencies in tandem with the ruble	**No observed disruptions to the banking sectors** across the region • In Kazakhstan, subsidiaries of Russian banks (Sberbank and Alfa bank) have been wound down and sold to domestic banks • Significant increase in money transfers by Russian households (to obtain international payment cards, put forex savings abroad and finance imports to Russia) • Gradual ban of Mir payment system across the region • Strengthened compliance measures to mitigate the risk of falling under secondary sanctions **Shift to payments in national currencies** by businesses **Stabilisation of exchange rates** • Currencies strengthened after initial drop, intervention of Central Banks, in Kyrgyzstan and Tajikistan • Moderate weakening of the currency in Kazakhstan
	TRADE AND ENERGY	**Higher revenues from energy and mineral commodities** as commodity prices surge, especially for Kazakhstan (oil), Mongolia (mineral commodities) and Uzbekistan (gold) **Lower export revenues for Central Asia** following Russia's economic contraction **Supply-chain disruptions** as Central Asia relies largely on Russia for sourcing of inputs **Reduced grain imports**, due to Russia's export restrictions • Kazakhstan imports substantial quantities of Russian grain • Ripple-effect on the region with Kazakhstan's grain export ban	**Strong increase in commodity exports** • Mongolia is a notable exception, as its main export product (coal) is highly reliant on Chinese demand **Increase in "shadow" trade with Russia**, especially in Kyrgyzstan and Tajikistan where re-exports of (mostly) Chinese goods to Russia seems to have become a major business activity **Higher costs for businesses** due to disruptions in sourcing inputs from Russia impacting profitability and access to credit
	INVESTMENT	**Falling investments** due to reduced Russian investments and higher uncertainty (risk sentiment) Risk of exposure to **secondary sanctions**	**No trend observed so far** China is pursuing investment projects in the region **Increased FDI inflows to Kyrgyzstan and Mongolia**, following the settlement of long-standing disputes over mining projects (Kumtor mine in Kyrgyzstan and Oyu Tolgoi mine in Mongolia)

Source: OECD analysis (2022).

The main engines of growth have not yet been negatively affected

Remittances have continued to support consumption across the region

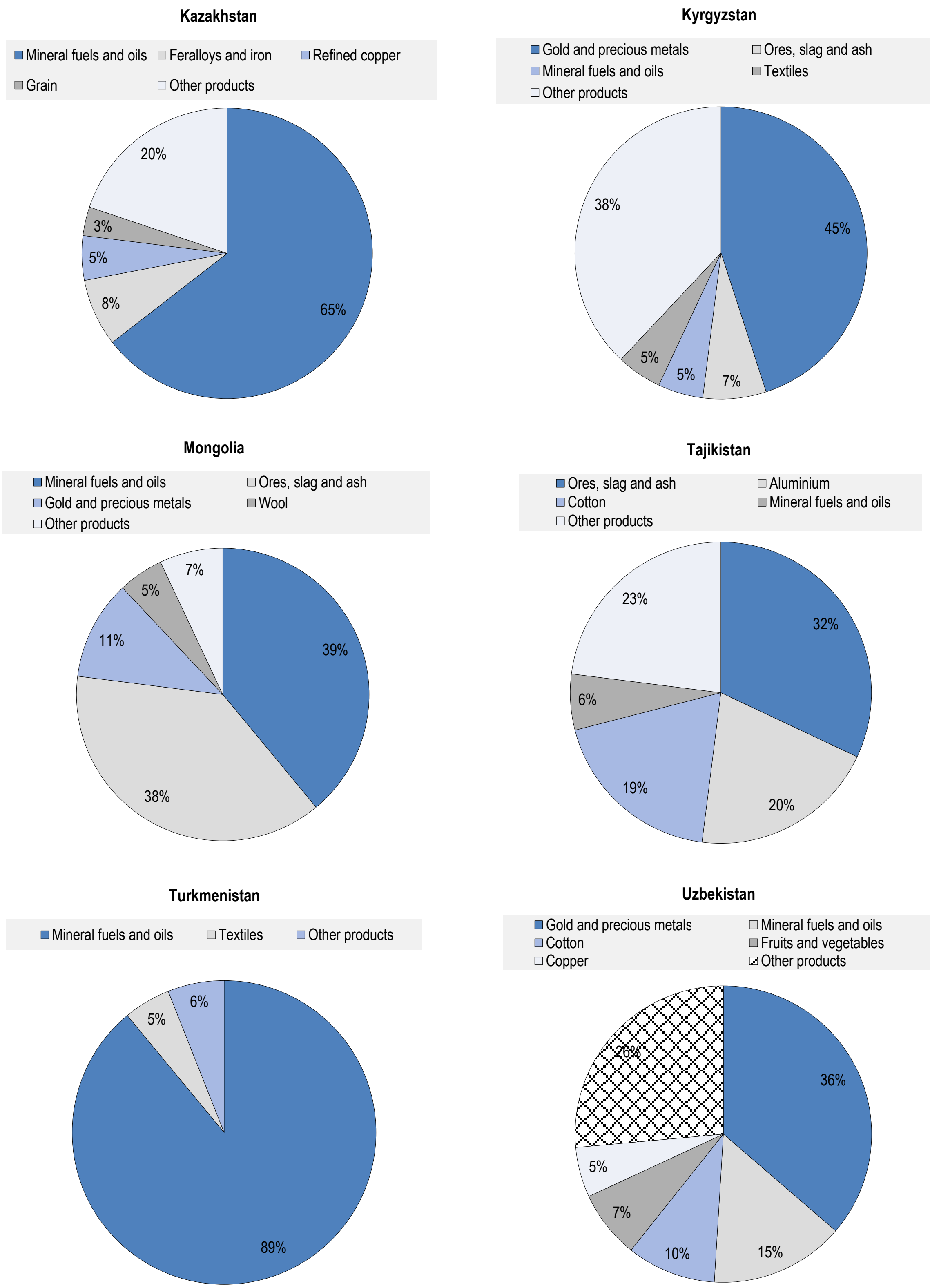
Migrant remittances represent a significant source of revenue for households, and indirectly governments, across Central Asia and are primarily used for immediate consumption by the poorest among the latter. At the beginning of Russia’s war against Ukraine, initial expectations pointed towards a sharp reduction of remittance flows in 2022 in terms of both value and volume. For instance, in Kyrgyzstan remittances were projected to drop by 33%, and by 22% in Tajikistan. Such expectations were widespread among migrant workers themselves, with surveys indicating that about 40% of labour migrants from Uzbekistan and Kyrgyzstan in Russia planned on returning home in Spring 2022. Financial difficulties, encompassing both loss of employment and initial fears of a lasting devaluation of the ruble against the dollar were cited among the main reasons for this decision (State Migration Agency of Uzbekistan, 2022[42]; Insan-Leilek Foundation, 2022[43]). This echoes what occurred in the mid-2010s, when remittances to the region dropped by 40% as Russia was hit by a combination of sanctions following the illegal annexation of Crimea and the end of the commodity-price “super-cycle” (KNOMAD, 2022[10]; World Bank, 2022[44]).

Contrary to expectations, Kyrgyzstan, Tajikistan and Uzbekistan experienced an increase in remittances in the half of 2022, providing a substantial contribution to consumption and growth figures (EBRD, 2022[45]). The most drastic increase was in Uzbekistan, where remittances are estimated to have increased by 96% year-on-year (yoy). The increase has been more modest in Kyrgyzstan (+11%) but is relatively more important to its economy given the higher share of remittances in GDP. However, reasons for this increase remain unclear. Even if demand for migrants workers, mainly employed in the construction sector, was on the rise in Russia, this is unlikely to account for the total of additional remittances. Moreover, newspapers and observers across Central Asia report a fall in employment and incomes of migrant workers in Russia. For instance, in the first quarter of 2022, 60,000 Tajik and 133,000 Uzbek migrants returned from Russia to their home countries (IOM, 2022[46]). Frontloading of savings transfers back home from some migrant workers worried by their future prospects, as well as the inability to statistically distinguish labour remittance transfers from other monetary transfers from Russia, to circumvent restriction of foreign currency purchases, might also contribute to explain these numbers. Especially for Kyrgyzstan in the first case, and Uzbekistan in the second. On the contrary, in Tajikistan, remittances seem to have decreased by 10% up to May 2022, in line with reports of job losses among Tajik migrants in Russia. However the rapid rebound of the Russian ruble and the Tajik somoni vis-à-vis the US dollar mitigated the remittance decline (ADB, 2022[47]), while Tajik migrants are also increasingly turning to Kazakhstan as a safer work destination (Radio Ozodi, 2022[48]).

The increase in energy prices has benefitted commodity exporters in the region

Central Asian economies remain highly concentrated, as protracted and stalled reforms have failed to expand export profiles and diversify production, with most countries relying heavily on the export of raw extractive goods (Figure 8). Commodity exports, such as energy and metals, represent on average more than 60% of total exports across the region, reaching 80% in Mongolia and Kazakhstan (UNCTAD STAT, 2022[1]). More broadly, exports constitute over a third of GDP across the region, and within each country’s export basket the top three products account for over two-thirds of all exports (OECD, 2021[4]). In addition, with the exception of Kazakhstan, the countries of the region export to a very narrow range of markets in which Russia holds a significant place. Such lack of diversification leaves the region highly vulnerable to external shocks, such as the COVID-19 pandemic, and large price fluctuations in commodities.

Figure 8. Export decomposition, average 2016-2020



Source: OECD based on (UNCTAD STAT, 2022[1]).

The drastic increase in global commodity prices observed over the past months, in particular for energy and metals, has so far had an overall positive impact on Central Asian economies. The impact has been particularly pronounced for large commodity exporters such as Kazakhstan. The first half of the year saw an 85% yoy increase in the value of oil exports, and a 10% yoy increase in volumes as purchase volumes of China, South Korea and Singapore increased. Kazakhstan therefore is expected to benefit from a strong economic and fiscal performance, with a current account surplus of about 3 % of GDP in 2022, and an annual increase of government revenues by 3.4 pp to 20.5% of GDP, of which 6.6 pp is attributable to oil revenues only (IMF, 2022[49]). However, a durable interruption of the Caspian Pipeline Consortium pipeline could reduce the country's oil exports, while a worsening of adverse global conditions could lower oil prices and raise borrowing costs.

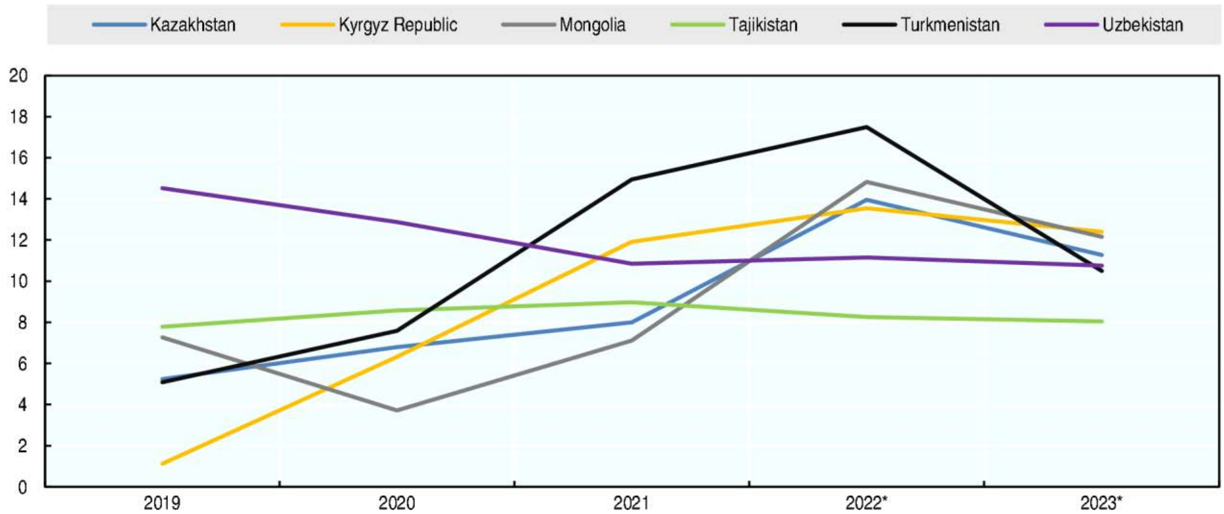
A similar trend can be observed in Uzbekistan, where the value of exports has almost tripled since February 2022, with the highest increase seen in the value of energy and chemical exports, which were multiplied by, respectively, 13 and 7.5 times, while the value of metal exports has risen fivefold. Combined, these three commodity groups represent about a third of the country's exports, and might result in a large increase in trade revenues. Finally, gold, the country's largest single export good, saw a more modest, albeit important, increase in value (+26%), mainly attributable to an increase in the volume of exports given that gold prices have been declining since the beginning of 2022 (State Committee on Statistics, 2022[50]).

The situation of the remaining economies of the region is more diverse. In Mongolia, for instance, the volume of coal exports declined in 2021 and until February 2022 due to trade restrictions with China, while increased prices compensated for that decline. Since February, the volume of coal exports seems to have caught up with the increase in prices, as both have been multiplied by 14. Copper exports seem to follow a similar dynamic (National Statistics Office of Mongolia, 2022[51]). Finally, the effect of commodity prices has been the lowest for Kyrgyzstan, as its export structure is more diversified and less reliant on energy, while gold exports even decreased in Tajikistan in the first half of the year (Tajstat, 2022[52]; National Bank of Kyrgyzstan, n.d.[53]).

Rising inflation is weighing negatively on firms and households

High levels of inflation are so far the most immediate and important effect of Russia's war in Ukraine on Central Asian economies (Figure 9). In August 2022, consumer price inflation reached 16.1%, and in July 15.7% in Mongolia (after a peak at 16.1% in June), 14% in Kyrgyzstan, and 12.3% in Uzbekistan (EBRD, 2022[45]). Indeed, the global rise in cereal prices and fertiliser costs translated into higher prices of both imported and domestically produced food, while supply chain disruptions also drove up firms' production costs. The most recent World Bank Business Pulse Survey indicates indeed that 87% of firms in Kyrgyzstan, 56% in Uzbekistan and 53% in Tajikistan have increased their production costs since February 2022, as they source many inputs from Russia (World Bank, 2022[54]). Energy is another important expenditure item for households and businesses alike, given that Russian energy imports accounted for 60% of total energy utilisation in Kyrgyzstan, a bit less than 30% in Tajikistan and 15% in Mongolia in 2019 (Figure 4).

Figure 9. Average consumer prices in Central Asia, October 2022 estimates (%)



Note: *estimates.
Source: (IMF, 2022[24]).

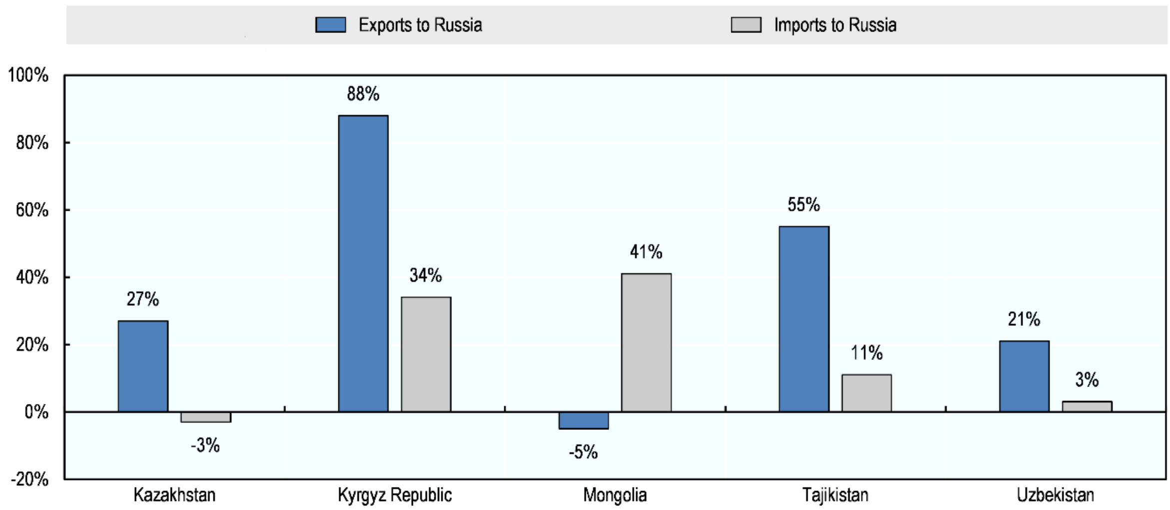
According to national statistical offices, food inflation has soared across the region, reaching 22.2% in Kazakhstan (August) and 9.7% in Tajikistan (July), where food represents more than 50% of household expenditures, 21.5% in Mongolia (July), and 16.5% in Uzbekistan (June). For the latter two, food represents 26% and 40%, respectively, of the consumption basket of households (Tajstat, 2022[55]; National Statistics Committee of the Kyrgyz Republic, 2022[56]; Bureau of National Statistics, 2022[57]; State Committee on Statistics, 2022[58]; National Statistics Office of Mongolia, 2022[59]; EBRD, 2022[45]). Even if inflation is expected to slow down in 2023, this outlook is subject to several negative risks, rising food and energy prices therefore add to food insecurity risks already raised by the COVID-19 pandemic (OECD, 2021[4]; OECD, 2021[60]; World Bank, 2022[44]). The situation might become most acute for the poorest households, for whom food and energy account for the largest share of the consumption basket. In Tajikistan for instance, these risks were already on the rise in 2021, with 33% of households reporting reduced food consumption in the first half of 2021, representing a 5% increase compared to the year before (World Bank, 2021[61]). This followed mainly from a strong increase in inflation (+9.2%) in the first half of 2021 and a decline in household wages.

The trade channel has remained robust across Central Asia, but the region's close ties with Russia leave it vulnerable to political and supply risks

Trade has remained dynamic in Central Asia, but suspicions of shadow trade with Russia might expose the region's economies to secondary sanctions

Given the region's composition of trade with Russia (Figure 2), a decline in Russian demand for mineral commodities and chemical imports was expected when the war began, in line with the projected contraction in Russia's infrastructure, construction and industrial sectors (Pestova, 2022[62]; IMF, 2022[5]). However, since food and manufacturing products also account for a non-negligible share of exports to Russia, Central Asian products were seen as potential cheap substitute for some European exports.

Figure 10. Annual change in trade flows with Russia in the first half of 2022 (%, yoy change)

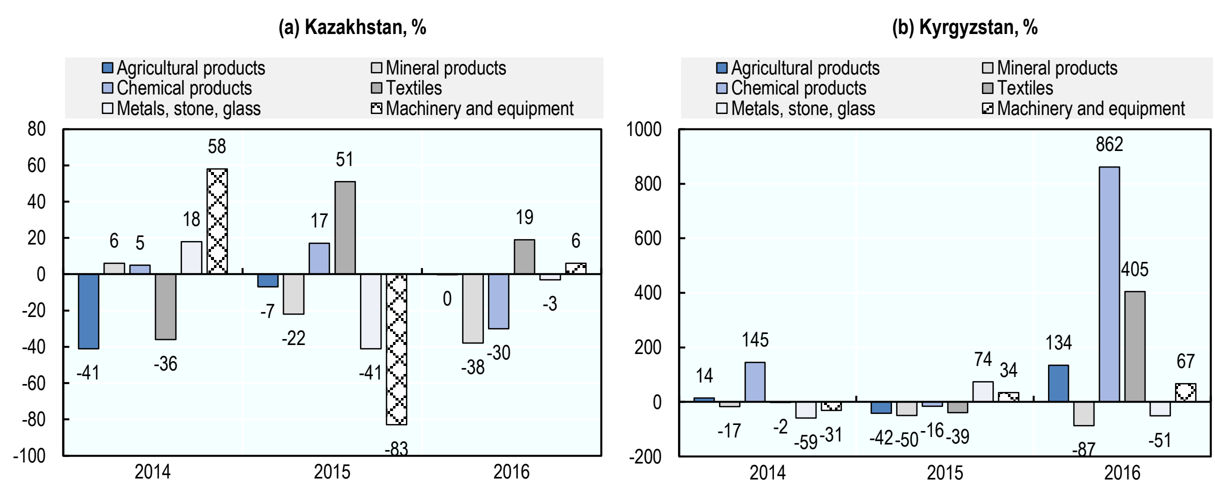


Note: Data for Kazakhstan, Tajikistan and Uzbekistan covers January-June, while covering also July for Kyrgyzstan, and August for Mongolia. No data is available for Turkmenistan.

Source:. (National Bank of Kyrgyzstan, n.d.[53]; National Bank of Kazakhstan, 2022[63]; State Committee on Statistics, 2022[50]; Tajstat, 2022[52]; National Statistics Office of Mongolia, 2022[51]).

National data for the first half of 2022 show a strong increase in exports to Russia for all countries of the region except Mongolia (Figure 10), whereas on the import side, increases mainly reflect the rise in energy and cereal prices. Interestingly enough, the overall export dynamic does not seem to follow the one observed after a first wave of sanctions against Russia following the annexation of Crimea in 2014 (Figure 11). Given the large difference in magnitude between both sanction regimes, this could indicate that Central Asia might currently be seen as a short-term alternative supplier of critical goods to the Russian economy.

Figure 11. Evolution of commodity exports to Russia following the first wave of international sanctions in 2014 (%, 2014-2016)



Source: (UN Comtrade, 2022[2]).

Kazakh exports to Russia have been on the rise, mainly due to the global increase in commodity prices. In the first half of 2022 alone, crude oil exports rose by 85% in value, with 89% of this increase attributable to higher prices rather than increased volumes (National Bank of Kazakhstan, 2022[63]). On the contrary, a reduction in Russian demand for mineral and energy exports is noticeable, especially for iron ores, gold, silver and rolled ferrous metals. Beyond Russia, Kazakhstan also benefits from increased oil exports to European countries (EBRD, 2022[45]). The picture is more mixed for Uzbekistan, as the value of the country's monthly global exports decreased by 47% since February 2022, and by 10% yoy, while bilateral trade with Russia has remained strong. Monthly exports to Russia rose by 78% between February and July, representing a 21% yoy increase in the first half of 2022 (State Committee on Statistics, 2022[50]). Finally, record increases in Kyrgyz and Tajik exports to Russia seems to be indicative of shadow trade patterns (EBRD, 2022[45]). In Kyrgyzstan indeed, increased bilateral trade with Russia coincides with falling exports to the rest of the world. Exports to Russia have mainly consisted of industrial goods and production inputs, while the value of imports of interim goods, mainly from China, increased by 65% between the first and the second quarter of 2022, and by 69% yoy (National Bank of Kyrgyzstan, n.d.[53]).

However, supply-chain disruptions are affecting some industries and likely to increase the costs of trade

Central Asia's reliance on a small portfolio of trading partners and goods leaves the region highly vulnerable to external shocks, since the impact of any decrease in demand for key export or import products is magnified by a small range of trading partners and a lack of alternative sourcing opportunities. Trade disruptions at the Russian and Chinese borders in early 2020 were a reminder of this vulnerability, amplifying shortages of food and basic necessities during the first months of the pandemic (OECD, 2021[4]). Since the beginning of Russia's war against Ukraine, disruptions of supply chains stemming from or integrating both countries have led to shortages of inputs for Central Asian businesses. Overall, 43% of firms participating in the World Bank Business Pulse Survey indicated that imports from Russia or Ukraine have decreased or that they stopped sourcing from these countries altogether. It is also interesting to note that firms that used to sell to exporters or multinationals from Russia or Ukraine experience, an average decline in sales between 5 and 13%, while firms not selling to these countries have seen their sales increase by 5% on average (World Bank, 2022[54]).

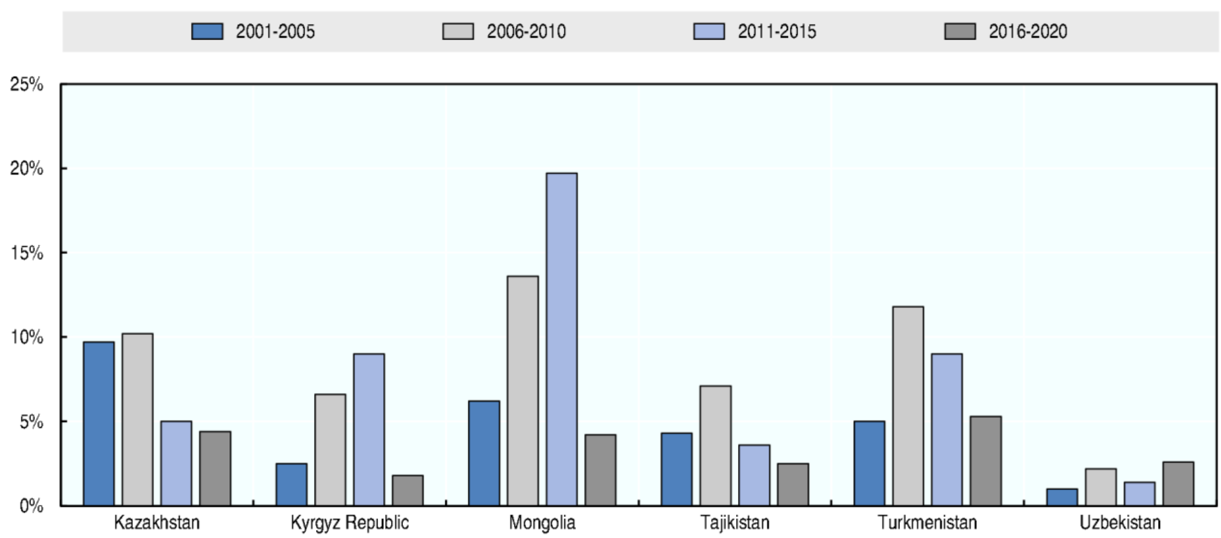
Russia, and to a lesser extent Ukraine, remain a major source of essential inputs for Central Asian economies, which remain concentrated in the lower stages of value chains (World Bank, 2020[64]). The former provides about a third of the region's mineral product imports, 13% of base metals and about 10% of chemicals, electric machinery and food (Figure 2). It also represented in 2018 the first foreign input provider to Kazakhstan, with its contribution concentrated in inputs to mining (both energy and non-energy) products and basic metals exports (WTO, 2020[65]). While Central Asia could benefit from some trade diversion at the global level, estimates suggest that in the short-term increased export demand would not compensate for the loss of trade opportunities with Russia (Korn, 2022[66]).

Beyond the direct impact on imports from Russia, the cost of trade for Central Asian economies is likely to further increase, which might further increase consumer goods prices, due to the disruption of transit routes via Russia. The latter remained a major transit nation for many goods entering and leaving the economies of Central Asia. While recent research suggests that global supply chains, especially for agricultural goods and the mining sector, adapt quickly to economic disruptions brought by conflict (Korn, 2022[66]), it might prove more difficult for Central Asia, due to both a persistent connectivity gap and the structure of Central Asian economies. The evidence suggests that manufacturing supply chains adapt more slowly, which could exacerbate the effect of supply-chain disruptions reliant on these products from Russia. In addition, since the region's isolation from global trade routes stems mainly from inadequate transport networks, lack of affordable transport services for containers, and missing links along major infrastructure corridors, developing alternative transit routes is likely to take time (OECD and ITF, 2019[67]).

Greater uncertainty might reduce Central Asia's investment attractiveness

Alongside public finances and firms' own funds, FDI remains a primary source of capital formation across the region, and Russia remains an important investor in the region contributing to know-how and the building of critical infrastructure, particularly in the mining and energy sectors, where most of the region's FDI remains concentrated. Russian FDI and portfolio investments has been growing especially in Kazakhstan in recent years, even if it represents a comparatively lower share of total investments in the country (Figure 12). Recent investment projects, amounting to several billions of dollars, include the development of Kazakhstan's Kalamkas-Sea and Khazar offshore oil fields with Russia's Lukoil, while Uzbekistan has been discussing plans for the construction of a nuclear power plant by Rosatom (Eurasianet, 2022[68]; Lukoil, 2021[69]). These investment projects are likely to be delayed, while smaller projects might be scaled-back or even cancelled (EBRD, 2022[7]; World Bank, 2022[44]).

Figure 12. Net FDI inflows as a share of GDP in Central Asia (5-year average)



Source: (World Bank, 2022[70]).

Preliminary data for the first half of 2022 suggest a scaling back of Russian investments. In Kazakhstan for instance, as the country registered outflows of Russian FDI in the second quarter of 2022, for the first time since the height of the pandemic in 2020 (National Bank of Kazakhstan, 202[71]). If this trend were to persist or strengthen, it would further compound a general downward trend in both FDI inflows and greenfield investment since the end of the commodity "super-cycle" in 2014-15. The dynamic of this decline largely reflects Central Asia's fragile investment environment, long-standing issues in the region's banking sectors, and the over-representation of extractive sectors in total FDI inflows and capital formation (OECD, 2021[4]). The COVID-19 pandemic led to an 18% decline in FDI inflows to Central Asia in 2020, which was nevertheless a smaller decline than in most other regions of the world, thanks mainly to a 35% increase in net FDI inflows to Kazakhstan related to the Tengiz hydrocarbon project. Nonetheless, the pandemic has highlighted the challenges Central Asian economies face in attracting new and more sustainable investment into those sectors of the economy that are more likely to contribute to job creation and diversification. The most marked declines in FDI inflows and greenfield investments were concentrated in the traditional recipient sectors for FDI, such as petroleum extraction, oil refining, and production of coke and chemicals, without seeing a redirection to sectors such as pharmaceuticals or technology offering opportunities for diversification (UNCTAD, 2021[72]).

Looking forward, the exceptionally high level of economic uncertainty, including major downside risks in the case of an intensification of the war, might lead to a global fragmentation of investment and add to a further decline of investment inflows to Central Asia. The fallout from the COVID-19 pandemic gave a first insight into such a possible scenario: while the world's most advanced economies saw a rise in investments as early as 2021, inflows to Central Asia were projected to begin rising only in 2022. Remaining issues in the region's business climate might explain the lag, reducing the region's attractiveness for investors amid heightened global competition for FDI (OECD, 2021[4]).

Box 1. Central Asia's banks have coped well with Russia's financial sector disruptions

Early expectations anticipated significant disruptions to the functioning of Central Asia's banking system following the exclusion of major Russian banks from the SWIFT international payment system, and the large correspondent relationships between Central Asian and Russian banks. In Spring, subsidiaries of Russian banks in Central Asia fell under international sanctions, such as Kazakh branches of VTB Bank, Sberbank, Alfabank which were either sold to local competitors or decided to pursue operations in national currency. In addition, sanctioned Russian oligarch Usmanov had to sell his stake in Uzbek privately-owned Kapitalbank to prevent the bank from falling under sanctions, and the sale of UzAgroExportBank to a Russian bank was cancelled.

Limited banking exposure to the Russian ruble may have explained Central Asia's financial sector resilience following the exclusion of ten Russian banks from the SWIFT international payment system. Whilst the ban initially affected cross-border money transfers and increased the cost of remittances, Central Asian banks rapidly switched to payments in national currencies and reinforced compliance measures not to fall under secondary sanctions: amongst other measures, several financial institutions across the region restricted or banned altogether the use of Russia's Mir payment card, as the United States stated that non-US financial entities entering into or expanding relations with the Russian operator could be deemed to be supporting Russia's efforts to evade sanctions. Banks also benefitted from significant currency savings transfers and demand for international payment cards from Russian citizens relocating to Central Asia, which boosted margins and profitability

Sources: (EBRD, 2022[45]) (EIU, 2022[73]) (EIU, 2022[74]) (Eurasianet, 2022[75]) (Eurasianet, 2022[76]) (IMF, 2022[77]) (Interfax, 2022[78]).

An influx of highly skilled workers might support raising the human capital profile of selected labour markets across the region

Persistently high levels of economic informality and labour migration, predominantly to Russia and Kazakhstan, remain a defining feature of Central Asia's economies, particularly Kyrgyzstan and Tajikistan. This follows mainly from a lack of quality jobs and labour-market pressures generated by rapidly expanding labour forces. In Uzbekistan, for instance, about half a million new labour market entrants are predicted annually for the next decade (ADB, 2020[79]). Labour migration, seasonal or more permanent, therefore represents an opportunity for countries that are struggling to create enough jobs to reduce unemployment and ease strain on public services. In 2021, Tajikistan, Kyrgyzstan and Uzbekistan sent an estimated 7.8 million workers to Russia (Hashimova, 2022[80]). A large number of Central Asian labour migrants in Russia are employed in low-skilled sectors, such as construction, delivery services, and taxi driving, leaving them vulnerable to economic contractions (OECD, 2021[4]). Following the withdrawal of many Western businesses from Russia and the reduction in activity in certain sectors of the Russian economy in the first quarter of the year, Tajikistan reported about 60 000 returning migrants, 2.6 times as many as in the corresponding period of 2021, while Uzbekistan reported 133 000 retuning migrants over the same period (Asia-Plus, 2022[81]; IOM, 2022[46]).

Beyond these initial numbers, the evolution of the situation is hard to predict. The number of returning migrants seems not to have increased drastically until the third quarter of 2022, while some sources report increased Russian demand for Central Asian workers. The latter are also increasingly targeted to join the Russian military forces, in exchange of a fast-track citizenship process (Carnegie, 2022[82]). If Russia were to enter a protracted slowdown, migrant returns to Central Asia could increase further, heightening competition among the lowest-skilled segments of the labour market.

In parallel, since the beginning of Russia's war against Ukraine, with an apparent acceleration since the announcement by the Russian government of a partial mobilisation in September 2022, Central Asian countries have witnessed an influx of Russians, and, to a lesser extent, Belarusians and Ukrainians. Actual numbers are difficult to estimate for each country, as Kazakhstan registers the most arrivals but acts also as a transit country, and some countries, such as Kyrgyzstan, offer visa-free regimes to Russian citizens. However, official numbers from Rosstat have indicated a net outflow of about 420 000 people from Russia in the first three quarters of the year, a doubling compared to the same period last year. Among these, about 80 000 have left for Ukraine, 58 000 for Tajikistan, 49 000 for Armenia, 44 000 for Kyrgyzstan, 41 000 for Kazakhstan and 39 000 for Uzbekistan. In comparison to the numbers communicated by the national press agencies of Central Asia, these numbers appear low, and they may constitute a sort of lower-bound estimate.

Among these new arrivals, many are highly skilled workers, mainly active in knowledge-intensive sectors as entrepreneurs or developers, supporting the knowledge industry, in particular in the IT sector, without putting additional pressure on local job markets. However, this massive influx is shifting the social equilibrium across Central Asia, contributing in particular to soaring housing and food prices in capital cities, raising fears of social tension (CABAR, 2022[83]). So far however, governments across the region have encouraged the relocation of businesses and highly-skilled workers. Uzbekistan for instance has created a three-year visa targeted at IT specialists, entrepreneurs and their families, in addition to the provision of free legal and administrative support services during their business journey (Government of Uzbekistan, 2022[84]). Kazakhstan is developing a number of measures to support and give preferences to foreign investors, and a newly signed presidential decree in Kyrgyzstan allows entrepreneurs from Russia to become residents of the creative industries park and conduct business in the country with a simplified tax regime (Government of Kyrgyzstan, 2022[85]). Looking forward, it will be important for governments across the region not to distort the level playing field with domestic businesses, and to integrate the current measures to support the relocation of Russian businesses into their longer-term reforms to the business environment. In addition, retaining these new talents, while maintaining social peace, will require policies to prevent the further polarisation of labour markets.

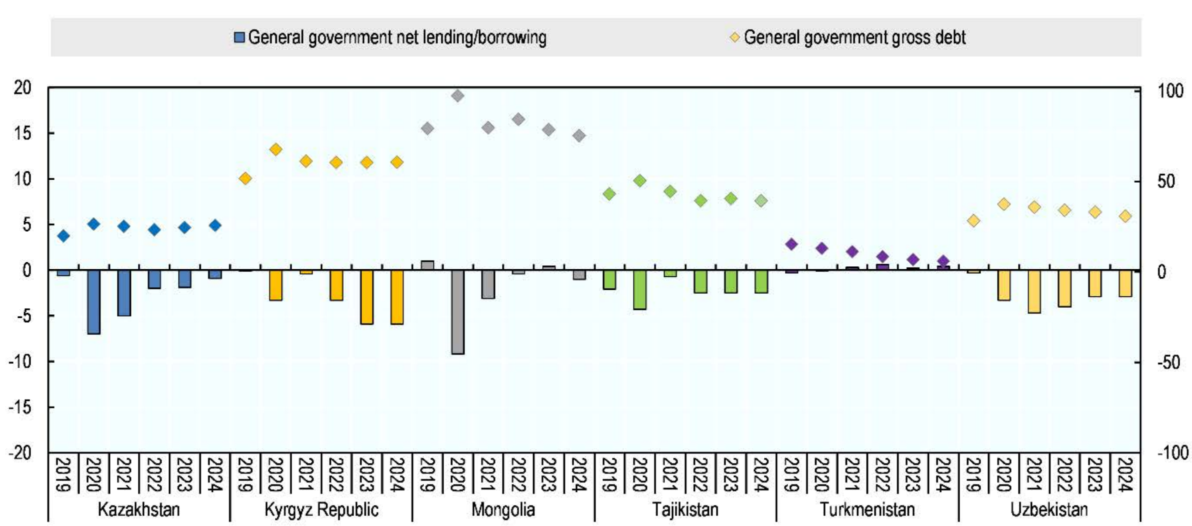
The longer-term impacts of the war might exacerbate fiscal imbalances across Central Asia

Central Asian governments are still dealing with the consequences of the pandemic

A fragile post-COVID recovery has not allowed governments to regain fiscal space

The impact of the COVID-19 pandemic in Central Asia has been profound, as the region's economies were still feeling the effects of the 2008-09 Global Financial Crisis and the 2014-15 commodity-price shock. The region's aggregate GDP shrank by almost 2% in 2020 according to official data, erasing at least four years of per capita income gains in some countries and pushing an estimated 1.4m people into poverty (OECD, 2021[4]). The lingering effects of the pandemic and a slow vaccination rollout throughout 2021 accounted for a slower than expected recovery, even if activity strengthened in the second half of the year, driven by strong domestic consumption. This trend was supported by large remittance flows, especially in Kyrgyzstan and Tajikistan (IMF, 2022[5]; OECD, 2021[4]).

Figure 13. Fiscal dynamics in Central Asia (% of GDP)



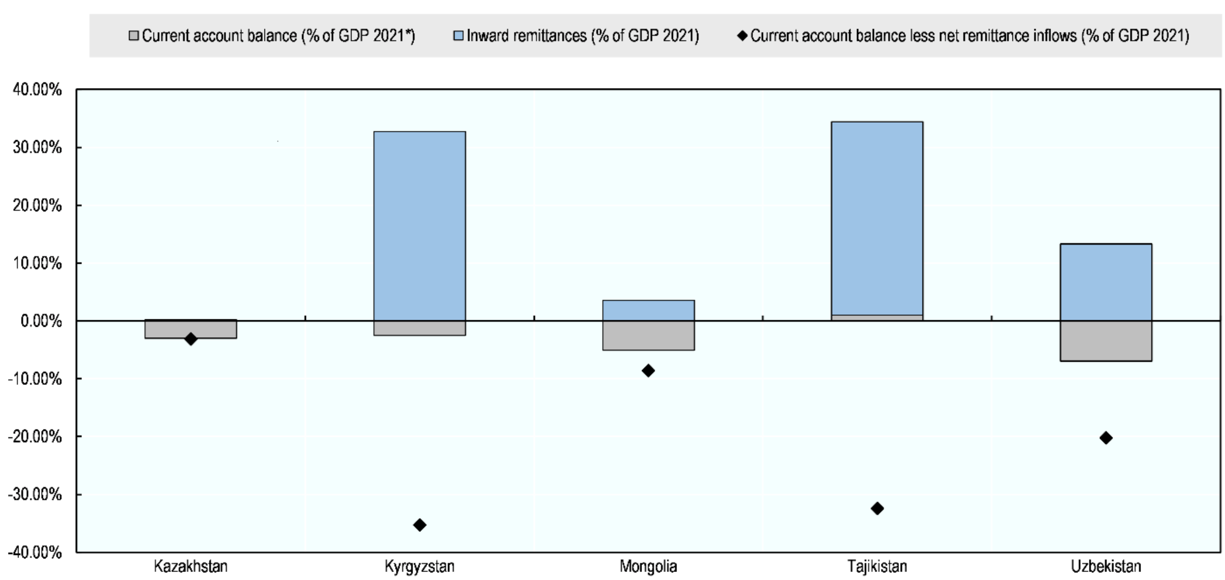
Notes: Data for 2022-2023 are estimates.
Source: (IMF, 2022[22]).

Overall, since 2020, fiscal space across the region has drastically declined and debt ratios have risen, due initially to a sharp decline in commodity prices and remittances in early 2020, and then to the cost of fiscal support packages. Most Central Asian countries took comprehensive measures to respond to both the sanitary and economic emergencies created by the COVID-19 pandemic, with fiscal support packages ranging from 3.5% of GDP in Tajikistan, to 5.7% in Uzbekistan, 6.1% in Kyrgyzstan, and 7.3% in Kazakhstan (OECD, 2021[4]). While this effort proved crucial in helping the region's economies withstand the slowdown, it also put great pressure on public finances. Throughout 2020 and early 2021, countries witnessed a large reduction of fiscal space and mounting external debt, as current accounts and fiscal balances were driven into the negative. While Central Asian governments have gradually reduced support measures, higher debt and a surge in inflation throughout 2021 did not result in a notable improvement of their public finances (IMF, 2022[5]).

So far, sustained consumption has supported government revenues

Remittances represent a substantial share of government revenues and GDP across Central Asia, comparable and sometimes even larger than the countries' share exports of goods and services (Figure 14). The increase in remittances in the first half of 2022 has contributed to boost consumption and government revenues in Kyrgyzstan, Tajikistan and Uzbekistan. The relocation of Russians with a comparatively high purchasing power, as well as of firms that used to be active in Russia, is further supporting consumption and generating additional tax revenues across the region (EUAA, 2022[86]).

Figure 14. Remittances and current-account dynamics in Central Asia



Note: *Data for 2021 are estimates. No data available for Turkmenistan.
Source: (KNOMAD, 2022[87]; World Bank, 2022[44]).

The main contribution is likely to come from both indirect consumption taxes, such as the value-added tax (VAT), as well as, in the longer run, corporate income taxes, and even personal income taxes if some of the newly arrived migrants settle on a more permanent basis in their host country. In the short run, VAT income which represents on average 33.6% of tax contributions to national budgets across the region (OECD, 2021[4]), will be the most immediate support to government revenues.

However, in the longer run, financial market developments might weigh negatively on the sustainability of public finances

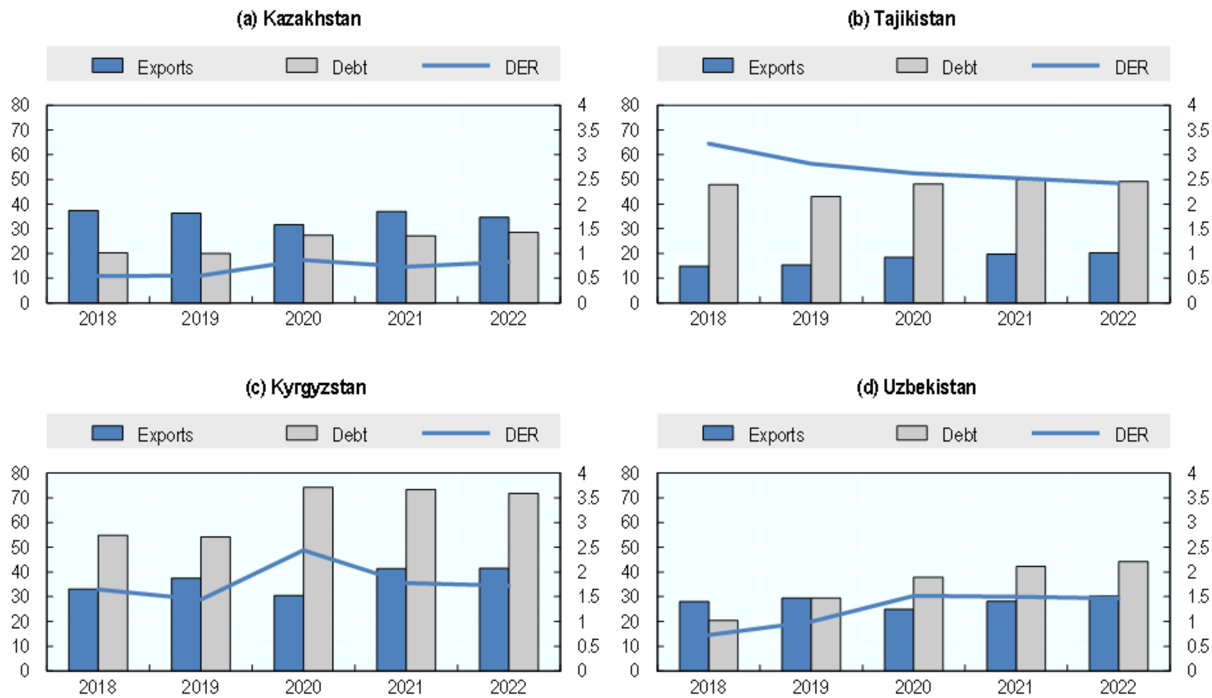
The pandemic already demonstrated that the ability of Central Asian countries to engage in debt-financed government spending remains restricted by relatively high borrowing costs and reduced access to financial markets. Only Kazakhstan, which has been issuing sovereign and corporate bonds since 1996, and Uzbekistan, which entered international debt markets in 2019, appear to have a relatively good position *vis-à-vis* external borrowing costs. Following the start of Russia's war in Ukraine and until August 2022, sovereign bond spreads rose between two and three times more in Central Asia than in other emerging markets, which suggests investors' concerns about Central Asia's close political, economic and financial ties with Russia. Until May 2022, financial markets seemed, for instance, to be more concerned with Kazakhstan's long-term sustainability prospects, as 10-year bond yields increased more than 2-year yields. Indeed, between the week of February 24 and end of May, these yields increased respectively by 184 and 114 basis points (bp). Since May, both yields have continued to increase, yet the two year maturity has seen the strongest relative increase. Between early May and end of August indeed, the 2-year bond yield increased by 246 bp, in comparison to 35 bp for the 10-year yield (World Government Bonds, 2022[88]; Investing.com, 2022[89]). Such a trend reversal might appear surprising given that globally financial conditions for oil exporters deteriorated relatively less as oil and gas prices surged, however might be the expression of an increased risk sentiment for Central Asia[3].

This comes against the backdrop of the pandemic which induced an increase in debt in 2020 that only slowly began to reverse in 2021, except for Mongolia, due to the lasting cost of fiscal support packages, and tightened global financial conditions, which put pressure on local currencies and sovereign spreads. The continued tightening of monetary policy in the United States and other OECD economies might lead to increasingly stringent financial conditions for Central Asia over the medium-term, while tighter domestic monetary policies to target inflation are increase borrowing costs and diminish fiscal space, at a time where debt will be carried over the next years. This could prove a major challenge to debt sustainability in Kyrgyzstan and Tajikistan especially, where fiscal space is already limited (IMF, 2022[22]; OECD, 2021[4]). Both countries are indeed still considered to have respectively moderate and high debt distress risk according to the IMF, mainly due to their dependence on exports (of raw materials) whose revenues are integral to their ability to service public borrowing (IMF, 2020[90]; IMF, 2020[91]; IMF, 2021[92]; IMF, 2022[93]).

[3] The 2-year bond yield exceeds the 10-year one since early August, which might indicate some fears of economic slowdown.

Figure 15. Debt sustainability in Central Asia

Tajikistan has the highest level of debt distress risk in Central Asia, indicated by a higher debt-to export revenue ratio (DER as % GDP, rhs), closely followed by Kyrgyzstan.



Notes: (1) Exports refer to total exports of goods and services, expressed as % of GDP based on the nominal GDP of the given year. (2) Government debt refers to all government or publicly backed liabilities, both internal and external, and is expressed as % of GDP. (3) The debt-to-export revenue (DER) is a commonly used indicator of sustainability of debt (rhs), expressed as a simple ratio of export earnings to outstanding debt; a lower number indicates that outstanding liabilities can be settled more quickly using export earnings. (4) The assessment of debt distress is taken from debt sustainability analyses compiled by the IMF in their most recent country reports for Kyrgyzstan, Tajikistan, and Uzbekistan.
Source: (IMF, 2022[22]).

In the longer run, the disentangling of Central Asia's economic relations with Russia might accelerate China's economic presence in the region

Central Asia could benefit from a rethinking of China's regional trade strategy

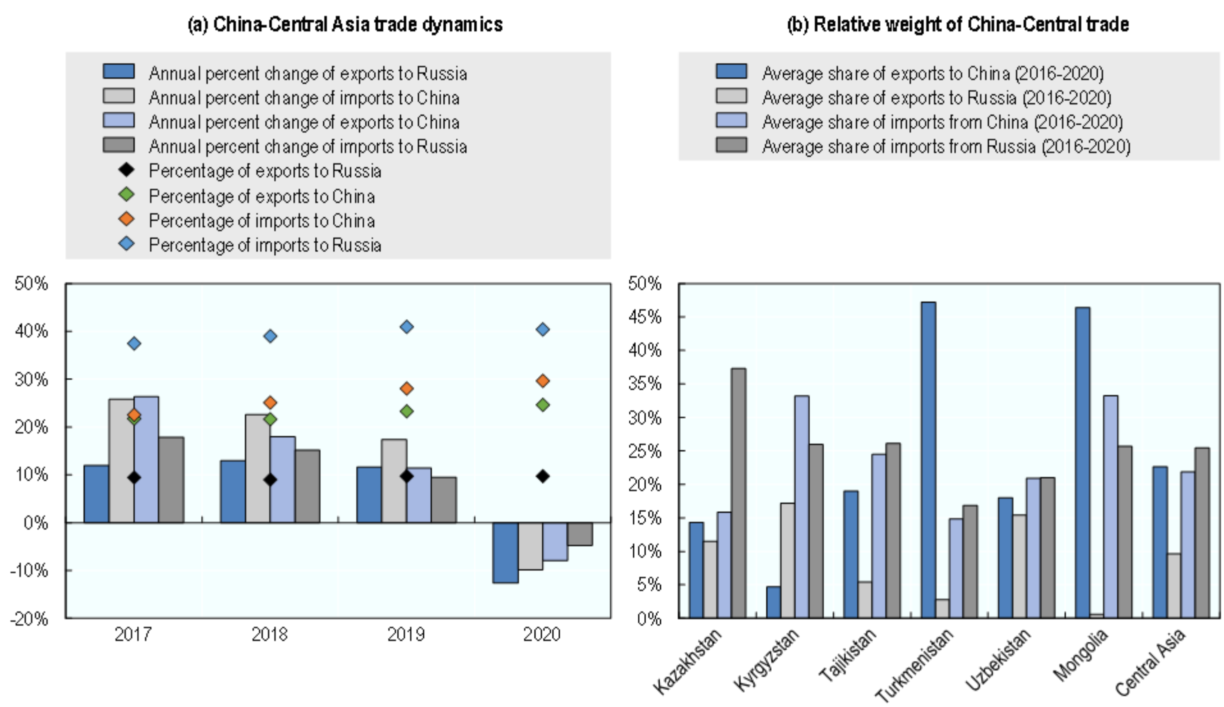
In recent years, China has become one of Central Asia's main trading partners (Figure 16), as well as an important source of investment and credit. China runs trade surpluses with all Central Asian countries except Turkmenistan, which mainly exports mineral and energy resources to China while importing little in return (IMF, 2022[22]). Room for expanded export dynamics exists, in particular for non-energy related commodities, as energy and mineral resources constitute the bulk of Central Asian exports to China, with Kazakhstan's exports to China dominated by crude oil, petroleum gas, refined copper, ferroalloys, and radioactive chemicals, and coal for Mongolia. The picture is very similar for Uzbekistan, Kyrgyzstan and Tajikistan where metals represent the largest share of exports to China (UNCTAD STAT, 2022[1]).

Over the past decade, especially with the Belt and Road Initiative (BRI), China has also deepened its political and financial presence in Central Asia. Recently investments have expanded beyond energy supply infrastructure, and discussions were engaged to open up the Chinese consumer market to Central Asia's food exports in an attempt to ensure food security. If the Chinese market were indeed to open up to

Central Asian products, new business opportunities might come along at a moment when the Russian market is increasingly problematic. A joint China-Central Asia summit in January 2022 called for a doubling of bilateral trade turnover by the end of the decade and for increased Chinese investment in the region.

The current disruptions to Chinese freight and traffic through Central Asia, especially on the northern route transiting *via* Russia to Europe, might force China to rethink its regional trade strategy, and could allow Central Asian countries to take a more strategic role vis-a-vis their large neighbour. However, strict zero-COVID policies throughout 2021 and the first nine months of 2020 in China resulted in additional and increasing border restrictions, especially with Kazakhstan and Mongolia, which might slow down possible trade reorientation (EBRD, 2022[94]), and casts doubt on China's willingness to engage with the region as import partners rather than just transit corridors (Eurasianet, 2021[95]). In the medium-term, if China's economic slowdown were to persist, prospects for increased exports from Central Asia might look bleak.

Figure 16. Evolution of China-Central Asia trade (2016-2020)



Source: (UN Comtrade, 2022[2]).

However, Central Asia's debt exposure to China could increase amidst tightening global financial conditions

Debt sustainability in Central Asia needs to be considered mainly as an issue of state revenue management, dollarisation, and exposure to a limited number of creditors, rather than an issue only of debt levels (OECD, 2021[4]). Indeed, the high level of dollarised debt for some countries leaves them vulnerable to exchange-rate movements and the tightening of global financial conditions, following, among other things, the normalisation of the US monetary policy (IMF, 2022[5]). The issue appears most pressing for Tajikistan and Uzbekistan which have almost all of their debt in USD (respectively 100% and 97%) (Reuters, 2022[96]; OECD, 2021[4]). If global financing conditions were to deteriorate further, Central Asian countries could seek financial support from China, as the interest of other investors might fade. However, the region's debt exposure to China already seems to be high, while the pandemic has highlighted the inherent sustainability issues it raises. Indeed, Kyrgyzstan, Mongolia and Tajikistan have seen their external debt to China increase drastically over the past decade, due to large amounts of funding for infrastructure projects under the BRI (Center for Global Development, 2018[97]). If the exact amounts and terms of China-held debt (both official bilateral loans and alternative loans channelled through SOEs) are unclear, recent research suggests that on average over 2000 to 2017, it could amount to close to 30% of GDP in Kyrgyzstan and Tajikistan, 25% in Turkmenistan, close to 20% in Kazakhstan and Mongolia, and about 10% in Uzbekistan. Official data from Kyrgyzstan even reports a debt exposure as high as 42% of GDP in 2022 (Standish, 2022[98]).

Table 4. Debt exposure of Central Asian countries to China

	Hidden debt exposure to China as % of GDP (2000-2017)	Sovereign debt exposure to China as % of GDP (2000-2017)	Total debt exposure to China as % of GDP (2000-2017)	Debt to GDP ratio (2021)
Kazakhstan	16	2	18	25.9
Kyrgyzstan	1	30	31	61
Mongolia	4	14	18	94.7
Tajikistan	3	24	27	46.5
Turkmenistan	23	2	25	10.6
Uzbekistan	9	2	11	36.8

Source: (AidData, 2021[99]; IMF, 2022[22]).

The pandemic has highlighted China's ambiguous stance towards Central Asia, as well as the difficulty some Central Asian governments face in servicing their debt. Tajikistan and Kyrgyzstan benefitted from the G20 Debt-Service Suspension Initiative (DSSI) in 2020 and 2021, the purpose of which was to allow low-income countries meet their social spending objectives throughout the pandemic, but conditions on their obligations to China have at best been only partially reduced, as China has not acceded to the countries' request for debt write-offs. While information on Chinese debt relief and suspension remains scarce, Tajikistan appears to have benefitted from USD 40 million debt relief from China under the DSSI in 2020, though additional debt relief was refused in 2021, and Kyrgyzstan's requests seem to have been unsuccessful (China-Africa Research Initiative, 2022[100]). The main issue seems to stem from the structure of Central Asia's debt exposure to China, as a non-negligible amount appears to occur outside sovereign channels, resulting in off-budget debt exposure to China (AidData, 2021[99]). Consequently, even though China was a signatory of the DSSI, it only applied DSSI terms to debt owned by its two official bilateral creditors (Eximbank and CIDCA); it did not extend this relief to other sources of finance used, in particular under the Belt and Road Initiative. Available information suggests that the region has increased its reliance on short-term, expensive, and sometimes resource-backed borrowing, which raises risks of debt unsustainability and distress, while reducing both future debt servicing capacity and access to concessional financing (OECD, 2020[101]; Natural Resource Governance Institute, 2020[102]; IMF, 2019[103]; OECD, 2021[4]; AidData, 2021[99]).

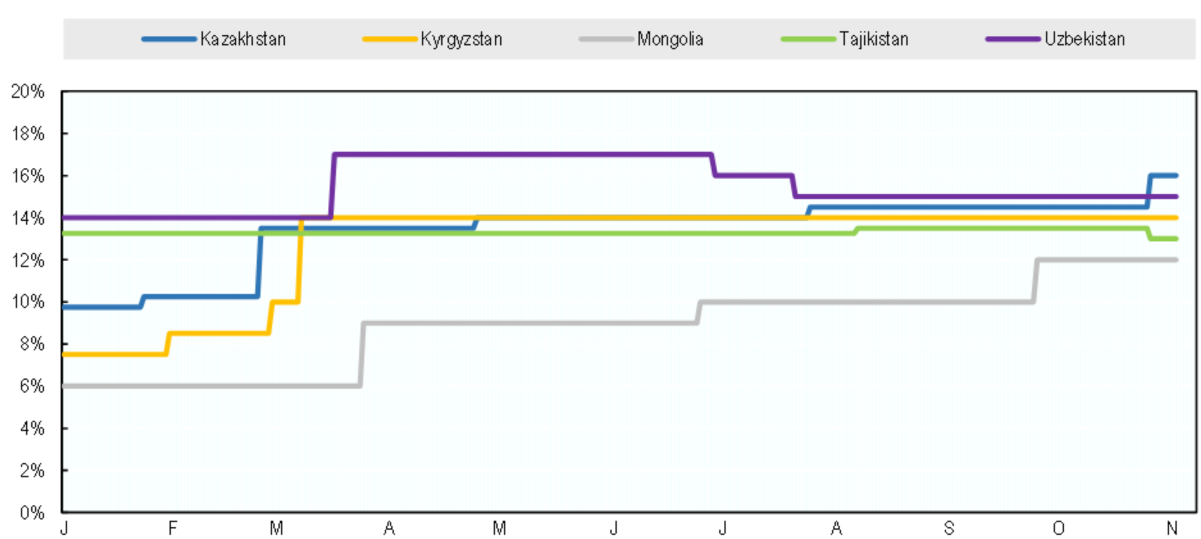
Policy responses in Central Asia

As of October 2022, Central Asian countries had predominantly taken monetary policy action to counteract currency depreciation and inflation, and measures to ensure food security. Little policy action was observed from Turkmenistan, though it is arguably the least affected country of the region. More noticeably, all countries of the region have shown an interest in developing new trade routes circumventing Russia westwards through the Middle Corridor, eastwards through China, and southwards through Afghanistan, Pakistan and India.

Monetary policy across Central Asia has proved effective in stabilising exchanges rates, but high inflation remains an issue

So far, the war's most important negative impact across Central Asia has mainly been in terms of inflation. In the first half of 2022, central banks in the region accelerated the monetary tightening initiated in 2021 to stabilise exchange rates and contain rising prices. Since February all national banks of the region, except for Turkmenistan incrementally increased their base rates (Figure 17). Uzbekistan has decreased its rate twice in June and July to a level still slightly above the pre-war one. Tajikistan also decreased its base rate early November, below its pre-war level. Since imported inflation accounts for a large part of the price dynamic, this monetary tightening has not yet had an impact on inflation, but it has affected financial conditions, which might have a negative impact in the longer-run especially on SMEs' access to finance and debt servicing costs (EBRD, 2022[45]).

Figure 17. Evolution of policy rates in Central Asia countries (2022)



Source: National Bank of Kyrgyzstan, National Bank of Kazakhstan, Central Bank of Uzbekistan, Bank of Mongolia, National Bank of Tajikistan, 2022.

During the first quarter of the year, as Central Asian economies were experiencing large exchange rate fluctuations, some central banks intervened to stabilise their currencies. For instance, the National Bank of Kazakhstan sold close to USD 1bn in March, while the National Bank of Kyrgyzstan imposed a temporary ban on financial enterprises to transfer cash US dollars outside of the country (Reuters, 2022[104]). By contrast, the National Bank of Tajikistan did not intervene to counteract the strong depreciation of the somoni in March, and the Central Bank of Turkmenistan kept the fixed exchange rate unchanged.

Windfall revenues have provided support to individuals and businesses

Higher than expected remittances, as well as relocation of Russian migrants with relatively high purchasing power, have sustained consumption across the region, especially in the services sector. The increase in the salaries of civil servants throughout 2022 decided by the Kyrgyz government also helped to support consumption in the country (Mir 24, 2022[105]). In addition, higher than expected revenues from energy and mineral commodity exports, have given governments some margins to support businesses in sectors affected by supply disruptions and rising costs, as well as to shield households from rising food and energy prices. However, constrained fiscal space might remain a lingering issue, as suggested by the Spring announcements of a halt in non-priority public spending for infrastructure and equipment made by the Tajik and Uzbek governments (Asia Plus, 2022[106]; Lex-UZ, 2022[107]).

Across the region, governments predominantly implemented measures in the agricultural sector to secure food and energy supplies, ensure price stability and increase agricultural output. The Kazakh government, for instance, enacted a new food security plan that aims to increase and diversify agricultural production, imposed temporary grain and flour export restrictions to its Central Asian neighbours, and introduced sales requirements on the domestic market (Kazinform, 2022[108]). The Kyrgyz government allocated an additional USD 85m to the Ministry for Emergency Situations to procure essential foodstuffs and energy commodities (24 KG, 2022[109]). In addition, the Uzbek, Kyrgyz and Tajik authorities introduced or extended several temporary exemptions to fiscal rules such as VAT waivers, transport tariff reductions, and customs, tax and excise breaks, to the benefit of food importers. They warned sellers of legal liability for unjustified price increases. The Turkmen authorities instructed farmers to increase planting and production of some foodstuffs to boost agricultural exports to Russia (Ozodi, 2022[110]). Governments in the region also announced measures to provide additional financial support to small and medium enterprises (SMEs) and reduce administrative burdens. Announcements were made in Kazakhstan, Uzbekistan and Kyrgyzstan to extend additional funding in the form of subsidies or loan guarantees to SMEs, and Tajikistan has enacted a moratorium on business inspections until 2023 and declared its intent to review more than 420 regulatory acts (Asia Plus, 2022[111]).

Central Asian countries have sought to diversify trade routes

Central Asian governments have been exploring new trade route options to offset the *de facto* closure of the “Northern Route” via Russia. As a result of sanctions against Russia, Central Asia has faced significant supply chain disruptions: forthcoming OECD surveys assessing the business climate in Kazakhstan and Uzbekistan found that an overwhelming 97% and 85% of respondents respectively have faced logistical challenges due to the disruption of supply chains.

The Trans-Caspian International Transport Route – often called the “Middle Corridor” – could provide an alternative, but its capacity is at present only a fraction of that of the northern route via Russia. The Middle Corridor has considerable – as yet unrealised – potential, but it will still involve both longer shipment times and higher costs than the northern route (Eurasianet, 2022[112]) (ADB, 2021[113]). Changing that will require substantial investment to address infrastructure bottlenecks not only in Central Asia and the South Caucasus but also in Türkiye and the Balkans. Even then, this route is longer and it will involve more modal switches, which implies more loading and unloading, as well as more international frontiers, which means more border formalities, documents and tariffs.

Attention has also focused on developing southward routes to India, Pakistan or even – as and when sanctions are relaxed – Iran and Afghanistan, and eastward links to China. Following two decades of discussions, the China-Kyrgyzstan-Uzbekistan railway project was signed during the Shanghai Cooperation Organisation (SCO) summit on 14 September, and will be used as an alternative to the Russian route for transit to Europe: once completed, the new line could become part of a shorter route from China to Europe through Kazakhstan, Turkmenistan, Iran and Turkey. In the same vein, the region has been developing trade links with Pakistan: Uzbekistan entered into a preferential trade agreement with its southern neighbour, which Kazakhstan and Kyrgyzstan intend to replicate (The News, 2022[114]). Despite the sanctions imposed on its southern neighbour, Uzbekistan is also looking to develop the Trans-Afghan railway, which would link Tashkent to Pakistani ports of Karachi, Gwadar and Qasim through Mazar-e-Sharif and Kabul in Afghanistan (The Diplomat, 2022[115]).

This makes it imperative that participating countries move rapidly and effectively to streamline customs and other border formalities and to reduce to a minimum the costs associated with crossing frontiers along the Corridor. Developing such routes, wherever they run, will require more attention to the “soft infrastructure” of trade. Improvements to customs and border management, unification of documents and the harmonisation of regulations will matter as much as developing and debottlenecking the *physical* infrastructures along the new routes. Kazakhstan, Azerbaijan and Georgia have this spring taken some important steps to make the Middle Corridor easier but much more must be done. A co-ordinated, region-wide approach to trade facilitation reforms could do much to stimulate trade both within and across Central Asia. Indeed, governments could move beyond trade facilitation and liberalise trade within the region and across the corridor. A regional trade zone with co-ordinated trade policy, practices, and standards, technical and legal developments would open up new opportunities for Central Asia and would also strengthen its position vis-à-vis Europe and China. Progress down this path would require both stronger intergovernmental dialogue mechanisms and deeper, more meaningful public-private dialogue within and across countries.

Table 5. Overview of the main announced measures in Central Asia as of October 2022

	Monetary policy	Support to firms	Support to households	Other
KAZAKHSTAN	Policy rate increase from 11.25% to 13.5% in February, to 14% in April, and 14.5% in July 600 M USD interventions of National Bank to stabilise the tenge	Reduction of administrative checks and procedures, expansion of preferential leasing programme for agricultural equipment, subsidies for fertiliser, pesticides and insurance premia in the agricultural sector	Temporary export restrictions on food products Deposit insurance guarantee on 10% of savings held on bank accounts as of February 23 Introduced price caps for basic food and energy products	Discussions with third countries (e.g. Azerbaijan)on alternatives to Russian ports for oil delivery
KYRGYZSTAN	Policy rate increase from 8.5% to 10% in February, to 14% in March, and to 16% in August	Tax breaks and reductions for food-importing companies, increase of concessional lending to firms in agricultural and energy sectors Launched a digital nomad program, allowing foreign citizens to enter and stay in the country without residence registration, and delivering them work permits	Temporary export restrictions on food products Increased wages for government officials Additional budget allocated to Ministry of Emergency Situations to increase food stock purchases Flour handouts and 50% capped discount on electricity bills to low-income households	Ban on USD transfers in cash outside of the country to prevent USD outflow China-Kyrgyzstan-Uzbekistan (CKU) railway project for 2023
MONGOLIA	Policy rate increase from 6.5% to 9% in March, 10% in June, and 12% in September	Expenditure cuts of about of about 100 million USD in Spring amendment to the government budget Subsidized loans provided by the government to the agricultural sector 80% discount for vegetable and greenhouse seeds, which were purchased by the government	Austerity Law was implemented for improving food security and coping with inflation Taxes were cut on selected food items (e.g. sugar and vegetable oil) 50% discount on social insurance payment for low-income employees until the end of 2022	Resumed trade cooperation with China (re-opening of border-crossing points, launch of new customs clearance systems, strengthened border cooperation)
TAJIKISTAN	Policy rate kept unchanged	Moratorium on business inspections till January 2023	Increase social spending with assistance of development partners	Halt in non-priority public spending for infrastructure and equipment purchases
TURKMENISTAN	No change	No information available	No information available	Farmers have been instructed to increase agricultural output to boost exports to Russia
UZBEKISTAN	Policy rate increase from 14% to 17% in March, decrease to 16% in June, and to 15% in July	Additional concessional financing to SMEs Work and visa programmes to attract foreign IT specialists Support to the agricultural sector (public purchase to supply seeds and seedlings to farmers; allocation of additional land for agriculture, fiscal exemptions for food imports) IT Visa for investors and IT professionals	Expansion of support programmes to labour migrants and their families	Halt in non-priority public spending for infrastructure and equipment purchases Hire of international consultants to review course of action for transactions with sanctioned Russian banks China-Kyrgyzstan-Uzbekistan (CKU) railway project for 2023

Source: OECD (2022).

Policy options for Central Asia

Supportive fiscal policies can offset some of the negative economic effects, but should be handled with caution to keep debt and inflation levels in check

Provide targeted, temporary support to households to ease the impact of price increases

High commodity prices and food shortages represent significant risks going forward, which could be exacerbated for the 2023 harvest with rising fertiliser costs (IMF, 2022[116]). Governments across the region should therefore focus efforts on providing targeted support to the most affected households. As lower-income economies and poorer households spend a higher share of their incomes on energy and food commodities, targeted, temporary and means-tested support is needed to help the most vulnerable. The scope for doing so will vary across the region as a function of fiscal space and state capacities, with energy exporters Kazakhstan, Turkmenistan, and Uzbekistan finding themselves in a more comfortable position than Kyrgyzstan and Tajikistan. In these two countries, as in Mongolia, shielding the most vulnerable households without undermining debt sustainability will prove challenging. Reforms initiated during the COVID-19 pandemic to expand social safety nets may serve as a good basis to prevent a sharp rise in poverty (OECD, 2021[4]).

In terms of targeted support to vulnerable groups, measures could include tax reductions or cash transfers. Support should also account for the fact that households may be affected in different ways. Urban and rural households that are net food buyers may be losing out, as they incur higher expenses to maintain the same levels of consumption, while food-producing rural households may benefit, though this depends on the degree to which rising food prices do or do not outstrip increases in the cost of inputs, particularly fuel and fertilisers (FAO, 2008[117]). Governments have also considered market-level policy responses such as eliminating or reducing import tariffs and restrictions on food products. Measures could be financed by considering windfall taxes on energy company profits, especially in energy exporting countries, by re-prioritising spending plans (OECD, 2022[23]), and/or by blending non-contributory (financed by the government) and contributory financing schemes (World Bank, 2022[118]).

Provide targeted and temporary support to businesses to help them weather supply chain disruptions, liquidity constraints and increased debt servicing costs

Firm-level policies to support the diversification of trade linkages could help partially offset the supply chain disruptions. Central Asian firms indeed face significant supply and export challenges with a lack of alternative routes bypassing Russia, skyrocketing transport costs, delivery delays and increasing difficulties accessing credit (World Bank, 2022[54]; Kurbanov, 2022[119]). Support measures may include tariff and customs reductions, streamlined customs procedures, temporary fiscal waivers and elimination of import licensing and concessional lending for firms operating in essential sectors (OECD, 2020[120]). Governments may also consider providing incentives for firms to hold additional inventory, as precautionary inventory management can help mitigate input disruptions (Lafrogne-Joussier, 2022[121]).

In the longer run, central banks and governments need to carefully adjust monetary and fiscal policies to hold a delicate balance between containing inflation and supporting growth. The current monetary tightening across the region, except for Uzbekistan, bears the risk of provoking a liquidity crisis for businesses, especially SMEs, and weigh negatively on growth. Governments should act to maintain access to finance for SMEs, and contain excess debt servicing costs. Such policies could be based on mitigation measures implemented during the pandemic, for instance targeted government-backed loans, investments into selected sectors, temporary tax reductions, as well as temporary loan and mortgage repayments freezes. Careful communication about timely support measures is also essential to encourage businesses maintain investments, and banks continue financing firms.

Refrain from protectionist policies to ensure trade and agriculture keeps flowing

Although Russia and China, the region's two large neighbours, have been implementing export restrictions, Central Asian countries should refrain from introducing similar protectionist measures, which might further exacerbate shortages (IMF, 2022[122]; OECD, 2022[23]). Export restrictions should be avoided as they magnify the surge in commodity prices and create a multiplier effect, whereby the increase in world prices leads governments to retaliate by imposing new export restrictions, pushing prices up (Espitia, 2022[123]). Attempts to "export" price pressures via export restrictions, if replicated by numerous countries, tend to make all worse off. As the experience of the 2008-09 crisis and the COVID pandemic show, freer and smoother trade tends to *enhance* food security. Import tariffs also affect prices on domestic markets, as they raise the prices of imported goods and lead to changes in the prices of domestically produced goods that compete with imports. Further, tariffs on imported intermediate inputs increase production costs and create a cascading effect through supply chains. In a period of increasing inflation rates, trade liberalisation can put downward pressure on prices, as lower import tariffs and prices can help reduce CPI inflation (Robinson and Thierfelder, 2022[124]).

In the longer term, the foreseeable reduced economic weight of Russia requires Central Asia to diversify trade and investment relationships

Seize the opportunity to reinforce integration into regional and global supply and value chains

The disruptions to global trade caused by the pandemic, and subsequently by the war, are an opportunity for the region to play a larger role in global supply and value chains (GVCs). A way for Central Asia countries to better integrate into GVCs starts with increasing regional economic integration. Regional cooperation indeed entails cost and efficiency gains, as well as an increase in market size for regional production (ADB, 2020[125]; OECD, 2021[4]; OECD, 2020[120]). Two obvious, significant barriers to regional integration that need to be addressed are the lack of quality infrastructure and disparities across legal and regulatory standards across Central Asia, as indicated by the performance gap of the countries of the region in the OECD Trade Facilitation indicators (OECD, 2020[120]; OECD and ITF, 2019[67]). With regard to infrastructure, customs automation, pre-arrival data processing and other digital solutions can ease customs operations and trade (OECD, 2022[126]). As for legal and regulatory disparities, the mutual recognition of standards or the adoption of common international standardisation and certification principles, such as EU certification, could ease trade flows, and increase products' competitiveness and value (OECD, 2021[4]).

Further, joining global alliances can promote integration into global value chains and diversify away from a declining trade partner. Four of the six countries in the region (Kyrgyzstan, Mongolia, Tajikistan and Uzbekistan) already benefit from favourable access to the EU market, through the Generalised Scheme of Preferences (GSP) or GSP+. Uzbekistan and Turkmenistan could accelerate WTO accession talks, while

Kyrgyzstan could ensure its compliance with WTO standards. Such initiatives can prove beneficial to boost trade, diversify export markets, and attract investment for sectors to move up in the value chains.

Improve the overall business environment to increase the region's longer-term growth prospects and attractiveness

Temporary mitigating measures should not lose sight of longer-term reforms needed to address market distortions and absorb a rapidly growing labour force. Latest OECD surveys assessing the business climate in Kazakhstan and Uzbekistan found that the three main impediments to conducting business in both countries remain bureaucracy, corruption and lack of qualified workers. Governments across the region should pursue their efforts to reduce the role of the state in the economy, by enhancing competition – including through the removal of SOEs' privileges and barriers to market entry –, widening access to financial services, designing efficient and non-distortionary tax systems and removing excessive rigidities in labour market codes (IMF, 2022[122]; OECD, 2020[120]). Efforts to improve the business environment can also contribute to tempering investors' perceptions of heightened risk in the region.

Building resilient and inclusive economies can support this agenda

Seize the opportunity to advance the region's green transition

Considering Central Asia's vulnerability to climate change, abundant renewable energy resources, and opportunities for energy efficiency, high global fossil energy prices provide momentum for the region to diversify its energy mix. Commodity exporters Turkmenistan and Kazakhstan, as well as Uzbekistan to some extent, can invest windfall revenue in their green transition, while Kyrgyzstan and Tajikistan may consider decreasing their reliance on hydrocarbon imports through investments in hydropower capacity. Moving away from fossil fuel dependence and reaching stated climate goals will require phasing out fossil-fuel subsidies and support to upgrade the energy transmission and distribution systems. OECD assessments suggest that post-COVID recovery funding in many countries has been allocated to existing infrastructure or to measures unlikely to have a sizeable positive environmental impact. More broadly speaking, Central Asian countries also need to develop long-term low-emission development strategies and integrate these objectives across other planning and policy making activities (OECD, 2022[127]).

Capitalise on highly skilled human capital flocking into the region

The war and subsequent mobilisation have triggered unprecedented migration flows from Russia to the Central Asia region. Beyond the need to address short-term pressures on national infrastructures, Central Asian countries should capitalise on the influx of migrants from Russia and Belarus to retain high-skilled workers (Foreign Policy, 2022[128]). Unlike more "typical" migration waves, Russian-speaking migrants do not encounter language barriers coming into the region and have high education levels. Given the skills shortages facing the private sector in Central Asia, integrating these workers in national labour markets can contribute to increase the general level of skills and reduce the skills mismatch, as well as provide additional fiscal revenue for governments. The latter should therefore ensure that conditions are in place to incentivise workers to stay in the long term. Relevant measures include employment matching services, experience and skills testing, and developing guidelines and FAQs to facilitate the establishment of opening a business.

Box 2. National programmes supporting business relocations to Central Asia

Kazakhstan, Kyrgyzstan and Uzbekistan quickly introduced measures to support entrepreneurs relocating to the region pursue their business activities.

Kazakhstan's Astana hub offers foreign IT specialists and companies registering in the hub a special tax regime, infrastructure, visa support and other benefits. Start-ups can benefit from 12-month free office rent and business-development grants of up to 50k USD.

Kyrgyzstan launched a *Digital Nomad* programme which allows foreign citizens eligible to the scheme to enter and stay in the country without a residence registration and grants them a work permit. The scheme is open for citizens of Azerbaijan, Armenia, Belarus, Kazakhstan, Moldova and Russia working in the field of digital technologies. As of October 2022, 600 citizens had applied to the scheme.

In the same vein, Uzbekistan introduced an IT visa for investors, founders of IT park resident companies and IT professionals. The scheme offers several tax breaks and incentives, including exemption from all types of taxes and customs charges for imported equipment for personal use. IT parks offer support to obtain medical insurance, open a bank account, and search for a job and accommodation, among other services.

Source: (The Astana Times, 2022[129]) (Ministry of Economy and Commerce of the Kyrgyz Republic, 2022[130]) (IT Visa, 2022[131])

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Weathering Economic Storms in Central Asia

INITIAL IMPACTS OF THE WAR IN UKRAINE

Russia's war against Ukraine and the international sanctions introduced against the former have had an unexpectedly mild impact on Central Asia, despite the region's deep economic dependence on its northern neighbour. Notwithstanding high inflation, the five Central Asian states – Kazakhstan, Kyrgyzstan, Mongolia, Tajikistan and Uzbekistan – have so far shown surprising resilience to the economic headwinds: remittances registered record-high figures in the first half of 2022, national currencies quickly rebounded to pre-war levels after an initial drop, and an influx of skilled workers boosted demand for services and hospitality. However, as the medium-term effects of the sanctions against Russia, the global cost-of-living crisis, and China's economic slowdown start to unfold, Central Asia is faced with lingering uncertainty. This publication provides an assessment of the short-term effects of Russia's war on Central Asian economies and the policy responses provided. It also analyses the challenges ahead and formulates policy recommendations to make Central Asian economies more resilient and diversified.

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