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Challenges, Policy Options, and the Way Forward

Economic Diversification in Selected Asian Landlocked Developing Countries (Bhutan, Kazakhstan, Mongolia, and Turkmenistan)

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EXECUTIVE SUMMARY

Landlocked developing countries (LLDCs) face multiple development challenges. On the one hand, they incur higher trade costs due to their geographical remoteness, inadequate transport infrastructure, and poor trade logistics. These problems are compounded by the challenges of multiple border crossings and diverging transport systems and regulations in transit countries. On the other hand, many LLDCs lack crucial productive capacities and are dependent on the exports of primary commodities, rendering them vulnerable to global commodity price shocks.

In 2014, the Second United Nations Conference adopted the Vienna Programme of Action for LLDCS for the decade 2014–2024 (VPoA) to address these trade and development challenges. In 2019, five years into implementation of the VPoA, the General Assembly will undertake a comprehensive midterm review of its progress pursuant to resolution UNGA 72/232. Preliminary assessments of progress, including by the United Nations Conference on Trade and Development (UNCTAD), show that, five years into the implementation of the priority areas contained in the VPoA, the socioeconomic conditions of LLDCs have not shown significant improvements.

This report forms part of UNCTAD's substantive contribution to the midterm review of the VPoA. It examines the micro- and macro-economic policies as well as the institutional and regulatory measures required to promote economic and export diversification in four Asian landlocked economies: Kazakhstan, Turkmenistan, Mongolia and Bhutan. The four countries are characterized by high levels of commodity-dependence, challenging geographical and historical contexts, and low socioeconomic outcomes.

The report argues that, despite complex trade and development challenges, the countries studied have significant potential to diversify their economies into the production and export of higher-value-added products in several sectors. These include agriculture (including agro-processing), light manufacturing (such as textiles, leather, and leather products), information and communications technology, tourism, and the construction sectors. Using the product-space approach, the report also identifies specific products that hold potential for export expansion and diversification in each country. For instance, agriculture and, to a lesser extent, manufacturing, are promising sectors for diversification, including niche products such as mandarin oranges (Bhutan), cashmere (Mongolia), silk (Turkmenistan), and cereal (Kazakhstan). The rich cultural heritage and varied geography of these countries are also conducive to tourism. In addition, there can be synergies between tourism and improvements in the quality of some local food and manufacturing products. However, a number of improvements in micro- and macro-economic policies and institutions are necessary to realize this potential.

I. INTRODUCTION

There are 32 countries classified by the United Nations as landlocked developing countries (LLDCs): 16 in Africa, 14 in Asia and Europe, and two in Latin America.[1] As the name of the group indicates, they all share two particular features: they are developing countries, and they do not have direct access to a sea. Otherwise, they differ in many respects. Their populations range from less than 1 million to more than 100 million. The income level of the poorest LLDCs is below US$1,000 at purchasing power parity (PPP), while that of the richest is above US$10,000, although most LLDCs are categorized as either low-income or middle-income countries. Despite their differences, many LLDCs share stark similarities along plenty of socio-economic dimensions that go beyond their lack of sea access. One such defining feature is considerable reliance on just a few natural resources, i.e. commodity dependence. For instance, in 2016 more than half of all export revenues in 22 LLDCs came from only three products.[2] In addition to this dependence on a few commodities, many of these countries are also reliant on a few large markets such as China, the European Union (EU), India, the Russian Federation, and the United States. Furthermore, LLDCs are characterized by poor transport infrastructure and trade logistics, as well as cumbersome trade facilitation processes, all of which substantially increase their trade costs and undermine their international (i.e. export) competitiveness.

The communalities of complex development challenges facing LLDCs are causes and consequences of severely underdeveloped and weak productive capacities,[3] lack of export diversification and absence of structural economic transformation.[4] Building on its conceptual and analytical work, the United Nations Conference on Trade and Development (UNCTAD) argues that the key to address

1. Afghanistan, Armenia, Azerbaijan, Bhutan, Bolivia, Botswana, Burkina Faso, Burundi, Central African Republic, Chad, Ethiopia, Eswatini, Kazakhstan, Kyrgyzstan, Lao PDR, Lesotho, Malawi, Mali, Moldova (Republic of), Mongolia, Nepal, Niger, Paraguay, Rwanda, South Sudan, Swaziland, Tajikistan, the Former Yugoslav Republic of Macedonia, Turkmenistan, Uganda, Zambia, and Zimbabwe.

2. At the 3-digit level of the SITC, Rev. 3.

3. Productive capacity is defined by UNCTAD as "the productive resources, entrepreneurial capabilities and production linkages which together determine the capacity of a country to produce goods and services and enable it to grow and develop" (UNCTAD 2006: 61). The definition stresses three distinct but interrelated dimensions – productive resources, entrepreneurial capabilities, and production linkages – that make up the fundamental elements of productive capacity.

4. Structural economic transformation, which is Priority 5 of the Vienna Programme of Action, refers to the movement of productive resources and policy actions from low-productivity economic activities to higher-productivity ones, and from traditional to modern sectors, with increasing value addition and sophistication of export products and services. Structural economic transformation can occur not only across sectors but also within sectors.

1.1 The paradox of natural resource wealth in the Central and South Asian context and prospects for economic diversification

One would expect natural resource abundance to be a great advantage in fostering prosperity in developing countries, given the right policy, institutional, and regulatory environments that support productive and transformational development. In practice, more often than not, natural resource wealth has proven to be a factor inhibiting rather than facilitating or promoting economic development (Venables 2016; Collier 2007). The growth performance of natural-resource-abundant countries has generally been lackluster, as Sachs and Warner (1995) were the first to point out. In the 2000s, the "commodity super-cycle" of rising commodity prices driven by Chinese demand for raw materials, particularly energy, led to booming growth in many natural-resource- exporting countries (Gangelhoff 2015). Falling oil and other commodity prices since 2015, associated in part with a slowdown in China's growth, has revealed the fragile foundation of this growth and the lack of structural transformation in many natural resource exporters, with many countries facing fiscal and balance of payments crises and sharp declines in growth.

There are a number of economic and political reasons for the gap between natural resource wealth and socio-economic development. From an economic point of view, natural resources are difficult to manage (Venables 2016). Extraction is often technically complex and beyond the capabilities of developing countries. Thus, many countries welcome foreign investment. Relations between multinational companies and national governments can be fraught, and in some cases developing countries may not bargain effectively or lack the capacity to do so. In other cases, developing countries are so wary of foreign involvement that they prohibit or dissuade it, thus reducing their ability to exploit and earn income from their resources. This is the case with Turkmenistan for natural gas and Mongolia for mining, as discussed below.

Moreover, management of resource revenues has proven to be the most significant problem. First, resource prices and revenues are highly volatile, making planning difficult. In principle, countries should save a large part of their income when prices and sales are temporarily high, perhaps into

a stabilization fund, and thus run current account and fiscal surpluses. Conversely, when prices are below their long-run level, countries can legitimately run fiscal and current account deficits. In practice, however, even ignoring the political distortions discussed below, it is not always easy to determine when prices are above or below an equilibrium level and whether price changes are permanent or temporary. Second, booming natural resources tend to result in "Dutch disease" – domestic currency appreciation and higher wages – that harms other tradable goods sectors, both traditional and non-traditional. This can be problematic for long-run development because of the acute dependence that results on one or a few commodities. Third, even when windfall revenues are used for investment rather than consumption, the investments sometimes support showcase monuments or inefficient public sector enterprises that do not contribute to long-run growth. Finally, and perhaps most importantly, natural resource extraction and distribution is capital-intensive and not conducive to shared growth and structural transformation.

Manufacturing and agriculture contribute more to technological progress, forward and backward linkages with other sectors, and employment creation, including for women and youth. The employment issue is of critical importance in countries with young and rapidly growing populations, and empowerment of women is of central importance in its own right as well as a way of fostering the demographic transition to lower birth rates. The so-called "East Asian miracle" was based on export-led growth of labor-intensive manufacturing. Export-oriented agriculture, fishing, and tourism can also play a transformative role for much the same reasons: employment creation and quality upgrading through participation in global value chains (Golub et al. 2008; Golub et al. 2011). Even when they were growing rapidly in the 2000s, many commodity-exporting countries such as Angola experienced very high levels of inequality and widespread underemployment (Golub and Prasad 2016).

While these economic downsides of natural resource dependence are important, economists increasingly recognize that the political, regulatory, and institutional consequences are even more crucial. The problem is simple: large resource rents (i.e. revenues in excess of costs) can provide an irresistible temptation to engage in wasteful spending and corruption. It is difficult to restrain spending when revenues are high, even for well-intentioned officials who recognize the temporary nature of price increases. Worse, with weak institutional restraints, resource rents occasion rent-seeking, i.e. battles over access to these rents. They also lead to patronage and corruption, sometimes even contributing to civil conflict and state failure (Collier 2007, 2010). Thus, revenues are often used by ruling elites in both democracies and dictatorships to enrich themselves and their families while buying support from the population with costly and inefficient subsidies. For example, some oil-exporting countries such as Nigeria have very low domestic prices of refined petroleum products, so much so that their refineries are bankrupt and the countries have to import gasoline, some of which is smuggled from neighboring countries with lower subsidies and thus higher prices.

Furthermore, international financial markets may abet procyclical fiscal policies by providing abundant loans in good times while pulling out abruptly when prices fall (Vegh 2015). Offshore financial markets also contribute to corruption by accepting and concealing plundered funds from elites in developing countries. Finally, corruption and fiscal irresponsibility are facilitated by off-budget management of resource revenues, often in the guise of a stabilization fund (Venables 2016).

Misuse of resource revenues and institutional dysfunction can go hand-in-hand in a vicious circle. Countries with weak institutions find it most difficult to prevent corruption or the wasteful use of revenues. Conversely, resource revenues can perpetuate institutional failures and poor policies by easing budget constraints and thus enabling avoidance or postponement of necessary reforms.

1.2 What can be done?

Reducing dependence on natural resource revenues involves both macroeconomic and microeconomic policies, as well as strengthening the governance and institutional capacity to implement such policies. It also requires fostering productive capacity, structural transformation, and diversification of exports, as well as clearly understanding market requirements and demand structures in export destinations.

1.2.1 Macroeconomic policies

It is important to follow countercyclical spending policies,

that is, saving resource revenues in boom times and reserving deficit spending for downturns in revenues. When prices are high, countries should run fiscal and current account surpluses, reducing public debt and accumulating foreign exchange reserves. As noted above, this is difficult due to political pressures to ramp up spending when revenues are high and credit is readily available. Establishing stabilization funds governed by spending rules can be a positive step, but only if these funds are operated transparently and the rule of law is followed. In addition to saving from windfalls, investment spending on infrastructure, education, and other projects that boost long-term development can be justified, but the investments must be driven by economic returns rather than political favoritism. Limiting real exchange rate appreciation is also important to mitigate Dutch disease effects. Accumulating foreign exchange reserves during booms can reduce pressure on the exchange rate to appreciate in both nominal and real terms. Countercyclical spending policies also are helpful in reducing appreciation.

A few countries, such as Botswana (Kojo 2016), have been quite successful in managing revenues. Botswana leveraged its diamond revenues into very rapid growth and poverty reduction by following the above principles: countercyclical fiscal policies, limited real exchange rate appreciation, and well-targeted investments in infrastructure, health, and education. Strong institutions and control of corruption are the keys to these relatively few success stories, although Botswana still struggles to reduce its dependence on a single export item (diamonds).

1.2.2. Structural policies to spur diversification

While sound macroeconomic management of resource revenues is necessary, it is also critical to create the microeconomic conditions that foster diversified economies. Extracting minerals can occur even in poorly functioning institutional environments due to the enclave nature of production and the large rents that accrue to firms and governments. Developing globally competitive manufacturing, agriculture, and tourism sectors is much more challenging because firms can choose where to locate and source based on the quality of the business environment.

Furthermore, it does not necessary make sense to foster downstream processing industries. For energy and mining, downstream sectors such as petrochemicals and metals are capital-intensive and require a high level of technical sophistication. Conversely, labor-intensive manufacturing may be viable even if the country does not produce the raw material in question, as East Asian countries have demonstrated. The East Asian experience also suggests that low-income countries should start with the least-skill-intensive products and gradually upgrade their production capabilities and the sophistication of their exports (Golub et al. 2008).

Increasingly, diversification into manufacturing and agriculture requires participation in global value chains. Multinational producers and buyers seek the most favorable locations for production of components or niche products (Pomfret and Sourdin 2014). Such factors as well-functioning infrastructure, limited administrative red tape, transparency of government operations, and labor with appropriate skills determine whether a country can gain a foothold in manufacturing global value chains. As Golub et al. (2007) put it, the quality of a country's "service links" (ports, roads, customs administration) affect the competitiveness of its "production blocks". For agriculture, fishing, and tourism, local determinants of comparative advantage such as climate, soil conditions, and historic patrimony matter more, but these sectors are also very competitive and success depends on quality control as much or more than in manufacturing (Golub et al. 2008; Golub and McManus 2009; Golub and Varma 2014).

The difficulty of participating in global value chains is exacerbated in resource-rich countries for the reasons mentioned above. Furthermore, the countries considered here, as summarized in the next section, have a history of central planning and isolation from the global economy. For these reasons, this report pays particular attention to the business climate for domestic and foreign investment, closely examining strengths and weaknesses of public services, institutions and infrastructure.

1.2.3. Quality of governance and institutions

Good macroeconomic and structural policies depend on institutions and governance (Collier 2007; Acemoglu and Robinson 2012). As Acemoglu and Robinson (2012) stress, inclusive rather than extractive institutions promote sustainable growth and improvements in living standards. Thus, this report closely examines issues of governance

such as the level of corruption and the functioning of the education system.

1.3. The Central / South Asian context

The four countries covered by this study are landlocked and face challenging geographical and historical circumstances, although in different ways. Kazakhstan and Turkmenistan were parts of the former Soviet Union and as such were almost completely planned economies until the Soviet Union imploded. They then faced the enormous task of reforming their economies and integrating into the world economy. Mongolia was not officially part of the Soviet Union but was so closely connected to it that it was sometimes referred to as the 16th republic of the Soviet Union (Pomfret 2011).

Bhutan, a very small country in South Asia nestled between giants China and India, was never colonized but was long known to pursue self-reliance in managing its economic growth and development based on the principle of maximizing its "Gross Happiness Index" for its citizens – a principle that is distinct from approaches to maximize output in the world economy.[5] These four countries are all highly dependent on one or several natural resources: oil for Kazakhstan, natural gas for Turkmenistan, minerals (particularly copper and gold) for Mongolia, and hydro-power for Bhutan. They all prospered to varying extents from the boom phase of the commodity super-cycle during the 2000s and are now reeling from declining commodity prices and weakening demand for their primary exports. Even during the boom phase, the capital-intensive nature of natural resource exploitation meant that relatively few jobs were created, and inequality worsened. As in the case of other developing countries, creating employment opportunities for young people is an urgent priority for the four countries examined in this report. Thus, the imperative of economic diversification into more labor-intensive sectors is clear. The decline in commodity prices, although painful, can be viewed as an opportunity to advance structural transformation.

Figures 1.1 and 1.2 respectively show the levels and changes of real GDP per capita and in international (purchasing-power-parity-adjusted) dollars for the four countries since 1990. Figure 1.1 shows that Kazakhstan has a distinctly higher level of per capita income than the other three countries, and Bhutan has the lowest. In the former Soviet Republics and Mongolia, per capita GDP dropped considerably in the aftermath of the breakup of the Soviet Union, but recovered strongly in the 2000s, especially in Kazakhstan. In terms of growth, however, Bhutan had the highest increase in per capita GDP over 1990–2016, with a cumulative increase of 350 per cent. The other three countries had cumulative increases of 150 to 200 per cent, also quite impressive. Figures 1.1 and 1.2 also show the recent deceleration of growth in Kazakhstan and Mongolia, while figures 1.3, 1.4, and 1.5 provide details on the degree of economic dependence on extractive sectors together with export structure, export concentration indices, and import markets by type of economy for the four countries for 2012–2016.

Figure 1.1: Real GDP per capita, 1990–2016 (in purchasing-power parity-adjusted US dollars)

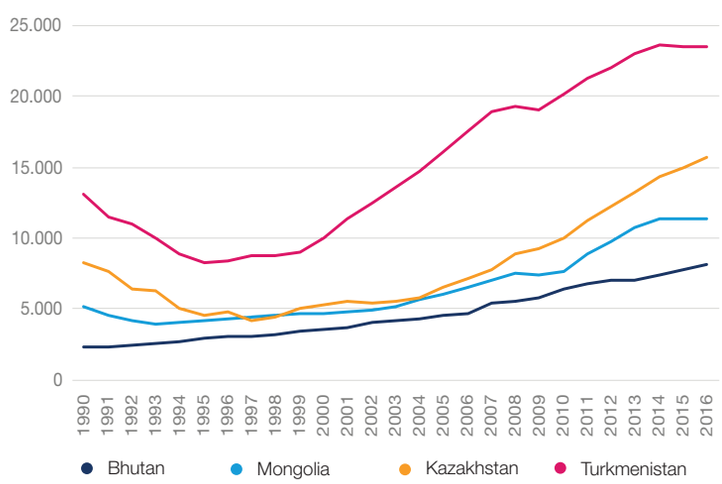
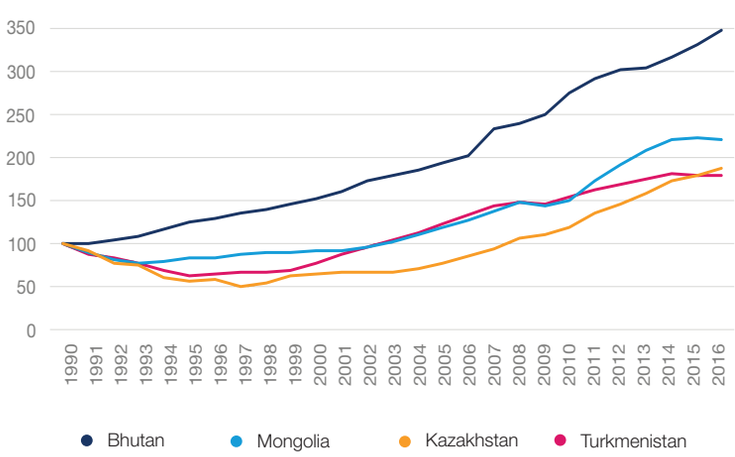


Figure 1.2: Real GDP per capita, 1990–2016 (in purchasing-power-parity-adjusted US dollars; index 1990 = 100)



Source: World Bank, World Development Indicators database

5. S Sengupta, 2007, Bhutan reluctantly embraces democracy. New York Times, 23 April.

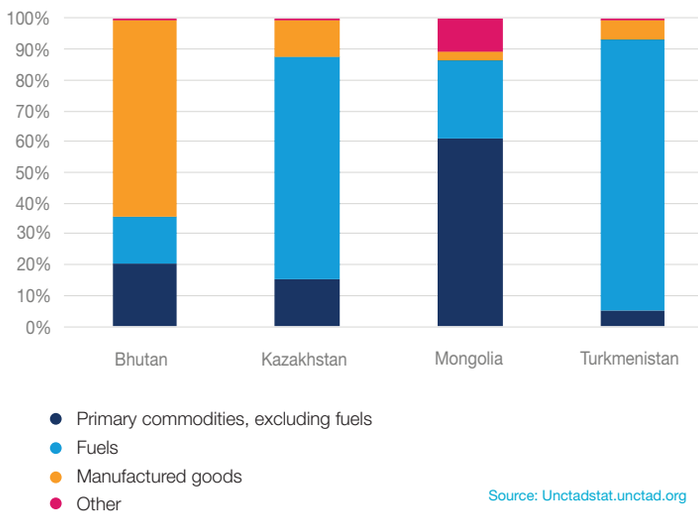
1.3.1. Overview of current export patterns and trends in the four countries

As a starting point, it is instructive to compare the current export structure of the four LLDCs discussed in this study. Figure 1.3 shows the export structure of each LLDC in four broad product categories: primary commodities excluding fuels, manufactured goods, and other types of goods. As such, it gives a rough indication of the diversification (or lack thereof) of the four economies. Bhutan appears to be the most diversified economy, with manufactures accounting for 63.9 per cent of all exports in 2012–2016. However, as will be seen in the chapter on Bhutan, this is a misleading statistic and Bhutan is in fact dependent on natural resources.. The other three countries are clearly commodity-dependent, with exports of primary commodities excluding fuels in Mongolia making up 61.3 per cent of the total during the five-year period and fuels being by far the most dominant export in Kazakhstan (71.7 per cent) and Turkmenistan (88.1 per cent).

A similar picture emerges when computing the degree of product concentration and looking at the share of the top three exports.[6] Based on the Herfindahl-Hirschmann Index – which estimates product concentration with values between 0 (lowest concentration) and 1 (highest concentration) – Bhutan is the most diversified economy of the four LLDCs, with an average score of 0.37 for the 2012–2016 period (figure 1.4). Turkmenistan is the least diversified economy with an average score of 0.76, while Mongolia and Kazakhstan have scores of 0.45 and 0.60, respectively. Similarly, the share of the top three products in total exports for 2012–2016 was lowest in Bhutan (59.5 per cent) and highest in Turkmenistan (88.2 per cent). As shown in figure 1.3, the top three products in Kazakhstan and Mongolia accounted for more than two-thirds of all exports (69.9 per cent and 67.9 per cent, respectively), although it should be noted that the high concentration in Kazakhstan was due to the top export (crude petroleum oils).

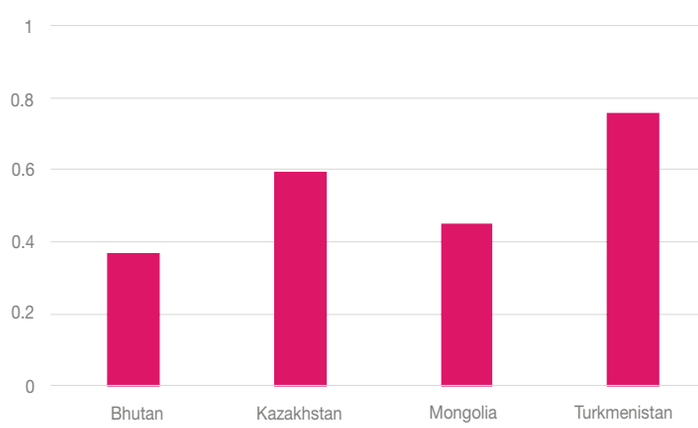
The focus of this report is on export diversification of products. It is nonetheless interesting to also consider the degree of import market concentration/diversification, i.e. the importance of various importing countries to the four LLDCs studied here.

Figure 1.3: Export structure, 2012–2016 (aggregate, percentage)



Source: Unctadstat.unctad.org

Figure1.4: Herfindahl-Hirschmann Index, 2012–2016 (average)

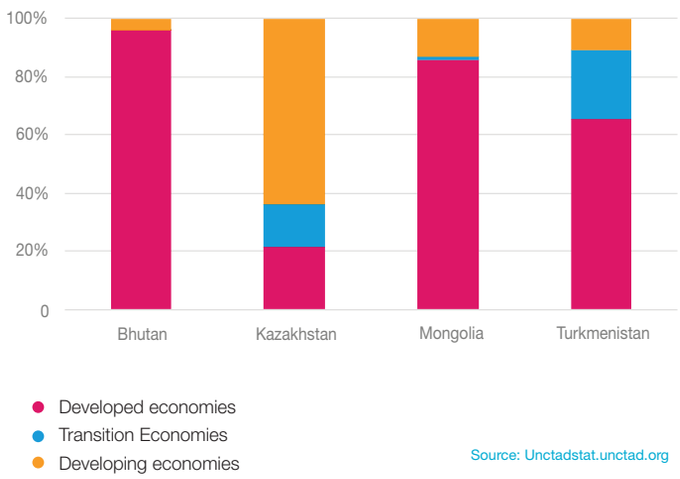


Source: Unctadstat.unctad.org

Figure 1.5 offers an initial impression, as it shows that developing countries are overwhelmingly important import markets for exports from Bhutan and Mongolia. In reality, however, for each of the two countries, it is only one country in particular that is the dominant trading partner: India in the case of Bhutan, and China in the case of Mongolia. The exports of Kazakhstan and Turkmenistan are more diversified with respect to importers (market destinations) and they have important markets in developing countries, transition countries and developed countries alike.

6. Exports are disaggregated at the 3-digit level of the third revision of the Standard International Trade Classification (SITC Rev. 3).

Figure 1.5: Importing markets by type of economy, 2012–2016 (aggregate, percentage)



Source: Unctadstat.unctad.org

To sum up, it is clear that the economies vary in their degree of diversification, ranging from the somewhat more diversified economy of Bhutan to the least diversified economy of Turkmenistan, which is the country most dependent on a single commodity. What is equally clear, however, is that the four LLDCs are dependent on natural resources, and that export diversification is a pressing concern for them all.

In analyzing prospects for export diversification in each of the four countries, this report examines two broad operational approaches (components): the intensive margin and the extensive margin. Growth at the intensive margin refers to increasing exports that are already being exported, whereas growth at the extensive margin relates to adding new products to the current export basket.
The Export Potential Map presented in Decreux and Spies (2016: 2 follows this distinction in computing its two indicators:

"The Export Potential Indicator (EPI) serves countries that aim to support established export sectors in increasing their exports to new or existing target markets. It identifies products in which the exporting country has already proven to be internationally competitive and which have good prospects of export success in specific target market(s) (intensive product margin)."

"The Product Diversification Indicator (PDI) serves countries that aim to diversify and develop new export sectors that face promising demand conditions in new or existing target markets. It identifies products which the exporting country does not yet export competitively but which seem feasible based on the country's current export basket and the export baskets of similar countries (extensive product margin)".

The next four chapters of this study focus on each country's progress, challenges, and opportunities for economic diversification. For analytical convenience, the order of the countries in subsequent chapters follows their economic size rather than the usual alphabetical order. While the structure of each chapter differs based on the particularities of each given country, they all address the following issues:

1. The significance of natural resources in the economy;
2. Macroeconomic policy management of natural resource revenues;
3. The business environment:
4. Institutional structure;
5. Promising sectors for diversification; and
6. Current export structure, key markets (destinations) and product diversification.

Detailed policy recommendations are provided for each country for each of the above topics. While the situation in these countries is undeniably challenging, in many cases governments are taking positive steps to improve macroeconomic stability, invest in infrastructure, upgrade the business climate, and strengthen institutions. Building on the synthesis of country-specific situations and related policy recommendations regarding the issues discussed for each of the countries studied, the final chapter provides broader policy conclusions and recommendations.

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KAZAKHSTAN

II. KAZAKHSTAN

Kazakhstan is located in Central Asia, south of the Russian Federation and west of China. At the southern border, it neighbors three other Central Asian countries: Turkmenistan, Uzbekistan, and Kyrgyzstan. The country extends over about 2.7 million square kilometers, as large as Western Europe. While the country does not face any ocean, it borders the Caspian Sea, an enormous landlocked salt lake surrounded by Kazakhstan, the Russian Federation, Azerbaijan, Islamic Republic of Iran, and Turkmenistan.[7]

Thanks to its huge oil reserves, Kazakhstan's economy grew rapidly during the energy boom in the early 2000s. Since its independence from the Soviet Union in 1991, Kazakhstan has transitioned from lower middle-income to upper-middle-income status in less than 20 years, and GDP per capita (purchasing power parity adjusted) in 2016 reached about US$25,000. The oil-fueled growth has also led to a dramatic reduction of the poverty rate, from 46.7 per cent in 2001 to 2.7 per cent in 2015.[8]

Table 2.1. Total exports and export shares of selected products

	1996	2001	2014	2018
Total value of exports	US$5.9 billion	US$8.5 billion	US$79.5 billion	US$61 billion
Mineral products	**32.9%**	**56.1%**	**76.4%**	**70%**
Crude oil	21.3%	50.1%	67.5%	62%
Manufactured products	**47.8%**	**29.5%**	**15.4%**	**19.9%**
Chemical and related products	9.1%	1.4%	3.6%	2%
Food and live animals	**11.0%**	**5.0%**	**2.7%**	**4%**
Cereals	8.5%	4.4%	2.2%	3%

Source: UN Comtrade database, 2019

The government of Kazakhstan has undertaken ambitious modernization programmes, and saved a large share of mineral revenues, thereby maintaining macroeconomic stability and containing Dutch disease.[9] With the recent change in the country's leadership, it is largely expected that previous policies and strategies will continue in the future. However, Kazakhstan has been struggling to overcome its over-dependence on mineral resources. Despite efforts to diversify the economy, Kazakhstan's exports have become increasingly concentrated on mineral products, especially oil (table 2.1). While both exports of crude oil and manufactured products have increased in absolute terms, the growth of oil exports has far outpaced that of manufactured products. From 2001 to 2014, before moderately declining in 2018, the average annual growth rate for mineral products was 21.6 per cent, while that for manufactured products was 11.1 per cent.[10]

As a result, the export share of crude oil increased from 21.3 per cent in 1996 to 67.5 per cent in 2014 before moderately decelerating to 62 per cent in 2018, whereas the share of manufactured products decreased from 47.8 per cent in 1996 to 15.4 per cent in 2014 and 19.9 per cent in 2018.[11]

A major challenge for Kazakhstan is to foster private sector development. The state-led development pushed by the government has enabled impressive growth but has inevitably resulted in dominance of the public sector in the economy. State entities account for about 30-40 per cent of GDP, and a large national holding company controls assets worth more than half of total GDP (OECD 2016). The public sector is also a major employer, accounting for about one-third of non-agricultural employment (World Bank 2013). The enormous public sector crowds out private

7. While some trades take place over water, the land route connecting Europe and China across the country is more important, as will be discussed later.

8. Measured based on national (i.e. country-specific) poverty lines according to the World Bank's World Development Indicators.

9. The previous president, Nursultan Nazarbayev, wrote his dissertation thesis on how to avoid waste of natural resources. Before leading the country, he was widely considered an expert on the Soviet economy, including its inherent inefficiencies. See Patrick and Pomfret (2016) for more about the president's background,

10. Authors' calculation based on the UN Comtrade database.

11. Manufacturing includes chemical and related products such as fertilizers, which depend heavily on subsoil resources like phosphate. If chemical and related products are excluded, the export share of manufactured products is even smaller.

initiatives. The government recognizes the problem and recently has been leading various reforms to improve the business environment. As a result, on the World Bank's 2017 Doing Business Indicators, Kazakhstan ranked 35th out of 190 economies, right after Japan. At the same time, the government has been advancing an ambitious privatization programme, although inadequate transparency and poor implementation have hampered progress (World Bank 2017b).[12]

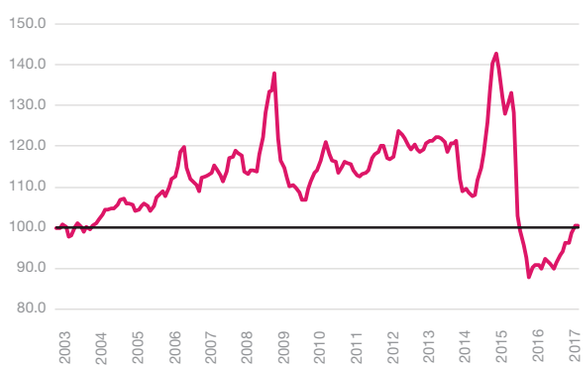
2.2 Oil and macroeconomic policy

The government has been prudently managing tax revenues collected from the extractive sector, saving most of them in the National Fund for the Republic of Kazakhstan (NFRK), established in 2000. During the 2008–2009 global financial crisis, the NFRK savings allowed the government to launch the large "Nurly Zhol" stimulus package, which helped the economy withstand the downturn and a collapse of its own financial system. As of 2017, NFRK assets amounted to about 45 per cent of GDP, and public debt is projected to remain below 25 per cent of GDP (IMF 2017).
While fiscal policy has been laudably prudent on the whole, as the economy recovers the authorities should scale back the stimulus. The government is also preparing a new tax code that will simplify and rationalize tax incentives and rely more on indirect taxation. These measures are praised by the IMF (2017), which also recommends greater transparency on extra-budgetary expenditures.

Thanks to the fiscal prudence, real appreciation of the Kazakh tenge has been mostly contained within a moderate level despite rapid mineral export growth (figure 2.1). The movement towards greater flexibility has also been helpful in adjusting to shocks (IMF 2017) and restraining the current account deficit.

The collapse of oil prices in the second half of 2014 quickly threw the oil-reliant economy into trouble, exposing the country's vulnerability to commodity price swings. The shock was exacerbated by falling external demand from China and the Russian Federation, Kazakhstan's two main trading partners. Export revenues plunged by a staggering US$47 billion between 2013 and 2016 before moderately picking up in 2017 and 2018. Kazakhstan's GDP growth also plummeted from 6 per cent in 2013 to 1.1 per cent in 2016 before reviving in 2017 and 2018 (table 2.2). In response to increasing pressure on the currency, the authorities gave up the peg, and the tenge depreciated sharply. While the introduction of a floating exchange regime helped absorb the trade shock, higher prices of imported goods drove up inflation (World Bank 2017b). The authorities undertook fiscal expansion to support the economy, and the public-debt-to-GDP ratio jumped from 14.5 per cent in 2014 to 21.9 per cent in 2015 (which is nevertheless still quite low) (IMF 2017).

Figure 2.1: Real effective exchange rate of the tenge (excluding oil, December 2003 = 100)



Source: National Bank of Kazakhstan
Note: The index captures the real effective exchange rate of the tenge (excluding oil) where December 2003 is equal to 100

By the end of 2017, the economy had bottomed out, and since then growth has picked up gradually, the exchange rate has been stabilizing, foreign direct investment (FDI) inflows have been recovering, and inflation has come down (World Bank 2017b; IMF 2017). Yet, oil prices are likely to remain low, and Kazakhstan urgently needs to diversify its economy in order to sustain development and prepare for potential future shocks.

12. The authorities aimed to privatize (either fully or partially) more than 780 state-controlled entities between 2016 and 2018.

Table 2.2. Impact of lower oil prices on Kazakhstan's economy

	2013	2014	2015	2016	2017	2018
GDP growth rate (per cent)*	6.0	4.3	1.2	1.1	4.1	4.1
Export revenue (billions of U.S. dollars)**	84.7	79.5	46.0	36.8	48.2	61
Inflation (per cent)*	5.83	6.72	6.66	14.6	7.43	6.41
Exchange rate (year-over-year per cent change; Tenge/US$, end of period)*	2.2	18.7	86.2	54.3	-4.7	5.7

Sources: *IMF (2019); **UN Comtrade database, 2019
Note: Positive value indicates depreciation of the tenge

Summary of policy recommendations

- Continue to follow a pragmatic and countercyclical fiscal policy.
- Pursue tax reforms to simplify the tax system and rationalize incentives.
- Improve transparency of fiscal policy by reporting off-budget expenditures in the budget process.
- Continue to allow exchange rate adjustments to external shocks.
- Foster diversification as analyzed further later in this chapter.

2.3. Private sector development

2.3.1. Overview of recent reforms

Kazakhstan has recently implemented a number of reforms and made outstanding progress in creating a business-friendly environment. The main driver of the reform was the State Programme of Accelerated Industrial-Innovative Development of Kazakhstan for 2010–2014 (SPAIID), launched in 2009. The programme aimed to establish the foundations for industrialization by (1) creating an appropriate legal framework, including new legislation on investment and amendments on more than 50 laws, (2) resolving the issue of energy shortages and updating transport infrastructure, and (3) providing business support programmes and tools, such as subsidized loans for small and medium-sized enterprises (Konkakov and Kubayama 2016).

The programme led to substantial progress. The manufacturing sector attracted 2.9 times more FDI over five years of SPAIID than in the five years preceding it, and for the first time in recent history the country's manufacturing sector began to grow at a faster pace than the mining sector (Konkakov and Kubayama 2016). While SPAIID ended in 2014,[13] the government continues to make progress, which can be seen in its World Bank's Doing Business Index ranking. In the 2017 Doing Business Indicators, Kazakhstan improved its rank by 16 positions,[14] and was ranked at 35th out of 190 economies. In that year, Kazakhstan was the second top reformer in the world (World Bank 2017a).

Figure 2.2: Kazakhstan's distance to frontier score on the 2017 Doing Business Indicators

Source: World Bank (2017a)
Note: The distance to frontier score is indicated on a scale from 0 to 100, where 0 represents the worst performance and 100 the frontier

13. The State Programme of Industrial and Innovative Development for 2015–2019 (SPIID) was launched to succeed SPAIID.

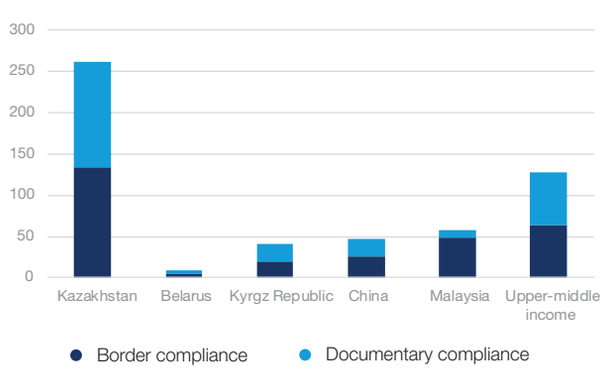
14. The improvement is measured not relative to the published ranking in 2016, but to a comparable ranking for 2016 that captures the effects of such factors as data revisions and the changes in methodology.

However, reforms are far from being complete. The economy continues to depend heavily on oil, and manufacturing accounts for merely a little more than 10 per cent of GDP.[15] It is therefore essential to keep improving the business environment, especially in areas where the advance has been slowest. The Doing Business Indicators suggest that progress is lagging for trading across borders and getting credit (figure 2.2). Other measures such as the Global Competitiveness Index point out weaknesses in institutions. This section analyzes each of these areas, and discusses ways to make further improvements.

2.3.2. Trading across borders: Customs procedures

Although landlocked, Kazakhstan is located at a strategically important position between Europe and China, with overland corridors crossing the country. Moreover, China's New Silk Road project,[16] announced in 2013, offers Kazakhstan an opportunity to become a transit hub bridging Europe, Asia, and the Middle East. The New Silk Road route through Kazakhstan could potentially reduce the delivery time from Asia to Europe from the current 40-60 days (via sea route) to 13-14 days (World Bank 2017c). Faster than sea transport and cheaper than air transport, the overland route has clear potential. Furthermore, as the New Silk Road project becomes a major transport route, Kazakhstan may become a more attractive participant in global value chains.

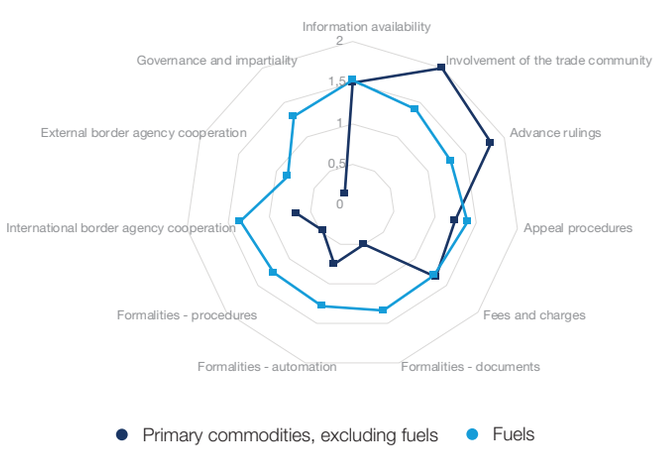
Figure 2.3: Time to export based on the 2017 Doing Business Indicators



Source: World Bank (2017a)

However, Kazakhstan's poor performance in trade facilitation poses serious impediments to such development. The 2017 Doing Business Indicators ranked Kazakhstan 119th out of 190 economies for trading across borders. In particular, exporting from Kazakhstan is time-consuming in terms of both border and documentary compliance (figure 2.3).[17] Resulting delays create high opportunity, inventory, and warehousing costs, and render Kazakhstan uncompetitive both as a transit country and as a value chain participant. The Trade Facilitation Indicators of the Organisation for Economic Co-operation and Development (OECD) provide further insight into the obstacles to cross-border trade (figure 2.4): Kazakhstan scores poorly on three indicators related to custom formalities and on indicators of governance and impartiality, and external border agency cooperation.

Figure 2.4: Kazakhstan versus Upper-middle-income country scores on the Organisation for Economic Co-operation and Development's Trade Facilitation Indicators



Source: OECD (2015)

Five reforms must be taken to streamline the customs formalities and improve transparency. First, the number of documents required for import/export clearance should be reduced. Currently Kazakh traders need to prepare at least six customs documents in order to export a product to China, as well as additional forms for other government agencies depending on the product (World Bank 2017c). In total, the average number of required documents adds up to 10 for exports and 12 for imports. Simplifying customs regulations and documentary requirements would make customs procedures more efficient.

15. Source: World Bank, World Development Indicators. The figure includes chemical-related manufacturing, which relies on subsoil reserves of phosphate.

16. Also known as the One Belt, One Road project. The name New Silk Road Economic Belt alludes to the ancient trade route across Central Asia through which China used to export silk to Europe. It aims to strengthen overland transport routes connecting China, Europe, and the Middle East and establish trade ties.

17. Note that border compliance and documentary compliance partially overlap, and the sum overstates the total time or costs involved. Nevertheless, the sum provides a good cross-country comparison.

Second, an online portal that summarizes information on all required documents and fees must be established. Additional delays and fines due to improper documentation are common, and they create significant uncertainty for traders. The authorities are currently in the process of establishing a Single Window, that is, a single-entry point to all regulatory authorities and agencies. The Single Window could coordinate information from different agencies and provide it online. The Single Window could also potentially improve internal border agency cooperation, another weak point in the Trade Facilitation Indicators.

Third, the entire customs process must be automated, and pre-arrival processing of documents should be introduced. While customs control and transit declarations are electronic, the clearance process is still paper-based and there is a 100 per cent manual check of documents. Electronic payment of duties, taxes, fees, and charges is not possible, either. To address the issue, the authorities are currently implementing ASYCUDA World, UNCTAD's customs management system. The new system was expected to be operational by mid-2017, and it could improve customs automation (World Bank 2017c). As part of automation, the authorities should seriously consider pre-arrival processing of documents. Pre-arrival processing is a common international practice that can greatly improve efficiency of custom clearance by reducing documentation errors. Each truck usually carries a huge variety of products, and there is a good chance that customs declarations for some goods are improperly prepared. Such errors can easily result in a delay of a few days, as the driver needs to contact the freight forwarder and wait until errors are corrected (CAREC 2014). Automated pre-arrival processing will reduce such delays, as it allows freight forwarders to detect many errors in advance.

Fourth, risk management (i.e. selective customs controls) must be fully adopted. While a general risk management system was implemented in 2010, the principle of selective control has not been fully adopted in practice, and a large proportion of consignments continue to be physically inspected at the discretion of customs officers. Customs officials estimate that around 24 per cent of goods crossing the border are physically inspected, while traders say that up to 50 per cent of goods are actually subject to physical inspection (World Bank 2017c). Developed economies commonly adopt risk management using advance manifest, whereby more than 90 per cent of shipments can be pre-cleared. Kazakhstan should try to implement a similar mechanism; with automated pre-processing of documents, this should become easier. Another way to make progress is to recognize authorized economic operators (i.e. traders who present a low risk of non-compliance) and offer them pre-approved clearance (CAREC 2015). Currently there are no authorized economic operators in Kazakhstan, as the level of guarantee for customs payment and taxes is prohibitively high for most Kazakh firms (World Bank 2017c).

Finally, interpretation and application of customs clearance procedures must be made consistent. Operations like speed of clearance, physical inspection, and administration of customs value vary significantly depending on customs officers and the locations of border crossing points (World Bank 2017c). Furthermore, CAREC (2015) suggests that there is a prevalence of unofficial payments in exchange for benefits, such as expedited processing of documents, waiver of penalties, or jumping queues to avoid long waiting time. The unpredictability resulting from such activities is likely to discourage business. Kazakhstan's low governance and impartiality score on the Trade Facilitation Indicators reflects a lack of mechanisms to ensure consistency and transparency. The authorities should make customs procedures clear to all border officials by providing guidelines, and by introducing internal audit mechanisms for border agencies. In addition, it should establish effective sanctions against demand for or acceptance of unofficial payments by border agents.

In November 2015, Kazakhstan joined the World Trade Organization (WTO) after 20 years of negotiation. Hence, the country will be working to satisfy the obligations under the WTO Trade Facilitation Agreement, which will help reduce trade costs. However, there were three provisions Kazakhstan did not commit to under that agreement: the creation of separate infrastructure for trade in transit; the possibility to provide guarantees for multiple transactions for the same operators or renewal of guarantees without discharge of subsequent consignments; and the appointment of a national transit coordinator to which enquiries and proposals relating to the effective functioning of transit operations could be addressed (World Bank 2017c). It is strongly recommended that Kazakhstan implement these provisions if it wishes to be a successful regional transit hub.

Summary of policy recommendations:

- Reduce the number of documents required for exporting/importing.
- Create an online portal summarizing all information on documents required by any agencies.
- Automate the entire customs process.
- Introduce automated pre-arrival processing of customs documents.
- Ensure full adoption of risk management.
- Make customs procedures clear to all border officials, for example by providing guidelines.
- Introduce internal audit mechanisms for border agencies.
- Set effective sanctions against misconduct of border agents to reduce unofficial payments.
- Implement all the provisions under the WTO Trade Facilitation Agreement.

2.3.3. Trading across borders: Infrastructure and logistics at border crossing points

Poor infrastructure and logistics at border crossing points are another impediment to trade facilitation. In particular, infrastructure constraints significantly limit the speed at which goods travel through Kazakhstan. The speed of rail transport along the corridor connecting China and Europe would be 48 km/h in the absence of delays; however, when delays at border crossings are considered, the time drops to 17 km/h (CAREC 2015).

The capability to handle cargo should be improved at border crossing points. Table 2.3 shows the duration of various types of delays at Dostyk, a crossing point at the Kazakh-Chinese border. Restriction on entry, the most time-consuming delay, occurs when terminals are full and cannot admit additional incoming trains. The major constraint is the need to trans-load cargo at the border, which results from different gauge standards between Kazakh and Chinese railways. The inadequacy of facilities for trans-loading slow the process, causing restriction on entry as the terminals become full (CAREC 2015). Long delays associated with busy reloading facilities also reflect the limited capability of facilities at the border crossing point. An effort was made to alleviate the congestion by opening a new railway route connecting Altynkol (Kazakhstan) and Khorgos (China) in 2012. The new route is 200 km shorter than the route through Dostyk, and the authorities had hoped to divert traffic from the Dostyk route. However, trans-loading capability at Altynkol is currently inadequate, and many freight forwarders continue to use the Dostyk border crossing point (CAREC 2015). Resolving capacity constraints at Altynkol would lower the burden on Dostyk and allow traders to enjoy the benefits of the shorter Altynkol-Khorgos route.

Border-crossing fees associated with trans-loading must be lowered as well. The fee for trans-loading has been expensive and volatile. For example, at the Dostyk border crossing point, the fee was $285 in 2013, went down to US$135 in 2014, but surged to US$327 in 2015 (CAREC 2013, 2014, 2015). Together with customs fees, the total cost of crossing the border at Dostyk added up to US$432 in 2015 on average (CAREC 2015). Expensive border crossing fees make Kazakhstan less attractive both as a transit hub and as a potential participant in global value chains. The volatility of the fees can create uncertainty and discourage businesses as well. Enhancing private sector participation in the rail industry (e.g. through private-public partnerships) could help make the pricing of border crossing fees (and railway tariffs in general) competitive.

In terms of road transport, the need to store cargo in bonded warehouses at the Kazakh-Chinese border creates a bottleneck in the supply chain. In theory, if a truck can transport goods directly, shipment from Urumqi (the customs office in China) to Almaty (in Kazakhstan) should take only one to two days. However, most Chinese trucks are not permitted to carry goods directly to Almaty. In practice, goods transported from Urumqi must be unloaded and stored in private bonded warehouse at Khorgos (in China) until custom clearance is complete and Kazakh trucks come to collect them (CAREC 2014). The process can take days. While a major breakthrough would be to arrange permission for bonded carriers to move goods directly from Urumqi to Almaty, such a measure is unlikely given the different customs regimes between the two countries (CAREC 2015). Nevertheless, Kazakh and Chinese authorities should consider mutual recognition of authorized economic operators in each country that can provide the bonded carriage.

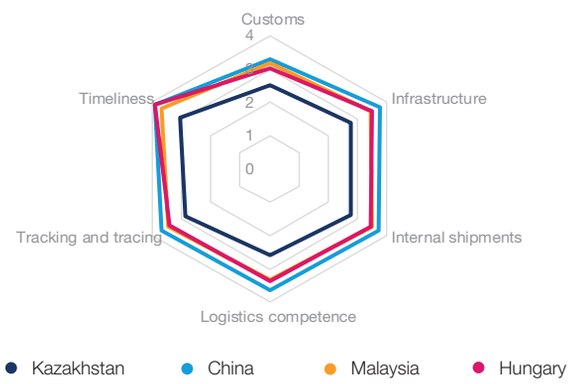
Poor logistics is another serious impediment to trading across borders. Kazakhstan ranked 77th out of 160 countries on the World Bank's 2016 Logistics Performance Index, lagging behind its peers in Asia and Eastern Europe on every subindicator of the index (figure 2.5). In particular, it does very poorly in logistics competence, ranking 92nd out of 160 countries.

Table 2.3. Duration of delays at Dostyk border crossing point (rail, inbound traffic) in 2015

Cause	Duration when it happens (hours)
Restriction on entry	32.7
No wagons available	19.0
Busy reloading facilities	8.0
Marshalling	7.3
Other reasons for waiting	6.0

Source: CAREC (2015)
Note: Data on the frequency of each type of delays were not available

Figure 2.5: Logistic Performance Index scores, 2016



Source: World Bank, 2016 Logistics Performance Index

Three reforms would improve the country's logistics performance. First, Kazakhstan lacks quality storage facilities and modern logistics centers, although the country is making progress in this regard. Modern facilities that can support multi-modal transport are being built at the Kazakh-Chinese International Centre of Boundary Cooperation at Khorgos,[18] a major border crossing point for the Kazakh-Chinese border. Furthermore, the government plans to establish several transport and logistics centers by 2020 (CAREC 2015). Kazakhstan should continue its effort to improve logistics infrastructure. Public-private partnerships (PPPs) for the management of logistics facilities could be effective in helping to achieve this.

Second, Kazakhstan needs to establish highly integrated logistics services overseeing the entirety of the supply chain. Fragmentation of supply chains at the border is a major issue for Kazakhstan's logistics. Border transit involves several transport and warehousing providers, and private operators' access to the railway system and inter-modal transportation is limited (World Bank 2017c).

The authorities have appointed Kazakhstan's national railway company (Kazakhstan Temir Zholy) as the country's integrated logistics operator (World Bank 2017c), but the public sector tends to lack incentive to increase efficiency. Development of private logistics services is essential to increase the competitiveness and lower the cost of the country's logistics. The authorities should accelerate liberalization of the transport sector and creation of appropriate legal frameworks to foster development of private logistics operators that oversee the entire supply chain, from warehousing to transport, be it by rail or road. Furthermore, given the lack of familiarity with modern logistics management methods among local providers, Kazakhstan should encourage the entry of international third-party logistics companies into the market in order to transfer know-how. Their operation would also help Kazakhstan better integrate its logistics with the international network. Here again, improving transparency of customs procedures would be important; uncertainty, inconsistency, and corruption discourage the entry of international third-party logistics companies.

Finally, greater use of information and communication technology (ICT) must be promoted. The lack of information exchange between supply chain participants limits the tracking and tracing of shipments, and causes inefficiencies such as overstocking of inventories and suboptimal load factors in trucks. Better ICT infrastructure and information-sharing would reduce fragmentation of the supply chain and increase its efficiency.

Summary of policy recommendations:

- Expand the capacity to handle cargo at border crossing points, especially for trans-loading.
- Lower border crossing fees associated with trans-loading, and keep them stable.

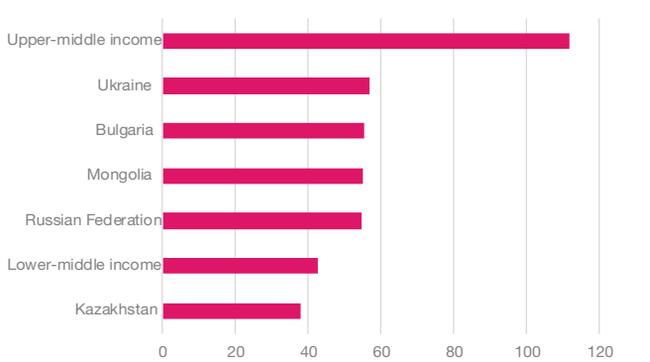
18. A Special Economic Zone has been established in Khorgos.

- Consider mutual recognition of authorized economic operators with China that can provide bonded-carriage across the Kazakh-Chinese border.
- Build more quality storage facilities and modern logistic centers.
- Consider PPPs in railway and logistics sectors.
- Accelerate liberalization of the transport sector and creation of appropriate legal frameworks to foster development of private logistics operators.
- Encourage the entry of international third-party logistics companies into the market.
- Promote greater use of ICT to address the fragmentation of the supply chain.

2.3.4. Getting credit

Together with trading across borders, getting credit is the weakest point in Kazakhstan's business environment. Kazakhstan ranks 104th out of 138 economies on the financial market development subindicator of the 2016–2017 Global Competitiveness Index (WEF 2017). Its credit-to-GDP ratio was around 40 per cent in 2015, far below the upper-middle-income-country average and even below the lower-middle-income-country average (figure 2.6). Among outstanding loans, consumer-oriented borrowing (households, trade, services) dominates with over 70 per cent, while most businesses are cut off from bank credit entirely (IMF 2017). According to the latest Enterprise Surveys by the World Bank (2014), less than 20 per cent of firms have a bank loan or a line of credit. Lack of access to credit impedes private-sector-led growth and diversification: 15.4 per cent of manufacturing firms identified lack of access to finance as a main obstacle to doing business in the 2013 Enterprise Surveys, making it the largest impediment for these firms following an inadequately educated workforce (table 2.4).

Figure 2.6: Domestic credit to the private sector, 2015 (percentage of GDP)



Source: World Bank, World Development Indicators

A major issue underlying the low availability of credit is the persistence of problem loans on bank balance sheets. The problem stems from the boom prior to the 2008–2009 financial crisis. A strong country credit rating under favorable economic conditions allowed Kazakh banks to borrow substantial sums abroad and make quick profits by lending domestically. Easy lending (partly due to lax regulations) fueled a real estate bubble domestically, and foreign debt amounted to over 90 per cent of GDP by 2008 (Pomfret 2011). Once the global financial crisis hit Kazakhstan, the banking sector collapsed. The real estate bubble burst, and many domestic loans turned bad. A 20 per cent devaluation of the tenge in February 2009 further increased the cost of paying back foreign debts. In the first semester of 2009, the Kazakh banking sector suffered astronomical losses of US$1.6 billion and a negative net worth of US$3.1 billion. The largest bank at the time, BTA, lost capital valued at three-quarters of its portfolio in the first three quarters of 2009 (Laruelle and Peyrouse 2013). Bank credit plunged after the crisis, and it remains low (figure 2.7). Despite repeated capital injections and government interventions following the crisis, problem loans continue to constrain bank balance sheets.[19]

While the official ratio of non-performing loans (NPLs) to total loans decreased from over 20 per cent in 2014 to below 10 per cent in 2015, the figure does not reflect the true state of bank balance sheets. Two reasons accounted for the decline in the official NPL ratio, neither of which actually reduced problem loans. First, the BTA Bank was delicensed in June 2015 and its NPLs were no longer included in the figure. Nonetheless, the NPLs were not written off and they remain in the system. Second, lack of consolidated reporting requirements encouraged banks to underreport NPLs and keep them off-balance-sheet. Loan restructuring is free of provisions and additional capital charges; restructured loans increased from 10 to 25 per cent of total loans in 2016. Banks also sometimes agree to exchange problem loans and record them as new loans (IMF 2017). There has also been a dramatic increase in the sale of problem assets into special-purpose vehicles (SPVs) and leniency in loan classification (World Bank 2017b). Overall, IMF (2017) estimates the actual problem loan level to be over 40 per cent of total loans.

19. IMF (2017) estimates that the authorities injected US$11.6 billion into the banking sector during 2008–2014, the equivalent of 5.3 per cent of 2014 GDP.

Table 2.4. Main obstacles to doing business for manufacturing firms in Kazakhstan, according to the 2013 Enterprise Surveys

Problem	Percentage of firms identifying the problem as an obstacle
Inadequately educated workforce	15.9
Access to finance	15.4
Corruption	13.6
Electricity	12.4
Practices of the informal sector	9.6
Tax rates	8.8
Transportation	6.4

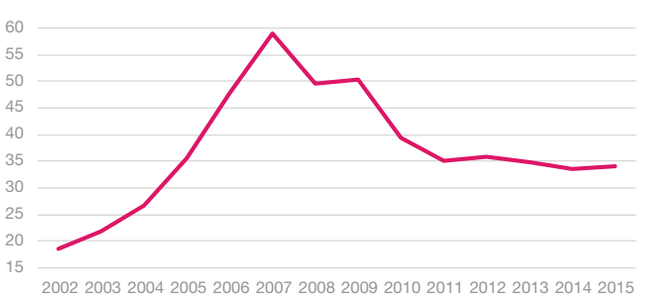
Source: World Bank (2014)

The authorities have been taking measures to address the issue, including establishment of a Problem Loan Fund in 2012 and the adoption of more detailed capital requirements. The authorities have also been facilitating acquisition of the troubled Kazkommertzbank (KKB), the current largest bank in the system, by Halyk, the second largest (IMF 2017).[20] However, progress has been slow and hardly enough to reduce problem loans in the system.

Three actions must be taken to restore the health of the banking sector. First, a consolidated reporting requirement must be reinstated in order to identify problems in the system. The authorities have been moving in the opposite direction. In July 2015, they relaxed prudential regulations, including those calling for consolidated financial reporting in line with the International Financial Reporting Standards. The relaxation played a part in the aforementioned drop in the official NPL ratio (World Bank 2017b). The move must be reversed. Lowering the official NPL figures by relaxing regulations not only fails to reduce the actual problem loans, but also makes it hard to assess real risks. Consolidated reporting that covers off-balance-sheet entities (such as SPVs) must be established and strictly enforced to enable better monitoring. Successful completion of Asset Quality Reviews, which have been delayed, would also help to more accurately assess the banks' health (IMF 2017).

Second, the authorities should force shareholders to recapitalize banks, and weak banks should be closed. To this end, additional legislation must provide more intervention power to the National Bank of Kazakhstan

Figure 2.7: Kazakhstan's bank-credit-to-GDP ratio (percentage)



Source: World Bank, World Development Indicators

(NBK). Under the current legal framework, the NBK has inadequate power to force shareholders to recapitalize their banks or to close weak banks (IMF 2017). Legal changes to give the NBK more authority as a regulator would enable the decisive and quick actions needed to fix the banking sector.

Finally, the Problem Loan Fund (PLF) must be fully utilized. To date, it has been used merely as a means to place public deposits at banks rather than to resolve bad assets (IMF 2017). However, given the sheer size of the problem, the PLF must play a more active role in reducing problem loans. To this end, the authorities must capitalize the PLF and provide more resources (such as staffing, etc.). For its part, the PLF must operate in a transparent and independent manner and with a clear mandate to maximize value recovery. In particular, bank shareholders must fully bear losses before public funds are used. Besides utilizing the PLF, changes in tax laws that facilitate loan-loss recognition and write-offs would also be effective in reducing problem loans.

20. The KKB has faced increasing difficulties since purchasing BTA from the state in 2016. The authorities should ensure that the merger of KKB-Halyk does not end up creating another large troubled bank that requires further state support. IMF (2017) stresses that the KKB-Halyk transaction should proceed only after robust due diligence.

A sound banking sector is essential for private-sector-led growth and diversification. Reduction of NPLs will restore bank confidence and improve credit availability to businesses, especially small and medium-sized enterprises. Aside from tackling the problem loans, the authorities should continue their efforts to improve prudential regulations to limit exchange rate risks and credit concentration. Introducing new regulations in these areas will reduce the banking system's vulnerability to future shocks and oil price volatility.

Summary of policy recommendations:

Establish a sound banking sector by reducing problems loans. This can be achieved by:

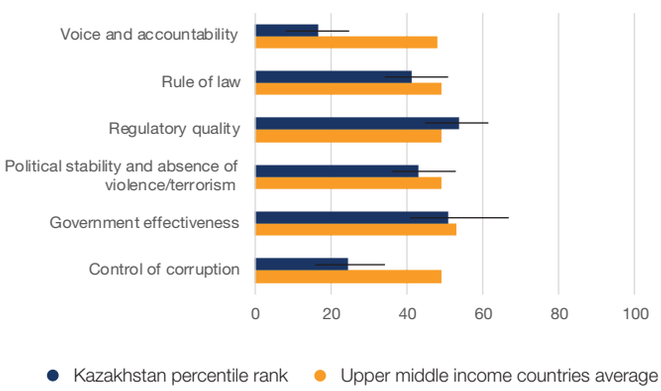
- Reintroducing a consolidated reporting system (covering SPVs) to monitor the system better.
- Forcing shareholder capital injection, and closing weak banks if they cannot raise capital.
- Giving the National Bank of Kazakhstan more intervention power.
- Using the Problem Loan Fund to resolve problem loans (but only after shareholders fully bear losses).
- Changing tax laws to facilitate loan-loss recognition and write-offs.
- Besides reducing problem loans, continue to improve the details of macro-prudential policies to limit banks' exposure to exchange rate and concentration risks.

2.4. Institutions and governance

2.4.1. Control of corruption and the rule of law

The government of Kazakhstan has been putting in place institutions and regulatory policies to address the challenges of corruption, including developing an Anti-Corruption Strategy for 2015-2025. However implementation and enforcement capacities are still low and corruption remains a major obstacle to doing business in Kazakhstan. While Kazakhstan performs more or less on par with other upper-middle-income countries in terms of regulatory quality and government effectiveness, it lags far behind in control of corruption (figure 2.8).[21] Transparency International's 2016 Corruption Perception Index 2016 ranked Kazakhstan at 131st out of 178 countries (Transparency International 2017). Firms in Kazakhstan see corruption as a major impediment to their business. In the 2013 Enterprise Surveys, corruption ranked as the top problem for doing business, with nearly 20 per cent of firms identifying it as an obstacle (World Bank 2014). The 2016–2017 Global Competitiveness Index also lists corruption as one of the most problematic factors, along with inflation, tax rates, and access to financing (WEF 2017).

Figure 2.8: Kazakhstan's scores on the Worldwide Governance Indicators



Source: World Bank, World Development Indicators

The authorities identify control of corruption as one of their key priorities, yet progress has been minimal. The government has taken several steps to fight corruption, including establishment of the Civil Service and Anti-Corruption Agency in 2014 and the launch of several anti-corruption programmes (OECD 2016). However, despite having set numerous provisions to criminalize corruption, the government has not implemented these laws in practice, and public officials continue to engage in corruption with impunity. Corruption charges have been used mostly as a tool for political maneuvering among elites or for punishing those who challenged the Government (GAN Integrity 2016). While corruption is rampant almost everywhere in the public sphere, three areas are of particular importance for improving the business environment: public services, the judiciary, and public procurement.

21. Another area where Kazakhstan performs poorly is voice and accountability. The indicator measures the level of democratization. Kazakhstan is an autocratic country, and therefore the poor performance in this indicator comes as no surprise. While interesting, however, the indicator may not be as relevant here as other indicators such as the rule of law.

Table 2.5. Expectation of irregular payments in various activities of public services

Activities	Percentage of firms expected to give gifts
Tax inspection	24.7
Getting a construction permit	28.8
Getting an import license	28.4
Getting an operating license	16.7
Getting an electric connection	34.4
Getting a water connection	26.5
Getting things done	20.4

Sources: World Bank (2014); and 2013 Enterprise Surveys

Irregular payments are common in public services. More than one in four firms expect to give bribes during tax inspection, and close to 30 per cent of firms expect to give gifts for getting construction permits and import licenses (table 2.5). Furthermore, public officials often apply laws and regulations in an inconsistent and arbitrary manner to extort bribes (US Department of State 2016). Such practices not only add costs to business operations, but also create uncertainty and discourage investment. In order to address the problem, the Kazakh authorities must urgently enforce laws that criminalize corruption, and introduce an internal inspection mechanism. In addition, introducing transparent and merit-based recruitment and remuneration in public administration would be helpful. OECD (2016) shows that a weaker belief in meritocracy tends to be associated with a high perception of corruption; that is, a lack of fairness and inequality of opportunities breeds a culture of corruption.

Making salaries for civil servants competitive with the private sector could reduce incentives for corruption, and would also reduce turnover of top civil servants, which is also adversely affecting the efficiency of public services.

According to a survey by Transparency International (2013), corruption is widespread in the judicial system: 63 per cent of respondents said that the judicial system was corrupt or extremely corrupt, and thus ranked among the most corrupt institution in Kazakhstan. Bribes are often exchanged to win favorable court decisions (GAN Integrity 2016). On the 2016–2017 Global Competitiveness Index, Kazakhstan ranked 68th out of 138 countries in this regard (WEF 2017). Week competitiveness can deter foreign investment, especially in non-extractive sectors, which Kazakhstan desperately needs for development of its agriculture and manufacturing sectors. Solutions are similar to the case of public service: enforcement of laws to criminalize corruption; introduction of internal audit mechanisms; and merit-based recruitment and remuneration.[22] In addition, the authorities should implement a legal framework to strengthen judicial independence. Being open to the use of foreign arbitration of disputes could also reassure foreign investors.[23]

Public procurement is another area of concern, with one in five firms expecting to give gifts to secure a government contract, according to the 2013 Enterprise Surveys (World Bank 2014). There has been significant progress in this area, including enactment of the Public Procurement Law (PPL) in 2007 and introduction of e-mandatory procurement procedures in 2012 (OECD 2016). The e-procurement procedures ensure that officials do not manipulate records, and that the records are easily accessible. However, the PPL does not cover a significant part of the public sector, including government holdings and state-owned enterprises (World Bank 2013). This includes Samruk-Kazyna (SK), Kazakhstan's largest national holding company that manages state-owned companies in the oil and gas, energy, mining, transportation, and ICT sectors. By some estimates, the SK controls more than half of the economy, and is the economy's largest buyer and seller (GAN Integrity 2016; US Department of State 2016). In addition, the SK has been given a special right to conclude large transactions between its holdings without public notification (US Department of State 2016). The PPL must be amended to cover the SK (and state-owned enterprises in general), given the sheer size of the public sector in Kazakhstan. The use of standardized e-procurement procedures is desirable. Furthermore, information about all the transactions that take place between national holdings within the SK must

22. GAN Integrity (2016) reports that current recruitment is plagued with corruption, and becoming a judge requires giving bribes to high-level officials and court administrators.

23. Firms have expressed reluctance to seek foreign arbitration for fear of straining relations with the government (US Department of State 2016).

be made public in order to reduce the room for fraud and embezzlement.

In general, cultivating a culture of integrity is essential to fight corruption. Transparency International (2016) reports that fewer than 40 per cent of respondents feel that it is socially acceptable to report corruption they witness, showing that corruption is currently a norm in Kazakhstan. The authorities must strive to reverse this and make the absence of corruption the norm.

Several reports argue that, apart from corruption, foreign investors complain of inconsistent implementation and application of laws and regulations, especially at the local level (World Bank 2013; US Department of State 2016). Preliminary findings of the Doing Business Indicators at the subnational level show that there is a gap between Almaty, the reference point for the national-level assessment, and other regions of the country (World Bank 2017b). The central authorities should ensure that local authorities implement legislation and regulations enacted by the central government. Ensuring judicial independence and shielding the court from pressures from local authorities will be key to reassure investors.

Summary of policy recommendations:

- Introduce transparent and merit-based recruitment and remuneration for civil servants and judges.
- Make salaries for civil servants competitive with the private sector.
- Extend the Public Procurement Law to cover government holdings and state-owned enterprises, including the Samruk-Kazyna.
- Disclose information about the transactions taking place between national holdings within the Samruk-Kazyna.
- Cultivate a culture of integrity in the public sector.
- Ensure consistent implementation and application of laws and regulations at the local levels.
- Establish judicial independence to shield the court from pressures from local authorities.

2.4.2. Human capital

One area where Kazakhstan needs to improve in order to attract investment in manufacturing is human capital. Skill mismatches currently hamper development of the manufacturing sector. In a survey undertaken in 2013–2014, EBRD (2017) found that 20.1 per cent of manufacturing firms identified skills as a major constraint to their growth. There is a deficit of 61 to 77 per cent in technical specialists, with the largest categories of unfilled vacancies being “higher skilled experts” (25.8 per cent of the total) and “skilled workers qualified in industrial engineering, construction, transport, communications and geology” (15.6 per cent). However, the problem is not a result of lack of access to education, as 80 per cent of workers in manufacturing firms have received training or education before or after joining the firm, and thus can be considered skilled. Furthermore, enrollment in tertiary education and vocational training is high, with about 38 per cent of youths in some form of post-secondary education in 2013 (EBRD 2017). This implies that the education system is failing to equip students with job-relevant skills and competencies. The authorities must enhance the quality of education and ensure that the skills and knowledge taught in the education system align with those demanded by the economy. Recommended policies include updating skill standards and verification mechanisms, revising the incentive structure for teachers, and getting input from employers when developing course offerings and curricula (OECD 2016; EBRD 2017).

Summary of Policy Recommendations:

Address skill mismatches by improving the quality of education and ensuring that the skills and knowledge taught in the education system align with demand. Achieving this goal requires:

- Improving skills standards and verification mechanisms.
- Revising the incentive pay structure for teachers.
- Getting employers’ input when developing course offerings and curricula.

2.5. Diversification strategies

Agri-business, and to lesser extent, manufacturing and tourism, are the sectors where Kazakhstan has the greatest potential outside the extractive sector. This section discusses each sector’s strengths and weaknesses, and offers a few policy recommendations. Fostering growth of the private sector in ways previously detailed and attracting FDI will be emphasized. Overall, Kazakhstan must aim to integrate into global value chains in order to reduce the dominance of minerals in its exports.

2.5.1. Agribusiness

Agribusiness encompasses the entirety of the agro-food supply chain, from agriculture to food processing and food retailing. Overall, the strategy for successful agribusiness development will entail two goals: improving the productivity of agricultural production, and developing competitive food processing and food retailing industries that are well integrated into the global market. Both agriculture and food processing/retailing are labor-intensive, and have important roles in poverty reduction, especially in rural areas.

Kazakhstan has a clear comparative advantage in agriculture. It is the largest landlocked country in the world, and has the second highest availability of arable land per capita. Its total cultivated area of 23.28 million hectares and its 181 million hectares of range land are among the largest in the world (World Bank 2017b). The main products are cereals (representing 19 per cent of total production in 2012), horticultural crops (17 per cent), dairy cattle (16 per cent), and beef cattle (14 per cent) (OECD 2015). Kazakhstan is a major exporter of grain, ranking 11th in the world for wheat exports in 2015.[24] However, productivity in agriculture remains low. Even though the sector employs nearly one-fifth of the working-age population, its value added accounts for only about 5 per cent of GDP. Yield remains low across major commodities, and household plots, a non-registered subsistence form of agricultural production, are estimated to produce nearly three-quarters of total milk and meat production (World Bank 2017b). The agro-food trade balance is negative. Given the low quality of local beef and dairy products, urban consumers tend to prefer imported, industrially processed products, while domestic products mostly serve rural consumers and urban marketplaces (Petrick and Pomfret 2016).

Food processing and food retailing are expected to grow rapidly in coming years. With Kazakhstan's economy growing quickly and disposable incomes increasing, demand for higher value and quality food products is increasing (OECD 2013a). These consumer trends tend to translate into development of a market for packaged foods and branded products. Kazakhstan's agribusiness segment is currently undercapitalized, and competition is low, so the market is potentially attractive for new entrants. Moreover, given the strategic location of the country, Kazakhstan could become a platform for accessing the entire region. An "ink-spot strategy" – selection of a country as a springboard for accessing a region – is a common approach to international retailer expansion (OECD 2013a). Development of food processing and food retailing industries would increase agricultural value added. In most OECD countries, the ratio between farm and retail prices ranges from 220 to 340 per cent for meat and dairy products and up to 720 per cent for fresh vegetables (OECD 2013a). In France, the food industry is the largest industrial employer and the second largest exporter (World Bank 2017b).

Attracting FDI is crucial for the development of food retailing and processing. In particular, entry of global food retailers in the market will be essential to obtain know-how about food retailing logistics and to integrate the domestic supply chain with the global retail network. In order to attract global retailers, the authorities should consider providing tax incentives for them and easing profit repatriation. Even if some profits are remitted to the retailers' home countries, entry of established international food retailers would benefit domestic food processors and farmers, as they commonly source a large number of products from local producers (OECD 2013a). Their distribution network would allow small producers whose products were previously consumed locally to access new markets in other parts of the country or even abroad. The retailers will hire local people to run the stores and the distribution system, creating jobs. In addition, the know-how they bring may be utilized by Kazakh entrepreneurs in the future. The same is true for food processing, even though domestic producers are more likely to dominate in the food processing sector.

Despite the ample potential, food retail investors face two main constraints. First, the quality and efficiency of the transportation infrastructure is low. While the authorities have been updating railways and major road corridors, investment and maintenance in regional and local roads lag (EBRD 2017). On the 2016–2017 Global Competitiveness Index, Kazakhstan ranked 108th out of 138 countries in terms of quality of roads.[25] Transport logistics in Kazakhstan are also poor (see section 2.3). Improving transport infrastructure is essential for development of the entire agribusiness sector (not only food retailing but also food processing and agriculture) given the perishable nature of many agricultural products. Development of better regional and local transport systems would also alleviate widening gaps between urban and rural development. Second, the

24. Authors' calculation based on the UN Comtrade database.

25. This is an area where PPPs can be effective, as discussed in section 2.3.

availability and quality of local supplies are limited. Large-scale and reliable local suppliers are few, and the quality of local products is often low; retail chains have to import meat supplies from Germany and Poland because of the low quality of locally produced meat (OECD 2013a). If retailers cannot source products from local suppliers, benefits for domestic food processors and farmers will be significantly limited. The authorities therefore need to take steps to improve the reliability of suppliers and the quality of their products in both agriculture and food processing.

In particular, state policies towards agriculture need two fundamental changes. First, authorities should switch their focus from increasing output to increasing the value added of products. Currently, the evaluation of policies focuses primarily on quantitative targets, mostly output (Petrick and Pomfret 2016). Subsidies that usually have little effect on productivity (and may even sustain inefficiency) dominate state spending on agriculture. Given the current low productivity level, there would be high returns from investing more in research and development (R&D) and other measures to improve productivity and quality (e.g. development of modern phytosanitary and veterinary laboratories). In 2016, spending on agriculture R&D represented only about 2 per cent of the agriculture ministry's budget (World Bank 2017b). This needs to be increased. The authorities should also provide better extension and advisory services to farmers so that they can benefit from knowledge gained from R&D activities. Updating plant and animal health systems would also greatly augment productivity and product quality. Improving the quality of agriculture products is essential for Kazakhstan's agribusiness sector to be competitive in the global market, particularly Europe.

Second, the state should incentivize the creation of cooperatives among small- and medium-sized farmers. Organizing small farmers into cooperatives can potentially be a breakthrough for improving the productivity and quality of meat and dairy production, where household plots and small individual farms dominate.[26] Cooperatives can address a number of areas where small farmers face constraints, including marketing, input supply, packaging and processing, agriculture extension, access to farm machinery, access to finance, and management of water distribution and irrigation (OECD 2015). Sharing farm equipment, machinery, and various facilities will lower costs of production, while coordinating production and distribution together increases efficiency and reduces fragmentation of supply chains. However, the greatest improvement hinges on improving access to finance. Small farmers face prohibitively high interest rates and stringent collateral requirements because transaction costs for issuing small loans are high and banks usually have little information about the farmers to assess their creditworthiness (OECD 2013b). Organizing small farmers into large cooperatives can lower transaction costs and make assessing creditworthiness easier for lenders.

Retailers will also find it easier to communicate and transact with a few, well-coordinated cooperatives rather than deal with each individual supplier. The authorities should promote the creation of cooperatives by reducing the tax burden and simplifying registration procedures. Efforts should also be made raise awareness about cooperatives in rural areas and provide technical assistance on how to set them up.[27] In addition, the authorities should employ policies that encourage input suppliers, processing facilities, and retailers to work with cooperatives.

As for food processing, three policies are recommended to improve quality and reliability. First, public quality standards and food safety systems should be developed to ensure availability of high-quality products for retailers. Second, incentives are needed to support investments in new technologies to improve the quality of products. Third, a database of local suppliers that retailers can use needs to be established. The database would help local suppliers integrate into the value chain. It has to be regularly updated and maintained, however, to be effective (OECD 2013a). In addition, inclusion of relevant food processors into cooperatives could be helpful to improve coordination of supply chains and access to finance for them.

Summary of policy recommendations:

Food retailing

- Attract international food retailers.
- Improve the quality and efficiency of transport infrastructure, especially regional and local roads.

26. In 2012, households and individual farms accounted for over 90 per cent of the production of milk, vegetables, potatoes, cotton, and wool, as well as most meat and oilseed production (OECD 2015).

27. A unique challenge in Kazakhstan is to build trust in cooperatives among farmers. They associate the term "cooperative" with a production cooperative, a remnant of the Soviet collective farm system. For more discussion and policy recommendations for developing cooperatives in Kazakhstan, see OECD (2015).

Agriculture

- Switch the focus of agricultural policies from raising output to increasing the value added of products.
- Increase investment in R&D activities.
- Create more modern phytosanitary and veterinary laboratories.
- Offer more extension and advisory services.
- Incentivize creation of agricultural cooperatives (including for food processors.)

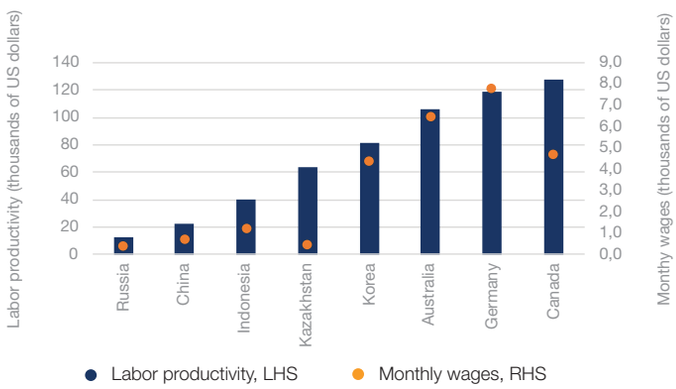
Food processing

- Develop public quality standards and food safety systems.
- Provide incentives to support investment in new technologies.
- Develop a database of local suppliers for retailers.

2.5.2. Manufacturing

Currently, Kazakhstan's manufacturing sector represents only about 10 per cent of GDP. However, if the business environment improves sufficiently, Kazakhstan has the potential to develop a competitive manufacturing sector by attracting FDI and integrating into global value chains. Thanks to its ample energy resources, Kazakhstan's electricity supply is relatively stable. According to the 2016–2017 Enterprise Surveys, the average number of power outages per month was 0.5, as opposed to the upper-middle-income-country average of 1.9, and value lost due to power outages was only 0.4 per cent of sales, as opposed to 0.7 per cent for the upper-middle-income average (World Bank 2014). [28] The labor market is very efficient, and Kazakhstan ranked 20th out of 138 economies on the 2016–2017 Global Competitiveness Index for labor market efficiency (WEF 2017). Labor productivity in key manufacturing sectors is above its peers such as China and Indonesia, although it lags developed countries. Cross-country comparison of labor productivity and wages by OECD (2016) seems to suggest that Kazakhstan's manufacturing sector can be competitive (figure 2.9). [29]

Figure 2.9: Kazakhstan and selected comparators: Labor productivity and wages for transport equipment



Source: OECD (2016)
Note: Data from 2013 are used for Kazakhstan, and 2011 data for other countries
Calculations are by OECD staff based on data provided by the Ministry of National Economy

Although the benefits of global value chains are not direct or automatic, Kazakhstan should aim to integrate into global value chains in sectors where it has comparative advantages. Finding niches of comparative advantage in production processes, rather than setting up industries on its own through an import-substitution industrialization strategy, could be beneficial, especially in the long run. For example, as part of a diversification strategy, Kazakhstan has been trying to establish a car industry through import-substitution industrialization within a protected domestic market (and within the custom unions with the Russian Federation and Belarus) (Pomfret and Sourdin 2014).

However, the authorities should recall the experience of Malaysia, which tried to establish a car industry and produced a national car, Proton, which failed to become competitive in the global market. In today's world where production is increasingly fragmented and each step is sourced where it can be performed best, Kazakhstan stands no chance unless it participates in global value chains (Pomfret and Sourdin 2014). By joining global value chains, the country can focus on particular steps in those chains (for instance, assembly or production of parts) where it has a

28. However, Kazakhstan's power sector is not without problems. While the imminent danger of electricity shortages in early the 2010s (the capacity margin fell to 4 per cent in 2012) has been resolved for the time being, the authorities have reversed previous reforms and increased their control of the sector, despite the need for more private participation. With prices unreflective of costs and heavy state regulations inhibiting private initiatives, the long-term prospect of the power sector is uncertain. See Aldayarov et al. (2017) for further discussion of Kazakhstan's power sector.

29. However, the reliability of the data can be questioned. OECD (2016) calculates the figures based on data received from Kazakhstan's Ministry of National Economy. Due to possible methodological differences, the cross-country comparison (especially that of wages) may not be entirely valid. OECD (2016) also compared figures for "food and related manufacturing" and "chemicals and pharmaceuticals", which showed a similar trend as figures for "transport and equipment", but it did not present comparisons for other manufacturing sectors such as textiles and machinery.

comparative advantage, without having to set up the entire production process on its own. In order to attract FDI and participate in global value chains, Kazakhstan must further facilitate trade and create a business-friendly environment in which the private sector can prosper, as outlined in section 2.3. Benefits from technological transfers would be significant for Kazakhstan, given its lack of technological sophistication. [30]

Summary of policy recommendations:

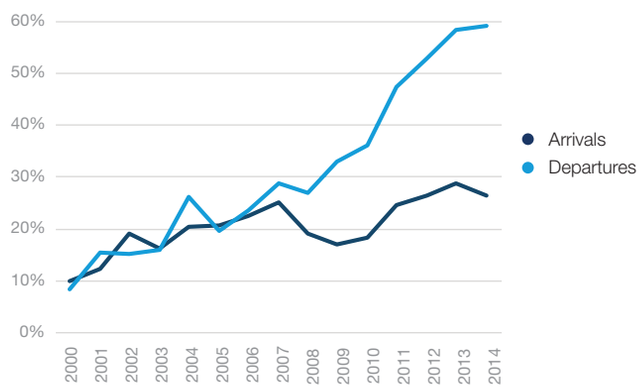
- Aim to participate in global value chains.
- Facilitate technological transfers by creating a business-friendly environment, as outlined in section 2.3.

2.5.3. Tourism

Tourism is relatively underdeveloped in Kazakhstan, but the number of visitors has risen steadily in recent years and the country has considerable potential to become a significant destination for business and leisure travelers seeking new destinations. Tourism contributes about 3 per cent of global GDP but only 1.6 per cent of GDP in Kazakhstan (Kennedy 2015). As the ninth largest country in the world, Kazakhstan has a range of natural settings, including mountains, lakes, and deserts, as well as some unique cultural attractions reflecting the country's multifaceted historical development, shaped by Islamic and Soviet influences, including the legacy of the historic Silk Road trading route in Asia, the largest mosque in Central Asia, and the remnants of a huge Soviet era gulag. The year 2017 was a watershed for tourism in Kazakhstan because it hosted EXPO 2017 and announced an updated tourism strategy (called the "Concept of Tourism Development until 2023"). As part of the process of boosting tourism, the government eased visa regulations for visitors in July 2017.[31]

Figure 2.10 shows tourist arrivals as a ratio of the country's population in Kazakhstan, the other three countries in this study, and the world. It reveals that arrivals have increased sharply in Kazakhstan and reached a high level compared to the three other countries examined here and the world as a whole. However, the number of outbound travelers has increased even faster, as figure 2.11 shows. In interpreting these figures, it should be noted that arrival and departure data are compiled by the United Nations World Tourism Organization (UNWTO) from national data based on differing methodologies, and may count anyone who enters the country, including citizens returning. Therefore, it is a very imperfect measure of tourism, particularly for cross-country comparisons. Much of this movement in and out of Kazakhstan may reflect short-term travel within the Central Asian region, particularly migrant workers. Indeed, most arrivals are from neighboring countries.

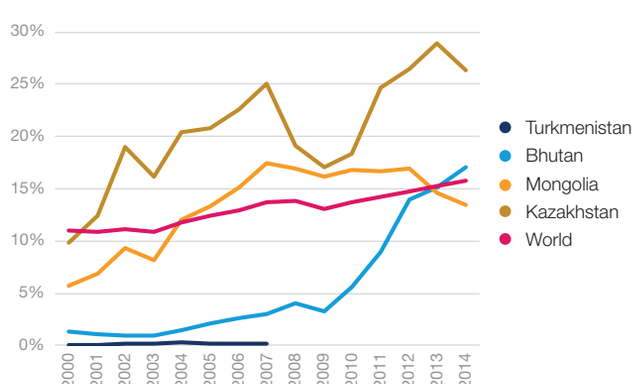
Figure 2.11: International tourist arrivals and departures in Kazakhstan (percentage of national population)



Source: World Bank, based on United Nations World Tourism Organization data

In 2011, the vast majority of visitors were from three countries: Uzbekistan (34 per cent), Kyrgyz Republic (27 per cent), and the Russian Federation (24 per cent) (Zhomartova 2013). Despite these limitations, however, it is clear that Kazakhstan is receiving additional visitors, and the contrast with its neighbor Turkmenistan is striking.

Figure 2.10: International tourist arrivals in Kazakhstan, Bhutan, Mongolia, Turkmenistan, and the world (percentage of national population)



Source: World Bank, based on United Nations World Tourism Organization data

30. In the 2016–2017 Global Competitiveness Index, Kazakhstan ranked 90th for availability of latest technologies and 95th for FDI and technology transfer out of 138 countries (WEF 2017).

31. D Omrgazy, 2017, Kazakh government approves tourism development concept, Astana Times, 6 July

At EXPO 2017, the head of the UNWTO, Taleb Rifai, lauded Kazakhstan's promise in tourism but noted several steps that the country needs to take in order to realize this potential.

First, he proposed simplification and speeding-up of the visa application process.

Second, he suggested that the country gradually increase the frequency of international flights by reducing barriers. Third, he said Kazakhstan should engage in an international marketing campaign to improve its image.

Finally, he recommended the training of skilled tourism personnel. These recommendations are similar to those of other studies. Zhomartova (2013) proposed facilitating the entry of small travel agencies, improving domestic as well as international transport infrastructure, establishing modern electronic systems for reservations and information, and improving data collection on the tourism sector. Kennedy (2015) observed that there is a shortage of mid-range (three-star) hotels and a surplus of luxury (five-star) hotels. Environmental preservation efforts must also be strengthened if Kazakhstan is to develop high-end ecotourism. In some cases, ecotourism can conflict with sports tourism such as skiing.

The government has moved to support tourism in recent years (Kennedy 2015). In 2014, the Tourism Industry Committee was replaced by the Department of Tourism. The government has created a helpful website for visitors (http://visitkazakhstan.kz), available in English and Russian. The new Tourism Development plan identifies five clusters for tourism with different sorts of attractions and activities. The Astana cluster has two parts, the "urban" component in the city itself named "Heart of Eurasia", and the rural component named "Unity of Nature and Nomadic Culture", which includes the Ulytau State Nature Reserve. Several other clusters are identified, including ones associated with the Silk Road, beaches along the Caspian Sea, and nature parks in different regions. The tourism development measures are to be implemented in two phases over 2017–2019 and 2020–2023.

The government has been gradually easing visa requirements since 2014, extending visa-free entry to citizens of more countries and extending the time they can stay without visas.[32] However, there are complaints about high prices, poor service, and bureaucratic hassles from government, such as having to register with the migration police.[33]

Summary of policy recommendations:

- Refine and implement the Concept of Tourism plan, emulating successful tourism development strategies in other countries such as Morocco and Malaysia.
- Reduce bureaucratic hassles for tourists such as having to register with the Migration Police.
- Remove barriers to foreign airlines serving Kazakhstan.
- Encourage visitors from Europe through additional marketing efforts, reduced costs, and improved quality of service.
- Develop training of skilled tourism management personnel, perhaps through a hotel school.
- Give more importance to preserving the natural environment in order to spur ecotourism.
- Provide additional data and analysis on the tourism sector.

2.6. Kazakhstan's current export structure, key markets, and prospects for product diversification

2.6.1. Current export structure and key markets

The need for product diversification in Kazakhstan is there for all to see in figure 2.12, as it shows how fuels (crude and refined) accounted for 71.7 per cent of total exports over 2012–2016. Above all, the economy is dependent on crude petroleum oil (SITC 333), which dominated the export basket with a share of 62.9 per cent. By contrast, the second and third largest products – copper (SITC 682) and petroleum oils or bituminous minerals containing by weight 70 per cent or more of oil (SITC 334) – only represented, respectively, 3.6 per cent and 3.4 per cent of the total. Kazakhstan has been an oil producer since 1911, but the exports were focused on the Russian Federation during

32. Kazakhstan lifts visa requirements to boost tourism, investment, Euractive, 3 January 2017, available at https://www.euractiv.com/section/global-europe/news/kazakhstan-lifts-visa-requirements-to-boost-tourism-investment/ (accessed 10 September 2018).

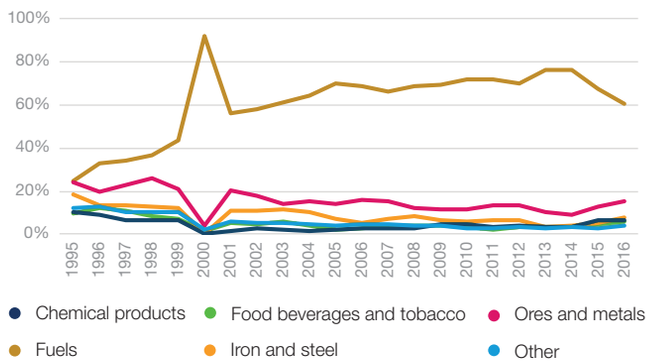
33. J Lillis, 2014, Summer holiday in Kazakhstan? Astana eases visa restrictions to attract tourists, The Guardian, 17 July, available at https://www.theguardian.com/world/2014/jul/17/kazakhstan-eases-visa-restrictions-attract-tourists (accessed 28 August 2018).

the Soviet era and it is only since the mid-1990s and the involvement of international oil companies that petroleum has become the dominant product it is today (US Energy Information Administration 2017).

As can be seen in figure 2.13, fuels represented about one-quarter of total exports in 1995, but a combination of investment and high oil prices led the share to grow to more than two-thirds 10 years later. Ores and metals, which accounted for a similar share as fuels in 1995, have remained the second largest product group exported by Kazakhstan, representing about 10 to 15 per cent of total exports in the past decade.

The growing dependence of Kazakhstan's economy on oil is reflected in its export concentration score (based on the Herfindahl-Hirschmann Index). In 1995 it had a score of 0.20, which was the lowest score among the four LLDCs discussed in this study. The average score in 1995–1999 was 0.28 (on par with Bhutan), but that surged to 0.54 in the following five-year period. The concentration score has exceeded 0.50 since 2002 and the average score in 2012–2016 was 0.60 (see figures 1.1 to 1.4 in Chapter I). This lack of diversification looks set to continue, as oil production is likely to only increase, especially in view of an accelerated output from the recently launched Kashagan oil field (Sarsenov and Aldiyarov 2017).

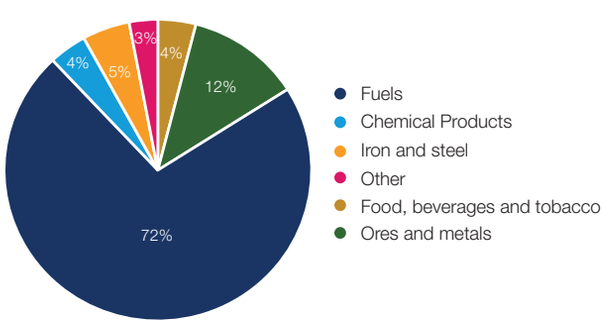
Figure 2.13: Evolution of export structure in Kazakhstan, 1995–2016 (percentage)



Source: World Bank, based on United Nations World Tourism Organization data

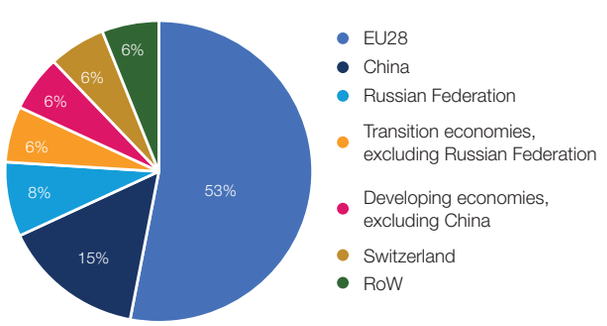
From 2012–2016, the European Union was the largest market for Kazakhstan's exports, accounting for more than half of the total (figure 2.14). This is different from the situation in the mid-1990s when the Russian Federation was the country's main importer (figure 2.15). Since then there has been a shift away from the Russian market towards the European market and, more recently, the Chinese market (mainly as a result of a pipeline linking Kazakhstan and China since 2006). Trade relations with China are likely to increase if China successfully implements the New Silk Road project and Kazakhstan manages to draw on its strategic location between China, Europe, and the Middle East (Golub et al. 2018).

Figure 2.12: Exports from Kazakhstan by product group, 2012–2016 (percentage)



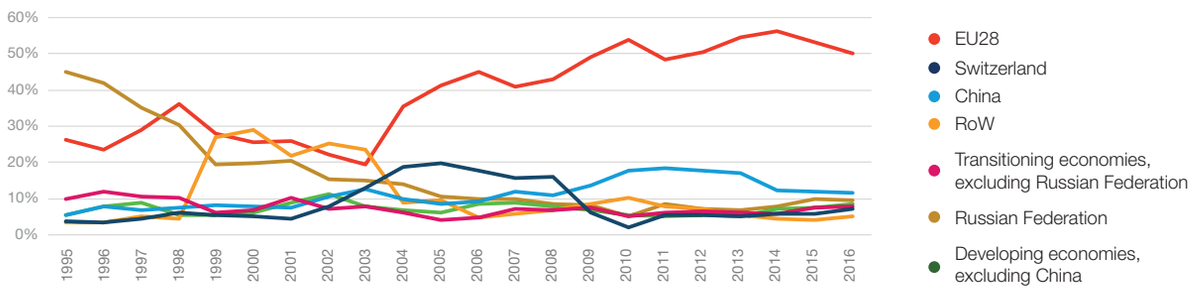
Source: Unctadstat.unctad.org

Figure 2.14: Main importers of Kazakhstan's exports, 2012–2016 (percentage)



Source: Unctadstat.unctad.org
Note: RoW: rest of world

Figure 2.15: Evolution of main importers of Kazakhstan's exports, 1995–2016 (percentage)



Source: Unctadstat.unctad.org
Note: RoW: rest of world

2.6.2. Prospects for product diversification

As discussed in the previous section, Kazakhstan has potential for economic and export diversification in three non-fuel sectors that offer opportunities for diversification: agribusiness (primarily), light manufacturing, and tourism. In agribusiness, despite the comparative advantage Kazakhstan enjoys by virtue of it being the largest LLDC in the world and having the second highest availability of arable land per capita, productivity in agriculture is low and more investment is needed to develop the sector. The country's value added of manufacturing to GDP is low, but the stable electricity supply and efficient labor market suggest that there is an opportunity to expand the sector. To achieve this, one priority is to improve the overall business environment. Tourism has increased recently, but it still only contributes 1.6 per cent to the country's GDP. Policy measures to boost the sector further could include removing barriers to foreign airlines serving Kazakhstan, reducing costs, and promoting ecotourism.

Looking first at the intensive margin, the category "other metals" represents Kazakhstan's largest possibility of expanding existing exports, with an untapped potential of US$2 billion (figure 2.16). The products included in this category that offer the greatest potential are copper cathodes (HS 740311), unwrought zinc, not alloyed, >=99.99 per cent zinc (HS 790111), and aluminum, not alloyed, unwrought (HS 760110). Other categories that seem to have considerable untapped export potential are ferrous metals (primarily ferro-alloys and flat-rolled products of iron or non-alloy steel – US$1.2 billion), wheat (US$775.5 million), processed cereals (wheat or meslin flour – US$312.8 million), oil seeds (mainly linseed and sunflower seeds – US$223.8 million), and machinery (cylindrical roller bearings and starter batteries – US$126.9 million). Fish & shellfish, cotton, and plastics & rubber are among the other top 10 subsectors with identified untapped export potential.

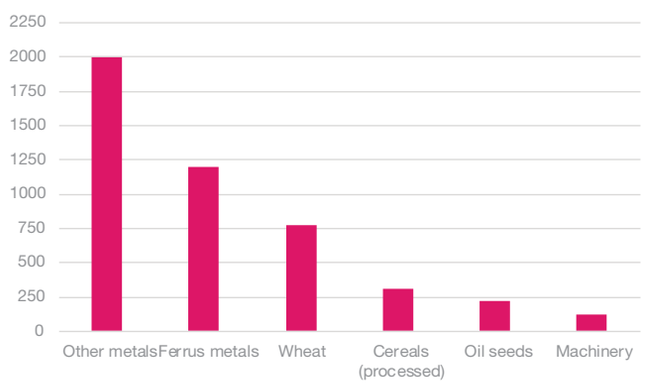
China is the market that offers the greatest opportunity for expanding existing exports for Kazakhstan, primarily with respect to other metals (US$964 million) and ferrous metals (US$503.4 million). Interestingly, Turkey – the ninth largest importing country – is one of the economies with the greatest prospects for growing Kazakh exports, with untapped potential in, above all, other metals (US$239.5 million), ferrous metals (US$214.1 million), and wheat (US$99.6 million). Other economies that offer considerable potential for Kazakhstan include Germany (other metals), the Islamic Republic of Iran (wheat), Japan (other metals), and Uzbekistan (processed cereals).

In the context of expanding exports at the intensive margin, it is also worth noting the results on Kazakhstan's comparative advantage reported in Felipe and Hidalgo (2015). They find that Kazakhstan has a comparative advantage in 127 products, of which 29 are in the natural resources category and 98 in the non-natural resources categry. Goods in the latter category include vegetable products, mineral products, textiles, and metals. The conclusion of the authors is that the government's efforts to diversify the economy should focus on identifying, together with the private sector, goods that use capabilities similar to the 127 exports in which the country has a comparative advantage.

With regard to the extensive margin, the greatest opportunities for promoting export diversification seem primarily to be in the iron and steel sector (table 2.6), where products of particular potential include pig iron containing by weight less than 0.5 per cent of phosphorous (HS 720110),

ferrous products obtained from iron ore (HS 720310), semi-finished products of iron or steel (HS 720712), and ferro-manganese products containing by weight more than 2 per cent of carbon, in granular/powder form (HS 720211). Other sectors where Kazakhstan has options to diversify are railway wagons and different food products such as nuts and fruits. China, the Russian Federation, and the United States are the three markets that offer the greatest potential for diversifying Kazakhstan's exports.

Figure 2.16: Export potential of Kazakhstan by product group (in millions of US dollars)



Source: International Trade Centre, Export Potential Map (exportpotential.intracen.org)

2.7. Conclusion

Kazakhstan has recently made significant progress in improving its business environment, but has yet to overcome its dangerously high dependence on the extractive sector. It needs to diversify the economy and exports in order to sustain the impressive growth and improvement in living standards it enjoyed in the previous decade, and to reduce its vulnerabilities to commodity price swings. The key sectors for diversification are agribusiness and, to a lesser extent, manufacturing. In the former, Kazakhstan has the potential to become an exporter of agricultural products and processed food, as well as a regional pivot for the international food-retailing network. In the latter, Kazakhstan should aim to join global value chains. Either way, the key for export diversification is to integrate into the global market and value chains by attracting FDI. To achieve this goal, the country must implement a number of reforms to help create a business-friendly environment. Areas that require further progress include trade facilitation, access to credit, control of corruption, infrastructure, and human capital.

It is important that Kazakhstan strive for growth led by private initiatives, rather than by public spending and intervention. State-led industrialization entails two dangers. First, public policies and initiatives tend to suffer from both bureaucracy and inefficiency, resulting in resource misallocation. This is especially likely for Kazakhstan, where corruption is prevalent and the capacity of public services is limited. Second, high spending levels by the government and public entities places upward pressures on wages and prices, and thus risks exacerbating Dutch disease. Given the sheer size of the public sector in Kazakhstan's economy, there is a high risk that state-led industrialization would end up damaging the non-oil tradable sector, in particular manufacturing industries. Therefore, the authorities must focus on spurring the private sector by lowering barriers to doing business, rather than attempting top-down industrialization. Even where the presence of the state is essential, such as in the provision of public goods, the authorities should seriously consider PPPs; it can introduce market mechanisms and ensure efficient operation and cost-reflective pricing. PPPs would be effective in areas such as transport infrastructure (e.g. construction of roads and maintenance), logistics, the power sector, and communications. The ongoing effort to privatize national holdings is also welcome, as long as it is kept transparent and competitive.

Once an efficiency-oriented environment that fosters private initiatives is established, FDI will naturally flow in where Kazakhstan turns out to have a comparative advantage. The state's main role will be to eliminate constraints that discourage private initiatives (e.g. streamline licensing processes) or introduce mechanisms that help overcome these constraints (e.g. promote formation of agricultural cooperatives). In particular, trade facilitation is crucial for Kazakhstan to be an active participant in global value chains. The New Silk Road project led by China offers a great opportunity for Kazakhstan to transform its geographic location, which always posed a constraint (i.e. no access to open sea), into an advantage (i.e. strategic location between China, Europe, and the Middle East), and to integrate into regional and global production networks. If Kazakhstan keeps up its current pace of reforms, it is likely that the diversification efforts are going to pay off in the near future.

Table 2.6. Top 10 product diversification opportunities for Kazakhstan

Rank	Product	HS code	Top three markets
1	Pig iron <=0.5 per cent of phosphorous	720110	United States, Turkey, China
2	Cobalt mattes & intermediate products; cobalt, powder, unwrought	810520	China, Japan, United States
3	Ferrous products obtained from iron ore	720310	United States, China, Belarus
4	Potassium chloride for use as a fertilizer	310420	China, India, United States
5	Groundnuts, excl. roasted or cooked	1202	Russian Federation, Great Britain, the Netherlands
6	Railway goods wagons, open	860692	Russian Federation, Australia, Belarus
7	Bovine cuts bone in, frozen	020220	Russian Federation, China, Republic of Korea
8	Semi-finished products of iron or steel	720712	United States, Turkey, Denmark
9	Grapes, dried	080620	Russian Federation, Great Britain, Germany
10	Ferro-manganese >=2 per cent of carbon	720211	Islamic Republic of Iran, Russian Federation, United States

Source: International Trade Centre, Export Potential Map (exportpotential.intracen.org)

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TURKMENISTAN

III. TURKMENISTAN

3.1. Introduction

Turkmenistan's economic growth has been impressive, with real GDP per capita tripling between 2000 and 2015, moving the country to upper-middle-income status, thanks largely the exploitation and export of natural gas. While data on poverty levels are unavailable, it is clear that the standard of living of the population has improved considerably (World Bank 2014). Natural gas revenue enables the government to provide electricity, gas, and water to the entire population free of charge. Prices of other basic consumer goods are also subsidized. Despite resulting distortions, low prices have generally improved the standard of living and secured the approval of the administration among the citizenry. In addition, natural gas exports have allowed Turkmenistan to accumulate large foreign exchange reserves, although their magnitude is difficult to ascertain, and thus to maintain a currency peg to the US dollar. Investment has been high as well, although many of the projects are of questionable usefulness in promoting diversification and inclusive growth.

Despite strong economic growth, a close analysis of a variety of economic and social indicators shows that the recent increase of GDP falls short of a structural transformation of Turkmenistan into a more developed economy. Turkmenistan faces many challenges in expanding the role of the private sector, diversifying the economy, and thus becoming a fully developed nation. Despite rapid growth of aggregate output and investment, a large share of the population ekes out a meager living in subsistence farming and poverty remains widespread, although once again no specific figures are available. Unemployment and underemployment are reported as high as 60 per cent (Bhor 2016).

The country's economic dependence on extractive sectors, notably natural gas, remains very high. Such a high level of dependence on a single commodity is not a solid foundation for long-term development. In 2013, natural gas accounted for 35 per cent of GDP, 85 per cent of fiscal revenues, 90 per cent of exports, and almost all inward foreign direct investment (FDI) (World Bank 2014). High volatility of output, low levels of employment creation, and lack of linkages to the rest of the economy are among issues that typify dependence on fossil fuels. Furthermore, natural gas is more difficult to transport than oil, as it requires expensive investment in pipelines. In addition, Turkmenistan's potential markets in Europe can only be reached after traversing politically unstable or hostile regions such as Afghanistan and the Russian Federation. These factors make regional diversification of exports challenging. At present, exports of Turkmen gas are precariously dependent on a single destination – China. The recent downturn in energy prices has brought these issues to the fore. The fiscal balance has deteriorated, international reserves are declining, and wage payments are in arrears for many workers.[34]

The government of Turkmenistan's National Programme for Socio-Economic Development for 2011–2030 sets ambitious targets for continued growth and rising living standards through a rising role of the private sector and economic diversification. As this report points out, Turkmenistan has promising areas of diversification in tourism, textiles, and agriculture. The government recognizes the importance of privatization, liberalization, and institutional development to realize its potential (World Bank 2014). On the other hand, various analyses agree that Turkmenistan is lagging in implementing reforms. While less information is available for Turkmenistan than other countries in the region, a number of indicators rate Turkmenistan's business climate as among the least conducive in the world, as described below. The barriers to economic diversification include nontransparent political institutions and the Soviet legacy of tight state control of the market, including the financial system. Tight restrictions of the private sector, poorly developed property rights, and corruption constrict the growth of agriculture and manufacturing. Insufficient progress towards democracy and concern about human rights abuses can also deter some foreign investment and international trade, as well as discourage the support of international organizations such as the European Bank for Reconstruction and Development (EBRD) and the World Bank. Furthermore, despite the professed goal of diversification, the natural gas sector absorbs a disproportionate share of government investment.

3.2. Dominance of natural gas

Turkmenistan possesses the fourth largest natural gas reserves in the world after the Russian Federation, Islamic Republic of Iran, and Qatar, and it has the second largest single deposit, Galkynish, from which extraction started in

34. Shrinking exports spell trouble for Turkmenistan, The Economist, 15 December 2016.

2013 (World Bank 2014; Bohr 2016). Though there remains considerable uncertainty about their exact size, Turkmen reserves are expected to last at least 250 years. The main challenge at present is extraction of gas from onshore and offshore fields, which is technically complex. In 2013, the country produced about 62 billion cubic meters (bcm) of gas, far below its potential and lower than the 81 bcm in 1989 at the end of the Soviet era, although up considerably from the 1990s.

On the supply side, Turkmenistan's capacity is constrained by its unwillingness to allow foreign energy companies to participate in onshore production, with the exception of Chinese companies. Shutting out Western firms results in a lack of domestic technical expertise and managerial skills and antiquated pipeline and drilling infrastructure.

On the demand side, Turkmenistan has limited ability to access the European market due to its inability or unwillingness to construct the requisite pipelines. Turkmenistan's lack of geographical (market) diversification has made it vulnerable to fluctuations in demand among its main customers, formerly the Russian Federation and now China. The deterioration of the Turkmen external position in 2009 reveals the country's vulnerability to natural resource price shocks (EBRD 2014). The plunge of demand in Europe, which was a significant destination of Turkmen gas exports before the crisis, along with tensions with the Russian Federation, led to a sharp drop of gas exports (World Bank 2014).

Furthermore, lack of market diversification undermines Turkmenistan's bargaining power in setting gas prices, and the prices it previously received from the Russian Federation and recently from China have often been well below world averages. Until 2010, the Russian Federation was the single biggest buyer of Turkmen gas, in part for trans-shipment to Europe. Pricing was a contentious issue in Turkmen-Russian relations, with the Russian Federation paying below world prices. A pipeline explosion in 2009 exacerbated tensions in the Russian-Turkmen trade relationship.[35] The conflict with the Russian Federation forced Turkmenistan to shift its exports to China, with which a new pipeline had recently been constructed, fortuitously (Bohr 2016). Today, China is by far Turkmenistan's most important export market, with trade between these two countries growing by 20 times between 2007 and 2012. In the first 10 months of 2016, Turkmenistan exported 25.6 bcm of natural gas to China, far more than to any other country. However, the price of Turkmen gas for China is significantly lower than it was for the Russian Federation. The dependency is exacerbated by the fact that China financed the construction of the Turkmen pipelines, leaving Turkmenistan with a large debt. It is thus advisable for Turkmenistan to further diversify its markets to the Middle East and Europe, though the latter may require allowing multinational companies as full partners in production as well as improving Turkmenistan's human rights record.

Unfortunately, however, increasing dependence on China remains the most realistic prospect. Russian Gazprom is not dependent on Turkmen gas, and hence it will only make purchases if Turkmenistan allows the company to access its gas fields directly, a privilege so far awarded only to a few Chinese companies. Expansion to the Middle East, in particular the Turkmenistan-Afghanistan-Pakistan-India pipeline, is severely constrained by the escalating political conflict in Afghanistan. By 2030, the Turkmen government plans to increase its natural gas production from 45 to 180 bcm per year, but it is unclear who will purchase the tripled amount of gas even if such an increase were feasible.[36] China remains the only destination that has plausible rationales both to increase its consumption of Turkmen natural gas and the ability to finance pipeline construction. China's recent commitment to environmental improvement encouraged the Chinese to switch away from coal to natural gas. A second gas pipeline to China is currently under construction (Bohr 2016).

The Turkmen government has clearly favored the extractive sector by implementing fee exemptions, reducing taxes, and simplifying licensing procedures for foreign and domestic companies involved in natural resources. As a result, in 2012, 46.1 per cent of public investment and 85.2 per cent of foreign investment were directed to hydrocarbons. The vast majority of the sector remains state-owned. Virtually no progress has been achieved in privatizing Turkmen oil and gas due to the state's commitment to maintaining control over this politically important industry. Turkmenistan could potentially benefit from allowing private domestic and foreign companies to participate in hydrocarbon extraction. The management of revenues is also regarded as highly non-

35. A new customer for Turkmen natural gas, Stratfor, 13 February 2017, available at https://worldview.stratfor.com/image/new-customer-turkmen-natural-gas (accessed 8 September 2018).

36. Why China will remain Turkmenistan's main gas buyer, Russia Beyond the Headlines, 26 January 2017, available at https://www.rbth.com/business/2017/01/26/why-china-will-remain-turkmenistans-main-gas-buyer_689386 (accessed 20 August 2018).

transparent, as discussed in the following section. Partial privatization of natural gas would increase competitiveness, improve technology, and boost the effectiveness of investment.

At the same time, governmental support should be shifted towards other sectors. Though extractive industries constitute over a third of the country's GDP, they provide only 2 per cent of employment (World Bank 2014). With 45 per cent of the population under the age of 25, the Turkmen workforce is expected to increase by at least a third in the years ahead, increasing the urgency of creating more employment opportunities. Given the high rate of underemployment and the projected increase in the labor force, the country must prioritize more labor-intensive sectors like manufacturing and agriculture.

Nevertheless, even with successful diversification, natural gas will continue to be an important pillar in the Turkmen economy. With more advanced technology, Turkmenistan has the potential to discover additional reserves and use the revenue to support the development of other sectors. It's important to recognize that though the physical amount of natural resources is fixed, the ability to extract and distribute the resources is heavily influenced by the quality of management and institutions in place (World Bank 2014). Turkmenistan's rich natural gas endowment could be exploited a lot more efficiently if it were managed by transparent institutions with a mix of public and private control, as is done almost everywhere else in the world. Finally, as Turkmenistan develops, it will need to address the issue of energy sustainability. State energy subsidies result in very low tariffs that fail to account for environmental costs and have large fiscal opportunity costs (EBRD 2014). Turkmenistan must establish a legal framework to support energy efficiency and introduce tariffs that are reflective of environmental costs.

Summary of policy recommendations:

- Permit private sector participation in natural gas and oil extraction, even if the government retains a majority stake and oversight, and include the industry in Turkmenistan's privatization programme.
- Transparently and fairly allocate participation rights to the most competitive private domestic and foreign companies.
- Allow Western companies to participate, which would make them more willing to invest in pipeline construction and maintenance.
- Develop policies to support sustainable energy use, gradually reducing subsidies

3.3. Macroeconomic management

3.3.1. Output, savings, and investment

As noted earlier, Turkmenistan's growth performance has been exemplary. In the decade following the breakup of the Soviet Union, per capita GDP dropped sharply in Turkmenistan as in most other transition economies, but it subsequently rose dramatically, moving the country into upper-middle-income status. Average GDP growth between 2005 and 2015 was 11.8 per cent, although the growth rate slowed to a still solid 6.2 per cent in 2016. Data on poverty and other social indicators are lacking, but living standards have also risen.

Though inflation is partially constrained by state control of prices of essential products, it has remained at around 5-6 per cent for the last several years. The government made substantial progress in fostering market competition by gradually liberalizing prices, specifically of meat and wheat products. That inevitably led to higher prices of food, notably the threefold increase of bread prices in July 2012 (EBRD 2014). Large increases in government wages and pensions also contribute to higher inflation.

Despite high gross savings, adjusted net savings are much lower, possibly negative, after allowing for depreciation of natural capital (World Bank 2014). Likewise, gross investment rates have been very high, surpassing 50 per cent of GDP in 2010.[37] Much of this investment is concentrated in the natural gas sector and in public works of often-questionable productive value, such as mausoleums and stadiums (Bohr 2016). FDI has also been high in recent years, at around 10 per cent of GDP, but is overwhelmingly concentrated in the natural gas sector, and much of that is from Chinese state-owned companies, given the restrictions on Western companies. With falling natural gas revenues, raising the productivity of public and private investment becomes even more important. In order for Turkmenistan to support the current level of investment, it must increase gross national saving by cutting inefficient

37. These figures are based on data from the World Bank's World Development Indicators.

governmental expenditures, including energy subsidies and public sector payrolls.

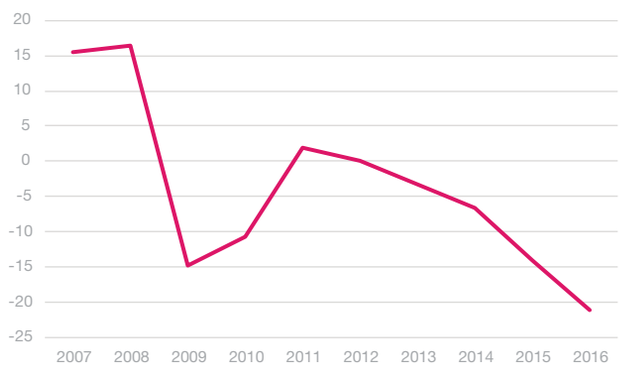
Reliance on natural gas revenue inevitably leads to high economic volatility. In an attempt to insulate the economy from shocks and to manage the fiscal balance, foreign exchange reserves, and public investment over time, the government has created three institutions in recent years (World Bank 2014). First, in 2007, the government instituted the Foreign Exchange Reserve Fund (FERF) to manage fluctuations in the balance of payments and maintain exchange rate stability. Second, in 2008 the Stabilization Fund (SF) was instituted to stabilize the government budget by accumulating assets in good times and spending them down in bad times. Finally, the State Development Bank of Turkmenistan (SDBT) was created in 2011 to fund public investments in priority sectors. These three institutions are intended to smooth spending of natural gas revenues and to fund priority investment.[38] In practice, their operations have been criticized as highly non-transparent and arbitrary (EBRD 2014; Bohr 2016). Turkmenistan needs to publicly identify and implement objective and transparent criteria for the operations of all three institutions as well as timely and full reporting of their activities.

IMF (2017) notes that the government budget deficit has remained commendably low, but that the overall balance hides large non-hydrocarbon deficits. The overall budget deficit has been kept low due to painful reductions in investment and a rise in utility charges. This underlines the importance of diversifying the economy and broadening the tax base.

3.3.2. Balance of payments and the exchange rate

As in other areas, information on the balance of payments is lacking. Data from the IMF show that the current account balance has swung widely in response to price and demand shocks affecting natural gas (figure 3.1). In the mid-2000s, when prices of natural gas were booming, Turkmenistan ran massive current account surpluses of near 20 per cent of GDP. The global recession led to falling demand in Europe and the Russian Federation for Turkmen gas and pushed the current account into deficit. Following a recovery of prices after 2010, the current account again moved into surplus. The renewed decline of energy prices since 2015 has pushed the current account into wide deficits of 10-20 per cent of GDP. No information is available on how these deficits are financed, but they surely entail large changes in foreign exchange reserves.

Figure 3.1: Turkmenistan's current account balance (percentage of GDP)



Source: International Monetary Fund

Following the exchange rate unification in 2008, Turkmenistan fixed the exchange rate at 2.85 manat per US$1 in early 2009. In early 2015, in response to the deteriorating balance of payments following the drop in natural gas prices, the currency was devalued to 3.50 manat per US$1. At the same time, domestic inflation averaged about 5 per cent over 2010–2015. This implies a cumulative real appreciation given the fixed exchange rate of about 30 per cent vis-à-vis the US dollar. The 2015 devaluation largely but not completely offset the previous real appreciation. As discussed earlier in this report, real appreciation associated with natural resource exports, known as Dutch disease, is a common problem in resource-exporting countries. In Turkmenistan, real appreciation has been relatively limited and is not the major factor impeding export diversification.

The debate whether Turkmenistan would benefit from a floating exchange rate is ongoing. On the one hand, a fixed nominal exchange rate promotes confidence towards the manat, which attracts foreign investment, and insulates the economy from external monetary shocks. A stable currency encourages saving, so deposits denominated in manat grew six times over between 2009 and 2013 (World Bank 2014). The fixed exchange rate stabilizes prices of imported consumer goods and thus plays an important role in maintaining social stability. After all, Turkmenistan appears to have sufficient foreign reserves to maintain the peg credibly.

38. President Berdymukhammedov refers to the stabilization fund in Turkmenistan, Chronicles of Turkmenistan, 13 December 2016, available at http://en.chrono-tm.org/2016/12/president-berdymukhammedov-refers-to-the-stabilization-fund-in-turkmenistan/ (accessed 24 September 2018).

The accumulation of reserves also has proven effective in limiting currency appreciation. On the other hand, a floating exchange rate would enable Turkmenistan to make use of exchange rate adjustments to stabilize the current account and the economy. Given the present state of Turkmenistan's heavily controlled economy, the fixed exchange rate is on balance beneficial, but flexibility should be introduced gradually.

Summary of policy recommendations

- Work with international organizations to improve data on the Turkmen economy, as information on basic macroeconomic indicators is lacking.
- Cut back on excessive expenditures and subsidies in order to finance investment in physical capital such as infrastructure, machines, and housing.
- Improve the transparency of the various off-budget government funds. Increased accountability of state entities will contribute to a more effective conversion of revenues into productive investment.
- Gradually move towards greater exchange rate flexibility to boost competitiveness and offset external shocks.

3.4. Obstacles to private sector development

Due mainly to a lack of available national data and frequent changes in laws pertaining to the registration of businesses, Turkmenistan is among the few countries that are excluded from the World Bank's Doing Business Index, the benchmark indicator of the local business environment. This report therefore relies on several alternative sources to evaluate Turkmenistan's business climate, including the World Bank's Logistic Performance Index, the Heritage Foundation Index of Economic Freedom and the World Bank's World Governance Indicators.

3.4.1.The overall business environment for private enterprise

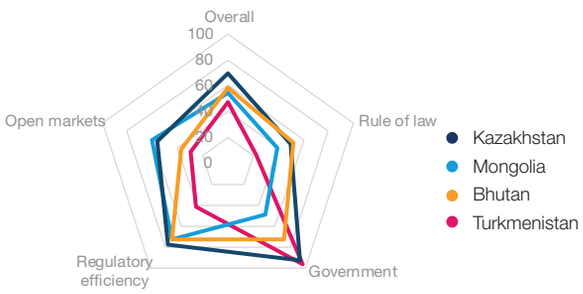
The Heritage Foundation's 2017 Index of Economic Freedom estimates the level of market openness by analyzing four vital aspects of an economy: rule of law, government size, regulatory efficiency, and openness of markets (figure 3.2).[39] Each of these four dimensions is subdivided into three topics that receive a score between 0 and 100 (100 being the best). In order to obtain separate scores for the four basic categories, as displayed in figure 3.2, we took the average score of the respective subareas. Finally, the overall score is the average of the four main dimensions.

Turkmenistan is ranked at the very bottom of the list as one of the most restricted economies. With its overall score of 47.4, Turkmenistan was rated 170th out of 180 countries, lower than any other Central Asian country. Rule of law, with a score of 22.3, appears to be Turkmenistan's greatest weakness. Subcategories of this section – property rights, governmental integrity, and judicial effectiveness – received scores of 32.4, 29.6, and 5, respectively. The commentary further noted that this poor performance could be explained by the governmental monopoly on land, tight control of the judicial system, and underdeveloped laws. Judges are appointed and removed directly by the Government, contracts are rarely properly enforced, and bribery is common among government officials. By contrast, Turkmenistan received a nearly perfect score in the government size category that assessed taxes and government spending. Government spending, the tax burden, and fiscal health were awarded 92.3, 95.3, and 98.9 points, respectively. The aggregate tax burden amounted to a relatively low 17.4 per cent of total domestic income.

Regulatory efficiency was awarded 41.6 points. Its components, business, labor, and monetary freedom, scored 30, 20, and 74.8, respectively. Absence of effective law enforcement, bureaucracy, and concentration of employment opportunities in the public sector were reported as the main constraints to regulatory efficiency. Turkmenistan scored 30 in the open markets category. Specifically, it received scores of 80, 0, and 10 in trade, investment, and financial freedom, respectively. These findings highlight Turkmenistan's lack of trade barriers but tight state control of the financial system and restrictions on investment. Figure 3.2 compares Turkmenistan's score on the four main economic indicators with the other countries from this study, showing that Turkmenistan scores consistently lower than the other three except for government size.

39. According to the Heritage Foundation's Index of Economic Freedom 2017, available at http://www.heritage.org/index/country/turkmenistan (accessed on 2 November 2018).

Figure 3.2: Index of Economic Freedom indicators, 2017



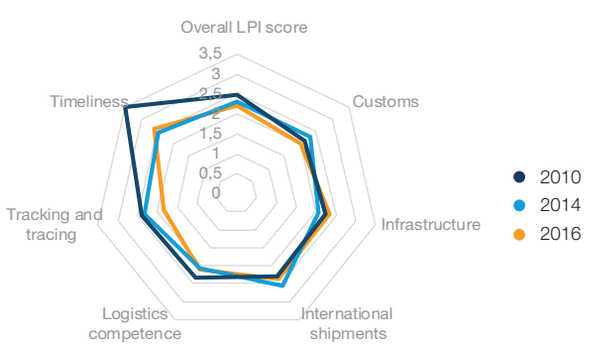
Source: Heritage Foundation, 2017

3.4.2. International trade logistics

The Logistics Performance Index focuses on trade-related institutions, with rankings of customs, port infrastructure, handling of shipments, logistics competence, tracking, and timeliness.[40] High performance in these six areas is essential for integrating successfully into the world economy. The six dimensions of trade logistics are assessed separately and their average value is taken to obtain the aggregate Logistic Performance Index score. The data are based on reports of local logistics professionals, and are recoded as an index with 5.0 being the highest and 1.0 the lowest scores.

In 2016, Turkmenistan ranked 140th out of 160 participating countries. Worse, its Logistics Performance Index score has declined steadily in recent years to 2.21 in 2016 from 2.30 in 2014 and 2.49 in 2010 (figure 3.3).

Figure 3.3: Logistics Performance Index indicators for Turkmenistan in 2016, 2014, and 2010

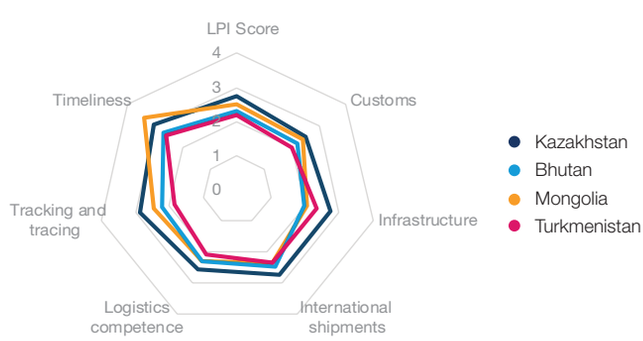


Source: World Bank Logistics Performance Index

In 2016, Turkmenistan scored a low 2.0 for efficiency of customs clearance. The list of documents required by the Main State Inspectorate (Turkmenstandartlary) varies by sector and may include, among other requirements, permission from the respective local ministry.[41] Trade and transport infrastructure was awarded a score of 2.34. While Turkmenistan has a relatively developed transportation system, most road networks were designed to benefit the extractive industries, and rural areas are often underserved (US Department of State 2016). Ease of arranging competitively priced international shipments was given 2.37 points, which highlights the necessity of private investment in the delivery and shipment sector. Quality of logistics services, including customs brokerage, trucking, and forwarding, is estimated to be 2.09. Turkmenistan's lowest score of 1.84 corresponds to the ability to track consignments. It would be helpful to implement an automated tracking service that would allow registration of shipments at all stopping points and provide traders online access to the location of their cargo. In addition, reliable insurance services could reduce the perceived risk of loss of shipments. Timeliness, with a score of 2.59, is Turkmenistan's most successful dimension on the Logistics Performance Index. Nevertheless, it is important to further increase the on-time delivery of shipments.

Turkmenistan scored below the other three countries covered in this study in 2016 in almost all categories of the Logistics Performance Index (figure 3.4).

Figure 3.4: Logistics Performance Index (LPI) indicators, 2016



Source: World Bank Logistics Performance Index

40. World Bank, 2016 Logistics Performance Index, available at https://lpi.worldbank.org/international/global- (accessed on 5 November 2018).

41. Turkmenistan's customs information, Logistics Capacity Assessment, 10 December 2013, available at http://dlca.logcluster.org/display/public/DLCA/1.3+Turkmenistan+-Customs+Information;jsessionid=1EA439D3E274989D65D8BF01A9E9A4BA (accessed on 5 November 2018).

3.4.3. Privatization

For the former Soviet Republics, state control of the economy was nearly total until the dissolution of the Soviet Union. Turkmenistan is moving more slowly towards privatization than most other Central Asian nations. Between 1994 and 2012, 2,123 enterprises were denationalized (World Bank 2014). Most of the companies privatized during that period were in non-essential services such as food services and parts of agriculture. In 2010, the Turkmen government announced plans to take privatization to the next level by denationalizing small and medium-sized enterprises (SMEs) as a part of the National Programme for Socio-Economic Development of Turkmenistan (US Department of State 2015). Subsequently, in 2012, Turkmenistan adopted the State Programme for Privatization of Enterprises and Objects of State Property in Turkmenistan for 2013–2016, which outlined the steps and goals of the privatization initiative.[42] This programme was designed to help Turkmenistan move away from its inherited Soviet central command system to become a functioning market economy, with a goal of achieving a 70 per cent private sector share of GDP by 2020 excluding the natural gas sector.

There are a number of restrictions regarding what entities are subject to privatization. For example, natural resources, research and academic institutions, institutions of cultural importance, and public transportation, among others, are excluded from the privatization programme. Nevertheless, the programme has led to a significant increase in the share of the private sector. In some cases, privatization has moved beyond smaller-scale services and agriculture to include industrial firms. Larger enterprises are privatized through direct sales or auctions to domestic and authorized foreign investors. Many state enterprises were transformed into joint stock companies. In 2014, the private sector was estimated to occupy a 40 per cent share of GDP, excluding the fuel and energy sector (World Bank 2014). Another source reported that by 2016 the share of private sector reached 62 per cent of GDP, including 90 per cent for retail trade and over 70 per cent in construction and communications.[43]However, the credibility of the source is questionable.

Due to relatively low domestic income, successful privatization inevitably requires foreign support. While officials announced that 36 facilities were successfully privatized in 2015, inadequate infrastructure and obsolete technology resulted in weak participation of foreign investors in privatization of the targeted sectors (US Department of State 2016). Extractive industries and transportation tend to attract significant foreign investment and loans. Since 2009, Turkmenistan has received a number of loans from the Chinese Development Bank, Islamic Development Bank, and Asian Development Bank, with the largest of these loans amounting to US$4.1 billion. Most of these funds went towards railroad construction and natural gas field development (US Department of State 2015). While this investment is beneficial, it would be desirable to attract more FDI to other sectors (see section 3.4.5).

The main criticism of the privatization programme remains lack of transparency and bureaucratic procedures. Allegations persist that the lack of transparency allows officials to make privatization decisions based on their personal ties to investors (US Department of State 2015). The process is even more burdensome and time-consuming for foreign investors, since they must be preapproved by the State Agency of Protection from Economic Risks.

3.4.4. Starting a business

In addition to privatizing state-owned businesses, Turkmenistan has tied to encourage the creation of new private enterprises. Due to the top-down governmental structure and the lack of institutional resources and information, Turkmen entrepreneurs face an array of challenges as they attempt to start their own companies. While many developed countries provide the opportunity to register a business and obtain a license online for a small fee, Turkmen businesspersons must undergo lengthy and bureaucratic procedures to register their company (US Department of State 2016). For different types of business entities, there is a specified minimum charter capital; for instance, the individual entity charter capital requirement is 1250 manat, but it may reach as high as 10,000 manat for other types of organizations (Baker Tilly International 2016).

42. Turkmenistan to launch large scale privatization, The Central Asia-Caucasus Analyst, 12 December 2012, available at http://cacianalyst.org/publications/analytical-articles/item/12623-analytical-articles-caci-analyst-2012-12-12-art-12623.html (accessed on 6 November 2018).

43. Share of private sector up in GDP of Turkmenistan, AzerNews, 22 April 2016, available at https://www.azernews.az/region/95587.html (accessed on 5 November 2018).

The governmental departments responsible for business registration often require a massive amount of paperwork from applicants. Applications for state registration have to be submitted to the Ministry of Economy and Development. While the ministry is required to issue the registration decision within two weeks after submission of all required documentation, government officials may request additional documents that can prolong the registration procedure (Baker Tilly International 2016). Some types of enterprises, such as representative offices and branches of foreign companies, are required to update their registration every two years. Newly created companies are required to register with the Turkmen tax authorities within 10 days after their state registration. Reducing the number of steps and fees would facilitate enterprise creation.

3.4.5. Foreign direct investment regulations

While Turkmen officials claim to welcome foreign investment and have instituted a number of incentive schemes, in practice tight state control and restrictive visa regulations create a difficult investment environment for foreign firms (US Department of State 2015). Foreign investment is subject to the regulations of the Foreign Investment Law. The ostensible privileges enjoyed by foreign investors that conduct their businesses in specifically designated free trade zones include exemptions from export and import license requirements for certain products, registration fees, and customs charges on imported inputs (Baker Tilly International 2016). Companies that operate under the Petroleum Law or contribute to the development of the Awaza National Tourist Zone are eligible for additional benefits.

Nevertheless, the foreign investment environment remains less attractive, especially to lure investors into non-extractive sectors. Since all main enterprises are state-owned, ties with government officials tend to play a significant role in gaining access to opportunities in the local market, and Turkmenistan has a reputation for lack of transparency and heavy bureaucratic obstacles (US Department of State 2013). Lack of protection of property rights and contract enforcement also discourages foreign entities from pursuing investment opportunities in Turkmenistan. Foreign investors cite lack of information arising from confusing and disorganized provisions in legislation, publicly unavailable by-laws, and a scarcity of high-quality English translation of legal documents.

The constraints for foreign investment also include the lengthy and tedious process of FDI approval and the difficulties of obtaining business visas. The State Agency for Protection from Economic Risks was established with the stated goal of streamlining the approval process, but in reality it only further complicated the already convoluted and cumbersome procedures. Registering a foreign business may require approval from five or more governmental entities and can take up to six months (US Department of State 2015). Application for a business visa to Turkmenistan requires an invitation letter from a local business partner, making it harder to organize an exploratory visit.[44]

Government retains the power to closely monitor foreign firm activities through additional tax examinations, customs controls, and judicial procedures, and 80 per cent of the workforce of a foreign-owned company is required to be comprised of Turkmen citizens. For all other firms, foreign workers cannot constitute more than 30 per cent of the employees (Baker Tilly International, 2016).

Though there are no official restrictions on the foreign ownership of companies, in practice foreign investment is almost exclusively limited to the hydrocarbon sector (US Department of State 2015). Construction, chemicals, and communications are also receiving an increasing amount

of foreign investment, but the promising agriculture and textile industries are not. The lack of FDI in agriculture and manufacturing is problematic for the economy's diversification.

3.4.6. Land rights

All land is considered state-owned and only a few dwellings have been privatized, authorizing citizens to sell and rent apartments (US Department of State 2015). While private citizens possess certain land usage rights, legislation prohibits sale and mortgage of land, making inheritance the only way to transfer these rights. More specifically, the Land Code permits private citizens to use up to three hectares of land without any right to sell, exchange, or transfer this property to anyone but their children. Foreign citizens and companies can only lease land. Generally, neither domestic nor foreign companies can be granted long-term rights to land, with the exception of agricultural use. In 2007,

44. Foreign travel advice. Turkmenistan, UK Department of International Trade, available at https://www.gov.uk/foreign-travel-advice/turkmenistan/entry-requirements

the Land Code was amended to authorize up to 40-year leases of land for hotels in National Tourist Zones, but land and all the newly built facilities must be transferred to the state upon the expiration date of the lease (US Commercial Service 2015). On the positive side, the Law on Foreign Investment bars nationalization and requisition of foreign-held land.

Lack of property rights to land constrains the creation of businesses directly and indirectly by preventing land use as collateral. As a result, state ownership of land discourages diversification, reduces foreign investment, and undermines financial intermediation.

3.4.7. Taxes

Taxation is not a major impediment to business creation and operations in Turkmenistan. The standard value-added tax in the country is 15 per cent, the corporate income tax is 8 per cent for domestic and 20 per cent for foreign companies, and the personal income tax is a flat 10 per cent rate for all income levels and is usually withheld at source.[45] Resident companies are taxed on worldwide income, while non-resident enterprises are only taxed on the income derived in Turkmenistan.[46] The withholding corporate tax rate is 15 per cent for both residents and non-residents, but a number of countries have separate agreements that may reduce that rate. There are a number of additional taxes that may apply, including the advertising levy, property tax, and subsurface-use tax (22 per cent on gas extraction and 10 per cent on oil). SMEs are exempt from the value-added and property taxes (Baker Tilly International, 2016). Companies operating under the Petroleum Law, as well as some businesses related to tourism, education, religion, and disability support, enjoy substantial tax exemptions.

In terms of taxation, Turkmenistan is relatively open to trade, with no export tax (except for gas and oil) and a 2 per cent import tax. About 50 items are subject to a specific customs duty that ranges from 5 to 100 per cent depending on the product. A customs clearance fee of 0.2 per cent also applies.

Despite the generally high levels of corruption, tax administration has the reputation as one of the less corrupt government entities, although there have been some incidents of abuse by tax officials. Excessive tax examination can be used as a way to discriminate against investors, which plays a significant part in discouraging foreign investment (US Department of State 2015). Tax officials are authorized to carry out unscheduled tax audits that cover up to five years preceding the start date of a given audit (Baker Tilly International 2016). However, in spite of these incidents, Turkmenistan has been largely successful in establishing a stable and well-functioning tax system.

Despite this favorable design, non-hydrocarbon tax revenues are low. An increase in financial literacy among the population is needed to encourage greater compliance in filing taxes. A number of tools such as an online tax calculator, an educational portal with video tutorials on financial literacy, and a platform for paying taxes online, would make filing taxes more accessible.

3.4.8. Access to credit

Providing access to credit for SMEs is essential to increase the share of private sector participation in the economy. Though the government has taken steps to improve access to credit, the deficiency of the legal framework significantly limits its positive impact. Turkmenistan has made some progress in establishing an appropriate legal framework – since 2010, the country has adopted a number of new laws designed to regulate lending, microfinance, and financial reporting standards (EBRD 2014). So far, however, low institutional capacity has prevented these laws from being properly enforced.

The banking sector in Turkmenistan is small and predominantly state-owned: out of 11 banks operating in the country, only one is privately owned (EBRD 2014). Meanwhile, the six largest state-owned banks account for more than 90 per cent of total lending. The assets of Turkmenistan's largest bank were estimated to be around US$3.15 billion in 2013; all other banks are believed to be much smaller (US Department of State 2015). Credit to the private sector amounted to only 4 per cent of GDP in 2012, but is growing rapidly. One of the main obstacles remains the absence of clear property rights, as described above. In 2009, the Turkmen government established a lending programme with a subsidized interest rate of 5 per cent (US Department of State 2015). However, most banks demand

45. Turkmenistan, Tax Summaries, available at http://taxsummaries.pwc.com/ID/Turkmenistan-Overview (accessed on 10 November 2018).

46. International tax. Turkmenistan highlights, Deloitte, 2017, available at https://www2.deloitte.com/content/dam/Deloitte/cn/Documents/international-business-support/deloitte-cn-ibs-turkmenistan-int-tax-en-2017.pdf (accessed on 10 November 2018).

collateral, which many enterprises are unable to provide due to property rights restrictions. As a result, many Turkmen entrepreneurs rely on informal sources of credit from friends and family.

The government heavily restricts domestic banking activity. For instance, commercial banks are not allowed to provide loans to state enterprises. Furthermore, the market is heavily distorted by state-directed lending that makes up over 50 per cent of all loans. The impressive 30 per cent credit growth in 2011 and 2012 reflects an increase in subsidized lending to government-run enterprises rather than the private sector. There is no securities market in Turkmenistan. Turkmenistan is not included in most major credit rating agency rankings. One exception is Dagong,[47] a credit ranking agency based in Beijing that evaluated Turkmenistan's credit rank at BBB+.

Turkmen enterprises have access to some outside credit sources such as the US Export-Import Bank, which recently decreased Turkmenistan's risk assessment from nine to eight, and the European Bank for Reconstruction and Development, which has established SME credit lines (EBRD 2014). Currently, the EBRD is working with three local banks and conducts policy dialogue with the government regarding the establishment of an appropriate regulatory framework for microfinance. Privatization of the banking sector and creation of a consulting industry are among the EBRD's highest priorities for its operations in Turkmenistan.

Establishing competitive financial markets requires that the government-owned banks terminate their traditional practice of financing state enterprises at artificially low interest rates. It is essential to increase competition between banks for private sector projects. Turkmenistan should concentrate on privatizing banks, reducing regulation of the banking sector where appropriate, finding additional channels to finance SMEs, updating property rights legislation to ensure the use of collateral, and establishing a coherent credit guarantee scheme (EBRD 2014).

3.4.9. Infrastructure

Turkmenistan's strategic location between Asia, Europe, and the Middle East positions it well to become a major transit country. It already has a relatively developed transportation system, though it is designed mainly to meet the needs of extractive industries. The TAPI and Lapis Lazuli corridors are the two biggest international railroads that cross Turkmenistan (CAREC 2015). The government has made major investments in transport infrastructure to boost the country's role as a transit hub. Construction of railways and roads in Turkmenistan receives substantial amounts of foreign financial support. Current projects include the Turkmenbashy-Ashgabat highway and an international North-South railway. Road quality in the capital Ashgabat is relatively good, but roads in rural areas need significant upgrading (EBRD 2014). There are almost 60,000 km of roadways in Turkmenistan, but a large portion of them need substantial upgrades. By 2020, Turkmenistan plans to create at least 20,000 km of new roads.

The transportation sector is characterized by lack of competition and distortionary policies. Fuel prices are very low, and road construction is controlled by the state-owned monopoly and often politically driven. To improve efficiency and promote economic diversification, Turkmenistan should increase private sector involvement and promote competitive pricing, as well as ensure that transportation networks are designed to serve key labor-intensive sectors such as agriculture and manufacturing.

The country's power infrastructure also needs significant reforms. The energy sector is a state-owned vertical monopoly with no private sector involvement (EBRD 2014). Inefficient generation and distribution of electricity results in frequent power outages that hamper businesses. In addition, unstable voltage is harmful to both business equipment and household appliances.[48] Foreign investment should be encouraged and excessive consumption reduced. This would require an increase in tariffs, improvement of the regulatory framework, reduced subsidies, and privatization.

Summary of policy recommendations

- Implement a strategic mission statement by accelerating the transition to a private-sector-driven economy by reducing state ownership, burdensome regulations, and lack of transparency.

47. Dagong Global Credit Rating, available at http://en.dagongcredit.com/ (accessed on 5 November 2018).

48. The energy minister was dismissed due to frequent power outages. See Turkmenistan energy minister-sacked, Radio Free Europe, 23 August 2015, available at https://www.rferl.org/a/turkmenistan-energy-minister-sacked-president/27203788.html; and Ashgabat in the dark, Chronicles of Turkmenistan, 24 November 2015, available at http://en.chrono-tm.org/2015/11/ashgabat-in-the-dark/ (accessed on 10 November 2018).

- Simplify customs clearance procedures. Reorganization of border management should involve relaxing some of the most tedious document requirements.
- Develop a strong privatized shipment industry in order to increase connectivity between domestic and foreign market agents.
- Increase transparency of privatization by avoiding assigning major enterprises through presidential decrees. The privatization procedure must be made less cumbersome and the pre-approval process for foreign investors needs to be simplified.
- Create a strong private sector by making it easier to register a company. Turkmen entrepreneurs should not have to face such high barriers to enter the market, including tedious paperwork and high initial capital requirements. There needs to be an online business registration portal available to both domestic and foreign entrepreneurs.
- Empower local authorities to grant business licenses in order to make the registration procedure faster and less tedious.
- Increase regulatory efficiency by professionalizing governmental institutions and creating more cohesive legislation.
- Update land rights legislation. A dynamic business environment requires domestic and foreign market agents to be able to rent, buy, and use land as collateral.
- Create a strong private-led banking sector. There is a need for additional credit lines for SMEs, especially outside of the extractive sector.
- Improve the availability of legal information and business consultation.
- Simplify FDI registration procedures.
- Ease requirements for business visas.
- Open up promising sectors such as agriculture and manufacturing to FDI.

3.5 Institutions and governance

3.5.1. Quality of governance

Turkmenistan's political regime has been subject to international controversies since its independence in 1991. The country is frequently criticized for lack of democracy and human rights violations.[49] While the focus of this analysis is on economic rather than political reforms, quality of governance and political freedom have important implications for economic progress for several reasons.

First, inclusive political systems characterized by the rule of law, control of corruption, government effectiveness, and accountability of government officials are generally recognized as essential for promoting the domestic private sector and attracting foreign investment – both of which are stated goals of the Turkmenistan government (Acemoglu and Robinson 2012). Turkmenistan's performance remains inadequate in these areas even when compared to other transition economies, according to the World Bank's World Governance Indicators (figure 3.5). Perceptions of widespread corruption and lack of transparency are particularly detrimental not only to doing business but also to ensuring inclusive growth. In 2016, Transparency International ranked Turkmenistan 154th out of 176 participating countries, giving it 22 out of a 100 possible points, and thus confirming the World Bank assessment.

The judicial system in particular creates a big red flag for international investors who only invest in countries where their property rights and contracts are protected. According to some reports, the Government appoints all Turkmen judges for a renewable term of five years, and authorities possess the power to prevent defendants from gaining access to attorneys and public trials (EBRD 2014; Bohr 2016). Many international organizations have also voiced complaints regarding the scarcity of publicly available data. Data on Turkmenistan in World Bank and International Monetary Fund (IMF) databases are far less complete than for other Central Asian countries.

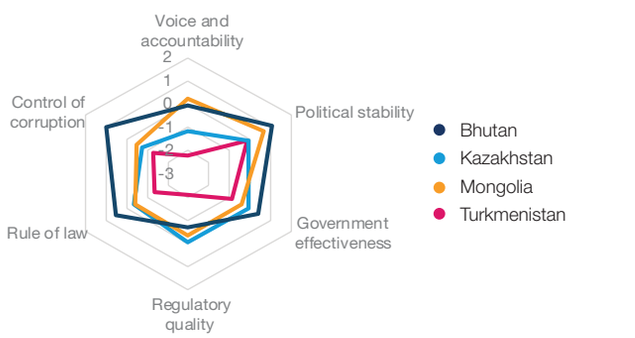
Second, lack of progress in the areas of human rights and claims of political repression can be harmful for foreign investment and international competitiveness in some important sectors, notably tourism, agriculture, and textiles. Activists in Europe and the United States organize campaigns to boycott companies that continue to buy cotton from Turkmenistan and other countries with poor human rights records.[50] While Turkmenistan's human rights record has not received the same level of attention as in Uzbekistan, some campaigners are targeting Turkmenistan's cotton sector. For example, H&M, Europe's

49. Turkmenistan: Events of 2016, Human Rights Watch Report, available at https://www.hrw.org/world-report/2017/country-chapters/turkmenistan.

50. Campaign protests IKEA, big clothing chains selling Turkmenistan cotton, OCCRP, 16 February 2016, available at https://www.occrp.org/en/daily/4944-campaign-protests-ikea-big-clothing-chains-selling-turkmenistan-cotton.

largest clothes retailer, refused to use Turkmen cotton after reports of the use of child labor on Turkmen cotton fields.[51] The experience of Uzbekistan shows that boycotts and derogatory press reports can put intense pressure on the government (Golub and Kestelman 2016). Furthermore, tourists from high-income European countries are less likely to visit countries known for flagrant abuses.

Figure 3.5: World Governance Indicators, 2015



Source: World Bank, World Governance Indicators

Third, freedom of the press promotes exchange of information and accountability. Reporters without Borders has ranked Turkmenistan 178th on its list of countries with free media, above only North Korea and Eritrea.[52] The government owns and runs the vast majority of the press, television, and radio, making them unlikely platforms for marketing and commercials. Empowerment of the private sector demands some media liberalization, creation of private channels that could serve as outlets for advertising, and increased Internet coverage for more effective communication between business partners. In fact, telecommunications could become a thriving area of diversification. Relaxing the control of the Ministry of Communications over the sector and challenging Telecom's monopoly on public telephone and Internet services would open multiple business opportunities for domestic and foreign companies, improve the quality of services, and encourage growth of Internet coverage (EBRD 2014).

On the other hand, one must recognize the severity of the challenge of moving away from the Soviet tradition of central planning so deeply rooted in all major institutions of the Soviet Union. The apparent popularity of the current leadership signals that Turkmenistan's authoritarian regime has been able to satisfy at least some of the population's social needs.

3.5.2. Health and education

Turkmenistan's dramatic increase in GDP per capita has largely failed to manifest itself in improvements in education and healthcare. For its level of income, Turkmenistan scores surprisingly low on most social parameters. The country is ranked 111th on the 2015 Human Development Index (HDI), despite a considerably higher ranking in per capita gross national income (79th). This reflects the fact that average income per capita (in 2011 US dollars, purchasing power parity) for the group is US$6,300, less than half of Turkmenistan's income per capita of US$14,000, while Turkmen life expectancy at birth, 65.7 years, and expected years of schooling, 10.8 years, are below the average for the group: 68.6 and 11.5 years, respectively. Only four other countries in the world have a larger negative gap between their income level and HDI rank.

Despite the country's relatively low level of human development, the government enjoys high approval ratings, which can be attributed to the tight price control of essential staples and provision of free education, healthcare, and utilities to the entire population (US Department of State 2016). While this may be an effective way to gain the support of the public, Turkmen social policies create massive market distortions. Prices for bread, water, and electricity, among other items, are heavily subsidized (EBRD 2014). State employees receive substantial discounts on transportation, rents, and mortgages. The IMF has estimated that utility subsidies that provoke wasteful and inefficient energy use amounted to 20 per cent of Turkmen GDP in 2010. Meanwhile, there are still a lot of gaps in the country's education and healthcare systems. The Turkmen government should scale back inefficient subsidies and redirect the funds towards education and healthcare, as well as to projects such as the National Programme on Improving Social and Living Conditions, which focuses on raising living standards in Turkmenistan's rural areas. Though social spending increased by at least 50 per cent between 2007 and 2010, its relative share in the state budget continued to fall.

While literacy rates are nearly perfect and mandatory

51. A number of companies put aside Turkmen cotton, East Time, 21 February 2016, available at http://easttime.info/news/turkmenistan/number-companies-put-aside-turkmen-cotton.

52. According to Reporters without Borders, available at https://rsf.org/en/turkmenistan (accessed on 18 November 2018).

schooling has recently been increased to 12 years, the quality of education in Turkmenistan is far short of international standards (World Bank 2014). The Soviet legacy may have ensured universal access to education, but resistance to Western influences resulted in an outdated curriculum and failure to incorporate contemporary teaching techniques. Turkmen schools should undergo a formal, internationally recognized assessment, such as the Organisation for Economic Co-operation and Development's Programme for International Student Assessment (PISA)[53] in order to identify the most problematic areas in their school programmes, then use the results of this assessment along with assistance from international consultants to develop a more modern curriculum. The Turkmen economy would benefit from international knowledge exchange. This may include sending domestic students to study abroad or inviting foreign specialists in management, communications, and technology.

The lack of job-relevant skills indicates a need for vocational training programmes, although Turkmenistan has made substantial progress in this area. In 2012, there were 129 registered vocational schools and training centers that provided training in 268 occupations (World Bank 2014). However, vocational schools receive no state funding, and hence the tuition is paid by students themselves or by the companies that plan to hire them. Since aligning workers' skills with employers' demands is crucial for creating a dynamic private sector, the government should consider financially supporting the vocational training programme.

A positive Soviet legacy is the celebration of healthy lifestyles. Turkmenistan has the lowest levels of smoking in the world, and many state TV and radio channels promote active and healthy practices.[54] Still, the quality of healthcare needs to be improved. The lack of trained specialists and up-to-date technology results in a weak healthcare system that is unable to meet the needs of the population.

Summary of policy recommendations

- Improve the impartiality of the judicial system to ensure that it meets modern accountability standards.
- Increase transparency and fight corruption and bribery by imposing more effective sanctions.
- Privatize media outlets and reduce control over news channels.
- Improve the country's its human rights record for the well-being of its own citizens and to prevent boycotts by developed countries.
- Redirect government funds from distortionary and costly energy subsidies to health and education.
- Reform the educational system in line with international standards.
- Provide government financial support to vocational schools.

3.6. Diversification strategies

3.6.1. Agriculture

As hydrocarbon and construction sectors became the main drivers of economic growth, resource reallocation away from agriculture and services led to 50 and 30 per cent declines in these sectors' share of GDP, respectively (World Bank 2014). Various sources estimate that agriculture accounts for 10 to 13 per cent of GDP but almost half of employment. Data for 2012 show that agriculture received 11.7 per cent of total investment. The state has recognized the importance of the agricultural sector and put in place policies to support its growth – as an example, in 2013 the government introduced concessional loans with 1 per cent yearly interest and a 10-year repayment period in order to expand the agricultural sector.

With about 50 to 60 per cent of the population living in rural areas, expansion of agriculture would be highly beneficial for poverty reduction and rural development, yet the concentration of resources in extractive industries and excessive state control prevents agriculture from evolving at a more rapid pace. As a result, this sector plays a much smaller role in Turkmenistan compared to its more agrarian neighbors like Uzbekistan and Kyrgyzstan (FAO 2012). Turkmenistan has preserved some aspects of the Soviet system of collective farms along with production quotas and controlled prices. The government controls four strategic crops: cotton, wheat, sugar beets, and rice. They are produced mainly by public enterprises to fulfill state orders.

Following its independence, Turkmenistan attempted to implement a number of reforms to boost the competitiveness of its agricultural sector. A series of presidential decrees laid out the foundation of the new

53. See http://www.oecd.org/pisa/ (accessed on 10 November 2018).

54. Turkmenistan the world's most non-smoking Country: WHO, SAMAA, 21 July 2015, available at https://www.samaa.tv/health/2015/07/turkmenistan-the-world-s-most-non-smoking-country-who/

agricultural order while preserving the main elements of the command system inherited from the Soviet Union. As a result, three types of producers now dominate Turkmen agriculture: individual households, daikhan (peasant) farms, and peasant associations comprised of leaseholders (FAO 2012). Peasant associations are tightly regulated by governmental orders, and they are compelled to sell their output and buy their inputs through state channels. The leaseholders have virtually no influence over the time of harvest, the seeds they use, and other practices. Daikhan farmers and peasant associations can sell their surplus output and non-strategic products on the market at competitive prices, but land leases from the government may be terminated if farmers repeatedly do not fulfill state orders. There are no large private enterprises involved in agricultural production.

An unfavorable climate and geography present a major constraint to agricultural development. The Karakum desert, one of the driest deserts in the world, covers over 80 per cent of the country. Altogether, agricultural land occupies 72 per cent of Turkmenistan's area, but 67.8 per cent of all land is dry pasture, leaving only 4.1 per cent of land arable.[55] Agriculture is highly reliant on irrigation mainly supplied by the Karakum canal, the largest irrigation canal in the world that draws almost 30 per cent of the total flow of the Amur Darya River. Karakum and other primary canals divert water from the rivers, secondary canals deliver water to large peasant associations, and tertiary canals distribute water to individual farms (FAO 2012). Though it has impressive coverage, flaws in the irrigation system are the single biggest cause of inefficiency in agricultural production, making Turkmenistan the largest user of water per capita in the world (Bohr 2016). The irrigation system is state-owned and is maintained in a bureaucratic fashion with little concern for financial, technical, or ecological efficiency; in fact, most water services are provided free, creating incentives for wasteful water consumption (EBRD 2014). Lack of investment and maintenance has led to deterioration of the Turkmen irrigation system. The open-air system leads to up to 70 per cent evaporation, while the absence of adequate drainage systems results in increased salinity and degradation of soil quality. The outdated drainage system has led to contamination of soil with agricultural chemicals and pesticides, and soil fertility has declined. Turkmenistan has yet to adopt modern techniques such as drip irrigation, lining canals, sprinklers, etc. (FAO 2012). It is essential that Turkmenistan direct more resources to renovating the irrigation system.

The composition of agricultural output has shifted somewhat since the Soviet era. Before 1991, cotton occupied over 50 per cent of cultivated land followed by 30 per cent for feed crops. After the dissolution of the Soviet Union, Turkmenistan increased its production of wheat and some other food crops in an attempt to achieve food self-sufficiency. Today, wheat and cotton are by far the most important products; wheat is mainly consumed domestically, while cotton is the largest agricultural export. Other crops include melons, grapes, potatoes, and various vegetables.

Household plots and daikhan farms produce most fruit and vegetables. Cotton and grains that are considered strategically important are mainly grown by the state sector. Despite a significant decrease in the relative share of cotton production, Turkmenistan remains one of the largest cotton producers in the region. The long tradition of cotton farming ensures the excellent quality of Turkmen cotton. However, cotton production suffers the most from inefficient irrigation and stifling government control. Its yields are only about a third of those of Mexico and Egypt. Moreover, scandals involving forced labor and child labor are increasingly detrimental to the reputation of Turkmen cotton. Turkmenistan has the potential to become a world-class cotton producer if it addresses these numerous obstacles that limit its development: an inefficient irrigation system, outdated technology, stifling of private initiative, distortionary pricing, and abusive labor practices.

Livestock production has dramatically expanded in recent years. Private farms are responsible for over 90 per cent of livestock output (FAO 2012). Sheep, cattle, and poultry constitute most of the livestock in Turkmenistan. Meat, milk, leather, and wool are the sectors in which Turkmenistan has the potential to establish an export-oriented policy. Turkmenistan is known for its Astrakhan wool, in particular. Although the private sector plays a larger role than in cotton, the promising livestock, dairy, and wool sectors suffer from excessive government intervention, outdated technology, and poor infrastructure, including inadequate storage and transport (Kerven et al. 2002). Turkmenistan's agricultural sector suffers from the difficulties of transitioning to a market economy: the breakup of the Soviet Union entailed a decline in investment and research, while heavy involvement of

55. Turkmenistan, The World Factbook CIA, 13 July 2017, available at https://www.cia.gov/library/publications/the-world-factbook/geos/tx.html.

the Turkmen government in production and distribution has constrained private sector growth. Agricultural competitiveness requires a combination of greater public investment in infrastructure and technical assistance and liberalization that harnesses the skills and initiative of farmers.

3.6.2. Textiles

The Soviet Union imposed a cotton monoculture in Turkmenistan. Being a raw cotton powerhouse, the Turkmen Soviet Socialist Republic was not responsible for processing raw cotton. After 1991, Turkmenistan was no longer fulfilling state orders to supply cotton to the rest of the Soviet Union. Thus, the existing cotton production capability enabled the development of the previously insignificant textile industry as the next logical step in the product value chain. Turkish companies provided significant support to the industry by establishing partnerships and providing direct investment.[56] Collaboration with Turkish enterprises has boosted quality standards and helped textiles become Turkmenistan's second largest export after extractives. Trading partners include the United States and China, but about 70 per cent of exports go to the former Soviet countries.

Currently, there are about 70 textile enterprises, over 30 cotton spinning factories, 17 garment plants, seven silk enterprises, and a few wool processing and knitting companies.[57] Together they produce 177,000 tons of various yarns, 186 million square meters of cotton fabric, 11,000 tons of knitted fabrics, 7,200 tons of terry fabrics, and 80 million pieces of garments. Turkmen bed linen, carpets, silk products, scarves, and a number of special fabrics like velvet, ketene, and rayon are internationally celebrated for their good quality. The bright colors and patterns of its products are another strength of the Turkmen textile industry. On the other hand, knitted garments and sportswear quickly lose their shape and become unusable; hence, domestic consumers often choose to buy clothing imported from Turkey.[58]

The government recognizes the importance of the textile industry for Turkmenistan. Over 30 factories have been constructed since independence, which, according to official reports, resulted in a 15-fold expansion of the textile industry. The government created the 2011–2020 State Programme for Development of the Textile Industry to support the sector by attracting FDI and allocating government investment. The programme agenda includes increasing the number of workers employed in textiles to 36,000 by 2020, upgrading facilities, and building new factories. Turkmenistan has a skilled human capital foundation, which is a requisite for development of a successful textile industry. Upgrading knitting, sewing, and dyeing equipment, experimenting with new fabrics like denims, and implementing new fabric designs would facilitate the development of the industry and, most importantly, provide jobs.

Further expansion of the textile industry could be highly beneficial for Turkmenistan. Simplifying bureaucratic procedures, improving infrastructure, and easing restrictions on FDI, as described above, are essential for the industry's success. Foreign firms with expertise and market access to Europe can transfer state-of-the-art technology and improve access to the European market. The government could assist by establishing representation offices selling Turkmen textiles abroad and advertising the industry through similar initiatives as the international exhibition of textile products that took place in June 2016.[59]

Modern-day Turkmenistan is located along the ancient Silk Road – the legendary route that was used to transport silk, among other goods, from Asia to Europe. Turkmenistan can trace its silk production far back and a recent revival of the industry is encouraging. In 2015, a CCTV News crew visited Ashkhabat's oldest silk filature and interviewed the workers about their sector. They reported that the factory processes over 500 tons of cocoon a year, making enough silk to produce over 2,000 dresses. Turkmen silk is of a very high quality and is directed to both domestic and international markets. So far, silk exports have reached the Republic of Korea, Islamic Republic of Iran, Dubai, and India. The excellent product quality certainly meets standards of developed countries such as the United States and the countries of Europe. Beautiful and elegant silk apparel, mainly traditional scarfs, meet a large demand in Ashgabat but also have a potential to succeed as an export product. Revival of the silk industry was financed with Chinese

56. Turkmenistan-textiles, Export.gov, 15 August 2016, available at https://www.export.gov/article?id=Turkmenistan-Textiles.

57. A glimpse of Turkmenistan's textile potential, Fibre2fashion, 2017, available at http://www.fibre2fashion.com/industry-article/7427/a-glimpse-of-turkmenistans-textile-potential?page=1.

58. Turkmen textiles, Chronicles of Turkmenistan, 25 July 2015, available at http://en.chrono-tm.org/2015/07/turkmen-textiles/.

59. Turkmenistan to hold an Int'l exhibition of textile products this June, YNFX, 30 May 2016, available at http://www.yarnsandfibers.com/news/textile-news/turkmenistan-hold-int%E2%80%99l-exhibition-textile-products-june#.WW12qNPyv-Y.

concessional loans, and a large share of equipment is also imported from China. Turkmenistan has the necessary human capital to become an even greater presence in the global silk industry.

While it is important to avoid state domination of the sector, governmental policies should facilitate attraction of FDI and create a favorable environment for business by reducing regulatory burdens and investing in infrastructure. It will also be increasingly important to improve human rights to avoid escalating boycotts of Turkmen cotton and textile products, as has occurred in Uzbekistan.

3.6.3. Construction

Construction remains one of the most controversial sectors in the Turkmen economy. Following independence, Turkmen leader Saparmurat Niyazov directed a large amount of funds to renovate governmental buildings in Ashgabat. Much of the spending was on showcase projects such as a new US$2.4 billion airport in Ashgabat and the US$5billion sports center for the Asian Martial Arts tournament.[60] While the usefulness of many of the projects is questionable, the boom created a group of highly skilled construction workers. After energy prices plunged, construction declined, though it remains the second largest recipient of FDI and public investment after the extractive industry. Instead of grandiose monuments, the Turkmen government should focus on investments with higher social returns, such as upgrading the agricultural irrigation system, constructing more roads in underserved areas, and making other improvements in infrastructure. Encouragingly, the Turkmen government has stated that construction of schools and hospitals, as well as upgrading facilities like gas and water pipes, are priorities.[61] Turkmenistan would benefit from development of a strong non-governmental construction sector by empowering private construction companies, material producers, and consulting services, as well as a commercial real estate industry. At present, these are all still largely controlled by the government. Reducing red tape, introducing more modern production technologies, and effectively enforcing contracts and property rights are crucial for the sector (EBRD 2014). One of the positive recent developments in the sector is the establishment of the annual international construction conference.

In 2016, 228 construction companies from 18 countries participated in the conference, establishing partnerships and discussing implementation of modern urban development programmes in Turkmenistan. Turkmenistan should continue to open up the construction sector to foreign companies. The abundance of skilled construction workers in Turkmenistan and the drop in domestic construction jobs encourages temporary worker migration, often illegal, to richer countries, especially the Russian Federation. Turkmenistan should also explore opportunities that would allow its private construction firms to legally access foreign markets.

3.6.4. Tourism

Tourism is another growing sector that is increasingly prioritized by the government.[62] In 2012, Turkmenistan established the State Committee for Tourism, officially declaring its intention to develop this sector and attract foreign tourists. The top destination, the Awaza National Tourist Zone, is advantageously located on the Caspian Sea and is attracting an increasing number of tourists every year. Construction of this tourist zone was very expensive but it is now equipped with over 60 world-class hotels, shopping, and entertainment centers. The government is attempting to attract FDI to the tourist zone by providing incentives that include exemption from some of the most burdensome registration procedures, reduced fees, and concessional loans. FDI is needed for construction of hotels, restaurants, and spas, as well as to provide entertainment, catering, and tourist services.

Turkmenistan has substantial potential to succeed as an international tourist destination. It has a number of marvelous historic sites remaining from the ancient Persian civilization, including three World Heritage sites connected to the ancient Silk Road. The warm Caspian Sea makes for an attractive coastal resort, although the quality of the beaches is not on par with most European resorts. Natural sites include a burning gas crater and the Karakum natural reserve with many rare animals.

However, there are many government-created obstacles to

60. Shrinking exports spell trouble for Turkmenistan, The Economist, 15 December 2016, available at https://www.economist.com/news/asia/21711943-authoritarian-president-pins-his-hopes-turkmen-las-vegas-shrinking-exports-spell.

61. Turkmenistan-construction, Export.gov, 15 August 2016, available at https://www.export.gov/article?id=Turkmenistan-Construction.

62. Turkmenistan - travel and tourism, Export.gov, 15 August 2016, available at https://www.export.gov/article?id=Turkmenistan-Travel-and-Tourism.

the development of a competitive tourism sector. The main one is certainly the restrictive visa regime. A visa is required for citizens of all foreign countries (with the exception of short visits of citizens from bordering Kazakh and Uzbek provinces), and the cumbersome application procedure involves providing a letter from an accredited Turkmen travel agency.[63] If Turkmenistan wants to develop its tourist sector, it must significantly simplify the visa issuance procedures, and ideally create special visa exemptions for strategic countries such as the Russian Federation, China, Islamic Republic of Iran, and other Central Asian countries. In addition to the visa impediment, a number of arbitrary regulations complicate taking a vacation in Turkmenistan.

For example, travel agencies may require visitors to sign up for expensive guided tours. The constant presence of police, bans on entering the country with some prescription drugs, required registration with migration services, and restricted photography discourage foreigners from visiting the country. No passenger trains are allowed to cross the Turkmen border; buses get stuck at border crossings for up to several hours; all entering cars require special liability insurance; and plane tickets are not available online. Turkmenistan must ease these regulations and constraints to create a successful tourism industry.

In short, Turkmenistan must choose between tourism development versus tight controls on visitors. Along with addressing the barriers to tourism development, Turkmenistan should launch an extensive marketing campaign that presents the country as an attractive tourist destination. This may involve participating in international tourist rankings like the World Economic Forum's Travel and Tourism Competitiveness rankings, neither of which currently includes Turkmenistan.

Summary of policy recommendations

- Introduce a series of reforms to relax control over agricultural production. Farmers should be allowed to buy their inputs and sell their outputs to channels of their choice for market prices, as well as have the agency to decide on the type and quantity of crops they produce. It is crucial to encourage privatization of agriculture.
- Upgrade the irrigation system to diminish inefficiency in water use. The government should offer favorable terms to foreign investors who are willing to finance new irrigation technology.
- Improve rural transport and storage infrastructure.
- Abolish forced labor practices and reduce political repression to avoid boycotts of the cotton and textile sectors as well as to improve the country's reputation as a tourist destination.
- Develop the country's substantial unexploited potential in textiles, in particular, silk products and wool.
- Support greater textile industry privatization and welcome foreign investment to obtain modern managerial skills, equipment, technology, and market access.
- Finance construction projects with high social or economic value.
- Privatize construction services and build a strong commercial real estate industry.
- Simplify the issuance of tourist visas. It may be useful to establish no-visa agreements with certain strategic countries like China and Turkey to encourage inflow of tourists.
- Identify and remove other regulations impeding tourism.
- Create a comfortable atmosphere for tourists by addressing the country's human rights record.
- Market the country as a location for tourism by establishing representation offices abroad and implementing modern marketing techniques.

3.7. Turkmenistan's current export structure, key markets, and prospects for product diversification

3.7.1. Export structure and key markets

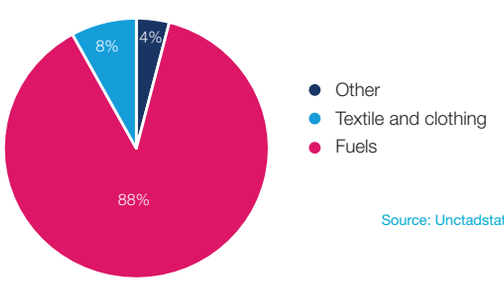
The heavy reliance of the economy of Turkmenistan on extractive sectors has made the country the least diversified economy of the four LLDCs discussed in this report. Figure 3.6 makes it abundantly clear why: exports of fuels accounted for nearly nine-tenths (88.1 per cent) of total exports in 2012–2016. The leading export by far was natural gas, whether or not liquefied (SITC 343), which had a share of more than three-quarters (77 per cent) of the

63. See the Turkmenistan Embassy website, available at http://www.turkmenistanembassy.org/ (accessed 10 September 2017).

total. Two other fuel products were, respectively, the second and fourth largest exports: petroleum oils or bituminous minerals > 70 per cent oil (7.3 per cent, SITC 334), and petroleum oils, oils from bituminous materials, crude (2.6 per cent, SITC 333). The only other product group that had a notable share of the export basket during the five-year period was textiles and clothing (7.7 per cent), with cotton (4 per cent, SITC 263) and textile yarn (1.6 per cent, SITC 651) the main products exported. The five SITC 3-digit products mentioned in this paragraph were the only exports in 2012–2016 that accounted for at least 1 per cent of total exports, which further underscores the pressing need for Turkmenistan to diversify its economy. Fuels were the dominant product group in Turkmenistan's economy and export basket from 1995–2016 (figure 3.7). The reliance on fuels was lower in the beginning of the period as a result of declining gas and oil production in the 1990s, which was partly attributed to output restrictions on gas and a lack of funds and equipment following the collapse of the Soviet Union (Dorian 2002). Since 2001, however, fuels exports have accounted for at least 80 per cent of total exports in every year bar one (2010). To be sure, the share of fuel exports fluctuated and there were years with significant drops, notably in 1998 when oil and gas prices tumbled in the midst of the Asian financial crisis and in 2009–2010, when prices fell in the wake of the global financial crisis. That said, fuels still accounted for 55.7 per cent of all exports in 1998 and 82 per cent and 77.1 per cent in 2009 and 2010, respectively.

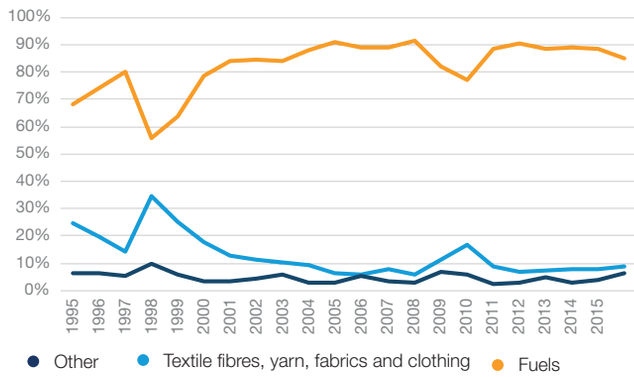
The lesser dominance of fuel exports in the 1990s can also be seen in the evolution of concentration scores based on the Herfindahl-Hirschmann Index (chapter I, figure 1.4). Whereas the average score for 1995–1999 was 0.48, it rose significantly after 2001 to an average score of 0.76 in 2012–2016. As would be expected, the score dipped in 2009 and 2010 to 0.51 and 0.53, respectively, following the onset of the global financial crisis. Since 2011, however, it has been above 0.7 every year.

Figure 3.6: Exports from Turkmenistan by product group, 2012–2016 (percentage)



Source: Unctadstat.unctad.org

Figure 3.7: Evolution of export structure in Turkmenistan, 1995–2016 (percentage)



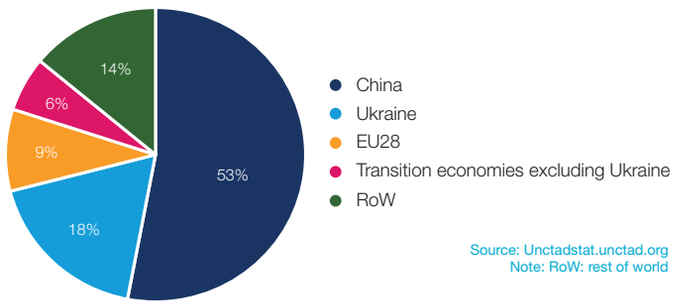
Source: Unctadstat.unctad.org

In contrast to its overwhelming reliance on fuel exports, Turkmenistan has a degree of diversification in its importing partners (figure 3.8). China is the main destination and accounted for 53.4 per cent of Turkmen exports in 2012–2016. Ukraine was the second largest market during that period (18.4 per cent), followed by the European Union (9.2 per cent). Transition economies other than Ukraine had a combined share of 5.4 per cent. However, the varied range of significant markets can primarily be seen in the remaining 13.5 per cent of exports that went to the rest of the world, including Turkey (4.9 per cent) and the Islamic Republic of Iran (3.1 per cent).

As can be seen in figure 3.9 the main destinations of Turkmen exports have changed considerably since 1995. One key development has been the rise of China as an importing partner, which took off with the launch of the Central Asia-China gas pipeline in December 2009 and was followed by two additional lines in 2010 and 2014 (Kocak 2016). The other key trend is the decline of Ukraine as Turkmenistan's most important importer. Until it was overtaken by China in 2010, Ukraine was the largest market for Turkmen exports apart from 1998 and 2000, when natural-gas-related disputes with the Russian Federation even led to a complete halt of deliveries.[64]

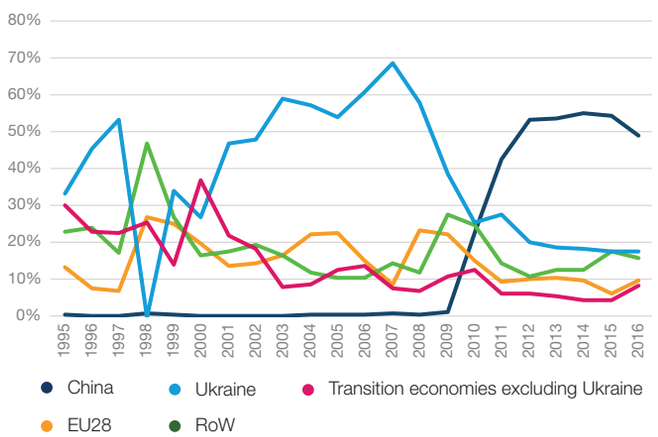
64. See Preyger and Omelchenko (2007) for details.

Figure 3.8: Main importers of Turkmenistan's exports, 2012–2016 (percentage)



Source: Unctadstat.unctad.org
Note: RoW: rest of world

Figure 3.9: Evolution of main importers of Turkmenistan's exports, 1995–2016 (percentage)



Source: Unctadstat.unctad.org
Note: RoW: rest of world

3.7.2. Prospects for product diversification

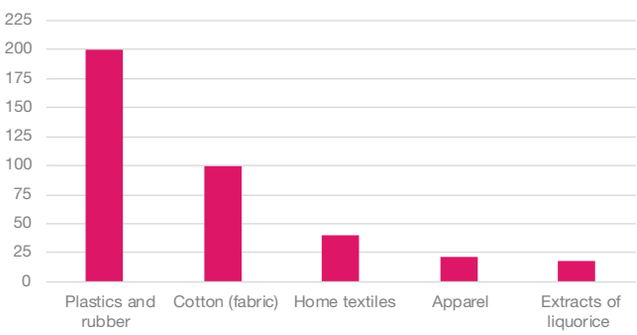
The previous analysis shows that Turkmenistan has the potential for economic and export diversification, notably in the agriculture, textile, and tourism sectors. The three sectors would make Turkmenistan less reliant on natural gas. Agriculture employs almost half of the population, but productivity remains low despite government efforts to boost the sector. To improve the situation, the most pressing needs, although there are others, are to loosen governmental control over agricultural production (including production quotas and price controls of cotton, wheat, sugar beets, and rice) and improve rural transport and storage infrastructure. The government could also create opportunities for non-farm services to expand and generate more jobs in rural communities. The tourism sector also offers opportunities to diversify its economy, and several efforts have been made to attract more FDI to this sector, including through exemptions from some of the most burdensome registration procedures, reduced fees, and concessional loans. However, the visa regime remains restrictive, and arbitrary travel regulations are still in place.

With regard to product diversification, at the intensive margin, Turkmenistan primarily has opportunities to expand existing exports in products related to plastics and rubber and to textiles and clothing. As for the former sector, analysis by the International Trade Centre suggests that the untapped potential reaches US$199.9 million, which is exclusively associated with exports in polypropylene, in primary forms (HS 390210). As for textiles and clothing, cotton (fabric) offers the greatest untapped potential (US$99.1 million), followed by home textiles (US$39.7 million) and apparel (US$21.8 million). The cotton (fabric) category includes a range of products such as cotton, not carded/combed (HS 520100) and single yarn, >=85 per cent cotton, uncombed fibres 232.56-714.29 dtex (HS 520512). The export potential in home textiles is mainly associated with bedlinen (printed bedlinen of cotton – HS 630221; and bedlinen of cotton, nes – HS 630231), while in the case of apparel the opportunity is primarily in men's trousers & shorts of cotton (HS 620342). Extracts of licorice (US$18.2 million, HS 130212) is the final product that has an untapped potential above US$10 million (figure 3.10) Three important markets for expanding existing Turkmen exports are the Russian Federation, Turkey, and the United Arab Emirates. In the case of the Russian Federation, the export potential is primarily in the textiles and clothing sector. Turkey has considerable untapped potential in polypropylene, in primary form, while the United Arab Emirates could expand its imports in extracts of licorice. Both markets also have untapped potential in apparel. Other markets with notable export potential for Turkmenistan include China (primarily cotton (fabric)) and the United States (primarily apparel).

Within the intensive margin, the main product-specific export diversification opportunities for Turkmenistan are in textiles and clothing and in edible fruits and nuts (table 3.1). More specifically, different types of yarn are among the best options for adding products to the country's export basket, with the Russian Federation and Turkey being the two large markets of interest. Beyond the three yarn products shown in the table, an additional three have been identified as among the 25 products with the greatest opportunity for export diversification: single yarn, <85 per cent cotton,

uncombed fibres 192.31-232.56 dtex (HS 520613), cabled yarn, >=85 per cent cotton, uncombed fibres 192.31-232.56 dtex (HS 520533) and cabled yarn, >=85 per cent cotton, combed fibres 125-192.31 dtex (HS 520544). As for the category of edible fruits and nuts, dried grapes (HS 081310), dried apricots (HS 080620) and pistachios (HS 0802Xb) are the three products that have the largest potential for export diversification, especially with respect to sales to the Russian Federation and the United Arab Emirates. Thus, just as with export potential, the Russian Federation, Turkey, and the United Arab Emirates appear to be important markets for Turkmenistan's efforts to diversify exports.

Figure 3.10: Export potential of Turkmenistan by product group (in millions of US dollars)



Source: International Trade Centre, Export Potential Map (exportpotential.intracen.org)

3.8. Conclusion

The concentration of resources in the extractive industries has had an adverse effect on Turkmenistan's development, but recent reforms have started to lay the foundation to support economic diversification. Turkmenistan has shown impressive improvements on several macroeconomic indicators, which has allowed the country to accumulate reserves, raise investment and increase the general standard of living. The main obstacles to further progress remain totalitarian state control of the economy and extensive administrative burdens that constrain private sector participation and dampen competition. Establishment of export-oriented industries outside of the natural resource sector requires significant market liberalization, attraction of foreign financing, and improvement of infrastructure and technology. Given the establishment of a favorable institutional and social environment, Turkmenistan has the potential to become a world-class producer of a number of agricultural and manufactured products and become a significant tourist destination. It is essential that the Turkmen government reduce its interference in the market while establishing a strong legal and institutional foundation that supports domestic and foreign companies operating in Turkmenistan.

Table 3.1. Top 10 product diversification opportunities for Turkmenistan

Rank	Product	HS code	Top three markets
1	Cabled yarn, >=85 per cent cotton, uncombed fibres 232.56-714.29 dtex	520532	Turkey, Russian Federation, Portugal
2	Semi-milled or wholly milled rice	100630	United Arab Emirates, Turkey, Russian Federation
3	Yarn, <85 per cent polyester staples, with cotton	550953	Turkey, Russian Federation, Bangladesh
4	Single yarn, >=85 per cent cotton, uncombed fibres 125-192.31 dtex	520514	Russian Federation, China, Turkey
5	Lac; natural gums (excluding gum arabic), resins, balsams, etc.	130190	India, United Arab Emirates, United States
6	Grapes, dried	080620	Russian Federation, United Arab Emirates, Great Britain
7	Apricots, dried	081310	United States, Russian Federation, United Arab Emirates
8	Black tea, packings >3kg	090240	Russian Federation, United Arab Emirates, Kazakhstan
9	Beans "Vigna mungo or Vigna radiata", dried & shelled	071331	India, United Arab Emirates, United States
10	Pistachios	0802Xb	United Arab Emirates, Russian Federation, India

Source: International Trade Centre, Export Potential Map (exportpotential.intracen.org)

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MONGOLIA

IV. MONGOLIA

4.1. Introduction

Mongolia is a large, sparsely populated country that lies between China and the Russian Federation, with vast deserts covering a large part of its land mass (the Gobi Desert to the south and extending into northern China). The country is endowed with substantial mineral resources such as copper, coal, gold, uranium, and other rare metals, and as such, it is one of the lowest-cost mineral producers in the world. In particular, it has among the largest copper and gold mines and coal deposits. However, most of the reserves remain unexploited and unexplored. The government's demand for a large share of the resource rents has been deterring major mining companies (although recently there has been some progress). Overall, proven reserves are valued at around US$1 trillion, and much of the country is yet to be prospected (IMF 2017).

Unlike Kazakhstan and Turkmenistan, Mongolia was an independent country before the Soviet dissolution in 1991, but the economy was so closely integrated into the Soviet economy that the country was often called the 16th republic of the Soviet Union (Pomfret 2011). After Soviet assistance ended, Mongolia's economy contracted drastically through the early 1990s. Yet, after it enacted the Minerals Law in 1997, the country started to attract foreign direct investment (FDI) in the extractive sector. Thanks to the mineral boom in 2003–2008, FDI increased rapidly from less than US$10 million annually in the early 1990s to US$844 million in 2008. The GDP growth rate in the 2003–2008 period averaged around 9 per cent, with total export value in 2008 reaching 4.7 times the value in 2000.[65] However, the 2008 financial crisis hit the mineral-dependent economy hard, as the price of copper (Mongolia's principal export) dropped by approximately 70 per cent. Slowing demand from China, then the destination for about 90 per cent of Mongolia's exports, also aggravated the situation (World Bank 2014). The GDP growth rate dropped from an impressive 10.2 per cent in 2007 and 8.9 per cent in 2008 to -1.3 per cent in 2009.

The economy's difficulties persist. While the economy stabilized thanks to a US$229 million balance-of-payment support package from the International Monetary Fund (IMF) in 2009, and growth surged to 17.3 per cent in 2011, the economy soon faced a renewed slowdown (World Bank 2010; IMF 2015). FDI dropped sharply as renewed disputes between the government and mining companies cast a shadow on the investment climate; falling prices of coal (and more recently copper) compounded the difficulty. The GDP growth rate in 2015 was only 2.4 per cent, and non-mineral real GDP growth was negative (IMF 2017). The government responded to the shocks with loose fiscal and monetary policies, which resulted in mounting public debt and increasing pressure on the current account. With large fiscal deficits and sharp depreciation combined, the general government debt reached nearly 70 per cent by the end of 2016. The government again turned to the IMF, which approved a US$440 million Extended Fund Facility in May 2017, with conditions on fiscal consolidation, monetary policy tightening, and banking sector reforms. Other international financial institutions such as the World Bank and Asian Development Bank were also expected to provide budget support loans on a concessional basis with a total financing package of around US$5.5 billion (EBRD 2017).

Mongolia has a functioning democracy with two major parties, the Mongolian People's Party (MPP) and the Democratic Party (DP), although it is susceptible to pre-election spending booms. The ex-communist MPP was the dominant political party in Parliament until the June 2012 elections, when the DP won a majority. However, fiscal profligacy by the coalition government formed after the election exacerbated the economy's difficulty during 2012–2014, and the DP lost popularity. As a result, in the June 2016 election, the MPP won a landslide victory, securing 65 out of 76 parliamentary seats in a single-chamber legislature, and quickly formed a single-party government (EBRD 2017). The new government is expected to be more committed to reform than the previous unstable coalition government. Nevertheless, fiscal consolidation programmes by the new government (with assistance from the IMF) have been unpopular. In the latest presidential election that took place in July 2017, Khaltmaa Battulga of the opposing DP won the election over the ruling MPP.[66]

Overall, mineral wealth management and export diversification are the two major issues the country faces. Fiscal spending, which is dependent on mineral rents,

65. Authors' calculations based on World Bank, World Development Indicators.

66. However, the president in Mongolia has limited power vis-à-vis the Parliament, and hence Battulga's assumption of office does not bring immediate changes to the new government's policies and reforms. While the president holds veto power over legislative actions, the Parliament can overrule those vetoes with a supermajority (Nikkei Asian Review 2017).

remains highly procyclical despite multiple IMF interventions. Lack of export diversification – in terms of both products and trade partners – makes the economy vulnerable to commodity price swings and declines in external demands. Minerals account for around 80 per cent of all exports, and over 80 per cent of these are bound for China. [67]As a result, while the country has been one of the fastest-growing countries in boom times, its economy has collapsed whenever commodity prices have fallen. Another development challenge for Mongolia is a high level of regional disparities; the incidence of poverty is eight times higher in rural areas (22.2 per cent) than in urban areas (2.8 per cent) (EBRD 2017).

4.2. Converting mineral wealth into development

Despite immense potential, most Mongolian mineral reserves remained unexploited through the 2000s, as the restrictive and changeable attitude of the Mongolian government towards FDI in mining deterred foreign investors. In particular, disputes over development of the Oyu Tolgoi (OT) copper and gold mine, Mongolia's first major mining project, kept investors alarmed for a long time. The Canadian company Ivanhoe discovered the mineral deposits in 2001 and started negotiating with the government as early as 2003. However, among other demands, the government's insistence on controlling a 51 per cent share prevented the deal from being signed. Furthermore, while the negotiation was in progress, Mongolia passed laws placing punitive taxes on foreign companies, exacting a 68 per cent tax on copper sold above US$2,600 per ton and gold sold above US$500 per ounce (in 2009 copper traded around US$6,470 per ton and golf sold above US$960 per ounce). Finally, in October 2009, Ivanhoe and its partner Rio Tinto signed an investment agreement, after the government accepted a 34 per cent stake in OT and revoked the windfall profits tax as well as some other mining laws (Pomfret 2011). The long disputes over the OT negotiation, together with the punitive taxes on mining revenues, discouraged other investment projects. Thus, while the authorities aimed to ensure that the state gained a large share of the country's mineral wealth, they ended up missing the 2003–2008 commodity boom.

Mongolia's attitude towards FDI remained inconsistent even after the settlement of the OT negotiations, and it soon reversed the temporary improvement of the investment climate. A year after completion of the OT negotiation, in 2010, Mongolia's National Security Council abruptly declared a moratorium on issuing new mining licenses, citing inadequate protection of the environment and local communities (UNCTAD 2013). The moratorium remained in effect until it was revoked in 2014. Furthermore, intense "foreigner bashing" took place during the 2012 parliamentary election campaign, leading to adoption of a FDI-discouraging Entities Foreign Investment Law (SEFIL) that made private company business decisions in certain sectors including mining, banking, and insurance subject to government review. While SEFIL was repealed in October 2013, Mongolia's resource nationalism continues to scare away investors. The second phase of the OT development (OT-2) was also delayed because of a shareholder dispute between the government and Rio Tinto (IMF 2017). [68]

There are some signs of progress. The authorities and Rio Tinto reached a US$6 billion agreement in May 2015to launch OT-2. In addition, the redevelopment of the Tavan Tolgoi (TT) coal mine – one of the largest in the world – was expected to begin in 2019. These two developments together brighten prospects for Mongolia's mineral sector development (IMF 2017). Yet, investors remain cautious. In the 2016–2017 Global Competitiveness Index rankings for Mongolia, government and policy instability ranked among the top problematic factors for doing business there (WEF 2017). Further improvement will depend on future actions of the new government.[69]

Mongolian authorities should understand that investment in natural resources entails large risks. Firms need to recoup their costs, make a normal profit, and self-insure for possible failures (Pomfret 2011). The authorities should keep the mining investment environment open, transparent, stable, and predictable. Volatile and restrictive policies influenced by resource nationalism discourage foreign investment, which is essential to realize development fueled by mineral wealth. If the government pushes too hard in negotiations, there will be no exploitation and the resources will remain idle underground. Mongolia may end up missing the next commodity boom if the government does not modify its stance. Beyond the negotiation stage, respecting foreign arbitration decisions is key to restore investor confidence,

67. According to the UN Comtrade database.

68. As a result, FDI declined by 95 per cent, from US$4.7 billion in 2011 to US$232 million in 2015 (US Department of State 2016).

69. Worryingly, the election campaign by Khaltmaa Battulga, the Mongolian president newly elected in July 2017, was marked by a nationalist tone (Nikkei Asian Review 2017). Nationalistic calls are still popular among the population.

given the lack of independence of Mongolia's judicial system. Sections 4.3 and 4.4 of this chapter provide more discussion and recommendations on the general investment climate.

Summary of policy recommendations:

- Allow more FDI into the mining sector to exploit reserves.
- Do not implement restrictive policies on foreign investment and contain resource nationalism.
- Keep the mining environment open, transparent, stable, and predictable.
- Continue to respect foreign arbitration decisions.

4.3. Macroeconomic policy and management of mineral wealth

One of the important tasks for the government of a resource-rich country is to manage mineral wealth in order to alleviate commodity price volatility, contain Dutch disease, and promote development of non-extractive sectors. However, the Mongolian authorities have shown little fiscal discipline and planning. While much of the mineral reserves remain unexploited, some mines have been operating in Mongolia since the Soviet era, and the country enjoyed the benefits of higher mineral prices during the 2003–2008 commodity boom. Mineral rents as a share of GDP increased from 6.7 per cent in 2003 to 30.3 per cent at their peak in 2006 (World Bank 2014).

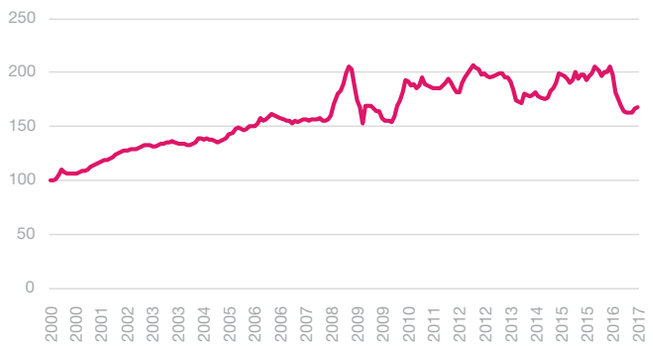
However, the government did little to save the windfall revenue for the future. The influx of government revenue led to euphoric spending, including public sector salary increases, poorly planned infrastructure investments, and badly targeted social transfer schemes (World Bank 2010, 2014). In particular, Mongolia's budget for subsidies and transfers, which amounts to some 8 per cent of GDP, largely disregards recipient income levels, instead targeting only according to different categories of the population (mothers, children, the elderly, the disabled, etc.) (IMF 2015). Election cycles also influenced spending decisions, with both major parties promising cash handouts in election campaigns. Hence, despite increased mineral revenues during the boom, the government ran fiscal surpluses of only 2-3 per cent from 2005–2007 (World Bank 2014).

In the aftermath of the 2008–2009 crisis, the government adjusted its fiscal policy through expenditure restraint with an IMF stabilization programme (World Bank 2010). As a result, the budget achieved a 0.5 per cent fiscal surplus in 2010 despite the economic downturn. Furthermore, with assistance from the World Bank and IMF, the authorities passed a Fiscal Stability Law (FSL) in July 2010 that came into effect in January 2013. The FSL has three key components: first, a ceiling on the structural deficit of 2 per cent of GDP; second, a cap on expenditure growth; and last, a provision that net present value of public debt cannot exceed 40 per cent of GDP (World Bank 2014).

However, once again the government soon started to spend without restraint as mineral prices recovered. In 2011–2012, increases in fiscal expenditures outpaced those of mineral revenues, and the fiscal deficit widened from 4.8 per cent of GDP in 2011 to 8.4 per cent in 2012 (World Bank 2014). Furthermore, as FDI and coal exports declined sharply in 2013–2015, the government resorted to expansionary fiscal policies. While the structural on-budget deficit was kept below 2 per cent of GDP in 2013–2014 (as required by the FSL), the government channeled an extra 8 per cent of GDP in capital spending through the newly created Development Bank of Mongolia (IMF 2015). The Bank of Mongolia also engaged in quasi-fiscal spending, such as mortgage subsidy programmes. Revenue projection during budgeting was frequently over-estimated as well. Consequently, the deficit (including these off-budget expenditures) was around 10 per cent of GDP in 2013–2015. In the run-up to the 2016 election, one-off spending spiked and the deficit reached 17 per cent of GDP in 2016. The large deficit and depreciation of the currency pushed up the general government debt to nearly 70 per cent at end-2016 (IMF 2017).

Fiscal overspending has resulted in Dutch disease. Persistent high inflation since the early 2000s led to continuous real effective exchange rate appreciation (figure 4.1). Although the upward trend has reversed since mid-2016 due to the sharp depreciation caused by recent macroeconomic instability, the appreciation trend is likely to resume as the economy stabilizes and the mineral rent keeps growing. This shows an urgent need for restoration of fiscal discipline and increased saving of mineral revenues. Furthermore, the macroeconomic instability caused by loose and unsustainable fiscal and monetary policies renders the country unattractive as a FDI destination. In the 2016–2017 Global Competitiveness Index, Mongolia ranked 121st among 138 economies in terms of macroeconomic environment (WEF 2017).

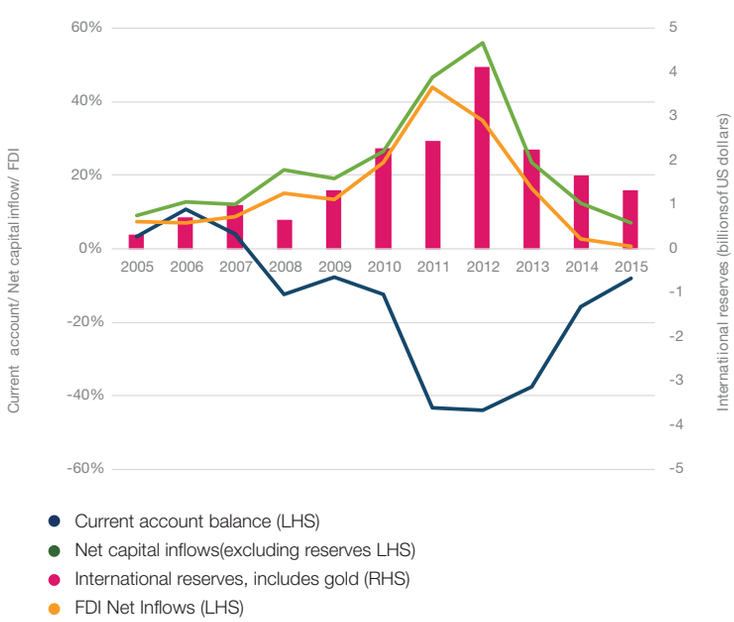
Figure 4.1: Real effective exchange rate of the togrog



Source: Unctadstat.unctad.org
Note: RoW: rest of world

Combined with the large current account deficit, falling capital inflows (largely FDI) since 2011 have been putting increasing pressure on Mongolia's international reserves in recent years (figure 4.2). This underlines the importance of liberalizing the entry of foreign investment along with macroeconomic adjustment.

Figure 4.2: Mongolia's balance of payments: Current account, private capital flows, and international reserves



Source: World Bank, World Development indicators

In the newly proposed Economic Recovery Programme, the new government showed its determination to discipline fiscal spending, tighten monetary policy, and undertake structural reforms. A US$440 million Extended Fund Facility recently approved by the IMF, which contains conditions on fiscal consolidation as well as monetary policy and banking sector reforms, will support the reforms. The new government has already taken some important actions, such as tightening monetary policy and bringing a large part of quasi-fiscal activities undertaken by the Development Bank of Mongolia and the Bank of Mongolia on budget (IMF 2017; EBRD 2017). Nevertheless, the new government's commitment to the programme is open to question given Mongolia's poor implementation record of past programmes. Fiscal discipline, introduced in times of crises to receive financial assistance from the IMF and other financial institutions, has always been short-lived.

The new government must commit to the reforms and follow through even after the situation stabilizes. Fiscal consolidation will require better social spending targeting. The authorities should stop providing large, untargeted subsidies, and instead focus on programmes that directly reach the poor, such as food stamps (IMF 2015). In addition, public investment, especially the road sector, needs more rigorous project evaluation (such as feasibility studies to assess economic viability as well as careful screening of contractors) and prioritization (World Bank 2010). Furthermore, the Fiscal Stability Fund – the sovereign wealth fund established concurrently with the Fiscal Stability Law in 2010 but yet to enter into operation – needs to be operationalized to enhance saving of mineral wealth (World Bank 2010; IMF 2015).[70] Saving windfall profits during booms will help reduce vulnerability to various shocks, as well as contain the risk of Dutch disease. Implementation of the sovereign wealth fund is particularly important now given that the completion of OT-2 and redevelopment of the TT coal mine are expected to generate increased mineral revenues in the near future.

70. In 2008, Parliament established another sovereign wealth fund called the Human Development Fund. However, it does not function as a sovereign wealth fund, but rather as a patronage tool to distribute mining revenues to the public in the form of various social benefits (e.g. pension, health insurance, mortgage support, and payments for education services). The purpose of the fund was to fulfill campaign promises to provide cash handouts in excess of US$1,000 (US Department of State 2016.).

Summary of policy recommendations:

- Urgently consolidate fiscal spending.
- In particular, reduce social transfer spending through better targeting.
- Introduce more vigorous project evaluation (e.g. feasibility studies) for public investment projects.
- Maintain fiscal discipline even after the situation stabilizes.
- Operationalize the sovereign wealth fund to save windfall profits and contain Dutch disease.

4.4. Private sector development

While mineral wealth can boost development if managed well, Mongolia also needs to diversify its economy and exports in order to shield itself from commodity price swings and achieve stable development. The key to diversification is to attract FDI, and for this, establishing a business-friendly environment is essential. Yet, Mongolia has much to improve in terms of ease of doing business. The World Bank's 2017 Doing Business Indicators show that, while it is relatively easy to start a business and pay taxes in Mongolia (which results in its decent overall ranking of 64th out of 190 economies), the country performed poorly with respect to trading across borders, getting electricity, and enforcing contracts, ranking 103rd, 137th, and 85th, respectively (figure 4.3). Additionally, the 2016–2017 Global Competitiveness Index shows that Mongolia underperforms in basic areas like infrastructure and institutions, along with macroeconomic stability (WEF 2017). Among a broad range of reforms Mongolia needs to undertake, this section focuses on four areas that are of highest importance: cross-border trade, transport infrastructure, electricity, and institutions supporting the rule of law.

Figure 4.3: Mongolia's performance on the 2017 World Bank Doing Business Indicators

Mongolia's Rank out of 190 countries
Source: World Bank, Doing Business 2007

4.4.1 Trade facilitation: Customs procedures and logistics

Although landlocked, Mongolia borders two important markets in the region, China and the Russian Federation, and it has potential to export consumer goods such as agro-food products and light manufactured products to these two developing markets. Nevertheless, the country's rather poor performance in trade facilitation poses an obstacle to such development. Mongolia ranked 103th out of 190 economies for trading across borders in the 2017 Doing Business Indicators (World Bank 2017a). In order to attract FDI and boost non-mineral exports, the country needs to reduce barriers to trade by improving customs inspection procedures and infrastructure at border crossing points, as well as by encouraging private sector participation in logistics services.

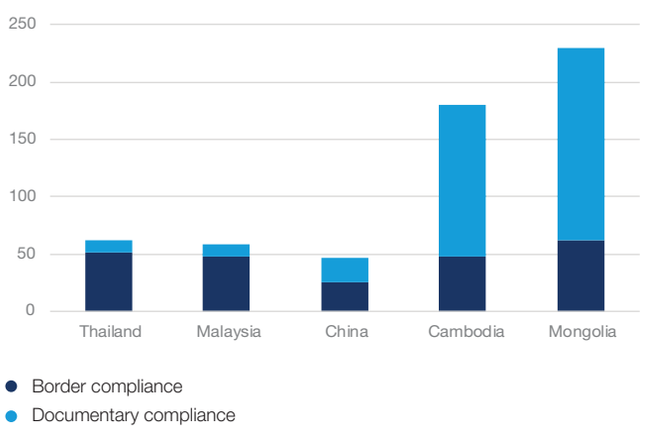
Mongolia has been making some significant progress in the area of customs. In 2008, the authorities amended the Customs Law and related regulations extensively in line with the revised Kyoto Convention, incorporating almost half of 600 recommendations made by the convention. With support from the Asian Development Bank, the authorities also set up a Customs Automated Information System (CAIS) in early 2011 (UN-OHRLLS 2013; UNCTAD 2013). More recently, a joint border controls initiative taken by the customs administrations of China and Mongolia significantly reduced border-crossing time for road transport; the average border-crossing time at the Erenhot-Zamyn Uud border crossing point (the main border crossing point between China and Mongolia) decreased from 24 to less than 8 hours (CAREC 2014, 2015).[71] Mongolian customs authorities have also started to implement risk management, although it is still at the beginning stage (UN-OHRLLS 2013). Despite this progress, there is still a need for further simplification of customs procedures. The 2017 Doing Business Indicators show that, while the cost to export and import is in line with comparable countries in Asia, the time it takes to export and import is much higher in Mongolia (figure 4.4).[72] The figure shows that time-consuming documentary compliance is the primary cause for the delay, as it takes 168 hours to export and 115 hours to import. Typically, eight documents are required for exporting and five for importing, according to the 2017 Doing Business

71. Border crossing time from China to Mongolia.

72. There is an overlap between border compliance and documentary compliance, and therefore the sum overestimates the actual time or cost to export/import. Nonetheless, the sum offers a useful cross-country comparison.

Indicators (World Bank 2017a). Such bothersome procedures discourage FDI and hinder development of non-extractive export sectors. The customs administration is in the process of implementing the National Single Electronic Window, which should help reduce the number of documents required and generally improve the efficiency of customs (UN-OHRLLS 2013). The authorities should also increase the capacity of customs border posts by improving customs inspection equipment and anti-smuggling detection facilities. This will help to more widely introduce risk management and post-clearance audits (UNCTAD 2013). Besides simplifying customs procedures, reducing widespread corruption at border crossing points will be important, as in Kazakhstan.[73]

Figure 4.4: Mongolia: Time to export relative to comparator countries (hours)



Source: World Bank, 2017 Doing Business Indicators

For rail transport (which is the main means of cross-border transport), inadequate trans-load facilities at border crossing points create a bottleneck. Like Kazakh railways, all Mongolian railways use the Russian Federation gauge standards, which differ from the standard used by Chinese railways. The resulting need to trans-load at the gauge change introduces a major delay at the Erenhot-Zamyn Uud border crossing point, the main gateway for rail transport at the Chinese-Mongolian border (Erenhot is on the Chinese side and Zamyn Uud on the Mongolian side) (table 4.1). According to CAREC (2015), trans-loading equipment (cranes, etc.) at the three stations in Zamyn Uud is limited, and the lack of wagons also constrains operations. Improving the trans-load facilities and availability of wagons could reduce the delays. Eliminating congestion at borders can increase the railroad capacity without building new railways, and help meet the future growth of cargo arising from new mining projects. Nonetheless, given that delays also occur at Erenhot on the Chinese side, cooperation with China is essential to address the issue.

73. See section 4.5 for more discussion on fighting corruption in public services.

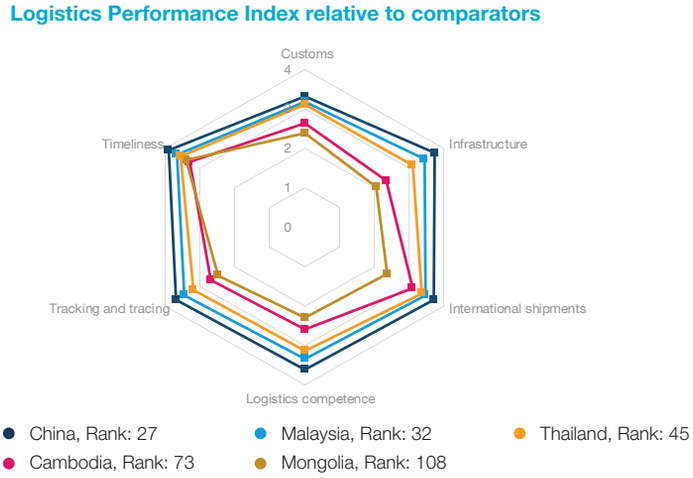
Table 4.1. Delays at the Mongolia-Chinese border (in hours)

Rank	Erenhot (China)	Zamyn Uud (Mongolia)
China to Mongolia	26.8	24.6
Mongolia to China	34.6	4.3

Source: CAREC (2015)

Mongolia also performs poorly in other areas of logistics. In addition to customs and infrastructure, the country underperforms in the areas of logistics competence and ease of arranging international shipments, according to the World Bank's Logistics Performance Index 2016 (figure 4.5). While there are multiple major freight forwarders providing integrated logistics services, both public and private, their knowledge and service levels are generally low, and small local freight forwarders in particular lack experience handling international freight. The authorities should develop a central logistics center equipped with modern facilities to increase logistics competence. They should also consider providing training for logistics and transport management, for example by offering relevant courses in tertiary public education (ADB 2009). Encouraging the use of information and communications technology (ICT) in logistics operations would improve performance in tracking and tracing, as well as overall efficiency. Entry of international third-party logistics companies could help create competition and transfer knowledge about modern logistics handling.

Figure 4.5: Mongolia's performance on the World Bank Logistics Performance Index relative to comparators



Source: World Bank, 2016 Logistics Performance Index
Note: Rank based on total Logistics Performance Index score out of 160 countries

Summary of policy recommendations:

Customs

- Streamline customs procedures by reducing the number of documents required.
- Augment capacity at border-crossing points by increasing customs inspection equipment and anti-smuggling detection facilities.
- Expand risk management.
- Continue implementation of the National Single Electronic Window.
- Further increase customs cooperation with China.

Cross-border infrastructure

- Upgrade trans-load facilities at rail border crossing points at the Chinese border.
- Improve the availability of wagons at rail border crossing points.
- Urge Chinese authorities to increase trans-loading capacity at border crossing points on the Chinese side.

Logistics

- Develop a central logistics center equipped with modern facilities.
- Provide training for logistics and transport management to address inadequate knowledge among domestic service providers (including offering relevant courses in tertiary public education).
- Encourage the use of ICT in logistics operations.
- Consider facilitating the entry of international third-party logistics providers.

4.4.2. Transport infrastructure

Rail and road are the two main means of transport in Mongolia. Railways play a vital role in export and import transportation, with up to 80 per cent of all freight transported on rail (UN-OHRLLS 2013). Rail is important for Mongolia's access to international markets beyond China and the Russian Federation, since it connects the country to the Chinese port of Tianjin. In addition, the country's strategic location between China and the Russian Federation makes Mongolia's railroad an important transit route for traffic moving between the two enormous markets; the main trunk line of Mongolia's railroad network links the Russian Federation's Trans-Siberian railroad to China's network.[74]

One issue with Mongolia's international transport traffic is over-dependence on the Chinese port of Tianjin; almost all Mongolia's overseas imports and exports transit through the port. The Tianjin port, however, does not have adequate capacity to trans-load containers from port to trains. Consequently, the dwell time at the port is long and unpredictable, especially for inbound containers destined for Ulaanbaatar. There are no green lanes for Mongolian containers, and Mongolian freight forwarders complain that their containers are treated as secondary priorities when the port is congested. Overall, the dwell time at the port averages 5-7 days, accounting for almost 50 per cent of the total transport time from the port to Ulaanbaatar.[75] To address the problem, Mongolian authorities plan to create alternative routes and reduce reliance on the Tianjin port. One plan is to open a new route that allows access to the Russian Federation ports of Vladivostok, Vostochny, and Vanino on the Pacific. While the route is more than four times longer than the route to Tianjin, the authorities are negotiating discount transit fees with the Russian Federation to make it competitive. Given the prospective increase in mineral exports, the plan is cost-effective (UN-OHRLLS 2013; UNCTAD 2013). There is also another plan to develop a new road-rail transport route to the Chinese seaport of Jinzhou (CAREC 2015). These new routes will reduce congestion at the Erenhot-Zamyn Uud border crossing point by diverting some traffic.[76]

Railway covers only a small part of the vast country, and therefore road transport plays a critical role in domestic transport. However, roads in Mongolia remain in poor condition. Only about 12 per cent of the country's road network is paved (UNCTAD 2013), and Mongolia ranks 109th out of 136 economies in the 2016–2017 Global Competitiveness Index in terms of quality of roads (WEF 2017). The difficulty of updating road infrastructure stems from the sheer size of the country and low population density, which raises the costs of serving rural areas (UN-

74. While the Mongolian railroad can serve to link China and Europe (via the Russian Federation's Tran-Siberian railway), this trans-Siberian route faces competition with the trans-Kazakhstan route, which is being strengthened through China's New Silk Road project. At present, the transit traffic moving between China and Europe through Mongolia remains relatively small. Nevertheless, with sufficient regional cooperation (especially with the Russian Federation, whose railroad constitutes most of the route), the trans-Siberian route could potentially become a good alternative to the trans-Kazakhstan route (UN-OHRLLS 2013).

75. Moreover, dependence on the single port makes the supply chain vulnerable. For example, an explosion at the Tianjin port in August 2015 resulted in significant delays in August and September (CAREC 2015).

76. The authorities are also expanding the railroad network domestically to link mines like TT and OT to existing railroads (UN-OHRLLS 2013).

OHRLLS 2013). While private sector participation such as public-private partnerships (PPPs) is growing in the road sector and is an important strategy to be pursued, its scope will be limited to commercially viable projects, and hence public funding will be necessary for many projects, especially in rural areas. Yet, given the need for fiscal restraint and the dangers of Dutch disease from over-spending, the authorities need to assess the economic viability of each project carefully and be selective. Current projects frequently lack feasibility studies, and they are mostly prioritized based on patronage and political interests (UNCTAD 2013). Tendering processes are problematic as well. Many projects are awarded through direct contracting with no accompanying technical documentation and no proper screening of contractors (World Bank 2010).

At least a basic feasibility study should be conducted for every project, and if the study suggests that maintenance would be too costly, then the project should not be undertaken. In order to accomplish better project evaluations and contractor screening, the authorities need to augment the capacity of the agencies in charge of new infrastructure projects. Establishing a transparent and competitive tendering process is also essential to reduce inefficiency and corruption.[77]

Summary of policy recommendations:

Rail

- Implement plans to reduce reliance on the Tianjin port by creating alternative routes to access seaports.

Roads

- Assess the economic viability of each project carefully and be selective.
- Undertake a feasibility study for every project.
- Do not undertake a project if future maintenance would be too costly.
- Undertake proper screening of contractors in tendering processes.
- Augment the capacity of the agencies in charge of assessing new infrastructure projects.
- Establish a transparent a competitive tendering process.

77. See section 4.5 for more discussion on building transparent and uncorrupt institutions.

4.4.3. Electricity

Reliable and accessible electricity supply is critical not only for the mining sector but also to develop non-extractive sectors (especially manufacturing) and improve the standard of living. However, Mongolia performs poorly here, ranking 137th out of 190 economies for getting electricity in the 2017 Doing Business Indicators (World Bank 2017a). Mongolia's power sector needs to upgrade infrastructure and lower obstacles to getting electricity.

With regard to physical infrastructure, both power plants and distribution systems should be updated.[78] The main issue is that most power facilities date to the Soviet era, with little subsequent upgrading, and hence are outdated, inefficient, and unreliable. For example, two of three combined heat and power plants in Ulaanbaatar (the capital), plants 2 and 3, have operated for more than 40 years, and the largest plant, plant 4, has operated for more than 25 years. In 2012, the average outage duration in Ulaanbaatar was above 2,000 minutes, and the average frequency of outages was more than 13 interruptions per customer. The reserve margin has come close to zero, and if the operation of combined heat and power plants 2 and 3 are interrupted – which is likely given that they are 40 years old – it could result in serious power shortages (ADB 2014c, 2014b). Furthermore, use of coal-based household stoves and inefficient heat-only boilers in areas lacking access to power supply has resulted in serious urban pollution in winter; Ulaanbaatar is regarded as among the most polluted cities in the Asia Pacific region.

Power transmission and distribution systems are also in urgent need of rehabilitation and upgrading. Electricity distribution losses totaled 19.6 per cent in 2012, much higher than the international best practice of about 5 per cent (ADB 2014c). To address the issue, the government plans to build a new combined heat and power plant 5 in Ulaanbaatar through a PPP, and install additional capacity in the existing combined heat and power plant 4 (ADB 2014c). These actions are welcome, but further investment in upgrading and maintaining the infrastructure is necessary to improve reliability and meet the demands of the growing economy. Encouraging more private sector participation (such as PPPs and FDI) would be a key for both construction of new facilities and rehabilitation of old

78. Mongolia ranked 97th out of 138 countries for quality of electricity supply on the 2016–2017 Global Competitiveness Index (WEF 2017).

facilitates. The revised Energy Law approved in 2015, which aims to adopt a more commercially oriented approach to the energy sector, is an important step in this direction (EBRD 2017).

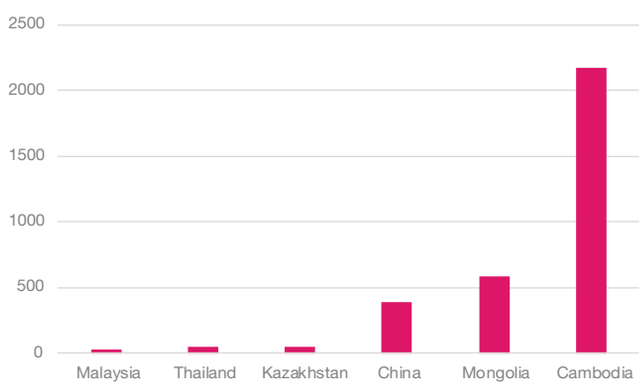
Mongolia has the potential to develop renewable energy, namely solar and wind power (UNCTAD 2013). Not only can renewable energy reduce air pollution from coal combustion, it will also address Mongolia's unique problem regarding electrification that stems from its geography. Mongolia is large and sparsely populated outside central cities like Ulaanbaatar, and hence building transmission infrastructure to rural areas is often not cost-effective. The fact that a third of Mongolia's population is nomadic herders also compounds the difficulty (UNCTAD 2013). Since solar and wind power production does not have to be centralized (a small solar power generator can be portable and hence suits the nomadic lifestyle), it can be an effective and economically viable way to provide electricity and heating to rural communities and nomadic herders. Renewable energy hence has an important implication for rural economic development and achieving inclusive growth. The World Bank has undertaken a project to promote solar energy in rural areas, and it continues the effort to scale up renewable energy production as part of the Second Energy Sector Project approved in June 2017 (World Bank 2012, 2017b).

Finally, procedures for getting an electrical connection in Mongolia are costly and should be simplified. According to the 2017 Doing Business Indicators, eight procedures need to be completed in order to get an electrical connection (as opposed to three procedures in best practices), and the cost associated with getting a connection is much higher in Mongolia than in other developing countries in Asia (figure 4.6). The 2013 Enterprise Surveys show that the process is also time-consuming; the delay to obtain an electrical connection is 78.3 days, as opposed to the East Asia and Pacific country average of 25.4 days and the low-income country average of 41.5 days. Improving the ease of getting an electrical connection is essential to attract investment in many sectors that Mongolia aims to develop, such as food processing and light manufacturing. Procedures for getting the connection must be streamlined in order to reduce the cost and time required to complete the process.[79]

Summary of policy recommendations:

- Increase investment in upgrading and maintaining electricity infrastructure (both power plans and distribution network).
- Encourage more private sector participation (such as PPPs and FDI) in both construction of new facilities and rehabilitation of old ones.
- Promote development of renewable energy, namely solar and wind power.
- Lower the cost to get an electricity connection, and simplify the procedures.

Figure 4.6: Cost to get electricity (percentage of income per capita)



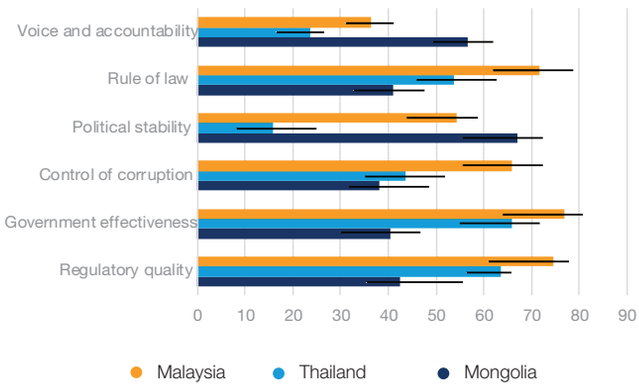
Source: World Bank, 2017 Doing Business Indicators

4.5. Institutions and governance

Weakness of institutions is a major deterrent to FDI and private sector development in Mongolia. The World Bank's Worldwide Governance Indicators show that the country lags behind its peers in Asia in areas such as the rule of law, control of corruption, government effectiveness, and regulatory quality (figure 4.7). This section discusses three major institutional weaknesses in Mongolia: widespread corruption, unclear legal and regulatory frameworks, and lack of judicial independence.

79. There is also significant corruption associated with getting electricity. See section 4.5 for more discussion on corruption.

Figure 4.7: Mongolia's performance on the World Governance Indicators, 2015



Source: World Bank, Worldwide Governance Indicators
Note: Percentile ranking (0 = worst, 100 = best). Error bars show 90 per cent confidence intervals

Economic management is a challenge in Mongolia's public administration. On Transparency International 2016 Corruption Perception Index, Mongolia ranked 87th out of 178 countries (Transparency International 2017). Irregular payments are common at all levels of public administration, especially for getting licenses and permits (table 4.2). In a recent survey by the Asian Foundation (2016) of Mongolian and foreign businesses in Ulaanbaatar, 47.9 per cent of respondents answered that there is a lot of corruption in public services, and 43.6 per cent said that their business is directly affected by corruption, with large firms reporting more damage than small firms.

Table 4.2. Irregular Payments

Activities	Percentage of firms expected to give gifts
Tax inspection	19.5
Securing a government contract	25.9
Getting a construction permit	45.4
Getting an import license	18.2
Getting an operating license	29.7
Getting an electricity connection	34.5
Getting a water connection	48.4
Getting things done	31.2

Source: World Bank, 2013 Enterprise Surveys

Overall, the tax office, inspection agency, and customs are identified as the most corrupt state agencies, followed by the land utilization agency and the government independent procurement agency. Public procurement is deeply affected by corruption: in the same survey, 53 per cent of respondents answered that political party membership or family relations influence tender awards. Corruption is deeply entrenched in the judiciary as well. In a 2013 survey by Transparency International, 73 per cent of respondents reported that the judiciary was corrupt or extremely corrupt.

The authorities have made some notable progress in fighting corruption. In 2006, Parliament passed the Anti-Corruption Law, which implemented an assets and income disclosure system for public servants, and established the Independent Authority against Corruption (IAAC), the principal agency responsible for investigating corruption cases. While some question the IAAC's political impartiality (the Government appoints the head), the agency has started to show some tangible results. By March 2011, it had investigated 916 corruption cases and referred 186 cases for prosecution, although they resulted in only 69 convictions over four years of activity (partly due to the limited capacity of the IAAC).

In March 2012, the first high-profile case led to the conviction of the former president of Mongolia, followed by the conviction of four senior members of the Mongolian police force in June 2012. In May 2012, a new law came into effect, expanding the staff of the IAAC from 95 to 145, regulating conflicts of interest, and requiring public officials to produce electronic private interest declarations and disclosure of assets and income (UNCTAD 2013; US Department of States 2016). As a result, Mongolia's ranking on the Corruption Perception Index improved from 120th (out of 182 countries) in 2011 to 94th (out of 176 countries) in 2012 and 87th (out of 178 countries) in 2016 (Transparency International 2017).

Despite these improvements, according to some reports, corruption remains prevalent, as indicated by the aforementioned surveys. Progress on implementation of the Anti-Corruption Law has been mixed, and some officials engage in corrupt practices with apparent impunity (US Department of State 2016). The limited effectiveness of anti-corruption programmes is attributable largely to three factors. First, the current Criminal Code of Mongolia has a limited scope for criminalization of bribes. The authorities

need to criminalize the offer and promise of a bribe, the acceptance of such an offer or promise, and the request for a bribe. In addition, they should specify the definition of "bribe", and ensure that it covers non-monetary benefits (OECD 2015). Second, the scope of immunities against prosecution of corruption offenses is too broad. Mongolia's Constitution immunizes virtually all high-level officials, including members of Parliament and the , and there is no clear way to lift the immunities (OECD 2015; US Department of State 2016). In addition, some officials of state organizations and their staffs also enjoy immunities based on various laws. This significantly limits the IAAC's ability to investigate and prosecute high-profile cases. While the IAAC has investigated several cases involving members of Parliament, none has so far led to conviction (UNCTAD 2013; OECD 2015). The authorities need to narrow the scope for immunity and establish an effective procedure for lifting it.

Finally, the activities of the IAAC suffer from insufficient resources. The current IAAC mandate is very broad, covering corruption prevention, corruption studies, public awareness-raising and education, investigation of corruption offenses, and the review of asset and income declarations of public officials (OECD 2015). The authorities should provide more resources to the IAAC (in terms of funding and staffing) and expand the capacity of the agency, for example through specialized training for investigators and prevention officers, as well as by establishing regional offices (UNCTAD 2013; OECD 2015).

There is a concern that the current political trend seems to be moving towards weakening the IAAC. In August 2015, Parliament passed an amnesty law that would have resulted in termination of 45 of the 55 cases that the IAAC has been investigating, reportedly pushed by those under investigation and by the former president. The alleged crime involved more than US$16.2 million. While the president issued a partial veto in September 2015 so that amnesty would not apply to those accused of corruption, abuse of power, illegal enrichment, embezzlement of budget funds, and appropriating others' property, this was a worrisome incident. In general, the authorities need to take more determined attitude towards fighting corruption. The previous anti-corruption strategy of Mongolia expired in 2010, and the country has failed to adopt a new national programme. The Anti-Corruption Agency developed a draft of a new strategy called the National Anti-Corruption Programme, but Parliament rejected the draft reportedly out of fear of any additional reinforcement of the agency. The draft has been resubmitted but has yet to be adopted (OECD 2015, 2016).

Four additional measures are recommended to reduce opportunities for corruption and foster a culture of integrity. First, the authorities need to promote e-governance initiatives. This will reduce opportunities for officials to demand bribes (e.g. in issuing licenses and permits) and increase transparency. The authorities must also establish relevant legal frameworks (such as an electronic signature law) and harmonize government databases (UNCTAD 2013). Second, a merit-based promotion system for civil servants needs to be introduced. This will also help augment the capacity of public administration, which is currently quite limited (as reflected in poor government effectiveness performance on the World Governance Indicators (figure 4.7). Third, comprehensive legislation on whistle-blower protection needs to be enacted to encourage reporting incidences of bribery. Finally, the Public Procurement Law needs to be improved and expanded so that it covers all public contracting, including procurement funded by the Development Bank of Mongolia and other extrabudgetary funds. Corruption in public procurement in Mongolia remains prevalent, in particular for large infrastructure programmes (OECD 2015). Legal and regulatory mechanisms to ensure competitive, transparent, and unbiased tendering processes must be established. Overall, fighting corruption and reducing opportunities for rent-seeking are urgent tasks given that the country's mineral revenues are expected to grow rapidly with new mining projects.

Unclear legal and regulatory frameworks and lack of judicial independence are two other problems with Mongolia's institutions. Mongolian laws and their implementing regulations lack specificity, and consequently are often interpreted and applied inconsistently. Furthermore, the regulatory vagueness invites corruption, especially where much money is at stake (US Department of State 2016). Lack of judicial independence compounds uncertainty in settling disputes in court.[80] Although the Constitution states that non-judicial branches of the government should not interfere with the discharge of judicial duties, investors report government interference in the dispute resolution process, especially in cases involving disputes with

80. Mongolia ranked 100th out of 138 countries in terms of judicial independence on the 2016–2017 Global Competitiveness Index.

government agencies, state-owned enterprises, or well-connected private parties (US Department of State 2016). Constitutional changes are needed to remove the role of political entities (the president and Parliament, in particular) in the judiciary and establish judicial independence (OECD 2015).

Implementation of merit-based recruitment of judges, which is in its initial stages, must be completed, and the transparency and fairness of the procedure needs to be ensured. In addition, the Judicial General Council, which has the constitutional duty to ensure the impartiality of judges, must be given express authority to investigate allegations of judicial misconduct and impose disciplinary measures on judges (US Department of State 2016).

There are two other issues with dispute settlement. First, judges are often unfamiliar with commercial practices and inexperienced in enforcing commercial laws and regulations (UNCTAD 2013). There is an urgent need for capacity-building in commercial justice and domestic arbitration. In 2012–2014, the authorities implemented a project to train over 200 judges with assistance from the European Bank for Reconstruction and Development (EBRD) and the International Development Law Organization (IDLO), and they should continue offering similar programmes. Establishment of a tribunal specialized in commercial disputes would also be effective. Second, implementation of court judgements related to commerce, particularly creditor claims, is reported to be problematic (US Department of State 2016). The authorities should ensure that court decisions (including foreign arbitrations) are enforced promptly to reduce uncertainty in settling disputes.

Summary of policy recommendations:

Corruption

- Criminalize the offer and promise of a bribe, the acceptance of such offer or promise, and the request for bribe.
- Specify the definition of “bribe” in the Criminal Code of Mongolia, and ensure that it covers non-monetary benefits.
- Narrow the scope for immunity, and establish an effective procedure for lifting it.
- Provide more resources to the IAAC.
- Enhance the capacity of the IAAC, for example through specialized training for investigators and prevention officers and by establishing IAAC regional offices.
- Promote e-governance initiatives, establish relevant legal frameworks (such as an electronic signature law), and harmonize government databases.
- Introduce a merit-based promotion system for civil servants to foster a culture of integrity.
- Enact comprehensive legislation on whistle-blower protection to encourage reporting incidences of bribery.
- Improve and expand the Public Procurement Law so that it covers all public contracting, including the procurement funded by the Development Bank of Mongolia and other extrabudgetary funds.
- Establish legal and regulatory mechanisms to ensure competitive, transparent, and unbiased tendering processes.

Legal and regulatory framework

- Make laws and regulations specific and unambiguous to reduce arbitrariness in interpretation.

Judicial independence

- Remove the role and influence of political entities , in particular) in judicial careers.
- Complete implementation of merit-based recruitment of judges, and ensure transparency and fairness in the selection procedure.
- Give the Judicial General Council express authority to investigate allegations of judicial misconduct and impose disciplinary measures on judges.

General issues with dispute settlement

- Promote capacity-building for commercial justice and domestic arbitration.
- Establish a tribunal specialized for commercial disputes.
- Ensure prompt enforcement of court judgements related to commerce, particularly creditor claims.

4.6. Diversification strategies

Agribusiness and tourism are two sectors where Mongolia has particular potential. In both sectors, strong government actions and support are necessary to augment competitiveness and attract FDI. Developing these two sectors is important to reduce dependency on

mineral exports and make the economy less vulnerable to commodity price swings. Furthermore, both sectors have significant implications for rural development and poverty reduction.

4.6.1. Agriculture and livestock

Agriculture is a key sector for Mongolia, both in terms of economic diversification and poverty reduction. Mongolia's two main agricultural subsectors are livestock (meat, dairy, leather, and, notably, cashmere) and, to lesser extent, crop production (wheat, potatoes, fodder crops, and other cereals). Livestock production accounts for about 75-80 per cent of total agricultural production (ADB 2014a; World Bank 2015). With its strategic location between two large economies, China and the Russian Federation, Mongolia has significant export potential in meat and dairy products, and the country also has potential to export cashmere wool and animal skin products globally. However, agricultural productivity is currently low: the sector accounts for almost 30 per cent of total employment, and yet produces less than 15 per cent of GDP.[81] Despite a dramatic increase in the national herd size over the years,[82] most herding households remain at or near the subsistence level. Value addition within the country is limited; Mongolia mostly exports raw materials and processes only a small portion domestically beyond the most basic stage (ADB 2014a). The main goals for the sector would be to boost the productivity and increase value added within the country. In addition, there is an urgent need to ensure sustainable livestock production through proper pasture management. Because of overstocking and poor pasture management, 70 per cent of pastures are now degraded (World Bank 2015). Developing the agricultural sector has important implications for poverty reduction in rural areas, especially for nomadic herders who constitute about a third of the entire population.

Given the peril of overstocking, Mongolia's livestock sector must switch its development approach from increasing the herd size to augmenting productivity. Five actions would be effective in boosting agricultural productivity. The first is to address issues with animal health and hygiene. Outbreaks of transboundary animal diseases (such as foot-and-mouth disease) are recurrent, causing significant economic losses (ABD 2014b). In addition, ensuring food safety is also important for exporting Mongolia's agro-food products. As incomes rise, the domestic demand for safe food will rise too. The authorities should offer more veterinary services to improve animal health, and implement better hygiene standards and food safety systems to improve the marketability of products.

Second, extensive advisory services need to be provided to inform herders about better production methods and management, and to introduce a quality-grading system so that they are incentivized to implement these changes. Lack of price differentiation based on product quality is one of the factors that discourage quality improvements in Mongolia (World Bank 2015). Also, producers need to be informed about safety and quality standards abroad; meeting sanitary and phytosanitary requirements of importer countries is crucial.

Third, better risk management needs to be introduced to reduce volatility caused by extreme weather conditions known as dzuds, which pose a large risk to Mongolia's livestock sector.[83] To make matters worse, long-term pasture degradation has exacerbated the severity of livestock mortality from dzuds. Smaller and poorer herders tend to be more vulnerable due to limited access to capital and pastures (World Bank 2015). The authorities should promote better winter preparation (such as winter forage production) to limit the damage to livestock. They should also expand the livestock insurance programme for herders.[84]

Fourth, a system of effective pasture management needs to be established to ensure the sustainability of production. The authorities must implement measures such as land leases and per head grazing fees to limit overgrazing. The herd size needs to be reduced, although reducing that size to a more sustainable level would mean that fewer households would be supported by the livestock sector, so the authorities would need to support labor transition in rural areas (World Bank 2015). Finally, the intensification of production needs to be promoted in order to improve both quality (e.g. more fattening through feeding programmes) and profitability. This is essential to gaining export competitiveness.

81. World Bank, World Development Indicators.

82. The national herd size increased from 23 million animals in 2002 to 45 million in 2013 (World Bank 2015).

83. For more details about dzuds and a discussion on risk management, see World Bank (2015).

84. The government should also introduce insurance for crop production to mitigate risks from extreme weather.

Mongolia also needs to strengthen agricultural value chains. Five actions are recommended in this respect.

First, as in Kazakhstan, organizing herders (and relevant food processors) into cooperatives would be effective to improve access to markets and finance (another significant obstacle for agricultural development in Mongolia), and it would also augment efficiency through the sharing of equipment and facilities. Contract farming can also help link small farmers with processors, wholesalers, and retailers, especially for perishable products such as milk. The authorities should establish a legal framework that encourages the formation of cooperatives and contract farming.

Second, road infrastructure and logistics need to be improved to remove supply chain constraints. Better transport infrastructure and logistics will facilitate the development of distribution networks (both domestic and international) and better linkages between primary producers, input-suppliers, processors, and retailers.

Third, the country needs to promote industrial cluster development for food processing. This is especially important for Mongolia, a vast country with underdeveloped transport networks. Clusters bring processors together and allow them to share input-output markets and other infrastructure and systems.

Fourth, a modern retail sector needs to be developed through FDI. Entry of international retailers (e.g. supermarket chains) can help build stronger distribution networks, introduce international standards and modern logistics practices, and stimulate commercialization of domestic producers.

Finally, trade agreements need to be negotiated with China and the Russian Federation to lower trade barriers and remove restrictions. Again, Mongolian producers also need to meet the sanitary and phytosanitary requirements of importers for stable access; the Russian Federation, for example, restricts Mongolian meat imports from time to time based on health concerns (World Bank 2015).

4.6.2. Manufacturing

In order to increase value added within the country, Mongolia must develop a stronger fiber processing industry, especially for cashmere. Mongolia produces 6,000 to 7,000 metric tons of raw cashmere annually, and as such, it is the second largest producer of cashmere after China (which produces 9,000 metric tons annually). However, only about a third of Mongolia's cashmere is processed domestically; the other two-thirds are exported to China either raw or after some primary washing and dehairing. Since the largest value addition takes place in processing (in particular, knitting accounts for 46 per cent of value added in processing), Mongolia is missing potential benefits from cashmere production. To make matters worse, bulk buying without price differentiation by Chinese traders has led to prioritization of quantity over quality, resulting in deteriorating Mongolian cashmere quality (i.e. loss of fineness from increased fiber diameter). The lowering of cashmere quality limits the development potential of domestic cashmere processing. Issues with product quality constrain other fiber processing, too. For example, 94 per cent of Mongolian wool is coarse, and only 1 per cent is fine or semi-fine and suitable for garment production, limiting the potential of weaving and garment factories.

To raise prices received by sellers of unprocessed cashmere and to develop a competitive fiber processing industry, the authorities must take four actions.

First, advisory services and training need to be provided to herders to enhance raw material quality through better livestock handling, management, and breeding.

Second, a quality-grading system needs to be developed, along with mechanisms to implement it, to ensure price differentiation based on quality.

Third, further effort needs to be put into international marketing and branding of Mongolian cashmere (UNCTAD 2013). It is imperative that Mongolia seek alternative markets to China to sell its raw products, as reliance on Chinese traders is currently undermining Mongolian producers' bargaining power. Although Mongolia could potentially become competitive in fiber processing over the long term, upgrading the quality of the raw products and selling with better prices should be the priority in the short to medium term. Improving logistics as outlined in section 4.4.1 is important toward this end.

Finally, investment and soft loan programmes should be undertaken to alleviate issues related to access to finance

and to upgrade facilities used by processors (World Bank 2015). However, the authorities must plan the investment programmes with caution, undertaking cost-benefit analysis through feasibility studies (possibly with assistance from institutions such as the World Bank and Asian Bank of Development, among others). Trying to develop garment industries without ensuring the supply of fine wool, for example, would be futile. In fact, Mongolia should start by improving the quality of basic processing and exporting semi-processed products of higher quality rather than trying to develop vertically integrated domestic fiber processing industries. Upgrading the basic processing facilities alone could bring a large increase in domestic value added. Overall, actions to increase FDI into the sector are important given the need for expertise, market access, and capital. Government subsides should be eschewed given the pressures on the fiscal balance and their tendency to be politicized.

Summary of policy recommendations:

Animal health, hygiene, and food safety

- Offer more veterinary services to improve animal health.
- Implement better hygiene standards and food safety systems.

Productivity of primary producers

- Offer extensive advisory services to inform herders about better production methods and management.
- Introduce a quality-grading system to incentivize herders to improve product quality.
- Inform producers about safety and quality standards abroad.

Risk management

- Introduce better risk management to reduce volatility caused by extreme weather.
- Promote better winter preparation (such as winter forage production) to limit the damage to livestock.
- Expand the livestock insurance programme for herders.

Pasture management

- Establish a system of effective pasture management to ensure the sustainability of production.
- Implement measures such as land leases and per head grazing fees to limit overgrazing, and reduce the national herd size.
- Promote labor transition in rural areas to support those displaced from herding because of reduced herd size.

Livestock production

- Promote intensification of production to improve both quality and profitability.

Agricultural and manufacturing value chains

- Organize herders (and relevant food processors) into cooperatives, promote contract farming, and establish a legal framework that encourages the formation of cooperatives and contract farming.
- Improve road infrastructure and logistics to remove supply chain constraints.
- Promote industrial cluster development for food processing.
- Develop modern retail sector by promoting FDI.
- Negotiate trade agreements with China and the Russian Federation to lower trade barriers and remove restrictions.
- Assist Mongolian producers in meeting the sanitary and phytosanitary requirements of European importers.
- Improve raw material quality by educating and training primary producers.
- Develop a quality-grading system and ensure price differentiation based on quality.
- Put further effort into the international marketing and branding of Mongolian cashmere.
- Implement investment and soft loan programmes to alleviate issues related to access to finance, but undertake such programmes only after careful cost-benefit analysis.

4.6.3. Tourism

Tourism is another key sector for economic diversification and inclusive growth. Mongolia's vast landscape and nomadic lifestyle make it an attractive travel destination. In particular, Mongolia has ample potential in niche-market tourism such as adventure tourism and ecotourism. Despite limited government support, tourism is estimated to account for around 10 per cent of GDP and 8 per cent of exports,

and there are already many local and foreign companies operating in and with Mongolia. The major sources of tourists are China, the Russian Federation, the Republic of Korea, the United States, and Japan (UNCTAD 2013). There is still large untapped potential in the sector, and stronger government support is needed to attract more FDI, market Mongolian tourism abroad, and promote industry-wide development. Development of the tourism sector could also support rural development through job creation and local sourcing of products.

The authorities need to recognize the importance of tourism in the country's development, and lead strong and sustainable development of the sector. In particular, five actions would be effective to promote the sector's development.

First, a strong institutional framework needs to be established to support tourism. Currently the government's tourism policy planning and administration is fragmented in various ministries, and there is no central body capable of coordinating policies and actions. The Mongolian National Tourism Centre (MNTC), established in 2009 as a state-owned (partially self-financing) enterprise, is both under-financed and under-staffed. The authorities should transform the MNTC into a proper national tourism organization that involves the private sector and plays a central role in marketing, sector development planning, and training. Associating the new national tourism organization through a PPP with a foreign-owned tourist organization would be effective (UNCTAD 2013). In addition, the authorities should provide the organization with more funding and professional staff.

Second, through the new national tourism organization, Mongolia needs to address constraints to high-end tourism development, such as lack of sanitary facilities and low service standards. These issues are among the least pleasant comments reported in a survey in 2004, and are important to building a positive image of the country (UNCTAD 2013).

Third, local sourcing needs to be facilitated. Currently, a high proportion of inputs and supplies in the tourism sector are imported, limiting the benefits of tourism for local development and poverty reduction. The new national tourism organization should promote linkages between the tourism sector and local suppliers. Nevertheless, it should be noted that to increase local sourcing, improving product quality of local supplies is crucial (UNCTAD 2013). Fourth, the quality of transport infrastructure needs to be improved. In addition to upgrading rail and road infrastructure, strengthening aviation is also important given the sheer size of the country. Internal travel by road involves long, uncomfortable journeys (UNCTAD 2013). The authorities must put efforts into increasing the number of domestic and international travel options, possibly through PPPs, and the quality of airport infrastructure must be improved. However, such investment should be undertaken only after careful feasibility studies.

Finally, the environment needs to be protected if there is to be sustainable development of tourism. Nature is the key resource for Mongolia's tourism. The government must ensure that new mining projects do not unduly harm the environment (especially national parks) and local communities in tourism areas. There have been allegations of high-level corruption involving construction projects in national parks (UNCTAD 2013). Environmental standards must be strictly enforced, with an emphasis on sustainable tourism development.

Overall, attracting FDI into the sector and linking foreign investors with local suppliers should be the key strategy for tourism development. The new national tourism organization should strive to create an environment favorable to such investment and build an appealing image of the country's tourism globally to attract FDI. As the number of visitors rises and demand for local products increases, more FDI may start flowing into sectors with linkages to tourism, such as cashmere and other light manufacturing.

Summary of policy recommendations:

- Recognize the critical role of tourism in development.
- Establish a strong institutional framework for supporting tourism.
- Transform the MNCT into a proper national tourism organization that involves the private sector and plays a central role in marketing, sector development planning, and training.
- Associate the new national tourism organization through a PPP with a foreign-owned tourist organization.
- Provide more funding and professional staff for tourism development.
- Address constraints to high-end tourism development

such as lack of sanitary facilities and low service standards.
- Facilitate local supply sourcing by promoting linkages between the tourism sector and local suppliers.
- Improve the quality of transport infrastructure (road, rail, and air).
- Put more effort into increasing the number of domestic and international travel options (possibly through PPPs).
- Improve the quality of airport infrastructure.
- Protect the environment for sustainable development of tourism.
- Ensure that new mining projects do not unduly harm the environment (especially national parks) and local communities located in tourism areas.

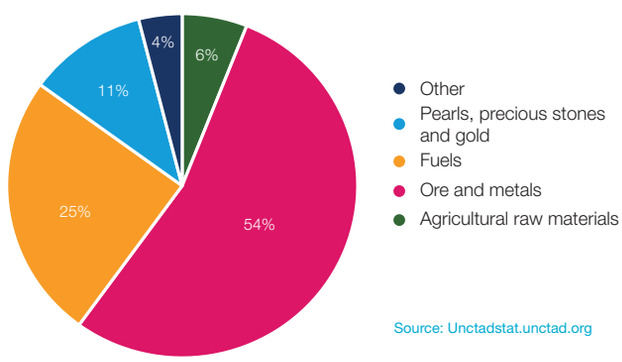
4.7. Mongolia's current export structure, key markets, and prospects for export diversification

4.7.1. Export structure and key markets

A quick glance at figure 4.8 shows the importance of natural resources in Mongolia's economy. The figure shows that Mongolia's export basket in 2012–2016 was overwhelmingly dominated by metals, minerals, and fuels. The main product group exported was ores and metals (54.3 per cent), followed by fuels (25.1 per cent), pearls, precious stones and gold (10.7 per cent), and agricultural raw materials (5.6 per cent). More specifically, copper ores (SITC 283), coal (SITC 321), and gold (SITC 971) were the three most exported products during the five-year period, accounting for more than two-thirds of the total.

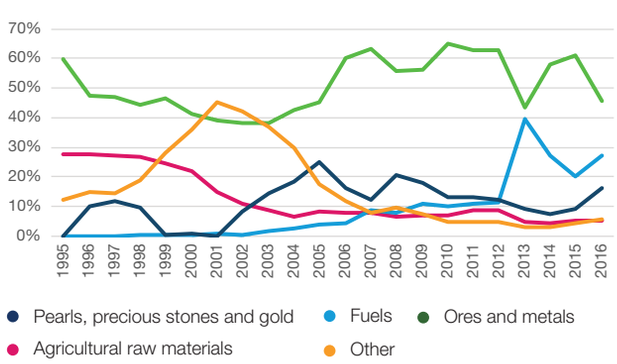
Ores and metals have been the dominant export of Mongolia in almost each year over the past couple of decades (figure 4.9). The exceptions were 2001 and 2002, when textiles and clothing was the sector that was most sold internationally (as reflected in the "other" category). The rise and fall of apparel exports from Mongolia was due to the circumstances under the global textiles and clothing quota system that ended on 1 January 2005. In particular, Mongolia had benefited from the quotas put in place by the United States, and their termination meant that Mongolia's exports dropped dramatically (Adhikari and Yamamoto 2007). However, more than the decline in the value of textiles and clothing exports, it is the surge of commodities exports that explains the pattern of trade in the figure. Above all, it is the production and export of petroleum oil that has taken off considerably over the past decade – a trend that seems likely to continue. Mongolia's concentration scores based on the Herfindahl-Hirschmann Index since 1995 (see figure 1.4 in chapter I) mirror the swings of textiles and clothing exports. At the beginning of the period, the score reached 0.48; it then declined to a low of 0.33 in 2002 and 2003 (i.e. indicative of greater diversification) before climbing again to an average score of 0.45 over 2012–2016.

Figure 4.8: Exports from Mongolia by product group, 2012–2016 (percentage)



Source: Unctadstat.unctad.org

Figure 4.9: Evolution of export structure in Mongolia, 1995-2016 (percentage)

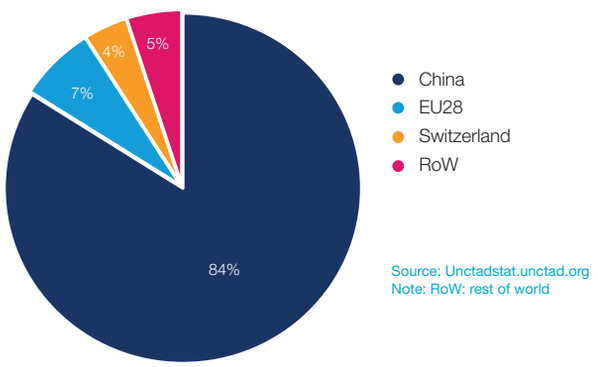


Source: Unctadstat.unctad.org

With respect to markets for Mongolia's exports, China is overwhelmingly the main destination, accounting for a full 84.2 per cent of all exports in 2012–2016 (figure 4.10). By contrast, the share of exports to Mongolia's second largest market – the European Union – was merely 6.7 per cent during the same five-year period. Switzerland was the third largest importing partner with 4.4 per cent of all exports, while the rest of the world accounted for 4.7 per cent.

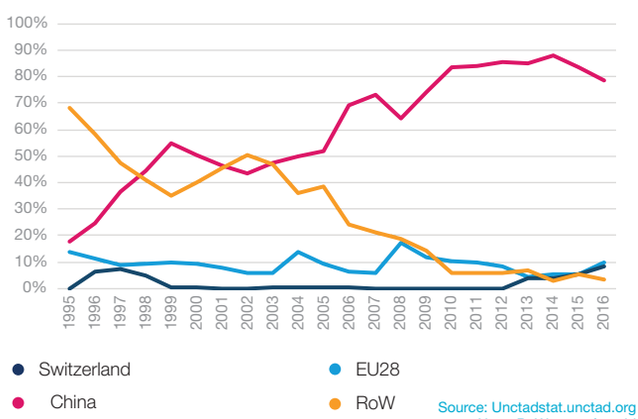
The importance of China as an importing partner has been on an upward trajectory since 1995 (figure 4.11). This stands in contrast to the evolution of exports to the rest of the world (excluding the European Union and Switzerland). In 1995, almost two-thirds of Mongolia's exports went to the Russian Federation, while US imports of textiles and clothing accounted for about one-quarter of international sales in 2000–2005. Other markets that have at one stage been notable destinations of Mongolia's exports include Japan (above 10 per cent in 1996–1997) and Canada (above 10 per cent in 2005–2006).

Figure 4.10: Main importers of Mongolia's exports, 2012–2016 (percentage)



Source: Unctadstat.unctad.org
Note: RoW: rest of world

Figure 4.11: Evolution of main importers of Mongolia's exports, 1995–2016 (percentage)



Source: Unctadstat.unctad.org
Note: RoW: rest of world

4.7.2. Prospects for product diversification

Earlier discussions in this chapter noted that three sectors not related to natural resources offer opportunities for economic and export diversification of Mongolia: agribusiness, manufacturing, and tourism. Based on its livestock and crop production, Mongolia has the potential to expand exports of meat and dairy products, especially to its two neighbors, China and the Russian Federation. However, productivity is low and needs to be improved by raising standards of animal health and hygiene and setting up cooperatives. In the case of manufacturing, it is notable that Mongolia is the world's second largest producer of cashmere, but that only one-third of it is produced domestically. The government should boost training of relevant stakeholders such as herders, develop a quality-grading system, and attract FDI by upgrading basic processing facilities. As for tourism, it already contributes 10 per cent of GDP, but it could be boosted further through measures to attract more FDI through better road and airport infrastructure, stepped up marketing efforts abroad, and establishment of a strong institutional framework to support tourism.

In terms of expanding Mongolia's existing exports (extensive margin), there seems to be potential above US$10 million in five different subsectors (figure 4.12). The greatest untapped potential is in products related to wool and animal hair (fabric) (US$32.9 million), including fine animal hair, not carded/combed, nes (HS 510219), and cashmere, not carded/combed (HS 510211). Nuts is another subsector where Mongolia has considerable untapped potential (US$20.3 million), Mongolia is a large producer and consumer of pine nuts. The other notable subsectors with high untapped export potential are meat (except poultry) (US$17.8 million, primarily equine meat – HS 020500); other metals (US$16.2 million, primarily copper cathodes); and apparel (US$10.8 million, including jerseys, pullovers & similar, of cashmere, knit/crochet – HS 611012).

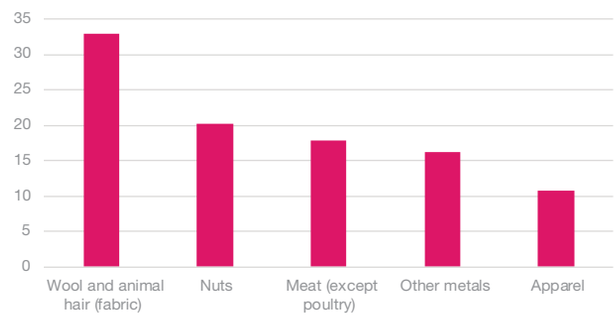
There are several different markets where Mongolia has extensive opportunities to expand exports. In the case of wool and animal hair (fabric), Italy is the importing economy with the highest market potential (US$12.4 million). Sri Lanka, Viet Nam, and Taiwan Province of China have been identified as particularly favorable markets for Mongolian nuts (US$3.6 million, US$2.7 million and US$2.2 million, respectively). The largest potential market opportunity for copper cathodes is Indonesia (US$7.5 million). Neither Switzerland, Belgium, nor France import equine meat from Mongolia, but they offer considerable market potential (US$5.6 million, US$4.1 million and US$3.2 million, respectively).

Interestingly, the Chinese market seems saturated from the perspective of Mongolia's existing export basket, with few products offering only limited export potential.

In a report prepared for UNCTAD, Dalrai (2014) finds that there are opportunities for Mongolia to hook into regional and global value chains in the coal and copper sectors. In order for Mongolia to take advantage of these growth opportunities, however, it is argued that the country needs to improve its transportation network and infrastructure, primarily with respect to railways. Other measures Mongolia could implement to facilitate participation in commodity value chains would be to build electricity plants close to large mining projects, address shortages in human skills and financial capital, and promote the processing of primary products.

Within the intensive margin, sheep cuts in various forms seem to be one of main opportunities for diversifying Mongolia's export basket, with Germany and Taiwan Province of China among the potential markets (table 4.3). The capabilities of Mongolia also suggest that the product group comprised of dried leguminous vegetables, including legumes nes, dried & shelled (HS 0713Xb) and beans "Vigna munga or Vigna radiata", dried & shelled (HS 071331), has export diversification potential, in particular to India and Indonesia. Different types of textiles and clothing constitute a third product group where there are opportunities to diversify Mongolian exports, including in greasy shorn wool, not carded/combed (HS 510111), and cotton, not carded/combed (HS 520100), with China a potentially important market.

Figure 4.12: Export potential of Mongolia by product group (in millions of US dollars)



Source: International Trade Centre, Export Potential Map (exportpotential.intracen.org)

4.8. Conclusion

Although blessed with ample mineral resources, Mongolia has been struggling to convert its mineral endowment into economic development. The government's resource nationalism and resulting disputes in mining project negotiations have deterred foreign mining companies and left much of the reserves unexplored and unexploited. Mongolia has also indulged in fiscal profligacy, spending mineral rents for wasteful social transfer programmes instead of implementing measures to promote economic diversification and development. Lack of fiscal discipline has resulted in serious macroeconomic instability and triggered

Table 4.3. Top 10 product diversification opportunities for Mongolia

Rank	Product	HS code	Top three markets
1	Sheep cuts bone in, frozen	020442	China, Taiwan Province of China, Saudi Arabia
2	Legumes nes, dried & shelled	0713Xb	India, Indonesia, China
3	Greasy shorn wool, not carded/combed	510111	China, Taiwan Province of China, Czech Republic
4	Sheep cuts boneless, frozen	020443	Taiwan Province of China, Germany, Russian Federation
5	Sheep cuts boneless, fresh	020423	Switzerland, Germany, Japan
6	Flours of fish and crustaceans	230120	Indonesia, Viet Nam, China
7	Beans "Vigna mungo or Vigna radiata", dried & shelled	071331	Indonesia, India, Viet Nam
8	Sesamum seeds	120740	Republic of Korea, Taiwan Province of China, China
9	Molluscs and other aquatic invertebrates	03XXXX	Taiwan Province of China, Viet Nam, Japan
10	Cotton, not carded/combed	520100	Indonesia, Viet Nam, China

Source: International Trade Centre, Export Potential Map (exportpotential.intracen.org)

Dutch disease, making non-extractive sectors uncompetitive and unattractive to FDI. Various obstacles to doing business, such as poor transport and power infrastructure and weak institutions, add to the difficulty of diversification.

A particular problem in Mongolia is the concurrent needs to restrain fiscal spending to stabilize the macro-economy and contain Dutch disease, on the one hand, and to increase public investment in infrastructure and other potential sectors to promote development and diversification, on the other. The authorities should prioritize fiscal consolidation. Stabilizing macroeconomic conditions and limiting Dutch disease effects are essential to keeping the non-extractive sector competitive and attracting FDI. Concurrently, the government should allow more foreign mining projects in order to generate more mineral revenues. Much of these revenues should be saved in a sovereign wealth fund to shield the economy from volatility and prioritize projects that can boost economic development and diversification in the long term. Even as mineral revenues grow, the authorities need to select public investment projects carefully based on cost-benefit analyses and feasibility studies, so that those projects do not involve over-spending.

Despite numerous difficulties, Mongolia's near-term prospects are bright. With multiple new mining projects planned, the flow of income from minerals is expected to increase. If Mongolia can manage the increased revenues prudently and further improve the investment climate, FDI is likely to increase, given the ample potential in the agriculture, light manufacturing (i.e. fiber processing), and tourism sectors and the country's strategic location between China and the Russian Federation. With fiscal discipline and a better institutional setting, Mongolia has the potential to become one of the fastest growing countries in the world.

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BHUTAN

V. BHUTAN

5.1. Introduction

Bhutan is a small, landlocked country in the eastern Himalayas situated between India and China. The country is almost entirely mountainous; the southern border with India is at an elevation of around 300 meters above sea level, and the northern border with China is more than 7,500 meters above sea level (ADB 2013). Limited access to the global market, together with the rugged terrain that constrains infrastructure development, poses a significant challenge to the country's development and diversification. Tense diplomatic relations with China, moreover, constrain the country's ability to overcome its reliance on India. India was the destination of 94 per cent of Bhutan's exports and the origin of 79 per cent of imports in 2012.[85] India also accounted for 93 per cent of net capital inflows in the 2014–2015 fiscal year.[86]

Despite its challenging geographical situation, Bhutan has been experiencing strong growth. Growth in 2000–2011 averaged 8.6 per cent, and though the economy slowed in 2012–2013, growth has bounced back to around 6 per cent since 2014.[87] Thanks to this rapid growth, Bhutan's GDP per capita reached about US$8,500 international dollars in 2016, more than tripling since 2000.[88] With income rising, the poverty rate decreased from 23 to 12 per cent between 2007 and 2012.[89] While Bhutan is endowed with some mineral resources and timber, the main driver of growth has been hydro-power projects largely financed by India. Bhutan currently exports about 80 per cent of the power it generates to India, and multiple large hydro-power plants are under construction to meet increasing electricity demand from its energy-hungry neighbor (ADB 2013). The booming capital spending associated with hydropower-related construction has driven economic growth.

However, volatility of foreign aid inflows related to hydro-power projects has created macroeconomic instability. Large and cyclical aid inflows financing hydro-power development have overheated the economy, which has translated into a large current account deficit and pressure on international reserves. The result was a balance of payments crisis in 2011–2012, known as the "rupee crisis." Today, with new projects nearing completion and hydro-power revenue slated to increase, Bhutan must improve its management of fiscal and monetary policies to restore macroeconomic stability.

Despite severe geographical limitations, Bhutan enjoys an advantage over its peers because of its unusually strong institutions for a developing country. While the country's overall ranking on the 2016–2017 Global Competitiveness Index was only 97th out of 138 economies, Bhutan ranked 33rd in terms of institutions, above India (42nd), China (45th), Kazakhstan (49th), Republic of Korea (63rd), and Bangladesh (125th) (WEF 2017). Control of corruption is strong, rule of law is established, and violence is rare (section 5.4). Politically, Bhutan transitioned from an absolute monarchy to a constitutional monarchy with parliamentary democracy in 2008, and accountability is gradually increasing (ADB 2013). Strong institutions reduce the risk of doing business and encourage investment. Famous for its pursuit of its measure of "Gross National Happiness" (GNH), Bhutan aims for inclusive and sustainable socio-economic development and preservation of culture and the environment.

However, growth led by capital-intensive hydro-power has resulted in high inequality and youth unemployment. To promote inclusive development and ensure stability, Bhutan needs to diversify into more labor-intensive sectors. Tourism is the most promising candidate for diversifying Bhutan's exports. The sector has significant implications for reducing chronically high youth unemployment in urban areas. Tourism can also support agriculture and manufacturing if tourists purchase locally produced goods such as traditional handicrafts. Most of the population is employed in agriculture, and that sector also has some potential for growth in niche areas such as mandarin oranges and cardamom, but cannot be a major source of diversification due to limited arable land and rugged landscapes.

85. Authors' calculations based on the UN Comtrade database.

86. Authors' calculations based on RMA (2017b).

87. Authors' calculations based on World Bank, World Development Indicators.

88. Adjusted for purchasing power parity. World Bank, World Development Indicators

89. Poverty headcount ratio at the national poverty line. World Bank, World Development Indicators.

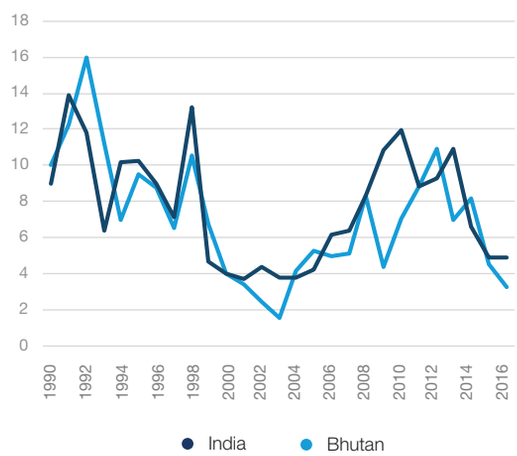
5.2. Macroeconomic management of hydro-power

5.2.1. Macroeconomic stability

The hydro-power sector provides huge development opportunities for Bhutan. The potential of the sector is estimated at 30,000 megawatts, out of which 1,606 megawatts are already operational and an additional 3,153 are coming on line in 2018 (World Bank 2015b). The hydro-power projects are implemented with India mainly through an inter-governmental model, under which the government of India finances the construction in the form of loans and grants. When the power plants start operating, all the electricity generated in surplus of domestic consumption is exported to India, through which Bhutan's debts are serviced automatically. Nonetheless, the electricity tariff for export is determined such that it guarantees a net return of 15 per cent to the Bhutanese government above debt repayment and operating cost (World Bank 2015b; Kojo 2015). Hydro-power drives Bhutan's economy. In 2012, electric current accounted for 32 per cent of total exports, the largest share among Bhutan's export products.[90] Yet, so far, the primary driver of Bhutan's growth has not been the export revenue from hydro-power itself, but rather the construction activities associated with hydro-power projects. Because of the high capital spending associated with hydro-power projects, Bhutan's gross domestic investment stood at 50 per cent of GDP in 2016.[91]

The bulky and volatile nature of hydropower-related investments poses a significant challenge to maintaining macroeconomic stability (Box 5.1). The government of India releases its funds on a "pay-as-you-go" basis in accordance with the progress of construction, such that the size of each year's fund release is equal to the amount spent on hydro-power development. Therefore, capital inflows surge during the construction phase, and decline sharply as soon as the projects are completed. Furthermore, Bhutan has no financial means to manage the cyclicality. While Bhutan's fiscal rule requires running a balanced budget on operating expenses and income, all the financial inflows associated with hydro-power development (receipt of grants and loans as well as capital expenditure towards construction) are kept off-budget, and hence are not subject to the fiscal rule. Thus, fiscal policy becomes unintendedly expansionary during construction phases. In recent years, adding quasi-fiscal spending from hydro-power construction increased the public sector deficit by up to 6 per cent of GDP over the official budget balance. Monetary policy, on the other hand, is used to maintain the one-to-one peg of the Bhutanese ngultrum to the Indian rupee, and hence it cannot function as a stabilization tool (World Bank 2015b; Kojo 2015). As figure 5.1 shows, Bhutan's inflation closely follows that of India.

Figure 5.1: Inflation in Bhutan and India (consumer prices, annual percentage change)



Source: World Bank, World Development Indicators

In the buildup to the balance of payments shock in 2011–2012[92], massive off-budget investments overheated the economy. Prior to and during the crisis, new hydro-power plant construction led a surge in capital inflows to about 20-30 per cent of GDP during the startup of new hydro-power plant construction (World Bank 2015b). The foreign-financed, quasi-fiscal spending boosted aggregate demand, pushed up domestic prices of non-tradables (including labor and land), and created a real estate bubble. Real interest rates fell as inflation rose faster than nominal interest rates, and rapid credit expansion followed. Between 2001 and 2012, credit to the private sector expanded by 34 per cent per year on average. The overheating placed a tremendous pressure on the external accounts. On the financial account, rapid credit expansion translated into greater demand for rupee borrowing, offsetting surpluses from hydropower-related capital inflows. The current account deteriorated to

90. Ferroalloy was the second, and accounted for 24 per cent. Authors' calculations based on the UN Comtrade database.

91. World Bank, World Development Indicators.

92. As a result, the authorities had to resort to short-term liquidity financing from India to meet import needs and pay back hydro debts. The high interest rate charged on short-term rupee borrowing strained the external account further. During 2011–2012 alone, debt service on the short-term facilities was equivalent to 120 per cent of exports of goods and services (Kojo 2015).

nearly 25 per cent of GDP in 2010–2011 due to booming aggregate demand pushing up demand for imports of consumer goods and to increasing imports of construction materials and fuels for hydro-power projects (World Bank 2015b; Kojo 2015).

By November 2011, Bhutan almost ran out of rupee reserves, leading to the "rupee crisis" of 2011–2012. In response, the Royal Monetary Authority (RMA) of Bhutan, the nation's central bank, introduced a number of exchange controls on holdings of Indian rupees. The capital controls not only undermined the credibility of the fixed exchange regime, but also caused price hikes of imported food items. To make matters worse, the policy response to the crisis was not adequate. While the RMA acted to tame credit growth, the Ministry of Finance could not tighten fiscal policy, as it continued to focus solely on keeping the official budget deficit, which, as noted previously, excludes hydropower-related expenditures, thus ignoring the root cause of the problem. Large-scale hydro-power investment thus continued to fuel aggregate demand (Kojo 2015). Due to the resulting shocks and instability, economic growth slowed from 7.9 per cent in 2011 to 5.1 per cent in 2012 and just 2.1 per cent in 2013.[93]

With many projects in progress or coming on line, Bhutan urgently needs to establish a mechanism to limit the volatility of hydropower-related spending. Given that Bhutan has little scope for independent monetary policy (because of the currency peg), fiscal policy must take the role as a stabilizer. Three fiscal reforms are recommended.

First, hydro-power development expenses need to be brought on budget. This will enable clearer assessments of the stance of fiscal policy.

Second, a new fiscal rule needs to be introduced such that overall fiscal expenditures (including hydro-power investments) are smoothed over time. Under the new fiscal rule, non-hydropower public expenditures must function as a countercyclical tool, reducing expenditures in periods when major hydro-power dams are under construction and increasing them when hydropower-related spending declines (World Bank 2015b).

Third, Bhutan needs to implement a mechanism for saving excess revenues, such as a sovereign wealth fund. This is especially important because hydro-power revenue was expected to increase dramatically starting in 2018, as new generation power plants started operating (Kojo 2015).[94] The current fiscal rule that focuses solely on balancing the operating budget cannot handle the prospective increase in revenue.[95] In order for a sovereign wealth fund (or other similar mechanisms for saving revenues) to function properly, the authorities must establish a strong governance framework to ensure strict adherence to fiscal rules and prevent the fund from being diverted to finance fiscal profligacy.

In the medium term, hydro revenue is expected to increase rapidly, and in response, there could be significant pressures to expand social spending and raise public sector wages. However, the authorities must deal with these pressures with caution and resist large increases in spending (IMF 2016). If the authorities fail to manage the increased revenue prudently, fiscal policy will become even more expansionary than it is now and sooner or later Bhutan will face more, and possibly more severe, macroeconomic instability.

Summary of policy recommendations:

- Bring hydro-power development expenses on budget.
- Introduce a new fiscal rule to smooth out fiscal expenditures over time.
- Let non-hydro public expenditures function as a countercyclical tool, i.e. reducing them in periods when hydro-related investment goes up, and increasing them in other periods.
- Establish a strong governance framework to ensure strict adherence to the new fiscal rule.
- Implement a mechanism for saving excess revenues, such as a sovereign wealth fund.
- Limit expansion of social spending and increases in public sector wages within non-expansionary levels.

93. World Bank, World Development Indicators.

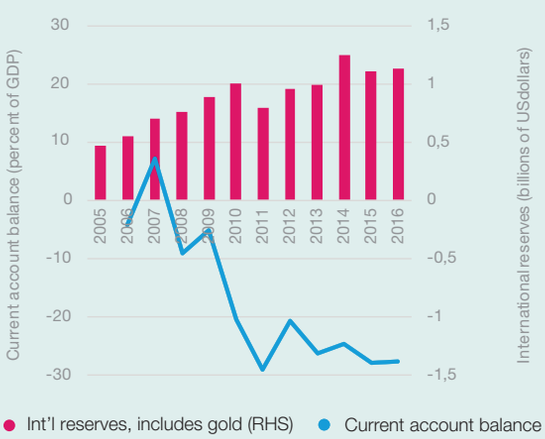
94. World Bank (2015b) estimates that electricity exports will rise more than 10-fold by 2025.

95. In addition, hydro-power revenues tend to fluctuate depending on the amount of rainfall, and require some smoothing out in general.

BOX 5.1 Are Bhutan's large current account deficit and external debt dangerous?

Because of imports of construction materials for hydro-power development, Bhutan's current account deficit has been at extreme levels, reaching nearly 30 per cent in recent years (figure 5.1.2). However, the large current account deficit is not dangerous by itself, because it is financed by large capital inflows associated with hydro-power development. In fact, as an overall trend, international reserves have been increasing gradually, despite large current account deficits.

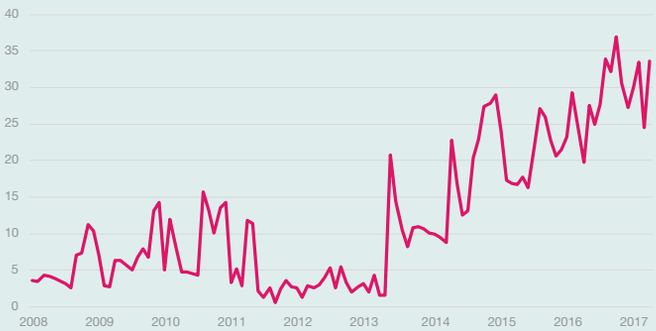
Figure 5.1.2a: Bhutan: Current account and international reserves



Source: World Bank, World Development Indicators

Yet, challenges encountered in reserve management combined with dependence on a single market (India) for trade and capital flows make the reserves prone to rupee shortages (as was the case with the "rupee crisis" of 2011–2012). The Indian rupee is not fully convertible, meaning that there are restrictions on converting major international reserve currency holdings like US dollars into rupees. In the rupee crisis, Bhutan's rupee reserves, which were at a very low level, failed to meet immediate demands created by bulky debt servicing for hydro-power projects and rising imports. While the share of imports and debt service denominated in rupees was about 80 per cent, the share of rupee-denominated assets in reserves was merely 5-15 per cent (equivalent to around US$40 million to US$140 million, or 0.5 to 2 months of imports from India) during the run-up to the rupee crisis (figure 5.1.2).[1]

Figure 5.1.2b Share of rupee-denominated assets in total reserves (percentage)



Source: Authors' calculations based on RMA (2017b)

Overall, the risk of rupee shortages increases when (1) the current account deficit reflects aggregate demand outpacing productive potential, and/or (2) domestic credit expands rapidly, financed by borrowing from India. Hence, the authorities must keep fiscal policy tight and refrain from overstimulating aggregate demand. At the same time, the Royal Monetary Authority of Bhutan (RMA) must strengthen its efforts to maintain the share of Indian rupees in reserves at a sufficient level, and implement other measures to improve its reserve management (e.g. making projections of rupee inflows and outflows for coming quarters).[2] The RMA has been increasing the share of rupee reserves since mid-2013, and as of May 2017, they constituted about 34 per cent of total reserves.[3] Nevertheless, IMF (2016) reports that the composition of reserves is still suboptimal.

1. The rupee crisis brought the share even lower to around 2.5 per cent (equivalent to around US$20 million or less than 0.3 months of imports from India) between 2011 and 2012. The share fell to a low of 0.6 per cent (US$5.7 million or 0.1 month of imports from India) in September 2011. Source: Authors' calculations based on RMA (2017b).

2. Recently, the RMA reached a swap agreement with the Reserve Bank of India (RBI), and is currently negotiating an arrangement with the RBI that would allow the RMA to convert US dollars into Indian rupees. Bhutan also plans to participate in the World Bank's Reserve Advisory Management Programme (IMF 2016). These agreements and actions will help mitigate the risk of renewed rupee shortages.

3. This is equivalent to US$354 million or 4.7 months of imports from India. Source: Authors' calculations based on RMA (2017b).

Bhutan's large external debt is not necessarily dangerous, either. External public and publicly guaranteed debt has been increasing steadily mainly because of hydropower-related lending, and reached 94.5 per cent of GDP in 2015 (IMF 2016).[4] However, given the commercial viability of hydro-power projects and explicit guarantees from India that cover financial and construction risks for all hydro-power projects, the risk of Bhutan's external debt distress remains moderate (World Bank 2015a; IMF 2016). Revenue from electricity sales will be more than enough to service all hydropower-related debts in the long term (World Bank 2015b). Nevertheless, Bhutan must make strong efforts to increase domestic tax revenues, as non-hydropower public expenditures are expected to grow in the future (as will be discussed in section 5.2.2 in this chapter).

4. As of March 2017, the total outstanding external debt was US$2,470 million (121.5 per cent of GDP), out of which 74 per cent was denominated in rupees. Source: Authors' calculations based on RMA (2017b).

Box 5.2. Currency peg to the Indian rupee: Implication for macroeconomic policies

Given that India is Bhutan's most important trade and development partner, the peg to the Indian rupee is appropriate, at least for now (IMF 2016). The peg can reduce transaction costs (such as financial risks for cross-border trades and businesses). After all, hydropower-related loans from India are denominated in the Indian rupee. Nevertheless, the peg necessitates careful management of the macro-economy. Loose fiscal policy can overheat aggregate demand and create another rupee shortage as consumption-related imports increase and domestic credit expands. Such a shortage would require re-implementation of capital controls, which are distortionary and harmful to the economy.

Furthermore, under fixed exchange regimes, high domestic inflation translates directly into real exchange rate appreciation. So far, Bhutan's inflation mostly has been kept in the single digits, and IMF (2016) assesses the ngultrum to be only mildly overvalued. Yet, if domestic inflation surges, the resulting real exchange rate appreciation could reduce the competitiveness of Bhutan's non-hydropower sectors, which are important for diversifying the country's economy.

5.2.2. Hydro-power and fiscal self-reliance

In addition to implementing a new fiscal rule to prevent procyclicality, Bhutan needs to increase its degree of fiscal self-reliance. Currently, foreign aid finances a large part of Bhutan's public investments, including hydro-power projects. The gap in self-reliance – the share of public investment not covered by government revenue – is currently about 15 per cent of GDP (World Bank 2015b). In addition to foreign financing of hydro-power projects, Bhutan relies upon grants and concessional finance from multilateral and bilateral donors for many other public investments. Hydro revenue is unlikely to eliminate the fiscal deficit. According to estimates by the World Bank (2015b), the gap in fiscal self-reliance is expected to decline for about the next 10 years to reach near zero, but over the long term it will start to widen again, returning to the current level by around 2030. This is because the increase in hydro revenue is expected to decelerate after around 2027–2028 (if no new projects come on stream), while the economy will keep growing and public investments will continue to increase. Nonetheless, Bhutan cannot continue to rely upon external grants from multilateral or bilateral donors (IMF 2016). As per capita rises income, Bhutan will no longer be eligible for many grants and concessional loans that it currently receives.

Thus, Bhutan must undertake tax reforms to strengthen domestic sources of government revenue. Bhutan's tax collection is low by international standards, and in recent years it has been declining relative to GDP (World Bank 2015b; IMF 2016). The cause of the decline is the increased use of tax expenditures (such as tax holidays and exemptions) that have been eroding the tax base, weakening tax compliance, and making tax administration burdensome (IMF 2016).[96] Sales tax exemptions, in particular, account for 50 per cent of foregone revenue (World Bank 2015b). The authorities are currently undertaking some reforms of the sales tax, with a goal of replacing the existing inefficient system with a simple, broad-based goods and services tax by 2018 (IMF 2016). The authorities must continue reforming the tax system and reassessing tax exemptions and incentives to increase the tax base, notwithstanding the expected increase in hydro-power revenue. IMF (2016) recommends avoiding new tax exemptions, not renewing expiring exemptions, and phasing out existing exemptions wherever appropriate, as well as listing and costing all tax expenditures on the budget in order to increase fiscal transparency.

Overall, the authorities must undertake tax reforms with long-term fiscal sustainability in mind, not just current levels of fiscal self-reliance. The authorities should not be deceived by a period of temporary improvement of fiscal self-reliance from revenues deriving from new hydro-power plants. Implementing fiscal rules, as was outlined in section 5.2.1, is also critical for achieving strong and sustainable fiscal self-reliance.

Summary of Policy Recommendations:

- Increase tax collection by reforming the sales tax and re-assessing tax exemptions.
- Avoid new tax exemptions, do not renew expiring exemptions, and phase out existing exemptions wherever appropriate,
- Increase fiscal transparency by listing and costing all tax expenditures on the budget.

5.3. Obstacles to private sector development

The capital-intensive hydro-power sector provides limited employment, and hence its benefit is limited only to a small part of the population. In order to achieve inclusive growth in line with the philosophy of the country's measure of GNH, Bhutan must develop growth drivers other than hydro-power. Given that large public investment programmes are not fiscally sustainable, job-creating growth must come from the private sector. In addition, fostering private enterprise will make the economy more resilient to the volatility of hydro-related capital investment, boost economic efficiency, and spur diversification.

To spur private sector growth, a business-friendly environment is essential. While Bhutan's overall rating on the World Bank's Doing Business Indicators is reasonable, there are some significant weaknesses. This section discusses the most important obstacles faced by the private sector – labor market skills, infrastructure, trade facilitation, access to finance, and regulation and licensing – and offers a few policy recommendations to address the issues.

96. Tax holidays and exemptions also distort incentives. For example, the current tax system discourages much-needed formal employment because it is more susceptible to taxation than (informal) self-employment (World Bank 2015b).

5.3.1. Skill mismatches and high youth unemployment

Skill mismatches constitute a critical constraint for development of a strong private sector and diversification beyond the hydro-power sector. While the youth of Bhutan are increasingly educated, many firms continue to identify lack of skills as an obstacle for doing business. In the most recent Enterprise Surveys by the World Bank (2015c), 14.4 per cent of firms identified an inadequately educated workforce as a major constraint. The number was particularly high in the hospitality and tourism sector (29.5 per cent) – Bhutan's most promising candidate as a diversification driver – while it was relatively low for the manufacturing sector (5.8 per cent).

Other evidence suggests that the lack of skilled labor also extends to professions like engineering, medicine, nursing, and teaching. Because of the shortage of domestic high-skilled workers, foreign technicians, mainly from India and Nepal, often fill the jobs requiring these skills (ADB 2013).[97] Skill mismatches are also reflected in high youth unemployment. While Bhutan enjoys low overall unemployment (just 2.6 per cent in 2014), youth unemployment was quite high at 9.7 per cent in 2014 (IMF 2016). Youth unemployment is particularly high in urban areas, and includes many educated youths. About 25 per cent of the urban unemployed have some secondary education, and a further 25 per cent have tertiary education (ADB 2013).

However, the skill mismatches stem less from deficiencies in the educational system than from a deeper "motivation mismatch" – most educated youth want to work in the public sector and are not interested in taking private sector jobs. In a recent survey, nearly three-quarters of those unemployed responded that they want to work in the public sector (World Bank 2015b). Public sector jobs typically offer higher salaries, better job security, and more prestige than private sector jobs.[98] In addition, benefits such as old-age pensions are largely unavailable outside the public sector (World Bank 2015b; IMF 2016). Thus, many youths do not pursue skill acquisition for the private sector jobs that are available, and continue to queue for highly competitive public sector jobs.

In order to achieve private-sector-led diversification, the authorities must align public sector compensation with that of the private sector. While there have been significant political pressures to raise civil servant salaries and to increase the number of public sector jobs, the authorities must keep compensation growth in the public sector in line with that of the private sector, and the public sector must be expanded only in very compelling cases. Such an expansion would risk not only overheating the economy (through increased government expenditure) but also distorting the labor market and undermining the competitiveness of Bhutan's private sector in two ways (World Bank 2015b).

First, if the public sector offers better salaries, benefits, and job security, talented youth will choose to go into the public sector, and the private sector will be crowded out in the labor market.

Second, compensation increases in the public sector (or through public sector expansion) will put upward pressure on private sector compensation, pushing up labor costs for private firms. At present, vacancies in the private sector point to the existence of such crowding-out effects. Aligning public sector compensation (and non-monetary incentives) with the private sector will incentivize a greater number of talented youth to acquire skills demanded in the private sector, and alleviate skill mismatches.

At the same time, the authorities must promote private sector development and spur productivity growth, which will raise private sector wages without undermining competitiveness,[99] and help close the pay gap between the public and private sectors. This is important because an attempt to cut public sector compensation will almost certainly face strong opposition. Rapid private sector growth, on the other hand, can induce faster private sector wage growth and close the compensation gap without political tensions. The government can actively foster private sector growth in two ways.

First, it can support private sector growth through outsourcing, procurement, and other public-private

97. Foreign workers also fill jobs requiring manual labor, which the locals are unwilling to take. The construction phase of hydro-power projects is labor-intensive, but only about 20 per cent of construction workers are Bhutanese citizens (IMF 2016). Overall, foreign workers accounted for 16 per cent of total employment in 2010 (ADB 2013).

98. World Bank (2015b) statistically analyses the difference of the pay between the public and private sectors, and finds that, even when controlling for characteristics like education and job types, the pay is higher in the public sector across most of the earnings distribution. The pay gap is as high as 20 per cent for a sizable share of the public sector workforce.

99. If wages rise at the same speed as productivity, unit labor costs remain constant and competitiveness stays the same

partnerships (PPPs).[100] This would be effective for sectors such as information technology services and infrastructure maintenance.

Second, it could support the development of small- and medium-sized enterprises (SMEs). Improving access to finance for such firms would be an important step towards achieving this (see section 5.3.4). In addition to aiming at raising private sector wages, the authorities should create a labor code to improve working conditions in the private sector (World Bank 2010a). Poor employment conditions (e.g. long hours, lack of paid leave) are one reason why educated youth prefer to work in the public sector.

In combination with reducing the compensation gap between the public and private sectors, the authorities should continue to support skill acquisition by Bhutanese youth through more training opportunities. ADB (2013) identifies limited access to vocational education as a problem. Enrollment in technical training institutes doubled from 2011 to 2013 thanks to the authorities' efforts, but it remains at only about 1 per cent of secondary education enrollment.[101] The authorities have been implementing many programmes to increase enrollment in tertiary and vocational education, and they should continue their efforts.[102] In addition, the authorities need to revise vocational courses and programmes such that their curriculum better matches private sector needs. World Bank (2010a) reports that the vocational courses offered are often not relevant for industry, and that some areas with strong industry demand are not covered by any courses. Private sector voices need to be consulted when creating a curriculum. The authorities may also consider greater utilization of PPPs in education to augment quality and cost-effectiveness.[103]

While the above reforms need to be pursed urgently, none of them can address the shortage of skilled labor in the short term. Therefore, in order to meet the immediate needs of the private sector, the authorities must also consider relaxing restrictions on employment of foreign skilled workers. Shortages of well-educated workers can severely constrain the development of important sectors like tourism and information and communications technology (ICT).

Summary of policy recommendations:

Align public sector compensation with that of the private sector by:

- Keeping the growth of compensation in the public sector in line with that of the private sector.
- Continuing to support skill acquisition by Bhutanese youth.

Spur productivity growth to raise private sector wages by:

- Utilizing outsourcing, procurement, and other PPPs to support sectors such as ICT services.
- Supporting the development of SMEs, for example by improving their access to finance.
- Improving working conditions in the private sector by creating a labor code.

Provide more training opportunities and improve access to vocational education by:

- Revising courses and programmes such that the curriculum better matches private sector needs, and, towards this end, consulting private sector voices when creating a curriculum.
- Considering more use of PPPs in education to augment quality and cost-effectiveness.

5.3.2. Transport infrastructure

Bhutan's poor infrastructure poses a serious obstacle to development. An inadequate road network limits access to markets for rural residents as well as cross-border trade, while the lack of modernized air transport infrastructure is a constraint to the development of Bhutan's tourism sector.[104] Bhutan's telecommunications infrastructure remains inadequate as well. The country's rugged terrain makes infrastructure projects costly and difficult, while small market size limits their profitability. This section first discusses Bhutan's road network, and then moves to air infrastructure.

100. Nevertheless, these policies need to be designed carefully. In a small country like Bhutan where competition is limited, outsourcing and procurement can end up cost-inefficient and expensive if poorly designed. See World Bank (2015b) for more discussion.

101. Authors' calculations based on NSB (2016b).

102. Nevertheless, it should be emphasized that providing more training opportunities alone does not solve the problem. Unless the underlying motivation mismatch is addressed, enrollment in vocational education will remain low and the problem will persist.

103. See World Bank (2015b) for more discussion.

104. There is no railway transport in Bhutan, which would be expensive to build given the country's mountainous terrain.

Bhutan's road network is limited in coverage and quality, though it is rapidly improving. In the 2016–2017 Global Competitiveness Index, Bhutan's road infrastructure ranked 80th out of 138 countries (WEF 2017). The poor road infrastructure is an impediment both to improving the ease of doing business and ensuring inclusive growth: 30.1 per cent of firms in the hospitality and tourism sector and 21.4 per cent of manufacturing firms identified transportation as a major constraint to doing business (World Bank 2015c). Highways are generally narrow, steep, and curvy, since they are built along land contours with a minimum number of bridges due to difficult topography and lack of resources (ADB 2013). Transportation costs are high, and landslides and adverse climate conditions such as heavy snowfall make road transport unreliable, undermining Bhutan's competitiveness. Low rural connectivity is also a challenge for rural development and inclusive growth. Almost 25 per cent of farm roads are considered to be in very poor condition (such roads total 5,375 km and constitute about half of Bhutan's road network) (ADB 2014b).

Nonetheless, Bhutan has been making a rapid progress in improving road infrastructure. Between 2007 and 2012, travel time to the nearest asphalt road on foot fell by about 75 per cent, and travel time to market declined by more than 50 per cent. In particular, in the Eastern region – the least developed part of Bhutan – average travel time to market fell from about one hour in 2007 to less than 30 minutes in 2012 (ADB 2013). New highways to increase the connectivity of various regions are also under construction (ADB 2014b). Bhutan should continue the development of its road network, as funding permits.

More important for successful development of tourism would be to improve air transport infrastructure. Currently Bhutan has only one international airport – Paro International Airport (PIA). PIA is in a deep valley near the capital of Thimphu in the western region, 2,200 meters above sea level and surrounded by peaks reaching up to about 5,500 meters. The airport lacks instrument landing facilities, and the approach into Paro is by visual flight rules. Hence, operations of the PIA are limited to daylight hours, and disruptions due to adverse weather conditions are frequent. Further, the capacity of PIA and related facilities is insufficient to accommodate an increase of international passengers during peak seasons (ADB 2013, 2014b). The ADB estimates that, in the absence of capacity constraints, total annual air passenger traffic at PIA will increase to 491,200 passengers by 2020 and 915,100 passengers by 2030 compared to 181,659 passengers in 2012 (ADB 2014b). In order to accommodate strong tourism growth, the authorities need to expand the capacity and facilities at PIA, in particular safety and navigation equipment and structures, while ensuring optimum operation of runways and other facilities.

In parallel with expanding the PIA, the authorities should continue to augment domestic air transport capacity. Due to inadequate domestic air connectivity, the tourism industry is much less developed in the central, southern, and eastern regions than in the west, where the PIA and the capital are located (ADB 2013). Increasing connectivity to these regions is essential to spread the benefits of tourism more widely across the country. The authorities recognize this need, and they have inaugurated three new domestic airports: Yonphula in the east, Bumthang in the central region and Gelephu in the south (ADB 2013, 2014b). They should continue to rapidly develop the airports to ensure reliable and safe operations. Besides improving physical infrastructure, ADB (2014b) points to the need to enhance staff training and skill upgrading, as well as to strengthen the regulatory framework for effective oversight of flight operations and airfield regulation.

While there is a significant need to expand and improve overall transport infrastructure, however, the authorities should be careful not to overspend. Like Mongolia, Bhutan needs to strike a balance between developing strong infrastructure and preventing procyclical fiscal policy. As with Mongolia, Bhutan should prioritize the maintenance of macro-economic stability (by saving excess hydro-power revenue) over rapid infrastructure development. In fact, public investment in infrastructure can smooth fluctuations of hydropower-related investment. The authorities should lower infrastructure spending when hydro-power expenditures are high, and increase it in other times (see section 5.2). In sum, the Bhutanese government should avoid making its fiscal policy too loose, and infrastructure development should be pursued within that parameter, with careful prioritization and planning.

Summary of policy recommendations:

Road transport

- Continue the development of the road network so long as it does not risk making the budget too expansionary.

Air transport

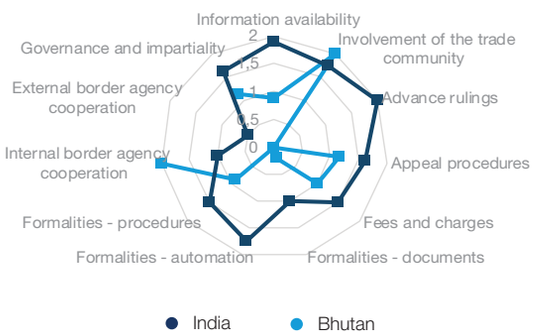
- Expand the capacity and facilities at the PIA, in particular safety and navigation equipment and structures, and ensure optimum operation of runways and other facilities.
- Continue to augment domestic air transport capacity and invest in three major domestic airports.
- Provide more staff training and enhance the upgrading of skills.
- Strengthen the regulatory framework for effective oversight of flight operations and airfield regulation.
- Prioritize macro-economic stability over infrastructure development, and refrain from overspending on it.
- Use public investment in infrastructure to smooth out the fluctuation of hydropower-related spending.

5.3.3. Trade facilitation

Given Bhutan's geographical isolation and small domestic market size, excellent trade facilitation is essential for the country to participate in global value chains and create new trade ties beyond India. However, Bhutan's performance in trade facilitation is mixed.[105] While Bhutan is ranked 26th on the Doing Business Indicators (World Bank 2017) in trading across borders, its performance on the Organisation for Economic Co-operation and Development's Trade Facilitation Indicators is uneven, with particular weaknesses in areas such as custom formalities and advance rulings (figure 5.4). Bhutan also needs to improve aspects of trade facilitation and logistics other than customs procedures. The country scores poorly for every indicator on the World Bank's Logistics Performance Index – infrastructure in particular, but also logistics competence – and thus ranks 135th out of 160 countries.

Four reforms are recommended in the area of customs procedures. First, the procedures should be streamlined by reducing the number of documents required and harmonizing them with international conventions. Second, customs procedures should be automated and risk management introduced. Automation will require improving the quality of telecommunications and IT systems. Third, certain new customs procedures should be adopted, including pre-arrival processing of import documentation, accelerated controls for perishable goods, and advance rulings. Finally, the country should pursue assistance from international institutions to help develop a Single Window, which would also help to improve information availability.[106]

Figure 5.4: Trade facilitation in Bhutan and India



Source: Organisation for Economic Co-operation and Development, Trade Facilitation Indicators
Note: Data for 2015

Aside from improving customs procedures, Bhutan needs to improve overall logistics competence. Expanding logistics-related facilities (e.g. logistics centers and dry ports) is essential. Also important for improving the freight movement is to resolve traffic congestion at major border crossing points to India by constructing new roads that bypass existing routes and by building dry ports that support them (ADB 2014b). Finally, promoting greater use of ICT will also help improve the logistics performance.

Summary of policy recommendations:

Customs procedures

- Streamline customs procedures by reducing the number of documents required and harmonizing them with international standards.
- Automate customs procedures and introduce risk management.
- Adopt modern customs procedures such as pre-arrival processing of import documentation, accelerated controls for perishable goods, and advance rulings.
- Seek assistance from international institutions for the development of a Single Window.

105. Different sources provide different pictures of Bhutan's trade facilitation, such as the time required to prepare documents for exporting and importing. According to the Doing Business Indicators of the World Bank (2017), Bhutan's performance is quite close to the international best practice, whereas on the OECD's Trade Facilitation Index, Bhutan compares rather poorly to its peers. In Enterprise Surveys, Bhutan's performance is about the same as the South Asia average (World Bank 2015c). The disparity must have stemmed from methodological differences, but it is not easy to ascertain exactly which ones. Still, all measures show there is clear room for improvement.

106. OECD, Trade Facilitation Indicators, available at http://compareyourcountry.org/trade-facilitation (accessed on 5 August 2018).

Logistics performance

- Expand logistics-related facilities (e.g. logistics centers and dry ports).
- Resolve traffic congestion at major border crossing points to India by constructing new roads that bypass existing routes and building dry ports that support them.
- Promote greater use of information and communications technology.

5.3.4. Access to finance

Improving access to finance for SMEs is important for spurring private sector growth in Bhutan, but the country presents a mixed picture in this regard. According to the 2105 Enterprise Survey, access to finance in Bhutan is consistently better than in other South Asian countries (table 5.1) but nonetheless is reported as the top constraint to doing business in the country, with 16.4 per cent of firms in Bhutan identifying it as a major constraint.[107] The difficulty is felt especially among manufacturing firms, 28.2 per cent of which identified access to finance as a major obstacle (World Bank 2015c). While access to credit is relatively high – 46.5 per cent of firms have a bank loan or line of credit – real interest rates are also high (though gradually coming down recently), and the spread between lending and deposit rates is large, reflecting inefficient financial intermediation (figures 5.5 and 5.6). While there is no "silver bullet" for solving the issue, five measures could help ease SMEs' access to finance.

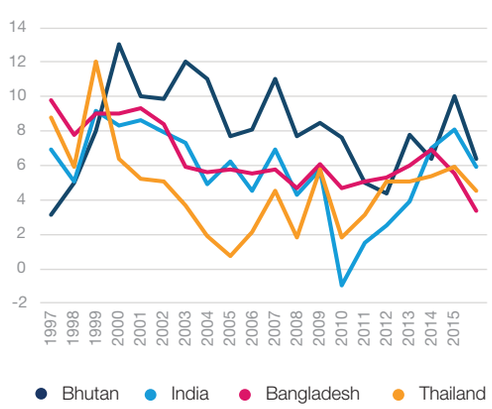
First, credit information needs to be made more available. Currently Bhutan's financial institutions depend on collateral-based lending with high interest rates. According to the most recent Enterprise Survey, 94.5 per cent of all loans required collateral in Bhutan, compared to the regional average of 81.1 per cent (World Bank 2015c). Collateral-based lending does not take into account creditworthiness of borrowers in determining terms and conditions, and hence results in inefficient financial intermediation and high interest rates for borrowers. Improving the availability of credit information makes it easier for lenders to assess the creditworthiness of borrowers, and thus encourages adoption of modern, risk-based lending (World Bank 2010a). Bhutan has been making significant progress with respect to enhancing the sharing of credit information. The country launched its first credit information bureau in 2009 and a public credit registry in 2012, then implemented additional regulations to improve access to credit information in 2014. Thanks to these reforms, Bhutan's performance for getting credit jumped from 176th among 183 economies in the 2011 Doing Business Indicators to 109th among 189 economies in the 2014 Doing Business Indicators (World Bank 2010b, 2013).[108] The authorities should continue efforts to enhance both coverage and accessibility of credit information systems in order to improve the efficiency of financial intermediation.

Table 5.1 Depth of financial sector outreach in Bhutan and South Asia: Selected indicators from the 2015 Enterprise Surveys (percentage)

Indicator	Bhutan	South Asia
Share of firms with a checking or savings account	93.3	77.6
Share of firms with a bank loan/line of credit	46.5	27.0
Share of firms using banks to finance investments	32.2	21.8
Share of investments financed by banks	18.9	14.4
Share of firms using banks to finance working capital	42.0	25.0
Share of firms using supplier/customer credit to finance working capital	5.5	14.5
Share of working capital financed by banks working capital	25.9	12.4
Share of firms identifying access to finance as a major constraint	16.4	26.5

Source: World Bank Enterprise Surveys

Figure 5.5: Bhutan and neighbors: Real lending interest rates (percentage)

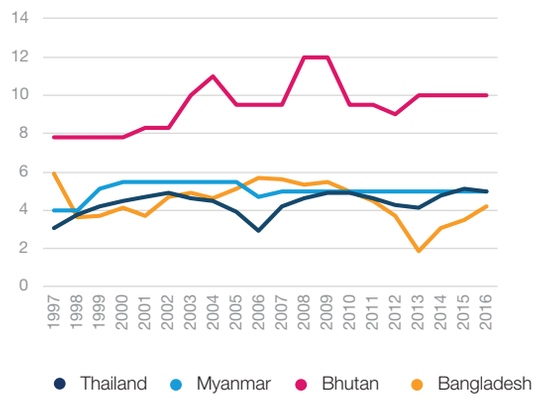


Source: World Bank, World Development Indicators

107. Nevertheless, this is far lower than South Asia average, which was 26.5 per cent.

108. The rankings for getting credit are not comparable between years before and after 2015 due to methodological changes. That being said, Bhutan's current getting credit ranking is 82nd out of 190 countries (World Bank 2017).

Figure 5.6: Bhutan and neighbors: Spreads between loan and deposit interest rates (percentage)



Source: World Bank, World Development Indicators

Second, the authorities should facilitate the streamlining of loan application procedures, which are reported to be confusing, rigid, and lacking in transparency (World Bank 2010a). Such documentary and procedural constraints tend to affect small-scale borrowers disproportionally (ADB 2013). Also underlying the issue is the limited capacity of staff at financial institutions (World Bank 2010a). In addition to urging banks to simplify procedures and improve customer service, the authorities should promote skill development in the financial sector, for example by promoting more training opportunities and improving the quality of training institutes for banking and finance.

Third, competition should be promoted by allowing foreign banks into the market. In 2010, two new domestic banks (Druk PNB and T-Bank) started operating, in addition to three existing ones, and yet competition in the market remains limited and lenders continue to set high spreads (ADB 2013). Allowing entry of foreign banks (beyond the existing Indian ones) would spur competition and improve the efficiency of financial intermediation, bringing interest rates down for borrowers and incentivizing provision of more banking products.

Fourth, credit-risk guarantee facilities need to be established for SMEs. Providing public-private partial loan guarantee schemes can promote lending to SMEs by sharing risks. In addition, there are other measures that could be undertaken to encourage longer-term lending to SMEs, such as the creation of credit line facilities to financial institutions specifically for this purpose (World Bank 2010a; ADB 2013).

Finally, the use of ICT in the financial sector needs to be facilitated, including through the development of electronic payment system infrastructure and mobile banking (World Bank 2010a; ADB 2013). These services can spread access to finance more widely, especially in rural areas, and thus promote inclusive growth. Given the relatively high usage of ICT among firms (including SMEs), greater use of ICT in the financial sector could be an effective way to alleviate the financial constraints on SMEs.

Summary of policy recommendations:

- Continue to improve the availability of credit information to encourage modern, risk-based lending.
- Facilitate streamlining of loan application procedures.
- Promote skill development in the financial sector, for example by providing more training opportunities and by improving the quality of training institutes for banking and finance.
- Spur competition by allowing foreign banks into the market.
- Establish credit-risk guarantee facilities for SMEs.
- Implement any other measures to encourage longer-term lending to SMEs, for example by creating credit line facilities to financial institutions specifically for this purpose.
- Facilitate utilization of ICT in the financial sector, including development of electronic payment systems and mobile banking, possibly through PPPs.

5.3.5. Regulations and licensing

Although Bhutan has effective institutions and an effective regulatory framework to facilitate business, there are still excessive regulations and cumbersome procedures to obtain licenses that constitute significant obstacles to doing business in the country. According to the latest Enterprise Surveys, 28.8 per cent of senior management time is spent dealing with government regulations. The issue is especially felt in the service and hospitality sectors, where nearly 35 per cent of senior management time involves dealing with regulations, and 20.6 per cent of firms in these sectors identify business licensing and permits as a major constraint (World Bank 2015c). The Enterprise Surveys do not break down senior management time spent on regulations into different activities, and hence it is unknown exactly which regulations are most burdensome. A previous survey suggests that time spent on meeting environmental

regulations is viewed as excessive (World Bank 2010a). UNCTAD (2013) also reports that investors often complain of complex and cumbersome environmental clearance procedures. While environmental protection is paramount (especially given its importance for the tourism sector), the authorities should streamline and simplify environmental regulations wherever possible, and clarify any confusion and ambiguity.

Among the licenses and permits analyzed by Enterprise Surveys (operating licenses, construction-related permits, and import licenses), construction-related permits are the most time-consuming to obtain.[109] While the average time for all firms surveyed of 32.9 days is below the regional average of 55.1 days, the average again masks widely differing burdens on specific sectors. The time to obtain a construction-related permit is more than 50 days for non-food manufacturing firms and almost 100 days for firms in the tourism and hospitality sector (World Bank 2015c). While there is not enough information to ascertain the cause of such sectoral disparities, the authorities must work to reduce the regulatory burden on the most adversely affected sectors.

Overall, the authorities must reduce inefficiency in procedures for obtaining licenses and meeting other regulations. World Bank (2010a) reports that licensing procedures are unclear and overly complex, with various agencies issuing numerous licenses. While many individual licenses can be obtained relatively quickly, applying for a license from one agency sometimes requires additional licenses or clearances from other agencies, making the overall burden frustrating and burdensome. The authorities must improve coordination between different agencies and reduce the regulatory burden by streamlining licensing procedures. They might also consider introducing an electronic licensing portal that (1) provides all information on licensing requirements, and (2) accepts applications and payments for obtaining licenses and permits, possibly with technical assistance from international organizations such as the United Nations or World Bank.

Summary of policy recommendations:

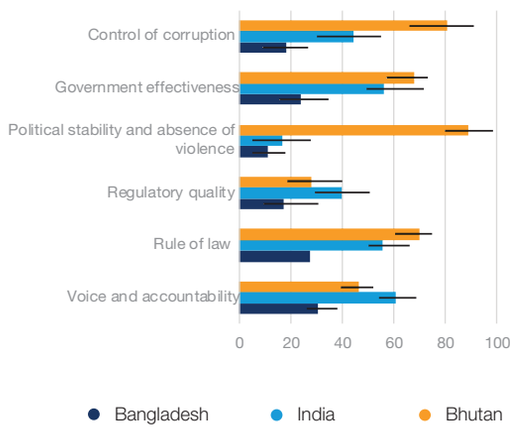
- Streamline and simplify environmental regulations wherever possible, and clarify any confusion and ambiguity, while maintaining strong environmental protection.
- Reduce inefficiency in procedures for obtaining licenses and meeting other requirements of regulations, for example by improving the coordination between different agencies.
- Consider introducing an electronic licensing portal that (1) provides all information on licensing requirements and (2) accepts applications and payments for obtaining licenses and permits, possibly with technical assistance from international organizations such as the United Nations or World Bank.

5.4. Institutions and governance

Despite the constraints identified in section 5.3, Bhutan has three important advantages over other Southeastern Asian countries that make the country attractive to foreign direct investment (FDI) and open up prospects for strong private sector growth. First and crucially, Bhutan's institutions are strong. In the 2016–2017 Global Competitiveness Index, Bhutan ranks 33rd out of 138 economies in terms of institutions (WEF 2017). In particular, Bhutan's control of corruption is excellent; the country ranked 27th out of 176 countries on the 2016 Corruption Perception Index (Transparency International 2017). Politically, Bhutan moved from an absolute monarchy to a constitutional monarchy and parliamentary democracy in 2008, and the public voice in political decision-making is gradually increasing (ADB 2013). In the World Bank's Worldwide Governance Indicators, Bhutan performs as well as or much better than neighboring counties (figure 5.7). In particular, the country is politically stable, and the rule of law is strong. Second, the cost of electricity in Bhutan is cheap thanks to hydro-power, with the price around one-third of the price in China and one-fifth of that in India (figure 5.8). Third, Bhutan's unit labor costs are lower than those of comparators (figure 5.9). While average labor costs in Bhutan are higher than in neighboring countries – for example, they are 45 per cent higher than in India – Bhutan's relatively high productivity (as a low-income country) justifies the higher wages, and unit labor costs are actually low, especially in the service sector (World Bank 2010a).

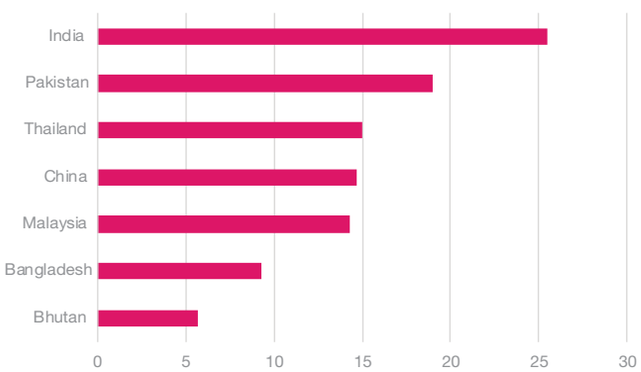
109. It is relatively easy to obtain operating and import licenses, taking 1.2 days and 8.3 days, respectively, as opposed to the regional average of 14.8 days and 15.5 days (World Bank 2015c).

Figure 5.7: Governance indicators: Bhutan and neighbors



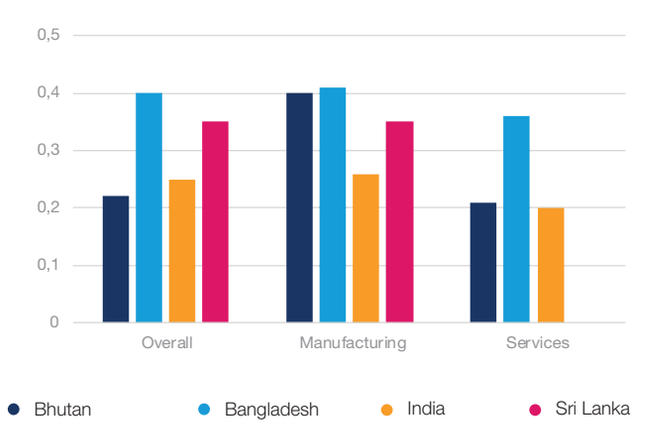
Source: World Bank, Worldwide Governance Indicators
Note; Percentile rank (0 = worst, 100 = best) in 2015. Error bars show 90 per cent confidence internvals

Figure 5.8 : Price of electricity: Bhutan and neighbors (US cents per kwh)



Source: World Bank, 2017 Doing Business Indicators

Figure 5.9: Unit labor costs: Bhutan and Neighbors



Source: World Bank (2010)
Note: Data for unit labor costs for services in Sri Lanka are not available

5.5. Diversification strategies

While the hydro-power sector is likely to remain central to the economy, Bhutan also needs new, labor-intensive sources of growth and employment. New hydro-power projects are labor-intensive in their construction phase, but only about 20 per cent of the workers are Bhutanese citizens because many local people are unwilling to take jobs requiring manual work (IMF 2016). Bhutan needs to improve the attractiveness of private sector employment, as described previously, and develop more varied employment opportunities across the country and for people with different education levels. The new sectors should also absorb unemployed urban educated youth. Rural employment opportunities are also important to discourage further migration to the cities. This section identifies Bhutan's tourism sector as a potential development driver, discusses its most serious challenges, and offers some policy recommendations. The section will also briefly touch upon Bhutan's potential in agriculture and in ICT sector.

5.5.1. Tourism

Bhutan's rich cultural heritage and festivals attract an increasing number of tourists. Bhutan brands its tourism as "high-value, low-impact", emphasizing preservation of the environment and culture and targeting high-end tourists. Average daily spending per visitor was estimated at US$330 in 2008, levels exceeded only by a few top tourist destinations like Switzerland and Peru. Similarly, only a few counties surpass Bhutan in terms of average length of stay, which was 7.5 days in 2011 (ADB 2013). Thanks to the authorities' efforts, the sector has been growing rapidly. Total visitor arrivals grew by 35 per cent in 2016 to 209,570 visitors, almost twice the 2012 level (TCB 2016).[110]

The sector has a large role in promoting inclusive growth. Not only does the tourism and hospitality sector employ a large number of local people, it also creates new demands for food and manufactured products, insofar as tourists consume local products. While the sector's growth has been impressive, three improvements are recommended to enable even more successful development it and to fully disseminate its benefits across the country.

110. Nearly 65 per cent of visitors in 2016 were from India. For more details on the composition of tourists, see TCB (2016).

First, tourism products should be diversified in order to reduce seasonality. Currently, most tourism products narrowly focus on cultural sites and, in particular, colorful festivals, resulting in high seasonality, which translates into a low hotel occupancy rate during lean seasons and undermines the profitability of hotels. The peak seasons are March-May and September-November. The industry needs to come up with new tourism products that attract tourists in other seasons. Products that focus less on festivals – for example, health tourism and community-based trekking – could alleviate seasonality. Additionally, targeting Indian tourists looking to escape the summer heat could help support the demand in off-peak summer months (ADB 2013).

Second, the tourism tariff structure needs to be reformed to allow for price differentiation. Under the current tariff structure mandated by the government, every tourist pays an all-inclusive tariff of US$250 per day (or $200 per day in off-seasons). Out of the US$250 tariff, US$93.20 is used to pay for the overseas tour agent's commission, a royalty to the government, and the business tax. The remaining US$156.80 goes to the tour operator for services such as accommodation, transport, guides, and meals. The one-price policy limits incentives for tour operators to compete and differentiate their products and services. Partly because of the lack of competition, hotel prices tend to be high in Bhutan; for example, US$150-US$225 rooms in Bhutan are valued at US$80-US$100 by international standards (ADB 2013). Competition could bring hotel prices down, and incentivize tour operators to develop and offer tours to less-travelled areas.

Finally, skill development and training of qualified tourism professionals needs to be accelerated. For example, the authorities should consider offering training programmes for interpreters and tour guides. Nearly 30 per cent of firms in the hospitality and tourism sector identified an inadequately educated workforce as a major constraint in the most recent Enterprise Surveys by the World Bank (2015c). In addition to providing training and advisory services, improving the overall education level as discussed earlier could alleviate the shortages of skilled workers in the sector. Skill development is also necessary in public agencies involved in tourism. ADB (2013) reports inefficient coordination of tourism development policies and marketing.

In addition to making the above three improvements, addressing the infrastructural issues identified in section 5.3.2 is critical for further development of the tourism sector. In particular, ensuring connectivity to rural areas is important to spread the benefits of the sector more widely across the country and to adjust the gap in tourism development between urban and rural areas.

In order to make tourism a driver of inclusive development, the authorities must actively link the sector with the agribusiness and manufacturing sectors. In particular, agriculture provides a livelihood for 58 per cent of the total population (though it only accounts for 17 per cent of GDP), and hence plays an essential role in reducing poverty and inequality.[111] Yet, in order for local sourcing to be a viable option for the tourism sector, agricultural productivity must increase beyond the current subsistence level, and the quality of the products needs to improve significantly (as is the case for Mongolia; see chapter IV). The next section will discuss the agribusiness sector and give policy recommendations to improve productivity.

The manufacturing sector – food processing and traditional handicrafts in particular – could also benefit from tourism development. For successful food processing sector development, implementing appropriate hygiene and food safety regulations is essential (in addition to improving agricultural product quality). The traditional handicraft sector is no less important for inclusive growth. The sector provides 5 per cent of total employment and engages about 65 per cent of the rural population during seasons with little cultivation activities (ADB 2013). Bhutan's traditional textile handicrafts can be nice souvenirs for tourists, and the sector also has potential to sell in the global market if export channels can be established (UNCTAD 2011). To promote expansion of the sector, the authorities should establish intellectual property protection for traditional designs, create a certification system for authentic, quality handicrafts, and pursue international branding of these products.

Summary of policy recommendations:

Tourism sector development

- Diversify tourism products to reduce seasonality by considering introducing products that focus less on festivals (e.g. health tourism and community-based

111. Data for 2015. World Bank, World Development Indicators.

trekking), and by targeting Indian tourists looking to escape the summer heat, in order to support the demand during off-peak summer months.
- Reform the tourism tariff structure to allow for price differentiation.
- Accelerate skill development and train qualified tourism professionals, for example by offering training programmes for interpreters and tour guides.

Linking tourism development to manufacturing sector growth

- Implement appropriate hygiene and food safety regulations for the food-processing industry.
- Establish intellectual property protection for traditional handicrafts, create a certification system, and pursue international branding of the products.

5.5.2. Agriculture

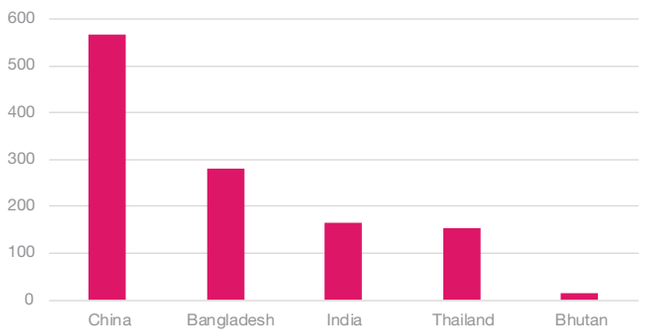
Despite severe geographical limitations, Bhutan's agriculture sector plays a crucial role for poverty reduction and inclusive growth.[112] As mentioned earlier, even though agriculture accounts for only 17 per cent of GDP, it provides a livelihood for 58 per cent of the total population. Yet, overall sector productivity is low, essentially comprised of small households farming for subsistence with little mechanization.

The average size of arable landholding is only 1.2 hectares, and about 14 per cent of farming landholdings have less than 0.4 hectares. Only 33 per cent of farmers use chemical fertilizer, 16 per cent use plant protection chemicals, and 10 per cent use power tillers (ADB 2014a). Even among farmers who use chemical fertilizer, the amount used is very small, as reflected in low fertilizer usage per hectare of arable land (figure 5.10). Inadequacy of infrastructure such as irrigation and farm roads also contributes to low productivity. Out of 75,000 hectares of arable land cultivated, only 25,000 hectares is currently irrigated (ADB 2014a).

Bhutan's agricultural products mainly consist of two commodity groups. The first is traditional cereal crops – mainly rice and maize but also wheat and barley – which are Bhutan's food staples.

112. Forest covers more than 70 per cent of Bhutan's land. Only 2.6 per cent is cultivated for temporary crops (crops that need to be replanted after each harvest) such as rice, and only 0.3 per cent for permanent crops like fruits and nut. World Bank, World Development Indicators.

Figure 5.10: Fertilizer use: Bhutan and comparators (kilograms per hectare of arable land)



Source: World Bank, World Development Indicators

Rice and maize dominate production toward southern subtropical areas. They constitute about 40 per cent of Bhutan's agriculture value added.[113] At the same time, Bhutan imports a large portion of the rice it consumes; in 2013, Bhutan domestically produced 75,229 megatons of paddy, from which it exported 118 megatons of milled rice, whereas it imported 69,885 megatons of rice.[114] The second commodity group consists of fruit and vegetable crops, such as citrus, apples, and potatoes. Along with livestock, these high-value crops are important in higher altitudes where rice production is difficult (FAO 2012; ADB 2013). They are also one of Bhutan's main export products. In 2012, vegetables and fruits accounted for 3.8 per cent of exports, the largest share among non-mineral, non-electricity exports.[115]

Many previous studies have concluded that Bhutan's comparative advantage lies in high-valued fruit production and comparative disadvantage in cereal production (where Bhutanese producers have to compete with cheap Indian imports), and that the country should shift production from the latter to the former (UNCTAD 2011; FAO 2012). They base their claim on the decline of the cereal subsector and rapid expansion of the fruit and vegetable subsector in the 2000s. However, recent figures show a reverse in the trend (table 5.2). Over 2010–2015, on average, the respective production of paddy rice and maize grew by 3.1 per cent and 2.1 per cent annually, while that of

113. Rice and maize accounted for 24 per cent and 17 per cent of agricultural value added in 2015, respectively. Authors' calculations based on NSB (2016a).

114. Note the subtle unit difference: paddy is rice before threshing, so it is slightly heavier than rice. Unlike rice, the importation of maize is rare. Data based on NSB (2016b).

115. Authors' calculations based on the UN Comtrade database.

apple and citrus shrank by 20.6 per cent and 3.6 per cent annually, respectively. Growth in the potatoes subsector also stagnated. Staggeringly, the value of gross output of the apple subsector in 2015 was less than one-third of that in 2010.[116] There is not enough information to ascertain the cause for the reversal of the trend, and there is a need for further research in this respect.[117] Nevertheless, it is likely that Bhutan's comparative advantage still lies in fruit and vegetable production. The country continues to be an exporter of citrus, apple, and potatoes, while an importer of rice and other cereals (NSB 2016b). The authorities should continue to support new private initiatives in the subsectors where Bhutan enjoys a comparative advantage, for example by improving access to farm inputs, providing advisory services about production methods, and attracting FDI.

Apart from fruits and cereals, nut and spice subsectors have recently been growing rapidly (table 5.2) and are deemed to have substantial potential. The ADB recently announced an investment project to boost small farmers' production of hazelnuts (ADB 2016).

Overall, Bhutan should aim to maximize the productivity of its agriculture, both for the fruit and nut subsectors and the cereal subsectors. To this end, the authorities must promote modern production techniques and technologies (e.g. use of herbicides and fertilizers) in four different ways.

First, the authorities should foster the growth of private input suppliers. Although public agencies currently dominate farm input distribution, their effectiveness in promoting the use of modern farm inputs has been limited. Private farm input suppliers are much smaller but more dynamic, and they are evolving rapidly to fill the growing need for more sophisticated farm inputs that public agencies fail to provide (FAO 2012). The authorities should support further expansion of these private suppliers.

Second, research and development spending should be shifted to areas where farmers demand the most (such as reducing losses due to wild animals and pests).

Third, more extension and advisory services need to be provided. Finally, the authorities need to promote the formation of private agricultural cooperatives, which could

Table 5.2. Bhutan's crop sector growth by commodity (percentage)

	Annual per cent growth (average 2000–2009	Annual per cent growth (average 2010–2015)	Contribution of crop to GDP growth (2000–2009)	Contribution of crop to GDP growth (2010–2015)	Share of crop GDP (2015
Arecanut	-1.6	41.4	-1.9	69.7	13.7
Cardamom	4.7	27.9	4.0	22.2	5.1
Other Vegetables	0.0	16.9	0.0	20.1	6.0
Maize	-3.7	3.1	-38.1	15.2	17.3
Paddy	-0.3	2.1	-3.3	14.7	23.6
Other fruits	1.1	32.1	0.3	8.0	1.7
Ginger	9.8	13.6	2.0	4.9	1.7
Pulses	10.2	11.1	5.7	3.4	1.4
Millets	n.a.	-4.8	n.a.	-0.7	0.4
Chili	7.1	-0.7	10.4	-0.8	3.5
Mustard	6.3	-12.8	2.9	-1.7	0.3
Wheat/Barley	-1.4	-9.2	-1.2	-3.3	0.9
Buckwheat	2.3	-14.1	3.4	-3.8	0.5
Potatoes	7.2	-1.6	38.6	-5.5	10.5
Citrus	9.8	-3.6	73.6	-13.9	11.4
Apple	2.3	-20.6	3.5	-28.4	2.1
Total	2.2	3.6	100.0	100.0	100.0

Sources: Data for 2000–2009: FAO (2012); Data for 2010–2015: authors' calculation based on NSB (2016a)

116. Authors' calculations based on NSB (2016a).

117. The fall in gross output for apples and citrus seems to be driven primarily by a decline in production rather than in price. NSB (2016b) shows that a large decline in production took place in 2012 for apples (by about 60 per cent) and in 2013 for mandarins (by about 30 per cent). As for prices, over 2010–2014, the price of apples fell by about 25 per cent, while that of citrus increased by about 20 per cen. However, one may question how well the data reflect the actual prices in local markets.

lower the cost of purchasing modern technologies through sharing as well as improve access to finance.

In addition to upgrading farming techniques, three actions are needed to boost agricultural productivity and growth. First, road infrastructure needs to be strengthened in order to improve access to finance, farm inputs, and markets (see section 5.2). Second, irrigation infrastructure for rice production needs improvement. Although Bhutan may not have a comparative advantage in the rice subsector, there is a substantial room to augment productivity and increase income for rice farmers, as a large part of the agricultural population is involved in rice farming. The priority is the southern region, where the climate is more suitable to rice production. Finally, the quality and safety of Bhutan's agricultural products need to be upgraded to encourage local sourcing in the tourism sector. Introduction of modern sanitary and phytosanitary regulations would reassure foreign visitors of the safety of local food, while also helping to reduce plant and animal diseases.

In parallel, the authorities must promote new export channels for fruit, nut, and high-value vegetable products. If farmers shift their production to these products in the absence of adequate export channels, excess supply in the domestic market could drive prices down. Thus, the authorities should help connect Bhutanese producers with retailers and wholesalers operating in India and Bangladesh by attracting FDI in the agribusiness sector. For example, organizing small producers into private cooperatives can make it easier for retailers to establish reliable supply chains. Improving logistics (in particular customs procedures) is also essential for perishable products like fruits (see section 5.3). While Bhutan's geography poses serious infrastructural constraints, its proximity to India and Bangladesh, the two largest markets in South Asia, provide an advantage to the agribusiness sector. With productivity improvement and commercialization, agriculture could be a driver of export diversification and inclusive growth.

Summary of policy recommendations:

- Support private initiatives in subsectors where Bhutan enjoys a comparative advantage.

Promote modern production techniques and technologies (e.g. use of herbicides and fertilizers) by:

- Fostering the growth of private input suppliers.
- Shifting research and development spending to areas where farmers need it the most (such as reducing losses due to wild animals and pests).
- Expanding extension and advisory services.
- Promoting the formation of private agricultural cooperatives.
- Strengthen road and irrigation infrastructure.
- Encourage local sourcing in the tourism sector by upgrading quality and ensuring safety, and by introducing modern sanitary and phytosanitary regulations.

Promote creation of new export channels for fruit, nut, and high-value vegetable products by:

- Connecting Bhutanese producers with retailers and wholesalers operating in India and Bangladesh.
- Attracting FDI into the agribusiness sector, in particular food retailing.
- Organizing small producers into private cooperatives.
- Improving logistics, in particular customs procedures.

5.5.3. Information and communications technology

ICT is an emerging sector in Bhutan. Although the ICT sector is still nascent, a number of comparative advantages – including a disciplined English-speaking workforce, a relatively developed telecommunications network in Thimphu, cheap electricity, and proximity to India (a major offshoring destination for IT-enabled services) – give Bhutan's ICT sector potential as a new growth driver (World Bank 2010a). ICT is a relatively clean industry, and thus it suits Bhutan's pursuit of environmentally friendly development. Furthermore, the ICT sector can create new jobs and thus absorb the increasing number of educated youth (ADB 2013).

The government has been actively leading the development of export-oriented IT services and IT-enabled services, including business process outsourcing, with World Bank assistance. In 2011, the authorities launched an IT Park – the Thimphu Tech Park – to attract FDI and enhance technology transfer as well as to foster local entrepreneurs. In order to maintain the rapid pace of ICT development, the authorities should pursue (or continue to pursue) four actions.

First, they should continue to facilitate FDI and technological transfer by improving the legal and regulatory framework for business as described in section 5.2.

Second, development of the IT Park should be continued, utilizing PPPs.

Third, continued improvements are needed for telecommunications infrastructure and connectivity, especially for the IT Park (e.g. by establishing back-up fiber connectivity and power supplies to guarantee reliability).

Finally, the authorities should support human capital and skill development in ICT, for example by creating ICT courses and programmes that address private sector needs, possibly in partnership with private training companies and educational institutions (World Bank 2010a; ADB 2013).

In parallel, the authorities should promote improvement of domestic ICT infrastructure and services – for example, cellular phone connectivity and mobile money servicing – in order to support inclusive growth. Utilization of ICT services helps Bhutan overcome its geographical limitations, for example by improving access to finance and knowledge in rural areas and by assisting transport and logistics services. In addition, utilizing IT services in the public sector – for example, e-licensing and customs automation – could reduce the regulatory burden on businesses.

Summary of policy recommendations:

- Continue to facilitate FDI and technological transfer by improving the legal and regulatory framework and business environment.
- Continue to invest in the IT Park.
- Continue to improve telecommunications infrastructure and connectivity, especially for the IT Park, for example by establishing back-up fiber connectivity and power supplies to guarantee reliability.
- Support human capital and skill development in ICT, for example by creating ICT courses and programmes that meet private sector needs, possibly in partnership with private training companies and educational institutions.
- Continue to promote improvement of domestic ICT infrastructure and services, such as mobile money servicing.
- Utilize IT services in the public sector such as e-licensing and customs automation.

5.6. Bhutan's current export structure, key markets, and prospects for diversification

5.6.1. Export structure and key markets

On the face of it, figure 5.11 – which shows Bhutan's main exports for 2012–2016 by product group[118] – seems to suggest that the country is not particularly dependent on natural resources. It can be clearly seen, for instance, that iron and steel products dominate exports and that the most important type of iron and steel sold internationally is, by some margin, pig-iron, spiegeleisen, sponge iron, iron or steel granules, and powders and ferro-alloys (SITC 671), accounting for more than one-third of total exports and more than one-half of all manufacturing exports during the five-year period.

However, the trade statistics reported here do not tell the full story Above all, the data seem to underrepresent the considerable role of hydro-power in Bhutan's economy and export basket. This can be clearly seen in figure 5.12, which depicts how the shares of Bhutan's top exports have changed since 1995. Most conspicuously, the figure suggests that hydroelectricity exports to India (categorized as fuels) accounted for almost half of Bhutan's exports in 2009 and plummeted to virtually nothing the following year.

However, this is a consequence of lacking updated international trade statistics rather than a reflection of falling trade flows. In fact, according to the RMA's 2016/17 annual report, hydroelectricity exports accounted for 34.2 per cent of total exports in 2016 (RMA 2017a). Moreover, several in-depth economic studies point to the increasingly important role of hydro-power to Bhutan, with five large hydro-power plants currently in operation and a further five major developments under way (IMF 2014; USAID et al. 2016; RMA 2017a). As indicated earlier, in 2015, installed hydro-power capacity in Bhutan has reached about 1,606 megawatts out of an identified potential of nearly 30,000 megawatts.[119] The current hydro-power development policy is to have 10,000 megawatts installed by 2020 (RMA 2017b). The completion of the hydro-power projects – and the increased export revenue that would follow – is likely to

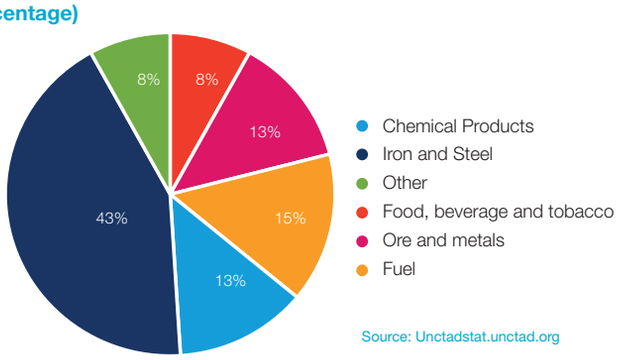
118. At the 1- and 2-digit level of SITC Rev. 3.

119. Latest available data from the website of the International Hydro-power Association, available at https://www.hydro-power.org/country-profiles/bhutan (accessed on 26 April 2018.)

have a negative impact on export diversification, including through Dutch disease effects and increased volatility of revenues (IMF 2014; USAID et al. 2016).

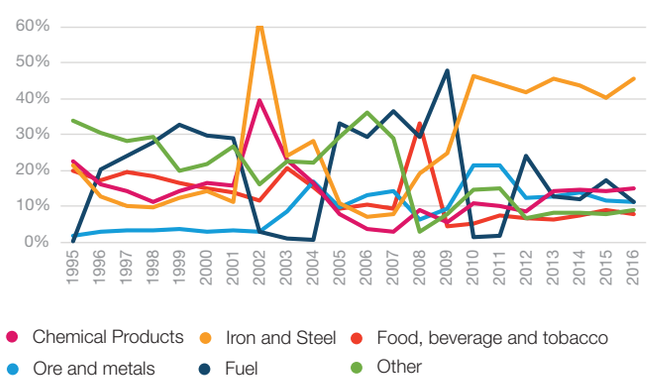
Despite statistical shortcomings, figure 5.11 is informative in two ways. First, it illustrates that natural resources are important for Bhutan. Second, it suggests that the economy has become less diversified in the past couple of decades, as the share of exports grouped as "other" has fallen from roughly one-third of total exports in 1995 to one-tenth in 2016, although there was a rise in the share in 2005–2007. The trend of an increasingly concentrated export basket is also underlined by looking at how the Herfindahl-Hirschmann Index has evolved in Bhutan over the years (see figure 1.4 in chapter I). Whereas the average score in 1995–1999 was 0.27, it climbed in the 2000s to reach an average score of 0.37 in 2012–2016. IMF (2014) reaches the same conclusion in its analysis of various indicators and finds that this trend is only likely to continue in the medium term as major hydro-power projects are launched.

Figure 5.11: Exports from Bhutan by product group, 2012–2016 (percentage)



Source: Unctadstat.unctad.org

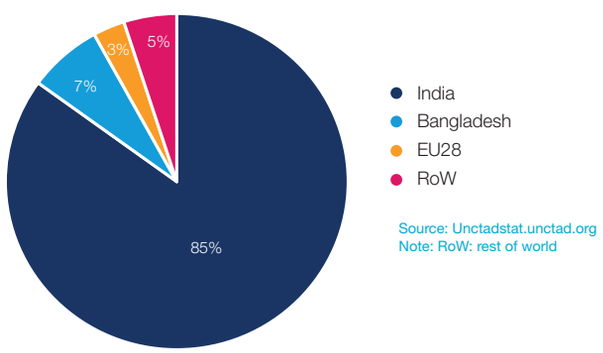
Figure 5.12: Evolution of export structure in Bhutan, 1995–2016 (percentage)



Source: Unctadstat.unctad.org

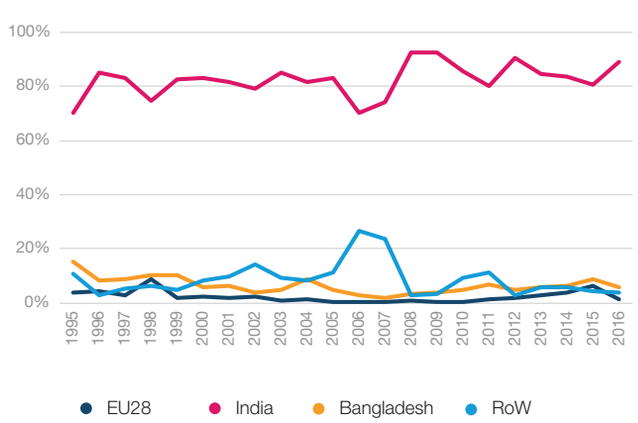
As would be expected, Bhutan's exports go to one market more than any other: India (figures 5.13 and 5.14). In fact, a full 85.5 per cent of the country's total exports in 2012–2016 went to India. The second largest importer during the period was Bangladesh, with a share of 6.5 per cent, and the third largest was the European Union, which only imported 3.3 per cent of total exports. Bhutan does not have any export relations with 115 of the world's economies. Annual fluctuations notwithstanding, the shares of the main importing markets and the rest of the world have not changed dramatically since 1995 (figure 5.14).

Figure 5.13: Main importers of Bhutan's exports, 2012–2016 (percentage)



Source: Unctadstat.unctad.org
Note: RoW: rest of world

Figure 5.14: Evolution of main importers of Bhutan's exports, 1995–2016 (percentage)



Source: Unctadstat.unctad.org
Note: RoW: rest of world

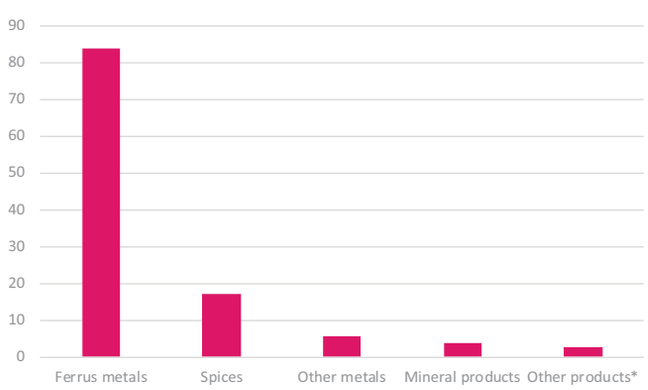
5.6.2. Prospects for product diversification

This report identifies three non-hydropower sectors as diversification opportunities for Bhutan: tourism, agribusiness, and ICT. Tourism has been on an upward trajectory as a result of the government's efforts to

market Bhutan as an ecotourism destination based on a "high-value, low-impact on the natural environment" approach. The sector can be further developed by reducing its seasonality and by creating stronger links to the manufacturing sector, among other steps. With regard to agribusiness, the sector employs a large majority of the population, but productivity is low, and more efforts could be made to support subsectors where Bhutan has a comparative advantage. ICT presents further opportunities for the country based on factors that include a disciplined English-speaking workforce, cheap electricity, and proximity to India. Efforts could still be made, however, to facilitate FDI and technological transfer by improving the legal and regulatory framework and by developing telecommunications infrastructure and connectivity.

Figure 5.15 shows the products groups where Bhutan has the greatest untapped export potential within the intensive margin. As can be clearly seen, ferrous metals represent the subsector with the largest potential to raise exports in value terms (US$83.9 million). The figure is based on the export potential of products at the disaggregated HS6-digit level, and almost all of the export potential related to ferrous metals is based on ferro-silicon containing by weight more than 55 per cent silicon (HS 720221). The other product groups with the greatest potential are spices (cardamom – US$17 million), other metals (copper – US$5.7 million), mineral products (monumental or building stone – US$3.6 million), and other products (plastics, wood, alcoholic beverages, beauty products and apparel – US$2.5 million).

Figure 15.5: Export potential of Bhutan by product group (in millions of US dollars)



Source: International Trade Centre, Export Potential Map (exportpotential.intracen.org)
* Other products are plastics and rubber; wood and vegetable material; alcoholic beverages; beauty products and perfumes; and apparel

India is, by far, Bhutan's largest importer and it also represents its greatest market opportunity for expanding existing exports. In the ferrous metals subsector, the untapped export potential of India reaches US$77.4 million, followed by Italy (US$1.6 million) and Germany (US$1.5 million). In the case of spices, the analysis suggests that Bangladesh and India are the largest untapped export potential destinations (US$8.3 million and US$8.2 million, respectively).

As for the extensive margin, the International Trade Centre's product diversification rank lists raw cane sugar (HS 1701), legumes not elsewhere specified, dried and shelled (HS 0713), and semi-finished products of iron and steel (HS 720711) as the three products with the greatest opportunity for export diversification (table 5.3). At the sector level, the main opportunities for Bhutan to diversify its export basket appear to be in products related to fruits, vegetables, and iron and steel. In terms of trading partners, India and Bangladesh feature prominently as the top three markets for Bhutan's product diversification opportunities. Other countries that recur as promising markets are Germany, Italy, and Singapore.

Table 5.3. Top 10 product diversification opportunities for Bhutan

Rank		HS code	Top three markets
1	Raw cane sugar	1701XX	Bangladesh, India, Italy
2	Legumes, dried and shelled	0713Xb	India, Bangladesh, Pakistan
3	Semi-finished products of iron and steel	720711	Bangladesh, India, Italy
4	Nuts nes	0802Xc	India, Bangladesh, Germany
5	Palm oil (excluding crude) and fractions	151190	India, Bangladesh, Italy
6	Ferro-silico manganese	720230	Bangladesh, Italy, Germany
7	Portland cement	252329	India, Bangladesh, Singapore
8	Bananas, fresh or dried	0803	Italy, Germany, France
9	Onions and shallots, fresh	070310	Bangladesh, India, Singapore
10	Unrefined copper	740200	India, Australia, Germany

Source: International Trade Centre, Export Potential Map (exportpotential.intracen.org)

5.7. Conclusion

While hydro-power will almost certainly continue to drive GDP growth, Bhutan needs to foster other development drivers in order to diversify its economy and achieve inclusive growth. Hydro-power is capital-intensive and creates limited jobs beyond construction work (which most Bhutanese people are unwilling to do). The public sector, where many urban youths are interested in working, cannot absorb the increasing number of graduates without risking macroeconomic stability. In this context, this chapter has identified tourism and ICT services as Bhutan's most promising new potential development drivers. Endowed with natural beauty and a rich cultural heritage, Bhutan has immense potential in tourism, the development of which could create jobs and increase income for both urban and rural residents, including those employed in the agriculture and manufacturing sectors. The ICT industry can take advantages of Bhutan's cheap electricity, competitive unit labor costs, and strong institutions, pursuing rapid growth through FDI and PPPs.

In order to accomplish successful private-sector-led development, however, Bhutan needs to improve both macroeconomic management and the business environment. Regarding macroeconomic policies, Bhutan must implement a fiscal mechanism, such as a new fiscal rule, to shield the economy from the volatility of hydropower-related expenditure. The rule should require the government to save some of the future increase in hydro-power revenues in order to prevent overspending. The current fiscal rule, which only focuses on the budget balance, will soon become insufficient for containing excessive fiscal spending as hydro-power revenue continues to increase. Loose fiscal policy undermines Bhutan's competitiveness because it threatens macroeconomic stability and risks real exchange rate appreciation.

To create a more business-friendly environment, the authorities must address skill and motivation mismatches in the labor market to alleviate shortages of skilled labor. In parallel, Bhutan needs to continue to make improvements in a number of public services, particularly transport infrastructure, customs, logistics, access to finance, and regulatory quality. Facilitating greater use of ICT will be important to overcome geography-related and human-capacity-related constraints in many of the above areas.

Spurring private-sector-led growth is essential for the pursuit of Bhutan's Gross National Happiness measure. While benefits from hydro-power are immense, it alone cannot bring happiness to the entire population; jobs must be created and incomes must rise in order to improve people's living standards. Tourism and ICT are key growth drivers that can help Bhutan boost job creation and income generation compatibly with environmental and cultural preservation. As tourism and ICT expand and the share of the private sector in GDP, trade, and foreign investment increases, Bhutan's macroeconomic environment will become less susceptible to the volatility of hydropower-related investment.

Nevertheless, it should be noted that development of tourism and ICT sectors does not necessarily guarantee inclusive growth. If managed poorly, they can exacerbate imbalances between urban and rural areas. The authorities must actively link the development of these sectors to others, particularly agriculture and manufacturing, while ensuring that the benefits are spread widely across the country, including rural areas. In short, the government's primary role in development is to (1) lead and support private sector growth, and (2) make sure that development is inclusive. Overall, given its immense hydro-power potential, natural beauty and rich cultural heritage, and strong institutions, Bhutan's prospects of achieving greater national happiness are bright, despite significant geographical constraints and macroeconomic challenges associated with hydro-power management.

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VI. POLICY CONCLUSIONS AND THE WAY FORWARD

Aided by the commodities boom, the group of landlocked developing countries (LLDCs) has seen impressive growth rates exceeding 7 per cent on average between 2000 and 2008. This growth performance continued until 2013, despite the 2008–2009 global financial crisis and its impact. However, while the growth performance of Asian LLDCs was robust during the commodities boom, a subsequent sharp slowdown to an average of 2.6 per cent in 2016 (0.4 per cent in per capita terms) revealed their persistent vulnerabilities to external economic shocks. The shock was prevalent in the extractive-resource-rich countries discussed in this report. Such vulnerabilities are causes and consequences of weak productive capacity, heavy commodity dependence, or lack of economic diversification. Coupled with geographical, political, regulatory, and institutional challenges, these vulnerabilities hamper the ability of LLDCs, including those in Asia, to foster structural economic transformation that leads to inclusive and sustainable economic growth, the creation of decent jobs, and substantial poverty reduction.

According to UNCTAD, LLDCs worldwide are commodity-dependent – 26 out of the 32 depend on primary commodities for more than 60 per cent of their exports. The degree of such dependence is even higher in Asian LLDCs. As argued in the preceding chapters, overcoming commodity dependence requires fostering productive capacity and structural economic transformation by moving resources and the policy focus away from traditional, low-productivity sectors towards higher-productivity sectors, and by diversifying exports away from primary commodities into exports of goods and services with higher technological content and sophistication.

This report has also shown that diversification away from extractive sectors poses significant challenges for LLDCs due to a combination of policy, regulatory, institutional, and political issues. It is particularly important for countries endowed with natural resources (extractive sectors), including those discussed in this report, to devise a mechanism for saving excess revenues from natural resource extraction during commodity booms, such as a sovereign wealth fund, in order to save windfall profits and contain Dutch disease. It is equally important to pursue pragmatic and countercyclical fiscal policies, smoothing out fiscal expenditures over time. One possibility is to limit the expansion of social spending and the increase of public sector wages within non-expansionary levels so as to maintain them when windfall profits decline. LLDC governments are encouraged to continue to improve tax collection through tax reforms, including by simplifying the tax system and rationalizing incentives.

Despite complex development challenges facing them, LLDCs, including those examined in this report, have significant potential for economic and export diversification. The analysis here clearly establishes that Bhutan, Kazakhstan, Mongolia, and Turkmenistan have the potential to expand economic activity and develop a number of new export sectors as part of their drive for structural economic transformation. In the case of Bhutan, the tourism and ICT sectors have shown potential for diversification. In Kazakhstan and Mongolia, agribusiness and tourism have been identified as higher-productivity-growth sectors with export potential. In Kazakhstan, light manufacturing, cereals, and tourism could be considered. Finally, in Turkmenistan, the textile, construction, tourism, and agriculture sectors hold ample diversification potential.

As discussed in this report, fully harnessing the potential in each of the countries covered requires fostering productive capacity and structural economic transformation, including export diversification within the intensive and extensive margins. This calls for effectively addressing micro and macroeconomic limitations, relieving binding constraints, and implementing policies to address the institutional and regulatory gaps assessed in the four countries. For instance, diversification into manufacturing and agriculture increasingly requires effective and beneficial participation in global value chains. This in turn calls for putting in place well-functioning soft and hard infrastructure such as roads, ports and railways, waterways, and customs operations. This should be combined with efforts to limit administrative red tape, increase the transparency of government operations, and equip labor with appropriate skills, among other measures. For agriculture, horticulture, and tourism, local determinants of comparative advantage such as climate, soil conditions, and historical patrimony matter more. However, success depends on quality control, effective delivery and efficient transport, and meeting international quality standards.

Overall, the strategy for successful agribusiness

development should focus on boosting productivity, effective mapping of export markets, and pitting in place entry requirements such as food safety and quality standards, certification processes that are critically important to beneficially integrate into the global market. Both agriculture and food processing/retailing are labor-intensive (e.g. the sectors employ a large majority of the population in Bhutan, although productivity is low). This shows an important role of the sector in employment generation and poverty reduction, especially in rural areas. Overall, the four Asian LLDCs in this study, all of which have huge potential for agro-processing, need to introduce a quality-grading system to incentivize farmers to improve product quality and inform producers about safety and quality standards abroad in parallel with boosting productivity of the sector.

For the tourism sector, the Asian LLDCs analyzed in this study need to emulate successful tourism development strategies in other developing countries, including undertaking additional marketing efforts, reducing costs, improving the quality of services, improving the quality of transport infrastructure (road, rail, and air), and facilitating local supply sourcing. Also important are promoting linkages between the tourism sector and local suppliers, and identifying and addressing bureaucratic requirements for tourists. These steps are key for LLDCs to tap into the potential of tourism for their socio-economic development. Furthermore, LLDCs need to consider the ways and means to accelerate skill development for qualified tourism professionals by offering training programmes for interpreters and tour guides. In terms of bureaucratic constraints, an example is in Turkmenistan, where a visa is required for citizens from all foreign countries (with the exception of short visits by citizens from bordering Kazakh and Uzbek provinces) and the cumbersome application procedure involves providing a letter from an accredited Turkmen travel agency.

If Turkmenistan wants to develop its tourist sector, it must significantly simplify the visa issuance procedure and, ideally, create special visa exemptions for strategic countries such as the Russian Federation, China, Islamic Republic of Iran, and other Central Asian countries.

With regard to manufacturing, the study underscores that the LLDCs covered here have significant potential, especially in such areas as light manufacturing of such products as leather and leather products, textiles, and clothing. Therefore, it is important to put in place supportive, complementary, and coherent trade, investment, and industrial policies and strategies in sectors where the countries have comparative advantages. Foreign direct investment (FDI) is important to bring not only capital and technology, but also intangible assets such as knowledge and modern managerial skills. Policies are also needed to support the participation of the domestic private sector and businesses in regional and global value chains in the sectors. In this context, it is crucial for LLDC governments to take a more proactive and catalytic stance to stimulate productive activities, including by creating enabling environments for business and investment (domestic and foreign). However, it is important to pay particular attention to ensuring that manufacturing is not pursued at the expense of other sectors such as agriculture and services. Rather, they should be promoted in a mutually supportive manner, facilitating backward and forward linkages, especially between agriculture and the industrial sectors.

With the exception of Bhutan, the countries examined in this report have had cultures of central planning and dominance of the economy by state-owned enterprises. These factors, combined with geographical and infrastructure-related challenges, have resulted in problematic rankings for these countries on the World Bank's Doing Business Indicators, although there have been noticeable improvements in some areas, especially privatization and attracting FDI. As a consequence, the role of the private sector in these countries, though slowly increasing, remains negligible compared to the comparative advantages and business opportunities that these countries offer. For instance, in Turkmenistan, most of the companies privatized during the period analyzed were in non-essential services such as food services and parts of agriculture. In Kazakhstan, lack of access to credit impedes private-sector-led growth and diversification. Access to credit was reported as the largest impediment for manufacturing firms after an inadequately educated workforce.

Governments of LLDCs in general and the countries studied here in particular need to encourage private sector development by enhancing private sector capabilities and improving governance and business regulations. In addition to facilitating access to finance and easing ways to conduct business, it is critical to build domestic entrepreneurial capabilities. To that end, LLDC governments are encouraged to take measures across the board to

strengthen infrastructure – from enhancing road and information and communications technology (ICT) networks to ensuring greater access to credit and reducing the cost of trade finance. In doing so, governments need to attract investments for new projects, as well as for upgrading and maintaining already existing infrastructure. It is also important to provide targeted incentives to carefully selected sectors and firms with potential for employment generation and diversification. However, governments need effective policies to strike the right balance between mandates and incentives.

Weak transport infrastructure (soft and hard) and poor logistics are other serious impediments to trading across borders in the countries studied. Addressing infrastructure gaps requires scaling up investment (public and private) in the sector, including through public-private partnerships. As documented in this report, some countries have substantially increased investment in transport infrastructure in recent years, although much remains to be done in the area of trade logistics. For example, while Turkmenistan has a relatively developed transportation system, most road networks were designed to benefit the extractive industries, and rural areas are often underserved. Some countries such as Kazakhstan lack quality storage facilities and modern logistic centers, although that country is making progress in this respect with modern facilities that can support multi-modal transport being built at the Kazakh-Chinese border. As with transport infrastructure, enhanced investment in ICT can bring quick results and effective solutions to facilitate trade, improve LLDCs' trade logistics, and foster their integration into global markets.

Further measures could include streamlining customs procedures by reducing the number of documents required for exporting/importing and harmonizing them with international standards in order to reduce trade costs and improve export competitiveness.

Interestingly, most of landlocked countries of the Asian region are either on the path of China's Road One Belt, One Road Initiative or in proximity to it. Some of the countries' exports to China have also been increasing over the years. Moreover, some of the LLDCs in the region also serve as transit countries, with potential to increase that role in the coming years. Turkmenistan's strategic location between Asia, Europe, and the Middle East positions it well to become a major transit country. The Turkmen government has made major investments in transport infrastructure to boost the country's role as a transit hub. Such efforts should be intensified to address some of the glaring disadvantages landlocked countries face, while maximizing their potential as investment destinations and sources of exports and transforming them from being landlocked into land-linked.

Beyond improving transit transport and trade facilitation objectives, regional cooperation provides important avenues for Asian LLDCs to harmonize and coordinate policies to build their productive bases, accelerate structural transformation, and enhance their socio-economic development. Therefore, particular attention should be paid to a development-led approach to regional integration that requires not only a coordinated set of policies to collectively address structural vulnerabilities, but also a greater provision of regional public goods: hard and soft infrastructure, energy, and telecommunications networks. In this context, regional development banks are particularly suitable to finance key investments in regional public goods.

CHALLENGES, POLICY OPTIONS, AND THE WAY FORWARD: ECONOMIC DIVERSIFICATION IN SELECTED ASIAN LANDLOCKED DEVELOPING COUNTRIES (BHUTAN, KAZAKHSTAN, MONGOLIA, AND TURKMENISTAN)