DOCUMENT OF THE EUROPEAN BANK
FOR RECONSTRUCTION AND DEVELOPMENT

STRATEGY FOR TURKMENISTAN

As approved by the Board of Directors on 23 June 2004

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I. EXECUTIVE SUMMARY

The Bank has been seriously concerned for a number of years by Turkmenistan's lack of progress in transition towards multi-party democracy, pluralistic society and a market-based economy. Since the adoption of the last Strategy for Turkmenistan in July 2002, there has been little evidence of improvement in the authorities' commitment to the principles of Article 1.

In the political sphere, there was a deterioration of the situation with regard to the protection of human rights and the rule of law, following an alleged assassination attempt against the Turkmen President in November 2002. In January 2004 the Turkmen authorities moved to lift exit visas, introduced as a result of the November 2002 events. Nonetheless, restrictions on travel remain. Turkmenistan is a one-party state. Opposition groups are forced to operate from abroad. The media is strictly controlled and the overall environment in the country is not conducive to any criticism of Government policies. Deterioration of educational standards is an area of serious concern. Civil society is weak and independent NGOs cannot operate freely.

In the economic sphere, there are continued doubts over the accuracy of official statistics. They show that output grew by 23.1 per cent in 2003, the third consecutive year with growth over 20 per cent, but a more realistic estimate of growth is about 11 per cent. This increase in output reflects in large part hydrocarbon exports. Inflation has been moderate due to the continued subsidy of basic goods and services and administrative control over the financial system, as well as a tight monetary policy. The official foreign exchange rates were stable, but the parallel market rates remained more than four times the official rates. The export earnings accumulate in extra-budgetary state funds, especially in the Foreign Exchange Reserve Fund (FERF) instead of the state budget. Despite increasing natural gas export revenues, the management of these funds is opaque. The spending and investment operations of these funds are under the discretionary control of the President without regulation and transparent accounting. The increasing trade surplus and the restructuring of debts owed to Turkmenistan by some CIS debtors have supported a positive external balance. Meanwhile, foreign direct investment (FDI) remains stagnant, reflecting the poor business environment.

Turkmenistan has made little progress in structural and institutional reforms. A rich natural resource endowment and sustained high growth rates have enabled the Government to resist calls to accelerate reforms. Rather, the Government has extended its control over almost all spheres of the formal economy. The dual foreign exchange rates and arbitrary Government interference in private sector activities have also contributed to an unfavourable business environment.

Enterprise privatisation has been halted since 2001, while the vital energy sector was formally excluded from privatisation. Maintaining essentially a command economy, the President has controlled directly key resources and set production targets for all sectors to achieve through a series of long-term national strategies. The financial sector continues to allocate funds in support of the state-directed investment programme.

In light of the above developments in political and economic spheres, the Bank maintains three alternative scenarios as a graduated response to domestic circumstances, referred to as a **Baseline**, an **Intermediate** and a **Regular** scenario. This approach, consistent with that adopted in 2000 and 2002, tailors the Bank's response to the reform commitment of the authorities and their willingness to implement concrete improvements. The scenarios below clarify the benchmarks on which the Bank would base its decision to expand operations.

Baseline scenario
If the authorities do not move forward with democratic and critical market reforms, the Bank will not be able to move beyond the **Baseline** scenario. In this scenario, the Bank's activities will be focused on the promotion of private sector activities, particularly in the SME and micro-finance areas, provided it can be shown that the proposed investments are not effectively controlled by the state or by state entities and Government officials will not personally benefit from such investments. New investments in the public sector, as well as those in the private sector that are directly related to the FERF, will be excluded until the authorities can demonstrate stronger reform commitment in the critical areas outlined below. The **Baseline** scenario thus recognises the link between the promotion of entrepreneurial initiative at the grassroots level and the consequent emergence of a civil society, which could underpin the move towards stronger political and economic reform. The Bank's operational priorities in the **Baseline** scenario include:

- Portfolio management of existing investments in Turkmenistan, in particular careful implementation and development of the SME credit line.
- Further development of a trade facilitation programme.
- Development of a new micro-finance programme.
- Selective direct investments in domestic and foreign-owned private enterprises, including through the Direct Investment Facility (DIF) and through the attraction of strategic sponsors into joint ventures. Given the distortions introduced by the multiple exchange rate regime, such investments will need to demonstrate clearly that they generate positive economic returns (i.e., measured at underlying market exchange rates). However, projects which are structured to make contributions to the FERF will be excluded. Also, the Bank will not undertake projects if allocation of revenues is not fully transparent.

Intermediate scenario
The Bank would be in a position to conduct a broader range of operations if progress is made in democratic reforms and if the authorities embark on a consistent programme of economic liberalisation and reform. In the **Intermediate** scenario, the Bank proposes to support reform efforts in specific areas by broadening the range of its activities. Specific benchmarks for the intermediate case would include:

- *In the oil and gas sector:* The Bank will consider financing private investments in the production and export of oil and gas, which are currently linked to the FERF, if an agreement can be reached with the Government on a strategy and there is demonstrable evidence of commitment towards reform of the FERF and the state enterprises in the oil and gas sector. For this purpose, the Bank would consider the provision of technical assistance to the Government Agencies responsible for the oil and gas sector, for the development of a strategy for corporatisation and commercialisation. The Bank will co-ordinate closely with the other IFIs on reform progress with the FERF. The leverage the Bank can exercise on these reform efforts through private sector projects is limited. It will monitor the situation closely and prepare new investments only if the Government demonstrates clear commitment to a reform programme, which is supported by all IFIs.

- *In the public sector:* The Bank will consider the financing of public sector investments if demonstrable progress has been made in democratic reforms that would confirm Turkmenistan's commitment to Article 1, and if such projects have high transition impact with respect to putting public services onto a financially sustainable basis, including through tariff reforms, and increased transparency and accountability in the Government's budget. The Bank will insist on time-bound actions and continue its close cooperation with other IFIs.

It is clear that a gradual and progressive approach to reform will open many new reform challenges and the Bank will need to support its financing in the **Intermediate** case with carefully structured policy dialogue to push the reform agenda further along.

Regular scenario
In the event that the authorities start to implement a comprehensive reform programme, the Bank would move to the **Regular** scenario, where the Bank would be active in a wide range of areas, both private and public. While such a possibility looks remote at the present time, it is important to be aware of and highlight the challenges facing Turkmenistan if it is to realise fully-fledged cooperation with the Bank.

In the political sphere the critical reform challenges include:

- Register independent opposition parties. Turkmenistan remains a de facto one-party state and is lacking political pluralism. There are no alternative parties in the country.

- Strengthen the legislature and the judiciary. The Constitution formally recognises separation of powers. However, in practice, power is concentrated in the presidency and is not properly balanced, either by the legislature or by the judiciary.

- Conduct free elections. The country's only presidential election took place in 1992 and had one candidate – Saparmurat Niyazov. The absence of a minimum level of pluralism for competitive elections prevented the OSCE/ODIHR from monitoring the election.

- Lift censorship of the media. The Government fully controls media and access to Internet; it continues to exercise censorship of the newspapers and TV/radio broadcasting.

- Improve human rights record and register NGOs in the area of human rights. The Government creates obstacles to the functioning of independent NGOs. The Government's overall human rights record remains very poor.

In the economic sphere, the critical reform challenges include:

- Achieve tangible progress in price and trade liberalisation and, importantly, unification of the dual exchange rate to promote more efficient resource allocation and to attract greater FDI inflows.

- Improve the transparency and accountability of public resource management, including the FERF.

- Accelerate agricultural reforms by transferring land to private farmers and substantially reducing Government procurement of main crops.

- Increase further the private sector's role in the economy by restarting enterprise privatisation and reducing state control over the financial sector.

The Bank would seek to expand its role in a process of accelerated political and economic transformation through financial support both in the private and public sectors. In such a **Regular** scenario, the Bank would look to exploit opportunities with strategic sponsors in the oil and gas and textiles sectors, the modernisation of transport, improvements in energy efficiency, further support for SMEs and financial sector development, and assistance with regional trade and economic cooperation.

The core of the Bank's approach in Turkmenistan is and will remain support for the private sector, and dialogue with the Government and civil society on ways to improve the investment climate for private entrepreneurs. In this way the Bank complements the efforts of the IMF, the World Bank and the Asian Development Bank as well as other IFIs and bilateral donors. Close cooperation with the entire international community will remain a pillar of the Bank's approach.

LIST OF ABBREVIATIONS

ADB	Asian Development Bank
BCM	Billion Cubic Metres
CAC	Central Asia Centre
CBT	Central Bank of Turkmenistan
DIF	Direct Investment Facility
EU	European Union
EUR	European Currency Unit
FDI	Foreign Direct Investment
FERF	Foreign Exchange Reserve Fund
FI	Financial Institutions
GDP	Gross Domestic Product
ICCPR	International Covenant on Civil and Political Rights
ICERD	International Convention on the Elimination of all forms of Racial Discrimination
ICESCR	International Covenant on Economic, Social and Cultural Rights
IDB	Islamic Development Bank
IFC	International Financing Corporation
IFI	International Financial Institution
IMF	International Monetary Fund
JV	Joint Venture
MSE	Micro and Small Enterprises
ODIHR	Office for Democratic Institutions and Human Rights
OSCE	Organisation for Security and Cooperation in Europe
PB	Participating Bank
PSA	Production Sharing Agreement
RO	Resident Office
SECO	Secrétariat d'Etat à l'économie (Government of Switzerland)
SME	Small and Medium Sized Enterprises
TACIS	Technical Assistance to the Commonwealth of Independent States
TAP	Turkmenistan-Afghan-Pakistan
TC	Technical Cooperation
TFP	Trade Facilitation Programme
TRACECA	Transport Corridor Europe-Caucasus-Asia
UNCAT	United Nations Committee Against Torture
UNDP	United Nations Development Programme
UNEP	United Nations Environmental Programme
UNICEF	United Nations Children's Fund
USD	United States Dollar
WB	World Bank

II. COUNTRY STRATEGY

1. THE BANK'S PORTFOLIO

1.1. Overview of the Bank's Activities to Date

In the last 10 years, the Bank has signed 7 projects for a total commitment of EUR 127.8 million. The Bank's portfolio in Turkmenistan was EUR 101 million at 10 May 2004 (Annex 3). As of 31 March 2004, gross cumulative disbursements are EUR 70.5 million.

The Bank's operations started in 1994 with the SME Credit Line followed by equity and lending for a fully integrated textile plant, two infrastructure investments in the transport sector, one of which, a road project, was later cancelled, an oil and gas sector project and a Direct Investment Facility (DIF) project.

Over the last two years, the Bank has focused its work on preparing and signing private sector projects. In July 2003 the Bank signed a project for a wool scouring plant under the DIF programme for EUR 0.6 million. The Bank re-activated the SME Credit Line in 2003. In addition, the Bank reached a framework agreement with Turkmen Vnesheconombank and National Bank of Pakistan (Ashgabat branch) as Participating Banks in the Trade Facilitation Programme (TFP).

Table 1: Bank's Activities to Date[1]

Investment	Number of investments	Total project cost € million	EBRD finance € million	% of EBRD finance
GAP Turkmen Textile JV	1	74.6	26.6	35.7
GAP Turkmen 2	1	12.6	3.4	27.0
GAP Turkmen 3	1	9.0	9.0	100.0
Dragon Oil Project	1	436.6	50.4	11.5
SME Credit Line	1	12.6	12.6	100.0
DIF - TMS Wool Scouring	1	1.8	0.6	33.3
Turkmenbashi Port Development	1	39.0	25.2	64.6
Country Total	**7**	**586.1**	**127.8**	**21.8**

1.2 Implementation of the Previous Country Strategy

The last country strategy, approved in July 2002, confirmed the Bank's three-stage (baseline, intermediate, and regular) scenario approach, adopted in 2000. In the absence of any progress in political or economic reforms, the Bank operated within the framework of the baseline scenario, which excludes any funding of public sector projects.

[1] In addition, the Bank has indirect investments of EUR 2.4 million through regional equity funds.

Under the baseline scenario, the Bank had the following strategic priorities for Turkmenistan:

- Development of the local private sector, which supports the development of civil society, through the resumption of the SME credit line, the launching of a micro credit programme and the inclusion of a local bank in the Trade Facilitation Programme.

- Selective direct investments into domestic and foreign owned private enterprises using instruments such as the DIF and through the attraction of strategic sponsors into joint ventures.

- Policy dialogue with the Government, especially on the need to integrate the dual exchange rate, to restructure the Foreign Exchange Reserve Fund (FERF) into a proper, transparent, stabilisation fund, and to provide economic data.

- Portfolio management of existing investments.

Implementation of these strategic priorities involved the following:

- After resolution of the foreign currency conversion problems with the Central Bank, the Bank extended the SME credit line loan agreement in late 2003 until September 2005 and signed the relevant agreements with the Central Bank. Participating Banks have started to take loan applications from clients and disbursements have resumed. The Bank remains the only institution making hard currency finance available to entrepreneurs.

- Discussions have continued with the Central Bank and local banks on launching a micro lending programme. With the resolution of the problems on the SME line, there should be good progress on the micro programme. The Central Bank wishes to see the SME line operating before progressing with the micro programme and we need assurances from the Central Bank on key pre-conditions such as cash disbursements and independent operation of the micro lending units.

- The Trade Facilitation Programme was approved for Turkmenistan in late 2003, provided the TFP would only be used in support of transactions for local private businesses. Two banks were included initially and a third has just been approved for inclusion in the TFP.

- The Bank approved and disbursed its first DIF project in Turkmenistan, a preferred equity investment into a wool scouring facility which will start operations in June 2004. Despite the constrained private sector, a number of good DIF projects were appraised and the Banking team has work in the pipeline for the coming year.

- In general, policy dialogue on the exchange rate, the FERF and the provision of reliable data has had limited results not only for the Bank but for all other international organisations and major bilaterals. However there have been some small positive developments. In February 2004 the Government commenced dialogue with the World Bank on resolving the negative pledge issues that had constrained World Bank activities since 1998; the IMF also conducted Article IV discussions in March 2004, the first such since 1999. Other minor positive developments include the resolution of the foreign exchange conversion problem, which has enabled the Bank to resume the SME credit line and the removal of the exit visa requirement following US representations (albeit with some de facto border controls still reported to be in operation).

- Monitoring continues on the Turkmenbashi Port renovation, Dragon Oil and Gap Turkmen projects. Implementation of the re-launched SME line, the DIF and TFP projects have required substantial resources in both the Resident Office (RO) and London.

1.3 Transition Impact of the Bank's Portfolio and Lessons Learnt

1.3.1 Portfolio Performance

The Bank's current portfolio stock is listed in Annex 3. The overall portfolio quality is good, with no arrears. To date, the full DIF investment in the TMS wool scouring plant, all the loan and equity investments for Gap Turkmen 1, 2 and 3, a part of the original approved SME Loan (about 24 per cent before the line was suspended), most of the of the Turkmenbashi Port project (90 per cent plus) and most of the Dragon Oil & Gas project (about 82 per cent) have been disbursed.

Two non-performing loans under the SME Credit Line account for 3 per cent of the original disbursements (but there are no arrears from the Central Bank to the Bank). Of the original 113 loans, 109 have been fully repaid, two have interest arrears and two have principal and interest arrears. This strong performance (following a long period of high arrears mainly arising from the now resolved conversion problems) is mainly due to the active collection and monitoring role of the local credit advisors, funded by the Swiss Technical Cooperation (TC) project and working closely with the Participating Banks and the RO. Disbursements which had been on hold for nearly three years have resumed under the extended SME line.

1.3.2 Transition Impact

The Bank continues to have limited influence (along with all other agencies) in promoting Turkmenistan's transition process, despite persistent efforts. Through implementing individual projects, however, the Bank has achieved reasonable transition impact in the following sectors:

The Enterprise Sector and Environment

- The DIF investment, together with SECO, in the TMS wool scouring project has created a private sector, value added, export orientated project that may serve as a pragmatic example to the authorities of the benefits of supporting private sector development. We anticipate that the project will commence operations and exports in June 2004 and with the active co-operation of the Textile Ministry should lead to positive perception by the Government of the beneficial role of international agencies and their ability to deploy capital for the benefit of the economy.

- Gap Turkmen was the first company in the CIS to receive international certifications in quality and environmental management and continues to be one of the few successful textile joint ventures in Central Asia. There are potential demonstration effects regarding quality management, marketing and successful cooperation with the Government. The company has created over 2,500 local jobs in a state of the art denim jeans manufacturing plant. Product is shipped mainly to the US (83 per cent) and supplied to major international brand companies such as Zara and Tommy Hilfiger. There has been substantial transfer of new skills and know-how, and the company has introduced clear and consistent accounting and auditing practices into the local textile sector.

- The Dragon Oil project has been an important milestone in testing the legal framework for Production Sharing Agreements in Turkmenistan and in supporting high corporate, financial and environmental standards. An example of the latter is the company's Decommissioning and Abandonment Programme for dilapidated platforms, which addresses the issues of marine pollution and the risks of navigation in the vicinity of the offshore production area. In cooperation with the International Maritime Organisation and TC funds mobilised by the Bank, a National Oil Spill Contingency Plan was developed, which was adopted by the Turkmen authorities. However the demonstration impact of this project has been limited by the Government's attitude to new foreign investment in the energy sector and the continuing lack of transparency with regard to the FERF.

Financial Sector

- A significant transition impact was the resolution of the currency conversion problems which led to the suspension of the SME credit line. The Central Bank of Turkmenistan, following dialogue with the Bank, allowed conversion in the latter part of 2003 for sub-borrowers to make repayment to participating banks. This enabled almost full repayment of the credits granted under the line and enabled the Bank to re-launch the SME credit line for a smaller commitment of USD 7.5 million.

- The SME line which disbursed to 113 private sector projects of which 109 have repaid in full is a powerful demonstration of the benefits of properly designed lending programmes for the banking system and for borrowers. The Bank anticipates that the next phase of the SME line will have similar success and this will be amplified by the launch of a micro programme in the coming year.

Infrastructure

- The Turkmenbashi Port project has brought standards of cost recovery, accountability and public procurement into one area of Turkmenistan's public sector. Moreover, the port is a key outlet for foreign trade and an important link on the TRACECA corridor linking Central Asia to Europe.

1.3.3 Lessons learnt

Experiences from the Bank's activities to date in Turkmenistan offer the following lessons:

- Regular dismissals of key contacts on the Government side and the sharp divergence between the Bank's mandate and strategic orientations and the Government's economic and political policy and practices have made policy dialogue very difficult. Furthermore strong growth in export revenues from gas and growing foreign exchange reserves have reduced the need for funding from IFIs and hence their leverage on the authorities.

- The Bank's leverage on the Government through the private sector investments on which it focuses is not strong. There is no commitment or acceptance on the part of the Government of the need for reform, corporatisation or privatisation in key areas such as energy, cotton and the financial sector.

- Major strategic investors continue to be very hesitant about committing large funds to Turkmenistan, while the value added by such investments in the face of large distortions is not always evident. Hence the Bank's activities in support of the private sector are likely to remain focused on SMEs, micro borrowers and support for trade, in the absence of new foreign investors.

- Private sector projects are extremely difficult to structure and implement with smaller foreign investors or local investors, requiring substantial negotiation with Government Agencies, leading to cost overruns, as in the case of the TMS wool scouring project. Nonetheless the effort has been worthwhile as the private sector projects serve as an alternative to the state model which dominates the economy.

- Meetings with entrepreneurs and agencies active in Turkmenistan confirm that the existing SME support and the possible micro lending programme are and will be an important vehicle for developing an independent civil society.

1.4 Portfolio Ratio

- As of 30 April 2004, the private/state sector portfolio ratio stood at 80/20.

- Maintaining the hold on public sector investments and focusing only on private sector development will further increase the private/public ratio in the short to medium term.

2. OPERATIONAL ENVIRONMENT

2.1 The General Reform Environment

2.1.1 Social Conditions and Labour Issues

Turkmenistan has maintained Soviet-style social programmes to guarantee minimum living standards, through free provision and extensive subsidies on basic necessities and public services. According to the budget for 2004, expenditure on the provision of free gas, water, electricity and salt to the population increased by 53 per cent over 2003, amounting to 10 percent of central budget expenditure.[2] The President declared that such a generous social policy would last at least until 2020. Despite the supposedly low level of absolute poverty, income inequality appears to be widening[3]. The extent of inequality in the country is highlighted by the fact that the rural areas account for 55 per cent of the total population but contribute less than 20 per cent of GDP.

Education is a significant problem. There is a severe shortage of teaching materials in most schools. Compulsory public education has been reduced from 10 to 9 years. University study has also been reduced by splitting its system into only two years of teaching and two years of practical work, and only 3,000-4,000 students are allowed to enter university every year, one tenth of the number entering before independence. According to UNICEF statistics, the higher education enrolment ratio in 2001 (per cent of population aged 19-24) was only 2.7 per cent, far below the 31 per cent average of transition countries.

The UNICEF data indicate the employment ratio (numbers of employed as per cent of population aged 15-59) in 2001 at 91 per cent. However, this demographic figure may be overstated. All those of working age in Turkmenistan are officially guaranteed employment, and rural workers, accounting for 48 per cent of the total labour force, are assumed to be fully employed in the agricultural sector. The lack of education and qualifications has restricted the development of a work force capable of supporting advanced industrial projects, resulting in high youth unemployment. In response to this situation, the Government has used the expansion of military conscription to reduce unemployment among the younger participants in the labour force. Following the large-scale dismissal of school teachers in 2001, from March 2004 about 15,000 medical workers face the loss of their jobs, by Presidential instruction.

2.1.2 Regional Issues

Turkmenistan has a strategic geographical location as an important transit country for trade between Europe, Iran and Central Asia and also as one of the countries bordering Afghanistan. In many respects, however, Turkmenistan remains isolated within the region, both economically and politically.

Having failed to secure alternative access to world markets for gas exports, Turkmenistan is falling back on its traditional trading partners from the time of the Soviet Union: Russia and the Ukraine. Turkmenistan urgently needs to secure stable

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[2] The main revenue sources for the free provision of basic goods are the extra-budgetary state funds, accounting for 89 per cent of the expenditure. The central budget covers 11 percent.

[3] The latest survey by the World Bank in 1998 indicates the GINI index at 40.8. The GINI index measures inequality over the entire distribution of income or consumption. A value of 0 represents perfect equality, and a value of 100 perfect inequality.

pipeline capacity in order to fulfil huge gas sales agreements with the two countries. However, Kazakhstan and Uzbekistan are competitors for pipeline access, as well as gas export markets: both countries have signed gas export agreements with Gazprom via the same pipeline, the Central Asia Centre (CAC) route. Pipeline access is therefore a potential source of regional tension. Negotiations over a Trans-Afghan pipeline still continue, but may yield little result as Turkmenistan has earmarked its main gas reserves for export to Russia. Also, the project will require a fully stabilised Afghanistan, some major investors, and access to the Indian market to become commercially viable.

The issue of the division of the Caspian Sea remains unresolved. Russia, Kazakhstan and Azerbaijan have reached common understandings, but these have not been supported by Iran and Turkmenistan. Following the agreement between the Presidents of the five Caspian states reached at the first Caspian summit in April 2002 to make their meetings regular, a recent meeting of the foreign ministers was held in April 2004 in Moscow, but did not reach a conclusion. Iran suggests holding a second summit in Tehran before the end of 2004.

2.1.3 Legal Environment

Turkmenistan has made minimal progress in moving to a market orientated economy supported by a society that is democratic and pluralistic. Due to the reluctance of the Government to embrace meaningful political reform, the state of legal transition of the country has not progressed during the last period.

Overall, the state of commercial laws and legal institutions in Turkmenistan does little to foster investment. Laws regulating bankruptcy, financial markets and secured transactions in particular fall well below internationally acceptable standards, although the Civil Code has been significantly improved in the last years. The courts and the institutions that implement and administer the law are not independent of the Government and there is little confidence on the part of potential users that the courts are capable of dispassionately enforcing contract rights.

Turkmenistan faces enormous challenges in developing its law to internationally acceptable standards. The principal impediment is the failure so far of the country to embrace politically the democratic values of a legal system based on the rule of law.

2.1.4 Environmental Issues

Since the last Country Strategy, key environmental issues for Turkmenistan's sustainable development have remained critical. These include the contamination of soil and groundwater with chemical fertilisers and pesticides, excessively used in the agricultural sector under the former regime; as well as the ongoing salination of soil – the most irreparable type of desertification; and water-logging of soil due to poor irrigation methods. A shortage of water, resulting from inefficient use of surface water for irrigation purposes and insufficient planning and management capacity in the water sector, is considered the primary environmental issue for the country.

The country's water supply comes principally from the Amudarya River in the east and the Karakum Canal, linking the Amudarya with the Caspian Sea, in the southwest. Water losses along the Karakum Canal are estimated at 40 per cent. The Amudarya also supplies irrigation water for Uzbek agriculture and drains into the Aral Sea, on the border of Uzbekistan and Kazakhstan. Inefficient use of freshwater resources in Turkmenistan has raised regional concerns and some tensions with neighbouring Uzbekistan. It has also contributed to the catastrophic shrinking of the Aral Sea. During the last 5-10 years the drying of the Aral Sea has brought about noticeable changes in climate conditions in the region. It has also increased desertification. The Aral Sea disaster has resulted in a drastic deterioration of living conditions; in particular, as a public health threat in the region, due to the increasing airborne pollution from dust contaminated by agrochemicals, as well as contaminated drinking water.

Institutional issues in Turkmenistan's environmental sector include inadequate administration and management of the environment and natural resources, as well as an unclear definition of national environmental priorities. The environmental health and safety legal framework has largely been inherited from that of the former Soviet Union. Whilst standards are in theory stringent, poor enforcement has led to specific environmental, health and safety issues and concerns. Whilst a National Environmental Action Plan has been developed, and recognises many of these concerns, little progress has been made in its practical implementation, due to lack of funds and adequately trained specialists.

Given the Bank's limited and potential investment portfolio in the country, the Bank's environmental focus will remain on providing support and guidance on health, safety and environmental issues and environmental monitoring on existing projects. Specific attention will continue to be paid to the environmentally sensitive Dragon Oil project and environmental due diligence training in the FI sector, to ensure full compliance with the Bank's Environmental Policy and Procedures requirements.

The Bank is collaborating with other organisations. UNEP together with the Bank has supported the development of guidelines on Environmental Impact Assessment in a transboundary context in the Caspian Sea region including Turkmenistan. The EU is supporting awareness raising and consultation meetings for sustainable development for the Caspian Coastal Community, also including Turkmenistan. From the perspective of international development agencies and financial institutions, the World Bank and ADB currently have no pipeline investment projects which could address natural resource management and environmental protection issues, such as water resource management. However, ADB plans to carry out a country environmental analysis for Turkmenistan in 2005 which will update our current understanding of the environment within the country.

2.2 Progress in Transition and the Economy's Response

2.2.1 Macroeconomic Conditions Relevant to Bank Operations

Output Growth

The official statistics point to a 23.1 per cent rise of GDP in 2003, registering expansion of over 20 per cent for the third year in a row. This surge in recorded output is largely a reflection of hydrocarbon exports. However, data are unreliable and contradictory, as is the case for the previous years. Gas and oil production in 2003, accounting for around 30 per cent of GDP, rose by 10.5 per cent and 11 per cent, respectively. Growth of electricity production was 2 per cent in 2003. Agriculture continues to struggle with decreasing cotton production. The economy harvested 0.7 million tonnes of cotton in 2003, far below the target of 2 million tonnes. Meanwhile, grain production reportedly grew by 10 per cent to 2.5 million tonnes, but some observers express significant doubts over the official figures. The Bank estimates real GDP growth in 2003 at 11 per cent, based on the performance of key sub-sectors (gas, oil and main agricultural production such as cotton and grain).

Monetary and Fiscal Policy

Annual average inflation in 2003 is estimated at 6.5 per cent, a significant decline from the 2002 figure of 10.6 per cent. Monetary policy has remained relatively tight, but prices are also kept artificially low through the continued subsidy of basic goods and pervasive price control. The parallel market exchange rate also remained stable at Manat 22,500 to the US dollar with a moderate appreciation in real terms, while the official rate remains pegged at Manat 5,200 to the US dollar.

State control over the banking system has been further tightened. A presidential decree of October 2002 mandated all commercial banks, except for the state owned Bank for Foreign Economic Affairs of Turkmenistan, to close correspondent accounts in foreign banks, and to concentrate their foreign currency in the Central Bank of Turkmenistan (the CBT).

Official data show that the state budget in 2003 maintained a position of near balance. However, a series of recent Presidential decrees do not support this. In February 2004, the announcement of a large-scale layoff of medical workers (to be replaced by military conscripts) was followed by a plan to abolish many free medical services, in order to reduce state spending. The head of the Main Tax Service was dismissed for non-fulfilment of tax collection targets. The tax collection system seems to face major difficulties due to widespread tax exemptions for public enterprises and a declining tax base, as the private sector's role in the economy has been negligible. Although earnings from energy exports have increased significantly, most of the increase has been accumulated in extra-budgetary state funds, especially the FERF[4]. Under the control of the President without transparent accounting, their opaque fiscal management risks the significant wasting of revenues. The CBT remains the principal financing source for the budget deficit.

External sector

Increased hydrocarbon exports in both volumes and prices pushed the trade surplus to USD 1.12 billion in 2003 (equivalent to 24 per cent of GDP) from USD 736 million of 2002. Total exports rose by 27 per cent, and imports increased by 18 per cent. The service account deficit, stemming from the Government's massive prestige construction and industrial projects, has supposedly led to a narrower current account

[4] The FERF receives 50 per cent of hard currency revenues from gas exports and 30 per cent of revenues from oil and cotton exports as a tax. The fund undertakes domestic investments, largely for national prestige, such as cultural or town reconstruction projects, and occasionally repays foreign debt. It is fully under the control of President.

surplus. The Bank estimates the current account surplus at 7.9 per cent of GDP in 2003, up from 4.5 per cent of GDP in 2002.

The restructuring of Ukraine's debt of USD 282 million to Turkmenistan, agreed in August 2003, will lead to additional capital inflows, and other debt talks with the CIS debtors (Russia, Georgia, Azerbaijan) are in progress. According to the Central Bank, foreign reserves reached the equivalent of 10 months of imports, amounting to around USD 2.6 billion, most of which is known to be accumulated in the FERF. The FERF has been the main financing source for the service account deficit and capital account outflows for foreign debt repayments. The authorities claim that foreign debt is at a manageable level. The economy is also likely to meet its external debt obligations with a moderate increase in foreign reserves in the short-medium term. Despite abundant natural resources, gross foreign direct investment remains limited, reflecting the poor investment climate.

Outlook and Risks

The economic outlook is strongly linked to gas export prospects. In April 2003 Turkmenistan concluded a 25-year agreement on gas exports to Russia, amounting to total deliveries of around 2,000 billion cubic metres (bcm), or 70-80 bcm per annum from 2007. Existing export commitments until 2006 include 36 bcm to Ukraine, 6-7 bcm to Gazprom, and 8-10 bcm to Iran. Another long-term agreement on gas sales with Ukraine is expected when Ukraine President Kuchma visits Ashgabat in the first half of 2004. Ukraine is expected to continue to buy 36-45 bcm of gas annually from Turkmenistan for 25 years. These huge gas supply agreements may allow the economy to grow at around 5-7 per cent over the medium term.

Turkmenistan's gas export prospects, however, are vulnerable to increasing competition for both pipeline access and export markets from neighbouring countries, Kazakhstan and Uzbekistan, which the main pipelines transit. Should the new gas export agreement with Ukraine be finalised, Turkmenistan will face around 120 bcm of gas export demands per annum from 2007 (70 bcm to Gazprom, 40 bcm to Ukraine, and 10 bcm to Iran). Apart from the Iran route, all these exports need to go through the Central Asia Centre (CAC) network, the current capacity of which is just 40-50 bcm per annum.

The CAC pipeline is being rehabilitated to raise its capacity to 80-90 bcm, but much of this additional capacity will be needed by Kazakhstan and Uzbekistan. Both countries have either already signed gas sales with Gazprom through the same pipeline, providing Gazprom with monopoly leverage to control export volumes and the prices it pays for Turkmen gas. Moreover, Uzbekistan announced in mid-2003 that it would use the CAC network for its own gas exports only, preventing oil and gas company Itera[5] from transiting its gas from Turkmenistan via Uzbekistan. This implies that Turkmenistan would get to use only the left-over capacity of the pipeline. In order to avoid overcrowding of the pipeline, the President of Turkmenistan proposed a new pipeline of 30 bcm capacity, hugging the Caspian coast and entering southern Russia. As an alternative route, the Turkmenistan-Afghan-Pakistan pipeline (TAP) with projected capacity of 30 bcm per annum, is under

[5] In March 2004, Itera, which had transported about 10 bcm of Turkmenistan gas annually through Uzbekistan, announced the closure of its office in Uzbekistan.

evaluation with support from the Asian Development Bank (ADB). However, its development remains in question due to political uncertainty and concerns about economic viability.

Another concern related to Turkmenistan's export commitments is the capacity to produce all the gas quantities needed. Compared to 53 bcm of production in 2003, from 2007 Turkmenistan would need to produce around 135 bcm per annum (120 bcm for export and 15 bcm for domestic consumption), even excluding the additional 30 bcm of exports for the TAP route, if it is developed. Turkmenistan was able to produce 90 bcm of gas in the early 1990s. Expansion of capacity to reach that level of production again will require very significant financing from both the Government budget and foreign investors. However, under the current unfavourable business environment and with restricted investment opportunities in the energy sector, FDI will continue to be limited unless there are dramatic changes in the Government's policy stance.

2.2.2 Transition Success and Transition Challenges

Since independence, Turkmenistan has essentially maintained a command economy of the Soviet era. The President directly sets unrealistic targets for all sectors, based on a series of long-term national programmes[6] supported by state-led investment. This economic policy has remained unchanged, with little progress in market-orientated structural and institutional reforms. Rich resource endowments and economic performance in recent years have allowed the government not only to resist demands from the international community to accelerate reforms, but even to extend its control over all spheres of the economy.

As shown in Table 2, Turkmenistan scored the lowest points across all the Bank's transition indicators and is least advanced among the countries of operations of the Bank. Enterprise privatisation has been halted since 2001, and the energy sector has been entirely excluded from privatisation. There has been no privatisation of banks and it is unlikely to take place in the foreseeable future. Although a land reform programme foreseeing the transfer of land ownership to individual farmers was declared in 1997 and again in 2003, its implementation was deferred to 2004, and remains uncertain.

The state maintains pervasive control over prices and resources. Together with provision of large subsidies to the population for basic goods and services, the Government continues to set administered prices for key staples and services, such as petrol and transportation. The highly distorted foreign exchange system provides an indirect price control mechanism. The financial system remains under tight state control, and Turkmen banks play a very limited role in the economy. Most lending is provided by state-owned banks and 95 per cent of all loans continue to go to state-owned enterprises at the direction of the Government.

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[6] In August 2003, the Government adopted a new national programme: "Strategy for the political, economic and cultural development of Turkmenistan until 2020".

Table 2: Transition Indicators 2003

	Small-scale p/sation	Price liberali-sation	Trade & foreign exchange system	Large-scale p/sation	Governance & enterprise restructuring	Competition policy	Banking reform & interest rate liberalisation	Securities markets & non-bank financial institutions	Infrastructure reform
Armenia	4-	4+	4+	3+	2+	2	2+	2	2+
Azerbaijan	4-	4	4-	2	2+	2	2+	2-	2-
Georgia	4	4+	4+	3+	2	2	2+	2-	2+
Kazakhstan	4	4	3+	3	2	2	3	2+	2+
Kyrgyz Rep.	4	4+	4+	3	2	2	2+	2	1+
Russia	4	4	3+	3+	2+	2+	2	3-	2+
Tajikistan	4-	4-	3+	2+	2-	2-	2-	1	1+
Turkmenistan	**2**	**3-**	**1**	**1**	**1**	**1**	**1**	**1**	**1**
Uzbekistan	3	3-	2-	3-	2-	2-	2-	2	2-
EBRD Average	**4-**	**4**	**4-**	**3**	**2+**	**2**	**3-**	**2+**	**2+**

The index ranges from 1, indicating little or no progress, to 4+ pointing to standards similar to advanced economies
Source: EBRD Transition Report 2003

While "Turkmenistan's economic model" based on the self-reliance policy has been associated with ostensible economic growth and minimum living standards for the population, this path of development has caused serious adverse effects on the economy and on future generations, by damaging education and health care provision. While the Turkmen authorities have started to show willingness to engage in dialogue with some IFIs, relations between them remain limited. Widespread interference of the Government in the economy has discouraged private sector activity and diversification of the economy, created a highly distorted pricing system, and caused enormous waste of resources. The following are the key transition challenges for future sustainable development in Turkmenistan:

- **Achieve tangible progress in price liberalisation, particularly adjustment of the official rate so that it reflects market rates more clearly**. The implicit fiscal transfers embodied in price and exchange rate distortions are estimated at around 30 to 40 per cent of GDP. The new National Strategy for the years to 2020 states that the Government plans that payments for social and municipal services, such as house rents, municipal, transport, communications and other services will remain at the present uneconomic levels during the period, and that free provision of gas, electricity, water and salt will continue. The parallel market rate, which is more than four times the official rate, remains the largest single price distortion in the economy and a key obstacle to foreign and private investments. Steady moves towards comprehensive price liberalisation, as well as a unified foreign exchange rate, however, are fundamental for efficient resource allocation, and for promotion of private sector activity and economic diversification.

- **Increase the private sector role in the economy**. Official figures indicate that the private sector in the economy accounted for 47 per cent of GDP in 2003, increased from 40 per cent in 2002. However, there are few evident factors to support this. There have been no enterprise privatisations since 2001 and state-led investment to state-owned or state-controlled enterprises continues to expand the state sector. Private firms receive only 5 per cent of total bank loans. The complex and arbitrary regulatory framework has also hampered private economic activities. The few areas in which the private sector plays a meaningful role are retail services, agriculture and other services. The Government has always stressed the importance of the private sector, but has taken no actual measures to support this priority. Priority lies on restarting enterprise privatisation, on improving the business environment and on reducing state control of the financial sector.

- **Accelerating agricultural reforms**. Despite its significance in the economy, with a 20 per cent share in GDP, agriculture remains underdeveloped. The poor state of the sector arises mainly from the state order system, a drive for self-sufficiency in grain production and for increased cotton production. The Government procurement price of raw cotton was estimated at USD 50 per ton in 2003; eight times lower than the export prices, and the price for wheat is USD 20 per ton; about a twelfth of the market value. Despite huge investments and subsidies (subsidies are estimated some 8 per cent of GDP), the result has been significant fluctuations in crop production with disincentives for farm production. Significantly reduced cotton output in two consecutive years led the Government to rethink plans for agricultural reforms. In July 2003 the President announced new measures to decrease Government interference in crop management, and to reduce government dependence on the cash crop, cotton. Transfer of land ownership to farmers in 5-10 years was promised, but its implementation was deferred to 2004. To secure dependable water supplies, several reservoirs and dams are under construction. Among those, a giant artificial lake, "Lake Turkmen", has been under way now for four years, despite criticism of its economic rationale.

- **Improvement in the transparency and accountability of public resource management.** The expected increase in gas and oil export earnings points to the urgent need for improvement in public finance operations. The IFIs continue to emphasise the need for public sector reforms, but they have not received a positive response from the Government. Most serious is the operation of the FERF, the largest state fund. Despite the importance of the fund, little information is provided to the public about its accumulated size and investments. The apparent fact is that its spending has been effected outside budgetary process and directed by the President. The critical reform in the public sector is the adoption of regulations on the several extra-budgetary state funds, especially the FERF, clarifying its functions, integrating its expenditures into the budget, and auditing and disclosing the results of the operations.

2.3 Access to Capital

Capital investment has risen strongly to support the National Strategy for the years to 2020. In 2003 investment increased officially by 21 per cent. Despite increasing investment demands, Turkmenistan has limited finance sources, particularly foreign finance sources, leading to higher dependence on internal capital mobilisation and forced savings by the state. According to official reports on the capital investment financed in 2003, the share of investment from state funds in total investment rose significantly to 30 per cent from 22 per cent in 2001, and the central and local budgets accounted for 5 per cent of total investment in 2003, up from 4 per cent in 2001. Meanwhile, the share of foreign loans significantly slipped to just 1 per cent of overall sum of investments from 10 per cent in 2001, and the contribution of foreign investment also dropped from 8 per cent in 2001 to 5 per cent in 2003.

With an unfavourable business environment and a lack of reforms across the economy, Turkmenistan is unlikely to receive sufficient assistance from IFIs and foreign investors for the foreseeable future. The banking sector will also continue to play a very limited role in financial intermediation. Therefore, the government budget and state funds – both of which benefit from increasing energy exports - will remain as the main source of investment.

3. STRATEGIC ORIENTATIONS

3.1 Bank's Priorities for the Strategy Period

The Bank maintains three alternative scenarios as a graduated response to domestic circumstances, referred to as a **Baseline**, an **Intermediate** and a **Regular** scenario. This approach, consistent with that adopted in 2000 and 2002, tailors the Bank's response to the reform commitment of the authorities and their willingness to implement concrete improvements. The scenarios below clarify the benchmarks on which the Bank would base its decision to expand operations.

Baseline scenario
If the authorities do not move forward with democratic and critical market reforms, the Bank will not be able to move beyond the **Baseline** scenario. In this scenario, the Bank's activities will be focused on the promotion of private sector activities, particularly in the SME and micro finance areas, provided it can be shown that the proposed investments are not effectively controlled by the state or by state entities and that Government officials will not personally benefit from such investments. New investments in the public sector, as well as those in the private sector that are directly related to the FERF, will be excluded until the authorities can demonstrate stronger reform commitment in the critical areas outlined below. The **Baseline** scenario thus recognises the link between the promotion of entrepreneurial initiative at the grassroots level and the consequent emergence of a civil society, which could underpin the move towards stronger political and economic reform. The Bank's operational priorities in the **Baseline** scenario include:

- Portfolio management of existing investments in Turkmenistan, in particular careful implementation and development of the SME credit line.

- Further development of a trade facilitation programme.

- Development of a new micro finance programme.

- Selective direct investments in domestic and foreign-owned private enterprises, including through the Direct Investment Facility (DIF) and through the attraction of strategic sponsors into joint ventures. Given the distortions introduced by the multiple exchange rate regime, such investments will need to demonstrate clearly that they generate positive economic returns (i.e., measured at underlying market exchange rates). However, projects which are structured to make contributions to the FERF will be excluded. Also, the Bank will not undertake projects if allocation of revenues is not fully transparent.

Intermediate scenario
The Bank would be in a position to conduct a broader range of operations if progress is made in democratic reforms and if the authorities embark on a consistent programme of economic liberalisation and reform. In the **Intermediate** scenario, the Bank proposes to support reform efforts in specific areas by broadening the range of its activities. Specific benchmarks for the intermediate case would include:

- *In the oil and gas sector:* The Bank will consider financing private investments in the production and export of oil and gas, which are currently linked to the FERF, if an agreement can be reached with the Government on a strategy and there is demonstrable evidence of commitment towards reform of the FERF and the state enterprises in the oil and gas sector. For this purpose, the Bank would consider the provision of technical assistance to the Government Agencies responsible for the oil and gas sector, for the development of a strategy for corporatisation and commercialisation. The Bank will coordinate closely with the other IFIs on reform progress with the FERF. The leverage the Bank can exercise on these reform efforts through private sector projects is limited. It will monitor the situation closely and prepare new investments only if the Government demonstrates clear commitment to a reform programme, which is supported by all IFIs.

- *In the public sector:* The Bank will consider the financing of public sector investments if demonstrable progress has been made in democratic reforms that would confirm Turkmenistan's commitment to Article 1, and if such projects have high transition impact with respect to putting public services onto a financially sustainable basis, including through tariff reforms, and increased transparency and accountability in the Government's budget. The Bank will insist on time-bound actions and will continue its close cooperation with other IFIs.

It is clear that a gradual and progressive approach to reform will open many new reform challenges and the Bank will need to support its financing in the **Intermediate** case with carefully structured policy dialogue to push the reform agenda further along.

Regular scenario
In the event that the authorities start to implement a comprehensive reform programme, the Bank would move to the **Regular** scenario, where the Bank would be active in a wide range of areas, both private and public. While such a possibility looks remote at the present time, it is important to be aware of and highlight the challenges facing Turkmenistan if it is to realise fully-fledged cooperation with the Bank.

In the political sphere the critical reform challenges include:

- Register independent opposition parties. Turkmenistan remains a de facto one-party state and is lacking political pluralism. There are no alternative parties in the country.

- Strengthen the legislature and the judiciary. The Constitution formally recognises separation of powers. However, in practice, power is concentrated in the presidency and is not properly balanced, either by the legislature or by the judiciary.

- Conduct free elections. The country's only presidential election took place in 1992 and had one candidate – Saparmurat Niyazov. The absence of a minimum level of pluralism for competitive elections prevented the OSCE/ODIHR from monitoring the election.

- Lift censorship of the media. The Government fully controls media and access to the Internet; it continues to exercise censorship of the newspapers and of TV/radio broadcasting.

- Improve human rights record and register NGOs in the area of human rights. The Government creates obstacles to the functioning of independent NGOs. The Government's overall human rights record remains very poor.

In the economic sphere, the critical reform challenges include:

- Achieve tangible progress in price and trade liberalisation and, importantly, unification of the dual exchange rate to promote more efficient resource allocation and to attract greater FDI inflows.

- Improve the transparency and accountability of public resource management, especially the Foreign Exchange Reserve Fund (the FERF).

- Accelerate agricultural reforms by transferring land to private farmers and substantially reducing government procurement of main crops.

- Increase further the private sector's role in the economy by restarting enterprise privatisation and reducing state control over the financial sector.

The Bank would seek to expand its role in a process of accelerated political and economic transformation through financial support both in the private and public sectors. In such a **Regular** scenario, the Bank would look to exploit opportunities with strategic sponsors in the modernisation of transport, improvements in energy efficiency, further support for SMEs and financial sector development, and assistance with regional trade and economic co-operation.

The core of the Bank's approach in Turkmenistan is and will remain support for the private sector, and dialogue with the Government and civil society on ways to improve the investment climate for private entrepreneurs. In this way the Bank complements the efforts of the IMF, the World Bank and the Asian Development Bank as well as other IFIs and bilateral donors. Close cooperation with the entire international community will remain a pillar of the Bank's approach.

3.2 Sectoral Challenges and Bank Objectives

3.2.1 Private Sector and Financial Institutions

Attempts will continue to encourage the Government to adopt a more positive approach to **the development of the private sector**. The key reform challenges identified in the last strategy remain unchanged:

- Encourage reform and abandonment of the dual exchange rate system, which limits access to hard currency resources for private businesses and creates distortions in all areas of the economy. However, the authorities continue to be committed to maintaining the present system and the Bank's and other IFIs' influence in this area is limited.

- Reduce interference in private businesses by Government ministries and agencies. This control provides the Government with a means to clamp down on any unwanted private sector competition, as well as on the business interests of potential political challengers. Success in addressing this challenge will be achieved only on a case by case basis.

- Successful demonstration of working partnerships with private investors, including foreigners as in the DIF wool scouring project, is probably the most effective way for the Bank to exercise its leverage on the reform process.

The main transition goal in **the financial sector** is to increase the availability of funding and lending activity to private companies, entrepreneurs and micro and small businessmen on commercial terms, in the light of the lack of credit available for the private sector. While directed lending through the state-owned or controlled banking system to agriculture is likely to continue until the state procurement system has been adjusted, loans to private businesses should be given free of any Central Bank intervention. For domestic currency credits, this requires banks to be able to set interest rates that reflect underlying risk and to choose to whom to give credit. For foreign currency loans, this requires unhindered access to foreign exchange for repayment. Given present exchange rate distortions, the Central Bank is naturally worried about borrowing by private businesses to exploit arbitrage gains.

Given these challenges, the Bank's operational priorities in the **Baseline** scenario will be:

- **Disburse and monitor the relaunched SME credit line**: the immediate priority is to work with the Participating Banks to ensure the line is utilised for good quality projects over the next two years. The Bank continues to provide TC to strengthen the credit capacity of Participating Banks, and to maintain policy dialogue with the Central Bank to improve the operational environment (avoiding intervention into the selection of borrowers, the decisions on interest rates, etc.).

- **Enable and encourage utilisation under the Trade Facilitation Programme** for the three approved Participating Banks and seek to qualify other banks (one more is being considered at present). There are encouraging signs of commitment on the part of the Central Bank to cooperate on this facility, as on the SME line.

- **Implement a Micro Finance Programme** initially on a non-funded basis by providing Technical Cooperation to enable three to four banks develop micro programmes, but lending their own Manat resources. Active discussions have started with the Central Bank on the framework to enable implementation of the micro programme (the eligible borrowers to include traders, the possibility of cash disbursements, independence in decisions for the banks, flexibility on security requirements). This will require strong commitment and support from the Central Bank.

- **Selective direct investments into private companies**: the Bank will continue to seek opportunities for direct investments into private companies. With the successful commencement of the DIF investment in the TMS wool scouring plant other opportunities are being sought in export-orientated projects. Joint ventures with strategic sponsors will be considered, if the value added by such investments to the economy, measured at underlying market rates can be clearly demonstrated. However, projects which are structured to make contributions to the FERF will be excluded. Also the Bank will not undertake projects if allocation of revenues is not fully transparent.

3.2.2 Oil and gas sector

Apart from price reform to reduce domestic waste (see Section 2), the key challenge in the oil and gas sector is to improve the transparency of financial flows among the state energy concerns, the FERF and the budget. In particular, the following steps would be desirable:

- For the long-term sustainability of Turkmenistan's economic development, the FERF needs to be transformed into a proper stabilisation fund, with some proportion of it saved for future generations. Critical for the operation of such a fund (similar funds exist in Azerbaijan and Kazakhstan) would be proper accounting of all financial flows, as well as the requirement to disclose all operations to the public. The President could still retain a key role in overseeing the funds activities, but the discretionary spending from the fund outside the annual budget would not be possible. Reform proposals along these lines have been made to the Government by the World Bank.

- The rational planning of investment decisions in Turkmenistan's energy sector and the proper use of its existing resources require dramatic improvements in management information systems and accounting standards within the state energy complex. The Bank made a first attempt to obtain better information on existing financial flows in the context of the new oil and gas project without success. It is understood that even the Government may not have fully adequate information on the financial position of the state energy concerns and the state oil and gas fund. Moreover, the energy complex is repeatedly asked by the Government to subsidise investments in other sectors of the economy, undermining its commercial viability and ability to develop long-term investment plans.

3.2.3 Infrastructure sector

With virtually free electricity and gas and low prices for petrol and diesel, the key challenge in infrastructure remains tariff increases so that public infrastructure begins a transition to commercial operations. In the Turkmenbashi Port project, this was achieved in part because the required tariff increases were borne by foreign transport companies rather than the local population. However Ashgabat-Mary road project, which was approved by the Board, was cancelled in 1999, mainly because the Government refused to introduce a small increase in the fuel price. It is recognised that domestic tariff increases will need to be combined with targeted subsidies to the poor, in those areas where public infrastructure delivers basic needs such as heating, light and drinking water.

As was the case in the previous Strategy, the Bank will not work in the public sector in the **Baseline** scenario. However, if the conditions existed for the Bank's **Intermediate** scenario, projects supporting the commercialisation of infrastructure, changes to public procurement practices, increased transparency and accountability in the Government's budget, and the introduction of financial reporting and environmental standards in public investments are key transition challenges that would be an important element of the Bank's support for transition. In addition to tariff reform and commercialisation, the continuation of close cooperation with international organisations, notably with the IMF and the World Bank, will be particularly important.

4. OTHER IFIS AND MULTILATERAL DONORS

4.1 The International Monetary Fund (IMF)

Turkmenistan has been a member of the IMF since September 1992. After five years of absence the IMF completed Article IV consultations in March 2004 and its Executive Board discussed this matter in June 2004. With this, Turkmenistan has normalised its relations with the IMF.[7]

4.2 World Bank/IFC

There are no active World Bank projects at present due to a negative pledge issue[8] and the lack of reform in the economy. The focus is on technical assistance activities only. In the past the World Bank has focused on improving Turkmenistan's budgetary practices and increasing transparency in Turkmenistan's foreign currency reserve fund. An initiative sponsored by the World Bank for regional cooperation on water and energy was ultimately not supported by the authorities. The World Bank and the EBRD are in agreement to exchange information and cooperate on the work of increasing efficiency and transparency of the FERF.

The IFC has not been involved in Turkmenistan to date.

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[7] It has not yet been decided, however, whether the report on the Article IV consultations will be made available to a wider audience.

[8] In the past the Government pledged to international banks the hydrocarbon revenues that accrue to state companies. The Government and the World Bank are currently working to resolve the issue.

4.3 Asian Development Bank (ADB)

The Board of Directors of ADB approved Turkmenistan's membership in August 2000 and its Board of Directors approved the Economic Report and Interim Operational Strategy (ERIOS) for the country in June 2002. The ERIOS recommends no lending for Turkmenistan, except for projects that focus on regional cooperation or directly benefit the reconstruction of Afghanistan.

At present ADB’s technical assistance programme includes two regional feasibility studies; the first one involves the Turkmenistan-Afghanistan-Pakistan (-India) gas pipeline project; the second one the Atamyrat-Imamnazar road rehabilitation project. ADB also had one country project at the National Institute of State Statistics and Information on income levels.

ADB opened a liaison office in Ashgabat in May 2002.

4.4 Islamic Development Bank (IDB)

IDB committed some USD 73 million for the construction of three medical centres, the purchase of an oil tanker, the rehabilitation of a portion of the Mary-Ashgabat highway and a rural water supply project. It is currently looking into the funding of more projects in the medical, water and infrastructure areas, as well as into the opening of a credit line for one of the banks.

4.5 UNDP

The United Nations Development Programme (UNDP) carries out a number of small scale TA projects in Turkmenistan aimed at strengthening the technical and institutional capacity of the Ministry of Economy and Finance, and of regional public authorities with respect to national economic planning, pension legislation and improvement of national insurance system. In addition UNDP works with the Central Bank on improving the country’s debt management and financial analysis system.

UNDP also funds TA projects to facilitate information sharing in Turkmenistan for sustainable human development, improve the energy efficiency in heating and hot water supply systems, improve natural parks and combat HIV/AIDS.

4.6 EU/TACIS

Since its independence Turkmenistan has been supported by the EU Tacis programme. In 2003 a regular Tacis National Action Programme was adopted for Turkmenistan. It covers the period 2003-2004 and amounts to EUR 5 million and covers mostly capacity building within the natural resources area, development in the agriculture sector, and education. In addition, Turkmenistan continues to benefit from a number of Tacis regional programmes including Inogate (Energy), Traceca (Transport) and Warmap (water management). In addition there are a number of regional budgets that can provide funding to projects in Turkmenistan on a competitive basis. Tacis essentially provides grant money for technical assistance.

4.7 OSCE

The Organisation for Security and Cooperation in Europe (OSCE) regularly conducts workshops, seminars and round tables on such issues as the prevention of drug and human trafficking, the strengthening of national border and customs services, environmental education, and SME development. The OSCE also supports local NGOs by providing grant funds for training and development.

III. ANNEXES

Annex 1 **Political Assessment**

Annex 2 **TC Projects**

Annex 3 **Legal Transition**

Annex 4 **Selected Economic Indicators**

Annex 5 **Bilateral Assistance**

Annex 1. Political Assessment

The Bank has been seriously concerned for a number of years by Turkmenistan's lack of progress in transition towards multi-party democracy, pluralistic society and a market-based economy. Since the adoption of the last Strategy for Turkmenistan in July 2002, there has been little evidence of improvement in the authorities' commitment to the principles of Article 1.

In the political sphere, there was a deterioration of the situation with regard to the protection of human rights and the rule of law, following an alleged assassination attempt against the Turkmen President in November 2002. In January 2004 the Turkmen authorities moved to lift exit visas, introduced as a result of the November 2002 events, and to relax registration requirements for religious organisations. However, these measures need to be fully implemented in practice.

Turkmenistan remains a one-party state. Power is concentrated in the Presidency and is exercised in an authoritarian manner. Opposition groups are forced to operate from abroad. The media is strictly controlled and the overall environment in the country is not conducive to criticism of Government policies. Civil society is weak and independent NGOs cannot operate freely.

Multi-party system and elections

Turkmenistan is a one-party state and lacks political pluralism. No alternative parties have been registered since the last assessment and there has been no movement towards a more open, pluralistic political system.

The Constitution formally recognises the executive branch headed by the President, the legislature consisting of a one-chamber parliament and the judicial branch embodied in the Supreme Court of Turkmenistan. In practice, power is fully concentrated in the presidency and is not balanced either by the legislature or by the judiciary. The Turkmen President continues to dominate domestic politics. In addition to presiding over the ruling – and the country's only – political party, the Turkmen President is also the Chairman of Halk Maslahaty (People's Council) and of the Cabinet of Ministers.

The country's only presidential election took place in 1992 and had one candidate – Saparmurat Niyazov. Absence of a minimum level of pluralism for competitive elections prevented the OSCE/ODIHR from monitoring the election. Last year the Turkmen President stated that he would retire in 2010. Presidential elections were promised for 2008 but no firm date has been established.

The last elections to the 50-member parliament (Mejlis) took place in 1999. The OSCE/ODIHR did not monitor the elections because of grave concerns that the broad electoral framework in Turkmenistan falls far short of OSCE commitments. More specifically, the OSCE/ODIHR's concerns included: absence of a minimum level of pluralism for competitive elections, restrictions of fundamental freedoms necessary for political activity and complete control over electoral activities for democratic elections.

At the end of 1999 Halk Maslahaty (a body entitled to decide on constitutional matters) granted to Saparmurat Niyazov an exemption from time limits for holding office, effectively making him President for life. In August 2003 President Niyazov was elected lifetime Chairman of Halk Maslahaty. The presidential elections are nominally to be decided by this unique council which was transformed in August 2003 into a permanent body, with the highest legislative authority. The People's Council, which has no analogues in the CIS, has 2507 members, representing a wide spectrum of the Turkmen Government and society, ranging from central and local Government officials and members of parliament, to representatives of various social organisations.

Human rights conditions

The Government's poor human rights record worsened in 2003. This has become evident since the alleged assassination attempt on President Niyazov on 25 November 2002, after which the authorities launched a wide-ranging campaign against the suspected perpetrators. The Government continues to maintain strict control of all media outlets and all aspects of the everyday life of Turkmen citizens, including the rights to travel and to worship, and the freedoms of association and assembly. Re-imposition of exit visas in 2003 was a serious regression to Soviet-era practices.

In January 2004 the Turkmen authorities announced that exit visas had been abolished. This was confirmed by a Presidential decree in March 2004. In practice, however, there are reports that individuals are unable to obtain permits for routine travel.

Further restrictions of human rights were introduced by new laws on Public Associations and Freedom of Religious Organisations. The first one prohibited operation of unregistered public associations and required all foreign assistance to be registered with the Justice Ministry. The law on religious organisations criminalises unregistered religious activity, but even registered religious groups are severely harassed. In a positive step, quantitative requirements for the registration of religious organisations and groups were removed in March 2004. It is essential that these laws be fully implemented. A possibility of allowing international access to prisons (with the exception of those prisoners who were involved in the alleged assassination attempt) was raised by the Turkmen President in May 2004.

In the regional context of Central Asia, Turkmenistan's media enjoys the lowest degree of freedom. The Government retains full control of the media and access to the Internet; it exercises strict censorship of the newspapers and TV/radio broadcasting. Access to the Internet is controlled by Turkmenistan's sole state-owned Internet service provider, Turkmen Telecom. All newspapers published in Turkmenistan have comparable content, differing only in their respective names and formats. A large part of any newspaper glorifies Saparmurat Turkmenbashi the Great ("Father of all Turkmens") and the rest of the articles resemble publications from the Soviet era, focusing on optimistic reports from the workplace or descriptions of national holidays and customs.

There are problems in the area of labour rights, including use of child labour. Violations of child labour laws were reported in rural areas, particularly during the cotton harvest season. Turkmenistan is not party to the ILO Convention on the worst forms of child labour. In May 2004 the Turkmen President called for an end to the practice of using child labour to pick the cotton harvest.

Over the last year, the international community has continued to raise serious concerns regarding freedom of movement; registration and free functioning of NGOs; deterioration of educational standards, which is likely to have a negative effect on future generations; individual cases of human rights violations. At the end of 2002 the OSCE invoked the Moscow Mechanism by designating a special rapporteur to investigate the human rights situation. The Rapporteur expressed strong concerns on arbitrary detentions, show trials and the presumed extraction of confessions by torture. Other international organisations, including the UN, have passed resolutions urging the authorities to take action to improve the situation.

Nonetheless, the impact of these measures has been so far limited. The Government rejected international criticism and did not facilitate visits by international envoys. In April 2004 the OSCE Chairman-in-Office (CiO) called upon the Turkmen authorities to strengthen cooperation with the OSCE. The OSCE, UN and the EU are present in the country and continue to develop dialogue with the authorities.

External relations

In its foreign policy, Turkmenistan continues to adhere to the principle of permanent neutrality. After the events of September 11, the country has reaffirmed its neutral status which prevented the use of its territory for military purposes, but allowed significant humanitarian transit for Afghanistan. A stable Afghanistan is important for Turkmenistan, which continues to entertain the idea of a trans-Afghan gas pipeline to Pakistan.

In the regional context of Central Asia, Turkmenistan gives preference to bilateral relations over multilateral ones remaining, for example, outside of a major regional structure, that of Central Asian Cooperation Organisation, comprising the rest of the region – Kazakhstan, Uzbekistan, Kyrgyzstan and Tajikistan.

Russia and Ukraine are major economic partners for Turkmenistan, as they represent its main gas export markets. Huge gas exports from Turkmenistan to Russia are envisaged by a long-term framework agreement with Gazprom, concluded in April 2003. Notwithstanding improved economic prospects, relations with Russia have been frustrated over the issue of the status of ethnic Russians living in the country after Turkmenistan's unilateral termination of the 1993 agreement recognising dual citizenship.

The legal status of the Caspian Sea remains unresolved primarily due to Iran's and, to a lesser degree, Turkmenistan's objections to the common stance of the remaining three littoral states of the Caspian basin – Russia, Kazakhstan and Azerbaijan. Iran's persistent position on the equal division (20 per cent for each of the five littoral states) of the sea and continuing Turkmen claims to Azerbaijan regarding two oilfields in the sea prevents finding a solution. However, on the positive side, all parties continue intensive negotiations, with the aim of signing a convention on the legal status of the Caspian Sea. A second Caspian Summit is expected to address the issue by the end of the year.

Annex 2. TC Projects in Turkmenistan

Commitment Name	€ Committed	€ Disbursed	Fund Approved Date	Commitment Stage	Sector	Funding Code
Business Advisory Services – export oriented credit line	393, 499	393, 499	09/12/94	Closed	Manufacturing	ECT
Administration and Financing of Road Improvement	153, 728	153, 728	21/12/94	Closed	Construction	ECT
Export Oriented Credit Line – Central Bank and participating banks / Institutional Development Programme	988, 086	988, 086	22/06/95	Closed	Finance, Business	ECT
Preparation of Road Improvement Project	395, 810	395, 810	08/10/96	Closed	Construction	ECT
Consultancy Services for Detailed Engineering Design and Procurement Assistance for a Dry Cargo Terminal	598, 975	598, 975	13/05/97	Closed	Transport, Storage	ECT
Commercialisation of Turkmenautoellari and Assistance with Project Implementation	496, 454	496, 454	12/09/97	Closed	Construction	ECT
Turkmenbashi Port Development project – Project Implementation Unit	571, 775	571, 775	20/07/98	Closed	Transport, Storage	ECT
Management Assistance to Turkmen Sea Administration	651, 326	651, 326	02/11/98	Closed	Transport, Storage	ECT
Management Assistance to Turkmen Sea Administration	262, 703	262, 703	26/11/01	Closed	Transport, Storage	ECT
Road Rehabilitation Study	53, 050	53, 050	08/06/95	Closed	Construction	FRB
TMS Wool Construction Supervisor	49, 990	25, 413	27/05/03	Disbursing	Finance, Business	ITA
Bank Restructuring and SME Development	192, 898	192, 898	01/12/93	Closed	Finance, Business	JAP
Export Oriented Line of Credit – Institution Building	196, 000	196, 000	01/08/94	Closed	Finance, Business	JAP
Development of Turkmen Sea Administration’s financial Management Information System	402, 090	402, 090	05/12/97	Closed	Transport, Storage	JAP
Turkmenistan SME Credit Advisors Programme	1, 322, 466	1, 322, 466	01/09/98	Closed	Finance, Business	JAP
Oil and Gas Field Services sector development	392, 074	392, 074	04/08/99	Closed	Extractive Industries	JAP
Institution Capacity Building for Oil Spill Preparedness	86, 431	86, 431	06/10/99	Closed	Extractive Industries	JAP
Turkmenistan Credit Advisors Programme: Extension	493, 714	493, 714	20/03/00	Closed	Finance, Business	JAP
Grain and Inputs Industry: Feasibility Study	98, 524	98, 524	01/04/94	Closed	Manufacturing	POR
Export Oriented Line of Credit – Project Preparation	45, 868	45, 868	16/09/94	Closed	Finance, Business	SPA
GAP Turkmen	36, 610	36, 610	19/09/00	Closed	Manufacturing	SWI

TC Projects in Turkmenistan continued

Commitment Name	€ Committed	€ Disbursed	Fund Approved Date	Commitment Stage	Sector	Funding Code
TMS Wool Swiss Legal Due Diligence	28, 127	28, 127	18/09/01	Closed	Manufacturing	SWI
TMS Wool Scouring: Additional Swiss Legal Due Diligence	22, 914	1, 929	21/03/02	Disbursing	Finance, Business	SWI
TMS Wool Swiss Legal Due Diligence	27, 666	27, 666	12/03/03	Closed	Finance, Business	SWI
TMS Wool: Local Legal Due Diligence	14, 650	14, 650	18/03/03	Disbursing	Finance, Business	SWI
TMS Wool Swiss Legal 3 Additional	9, 564	9, 564	23/07/03	Closed	Finance, Business	SWI
TMS Wool Swiss Legal 3c	7, 831	7, 831	28/08/03	Closed	Finance, Business	SWI
Turkmenistan – Local Credit Advisors: new programme	58, 562	9, 146	20/10/03	Committed	Finance, Business	SWI
Trade Facilitation Programme: Basic Training for Local Banks	12, 465	0	26/02/04	Committed	Finance, Business	SWI
Gas Sector Development Strategy	111, 574	111, 574	01/10/93	Closed	Energy	TAI
Review of Tax and Foreign Investment Legislation	29, 407	29, 407	13/01/97	Closed	Community, Social Services	TCS
Turkmenistan Local Credit Advisors	38, 938	39, 546	11/10/01	Disbursing	Finance, Business	TFS
Gas Sector Development Strategy	74, 569	74, 569	27/08/93	Closed	Energy	TUR
Review of Tax and Foreign Investment Legislation	13, 233	13, 233	21/01/97	Closed	Community, Social Services	UKB
Digital Overlay Network	53, 866	53, 866	30/04/97	Closed	Telecoms	UKB
Feasibility Study for Turkmenbashi Port Development	407, 609	407, 609	01/07/95	Closed	Transport, Storage	USTDA
Digital Overlay	183, 307	183, 307	18/03/96	Closed	Telecoms	USTDA

Annex 3. Legal Transition

COMPARATIVE ASSESSMENT OF TURKMENISTAN'S COMMERCIAL LAW

I. Assessment Over Time

Turkmenistan's unreformed commercial laws continue to be out of step with those standards considered acceptable internationally. While Turkmenistan took a step towards improving the commercial legal environment in 1999 through the adoption of a new Civil Code which created a basis for a modern commercial legal system, much work remains necessary to develop implementing legislation and regulations and create the necessary implementing institutions.

Due to the fact that an independent legal profession is at best in a nascent state in Turkmenistan, there has been a paucity of reliable responses for the EBRD's legal sector assessment tool, the EBRD Legal Indicator Survey[9], over the past years. Consequently, there has been difficulty in accurately assessing extensiveness and effectiveness of Turkmenistan's commercial laws. The following paragraphs do however provide a sectoral analysis of the country's main commercial laws.

LEGAL SECTOR ASSESSMENT

Bankruptcy

Bankruptcy and insolvency is governed by the Law on Bankruptcy of the Republic of Turkmenistan, as amended (the "Insolvency Law"). The Insolvency Law was assessed in 2003 in the EBRD Sector Assessment Survey on Bankruptcy and Insolvency and received an extremely low score, despite being clear and strong in some respects.

The Insolvency Law's strengths lie primarily in the area of commencing proceedings. The Insolvency Law seems to provide both a "liquidity" and a "balance sheet" test for insolvency (generally a feature of good insolvency laws), allows both debtors and creditors to commence proceedings and permits proceedings to be commenced based upon an anticipated payment default, as opposed to waiting for an actual one to occur (often, by the time an actual default occurs, it is too late for a rescue). In addition, the Insolvency Law clearly prescribes the threshold test required to be met by a creditor in initiating insolvency proceedings and the court in which these proceedings will take place.

[9] From 1997 to 2002, the EBRD has conducted a Legal Indicator Survey each year to measure the progress in legal reform in Central and Eastern Europe, the Baltic States and the Commonwealth of Independent States, as viewed by local lawyers and academics. The results of such survey are based on responses to the questionnaire sent out to lawyers practising in any given country. The survey represented their perception of the country's legal system and, in particular, the degree to which key commercial and financial laws have reached internationally acceptable standards (extensiveness) and to which extent these laws are implemented and enforced (effectiveness). The survey is based purely on local lawyers' perception of their own country legislation and does not represent EBRD's own view on these legal systems. In addition, it must be noted that each respondent is asked to answer the questionnaire for his/her country only, and not on a comparative basis.

The Insolvency Law's deficiencies are found in the all-important substantive provisions of how insolvency proceedings are conducted, once they have been initiated. It is generally accepted that a good insolvency law will facilitate, in a reasonable and balanced way, the re-organisation and rehabilitation of the debtor. Unfortunately, the Insolvency Law is drafted in such a way as to make re-organisation extremely difficult and is one of the few in the region that does not provide for a stay of proceedings to protect the debtor once reorganisation proceedings are commenced. In addition, there is no interim form of stay between the initial filing of proceedings and their formal opening. There appear to be no clear qualifications that an insolvency administrator must meet before being appointed and there are no mechanisms for the removal of the administrator. Not unexpectedly, the Insolvency Law does not provide for re-organisation financing. It is also uniquely deficient in that it does not provide for the discharge of the debtor's obligations once it emerges from the bankruptcy process. In fact, section 36 seems to suggest that a creditor may continue to pursue the debtor. The cumulative effect of all of these deficiencies is to make it highly unlikely that a re-organisation would be completed, or even attempted, in Turkmenistan.

While it is not uncommon in the Region for re-organisation to be poorly addressed in the legislation, the Insolvency Law also seems to fall short in addressing terminal/liquidation proceedings. It is not clear from the Insolvency Law that, in cases where there are insufficient assets to cover the costs of liquidation, the estate will be properly wound up. In fact, it is not precisely clear as to what assets will comprise the bankrupt estate. The Insolvency Law does, however, appear to exceed expectations in its treatment of secured creditors who are left out of the bankruptcy process altogether and appear to be free to deal with their security in accordance with their contractual rights.

Capital Markets

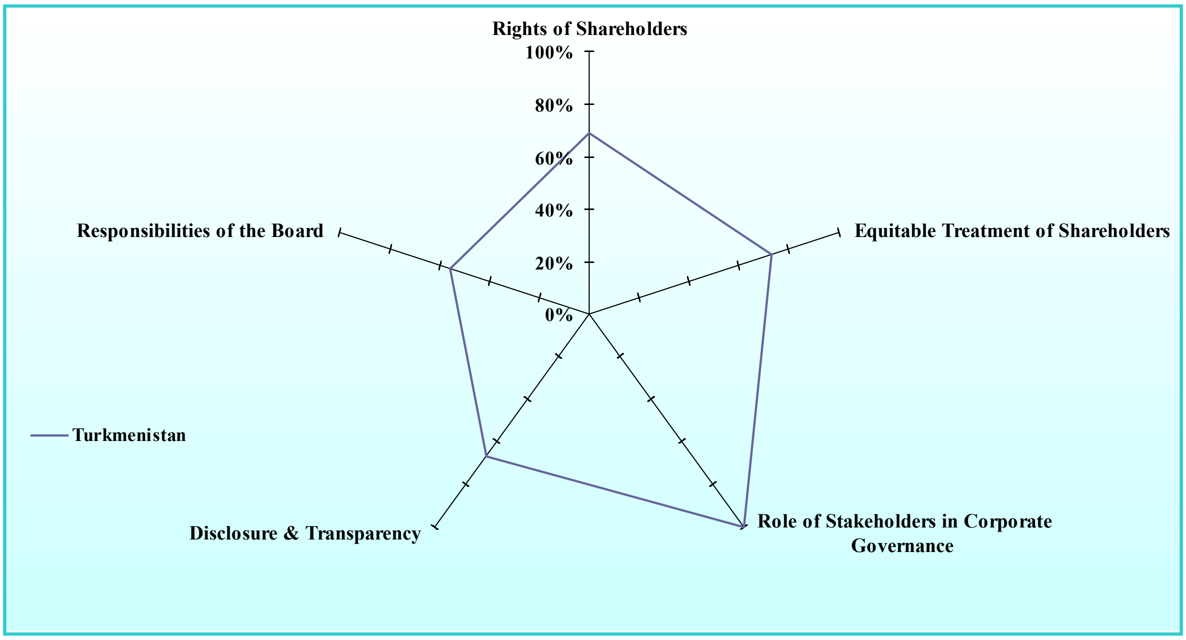
The capital markets of Turkmenistan are still at a very early stage of development. The majority of the capital markets legislation of Turkmenistan was adopted in the early 1990s and has not been substantially improved since then. For example, the Law on Securities and Stock Exchange was promulgated in December 1993 and the Law on Investment Activities in May 1992. While the development of capital markets has been an area where the Government has paid less attention in the past, a reform priority for Turkmenistan still is to overhaul the country's outdated legislation so as to pave the way for any potential market development in the future.

Company Law and Corporate Governance

The Law on Joint Stock Companies (the "JSC Law") was adopted in November 1999 and has not been amended since. This law provides for the basic legal framework for the establishment, functioning, re-organisation and liquidation of joint stock companies ("JSC") and the rights and duties of shareholders.

According to the 2003 results of the EBRD's Corporate Governance Sector Assessment Project, Turkmenistan is a country whose existing corporate governance related laws (i.e., "law on the books", not how the relevant legislation is being implemented) when compared to the OECD *Principles of Corporate Governance* were rated among "low compliance" countries. A reform priority for countries in this category is to continue to improve the quality of existing laws, including strengthening the institutional design for enforcing the laws.

Comparison of different aspects of corporate governance law in Turkmenistan



Note: The extremity of each axis represents an ideal score, i.e., corresponding to OECD Principles of Corporate Governance. The fuller the 'web', the closer the corporate governance laws of the country approximates these principles

Source: EBRD Corporate Governance Legal Assessment, 2003

As is apparent from the chart above, improvements are particularly needed in the following areas:

- **responsibilities of the board**: the JSC Law should give more responsibilities to the board, such as reviewing key executive remuneration, ensuring the integrity of the company's accounting and financial reporting systems, or monitoring the effectiveness of the governance practices under which the board operates. Also, there is no limitation at the moment to the number of board directorships that a director can hold.
- **rights of shareholders**: the JSC Law does not systematically provide for a super-majority vote (e.g., 75 per cent) for amendments to the company charter, or the merger, reorganisation or winding-up of the company. A similar super-majority threshold is lacking in the context of the board entering into transactions other than for full and valid consideration as a measure to prevent a change of control in the company. Neither does the JSC Law address the issue of cross-shareholdings (where the company owns shares in another company which is also one of its own shareholders).
- **disclosure and transparency**: there is currently no requirement for the company to prepare group accounts on a consolidated basis. Nor is there any requirement that the company prepare and disclose financial and operating data in accordance with internationally recognised accounting standards.

Concessions

The Law on Foreign Concessions, 1993, (the FC Law) governs the granting of concessions in Turkmenistan. The FC Law is applicable to foreign persons only and permits concessions to be granted for any type of activity, including industrial or natural resources exploration, provided such concessions are not otherwise prohibited by law. Infrastructure projects or municipal concessions are not expressly mentioned in the FC Law.

Pursuant to the FC Law, concessions are granted on a competitive basis and can have duration of between 5 and 40 years. While the FC Law contains a basic set of rules on tender procedures, these rules are very limited and the scope of their application unclear, leaving room for arbitrary decisions by the authorities in each particular case. The FC Law provides that concession agreements may only take the form of Build Operate Transfer (BOT) arrangements, whereby assets are transferred to the State upon expiration of a concession. Additionally, the FC Law provides for the right of the grantor to have a share in the concession's profit, purchase the concession's product and control the performance of the agreement.

There is a clause providing for compensation where the concession is terminated by the grantor. However, the rule is somewhat declarative and vague and does not suggest any mechanism or principles for such compensation. The FC Law declares that any amendments to the concessions' terms may only be exercised by a mutual agreement and that disputes are to be resolved by the courts of Turkmenistan. There are no provisions for international arbitration.

The FC Law, together with the Hydrocarbon Resources Law enacted in 1997 forms the basis for the government to grant concessions to several multinational energy companies to participate in the development of Turkmenistan's large oil and gas reserves through production sharing and joint venture agreements. The Hydrocarbon Resources Law is a sector specific act that applies to both foreign and domestic entities. Together with a number of sector specific regulations it regulates energy-related licenses, contracts and operations in Turkmenistan. It also regulates the powers, rights and duties of state agencies, companies and state enterprises engaged in oil operations.

In addition to the above legislation there have been reports of plans to draft a new concessions act for Turkmenistan.

Secured Transactions

Security rights on movable and immovable assets are governed by the Civil Code of 1 December 1998 (arts 267-299, 325-329), enacted on 1 March 1999, and the Law on Pledge (the "Pledge Law") of 1 October 1993. The Pledge Law can only apply to the extent that it does not contradict the Civil Code. The Civil Code primarily covers security over immovable assets (mortgages), possessory pledges (i.e. when the debtor must transfer possession of the collateral to the creditor or a third party) and also the rules of enforcement. The Pledge Law provides more detailed provisions on non-possessory charges and envisages the establishment of a registration system by which non-possessory charges would be publicised.

Despite attempts to create a modern system for secured transactions, the legal regime remains limited in many respects. Confusion and uncertainty on the rules and practice further undermine the system. Unfortunately, the situation does not seem to have improved since the last EBRD Strategy for Turkmenistan was published.

For example, collateral must be specifically identified in the charge agreement, including the value and location of the assets. When inventory is offered as collateral, changes in the composition are only allowed provided the assets' total value does not fall under the amount agreed in the charge agreement. This makes security over inventory of limited use.

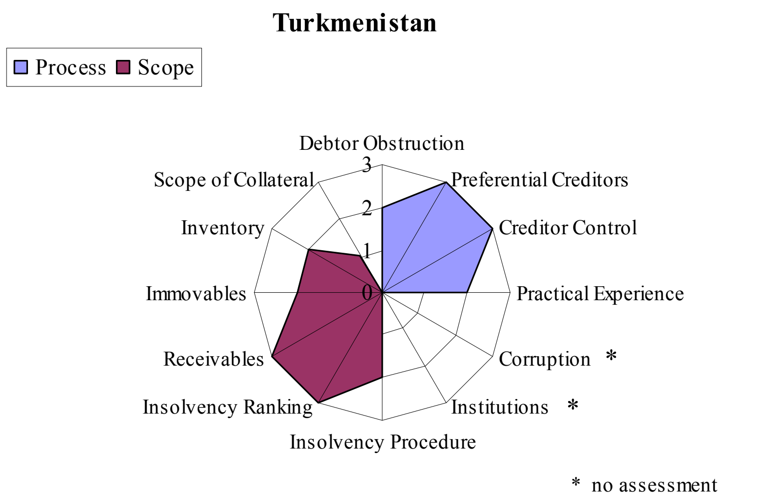
Formalities of creation are complex and somewhat confused. The Pledge Law provides that the charge agreement must be in writing and subject to authentication and registration at a notary office. However, as implementing rules were lacking at first, notaries did not accept applications. A Presidential Decree issued in December 1997 introduced rules and fixed fees but these are generally considered to be prohibitively high. Furthermore, notarisation requires presentation of many documents and titles as well as the establishment of an inventory - this is bound to make the process slow and subject to delays. After notarial authentication of the charge agreement, the agreement must then be registered, depending on the type of charge. It was probably envisaged that notaries could run a general registration system in parallel with specific asset-based registries. However, this system was never put in place.

Enforcement can be initiated either by way of inscription of execution by public notary, or on the basis of court decision (judgement), followed by realisation by a court enforcement officer. In the first case, the chargeholder must submit the notarised charge agreement to a notary public who is authorised to execute an execution inscription on it, in order for realisation to proceed. A state duty of 2 per cent of the claimed amount is charged for execution of the inscription of execution by a public notary. In the case of enforcement via court, the state charges a duty of 10 per cent of secured debt. Whatever the chosen route, realisation may only be effected by way of public auction at the State Commodity and Raw Materials Exchange of Turkmenistan. A remuneration of 5 per cent of the recovered sum must be paid to the enforcement officer.

One of the problems faced in enforcement is the obstruction by the debtor - where the debtor challenges the inscription of execution executed by a public notary or even the judgement, it is open to the court to decide to suspend enforcement. This is common practice. Upon enforcement (whether or not the debtor is insolvent) the creditor will be satisfied after alimony claims and salary arrears, as well as tax claims. All this makes the recovery of the secured debt highly uncertain.

In a survey on enforcement of charges conducted by the EBRD in summer 2003, Turkmenistan scored very low in comparison to other countries, and second last in the CIS region. The survey also highlighted a number of qualifying factors that can negatively impact on the charge enforcement process, such as the role of other creditors' claims or the limited ability for the creditor to control the conduct of the enforcement proceedings (see chart below).

Qualifying factors in the charge enforcement process



Scoring on scale of 3 (problematic area) to 1 (not problematic)

1 = no significant problems or limitations
2 = relatively minor problems or limitations
3 = major problems or limitations

The fuller the "web" of the graph, the more serious the problems are in each of the respective categories.

Process factors
Debtor obstruction: The possibility for the debtor to prevent, slow down or otherwise obstruct the enforcement proceedings to the detriment of the chargeholder. Legitimate exercise of right of defence or appeal is not included.
Preferential creditors: The impact of claims of other creditors (other than prior-ranking secured claims) on the satisfaction of the secured creditor's claim.
Creditor control: The ability of the creditor to control or influence the conduct of the enforcement procedure.
Institutions: The reliability of the courts and other institutions necessary to support the enforcement process.
Practical experience: *The general level of practical experience with the enforcement process in the country in question.*
Corruption: *The impact of corruption within the court system on the enforcement process.*

Scope factors
Insolvency procedure: The impact of the debtor's insolvency on the enforcement process.
Insolvency ranking: The priority of the secured creditor's claim upon insolvency of the debtor.
Receivables: An assessment of the simplicity and certainty of the enforcement process for a charge over receivables.
Immovables: An assessment of the simplicity and certainty of the enforcement process for a charge over immovables.
Inventory: An assessment of the simplicity and certainty of the enforcement process for a charge over inventory.

Source: EBRD New Legal Indicator Survey 2003

Telecommunications

The telecommunications sector is currently governed by the Telecommunications Law of 1996 (the "Telecoms Law") and is regulated by the Ministry of Communications (the "Ministry"). The Ministry was established by the Telecoms

Law and acts as both policy maker and regulator for the sector. In essence, the structure of the sector has changed little from Soviet times.

Generally, the telecommunications market in the Turkmenistan is relatively small and whatever growth generated has been stifled by the overpowering presence of the state and the absence of any meaningful private sector participation. Among the Commonwealth of Independent States (CIS) countries, Turkmenistan has the least developed communications services. This low level of development is reflected in sector statistics – fixed line penetration rates of less than 8 per cent in 2002, having risen from just over 6 per cent in 1991; mobile penetration of less than 0.2 per cent and a digitisation rate of approximately 20 per cent.

State-owned Turkmen Telecom is the primary provider of public telephone, e-mail and Internet services and possesses an indefinite exclusivity over fixed line telephony. Up until May 2000 here was some very limited competition in data, Internet services and satellite services, at which time the Government revoked the licenses of all Internet service providers other than that of the state owned Turkmen Telecom. Efforts by the Government to restrict Internet access in Turkmenistan are continuing as the regime seeks to isolate the country and prevent what are perceived as subversive influences from penetrating the country.

Annex 4. Selected Economic Indicators

(as at 10 May 2004)

Turkmenistan

Updated 04/2004

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
												Estimate	*Estimate*	*Projection*
Output and expenditure					*(Percentage change in real terms)*									
GDP 1/	-4.7	-5.3	-10.0	-17.3	-7.2	-6.7	-11.3	7.0	16.5	17.6	11.8	5.1	11.4	9.1
Industrial gross output	4.8	-14.9	4.0	-27.9	21.4	30.7	-33.0	25.8	13.0	29.0	13.6	5.9	9.7	na
Agricultural gross output	-4.2	-8.5	8.0	-17.6	4.5	-45.2	123.7	8.7	35.0	17.0	8.0	-6.6	11.8	na
Employment					*(Percentage change)*									
Labour force (end-year)	3.4	3.6	3.1	2.5	9.2	-0.1	0.2	5.5	-1.6	3.1	5.0	2.6	3.7	na
Employment (end year)	1.9	0.1	4.4	1.4	5.0	1.8	2.0	1.3	0.7	na	na	na	na	na
					(In per cent of labour force)									
Unemployment 2/	2.0	na	na	na	na	na	na	na	na	na	na	na	na	na
Prices and wages					*(Percentage change)*									
Consumer prices (annual average)	103	493	3,102	1,748	1,005	992	83.7	16.8	24.2	8.3	11.6	10.6	6.5	8.8
Consumer prices (end-year)	155	644	9,750	1,328	1,262	446	21.5	19.8	21.2	7.4	11.7	7.8	5.7	10.0
Producer prices (annual average)	na	na	na	na	na	na	na	na	na	na	na	na	na	na
Producer prices (end-year)	na	na	na	na	1293.0	na	na	10.3	na	na	na	na	na	na
Gross average monthly earnings in economy (annual average)	92.9	664.5	2119.3	587.7	639.8	757.1	220.0	46.3	21.9	60.3	35.0	32.8	84.2	na
Government sector 3/					*(In per cent of GDP)*									
General government balance	3.0	-9.4	-3.5	1.7	0.4	0.3	-0.2	-2.6	0.0	0.3	1.0	-2.7	-1.5	-1.0
General government expenditure	35.6	30.3	16.6	19.3	20.1	16.3	25.0	24.6	22.7	28.8	24.2	24.5	na	na
General government debt	na	na	na	na	na	na	na	na	na	na	na	na	na	na
Monetary sector					*(Percentage change)*									
Broad money (M3, end-year)	na	na	na	983.9	448.0	411.7	81.2	83.2	22.6	81.9	17.5	15.0	15.0	na
Domestic credit (end-year)	na	na	na	915.0	402.8	1389.3	88.4	77.8	24.6	24.4	15.0	15.0	15.0	na
					(In per cent of GDP)									
Broad money (M3, end-year)	na	na	11356.0	25.6	18.8	8.1	10.2	14.9	14.9	20.3	17.6	16.6	15.3	na
Interest and exchange rates					*(In per cent per annum, end-year)*									
Refinance rate	na	na	na	50.0	15.0	105.0	35.0	30.0	27.0	20.0	12.0	12.0	10.0	na
Interbank market rate	na	na	na	na	55.0	121.4	45.2	30.0	27.0	15.0	7.7	7.0	7.0	na
Deposit rate (one year) 4/	na	na	50.0	206.0	80.0	130.0	41.1	24.2	27.1	na	na	na	na	na
Lending rate (one year) 4/	na	na	108.0	300.0	70.0	200.0	52.6	58.6	41.8	11.3	na	na	na	na
					(Manats per US dollar)									
Exchange rate (end-year) 5/	na	na	30	75	2,442	5,126	5,222	8,148	8,200	9,790	10,060	10,150	10,390	10,240
Exchange rate (annual average) 5/	na	na	na	42	240	3,546	4,627	5,500	8,524	9,013	10,158	10,094	10,020	10,278

External sector	*(In millions of US dollars)*													
Current account	447	927	776	84	24	2	-608	-952	-583	386	-74	167	370	na
Trade balance	590	1,140	1,100	485	441	304	-259	-539	-210	644	325	737	1,120	na
Merchandise exports 6/	1,238	2,149	2,693	2,176	2,084	1,692	743	597	1,162	2,383	2,526	2,856	3,632	na
Merchandise imports 6/	648	1,009	1,593	1,691	1,644	1,388	1,003	1,136	1,372	1,739	2,201	2,119	2,512	na
Foreign direct investment, net	na	na	79	103	233	108	108	62	125	126	170	150	150	na
Gross reserves (end-year), excluding gold 7/	na	na	818	927	1,165	1,172	1,285	1,379	1,555	1,808	2,055	2,140	2,650	na
External debt stock	0	0	168	418	550	668	1,356	1,749	2,047	2,230	2,400	2,550	2,500	na
	(In months of imports of goods and services)													
Gross reserves (end-year), excluding gold 6/	na	na	4.5	4.5	5.8	7.0	9.2	9.0	9.1	9.3	8.8	9.1	9.5	na
	(In per cent of exports of goods and services)													
Debt service	na	na	na	1.7	11.7	13.6	28.1	41.0	38.6	18.7	30.9	18.6	na	na
Memorandum items	*(Denominations as indicated)*													
Population (end-year, millions)	3.8	3.8	3.9	4.0	4.6	4.7	4.9	5.0	5.2	5.4	5.6	5.8	6.0	6.2
GDP (in millions of manats)	17,000	306,000	10,900	87,200	652,000	7,751,800	11,108,800	13,994,700	17,157,600	22,900,000	31,000,000	37,836,315	47,122,332	na
GDP per capita (in US dollars)	134.6	351.8	3	517.0	591.9	464.1	495.1	509.9	387.1	473.3	541.1	648.0	783.8	na
Share of industry in GDP (in per cent)	20.0	59.0	49.0	39.6	56.0	57.4	35.1	29.0	33.6	37.2	38.0	38.0	38.5	na
Share of agriculture in GDP (in per cent)	46.0	19.0	19.2	33.8	17.2	13.3	21.4	26.5	27.8	27.3	26.0	21.0	18.0	na
Current account/GDP (in per cent)	88.6	68.5	7244.6	4.0	0.9	0.1	-25.3	-37.4	-29.0	15.2	-2.4	4.5	7.9	na
External Debt - Reserves, in US$ millions	na	na	-650.0	-509.0	-615.0	-504.0	70.5	370.0	492.0	422.0	345.0	410.0	na	na
External Debt/GDP (in per cent)	0.0	0.0	1569.0	20.0	20.2	30.6	56.5	68.7	101.7	87.8	78.6	68.0	na	na
External Debt/Exports of goods and services (in per cent)	0.0	0.0	5.8	16.9	22.9	33.5	133.5	209.9	150.3	84.2	86.4	81.6	na	na

Note: Data for 1992-99 represent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD. Data for 2000-2003 reflect EBRD evaluations, partly based on information from these sources.
Data dissemination by Turkmen authorities has become increasingly restrictive. Data for 2000-2003 is thus subject to considerable uncertainty.
1/ Data for 2001-2003 are EBRD estimates. Official GDP growths were 20.5 per cent in 2001, 21.2 per cent in 2002 and 23.1 percent in 2003, but there are serious data concerns over this figure.
2/ Every Turkmen citizen is guaranteed employment, thus official unemployment does not exist. According to a household survey, unemployment was 19% in 1998.
3/ Significant off-budget expenditures occur through extra-budgetary funds and directed lending.
4/ Deposit and lending rates are quoted for legal entities at joint-stock banks accounting for the bulk of financial transactions in the banking sector. For 1996-1999, data are average for loans and deposits of 3-6 months maturity. Lending and deposit rates for 1993-1996 are the highest of the total range. All interest rates are annual uncompounded.
5/ Refers to Russian rouble until 1993. Turkmenistan has had dual exchange rates for most months after the introduction of the Manat in November 1993. The series refers to a weighted average between the official exchange rate and the commercial rate, given as the buying rate offered at commercial banks until September 1998 and the black market rate thereafter. Weights are variable depending on the relative size of official and shuttle trade.
6/ From 1996 exports of gas are recorded free-of-board and transit costs are added to imports.
7/ Foreign exchange reserves of the central bank plus the foreign exchange reserve fund.

Annex 5. Bilateral Assistance[10]

Canada

Canada has no bilateral programing in Turkmenistan.

France

Year 2002: EUR 463.000 of which EUR 212.000 for technical cooperation and EUR 251.000 for various projects.

Italy

Italy and Turkmenistan are currently negotiating the agreement on cultural, scientific and technological cooperation. Italian interests focus on the archeological sector, where significant cooperation is already under way, notably with the Centro Ricerche Archeologiche e Scavi of Turin and the Centro Studi Ricerche Ligabue of Venice. These centres operate on several sites of historical interest in Turkmenistan.

Japan

Japan began bilateral assistance (ODA) to Turkmenistan in 1991. Total disbursements had reached USD 25.7 million at the end of 2001. This consisted of USD 18.0 million (70%) of loans, USD 4.3 million (16%) of grant aid and USD 3.6 million (14%) of technical cooperation. According to OECD (DAC) data, Japan was the top bilateral donor in 1998 and the second largest in 1999 and 2000 respectively.

The first yen loan project totalling JPY 4.5 billion was committed in 1997, in order to modernise the country's railway transportation system. Disbursements commenced in 1999.

Switzerland

One co-investment alongside DIF (though CARSSF) in Turkemenistan. SECO, the Swiss development agency, is a shareholder along with the Bank in TMS Wool Scouring Plant for USD 700,000. SECO also finances the credit advisors supporting the SME line, as well as a TFP training programme for Turkmen bankers.

UK

The Department For International Development does not have a bilateral programme in Turkmenistan. They have a small grants scheme administered by the British Embassy , including the Serhetabad inspection shed project (USD 500,000).

[10] This information was supplied by the respective Governments.

US

OVERVIEW OF USAID'S FOCUS IN TURKMENISTAN

FY03: Total FSA - $7.7 million, USAID Total - $3.9 million

Economic Reform (FY03 $0.6 million, 15.4%): The GOT's restrictive economic policies have limited USAID's involvement in advancing significant economic reforms. Instead, USAID focuses on preparing the next generation of entrepreneurs by offering basic business education courses, including marketing, business planning, and international accounting standards (Pragma). The EdNet program (Carana) offers training to university professors and others in economics and business education, and provides research opportunities and scholarships. Seminars of international and commercial law are provided to Turkmen law students, legal professionals, and entrepreneurs (ABA/CEELI).

Energy and Water (FY03 $0.4 million, 10.3%): As part of its capacity-building effort toward future generations of energy officials, USAID supports training and partnerships with U.S. policy specialists to help government oil and gas companies better manage their resources. USAID also assists the government in enforcing recently-passed regulations that bring Turkmenistan into conformity with international standards governing oil and gas production, and has introduced new ideas to clean oil fields and minimize waste in oil and gas fields. Water activities include training in water management and support of a regional transboundary program designed to improve interstate cooperation (PA Consulting).

Democracy (FY03 $1.1 million, 28.5%): Despite difficult challenges in Turkmenistan, limited democracy work is possible at the grassroots level. USAID supports the development of the NGO sector broadly through its network of Civil Society Support Centers. These Centers provide key intermediary support for local civil society actors and provide small grants and training on issues such as advocacy, strategic planning, and fundraising (Counterpart). USAID also supports a law clinic "summer camp" for students to explore legal issues intensively and a Street Law program and a legal resource library at Turkmen State University (ABA/CEELI).

Conflict Mitigation: Although no FY03 funding will be added to already obligated Fy02 funds, USAID's Community Action Investment Program (Mercy Corps) promotes public dialogue and participation in identifying sources of conflict, and then provides funding to address those concerns, often resulting in community-managed infrastructure projects. Target areas in Turkmenistan will focus on the Afghanistan humanitarian transport corridor, Ashgabat, and other areas of potential conflict.

Health and Population (FY03 $1.2 million, 30.8%): USAID infectious disease activities include support for reduction of TB (Project Hope) and HIV/AIDS (UNAIDS). In primary health care, USAID provides training in family medicine and the Integrated Management of Childhood Illnesses approach (Abt Assoc). USAID is also strengthening the capacity of health NGOs to promote maternal and child health (Counterpart). Health partnerships provide retraining for doctors and nurses (AIHA).

Basic Education Initiative (FY03 $0.3 million, 7.7%): Once started, this new program will work to improve the quality of teaching, increase parent involvement in schools, and strengthen institutional capacity of the school system, focusing on primary education. Implementation has been stalled pending agreement of the government. (AED)