DOCUMENT OF THE EUROPEAN BANK
FOR RECONSTRUCTION AND DEVELOPMENT

STRATEGY FOR TURKMENISTAN

As approved by the Board of Directors at its meeting on 15 June 2006

TABLE OF CONTENTS

EXECUTIVE SUMMARY

The Bank is seriously concerned by Turkmenistan's continued failure to take any measures which would indicate a willingness to make progress towards multi-party democracy, pluralistic society and a market-based economy. Since the adoption of the last Strategy for Turkmenistan in July 2004, there has been no evidence of improvement in the authorities' commitment to the principles of Article 1 of the Agreement Establishing the Bank.

Turkmenistan remains a one-party state, dominated by President Saparmurat Niyazov, who exercises power in a highly centralised, authoritarian manner. Opposition groups are forced to operate from abroad and have little influence inside the country. Lack of independent media, free speech and political pluralism contributes to the environment in the country which is not conducive to any criticism of government policies. The government's human rights record remains very poor. Small steps undertaken by the authorities failed to adequately address concerns raised by the OSCE, the UN and human rights groups. Deterioration of educational standards goes unabated and 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, but official data suggest that real output grew by 17 per cent and 21 per cent in 2004 and 2005 respectively. However, a more realistic estimate of GDP growth is about 10 per cent for 2005. This increase in output reflects in large part hydrocarbon exports and public investment programmes. Inflation has increased from 3 per cent in 2003 to approximately 10 per cent in 2005. Export revenue has risen sharply, mainly because of higher hydrocarbon prices and the level of external debt has been reduced. Meanwhile, foreign direct investment (FDI) remains limited to a few sectors, reflecting the poor business environment. The official foreign exchange rate remains fixed, while the exchange rate determined at the parallel foreign exchange market continues to be nearly 5 times the official rate. Export earnings, supported by oil and gas revenues, mainly accumulate in extra-budgetary state funds, especially in the Foreign Exchange Reserve Fund (FERF). The spending and investment operations of these funds are under the discretionary control of the President without appropriate regulation and transparency. While there are near-balanced budgets officially, the government recently reduced resources for the health and education sectors and stopped or reduced pension payments.

Over the latest strategy period Turkmenistan has made very limited progress in liberalisation and structural and institutional reforms, but registered some improvements in the tax system and agricultural land reform. State policies remain guided by central plans and state control over investment, production, distribution and key prices. Enterprise privatisation has been slow, particularly for large-scale enterprises, while the vital energy sector is formally excluded from privatisation. Private sector development is still at an initial stage. The financial sector continues to allocate funds in support of state-directed investment programmes.

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, 2002 and 2004, 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 and that selected financial intermediaries will run SME and MSE programmes on a commercial basis. 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 monitoring and management of existing investments in Turkmenistan.
- Appraisal, implementation and development of a replacement SME credit line with direct exposure to some of the local banks.
- Appraisal, implementation and development of a micro-finance programme including intensive capacity building and potentially a framework MSE finance facility.
- Selective direct investments in domestic, joint venture and foreign-owned private enterprises by direct lending or through the Direct Investment Facility (DIF).
- Further development of the trade facilitation programme with inclusion of new participating banks.

Because of the distortions introduced by the multiple exchange rate regime and subsidised or under priced inputs such as electricity and gas, any new investments will need to demonstrate clearly that they generate real economic returns. Any projects that are non-transparent or that are structured to make contributions to the FERF or other state funds will be excluded.

If substantial progress is made in democratic reforms and if the authorities embark on a consistent programme of economic liberalisation and reform, the Bank would be in a position to conduct a broader range of operations either on an Intermediate or a Regular Scenario. As in the past, the Bank will employ a number of benchmarks in gauging political and economic progress. These benchmarks are explicitly described in the Strategy and the respective operational priorities.

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. The Bank's strategy is in line with the approach by 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
DLF	Direct Lending Facility
DIF	Direct Investment Facility
EU	European Union
EUR or €	Euro
FDI	Foreign Direct Investment
FERF	Foreign Exchange Reserve Fund
FI	Financial Institutions
GEF	Global Environment Facility
GDP	Gross Domestic Product
IDB	Islamic Development Bank
IFC	International Finance 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
TCM	Thousand Cubic Metres
TCP	Trans Caspian Pipeline
TFP	Trade Facilitation Programme
TRACECA	Transport Corridor Europe-Caucasus-Asia
UNDP	United Nations Development Programme
UNEP	United Nations Environmental Programme
UNICEF	United Nations Children's Fund
US$	United States Dollar
USAID	United States Agency for International Development
WB	World Bank

II. COUNTRY STRATEGY

1. THE BANK'S PORTFOLIO

1.1. Overview of the Bank's Activities to Date

Since operations commenced in 1994 in Turkmenistan the Bank has signed 8 projects for a total commitment of EUR 121.4 million (excluding regional funds and TFP). The bulk of the Bank's portfolio in Turkmenistan was developed between 1994 and 2000 when the country strategy restricted new operations to the private sector which should not have links or make contributions to the Foreign Exchange Reserve Fund (FERF) under the baseline scenario.

In recent years, the Bank has been focused on developing private sector projects. In 2003 the Bank signed a project for a wool scouring plant under the Direct Investment Facility (DIF) for EUR 0.6m with a follow up loan of EUR 0.8 million in 2005. The Bank re-activated the SME Credit Line in 2003 but, due to a change in government policy relating to sovereign guarantees, this was cancelled in late 2005. The Bank is considering whether this could be replaced with direct SME lines to the banks. In addition, the Bank reached agreement with Senegat Bank and National Bank of Pakistan (Ashgabat branch) to participate in the Trade Facilitation Programme (TFP); with so far only Senegat Bank issuing Letters of Credit (LCs).

Operating assets in Turkmenistan are now EUR 32.7 million, excluding regional venture funds, following a major reduction as a result of the pre-payment of EUR 23 million by Dragon Oil in February 2006 and the settlement of a put to the shareholders of GAP Turkmen for US$ 3 million of equity in December 2005.

Table 1 Bank's activities to date

Investment[1]	Total project costs EUR million	EBRD Finance EUR million	Current Portfolio EUR million	Operating Assets EUR million	% EBRD finance
Export-oriented Credit Line	7.1	7.1	0.8	0.8	100%
Gap Turkmen	74.3	26.4	11.9	11.9	36%
Gap Turkmen 2	13.3	3.4	0.0	0.0	26%
Gap Turkmen 3	8.8	8.8	3.5	3.5	100%
Turkmenbashi Port Development	38.4	24.8	15.7	15.7	65%
Dragon Oil	429.2	49.5	0.0	0.0	12%
DIF - TMS Wool Scouring	1.8	0.6	0.6	0.6	33%
DIF - TMS Wool Scouring II	1.5	0.8	0.8	0.2	53%
	574.4	**121.4**	**33.3**	**32.7**	**21%**

[1] As of 31 March 2006, and excluding regional funds and TFP

1.2 Implementation of the Previous Country Strategy

In the absence of progress in political or economic reforms, the Bank operated within the framework of the baseline scenario as outlined in the 2004 strategy, which excludes any funding of public sector projects or any project with contributions to the Foreign Exchange Reserve Fund.

The Bank has the following strategic priorities for Turkmenistan:

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

- Further development of TFP (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 and through the attraction of strategic sponsors into joint ventures within the limits of the baseline scenario approach.

Implementation of these strategic priorities during the strategy period was as follows:

- Monitoring continues on the active portfolio of projects which are all being serviced and there are no impaired assets. On the SME credit line Senegat and Turkmenbashi banks approved together 6 subprojects for a total amount of EUR 0.7 million and a pipeline was developing with two other banks willing to participate until the line was cancelled due to the withdrawal of the sovereign guarantee.

  Equity costing US$ 3.0 million in Gap Turkmen was sold back to the shareholders in December 2005 for US$ 4.6 million. While the company honoured a second put for shares costing US$ 1.5 million for US$ 1.8 million to be settled in December by transferring funds via its account with the main bank in Turkmenistan, these funds were diverted by the Bank to a Ministry of Textiles account. The Bank is in active discussions with the authorities to restore the funds to enable payment.

  In light of the concerns expressed by NGOs over the use of child labour in the cotton sector, the Bank's Environment Department conducted a labour audit at the Gap Turkmen Jeans Factory in May 2005. The audit confirmed that this Bank project was in full compliance with labour requirements under EBRD's Environmental Policy. However, despite efforts by the authorities in formally banning the use of child labour in cotton fields, the audit stated that child and forced labour still exists in primary agriculture including cotton picking, although it appears that the use of child labour was reduced in the last harvesting season in late 2005.

- One more bank signed the TFP participation agreement, bringing the total number of participating banks to two, for a total amount of some EUR 0.2 million, with another under preparation.

- Discussions have continued with the Central Bank and local banks on launching a micro-credit programme although progress is slow due to concerns on the part of the Central Bank regarding loan size, the risk that new liquidity may further widen the gap between the official and informal exchange rates, and general unwillingness to make formal decisions.

- In 2005, the Bank approved a further EUR 0.8 million loan to the first DIF project in Turkmenistan, of which EUR 0.7 million has been disbursed. This, together with the two LCs on the TFP, brings the total business volume over the strategy period to approximately EUR 1 million and disbursements to EUR 1.75 million.

In general, policy dialogue on economic reform has had limited results. Discussions with the Central Bank and senior ministers, and recommendations on exchange rate reform and introducing transparency into the Foreign Exchange Reserve Fund, has produced limited changes in policy or practice. Similarly, discussions on allowing more private sector involvement in the so-called strategic areas such as Textiles or Telecommunications have not changed governmental policies to dominate industry and direct investment. When the exclusivity period of operations for the one private sector mobile operator expired in the second quarter of 2004, the state telecommunication company started its own mobile operation despite representations from the Bank that an open tender with technical assistance would yield positive benefits for both the sector and the economy. Limited success with policy dialogue is shared by all the other international organisations and major embassies. In fact the climate for reform, dialogue and decision making has deteriorated since the middle of 2005 following major changes of the key figures in the administration.

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

1.3.1 Portfolio Performance

Portfolio quality is generally good. Loans, both sovereign and private, are mostly serviced on time albeit with some timing delays due to the fact that only one bank in the country has SWIFT and that the approval processes as well as the coordination among state entities are time consuming.

Equity costing US$ 3.0 million in Gap Turkmen was sold back to the shareholders in December 2005 for US$ 4.6 million. While the company honoured a second put for shares costing US$ 1.5 million for US$ 1.8 million to be settled in December by transferring funds via its account with the main bank in Turkmenistan, these funds were diverted by that Bank to a Ministry of Textiles account. The Bank is in active discussions with the authorities to restore the funds to enable payment.

1.3.2 Transition Impact

In line with the previous strategy, only limited progress can be reported in promoting Turkmenistan's transition process, despite substantial and persistent efforts on the part of the Bank, in common with the rest of the international community. However at the level of individual projects, the Bank has achieved good transition impact in specific areas.

The Enterprise Sector and Environment

The Bank was involved in the enterprise sector through its loan and equity investments in Gap Turkmen and also through a small DIF equity investment in TMS Wool.

Gap Turkmen is one of the first successful light industry investments in Central Asia and a rare private sector investment in Turkmenistan. Gap Turkmen was the first company in the CIS to receive international certifications in quality and environmental management. There are potential demonstration effects regarding quality management and marketing. The tightening economic and political climate since November 2002, however, makes it increasingly unlikely that the project could achieve its demonstration effects of attracting more foreign investment (particularly with majority foreign control). Nevertheless, the project continues to achieve some transition impact through the setting of standards (ISO, environmental health and safety and ethical) and transfer skills.

The DIF investment with SECO in the TMS wool scouring project has created a private sector, value added, export-orientated project that should serve as a pragmatic example to the authorities of the benefits of allowing private sector development. The DIF project is also generating transition impact by way of improved business standards, and skills transfer has also been achieved through interaction between the investee companies and EBRD staff and other TC funded advisory work.

The project has performed well with the PSA being adhered to, the company meeting production targets, improving its environmental standards and successfully implementing training programmes. The demonstration effect, however, has been limited by the government's restrictive attitude to new foreign investment in the energy sector and the continuing lack of transparency with regard to the Foreign Exchange Reserve Fund. The Fund is under the control of the President, without regulatory framework and public information.

Financial Sector

The Bank has two projects in the Financial Sector, TFP and the SME Credit Line. Some transition impact was achieved through the SME credit line, where the Bank using TC funding has provided three credit advisers to train and assist the participating banks and where the Bank's loan covenants require IFRS external auditing. The SME line disbursed 120 private sector projects over its lifetime, and it is a powerful demonstration of the benefits of properly designed lending programmes for the banking system and for the borrowers.

Two banks have been included in the TFP programme, but so far only one is actively participating, and this bank has developed an active LC unit complementing the skill and product base of the bank, and providing improved service to the business community. Since early 2004, two trade finance training courses funded by donors were organised for the whole banking sector, including the Central Bank and the Banking Institute.

The Bank's impact in the financial sector is limited, however, because disbursements are low and the sector remains largely unreformed, with state intervention and directed credit being the norm. For all that, the SME and TFP lines will continue to be significant in developing the constrained private sector.

Infrastructure

The Bank was involved in two sovereign-guaranteed infrastructure projects, one in the road sector which was subsequently cancelled, and the Turkmenbashi Port development project. The Turkmenbashi Port project has brought standards of cost recovery, accountability and public procurement into Turkmenistan's public sector. Moreover, the port is a key outlet for foreign trade and is one element of the TRACECA corridor linking Central Asia to Europe. The transition rationale of the port project was trade facilitation and the jumpstart of the institutional reform in the regulation and operations of the port. Special emphasis was placed on changes in tariffs to improve cost recovery. The project experienced some problems, and the authorities have been reluctant to implement changes that would have improved the transition impact.

Mobilisation of Co-Financing

The Bank has been very successful in mobilising co-financing for its operations. The total cost of projects financed by the Bank amounts to EUR 574 million, with a multiplier ratio to EBRD financing of 4.7/1. The Bank has a crucial role as a supporter and promoter of investment in the private sector.

1.3.3 Lessons learnt

It is very difficult to make progress on the key policy reform issues and transition challenges because of regular changes of key contacts on the government side and the sharp divergence between the Bank's strategic orientations and the government's policies. The Bank's leverage on the government is not great in light of the government's firm commitment to state ownership and direction of all key industries, and also because Turkmenistan does not depend on external funding. Strong growth in export revenues from oil and gas arising from the sharp increases in market prices, especially for oil and growing foreign exchange reserves, have reduced the need for funding from IFIs, hence their leverage on the authorities.

The current relatively small private sector portfolio and non financing of state projects does not give the Bank much leverage with the government. There is little commitment or acceptance on the part of the government for the need for reform, corporatisation or privatisation in key areas such as power and energy, transport, telecommunications, agriculture, or the financial sector.

Private sector projects are difficult to structure and implement with smaller foreign investors or local investors. The TMS project required substantial negotiation with government agencies and suffered cost overruns as a result, requiring additional financing. Nonetheless, the effort has been worthwhile as private sector projects serve as an alternative to the state model which dominates the economy.

EBRD's relatively small portfolio and the restrictions of the Bank's country strategy also limit the Bank's ability to push for reforms in key areas such as energy and agriculture. However, some limited progress is possible through persistent policy dialogue, even if it is in small steps and in few areas.

In addition to the general lessons learnt, there are also some specific project related lessons. For instance, the first GAP Turkmen project shows that the transition impact of an investment project tends to decrease if fostering relations with an interventionist government becomes more important than market driven management. A fundamental competitive advantage and a strong sponsor in export oriented projects can help mitigate the risks. Commensurate recourse to the sponsor should be sought, however, in the form of loan guarantees and/or equity put options.

A lesson from the Turkmenbashi Port project is that, while the Bank should rightly explore all potentials for expedient project delivery, this faces limits where the counterpart cannot keep pace with the Bank, or where due diligence scrutiny is at risk. Maintaining counterpart ownership and preparation thoroughness should not be compromised.

The Bank had some transition impact success in the natural resource industry with its Dragon Oil project through extensive policy dialogue over the PSA framework. The project has been an important milestone in testing the legal framework for PSAs in Turkmenistan, and in supporting high corporate, financial and environmental standards.

A lesson from the Dragon Oil project is that the Bank should evaluate the use of carbon credits for the financing of measures which would facilitate the closure of the environmentally damaging carbon black plant and reduce or eliminate the flaring of associated gas, including encouraging the dialogue with the Turkmenistan Government and neighbouring countries on necessary gas transportation upgrades.

1.4 Portfolio Ratio

As at end of April 2006, the private/state sector portfolio ratio stood at 53/47.

The prepayment of the substantial private Dragon Oil loan has had a serious impact on the private/public ratio, and the small size of new private sector projects will not reduce this impact in the short to medium term.

2. OPERATIONAL ENVIRONMENT

2.1 The General Reform Environment

2.1.1 Social Conditions and Labour Issues

Social issues in Turkmenistan are characterised by the further deterioration of the socio-economic status of the majority of the population, primarily due to higher levels of unemployment, reduced education opportunities, wide-spread use of drugs, lack of adequate medical facilities and services, and a spread of communicable diseases and deterioration of housing conditions.

The determination of the poverty level is difficult due to lack of data, as 45 to 50 per cent of the population was estimated to have consumption below the subsistence minimum in 2003. Moreover, income inequality appears to be the worst among the Central Asian republics, according to a recent living standards survey conducted by the National Institute of State Statistics. In the absence of reliable statistics, estimates put unemployment at 30 percent or even higher.

The literacy of Turkmenistan's population is statistically high at 98.8 per cent, but the educational system continues to deteriorate in recent years. School and university curricula have been significantly curtailed and important disciplines were excluded from the educational programmes. Compulsory education is limited to nine years. Since 2000, universities have reduced the period of classroom instruction from 4 years to 2 years, as 2 years are allocated for vocational training. Moreover, the number of enrolments declined from 40,000 in the 1990s to 3,000 per annum in 2004. This triggered a major redundancy of the teaching personnel in the last 2 years.

Turkmenistan is an ILO member state and has ratified six of the eight core ILO conventions. The country has not ratified the conventions dealing with minimum age for labour (C138) and the worst forms of child labour (C182). Although the Constitution of Turkmenistan prohibits forced or compulsory labour, child labour has been widely used in the agricultural sector during the cotton picking season. However, under international pressure, last year the President issued a decree making the use of child labour illegal. The situation regarding the use of child labour has improved since, which was confirmed by the latest US State Department Report on Human Rights published in March 2006. The report states that "some child labour was seen in the cotton fields during the harvest; however, this was not encouraged by the government and contrary to a presidential decree". In May 2005 the Bank conducted a labour audit of its Gap Turkmen project in the textiles sector. This was found to be fully compliant with the EBRD labour requirements. Nevertheless, forced labour issues are also a concern in Turkmenistan as army conscripts are widely used as unpaid labour in the country, in various fields ranging from hospitals to construction activities.

The healthcare system is in decline and many hospitals lack qualified specialists and stocks of emergency medicine. There have been some investments in state of the art medical equipment and facilities in the capital; however, the government did not invest in the training or budgeting of doctors or other medical personnel. Recently, the authorities decided to close some of the health facilities located in rural areas. From February to July 2004, the government dismissed approximately 15,000 nurses, replacing them with military conscripts untrained in administering medical treatment. While official health statistics indicate progress on reducing infant mortality, other surveys indicate the opposite trend, suggesting that poverty and healthcare problems led to a high rate of infant mortality. Other health-related concerns include use of drugs, spread of communicable diseases (the increase in the incidence of tuberculosis is one such example) and a general lack of awareness on the spread and prevention of HIV.

Recent reductions in state benefits are another social concern. Legislation relating to pensions introduced in January 2006 ended state maternity and sick leave payments and cancelled pensions for 100,000 senior citizens. Many of the remaining 229,000 pensioners receive payments less than the current provision of US$ 10-90 a month.

NGOs and civil society are still at the very early stages of development in Turkmenistan. Although the Constitution provides for freedom of association, however, the government restricts this right in practice. The 2003 Law on Public Associations and NGO Registration requires that all non-governmental organizations (NGOs) register with the Ministry of Justice, criminalizes the operation of unregistered groups, and restricts the ability of foreign donors to provide grants and assistance to civil society groups by requiring that all foreign assistance be registered with the State Agency for Investment, Ministry of Justice, and coordinated through the Ministry of Foreign Affairs. By the end of 2004, however, the government began to make some concessions, including abolishing a law that criminalised participation in an unregistered organization. The government also permitted Counterpart International to conduct the NGO and Community Leaders Forum. Before the government decriminalised participation in a non-registered NGO, however, many organizations were shut-down for violations, including longstanding organisations such as Katena and Eco Club.

2.1.2. Legal Environment

Minimal legal reform and transition has taken place over the last two years. Key sectors of Turkmenistan's commercial laws continue to fall well below internationally accepted standards, as is reflected by the results for Turkmenistan of the series of assessments of legal transition undertaken by EBRD in its countries of operation.

Much of Turkmenistan's commercial law was enacted in the 1990s and has remained unamended and unreformed since first coming into force. The present legal framework does little to foster investment, and comprehensive reform is required in order to encourage and facilitate private sector participation. Extensive progress is also required at the institutional level. The courts and institutions which implement and administer the law are not independent of the government and remain subject to political influence.

Turkmenistan continues to face serious challenges in developing both its commercial laws and legal infrastructure to internationally accepted standards. The country has, to date, failed to adopt the democratic values of a legal system based on the rule of law and this remains the principal impediment to the progress of legal reform and transition.

2.1.3 Environmental Issues

Turkmenistan's National Environmental Action Plan (NEAP), approved by the President of Turkmenistan in 2002, has now been incorporated into the National Development Strategy and its implementation is mandatory for all sectors and government organisations. NEAP activities include (1) improving legal and institutional arrangements for better environmental management, (2) protecting ground and surface water, (3) preserving rare and endangered species of flora and fauna, (4) enhancing public environmental awareness, and (5) reversing land degradation and the desertification process.

The Ministry of Nature Protection actively participates in the implementation of activities required by the NEAP as well as other international and regional environmental initiatives and projects aimed at tackling existing environmental issues. However, limited funding and resources make it difficult to address environmental issues in a timely manner and Turkmenistan continues to be highly vulnerable to environmental damage, particularly with regard to the fragile, arid ecosystems and limited water resources.

Water management is not adequate and high water intake for irrigation by the cotton industry, along with low efficiency of irrigation systems, soil leaching, leakage and seepage losses and evaporation take their toll on the already limited water resources in Turkmenistan. Construction of the huge artificial lake in the Karakum desert, which would collect waste and drainage water from all 5 regions in Turkmenistan, raises serious concerns as scientists and international organisations fear that the lake would pollute massive areas of land with salt and that, due to the arid climate in Turkmenistan and the high evaporation rates, the lake would not solve water shortage problems but aggravate them.

Irregular supplies and quality of drinking water, especially in rural areas, are a cause of water borne diseases. Chemical pollution caused by use of defoliating agents in the cotton fields causes health problems.

Depletion of the sturgeon population in the Caspian Sea, mainly due to the illegal poaching for subsistence and sale by the coastal communities, is a serious regional and international concern. Obsolete offshore oil production platforms in the Turkmen sector of the Caspian Sea increase the risk of oil spill and marine pollution.

Management of natural reserves, which are home to a number of the Red Book of Protected Species, is a concern as protected areas are often used by local communities for collection of medicinal herbs and cattle grazing.

There are a number of environmental activities which are implemented by other international institutions. UNDP, UNEP and the OSCE are leading the regional Environment and Security Initiative for Central Asia, with the objective to engage a wide number of governmental and developmental stakeholders in a coordinated effort to assess the environmental risks and find solutions for the sustainable management of environmental resources.

UNDP, in cooperation with the British Government, is also assisting Turkmenistan in its water assessment exercise and developed a number of recommendations for water management within the framework of the Amudaria Water Quality Assessment initiative. Moreover, UNDP, jointly with GEF and OSCE funds, is implementing the Khazar Nature Reserve project within the objectives of the Biodiversity Strategic Action Plan. The project is aimed at strengthening Turkmenistan's capacity to manage protected areas.

In addition there is the Caspian Environmental Programme which is currently implementing three regional projects: the GEF Phase II Project titled "Towards a Convention and Action Programme for the Protection of the Caspian Sea Environment"; EU/TACIS Sustainable Management of Fisheries Project; and EU/TACIS Sustainable Development of Coastal Communities Project.

The Asian Development Bank is providing Technical Assistance to Turkmenistan within its regional Central Asia Counties Initiative for Land Management, co-financed by the GEF and the Global Mechanism of the United Nations Convention to Combat Desertification. The objective of this initiative is to combat land degradation and improve rural livelihoods in Central Asia.

Efforts of environmental organisations in Turkmenistan are directed to dissemination of environmental information and supporting initiatives aimed at nature protection. Public consultation on environmental issues and the involvement of environmental organisations remains limited, however, due to the political and legal circumstances in the country, the severely limited freedom of speech being a serious obstacle for public involvement in decision making.

2.1.4 Regional Issues

The key issues for Turkmenistan from a regional perspective relate to mainly oil and gas transportation and the division of the Caspian Sea. Turkmenistan exports gas to Russia and Ukraine (through Russia), but the main pipeline, the Central Asia Centre (CAC) pipeline is fully controlled by Russia and has capacity constraints. Moreover, Turkmenistan has been trying to diversify export partners (e.g., India, China, Pakistan, etc.). Under these circumstances, the key objective of the authorities has been the construction of new pipelines.

There are several potential pipeline projects under consideration. One potential project is an east-west gas pipeline under the Caspian Sea to Azerbaijan and via Georgia to Turkey (Trans Caspian Pipeline or TCP). Another is the Turkmenistan-Afghan-Pakistan (TAP) pipeline. The TAP pipeline has been supported by the Asian Development Bank, the feasibility study is ready, and the respective three countries signed a protocol for the project in April 2005. However, the plausibility of these, or other potential pipelines, depends on the actual gas reserves of Turkmenistan gas-fields as well as the stability of Afghanistan in the case of the TAP pipeline. The construction of a gas pipeline to China was agreed between the governments in April 2006 with completion in 2009, but this project is still at an early stage.

The issue of the division of the Caspian Sea remains unresolved. There was progress on resolving issues such as shipping, ecology and fishing while there is no consensus on the division of the seabed. Russia, Azerbaijan and Kazakhstan agreed on the division on the basis of bilateral talks in 2003, but Iran and Turkmenistan have not yet joined the emerging agreement. Working group meetings on the legal status of the sea continue to be held on a regular basis.

2.2 Progress in Transition and the Economy's Response

2.2.1 Macroeconomic Conditions Relevant to Bank Operations

The availability and accuracy of data and information continue to be major constraints in the analysis of economic developments in Turkmenistan. According to official data, the economy grew strongly in recent years, by 17.2 per cent in 2004 and 20.7 per cent in 2005. This is in line with high growth rates over the past five years. However, it is generally accepted that the official figures are significantly overstated. The IMF made a more realistic estimate for the 2005 GDP growth rate at 9.6 per cent. The main drivers of growth have been construction (supported by public investment programmes) and trade and services as well as non-oil and gas industry and non-cotton agriculture. The country also benefited from higher hydrocarbon export prices. Nevertheless, the growth in the key sectors (i.e. oil, gas, electricity and cotton) decelerated significantly. For example, the production volumes in the hydrocarbon and electricity sectors grew only marginally (oil output slightly fell).

Over the last two years, monetary policy remained relatively tight, with the main objective to keep inflation at a low level. The rate of money supply growth slowed down in 2004-05 after a large expansion in 2003. However, extensive subsidies and price controls over key products and utilities prices, which should be liberalised, help to contain inflation. In 2004-05, as a result of the lagged effects of the fiscal and monetary expansion in 2003 and higher foodstuff prices, inflation has risen. The year-end inflation rate increased from 3 per cent in 2003 to 9 per cent in 2004, and to 10 per cent in 2005. The authorities have kept the official exchange rate fixed at 5,200 manat per US Dollar. The parallel market, which is not recognised by the authorities, has been relatively stable during 2005, and continues to be nearly 5 times the official rate.

Fiscal policy also remained tight during the past two years. However, the government continues to conduct fiscal operations in a non-transparent manner and with large off-balance sheet activities.[2] Export earnings, supported by oil and gas revenues, mainly accumulate in extra-budgetary state funds, especially in the Foreign Exchange Reserve Fund (FERF). The spending and investment operations of these funds are under the discretionary control of the President without proper regulation and transparency. The official budgets have been balanced both in 2004 and 2005, and the approved state budget for 2006 envisages no deficit. On the revenue side, a new tax code was adopted in October 2004 in order to simplify the tax system, encourage private sector development, and improve tax compliance. Moreover, in October 2005, the authorities unified five taxes, including an 8 per cent profit tax and 15 per cent VAT for private businesses, into a single turnover tax of 2 per cent.

On the expenditure side, overall expenditures remain tight but there is substantial concern over the prioritisation and expenditure management. For example, the authorities increased public sector wages by 50 per cent in 2005. The supply of electricity, water and salt continues to be free of charge. But resource allocations to the education and health sectors continue to fall. Following the lay-off of 12,000 medical staff in 2003, an additional 15,000 medical workers were made redundant in 2004. The government also cancelled a number of free medical services in 2004. Moreover, the government stopped or reduced pension payments starting from February 2006. These facts suggest that the fiscal situation is more difficult than official data indicate.

The external performance over the past two years, especially in terms of export growth, has been favourable. The trade account benefited from higher oil and gas prices while imports grew only moderately. Total exports in 2005 rose by 28 per cent while imports increased by 16 per cent. The trade surplus reached US$ 1.3 billion in 2005 (15.6 per cent of GDP), the highest since independence. Accordingly the current account surplus increased from 1.2 per cent in 2004 to 8.2 per cent of GDP in 2005. The gross international reserve (including the FERF) is estimated to have reached the equivalent of 8.6 months of imports of goods and services at the end of 2005. The authorities made early repayments from excess cash-flows

[2] Extra-budgetary expenditure carried out through state funds and self-financing ministries is 3.5 times bigger than the expenditure of the state budget and equivalent to 68 per cent of GDP in 2004.

from the FERF, and accordingly the external debt-to-GDP ratio dropped from 18 per cent in 2004 to an estimated 12 per cent of GDP in 2005.

The largest concerns relate to the volumes and prices of exported gas to Russia and Ukraine. In early 2005, the gas export price for Ukraine was raised to US$ 58 per thousand cubic metres (tcm) from US$ 44 tcm (but 50 per cent on a barter base). As it was difficult to receive appropriate payments from Ukraine, the authorities agreed to revert the price to US$ 44 tcm, but with full cash payments. Turkmenistan also reached an agreement with Russia to switch to full cash payments in 2005. These changes should lead to more transparent trade relations with both countries. Looking forward, Turkmenistan is to export 30 billion cubic metres (bcm) of gas to Russia for 2006 at the new price of US$ 65 tcm. The bilateral negotiations with Ukraine resulted in the commitment of 40 bcm in 2006 at the price of US$ 50 during the first half and then US$ 60 for the second half. The country also recently agreed with Iran to increase gas export prices (US$ 42 per tcm to US$ 65 from February 2006) and volume (around 6 bcm per year to 14 bcm from 2007). The higher gas prices should lead annually to an additional US$ 500 million or more. However, the current pipeline access and production capacity raise some doubts about whether gas sale commitments can be met.

The economic outlook remains highly dependent on the hydrocarbon sector. The long-term gas supply agreement with Russia and high hydrocarbon prices may underpin annual real GDP growth of 5-7 per cent in the medium term. However, the dependence on the hydrocarbon sector, combined with the lack of market-oriented reforms, leaves the economy vulnerable to external shocks as well as gas production and pipeline constraints. The increasing competition for the pipeline and export markets with Uzbekistan and Kazakhstan would be another risk. More generally the sustainability of economic growth is questioned since extensive public investments have been made in non-productive sectors, such as prestige constructions.

2.2.2 Transition Progress and Transition Challenges

Transition Progress

Over the last two years, Turkmenistan has made very limited progress in liberalisation and structural and institutional reforms. Some progress was made in the areas of agriculture land reform and the tax system. However, state policies remained guided by central plans and state control over investment, production, distribution, and key prices. The government medium-long terms policies are based on the "Strategy for Economic, Political, and Cultural Development until 2020", which was adopted in 2003. The strategy envisages "gradual" transition to a market economy and private sector development, but also emphasises the importance of state-directed investment, production, and resource allocations.

The country remains the least reformed state among the EBRD's countries of operation (see Table 2). The detailed sector-by-sector analysis of the remaining transition challenges in the EBRD's countries of operation is in Annex 9. The analyses have been made to map specific transition challenges under the transition indicator headings i) Structure and extent of markets (e.g., extent of competition); ii) Market institutions and policies (e.g. regulatory framework); and iii) Market-based skills, conduct and innovation (e.g., improvements in corporate governance). Turkmenistan faces large transition challenges in all sectors and in all dimensions.

Table 2 Transition Indicators of the CIS countries, 2005

	Enterprises			Markets and Trade			Financial Institutions		Infrastructure
Countries	**Large-scale privatisation**	**Small-scale privatisation**	**Governance & enterprise restructuring**	**Price liberalisation**	**Trade & foreign exchange system**	**Competition policy**	**Banking reform & interest rate liberalisation**	**Securities markets & non-bank financial institutions**	**Infrastructure reform**
Armenia	4-	4	2+	4+	4+	2+	3-	2	2+
Azerbaijan	2	4-	2+	4	4	2	2+	2-	2
Belarus	1	2+	1	3-	2+	2	2-	2	1+
Georgia	4-	4	2+	4+	4+	2	3-	2-	2+
Kazakhstan	3	4	2	4	3+	2	3	2+	2+
Kyrgyz Republic	4-	4	2	4+	4+	2	2+	2	2-
Moldova	3	3+	2	4-	4+	2	3-	2	2+
Russia	3	4	2+	4	3+	2+	2	3-	3-
Tajikistan	2+	4	2-	4-	3+	2-	2	1	1+
Turkmenistan	**1**	**2**	**1**	**3-**	**1**	**1**	**1**	**1**	**1**
Ukraine	3	4	2	4	3+	2+	3-	2+	2
Uzbekistan	3-	3	2-	3-	3-	2-	2-	2	2-
CIS Average	3-	3+	2-	4-	3+	2	2+	2-	2
EBRD Average	3	4-	2+	4	4-	2+	3	2+	2+

Note: The index ranges from 1, indicating little or no progress, to 4+ pointing to standards similar to advanced economies. See Transition Report 2005 for the detailed definitions.

Liberalisation, Market and Trade

Reforms in price and trade liberalisation continued to be slow. Price regulations on flour, meat, milk, rice and sugar were abandoned during the 1990s.[3] However, price controls on selected items, such as rents, bread, petroleum products, utilities and transport fares, remained in place and no changes were made in recent years. The trade and foreign exchange systems remain restrictive. Approval from the State Commodity Exchange is required for all trade transactions, and access to foreign exchange auctions is restricted to those who are in line with the authorities' objectives.[4]

Privatisation and Business Environment

Enterprise privatisation has been limited, particularly for large-scale privatisations. According to official data, a total of 146 enterprises have been privatised during 1999-2004. However, privatisation of medium and large enterprises has been limited to only three enterprises. The energy sector is formally excluded from the list of privatisations at least until 2020. Moreover, the authorities indicated that the government is ready to renationalise privatised companies if they do not meet originally agreed goals (including social and commercial goals).

During the last strategy period, one notable development was the adoption of a new tax code. The tax system was simplified and the overall tax burden for private businesses has been lowered. However the business environment in Turkmenistan remained among the most difficult in the region. It seems the authorities tightened day-by-day operational controls, particularly with regard to trade restrictions (both trade permissions and access to foreign exchange). Access to finance remains a major problem. Foreign investors also complain about frequent personnel and policy changes in the government. A survey conducted by USAID in 2005 concluded that the Turkmenistan business environment is extremely difficult for small and medium-sized enterprises. According to the survey, 98 per cent of SMEs had difficulties with transactions in foreign currency (up from 83 per cent in 2001). Only 2.5 per cent of exporters said that they were free to sell their products abroad, while 19.5 per cent said that they were free to set prices.

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[3] A number of regulated items were declined from 22 items in 1998 to 17 items in 1999.
[4] The authorities indicated that it is open to anyone as long as legal documents are prepared.

Financial Sector Development

The financial sector remains underdeveloped. There are currently 11 banks, of which six are majority state-owned banks, two are private banks and three are foreign banks. State-owned banks account for more than 90 per cent of total assets. The ratio of domestic credits to the private sector is limited to 1.4 per cent of GDP and the majority of deposits are from state owned enterprises. In some areas (e.g., agriculture), the Central Bank provides directed credits to state-owned banks at low interest rates to provide concessional finance to selected industries. Moreover, the Kartotheka system, which establishes a priority of wage and tax payments over other payments from enterprises' bank accounts, remains in place. Commercial banks, except for the Bank for Foreign Economic Affairs of Turkmenistan, are not allowed to conduct foreign exchange transactions. Private banks play limited roles while they appear to be significantly influenced by the authorities. According to the authorities, all banks have met the prudential requirements.[5] There is a deposit insurance scheme operational since 2002, which guarantees deposits of the population.

Agriculture Sector Reform

Agriculture is the key sector of the domestic economy, accounting for nearly 50 per cent of employment. Cotton and grain are the main agricultural products. Following disappointing agricultural harvests in recent years, a new land code was adopted in October 2004. It allows individual farmers to lease plots of land up to three hectares in size for up to 10 years (up to 200 hectares for private associations and enterprises). The authorities also have given freedom for farmers to sell their agricultural products on the market since mid-2005, but the state continues to intervene in all aspects of agricultural activity (including inputs, outputs, trade and finance). In 2005, the State Agricultural Joint Stock Company was created to facilitate all agriculture-related resources. Farmers receive 50 per cent of the costs of agricultural equipments and fertilizer as subsidies, and instead they are obliged to deliver 30 per cent of harvests to the state.

Infrastructure Reforms

Market-based reforms in infrastructure remain at the initial stage. The units providing utility services were corporatised but they are not operating in a commercial manner. Utilities are provided for free or prices are set much below the cost recovery levels. Gas, electricity and water are provided free of charge. Tariffs for petrol and diesel are also extremely low. The IMF estimated that quasi-fiscal subsidies in gas and electricity in 2003 accounted for 4.2 and 1.5 per cent of GDP, respectively.

In the telecommunication sector, the fixed line and mobile penetration rates remain the lowest in the transition economies. Mobile services used to be provided solely by a private American company (which was sold to a Russian mobile operator in 2005), but following the expiry of the exclusivity period, the government established a state-run mobile company in March 2005. In the postal sector, the government also decided not to extend existing licences of any of the foreign postal services companies (including Germany's DHL) beyond April 2005.

[5] Minimum capital requirements are US$ 5 million for private and US$ 10 million for state banks. The authorities aim to increase the minimum capital requirement for state banks to US$ 20 million in future.

Transition challenges

Considering the country's key priorities and the assessments made by the Bank, the following areas emerge as the key transition challenges for Turkmenistan over the next strategy period:

- ***Price, Trade and Exchange Rate Liberalisation***: Abandon price controls of goods, while a proper regulatory framework needs to be established on utility prices. Unification of the exchange rate and liberalisation of all current account transactions. The abolition of the present state trading system and the transformation of the present implicit export taxes through the dual exchange rate system into explicit taxes.

- ***Fiscal Reform***: Improve the transparency and accountability of public sector resources, particularly by the adoption of regulation on extra-budgetary funds' operation, especially FERF, clarifying its functions and integrating its expenditure into the budget, and auditing and disclosing the results of the operation.

- ***Private Sector Development***: Foster the private sector in the economy by jumpstarting enterprise privatisation and reducing state control over the financial sector. The business environment needs to be improved substantially through integration of the dual exchange rate system and liberalization of the currently controlled trade system, heightening accessibility to foreign currency for private businesses.

- ***Financial Sector***: Strengthening financial institutions and intermediation through bank privatisation and the abolition of direct control by the Central Bank over the sector through direct screening of lending decisions, limits on interest rates and forced bank mergers. The Central Bank should adopt an effective regulatory and supervisory role.

- ***Agricultural Sector***: Deepening agriculture sector development through further easing of government control, including phasing out of subsidies and real transfer of land ownership to farmers, combined with the development of private agriculture services and commercial financing.

2.3 Access to Capital

Turkmenistan has developed relatively good infrastructure and production facilities in urban areas but has substantial capital investment needs in rural areas. In the hydrocarbon sector, there remain substantial investment needs in all areas, particularly for the construction of new pipelines. However, Turkmenistan has limited external sources of finance and mostly relies on internal financial sources, particularly through state funds.

IFIs are not very active in Turkmenistan. The authorities concluded no new lending projects with neither IMF, the World Bank, nor Asian Development Bank during the past two years. Bilateral aid programmes are also limited (between US$ 20-40 million in recent years). Nevertheless, limited concessional lending is available; for example, Turkmenistan recently agreed to borrow in total US$ 104 million from China for the development of the oil and gas industry and the communications sector.

Despite some legislation on capital markets (see Annex 7) the securities market barely exists. The government issued treasury bills in the past but has not issued any since 1998. The country does not have access to international capital markets (no bond issuance). Foreign direct investment continues to play a role in investment, but only limited sectors are able to attract foreign investors (i.e., hydrocarbon and textile sectors). In recent years, net annual FDI inflows amounted to approximately US$ 300 million (3-5 per cent of GDP). However, this is much below the levels of other resource-rich transition countries.

For private enterprises, access to finance remains limited at less than 10 per cent of total lending. Private businesses are not able to raise capital from abroad. Domestically private enterprises can, in principle, borrow from banks, but their business objectives need to be in line with state objectives. Pricing and maturities for loans vary significantly across sectors depending on state priorities. The banking system is under tight state control and allocates funds in accordance with the state-directed investment programmes.

3. STRATEGIC ORIENTATIONS

3.1 Bank's Priorities for the Strategy Period

For the recent strategy periods the Bank has maintained three alternative scenarios as a graduated response to domestic circumstances, referred to as a **Baseline**, an **Intermediate** and a **Regular** scenario. As there has been no progress in transition towards democracy, pluralism and a market economy, the existing Baseline, Intermediate and Regular scenario approach for strategic orientation is proposed for the coming years so that the Bank can continue to offer a graduated response to improvements in the reform environment. Should evidence emerge of reform progress in any of the areas outlined below resulting in an improvement of the investment climate, the Bank will consider additional involvement on a project-by-project basis. The Board of Directors will be closely involved in any such decision.

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, and that selected financial intermediaries will run SME and MSE programmes on a commercial basis. New investments in the public sector, as well as those in the private sector which 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 monitoring and management of existing investments in Turkmenistan.
- Appraisal, implementation and development of a replacement SME credit line with direct exposure to some of the local banks.
- Appraisal, implementation and development of a micro-finance programme including intensive capacity building and potentially a framework MSE finance facility.
- Selective direct investments in domestic, joint venture and foreign-owned private enterprises by direct lending or through the Direct Investment Facility (DIF).
- Further development of the trade facilitation programme with inclusion of new participating banks.

Because of the distortions introduced by the multiple exchange rate regime and subsidised or under priced inputs such as electricity and gas, any new investments will need to demonstrate clearly that they generate real economic returns. Any projects which are non-transparent or which are structured to make contributions to the FERF or other state funds will be excluded.

Intermediate scenario

The Bank would be in a position to conduct a broader range of operations if progress is made in democratic reforms, measured against the political benchmarks described in the regular scenario, 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.

The main reform challenges, formulated in the country strategy two years ago, remain valid as the situation in Turkmenistan has not improved significantly either politically or economically.

In the political sphere the critical reform challenges include:

- *Multi-party democracy*: Allow independent political parties and NGOs. Turkmenistan remains a de facto one party state and is lacking multi-party structure and political pluralism.

- *Free elections*: Conduct free elections. Presidential elections have been promised for 2009, preceded by a set of local and parliamentary polls. A minimum level of pluralism is needed to make these elections competitive.

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

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

- *Protection of human rights*: Improve the government's human rights record. A substantial improvement must be achieved in close cooperation with the OSCE, the UN and specialised human rights organisations.

In the economic sphere, the critical reform challenges include:

- *Price, Trade and exchange rate liberalisation*: Abandon price controls of goods, while a proper regulatory framework needs to be established on utility prices. Unification of the exchange rate and liberalisation of all current account transactions. The abolition of the present state trading system and the transformation of the present implicit export taxes through the dual exchange rate system into explicit taxes.

- *Fiscal Reform*: Improve the transparency and accountability of public sector resources, particularly by the adoption of regulation on extra-budgetary funds' operation, especially FERF, clarifying its functions and integrating its expenditure into the budget, and auditing and disclosing the results of the operation.

- *Private sector development*: Foster the private sector in the economy by jumpstarting enterprise privatisation and reducing state control over the financial sector. The business environment needs to be improved substantially through integration of the dual exchange rate system and liberalisation of the currently controlled trade system, heightening accessibility to foreign currency for private businesses.

- *Financial sector*: Strengthening financial institutions and intermediation through bank privatisation and the abolition of direct control by the Central Bank over the sector through direct screening of lending decisions, limits on interest rates and forced bank mergers. The Central Bank should adopt an effective regulatory and supervisory role.

- *Agricultural sector*: Deepening agriculture sector development through further easing of government control, including phasing out of subsidies and real transfer of land ownership to farmers, combined with the development of private agriculture services and commercial financing.

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 MSEs 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.

3.2 Sectoral Challenges and Bank Objectives

3.2.1 Enterprise Sector

Private sector development and fostering entrepreneurship are key drivers for a successful transition to a market economy and the main focus of the Bank's activity under the Baseline scenario. While the government regularly endorses the significance of the private sector in the economy, this is not translated into tangible support for **the development or expansion of the private sector**. There are fundamental reform challenges as identified in past strategies which need to be addressed to stimulate development of the private sector as follows:

- **Dual Exchange Rate:** The dual exchange rate system with the very large gap between the official and unofficial rates and rationed access to foreign currency for private businesses acts as a disincentive to investment and creates distortions in prices and resource allocation in all areas of the economy. The government should unify the exchange rates at a level justified by economic performance and allow free convertibility. However, the authorities are committed to maintaining the present system and the Bank's ability to push reform in this area is limited.

- **Government Interference:** There is widespread interference in, and control of, private businesses by government ministries and agencies and red tape in all areas of production and trade activity. This acts as a disincentive to local and foreign investment and allows the government to restrict private sector competition. Despite a recent progressive move to reduce the corporate tax rate for productive legal entities to a flat 2% of revenue, extensive further reform is needed as well as changes in governmental structures.

- **State Dominance:** Despite successful examples of EBRD working in partnership with private investors and state entities producing cost efficient investments delivered on time and budget, the state continues to favour state majority owned and directed investment even in sectors which had been private, such as the mobile phone market and bottled portable water.

- **Agricultural Reform:** There has only been minor reform of the structure of agricultural production, crop sales and marketing. Whilst there has been significant state investment in new machinery such as cotton seeders, cotton pickers and combine harvesters, this has not increased production of the key wheat and cotton crops. In fact production has stagnated and the key challenges would include investment in education and agronomy, better farm management practices, the end of state procurement, allowing market prices to producers and private ownership of land or secure tenancies.

The capacity of the Bank to address these challenges is limited in light of the Bank's Baseline scenario, the limited response by the authorities to policy dialogue and the relatively weak reform programme in the country, and consequently the operational priorities of the Bank will focus on directly supporting the small private sector as described below:

- **Implement a Micro Finance Programme**: The limited credit in the market for small traders and initial investigations of the market show that there is strong demand from small traders and keen interest on the part of a number of banks in participating in such a programme. Active discussions have continued over the last two years with the Central Bank on the framework to enable implementation of a micro programme (the eligible borrowers to include traders, the possibility of cash disbursements, independence in decisions for the banks, flexibility on security requirements). There will be further intensive discussion with the authorities in the coming months to help assess the feasibility of a microfinance programme.

- **Expand the Trade Finance Programme:** Three banks were originally approved for participation in the TFP. One has signed all the documentation and has opened three LCs, and one is about to finalise the documentation with the third requiring a new approval from the Bank due to the long delay in agreeing the terms. The Bank will be seeking to increase utilisation under the existing lines and will also be looking into further development of the Trade Facilitation Programme as some other banks may be interested in the programme.

- **Consider structuring a SME credit line with direct risk to the local banks**: The immediate priority is to replace the cancelled sovereign guaranteed SME line with a new line directly to private local banks, to the extent that this would be consistent with the Baseline scenario. One of the two most active banks under the old SME line, is majority owned by private interests and has an extensive private sector portfolio. Another bank being considered is a foreign joint venture bank which is very private sector orientated in its business. The previous SME line performed well with no losses for the participating banks and financed 120 totally private sector SME projects with typical loan sizes in the range of US$ 100,000 to US$ 200,000. Before the SME line was cancelled following the withdrawal of the sovereign guarantee the Participating Banks had built up a pipeline of 20 projects amounting to US$ 4.5 million, so there should be demand for a new line.

- **Selective direct investments** in domestic, joint venture and foreign-owned private enterprises by direct lending or through the Direct Investment Facility (DIF). Now that the first DIF investment, the TMS wool scouring plant, is operating successfully, other opportunities are being sought in export-orientated projects for equity investment. Direct loans to local companies or joint ventures with strategic sponsors will be considered even though they are likely to be relatively small. Since the distortions introduced by the dual exchange rate regime and subsidised or under priced inputs such as electricity and gas, any new investments will need to demonstrate clearly that they generate real economic returns. Any projects which are non-transparent or which are structured to make contributions to the FERF or other state funds will be excluded. Also, the Bank will not undertake projects if allocation of revenues is not fully transparent. Particular care will be taken with new textile projects in the light of recent public comment on forced and child labour, although Turkmenistan is seen to be reforming in this area by the US and EU amongst other observers.

3.2.2 Financial Sector

The main challenges and transition goals in **the financial sector** are to increase the strength and capability of the local banks, increase their role in intermediation and increase availability of funding via the banks to private companies, entrepreneurs and small business on commercial terms. However the banks are still predominantly state-owned and controlled and there are no government plans to privatise or introduce foreign investors to the state owned banks. Credit is scarce and not generally available to private business. Directed lending to key industrial sectors, agriculture and construction continues. Pricing is not determined by the risk profile of borrowers, and delinquent loans are regularly restructured or extended. Foreign currency lending which is vital to support investment in foreign produced capital goods is restricted. Furthermore, the official exchange rate and its distorting effect on the balance sheets of the banks make consideration of equity investment in the privately owned banks unlikely.

The capacity of the Bank to address the transition challenges in the Financial Sector is limited by the Baseline Scenario, the lack of response by the authorities to policy dialogue and the lack of any reform programme in the financial sector, particularly in relation to introducing new private capital or joint venture partners. However due to the conditionality on EBRD SME and TFP lines IFRS has been introduced to three banks. The CBT is generally a good supervisor and a deposit insurance system has been in place for three years. Consequently the operational priorities of the Bank will focus on combining intensive capacity building in selected financial intermediaries as described below:

Technical Assistance for a Micro Finance Programme: Subject to a positive assessment of the environment for Micro lending, donor funds will be sought for capacity building in the selected private financial intermediaries. The Micro programme will initially be launched on a non-funded basis by providing Technical Cooperation to enable at least two private banks to develop micro programmes, but lending their own Manat resources. This start-up phase, prior to the consideration of MSE credit lines, will allow the Bank to test the level of independence that partner banks might have in defining their lending operations in terms of flexible collateral, interest rates, and cash disbursements among others.

Support the SME and TFP lines with Technical Assistance: The Bank is looking to continue funding the local credit advisors in support of the SME line and also to provide training for local bankers in trade finance, corporate and bank credit analysis and governance.

3.2.3 Oil and gas sector

The key challenges in the oil and gas sector are: increase investment in development and production of oil and gas both onshore and in the Caspian; increase and diversify transport routes; improve the transparency of financial flows among the state energy concerns, the FERF and the budget; and rationalise domestic consumption which is excessive due to significant underpricing. A recent concern and new challenge is the deterioration in the operation of the Production Sharing Agreements (PSA) covering Caspian Sea oil projects which in the recent past were regarded as a model in the region. This deterioration is the result of the removal of knowledgeable key counterparts in the relevant government agencies without adequate replacements.

Critical reforms required to begin addressing these challenges would include:

- Transformation of the FERF into a transparent fund, with some proportion of it saved for future generations. Critical to 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 operations publicly. Discretionary spending from the FERF outside an annual unified budget would need to be restricted. Reform proposals along these lines have been made to the government by the World Bank and are supported by EBRD.

- Rational planning of investment decisions in the energy sector would ensure the proper use of existing resources. This would require modern, reliable management information systems and accounting standards within the state energy complex. Moreover, the energy complex is used to subsidise investments in other sectors of the economy through the transfers of export earnings at the official exchange rate and the surrender of hard currency to the funds, thus undermining its commercial viability and ability to develop long-term investment plans.

- The introduction of PSA structures to facilitate FDI in onshore gas exploration, development and production.

In the absence of any such reforms and operating under the **Baseline** scenario there is little likelihood of any Bank involvement in the natural resources sector. However, where state involvement is minimal and project revenues are ring fenced outside the FERF, financing opportunities may be presented in:

- Projects to maintain and/or expand existing regional pipeline and transport options and develop new ones entailing more extensive regional co-operation and policy dialogue with the IFIs, such as the Trans Caspian Pipeline, the Turkmenistan Afghanistan Pakistan Pipeline and the Central Asia Centre - 3 pipeline.

- Environmentally important gas utilisation and energy efficiency projects, now that flaring of associated gas is becoming a serious problem with more wells in production in the Caspian.

3.2.4 Infrastructure sector

With extremely low prices for electricity, gas, petrol and diesel, the key challenge in the infrastructure remains to reduce consumption through 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 for cargo and freight to justify the upgrade in facilities were borne by foreign transport companies rather than the local population. However, the 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 Strategies, the Bank cannot work in the public sector in the **Baseline** scenario. However, if the conditions existed for the Bank's **Intermediate** scenario, the key transition challenges would be 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, and the Bank could support projects that addressed these challenges. In addition to tariff reform and commercialisation, renewed cooperation with international organisations, notably with the IMF and the World Bank, would 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. Currently the IMF maintains a local liaison officer in Ashgabat, following withdrawal of the country representative in 1999 due to IMF frustration over the slow pace of reform and the limited provision of information. Following a long break from 1999, an Article IV consultation was held in the first quarter of 2004, but the report on the 2005 mission with more exacting requirements on information provision was not presented to the IMF Board until January 2006, due to delays in provision of the required information. Turkmenistan has requested that the report should not be published.

4.2 World Bank/IFC

Turkmenistan signed the Articles of Agreement of the World Bank Group in September 1992. It became a member of MIGA in October 1993 and of the IFC in 1997. Since 1996, the World Bank has maintained a Liaison Office in Ashgabat. The first Country Assistance Strategy (CAS) for Turkmenistan was approved in 1997. The World Bank prepared a regional development study for Dashoguz, the poorest region of the country (in 1998), a report on Improving the Management of Public Expenditures (in 1999), and a Living Standards Assessment (in 2001).

The last of the three loans extended to Turkmenistan in the 1990s, the US$25 million Institution Building/Technical Assistance Loan (IBTA), closed in December 2003, due to the lack of progress in implementation. In January 2004, the World Bank also closed its last active IDF grant on International Accounting Standards. As a result, the World Bank has currently no ongoing activities in Turkmenistan, except a small outreach programme and a Small Grant Programme which supports local NGOs, and no new lending and/or technical assistance is envisaged in the near term. The IFC has not undertaken any operations in Turkmenistan.

In 2005, the Turkmen authorities and the World Bank agreed on a re-engagement plan to address the basic obstacles to the Bank’s work in Turkmenistan: (i) the negative pledge clause violation; (ii) the non-reporting of external debt to the Bank’s Debt Reporting System, and (iii) procedural barriers (e.g., difficulties in obtaining visas). Turkmen authorities have taken certain positive steps to address these pending issues and continue the dialogue with the World Bank.

4.3 Asian Development Bank (ADB)

The Board of Directors of ADB approved Turkmenistan's membership in August 2000. ADB opened a liaison office in Ashgabat in May 2002 and is operating under an Interim Operational Strategy intended for the years 2002 to 2004. The interim strategy has not been renewed yet. The strategy proposes no lending for Turkmenistan, with the exception of projects that focus on regional cooperation, or which directly benefit the reconstruction of Afghanistan. At present ADB’s technical assistance programme includes three regional projects; the Turkmenistan-Afghanistan-Pakistan (TAP) gas pipeline feasibility study (completed in late 2004), a land management project and environmental information management systems. The TAP project has gained new life in recent months following increased interest in alternative pipeline routes to Russia and following a high level steering committee meeting in Ashgabat where reserve data was released reassuring the participants that the reserve position was sufficient to justify the cost of a US$ 3.6 billion pipeline. India is now considering participating but as yet there is no credible commercial sponsor.

4.4 Islamic Development Bank (IDB)

Turkmenistan has been a member of the IDB since 1997. IDB committed US$ 74.3 million for 11 projects (37% concessional) including the construction of medical centres, the purchase of an oil tanker, the rehabilitation of a portion of the Mary-Tejen highway, a rural water supply project, and an optical fibre cable project for the state telecom company. Two of the projects were cancelled subsequently and US$ 48 million has been disbursed.

4.5 UNDP

UN activities and programmes in Turkmenistan are structured under the United Nations Development Assistance Framework (UNDAF) for the years 2005-2009, an agreement reached in February 2004 with the Turkmenistan Government. It focuses on priorities identified by the Turkmenistan Government, areas for collaboration proposed by the UN, and the Millennium Development Goals. The work of the UN and its agencies in Turkmenistan concentrates on three broad categories: (a) development of economic and social policies and plans, (b) basic social services and (c) environment.

Cooperating with the Government of Turkmenistan, the UNDP supports the arrangements carried out by the Turkmenistan Government to fulfil the tasks set by the National Strategy of Development to 2020 as well as to meet its engagements within the framework of the Millennium Declaration. The governmental institutions cooperate with the UNDP within some UN projects and programmes aimed at providing assistance in improving the national insurance system, introducing advanced technologies for stable human development, building human and institutional capacity to better address existing and emerging environmental issues and HIV/AIDS prevention.

UNDP estimated expenditures for the period 2005-2009 of Regular Resources are US$ 5.5 million and of Other Resources are US$ 3.9 million for a total of US$ 9.4 million.

4.6 EU

The annual budget for Turkmenistan amounts to approximately EUR 5 million, and the regional budget for Central Asia is EUR 60 million per year, including EUR 15 million for cooperation among Central Asia states. Turkmenistan is also engaged in EC regional initiatives such as the "Baku" processes on EU Black Sea, and Caspian Basin cooperation on energy and transport, regional programmes supported by Tacis, such as INOGATE, TRACECA or the Border Management Modernisation Programme for Central Asia (BOMCA), and Central Asia Drug Action Plan (CADAP). Turkmenistan has also taken the lead in programmes in the structure of the Caspian Sea Environmental Convention. The budget used for technical assistance programmes is supporting sustainable economic development, institutional and capacity building and infrastructure investments. Areas such as economic reforms, SMEs and rural development, education, customs, trade, transit, energy, water and environment are also targeted.

4.7 OSCE

Organisation for Security and Cooperation in Europe (OSCE) activities are focused on programmes designed to promote confidence and security building, to speed up the rebuilding of the economy in the direction of a market economy and to assist the country in the democratization process, in implementing legal reforms and in translating fundamental rights and freedoms into concrete policy and actions.

OSCE aims at intensifying the dialogue and co-operation with the country's authorities and the emerging civil society, stimulating the involvement of the country in OSCE activities and expanding its co-operation with International Organizations. It seeks to raise awareness of OSCE principles and commitments and the necessity to translate them into national legislation and policy.

Priorities are: (a) combating trafficking of drugs, small arms and light weapons and organised crime, (b) support to private enterprise development, advancement of businesswomen and young entrepreneurs, (c) support the implementation of the National Environmental Action Plan of Turkmenistan and the country's participation in the UNDP/OSCE/UNEP initiative on environmental security in Central Asia, (d) training of judges, lawyers, law enforcement agencies, (e) support to civil society, and (f) capacity building in the educational sector. The annual budget is approximately EUR 1.2 million

III. ANNEXES

Annex 1	**Political Assessment**
Annex 2	**Signed Bank Operations**
Annex 2A	**EBRD Operations to Date**
Annex 2B	**Signed Bank Operations by Sector**
Annex 3	**Current Portfolio Stock**
Annex 4	**TC Projects**
Annex 5	**Investment Project Pipeline**
Annex 6	**TC Project Pipeline**
Annex 7	**Legal Transition**
Annex 8	**Selected Economic Indicators**
Annex 9	**Assessment of Transition Challenges**
Annex 10	**Bilateral Assistance**
Annex 11	**Map of Turkmenistan**

ANNEX 1: POLITICAL ASSESSMENT

The Bank continues to be seriously concerned 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 country strategy, there has been no evidence of improvement in the authorities' commitment to the principles of Article 1 of the Agreement Establishing the Bank.

The main reform challenges, formulated in the country strategy two years ago, remain valid as the situation in Turkmenistan has not significantly changed either politically or economically. Turkmenistan is still a one party state which is lacking political pluralism. A minimum level of pluralism is needed for making elections, which were promised to take place in the next three years, competitive. The power is concentrated on the presidency and is not balanced either by legislature or judiciary. The government retains full control over TV and radio broadcasting, print media and access to the Internet. The environment, which is not conducive to any criticism of the President's line, undermines freedom of speech. Civil society remains weak and NGOs cannot operate freely.

An improvement in registration of minority religious organisations and a reported decrease in the number of children working in the fields during cotton harvest, were not sufficient steps to adequately address grave concerns raised by the OSCE, the UN and human rights groups. Continued deterioration of educational standards goes unabated and is an area of serious concern.

The international community continues its efforts to develop dialogue with Turkmen authorities. In recent months several high-ranking EU and OSCE officials have been received by the Turkmenistan President. In March the visiting OSCE Chairman-in-Office stressed again the importance of starting political reforms and democratisation and confirmed the organisation's readiness to assist in this process.

Political Environment

Turkmenistan is the only CIS country which continues to have one political party. No alternative parties have been registered since independence and there was no progress 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 Supreme Court of Turkmenistan. In practice, power is fully concentrated in the hands of the Turkmen President, who retains monopoly on political power. In addition to presiding over the ruling – and the country's only – political party, the Turkmenistan President is also chairing the Cabinet of Ministers (Prime Ministerial position) and the Halk Maslahaty (People's Council). The latter, which has no analogues in the CIS, is the highest body entitled to decide on constitutional matters. Since 2003 President Saparmurat Niyazov is lifetime Chairman of Halk Maslahaty.

The country's only presidential elections since independence took place in 1992 and had one candidate – Saparmurat Niyazov. Absence of minimum level of pluralism for competitive elections prevented the OSCE/ODIHR from monitoring the elections. The Turkmenistan leader stated on many occasions that he would retire by 2010.

The last elections to parliament (Mejlis) took place in 2004 with 131 candidates running for 50 seats in a single-chamber parliament. The candidates included government officials of different levels. The OSCE/ODIHR was not invited to monitor or assist with the elections.

The Turkmenistan President outlined plans for future political changes. According to him, new political parties might be allowed provided that they do not oppose each other. Presidential elections will be conducted on a competitive basis with a special commission, chaired by the President, identifying candidates to run for President. Elections are to be held at the Etrap (district) in 2006, followed by Welayat (region) in 2007 and Mejlis elections in 2008. Presidential elections in 2009 are to end the election cycle. A minimum level of political pluralism is required to make these elections competitive.

Human Rights Conditions

In the last two years human rights conditions remained extremely poor. In November 2005, the UN General Assembly passed a resolution on the situation of human rights in Turkmenistan summarising grave concerns of the international community at the "continuing and serious human rights violations occurring in Turkmenistan".

The long list of human rights violations, contained in the resolution, included a policy of repression of all political opposition activities; the continuing abuse of the legal system through arbitrary detentions, imprisonment and surveillance of persons who try to exercise their freedom of expression; the continued denial of access to prisoners by the International Committee of the Red Cross (ICRC); complete control of the media censorship of all newspapers and access to the Internet (but access to foreign television programming is widespread via satellite dishes) and intolerance of independent criticism of government policy and harassment of local journalists; continued restrictions on the exercise of the freedom of thought, conscience, religion and belief, including the use of registration procedures as a means to limit these freedoms and discrimination against national and ethnic minorities in the field of education and employment.

The resolution also pointed out the continuing failure of the Government of Turkmenistan to respond to the criticisms identified in the report of the special rapporteur of the Moscow Mechanism of the OSCE as to the investigation, trial and detention procedures following the alleged assassination attempt against the Turkmen President in November 2002.

Since the last strategy, two areas saw measured improvements in addressing human rights concerns. These are related to minority religious groups and use of child labour. The government allowed functioning of additional minority religious groups and released from jail four prisoners of conscience. The President also passed a special decree prohibiting child labour, leading to a decrease in the number of children working in the cotton fields during the harvest. However welcome, these improvements did not eliminate violations in these areas, as pointed out by independent human rights observers, and full implementation of the laws prohibiting child labour should be ensured.

Other labour rights problems include lack of independent trade unions and government interference in union activities. According to the latest US State Department report of March 2006, human trafficking is not a significant problem in Turkmenistan.

While considering approving an Interim Agreement relating to Partnership and Cooperation Agreement (PCA) between Turkmenistan and the EU, the Committee on Foreign Affairs of the European Parliament issued a favourable opinion referring to some encouraging signs in the area of human rights, such as the abolition of the death penalty, the elimination of child labour, the release of prisoners, and increased willingness by the Turkmen side to engage in a dialogue.

This decision came under criticism from independent human rights groups, indicating that the abolition of the death penalty was not a recent event and was taken in the year 2000, the abolition of child labour still requires significant follow-up, and the release of prisoners did not include political prisoners. An Interim Agreement is dedicated to trade matters but also contains an important human rights and democracy clause. The EU Commission supported the Interim Agreement arguing that this is part of the ongoing human rights dialogue with the country. Although no great progress has been achieved in the dialogue, Turkmenistan nevertheless has been cooperating in the region's environmental policy, border management, and drug/energy/transport policy.

Practically all areas of human rights protection are causing grave concerns but dramatic lowering of the educational standards is particularly damaging as affecting future generations of Turkmens. Human sciences are overemphasised in comparison to natural sciences and economics. Russian-language instruction has been curtailed; fewer students are admitted to institutions of higher education, while curricula is overburdened with one subject, the 'Holy Book' of Rukhnama, written by the Turkmenistan President. The President's poetry book was also incorporated into the curriculum. The disproportionately large amount of time dedicated to learning Rukhnama is reducing time available for core academic subjects.

Foreign Policy Orientations

Turkmenistan's foreign policy is based on the principle of permanent neutrality. Turkmenistan's neutral status has been recognised by the UN. After the events of September 11, the country has reaffirmed its neutrality which prevented the use of its territory for military purposes, but allowed significant humanitarian transit for neighbouring Afghanistan.

Drug transit from Afghanistan, and related corruption, is a serious problem. A stable Afghanistan is important for Turkmenistan which continues to consider the idea of a Trans-Afghan gas pipeline to Pakistan and, possibly, India.

A reluctant member of the CIS, Turkmenistan continues to give clear preference to bilateral relations over multilateral ones remaining outside such regional groupings as Eurasian Economic Community, comprising in addition to Russia and Belarus all four Turkmenistan's Central Asian neighbours.

Turkmenistan's huge natural gas reserves, and its significant oil reserves, makes energy a crucial foreign policy priority. Russia and, to a lesser degree, Ukraine are the main economic partners of Turkmenistan, representing major gas export markets. This year Iran doubled its purchase of Turkmenistan gas but the overall volume of trade remains relatively small.

In addition to advanced talks about Trans-Afghan pipeline, now also involving representatives of India together with Turkmenistan, Afghanistan and Pakistan, there are reports about reviving the idea of the Trans-Caspian gas pipeline under the Caspian seabed to Azerbaijan and further to Turkey, as well as a possible gas pipeline to China. The prospects for these pipelines remain uncertain as all of them are facing significant environmental, legal, financial and geopolitical constraints.

The legal status of the Caspian Sea is still unresolved, although some progress has been reported in the regularly-held negotiations between the five littoral states including Russia, Kazakhstan, Azerbaijan, Turkmenistan and Iran.

ANNEX 2: SIGNED BANK OPERATIONS

ANNEX 2A: EBRD OPERATIONS TO DATE

(as at 31 March 2006, EUR millions)

Operation Name	Signing Date	Total Project Value	EBRD Finance	Debt	Equity	Operation Stage
AIG Silk Road Fund	25/09/97	5.9	1.4	0.0	1.4	Repaying
Baring Vostok Private Equity Fund	13/12/00	4.3	1.9	0.0	1.9	Disbursing
DIF - TMS Wool Scouring	08/07/03	1.8	0.6	0.0	0.6	Disbursing
DIF - TMS Wool Scouring II	07/09/05	1.5	0.8	0.8	0.0	Repaying
Dragon Oil	20/12/99	429.2	49.5	49.5	0.0	Completed
Export-oriented Credit Line (Turkmenistan)	24/11/94	7.1	7.1	7.1	0.0	Repaying
First NIS Regional Fund	21/11/94	0.6	0.3	0.0	0.3	Repaying
Gap Turkmen	05/01/96	74.3	26.4	14.4	11.9	Repaying
Gap Turkmen 2	10/11/99	13.3	3.4	0.0	3.4	Completed
Gap Turkmen 3	19/01/02	8.8	8.8	8.8	0.0	Repaying
NIS Restructuring Facility	16/03/00	1.3	0.3	0.0	0.3	Repaying
Turkmenbashi Port Development	18/12/97	38.4	24.8	24.8	0.0	Repaying
Total		**586.4**	**125.2**	**105.4**	**19.7**	

ANNEX 2B: SIGNED BANK OPERATIONS BY SECTOR

(as at 31 March 2006, EUR millions)

Sector Business Group (SIC)	Sector Team (SIC)	No. of Projects	Total Project Value	EBRD Finance	Debt	Equity	% Share of Commitments
Energy	Natural Resources	1.0	429	50	50	0	40%
Sub-total Energy		**1.0**	**429**	**50**	**50**	**0**	**40%**
Financial Institutions	Bank Lending	1.0	7	7	7	0	6%
	Equity Funds	0.2	12	4	0	4	3%
Sub-total Financial Institutions		**1.2**	**19**	**11**	**7**	**4**	**9%**
General Industry	General Industry	2.0	100	40	24	16	32%
Sub-total General Industry		**2.0**	**100**	**40**	**24**	**16**	**32%**
Infrastructure	Transport	1.0	38	25	25	0	20%
Sub-total Infrastructure		**1.0**	**38**	**25**	**25**	**0**	**20%**
TURKMENISTAN TOTAL		**5.2**[6]	**586**	**125**	**105**	**20**	**100%**

[6] Dragon Oil, Gap Turkmen (three projects counted as one), TMS Wool Scouring (two projects counted as one), Turkmenbashi Port Development and Export-oriented Credit Line. The 0.2 represents Turkmenistan's share of the regional equity funds.

ANNEX 3: CURRENT PORTFOLIO STOCK

(as at 31 March 2006, EUR millions)

	Portfolio*	Undrawn Commitment	Operating Assets*
DIF - TMS Wool Scouring	0.6	0.0	0.6
DIF - TMS Wool Scouring II	0.7	0.1	0.6
Export-oriented Credit Line (Turkmenistan)	0.8	0.0	0.8
Gap Turkmen	11.9	0.0	11.9
Gap Turkmen 2	0.0	0.0	0.0
Gap Turkmen 3	3.5	0.0	3.5
Regional TFP: National Bank of Pakistan (Turkmenistan)	0.0	0.0	0.0
Regional TFP: Senagat Bank	0.0	0.0	0.0
Turkmenbashi Port Development	15.8	0.0	15.8
	33.3	**0.1**	**33.2**
AIG Silk Road Fund	0.5	0.5	0.0
Baring Vostok Private Equity Fund	0.5	0.4	0.1
	1.0	**0.9**	**0.1**
	34.3	**1.0**	**33.3**

ANNEX 4: TC PROJECTS IN TURKMENISTAN

Commitment Name	EUR Committed	EUR Disbursed	Fund Approved Date	Commitment Stage	Sector	Funding Code
Gas Sector Development Strategy	74, 569	74, 569	27/08/93	Closed	Energy	TUR
Gas Sector Development Strategy	111, 574	111, 574	01/10/93	Closed	Energy	TAI
Bank Restructuring and SME Development	192, 898	192, 898	01/12/93	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 – Institution Building	196, 000	196, 000	01/08/94	Closed	Finance, Business	JAP
Export Oriented Line of Credit – Project Preparation	45, 868	45, 868	16/09/94	Closed	Finance, Business	SPA
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
Road Rehabilitation Study	53, 050	53, 050	08/06/95	Closed	Construction	FRB
Export Oriented Credit Line – Central Bank and participating banks / Institutional Development Programme	988, 086	988, 086	22/06/95	Closed	Finance, Business	ECT
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
Preparation of Road Improvement Project	395, 810	395, 810	08/10/96	Closed	Construction	ECT
Review of Tax and Foreign Investment Legislation	29, 407	29, 407	13/01/97	Closed	Community, Social Services	TCS
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
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
Development of Turkmen Sea Administration's financial Management Information System	402, 090	402, 090	05/12/97	Closed	Transport, Storage	JAP
Turkmenbashi Port Development project – Project Implementation Unit	571, 775	571, 775	20/07/98	Closed	Transport, Storage	ECT
Turkmenistan SME Credit Advisors Programme	1, 322, 466	1, 322, 466	01/09/98	Closed	Finance, Business	JAP

Management Assistance to Turkmen Sea Administration	651, 326	651, 326	02/11/98	Closed	Transport, Storage	ECT
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
GAP Turkmen	36, 610	36, 610	19/09/00	Closed	Manufacturing	SWI
TMS Wool Swiss Legal Due Diligence	28, 127	28, 127	18/09/01	Closed	Manufacturing	SWI
Turkmenistan Local Credit Advisors	38, 938	39, 546	11/10/01	Disbursing	Finance, Business	TFS
Management Assistance to Turkmen Sea Administration	262, 703	262, 703	26/11/01	Closed	Transport, Storage	ECT
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 Construction Supervisor	49, 990	25, 413	27/05/03	Disbursing	Finance, Business	ITA
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
TMS Wool Swiss Legal Due Diligence	37,400	0	11/04/05	Committed	Finance, Business	SWI
TMS Wool Turkmen Legal Due Diligence	6,050	0	11/04/05	Committed	Finance, Business	SWI
TMS Wool Construction Supervisor 2	7,820	7,346	27/05/05	Committed	Finance, Business	ITA
Turkmenistan: Advance Trade Finance Training for Local Banks	14,531	14,531	28/06/05	Closed	Finance, Business	SWI
	9,018,587	**8,971,429**				

ANNEX 5: TC PROJECT PIPELINE

TC Title	Sector Name	Provisional Amount EUR '000
Turkmen banking sector: Banking training initiative	Financial Institutions	70
Turkmen banking sector: Local Credit Advisors	Financial Institutions	76
Turkmen banking sector: Capacity building Central Bank	Financial Institutions	200
Turkmen Micro Small Credit Line Training of loan officers for micro, small and medium loans and capacity building in Turkmen commercial banks	Small Business Finance	1,500

ANNEX 6: LEGAL TRANSITION

COMPARATIVE ASSESSMENT OF TURKMENISTAN'S COMMERCIAL LAW

The EBRD has developed and regularly updates a series of assessments of legal transition in its countries of operations, with a focus on selected areas relevant to investment activities: capital markets, company law and corporate governance, concessions, insolvency, secured transactions and telecommunications. The existing tools assess both the quality of the laws "on the books" (also referred to as "extensiveness") and the actual implementation of such laws (also referred to as "effectiveness"). All available results of these assessments can be found at www.ebrd.com/law. This annex presents a summary of the results for Turkmenistan, accompanied by critical comments of the Bank's legal experts who have conducted the assessments.

Capital Markets

The principal legal acts dealing with the securities markets are the law "on Securities and Stock Exchanges in Turkmenistan", issued in 1993, the Law on "Investment Activities in Turkmenistan", 1992 and the Law on "Securities Transaction Tax", 1993. No amendments to the above legislation have been reported since its adoption.

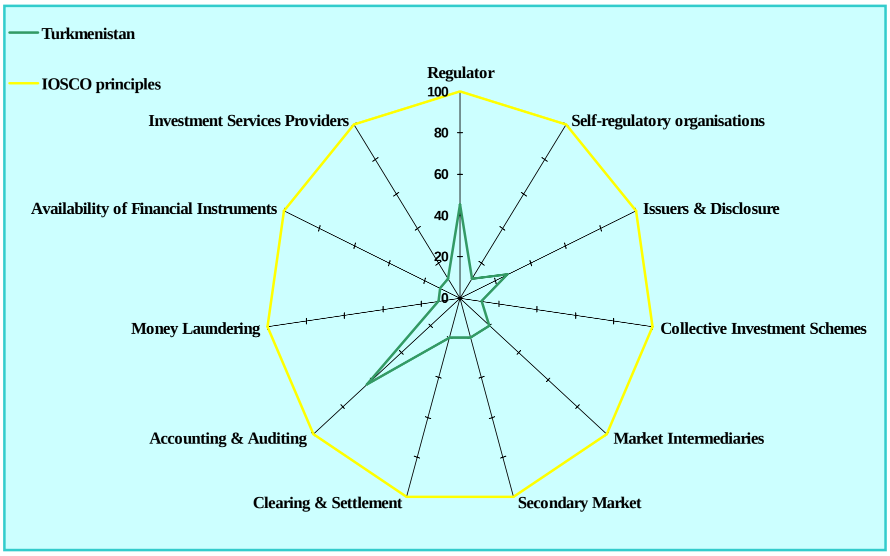
The Ministry of Economy and Finance is the state regulator in charge of securities issuance and offering, change of control transactions (along with the State Service for Foreign Investment of the President of Turkmenistan), securities market and brokerage and dealing activities.

The 1993 Law on Securities and Stock Exchanges outlines the main principles of private securities issuance and circulation, and addresses basic provisions on stock exchange operations. According to that law, securities must be registered with the Ministry of Economy and Finance and can be traded at the State Raw Materials and Commodities Exchange. However, this only seems true on paper as there appears to be no functioning stock exchange in Turkmenistan. Some state investment funds were created to accumulate and reinvest hard currency for the state strategic sectors (oil and gas industry and mineral resources) but these funds are not permitted to issue securities for public distribution. These investment funds work closely with the State Service for Foreign Investment and Vnesheconombank (the primary fiscal agent of the government for foreign investment and import/export projects).

From 1991-1994, the government "privatised" several state entities involved in industry, banking and trade and converted them into Joint Stock Companies (JSCs) by simply changing their names and dividing their assets into shares. By 1 January 1998, there were 300 such JSCs in Turkmenistan, in which the government remains the controlling shareholder.

The results of the EBRD's 2004 assessment of securities markets legislation placed Turkmenistan last of all the countries in the Commonwealth of Independent States. When benchmarked against the IOSCO Principles, Turkmen legislation rated "very low compliance", showing an urgent need for reform. The assessment was updated in 2005 and the results confirmed the very low compliance rating as no amendment of the legislation has occurred.

Quality of securities market legislation – Turkmenistan (2004)



Note: The extremity of each axis represents an ideal score, i.e., corresponding to the standards set forth in IOSCO's *Objectives and Principles for Securities Regulations*. The fuller the 'web', the closer the relevant securities market legislation of the country approximates these principles.

Source: EBRD Securities Market Legislation Assessment 2004

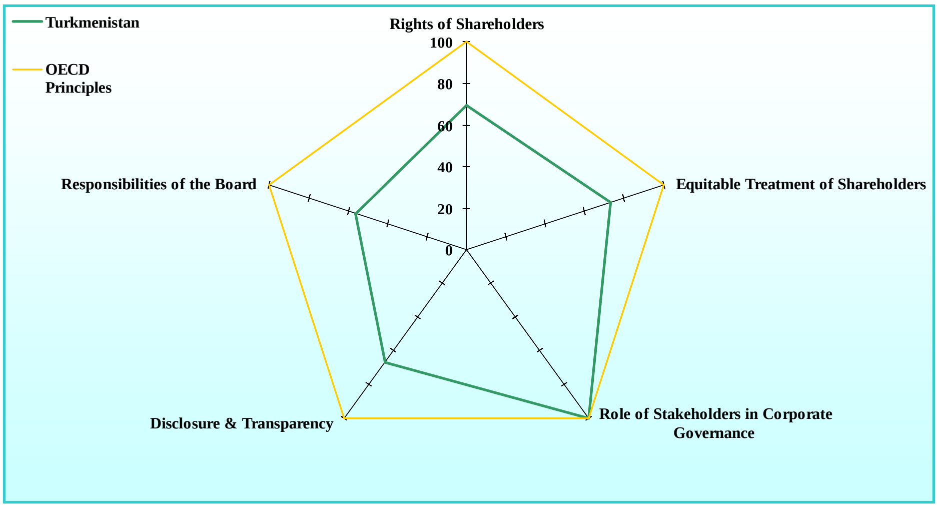
The assessment revealed a framework in urgent need of reform in all sections under consideration, the only exception being "Accounting and Auditing", where the country achieved medium compliance, having provided for some regulation in the 1996 Law "on Accounting in Turkmenistan".

Company Law and Corporate Governance

The Law on Joint Stock Companies (the "JSC Law") adopted in November 1999 is the main regulation concerning corporate governance. The JSC Law provides the basic legal framework for the establishment, functioning, re-organisation and liquidation of joint stock companies and the rights and duties of shareholders.

According to the 2004 results of the EBRD's Corporate Governance Sector Assessment, which assessed corporate governance related "laws on the books", Turkmenistan was rated as having achieved "medium compliance", when compared to the OECD Principles of Corporate Governance. As shown in the chart below, some weaknesses were found mainly in the "rights of shareholders", "equitable treatment of shareholders", "disclosure and transparency" and "responsibility of the board" sections.

Quality of corporate governance legislation – Turkmenistan (2004)



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

Source: EBRD Corporate Governance Sector Assessment, 2004 assessment

Among the deficiencies are: the law does not provide shareholders with the authority to require additional information on the auditors' report and is silent on cross-shareholdings; no notification is required in case a shareholder builds up a significant shareholding in the company; and, there are no provisions to ensure a fair price in transactions between the company and related parties.

Concessions

The 1993 Law on Foreign Concessions, ("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 a 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, arguably leaving room for arbitrary decisions by the authorities from case-to-case. The FC Law provides that concession agreements may only take the form of Build Operate Transfer 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.

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

Among the additional deficiencies of the FC Law are the following: Concession is defined as "a permission of the state to carry out a specific type of business activity". The Contracting Authority is not clearly defined. Sectors that may be subject to concessions are not specified, and the FC Law seems to limit its application to natural resources only. The selection procedure is not sufficiently developed. The FC Law refers to the Cabinet of Ministers decisions in this respect but no publicly available document on this account was identified (except in the oil and gas sector).

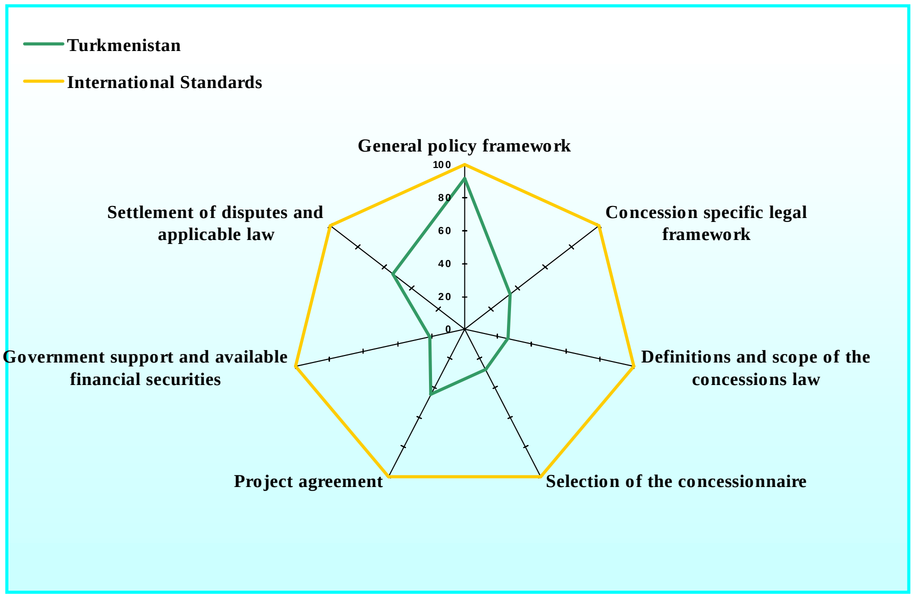
Notwithstanding these deficiencies, there are a certain number of positive elements, such as the provisions regulating compensation for early termination and general principle of government assistance in "achieving objectives" of concession agreements).

The FC Law, together with the recently enacted Hydrocarbon Resources Law, 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.

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

On balance, despite certain positive components, the FC Law does not constitute a sufficiently solid legal basis for the development of PSP in infrastructure and utility services in Turkmenistan.

Quality of concession legislation –Turkmenistan (2005)



Note: the extremity of each axis represents an ideal score in line with international standards such as the UNCITRAL Legislative Guide for Privately Financed Infrastructure projects. The fuller the 'web', the more closely concessions laws of the country approximate these standards.

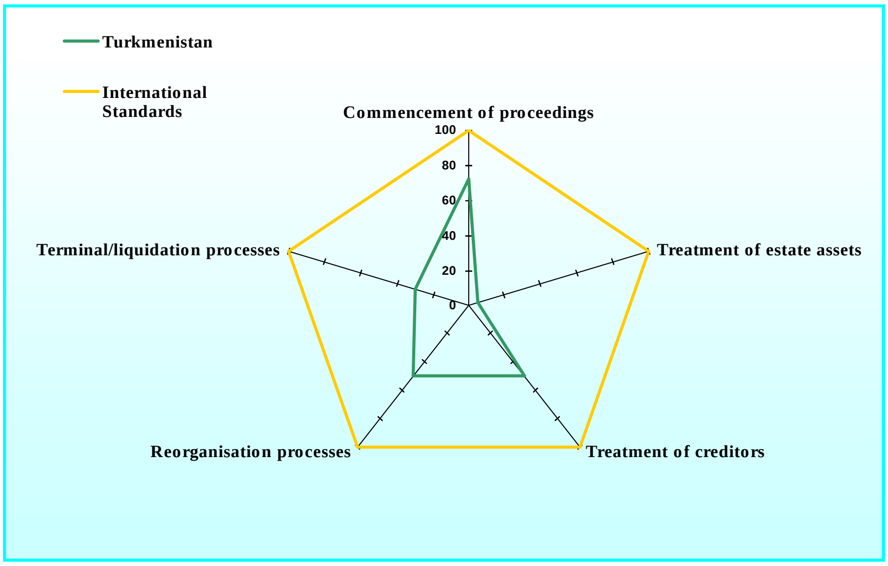
Source: EBRD Concessions Sector Assessment 2005

The EBRD's recent Concession Laws Assessment undertaken to evaluate applicable regime in the Bank's 27 countries of operations (the laws on the books only rather than how they work in practice), confirmed the above evaluation and revealed that Turkmenistan's laws had "low compliance" with internationally accepted standards in this sector. As can be seen from the spider graph above, rules governing nearly all dimensions need to be dramatically improved in order to meet the requirements of a modern legal framework facilitating private sector participation. In particular need of attention are the definitions of the scope of application, provisions for selection of a concessionaire and availability of financial instruments and state support.

Insolvency

Insolvency and bankruptcy in Turkmenistan are governed by the Law on Bankruptcy of the Republic of Turkmenistan, 1993, as amended (the "Insolvency Law"). The Insolvency Law was assessed in 2003 in the EBRD Insolvency Sector Assessment (updated in 2004) and scored "very low compliance" when compared with international standards.

Quality of insolvency legislation – Turkmenistan (2004)



Note: The extremity of each axis represents an ideal score, i.e., corresponding to the international standards such as the World Bank's Principles and guidelines for Effective Insolvency and Creditor Rights Systems, the UNCITRAL Working Group on "Legislative Guidelines for Insolvency Law", and others. The fuller the 'web', the more closely insolvency laws of the country approximate these standards.

Source: EBRD Insolvency Sector Assessment, 2003/4

The Insolvency Law's main deficiencies are to be found in the all-important substantive provisions of how insolvency proceedings are conducted, once they have been initiated. The weakest area is the regulation of treatment of estate assets. Thus, there are no established duties of the debtor (its management, other connected parties) to deliver or make the assets available to the insolvency administrator or other ways to safeguard the assets. Nor are there any obligations established for the debtor to provide full information regarding the assets, liabilities and business affairs of the debtor, except for the latest financial statement. Further, the Insolvency Law merely states that the pre-bankruptcy transactions can be contested, failing to provide any clear criteria and detail of the elements of such transactions that permit avoidance or set aside. Treatment of secured creditors appears to be vague, the Law granting secured claims priority over other claims without describing the procedure and the person authorised to deal with the foreclosure of the collateral which, coupled with other provisions on priority of claims and insolvency administration procedure, makes the implementation of the provisions regarding secured creditors uncertain.

It is generally accepted that a good insolvency law will facilitate, in a reasonable and balanced way, the reorganisation and rehabilitation of the debtor. Despite the range of available rehabilitation procedures that the Insolvency Law offers, the uncertainty with which they are drafted and lack of detail and comprehensive procedure would make reorganisation extremely difficult to implement. In addition, there is no interim form of stay of proceedings against the debtor between the initial filing of proceedings and their formal opening.

Overall, the Insolvency Law requires very little involvement by the general body of creditors and no supervision of the reorganisation plans and liquidation implementation. On the other hand many of the proceedings require strong involvement and continuous decision making by the court, which may considerably delay the insolvency proceedings. Additionally, there appear to be no clear rules on the qualifications that an insolvency administrator must hold before being appointed. 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.

Secured Transactions

Security rights on movable and immovable assets in Turkmenistan 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 (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 covers primarily security over immovable assets (mortgages), possessory pledge (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.

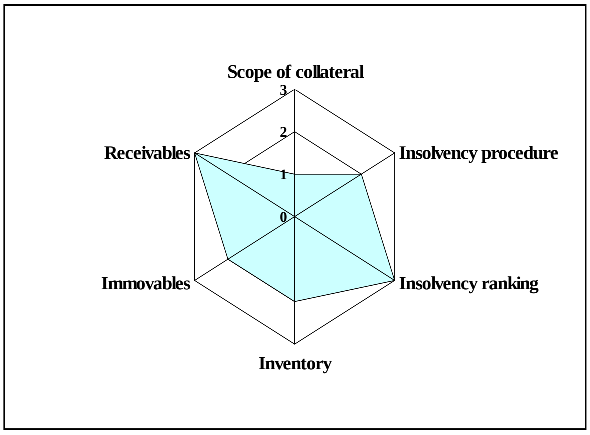
Despite some attempts to create a modern system for secured transactions, the legal regime remains limited in many aspects, without any apparent recent efforts in this respect. Confusion and uncertainty of the rules and practice further undermine the system. For example, collateral must be specifically 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 providing that the assets' total value does not fall under the amount agreed in the charge agreement. This makes security over inventory of limited use.

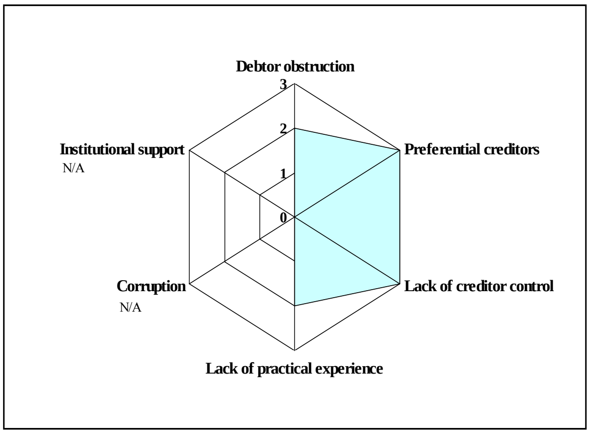
Formalities of creation appear complex and slightly confused. The law provides that the charge agreement must be in writing and subject to authentication and registration at a notary office. However, as implementing rules were lacking at first, notaries did not accept applications. A Presidential Decree issued in December 1997 introduced rules and fixed fees but these are considered to be prohibitively high. Furthermore, notarisation requires presentation of many documents and titles as well as the establishment of an inventory - such a requirement is likely to make the process slow and subject to delay. After notarial authentication of the charge agreement, the agreement must 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 has yet to be put in place.

Enforcement is a challenging process. 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.

Obstacles to charge enforcement process – Turkmenistan (2003)

Scope **Process**





Note: The fuller the web, the more serious the problems are in each of the respective categories. "Process" factors measure the impact that specific obstacles would have on the enforcement proceedings. "Scope" factors give an indication of how effective enforcement would be when conducted on various types of collateral and in the case of debtor insolvency.

Source: EBRD Legal Indicator Survey 2003

As shown in the graphs, almost all factors are problematic (note that the factors associated with the institutional context could not be assessed). 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% 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% of the secured debt. Whatever the chosen route, realisation may only be carried out by way of public auction at the State Commodity and Raw Materials Exchange of Turkmenistan. A fee of 5% of the recovered sum has to be paid to the enforcement officer.

One of the problems faced in enforcement is the obstruction that the debtor could exercise - by challenging the inscription of execution executed by a public notary or even the judgement, in which case the court could decide to suspend the enforcement. This is common practice. On 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 of this makes the recovery of the secured debt highly uncertain.

Telecommunications

The telecommunications sector in Turkmenistan is currently governed by the Telecommunications Law of 1996 and is regulated by the Ministry of Information and Communications (the "Ministry"). The Ministry acts as both policy maker and regulator for the sector and, in essence, the structure of the sector has changed little from Soviet times.

Generally, the telecommunications market in Turkmenistan is relatively small and has advanced little from Soviet times. Whatever growth generated has been stifled by the continuing presence of the state and the absence of any meaningful private sector participation. Among the Commonwealth of Independent States countries, Turkmenistan is understood to have the least developed communications services. This low level of development is reflected in sector statistics – fixed line penetration rates currently remaining at about 8%, recording negligible rises since Soviet times and a digitisation rate of about 25%. Mobile penetration currently stands at less than 1%.

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 there was limited competition in data, Internet services and satellite services, at which time the government revoked the licences of all Internet service providers except the severely limited service of the state owned Turkmen Telecom.

The mobile sector comprises Barash Communications Technologies (BCTI) and Altyn Asyr, a subsidiary of state-run Turkmen Telecom. Although BCTI was in possession of a 10-year exclusive mobile licence, this did not prevent the government from awarding a licence to newly established state mobile operator, Altyn Asyr, and revoking BCTI's licence the day after Russia's MTS mobile company bought 51% of BCTI, summarily cutting off about 60,000 BTCI subscribers from the network. The government claimed the MTS deal was illegal for failing to be agreed and registered in accordance with Turkmenistan's legislation. The MTS/BCTI deal was finally approved and MTS subsequently went on to acquire 100% of BCTI, though with a much diminished licence.

Whilst private participation and competition within the telecom sector is welcomed, the benefits to be yielded from such developments will continue to be negligible in the absence of a modern, internationally compliant telecom regulatory regime. While there are reports of government programmes to increase availability of telecom lines, the absence of a modern regulatory regime will likely limit the impact of such programmes in terms of meaningful sector development. The reported practices of the government and telecom authorities in the telecom sector appear to fall short of internationally agreed best practices and without serious efforts on the part of the government to engage in significant general economic and sector specific telecom reform, there is little possibility of meaningful improvements within the telecoms sector.

ANNEX 7: SELECTED ECONOMIC INDICATORS

	2000	2001	2002	2003	2004	2005	2006
						Estimate	*Projection*
Output and expenditure			*(Percentage change in real terms)*				
GDP[1]	18.6	20.4	15.8	17.1	17.2	9.6	10.6
Private consumption	na	na	na	na	na	na	na
Public consumption	na	na	na	na	na	na	na
Gross fixed capital formation	na	na	na	na	na	na	na
Exports of goods and services	92.6	4.8	13.0	4.0	na	na	na
Imports of goods and services	14.9	20.1	-3.7	4.3	na	na	na
Industrial gross output	21.0	16.8	12.8	13.5	16.4	8.5	na
Agricultural gross output	17.0	23.0	9.5	9.5	13.0	4.0	na
Employment			*(Percentage change)*				
Labour force (end-year)	3.1	3.2	3.2	3.0	3.0	0.0	na
Employment (end-year)	3.0	2.0	2.5	2.2	na	na	na
			(In per cent of labour force)				
Unemployment[2]	27.9	28.8	29.3	29.8	30.2	na	na
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	8.3	11.6	8.8	5.6	5.9	10.6	9.2
Consumer prices (end-year)	7.4	11.7	7.8	3.1	9.0	10.0	9.6
Producer prices (annual average)	na	na	na	na	na	na	na
Producer prices (end-year)	na	na	na	na	na	na	na
Gross average monthly earnings in economy (annual average)	80.4	47.1	8.2	84.2	5.7	21.6	na
Government sector[3]			*(In per cent of GDP)*				
General government balance	-0.3	0.6	0.2	-1.3	0.0	0.0	0.0
General government expenditure	23.9	21.1	18.1	19.4	19.6	19.6	na
General government debt	na	na	na	na	na	na	na
Monetary sector			*(Percentage change)*				
Broad money (M3, end-year)	94.6	16.7	1.5	40.9	13.4	26.3	na
Domestic credit (end-year)	24.4	7.7	-2.9	-0.6	3.6	0.6	na
			(In per cent of GDP)				
Broad money (M3, end-year)	19.4	16.1	13.0	13.9	12.9	12.9	na
Interest and exchange rates			*(In per cent per annum, end-year)*				
Refinance rate	20.0	12.0	12.0	10.0	5.0	5.0	na
Interbank market rate	15.0	7.7	7.0	6.9	4.6	6.0	na
Deposit rate (6-12 months)[4]	22.8	16.9	17.8	15.4	11.3	8.6	na
Lending rate (6-12 months)[4]	27.9	26.7	21.9	20.4	17.3	17.3	na
			(Manats per US dollar)				
Exchange rate (end-year)[5]	9,790.0	10,060.0	10,150.0	10,390.0	10,540.0	10,870.0	na
Exchange rate (annual average)	8,478.6	9,827.9	10,097.5	10,033.5	10,375.0	11,015.2	na
External sector			*(In millions of US dollars)*				
Current account	411	116	583	305	84	688	1,200
Trade balance	766	515	1,030	886	706	1,302	1,809
Merchandise exports	2,508	2,623	2,862	3,465	3,854	4,939	6,174
Merchandise imports	1,742	2,108	1,832	2,579	3,148	3,637	4,364
Foreign direct investment, net	131	170	276	226	354	300	308
Gross reserves, excluding gold (end-year)[6]	1,808	2,055	2,346	2,673	2,714	3,314	na
External debt stock	2,184	1,865	1,660	1,519	1,273	1,007	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	9.2	9.1	11.8	9.5	8.0	8.6	na
			(In per cent of exports of goods and services)				
Debt service[7]	14.2	17.3	14.3	11.6	9.6	5.6	na
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	5.4	5.6	5.8	6.2	6.5	6.5	na
GDP (in billions of manats)	25,648	36,052	45,240	59,405	72,706	91,863	110,917
GDP per capita (in US dollar)	563	650	774	955	1,078	1,283	na
Share of industry in GDP (in per cent)	45.8	39.8	40.9	39.7	38.6	na	na
Share of agriculture in GDP (in per cent)	24.5	23.0	21.8	19.6	18.4	na	na
Current account/GDP (in per cent)	13.6	3.2	13.0	5.2	1.2	8.2	11.9
External debt - reserves (in US$ million)	376	-190	-686	-1,154	-1,441	-2,307	na
External debt/GDP (in per cent)	72.2	50.8	37.1	25.7	18.2	12.1	na
External debt/exports of goods and services (in per cent)	78.7	64.8	53.9	40.8	30.2	18.9	na

1 Official statistics until 2004, but EBRD estimates for 2005 and 2006.
2 Officially registered unemployed.
3 Significant off-budget expenditures occur through extra-budgetary funds and lending.
4 Unweighted average deposit and lending rates for individuals (in local currency) of state commercial banks.
5 Turkmenistan operates a dual exchange rate system. The series refers to a weighted average between the official exchange rate and the commercial rate (given as the black market rate). Weights are variable depending on official and shuttle trade.
6 Includes foreign exchange reserves of the Central Bank plus the foreign exchange reserve fund.
7 Excludes rescheduled amounts.

ANNEX 8: ASSESSMENT OF TRANSITION CHALLENGES

	Structure	Institutions	Conduct	Comments
Agribusiness	*Large*	*Large*	*Large*	Government intervention in the sector is high. Imports and exports need to be registered through the state commodity exchange. Only around 10% of land is in private ownership. The government has promised to transfer land ownership to farmers within 5 to 10 years, but the new land code adopted in 2004 still retains state control of land use. The government also continues to control inputs, outputs and agro-processing enterprises. There is a high dependence on subsidised and directed credit through government controlled banks.
Banking	*Large*	*Large*	*Large*	Continued tight state control over the banking system, for instance through a Presidential decree to close the foreign correspondent account of commercial banks in 2003. There is formal and informal interference in credit allocation, and a largely opaque set of prudential norms. No recent entry into the largely state-owned banking sector.
Energy Efficiency	*Large*	*Large*	*Large*	Persistently low energy tariffs and inappropriate metering fail to provide the appropriate signals for efficiency and conservation. The country continues to be one of the most energy intensive in the region. Ratification of the Kyoto protocol may provide future profit opportunities in the sector, but they are unlikely to materialise in the absence of appropriate market institutions.
General Industry	*Large*	*Large*	*Large*	Transition in general industry has not started. Private sector almost non-existent, key staple prices are state controlled, rule of law is not established, and regulatory framework is complex and arbitrary. Restructuring yet to commence.
MEI	*Large*	*Large*	*Large*	There has been no progress in MEI reform. Water is provided for free. Corporate governance is very poor and municipal services are operated as departments of state administration, lacking basic rules of transparency.
MSMEs	*Large*	*Large*	*Large*	The costs for starting up a business are large and the institutional set up and business environment for SMEs are poor. Access to credit for MSMEs is poor.
Natural Resources	*Large*	*Large*	*Large*	State-owned concerns under direct supervision of the President are carrying out upstream and downstream oil and gas functions. Privatisation is not envisaged. Although the government is trying to attract more FDI by PSAs, complex regulation and unfavourable business practices deter investment. Most of the revenue from hydrocarbon exports is accumulated in extra-budgetary funds. A key challenge is to integrate these funds into public budget (to enhance the transparency) and to liberalise energy prices (to increase efficiency).
NBFIs	*Large*	*Large*	*Large*	Basic legislation and regulation on securities markets are in place but they substantially fall below IOSCO standards in all aspects. There is no stock exchange. Foreign entry into the insurance sector is allowed only through minority joint ventures. After the revocation of licences of four private insurance companies in 2000, the state-owned Turkmen Gosstrakh is the only insurance company in the country. There is a small leasing and consumer financing market. There are also privately managed mandatory and voluntary pension funds.

	Structure	Institutions	Conduct	Comments
Power	*Large*	*Large*	*Large*	The power sector is still vertically integrated and characterised by high transmission and distribution losses. No independent regulator and tariffs lowest in the region (energy is provided for free to residential customers).
Private Equity Funds	*Large*	*Large*	*Large*	The country needs further progress in creditor rights protection and corporate governance and has not yet developed a class of local managers or investors committed to local private equity investments.
Property + Tourism	*Large*	*Large*	*Large*	Tradability of land limited de jure. Widespread state intervention in the sector. Property development financed by gas exports is driven by the state. Many standard market products and financing methods are not available.
Telecoms	*Large*	*Large*	*Large*	Development of the sector is still stifled by the overpowering presence of the state and the absence of private sector participation. The dominant fixed line operator is the primary provider of public telephone, e-mail and Internet services and possesses an indefinite exclusivity over fixed line telephony. The mobile sector took a step back in terms of development since the state re-entered a sector that had previously been served by a private operation.
Transport	*Large*	*Large*	*Large*	In railways, operating and policy setting functions are not separated and core railway businesses (infrastructure, passenger, freight, etc.) are operated by the same entity. The road sector remains mostly unreformed in all aspects (institutions, road user charges, private sector participation).

ANNEX 9: BILATERAL ASSISTANCE[7]

France

In 2004 France spent EUR 133,500, and in 2005 EUR 100.000, of which 63% was in favour of cultural initiatives, 30% for scientific cooperation (mainly in the form of grants to students) and 7% for technical cooperation (food safety and fighting against desertification).

Italy

In 2000 the Italian Government included Turkmenistan among the countries eligible for bilateral assistance only for programmes promoted by NGOs and humanitarian aid. At present, however, no humanitarian interventions or initiatives promoted by NGOs have been financed by the Italian Government.

On multilateral assistance, Italy contributed an amount of US$ 250,000 to the UNODC for the implementation of the project "Precursor Control in Central Asia" (2000-2006), oriented to the drug trafficking control in Uzbekistan, Tajikistan, Kyrgyzstan, Azerbaijan and Turkmenistan.

Japan

In the last 5 years, Japan has extended to Turkmenistan two cases of new small grant aid in the education sector, and implemented some technical cooperation, mainly technical training in the health and environment sectors. In 2004, the total disbursement for loan project was US$ 2.1 million, and for grant (all technical cooperation) the amount was US$ 0.1 million.

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

Switzerland has no bilateral projects in Turkmenistan, but is present with targeted support alongside EBRD. This includes one co-investment alongside DIF (through CARSSF) in Turkmenistan. Switzerland also supports EBRD SME credit lines and TFP training programmes.

United States

USAID plans to provide US$ 3.5 million in assistance to Turkmenistan in Fiscal Year 2006. The priority areas will be health (US$ 1.4 million) and democracy (US$ 1 million). Despite difficult challenges in Turkmenistan, AID believes limited democracy work is possible at the grassroots level. USAID supports the development

[7] This information was supplied by the respective governments.

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. USAID's legal reform programme targets future legal professionals by building students' practical writing and oral advocacy skills through moot courts, mock trials, and Street Law, while giving them practice through the establishment of university-affiliated legal clinics. While the political environment continues to prohibit comprehensive health reform, USAID is able to support the Turkmenistan Government to improve health systems in specific areas, which include the improvement of the quality of maternal and child health services, improvement in laboratory quality control for TB diagnosis, and the development of blood screening programmes.

The remaining funds will be used to support economic reform, initiatives in the energy and water sectors, and other programmes. To support economic reform, USAID focuses on preparing the next generation of entrepreneurs by offering basic business education courses, including marketing, business planning, and international accounting standards. USAID also supports seminars on international and commercial law for Turkmenistan law students, legal professionals, and entrepreneurs and the development of sustainable civic organizations in the agricultural sector. With respect to energy, USAID is exploring opportunities to assist Turkmenistan with regional energy market development. Water activities include training in water management, work with water users associations, and support for a regional transboundary programme designed to improve interstate cooperation. Other programmes will provide training and exchanges to support USAID's technical assistance programmes.