Regional Economic Outlook UPDATE
May 2014
Middle East and Central Asia Department

Caucasus and Central Asia: Moderating Growth, Rising Uncertainty

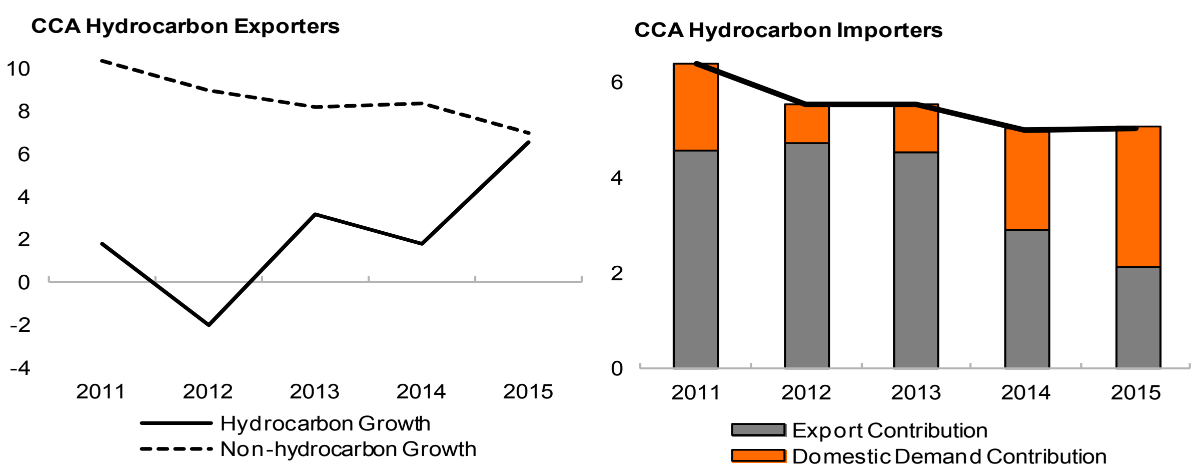
Economic growth in the Caucasus and Central Asia (CCA) is expected to decline from 6½ percent in 2013 to 6 percent in 2014, mainly because of weakening growth momentum in emerging market trading partners (particularly, China, Russia, and Turkey) and a temporary decline in oil output growth in Kazakhstan. Risks remain tilted to the downside. In particular, a slowdown in emerging market trading partners may weaken exports, foreign direct investment, and remittances. Policy priorities center on rebuilding buffers and increasing exchange rate flexibility to help adjust to unanticipated shocks. Stronger macroeconomic frameworks would provide a more credible anchor to economies. Rapid credit growth in some countries calls for strengthening the prudential policies to ensure the continued soundness of financial institutions. Structural reforms to improve the business environment and governance, as well as closer regional cooperation, would enable CCA countries to achieve their goal of becoming dynamic emerging market economies.

Growth Softening in Tandem with Trading Partners' Growth

Economic activity in the CCA continued to expand at a strong rate of 6½ percent last year. Domestic demand in the oil- and gas-exporting countries remained robust, supported by expanding production. Oil- and gas-importing countries continued to benefit from strong export growth, boosted in part by past currency depreciations and rising remittances.

This year growth is projected to soften to about 6 percent. Moderating growth prospects in the main emerging market trading partners (particularly Russia, China, and Turkey) will weigh on exports, although Europe's recovery will mitigate the impact. A weakening of oil output growth in Kazakhstan and flat gold exports from the Kyrgyz Republic will also tend to reduce economic growth. By contrast, domestic demand in Armenia and Georgia will strengthen, owing to fiscal stimulus.

Real GDP growth softening but strong in 2014
(Real GDP, percentage change from previous year)



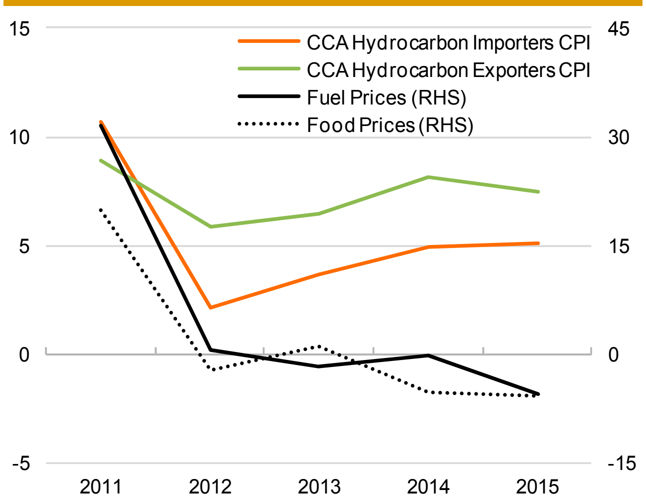
Sources: National authorities; and IMF staff calculations.

A slowdown in regional economic activity is expected to be temporary. Regional economic growth is projected to recover in 2015 as hydrocarbon production in Kazakhstan and Turkmenistan accelerates, although subject to increased uncertainty associated with production delays in Kazakhstan's Kashagan oil field.

Inflation Rising on Currency Depreciation

CCA inflation is expected to rise by 1½ percentage points to 7½ percent in 2014–15, mainly because of recent large currency depreciation in Kazakhstan and, to a lesser extent, strengthening domestic demand in Georgia. Declining global food prices and continued expansion of productive capacity will continue to limit inflationary pressures.

Inflation rising despite cheaper food and fuel
(CPI and commodity prices, percentage change from previous year)



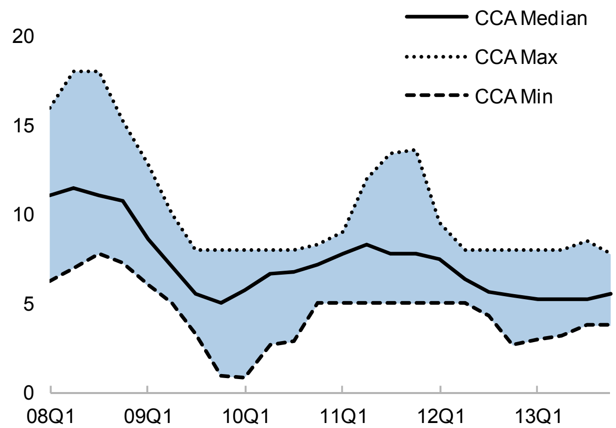
Sources: National authorities; and IMF staff calculations.

In Kazakhstan, inflation projections may be biased upward. The authorities have introduced administrative measures to limit price increases for a number of goods and services that they deem socially significant, to mitigate the impact on inflation of the tenge's depreciation. (The devaluation should not have large regional spillovers because trade and financial links between Kazakhstan and the rest of the CCA are weak.) In Uzbekistan, inflation will continue to linger in the double digits because of increases in administered prices, currency depreciation, and strong credit growth.

In countries where inflation is expected to stay within central bank target ranges, monetary policy can remain at a neutral setting. Central banks should stand ready to tighten policy if inflation pressures build up more quickly than expected, for example, because of tightening supply constraints or second-round effects. Uzbekistan should raise interest rates, reduce reliance on administrative measures and refrain from intervening in the foreign exchange market.

Risks Are Slanted to the Downside

Policy rates are more accommodative[1]
(Policy rates, percent)



Sources: National authorities; and IMF staff calculations.
[1]Excludes Turkmenistan and Uzbekistan.

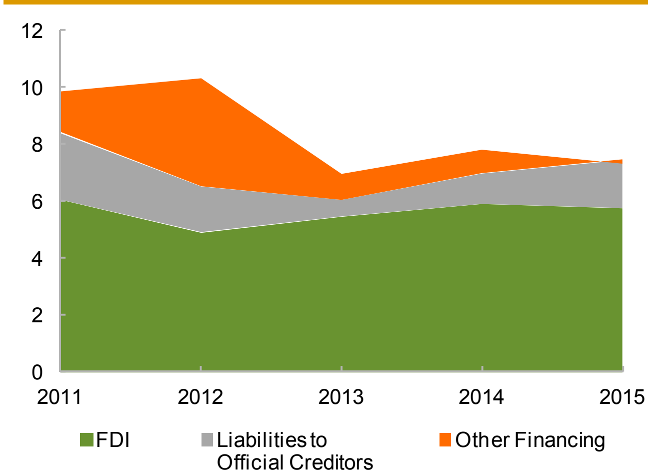
Risks to the growth forecasts have risen because of increased emerging market risks, and are still tilted to the downside. The main regional risk stems from a further slowdown in Russia's growth prospects, which may reduce growth in most of the CCA economies through lower remittances (particularly, Armenia, Kyrgyz Republic and Tajikistan), lower exports (especially, Turkmenistan and Uzbekistan) and lower project financing (for example, Tajikistan). Geopolitical risks related to Ukraine may also affect the CCA through a gamut of trade, remittance, and financial channels, as well as possible disruptions in production or tansportation of natural gas, crude oil, corn, and wheat.

A slowdown in China, resulting from a faster-than-expected unwinding of the policy stimulus put in place there during the global financial crisis, is also an important regional risk. Turkmenistan is especially exposed to China and Russia, which together account for 90 percent of its gas exports. More generally, slower demand growth in emerging market economies as they adjust to weaker medium-term growth prospects and tighter financial conditions is a key risk for the CCA region. Slower growth in emerging market economies may cause a decline in commodity prices. This would slow economic activity and reduce fiscal and current account balances in the oil- and gas-exporting CCA countries, though their strong policy buffers would mitigate the impact.

A slowdown in demand in emerging trading partner countries would also adversely affect the CCA oil and gas importers through trade as well as foreign direct investment (FDI), project financing, and remittances. Low fiscal and external buffers, which have not increased significantly in recent years despite strong growth, would make it difficult for the CCA oil and gas importers to avoid an adjustment in the event of a large adverse shock.

A further tightening of global financial conditions due to an earlier-than-expected normalization of U.S. monetary policy is unlikely to affect the CCA significantly because of the region's small exposure to international capital markets and because of stable sources of external funding (FDI and official lending).

Stable sources of current account financing
(CCA hydrocarbon importers: financial flows, percent of GDP)



Sources: National authorities; and IMF staff calculations.

Time to Put Fiscal House in Order

Given strong growth and narrowing output gaps, fiscal policies in most countries can switch to a tightening stance. Most CCA countries have indicated their intention to make inroads in fiscal consolidation. This move would improve debt sustainability, increase resilience to shocks, and preserve wealth for future generations. Kazakhstan, for example, has been planning to bring the non-oil fiscal deficit to a sustainable level in three years, although a recently announced spending package, financed from the oil fund, may delay these plans. Azerbaijan also recently signaled the long-awaited start of fiscal consolidation. Although Georgia and Armenia will provide a fiscal stimulus to their weak economies in 2014, they intend to return to fiscal consolidation in 2015.

For the oil and gas exporters, the challenge is to resist pressure to increase spending; there is still ample room to increase tax revenues and improve the efficiency of public investment. Oil and gas importers should continue to rebuild their fiscal buffers to create room to respond to future adverse shocks. Fiscal consolidation will also help these countries reduce debt to sustainable levels. Reining in wage increases, broadening the tax base and/or raising tax rates are the key steps that would help strengthen fiscal positions.

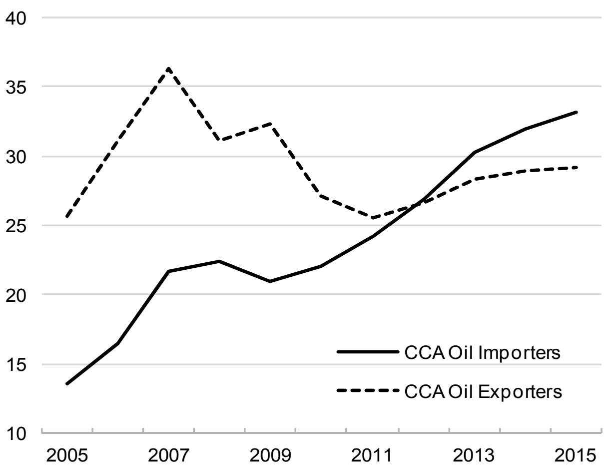
Stronger Monetary Policy Frameworks Can Reduce Inflation Volatility

To varying degrees, CCA countries have made important progress towards the emulating best-practice monetary policy frameworks of emerging markets, such as providing greater independence to central banks, and improving national statistics and transparency. Some countries require further development of instruments, while others can shift attention to communication strategies. These improvements to operational frameworks, together with measures to reduce dollarization, would improve monetary transmission and help reduce inflation volatility.

Rapid Credit Growth Calls for Stronger Financial Sector Supervision

Consumer credit has been expanding at a rapid pace in recent years, and though this expansion is a welcome sign of financial deepening, it raises concerns about future financial stability. Kazakhstan is still struggling to resolve the legacy problems of large nonperforming loans, while the recent devaluation may further weaken bank balance sheets. In Tajikistan, directed lending has undermined the largest banks.Strengthening macroprudential policy and supervision can help preserve financial stability in an environment of rapidly expanding credit. Azerbaijan and Kazakhstan have taken measures to curb consumer lending. The Kyrgyz Republic has started to improve its financial sector regulation, but additional measures may be needed in other countries.

Credit has expanded rapidly
(Private sector credit, percent of GDP)



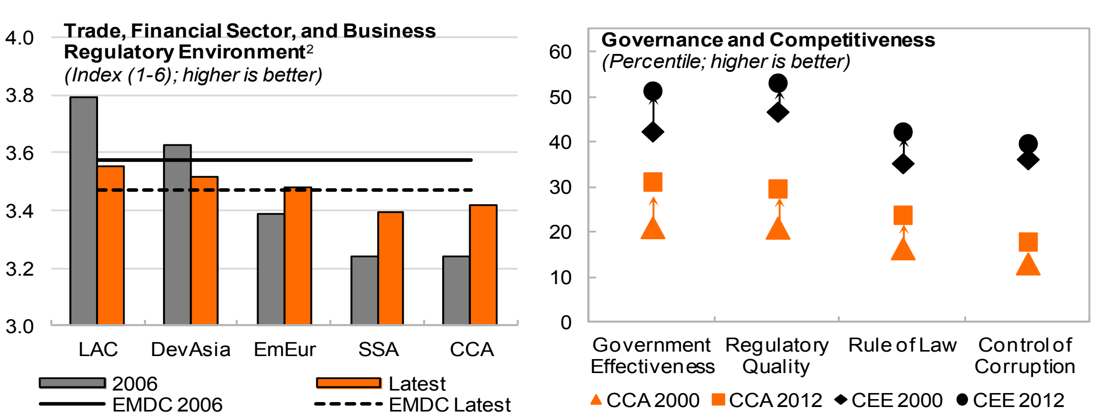
Sources: National authorities; and IMF staff calculations.

Striving to Sustain Growth over the Medium Term

Medium-term policy priorities center on the need to raise potential growth, improve competitiveness and enhance the economy's resilience to unanticipated shocks. Stronger macroeconomic policy frameworks can provide a credible anchor to the economy, while greater exchange rate flexibility can help buffer shocks. Reinvigorated structural reforms are needed to improve the business environment and governance, diversify economies, and make them more competitive and inclusive.

In particular, trade integration and reforms can help diversify economies and improve medium-term growth prospects. Progress in strengthening regional cooperation has generally been slow and uneven so far. Integration with the Eurasian Customs Union (Belarus, Kazakhstan and Russia) Armenia and the Kyrgyz Republic recently announced their intention to join, as well as with European and other partners, will improve prospects for exports, financing, and FDI.

Structural reforms needed for competitive and inclusive economies[1]



Sources: World Bank; and IMF staff calculations.
[1] Country aggregates are as follows: LAC - Latin America and the Caribbean; DevAsia - Developing Asia; EmEur - Emerging Europe; SSA - Sub-Saharan Africa; CCA - Caucasus and Central Asia; EMDC - Emerging Market and Developing Countries; and CEE - Central and Eastern Europe.
[2] Data are from the structural policy cluster of the World Bank's Country Policy and Institutional Assessment (CPIA).

CCA Region: Selected Economic Indicators, 2000–15

(Percent of GDP, unless otherwise indicated)

	Average 2000–08	2009	2010	2011	2012	2013	Projections 2014	2015
CCA								
Real GDP (annual growth)	9.9	3.7	6.8	6.8	5.7	6.6	6.2	6.4
Current Account Balance	0.5	0.4	4.5	7.4	3.0	2.6	3.0	2.4
Overall Fiscal Balance	1.9	0.8	3.7	6.4	4.5	2.1	1.5	0.9
Inflation, p.a. (annual growth)	10.5	6.2	7.0	9.1	5.3	6.0	7.7	7.1
CCA oil and gas exporters								
Real GDP (annual growth)	10.3	4.9	7.2	6.8	5.7	6.8	6.4	6.7
Current Account Balance	1.7	1.8	6.2	9.3	4.5	3.6	4.2	3.4
Overall Fiscal Balance	2.8	2.1	5.1	7.9	5.6	2.8	2.2	1.4
Inflation, p.a. (annual growth)	10.9	6.5	7.0	8.9	5.8	6.4	8.1	7.4
CCA oil and gas importers								
Real GDP (annual growth)	8.0	-3.5	4.0	6.4	5.5	5.5	5.0	5.0
Current Account Balance	-7.4	-10.0	-9.4	-9.8	-10.3	-6.9	-7.8	-7.3
Overall Fiscal Balance	-2.9	-6.8	-5.3	-3.3	-2.2	-2.4	-2.8	-2.3
Inflation, p.a. (annual growth)	8.6	4.2	7.1	10.7	2.1	3.6	4.9	5.1

Sources: National authorities; and IMF staff calculations and projections.
CCA oil and gas exporters: Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan.
CCA oil and gas importers: Armenia, Georgia, the Kyrgyz Republic, and Tajikistan.

CCA: Selected Economic Indicators

	Average 2000–08	2009	2010	2011	2012	2013	Projections 2014	2015
Real GDP Growth	**9.9**	**3.7**	**6.8**	**6.8**	**5.7**	**6.6**	**6.2**	**6.4**
(Annual change; percent)								
Armenia	11.4	-14.1	2.2	4.7	7.1	3.2	4.3	4.5
Azerbaijan	15.4	9.3	5.0	0.1	2.2	5.8	5.0	4.6
Georgia	7.0	-3.8	6.3	7.2	6.2	3.2	5.0	5.0
Kazakhstan	9.4	1.2	7.3	7.5	5.0	6.0	5.7	6.1
Kyrgyz Republic	4.9	2.9	-0.5	6.0	-0.9	10.5	4.4	4.9
Tajikistan	8.6	3.9	6.5	7.4	7.5	7.4	6.2	5.7
Turkmenistan	15.1	6.1	9.2	14.7	11.1	10.2	10.7	12.5
Uzbekistan	6.3	8.1	8.5	8.3	8.2	8.0	7.0	6.5
Consumer Price Inflation	**10.5**	**6.2**	**7.0**	**9.1**	**5.3**	**6.0**	**7.7**	**7.1**
(Year average; percent)								
Armenia	3.6	3.5	7.3	7.7	2.5	5.8	5.0	4.0
Azerbaijan	7.8	1.6	5.7	7.9	1.0	2.4	3.5	4.0
Georgia	6.8	1.7	7.1	8.5	-0.9	-0.5	4.0	4.6
Kazakhstan	9.4	7.3	7.1	8.3	5.1	5.8	9.2	7.5
Kyrgyz Republic	8.8	6.8	7.8	16.6	2.8	6.6	6.1	6.6
Tajikistan	17.6	6.5	6.5	12.4	5.8	5.0	5.4	5.9
Turkmenistan	8.8	-2.7	4.4	5.3	5.3	6.6	5.7	6.0
Uzbekistan	16.3	14.1	9.4	12.8	12.1	11.2	11.0	11.0
General Gov. Overall Fiscal Balance	**1.9**	**0.8**	**3.7**	**6.4**	**4.5**	**2.1**	**1.5**	**0.9**
(Percent of GDP)								
Armenia[1]	-2.9	-7.7	-5.0	-2.9	-1.6	-2.5	-2.3	-2.0
Azerbaijan[1]	2.7	7.0	14.6	13.6	4.9	1.0	0.3	-3.1
Georgia	-2.2	-9.2	-6.6	-3.6	-3.0	-2.5	-3.8	-3.0
Kazakhstan	3.0	-1.4	1.4	5.9	4.5	4.9	4.2	3.9
Kyrgyz Republic	-4.0	-3.4	-6.3	-4.6	-5.3	-4.0	-4.2	-3.2
Tajikistan	-3.0	-5.2	-3.0	-2.1	0.6	-0.8	-0.9	-0.9
Turkmenistan[2]	2.8	7.0	2.0	3.6	6.4	0.2	-0.3	0.5
Uzbekistan	1.9	2.8	4.9	8.8	8.5	1.3	0.8	0.7
Current Account Balance	**0.5**	**0.4**	**4.5**	**7.4**	**3.0**	**2.6**	**3.0**	**2.4**
(Percent of GDP)								
Armenia	-6.5	-15.8	-14.8	-10.9	-11.2	-8.4	-7.2	-6.8
Azerbaijan	0.8	23.0	28.0	26.5	21.8	19.7	15.0	9.9
Georgia	-11.7	-10.5	-10.2	-12.7	-11.7	-6.1	-7.9	-7.3
Kazakhstan	-1.6	-3.6	0.9	5.4	0.3	0.1	1.9	2.0
Kyrgyz Republic	-2.8	-2.5	-6.4	-6.5	-15.0	-12.6	-15.5	-14.3
Tajikistan	-3.9	-5.9	-1.2	-4.8	-2.0	-1.9	-2.1	-2.3
Turkmenistan	8.1	-14.7	-10.6	2.0	0.0	-3.3	-1.1	1.3
Uzbekistan	5.3	2.2	6.2	5.8	1.2	1.7	2.2	1.9

Sources: National authorities; and IMF staff estimates and projections.

[1]Central government.

[2]State government.