Caucasus and Central Asia: Battered by External Shocks

Economic growth has slowed to a two-decade low in the Caucasus and Central Asia (CCA) region, owing to the large and sustained decline in commodity prices, wide-ranging spillovers from Russia's recession, and the slowdown and rebalancing of China's economy. Fiscal and external balances have deteriorated and financing costs have risen. Although currency weakening and fiscal easing have helped to mitigate the impact of these shocks, inflation and financial sector vulnerabilities have increased, in some cases exacerbated by policy uncertainty. Strengthening macroeconomic policy frameworks and financial sector supervision is essential to maintain stability in these challenging circumstances. Fiscal policy should strike a balance, depending on the size of buffers and available financing, between supporting economic activity in the near term and ensuring debt sustainability over the medium term. Intensifying structural reforms would facilitate the adjustment by boosting medium-term economic prospects, improving competitiveness, and creating jobs.

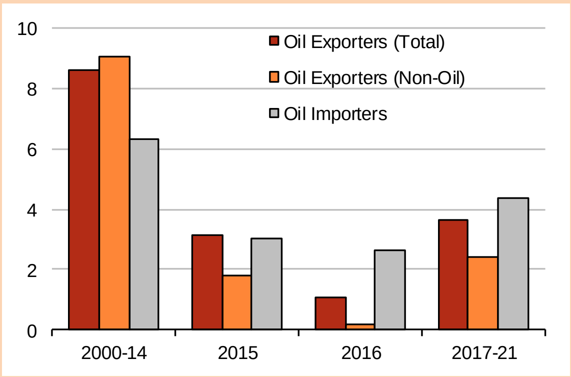
Sharp Economic Downturn

The external environment has continued to deteriorate since October 2015 from an already challenging position. Oil prices are projected to average around $35 a barrel in 2016, $16 below the 2015 average. Russia's economy is expected to contract further this year, by about 1¾ percent, reducing trade, remittances, and investment to the region. And China's slowdown is expected to weaken external demand and commodity prices further.

As a result of these external shocks, growth in the CCA region is projected to decline to 1.2 percent in 2016—a two-decade low—and recover only modestly in 2017 (Figure 1). With the shocks expected to persist, the medium-term outlook has also weakened significantly, with average growth for 2017-21 projected at 3.7 percent, well below the growth of 8.3 percent in 2000-14.

In oil exporters, growth is projected to decline to 1.1 percent this year, from 3.2 percent in 2015, because of declining oil production and public investment, softening private demand—in part, reflecting weakening confidence—and increased exchange rate and monetary policy uncertainty.

Figure 1
Dimming Growth Prospects
(Real GDP, Percent Change)



Sources: National authorities; and IMF staff estimates.

In oil importers, growth is projected at 2.6 percent, down from 3 percent in 2015. The positive impact of lower oil prices on economic activity has been limited because domestic fuel prices have declined only modestly (some 20 percent since 2014), owing to low competition and currency depreciation. Any boost to consumption has been partially offset by declining remittances from Russia (an important source of income in Armenia, the Kyrgyz Republic, and Tajikistan, where remittances ranged between 9 and 32 percent of GDP in 2015). Lower exports to

Russia and weaker direct investment from Russia, as well as subdued demand (mainly from China) and prices for key non-oil commodity exports (copper, aluminum, cotton) are also weighing on the outlook.

Risks Tilted to the Downside

Risks to the outlook stem mostly from a further deterioration of the external environment, as well as the domestic banking system. A further weakening of oil prices would affect oil exporters directly, and oil importers through its impact on Russia's economy, the value of the Russian ruble, and spillovers through trade and remittances. Lower oil prices could also reduce investment in hydrocarbons, which drive medium-term growth prospects in oil exporters. A deeper slowdown in China would also reduce external demand, both directly, as the region has seen its share of exports to China increase by about 10 percentage points of total exports since 2005, and indirectly, through other commodity prices and investor confidence.

Domestic risks mainly relate to the vulnerability of banks to further currency depreciation. Capital buffers have helped absorb the impact of the recent macroeconomic shocks so far. In countries with high vulnerabilities and weak supervision, risks to financial stability may materialize if economic conditions continue to deteriorate.

Currencies under Pressure

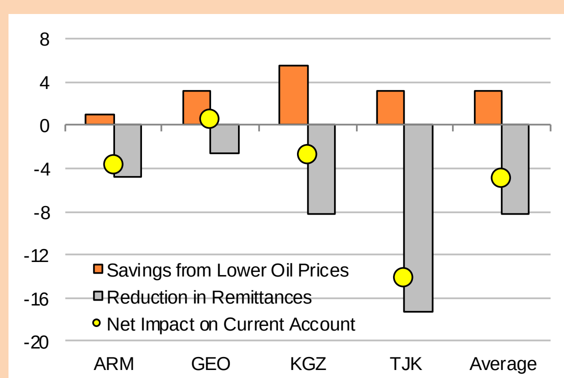
All countries have adjusted their currencies since 2014, five of them by at least 30 percent as of February 2016. This has helped mitigate the effects of the external shocks and limit foreign exchange reserve losses; reserves remain above 3 months of imports in all countries except Tajikistan, where coverage is about 1½ months of imports. Georgia, the Kyrgyz Republic, and, more recently, Kazakhstan have allowed considerable exchange rate flexibility. Others have opted for managing their currencies more tightly. Azerbaijan has maintained a narrow band after large devaluations in 2015. Tajikistan, Turkmenistan, and Uzbekistan have intervened heavily and implemented administrative controls. The exchange rate in Armenia has remained stable, supported by periodic interventions.

Despite the currency adjustment in 2015, real effective exchange rates have appreciated in Armenia, Turkmenistan, and Uzbekistan. Currencies remain under pressure as foreign exchange earnings have been declining, with parallel market spreads rising in countries with administrative controls (especially in Uzbekistan).

External Balances Adjusting

External balances are adjusting in response to the external shocks and currency depreciations. In oil exporters, the combined current account deficit is projected to widen to 4 percent of GDP this year, from 2.7 percent last year, mainly due to the sharp drop in oil export revenues, with only a partial offset from import contraction of 15 percent of GDP. In oil importers, the current account deficit is set to remain at a rather high 9.6 percent of GDP this year. Lower remittances and exports (including of non-oil commodities) offset reductions in oil import bills and non-oil imports, due to weakening domestic economic activity and currency depreciation (Figure 2). Across the region, import compression has been largest where currencies depreciated the most.

Figure 2
CCA Oil Importers: Reduction in Remittances Offsets Gains from Lower Oil Prices
(Percent of GDP, 2015)

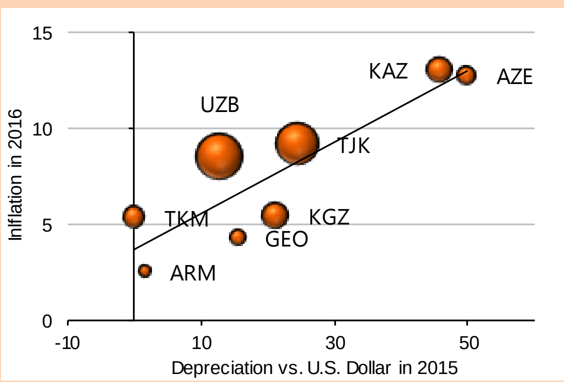


Sources: IMF staff estimates.

Stronger Policy Frameworks Needed

Monetary policy is expected to remain tight as currency depreciations have heightened inflationary pressures, especially in countries where inflation has been historically higher (Figure 3). In Azerbaijan and Kazakhstan, after sizable depreciations, inflation has reached double digits for the first time in more than 15 years. In oil importers, where currency depreciations have been smaller, lower fuel and food prices, along with weak domestic demand, have helped contain inflationary pressures. In Armenia and the Kyrgyz Republic, average inflation is projected to decline in 2016.

Figure 3
Currency Depreciation and Expected Inflation
(Percentt)



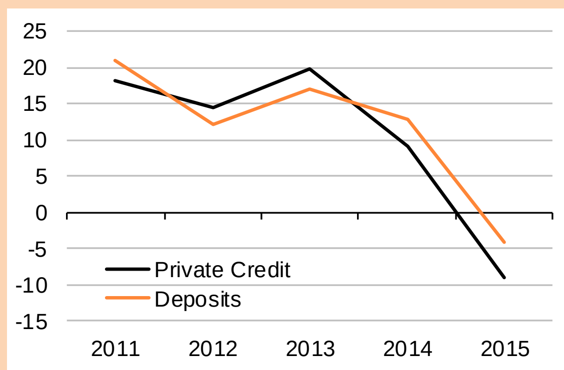
Sources: National authorities; and IMF staff estimates.
Note: Marker size indicates average inflation in 2000-13.

Since all central banks in the region have price stability as their main policy objective, this environment illustrates the importance of modernizing exchange rate and monetary policy frameworks. An effective interest rate instrument is needed to replace the exchange rate as the nominal anchor. To this end, it is important to enhance the independence and institutional capacity of central banks, improve transparency and accountability, and strengthen communication on policy actions.

Financial Sector Risks Elevated

The highly dollarized bank balance sheets are likely to continue to weaken, at a pace augmented in some cases by bad loans from previous crises. Liquidity is declining, largely because of slowing foreign currency earnings and capital flight, exacerbated by increasing deposit dollarization. Credit risks are on the rise, as creditworthiness of unhedged borrowers declines because of slower growth and weaker currencies. With economic activity weakening, private sector credit will continue to soften (Figure 4). Bank profitability is also projected to decline further. The number of loss-making and undercapitalized banks has increased, leading to mergers and/or closures in a number of countries (Azerbaijan, Kazakhstan).

Figure 4
Financial Intermediation Slowing Down
(Private Credit and Deposits, Percent Change 1/)



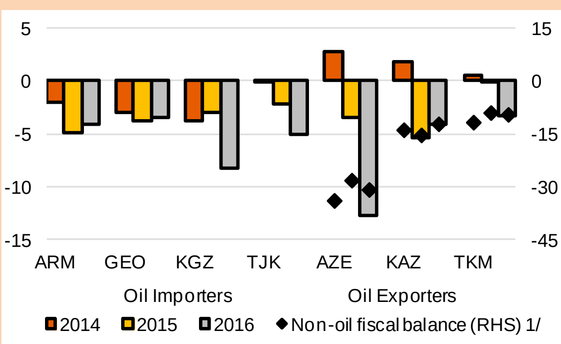
Sources: National authorities; and IMF staff estimates.
1/ Adjusted for exchange rate effects.
Note: Excludes Turkmenistan and Uzbekistan.

Country authorities have taken some measures in response, but more is needed to minimize the risks to financial stability. Some countries have changed capital adequacy and net open position requirements, and increased required reserves for foreign currency deposits. It is also essential to enhance financial surveillance through intensified monitoring of liquidity risks and regular stress-testing, as well as strengthen supervision, and macroprudential and crisis management policies. Forbearance should be avoided.

Ensuring Fiscal Sustainability While Supporting Growth

To mitigate the impact of the shocks, most CCA countries allowed their fiscal deficits to widen last year, which helped support economic activity. This year, with the shocks continuing, buffers declining, and financing costs edging up, some countries have started to consolidate their fiscal positions, and/or rationalize high levels of public investment, to help ensure fiscal sustainability. Other countries are continuing to allow their fiscal deficits to widen in support of growth (Figure 5). In oil exporters, the fiscal deficit is anticipated to widen by 1.7 percentage points of GDP to 4.9 percent in 2016, while in oil importers, it is projected to reach 4.9 percent of GDP, 1.4 percentage points higher than 2015.

Figure 5
Fiscal Tightening in Some Countries
(Overall fiscal balance in percent of GDP)



Sources: National authorities; and IMF staff estimates.
1/ In percent of non-oil GDP.

With oil prices likely to remain low and debt projected to rise (especially in the Kyrgyz Republic and Tajikistan), countries need to start fiscal consolidation as soon as cyclical conditions allow.

Countries with larger fiscal buffers can choose a slower pace of consolidation. Fiscal consolidation should avoid expenditure cuts that harm medium-term growth prospects, while safeguarding targeted social spending. Broadening the tax base and diversifying revenues would help reduce public sector exposure to commodity terms-of-trade shocks. Some countries have announced privatization plans, which, if implemented, should lead to much-needed revenue gains.

Promoting Private Sector-Led Growth

The recent external shocks have increased the urgency of unlocking the region's significant growth potential by diversifying away from commodities and reducing the reliance on remittances.

Living standards, as measured by GDP per capita, doubled over the past 12 years, largely owing to booming revenues from commodity exports and remittances. Now, with declines in commodity prices and remittances, it would take almost 25 years for living standards to double again. The region would lag behind other emerging market economies, unless structural reforms are enacted and accelerated.

The World Economic Forum's 2015–16 *Global Competitiveness Report* shows that Kazakhstan and all CCA oil importers made some progress in improving their business competitiveness last year. Yet, to foster vibrant market economies and boost economic prospects, countries need to take bolder steps to further improve the business environment, raise the quality of education, strengthen governance, and increase access to finance. This would foster private entrepreneurship, create much-needed jobs, and alleviate poverty, while improving confidence in a testing economic environment.

CCA Region: Selected Economic Indicators, 2000–17

(Percent of GDP, unless otherwise indicated)

	Average 2000–12	2013	2014	2015	Projections 2016	Projections 2017
CCA						
Real GDP (annual growth)	8.7	6.6	5.3	3.1	1.2	2.5
Current Account Balance	1.4	1.9	2.0	-3.4	-4.7	-3.0
Overall Fiscal Balance	2.8	2.8	1.4	-3.2	-4.9	-3.3
Inflation, p.a. (annual growth)	9.4	6.1	5.9	6.2	10.6	8.5
CCA oil and gas exporters						
Real GDP (annual growth)	9.0	6.8	5.4	3.2	1.1	2.4
Current Account Balance	2.8	2.9	3.4	-2.7	-4.0	-2.2
Overall Fiscal Balance	3.6	3.4	1.9	-3.2	-4.9	-3.2
Inflation, p.a. (annual growth)	9.6	6.4	6.1	6.3	11.2	8.8
CCA oil and gas importers						
Real GDP (annual growth)	6.5	5.6	4.6	3.0	2.6	3.5
Current Account Balance	-8.3	-7.2	-10.5	-9.6	-9.6	-8.7
Overall Fiscal Balance	-3.2	-2.4	-2.2	-3.5	-4.9	-3.7
Inflation, p.a. (annual growth)	7.7	3.6	4.6	4.8	5.2	5.7

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.