Regional Economic Outlook UPDATE
May 2015
Middle East and Central Asia Department

Caucasus and Central Asia:
Oil Price Decline and Regional Spillovers Darken the Outlook

Economic activity in the Caucasus and Central Asia (CCA) will continue to decelerate in 2015 mainly as a consequence of lower commodity prices and spillovers from Russia's slowdown. Where fiscal space and available financing allow, temporary fiscal easing would help economies respond to weakening demand and declining remittances. Over the medium term, fiscal consolidation is needed to rebuild depleted buffers and adjust spending plans to the new regional and global economic context. In light of the depreciation of the ruble and the appreciation of the dollar, greater exchange rate flexibility would ease pressure on reserves while helping oil exporters adjust to lower oil prices. Monetary policy may need to be tightened to keep inflation expectations anchored in the face of weakening currencies. Over the medium term, deep structural reforms, particularly to improve the business climate and governance, would raise prospects and make economic growth more inclusive and diversified.

External Shocks Weaken Growth

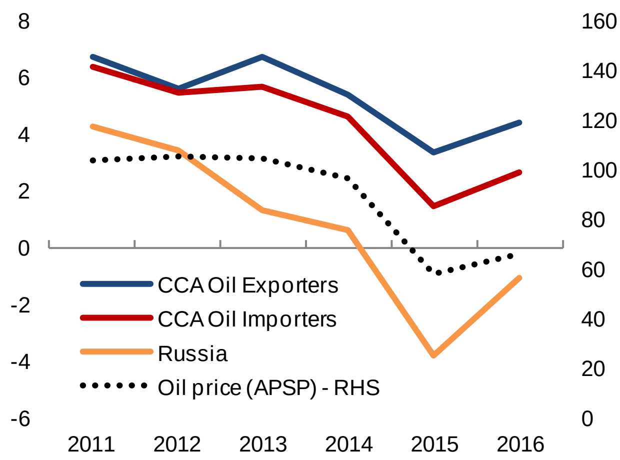
Economic growth in the CCA declined by 1¼ percentage points (pp) to 5¼ percent in 2014 in part driven by lower commodity prices (in the latter half the year) and economic slowdown in Russia, which has close linkages with the region through remittances, trade, and foreign direct investment.

With a sharp decline in oil prices and expected contraction of Russia's economy in 2015, the CCA outlook is projected to weaken further (Figure 1). Growth is expected to decline by another 2 pp this year, to 3¼ percent, a downward revision of 2½ pp from the October 2014 REO.

In the CCA oil exporters, the impact from lower oil prices and Russia's contraction is being amplified by a slowdown in domestic oil production (Kazakhstan, Azerbaijan), with delays in development of new oil fields (Kazakhstan). As a result, growth in the CCA oil exporters is projected to decline by 2 pp to 3½ percent in 2015.

In the CCA oil importers, domestic demand is weakening with declining remittances, while lower prices for non-oil export commodities (gold, copper, and aluminum) are reducing export revenues.

Figure 1.
Real GDP Growth
(Annual percent change)



Sources: National authorities; and IMF staff calculations.

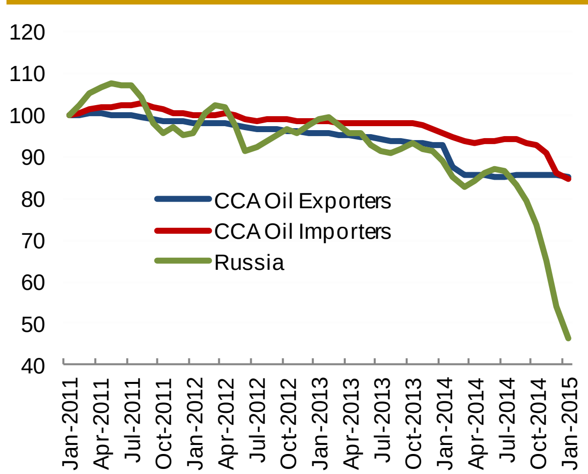
The boost from lower global oil prices to growth is partially offset by currency weakening and incomplete pass-through to local fuel prices because of low competition (Armenia, Kyrgyz Republic) and long-term contracts that keep energy import prices rigid. Overall, growth in this group of countries is projected to slow by 3 pp to 1½ percent in 2015.

Rising Inflationary Pressures

Inflationary pressures are rising on the back of currency depreciation across the region. Despite slight declines in 2014, owing to lower global food and commodity prices, weakening economic activity, and monetary tightening in some countries (Armenia, Kazakhstan, Georgia, Tajikistan), inflation is expected to rise by 1 pp to 7 percent this year. Declining exports and remittances as well as ruble depreciation have put pressure on the CCA currencies (Figure 2), resulting in Turkmenistan and Azerbaijan devaluing their currencies in early 2015. Meanwhile, Armenia, Georgia, Tajikistan, and the Kyrgyz Republic have allowed depreciation against the U.S. dollar to a varying degree to protect international reserves and support the domestic currency value of remittances.

As a result of the strong pass-through, coupled with credit growth (Kyrgyz Republic), inflation will reach double digits in the Kyrgyz Republic and Tajikistan. In other countries, inflation will remain contained, as increases in import and food prices will be offset by lower wage and input cost pressures, reflecting subdued domestic demand and lower oil prices.

Figure 2.
Nominal Exchange Rates
(U.S. dollars per unit of national currency; index, Jan. 2011=100)

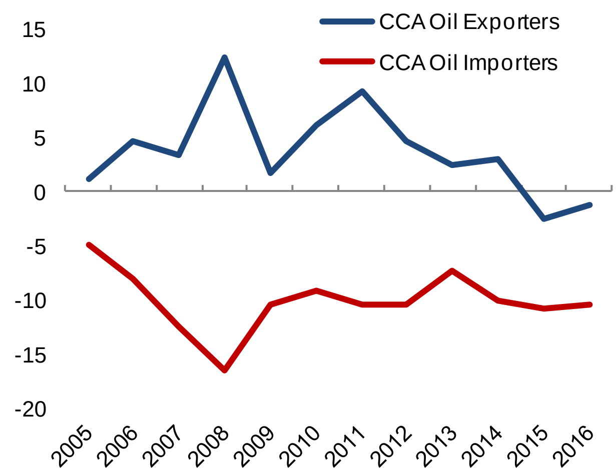


Source: INS database; and IMF staff calculations.

Deteriorating External Positions

External positions in the CCA region are expected to weaken sharply in 2015, mainly as a result of lower oil prices and remittances. The current account balance in the CCA oil exporters is expected to turn from a surplus of 3 percent of GDP in 2014 to a deficit of 2½ percent in 2015, reflecting large oil export revenue losses and, in some cases, stronger import growth effected by fiscal easing (Figures 3–4).

Figure 3.
Current Account Balances
(Percent of GDP)



Sources: National authorities; and IMF staff estimates.

The current account deficit in the CCA oil importers is expected to worsen slightly to 11 percent in 2015. A large drop in remittances is expected to offset gains from lower oil prices and moderating import growth.

Risks Are to the Downside

The balance of risks remains tilted to the downside. Key risks relate to a larger-than-expected slowdown in trading partners, particularly Russia, China, or the euro area, lower oil prices, and/or a faster-than-expected tightening of global financial conditions. For example, a deeper contraction in Russia would further slow remittances, exports, and direct investment. A continued depreciation of the ruble would further depress the value of remittances from Russia (Armenia, Kyrgyz Republic, Tajikistan). A further decline in oil prices would weaken the external and fiscal balances of the CCA oil exporters, while any additional benefit for the CCA oil importers is likely to be partly offset by adverse spillovers from a resulting further slowdown in Russia. An increase in external financing costs from a tightening of U.S. monetary policy would adversely affect countries that may borrow in the international markets (Georgia, Kazakhstan).

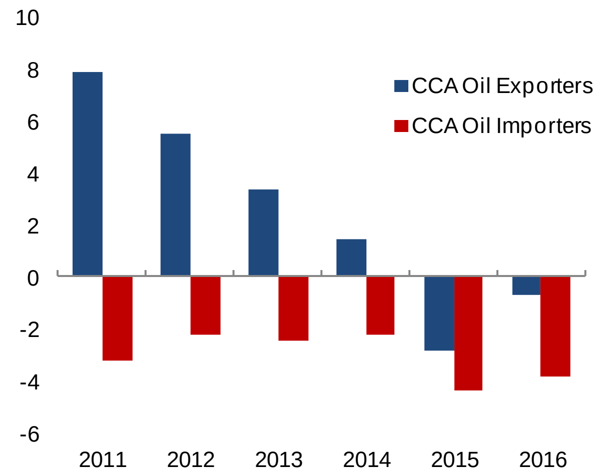
Temporary Fiscal Easing, Consolidation in Medium Term

While the drop in oil prices is expected to endure for sometime, Russia's recession is likely to be temporary. Some CCA oil exporters (Kazakhstan, Uzbekistan) are expected to use their large buffers to provide countercyclical stimulus to the economy over the near term (in Kazakhstan, through increases in infrastructure spending). By contrast, Azerbaijan and Turkmenistan plan to undertake sizable consolidations in 2015 and over the medium term; with investment levels already high and reaching capacity constraints, fiscal stimulus through capital spending is not advisable. The countercyclical fiscal stance (especially in Kazakhstan), together with lower oil prices, is contributing to a turn in the oil exporters' fiscal balance from a surplus of about 1½ percent in 2014 to a deficit close to 3 percent in 2015 (Figure 4).

Fiscal breakeven prices have risen in CCA oil exporters in recent years, and countries such as Azerbaijan and Kazakhstan cannot cover government spending at oil prices below $58, as is currently projected for 2015 (Figure 5).[1] As soon as cyclical conditions allow and before buffers are exhausted, all CCA exporters need to return to the path of fiscal consolidation to rebuild buffers, strengthen fiscal sustainability, and ensure a fair sharing of resource revenues with future generations. Pension reforms (Azerbaijan) and the scaling down of energy subsidies (Turkmenistan, Uzbekistan) should continue, along with steps to improve the quality and efficiency of public spending.

The fiscal deficit in the CCA oil importers is projected to rise from about 2¼ percent in 2014 to about 4½ percent in 2015, mainly because of lower revenue collection due to weaker growth, and because of higher capital spending (a significant amount financed by China) in an effort to shore up domestic demand (Armenia, Kyrgyz Republic).

Figure 4.
Fiscal Balances
(Percent of GDP)



Sources: National authorities; and IMF staff estimates.

Given limited fiscal space, the oil importers need to return to consolidation soon. Prioritizing capital spending, streamlining current expenditures, eliminating tax exemptions, and improving revenue administration would rebuild buffers and create space to raise targeted social transfers and productive infrastructure investment, which would boost potential growth and make it more inclusive.

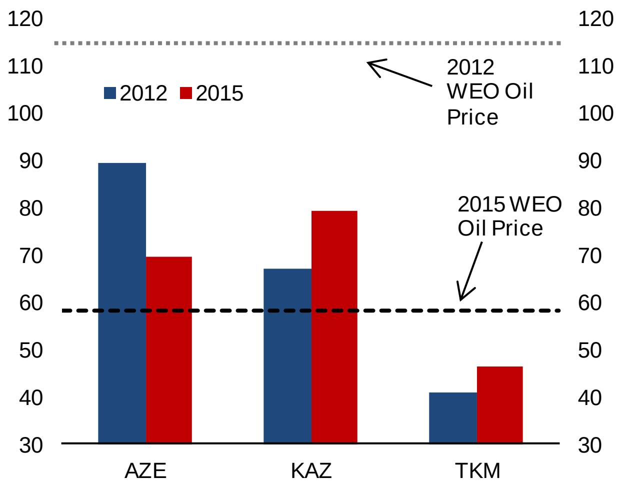
Greater Exchange Rate Flexibility, Monetary Tightening, Addressing Dollarization

The external pressures from the twin shocks of lower oil prices and Russia's slowdown, as well as ruble depreciation and dollar appreciation, suggest that greater exchange rate flexibility will be needed for some countries to absorb the shocks, retain competitiveness in the face of upward pressure on the real exchange rate, and prevent a drain on reserves.

In countries where inflation is expected to be elevated, central banks should tighten monetary policy by raising the policy rate and improving liquidity management so as to contain excess liquidity, while using macroprudential instruments to discourage excessive credit growth.

[1] The fiscal breakeven oil price is the average oil price that is needed for an oil-exporting country to balance its budget in a given year.

Figure 5.
Fiscal Breakeven Oil Prices
(U.S. dollars per barrel)



Sources: National authorities; and IMF staff estimates.

In the medium term, efforts should focus on making monetary policy more effective in the context of high dollarization. A gradual move toward more flexible exchange rates, together with credible monetary and exchange rate frameworks, and deeper domestic financial markets would not only make monetary policy more effective but would also help to reduce dollarization.

Financial Sector Facing Increasing Challenges

The current economic environment is testing for banks, as financial systems are facing pressures from multiple sources. Currency depreciations, against the backdrop of dollarized banking systems and foreign currency lending to unhedged borrowers, increase credit and solvency risks. The depreciations also increase currency mismatches and exacerbate the already high dollarization by encouraging substitution into dollars on the deposit side and curtailing demand for foreign currency loans.

Slowing economic growth heightens the credit risks, particularly in countries where bank governance and underwriting standards are weak and directed lending is common. Declining remittances may erode banking system liquidity and the debt-servicing capacity of households, which account for a significant share of banks' loan portfolios. With Russian banks facing a credit crunch, cross-country banking linkages with Russia could be a conduit for further liquidity pressures in some countries.

Supervisors will need to intensify surveillance of the financial systems, especially in countries where nonperforming loans are high (25 percent in Kazakhstan and 27 percent in Tajikistan) or rising (for example, Armenia) and capital adequacy ratios are declining. Forbearance and evergreening of loans should be avoided; instead, banks should be required to appropriately classify the loans and have adequate provisions. Liquidity support by central banks should be limited to solvent banks that face temporary liquidity challenges, and shareholders should be required to provide capital to undercapitalized banks. In addition, crisis management frameworks should be strengthened.

Bold Structural Reforms Are Needed

Some CCA countries have already undertaken market-enabling reforms such as privatization and price liberalization, but progress in market deepening, governance, and closing infrastructure gaps has been slow. Intensified efforts in these areas would create jobs, alleviate poverty, and diversify economies away from reliance on commodity exports and remittances.

Further reforms of business regulations are urgently needed. For example, the requirements for starting a business need to be based on simple and transparent rules. A new law on the fiscal regime for mining activities would enhance transparency in this sector in the Kyrgyz Republic. Trade integration, labor market reforms, and increasing competition in domestic industries (for example, in the energy sector in Armenia) would benefit the region.

CCA Region: Selected Economic Indicators, 2000–16

(Percent of GDP, unless otherwise indicated)

	Average 2000–10	2011	2012	2013	2014	Projections 2015	2016
CCA							
Real GDP (annual growth)	9.2	6.7	5.6	6.6	5.3	3.2	4.2
Current Account Balance	0.8	7.3	3.1	1.5	1.7	-3.4	-2.0
Overall Fiscal Balance	2.2	6.7	4.7	2.8	1.1	-3.0	-1.0
Inflation, p.a. (annual growth)	9.8	9.0	5.3	6.0	5.8	7.0	6.6
CCA oil and gas exporters							
Real GDP (annual growth)	9.5	6.7	5.6	6.8	5.4	3.4	4.4
Current Account Balance	2.1	9.3	4.6	2.4	3.0	-2.6	-1.2
Overall Fiscal Balance	2.9	7.9	5.5	3.4	1.5	-2.8	-0.7
Inflation, p.a. (annual growth)	10.0	8.8	5.7	6.3	5.9	6.9	6.7
CCA oil and gas importers							
Real GDP (annual growth)	6.6	6.4	5.5	5.7	4.6	1.5	2.6
Current Account Balance	-8.2	-10.4	-10.4	-7.3	-10.1	-10.9	-10.5
Overall Fiscal Balance	-3.2	-3.2	-2.2	-2.5	-2.2	-4.4	-3.8
Inflation, p.a. (annual growth)	8.0	10.7	2.1	3.6	4.6	7.5	5.8

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

As of March 23, 2015	Average 2000–10	2011	2012	2013	2014	Projections 2015	2016
Real GDP Growth	**9.2**	**6.7**	**5.6**	**6.6**	**5.3**	**3.2**	**4.2**
(Annual change; percent)							
Armenia	8.2	4.7	7.1	3.5	3.4	-1.0	0.0
Azerbaijan	13.9	0.1	2.2	5.8	2.8	0.6	2.5
Georgia	6.0	7.2	6.4	3.3	4.7	2.0	3.0
Kazakhstan	8.5	7.5	5.0	6.0	4.3	2.0	3.1
Kyrgyz Republic	4.2	6.0	-0.9	10.5	3.6	1.7	3.4
Tajikistan	8.0	7.4	7.5	7.4	6.7	3.0	4.1
Turkmenistan	13.8	14.7	11.1	10.2	10.3	9.0	9.2
Uzbekistan	6.7	8.3	8.2	8.0	8.1	6.2	6.5
Consumer Price Inflation	**9.8**	**9.0**	**5.3**	**6.0**	**5.8**	**7.0**	**6.6**
(Year average; percent)							
Armenia	3.9	7.7	2.5	5.8	3.1	6.4	4.0
Azerbaijan	7.1	7.9	1.0	2.4	1.4	7.9	6.2
Georgia	6.4	8.5	-0.9	-0.5	3.1	3.0	5.0
Kazakhstan	9.0	8.3	5.1	5.8	6.7	5.2	5.5
Kyrgyz Republic	8.6	16.6	2.8	6.6	7.5	10.7	8.6
Tajikistan	15.5	12.4	5.8	5.0	6.1	12.8	6.3
Turkmenistan	7.4	5.3	5.3	6.8	6.0	7.7	6.6
Uzbekistan	15.5	12.8	12.1	11.2	8.4	9.5	9.8
General Gov. Overall Fiscal Balance	**2.2**	**6.7**	**4.7**	**2.8**	**1.1**	**-3.0**	**-1.0**
(Percent of GDP)							
Armenia[1]	-3.5	-2.9	-1.6	-1.7	-2.1	-4.5	-2.8
Azerbaijan[1]	4.2	13.6	4.9	0.8	0.5	-5.8	1.5
Georgia	-3.2	-3.6	-3.0	-2.6	-2.9	-4.2	-3.9
Kazakhstan	2.5	5.9	4.5	5.0	1.9	-3.3	-2.0
Kyrgyz Republic	-3.0	-4.1	-4.7	-5.1	-3.7	-7.8	-6.7
Tajikistan	-3.2	-2.1	0.6	-0.8	0.1	-1.8	-2.2
Turkmenistan[2]	3.1	3.6	6.3	1.3	0.8	-0.6	0.2
Uzbekistan	2.3	8.8	8.5	2.9	1.7	0.0	-0.1
Current Account Balance	**0.8**	**7.3**	**3.1**	**1.5**	**1.7**	**-3.4**	**-2.0**
(Percent of GDP)							
Armenia	-9.3	-11.1	-11.1	-8.0	-9.2	-8.6	-8.6
Azerbaijan	5.3	26.5	21.8	17.0	15.3	5.3	8.2
Georgia	-11.5	-12.8	-11.7	-5.7	-9.6	-11.5	-12.0
Kazakhstan	-1.5	5.4	0.5	0.5	1.6	-4.1	-3.1
Kyrgyz Republic	-3.0	-9.6	-15.6	-15.0	-13.7	-17.0	-15.2
Tajikistan	-3.8	-4.8	-2.5	-2.9	-9.1	-7.1	-5.8
Turkmenistan	4.3	2.0	0.0	-7.3	-5.9	-11.1	-6.7
Uzbekistan	5.1	5.8	1.2	-1.7	0.1	0.2	0.2

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

[1]Central government.

[2]State government.