Caucasus and Central Asia Regional Report
Well-Positioned to Confront Challenges

INSTITUTE OF INTERNATIONAL FINANCE

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EXECUTIVE SUMMARY

- Real GDP growth in the Caucasus and Central Asia (CCA) remains strong at 4.4% in 2019, following recoveries from the simultaneous 2015-2016 external shocks of a steep fall in oil prices and sanctions on Russia.
- Growth is expected to remain strong beyond the near term, although there are risks including lower commodity prices and weaker growth in Russia and China. On the upside, ongoing structural reforms in most CCA economies, and the Belt-Road Initiative (BRI) in Kazakhstan and Uzbekistan (the two largest economies in the region), would provide scope for higher trade, investment, and diversification.
- Monetary policy can remain supportive of growth, given benign inflation outcomes (except Uzbekistan) and a move toward easing in Russia and advanced economies.
- While credit growth has been robust in Armenia and Georgia, where banking sectors are relatively in good health, it remains weak in Azerbaijan and Kazakhstan, where banking sectors are yet to fully recover from the financial stress.
- The banking systems in some CCA countries are burdened with problematic assets, which emerged on the back of directed and inefficient lending to state-owned enterprises (SOEs) and connected firms. However, progress has been made in alleviating the weakness.
- The sharp depreciation of the currencies and the move toward more flexible exchange rates, particularly in Azerbaijan, Kazakhstan and Uzbekistan, have helped authorities manage external pressures.
- Unlike many MENA economies, the CCA region does not face elevated debt distress risks.
- Most CCA countries have successfully implemented the first round of economic reforms, including foreign exchange liberalization, tax reforms, and improvement in the business environment. However, achieving higher and sustainable economic growth requires focusing on structural challenges that remain unaddressed, including the large footprint of the state as well as governance and institutional weaknesses.
- Significant impediments continue to hamper private local investment. The CCA economies need to create more freedom and space for private-sector initiative, facilitating growth of SMEs.

(Note: Full databases available on our website for Armenia, Azerbaijan, Georgia, Kazakhstan, and Uzbekistan).

Exhibit 1: Key Economic Indicators

	GDP ($ bn)	Gov't Debt (% GDP)	Real GDP Growth (% Change)			CPI Inflation, Average, %			Fiscal Balance (% GDP)			Current Account Bal. (% GDP)		
	2019	**2019**	**2018**	**2019**	**2020**	**2018**	**2019**	**2020**	**2018**	**2019**	**2020**	**2018**	**2019**	**2020**
CCA	**408.5**	**26.1**	**4.3**	**4.4**	**4.6**	**7.7**	**7.1**	**6.4**	**0.0**	**0.4**	**0.2**	**0.2**	**-2.3**	**-1.8**
Hydrocarbon importers	47.1	49.1	5.0	5.1	5.0	2.6	3.4	3.2	-1.8	-2.5	-2.4	-7.8	-7.6	-6.8
Armenia	13.3	53.8	5.2	6.0	5.1	2.5	2.0	2.0	-1.8	-2.0	-1.9	-9.1	-7.1	-6.1
Georgia	17.6	42.4	4.7	4.8	5.0	2.6	3.8	3.0	-0.8	-2.1	-1.9	-7.7	-7.5	-6.7
Kyrgyz Republic	8.4	56.1	3.5	3.8	4.0	1.5	2.0	3.5	-1.3	-2.4	-3.0	-8.6	-9.2	-8.0
Tajikistan	7.7	49.5	7.0	5.5	6.0	3.8	6.0	5.5	-4.5	-4.3	-3.8	-5.3	-7.0	-6.6
Hydrocarbon exporters	361.5	22.9	4.2	4.2	4.6	8.4	7.6	6.9	0.2	0.9	0.6	1.3	-1.6	-1.2
Azerbaijan	51.2	46.0	1.4	2.8	2.9	2.3	3.3	2.5	5.7	5.9	4.0	12.9	3.7	4.9
Kazakhstan	198.0	16.1	4.1	3.7	4.2	6.0	5.5	5.0	-0.6	0.6	0.7	0.0	-1.6	-1.1
Turkmenistan	50.3	30.3	6.2	6.3	6.5	13.2	13.0	12.0	-0.3	-0.2	-0.5	5.0	-1.2	-1.9
Uzbekistan	61.9	19.3	5.1	5.5	5.7	17.7	13.8	12.7	-1.2	-1.8	-1.7	-7.1	-6.7	-6.0

Source: National authorities and IIF estimate for 2018 and forecast for 2019 and 2020.

OVERVIEW: HIGHER GROWTH CHALLENGES

By Garbis Iradian, giradian@iif.com, +1-202-857-3304

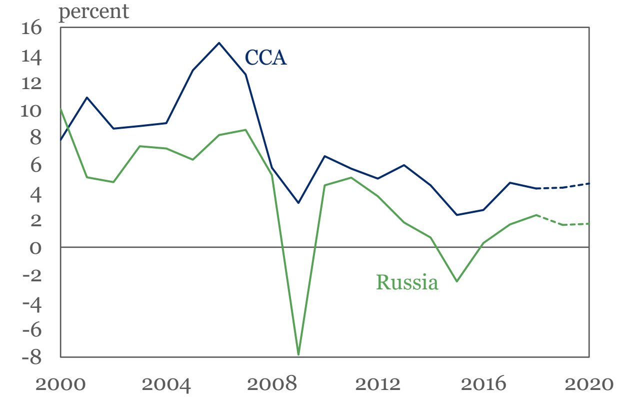
Growth in the Caucasus and Central Asia (CCA) has stabilized at 4.3% since the simultaneous 2015-2016 external shocks of a steep fall in oil prices and sanctions on Russia (Exhibit 2). Monetary policy has strengthened in the past few years. Low inflation, narrowing fiscal deficits, and relatively stable banking sectors in Armenia and Georgia point to the success of macroeconomic stabilization policies and the ability of structural reforms to raise potential growth. Still, Armenia, the Kyrgyz Republic, and Tajikistan will need to sustain higher and more inclusive growth to stem emigration and raise living standards significantly.

In the CCA hydrocarbon exporters, the sharp depreciation of the exchange rates in real effective terms in 2015-2016 (Azerbaijan and Kazakhstan) and 2017 (Uzbekistan), has improved competitiveness and helped reduce the impact of external shocks, including lower energy prices (Exhibit 3). Bilateral exchange rates against the USD have been broadly stable in 2018 and during the first seven months of 2019, which has helped contain inflationary pressures across the region. In Uzbekistan, price reforms and the lagged effects of the sharp depreciation have raised inflationary pressures, which we expect to subside in the second half of this year.

We expect CCA growth to edge up to 4.4% in 2019 and 4.6% in 2020, driven by private consumption and public investment. Medium-term prospects remain favorable, with growth expected to reach 5% by 2023. Monetary policy can remain supportive of growth, given benign inflation outcomes and a move toward easing in Russia and across advanced economies. However, at this growth rate, it would take more than 15 years for the region to achieve the living standards that have already been realized in emerging Europe. Furthermore, the region remains exposed to significant domestic and external risks, including delays in implementing reforms, lower growth in key trading partners (including the EU, Russia and China), and lower commodity prices. Lack of diversity in exports makes CCA countries vulnerable to commodity price swings and a further slowdown in global growth. The possibility of sharp declines in energy prices presents a major downside risk to the region's energy exporters of Azerbaijan, Kazakhstan, and Turkmenistan.

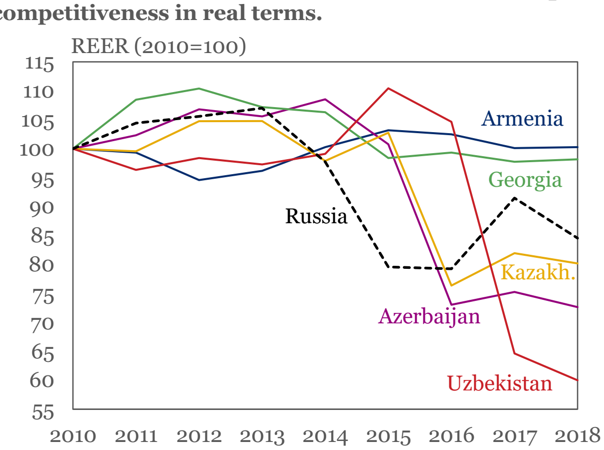
In Armenia and Georgia, while the current account remains in large deficit, at around 7% of GDP, the financial account surplus will continue to more than offset the deficit, leading to a small increase in official reserves. Even with projected lower oil prices, we expect the current account to remain in significant surplus in Azerbaijan and Turkmenistan and in a small deficit in Kazakhstan on the back of highly competitive exchange rates and moderation in imports (Exhibit 4).

Exhibit 2: Real GDP growth in the CCA has exceeded growth in Russia but followed the same general trend.



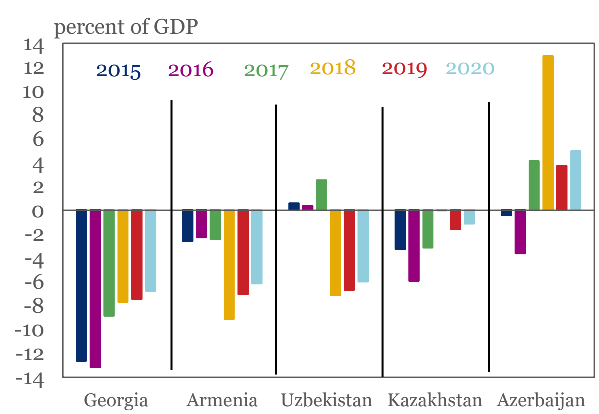
Source: Authorities and IIF estimates and forecast

Exhibit 3: Depreciation of the currencies in Azerbaijan, Kazakhstan, and Uzbekistan has translated into improved competitiveness in real terms.



Source: Haver, IIF

Exhibit 4: Current account deficits are narrowing but remain large in Armenia, Georgia, and Uzbekistan.



Source: Authorities and IIF forecast for 2019 and 2020

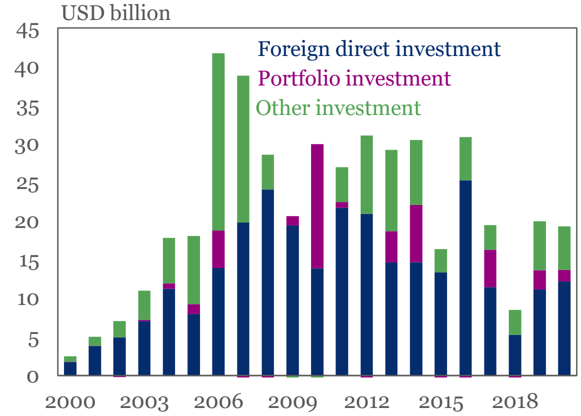
Non-resident capital inflows are likely to increase in 2019 and 2020, driven by large energy-related FDI inflows to Azerbaijan, Kazakhstan and Uzbekistan (Exhibit 5).

In general, the CCA region does not face elevated debt distress risks as compared with some MENA economies. Hydrocarbon exporters (Azerbaijan, Kazakhstan and Uzbekistan) face different fiscal challenges then hydrocarbon importers (Armenia and Georgia). Given that recent years have seen narrowing of fiscal deficits and even a shift to small surpluses in some countries, the authorities in Azerbaijan, Kazakhstan and Turkmenistan may need to strike the right balance between building up additional net financial assets to smooth future consumption once hydrocarbon resources are depleted and stabilizing net financial assets at present levels. Greater fiscal transparency is needed in Turkmenistan and Uzbekistan (Exhibits 6 and 7). The choice in Armenia and Georgia is between stabilizing their public debt levels or reducing public debt to pre-2010 levels. Better enforcement of tax collection and raising the tax rate on higher-income individuals could raise the tax-to-GDP ratio and at the same time improve tax fairness perceptions.

The unfavorable external environment has increased the urgency of improving the CCA's economic resilience through the implementation of deep structural reforms, which would promote stronger, more sustainable, and more inclusive growth and help diversify their economies away from remittances and commodities. For Azerbaijan, Kazakhstan, and Tajikistan, tackling lingering financial sector fragility will be critical to support growth. Across the region, work remains to be done to empower the private sector to drive growth by reducing the state footprint in the economy, while improving the business climate and promoting competition.

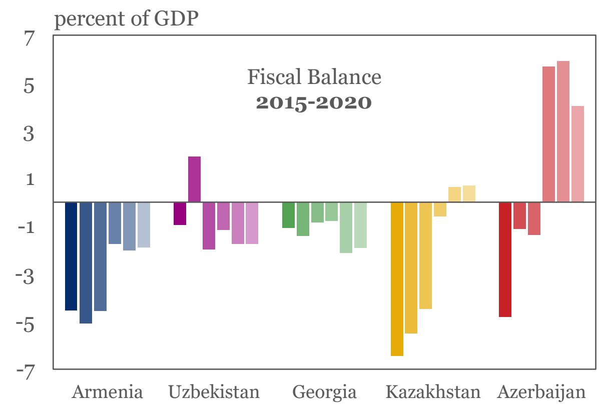
The banking systems in some CCA countries are burdened with problematic assets, including high NPLs, restructured loans, and watch loans in Tajikistan, Azerbaijan, Kazakhstan, and Kyrgyz Republic (Exhibit 8). These problems emerged on the back of directed and inefficient lending to state-owned enterprises (SOEs) and connected firms. The persistently high share of problem assets has suppressed banks' appetite to extend credit to the private sector, which has hampered faster real GDP growth (Exhibit 9). While official reported NPL ratios are relatively low in Armenia and Georgia, foreign currency lending to unhedged borrowers remains high. Some progress has been made in the few years in Azerbaijan and Kazakhstan to address the weaknesses in the banking sectors, including purchase of non-performing bank assets by the government, capital support, withdrawals of licenses of banks that failed to implement the needed prudential regulations, and legal changes that strengthen supervisory powers.

Exhibit 5: Nonresident capital inflows will increase, driven by FDI in the energy sector.



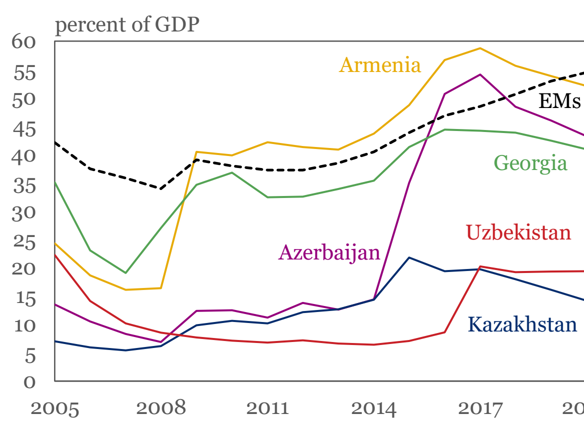
Source: Haver, IIF

Exhibit 6: Armenia, Georgia and Uzbekistan should record relatively small fiscal deficits. Meanwhile, Azerbaijan and Kazakhstan should record fiscal surpluses.



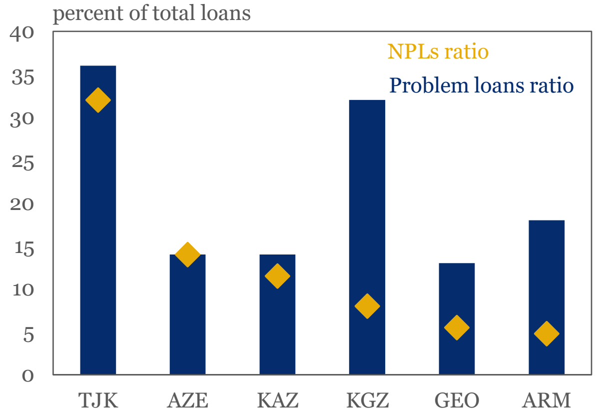
Source: Authorities and IIF forecast for 2019 and 2020

Exhibit 7: In contrast to the EM average, debt ratios in the CCA region are generally low and trending downward.



Source: Authorities and IIF forecast for 2019 and 2020

Exhibit 8: The banking systems in Tajikistan, Azerbaijan, Kazakhstan and Kyrgyz Republic remain burdened with high levels of problem assets.

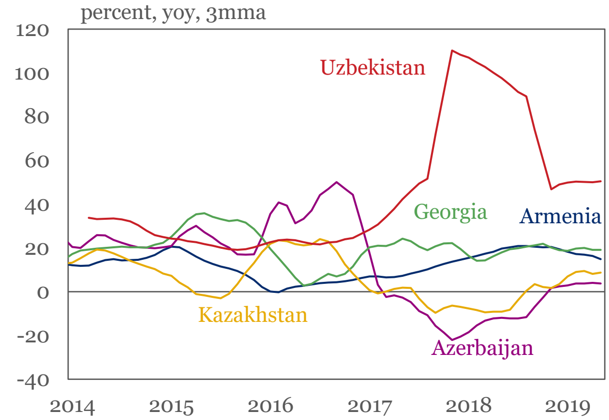


Source: National authorities (NPLs) and IMF estimates (problem loans). NPLs ratio = nonperforming loans / total loans. Problem loans include watch, nonperforming, and restructured loans. NPLs are classified into substandard, doubtful and loss loans.

While the region has seen widespread improvement in Doing Business rankings (Exhibit 10), the share of state-owned enterprises (SOEs) remains very high, particularly in Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan. Weak SOE governance has contributed to inefficient production and high NPLs, as credit allocation to SOEs has crowded out the private sector. Reducing the role of SOEs would facilitate private investment and help boost growth. Additional reforms to promote openness to trade and FDI in the non-energy sector, ease the labor markets, and improve the quality of human and physical capital to raise total factor productivity could yield further results. Investment-to-GDP in the CCA peaked at 32% in 2007 and then declined steadily to about 24% by 2011 due to lower FDI inflows and weaker domestic private investment. The gradual recovery in investment since 2011 is dominated by FDI in the energy sector, particularly in Kazakhstan and Azerbaijan (Exhibit 11).

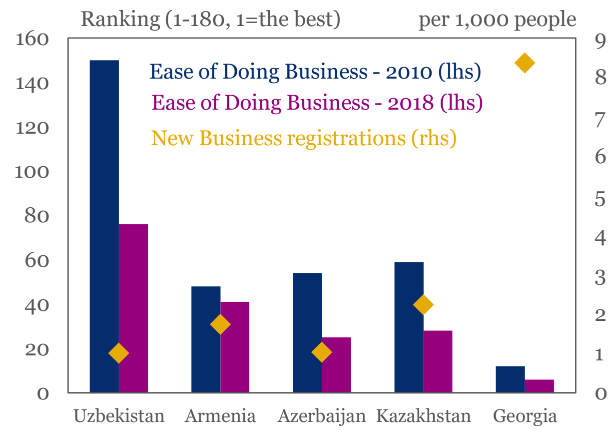
The aggregate growth figures mask the diversity of performance in the region. In Armenia, we see growth accelerating to 6%, driven by services on the production side and consumption on the expenditure side. In Georgia, the successful structural reforms of the 2000s continue to support robust growth. Growth in oil exporters (Azerbaijan, Kazakhstan, and Uzbekistan) will depend on prices and production of crude oil and natural gas. In these countries, a surge in public investment and FDI inflows could spur higher growth in 2019 and 2020. Growth in Azerbaijan is driven by the opening of a new gas pipeline and continued improvement in the services sector. In Kazakhstan and Uzbekistan, acceleration of nonhydrocarbon growth is partly driven by structural reforms, which have raised productivity of labor and capital. However, bank fragility and anemic credit growth continue to impede a stronger recovery.

Exhibit 9: Credit to the private sector surged in Uzbekistan, stayed strong in Armenia and Georgia, and remained weak in Azerbaijan and Kazakhstan.



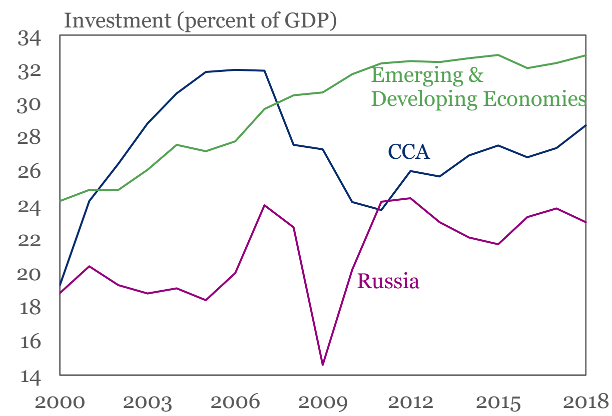
Source: Haver, IIF

Exhibit 10: The region has seen marked improvement in global rankings of the ease of doing business.



Source: World Bank Ease of Doing Business, 2019 Report

Exhibit 11: Investment in the region has outpaced Russia but persistently lagged the EM average since the global financial crisis.



Source: Haver, IIF

ARMENIA: NEW ERA

By Garbis Iradian, giradian@iif.com, +1-202-857-3304

Armenia underwent an immense political change in May 2018, which resulted in the replacement of the corrupt and authoritarian government of Prime Minister Serge Sargsyan with a team of young reformers. With enthusiasm high but political and economic expertise in relatively short supply, they will need help from well-informed experts and dedicated individuals on a range of political and economic issues. The December 2018 parliamentary elections led to the ouster of several parliamentarians who used to control the economy. The current government, led by Prime Minister Mr. Nikol Pashinyan, is determined to crack down on corruption, end lucrative import monopolies, and reduce the high unemployment and poverty. However, the grip on Armenia from Russia may in the future undo the gains of the new political order. In May of this year, the IMF approved a three-year Stand-By Arrangement to support the authorities' efforts to strengthen economic fundamentals, improve access to finance, and help implement deep structural reforms, with more emphasis on inclusiveness and governance.

We expect growth to pick up from 5.2% in 2018 to 6% in 2019, in the context of improvement in private sector confidence and higher government spending, particularly on social sector and infrastructure. Estimates for the first half of this year show a growth rate of 6.5%, driven by services on the supply side and private consumption on the expenditure side. The agriculture and mining sectors remained weak. Looking ahead, the landscape could remain difficult. Russia, Armenia's longstanding partner, faces a long period of slow growth. Moreover, private investors are still concerned about the rule of law and the country's de facto geographic isolation due to closed borders with Turkey and Azerbaijan. Even a medium-term growth rate of 5% may still be not enough to generate adequate new jobs to stem emigration and raise living standards significantly, if it is not inclusive.

For the fourth consecutive month, the Central Bank of Armenia (CBA) kept its policy rate at 5.75%, as inflation remained at the lower end of the inflation target range (4%, +/-1.5%). Month-to-month consumer prices fell, and CPI inflation eased to 1.7% y/y in July 2019. However, inflationary pressures may increase in 2020 if fiscal policy becomes more expansionary and global commodity prices rise. The exchange rate of the dram against the USD remained broadly stable for the fourth consecutive year. The banking system remains liquid and sound with a capital adequacy ratio of 17.7%, a further decline in the NPL-to-total loans ratio to 4.8%, and improvement of return on assets to 1.4% as of end-2018. Nonetheless, the IMF/World Bank FSAP report suggested that FX liquidity cushions remain insufficient to withstand tail risk shock.

Exhibit 12: Main Macroeconomic & Financial Indicators

	2016	2017	2018	2019	2020
Nominal GDP, $ billion	10.5	11.5	12.4	13.3	14.3
Real GDP, % change	0.2	7.5	5.2	6.0	5.1
Agriculture (%)	-5.0	-5.3	-8.5	2.5	3.0
Non-agriculture (%)	1.6	10.7	6.0	6.6	5.5
Unemployment %	17.6	17.8	17.7	17.0	16.0
CPI Inflation, Avg., %	-1.4	0.9	2.5	2.0	2.0
Fiscal Balance, % GDP	-5.1	-4.6	-1.8	-2.0	-1.9
Current Acc., % GDP	-2.3	-2.4	-9.1	-7.1	-6.0
Official Reserves, $bn	2.20	2.31	2.26	2.32	2.49
In months of imports	5.1	4.4	3.7	3.7	3.7
Gov't Debt, % GDP	56.7	58.7	55.7	53.8	52.1
Policy Rate, eop, %	6.3	6.0	6.0	5.5	5.5

Source: National authorities; IIF forecast for 2019 and 2020

The current account deficit widened to 9.1% of GDP in 2018 as imports grew by 16% and exports by 9%. Most of the growth in imports were due to transitory factors including the jump in imports of machinery and transport equipment. The temporary closure of two copper mines on environmental concerns led to some loss in export revenue. FDI, largely concentrated in mining and energy sectors, remained modest at around 2% of GDP. We expect the current account deficit to narrow to 7% of GDP, with growth in imports decelerating to lower single digit levels and growth in exports of goods and services accelerating.

The fiscal deficit narrowed to 1.8% of GDP in 2018, helped by the 8.4% increase in revenue and a small decline in public spending. We expect the deficit to remain around 2% of GDP in 2019 and 2020. As a result, the public debt-to-GDP ratio is projected to decline further to 52% by 2020. The projected substantial increase in tax revenues, helped by the progress in fighting tax evasion and pickup in nonagricultural economic activity, may more than offset the envisaged increase in public spending. Indeed, following the implementation of measures to fight tax evasion, tax revenues have increased by 20% in the first half of 2019 as compared with the same period of the previous year, with VAT, income tax, and profit taxes showing especially marked improvement.

Long-term rapid and inclusive growth will be increasingly dependent on physical and human capital accumulation. While most investment needs to originate in the private sector, continued public investment in infrastructure and the social sector could play an additional facilitating role. Deep reforms are also needed to raise total factor productivity (TFP), which has declined since 2010. Higher TFP and investment could raise potential growth to over 6%. Priorities for reform include improvement in the business environment and strengthening governance to attract investment and create more inclusive and durable growth.

AZERBAIJAN: MEASURABLE PROGRESS

By Jonah Rosenthal, jrosenthal@iif.com, +1-202-857-3311

Azerbaijan is experiencing a gradual recovery, with the non-oil sector playing an ever-increasing role. Growth stood at 1.4% in 2018 (1.9% in the non-oil sector), and preliminary data shows growth of 2.4% y/y in 2019 H1. With monthly figures implying acceleration, we project an annual figure of 2.8% for 2019 (Exhibit 13). With inflation low (bottoming out below 1% y/y in late 2018), the central bank is moving toward inflation targeting and away from a de facto peg to the dollar. While inflation crept back up above 3% in June, it remains well below the midpoint of the target band of 4%+/-2%. Consequently, the central bank reduced its policy rate (refinancing rate) by 25 bp to 8.5% in June (Exhibit 14). Lower interest rates should facilitate activity in local bond markets and make issuance of bonds more viable for SMEs.

Both the fiscal and current account balances are in surplus, and favorable movements in global oil prices have bolstered official reserves. Cargo transportation was up 1.5% in 2019 H1 compared to a year earlier. Nevertheless, a deteriorating global economic outlook and geopolitical tensions in neighbors and major trading partners of Russia and Turkey may limit the prospects for a further pickup in external demand.

Infrastructure development, including the Southern Gas Corridor, should enable increased hydrocarbon production, particularly natural gas. A key element of the Southern Gas Corridor is the Trans Adriatic Pipeline, a massive undertaking by the national oil company SOCAR and international partners to transfer 10 billion cubic meters per year of natural gas from the offshore Shah Deniz field to Europe starting in 2020. SOCAR has produced crude and natural gas on par with 2018; crude oil exports have increased modestly in volume terms, but natural gas, refined oil and petrochemicals have climbed substantially. At the same time, the country has become a net exporter of electricity to Eastern Europe.

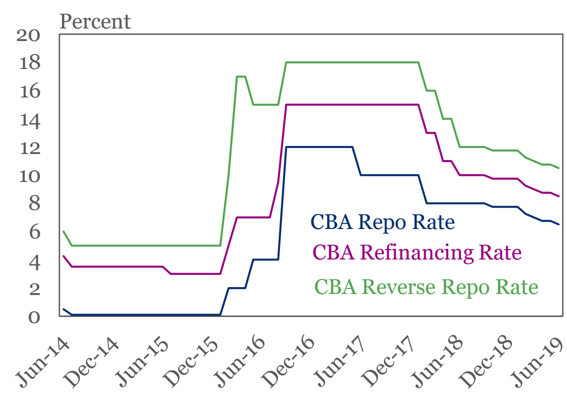
Structural reforms are ongoing. Azerbaijan has risen to #25 in the Doing Business rankings, the highest in the CIS. While infrastructure and regional integration remain areas of weakness, the country ranks in the top 50 on most metrics. The challenge is fostering diversification, inclusion, and empowerment of the private sector. Oil-related products still generate over 90% of export income (Exhibit 15), contributing to high economic volatility. Financial sector vulnerabilities, including high NPLs due to lax corporate governance and connected lending, are a significant legacy challenge and source of contingent fiscal liabilities. Prospects for privatization of the state-owned International Bank of Azerbaijan remain unclear. Much work remains to improve governance, promote competition and transparency, and reduce corruption, and longtime tensions with neighbors persist.

Exhibit 13: Main Macroeconomic & Financial Indicators

	2016	2017	2018	2019	2020
Nominal GDP, $ bn	37.8	40.9	46.9	51.2	53.4
Oil production, mbd	0.82	0.78	0.78	0.76	0.75
Real GDP, % change	-3.0	-0.3	1.4	2.8	2.9
Hydrocarbon	-1.7	-4.9	1.8	2.2	2.0
Non-hydrocarbon	-4.2	3.8	1.1	3.3	3.6
Domestic demand	-7.1	3.3	0.9	3.2	4.0
Exports of goods & serv.	2.5	-7.1	-6.0	2.4	1.4
Imports of goods & serv.	-2.9	-3.8	-9.3	3.1	3.1
Exchange rate, average	1.60	1.72	1.70	1.70	1.70
CPI inflation, average, %	12.4	12.8	2.3	3.3	2.5
Current account, % GDP	-3.6	4.1	12.9	3.7	4.9
Public foreign assets, $ bn*	39.0	42.5	45.2	48.4	52.1
Fiscal balance, % GDP	-1.1	-1.4	5.7	5.9	4.0

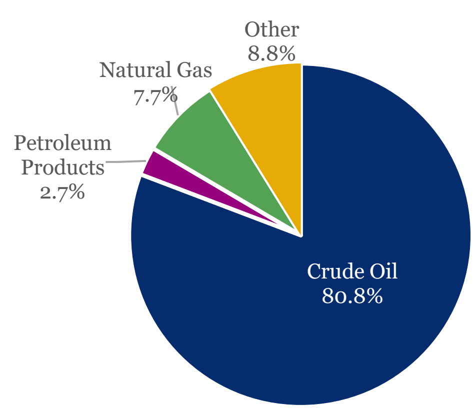
Source: Haver, IIF
**Includes official reserves and SWF.*

Exhibit 14: The central bank has reduced interest rates since the start of 2018.



Source: Haver, IIF

Exhibit 15: Hydrocarbons and derivatives still account for over 90% of export revenue as of 2018.



Source: Haver, IIF

GEORGIA: MANEUVERING REGIONAL TENSIONS

By Boban Markovic, bmarkovic@iif.com, +1-202-857-3632

Georgia continues to register strong growth despite weaker economic activity among its main trading partners, particularly Turkey and Russia. A gradual thaw in Georgia-Russia tensions could enable a growth rate of 4 to 5%. The main drivers of growth will be public spending on infrastructure and net exports. The government's *Four Point Plan* is expected to raise productivity of labor, invest in infrastructure to benefit more from Georgia's strategic location as a transit and tourism hub, improve government efficiency, and stimulate the private sector to be the main engine of growth.

Georgia's program with the IMF under the EFF arrangement is broadly on track. The fiscal deficit has been contained, monetary policy remains adequate, and further structural reforms are being carried out. With somewhat lower tax revenues, we project a fiscal deficit of 2.1% of GDP this year. Current spending will be restrained to create more space for public investment, which is expected to increase by about 15-20%. With a small and manageable deficit, public debt is expected to stabilize around 40% of GDP.

Monetary policy remains appropriately focused on price stability and supported by exchange rate flexibility. After increasing the policy rate to rein in inflation in 2017, the National Bank of Georgia (NBG) has gradually loosened monetary policy in 2018 and 2019. Despite low inflationary pressure from aggregate demand, we expect the higher tobacco excise tax to push inflation close to 4% this year before stabilizing at a target rate of 3% in the following year (Exhibit 17). While dollarization declined, it is still significant at around 60%. Growth in dollar-denominated loans and deposits slowed down since the introduction of the Larization policy in 2017. However, recent lower interest rates led to a pickup in foreign currency lending.

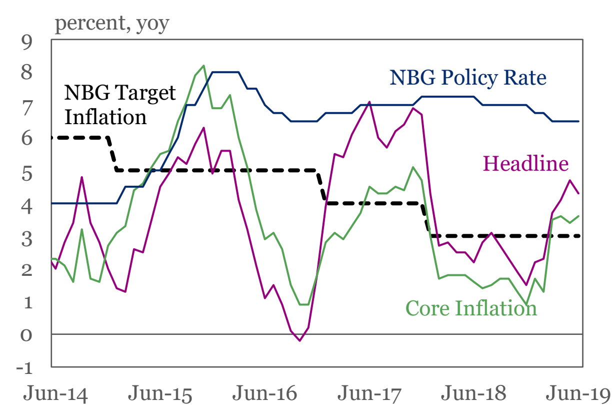
While the current account deficit will gradually narrow, weakening remittances and lower tourism receipts due to a recent move by Russia to ban direct flights between the countries may present an obstacle (Exhibit 18). FDI (around 10% of GDP) remains the primary source of financing for the current account deficit. While Georgia's official reserves cover the basic adequacy ratio of three months of imports, the overall external position is subject to vulnerabilities. External debt reached 110% of GDP at the end of 2018, a large portion of which are the government's multilateral financing and banking sector liabilities. With annual external financing needs at around 30% of GDP, Georgia is exposed to external shocks. Consequently, regional strife, trade tensions, and high financial market volatility could have a material effect on near-term growth prospects.

Exhibit 16: Main Macroeconomic & Financial Indicators

	2016	2017	2018	2019	2020
Nominal GDP, $ billion	14.4	15.1	16.2	17.6	19.2
Real GDP, % change	2.8	4.8	4.7	4.8	5.0
Unemployment %	14.0	13.9	12.7	11.8	11.1
CPI Inflation, Avg., %	2.1	6.0	2.6	3.8	3.0
Fiscal Balance, % GDP	-1.4	-0.9	-0.8	-2.1	-1.9
Current Acc., % GDP	-13.1	-8.8	-7.7	-7.5	-6.7
FDI Inflows % GDP	10.9	12.1	7.3	7.2	8.2
Official Reserves, $bn	2.8	3.0	3.3	3.7	3.8
In months of imports	3.3	3.2	3.1	3.2	3.2
Public Debt, % GDP	44.4	44.2	43.9	42.4	40.9
Private Credit, % change	22.3	15.5	18.7	18.9	13.0
Policy Rate, eop, %	6.5	7.3	7.0	6.5	6.0

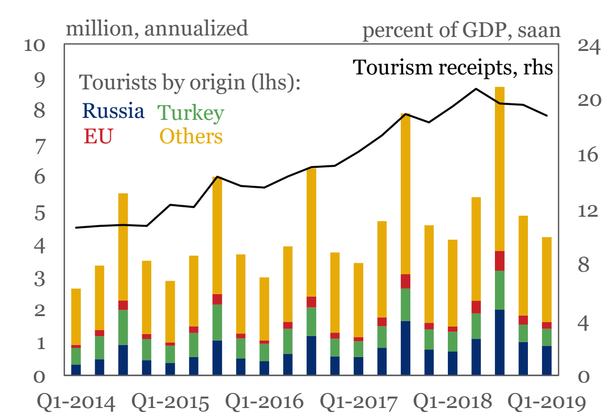
Source: National authorities; IIF forecast for 2019 and 2020

Exhibit 17: Inflation overshoot is temporary.



Source: National Bank of Georgia, IIF

Exhibit 18: Tensions with Russia might hinder tourism.



Source: GeoStat, NBG, IIF

KAZAKHSTAN: NEW DRIVER, SAME ROAD

By Jonah Rosenthal, jrosenthal@iif.com, +1-202-857-3311

After a noticeable slowdown in 2015-16, Kazakhstan's growth has hovered around 4%. Growth has remained in this range in 2019, with industry, construction, transport, trade, and agriculture all performing strongly. The June short-term economic indicator implies a slightly higher growth of 4.3% y-o-y relative to 2018 H1, reflecting a state push for investment during the presidential election campaign. Demand should remain strong for the rest of the year aided by tax amnesty, public wage increases, and a low-income borrower initiative. On the other hand, oil production is down slightly from 2018, signifying the country's compliance with OPEC+ production cuts and its emphasis on developing the non-oil sector as the primary engine of growth (Exhibits 19 and 20).

Inflation continued falling through 2019 Q1, reaching as low as 4.8% y-o-y in March, but picked up modestly in Q2. However, it remained solidly within the central bank's 4-6% target band. While household inflation expectations are inching up, the central bank has held its policy rate constant at 9% since April amid loosening global conditions. The tenge weakened markedly in 2018 but has hovered around 380 per USD in 2019 (Exhibit 21). The current account has generally been in deficit since 2015 due to relatively low oil prices. However, the surplus in the financial account will more than offset the current account deficit leading to further accumulation of public foreign assets. Further development of international economic and infrastructure links, including via the Belt and Road Initiative and expansion of commodity exports via Azerbaijani facilities, is a key priority.

The government continues to implement an ambitious structural reform agenda in areas including privatization, infrastructure development, and regional integration. The country has improved to #28 in the World Bank's Doing Business rankings, and the Astana International Financial Centre continues to expand its scope of operations. However, significant gaps remain in areas such as access to credit, reliable electricity, and regional integration. Furthermore, the fragility of the financial sector remains an impediment to growth. For a sparsely populated country far from major markets, developing physical and legal infrastructure is only half the battle; the real test is attracting demand for the product.

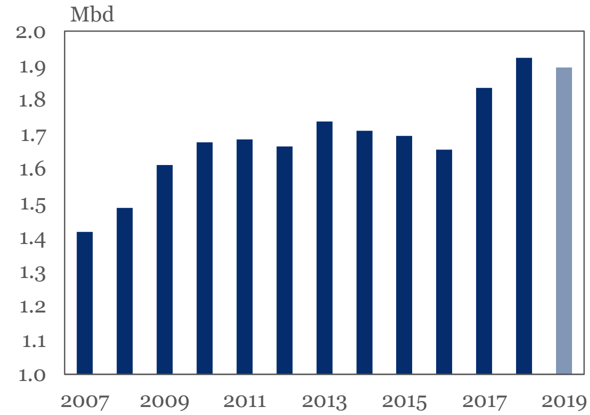
Former president Nursultan Nazarbayev stepped down in March after nearly thirty years in power, ceding the presidency to the Speaker of the Senate, Kassym-Jomart Tokayev. Tokayev subsequently won a full term with over 70% of the vote in the June elections. However, Nazarbayev remains the leader of his Nur Otan political party, lifetime chairman of the Security Council, and honorary "leader of the nation", and retains significant influence behind the scenes.

Exhibit 19: Main Macroeconomic & Financial Indicators

	2016	2017	2018	2019	2020
Nominal GDP, $ bn	137.3	162.9	185.0	198.0	214.4
Oil Production, mbd	1.65	1.83	1.92	1.89	1.93
Real GDP, % change	0.9	3.9	4.1	3.7	4.2
Hydrocarbon	-1.7	10.5	4.8	-0.8	2.4
Non-hydrocarbon	1.2	3.2	4.0	4.3	4.4
Domestic demand	1.8	1.7	-0.5	5.2	3.2
Exports of goods & serv.	-4.5	6.4	11.5	-0.3	4.1
Imports of goods & serv.	-2.0	-1.4	3.2	1.8	3.0
Exchange rate, average	342.1	326.0	344.7	375.2	375.2
CPI Inflation, average, %	14.6	7.4	6.0	5.5	5.0
Current Account, % GDP	-5.9	-3.1	0.0	-1.6	-1.1
Pub. foreign assets, $ bn*	81.3	76.6	74.5	78.6	82.7
Fiscal Balance, % GDP	-5.5	-4.5	-0.6	0.6	0.7
Government debt, % GDP	25.0	26.1	23.8	21.4	18.8

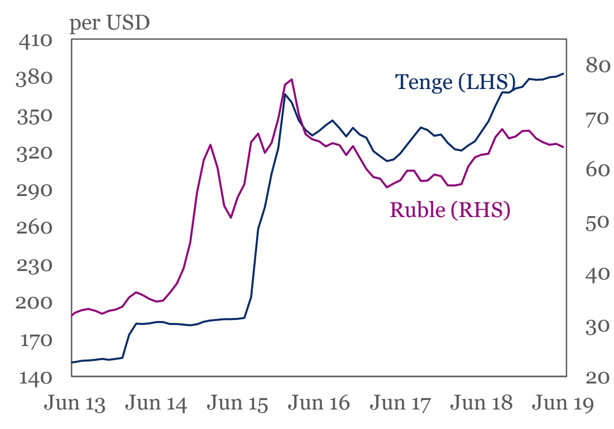
*Source: Haver, IIF. *Includes official reserves and SWF.*

Exhibit 20: Oil production is likely to fall slightly in the context of the OPEC+ production cuts.



Source: Haver, IIF

Exhibit 21: The exchange rate is strongly influenced by movements in the ruble.



Source: Haver, IIF

UZBEKISTAN: EMERGING FROM ISOLATION

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Following more than two decades of isolation, Uzbekistan started opening under the new president Shavkat Mirziyoyev. Since taking office in late 2016, Mirziyoyev has shifted the course of the ex-Soviet republic and pushed for market-friendly reforms with the aim to modernize the country's command-style economy and raise living standards, which remain among the lowest in the region.

Overall growth picked up to 5.1% in 2018, as underperformance in the agriculture sector (30% of GDP) was more than offset by strong performance in mining, manufacturing, and construction (Exhibit 22). With the completion of the first wave of reforms, including exchange rate liberalization, easing of trade barriers and price controls, we expect growth to pick up to 5.5% this year and reach 6% beyond 2020. Despite the steady growth, unemployment remains a stark concern, as around half of the population is below the age of thirty, and over half a million people join the workforce annually. Uzbekistan has ample potential to increase its growth by improving infrastructure, positioning itself as a regional transit hub, and integrating into regional supply chains.

Inflation reached 14% last year, driven by the pass-through effect from a large currency depreciation (as the official rate depreciated by 50% in September 2017 to close the spread with the parallel rate) and strong domestic demand (Exhibit 23). With continuous price adjustments and buoyant economic growth, we expect inflation to remain elevated in 2019. Private credit soared in the last two years despite monetary policy tightening.

A domestic credit boom and easing of trade restrictions spurred a surge in imports, causing the current account to shift from a small surplus to a deficit of 7.1% of GDP in 2018. We expect the deficit to narrow gradually but remain sizable, as the market liberalization continues, and growth picks up. Official reserves, half of which are held in gold, represent an adequate buffer (Exhibit 24). Despite the low fiscal financing needs, the authorities issued their first international bond in February this year and announced further issuance to attract attention from investors and raise the profile of the country.

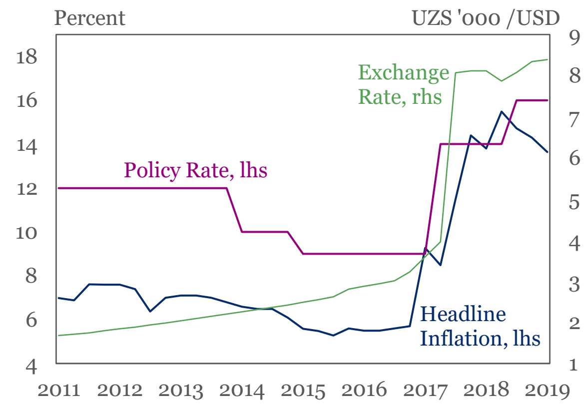
A conservative fiscal stance and low government debt provide Uzbekistan with a strong base for pursuing reforms. While Uzbekistan has already made a commendable improvement in the World Bank's Doing Business rankings, serious reforms are still needed, including in price liberalization, restructuring of SOEs, tax reform, curbing corruption, and improving public governance.

Exhibit 22: Main Macroeconomic & Financial Indicators

	2016	2017	2018	2019	2020
Nominal GDP, $ billion	81.8	59.0	50.5	61.9	72.5
Real GDP, % change	6.1	4.5	5.1	5.5	5.7
Agriculture % ch.	6.2	1.2	0.3	2.5	3.0
Non-agriculture % ch.	6.1	6.0	7.2	6.7	6.7
Unemployment %	5.2	5.8	9.3	10.4	11.3
CPI Inflation, Avg., %	8.0	13.8	17.7	13.8	12.7
Fiscal Balance, % GDP	1.9	-2.0	-1.2	-1.8	-1.7
Current Acc., % GDP	0.4	2.5	-7.1	-6.7	-5.9
Reserves ex. gold, $bn	14.2	14.0	12.4	12.8	13.5
In months of imports	7.5	6.6	4.1	4.0	4.0
Gold Reserves, $bn	12.3	14.0	14.6	16.2	16.2
Gov't Debt, % GDP	8.6	20.2	19.2	19.3	19.3
Private sector credit, % ch.	28.2	104.4	50.3	33.5	25.5
Policy Rate, eop, %	9.0	14.0	16.0	16.0	15.5

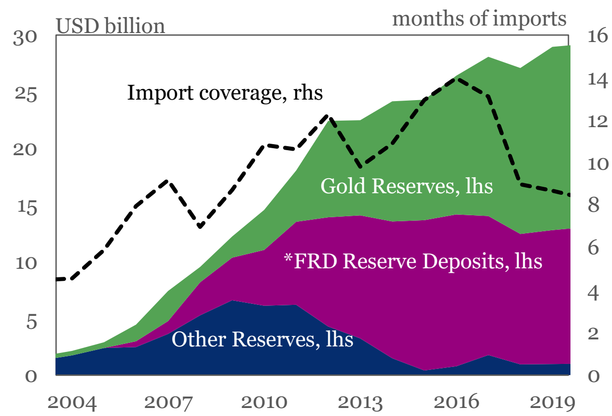
Source: National authorities; IIF forecast for 2019 and 2020

Exhibit 23: Liberalization of the exchange rate will keep inflation elevated.



Source: Haver, IIF

Exhibit 24: Official reserves represent a significant buffer against external shocks.



Source: CBU, IIF
** Fund for Reconstruction and Development*

