EDB MACRO REVIEW

06’2018

EDB economies: in search of new growth drivers
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INTRODUCTION BY THE CHIEF ECONOMIST

EDB economies: in search of new growth drivers

The extent of global protectionism risks became obvious in the first half of 2018. The US’s escalating trade dispute with the EU and China creates considerable risks to global economic growth, which brings additional risks of an energy price correction for the EDB countries. Apart from external economic risks, weakening existing growth drivers and the need for new sources to boost economic development become new and growing challenges facing the EDB countries.

At the same time, the potential to stimulate economic activity with monetary policy tools has declined due to unprecedented low inflation and base rates of the largest EDB countries approaching neutral values. Resumed volatility in exchange rates and continuous medium-term inflation risks (high inflationary expectations) create additional obstacles to monetary stimuli in the short term. These conditions compel most of the EDB countries to look for new sources of growth to take advantage of favorable external conditions and accelerated integration processes taking place in the Eurasian region.

One of the possible steps under the present conditions can be some softening in fiscal policy. Prospects of a fiscal stimulus emerged this year with the Russian President’s executive orders issued in May to provide additional financing to high-priority sectors, especially to those that support the development of human capital. According to the Russian Ministry of Finance’s estimates, additional expenditures can amount to up to RUB 8 trillion by 2020. Amid growing energy prices, there was an increase in spending in Kazakhstan in 1Q 2018, by 13.5% YoY, compared to almost zero growth in the same period of the previous year. At the same time, social expenditures (+20% YoY), particularly on healthcare (+23.6% YoY), outpace overall expenditure growth.

However, using the budget mechanism to stimulate economic activity has some limitations, including budget rules established in oil exporting countries, such as the RF. On the other hand, some countries, like Belarus and Armenia, need to reduce government debt. An increase in spending amid a rise in commodity prices may also increase EDB countries’ dependence on global economic conditions. Thus, in order to find additional growth drivers, the EDB countries have to take measures to increase efficiency and labor productivity in their economies and to improve the investment climate.

It must be noted that the EDB countries have been actively adopting medium-term and long-term programs and strategies over the last year. This particularly relates to Kazakhstan, where a number of programs have been announced. The industrialization program progressed in 2017 and a comprehensive program called Digital Kazakhstan was approved. The Kazakhstan Strategic Development Plan to 2025 was approved in 2018. It aims for high-quality and sustainable economic development and to raise living standards to the level of OECD countries. In March 2018, the President of Kazakhstan announced five social initiatives: to make mortgages more affordable and
higher education more available, to ease the tax burden on the most vulnerable part of the population, to develop microfinancing and to connect more households to gas.

The Russian Ministry of Economic Development is developing measures to improve the business climate. The Transformation of the Business Environment Plan is reported by RBC to include 14 initiatives to protect property rights, develop human capital, grow productivity and improve corporate governance.

Diminishing the share of the shadow economy can be a potential economic growth driver for the EDB countries. According to the IMF¹, the shadow economy in the EDB countries constitutes 32.8% of Kazakhstan’s GDP, 30.1% of Kyrgyzstan’s GDP, 32.4% of Belarus’s GDP, 37.8% of Tajikistan’s GDP, 36% of Armenia’s GDP, and 33.7% of Russia’s GDP. These estimates do not correspond to the countries’ official data due to differences in assessment methods applied. According to the Kazakhstan Statistics Committee, the shadow economy amounted to 25.8% of Kazakhstan’s GDP in 2016 and 23.8% of Kyrgyzstan’s GDP (the data for 2015 does not cover the agricultural sector). No matter how you calculate it, though, the share of the shadow economy is high. However, all conditions currently exist to decrease it. By decreasing the shadow economy, it will be possible to increase budget revenues, distribute revenues more equally, and improve the business climate and economy in general.

Domestic growth drivers become more important for the EDB countries, considering increasing global risks. Reforms to boost economic activity are better to implement when global economic conditions are relatively favorable. Such measures can be further coordinated by the EDB countries to benefit from the synergy from regional economic integration, which has become a key growth factor in recent years.

Yaroslav Lissovolik,
Eurasian Development Bank Chief Economist

This bulletin is the first and only comprehensive macroeconomic review of the member states of the Eurasian Economic Union. The review provides a detailed description of the current internal and external macroeconomic conditions and a forecast that takes into account interlinks between the economies of the region and the external sector.

In the present review, EDP employs methods that are a sort of mainstream economic analysis and forecasting and are successfully used by central banks and leading international financial institutions. The main analysis and forecasting tool used by EDB is an integrated model system (IMS), which is based on a multi-country structural dynamic macroeconomic model of general equilibrium. The IMS was developed and introduced by the EDB Center for Integration Studies in 2013-2014 with a view to meeting the needs of EDB and the Eurasian Economic Commission for analyzing and forecasting the macroeconomic situation in the region. The use of this tool also makes it possible to analyze strategic measures in response to shocks and risks related to the world and national economic systems and changes in prices of primary commodities. An important advantage of the model complex is the opportunity to make analysis and forecasting for both each particular EAEU member country and the integration alliance as a whole.

More detailed information about the structure of the IMS, its main components and its use within the framework of the analyzing and forecasting of the macroeconomic situation can be obtained from a joint report by the EDB Center for Integration Studies and the Eurasian Economic Commission, which is titled “The System of Analysis and Macroeconomic Forecasting” (the full text of the report is available at EDB’s website: https://eabr.org/en/analytics/integration-research/cii-reports/forecasting-system-for-the-eurasian-economic-union/).

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EXTERNAL CONDITIONS

Acceleration of global economic growth
According to IMF estimates, global GDP growth in 2017 stood at 3.8%, up 0.5 pp. YoY. The growth is attributed to increased investments in developed countries due to stimulatory monetary measures and increased private consumption in developed countries. An increase in oil prices substantially supported an economic activity recovery in oil exporting countries.

Risks of economic activity slowdown
Despite a better outlook for this year’s economic growth, risks of a global economic slowdown remain due to potential escalation of geopolitical tensions, intensified protectionist measures in international trade and the tightening of financing terms in developed countries more quickly than expected by market participants.

Fiscal stimuli for the US economy
According to preliminary estimates, the US’s GDP increased by 2.9% YoY in 1Q 2018 (versus 2.6% YoY in 4Q 2017). Economic growth accelerated amid stimulatory monetary policy, a weaker USD and ongoing tax reforms. Strong economic activity in the US is expected to continue in 2018–19 amid short-term positive effects from tax reforms.

Inflation in US exceeds targets
In March 2018, the US’s 12-mo CPI accelerated to 2.4%, after 2.2% and 2.1% in February and January, respectively. Increased inflation in January–February 2018 is mainly attributed to higher energy prices, while in March there was a notable increase in core inflation. 12-mo CPI, excluding food and energy, amounted to 2.1% in March after 1.8% in January–February 2018.

Normalization of US Fed’s monetary policy continues
Strong economic growth, low unemployment and a gradual inflationary recovery let the Fed continue with normalization of its fiscal policy. Following its meeting in May, the Fed increased the target range for the federal funds rate by 25 p.p. to 1.5–1.75%. The federal funds rate is expected to be increased again at least twice throughout this year.

High economic growth in EU
According to Eurostat preliminary estimates, Eurozone GDP growth amounted to 2.5% YoY in 1Q 2018. It was mainly attributed to strong consumer demand supported by increasing lending and favorable labor market conditions (employment and wages are rising).

Inflation in the Eurozone is far below target. 12-mo CPI amounted to 1.3% in March 2018. Consumer prices are restrained by low inflationary expectations and a strong EUR.
Low actual and expected inflation resulted in unchanged key ECB interest rates in 1Q 2018. Following its meetings in March and April 2018, the European regulator confirmed its intention to hold its interest rates at their present level for a long time and to prolong quantitative easing where necessary.

There was a sharp increase in oil prices in 1Q 2018. Brent increased by 23.8% YoY, or by 8.9% QoQ. This was chiefly caused by supply factors. With the OPEC+ agreement extended, there was a decrease in global oil reserves, as well as in production volumes, especially in Venezuela where the production decline exceeded expectations. Growing demand on the back of rising global economic growth and escalating geopolitical tension in Syria and Iran also contributed to the increase in oil prices.

Higher oil prices and continuing high economic growth in developed countries and China resulted in an increase in prices for most base metals in 1Q 2018. Aluminium was up by 16.4% YoY, copper by 19.1%, nickel by 29.3%, and zinc by 22.9%. A weak USD affected the price of gold, which increased by 9% YoY in 1Q 2018.

### Forecast for key external economic indicators

<table>
<thead>
<tr>
<th></th>
<th>Average annual price of URALS oil, in U.S. dollars per barrel</th>
<th>Average annual price of gold, in U.S. dollars per ounce</th>
<th>Food price index, 2010=100</th>
<th>Average annual exchange rate of the euro to the U.S. dollar</th>
<th>Average annual Fed Funds rate, in percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>2018</td>
<td>65</td>
<td>1318</td>
<td>96.6</td>
<td>1.2</td>
<td>1.8</td>
</tr>
<tr>
<td>2019</td>
<td>61</td>
<td>1340</td>
<td>97.0</td>
<td>1.2</td>
<td>2.6</td>
</tr>
<tr>
<td>2020</td>
<td>58</td>
<td>1382</td>
<td>98.3</td>
<td>1.2</td>
<td>3.2</td>
</tr>
</tbody>
</table>

Source: Estimates by the authors, EEU
The Armenian economy continues to grow at a high rate. The country’s GDP increased by 9.6% YoY in 1Q 2018 (after growing by 11% YoY in the previous quarter). Both domestic and external factors continue to support growth.

Growing consumer demand amid increasing wages and double-digit growth in remittances from labor migrants significantly contributed to high economic growth in 1Q 2018. Retail trade turnover increased by 3.7% YoY in 1Q 2018.

Recovering external demand and the successful implementation of export support measures resulted in exports maintaining their major contribution to economic growth for three consecutive years. Exports in value terms increased by 34.4% YoY in 1Q. Economic activity is still restrained by increasing imports (+39% YoY in 1Q 2018) amid growing domestic demand.

The low base effect resulted in accelerated growth in the construction and agricultural sectors of 23% and 2.2% YoY, respectively. Despite growing external and domestic demand, the manufacturing sector exhibits an opposite trend where growth slowed to 8.2% in 1Q, compared with 16.2% in the same period a year earlier.

Positive economic development resulted in an improved Armenian sovereign rating outlook. In March, Moody’s confirmed its B1 long-term credit rating on Armenia’s debt in national and foreign currency, while changing its outlook from “stable” to “positive”.

Leading indicators calculated by the EEC indicate that a high level of economic activity continued in 2Q 2018. This is confirmed by such components of indicators as the amount of loans provided by banks to manufacturing companies and the amount of remittances from individuals.
Inflation

Inflation approaches target level

Growing economic activity in 1Q 2018 continued to exert inflationary pressure. As a result, 12-mo CPI amounted to 3.7% in March, close to the 4% target set by the Central Bank of Armenia. Consumer prices were under further pressure from fuel, tobacco and alcohol excise taxes which were increased in order to harmonize tax legislation across the EAEU countries.
Exchange rate

The nominal effective exchange rate of the Armenian dram (AMD) continued to decrease. It was down by 4.9% YoY in 1Q 2018 (~4% in the previous quarter). The decrease is attributed to a weakened AMD against the EUR and RUB, which strengthened against the USD in 1Q 2018. The AMD real effective exchange rate decreased by 5% YoY in 1Q 2018 (~5.5% in the previous quarter), which continued to provide support to the price competitiveness of Armenian exports.

Rapid growth in labor migrant remittances

Economic recovery in countries which are key trading partners of Armenia supported the high growth in remittances of labor migrants. According to the Central Bank, the amount of remittances in USD terms increased by 14.5% YoY in 1Q 2018. Remittances from Russia were up by 22.1%.

Fiscal policy

Government budget deficit

In 1Q 2018, Armenia’s budget deficit amounted to AMD 26.3 billion, compared to AMD 19.2 billion a year earlier. Budget spendings decreased by 2.6% YoY, mainly due to decreases in transfer payments (by 25.1%) and in purchases of goods and services (by 18.6%). At the same time, the decrease in revenues amounted to 5.4% YoY.

New Tax Code comes into force

A new Tax Code is effective in Armenia as of January 1, 2018. It incorporates all regulations regarding taxation. Among its innovations, there is a progressive tax scale for personal income, as well as increased excise taxes for tobacco and alcohol products and liquid natural gas, which harmonize Armenia’s excise rates with those of other EAEU countries. The new code is generally aimed at simplifying business regulation and harmonizing tax legislation across EAEU countries.

Increasing government debt and its cost of servicing

The government is going to carry on with its fiscal consolidation policy in 2018. The budget deficit is intended to be decreased to 2.7% of GDP, compared to 4.7% of GDP in 2017.

The government debt increased last year, which led to significant 16.8% YoY growth in the cost of its servicing in 1Q 2018.

Armenia’s government debt continued to increase in 1Q 2018 to about USD 6.9 billion. The government debt has increased by USD 112.5 million YTD, mainly due to an increase in government borrowings (which have increased by USD 70.5 million YTD).
Monetary policy

The refinancing rate stayed unchanged at 6% in 1Q 2018. Given the accelerating inflation, an unchanged refinancing rate effectively implies a still expansionary monetary policy and that the Central Bank plans to stabilize inflation near the target level. According to the Central Bank, moreover, it may reduce the stimulatory effect of its monetary policy in the medium term amid increasing inflationary pressure caused by domestic demand.

Lending activity increases

Decreasing interest rates on bank loans (by 3.6 p.p. and 3.3 p.p. YoY in March 2018 for short-term and long-term loans in AMD, respectively) further encouraged lending. There was an acceleration of growth in loans provided to both households (26.3% in March 2018 vs. 22.1% in December 2017) and businesses (39.4% in March 2018 vs. 33.5% in December 2017).

Trend towards less use of USD in the economy continues

Interest rates on loans in USD and in AMD still differ considerably (by some 5 p.p.), which helps to reduce the share of bank deposits in USD. As of the end of March 2018, the share of deposits in foreign currency amounted to 54.2% of total deposits, down by 1.5 p.p. YTD (and down by 5.2 p.p. YoY). Both households and businesses decreased their deposits in foreign currency (by 1.8 p.p. and 0.8 p.p. YTD, respectively).
FORECASTS

High economic growth to continue

High economic growth is expected to continue in 2018. Economic activity will be supported by the stimulatory monetary policy and increasing external demand. Implementation of structural reforms to boost economic growth, above all by developing export-oriented sectors, is expected to continue. We expect GDP to grow by 5.6% in 2018 and the growth rate to stabilize at the 5% level by 2020.

Source: calculations by the authors, EEC

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2 Here and elsewhere fan chart ranges correspond to 10%, 50% and 75% confidence intervals.
Inflation to stay within target range

Inflation is expected to be at 4.1% in 2018 and to stay in the medium term within the target range set by the Central Bank. Consumer prices will be under pressure from domestic demand and higher excise taxes.

Increasing inflationary pressure will compel the regulator to gradually abandon its expansionary monetary policy. The refinancing rate is expected to be increased to what we view as its neutral level of 7–7.5%.

SUMMARY

Macroeconomic forecasts for the Republic of Armenia

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<th>2018</th>
<th>2019</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>CPI</strong> <em>(growth in percent as of year-end)</em></td>
<td>4.1</td>
<td>4.0</td>
<td>3.9</td>
</tr>
<tr>
<td><strong>GDP</strong> <em>in constant prices (growth in percent, y/y)</em></td>
<td>5.6</td>
<td>4.0</td>
<td>4.9</td>
</tr>
<tr>
<td><strong>Interbank repo rate</strong> <em>(in percent per annum)</em></td>
<td>6.7</td>
<td>7.4</td>
<td>7.5</td>
</tr>
<tr>
<td><strong>Exchange rate</strong>, the national currency against the U.S. dollar <em>(final average for the year)</em></td>
<td>480</td>
<td>486</td>
<td>494</td>
</tr>
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Source: calculations by the authors, EEC
TRENDS

GDP

Economic growth significantly accelerates

According to the country’s National Statistical Committee’s preliminary estimates, Belarus’s GDP increased by 5.1% YoY in 1Q 2018. Economic growth continues to accelerate (Belarus’s GDP increased by 4.3% YoY in 4Q 2017) which according to our estimates helped to close a negative output gap in 1Q 2018.

The following factors contributed to economic activity’s acceleration in 1Q 2018:

• An increase in lending with prices staying at favorable levels, as well as a substantial increase in wages at the end of December 2017, which provided significant support to consumer demand. The increase in capital investments amounted to 21.8% YoY in 1Q 2018 and was due mainly to purchases of machines, equipment and vehicles.

An increase in oil supplies from Russia amid a low comparison base helped to increase exports in volume terms (by 13.7% YoY in 1Q 2018). Economic activity in 1Q 2018 was restrained by an increase in imported goods (by 14.4% YoY in volume terms) due to the quick recovery of domestic demand and high import capacity of the country’s economy.

• According to National Statistical Committee data, Belarus’s GDP growth in 1Q 2018 was mainly attributed to manufacturing (some 2.4 p.p.) with its output increased by 9.4% YoY. A low previous year’s comparison base caused by the conflict with Russia over gas prices helped to increase the production of coke and oil products (by 20.1% YoY in 1Q 2018). Cold weather in March resulted in greater consumption of electricity, gas, steam, hot water and conditioned air (an increase of 7.5% YoY in 1Q 2018). Increased domestic demand and the attractive prices of goods made by Belarusian manufacturers provided support to other manufacturing sectors.

High growth in manufacturing

Belarus’s ratings upgraded by international agencies

Positive trends in the country’s economy are confirmed by Belarus’ improved sovereign ratings assigned by international rating agencies. Fitch Ratings upgraded its rating to B from B- and Moody’s changed its rating from Caa1 to B3.
Belarus improved its position in the OECD’s Country Risk Classification, which will decrease the cost of debt for the country. Belarus moved from group 7 to group 6 in January 2018 in the OECD’s Country Risk Classification used by international financial institutions to price their loans.

Inflation

12-mo inflation amounted to 5.4% in March, compared to 4.6% for 2017. This 1Q 2018 acceleration in inflation is due to both an increase in core inflation as well as in prices and tariffs regulated by the government. Core annual inflation increased from 2.5% in December 2017 to 3% in March 2018 due to a decline in the influence of inflationary expectations on domestic demand. Low inflation in countries which are key trading partners of Belarus, above all in Russia, is keeping a lid on the country’s core inflation. The 12-mo increase in prices and tariffs regulated by the government amounted to 9.7% in March 2018, compared to 8.1% in December 2017. The increase resulted from higher public utility tariffs, higher prices for fuel and tobacco products, as well as higher prices for education.

High inflationary expectations

According to the National Bank of the Republic of Belarus, high inflationary expectations persist, and this creates additional inflationary risks if factors holding back prices weaken.
The quick recovery in economic activity supported the demand for foreign currency by businesses in 1Q 2018 (USD 385.3 million), given the country’s high import capacity. Amid an increase in household income, there was a decrease in net sales of foreign currency by households (USD 303.3 million in 1Q 2018, compared to USD 500.3 million in the same period a year earlier). If the current trend continues, the foreign currency market may be put under additional pressure.

The currency basket value calculated using average weighted exchange rates increased by 8.2% YoY in 1Q 2018 (a 1.3% QoQ increase) due to a weaker Belarusian ruble (BYN) against the RUB and EUR as they strengthened against the USD. The real effective exchange rate decreased by 4.4% YoY in 1Q.

According to the National Bank, the balance of trade was positive in 1Q 2018 and amounted to USD 315.2 million, or USD 86.6 million higher than in 1Q 2017. This surplus is attributed solely to exported services, while the trade deficit in goods increased due to imports outpacing exports.

As of April 1, 2018, Belarus’s foreign-exchange reserves amounted to USD 6,994.6 million, a decrease of USD 320.6 million YTD. The decrease in foreign-exchange reserves resulted from the repayment of loans in foreign currency by the National Bank in the amount of about USD 2.3 billion (of which USD 835.8 million was spent on redeeming eurobonds). In 1Q, Belarus’s foreign-exchange reserves were supported by eurobonds issued for USD 600 million and loans obtained from other external sources, as well as by an offering of government bonds denominated in foreign currency in the domestic market.
Fiscal policy

Increased budget surplus

There was a substantial increase in the budget surplus in 1Q 2018 to 4.8% of GDP, compared to 1.7% of GDP in the same period a year earlier. This increase was caused by the following key factors:

- Significantly accelerated economic growth, which resulted in much higher indirect tax revenues (VAT and excise tax revenues increased by 25.6% and 11.2% YoY, respectively) and income and profit tax revenues (by 16.8% YoY).
- Increased oil prices, which resulted in higher export revenues (a 46.8% YoY increase).

The situation in the fiscal sector can help to reduce the amount of government debt that needs to be refinanced.

Decreased government debt

According to the Ministry of Finance, as of April 1, 2018, government debt amounted to 38% of GDP, down from 39.8% of GDP as of the beginning of this year. This decrease in 1Q 2018 is attributed to government debt repayments (the government’s external debt is down USD 0.3 billion YTD).

Monetary policy

The refinancing rate close to neutral level

In January 2018, the National Bank decreased the refinancing rate by 0.5 p.p. to 10.5%. Amid inflationary pressure due to an increase in domestic demand and high inflationary expectations, the refinancing rate remained unchanged in March. We expect the refinancing rate to stay at its current level of 10.5% in 2Q.
Increased interbank lending rate did not affect interest rates on bank loans

An increase in the reserve requirements for banks’ deposit liabilities in foreign currency to 17.5% resulted in a considerable reduction of the liquidity surplus in the banking sector, which in turn led to an increase in the overnight interbank lending rate which serves as a benchmark for monetary policy (from 9.7% in December 2017 to 11.2% in March 2018).

High lending activity

A further increase in lending activity may bring about additional inflationary risks. The total amount of bank claims in rubles increased by 23.4% YoY in March 2018 (compared to an increase of 15.5% in December 2017). This growth is attributed to more loans provided to both corporate and individual borrowers.

FORECASTS

3.7% economic growth expected

High economic activity is expected to continue this year. Monetary conditions will continue to stimulate the economy and provide support to consumer and investment activity, which will be also backed up by growing household incomes. GDP is expected to grow by 3.7% in 2018, 1.1 p.p. higher than our previous forecast, which is explained by a faster than expected economic recovery in 1Q. A slowdown in growth is expected as of 2Q, mainly due to the end of the low base effect in both manufacturing and oil product exports.

In 2019–20, the Belarusian economy will continue to grow at its long-term potential rate, given its current structure (by about 2% per year).

Source: Calculations by the authors, EEC
**Inflation to stay within target range**

The deferred effect of increased wages and lending amid high inflationary expectations will be an inflation growth driver in 2018. We expect annual inflation to be 6%, within its target range set by the National Bank, if interest rates remain unchanged. In 2019 and 2020, inflation is expected at 5.3% and 4.9%, respectively, if there are no significant domestic or external shocks.

Amid growing inflation and a closing GDP gap, the overnight interbank loans rate is expected to stay at 10–11%. At the same time, success in reaching National Bank targets will mainly depend on how close the overnight interbank rate and banks’ interest rates converge. See our special report «Key factors to further decrease Belarus’s refinancing rate” for more details about the chances of the refinancing rate in Belarus decreasing.

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**GDP in constant prices (annual percentage change)**

**Nominal USD/BYN exchange rate**

**USD/BYN real exchange rate gap, %**

**Output gap, %**

*Source: Calculations by the authors, EEC*
## SUMMARY

### Macroeconomic forecasts for the Republic of Belarus

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<tr>
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<th>2018</th>
<th>2019</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>CPI</strong> (growth in percent, end of year)</td>
<td>6.0</td>
<td>5.3</td>
<td>4.9</td>
</tr>
<tr>
<td><strong>GDP in constant prices</strong> (growth in percent, y/y)</td>
<td>3.7</td>
<td>1.9</td>
<td>2.0</td>
</tr>
<tr>
<td><strong>Interest rate on overnight interbank loans</strong> (in percent per annum)</td>
<td>10.5</td>
<td>9.5</td>
<td>9.1</td>
</tr>
<tr>
<td><strong>Exchange rate</strong>, Belarusian rubels per U.S. dollar (final average for the year)</td>
<td>2.01</td>
<td>2.07</td>
<td>2.12</td>
</tr>
</tbody>
</table>

**Source:** Calculations by the authors, EEC
TRENDS
GDP

GDP growth stabilization

Favorable external conditions and domestic drivers support Kazakhstan’s GDP growth, which amounted to 4.1% YoY in the quarter (+3.6% YoY in 1Q 2017).

Growing oil prices provide support to both the manufacturing sector (+5.4% YoY) and the service sector (+4.0% YoY). Growth in wholesale and retail trade in 1Q 2018 to 6.2% YoY (+2.8% YoY in 1Q 2017) indicates a recovery of consumer confidence amid increasing wages and slowing growth in consumer lending. Another 1Q 2018 growth driver was investments, which increased by 39.5% YoY. After declining for two quarters, the construction sector regained its status as a growth driver (+5.9% YoY).

Increasing investments and consumer sector rebalancing

Net exports also contributed to GDP growth. Increasing exports in volume terms were accompanied by recovering imports. Domestic demand is also contributing to GDP growth.

Structure of GDP growth in constant prices by income components (in p.p., annual percentage change)

Structure of GDP growth in constant prices by production (in p.p., annual percentage change)

Source: National statistical offices, calculations by the authors, EEC

Leading indicators point to growth acceleration

The EEC aggregate leading indicator signals that economic growth likely accelerated in the first months of 2Q 2018, which is backed up by growth in the trade and transportation sectors. According to a survey conducted by the National Bank of Kazakhstan, businesses are optimistic about future demand and plan to increase production, including creating new jobs. The lending recovery should also contribute to GDP growth.
Inflation

Inflation stays within target range  In 1Q 2018, inflation stayed within the new 5.0–7.0% target range set for end 2018. Low inflation resulted from a slowdown in food prices (to 5.6% YoY) and moderate growth in tariffs for public utilities (6.2% YoY). Price increases in the non-food segment are still above the target (8.5% YoY). This was mainly attributed to increases in fuel prices and higher excise taxes for tobacco and alcohol products. 12-mo inflation amounted to 6.6% in 1Q 2018.

Inflation slowing  According to the National Bank survey, inflationary expectations have decreased. If one-year ahead inflation was expected at 7.7% in November 2017, this estimate decreased to 5.8% in March 2018. The number of respondents expecting price growth for consumer goods to accelerate was down in 1Q 2018. Volatility in the exchange rate increased in early April amid growing uncertainty in regional financial markets, but it is unlikely to affect the annual inflation figures.

External Sector

Balance of payments surplus  Amid a stable real effective exchange rate and increasing global prices for key goods exported by Kazakhstan, the country’s current account deficit was sharply reduced in 4Q 2017 (3.9 times compared to 4Q 2016). There was a two-fold increase in the balance of payments surplus, that more than compensated for the increase in revenues from direct foreign investors. Moreover, in 4Q 2017 18.2% of non-residents’ income from direct investments was reinvested in the Kazakhstan economy.

There was a capital outflow in the financial transactions account as a result of the government buying non-resident short-term securities, partially using National Bank...
reserves for this purpose. Moreover, the increased inbound direct foreign investments and maturing of deposits placed by businesses and households with foreign banks contributed to an increase in the net capital inflow in 4Q 2017.

**Fiscal policy**

**Budget surplus in 1Q 2018**

There was a budget surplus in 1Q 2018 of 0.8% of GDP, compared with a budget deficit in 1Q 2017 of 0.1% of GDP. Key sources of budget revenues were taxes and inflows from the National Fund. The growth of both tax revenues (+11.6% YoY) and transfer payments (+30.0% YoY) slowed on a year-on-year basis, while budget spending growth accelerated. Whereas spending decreased by 0.7% YoY in 1Q 2017 it increased by 13.5% YoY in the reporting period. The acceleration was mainly attributed to increased social spending. Public spending on healthcare was up by 23.6% YoY and spending on social security increased by 19.1% YoY.

**Moderate indebtedness of public sector**

The government debt increased by 6.2% QoQ in the first quarter, mostly covered by notes issued by the National Bank. The rapid increase in government domestic debt was partially caused by excessive bank liquidity and final measures taken under the Bank Recovery Program. The National Bank issued short-term securities, while the Ministry of Finance offered its 10-year and 15-year notes to optimize the yield curve. State bonds were issued by local authorities to raise funds for the Nurly Zher residential construction program. The government’s external debt decreased as scheduled repayments were made.

**Public debt (end of period, % of GDP)**

[Graph showing public debt by period and type]

**State budget implementation (% of GDP)**

[Graph showing state budget implementation by period and type]

**Source:** National agencies, calculations by the authors, EEC
In 1Q 2018, risks of disinflation emerged, partially due to a stronger tenge (KZT) against the USD and lower prices in the global food markets. On the other hand, a more active monetary policy aimed at creating neutral monetary conditions, together with recovering households’ income, will prevent inflation from falling below its 5.0–7.0% target range in 2018. In the medium term, amid inflationary expectations settling down, inflation will stay close to the target, which will gradually decline to 4.0% by the end of 2020.

**MONETARY POLICY**

**Base interest rate decreased**

Decreased inflationary expectations and signs of disinflation are encouraging the regulator to speed up the transition to neutral monetary conditions. The base rate was decreased three times in 2017, and it was reduced on two more occasions in 1Q 2018. The base rate was decreased from 10.25% to 9.25%. The TONIA rate, which serves as a benchmark for the regulator, stayed at the bottom of the interest rate range, indicating excessive liquidity in the system.

**Banking sector transforming**

Amid restructuring of the banking sector, the amount of deposits excluding current and non-residents’ accounts decreased by 2.1% over 1Q, while the amount of loans was down by 1.1%. The share of loans overdue 90 days or more accelerated its growth rate. It accounted for 10.0% of the total loan portfolio in 1Q 2018, compared to 9.3% at the end of 4Q 2017. Nevertheless, banks getting rid of bad debts increases the potential of the banking sector and strengthens people’s confidence in banks. The amount of newly-issued loans increased by 23.0% YoY in 1Q 2018, as compared to 3.6% YoY growth in 1Q 2017. The amount of newly-raised bank deposits increased by 25.9% YoY.

**FORECASTS**

**Inflation to stay within target range**

In 1Q 2018, risks of disinflation emerged, partially due to a stronger tenge (KZT) against the USD and lower prices in the global food markets. On the other hand, a more active monetary policy aimed at creating neutral monetary conditions, together with recovering households’ income, will prevent inflation from falling below its 5.0–7.0% target range in 2018. In the medium term, amid inflationary expectations settling down, inflation will stay close to the target, which will gradually decline to 4.0% by the end of 2020.

**Source:** Calculations by the authors, EEC
Steady growth in long term

Increasing oil prices and stable economic growth in countries which are key trading partners of Kazakhstan create favorable conditions for the country’s international trade. Volatility in regional markets seems to be transient and is likely to have little effect on economic growth. Key sources of domestic growth currently are investment and consumer demand. There was a sharp increase in fixed capital investments in the first months of 2018, which creates conditions for economic growth to accelerate in the long term. Real wages have demonstrated a positive trend for the first time over recent months, creating conditions for consumer demand growth. Domestic demand will be also supported by five social initiatives announced by President Nazarbayev in March 2018. In particular, the 7–20–25 mortgage program being developed by the National Bank will become a growth driver in the long term. It is also expected that the Bank Recovery Program will help to release sources of lending, which can also serve as a growth driver.

Among potential growth-hindering factors, we highlight mounting geopolitical tension in the region, rising protectionist risks to international trade, and the still high dependence of Kazakhstan on oil prices.

Source: Calculations by the authors, EEC
## SUMMARY

Macroeconomic forecasts for the Republic of Kazakhstan

<table>
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<tr>
<th></th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
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<tbody>
<tr>
<td><strong>CPI (growth in percent, end of year)</strong></td>
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<tr>
<td><strong>GDP in constant prices (growth in percent, y/y)</strong></td>
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<td><strong>TONIA rate (in percent per annum)</strong></td>
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<tr>
<td>336.1</td>
<td>357.4</td>
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*Source: Calculations by the authors, EEC*
There was a sharp decline in the country’s economic growth in 1Q 2018. Apart from the Kumtor factor, the decline resulted from a decrease in the service and construction sectors. Kyrgyzstan’s GDP growth amounted to 1.3% YoY in the first quarter (+5.2% YoY in 1Q 2017).

Typical fluctuations in output at the Kumtor gold mine resulted in a decrease in overall manufacturing of 1.1% YoY. Mining industry output was down 15.5% YoY due to a reduction in metal ore and coal mining. This decline was compensated for by growth in the power and public utility sectors (electricity, water and gas), which resulted in a zero overall contribution to GDP growth from the manufacturing sector. There was a slowdown in the service sector, from 6.7% growth YoY in 4Q 2017 to 1.5% YoY in 1Q 2018. That said, the key wholesale and retail trade segment demonstrates stable growth (+3.7% YoY), while the decline in the hotel and restaurant segment resulted partially from a seasonal factor, given that the highest demand in this segment falls in the fourth quarter. A decline in the information and telecommunication sector of 5.8% YoY was an additional negative factor.

In terms of use of GDP, a trade balance surplus (due to both higher exports and lower imports), household consumption and gross domestic capital formation made a positive contribution to GDP growth in 2017.
The EEC aggregate leading indicator signals that economic growth is likely to decelerate in the short term, mainly due to a slowdown in gold mining. At the same time, other sectors continue to grow at their previous year’s rate. Lending to the construction and consumer sectors grew in March 2018, which supported economic growth. Domestic demand continues to grow and there are favorable conditions in export markets.

Inflation

Inflation is below 5.0–7.0% target range

Despite excise taxes for tobacco products and tariffs for telecommunication services increasing in 1Q 2018, low prices in the global and regional food markets kept inflation below its target range. Prices of alcoholic drinks and tobacco products grew by 6.5% YoY and those of services grew by 6.9% YoY. The monthly decline in prices in the global sugar market that has been ongoing since December 2017, as well as weak prices in regional grain markets resulting from high yields in Kazakhstan and Russia, contributed to a slowdown in prices in Kyrgyzstan’s consumer sector. The 12-mo increase in food prices amounted to 2.7% in 4Q 2017 and decelerated to 1.2% in 1Q 2018. This resulted in 12-mo CPI growth of 3.2%.

Low inflation is likely to have continued in the first months of 2Q 2018 in the absence of supply shocks and with the national currency stable.

Source: National agencies, calculations by the authors, EEC
International trade

Current account surplus

Movements in the real effective exchange rate of the Kyrgyzstani som (KGS) did not affect the country’s international trade in 4Q 2017. Despite an increase in the balance of payments deficit compared to 4Q 2016, there was a surplus in the current account in 4Q 2017 (a preliminary estimate) due to lower interest payments to non-residents, an increase in the profit reinvested by direct investors and increased remittances. The net outflow of direct investments due to principal payments on loans was partially compensated for by the growing amount of loans provided to both the public and private sectors.

Fiscal policy

Budget surplus

There was a budget surplus in 1Q 2018 amounting to 1.1% of GDP. By comparison, the country saw a budget deficit in 1Q 2017 of 0.9% of GDP. This was mainly attributed to increased tax revenues, up 20.1% YoY, and decreased spending on purchasing non-financial assets (down 45.5% YoY). The share of non-tax budget revenues and transfer payments in total revenues decreased from 25.9% in 1Q 2017 to 17.4% in 1Q 2018. The rate of budget spending growth remained unchanged.

Government debt decreased by 4.1% QoQ and amounted to 57.1% of GDP as of April 1, 2018. At the same time, there was a decrease in government external debt of 4.4% QoQ, while government domestic debt increased by 16.5% QoQ.

Source: National agencies, calculations by the authors, EEC
Monetary policy

The refinancing rate was unchanged in 1Q 2018 at 5%, within its target range of 6.25–0.25%. The upward trend in financial market interest rates that emerged in 4Q 2017 ceased in 1Q 2018. One of the reasons for this was the National Bank’s decision to resume providing liquidity to commercial banks through credit auctions. Real financial market interest rates have been of a stimulative nature for over a year, making commercial banks revise their interest rates on both liabilities and assets. Interest rates for new deposits in KGS decreased on average from 3.0% to 2.7% in 1Q 2018. The cost of loans in KGS provided to commercial banks amounted on average to 19.6% in 1Q 2018 (20.5% in 1Q 2017).

As the KGS exchange rate increased in 1Q 2018, the National Bank was a net buyer of the national currency.

FORECASTS

Inflation to reach its target range in long term

We have revised the country’s inflation forecasts downwards due to low prices in regional food markets and stability of the national currency. Consumer prices are now expected to show weak growth throughout 2018 and to reach the 5.0–7.0% inflation target range by mid-2019. If there are no additional shocks, we expect inflation to accelerate in the medium turn due to increasing domestic demand and rising global energy prices. Inflation is expected to stay within the target range subsequently if monetary policy is tightened in time.

Source: Calculations by the authors, EEC
Growth slowing

We have also revised our GDP growth outlook downwards. As new risks emerge, GDP growth in countries which are key trading partners of Kyrgyzstan is expected to be moderate. Decreased gold mining will also contribute to a slowdown in GDP growth in 2018. Domestic demand and fiscal measures will support the economy in the medium turn. Faster GDP growth may be hindered in the medium turn by systemic factors that need to be eliminated through reforms. Such reforms are envisaged by the Long-Term Economic Development Strategy, which is currently under discussion.

Source: Calculations by the authors, EEC
## SUMMARY

### Macroeconomic forecasts for the Kyrgyz Republic

<table>
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<tr>
<th></th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
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<tr>
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<td><strong>Interbank repo rate (in percent per annum)</strong></td>
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<td><strong>Exchange rate, the national currency against the U.S. dollar (average for the year)</strong></td>
<td>69.0</td>
<td>70.6</td>
<td>73.4</td>
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</table>

*Source: Calculations by the authors, EEC*
RUSSIAN FEDERATION

**TRENDS**

**GDP**

<table>
<thead>
<tr>
<th>Category</th>
<th>Description</th>
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</thead>
<tbody>
<tr>
<td>Moderate economic growth to continue</td>
<td>Russia’s GDP growth accelerated in 1Q 2018 after a slowdown at the end of the previous year. According to preliminary estimates of the Russian Federal State Statistics Service, GDP increased by 1.3% YoY in 1Q 2018, compared to a 0.9% YoY increase the quarter earlier. Amid mixed external factors, better economic conditions resulted from recovering domestic economic activity.</td>
</tr>
<tr>
<td>Consumer activity increasing</td>
<td>Improved consumption supported by increased households’ income and retail lending were key trends in the first quarter. Real wages increased by 9.5% YoY in 1Q to a 5-year high, mainly due to the public sector wages increase to comply with the May 2012 RF President’s executive order.</td>
</tr>
<tr>
<td>Benign prices on commodity markets</td>
<td>Benign commodity prices and increased demand for Russian exported goods resulted in an increase in the trade surplus to USD 44.2 billion in 1Q (+28% YoY). There was an upward trend demonstrated by both exports, which were up by 22.9% YoY, and imports (+19.1%) amid improved domestic demand.</td>
</tr>
<tr>
<td>Mixed manufacturing output data</td>
<td>Industrial production returned to growth in 1Q 2018 and increased by 1.9% YoY compared to a decrease of 1.7% YoY in the previous quarter. Amid cold weather, the growth was supported by the mining industry and the power sector. Despite quarterly growth in manufacturing (and up 2.2% YoY), its month-by-month trend remains quite volatile. After a 4.7% YoY increase in manufacturing in January, there was a 0.2% YoY decrease in March. Some recovery in manufacturing is expected in 2Q, as, according to PMI data, there was an increase in production in April against a background of rising employment and new orders.</td>
</tr>
<tr>
<td>Optimistic leading indicators</td>
<td>The EEC leading indicator also points to an acceleration of economic activity in Russia in 2Q due to positive trends in its freight turnover, household income, oil price and stock market index components.</td>
</tr>
</tbody>
</table>
Economic recovery is also confirmed by the higher credit ratings assigned by leading rating agencies. Standard & Poor’s upgraded Russia’s sovereign credit rating in foreign currency back to investment grade (BBB-) in 1Q and Moody’s revised its outlook to «positive». Having two investment grade ratings in foreign currency increases the chances of attracting investors in Russian securities.

In January–February, 12-mo inflation in Russia decreased to a historic low of 2.2%, which is also the lowest value among the EDB countries. The slowdown in consumer prices is a result of a high previous year comparison base and the absence of any significant external or domestic factors affecting the economy.

The annual inflation rate remained at its March level of 2.4% in April. However, inflation risks grew in April with increased volatility in the Russian currency. It is unclear how the changes in financial markets that occurred in April will affect both inflation and inflationary expectations, with the latter decreasing to their historic low of 7.8% in March, according to the Bank of Russia.
Inflation and key interest rate (%)

External trade and the real exchange rate (Percent change YoY)

Source: National statistical offices, calculations by the authors, EEC

Exchange rate

Volatility returns to financial markets
After a long period of calm, volatility in RUB rates soared in April. The reason for this was a new round of US sanctions imposed on Russia that caused devaluation of the RUB. In April, the nominal RUB/USD exchange rate declined by 7.7% YoY after an increase of 3.3% YoY in 1Q. The real effective exchange rate decreased by 13.4% YoY in April. At the same time, higher oil prices and favorable domestic macroeconomic conditions provided support to the exchange rate.

Foreign capital outflow continues
Foreign capital outflow exerted additional pressure on the RUB in January–April 2018. Whereas the net capital outflow in 1Q (USD 13.4 billion) was attributed to the increased acquisition of foreign assets in other sectors amid growing yields in developed markets, deteriorating external relations were an additional driver in April. According to Bank of Russia preliminary estimates, the net capital outflow of the private sector increased to USD 7.6 billion in April (and the total outflow amounted to USD 21 billion YTD, compared to USD 17.9 billion in the same period last year).

The trend toward an increasing current account surplus continued in January–April 2018, mainly due to higher commodity prices. The positive current account balance amounted to USD 41 billion in January–April 2018, compared to USD 23.8 billion a year earlier.

Fiscal policy

Budget surplus in 1Q 2018
Russia runs budget
According to Ministry of Finance preliminary estimates, the budget surplus amounted to RUB 405 billion, or 1.8% of GDP, in 1Q 2018 (compared to a RUB 273 billion deficit, or 1.3% of GDP, a year earlier). A 22.5% YoY increase in revenues from oil and gas
surplus for first time since 2011 made a major contribution to the budget surplus, while the annual growth of revenue from non-oil and gas sectors amounted to a more moderate 4.8% YoY. Budget spending decreased by 6% YoY in 1Q 2018.

High capital inflows into Russian National Wealth Fund The increase in budget revenues made it possible to revise the budget for 2018. According to the budget amendment bill, a budget surplus of RUB 440.6 billion, or 0.45% of GDP, is expected, compared to a RUB 1.27 trillion, or 1.3% of GDP, deficit expected earlier. The increase chiefly resulted from increased revenues from oil and gas. Budget spending in this version is virtually unchanged.

There has been a new budget rule in force since 2018 to direct additional revenues from oil and gas\(^3\) to the Russian National Wealth Fund. Thus, if oil prices remain at their 1Q level (USD 65.2 per barrel) throughout this year, inflows to the National Wealth Fund will amount to approximately RUB 3 trillion in 2018.

In 1Q, a new issue of 11-year and 29-year eurobonds was placed by the Ministry of Finance for total amounts of USD 1.5 billion and USD 2.5 billion, respectively. The bonds were mainly sold to bidders from the US and the UK (about 64%), while Russian investors bought 22% of the issue. The funds raised from bonds were mostly used by the Ministry of Finance to buy back Russia-2030 bonds to optimize its debt portfolio and to increase the liquidity of sovereign eurobonds in circulation.

\(^3\) Revenues exceeding the basic scenario level from oil and gas calculated based on a Urals oil price of USD 40 per barrel.
Monetary policy

Key rate decrease on hold

Amid record low inflation in 1Q 2018, the Bank of Russia lowered its key interest rate on two occasions, to 7.25% in 1Q 2018. The situation changed in April, when it became unclear how global economic conditions would affect inflation. In April, the Bank of Russia decided to keep its key interest rate unchanged and toughened its rhetoric towards interest rates. Thus, while the key interest rate is likely to be lowered further, we believe it more plausible to occur in 2019.

FORECASTS

GDP growth in 2018 will exceed previous year’s figures

Economic activity will continue to gradually recover in 2018. We expect annual GDP growth to amount to 1.8%. The downgrade from 2% forecasted earlier is explained by the more moderate economic growth in 1Q 2018 and unfavorable global economic conditions. A potential negative effect from the extension of sanctions against Russia will be partially compensated by high commodity prices. Increasing households’ income and demand for credit will continue to support consumer and investment activity.

Economic growth potential may increase in medium term

Considering the current structure of the economy, Russia’s GDP will grow annually by 1.7% in the medium term. In the medium term, an additional stimulus to economic development can be provided by increasing budget spending to implement the President’s executive order issued in May on the development of the Russian economy to 2024. With the implementation of reforms planned by the government, our outlook for GDP growth may be revised upward.

GDP in constant prices (annual percentage change)  
Nominal RUB/USD exchange rate

Source: Calculations by the authors, EEC
Exchange rate stabilization

If the geopolitical tension from the sanctions is defused and oil prices remain high, the RUB exchange rate can strengthen a bit after its significant decline in April and RUB/USD can be expected at 60.5 by the end of 2018.

Inflation to stay within target range in 2018–20

The exhausting of the low base effect and increasing inflationary pressure caused by domestic demand and global economic conditions will gradually push inflation to its 4% target level. If there are no external shocks this year, we expect inflation to be 3.7% in 2018 and to stay within the target range set by the Bank of Russia in the medium term.

Key interest rate to decrease

The regulator is expected to continue with its cautious approach to decreasing the key interest rate. We expect the next decreases in the key interest rate to be postponed until 2019.

Source: Calculations by the authors, EEC
SUMMARY

Macroeconomic forecasts for the Russian Federation

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<th>2018</th>
<th>2019</th>
<th>2020</th>
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<tr>
<td><strong>CPI (growth in percent as of year-end)</strong></td>
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<tr>
<td><strong>GDP in constant prices (growth in percent, y/y)</strong></td>
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<td><strong>Exchange rate, the national currency against the U.S. dollar (final average for the year)</strong></td>
<td>60.5</td>
<td>61.6</td>
<td>62.7</td>
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Source: Calculations by the authors, EEC
Tajikistan’s GDP growth amounted to 7.0% YoY (+6.5% YoY in 1Q 2017). The construction sector regained its status as a growth driver due to its investment momentum in the first months of 2018. Its share in GDP, according to our estimates, declined to 0.4 p.p. in 4Q 2017, but it rose to 1.0 p.p. in 1Q 2018.

The mining industry remains the locomotive of GDP growth, although it demonstrated a slowdown to 15.6% YoY. Sources of growth in manufacturing (+17.4% YoY) mostly consist of the production of textiles and other non-metal mineral products. The stabilization of global cotton prices at a higher level compared to 1Q 2017, together with a large cotton crop in 2017, contributed to an increase in fiber and fabric production (by 3.7 times YoY) and in the seed stock (by 3.5 times YoY). New production facilities enabled a huge increase in the production of cement (by 1.8 times) and concrete (by 1.9 times). The agriculture sector (+5.1% YoY) and retail trade (+5.0% YoY) continue to contribute to GDP growth.

The output gap amounted to –0.2% in 1Q 2018.

Plans to implement investment projects create conditions for GDP growth to continue. According to Rogunskaya HPP’s contractors, the work delivery timetable is being observed. There was a three-fold increase in nominal volumes of imports of machines, equipment and vehicles, as well as a two-fold increase in freight turnover, which clearly points to strong investment activity. Some positive signals are also coming from the consumer sector, where retail trade is recovering as inflation slows.

The large share of food products in the consumer basket (over 2/3) determines the sensitivity of inflation to supply shocks, specifically with regard to agricultural products. The new season’s heavy crop resulted in an inflation trend reversal. Inflation was down by 2.5% YoY in March 2018 from its 9.0% peak in June 2017. Inflation in the non-food sector remains stable and amounted to 4.1% YoY in 1Q 2018. Increased public utility tariffs contributed to inflation in this sector (6.3% YoY).
The net inflow of remittances in 4Q 2017 (by 25.3% YoY, according to our estimates) was accompanied by a four-fold increase in interest payments to foreign investors. As a result, the foreign currency inflow from primary and secondary incomes was up only 5.2% YoY. The nominal growth in exports of goods (+38.0% YoY) and nearly flat imports (−0.2% YoY) resulted in a near halving of the current account deficit to 2.5% of GDP, compared to 4Q 2016. There was a net capital inflow in the financial transactions account due to new direct foreign investments and new external borrowings made by both the public and private sectors. The country’s foreign-exchange reserves were used to fill the gap.

Inflation is expected to remain low in 2Q 2018 due to the comparison base effect. Non-food segment price fluctuations will be determined by external factors.

**External sector**

**Current account deficit**  The net inflow of remittances in 4Q 2017 (by 25.3% YoY, according to our estimates) was accompanied by a four-fold increase in interest payments to foreign investors. As a result, the foreign currency inflow from primary and secondary incomes was up only 5.2% YoY. The nominal growth in exports of goods (+38.0% YoY) and nearly flat imports (−0.2% YoY) resulted in a near halving of the current account deficit to 2.5% of GDP, compared to 4Q 2016. There was a net capital inflow in the financial transactions account due to new direct foreign investments and new external borrowings made by both the public and private sectors. The country’s foreign-exchange reserves were used to fill the gap.

**Fiscal policy**

**Budget surplus**  In 1Q 2018, there was a budget surplus of 2.8% of GDP, which is 1.7 times lower than in the same period a year earlier. Amid a high comparison base, budget revenues decreased by 11.1% YoY while expenditure decreased by 4.9% YoY. The share of budget tax and non-tax revenues increased by 19.0 p.p. to 82.6%, while the share of other revenues decreased by 2.1 times. Growth in tax revenues accelerated from 9.5% a year earlier to 19.9% YoY in 1Q 2018. Despite the overall decrease in budget spending, public investments in the power sector continue to increase (by 13.0% YoY). There was a reduction in financing of the public administration sector (by 24.4% YoY) and the agricultural and manufacturing sector (by 19.6% YoY), as well as in other expenditures (by 38.7% YoY).
Monetary policy

The refinancing rate down 200 bp

In 1Q 2018, the National Bank of Tajikistan decreased the refinancing rate on two occasions, from 16.0% to 14.0%. With decelerating inflation and a stable Tajikistani somoni (TJS) since the second half of 2017, favorable conditions supported the easing of monetary policy. At the same time, external factors, including geopolitical risks, are seen by the authorities as potential sources of instability for the domestic market. If such risks materialize, the National Bank is likely to change its monetary policy.

Key financial indicators remain weak despite measures taken to revive the banking sector. In 1Q 2018, the share of overdue loans amounted to 22.9% of total loans, or 34.3% including interbank loans. With some decrease in bank deposits in March 2018 (by 2.3% QoQ), the loan portfolio decreased by 4.7% QoQ.

FORECASTS

Investments to remain growth driver

With more clarity emerging about infrastructure project financing, there is a hope that investments will continue to be the locomotive of GDP growth in 2018. Investment activity in the medium term will partially depend on whether or not additional financial sources are found to proceed with hydro energy projects.

Persisting economic growth in countries which are key trading partners of Tajikistan together with higher prices in the global cotton and aluminum markets will support the country’s economy through international trade and remittances. The latter will be a driver to restore the country’s consumer demand. A bad performance from the banking sector could negatively affect economic growth in the medium term.

Source: National agencies, calculations by the authors
Inflation to revert to 7.0% (+2 p.p.) target range

Low inflation will remain throughout 2018 due to a high base effect and low prices in regional food markets. Inflation in the non-food sector may reach the target range sooner with growing global energy prices and a weakening national currency. With the low base effect decreasing, inflation will reach its target range.

Source: Calculations by the authors

SUMMARY

Macroeconomic forecasts for the Republic of Tajikistan

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<th>2018</th>
<th>2019</th>
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<td>Interest rate on interbank loans (in percent per annum)</td>
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<tr>
<td>Exchange rate, somoni per U.S. dollar (average for the year)</td>
<td>8.9</td>
<td>9.3</td>
<td>12.2</td>
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</table>

Source: Estimates by the authors
SPECIAL REPORT.

KEY FACTORS TO FURTHER DECREASE BELARUS’S REFINANCING RATE

By N. L. Mironchick, PhD

The monetary policy of the National Bank of the Republic of Belarus is aimed at supporting all market interest rates at a level that enables it to target inflation in order to ensure financial stability and sustainable economic development. The current inflation targets are to keep growth in consumer prices to within 6% in 2018, with a decrease to 5% by 2020, and to reduce it to 4% in subsequent years.

The refinancing rate set by the National Bank is a key tool to regulate all financial market interest rates and is used as a benchmark to set interest rates on loans provided to banks to maintain their liquidity. It determines the lower limit for interest rates on instruments to maintain banks’ liquidity and the upper limit for instruments to drain liquidity from the banking system.

There are many factors that determine the optimal level of the bank refinancing rate, including both domestic and external ones, fundamental and cyclical factors. At the same time, domestic factors play a major role in the process. The most important of these are inflationary expectations, the deviation between the forecast and target rates, the output gap, the risk premium and potential changes in the real exchange rate balance. It must be added that if these factors remain stable their contribution to changes in the refinancing rate will depend on current economic and monetary conditions.

The nominal refinancing rate decreased by 7.5 p.p. to 10.5% over the last two quarters. At the same time, annual inflation measured by the Consumer Price Index (CPI) decreased by 5.2 p.p. and amounted to 5.4% in March 2018. Thus, the real refinancing rate calculated based on actual inflation decreased over 2017 and 1Q 2018 by 1.9 p.p. and amounted to 4.8% in March 2018. This indicates that the decrease in the nominal refinancing rate in this period resulted in a decrease in its real level, thus determining the extent of easing for the monetary policy pursued by the National Bank (see Figure 1).
The real refinancing rate reached its neutral level of 4.5–5.5% in 1Q 2018. That is why its further rate changes will depend, firstly, on how inflationary expectations react to pro-inflationary factors and cause changes in prices, and, secondly, on changes in the neutral rate itself.

Inflationary expectations of Belarusian households remain quite high — they were estimated at 11.6% in February 2018 [1]. The convergence of inflationary expectations with the medium term inflation target takes time, because, as both foreign and domestic experience suggests, the process of decreasing inflationary expectations is slow in developing countries. This is explained by the sluggishness of expectations and their high sensitivity to temporary volatility in the national currency.

It must also be noted that the monetary policy easing in 2017 and 1Q 2018 by decreasing the refinancing rate was possible not only due to a slowdown in inflation, but also due to the fact that the economy did not function to its full capacity. The output gap gradually closed during this period, yet remained negative (Figure 2). Monetary policy had a stimulating effect supporting economic recovery. This disinflationary effect is expected to disappear as early as this year. When the output gap turns positive, that will become a pro-inflationary factor and economic growth will cease to be stable.
In these circumstances, only higher labor and capital productivity will enable faster economic growth. This requires a set of structural reforms to increase the performance of state-owned companies and their competitiveness in non-price terms, to improve the effectiveness of investments in education, infrastructure and technology, to diversify international trade, to improve the business climate, to upgrade traditional industries, and to develop corporate governance, small and medium businesses, legal institutions, etc.

It must also be realized that the recession in the Belarusian economy in 2015–2017 was caused not by monetary policy, but by the inability of many local companies to resist external shocks — to adapt rapidly and effectively to a changing environment where the RUB exchange rate plummeted and demand in Russia shrank in 2015–2016. This resulted in devaluation of the BYN in early 2015 and higher inflationary expectations of economic agents [3].

There are also higher risks of inflationary pressure from the labor market this year. Objectives to raise wages increase the risk that wages will unjustifiably grow at a faster rate than productivity. On the one hand, increased wages mean higher costs for employers. On the other hand, faster consumer demand growth boosted by increased wages whose growth exceeds that of goods and services creates conditions for the emergence of excess consumer demand and acceleration in inflation.

Real interest rates can also be reduced by lowering their neutral level, which is determined solely by fundamental factors. According to the interest rate parity concept, such factors include a balanced real interest rate abroad, expected changes in the balanced real exchange rate and a balanced risk premium tied to exchange rate movements.

**Figure 2. Output gap in Belarus**

Source: National Bank of the Republic of Belarus
The balanced real interest rate abroad is estimated at about 1.5–2%. It was calculated using a weighted estimate of the neutral level of balanced interest rates set by the Bank of Russia, the European Central Bank and the US Federal Reserve System [3]. The level of the weighted balanced interest rate abroad is highly unlikely to change over the next year or two.

The balanced risk premium for foreign investors that protects them from the risk of BYN exchange rate changes in the short term is estimated at about 0.5–0.8 p.p. This component is also unlikely to materially reduce its contribution to the neutral interest rate in the coming years. The balanced risk premium for short-term exchange rate fluctuations is a positive value for the majority of developing countries and amounts to at least 1 p.p. It also highly depends on the liquidity position of the country in foreign exchange terms and the maturity of its financial market.

Unfortunately, Belarus’s foreign exchange reserves are insufficient, while the country’s need for foreign currency is high. Borrowings are the main source for covering the balance of payments current account deficit. As of January 1, 2018, total external government debt amounted to 73.4% of GDP (it is recommended to be under 55% of GDP to ensure economic safety), while Belarus’s net international investment position amounted to –76.3% of GDP (it is recommended by the EU to be no lower than –35% of GDP). This large negative net international investment position indicates additional risks to the balance of payments being balanced and, thus, to national currency stability. Consequently, Belarus’s credit rating is insufficient, despite its recent upgrades by international rating agencies and the Organisation for Economic Co-operation and Development (OECD).

Further, the Belarusian financial market is not mature enough to enable non-financial organizations to properly hedge their currency risks. The regulatory framework requires amendments to regulate and detail the process under which non-financial organizations execute and account for hedging operations, as well as amendments regulating how currency hedging operations profits should be taxed, including tax treatment of costs of such operations. Improving the quality of the risk management function of businesses and benchmarking returns on long-term financial instruments are also required. Furthermore, other constraints include the fact that there are no risk taking players in the financial market to take buying or selling positions in currency forward contracts, as well as other factors [2].

As to the balanced real effective exchange rate (REER), it is known that it is determined by a country’s economy’s productivity compared to other countries which are this country’s trading partners (the Balassa–Samuelson effect). In the short-term, the REER of BYN is expected to decrease by 2.5–2.7% per year. This indicates a continuing lag in Belarus’s economic development required to ensure high economic growth and, as a result, to raise the neutral interest rate level. The REER can be strengthened by implementing structural reforms to overcome structural restrictions, to promote economic growth and to decrease dependency on global market conditions.

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4 In October 2017, Standard & Poor’s for the first time since 2011 upgraded its long-term sovereign credit rating for Belarus’s foreign currency liabilities to B with a stable outlook. The country’s sovereign ratings were also upgraded by Moody’s and Fitch in early 2018. In January 2018, Belarus was upgraded from group 7 to group 6 in the OECD’s Country Risk Classification.
Thus, the real refinancing rate is currently at its neutral level of 4.5–5.5% and its further movements will depend on inflationary expectations and changes in fundamental factors which determine the bank refinancing rate’s neutral level itself and do not depend on the monetary policy of the National Bank. If pro-inflationary risks materialize, interest rates could again increase above the neutral level.

REFERENCES


GLOSSARY

**Basis point.** A common unit of measure for interest rates and other percentages in finance. One basis point is equal to one hundredth of 1%, or 0.01%.

**Consumer Price Index (CPI).** The CPI characterizes changes over time in the general level of prices of goods and services that are purchased by households for non-productive consumption. It is an indicator for changes in the value of a fixed set of consumer goods and services in the current period compared with the previous (base) one. The CPI is calculated by the national statistical agency on the basis of data about the actual structure of consumer expenses, and therefore is the main indicator of the cost of living faced by households.

**Core inflation.** Inflation measured on the basis of the core consumer price index (Core CPI), which excludes changes in prices of certain goods and services regulated by the government, as well as the prices of goods and services that are subject to seasonal changes, such as fruits, fuel, passenger transport services, telecommunications services and most utilities.

**Dollarization.** The share of foreign currency deposits and loans in the total volume of deposits and loans in the banking sector.

**Floating exchange rate regime.** The International Monetary Fund describes a floating exchange rate as a largely market determined rate. The floating exchange rate regime implies that the centrally bank does not set targets and lets the rate be determined by market factors. However, the central bank reserves the right to purchase foreign currency to replenish the international reserves and make direct or indirect interventions to influence the exchange market to moderate the volatility of the exchange rate and prevent undue fluctuations.

**Inflation targeting regime.** A monetary policy regime envisaging that the main priority of the central bank is to ensure price stability. This involves the public announcement of numerical targets for inflation, with an institutional commitment by the central bank to achieve these targets. The monetary authorities influence the economy through changes in interest rates. Monetary policy decisions are primarily made on the basis of forecasts for economic development and the dynamics of inflation. An important component of the inflation targeting regime is that the public is regularly informed about measures taken by the central bank, which ensures its accountability for achieving its inflation objectives.

**KASE Index.** A free-float capitalization-weighted index that is the main index of the Kazakhstan Stock Exchange (KASE). The index is the ratio of the market prices of the stocks on the KASE Index list on the date of listing to their prices on a particular date.

**Managed float exchange rate regime.** In a managed float exchange rate regime, the central bank does not influence trends in the dynamics of the national currency’s exchange rate that are determined by fundamental macroeconomic factors. The regulator does not impose fixed restrictions on the exchange rate of the national currency and does not set target levels. The central bank smooths out fluctuations in the exchange rate to ensure the gradual adaptation of economic entities to changes in the external economic situation.
Monetary policy transmission mechanism. A process of influencing the economy and, primarily, the dynamics of prices through monetary policy decisions, including the central bank’s decisions with regard to changes in the interest rates on its transactions. The most important channel of monetary policy transmission is the interest rate channel, whose influence is based on the impact of the central bank’s policy on the interest rates at which economic entities can deposit or obtain funds and its impact on decisions on consumption, saving and investment, and thereby on the level of overall demand, economic activity and inflation.

Nominal effective exchange rate. A measure of the value of a country’s currency against a weighted average of foreign currencies. The rate compares the local currency against a basket of the currencies of the country’s most important trading partners, as well as the world’s major currencies. The value of foreign currencies in the basket are weighted according to the share of trade with the domestic country.

Real effective exchange rate. The weighted average value of a country’s currency against a basket of foreign currencies, adjusted for the effects of inflation. The weights are determined by comparing the relative trade balance of a country’s currency against each country represented in the basket. A country’s real effective exchange rate is derived by taking the average of the bilateral real exchange rates between the country and its trading partners and then weighting it using the share of each partner in the total volume of trade. The real effective exchange rate reflects changes in the competitiveness of a country’s goods against the goods of its major trading partners.

RTS (Russia Trading System) Index. A free-float capitalization-weighted index of 50 Russian stocks traded on the Moscow Stock Exchange, calculated in U.S. dollars. The list of stocks is reviewed every three months by the RTS Information Committee. The RTS Index value is calculated in a real-time mode. The index was introduced on September 1, 1995 with a base value of 100.

Output gap. An indicator of the difference between the actual output of an economy and the maximum potential output, expressed as a percentage of GDP. The output gap characterizes the ratio between demand and supply and is an aggregated indicator of the impact of demand on inflation. A country’s output gap can be either positive or negative. A positive output gap indicates that the actual output is higher than the economy’s recognized maximum-capacity output. A positive output gap is a sign of an acceleration in the rise in prices, whereas a negative output gap indicates a slowdown in inflation.

Potential (inflation-neutral) output. The overall level of output in an economy that can be produced and sold without creating conditions for changes in the rise in prices. The level of inflation-neutral output is not linked to any specific level of inflation and only indicates the existence or non-existence of conditions for its acceleration or deceleration.

Short-Term Economic Indicator of Kazakhstan. An instrument used to measure economic activity, which provides periodic tracking of economic trends generally at frequencies of more than once a year and is based on changes in the output indices of major sectors such as agriculture, industrial production, construction, trade, transportation and telecommunications. These sectors account for 67 to 68% of the nation’s GDP.

Structural liquidity deficit of the banking sector. The banking sector’s state characterized by lending organizations’ steady need to obtain liquidity through transactions with the central bank. A structural liquidity surplus means that lenders have a steady need to deposit resources with the central bank. The estimated level of a structural liquidity deficit or surplus is the difference between the debts in the central bank’s refinancing transactions and its liquidity-absorbing transactions.


**LIST OF ABBREVIATIONS**

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
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<tbody>
<tr>
<td>ADB</td>
<td>Asian Development Bank</td>
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<tr>
<td>CB RA</td>
<td>Central Bank of the Republic of Armenia</td>
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<tr>
<td>CIS</td>
<td>Commonwealth of Independent States</td>
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<tr>
<td>CPI</td>
<td>Consumer Price Index</td>
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<tr>
<td>Core CPI</td>
<td>Core Consumer Price Index</td>
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<tr>
<td>DSGE</td>
<td>Dynamic Stochastic General Equilibrium</td>
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<tr>
<td>EAEU</td>
<td>Eurasian Economic Union</td>
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<td>EBRD</td>
<td>European Bank for Reconstruction and Development</td>
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<td>EC</td>
<td>European Commission</td>
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<tr>
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<td>European Central Bank</td>
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<td>EDB</td>
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<tr>
<td>EDB/CIS</td>
<td>Center for Integration Studies of Eurasian Development Bank</td>
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<td>EEC</td>
<td>Eurasian Economic Commission</td>
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<td>EFSD</td>
<td>Eurasian Fund for Stabilisation and Development</td>
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<td>EU</td>
<td>European Union</td>
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<td>FRS</td>
<td>Federal Reserve System of the United States</td>
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<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
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<tr>
<td>GFCF</td>
<td>Gross Fixed Capital Formation</td>
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<td>IMS</td>
<td>Integrated Model System</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<td>IPPI</td>
<td>Industrial Producer Price Index</td>
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<td>ITR</td>
<td>Inflation Targeting Regime</td>
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<td>KASE</td>
<td>Kazakhstan Stock Exchange</td>
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<td>MEKR</td>
<td>Ministry of Economy of the Kyrgyz Republic</td>
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<td>MERB</td>
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<td>MEDRF</td>
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<td>OECD</td>
<td>Organization for Economic Cooperation and Development</td>
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<td>PPI</td>
<td>Producer Price Index</td>
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<td>RTS</td>
<td>Russian trade system</td>
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<td>SNA</td>
<td>System of National Accounts</td>
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<td>WB</td>
<td>World Bank</td>
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Major macroeconomic indicators of the EDB member countries

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Source: National statistical agencies, estimates by the authors
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