EDB economies: a course for sustainable development

08’2018
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INTRODUCTION

**EDB economies: a course for sustainable development**

In early August, external conditions for EDB countries deteriorated amid a further escalation of trade restrictions and US sanctions. An additional negative factor was the growth of volatility in emerging markets, especially in Turkey, where the currency showed a record level of depreciation. Among EDB countries, the highest pressure was seen in the Russian and Kazakh exchange rates – the Russian ruble in August exceeded 68.8 rubles to the US dollar, depreciating by 9.1% since the start of the month, while the depreciation of the tenge was limited to 4.3%. To neutralize the negative external factors, the Russian Central Bank suspended purchases of foreign currency for the Ministry of Finance, but, starting from August 17, it resumed purchasing foreign currency, thereby signaling a reduction in risks.

It should be noted: despite the challenges for the ruble, which needs to overcome the general downward pressure affecting developing countries’ currencies, the Russian economy’s macroeconomic indicators differ favorably from those of Turkey and most other emerging markets. At present, the Russian economy is experiencing twin surpluses – a positive budget balance supported by growth in fiscal and foreign exchange reserves against a background of favorable oil prices. At the same time, inflation is close to historical lows at a level slightly above 2%. Monetary and fiscal policy is based on rules that have contributed to an increase in Russia’s sovereign rating this year to investment grade.

Against a backdrop of increased volatility in world financial markets, a key priority for EDB countries should be maintaining sustainable development, which implies achieving the potential for economic growth while strengthening the foundations of macroeconomic stability. A key factor in the macroeconomic stability of emerging markets in the current environment is the overall debt load, which includes both public debt and private sector debt, including corporate.

In this regard, the low level of public debt should be noted in the largest economies of the EDB countries – Russia and Kazakhstan. At the same time, the trend towards growing debt in other EDB countries has in a number of cases led to the need for stricter fiscal policy and more attention to the problem of debt sustainability. In this macro overview’s special report, the Eurasian Fund for Stabilization and Development’s (EFSD) team of authors presents its debt sustainability assessments for a number of EDB/EFSD countries.

The analysis carried out by the economists of the EFSD points to the growth in debt of EDB/EFSD countries for 2009–2017 being in many respects a consequence of the active use of fiscal stimulus, in which budget expenditures were supported by government borrowing, “compensating” for falling tax revenues due to economic recession. The study analyzed risk factors that could affect the debt sustainability of the region’s economies in the medium term and a number of conclusions were drawn. The first was that they had experienced an increase in the share of less concessional loans and, consequently, the cost of debt servicing in the medium term may put
pressure on fiscal accounts and macroeconomic stability. The second was that the high level of accumulated debt, in particular, its foreign currency component, limits the options for macroeconomic policy in terms of countering external shocks.

Despite the increased external challenges and the need for further measures to stabilize the debt trends of a number of countries in the region, we note in general a significant improvement in the macroeconomic parameters of EDB countries over the past few years. At the same time, budget policy is beginning to focus more on providing greater stability to economic development. The favorable development of domestic economic conditions has been noted by international rating agencies in respect of EDB member countries. Ratings of Russia (S&P), and Belarus, Armenia and Kazakhstan (all Fitch) were confirmed over the second and early third quarters of 2018.

As for economic growth in the region, our overall forecast for the EDB member countries for 2018 has remained unchanged at 2.1%. The main driver of growth in most countries of the region this year has been the expansion of consumer demand amid growth of household real income and growth in lending. The slowdown in inflation observed in 2Q of this year has been reflected in the downward revision to our 2018 inflation projections. Our inflation forecasts have been reduced from 4.1% to 2.2% for Armenia, from 6% to 5.1% for Belarus and from 4.2% to 3% for Tajikistan. However, our 2019 inflation forecast for Russia exceeds the government’s target, with a rise to 4.9%, the main source of inflation growth being the planned increase in value-added tax.

In conclusion, it must be noted that the importance of regional integration in Eurasia serves as a kind of “contrast effect” in relation to the growth of protectionism in the world economy, as well as being a means to stimulate economic growth in the countries of the Eurasian Economic Union. According to the Eurasian Economic Commission, in the first half of this year all EAEU countries demonstrated positive growth in mutual trade, with the largest growth rates being shown by Armenia (28.5% YoY) and Kyrgyzstan (19% YoY). The same countries also showed an increase in growth rates for the first half of this year compared with the growth achieved in the same period for 2017. In the Russian Federation, the growth in trade with the EAEU countries in the first half of this year was 16.7%, while Kazakhstan demonstrated 11.3% growth over the same period. Further progress along the path of integration will help the region’s countries maintain quantitative economic growth rates and meet quality targets for sustainable development.

Yaroslav Lissovolik,
Chief Economist of the Eurasian Development Bank
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/).

The present report is for solely information purposes and cannot be viewed as a recommendation to buy or sell securities or other financial instruments. Neither information contained in the present analytical review nor other information related to the subject of this review that can be disseminated in the future cannot be used as a basis for the emergence of any contract. Information contained in the present review and conclusions drawn on its basis was obtained from open sources that EDB considers to be reliable. Despite all the scrupulousness in the preparation of this review, none of the experts, directors, managers, officers or counteragents of EDB gives any guarantee or assurance expressed or implied, and undertakes any responsibility with regard to the reliability, accuracy and fullness of the information contained in the present review. Any information contained in the present review can be changed any time without preliminary notice. None of the members of EDB undertakes the obligation to update, alter or supplement the present analytical review, or notify readers in any way if any of the facts, opinions, estimates, forecasts or assessments changes or loses its meaning.
EXTERNAL CONDITIONS

Economic activity remains at a high level. According to IMF forecasts, world GDP growth in 2018 and 2019 will stand at 3.9%. Economic growth in developed nations will be supported by an expanding fiscal policy. Increased oil prices will continue to contribute to the economic recovery of oil exporting countries.

Uncertainty concerning further growth in the world economy has increased. The United States’ increase in tariffs on imports of some goods from China and the European Union increased the risk of a further deterioration in world trade, which raises the uncertainty over world economic growth in the medium term. Furthermore, a noticeable acceleration in inflation in the United States could result in a faster-than-expected normalization of monetary policy, which will lead to an outflow of capital from emerging markets. Geopolitical risks remain, especially in the Middle East.

Economic activity in the United States accelerated in 2Q 2018. Annual GDP growth was 2.8%, following 2.6% a quarter earlier. The expansion of economic activity is tied to an increase in private household consumption expenditures and higher exports. The economy has been supported by soft fiscal and monetary policy.

The growth of oil prices contributed to an increase in inflation in the US and the Eurozone. High consumer activity and improved labor market conditions contributed to a further increase in the rate of price growth in the United States. Annual inflation in June increased to 2.9% (2.4% in March 2018). The rising energy prices in addition to expanding economic activity contributed to the acceleration of inflationary processes in 2Q.

The Federal Reserve System continued its cycle of raising interest rates. Following the June 2018 Fed meeting, the target range of the Fed rate was increased by 25 basis points to 1.75–2%. The decision was driven by the acceleration of inflationary processes, high economic growth rates and strong labor market indicators. This year, two further increases in the Fed’s interest rate are expected, with a subsequent approach to a neutral level in 2019.
Eurozone GDP growth remains at a fairly high level and, according to preliminary Eurostat estimates, totaled 2.2% in 2Q 2018 compared with 2Q 2017. Economic growth continues to be supported by a steady expansion of consumer activity against a backdrop of falling unemployment and continuing favorable credit conditions. In the medium term, a slowdown in economic growth is expected as monetary policy normalizes.

Inflation in the euro area in 2Q significantly accelerated and reached 2% in June in annual terms (1.3% in March 2018). The increase in the growth of consumer prices is mainly due to an increase in prices for energy carriers against a backdrop of rising oil prices. Inflation, excluding energy commodities, remains in the range of 1–1.4%, which is well below the ECB’s benchmark.

At the June meeting, the ECB confirmed plans to maintain key interest rates unchanged until the end of summer 2019. The maintenance of a significant stimulus from monetary policy was dictated by low core inflation and the need to bring it towards the target level over the medium term.

In 2Q 2018, oil prices continued to rise. Prices for Brent oil in 2Q increased by 11.5% compared with 1Q 2018 (and up 50% compared with the same period in 2017). Price growth factors included a reduction of stockpiles and the preservation of high demand against a background of accelerated global economic growth. Continued growth in oil prices in the second half of this year may be constrained by an increase in oil production within the framework of the agreements reached in June by OPEC+ countries, but this effect could be offset by a possible reduction in oil production by Venezuela and Iran.

### Forecast for key external economic indicators

<table>
<thead>
<tr>
<th>Year</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>
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</thead>
<tbody>
<tr>
<td>2018</td>
<td>71.1</td>
<td>1300</td>
<td>96.3</td>
<td>1.19</td>
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<tr>
<td>2019</td>
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<td>97.1</td>
<td>1.25</td>
<td>2.5</td>
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<tr>
<td>2020</td>
<td>66.2</td>
<td>1343</td>
<td>97.7</td>
<td>1.25</td>
<td>2.9</td>
</tr>
</tbody>
</table>

*Source: International agencies, calculations by the authors, EEC*
Continued high economic growth rates
Economic activity in Armenia in 2Q 2018 remained at a high level. The annual increase in the economic activity indicator calculated by the Statistical Committee was 7.4% on average for 2Q (10.6% a quarter earlier). Given the indicator’s high correlation with the GDP growth rate, economic growth in 2Q may be approximately 7%, while for 1H it may exceed 8% compared with the same period of last year, retaining its leadership in terms of GDP growth among EDB participant countries.

Decrease in consumer demand
After an annual increase of 3.7% in January-March 2018, retail trade turnover in 2Q decreased by 2.2% compared with the same period of last year. One factor in the decline in consumer activity may have been a slowdown in the growth of remittances, while lending and real wages growth continued to support consumption.

The slowdown in consumer demand was reflected in a decrease in the growth of imports in value terms, from 40.6% YoY on average for 1Q to 29.2% in 2Q. The export growth rate for the same period declined from 30% to 12.6%, reflecting a slowdown in industry, while the persisting high price competitiveness of Armenian goods continued to support exports.

Industry is slowing down after a high rate of growth recovery
Industrial production in 2Q 2018 decreased by 0.3% compared with the same quarter of last year after an increase of 8.2% a quarter earlier, which can be explained by a reduction in consumer activity and the high base effect of last year. Manufacturing was a major contributor to the slowdown – annual growth for which in 1H 2018 declined to 8.6% compared with a growth level of 18.8% in 1Q. The drop in output compared with the previous year continues in the mining industry too, against a background of declining copper prices on world markets and the suspension of the development of the Teghut deposit.
Construction, agriculture and services provided support for economic growth. Output in these sectors in January–June 2018 increased by 13.5%, 5.5% and 18.1%, respectively, compared with the corresponding period of 2017.

International rating agency Fitch confirmed the long-term credit rating of Armenia’s domestic and foreign currency bonds at the level of “B+” with a positive outlook, noting the persistence of macroeconomic and financial stability and fiscal consolidation measures.

Inflation

**Slowdown of inflationary processes**  
Inflation’s deviation from the target rate increased in 2Q. Annual inflation in June was 0.9%, slowing from 3.7% in 1Q 2018. This is largely due to this year’s good harvest and, as a result, a fall in prices for fruit and vegetables (prices for fruit and vegetables in June 2018 decreased by 16.1% and 22.6%, respectively, compared with June 2017).

![Inflation and the refinance rate](chart1)

**External trade and the real exchange rate**  
In 2Q 2018, the Armenian dram strengthened compared with the majority of the currencies of Armenia’s trading partner countries. It strengthened most of all against the Russian ruble (by 8% and 7.9% against the previous quarter and 2Q

![Exchange rate](chart2)
2017, respectively), which was due to the weakening of the Russian currency on the world market after the announcement in April 2018 of new US sanctions. As a result, the annual depreciation of the nominal effective exchange rate of the dram in 2Q decreased to 2.2%, from 4.9% a quarter earlier.

The trade deficit continued to expand in 2Q of this year and reached USD 1.1457 billion in the first half of the year (compared with a deficit of USD 755 million a year earlier). The increase in the trade deficit is due to faster growth of imports versus exports given continued strong economic activity.

**Growth in remittances more restrained**

The high base of last year in the volume of remittance inflows, driven by the Russian economy’s recovering growth rate, had a restraining effect on inflows trends in 2Q of this year. According to the Central Bank of Armenia, the growth rate of remittances to the country slowed in 2Q to 4.2% YoY after an increase of 14.5% a quarter earlier. At the same time, the volume of incoming transfers for January-June 2018 (USD 787.6 billion) was the highest level for a first half year since 2014.

**Fiscal policy**

**Falling fiscal deficit and public debt**

The state budget of Armenia saw a deficit of AMD 3.9 billion in January-June 2018, which is nearly 10-fold down compared with the same period of last year (AMD 38.3 billion). The deficit reduction was due to the country’s budgetary consolidation policy, which led to a reduction in budget expenditures for the period by 1.6% compared with the corresponding period of last year. The largest decreases were in transfers to the economy (by 18.4%), expenses on services and goods (by 5.9%) and operations with non-financial assets (by 9.5%). Furthermore, budget revenues exceeded the level of the same period last year by 4.3%.

Earlier years’ growth in public debt predetermined the further expansion of its servicing costs, which, in 1H 2018, amounted to AMD 68.3 billion, which is 16.4% higher than the level for January-June 2017.

Armenia’s state debt in 2Q 2018 decreased by USD 182.9 million and amounted to USD 6.7 billion at the end of June. The debt decrease in the fiscal quarter was due to repayments of both domestic debt (USD 57.4 million), as well as external debt of the government and the Central Bank (USD 125.5 million).
Monetary policy

Refinancing rate at 6%  Given inflation’s increasing deviations from the target level in 2Q, the Central Bank kept the refinancing rate at the level of 6%, which, according to the regulator, will contribute to inflation approaching its target level.

Growth in consumer lending  Despite the fact that the refinancing rate has remained unchanged for an extended period of time, interest rates on bank loans in 2Q 2018 continued to decline, which was reflected in the further expansion of lending to residents in AMD, the annual growth rate of which in 2Q 2018 was 35.1% after 32.7% a quarter earlier.

Dollarization continues to decline  Dollarization of residents’ bank deposits continued its decreasing trend. In June 2018, the dram’s share of residents’ deposits rose to 46.4%, 4.5 p.p. more than in June 2017. The continued positive trend was aided by higher yields on deposits in AMD compared with USD deposits (the spread between interest rates in 2Q of the current year amounted to 5.9 p.p. and 5.3 p.p. in short-term and long-term deposits, respectively).

FORECASTS

Continued high economic growth rates  A high level of economic growth is expected in 2018, which, according to our forecasts, will be 5.8%. Support for economic growth will continue to be stimulated by monetary conditions, expanding external demand and the continued positive...
trend in inflows of remittances. Fiscal policy will produce a restraining influence on the economy against a backdrop of the ongoing fiscal consolidation. In the medium term, we forecast economic growth at 5%, which is consistent with the economy’s long-term potential.

**GDP in constant prices\(^1\)**

(Year-over-year percent change)

**Nominal exchange rate,**

**AMD per U.S. dollar**

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\(^1\) Here and elsewhere fan chart ranges correspond to 10%, 50% and 75% confidence intervals.

**CPI**

(Year-over-year percent change, end of year)

**Interbank REPO rate**

(in percent per annum)

**Source:** calculations by the authors, EEC
After a slowdown in inflation in 2Q 2018, which was largely due to temporary factors, it is expected to gradually return to the target in the second half of the year. Preserving high economic growth amid rising wages and lending could stimulate an increase in domestic inflationary pressures. As a result, we forecast the growth in consumer prices in 2018 at 2.2%, followed by the development of inflationary processes in line with the target benchmark.

As inflation accelerates, the refinancing rate is expected to increase to its neutral level, which we estimate at 7–7.5%.

**Gradual return of inflation to target levels**

**Refinancing rate to reach a neutral level**

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**SUMMARY**

**Macroeconomic forecasts for the Republic of Armenia**

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<th>2020</th>
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<td>3.8</td>
<td>4.0</td>
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<tr>
<td><strong>GDP in constant prices (YoY percent change)</strong></td>
<td>5.8</td>
<td>4.7</td>
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<tr>
<td><strong>Interbank repo rate (in percent per annum)</strong></td>
<td>6.1</td>
<td>7.4</td>
<td>7.4</td>
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<td><strong>Exchange rate, the national currency against the U.S. dollar (average for the year)</strong></td>
<td>482</td>
<td>484</td>
<td>489</td>
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</table>

**Source:** calculations by the authors, EEC
Republic of Belarus

Trends

GDP

A slowdown in economic growth

According to the National Statistics Committee, the Republic of Belarus’ economic growth in 2Q 2018 compared with the corresponding quarter of last year amounted to 3.9% (5.2% for the quarter before).

GDP trends in 2Q 2018 were driven by the following factors:

- Slowing investment activity. The annual growth rate of investment in fixed assets in 2Q 2018 was 7.1%, compared with 20.8% a quarter earlier. The slowdown in investment activity may reflect a gradual change in enterprises’ economic sentiment, as recorded by the National Bank of the Republic of Belarus²;

- High consumer activity. Retail trade turnover in 2Q 2018 increased by 10.1% compared with the same period in 2017, versus 9.7% growth one quarter earlier. Consumer demand was supported by continued high lending activity and growth in household incomes;

- The growth in industrial production in 2Q 2018 slowed to 6.2%, after 9.4% a quarter earlier. Against a backdrop of enterprises’ declining economic sentiment, a slowdown in growth was observed in most manufacturing industries. The largest drop was recorded in petroleum products output, owing to the receding low base effect of last year due to the resolution in April 2017 of the “gas conflict” between the Republic of Belarus and the Russian Federation.

The persistence of high economic growth rates and the macroeconomic balance in general led to international rating agency Fitch’s confirmation in July 2018 of Belarus’ credit rating of “B” with a stable outlook for debt in both domestic and foreign currency.

### Inflation

**Slowing inflation due to the impact of temporary factors**

Annual inflation in 2Q 2018 slowed to a new historic low and amounted to 4.1% in June. According to our estimates, slowing inflation in April-June 2018 was temporary and mainly due to the impact of climatic factors. Core inflation accelerated slightly in 2Q (to 3.1% YoY in June, compared with 3% YoY in March 2018), but still remains at historically low levels. High consumer demand and accelerated price growth for certain commodities continued to exert pressure on core inflation. A restraining factor was the strengthening of the Belarusian ruble and the persistence of low inflation in Russia.

**Source:** National statistical office, calculations by the authors, EEC
**Exchange rate**

**Reduction in demand for foreign currency**
The slowdown in economic activity in April-May 2018 contributed to a decrease in 2Q of net demand for foreign currency on the part of businesses, which amounted to USD 92 million (USD 386.6 million a quarter earlier). Net foreign currency supply from individuals increased in 2Q, which could be due to deferred demand for tourism. As a result, the Republic of Belarus’ domestic currency market had a net supply of foreign currency in 2Q 2018, which, among other factors, contributed to the increase in the level of international reserve assets.

**Reduction in undervaluation of the Belarusian ruble**
As of July 1, 2018, the volume of gold and foreign currency reserves amounted to USD 6.8314 billion, having fallen since early April 2018 by USD 163.3 million. The decrease in international reserve assets was due to the scheduled repayment by the National Bank and the government of Belarus of foreign currency obligations (about USD 1.1 billion in 2Q 2018).

**High import intensity leads to a deterioration in the trade balance**
The appearance of a net supply in the foreign exchange market had a strengthening influence on the Belarusian ruble’s exchange rate. The value of the basket of currencies calculated at weighted average rates in 2Q 2018 decreased by 3.5% compared with the previous quarter. The Belarusian ruble has shown its strongest strengthening against the Russian ruble, which is due to the weakening of the Russian currency in the international currency market after the introduction of additional US sanctions in April. As a result, the annual weakening of the real effective rate of the Belarusian ruble in 2Q 2018 slowed to 1% compared with 6.1% a quarter earlier.

High domestic demand growth rates with high import intensity led to a decrease in 2Q 2018 of the positive balance of trade in goods and services to USD 12.6 million, compared with USD 412.5 million a year earlier. The deterioration in the balance was due to an increase in the negative trade balance, while the positive balance of trade in services continued to increase.

**Fiscal policy**

**Expansion of the budget surplus**
Favorable price conditions on the oil market and continued high consumer activity led to the creation of a significant surplus in the republic’s budget, which in January-June 2018 amounted to BYR 2.7 billion, or 4.8% of GDP (BYR 1.3 billion, or 2.7% of GDP, a year earlier). The main contribution to the expansion of the budget surplus came from an increase in revenues from foreign economic activity by 51% YoY and value added tax by 27% YoY.
Monetary policy

**Refinancing rate is reduced to 10%**

A slowing of inflation to historically low levels and the prediction by the National Bank of the Republic of Belarus that inflation processes will remain stable within target levels through to the end of the current year and in the medium term allowed the regulator to lower the refinancing rate in June 2018, by 0.5 p.p. to 10%.

**Lending activity at a high level**

Lending activity in 2Q 2018 remained high, but its expansion began to gradually slow down. The issuance of ruble loans by banks in 2Q 2018 increased by 39.3% compared with the corresponding quarter of last year, while in 1Q 2018 the annual growth was 59.8%.

**Dollarization of bank deposits is decreasing**

The higher yield of ruble deposits compared with foreign currency, given continuing low inflation and a stable Belarusian ruble to the US dollar exchange rate, led to a further influx of fixed term ruble deposits from the population, the share of which in all banking deposits in June 2018 amounted to 18%, an increase for the year of 1 p.p. (for the quarter – 0.7 p.p.). As a result, the level of dollarization of the broad money supply continued to decline and the share of the ruble component in June 2018 increased to 37.5%, compared with 26.9% a year earlier.
FORECASTS

Continued high growth rates

Our outlook for the Republic of Belarus’ economic growth remains unchanged. 2018 should see GDP growth of 3.8%, which is the highest level since 2011. Persistent strong consumer activity at a time of increasing incomes and expanded lending will contribute to continued high growth rates. External demand will be supported by the steady growth of the main economic partners and somewhat favorable external conditions. In the medium term, economic growth rates will move towards their potential level, which we estimate at 2%. As structural transformations in the economy are implemented, potential growth rates could be revised upwards.

Source: Calculations by the authors, EEC

Acceleration of inflation through to the end of 2018

Inflation is projected to increase to 5.1% by the end of this year. Acceleration of inflationary processes in the second half of this year is attributed to a receding of the disinflationary influence from the real sector against a background of high consumer activity indicators. Additional pro-inflationary factors include growth in fruit and vegetable inflation due to a receding of the high base effect of last year, a gradual increase in inflation in Russia and the growth of volatility in foreign exchange markets observed at the beginning of the second half of the year. In subsequent years, we expect inflation to remain within the target levels of the National Bank of Belarus.

According to our estimates, maintaining the interbank rate within the range of 10–11% given the expected acceleration of inflationary processes will help to level out possible economic imbalances. In the medium term, in the absence of shocks to the economy, the potential for a further lowering of interest rates remains.
SUMMARY

Macroeconomic forecasts for the Republic of Belarus

<table>
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<th>2019</th>
<th>2020</th>
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<tbody>
<tr>
<td><strong>CPI (end of period, YoY percent change)</strong></td>
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<td>5.3</td>
<td>4.9</td>
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<tr>
<td><strong>GDP in constant prices (YoY percent change)</strong></td>
<td>3.8</td>
<td>1.7</td>
<td>2.1</td>
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<td><strong>Interest rate on overnight interbank loans (in percent per annum)</strong></td>
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<td>10.2</td>
<td>10.0</td>
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<td><strong>Exchange rate, Belarusian rubels per U.S. dollar (average for the year)</strong></td>
<td>2.01</td>
<td>2.04</td>
<td>2.13</td>
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</table>

Source: Calculations by the authors, EEC
REPUBLIC OF KAZAKHSTAN

TRENDS

GDP

Stabilization of GDP growth

The continuing favorable price environment on the world oil and metals markets is ensuring stable growth in the mining sectors and contributing to the recovery of domestic consumer demand. According to preliminary estimates, in 2Q 2018 GDP grew by 4.1% (+4.1% YoY in 1Q 2018). In 2018, the low base effect was exhausted, which partly ensured stable quarterly growth.

The mining and services sectors are the growth drivers in 2Q 2018

In 2Q 2018, the contribution of the industrial sector to GDP growth decreased somewhat, mainly due to a reduction in output in the water supply sector and a slowdown in growth in manufacturing industries. In the mining industry, the accelerating production trend continued (+5.8% compared with 2Q 2017). Also, there was a strengthening of growth in the services sector, partly reflecting the restoration of consumer confidence against a background of real income growth. Despite the fact that the construction sector’s contribution has decreased, it still provides support to the economy (+2.0% YoY).

On the expenditure side, net exports are supporting the economy. The increase in exports in real terms is being accompanied by a restoration of imports. Domestic demand on the part of households and the growth of investments are also making a positive contribution to GDP growth.

Leading indicators point to continued growth

The consolidated leading indicator calculated by the EEC signals that in the first months of 3Q 2018 the attained level of economic activity will remain in place. Expectations suggest that the current level of business activity in the construction sector, trade and industry will continue. According to a survey conducted by the National Bank of Kazakhstan, economic agents do not expect economic activity to accelerate in 3Q 2018 and believe that the demand for final goods will grow at the current rate.
Inflation

Inflation within the target corridor

On average in 2Q 2018, annual inflation was 6.2% and was within the target corridor of 5.0–7.0% for the end of 2018. During 2Q, food prices fell (mainly for vegetables), reaching the level of 4.2% YoY at the end of June 2018. Despite the increased volatility of the tenge exchange rate in April 2018 and the growth of excises for some goods, inflation in the non-food sector remained stable (8.4% YoY on average for 2Q). The effect of increasing excises on diesel fuel was partially offset by a decrease in gasoline prices given the excess supply. The price and tariff trends for services remain within the inflationary corridor, and at the end of June 2018 the annual price change in this consumer basket group was 5.5%.

Exchange rate volatility has a limited effect on inflation

According to a survey published by the National Bank of Kazakhstan, after some spike in April 2018 inflation expectations again began to slow down and, by the end of June 2018, stabilized at 5.9%, which in part underscores the level of confidence in the monetary policy pursued by the National Bank of Kazakhstan. In this context, the new increased exchange rate volatility in early August 2018 may also have a limited impact on inflation expectations, and the downward inflation trend is likely to slow down, but will remain within the targets.

Source: National agencies, calculations by the authors, EEC
**External sector**

**Current account surplus**

According to preliminary estimates, the trade surplus expanded against a background of depreciation of the tenge’s real exchange rate (~3.4% in comparison with 2Q 2017) and rising world prices for the country’s main export commodities. In 2Q 2018, the positive balance of goods and services amounted to USD 5.1 billion, which is 1.6-fold more than the surplus a year earlier. Exports of goods and services grew faster (+15.1% YoY), while nominal imports grew by 1.6% YoY. Increased nominal volumes of export earnings were accompanied by rising incomes for foreign direct investors, which increased by 36.0% compared with 2Q 2017. This factor limited the reduction of the current account deficit, which in 2Q 2018 amounted to USD 834.3 million (USD 1.4 billion a year earlier). In terms of financial account operations, the main inflow of capital was from foreign direct investment (USD 1.2 billion). Reserve assets (excluding assets of the National Fund of the Republic of Kazakhstan) as of July 1, 2018, amounted to USD 30.1 billion, which covers the financing needs for 8.2 months of imports of goods and services.

**Fiscal policy**

**Budget deficit in 1H 2018**

In 1H 2018, the state budget saw a deficit of KZT 78.9 billion (KZT 1.1 trillion a year earlier). The improved level of public finances occurred against a backdrop of rising world prices for metals, which led to tax revenue plans being exceeded. An additional factor that contributed to the growth of state revenues consisted of measures taken to improve tax administration. In this regard, despite a decrease in the contribution of transfer payments, revenue grew by 4.8% compared with January–June 2017.

State budget expenditures increased by 9.6% YoY. Out of the total expenditure for 1H 2018, 57.0% was spent on the social sphere. The 2018 budget provides for financing within the framework of the president’s five social initiatives. In 1H 2018, funds were allocated from the state budget to support entrepreneurship and additional payments for teachers’ salaries.

**Moderate level of debt in public sector**

The growth of public debt by 5.2% in 1H 2018 compared with 4Q 2017 was mainly provided by the issue of National Bank of Kazakhstan notes and government long-term treasury bonds. Government external debt has increased by 1.5% since early 2018, mainly due to an increase in the volume of Eurobonds (+2.6%) and loan proceeds from the Asian Development Bank (+1.5%).
Monetary policy

Base rate reduction  In 2Q 2018, the base rate was reduced on two occasions, from 9.5% to 9.0% overall. At the same time, the monetary authorities signaled limited potential for a further easing of monetary conditions against a backdrop of an increased probability of inflationary risks from the external sector.

The average Tenge OverNight Index Average rate in 2Q 2018 was 8.29%. For more than a year now, it has stood at the level of the lower boundary of the interest rate corridor for the National Bank of Kazakhstan’s base rate, reflecting the excess liquidity in the system. In 2H 2018, the National Bank of Kazakhstan will consider narrowing the boundaries of the rate corridor.

Growth in newly issued loans  By the end of 2Q 2018, key restructuring stages of the banking sector had been completed. In June 2018, the compression trend in the deposit base of individuals and corporates was interrupted (+1.2% compared with the beginning of the year). While the proportion of customer deposits in foreign currencies dropped to 44.1% as of July 1, 2018, compared with 47.6% at the beginning of 2018. The loan portfolio of banks so far has continued to decline, falling by 0.8% compared with the beginning of the year. The share of NPL fell to 8.8% by the end of June 2018. The volume of new loans in 2Q 2018 exceeded the level of the same period previous year by 30.3%. The average rate on loans to corporates in the domestic currency decreased from 13.2% in December 2017 to 11.7% in June 2018.
Inflation will remain within the target corridor

The risks of slowing inflation that prevailed in the 1Q exhausted themselves in 2Q against a backdrop of more intensive external economic factors. By the beginning of 3Q 2018, the balance of risks had shifted toward accelerating inflation. On the other hand, the possible tightening of monetary conditions as a result of a narrower interest rate corridor will keep inflation within the target corridor of 5.0–7.0% at the end of 2018. In the medium term, given stabilization of inflation expectations, inflation will be within the target, which is gradually decreasing and by the end of 2020 will be at 4.0%.

Gradual economic growth in the long run

Rising prices on world markets for oil and metals create a favorable external economic background for both the real sector as well as the public finance sector and foreign trade accounts. Among the domestic drivers of growth, consumption and investment will make the main contribution. Growth in the household’s real incomes, in addition to slowing inflation factors, will be indirectly supported by the government’s measures for the implementation of the five social initiatives of the president. The implementation of infrastructure projects within the framework of state development programs will support economic growth in the medium term.

At the same time, fiscal stimulus will gradually decline, including as a result of the development of public-private partnerships. Lending potential remains limited for the time being but, as the restructuring process in the banking sector is completed, it will become an additional source of growth.

The key factors that could limit growth include a worsening in the external environment, including the risks of protectionism in world trade, and the economy’s still high dependence on oil prices.
**SUMMARY**

Macroeconomic forecasts for the Republic of Kazakhstan

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*Source: Calculations by the authors, EEC*
KYRGYZ REPUBLIC

TRENDS

GDP

Decrease in GDP in 2Q 2018

2Q 2018 saw a low level of economic activity, which in general was in line with our expectations (see EDB Macro Review, June). At the same time, the amplitude of the slowdown in economic growth surpassed our estimates somewhat. In January-June 2018, GDP growth slowed to 0.1% (compared with January-June 2017), and in 2Q 2018 there was a decline of 0.8% compared with 2Q 2017.

Decline in extractive industry continued; services and construction supported the economy

In April-June of 2018, the rate of reduction in gold production at the Kumtor mine accelerated (~39.6% compared with 2Q 2017). This was the key reason for the production fall in the manufacturing industry (~10.6% YoY). A reduction in production was also noted in the extractive industry, which was partly due to the high base effect. Other sectors of the economy showed positive growth, and services (+4.8% YoY) and construction (+7.7% YoY) continued to make the main positive contributions. Despite the long winter and sharp temperature swings in the spring months of 2018, growth in the agricultural sectors remains stable (+1.5% YoY).

On the expenditure side of GDP in 1Q 2018, household consumption and gross capital formation contributed positively, while net exports declined amid a contraction in exports and an increase in imports in real terms.

Leading indicators signal a restoration of economic activity

The composite leading indicator calculated by the EEC indicates a recovery in economic activity in the short term. In all probability, 3Q 2018 will witness a reversal in the annual gold production growth trend, and the rate of reduction will begin to slow. In other sectors of the economy, business activity will continue at current levels. The preconditions for this are a stable level of consumer confidence and a positive credit impulse.

Inflation

Inflation remains below the target corridor of 5.0–7.0%

In 2Q 2018, annual deflation in the food sector accelerated on a monthly basis, thereby ensuring a sharp slowdown in the growth of the general price level. The sharp slowdown is explained in part by the effect of a high base: a year earlier, vegetable...
prices rose 1.6-fold YoY. Weak price conditions on the regional grain market and the world sugar market also contributed to deflation in the food sector. Despite the growth of fuel prices amid rising world oil prices, the strengthening of the som against the US dollar since the beginning of the year has ensured low inflation in the non-food sector. Inflation in the services sector remained stable. In 2Q 2018, CPI increased by 1.4% YoY. Of its main components, food prices decreased by 3.5% YoY, non-food sector prices rose by 3.2% YoY, and service sector prices were up 7.3% YoY.

In the first months of 3Q 2018, inflation will remain below the target corridor. The preconditions for this are the absence of supply factor shocks and a stable domestic currency.

External sector

Current account deficit

The som’s real effective exchange rate did not have a significant impact on the foreign trade performance in 1Q 2018. According to preliminary estimates, in 1Q 2018 the current account deficit expanded to USD 426.9 million. A year earlier, the deficit was USD 92.9 million. The decrease in exports of goods by 10.9% YoY was accompanied by a 36.5% increase in imports and a moderate increase in the net inflow of remittances (11.6% YoY). The export of goods decreased for such items as raw materials (–19.0% YoY), investment goods (–64.1% YoY) and intermediate goods (–4.4% YoY). The import growth was due to an increase in volumes of imported consumer goods (1.6 times more compared with 1Q 2017), intermediate goods (+15.2% YoY), investment goods (1.8-times more), and energy products (+5.9%).
Fiscal policy

Budget deficit at 0.2% of GDP

In 1H 2018, the budget deficit was reduced to 0.2% of GDP, while a year earlier the budget deficit was 1.9% of GDP. Growth of the budget’s revenue side was ensured by tax revenues (+18.1% YoY) and proceeds from the sale of non-financial assets up by 1.6 times, while a decrease was noted for other incomes. Budget revenue for 1H 2018 grew by 1.1% YoY. Current expenses increased by 5.1% compared with 1H 2017, while expenses on the acquisition of non-financial assets decreased by 40.2% YoY. Total expenses decreased by 3.9% compared with 1H 2018.

Public debt increased by 0.7% compared with the beginning of 2018 and amounted to 57.1% of GDP at the end of May 2018. The decline in external debt was 1.2% compared with the beginning of the year, while domestic debt in the first five months grew by 13.7%.

Monetary policy

The discount rate was reduced from 5.0% to 4.75%

In May 2018, the discount rate was reduced by 25 basis points to 4.75%. The current recovery of domestic demand is accompanied by a low inflationary background in the food sector, which we expect in the medium term to lead to continued moderate price changes within the monetary policy target range of 5.0–7.0%. Money market rates on average for 2Q 2018 amounted to 2.5%.

Rates on newly placed deposits in domestic currency for the year decreased from 2.7% on average for 2Q 2017 to 2.5%. The cost of credit resources provided by commercial banks in domestic currency on average for 2Q 2018 was 18.3% (19.2% a year earlier).
The volume of newly issued loans increased by 11.9% compared with 2Q 2017, mainly due to the growth of loans issued in domestic currency (+15.1% YoY). Despite the reduction in deposit rates, the volume of newly accepted deposits in 2Q 2018 increased by 15.5% YoY, including an increase in those attracted in the domestic currency by 15.3% YoY.

**FORECASTS**

**Inflation will rise to reach the target corridor in the medium term**

In the second half of 2018, a number of factors are appearing that could increase the risk of accelerating inflation. Increased volatility in the regional financial market could spread to the domestic foreign exchange market and, through the exchange rate channel, may contribute to accelerated inflation. In 2018–2019, a smaller grain harvest in Kazakhstan is expected, which could potentially interrupt deflation in domestic flour and breadstuffs. World energy prices were fixed at a new, higher level, and if this trend continues, the overall level of prices may climb due to a second-round effect. However, these factors have so far only just appeared and the strength of their momentum will be determined over time. Among the existing factors, the balance of risk is leaning toward a continued weak inflationary background until the end of 2018, and, as domestic demand recovers, inflation will reach the target corridor of 5.0–7.0%.

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

**Nominal exchange rate, KGS per U.S. dollar**

*Source: Calculations by the authors, EEC*

**Slowdown in economic growth**

With the release of statistics for 2Q 2018, we have revised our assumptions about quarterly production at the Kumtor mine. Whereas we expected a relatively uniform quarterly output pattern, according to new management guidance peak production
should be reached in 4Q 2018. Accordingly, the negative contribution made by Kumtor’s production levels will decrease by the end of the year. In the medium term, economic growth will reach a level close to its potential against a background of gradual consolidation of the budgetary sector and a limited increase in the inflow of remittances.

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

**Macroeconomic forecasts for the Kyrgyz Republic**

<table>
<thead>
<tr>
<th></th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
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<tbody>
<tr>
<td><strong>CPI (end of period, YoY percent change)</strong></td>
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**Source:** Calculations by the authors, EEC
Russia’s economic growth in 2Q 2018, according to preliminary Rosstat estimates, was 1.8% compared with the same period previous year, after an increase of 1.3% a quarter earlier. Consumer demand was one of the main drivers of growth.

Increased consumer activity was driven by the positive growth in real income seen since the beginning of 2018. In 2Q 2018, real income exceeded the level of 2Q of last year by 2%, while the increase in real wages for the same period amounted to 7.4%.

In 2Q, consumer lending also expanded. Banks claims on households in 2Q increased by 5.3%, or RUR 729 billion, and on July 1, 2018 amounted to RUR 14.4 trillion, which is 18.5% higher than the same period of previous year.

The turnover of retail trade in 2Q exceeded the level of the same period of last year by 2.7%. The largest volume increases occurred in June, when the World Cup provided an additional stimulus. According to Central Bank estimates, the championship provided a positive contribution to the annual rate of GDP growth of 0.1–0.2 p.p.

Industrial production stats in 2Q improved considerably, in particular after the Rosstat data for the period from 2017 to the beginning of 2018 was revised. Most of the major manufacturing industries in 2Q showed growth in volumes, though metallurgy was an exception, with the largest production decline for many years at 14.2% YoY in June. A revision in June of the OPEC+ agreement’s conditions and a gradual increase in oil production had already had a positive impact on extractive industry trends by the end of 2Q, which we expect to continue in the second half of the year.

More moderate optimism about the development of industrial production in 3Q has been incorporated into the leading indicators. The July PMI for the manufacturing industries indicates the most significant deterioration in the market environment since April 2016.

Agricultural output continues to exceed the level of the same period of last year (an increase of 1.9% YoY in 2Q compared with 0.1% YoY a year earlier), however, the
growth rate is slowing down. In second half of 2018, the slowing trend is expected to continue, given the record harvest last year.

**Rating agencies do not rule out an upgrade of Russia's rating**

International rating agency S&P confirmed Russia’s sovereign rating at "BBB-" with a stable outlook. At the same time, information about a possible upgrade of the rating was a positive signal from the agency.

**Inflation**

**Inflation at a low level**

Annual inflation in 2Q was at a low level and amounted to 2.3% in June. The main pressure on general price levels was derived from non-food products and, to a greater extent, gasoline prices, which were boosted by the growth of excise taxes and world oil prices. The slowdown in the growth of prices for food products against a backdrop of an increase in the supply of fruit and vegetable products restrained inflation.

**Stabilization of inflation expectations**

Inflationary expectations stabilized and became less sensitive to short-term factors, but they remain above actual inflation (according to the Central Bank of Russia, the household’s inflationary expectations in July were 9.7%).

**Reduction in the influence of external factors on domestic prices**

The main inflationary risks include geopolitical factors and the growth in volatility on the foreign exchange market observed in August. However, judging by consumer prices’ limited reaction to the depreciation of the ruble in April this year, the exchange-rate pass-through effect in 3Q may be rather restrained.

**Source:** National statistical office, calculations by the authors, EEC
External sector

Stabilization of the exchange rate in 2Q

After sharp depreciation in the Russian ruble exchange rate at the beginning of 2Q 2018 against a backdrop of a new round of US sanctions, a period of stabilization of the Russian currency followed. The effect on the ruble and financial markets was largely mitigated by high oil prices. In 2Q, the depreciation of the real effective ruble exchange rate was 5.3% compared with the previous quarter, while the nominal rate to the US dollar depreciated by 7.9% over the same period.

Return of volatility

External conditions worsened further and pressure on the Russian ruble grew in the first half of August, when the nominal exchange rate of the ruble against the US dollar depreciated to the worst level over the past two years and exceeded 68 rubles per US dollar. According to our estimates, after the change in the exchange rate at the beginning of 3Q the undervaluation of the real ruble exchange rate against the US dollar was about 8%. In order to neutralize the weakening of the Russian currency, the Central Bank of Russia suspended purchases of currency for the Ministry of Finance in August.

Reduction in capital outflow volumes

Despite the change in external conditions and the expansion of sanctions, the net capital outflow, according to the Bank of Russia, fell in 2Q to USD 0.4 billion, after USD 17 billion in the previous quarter. One of the determining factors was the reduction of banks’ foreign assets, with a continuing decline in liabilities to non-residents.

Expansion of trade surplus

Favorable price conditions for Russia’s main export goods continued to contribute to the expansion of the trade balance, which in 2Q amounted to USD 46 billion (USD 90.6 billion since the beginning of 2018), which is the highest value since 2014.

Fiscal policy

Budget surplus increase

According to the preliminary estimate of the Ministry of Finance, the federal budget surplus for 1H 2018 increased to RUR 948 billion, or 2% of GDP (compared with a deficit of RUR 408 billion a year earlier). While expenditure has been maintained at a level close to last year’s, there has been a significant increase in budget revenues (21% compared with January-June 2017), a key factor in which was the growth of oil and gas revenues (36.2% YoY), against a backdrop of a continuing favorable price environment for energy. Positive trends in the first half of the year increased the probability of the surplus planned for the year exceeding RUR 449.6 billion.

New fiscal maneuvers

A key benchmark in budget expenditures in the medium term is the Russian president’s new May decree on the development of the Russian economy through
to 2024. Additional budgetary expenses for fulfilling the decree may amount to about RUR 8 trillion by 2024. One of the sources for financing the costs will be an increase in the VAT rate from 18% to 20% from 2019. The corresponding bill was approved by the State Duma, and its implementation, according to estimates of the Ministry of Finance, will lead to additional budget revenues of more than RUR 600 billion a year. However, in the short term this measure will also be accompanied by an increase in inflation. A planned increase in excise rates should serve as another source of additional revenue for the Russian Federation.

The decline in the key rate was suspended in 2Q 2018 after its decrease from September 2017 to March 2018 to the level of 7.25%. The reason behind this decision was uncertainty about the impact of the evolving external conditions in 2Q on inflation and the impact of fiscal decisions that had been adopted (the VAT increase starting from 2019) on inflation expectations in the current year. The weakening of the ruble exchange rate observed in August may also have led to the regulator’s tough rhetoric about further lowering of the key rate.

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**Monetary policy**

**Decrease in the key rate put on hold**

The decline in the key rate was suspended in 2Q 2018 after its decrease from September 2017 to March 2018 to the level of 7.25%. The reason behind this decision was uncertainty about the impact of the evolving external conditions in 2Q on inflation and the impact of fiscal decisions that had been adopted (the VAT increase starting from 2019) on inflation expectations in the current year. The weakening of the ruble exchange rate observed in August may also have led to the regulator’s tough rhetoric about further lowering of the key rate.

**FORECASTS**

**Domestic demand will remain the driver of growth in 2018**

Our Russian economic growth forecast for 2018 remains unchanged – 1.8%. The possible negative consequences from the expansion of sanctions against Russia will be mitigated by the favorable price environment on the energy market. The growth of income and increased lending will continue to strengthen consumer and investment activity.
GDP growth in 2018–2020 is projected at 1.8%

In 2019–2020, the Russian economy’s growth rate will be within the potential level, which, according to our estimates, is about 1.8%. In 2019, there is a risk of slowing economic activity given the tax realignment. Additional support for economic growth in the medium term will be provided by budgetary policy through increased spending under the May presidential decrees on economic development until 2024.

As structural transformations in the economy are implemented, potential growth rates could be revised upwards.

The exchange rate will partly reclaim lost ground

According to our estimates, the Russian ruble in the second half of this year will partially recover following its depreciation in August. We expect to see the main effort to close the gap with the real exchange rate in 2019, which in turn will help strengthen the Russian currency.

Inflation to exceed target in 2019

According to our forecasts, annual inflation will be closer to the Central Bank target in the remainder of 2018, and will be 3.7% at the end of the year amid the exhaustion of favorable base effects and accelerating food inflation. The weakening of the Russian ruble will also affect inflationary processes, however, according to our estimates, this influence will be moderate. In 2019, inflation will somewhat exceed the regulator’s target, and the planned increase in value added tax will be the main driver of price growth.

Key rate will not decline by the end of 2018

According to our estimates, in order to contain inflation within the target level of 4%, the Russian Central Bank’s key rate will not decline between now and the end of this year, but will have subsequent potential for further reduction as inflationary processes stabilize.

Source: Calculations by the authors, EEC
SUMMARY

Macroeconomic forecasts for the Russian Federation

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Source: Calculations by the authors, EEC
TRENDS
GDP

Continuing high level of economic activity

Infrastructure projects are providing the investment momentum for the economy, thereby helping to ensure a consistently high GDP growth rate. In January–June 2018, GDP growth accelerated to 7.2% YoY (+7.0% YoY in 1Q 2018).

Manufacturing and construction are key growth engines

In 1H 2018, the volume of investments increased by 33.1% YoY. At the same time, more than 50% of investments were distributed among two fields of economic activity: production, transmission and distribution of electricity (46.0% of the total volume) and textile and clothing production (10.0%). The share of state investments increased by 3.1 p.p. compared with January–June 2017, foreign investment grew by 1.7 p.p., while private investment decreased by 3.8 p.p.

According to our estimates, in 2Q 2018 textile production, which was the main driver of industrial growth in 1Q 2018, ceded that role to metallurgy and the production of final metal products. Against a backdrop of high activity in the construction sector, the production of other nonmetallic mineral products maintained its high contribution to industrial production growth.

In 2Q 2018, agriculture and retail trade’s contribution to economic growth also increased. Despite the relatively dry summer, the growth rates of crop production output were maintained at a high level.

The growth of retail turnover is accompanied by a slowdown in annual inflation and an increase in the inflow of remittances.

Investment will continue to support the economy

Infrastructure projects in the hydropower industry are adhering to established medium-term plans, which is creating the preconditions for maintaining growth in the remainder of 2018. The investments made in textile production and the revitalization of the metallurgical industry in 2Q 2018 may be factors for growth in export earnings in the remainder of the year. A low inflationary background will continue to support domestic consumer demand during 3Q 2018.
Inflation

**Inflation remains below the target corridor of 7.0% (± 2 p.p.)**

For the fourth month in a row, annual inflation is below target, which is largely due to a weak price environment in the food sector. Despite the fact that in 1H 2018 world grain prices began to recover, the price situation in the region remained weak, which was reflected on the domestic market for breadstuffs and grains. An additional external factor was the decline in world sugar prices. These external factors combined with an excess supply of fruit and vegetable products contributed to a slowdown in food inflation, which in May 2018 moved into the deflation zone. This more than neutralized the effect of accelerating tariff growth for services (mainly utilities) and the growth of prices in the non-food sector (mainly due to an increase in gasoline prices). In 2Q 2018, CPI grew by 1.7% YoY, food prices decreased by 0.6% YoY, in the non-food sector prices increased by 4.6%, and the increase in prices for services amounted to 5.5% compared with 2Q 2017.

As the base effect continues, inflation in 3Q 2018 in the food segment will remain weak. Price dynamics in the non-food segment will depend on world energy prices, while an acceleration in the depreciation of the somoni exchange rate against the US dollar, observed in April-June 2018, may act as an additional factor.

![Inflation and the refinance rate](chart1)

![External trade and the real exchange rate](chart2)

**Source:** National agencies, calculations by the authors

External sector

**Current account deficit**

Given the stable dynamics of the TJS-USD currency pair, which lasted 11 months to April 2018, domestic consumer and investment demand in 1Q 2018 was partly financed from external sources. The reduction in export proceeds (–6.9% compared
Fiscal policy

Budget surplus at 3% of GDP

In 1H 2018, the budget surplus amounted to 3.0% of GDP, which was 1.6 times more than the previous year. Budget revenues for the year increased by 11.8%, and expenses by 8.9%.

On the revenue side the share of tax and non-tax revenues increased by 8.1 p.p. to 80.6%, while the share of other revenues fell by 1.4 times. Expenditures in the social sphere (38.1% of total spending) and the fuel and energy complex (23.4%) continue to be priority areas for funding (23.4% of total expenditures).

Budget surplus at 3% of GDP

with 1Q 2017), accompanied by growth in the nominal volume of imports (+24.3% YoY), led to the 1.5-fold expansion of the goods and services deficit. Despite this, there was a noted improvement in the current account: its negative balance decreased by 38.2% YoY. This was mainly due to an increase in the total net inflow of balance of payments “primary and secondary income” items (+82.7% YoY), which, among other indicators, include remittances. This partly contributed to the positive growth rates in retail trade. At the same time, the largest increase in the nominal volume of imported products was seen in investment goods (machinery and equipment), the deliveries of which were partially financed from reserve assets accumulated from portfolio investments that had been previously attracted.
Monetary policy

Refinancing rate has not changed

In 2Q 2018, the National Bank of Tajikistan did not change the refinancing rate and kept it at the level of 14.0%. The terms for withdrawal and provision of short-term liquidity conditions for commercial banks changed. Thus, the interest rates for overnight loans were reduced from 16.0% to 15.0%, while overnight deposit rates fell from 7.0% to 5.0%. The decrease in interest rates on operational monetary policy instruments was most likely due to the need to bring the operational monetary policy targets into line with the new monetary terms that were introduced in 1Q 2018.

The probability of long-term inflation falling below the target benchmark has decreased against a background of an acceleration in the somoni’s rate of depreciation. In 1Q 2018 the somoni’s exchange rate against the US dollar remained stable (in March 2018 the somoni strengthened by 0.1% compared with December 2017), but by the end of June it had depreciated by 3.8% compared with the beginning of the year.

In the financial sector, despite measures taken to improve the banking sector, key indicators are still weak. The share of NPL as of the end of June 2018 was 32.0% of the total volume of loans, while the loan portfolio decreased by 11.3% compared with June 2017.

FORECASTS

Investments will remain the key driver of growth

Current infrastructure projects are being carried out in accordance with plans. According to the authorities, the modernization of the economy’s key enterprises is planned to be completed by the end of 2018, which will not only increase the volume of industrial output in 2019, but will also increase export earnings.

Continuing growth in trading-partner countries, as well as improving the price situation on world cotton and aluminum markets, will support Tajikistan’s economy through foreign trade and remittances. The latter factor will be among those driving recovery in domestic consumer demand. Weaker indicators in the banking sector may become a deterrent to economic growth in the medium term.
Inflation will return to the target corridor of 7.0% (± 2 p.p.)

The low inflationary background will persist throughout 2018 as a result of the high base effect and low prices on regional food markets. Inflation in the non-food sector may reach the target corridor earlier against a backdrop of rising world energy prices and some depreciation of the somoni. As the base effect diminishes, annual inflation will reach the target corridor.
# SUMMARY

**Macroeconomic forecasts for the Republic of Tajikistan**

<table>
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<th>2019</th>
<th>2020</th>
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<td><strong>CPI (end of period, YoY percent change)</strong></td>
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<td>6.7</td>
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<td><strong>Interest rate on interbank loans (in percent per annum)</strong></td>
<td>13.7</td>
<td>13.4</td>
<td>13.2</td>
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<tr>
<td><strong>Exchange rate, somoni per U.S. dollar (average for the year)</strong></td>
<td>9.2</td>
<td>9.5</td>
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</tbody>
</table>

**Source:** Estimates by the authors, EEC
SPECIAL REPORT

A BRIEF REVIEW OF THE PUBLIC DEBT OF ARMENIA, BELARUS, KYRGYZSTAN AND TAJIKISTAN*

E.S. Kurmanalieva, Y. S. Rudakovski

In 2009–2017, economies of Armenia, Belarus, Kyrgyzstan and Tajikistan lived through periods of adverse external and domestic conditions characterized by weak external demand and falling export prices. Devaluation of domestic currencies following the sharp depreciation of the Russian ruble, led to fast growth of public debt in Armenia, Belarus, Kyrgyzstan, and Tajikistan. This growth of debt was also a consequence of fiscal stimulus, which supported budget expenditures, “compensating” for fall in tax revenues due to economic recession. During this period, government debt not only increased, but its structure changed, which created additional risks to debt sustainability. This article analyzes four risk factors for the public debt of these economies. First, the decrease in the share of concessional loans, and, consequent increase of debt service can put pressure on fiscal situation and macroeconomic stability in the medium term. Second, the high level of accumulated debt, in particular, its foreign currency component, limits the “room for maneuvers” for macroeconomic policy in terms of resistance to external shocks. Third, the growth in domestic currency debt, despite the lowering of currency risk, may have a negative impact on the economy in the form of upward inflationary pressure and crowding out of private investment. Fourth, extra-budgetary public support of state enterprises leads to an increase in contingent liabilities and the risk of them being incurred, especially in economies with a significant government role, such as Belarus and Tajikistan.

Over the past 10 years, there has been a rapid increase in public debt, including emerging and middle-income economies (Fig. 1). Government debt to GDP ratio in these countries reached almost 50% by 2017 against a backdrop of soft monetary conditions in the US and other developed economies. Similar situation was observed in the 1980s. After the 2008–2009 global financial crisis, the main reason behind the debt increase, particularly in middle-income economies, was the fiscal stimulus that were used by the authorities to support sluggish economic growth as a result of lowered export prices and reduced external demand.

* Disclaimer – the article reflects the authors’ personal opinion, which may not coincide with the official position of the Eurasian Development Bank, the manager of the Eurasian Fund for Stabilization and Development.
Four EDB/EFSD countries (Armenia, Belarus, Kyrgyzstan and Tajikistan), experienced a significant reduction in the debt burden before 2008 (with the exception of Belarus). However it exceeded 50% of GDP after the global financial crisis (Fig. 2) against a backdrop of a slowdown in economic growth and widening fiscal deficits. The greatest increase in debt levels was observed in Armenia and Belarus, where, during this period, it grew by 38.8 percent and 32.3 percent of GDP, respectively. In addition, the structure of public borrowings changed significantly. In all countries, in addition to public investment programs that are financed by multilateral donors on concessional terms, the level of more expensive bilateral and commercial foreign borrowings grew substantially. In particular, in recent years, Armenia, Belarus and Tajikistan have issued Eurobonds. Countries also increased the share of domestic borrowing. While in Armenia and Kyrgyzstan the authorities sought to reduce currency risks, in Belarus and Tajikistan the growth of domestic borrowing occurred amid of limited access to preferential external financing. The rapid growth of government debt led to revision of the previously established thresholds for the level of public debt in three of the countries – Kyrgyzstan in 2015, Armenia in 2016 and Tajikistan in 2017.

The main trigger for debt growth in the EDB/EFSD countries in 2009 and 2015 was a sharp weakening of domestic currencies (Fig. 3), which occurred during the 2008–2009 and 2014–2015 crises as a result of a fall in world prices for their exported goods, as well as a sharp reduction in the flow of remittances and the weakening of the Russian ruble. Against a backdrop of large volumes of currency obligations, the depreciation of domestic currency led to an increase in the value of public debt in terms of GDP. Amid high level of dollarization in Armenia, Belarus, Kyrgyzstan and Tajikistan, the devaluation of their domestic currencies led to an increase in the cost of imported goods and expenses for servicing the foreign currency liabilities of households and enterprises. The resulting currency mismatch caused an increase in non-performing loans, which affected the banking system and slowed the process of economic recovery. With a goal to mitigate the impact of the crisis, the authorities

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4 In Belarus in 2017, the national debt was 40.1% of GDP given a threshold of 45% of GDP (excluding guarantees).
used fiscal stimulus, which led to the expansion of budget deficits, especially in a situation of falling revenues. Additional fiscal pressures were exerted by other factors, including the revaluation due to exchange rate changes and quasi-fiscal operations. On the other hand, the subsequent economic recovery positively affected public debt dynamics. The decline in real interest rates also reduced pressure on the level of public debt in Belarus, Kyrgyzstan and Tajikistan.

ARMENIA

After the weakening of Armenian dram by 23% in 2009 and 17% in 2014, the government increased government spendings to support the economy. It was accompanied by an increase in borrowings, in particular, through a Public Investment Program (PIP). In addition, since 2015, the Armenian Ministry of Finance has been pursuing a policy towards diversification of debt by increasing the share of domestic short-term borrowings. This, on the one hand, reduced vulnerability to currency fluctuations, but on the other, increased the interest rate on issued government bonds. The increase in external and domestic borrowing against the backdrop of weak GDP growth was the reason for the debt level to exceed its 50% of GDP threshold in 2016. This triggered the implementation of the fiscal rule in 2017, which implied a tightening of fiscal expenditures by significantly limiting the maximum level of budget deficit.\(^5\) Against a background of expenditures’ consolidation and the reduction in the fiscal deficit, the level of public debt amounted to 53.7% of GDP in 2017 (Fig. 4). The structure of Armenia’s government debt, in addition to concessional external borrowing, includes eurobonds (7.3% of GDP) and domestic borrowings in national currency (11.1% of GDP).

\(^5\) Under the fiscal rule, exceeding the threshold for public debt of 50% of GDP automatically invoked a mechanism whereby the budget deficit the following year could not be more than 3% of the nominal average size of GDP over the past three years. At the end of 2017, the fiscal rule was revised and the new version entered into force in 2018. The new fiscal rule provides for the phased introduction of spending restrictions starting from the moment when the government’s debt reaches 40% of GDP.
BELARUS

The growth of Belarus’ public debt was mostly caused by the cumulative change in the exchange rate of the national currency against the US dollar, which over nine years amounted to about 800% (the devaluation totaled 89%). The greatest impact was exerted by the 2011 currency crisis, when the Belarusian ruble devalued by 64.1%, leading to an increase in expenses on servicing the foreign-currency liabilities of public enterprises that play a dominant role in the Belarusian economy. The financial weakening of the real sector required government support, which was financed through accumulation of public debt. In addition, the growth of public debt in 2014–2017 was influenced by the need to service the earlier issues of Eurobonds and domestic treasury bonds, which were issued in both domestic and foreign currencies. According to official data, the total level of public debt at the end of 2017 amounted to 47.5% of GDP. Belarus government debt consists of Eurobonds’ issues (4.1% of GDP) and other external debt (27.2% of GDP), domestic borrowing in the roubel (1.5% of GDP) and foreign currency (7.2%), as well as debt of public enterprises guaranteed by the central government (7.4% of GDP). The level of Belarus’ public debt, excluding the guaranteed part, is currently below the legally established threshold of 45% of GDP. However, public debt in broader definition, which includes the debt of state-owned enterprises (which is largely denominated in foreign currency), reached 54.6% of GDP by the end of 2017.

KYRGYZSTAN

In Kyrgyzstan, the level of public debt, which historically has been high, fell to 48.3% of GDP by late 2008 accompanied by restructuring. The devaluation of the som by 19.5% in 2008–2009 and 35.1% in 2014–2015 caused an increase in the nominal value of public debt. Despite the fact that during 2009–2017 part of the debt to Russia was forgiven\(^6\), and the government sought to attract mainly concessional external borrowings, its level in 2015 exceeded the legally established threshold value, which was revised upwards. The growth of the public debt was due to borrowings for Public Investment Program (PIP). By the end of 2017 Kyrgyzstan experienced the highest level of public debt, which reached 59.9% of GDP. It mostly consisted of external borrowings (53.9% of GDP) under the PIP, which are disbursed by bilateral and multilateral creditors under concessional terms.

TAJIKISTAN

In Tajikistan, the increase in public debt was caused by fiscal deficit and devaluation of the somoni. In 2007–2009, the increase in government debt was accompanied by a high primary budget deficit, which averaged around 5% of GDP. In December 2016, the growth of debt level was intensified by the recapitalization of two large banks, the costs of which was monetized by the National Bank. The devaluation of the somoni, by 21% in 2009 and 24.1% in

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\(^6\) In 2009, Russia wrote off Kyrgyzstan’s debt in the amount of USD 193.5 million. In 2012, Russia and Kyrgyzstan signed an agreement to write off another USD 188.9 million, and in 2014 an agreement was reached on the gradual write off of the remaining part of the debt in the amount of USD 300 million in equal tranches over a 10-year period. In 2015–2016, USD 60 million was written off. At the end of 2016, the agreement was revised to write off the remaining debt (USD 240 million) in 2017–2018.
2015, led to a sharp increase in nonperforming loans of both enterprises and individuals, which in 2016 amounted to 47.6% of total loans, destabilizing the banking sector. In 2017, the Tajikistan Ministry of Finance announced its first issue of Eurobonds to finance the construction of the Rogun hydroelectric power station. In addition, Tajikistan has continued implementation of large-scale PIP projects in the transport and energy sectors, which are mostly supported by Eximbank of China and international development donors. As a result, by the end of 2017 the level of public and publicly guaranteed debt reached 51.4% of GDP, of which 40.4% of GDP was external debt, and 11% of GDP was domestic debt.

To summarize, there has been important changes in the structure of public debt in four EFSD countries: (1) an increase in the share of more expensive (no concessional) external borrowings; (2) an increase in domestic borrowing in foreign currency; (3) an increase in domestic borrowings with higher interest rates; and (4) an increase in contingent liabilities and quasi-fiscal costs due to support extended for the banking system and state-owned enterprises. These changes may carry the risk of reducing the sustainability of public debt.

The increased volume of principal and interest payments over the next five years raises the risks to macroeconomic stability.

The issuance of five-and seven-year Eurobonds in Armenia, Belarus and Tajikistan, as well as short-term and medium-term domestic borrowings, accompanied by increased debt service on earlier obligations, have generated high levels of principal and interest payments for the next five years. On average, interest and principal payments on public debt on average amounted to 4–5% of GDP in 2017 (Fig. 5). In Belarus, the highest debt service ratio, is explained by relatively high interest rates on debt issues as a result of limited access to concessional financing from international development institutions. In Armenia, the increase in the volume of public debt service was influenced by an increase in domestic borrowing at higher interest rates. In Kyrgyzstan and Tajikistan, volumes of principal and interest payments on broadly concessional borrowings from multilateral development donors have also shown steady growth.

According to EFSD/EDB estimates, during 2018–2022, the governments of these four countries will have to pay out more than half of the current (by the end-2017) public debt level (Fig. 6). The bulk of these payments constitute principal payments on previously issued Eurobonds (Belarus in 2018 and Armenia in 2020), as well as payments on domestic debt, which has a shorter maturity. The domestic foreign currency debts of Belarus and the obligations of the Government of Tajikistan to the National Bank place an especially high burden on their budgets in the next five years. The bulk of the forthcoming payments by the Kyrgyz government are liabilities to bilateral and multilateral creditors.

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7 In September 2017, the Tajikistan Ministry of Finance issued 10-year Eurobonds worth USD 500 million with a current coupon rate of 7.125%.

8 According to the World Bank’s economic survey, the exceeding of the 40 percent threshold for the external debt level of Tajikistan led to a revision of the threshold to 60 percent of GDP.
Because of vulnerability of these economies to external shocks (an unexpected fall in export prices, a sharp reduction in remittances and other capital inflows, a sudden increase in interest rates on external debt) the continuation of the current trend poses additional risks to macroeconomic stability. The growth of sovereign risk premiums may worsen investors’ sentiments, which, given the tightening of monetary conditions in the global economy, may complicate access to external financing and lead to financial disruptions. Empirical studies from the IMF (Gerling and others, 2017) showed that financial meltdowns in the form of debts default often occur as a result of the sharp increase in debt financing requirements and the subsequent loss of investors’ confidence.

**A high level of public debt, in particular, its foreign exchange component, reduces the “room for maneuvers” in macroeconomic policy.**

Foreign currency borrowings constitute the main share of the public debt in the four considered EFSD countries. These borrowings grew substantially as a result of the crises of 2008 and 2014. Foreign currency liabilities comprised 90% of Kyrgyzstan’s public debt, 81% of Belarus’ public debt, 79% of Armenia’s public debt and 78% of Tajikistan’s public debt by the end of 2017 (Fig. 7). Hence there is a significant currency mismatch in the government balance between the debt service expenses and revenues. This makes the economies vulnerable to currency fluctuations. In the context of high dollarization, the phenomenon of “currency mismatch” has spread to all sectors of the economy. In 2017, the negative net investment position, demonstrating the excess of foreign liabilities over assets, amounted to 76.7% of Armenia’s GDP, 77.9% of Belarus’ GDP and 90.9% of GDP in Kyrgyzstan*. 

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* There are no statistics for Tajikistan.
The susceptibility of these economies to external shocks is now forcing their central banks to use a more flexible exchange rate policy as a tool to confront these shocks. The weakening of the Russian ruble in 2014 and the subsequent transition of the Central Bank of Russia to a floating exchange rate policy have motivated other central banks to shift to more flexible exchange rate arrangements. However, despite the increased magnitude of exchange rate fluctuations, central banks continue to conduct foreign exchange interventions, thereby limiting exchange rates’ ability to counteract shocks. One of the reasons for the excessive dampening of currency fluctuations is the high level of foreign currency liabilities in these economies, in particular in the public sector. Kliatskova and Mikkelsen (2015) noted that the situation with currency mismatches in the face of a large foreign exchange debt burden is the main reason for the “fear of exchange rate floating”.

In the context of a “managed float” of the exchange rate, the use of fiscal stimulus is an important tool of macroeconomic policy to steer an economy out of a crisis. However, a high level of public debt also makes it difficult to carry out countercyclical policies. The use of public debt thresholds in the countries against the backdrop of declining budget revenues has led to the consolidation of fiscal expenditures. The issue of non-priority public expenditure cuts was considered in Kyrgyzstan when debt exceeded its threshold level (in 2015). In 2017, Armenia’s consolidation of current expenditures resulted from the enactment of the budget rules.

Thus, in a situation of sudden external shocks, with unstable economic growth due to increased debt burden, countries will have to continue to restrain fiscal expenditures, thereby pursuing pro-cyclical policies and limiting the use of fiscal instruments for anti-crisis regulation, which ultimately can exacerbate the depth and duration of crises’ effects. Romer and Romer (2018) in their study showed that the decline in output in the wake of a financial crisis is less than 1% when the country has space for maneuver in monetary and fiscal policy, but nearly 10% when there is neither one.
The growing level of domestic debt has negative consequences in the form of rising inflation, high dollarization or crowding out of private investment

As of the end of 2017, in reviewed countries, domestic debt remained at a relatively low level, not exceeding 12% of GDP (in 2008, domestic debt did not exceed 5% of GDP). Despite the fact that attracting domestic savings is the preferred form of debt diversification, the accessibility of concessional external financing is considered as the main obstacle for rapid growth of domestic debt. Nevertheless, within the last three years, the level of domestic state borrowings in the countries under consideration has increased on average from 6% of GDP to 10% of GDP. Given the weak development of financial markets, such rapid growth has been accompanied by certain negative factors:

1) In Tajikistan, the growth of domestic debt to 11% of GDP (from 5.5% of GDP in 2015) was due to the need for public support of the banking system. At the same time, the financing of these state expenditures was accompanied by monetization. The recapitalization of problem banks at the end of 2016 led to a sharp increase in the money supply. This triggered the devaluation of the somoni and an acceleration in consumer prices inflation from 6.1% in December 2016 to 9.1% in June 2017.

2) Despite the fact that Belarus’ domestic debt has been decreasing in recent years (from 10.8% of GDP in 2015 to 8.7% of GDP in 2017), more than 80% of it is denominated in foreign currency. In 2017, the foreign exchange component of domestic debt was equal to 7.2% of GDP. Partly this was due to large liabilities on previously taken external loans, as well as the difficult access to external preferential borrowing. Therefore, exchange rate fluctuations largely affect public debt service spendings. The need to accumulate foreign exchange funds has an impact on monetary policy and supports devaluation expectations in the economy.

3) In Armenia, domestic debt in 2011 amounted to 11.1% of GDP. It grew from 6.5% of GDP in 2014 in the course of debt diversification policy. In 2015, shortly after the Central Bank raised the key rate, the Ministry Finance raised its interest rate on its domestic bonds in an effort to finance the widening fiscal deficit. As a result, against a background of low liquidity in 2016, lending to the private sector was crowded out – commercial banks preferred to invest the available financial resources in government bonds. Given this, the effective yield on domestic treasury bonds increased up to 22.2%.

The relatively small increase in domestic debt in Kyrgyzstan, from 4.0% of GDP in 2008 to 5.9% of GDP in 2017, was due to the limited capacity of the authorities to increase its public debt, as well as the underdevelopment of the securities market and undeveloped banking system.

The state’s high share in the economy increases the risk of contingent liabilities and may lead to an increase in quasi-fiscal expenditures.

The existence of large contingent liabilities for state enterprises debts in Belarus and Tajikistan, as well as the significant role of the public sector in these economies, suggest the need to consider broader definitions of debt. According to official data, the public debt of Belarus (excluding state guarantees) amounted to 40.1% of GDP in 2017. But taking into account both direct and guaranteed by the government debt of state-owned enterprises, its value exceeded 54% of GDP.
The official level of public debt in Tajikistan, was 51% of GDP in 2017. But according to World Bank estimates, public debt, which includes external borrowings of public enterprises, amounted to 54.7% of GDP. In this context, experience of international organizations’ in assessing quasi-fiscal risks can be useful (Box 1).

Box 1. The impact of contingent liabilities on the sustainability of public debt, international experience

International organizations include government guarantees and debt of state-owned enterprises in their calculations when assessing the sustainability of public debt because of the high likelihood that the government will have to “bail out” debt obligations of state-owned enterprises. Due to the large presence of state-owned enterprises in the economies of some countries, sharp fluctuations (depreciation) in the exchange rates pose risks to debt sustainability and the need to fulfill obligations of state enterprises, which are often in foreign currency. State-owned enterprises, which are usually characterized by low productivity, inefficiency and high debt obligations, are the weakest link of these economies and hinder their development.

Countries with a high share of contingent liabilities are often exposed to unexpected shocks that could disrupt the sustainability of public debt. A number of studies have shown (Jaramillo and others, 2017) that the greatest drivers of debt surges are not budget deficits, recessions or high interest rates, but rather, the realization of contingent liabilities, which cause the growth of public debt and, accordingly, quasi-fiscal expenditures. Moreover, the IMF (2016) believes that this factor is sufficiently strong for fiscal risks to overlap each other, exacerbating the depth of the crisis. If other risk factors are easily assessed and prevented before a crisis by increasing transparency and tightening fiscal reporting, then the implementation of contingent liabilities is often very difficult to foresee.

Analysis of the public debt of Armenia, Belarus, Kyrgyzstan and Tajikistan in 2009–2017 has identified a number of problems that may have certain negative consequences for debt sustainability and the economy. In particular, it is necessary to pay attention to the following aspects of debt dynamics and structure. Firstly, increasing debt, especially short-term and medium-term borrowings, is accompanied by a rise in the cost of its service, and increases the risk of default due to mounting financing needs. International experience shows that a breakdown in debt sustainability, particularly in the face of increased debt refinancing needs, influences investor sentiment, which sharply tightens financing terms or makes difficult access to capital markets. Secondly, a high level of public debt reduces the scope for fiscal maneuvers, which makes it difficult to carry out countercyclical macroeconomic policies. Thirdly, the growth of domestic borrowing can have negative consequences in the form of inflation, higher devaluation expectations and the crowding out of private investments. Fourthly, in the midst of significant contingent liabilities of state enterprises’ debts, the government may face the risk of default in case of a sudden shock and a deteriorating financial condition of state-owned enterprises.
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APPENDIX. METHODOLOGY FOR ESTIMATING PUBLIC DEBT CHANGE FACTORS

Public debt can be considered sustainable if: 1) the size of the primary balance sheet (excluding interest payments) is sufficient to service the current level of debt and stabilize the macroeconomic situation in the event of shocks; 2) the level of debt does not adversely affect the potential growth rate of the economy. The classical approach takes into account the impact of five macroeconomic shocks: real GDP growth, primary balances (state balances minus interest payments on debt), real interest rates, exchange rates and contingent liabilities.

Analysis of the sustainability of public debt begins with the following components:

$$D_{t+1} = \frac{e_{t+1}}{e_t} \times (1 + i_{t+1}^f) \times D_t^f + (1 + i_{t+1}^d) \times D_t^d - (T_{t+1} - G_{t+1} - S_{t+1}) + O_{t+1}$$

where $$D_t$$ and $$D_{t+1}$$ are the levels of debt in the base and forecast periods, respectively;
$$e_t$$ and $$e_{t+1}$$ are the nominal exchange rates of the domestic currency in the base and forecast periods, respectively;
$$i_{t+1}^f$$ and $$i_{t+1}^d$$ are the nominal effective rates of the forecast period for the level of debt in foreign and domestic currency, respectively;
$$T_{t+1}$$, $$G_{t+1}$$ and $$S_{t+1}$$ are the volume of taxes, budget expenditures and interest payments in the forecast period;
$$O_{t+1}$$ are other factors, including privatization, contingent liabilities, revaluation of assets, etc.

The contribution of each factor is estimated as a percentage of GDP. At the same time, the nominal GDP of the forecast period is calculated as the GDP level of the base year multiplied by the real growth rate and GDP deflator of the forecast year:

$$Y_{t+1} = Y_t \times (1 + g_{t+1}) \times (1 + \pi_{t+1})$$

Then the contribution of each factor as a percentage of GDP is defined as:

$$d_{t+1} = d_t \times \frac{i_{t+1} - \pi_{t+1} \times (1 + g_{t+1}) + a \times e_{t+1} \times (1 + i_{t+1}) - g_{t+1}}{1 + \pi_{t+1} + g_{t+1} + g_{t+1} \pi_{t+1}} - p_{b_{t+1}} + o_{t+1}$$

where $$d_t \times [i_{t+1} - \pi_{t+1} \times (1 + g_{t+1})]$$ is the contribution from the change in the effective borrowing rate in the forecast period;
$$d_t \times [a \times e_{t+1} \times (1 + i_{t+1})]$$ is the contribution from the change in the exchange rate of the national currency (a is the share of the national currency debt in its total volume);
$$d_t \times [g_{t+1}]$$ is the contribution of changes in the real growth rate of the economy;
$$p_{b_{t+1}}$$ and $$o_{t+1}$$ are the contribution of the primary balance sheet and other factors, respectively.
## Major macroeconomic indicators of the EDB member countries

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<td>15.6</td>
<td>9.9</td>
<td>8.5</td>
<td>7.3</td>
<td>6.4</td>
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<tr>
<td>Exchange rate, the national currency against the U.S. dollar (average for the year)</td>
<td>221.7</td>
<td>342.2</td>
<td>326.0</td>
<td>338.9</td>
<td>360.8</td>
<td>373.8</td>
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<tr>
<td>CPI (end of period, YoY percent change)</td>
<td>3.4</td>
<td>-0.5</td>
<td>3.7</td>
<td>2.0</td>
<td>6.3</td>
<td>6.5</td>
</tr>
<tr>
<td>GDP in constant prices (YoY percent change)</td>
<td>3.9</td>
<td>4.3</td>
<td>4.6</td>
<td>3.2</td>
<td>3.0</td>
<td>3.0</td>
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<tr>
<td>Interbank repo rate (in percent per annum)</td>
<td>9.0</td>
<td>3.7</td>
<td>1.7</td>
<td>2.7</td>
<td>5.7</td>
<td>9.3</td>
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<tr>
<td>Exchange rate, the national currency against the U.S. dollar (average for the year)</td>
<td>64.5</td>
<td>69.9</td>
<td>68.9</td>
<td>68.9</td>
<td>69.5</td>
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<td>Russia</td>
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<tr>
<td>CPI (end of period, YoY percent change)</td>
<td>12.9</td>
<td>5.4</td>
<td>2.5</td>
<td>3.8</td>
<td>4.9</td>
<td>4.4</td>
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<tr>
<td>GDP in constant prices (YoY percent change)</td>
<td>-2.5</td>
<td>-0.2</td>
<td>1.5</td>
<td>1.8</td>
<td>1.8</td>
<td>1.9</td>
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<tr>
<td>MIACR (in percent per annum)</td>
<td>12.8</td>
<td>10.6</td>
<td>9.0</td>
<td>7.1</td>
<td>7.0</td>
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<tr>
<td>Exchange rate, the national currency against the U.S. dollar (average for the year)</td>
<td>61.3</td>
<td>66.8</td>
<td>58.3</td>
<td>62.5</td>
<td>63.3</td>
<td>65.2</td>
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<td>Tajikistan</td>
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<tr>
<td>CPI (end of period, YoY percent change)</td>
<td>5.1</td>
<td>6.1</td>
<td>6.7</td>
<td>3.0</td>
<td>6.7</td>
<td>6.1</td>
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<tr>
<td>GDP in constant prices (YoY percent change)</td>
<td>6.0</td>
<td>6.9</td>
<td>7.1</td>
<td>7.1</td>
<td>7.0</td>
<td>6.7</td>
</tr>
<tr>
<td>Interest rate on interbank loans (in percent per annum)</td>
<td>8.0</td>
<td>9.8</td>
<td>15.1</td>
<td>13.7</td>
<td>13.4</td>
<td>13.2</td>
</tr>
<tr>
<td>Exchange rate, the national currency against the U.S. dollar (average for the year)</td>
<td>6.2</td>
<td>7.8</td>
<td>8.5</td>
<td>9.2</td>
<td>9.5</td>
<td>9.9</td>
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</table>

Source: National agencies, estimates by the authors, EEC
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 central 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>
</tr>
<tr>
<td>CB RA</td>
<td>Central Bank of the Republic of Armenia</td>
</tr>
<tr>
<td>CIS</td>
<td>Commonwealth of Independent States</td>
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<tr>
<td>CPI</td>
<td>Consumer Price Index</td>
</tr>
<tr>
<td>Core CPI</td>
<td>Core Consumer Price Index</td>
</tr>
<tr>
<td>DSGE</td>
<td>Dynamic Stochastic General Equilibrium</td>
</tr>
<tr>
<td>EAEU</td>
<td>Eurasian Economic Union</td>
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<tr>
<td>EBRD</td>
<td>European Bank for Reconstruction and Development</td>
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<tr>
<td>EC</td>
<td>European Commission</td>
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<tr>
<td>ECB</td>
<td>European Central Bank</td>
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<td>EDB</td>
<td>Eurasian Development Bank</td>
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<tr>
<td>EDB/CIS</td>
<td>Center for Integration Studies of Eurasian Development Bank</td>
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<tr>
<td>EEC</td>
<td>Eurasian Economic Commission</td>
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<tr>
<td>EFSD</td>
<td>Eurasian Fund for Stabilisation and Development</td>
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<tr>
<td>EU</td>
<td>European Union</td>
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<tr>
<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>
</tr>
<tr>
<td>GFCF</td>
<td>Gross Fixed Capital Formation</td>
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<tr>
<td>IMS</td>
<td>Integrated Model System</td>
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<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
</tr>
<tr>
<td>IPPI</td>
<td>Industrial Producer Price Index</td>
</tr>
<tr>
<td>ITR</td>
<td>Inflation Targeting Regime</td>
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<td>KASE</td>
<td>Kazakhstan Stock Exchange</td>
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<tr>
<td>MEKR</td>
<td>Ministry of Economy of the Kyrgyz Republic</td>
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<tr>
<td>MERB</td>
<td>Ministry of Economy of the Republic of Belarus</td>
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<tr>
<td>MEDRF</td>
<td>Ministry of Economic Development of the Russian Federation</td>
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<td>MEDTRT</td>
<td>Ministry of Economic Development and Trade of the Republic of Tajikistan</td>
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<td>MNERK</td>
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<td>NBKR</td>
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<td>NBRK</td>
<td>National Bank of the Republic of Kazakhstan</td>
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<tr>
<td>NPL</td>
<td>Non-performing loan</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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<tr>
<td>RTS</td>
<td>Russian trade system</td>
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<tr>
<td>SNA</td>
<td>System of National Accounts</td>
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<td>WB</td>
<td>World Bank</td>
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</table>
EDB CHIEF ECONOMIST GROUP

Yaroslav Lissovolik | (+7) 495 258 27 60 (ext. 2750) | lisovolik_yd@eabr.org

Aleksey Kuznetsov | (+7) 495 258 27 60 (ext. 2743) | kuznetsov_as@eabr.org

Aigul Berdigulova | (+996) 312 66 04 04 (ext. 2315) | berdigulova_ar@eabr.org