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The present analytical report was prepared by the Research Department of the Eurasian Development Bank (EDB). The information and conclusions contained in this report are not a recommendation and are based on public data.

Vladimir Yasinsky, Managing Director for Research, Member of the Board

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Macroeconomics of the region

A revival of economic activity in the world in Q1 led to a rise in international trade in the first five months of 2012. However, increased tension in financial markets, due to the uncertain situation in a number of countries in the Eurozone – in particular, Greece, Spain and Italy – had a negative impact on the macroeconomic picture of Q2 2012. In Q2 the GDP growth rate of the greater part (75%) of the world economy, which includes the United States, Europe, Japan, China, India and the ASEAN countries, fell to 2.3% from 2.8% in Q1. The slowdown in economic activity in the world affected the growth rate of prices of raw materials. In particular, the price of Brent crude fell by 7% in Q2 in annual terms after a 13% year-on-year increase in Q1.

The decrease in oil prices had an effect on the indicators of the real sector of all CIS economies without exception. A common feature of the economic situation in the region throughout Q2 was a decline in industrial output. Output growth in the agricultural sector also slowed due to last year’s high base effect and this year’s drought. The consumer sectors – retail trade and services – remained drivers of growth in almost all CIS economies. A rise occurred in construction activity, while the financial sector showed steady lending growth, which indicates some revival of investment activity.

As a result, the aggregate GDP of the CIS member countries rose by 4.4% in real terms in the first half of 2012 compared with a 4.3% increase in the same period in 2011. The economic growth of the EDB countries accelerated from 4.2% in January-June 2011 to 4.5% in the first half of 2012. A significant contribution to the acceleration was made by a 4.5% increase in Russia’s GDP, up from 3.7% in the first half of 2011. At the same time a noticeable economic growth decline occurred in the countries that are net exporters of industrial goods – Belarus, Uzbekistan and Ukraine – whose GDP growth rate turned out to be 3% lower than in the first half of 2011. The aggregate GDP growth rate of the countries that are exporters of labor also fell, decreasing from 4.9% in January-June 2011 to 3% in the first half of 2012. This was caused by a 5.6% year-on-year decline in the economy of Kyrgyzstan.

Figure 1.1. World economic growth (% y-o-y)

Figure 1.2. CIS countries’ GDP growth (%)

Source: CEIC

Source: national agencies and the CIS Statistics Committee
The financial account balance of the CIS member countries did not undergo significant change in the first half of 2012. Direct investment remained at the former low level. There was an outflow of portfolio investment from Kazakhstan due to an increase in the public sector’s assets abroad, which grew by $8.6 billion. All the CIS countries, except Belarus, had a net inflow of credit capital and a corresponding increase in their external debt. The aggregate external debt of the CIS member countries grew by 4.3% in the first half of 2012. Private sector borrowing was the main contribution to the increase in the external debts of Kazakhstan, Russia, Tajikistan, Kyrgyzstan and Moldova. The private sector of the region’s countries as a whole increased its debt by 4.5%, while the debt of the public sector grew by 3.4%.

Thus the dynamics of the region’s balance of payments led to a net increase of $24.2 billion, about 2% of GDP, in the international reserves of the central banks. Significant increases in the reserves occurred in Azerbaijan (11.9% of GDP), Kyrgyzstan (3.8% of GDP) and Moldova (3.5% of GDP), whereas the reserves decreased in Armenia (4.4% of GDP) and Ukraine (2.8% of GDP). As a result of these dynamics of the balances of payments, the real effective exchange rate (REER) of the national currency rose in Belarus, Russia, Kazakhstan and Azerbaijan, and fell in Kyrgyzstan and Armenia.
There is a moderate consolidation of the public finances amid increased risks of a crisis.

Public expenditure in all countries in the region increased compared with 2011 due to a rise in public employees’ salaries, social payments, and government investment. The consolidated budget surpluses of the oil exporter countries in the first half of 2012 exceeded the levels for the same period in 2011. This was due to both an increase in revenues and governments’ more cautious policy regarding spending. A moderate consolidation of public finances also took place in countries with chronically negative state budget balances, with the exception of Kyrgyzstan.

Amid a growth slowdown in the real economic sector and 2011’s high base effect for foodstuffs, the first half of 2012 was notable for a low growth rate of prices in the consumer market. The relatively low inflation prompted the central banks of Belarus, Kazakhstan, Kyrgyzstan and Tajikistan to proceed with loosening their monetary and lending policies, which they started to do in Q1. The Bank of Russia kept the refinance rate unchanged throughout the first eight months, and raised it only in September 2012. They did this due to an inflation acceleration following an increase in regulated tariffs. The annual inflation rate in Belarus fell to 55.6% in August, following an unprecedented 108.7% increase in consumer prices in 2011. However, as the National Bank of Belarus gradually reduced the refinance rate, the country’s inflation continued to be high. The region as a whole, excluding Belarus, had an annual inflation rate of 4.9% in August 2012, down from 5.8% in December 2011.

Amid a decline in inflation risks, there was a certain acceleration of the growth of banks’ lending activity in a number of CIS countries. However, the growth of lending in annual terms was within reasonable limits – between 12% and 22% – in almost all countries except Armenia and Belarus, which had lending growth rates of 35% and 44%, respectively. In Belarus, the volume of loans issued in foreign currency increased by 112.5%, which was due to 2011’s currency devaluation. In Armenia, the volume of foreign currency loans showed a worrisome 49% increase due to a rise in lending to the mining and metallurgical industries. In Russia, the growth of lending slowed amid uncertainty in the economy and the central bank’s relatively tight monetary policy. Kazakhstan’s banking sector continued to have a large share of non-performing loans – 37.1% of the total volume – amid some revival of investment activity.

Figure 1.5. Government budget: (in % of GDP)  
Figure 1.6. Monetary sphere: CPI growth (in %, year-on-year)

Source: national agencies and the CIS Statistics Committee  
Source: national agencies, IMF (IFS)
The IMF forecasts the growth rate of the world economy to be 3.3% this year and increase to 3.6% in 2013, with a subsequent acceleration to 4.6% by 2017. In addition, the IMF expects relatively high growth rates in oil exporter countries, which continue to increase their oil production, with internal demand rising. Given the new measures adopted by the European Central Bank and the US Federal Reserve System in September to stimulate the economies, it is probable that oil prices will remain at a high level. Thus the baseline scenario for the medium-term development of the EDB member countries assumes that acute crisis phenomena in the Eurozone will be gradually overcome, and most of the European countries will start to have positive growth between 2013 and 2015. The growth will remain slow as the process of reducing the debt burden weighs on consumption. The US economy will avoid recession as the authorities refrain from drastic measures in the fiscal sphere - such as a significant reduction of expenditure or a sharp increase in taxes - and the growth rate of the US economy will gradually rise. Positive developments in Europe and the United States, and also China’s own stimulus measures would lead to acceleration in the Chinese economy’s growth. Monetary and lending policy is expected to remain easy next year in all leading economies. The prices of the raw materials exported by EDB countries will therefore remain relatively high and so will their volatility. A consensus forecast from various international organizations predicts the average price of Brent crude to be $109 in 2012 and $107 in 2013, down from $112.5 in the first nine months of 2012 (see the analytical insert, pp. 45-50).

Consensus forecasts:

The price of Brent crude will be $109 per barrel in 2012 and $107 in 2013

The CIS countries’ GDP will grow by 3.9% in 2012 and by 4.2 to 4.3% in 2013 and 2014

Consensus forecasts:

The price of Brent crude will be $109 per barrel in 2012 and $107 in 2013

The CIS countries’ GDP will grow by 3.9% in 2012 and by 4.2 to 4.3% in 2013 and 2014

Oil exporter countries account for the greater part of economic activity in the CIS region. That is why it is obvious that the region will continue to have a high growth rate. A consensus forecast from various institutions puts it at 3.9% in 2012 and 4.2% to 4.3% in 2013 and 2014. In the short term, the region may face a rise in prices, which would be a consequence of the stimulus measures taken by the central banks of leading nations of the world; but in the longer term, the low growth rate of the world economy would keep inflation in check. The oil and gas exporter countries are expected to have an economic growth rate of 4% to 4.2%; and the labor exporter countries are expected to have a growth rate of between 3.9% and 5.6%. The latter economies’ dependence on cash remittances from abroad will increase, and their current account deficits will remain steadily high. The economic growth of Ukraine and Belarus, which are exporters of industrial goods and the most dependent on the economic situation in Europe, is expected to be within the range of 3.7% to 4.2%.

According to the EDB’s neutral-optimistic forecast, which predicts the average price of Brent crude to be $110 per barrel, the average weighted growth of the EDB member states would slightly slow in 2012 – to 4.5% against 4.6% in 2011 – amid the above global trends. Given the relatively high prices of energy resources and rather high tax revenues, exporters of petroleum products are expected to have state budget surpluses and a slowdown in the negative contribution of net exports in real terms in 2012. Apart from some revival in investment, the growth of imports would be mainly caused by a rise in consumer demand. The loosening of monetary policy in the world’s major economies would lead to a rise in prices in the EDB countries until the end of 2012. Of critical importance in this regard is a shift of the policy of the Bank of Russia towards a more flexible exchange-rate regime and inflation targeting. This would help curb the rise in prices in not only Russia but also other economies in the region.

In subsequent years, the growth of internal demand would gradually accelerate. A major contribution to this process would be made by consumer expenses. The impact of investment on the dynamics of internal demand will increase starting 2013. This would be largely due to an increase in the share of investment in non-raw material sectors. Amid a decline in the share of external trade, structural changes in the economy will be shifting towards sectors that serve investment demand - such as manufacturing.
If the average price of Brent crude is $90 per barrel between 2012 and 2014, the GDP growth of the EDB countries will be 3.8% in 2012 and accelerate to 4.7% by 2014.

Industries and construction. The share of the extraction of minerals will gradually decrease considering the insignificant increase in physical volumes of production, and the stabilization of the world prices of raw materials. Consumer demand will be oriented towards consumer imports and products of the non-tradable sector. Recovering investment demand would be a driver for the import of investment and intermediate goods. In the forecast period, a steady growth will be shown by the transportation and communication sectors, and higher growth rates by construction, wholesale and retail trade, and financial services.

The continued risk of an escalation of crisis developments in the world economy and of a transmission of the crisis to the EDB countries (see the analytical insert, pp. 38-44) has created a need for developing an alternative, pessimistic scenario for the region’s economy. The EDB’s pessimistic forecast for the GDP growth of the EDB countries assumes a decline in the average price of Brent crude to $90 per barrel in 2013 and 2014. This scenario predicts that the GDP growth rate of the region’s economies will range between 3.8% and 4.7% in the next two years.

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**Figure 1.7. Economic growth** (GDP growth): consensus forecasts by national and international institutions (in %)

<table>
<thead>
<tr>
<th>Country</th>
<th>2012</th>
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<tbody>
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<tr>
<td>Ukraine</td>
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</tbody>
</table>

Source: estimates and forecasts by national agencies, the EDB, the ADB, the World Bank, the EBRD, the IMF and the CIS Statistics Committee

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**Figure 1.8. Savings and investment** (in % of GDP): balance of private investment and savings (Sp-Ip), state budget (Sg-Ig), current account (X-M)

Source: national agencies, estimates and forecasts by the IMF and the EDB
**Trends**

**Azerbaijan: Growth acceleration in non-oil sector, slow rise in reserves**

The Gross Domestic Product (GDP) of Azerbaijan grew slightly in Q2 - increasing by 0.8% year-on-year compared with 0.7% in Q1. The low economic growth rate was due to a decline in the oil and gas sector, whose output was more than 7% lower than in Q2 2011. The non-oil sector increased by 10.5% in real terms compared with April-June 2011. This was the rate for the communications industry and agriculture.

A significant increase occurred in the growth rate of fixed capital expenditure, which reached 29.6% in the first half of 2012 against 16.5% in Q1. There was probably no change in household consumption growth, as the growth rate of retail sales remained stable - 9.3% in Q1, and 9.2% in the first half of 2012.

Inflation continued to slow. The annual consumer price index (CPI) was 2.2% in June compared with 3.1% in March. Against the backdrop of de-facto fixed exchange rate of the national currency against the US dollar and a low capital inflow to the country, inflation pressure in the economy remains minimal: the M2 growth rate was 4.4% in Q2 against 7.2% in Q2 2011.

State budget expenditure increased compared with 2011 due to a rise in the pay of employees, social payments, and government investment. In January-June 2012 the government spent 5.6 billion manat (21.9% of GDP). This compares 3.7 billion manat (16.4% of GDP) in January-June 2011. State budget revenue fell amid lower oil prices and a decrease in oil production compared with 2011. As a result, a significant decline occurred in the growth rate of the State Oil Fund’s assets. In the first half of 2012, the fund’s wealth increased from $29.8 billion to $32.7 billion (2.9% of the period’s GDP); whereas it grew from $22.8 billion to $30.4 billion in the first half of 2011. The Fund’s assets are currently equal to about 50% of annual GDP. This means that it reliably isolates the state budget from the effects of short-term fluctuations in tax revenues caused by the volatility of energy prices – government revenue from oil and gas exports amounted to 23.7% of GDP in 2011. However it cannot yet ensure long-term stability for the economy considering the expected fall in oil production in the country in the late 2010s. The oil sector output is forecast to decrease by 40% from the current level by the mid-2020s (see the IMF’s Country Report No. 12/5).

The growth of bank lending accelerated compared with the beginning of 2012, averaging 1.3% a month in Q2 against 1.1% in Q1. The period did not see a fundamental change in the stability of the financial system. The ratio of regulatory capital to assets rose to 14.3% on average in Q2 from 14% in Q1. This indicator fell from 15.2% in Q2 2011, when it rose amid a noticeable fall in lending activity.
Outlook

Azerbaijan: Stagnation in oil production, need to strengthen budget

Major trends in the economy of Azerbaijan will not undergo change in the remaining months of 2012 compared with Q1 and Q2 2012. The growth rate of the non-oil sector was stable amid deterioration in the global economic situation. It will keep stable in the short term, ensuring a general GDP growth rate of about 1% in 2012. The IMF expects oil production in the country to stabilize and begin to have growth rates close to zero from 2013. Under these circumstances, the growth of GDP will accelerate to 4 to 5% if the non-oil sector continues to grow at a rate close to the current one. If the government begins to pursue a tighter budgetary policy, economic growth will significantly slow. The high degree of its dependence on the dynamics of government expenditure is a controversial feature of the Azerbaijan development model; although it currently protects the national economy from the effects of negative external developments.

CPI growth continued to slow in Q3, reaching 1.5% in September. The inflation situation in the country represents a good opportunity for abandoning the policy of rigidly pegging the manat to the US dollar. Under the current circumstances, a transition to a floating exchange rate will not cause a dramatic increase in the real value of the national currency. At the same time a flexible exchange rate policy would increase the Central Bank’s ability to support economic growth. This can be used when and if the government of the country tightens its budgetary policy. A flexible exchange rate regime would also help prevent an acceleration of inflation in the event of an increase in the inflow of capital to the country. This can be expected if the economic situation in the world stabilizes.

The state of the public finances is not a source of risk in the short term due to the existence of considerable financial reserves. It requires, however, certain consolidation. Oil exports, which account for 70% of government revenue, have stopped increasing. The government cannot therefore maintain the growth of public expenditure at the rates that existed in 2011 and this year. Depending on the level of world energy prices, resuming the accumulation of reserves in the State Oil Fund will require the government to either reduce, or significantly curb the growth its expenditure. A partial alternative to this is an increase in tax pressure on the non-oil sector; although the growth rate of government expenditure should significantly decrease even if this approach is used.

The authorities have opportunities to minimize the negative impact of the forthcoming fiscal consolidation on the economic development of the country. One of the tools to support economic growth could be a transition to a more flexible exchange rate policy. In addition, economic growth can receive an impetus if the government carries out a number of important measures aimed, in particular, at de-monopolizing and reinvigorating the banking sector. A positive effect on economic growth will be produced by the completion of infrastructural projects, including those aimed at enhancing the transit potential of the nation.
Azerbaijan

Figure 2.1. **GDP and output**: GDP growth and output change by sectors, (in %, year-on-year)

- Agricultural output growth
- Industrial output growth
- GDP growth

Source: the State Statistics Committee of Azerbaijan

Figure 2.2. **Foreign trade**: exports, imports, current account (left scale, in billions of US dollars), real effective exchange rate – REER (right scale, index – Q1 2008 = 100)

- Exports of goods
- Imports of goods
- Current account balance
- REER

Source: national agencies, IMF

Figure 2.3. **Government sector**: state budget (in % of GDP)

- Sp-Ip (private)
- Sg-Ig (public)
- X-M (CAB)

Source: national agencies

Figure 2.4. **Monetary sector**: the left scale - the central bank’s rate (in %) and CPI growth (in %, year-on-year); the right scale - M2 growth (in %, year-on-year)

- IPC
- policy rate
- M2

Source: national agencies, IMF (IFS)

Figure 2.5. **Economic growth**: GDP growth and forecasts by national and international institutions (in %)

Source: national agencies, estimates by the ADB, the World Bank, the EBRD, the IMF and the CIS Statistics Committee

Figure 2.6. **Savings and investments**: (in % of GDP): balance of private investment and savings (Sp-Ip), state budget (Sg-Ig), current account balance (X-M)

Source: estimates and forecasts by national agencies and the IMF
## Armenia: Higher growth rates of GDP and cash remittances

The annual growth rate of real GDP increased from 6.7% in Q1 2012 to 7.4% in Q2. The acceleration of economic growth was due to: the restoration of domestic demand; relatively high prices of exported metals; more favorable weather conditions for agricultural production; and a low-base effect. Economic growth became more even compared with 2011 and early 2012. Good results were shown by: the industrial sector, whose output increased by 10% year-on-year in April-June 2012; agriculture (11%); and services (12.5%). The growth rates of trade and imports in annual terms remained modest – 4.5 and 4%, respectively – but there was a marked acceleration in quarterly terms - 28.5 and 11%. This can be linked to: seasonal factors; growing lending volumes; and a large amount of cash remittances from abroad during the period.

Given the relatively low competitiveness and weak production potential of the economy, the acceleration of economic activity was accompanied by deterioration in the foreign trade balance and a high current account deficit. In Q2 2012, the nation’s foreign trade deficit increased by 6.3% in annual terms to $531.4 million; whereas it decreased in Q1 2012. Since foreign investment remains limited - totaling $107 million in Q1 2012 and $73 million in Q2 - and the government has to spend a lot to service its external debt, the foreign trade deficit continues to be a major challenge for the Armenian economic authorities. The foreign trade imbalance is largely offset by a significant inflow of cash remittances, in particular from Russia. In Q2 2012, the net volume of cash remittances totaled $312 million, a 9% year-on-year increase, and compensated for around 58% of the foreign trade deficit in the period.

The rise in economic activity, and the balanced policy pursued by Armenian authorities, had a favorable effect on the current situation in the fiscal sector. In the Q2 2012, state budget expenditure and revenue demonstrated moderate and balanced growth (6.5% in annual terms). The growth of revenue in the first half of 2012, especially from VAT and excise taxes, outpaced the rise in expenditure. As a result, the budget deficit decreased to 1.25% of GDP in Q2 compared with Q2 2011, and the government managed to achieve budgetary stability.

The growth of M2X – up 23% year-on-year as of late June 2012 – which was mainly due to bank lending growth (up 35% year-on-year) led to an increase in domestic demand. It is notable that this increase was accompanied by a decline in prices in monthly terms during Q2 2012. The annual CPI was up only 0.7% in June, whereas the Central Bank of Armenia had projected a rise of 2.5 to 5.5%. The low inflation rate was due to a fall in food prices and a high-base effect. However, given a potential increase in inflation pressure, the Central Bank kept its refinance rate unchanged at 8% during the entire period.
Outlook

Armenia: Risk of slowdown in economic activity

Despite the acceleration of economic activity in Q2 2012, there is a worrying downward trend in monthly terms in industrial output, which decreased by 0.2% in June. The trend was due to a fall in the production of metal ores, and a slight decline in the manufacturing industry. This slowdown was caused by a decrease in metal prices, which also affected export revenues in Q2 2012 (down 3.1% compared with Q1, and down 1.1% compared with Q2 2011). Other worrying facts were: a decrease in imports in monthly terms (down 7.1% in June 2012); a continued decline in fixed capital expenditure (down 6.7% in the first half of 2012); and a continued general downward trend in the construction sector, whose output decreased by 8.9% year-on-year in Q2 2012. Since April 2012 there has been a decline in the net inflow of cash remittances in monthly terms due to a slowdown in economic activity in Russia. All this indicates a potential weakening of the growth drivers amid uncertainty regarding the external situation. Given the limited use of various instruments of economic policy – the government aims to reduce the budget deficit and stabilize the dram – one should expect a slight slowdown in economic growth in Q3 and in the entire year to 6% following a 6.2% rise in the first half of 2012.

Despite the expected relative slowdown, the actual economic growth exceeds the government’s projection of 4.2% that was used in making the 2012 budget estimates. The outlook for the fiscal sector remains favorable. Within the framework of its program of cooperation with the IMF, Armenia’s authorities continue to carry out fiscal measures and tax reforms aimed at the reduction of the deficit of the central government budget to 3.1% of GDP in 2012. They will apparently achieve this.

The outlook for the monetary sector is less certain. The Central Bank left the refinancing rate unchanged at 8% despite the continued deflation in monthly terms, and a low inflation rate in annual terms - which coincided with the lower bound of the target inflation band of 2.5 to 5.5%. This decision was mainly caused by a rise in prices in the world grain market in recent months, as well as by the existence of a surplus of money in the economy. The Central Bank tries to prevent a possible increase in inflation pressure. This manifests itself in the current acceleration of annual inflation. It also tries to alleviate pressure on the dram from deterioration of external indicators, and a decrease in inflows from stable sources of foreign currency in the form of foreign direct investment.

There are grounds to expect the Armenian dram to resume weakening - but this weakening would be limited They include: the high level of the structural current account deficit; the risk of a decrease in the volume of cash remittances from abroad; the high costs of servicing the external debt in 2012; and the potential deterioration of the international economic situation.
Armenia

Figure 3.1. **GDP and output**: GDP growth and output change by sectors, (in %, year-on-year)

![GDP and output chart](https://example.com/gdp_output_chart.png)

Source: the National Statistical Service of the Republic of Armenia

Figure 3.2. **Foreign trade**: exports, imports, current account (left scale, in billions of US dollars), real effective exchange rate – REER (right scale, index – Q1 2008 = 100)

![Foreign trade chart](https://example.com/foreign_trade_chart.png)

Source: national agencies, IMF

Figure 3.3. **Government sector**: state budget (in % of GDP)

![Government sector chart](https://example.com/government_sector_chart.png)

Source: national agencies

Figure 3.4. **Monetary sector**: the left scale - the central bank’s rate (in %) and CPI growth (in %, year-on-year); the right scale - M2 growth (in %, year-on-year)

![Monetary sector chart](https://example.com/monetary_sector_chart.png)

Source: national agencies, IMF (IFS)

Figure 3.5. **Economic growth**: GDP growth and forecasts by national and international institutions (in %)

![Economic growth chart](https://example.com/economic_growth_chart.png)

Source: national agencies, estimates by the ADB, the World Bank, the EBRD, the IMF and the CIS Statistics Committee

Figure 3.6. **Savings and investments**: (in % of GDP): balance of private investment and savings (Sp-Ip), state budget (Sg-Ig), current account balance (X-M)

![Savings and investments chart](https://example.com/savings_investments_chart.png)

Source: estimates and forecasts by national agencies and the IMF
Belarus: Slow GDP growth, current account surplus

The economic situation in Belarus generally underwent no change in Q2 compared with the beginning of 2012. Economic growth figures remained low following the large-scale balance of payments crisis in 2011. The government had achieved stability in the external balance through reducing domestic demand, and thanks to support from Belarus’ EurAsEC partners. The nation’s real GDP increased by 2.7% year-on-year in Q2 2012 against an increase of 3.1% in Q1. Fixed capital expenditure decreased by 19% in Q2 compared with Q2 2011, while household consumption rose by 4.5% year-on-year following a decrease of 5.9% in Q1. Government expenditure decreased by 4.5% in real terms. Exports rose by 28.9%, largely due to an increase in the production of petroleum products from crude oil supplied under a special trade regime with Russia.

The rise in consumer prices in Belarus was higher than in neighboring countries. From January through June, the CPI increased by 1.5 to 1.9% a month. Consumer prices at the end of Q2 were 9.5% higher than at the beginning of 2012. The National Bank of Belarus loosened its monetary policy to a certain extent, gradually lowering the refinance rate from 45% in January to 32% in June. This adjustment of the policy was apparently neutral as it did not have an appreciable effect on inflation, which neither accelerated nor decelerated during the period between January and June. The government continued to have a state budget surplus, although it decreased from 3.2% of GDP in Q1 to 1.6% in the first half of 2012, apparently due to seasonal factors. The balance of payments kept improving: the current account surplus rose to $879.6 million (5.9% of GDP) in Q2, compared with $40 million (0.3% of GDP) in Q1, when Belarus had a current account surplus for the first time since early 2006. The Q2 financial account deficit remained close to the Q1 level ($910.5 million against $900.2 million) amid a decrease in the payables of companies and the government. The rise in the current account surplus facilitated the rise in the National Bank’s international reserves by $244.3 million in Q2.

The National Bank still tightly restricts fluctuations in the ruble’s exchange rate against a currency basket of the US dollar, the Euro, and the Russian ruble. The range of the fluctuations did not exceed 2.5% between January and June despite the unstable economic situation in the region during the period. The exchange rate did not therefore play a protective role with regard to the impact of external negative shocks on the economy of the country. At the same time the exchange rate’s stability had a deterrent effect on inflation.

The volume of bank lending grew at a steady pace, increasing by 6.3% in Q1 and 11.9% in the first half of 2012. This growth generally corresponded to the rise in the producer price index and the real economic growth. According to data from the National Bank - capital sufficiency indicators and the share of problem loans in the banking sector remained stable in the first six months of 2012.
Outlook

Belarus: Increasing risk to the stability of BoP

Changes that occurred in Belarus in Q3 2012 posed an increased threat to the nation’s external stability, which had been restored through a lot of effort in late 2011 and early 2012. The foreign trade balance was positive throughout the first half of 2012, and reached a surplus of $430 million in June. It dropped to only $23 million in July, and shifted to a deficit of $386 million in August. These developments were due partly to seasonal factors, and partly to restrictions imposed by Russia on the supply of specially-priced crude oil and petroleum products to the country. Due to this, one can expect that the nation will have a current account deficit amounting to 1 to 5% of GDP in 2012. That will represent an advance compared with 2010 and 2011, when the deficit was equal to 10 and 10.5% of GDP, respectively. However, the continued current account deficit suggests that the authorities have not yet accomplished the task of consolidating the balance of payments. The Belarusian economy still remains vulnerable to the impact of external and internal shocks.

GDP growth declined throughout Q3. The year-on-year GDP growth rate fell from 2.9% in the first half of 2012 to 2.5% in the first eight months of 2012. The petrochemical industry refines oil and petroleum products supplied from Russia, and its output rose by 42.5% year-on-year in January-August. It gives a considerable contribution to the growth of GDP. Russia’s restrictions on the supply in the latter half of 2012 will lead to a further decline in the economic growth rate in the remaining part of 2012. The country’s authorities have set themselves the task of achieving a GDP growth rate of 8.5% in 2013, which would be higher than the average growth rate of 7.4% in the past decade.

Inflation slightly accelerated in Q3, with the monthly rise in the CPI increasing from 1.7% in the first half of 2012 to 1.9% in Q3. Consumer prices in the country rose by 16.6% between January and September. The inflation situation does not show signs of improvement. However, the National Bank lowered its refinance rate to 30% in September. It plans to reduce it to 25 or 26% by the end of 2012, and to between 13 and 15% by the end of 2013. The inflation process was accompanied by a marked increase in lending activity: the volume of bank loans rose by 20.2% in the first eight months of 2012 compared with an increase of 11.9% in the first half of 2012. The National Bank’s policy is approaching a line the crossing of which would trigger an acceleration of the rise in prices in the country. To all appearances, the attention of the country’s authorities has been shifted from stabilizing the economic situation in the country following the 2011 crisis to stimulating economic growth. Achieving this aim requires loosening the National Bank’s policy and increasing lending to the economy. The government plans to continue to move in this direction next year. Given the weak balance of payments position, and the nation’s limited opportunity to borrow from external sources, this policy change increases threats to the stability of the economy.

The foreign trade balance deteriorates in July and August

There may be a current account deficit in 2012

The task of consolidating external sustainability is yet to be accomplished

A slowdown in GDP growth may continue in the second half of 2012

Inflation slightly accelerates in Q3

The National Bank’s policy may trigger an inflation spiral

Authorities’ priorities shift to stimulating growth, which increases threats to economic stability
Belarus

Figure 4.1. **GDP and output**: GDP growth and output change by sectors, (in %, year-on-year)

![Graph showing GDP growth and output change by sectors](image)

Source: the National Statistics Committee of Belarus

Figure 4.2. **Foreign trade**: exports, imports, current account (left scale, in billions of US dollars), real effective exchange rate – REER (right scale, index – Q1 2008 = 100)

![Graph showing foreign trade](image)

Source: national agencies, IMF, EBD

Figure 4.3. **Government sector**: (in % of GDP)

![Graph showing government sector](image)

Source: national agencies

Figure 4.4. **Monetary sector**: the left scale - the central bank’s rate (in %) and CPI growth (in %, year-on-year); the right scale - M2 growth (in %, year-on-year)

![Graph showing monetary sector](image)

Source: national agencies, IMF (IFS)

Figure 4.5. **Economic growth**: GDP growth and forecasts by national and international institutions (in %)

![Graph showing economic growth](image)

Source: national agencies, estimates by the World Bank, the EBRD, the IMF and the CIS Statistics Committee

Figure 4.6. **Savings and investments**: (in % of GDP): balance of private investment and savings (Sp-Ip), state budget (Sg-Ig), current account balance (X-M)

![Graph showing savings and investments](image)

Source: estimates and forecasts by national agencies, the IMF and the EBD
Kazakhstan: Internal demand determines economic growth

Kazakhstan’s economic growth rate did not change in Q2 2012. The nation’s GDP rose by 5.6% year-on-year in both Q1 and the first half of 2012. There was a slowdown in the industrial sector – a 1.7% increase in annual terms in the first half of 2012 – which was caused by a decline in external demand. The period saw a 4.4% year-on-year increase in the manufacturing industry, a 0.2% decrease in the extractive industry, while the construction sector showed some revival of activity and posted a 0.5% increase. The growth deceleration in the industrial sector was compensated for by the acceleration in the services sector (8.9%), which was stimulated by the strengthening of internal demand, in turn reflected in a rise in real pay (13.3%), and a rise in government spending. Due to unfavorable weather conditions, agricultural output continued to decrease, falling by 6.3% year-on-year, but to a lesser extent than in Q1 2012. Despite the slowdown, the economic growth rate remained relatively high.

A decline in international prices of major export commodities led to a 2.9% year-on-year decrease in exports in Q2. Simultaneously, under the influence of increased internal demand, the import of goods rose by 2.1% and the export surplus decreased by 6.8%. The deterioration in the foreign trade balance, and the services balance was partly offset by a slowdown in the outflow of capital in the direct investment balance-of-payments category. As a result the current account surplus decreased by only 1.4% compared with Q2 2011. The capital and financial account balance noticeably improved. It became positive due to a significant increase in medium-term and long-term borrowings, and a decrease in Kazakh economic entities’ direct investment abroad. In general, the current account surplus remained high in the first half of 2012, amounting to $8.8 billion, or 10.5% of GDP.

Despite a fall in oil prices in Q2 2012, export revenues remained at the same level. Together with the improvement of tax administration mechanisms, this led to a rise in tax revenues. Simultaneously, transfers from the National Fund of Kazakhstan and non-tax revenues considerably increased. This led to an 18% rise in consolidated budget revenues compared with Q2 2011. Government expenditure increased at a moderate pace, which contributed to a 6.8% rise in the consolidated budget surplus in Q2 2012. The budget surplus rose by 28% in first half of 2012 to total 1.7 trillion tenge, or 13.9% of GDP.

The inflation rate in Q2 2012 was determined by a combination of declining prices of food and non-food consumer goods with rising prices in the services sector. The rise in prices of services pushed up inflation in the country to 4.9% in June 2012. However, the real inflation rate remained below the upper bound of the medium-term inflation projection range of 6 to 8%. The limited inflation pressure can be linked to; a moderate rise in world energy and food prices; the restrained monetary and lending policy of the National Bank; and internal demand that remained moderate despite some increase.

The combination of these factors prompted the National Bank to reduce the refinancing rate to 6% in June 2012.
Outlook

Kazakhstan: Macroeconomic situation remains stable

The economy of Kazakhstan is poorly diversified. Despite the increased role of domestic sources of growth, it still strongly depends on prices of major export items. Given a slowdown in the world’s economic growth, especially in the economies of the European Union and China, it is evident that it will be difficult for Kazakhstan’s industrial sector and its economy as a whole to avoid suffering from this slowdown. One can expect that non-raw material sectors will continue their growth, driven by internal consumption and, to a certain extent, investment. The strengthening of the domestic sources of economic growth will have a stimulating effect. The country’s leadership will obviously try to use these growth drivers to a greater degree.

The Eurasian Development Bank (EDB) has revised its forecast, and predicts that if oil prices continue to be at a level of $110 per barrel Kazakhstan’s GDP growth rate will be 5.9% in 2012. This forecast coincides with that of the IMF, and is close to the forecast of the country’s Ministry of Economic Development and Trade, which projects a growth rate of 5.8%.

High oil prices, coupled with the recovery of prices of industrial metals and a rise in grain prices, will help retain high export revenues. Apart from the predicted strengthening of internal demand, one should expect that imports will continue to rise at a high rate. Kazakhstan’s foreign trade surplus will additionally decrease, but it will remain high. At the same time, due to the scale of problems existing in the world economy, there will continue to be tension in international financial markets. This may have a negative effect on the financial account balance and the exchange rate of the tenge. The volatility of the tenge will remain low due to the National Bank’s policy, and the high level of the international reserves.

The continued high export revenues, and increased internal demand will contribute to a further increase in tax revenues, and in the reserves of the National Fund of Kazakhstan. The existence of this security cushion should, in the foreseeable future, ensure the possibility of implementing government programs aimed at the acceleration of social and economic development. The government of Kazakhstan keeps the growth of public spending at a moderate level. This gives grounds to be confident of a favorable outlook for the fiscal sector.

In the context of reduced inflation pressure – 4.7% in August 2012 – and the slowdown in the economy, the National Bank lowered its refinance rate to 5.5% in August. The rise in bank lending will largely depend on the pace of the recovery of the quality of the banking sector’s assets. Major inflation risks will come from: a possible rise in food prices due to unfavorable weather conditions; and from the possible acceleration of the rise in prices in non-raw material sectors caused by the strengthening of internal demand. One can expect with a high degree of confidence that the inflation rate will remain within the medium-term projection range that the National Bank set at 6 to 8%.
Kazakhstan

Figure 5.1. **GDP and output**: GDP growth and output change by sectors, (in %, year-on-year)

[Graph showing GDP growth and output change by sectors for Jan-Jun 2011 and 2012.]

Source: the Agency of Statistics of Kazakhstan

Figure 5.2. **Foreign trade**: exports, imports, current account (left scale, in billions of US dollars), real effective exchange rate – REER (right scale, index – Q1 2008 = 100)

[Graph showing foreign trade data with exports, imports, current account, and REER indices.]

Source: national agencies, IMF, EBD

Figure 5.3. **Government sector**: consolidated budget (in % of GDP)

[Graph showing government sector budget for Jan-Jun 2011, 2011, and Jan-Jun 2012.]

Source: national agencies

Figure 5.4. **Monetary sector**: the left scale - the central bank’s rate (in %) and CPI growth (in %, year-on-year); the right scale - M2 growth (in %, year-on-year)

[Graph showing monetary sector data with IPC, policy rate, and M2 growth.]

Source: national agencies, IMF (IFS)

Figure 5.5. **Economic growth**: GDP growth and forecasts by national and international institutions (in %)

[Graph showing economic growth data for 2000 to 2014.]

Source: estimates and forecasts by national agencies the ADB, the World Bank, the EBRD, the IMF, the EBD and the CIS Statistics Committee

Figure 5.6. **Savings and investments**: (in % of GDP): balance of private investment and savings (Sp-Ip), state budget (Sg-Ig), current account balance (X-M)

[Graph showing savings and investments data for 2005 to 2014.]

Source: estimates and forecasts by national agencies, the IMF and the EBD
Kyrgyzstan: Continued downturn in gold mining industry, rise in retail trade and services

The fall in the real sector of the country’s economy that could be observed in the first months of 2012 extended into Q2, when Kyrgyzstan’s GDP decreased year-on-year by 4.7%. If the performance of gold mining company Kumtor is not taken into account, the economic growth rate fell to 3.9% in the first eight months of 2012 from 4.8% in the same period in 2011. This gives grounds to believe that the downturn in the gold mining industry began to affect other sectors of the economy. Simultaneously, the general slowdown in economic activity in the world and in the region had a negative effect on the country’s foreign trade. The annual growth rate of non-gold exports fell from 74% in Q1 2012 to 2.7% in Q2; and the volume of cash remittances from abroad decreased by 15.5% in annual terms in Q2. The extractive industry had a growth rate of 13.7% in Q2; while the manufacturing industry, which includes Kumtor, posted a decrease of 42.5%. Agricultural output increased by 1.3% against a 1.9% year-on-year increase in the first half of 2011. The industrial sector made a negative contribution to GDP with a decline of 7.6%, whereas the trade sector had an increase of 1.5%.

Weak economic activity, coupled with the continued decline in prices in the world food market, led to the strengthening of the disinflation trend. Amid record low inflation figures – the CPI fell by 0.5% in annual terms in June 2012 – the National Bank of Kyrgyzstan continued loosening its monetary and lending policy. The interest rate on the National Bank’s short-term notes was lowered from 9.6% in late March 2012 to 6.8% at the end of June. A 10.3% fall in food prices made an 86% contribution to the general price dynamics. The base inflation rate, which was 1.2%, testified to the existence of inflation pressure.

As for the government’s fiscal policy, despite an improvement in tax administration, in Q2 2012 the state budget had a deficit amounting to 4.6% of GDP compared with 1.9% in Q1 2012, and 3% in Q2 2011. The government’s increased obligations regarding the pay of public employees led to a 15% year-on-year increase in expenditure in Q2 2012. Tax payments in the period increased to 19% of GDP. The main contribution to the increase was made by a rise in VAT payments, which increased by 26%, and the advance payment of tax on the gross earnings of Kumtor.

The situation in the banking sector can be described as generally stable. The financial indicators of the profitability and adequacy of capital remained at rather high levels. The share of un-serviced loans was at a controllable level, making up 10% of the total volume of loans in the banking sector.

The annual growth of the banking sector’s lending to the economy was 23.5% in June 2012, with the highest increase occurring in consumer loans. However, the influence of the banking sector on the economy remained limited: banks’ assets amounted to 24% of GDP; and the monetization of the economy, as measured by the ratio of M2 to GDP, was 21.8% at the end of June 2012.
Outlook
Kyrgyzstan: 1% GDP growth this year, acceleration to 7% in next two years

Amid the poor diversification of the economy - technological problems experienced by gold mining company Kumtor led to a sharp decline in the real sector of the economy, and a significant increase in Kyrgyzstan's foreign trade deficit throughout the first nine months of 2012. According to data for January-September, the country’s GDP was 12.5% in January and it fell by 4.6%. Amid a rise in the non-tradable sectors of the economy - the impact of the problems in the gold mining industry on the GDP decline gradually weakens. There are grounds to expect that the growth rate of Kyrgyzstan’s economy will become positive by the end of 2012. The consensus forecast of international organizations predicts a GDP growth of 2.3% in 2012 and acceleration to 7.2% in 2014. The EDB expects the nation’s GDP to grow by 0.5 to 1% in 2012, which implies a very high acceleration in Q4. The expected resumption of gold production in Q4 2012 would help improve the annual figures for exports, and reduce the foreign trade deficit. Amid a slowdown in the goods-manufacturing sectors of the economy - retail trade and services will apparently remain the principal driving force of economic growth in both Q4 2012 and 2013. The retail trade and services sector has had significant growth rates in recent years. Cash remittances from abroad, which offset the foreign trade deficit, are currently almost the only factor that ensures the stability of the balance of payments, and the stability of imports. The resumption of gold production would lead to a significant increase in net exports next year. Coupled with this year’s low base and a gradual rise in investment, this would accelerate economic growth to between 6 and 7% in 2013.

As for inflation, one can expect a sharp acceleration of the rise in prices in Q4 due to both last year’s low base, and an increase in the growth rate of world food prices. The National Bank’s target of preventing the annual inflation rate from exceeding 9% in December 2012 looks feasible. The rise in prices, despite a significant effort made by the National Bank, is determined by public sector operations and the dynamics of world food prices, amid a narrow range of fluctuations in the exchange rate of the national currency. Given the increased rise in world food prices, especially the prices of grain and oil crops, one should expect the country’s inflation to accelerate to 7% this year and to 7.5% in 2013.

The existing development model is characterized by: stagnant productivity; a shortage of capital in the economy; and a lack of balance in economic growth. The strong dependence on the export of gold, and the low competitive capacity of the national economy as a whole, are reflected in significant negative figures for the foreign trade balance. These are offset by cash remittances from labor migrants.

Given the current circumstances - pursuing a cautious macroeconomic policy, and the adoption of a more flexible exchange rate regime, represents an important task for the country’s leadership. This would make it possible to counter the impact of both external and internal shocks.
**Kyrgyzstan**

**Figure 6.1. GDP and output**: GDP growth and output change by sectors, (in %, year-on-year)

Source: the National Statistics Committee of Kyrgyzstan

**Figure 6.2. Foreign trade**: exports, imports, current account (left scale, in billions of US dollars), real effective exchange rate – REER (right scale, index – Q1 2008 = 100)

Source: national agencies, IMF, EBD

**Figure 6.3. Government sector**: state budget (in % of GDP)

Source: national agencies

**Figure 6.4. Monetary sector**: the left scale - the central bank’s rate (in %) and CPI growth (in %, year-on-year); the right scale - M2 growth (in %, year-on-year)

Source: national agencies, IMF (IFS)

**Figure 6.5. Economic growth**: GDP growth and forecasts by national and international institutions (in %)

Source: estimates and forecasts by national agencies the ADB, the World Bank, the EBRD, the IMF, the EBD and the CIS Statistics Committee

**Figure 6.6. Savings and investments**: (in % of GDP): balance of private investment and savings (Sp-Ip), state budget (Sg-Ig), current account balance (X-M)

Source: estimates and forecasts by national agencies, the IMF and the EBD
Moldova: Budgetary consolidation and loosening of monetary policy in response to slowdown in economy

In Q2, GDP growth continued to slow, falling to 0.6% compared with Q2 2011. The year-on-year GDP growth rate was 1% in Q1 2012. The slowdown in economic growth was due to a sharp decline in the consumption of the private sector. Fixed capital expenditure decreased by 0.9% amid deterioration in the economic situation in Europe. Agricultural output fell by 7.5% compared with Q2 2011. At the same time the industrial sector, retail trade, and services showed positive growth rates.

Despite a slowdown in the volume of re-exports, the export and import of goods and services rose by 5.6% and 3.9%, respectively, compared with Q2 2011. The structure of foreign trade generally did not undergo significant change. The share of food and clothes still accounted for about 40% of exports; while mineral fuels and transport equipment made up more than 40% of the total import of goods.

The foreign trade deficit slightly decreased, amounting to 39% of GDP in Q2 2012 against 40.3% in Q1. The inflow of cash remittances by individuals increased by 10% compared with Q1, but declined by 3.8% compared with Q2 2011. The current account deficit, which amounted to 11.2% of GDP, was financed by both foreign direct investment (2.8% of GDP) and loans (6.3% of GDP).

The continued consolidation of public finances prevented the state budget deficit from growing. The deterioration in the economy affected tax revenues, and the government could not reduce expenditure obligations that it had undertaken. In early 2012, the government adopted a number of important changes to laws, which provided for additional tax incentives for private sector. As a result, the state budget deficit amounted to 1.9% of GDP, down from 2.9% in Q1 2012.

The flexible exchange rate of the national currency, and the timely loosening of the National Bank’s monetary policy, helped stop disinflation amid the slowing economy. This prevented a drastic decline in consumer price growth. Inflation continued to decelerate in the first half of 2012, and stopped at 3.7% in June. The inflation dynamics were to a greater extent determined by lower pressure from prices in world food markets, and a good crop in Moldova in 2011.

The situation in the banking sector continued to be generally stable. The sector’s capitalization and profitability figures remained rather high. The annual growth rate of lending to the economy was 15.5% in June 2012. The volume of non-performing bank loans slightly grew amid the slowing economy, accounting for 15.3% of the total volume in June 2012. A risky lending policy and shortcomings in management considerably weakened Moldova’s state-owned bank Banca de Economii. Its assets account for about 13% of all assets of the country’s banking sector. The position of the bank required urgent measures to be taken to clean up its balance sheet assets.
Outlook

Moldova: Growth acceleration in second half of 2012, positive outlook for 2013

The deterioration of the economic situation in the region has already affected the volume of exports, the inflow of cash remittances, and internal demand in Moldova. The 2012 summer’s drought that damaged agriculture, and the continued crisis in Europe, are major factors that can pull down the national economy. The forecasts of both international organizations, and national government agencies, predict an acceleration of economic growth in the latter half of 2012. This is due to positive changes in the macroeconomic policy pursued by the government. Measures taken in the field of public finances - such as tax incentives for investors and automatic stabilizers - make it possible to stabilize the fiscal situation. The condition of the state budget, and the National Bank’s flexible exchange rate policy, provide a certain margin of safety against negative external shocks; while a consistent monetary and lending policy helps keep the inflation rate at an acceptable level. The nation’s economic ministry has revised moderately downward its economic growth forecast for this year from 4% to 3.5%. The ministry does not rule out that next year’s GDP growth will exceed 4%; and may even reach 5% in the event of favorable developments in the economies of the European Union and Russia.

Despite the loosening of the monetary and lending policy in late 2011 and early 2012, the annual rise in prices should not significantly exceed the 5% target level of the National Bank. It was 4.4% in August 2012,

Given the surplus liquidity of the banking sector, and rather steady growth rates of lending: the National Bank has not reduced the refinance rate since March, leaving it at the level of 4.5%. It rose to 17% in March 2012 and slightly fell in June and September to 15.5% and 16.7%, respectively.

Moldova’s balance of payments remains stable. The government believes that: cash remittances from labor migrants will rise, provided Russia’s economic growth continues; and that the economic reforms it is carrying out should ensure an inflow of foreign investment, and an export growth rate higher than that for imports, in the period between 2012 and 2015. In this context, the National Bank’s continued flexible policy regarding the exchange rate of the leu gives grounds to expect that the economy will not lose its external sustainability.

The Moldovan banking sector’s debt owed to European banks amounted to $800 million in March 2012 (about 12% of GDP). This fact, coupled with a rise in non-performing loans - caused by problems with the assets of a large state-owned bank in the country - is another major threat to the steady development of the national economy. Increased banking supervision is required, and measures must be taken to improve regulations and enhance transparency in the banking system.
Moldova

Figure 7.1. **GDP and output**: GDP growth and output change by sectors, (in %, year-on-year)

Source: the National Bureau of Statistics of Moldova

Figure 7.2. **Foreign trade**: exports, imports, current account (left scale, in billions of US dollars), real effective exchange rate – REER (right scale, index – Q1 2008 = 100)

Source: national agencies, IMF

Figure 7.3. **Government sector**: state budget (in % of GDP)

Source: national agencies

Figure 7.4. **Monetary sector**: the left scale - the central bank’s rate (in %) and CPI growth (in %, year-on-year); the right scale - M2 growth (in %, year-on-year)

Source: national agencies, IMF (IFS)

Figure 7.5. **Economic growth**: GDP growth and forecasts by national and international institutions (in %)

Source: estimates and forecasts by national agencies, the World Bank, the EBRD, the IMF and the CIS Statistics Committee

Figure 7.6. **Savings and investments**: (in % of GDP): balance of private investment and savings (Sp-Ip), state budget (Sg-Ig), current account balance (X-M)

Source: estimates and forecasts by national agencies and the IMF
Russia: Slowdown in growth amid deterioration in external conditions

The growth of the Russian economy decelerated in Q2 2012 compared with Q1 2012. The country’s GDP increased by 4% year-on-year in Q2 compared with a 4.9% rise in Q1. The growth rate of private consumption fell to 6.6% from 7.2% in Q1. The growth rate of fixed capital expenditure also turned out to be lower than in Q1, when it was 15%, falling to 7.9% compared with Q1 2011. Exports showed negative growth, decreasing by 1.4% in Q2 in real terms. On the side of supply, the growth rate decreased to 0.5% from 2% in Q1 in the extractive sector, and to 2.9% from 3.5% in Q1 in the manufacturing sector. The growth rate in agriculture slightly increased to 2.5% from 1.8% in Q1, but the bulk of activity in this sector is in the latter half of the year. The main factor that determined the generally lower economic growth figures for Q2 compared with Q1 was deterioration in the foreign trade conditions due to a new twist in the debt crisis in the Eurozone in May and June. However, domestic demand, including investment demand, retained a relatively high growth rate. The current account surplus significantly shrank in Q2 amid a decrease in export revenues, amounting to $19.2 billion against $39.3 billion in Q1. The outflow of capital from the private sector also sharply decreased: from $33.9 billion in Q1 to $9.5 billion in Q2.

The fiscal outcome of Q2 was favorable despite a fall in prices of major Russian exports in May and June. The impact of that fall was offset to a significant extent by the simultaneous weakening of the ruble. As a result, the nation’s consolidated budget had a surplus of 1,126 trillion rubles, or about 4% of GDP, in the first half of 2012.

The annual inflation rate in the country stood at an all-time low of 3.6% in April and May. It began to rise in June under the influence of the ruble’s weakening against major world currencies and, probably, because of the upcoming scheduled increase in regulated prices. In the last month of Q2, the annual growth rate of the CPI increased to 4.3%. The central bank did not change the parameters of its monetary policy. It was waiting for more clarity with regard to: the inflation effect of the increase in regulated prices, and fluctuations in the exchange rate of the national currency; and the general trends in the economic situation in the remaining part of 2012.

The annual growth rate of banks’ lending to the economy gradually fell amid uncertainty in the economic outlook; and under the influence of the relatively tight monetary policy by the central bank. This rate decreased to 12.4% in June from 17% in March. The rapid growth of certain segments of lending activity, in particular consumer lending, did not change the general trend in this area. The banking sector continued the consolidation of its balance. In particular, the ratio of Russian banks’ capital to assets decreased to 13.1% as of early July compared with 14.2% at the end of Q1.
Outlook

Russia: Growth amid recovery of prices of exports, continued external risks

A recovery of international prices of the nation’s major exports took place between July and the first half of September. Trends in the Russian economy in the remaining part of 2012 will largely depend on whether this recovery is steady. This is a condition for a continued high growth rate of investment activity; the bulk of which is reflected in statistical data for the latter half of 2012. High investment activity can ensure a relatively high growth rate in the economy as a whole in this period. Indicators of business confidence, and purchasing managers’ indices (PMIs), indicate acceleration in economic dynamics in late Q3. This suggests that developments are moving in this direction. At the same time a number of circumstances - such as the high base of the latter half of 2011, and the negative impact of this year’s unfavorable weather conditions on agricultural production - put downward pressure on economic growth. In the event of relatively favorable developments in the world economic situation, Russia may still have a GDP growth rate of between 4 and 5% in 2012. In case of a persistent fall in the prices of Russia’s major exports – under our negative scenario the price of Brent crude oil falls to $90 per barrel and remains at this level for long time – we expect a decline in Russia’s rate of economic growth to 2 to 3%.

Inflation in Russia accelerated due to: the July and September increases in regulated tariffs; and the rise in international energy and food prices. As a result, consumer prices increased by 5.2% in the first nine months of 2012 compared with a rise of 4.7% in the same period of 2011. One can expect the CPI growth rate for this year to be 6.5%, up from 6.1% in 2011. The authorities will therefore apparently fail to make any progress this year in combating inflation. However, the Bank of Russia has recently displayed some firmness and tightened its monetary policy - on September 14, it raised the interest rates on all instruments of the central bank.

Russia’s budget proved relatively immune to the fall in the revenues from the export of raw materials that occurred in May and June. It is highly probable that the budget will have a surplus in 2012.

The current account surplus, and the corresponding outflow of capital from the private sector, will remain significant for 2012 unless prices of major Russian exports experience a sharp fall again. The recovery of the economy’s revenue from exports will supply it with resources for investment abroad. The decline in the export of capital and in the current account surplus in Q2 will be short-lived in this case.

The unstable situation in the economy in May and June contributed to deterioration in the financial sector’s access to liquidity. This led to a rise in interest rates in the money market. However, the rates reversed their upward trend in July and August, and have now declined back to their April levels.

Given the outcome of Q2 and Q3, one can conclude that the economy of Russia showed stability amid negative external shocks, although their negative impact on the nation’s economic growth was appreciable.

Trends in the Russian economy will depend on whether the recovery of international prices of major exports is steady

In the event of favorable developments in the world economy, Russia will have a GDP growth rate of between 4 and 5% in 2012

Inflation accelerates under the influence of the July and September increases in regulated prices, and due to a rise in energy and food prices

The state budget will probably have a surplus in 2012

The current account surplus and the outflow of capital will remain significant

The economy shows stability against external shocks, but their impact is appreciable
Russia

Figure 8.1. **GDP and output**: GDP growth and output change by sectors, (in %, year-on-year)

![Diagram showing GDP growth and output change by sectors]

Source: the Federal State Statistics Service

Figure 8.2. **Foreign trade**: exports, imports, current account (left scale, in billions of US dollars), real effective exchange rate – REER (right scale, index – Q1 2008 = 100)

![Diagram showing foreign trade, current account and REER]

Source: national agencies, IMF, EBD

Figure 8.3. **Government sector**: consolidated budget (in % of GDP)

![Diagram showing government sector budget]

Source: national agencies

Figure 8.4. **Monetary sector**: the left scale - the central bank’s rate (in %) and CPI growth (in %, year-on-year); the right scale - M2 growth (in %, year-on-year)

![Diagram showing monetary sector]

Source: national agencies, IMF (IFS)

Figure 8.5. **Economic growth**: GDP growth and forecasts by national and international institutions (in %)

![Diagram showing economic growth]

Source: estimates and forecasts by national agencies, the EBD, the World Bank, the EBRD, the IMF and the CIS Statistics Committee

Figure 8.6. **Savings and investments**: (in % of GDP): balance of private investment and savings (Sp-Ip), state budget (Sg-Ig), current account balance (X-M)

![Diagram showing savings and investments]

Source: estimates and forecasts by national agencies, the IMF and the EBD
Tajikistan: Economic growth accelerates, driven by consumption

Tajikistan’s economic growth accelerated to 7.6% in Q2 2012 against 7.2% in Q1. Consumption remained the main driver of the growth. It was stimulated by cash remittances by labor migrants and a rise in real pay. Fixed capital expenditure decreased, mostly due to the reduction of government investment in the transport infrastructure. Under these circumstances, trade and services had growth rates of 20.6% and 13.4%, respectively. The goods-manufacturing sectors experienced some deceleration. The growth rate of agricultural output fell to 5.8% from 7.4% in Q1, mainly due to the food industry and the production of electric equipment. The metallurgy industry, which stagnated in Q1, having a 9.8% year-on-year drop, showed a rise of 12.4%. This led to the improvement of the figures for the export of non-precious metals. Amid a 24% annual fall in the price of aluminum, exports decreased by 3.4% in terms of value. The export of this category of commodities accounts for 45% of the total volume of the country’s exports. In Q1 2012 it plummeted by 36.2% in annual terms. Another important feature of Q2 2012 was a 50% rise in cotton fiber production. This led to a 103% increase in the export of cotton fiber amid a continued decline in world cotton prices. The favorable export dynamics helped reduce the foreign trade deficit from $580 million to $500 million. At the same time an 8.9% increase occurred in the import of goods. This was caused by both a rise in the prices of imported mineral products, and a rise in the demand for used cars. The import of cars doubled.

The trend in public finances was favorable. Government revenue increased by 3.2% compared with Q2 2011, while expenditure decreased by 2.3%. Amid GDP growth and an improvement in administration, the rise in public revenue outpaced the growth of expenditure. The contribution of tax revenues (VAT, income tax) to the revenue growth as 17%. A significant contribution to expenditure was made by the social sector, while the share of transportation and communications noticeably shrank. The state budget had a surplus amounting to 0.4% of GDP in the first half of 2012.

Annual inflation continued to decelerate, falling to 4.8% in June and 4.5% in July. The National Bank of Tajikistan lowered the refinance rate from 8 to 6.5%. The inflation slowdown also allowed the government to raise the minimum pay level and pay for public sector’s employees. Although this move was expected, it creates conditions for price growth until the end of 2012, and increases the burden on the state budget.

A downward trend in the annual growth rates of both loans and deposits indicates a slowdown in activity in the banking sector. There is a considerable slowdown in banks’ transactions in the national currency. Despite authorities’ efforts and some apparent improvements, the country’s banking sector remains weak and vulnerable to shocks. This is due to banks’ profitability rates being still low, and non-performing loans making up a large share of the total credit portfolio.
Outlook

**Tajikistan: Increased inflation risks from both external and internal factors**

Throughout the greater part of 2012, contrary to general world and regional trends, Tajikistan had growth acceleration in both the production sector and retail trade and services. Crop production was the driver of growth in agriculture. The industrial sector was notable for a growth rate of 11.7%, which was ensured by textile and garment production (80% growth), and metallurgical production (5.3% growth). This growth may help reverse the downward trend in the production and export of aluminum, and the metallurgical sector may show a higher growth rate. Despite a continued decline in cotton prices, the first eight months of 2012 saw a rise in the production and export of cotton fiber. The country’s foreign trade deficit, which totaled $1.2 billion last year, grew by 24% due to imports having a higher growth rate (15%) than exports (2%). Consumer price inflation accelerated to 5% in August 2012 due to both an easier monetary policy and a sharp rise in food prices in world commodity markets. The loosening of monetary policy and the simultaneous increase in pay, amid increased risks of external inflationary shocks, may eventually lead to a dramatic rise in prices in the Tajik economy. Other short-term risks in this regard include the forthcoming significant payments on the nation’s external public debt, which currently amounts to 32% of GDP. It is important for the government to make a transition to a more flexible exchange rate policy to: prevent the external debt from growing; reduce external imbalances; and alleviate the burden on the state budget.

The weakness of the banking sector, and a considerable share of non-performing loans, is another risk for the country’s economy. Other sources of risks for economic development in both the short and long term are the insufficient diversity of exports, and the considerable dependence of the economy on external revenues. The foreign trade situation has deteriorated due to a decline in prices of exported aluminum and cotton, and a rise in price of imported petroleum products in recent years. This has led to an increase in the trade deficit. This is also caused by high demand for consumer imports, fueled by a growing inflow of cash remittances. The nation’s GDP growth is underpinned by the growth in government investment and public consumption, amid imbalances in foreign trade and the growing external debt. Government investment is financed with external borrowings, while the inflow of cash remittances is accompanied by an increasing consumption of imported goods.

The current consensus forecast by analysts predicts a GDP growth rate of 5.6% to 5.7% in the next two years. GDP growth’s decline from 7.4% in 2011 will be a consequence of deceleration in the economies of the countries that are key trading partners of Tajikistan, as well as the countries where cash remittances come from. The EDB expects Tajikistan’s GDP to grow by 6% to 7% in both 2012 and 2013. Consumer prices are expected to rise by 8% to 9% amid increased risks from world food prices.

Contrary to general world and regional trends, Tajikistan has growth acceleration in both the production sector and retail trade and services.

The loosening of monetary policy and a rise in pay amid a rise in world food prices may lead to high inflation.

The weakness of the banking sector and insufficient diversity of exports are major sources of risks for economic development.

The EDB forecasts a GDP growth rate of 6 to 7% in both 2012 and 2013.
**Tajikistan**

**Figure 9.1. GDP and output:** GDP growth and output change by sectors, (in %, year-on-year)

- Agricultural output growth
- Industrial output growth
- GDP growth

Source: the Agency on Statistics under President of Tajikistan

**Figure 9.2. Foreign trade:** exports, imports, current account (left scale, in billions of US dollars), real effective exchange rate – REER (right scale, index – Q1 2008 = 100)

Source: national agencies, IMF, EBD

**Figure 9.3. Government sector:** state budget (in % of GDP)

Source: national agencies

**Figure 9.4. Monetary sector:** the left scale - the central bank’s rate (in %) and CPI growth (in %, year-on-year); the right scale - M2 growth (in %, year-on-year)

Source: national agencies, IMF (IFS)

**Figure 9.5. Economic growth:** GDP growth and forecasts by national and international institutions (in %)

Source: estimates and forecasts by national agencies, the EBD, the ABD, World Bank, the EBRD, the IMF and the CIS Statistics Committee

**Figure 9.6. Savings and investments:** (in % of GDP): balance of private investment and savings (Sp-Ip), state budget (Sg-Ig), current account balance (X-M)

Source: estimates and forecasts by national agencies, the IMF and the EBD
Trends and outlook
Turkmenistan: Rise in export of natural gas and in investment

In Q2 2012, the economy of Turkmenistan showed stable economic growth. It was mainly driven by the industrial sector stimulated by investment - which increased by 38.1% in the first half of 2012 - and by growing external demand for natural gas, in particular from China and Iran. According to reports by the government, economic growth accelerated to 11% in the first half of 2012, but remained below the figure for 2011. Industrial output increased by 32%, while the volume of construction grew by 18% through the implementation of infrastructural, industrial and social projects. The growth rate in the services sector was 21.8%. The rate of growth in the agricultural sector was more modest, varying from 0.0 to 3.7% depending on the type of product.

The expansion of opportunities for the transportation of gas, coupled with high prices of exported hydrocarbon raw materials, allowed export revenues to remain at a high level. The export of natural gas rose by 16.1% in annual terms in the first half of 2012, accounting for 90% of the total volume of exports. The aggregate nominal volume of exports grew by 47.7%. The country’s imports, 80% of which was made up by goods for production and technical purposes, rose by 48.4%, mainly through a rise in the export of production equipment. According to a report by the International Monetary Fund, the current account balance became positive, while the government’s reserves remained at a comfortable level, supporting the stability of the manat.

The increased volume of exports in turn contributed to an increase in state budget revenues and helped increase resources in the Stabilization Fund. In the first half of 2012, the government’s revenue exceeded the target by 20.5%, while expenditure only reached 94.5% of the projected level. The high level of government revenue contributes to the implementation of the 2011-2030 National Program of Social and Economic Development. This is aimed at: the strengthening of the economic security of the country; the diversification of the national economy; and the implementation of the government’s social policy. Despite the massive stimulation of the economy, and an 11.1% increase in pay, consumer prices in June 2012 were 1.8% lower than in December 2011, according to official statisticians. According to the IMF, the annual inflation rate was 3% in June 2012, whereas the leadership of Turkmenistan had expected a rate of 4% between 2011 and 2015.

The IMF’s revised forecast predicts Turkmenistan’s real GDP to continue growing at a high pace, and to have a growth rate of 8% in both 2012 and 2013. The EDB and the Asian Development Bank forecast growth rates of 10% and between 9 and 10%, respectively.

The optimistic forecasts are based on: the continued high prices of hydrocarbon raw materials; growing demand; and the high level of investment projected for the period between 2011 and 2015, which amounts to 162 billion manat, or $57 billion at the current official exchange rate. Despite the active stimulation of the economy and growing inflation risks, inflation should remain moderate due to administrative control. The IMF forecast the inflation rate to be below 10%. Forecasts also remain positive for public finances. One should expect the nation to have a high growth rate in the medium term due to the increased expansion of opportunities for the transportation of natural gas, and the doubling of the amount of proven gas reserves.
Turkmenistan

Figure 10.1. **GDP**: GDP growth (in %, year-on-year)

![GDP Growth Chart]

Source: the CIS Statistics Committee and national agencies

Figure 10.2. **Foreign trade**: exports, imports (in billions of US dollars)

![Foreign Trade Chart]

Source: national agencies and IMF

Figure 10.3. **Government sector**: state budget (in % of GDP)

![Government Sector Chart]

Source: ADB

Figure 10.4. **Monetary sector**: the left scale CPI growth (in %, year-on-year); the right scale - M2 growth (in %, year-on-year)

![Monetary Sector Chart]

Source: ADB

Figure 10.5. **Economic growth**: GDP growth and forecasts by national and international institutions (in %)

![Economic Growth Chart]

Source: estimates and forecasts by the ABD, the EBRD, the IMF

Figure 10.6. **Savings and investments**: (in % of GDP): balance of private investment and savings (Sp-Ip), state budget (Sg-Ig), current account balance (X-M)

![Savings and Investments Chart]

Source: estimates and forecasts by the IMF
Trends and outlook

Uzbekistan: High growth rate and inflation risks

Economic growth in Uzbekistan accelerated to 8.1% in the first half of 2012. This can be linked to the strengthening of domestic demand, and high prices of major export items (natural gas, cotton and gold). Internal demand strengthened, offsetting a decline in external demand. This was due to the government’s policy aimed at increasing the competitive capacity of the industrial sector, modernizing agriculture, supporting domestic manufacturers and increasing real pay. It was also due to an increase in the inflow of cash remittances from abroad in Q2 2012, with remittances from Russia alone totaling $1.9 billion in the first half of 2012. Industrial output increased by 7% in annual terms in the first half of 2012, while agricultural output rose by 7.1%, retail trade by 12.5% and services by 14%.

The foreign trade dynamics were determined by a combination of a rise in imports, which increased by 14.1% in the first half of 2012, and deceleration in the growth of exports, which rose by 1.1%. The strengthening of internal demand contributed to a rise in the import of machines, equipment, chemical products, foodstuffs and other goods. At the same time the weakening of external demand for the goods exported by Uzbekistan led to a deceleration in the growth of exports. As a result, the nation had a trade surplus amounting to $1.2 billion, or 5.6% of GDP. The high volume of cash remittances from abroad, together with the surplus, led to a positive current account balance. The volume of foreign investment grew, and totaled an estimated $1 billion in the period. Both the surplus and the investment helped the government accumulate foreign exchange reserves.

The situation in the monetary sector is characterized by uncertainty. According to data from Uzbekistan’s State Statistical Committee, inflation in the consumer market was 3.4% in annual terms in the first half of 2012. The International Monetary Fund forecast an inflation rate of 12% for 2012. Given the high level of government stimulation, a 30.3% increase in bank assets, a 26.1% increase in the population’s nominal income, and the weakening of the national currency, the IMF’s forecast seems closer to reality. It should be noted that the Central Bank of Uzbekistan left the refinance rate unchanged at 12% and set bounds of 7 to 9% for inflation.

Although the tax burden was reduced, state budget revenue increased due to the expansion of the tax base, and better tax collection. The state budget surplus slightly decreased in January-June 2012, amounting to 0.2% of GDP. If the assets of the Fund for Reconstruction and Development, which increased to $11 billion in August 2012, are taken into consideration, one can say that the situation in the fiscal sector does not cause any anxiety.

Given the potential weakening of external demand and a possible decline in cash remittances from abroad, economic growth should decelerate in the second half of 2012, but it will remain generally high. Continued high prices in world markets for Tajikistan’s major export items would have a positive effect on the fiscal and foreign trade sectors. This will allow the leadership of the country to continue implementing government programs, which would offset the weakening of external demand. Consensus forecasts from analysts for Uzbekistan’s economic growth, and national agencies’ forecasts, predict a GDP growth rate of 7.7% for 2012, 7.2% for 2013 and 7.1% for 2014.

Economic growth accelerates to 8.1% in the first half of 2012, which can be linked to the strengthening of domestic demand and high prices of major exports

The foreign trade dynamics are determined by a combination of a 14.1% increase in imports and deceleration in the growth of exports

The situation in the monetary sector is characterized by uncertainty

Given national agencies’ forecasts, the GDP growth rate is expected to be 7.7% in 2012, 7.2% in 2013 and 7.1% in 2014
Uzbekistan

Figure 9.1. **GDP and output**: GDP growth and output change by sectors, (in %, year-on-year)

![GDP and output](chart)

Source: the CIS Statistics Committee and national agencies

Figure 11.2. **Foreign trade**: exports, imports (in billions of US dollars)

![Foreign trade](chart)

Source: national agencies

Figure 11.3. **Government sector**: state budget (in % of GDP)

![Government sector](chart)

Source: IMF

Figure 11.4. **Monetary sector**: the left scale - the central bank’s rate (in %) and CPI growth (in %, year-on-year); the right scale - M2 growth (in %, year-on-year)

![Monetary sector](chart)

Source: IMF

Figure 11.5. **Economic growth**: GDP growth and forecasts by national and international institutions (in %)

![Economic growth](chart)

Source: estimates and forecasts by national agencies, the ABD, World Bank, the EBRD, the IMF and the CIS Statistics Committee

Figure 11.6. **Savings and investments**: (in % of GDP): balance of private investment and savings (Sp-Ip), state budget (Sg-Ig), current account balance (X-M)

![Savings and investments](chart)

Source: estimates and forecasts by national agencies and the IMF
Trends
Ukraine: Slow growth amid low external demand

Ukraine’s GDP increased by 3% year-on-year in Q2 2012 compared with a 2% year-on-year rise in Q1. The acceleration in the nation’s economic growth was largely due to strong dynamics in the agricultural sector - output increased by 11.4% compared with Q2 2011. There was also growth acceleration in the trade sector - to 6.9% from 5.5% in Q1. There were high growth rates for household consumption – 14.3% compared with 9.8% in Q1 – and fixed capital expenditure - 16.9% year-on-year increase compared with 7.6% in Q1. The production dynamics in both the extractive and manufacturing industries remained weak. The growth rate of the production of minerals fell to 2.4% from 3.7% in Q1; and the extractive sector showed a decline of 0.2% after an increase of 0.2% in Q1. The low production figures were mainly due to a fall in external demand - exports decreased by 6.8% in Q2 compared with Q2 2011 following the same year-on-year decrease in Q1. The considerable increases in consumption and fixed capital expenditure were almost fully covered by the rise in imports.

Inflation continued to decelerate - the consumer price index had zero or negative monthly growth rates between April and September. The annual growth rate of the CPI has remained zero or negative since May. This became possible due to low growth rates of monetary aggregates – the annual M2 growth rate fell to 9% in June from 14.2% in December 2011 – amid the tight pegging of the national currency to the US dollar. Despite the fact that the peg was slightly loosened in late May, fluctuations in the exchange rate of the hryvnia against the dollar remained within 1.5% compared to the beginning of 2012.

The state budget deficit in the first half of 2012 amounted to 1% of GDP, down from 1.9% in the same period of 2011.

The balance of payments deteriorated in Q2 compared with both Q1 and Q2 2011. The current account deficit amounted to $3.5 billion (8% of GDP), against $1.8 billion (4.9% of GDP) in Q1 2012, and $1.7 billion (4.3% of GDP) in Q2 2011. Amid the continued tight control of the exchange rate of the national currency, the external imbalance led to a decrease in the international reserves of the National Bank of Ukraine. They shrank from $31.1 billion at the end of March to $29.3 billion at the end of June. This was despite the fact that the current account deficit was partly offset by an increase in external borrowings by both the public and private sectors.

The growth of the banking sector’s lending to the economy continued to slow amid the low growth rates of the country’s GDP and the money supply. The total volume of loans issued by banks to non-financial organizations in June was 7.8% higher than in June 2011 compared with a 10.7% year-on-year increase in March. The volume of loans issued to households fell by 9% year-on-year in June 2012. A decrease occurred in the ratio of regulatory capital to assets, which fell from 19.2% in Q2 2011 to 18% in Q2 2012. However, the share of non-performing loans in the total amount also decreased, shrinking to 14.1% in Q2 2012 from 15.4% in Q2 2011.
Outlook
Ukraine: More flexible exchange rate policy, strengthening of external balance

It is most likely that Ukraine will continue to have a low economic growth rate in the short term. In Q3 2012, GDP growth may slow due to an output decrease in the agricultural sector. It was affected by a drought, like the agricultural sectors in many other countries. The growth rate of the industrial sector will also remain low considering data for July and August. The situation may change for the better in the last months of 2012. It should be influenced by the recovery of prices of raw materials, which started this summer, as well as by the apparent strengthening of economic activity in Russia. The economy of Ukraine will probably show a GDP growth rate of between 1.5% and 2.5% in 2012. The situation in 2013 will depend on whether there is a reverse in the downward trend in the country’s key industries - in particular the production of iron and steel, and machine-building, whose performance is largely determined by external demand. If that does not happen, the country will not be able to retain the current levels of consumption and fixed capital expenditure; and the economy will experience adjustment accompanied by a decline in GDP. Matters relating to the stability of the balance of payments ceased to be of a hypothetical nature after the current account deficit reached 8% of GDP in Q2. Due to seasonal dynamics this indicator in Ukraine peaks in Q1 and Q4. The current account deficit for the entire year will therefore be between 6 and 9%. Since the gross external public and private debt amounts to more than 70% of GDP, the country will not be able to finance this balance of payments deficit for a long period of time.

Given the outcome of the first half of 2012, the 2012 state budget may have a deficit equal to 1% of GDP compared with 5.9% in 2010 and 1.8% in 2011. More rapid consolidation of the public finances would be justified despite the low GDP growth rate. This would be a tool to regain control over the growing external imbalance of the Ukrainian economy. At the same time, there are grounds to loosen the government’s monetary policy. The deceleration of consumer price inflation, which exceeded 10% during the greater part of the past decade, represents a considerable achievement; but there is no reason to try to keep it at the current zero or negative level. If the National Bank of Ukraine starts to pursue an easier monetary policy and a more flexible exchange rate regime, this will help stimulate lending activity, support economic growth, and regain control over the current account deficit.

Thus strengthening the external balance and ensuring economic growth require readjusting the government’s macroeconomic policy. This would include tightening fiscal policy, loosening lending and monetary policy, and reducing control over the exchange rate of the national currency. The need for these measures will decrease or disappear in the event of significant positive changes in the balance of payments - such as a considerable improvement in the conditions of trade or the inflow of capital. However the current trends suggest that the time for waiting for such changes is not unlimited.
Ukraine

Figure 12.1. **GDP and output**: GDP growth and output change by sectors, (in %, year-on-year)

![GDP and output chart]

Source: the State Statistics Service of Ukraine

Figure 12.2. **Foreign trade**: exports, imports, current account (left scale, in billions of US dollars), real effective exchange rate – REER (right scale, index – Q1 2008 = 100)

![Foreign trade chart]

Source: national agencies, IMF

Figure 12.3. **Government sector**: state budget (in % of GDP)

![Government sector chart]

Source: national agencies

Figure 12.4. **Monetary sector**: the left scale - the central bank’s rate (in %) and CPI growth (in %, year-on-year); the right scale - M2 growth (in %, year-on-year)

![Monetary sector chart]

Source: national agencies, IMF (IFS)

Figure 12.5. **Economic growth**: GDP growth and forecasts by national and international institutions (in %)

![Economic growth chart]

Source: estimates and forecasts by national agencies, the World Bank, the EBRD, the IMF and the CIS Statistics Committee

Figure 12.6. **Savings and investments**: (in % of GDP): balance of private investment and savings (Sp-Ip), state budget (Sg-Ig), current account balance (X-M)

![Savings and investments chart]

Source: estimates and forecasts by national agencies and the IMF
Review of global risks and channels of transmission of external shocks to EDB economies

By Elvira Kurmanalieva

Recent developments and their impact on long-term processes in the world economy

The debt crisis started to negatively affect the economies of developed countries in 2011, when GDP growth in the greater part of the world economy decelerated to 2.8% from 4.2% in 2010. After some revival in Q1 2012, an increase in tension in financial markets due to uncertainty regarding the solution of the debt problems of Greece, and difficulties in the banking system of Spain, affected the macroeconomic indicators for Q2 2012.

Amid a deterioration in the state of the world economy, during one week in September 2012, the central banks of leading countries in the world announced new measures to stimulate the economy. The European Central Bank made a statement about the launch of a new program of purchasing government bonds of problem countries in the Eurozone in the secondary market with an unlimited volume of interventions. This reduced considerably the probability of a dramatic spread of the debt crisis. The US Federal Open Market Committee decided to start an open-ended program of buying mortgage-backed securities from the market at a rate of $40 billion per month, until the end of 2012. This decision, in addition to existing Operation Twist, formed a package of measures, which suggest that with relatively low inflation the central bank can pay more attention to solving the unemployment problem. Inflation in the USA was 1.69% in August, whereas the target was 2%. A program announced by the Bank of Japan for purchasing assets worth 10 trillion yen ($127 billion) came as a response to the actions by the US Federal Reserve System and the European Central Bank. The BoJ intended to prevent the yen from strengthening with a view to support exporters.

The current problems of the world economy are of a long-term nature. The world economy has encountered two deep and interlocked processes. One of them has to do with structural changes in the global economy due to demographic, migratory and integrationist changes in the world. The strengthening of interaction and interdependence in the world economy, and the emergence of multi-polar consensus, leads to a serious transformation of the international financial architecture. The other process is deleveraging and rebalancing, or the process of getting rid of debts and imbalances between economic sectors and between certain countries. This process implies the withdrawal of a certain part of revenue from one economy or sector to eliminate debts in another. That is why, amid limited fiscal opportunities, the central banks of many countries try to combat debt problems through loosening their monetary policy. This is a painful and lengthy process that implies the emergence of inflation bubbles amid inflows and outflows of significant volumes of speculative capital. The uncertainty and volatility of prices in world markets are a natural consequence of this process. A rise in prices of raw materials is a positive phenomenon for countries that produce raw materials; but at the same time an increase in food prices would cause crises in countries with a large share of low-income households. Amid these processes, there has been instability and uncertainty in the world economy for several years, which complicates forecasting economic development. In a previous issue of the CIS Macromonitor (March 2012), we described major risks that can drastically change the picture of the world economy’s development. In this article, we provide a review of the current state of these risks in the context of the recently adopted measures of the central banks of leading countries to stimulate the economy.

1. **Europe.** Despite the fact that the European Central Bank did not specify the volume of forthcoming purchases of debt securities, and did not set a time limit for the implementation of the program, the very announcement of the intention had a positive effect on financial markets. The profitability of the government bonds of Spain and Italy started to sharply decrease on July 26, when ECB President Mario Draghi promised to do everything necessary to protect the euro. It should be noted that the existence of unlimited opportunities and the display of determination by the ECB considerably reduced the risk of the breakup of the European integration bloc. The announced program imposes strict conditionality on debtor countries. This makes it highly probable that the debt crisis will have periods of escalation while the institutional basis is
created for deeper integration in Europe. The long-term nature of this process implies subdued economic growth in Europe, as can be seen already. The member countries of the EDB have now, to a considerable extent, got rid of debts owed to the European banking sector. A direct short-term effect will be a slowdown in the growth of demand and fluctuations in world prices of raw materials. The bulk of the exports of the two largest member countries of the EDB is raw materials.

2. **The United States.** The duration of tax cuts, and budgetary incentives, adopted in the last two years ends at the end of 2012. The procedure of automatic sequestration of federal spending may also start to be effective at that time, with the aim of counteracting a rise in the federal budget deficit. According to official estimates, the total volume of expiring tax cuts and budgetary incentives may amount to $600 billion or 4% of the US GDP. To a considerable degree, the amount will depend on the outcome of the presidential election to be held in November. Heightened political competition in the run-up to the election prevents radical steps from being taken in the field of budgetary policy. The situation in the US economy has changed for the better in recent months. If this trend continues, fiscal consolidation, which is needed to restore the stability of the public finances, may turn out less radical. As in Europe, a direct effect of deleveraging in the United States will be a slowdown in economic activity in the world, and fluctuations in world prices of raw materials in the long term. The absence of direct trade ties between the EDB member countries and the United States does not insulate the former from adverse effects. The trade in crude oil, metals and grain is international. A decline in demand for them in one part of the world will affect prices of raw materials exported from the EDB member countries.

3. **China.** The recovery of the growth of the Chinese economy – under the influence of stimulus measures taken by the government in 2009 and 2010 – has considerably facilitated overcoming the crisis for both China itself and the rest of the world. However, in the last two years the Chinese economy has significantly decelerated its growth. This was due to a fall in demand for its export products, and a decline in competitiveness resulting from a rise in prices and workers’ pay in the country. The slowdown is also partly due to the reversal of the economic policy in 2011. The overheating of the economy manifested itself in inflation acceleration, and a sharp rise in prices of real estate. Chinese authorities therefore took measures to contain lending expansion, which yielded some results: inflation in the country decelerated, and the boom in the real estate sector is fading away. In the recent past, one could see some loosening of the Chinese government’s monetary and lending policy (see the figure). If, amid the new measures of qualitative loosening in the United States and Europe, the Chinese economy avoids acute crises in the banking sector and the real estate market, then China should continue to be a source of positive effects for the world economy in the next few years. The existence of sufficient room for fiscal stimuli makes such an outcome quite probable. However, one should not rule out that the situation will start to change in an unfavorable direction. The EDB member countries, which have close trade ties and growing financial ties with China, are becoming increasingly more dependent on changes in that economy, both structural and short-term ones. The most recent forecast of the Chinese government for GDP growth in 2012 is 7.6%.

4. **Prices of raw materials.** The consensus forecast from a number of institutions predicts that two contrary factors – geopolitical tension, and the expected weakening of world demand for crude oil – will continue to have polar effects on oil prices. Energy and food prices may resume rising at an unexpectedly fast pace. This would be due to: the current very loose monetary and lending policy of central banks; and the existing limited opportunities to increase the production of most of the types of energy, and food raw materials. Simultaneously, owing to continued interruptions in production, the oil market will continue to be under pressure and the average level of oil prices will remain high, as will their volatility. The consensus forecast predicts the average price of Brent crude to be $109 in 2012 and $107 in 2013. In this case, developments regarding oil and food prices will follow the scenario of 2007 and 2010. This year’s drought in countries producing grain and oil crops led to a rise of 20% to 30% in the price of these products in July and August 2012. Countries that have a large share of low-income households, and are net importers of food, will be the most sensitive to a rise in food prices in the EDB region.
Channels of transmission to EDB countries

1. Structure of trade

Depending on the current account dynamics, the EDB countries can be divided into three groups. These include exporters of oil and natural gas (Russia and Kazakhstan), and exporters of labor (Kyrgyzstan and Tajikistan). Due to a significant volume of cash remittances, Armenia can also be added to the second group considering the fact that the bulk of remittances come from Armenian communities in foreign countries. Being a re-exporter of petroleum products and a net exporter of goods for industrial purposes, Belarus belongs to the third group, which includes exporters of industrial goods. Owing to existing natural geographic and infrastructural ties, the geographic destinations of the international trade of the EDB countries have not undergone significant change; neither has the structure of exports and imports of these countries. Almost all of them largely trade with the European Union. The Central Asian countries are becoming involved in intensive trade and financial relations with China. The preserved cultural, infrastructural and economic ties has resulted in each economy retaining a significant share of intra-regional trade. Coupled with the low diversity of the structure of exports, all these factors make the region’s countries vulnerable to changes in demand for, and prices of raw materials.

Table 1. Geographical directions and structure of EDB countries’ trade

<table>
<thead>
<tr>
<th>Product groups, that takes more than 10% in exports</th>
<th>Share of trade with EU (in %)</th>
<th>Share of trade with China (in %)</th>
<th>Share of trade with CIS (in %)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Armenia</td>
<td>food (17%), mineral products (31%), stone, cement, precious metals (16%), metals (28%)</td>
<td>31</td>
<td>9</td>
</tr>
<tr>
<td>Belarus</td>
<td>food (13%), mineral products (29%), chemicals (16%)</td>
<td>25</td>
<td>4</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>mineral products (76%), metals (13%)</td>
<td>47</td>
<td>17</td>
</tr>
<tr>
<td>Kyrgyzstan</td>
<td>food (13%), textile (11%), stone, cement, precious metals (46%), others (11%)</td>
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<td>15</td>
</tr>
<tr>
<td>Russia</td>
<td>mineral products (66%), metals (10%)</td>
<td>47</td>
<td>9</td>
</tr>
<tr>
<td>Tajikistan</td>
<td>food (18%), textile (16%), metals (57%)</td>
<td>6</td>
<td>34</td>
</tr>
</tbody>
</table>

2. Terms of trade

Due to the existing commodity structure of trade, the terms of trade have a significant effect on the dynamics. For instance, a sharp fall in oil prices in 2008 affected the GDP of the region’s countries. Russia’s GDP showed a decline, and the economic growth of Kazakhstan sharply slowed from 8.1% to 1.2%. At the same time the economies of the countries that are less dependent on the export of oil (Kyrgyzstan and Tajikistan) did not experience an immediate deterioration. The diagrams below demonstrate the interconnection between changes in oil prices, the terms of trade, and the GDP of the EDB member states – they are shown by trend lines. In particular, for the economies of Russia and Kazakhstan, a limited decline in oil prices is associated with a considerable deterioration in the terms of trade. This also immediately leads to lower economic growth rates. Not only the economy of Russia, but also those of Armenia and Belarus significantly depend on fluctuations in oil prices, as they have very close ties with the Russian economy. Kyrgyzstan and Tajikistan are net importers of petroleum products and net exporters of metals – metal prices strongly correlate with oil prices. As the diagrams indicate, their economies also eventually benefit from a rise in oil prices. It is apparent that agreements on petroleum products, and existing restrictions in trade, are of great importance to the economies that do not have direct access to international markets. At the same time the structural problems in the economy and flaws in economic policy prevent those countries from deriving benefit from a rise in prices of gold and metals.
3. Remittances

In the EDB region, there are economies that hold leading positions in the world in terms of the volume of cash remittances from abroad. The freedom of movement for the labor force, which has been preserved in the region since the Soviet era, allows these countries to offset significant imbalances in trade, and counter external shocks. The volume of cash remittances into Tajikistan and Kyrgyzstan in 2011 amounted to 45% and 31% of GDP, respectively. Armenia can, to a significant extent, be ranked among exporters of labor migrants, as transfers from abroad are equal to between 7% and 10% of GDP. Russia and Kazakhstan are the main donors for these and other CIS countries. Statistical data for cash remittances are not accurate. The free movement of labor resources does not make it possible to determine exact volumes of cash transfers between neighboring countries such as: Kazakhstan and Central Asian states; Russia and Armenia; and Russia and Belarus.

The figures above indicate the significant positive dependence of the “current transfers” in the balance of payments, which include cash remittances, on the Russian economy for three EDB countries: Armenia, Kyrgyzstan and Armenia. There is also a positive interconnection between cash remittances and those countries’ GDP growth. Therefore, a decline in GDP growth can be offset by the inflow of cash remittances. This explains the stable relationship between remittances and the recipient countries’ GDP.
4. Foreign direct investment

Another channel through which changes in the international economic situation are transmitted to the economies of the EDB countries lies through the financial account of the balance of payments, i.e. financial transactions between residents and non-residents. By definition, direct investment occurs when the investor owns at least 10% of a foreign business. The inflow of direct investment is thought to influence not only economic growth, but also “invisible” parameters such as: institutional development; the development of technologies; and know-how transfers. The emergence of financial problems in the donor country can lead to both a slowdown of in- and outflow of direct investment. The simple linear trend depicted in the figure shows that in the EDB region - despite a modest volume of foreign direct investment (between 5% and 15% of GDP) - an increase in the share of FDI in GDP is associated with a higher growth rate in the economies of Kazakhstan, Tajikistan, Russia and Kyrgyzstan.

5. External debt

A shortage of investment in an economy is often covered by borrowings from abroad. Unlike direct investment, loans, especially short-term ones, are highly volatile. When there is a crisis in the donor country, loans may cause a currency and financial crisis in the recipient country. At present the accumulated gross external debts of most of the countries in the region are relatively large. The diagram below indicates that four EDB member countries have increased their external borrowings since the pre-crisis year of 2008. Russia and Kazakhstan have reduced the ratio of their external debt to GDP.

The external debt levels of Armenia, Belarus and Tajikistan exceed 20% of their GDP; and the external debt of Kyrgyzstan amounts to 50% of the country’s GDP. However, these countries’ external public debt represents indebtedness on loans from international institutions. These are usually long-term, and carry low interest rates. It should be noted that the current external debt of Armenia and Belarus is considerably larger than it was in 2008. Each of the four economies saw the private sector’s external debts significantly grow during and after the crisis.

6. Borrowing by banks

In 2009, the international financial crisis affected the economies of Russia and Kazakhstan through a sharp reduction in access to international liquidity for commercial banks. They had accumulated a high volume of non-performing loans by that time. To date, the banking sectors of the two countries have been, to a significant extent, repaying their debts owed to the banking sectors of Europe and the United States. It can therefore be concluded that an aggravation of the debt crisis in Europe, or the USA, should not have a significant impact through this transmission channel. This is provided that there are no crisis phenomena within the banking system itself. At the same time, there is a worrisome rise in the borrowings of commercial banks in
Armenia and Kyrgyzstan. However, given the relatively small share of outstanding loans in both Armenia (about 5% of the total volume of loans) and Kyrgyzstan (9% of the total), and the fact that prudential indicators remain at a satisfactory level, one can conclude that the probability of a crisis in the banking system is low.

7. Non-bank borrowings of private sector

The corporate sectors in all EDB countries without exception increased their borrowing in the post-crisis years. In Armenia, Kazakhstan, Kyrgyzstan and Russia, this rise occurred through long-term borrowing. In Belarus, the non-bank private sector accumulated a considerable debt on short-term loans, which is worrisome. Being speculative by nature, short-term capital can increase pressure on the exchange rate of the national currency, and thereby cause a balance of payments crisis.

Conclusion: The channels of transmission for the EDB countries have not changed. The trade channel continues to be the main one for all countries. At the same time, determining the main export commodity helps understand through which channels the world economy is influencing the EDB economies. The cash remittances are channels that are involved to a lesser extent in the transmission of external shocks to the economies of the EDB member countries. A review of changes that have taken place since 2008 indicates a noticeable decrease in the external debts of the banking sectors of Russia and Kazakhstan. The long-term indebtedness of the private sectors in these two countries has significantly grown. The rise in the short-term indebtedness of the non-bank corporate sector in Belarus and, to a lesser extent, in the short-term indebtedness of banks in Armenia and Kyrgyzstan makes them more vulnerable to a sharp reduction in access to liquidity in the event of a crisis.
Long-term rise in oil prices

By Arman Ahunbaev

1. Importance of oil for world economy

The dynamics of oil prices play an important role in the world economy. Despite a decline in the importance of oil in general energy consumption after the second oil shock, in 2011, the consumption of crude oil totaled 4,059.1 million tons, or 33% of global energy consumption (BP, June 2012). Oil continues to be the main conventional source of energy in the world. In particular, oil accounts for 37% of all carbon dioxide emissions from energy consumption. According to different estimates, the world’s energy needs should considerably increase in the period between 2010 and 2035. The energy consumption of the developing countries that are members of the Organization for Economic Cooperation and Development (OECD) should increase by 24%. The consumption of countries that are not members of the OECD, especially China and India, should jump by 95% (US EIA, 2012). Given the high dependence of the world economy on the oil sector, the dynamics of oil prices will continue to be extremely important. A clear understanding of the factors determining these dynamics is of strategic interest.

The mechanism of oil prices’ influence on economic activity is notable for its complexity. This is due to the fact that the mechanism of interactions between economic variables changes depending on: alterations in the structure of the world economy; and on the cyclical phase corresponding to changes in oil prices. The analysis of the dynamics of oil prices remains an important component of the analysis of changes in both the world economy, and the medium-term and long-term economic growth prospects of individual countries that export energy resources. From the standpoint of the analysis of CIS member countries - the analysis of the dynamics of demand and prices for oil plays an important and strategic role in understanding the short-, medium- and long-term prospects for economic growth and development. This applies especially to energy exporters such as Russia and Kazakhstan, considering their relatively low diversity and their dependence on the oil sector. Given these countries’ role as the locomotives for the region, and the historically established economic ties between countries in the region, the dynamics of oil prices plays a significant indirect role for the other CIS countries.

2. Mechanism of formation of oil prices: high demand and declining production capacity

The volatility of oil prices reflects the complexity of price formation in this sector. The economic context and equilibrium between demand and supply in the oil market, various factors of uncertainty connected with climatic and geopolitical conditions, and financial expectations are major factors determining oil prices (see Figure 1). Economic growth, which frequently depends on oil prices, is a dominant factor in this complex mechanism. It determines the dynamics of demand, which in turn determine the policy of the members of the Organization of the Petroleum Exporting Countries (OPEC) regarding supply and production.

Oil supply from countries outside OPEC is always at the maximum possible level. This is why it is the OPEC nations that should adjust their production volumes to prevent a sharp fall and, in some cases, a rise in oil prices. On the other hand, the maximum production costs of non-OPEC countries determine the lower price limit for covering production costs. It is therefore the maximum production costs, not the average level of costs, which determine the lower price limit.

Factors that influence the formation of oil prices, but are outside the “economic growth-oil market-oil price” triangle, include the value of the US dollar, the tax burden and inflation. Unexpected natural and climatic phenomena (air temperatures and hurricanes), or geopolitical factors relating, in particular, to the situation in Middle East countries play a key role in determining risk surcharges added to the price. The level of the United States’ oil reserves is frequently used as an indicator of the short-term state of the oil market. All the above-mentioned factors determine oil prices through influencing the behavior of economic agents. They also influence participants of financial markets, who play a certain role in the price formation mechanism; and can provoke speculative surges, which are quite quickly suppressed by fundamental factors.
An analysis of the structure of consumption makes it evident that, for a long period of time, the OECD member countries accounted for the greater part of consumption (75% on average in the 1960s; 72% in the 1970s; 64% in the 1980s and 90s; and 58% in the 2000s). Gradually, with the acceleration of economic growth in large developing countries, and a sharp increase in the level of the world’s oil consumption – from 66 million barrels per day in the late 1970s to 84 million barrels per day in 2011 (see Diagram 3) – the share of the OECD countries decreased in favor of developing countries. In the context of the stabilization of the general level of consumption, and even its decline in the 2000s in the OECD countries (see Diagram 3) - the dynamic economic growth in developing countries, especially in the 2000s, became the main source of an increase in energy needs and consumption and, consequently, a rise in oil prices. Consumption rose from 19.8 million barrels per day in the late 1970s to 42 million barrels per day in 2011. Due to certain demographic features, the rapid economic development of those countries was accompanied by the growth of the industrial sector, motor vehicles and transportation. This provoked a swift increase in demand for energy resources, including crude oil. For instance, China became the world’s second largest importer of energy resources after the United States. The growth of the world’s oil consumption began to outpace the rise in production (see Diagrams 1 and 2).

From the standpoint of supply, the OPEC countries continue to be the main oil producer. They accounted for 43% of the world’s oil production in 2011, compared with 45% in the late 1970s. They retain certain control over price formation in the oil market, and remain a center of geopolitical tension. Throughout the 1990s, the OPEC countries’ main task was to manage the surplus production of oil. The expansion of the supply and production capacity in the previous decade led to OPEC establishing production quotas for the purpose of stabilizing the average oil price at a level satisfying OPEC, and other oil producers. In 2004, the state of overproduction gradually vanished throughout the entire production chain of the oil sector, including production, transportation and refining. The market responded by generating the phenomenon of the adjustment of potential demand through overpricing.

Source: IFP Energies Nouvelles
The price determination mechanism in the 2000s was distinguished by the fact that oil prices rose to an all-time high of $134 per barrel in July 2008. This can be compared to a crisis situation caused by oil shocks. It was simultaneous with the growth of the world economy and did not lead to a slowdown.

The relative insensitivity of the world economy to the rise in oil prices in that period can be linked to: decreased interaction between economic growth and oil prices; and to an expansionist phase in the international market situation. After a fall in oil prices to $42 in December 2008, which took place amid a global crisis caused by a dramatic decrease in demand, the oil market resumed its former state characterized by surplus production. This prompted the OPEC countries to reduce the amount of production at the end of 2008, which, coupled with the beginning of the world economy’s recovery, the implementation of government programs aimed at stimulating demand in developed and developing countries, the emergence of new sources of geopolitical tension (the Arab Spring, civil wars in Libya and Syria, and so on), and debt problems in the eurozone, led to oil prices recovering to their former levels and then to their stabilization at around a new high equilibrium level.

The oil market found itself in a paradoxical situation (see Diagram 5) where oil prices continued rising – to $106 on average from March 2011 to August 2012 – and remained at high levels, although consumption was on the decline. Apart from increased production costs and the re-emergence of tension in the oil market, oil prices started to reflect increased risks caused by the unstable geopolitical situation in the Middle East, and continued uncertainty regarding the international market situation (the crisis in the eurozone and a slowdown in the United States and developing countries). The end of 2011 and the beginning of 2012 were marked by new hikes in prices. These were due to the emergence of a new source of geopolitical tension in connection with the European Union’s decision to impose an embargo on Iranian oil. This in turn provoked Tehran into threatening to blockade the Strait of Hormuz, a strategic waterway in the Persian Gulf through which one-third of the world’s tanker-borne oil is carried.
The general acceleration of the growth of the world’s demand for oil, due to the high growth rates of developing countries, led to increased tension in the oil market due to undersupply. The flexibility that OPEC used to ensure stability in the oil market gradually weakened, which caused a dramatic rise in the equilibrium oil price. The supply/demand balance in the market became increasingly more dependent on the development of new methods of extracting unconventional hydrocarbon resources, such as deep-water oil production and the extraction of super heavy oil from tar sands in Canada.

From the standpoint of geological reserves (see Diagram 6), despite a significant slowdown in the exploration and discovery of new fields, the announced oil reserves unexpectedly grew in 2009 and 2010 due to an increase in OPEC countries’ reserves (the subject of announced oil reserves and the Hubbert production peak theory deserve a separate article). It should be noted that the geological limits of oil production have not yet been reached, and the available oil reserves are quite sufficient. The main problem is their use and timely production. Many projects aimed at the expansion of production capacity are too late in implementation, because many industrial sectors involved in supporting the oil sector fail to provide the necessary equipment and services. The tension in the industries serving the oil sector leads to an increase in exploration and production costs. According to recent estimates, the marginal cost of oil production increased by 11% to $92.26 a barrel in 2011 for the 50 largest listed oil and gas companies. It will reach $100 in 2012 (Beveridge N. & al., May 2012).

Higher oil prices can increase the profit margin of producers. This prompts the governments of many oil-exporting countries to revise agreements and contracts, contributing to the emergence of barriers and lags. It should also be noted that the imposition of stricter environmental standards throughout the world has led to consumption and demand shifting to lighter petroleum products. This has caused shortages due to the disparity between production capacity and demand. According to data from OPEC (OPEC, 2011), solving the problem of shortages of crude and petroleum products in the medium and long term requires high volumes of investment throughout the entire production chain of the oil sector. In particular, OPEC estimates in its baseline scenario that more than $1.2 trillion has to be invested in the oil refining sector; and more than $3 trillion in the oil production sector in the period between 2010 and 2035.

### 3. Forecasts: geopolitical tension, uncertain market conditions and production complications

**Short- and medium-term forecasts for oil prices**

It should be noted that in the short and medium term, two contradicting factors - geopolitical tension and the expected decline in demand - will continue to influence the price of oil. The oil market will remain under additional pressure from continued production interruptions. The average price of oil, and its volatility, will continue to be at a high level. Due to production interruptions the price of Brent crude, after reaching the year’s lowest level of $89 per barrel on June 25, 2012, rose at a fast rate to $117 on September 13, 2012. Despite recent decisions by the central banks of large developed countries - the International Energy Agency (IEA) expects a continued economic slowdown and, consequently, some decline in oil prices throughout the remaining months of 2012 to an average level of $111, and to $103 in 2013. The World Bank expects the average price to be $107 in 2012, and $103 in 2013. Whereas the European Central Bank predicts it to be $112 in 2012, and $107 in 2013. The International Monetary Fund has revised its forecast and expects
prices of $106 and $105, respectively. The consensus forecast puts the average price of Brent crude at $109 in 2012 and $107 in 2013.

Diagram 7. Middle-term consensus-forecasts for oil prices (Brent)

Source: Consensus Economics

Diagram 8. Long-term consensus-forecasts for oil prices (average)

Source: US EIA

Long-term forecasts for oil prices

In the long term one should not expect a drastic decline in oil prices. This is in the context of the OPEC-expected economic growth in developing countries and, consequently, a predicted increase of 26% in the world’s oil consumption compared with 2010 (see Diagram 9). The growth of developing countries’ consumption is estimated at 72% compared with 2010. It is linked to growing needs for transportation and mobility. The absolute level of developing countries’ consumption should exceed the declining consumption level of the developed countries among the OECD member states in less than a decade. It should also be noted that the potential for energy saving and the replacement of oil by new energy sources remains limited. Moreover, existing alternative solutions, in particular electric or hybrid technology in automotive engineering, are still much more expensive and frequently require additional infrastructural investment. The exploration and production of unconventional oil is only possible if the minimum price is between $50 and $80 per barrel. The production of biofuel and the transformation of gas, coal and biomass into a synthetic petroleum substitute, with the use of the Fischer-Tropsch technology, can only be expedient if the minimum price is $100 per barrel. Thus baseline scenarios assume that the average price of oil will not fall below $100, and that it will continue to rise to reach $120 per barrel in 2035, according to the baseline consensus forecast.

Diagram 9. World oil consumption outlook

Source: OPEC

Diagram 10. World oil production outlook

Source: OPEC
References:

- World Bank Commodity Price Data.
Analytical insert

Economic growth in EDB member countries: analysis of trends and long term forecast

By Konstantin Fedorov

This note studies the dynamics of the economies of the EDB member countries throughout the 1990s and the 2000s. Its objective is to provide a comparative analysis of their economic growth rates, the sources of growth, and the evolution of the economic structure. Apart from this, we offer a long-term forecast for the growth of Gross Domestic Product (GDP) on the basis of the results of our analysis.

Comparative analysis: differences between EDB countries, EDB countries’ position in region and world

As the theoretical basis of our analysis, we use a simple model that links a country’s GDP (Y) with capital stock in the economy (K) as the factor of production and the number of workers (L), as well as with aggregate factor productivity (A), which looks as follows:

\[ Y = AK^\alpha L^\beta, \quad \alpha + \beta = 1 \]  

(1)

From the standpoint of economic theory, the long-term GDP growth rate per worker (Y/L) is determined by the dynamics of the value A. This explains why both parameters are used by economists as indicators of productivity. The use of Y/L in this capacity, properly speaking, is not quite correct, in particular because its value depends on the size of capital stock (K), but this parameter is easier to measure and therefore data for its value are available for a large number of countries and long periods of time. The parameter A is the most theoretically attractive measure of productivity, but it can be estimated only indirectly. Such estimates are available for a smaller number of countries and often for relatively short periods of time. In addition, it is difficult to measure its level. This is the reason data for the parameter A represents percentage changes or indices. In this connection, we use both parameters, Y/L and A, in our analysis.

So Figure 1 shows graphs of GDP per worker for the period between 1989 and 2011 for the CIS countries, including the EDB members, as well as Georgia and certain East European countries.

The source of the data on the basis of which the graphs are drawn is the database of a US organization called the Conference Board (see http://www.conference-board.org/data/economydatabase/). GDP per worker is measured in 2011 dollar prices adjusted to purchasing power parity (PPP) so that the values of the parameter can be compared across countries.

The graphs in Figure 2 show the dynamics of total factor productivity (TFP) for the CIS countries and some other countries in the region. The Conference Board is the source of the used data as well.
It is possible to conclude from the graphs in Figure 1 that the area in which the EDB operates can be clearly divided into three regions: the European countries of the CIS and Kazakhstan (most of them are members of the EDB), the Transcaucasian countries (Armenia is a member of the EDB) and Central Asia (Kyrgyzstan and Tajikistan are members of the EDB). The countries belonging to each of those regions are comparable in terms of GDP per worker. In most cases, they show similar dynamics of both this indicator and the TFP (see Figure 2), i.e. one can expect that there will continue to be comparability in terms of productivity within the regions in the foreseeable future.

Ukraine is negatively distinguished among the European countries of the CIS, as it fell rather far behind Russia, Kazakhstan and Belarus in terms of GDP per worker and is already behind Armenia and Azerbaijan. At the same time, the growth of the TFP of the Ukrainian economy throughout the 2000s was similar to those of neighboring countries. Thus the slow growth of that country in terms of GDP per worker is to a greater extent caused by a relatively low level of investment than the slow growth of its TFP. If this is the case, the gap between Ukraine and the other European EDB member countries and Kazakhstan will probably stop widening in the foreseeable future.

In the Transcaucasian region, the highest growth rate in the 2000s in terms of both GDP per worker and TFP was shown by Armenia, that is, the only EDB member country in the region. Azerbaijan achieved a sharp increase in productivity between 2005 and 2007 because of a rise in oil and gas production. However, even apart from this increase, the Azerbaijani economy had a reasonable productivity growth rate.

The Central Asian region, in which GDP per worker is relatively low, had, nevertheless, TFP growth rates similar to those of other CIS countries. Thus the gap between the economic development levels of the region’s countries and neighboring countries may decrease in the future.

This is true for not only Central Asia - the absence of fundamental differences between the TFP growth rates of all the three regions means that the differences between the regions in terms of GDP per worker, and also in terms of GDP per capita, will gradually diminish, although this process may take a long time because the starting differences between them were significant. In addition, the gap between the regions increased during the period of transitional recession in the 1990s.

EDB member countries in the world context

It is interesting to compare the level and growth rate of productivity in the EDB countries with the respective indicators for countries outside the CIS. Figure 3 shows graphs of GDP per worker for both the EDB members and several groups of other countries. The first of these groups includes developed countries. The second group consists of the BRIC countries excluding Russia, that is, Brazil, India and China. The third group comprises a number of East European countries that have productivity dynamics more or less typical for the region, and the fourth group includes countries that are large exporters of raw materials (not necessarily energy resources).
One can conclude from the graphs in Figure 3 that in absolute terms, the productivity of the economies of the EDB countries are at least twice as low as that of the developed countries. Nonetheless, the gap is diminishing, especially with regard to Western Europe. Throughout the 2000s, the EDB economies increased their productivity at a much higher rate than Western Europe.

In terms of productivity growth, the EDB countries are similar to the East European countries. The level of GDP per worker for the European EDB countries and Kazakhstan are well within the bounds of its values for Eastern Europe. The two groups’ general long-term dynamics expectedly coincide - both the EDB and East European countries experienced a decline in productivity throughout the 1990s and then had a steady and rather rapid rise.

The EDB countries are not inferior to other fast-growing economies in productivity growth. In particular, out of the BRIC countries, only China was ahead of the EDB countries throughout the 2000s in terms of the growth rate of GDP per worker. In addition, as can be seen, China was not ahead of the EDB countries in terms of the TFP growth.

If we compare the EDB countries with the exporters of raw materials, we will, in the first instance, find that the countries within this group do not have similar dynamics of GDP per worker. In some of the countries of the group, productivity stagnated throughout a considerable part or the entire period under review and it was on the decline in others. High growth rates of productivity were shown by the developed countries in the group, though they were higher in the 1990s – when prices of raw materials were low – rather than in the 2000s. It seems that the productivity dynamics of Russia and Kazakhstan are not similar to those of the countries of this group, even though both belong to it. It is possible that they are currently the only nations that are large exporters of raw materials and simultaneously have relatively high productivity growth rates.

The latter observation is important because if it reflects a stable fact, the growth of productivity and, consequently, long-term economic growth in the key EDB countries do not critically depend on the behavior of prices of their key exports. In particular, the parameters can grow at a relatively high rate provided energy prices are stable, but probably not low. In the following part of this insert, we present our forecasts of the economic growth in the EDB countries for the period until 2025, which are based on the same theoretical approach as the analysis of trends demonstrated above.

**Figure 3: EDB member states in world context. GDP per worker, in 2011 US$ by PPP**

*EDB members and advanced economies*

*EDB members and Eastern Europe*
Economic growth forecasts for EDB countries for 2013-2025

Forecasts for the growth rates of the EDB countries’ economies for a long period of time can be made on the basis of a model that consists of Equation (1) and equations describing the dynamics of productivity, capital stock and the number of workers in an economy:

\[ A_{t+1} = (1 + g)A_t, \]
\[ K_{t+1} = sY_t + \delta K_t, \]
\[ L_{t+1} = (1 + n)L_t, \]

where \( g \) is the growth rate of aggregate factor productivity, \( s \) represents the rate of savings (the share of investment in GDP), \( \delta \) is the rate of depreciation and \( n \) is the growth rate of the number of workers. Model (1)-(4) represents a version of the well-known Solow growth model. We use the assumption that these parameters are constant. For the value \( \delta \), we use 0.04 (after, in particular, Romer, Advanced Macroeconomics, 1996). The initial levels of capital stock are chosen in such a way that the growth rates of capital stock are the same as the estimates made by the Conference Board and available in the Total Economy Database (we can provide the technical details of our estimations if readers are interested). The section below describes data used for estimating the parameters of the model for the EDB countries and gives the results of forecasting GDP growth on the basis of this model.

For each of the countries, the forecasts were made for several sets of the values \( g, s, n \), which correspond to different economic growth scenarios. In the framework of the inertial scenario, \( g, s, n \) are viewed as average for the period of time for which the necessary data are available. Each of the other scenarios is distinguished from the inertial one by the value of one of the parameters. A description of all scenarios can be found in Table 2. For the Central Asian countries and Kazakhstan, the alternatives to inertial scenarios assume convergence regarding TFP growth, the share of investment in GDP or the growth rate of employment to Russia’s indicators, which are viewed as close to the average indicators for the EDB countries. For Armenia, the alternative scenarios regarding the TFP growth and the share of investment in GDP are chosen in the same way, but as an alternative hypothesis regarding the growth of employment, we use the assumption that it will remain constant throughout the forecast period. For Russia, the alternatives regarding the TFP growth rate and the share of investment assume higher values compared with the inertial scenario (4.5% TFP growth, which corresponds to the average for 2001-2008, and a 20% share of investment in GDP, i.e. a share approximately equal to the share of investment in 2011), while the alternative scenario regarding employment assumes its zero growth.

Forecasts corresponding to our scenarios for each of the EDB countries are given in Table 1. With regard to
these forecasts, one should bear in mind that Model (1)-(4) does not take into account short-term economic dynamics. Therefore, forecasts made on its basis are merely indicative by nature, especially when it comes to years in the immediate future. Nonetheless, these results make it possible to estimate at what levels the growth rates of the EDB economies may be if their development follows each of the scenarios that we offer.

**Table 2. GDP growth: forecasts for 2012–2025**

<table>
<thead>
<tr>
<th>Country</th>
<th>Inertia scenario</th>
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<th>Alternative growth of I/Y</th>
<th>Alternative growth of L</th>
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</tbody>
</table>

Bold in the Table 1 indicates the forecasts that were made within the framework of scenarios that, in our opinion, are likely for one country or another and therefore can be viewed as baseline scenarios. These scenarios are indicated in bold in Table 2. In most cases, with the only exception of Russia, these are not inertial scenarios. For Kazakhstan, Tajikistan and Armenia, one can expect some slowdown in the TFP growth, whose rate was extremely high in these countries throughout the 2000s. In Kyrgyzstan, the total factor productivity, on the contrary, has stagnated for many years and therefore growth acceleration is probable in the future. The share of investment in GDP in Kyrgyzstan and, especially, Tadjikistan has been low and may increase with the passage of time. In Kazakhstan and Armenia, this parameter was relatively high for a long period of time and may fall to the average level for the EDB region. For Russia, the most probable scenarios are the inertial one and the one assuming a higher share of investment in GDP. There are grounds to believe that the latter was unnaturally small for the country throughout the greater part of the 2000s.

**Table 2. Alternative scenarios of development**

<table>
<thead>
<tr>
<th>Inertia scenario</th>
<th>Armenia</th>
<th>Belarus</th>
<th>Kazakhstan</th>
<th>Kyrgyzstan</th>
<th>Russia</th>
<th>Tadjikistan</th>
</tr>
</thead>
<tbody>
<tr>
<td>5.6, 20.2, -1.7</td>
<td>3.9, 19.9, 0.5</td>
<td>4.7, 24.7, 2.8</td>
<td>0.5, 10.7, 2.6</td>
<td><strong>2.9, 16.3, 0.5</strong></td>
<td>6.0, 5.8, 2.8</td>
<td></td>
</tr>
<tr>
<td>Alternative AFP growth</td>
<td><strong>2.9, , ,</strong></td>
<td><strong>2.9, , ,</strong></td>
<td><strong>2.9, , ,</strong></td>
<td><strong>2.9, , ,</strong></td>
<td><strong>4.5, , ,</strong></td>
<td><strong>2.9, , ,</strong></td>
</tr>
<tr>
<td>Alternative growth of I/Y</td>
<td><strong>~ , 16.3, ~</strong></td>
<td><strong>~ , 16.3, ~</strong></td>
<td><strong>~ , 16.3, ~</strong></td>
<td><strong>~ , 16.3, ~</strong></td>
<td><strong>~ , 20.0, ~</strong></td>
<td><strong>~ , 16.3, ~</strong></td>
</tr>
<tr>
<td>Alternative growth of L</td>
<td>~ , ~ , 0</td>
<td>~ , ~ , 0</td>
<td>~ , ~ , 0.5</td>
<td>~ , ~ , 0.5</td>
<td>~ , ~ , 0</td>
<td>~ , ~ , 0.5</td>
</tr>
</tbody>
</table>

*Note: The three figures in the boxes of the first line of the table are the average figures for AFP growth, the share of investment in GDP and the growth of employment in the period between 2001 and 2009. Each of the alternative scenarios is distinguished from the inertia one by the value of one of these three parameters.*