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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

The annual growth rate of global trade (exports) slows to 2% in April 2012 from 7.6% a year ago.

Acceleration in the growth of the Russian economy in Q1 2012 leads to 4.9% growth in the economies of the EDB countries, which is a higher than in Q1 2011.

The growth of the world economy decelerated under the influence of debt problems in the Eurozone, with the growth rate being only 0.1% in Q1 2012. The annual growth rate of global exports slowed to 2% in April 2012 from 7.6% a year ago. The deterioration of the economic situation in developed countries affected the economies of developing countries. They encountered a fall in external demand for their goods and a slowdown in foreign investment. One of the consequences was that the economic growth of China, the world’s second largest economy, continued to slow down - its growth rate was 8.1% in Q1 2012. The decreased demand for energy resources had an immediate effect on energy prices: the average price of crude oil rose by 13% in Q1 2012 against 29% in Q1 2011.

The CIS economy, usually dependent on the dynamics of oil prices, experienced very slight change in its growth. It slowed from 4.67% in Q1 2011 to 4.65% in Q1 2012. A serious slowdown occurred in the group of countries exporting industrial goods (Ukraine, Belarus and Uzbekistan) whose growth rate fell from 6.9% in Q1 2011 to 3% in Q1 2012. The growth rate of the member countries of the Eurasian Development Bank rose from 4.5% to 4.9%, which was mainly due to the acceleration of Russia’s economic growth from 4.1 to 4.9%. The economy of Kyrgyzstan experienced the greatest drop (minus 6.8%). This was caused by geological problems at the Kumtor gold mine, which accounts for up to 50% of the country’s industrial production.

All economies, except Armenia and Tajikistan, have a steady slowdown in industrial production. This is due to a continued decline in external demand for raw materials amid a rise in their prices. At the same time upward trends in retail trade and services point to both a rise in consumer activity and, when coupled with resumed growth in the construction sector and bank lending, to the recovery of investment activity. Recent trends indicate the shifting of aggregate demand from external to internal sources in the key CIS economies.

Figure 1.1. World trade volume growth (in %)

Figure 1.2. GDP growth in CIS countries (in %)

Source: World Trade Monitor, April 2012

Source: national agencies, the CIS Statistics Committee
Continued high energy prices in Q1 2012 determine trade surpluses in oil-exporting countries, and inflow of cash remittances into labor-exporting countries

Oil prices stand at a relatively high level - the average oil price in the first five months of 2012 was $111 per barrel. This ensured an increase in the trade surpluses of the oil-exporting countries (Russia, Kazakhstan, Azerbaijan and Turkmenistan), bringing extra revenues into their budgets and foreign exchange reserves. The net energy importers recorded a rise in their trade deficits, which was offset by an inflow of cash remittances from abroad in the group of labor exporting countries (Tajikistan, Kyrgyzstan, Moldova and Armenia). According to official statistical data the movement of labor and cash remittances amount to 1 to 2% of GDP in donor countries, and more than 20% of GDP in recipient countries. This serves as a mechanism of risk sharing in the region. This mechanism allows the CIS to stand against the negative impact of the slowdown in the world economy.

The capital outflow is estimated at $38 billion

The financial account of the region’s balance of payments was characterized by: an outflow of excess capital through the net increase in the foreign assets of both the public and the private sectors in the group of oil-exporting countries ($38 billion); and by a net increase in liabilities on direct investment and debt capital in Ukraine and Belarus, which are in the group of net exporters of industrial goods.

The growth of reserve assets totals $7.9 billion

In Q1 2012, the net increase in the reserve assets of the central banks of the CIS countries amounted to $7.9 billion - about 1.4% of the region’s GDP. The exchange rate dynamics was, in general, determined by the exchange rate regime used in each particular economy. All economies, except Belarus, Armenia and Kyrgyzstan, saw an insignificant increase in the real effective exchange rate (REER). Compared with Q1 2011, the national currency strengthened in real terms in Moldova - 9%, Azerbaijan - 4.6%, Ukraine - 3.1%, Kazakhstan - 2.6%, and Russia - 2.2%. A 24% devaluation of the Belarusian ruble in real terms helped the country overcome a balance of payments crisis that it experienced in 2011.

Figure 1.3. Foreign trade: trade balance (in % of GDP)

Figure 1.4. Cash remittances by individuals: net, from Russia to CIS countries (in % of GDP)

Source: national agencies, CEIC database

Source: the Bank of Russia
Mounting external economic risks have also affected the dynamics of macroeconomic policy. The governments of almost all CIS countries have developed anti-crisis programs for use in case of deterioration in the economic situation. Some of them plan to revise their budgets for 2013. High oil prices determined trade surpluses in the oil-exporting countries, which averaged out at about 4% of GDP in Q1 2012 compared with 7% in Q1 2011. The decrease in the surpluses was mainly due to the governments’ increased expenditure to finance social obligations that they took up last year. Improvements in the state budget of Belarus were a result of the consolidation of the public finances, and a slowdown in the growth of government lending. In the CIS the public finance surplus decreased by 2%, from 6% of GDP in Q1 2011 to 4% in Q1 2012.

Amid low demand and a decline in world prices, inflation falls to record low levels

A fall in world food prices, which began in the second half of 2011 and continued into 2012, have led to a sharp deceleration in inflation in the CIS. Ukraine saw deflation (year-on-year) of 0.5% in May 2012, while the year-on-year growth rates of consumer prices in Kyrgyzstan, Azerbaijan and Armenia were 0.5%, 1.2% and 0.5%, respectively. In Belarus, a significant slowdown in the growth of government lending contributed to a deceleration of the rise in prices, with the annual price growth rate being 80.5% in May. The region as a whole, excluding Belarus, had an inflation rate of 2.4% compared with 11.3% last year. The central banks of some countries lowered their policy rates following the inflation deceleration.

Bank lending grows amid hesitant investment activity

There was some rise in companies’ investment activities, which can be evidenced by an increase in bank lending, although private sector continues to feel uncertain in view of mounting negative external shocks. The volume of loans in rubles issued by banks in Russia in March was 25% higher than in March 2011. Deterioration could be seen in banks’ financial indicators in the economies where the expansion of lending was accompanied by a higher rise in foreign currency lending.
Sustained high energy prices in the beginning of 2012 prompted many experts to revise their forecasts regarding economic growth in CIS countries. Forecasts for the economies of Belarus, Armenia, Russia and Kazakhstan were revised upwards. At the same time consensus forecasts for GDP growth for 2012 were downgraded for Kyrgyzstan (from 5.8% to 4.5%), for Tajikistan (by 0.2%), and for Azerbaijan (by 0.2%). In early 2012, the weighted average consensus forecast for the CIS region’s economic growth rate for this year was 4.1%, whereas now it is 4.2% for 2012 and 4.4% for 2013.

Due to the slow-moving crisis in Europe, there continues to be volatility in financial markets, and uncertainty regarding the outlook for the world economy. The CIS economies are highly dependent on the world prices of raw materials, which are their main export items. A gradual fall in these prices would lead to a slowdown in the growth of their economies.

According to the EDB’s forecast, if oil prices remained at the current level of around $115 a barrel, the region’s average economic growth rate would be 4.9% in 2012 and increase to 5.2% in 2013. A more pessimistic scenario predicts no improvement in the economic situation in the Eurozone, and a further slowdown in the world economy. Oil prices would be affected, and would fall to $90 per barrel on average in 2012 and 2013. This would slow the CIS economies’ growth to 3.2% in 2012 and to 3.9% in 2013.

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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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<td>Azerbaijan</td>
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<tr>
<td>Ukraine</td>
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Source: estimates by national agencies, the EDB, the IMF, the EBRD, the World Bank, the ADB, 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
### Azerbaijan: Decline in oil and gas production, slowdown in inflation

The Gross Domestic Product (GDP) of Azerbaijan increased by 0.5% year-on-year in Q1 2012. The country’s economic growth therefore improved slightly compared with 2011, when it was 0.1%. The low GDP growth rate in Azerbaijan can be linked to a 4.4% year-on-year fall in the production of oil and natural gas in Q1 2012. As hydrocarbon production accounts for 59.3% of GDP, this fall had a considerable effect on general economic indicators. Meanwhile, the non-oil and gas sector had an output increase of 7.7% in Q1 2012. A considerable contribution to the increase was made by trade, services and the communications sector, whose output rose by 9.3, 9.4 and 8%, respectively. The growth rate in agriculture was 3.2% - lower than in the non-oil and gas sector on the average.

The Central Bank of Azerbaijan continued to use the regime of a tightly controlled exchange rate float. The national currency, the manat, therefore strengthened insignificantly by 1 to 2% against the US dollar in Q1 2012 amid a rise in world oil prices. Due to the stable exchange rate of the manat and the absence of a significant capital inflow, the rise in prices drastically slowed down in the country in Q1 2012. Annual inflation, which was relatively high until the end of 2011, was 3.2% compared with 7.9% in December.

Government expenditure in Q1 2012 was equal to 23% of GDP, increasing by 3% compared with Q1 2011. Despite high oil prices in Q1 2012, the fall in oil production led to a decrease in government revenues compared with 2011. The state budget surplus in Q1 was therefore lower than in Q1 2011, 5.2% of GDP against 6.5%. The government’s 2012 budget estimates provide for a significant increase in expenditure. This is due to: a planned rise in the pay of public employees; a rise in social payments; and a considerable rise in government investment.

The economy of Azerbaijan continued to have strong external position in Q1 2012, even though the current account surplus decreased year-on-year to $4.6 billion (30% of GDP) from $4.8 billion (37% of GDP) in Q1 2011. The overall balance of payments surplus amounted to $2.4 billion - 16% of GDP. This allowed the nation to increase its reserve fund from $29.8 billion at the beginning of 2012 to $32.4 billion at the end of March.

The total volume of loans provided by banks in March was 18.7% higher than in March 2011. This compares with an 8.7% year-on-year increase in December 2011. The high loan growth rate was largely due to a low base effect: there had been a fall in lending in Q1 2011. Lending grew much slowly month-on-month than during the greater part of last year. The capitalization of the International Bank of Azerbaijan, which had held an amount equal to 44% of all deposits in 2010, was found to be insufficient due to the accumulation of non-performing loans. This prompted the Central Bank to provide support in February 2012. The nation’s third-largest bank, Technikabank, experienced financial difficulties.
Outlook

Azerbaijan: Stagnation in oil production, growth amid an increase in government expenditure

The production of oil and gas in Azerbaijan in the remaining part of this decade is expected to be close to the current level (see, for instance, IMF Country Report No. 12-5). The country’s economic dynamics will therefore be uneven as was the case in 2011 and at the beginning of 2012. The oil and gas sector will go from a decline to a long-lasting stagnation, whereas the other sectors of the economy will continue growth driven by consumption and investment, which is financed by the government to a considerable extent. Despite the restrictions and risks inherent to this development model, the leading role of the budget in financing such growth makes it stable in the short term. In particular, in 2012, the non-oil and gas sector will retain the current annual growth rate of about 7%, even if oil prices do not recover to the level seen before they fell in May and June. The overall GDP will have a low growth rate because there will be a fall in oil and gas production in 2012. In 2013 GDP may rise by some 4%, with the oil and gas sector having a zero growth rate.

The Central Bank’s policy of pegging the national currency to the US dollar limits the government’s opportunities to control inflation. The rise in prices in the country fully depends on the government’s fiscal policy, and on the dynamics of the balance of payments. In particular, the planned increase in government expenditure this year may lead to acceleration in the rise in prices, especially if the inflow of capital into the country increases amid an improvement in the general economic situation in the world.

Azerbaijan’s external balance and its government’s finances have a high safety margin. Last year the country had a current account surplus amounting to 29% of GDP, while, according to the IMF, the consolidated budget surplus totaled 8.5% of GDP. The resources that have been accumulated by the State Oil Fund of Azerbaijan amount to nearly 100% of GDP. In the short-term, the country’s balance of payments and budget balance will undoubtedly continue to be stable, providing there are no drastic changes in the global energy market. According to the IMF’s estimates, Azerbaijan’s current account surplus will decrease to zero if the average oil price in the world steadily falls to $50 per barrel. This is much lower than the oil price forecasts for the next few years made by investments banks – according to Bloomberg, those range from $95 to $130 per barrel of Brent for 2012 and 2013. However, in the long term, Azerbaijan’s economy may face stability risks connected with the factor that currently ensures its stability – the dominance by the oil and gas sector, which accounts for more than 50% of GDP and about 70% of all government revenues.

One of the impediments to more dynamic growth in sectors not related to oil and gas production is the poor development of the banking sector. Azerbaijan is significantly behind neighboring countries in terms of the volume of lending to the private sector and the volume of deposits. The predominant role of state banks, and their use as an instrument of the government policy, leads to the deterioration of the quality of the banks’ loan portfolio. This impedes the development of the sector, and makes it a source of risk for economic growth in general, which is evidenced by the problems that the International Bank of Azerbaijan and Technikabank experienced in early 2012.

Oil and gas production in Azerbaijan in the remaining part of the decade is expected to be close to the current level

The non-oil and gas sector is expected to retain the current annual growth rate of about 7% in 2012

The policy of pegging the national currency to the US dollar limits the government’s opportunities to control inflation

Azerbaijan’s external balance and its government’s finances have a high safety margin

The dominance by the oil and gas sector may pose risks to the stability of the economy in the long term

The poor development of the financial sector is viewed as an impediment to more dynamic growth in sectors not related to oil and gas production
Azerbaijan

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

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)

Source: national agencies, IMF

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

Source: national agencies

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

Source: national agencies, IMF

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
Trends

Armenia: Rise in industrial output, zero inflation, budget strengthening

In Q1 2012 Armenia’s economic growth retained the dynamics and general features that it had in the second half of 2011. The country’s GDP in Q1 2012 was 4.7% higher than in Q1 2011 (growth for 2011 was 4.6% year-on-year). As in 2011 a key driver of growth was the industrial sector, especially the mining and metallurgy industries, with industrial output increasing by 16.6% compared with Q1 2011. The volume of the agricultural sector’s output remained almost unchanged, increasing by only 0.1% year-on-year, whereas the construction sector’s output continued to be on the decline, decreasing by 4.5%. Private consumption also experienced a decline as retail trade fell by 0.3.

Amid low domestic demand, the annual inflation rate continued to slow down, reaching 0.5% by May 2012 - the lowest level in six years. Despite the slowdown in the rise in prices in the country, the Central Bank of Armenia had kept its refinancing rate unchanged at 8% since September 2011. In its reports, the Central Bank described its policy as neutral regarding inflation, refraining from sending any signals regarding possible changes in the near future. With regard to the national currency, the Central Bank continued to adhere to a de jure floating exchange rate system, smoothing fluctuations in the dram’s rate against the US dollar.

As for the public finances, Armenia showed considerable progress compared with previous years. An increase in government revenue, amid the acceleration of economic growth and high prices of exports, led to the consolidated budget deficit amounting to only 0.2% of GDP in Q1 2012. This is the lowest level since 2009, and compares with 0.8% of GDP in Q1 2011. Government expenditure showed an insignificant year-on-year increase in the period.

The Armenian economy also showed some progress regarding the improvement of the external balance. In Q1 2012 the country had a current account deficit amounting to 22% of GDP, down from 25% in Q1 2011.

The total volume of loans issued by banks in Armenia continued to grow at a high pace, increasing by 30.3% year-on-year in Q1 2012. In 2011 lending increased by 33.7%. Given the significant slowdown in inflation, the rise in lending in real terms may even have accelerated. Amid this trend, the sustainability indicators of banks continued to gradually decline. In particular, the ratio of capital to risk-weighted assets reached a record low of 17.5% in April. The ratio of liquid assets to the total volume of assets was also close to the all-time record low. A significant share of loans in foreign currencies in the total volume of lending - 62.7% at the end of April 2012 - also represents a risk for the Armenian economy.
Outlook

Armenia: Transition to balanced growth, risk of deflation, lending growth control

The current nature of economic dynamics in Armenia, where the industrial sector is almost the only growing sector, appears to be a transient phenomenon. The direction in which the Armenian economy will develop in the remaining part of 2012 depends to a considerable extent on external conditions. Upward trends may resume in Armenia’s economic sectors that currently experience stagnation or decline: if the price of goods exported by Armenia continue to be relatively high; and if there is a significant money inflow from people living outside the country, or from the Armenian community abroad. This would result in the acceleration of the general economic growth in the country to levels close to those seen before the 2008 to 2009 crisis. From 2000 through 2007, the country had an average growth rate of 12%. However, the imbalanced nature of economic growth makes the Armenian economy vulnerable to negative external shocks. If the price of metals in the world steadily fall, the country will lose its almost only existing driver of growth.

The fiscal policy outlook is relatively favorable for Armenia. If the country avoids negative effects from external or domestic shocks during the remaining part of 2012, it may achieve more significant fiscal consolidation this year than what is specified in the current program of cooperation between Armenia and the IMF – this says that the central government’s budget deficit should amount to 3.1% of GDP in 2012.

According to the current official forecast of the Central Bank, the country’s monetary authorities expect the annual inflation rate to rise in the remaining part of the year to be within the Central Bank’s target band of 2.5 to 5.5%. Such developments are possible, but an increasingly more likely scenario is that the country has deflation. This would result from the simultaneous impact of seasonal factors relating to agricultural production, and the recent fall in the international price of energy resources and raw materials. The deflation may negatively affect Armenia’s economic growth.

In this regard, keeping the refinance rate at a relatively high level, despite the risk of deflation, can be linked to the Central Bank’s intention to slow down the rise in lending, which we mentioned above. In addition to negative effects from lending growth on the sustainability indicators of the banking system, a source of danger to the stability of the country’s economic development is the higher rise in the volume of loans in foreign currencies. If this trend continues at the same pace as in 2011 and the first months of this year, the Central Bank of Armenia may face a situation where fluctuations in the exchange rate of the national currency constitute a growing threat to the economy. As a result the Central Bank would become much less able to pursue a flexible exchange rate policy, and to implement an independent monetary policy. This would, in turn, reduce the ability of the Central Bank to control lending growth. The likelihood of such a scenario suggests a need for the government to take well-considered measures to prevent it at an early stage.
Figure 3.1. **GDP and output**: GDP growth and output change by sectors, (in %, year-on-year)

![GDP and output chart](image)

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](image)

Source: national agencies, IMF

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

![Government sector chart](image)

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](image)

Source: national agencies

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

![Economic growth chart](image)

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](image)

Source: estimates and forecasts by national agencies and the IMF
In Q1 2012, the economy of Belarus showed signs suggesting that the serious balance-of-payments crisis experienced by the country in 2011 was ending. Due to measures taken in 2011 in the area of fiscal and monetary policies, which resulted in the consolidation of public finances and a slowdown in the rise in lending, the pace of inflation decelerated sharply. In Q1 2012 consumer prices rose by less than 2% a month - in 2011 the year-on-year inflation rate was 108.7%. In 2011, the government had a budget surplus equal to 2.4% of GDP. In Q1 2012, there was also a budget surplus, which amounted to 3.2 percent of GDP. In addition, the period saw a significant decrease in the Belarusian economy’s current account deficit, which decreased to 2% of GDP compared with 13.2% in the last three months of last year and 10.5% in the entire year of 2011. The National Bank’s international reserves totaled $8,085 bln at the end of March, which was equal to 2.1 months’ worth of imports and more than twice as much as a year ago.

A price paid for the reduced economic imbalances in Belarus was a decline in consumption and investment. In Q1 2012, fixed capital expenditure decreased by 15.1% year-on-year. Households’ consumption and government expenditure fell less significantly: by 6.8 and 2.8%, respectively. A sharp increase occurred in the volume of exports, which jumped by 38% in real terms. The rise in net exports led to GDP increasing by 3% in real terms in Q1 2012. Apart from the sharp depreciation of the national currency last year, which significantly increased the competitive capacity of Belarusian goods, a reason for the increase in Belarusian exports were agreements signed with Russia on trade in energy resources. Belarus drastically increased the export of petroleum products made from crude oil supplied from Russia at preferential prices.

Amid the slowdown in inflation and slow economic growth in the first months of 2012, the National Bank of Belarus (NBB) lowered its refinance rate, which was raised last year from 10.5% in January to 45% at the end of the year. The refinance rate was reduced to 38% during Q1 2012 and then to 36% in April, 34% in May, and 32% in June. This level exceeds the inflation rate of 19 to 22% that the government forecasts for this year. Nonetheless, the lack of certainty regarding the pace of inflation in the remaining part of 2012 makes it difficult to say how far in the positive this rate is in real terms. The acceleration in lending growth during the spring months - 10.4% compared with the beginning of the year against 4.6% in March and 1.7% in February - may suggest that the restrictions imposed by the National Bank’s policy on lending growth were loosened.

The NBB-declared transition to a controlled floating exchange rate system led to only a partial flexibility of the national currency’s rate in the first half of 2012. The Belarusian ruble’s exchange rate stayed within a relatively narrow range during the dramatic developments in the Eurozone that took place in May and June, which had a significant potential to influence the national economy.
Outlook

Belarus: Completion of macroeconomic stabilization amid risks

Despite the considerable improvement of the Belarus economic situation that was achieved in 2011 and early 2012, its stability remains fragile. To begin with, the country still has a current account deficit ($250.6 million - 2% of GDP, in Q1 2012), although it is not as high as in previous years. Between 2009 and 2011, Belarus’ current account deficit amounted to more than 10% of GDP. The gross external debt grew from $6.7 billion in January 2007 (18% of Belarus’ GDP in 2006) to $34 billion (62% of GDP in 2011) in early 2012. Against this backdrop, the large-scale use of external borrowing to finance the external imbalance, which was a characteristic feature of the Belarus’ economic development model in previous years, has now become impossible. The results of Q1 2012 suggest that there were important changes in the country’s external balance. In particular, the financial account balance went into the negative for the first time since early 2006, which means that Belarus has started reducing its debt burden. If this trend turns out to be steady, the country may experience difficulties in financing a balance of payments deficit even though it has decreased.

Meanwhile, the state of the external balance is a condition for preserving the main achievements of 2011. As previous years suggest, Belarus’ inflation rate is extremely sensitive to the dynamics of the exchange rate of the national currency. It is highly probable that a significant weakening of the ruble will cause a new surge of inflation in the country. The ruble’s weakening will also jeopardize the recovery of private and investment demand. In a situation where opportunities for increasing exports are limited following the export explosion in 2011 and the first half of 2012, such a scenario may negatively affect the general economic growth.

In the short term, the risk of losing stability for the Belarusian economy is connected with the danger of a further deterioration in the economic situation in the world. Negative developments, not necessarily a breakup of the Eurozone but just another significant economic downturn in Europe because of the credit crunch, would affect Belarus’ exports to all countries, including CIS member states and China. In addition, the stability of the economic situation in the country may be disturbed if the Belarusian government loosens its budgetary or monetary policy too quickly. The current GDP growth rate, which is lower than in previous years, may prompt the government to loosen its policy, although the current economic conditions, including continuing economic growth, a low unemployment rate and a limited decrease in consumption, can actually be regarded as favorable for a country that has just come out of a balance-of-payments crisis of such a scale.

Given these circumstances, it would be reasonable for the National Bank to pursue a conservative macroeconomic policy that would envisage controlling lending growth in the economy and gradually increasing the country’s international reserves in order to expand the room for support of growth when there is a need for it.
Belarus

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

- Agricultural output growth
- Industrial output growth
- GDP growth

Source: the 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)

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

Source: national agencies, IMF

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

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)

Source: national agencies

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

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)

Source: estimates and forecasts by national agencies and the IMF
Trends

Kazakhstan: Weakness of export-oriented sectors amid strong consumer demand

Following a growth rate of 7.5% in 2011, the economic growth of Kazakhstan slowed to 5.6% in real terms in Q1 2012. The period saw a decline in agricultural output, which was caused by both seasonal factors and a “high base” in 2011. Statistical data of the industrial sector indicate a strong performance of industries that are focused on domestic demand, and a weaker performance of the export-oriented industries. In the mining industry, a 13% decrease in oil production, and a 0.7% decrease in iron ore production were compensated for by a 5% rise in the production of natural gas, and a 3.3% increase in the production of non-ferrous metals. An overall 0.2% decline in the mining industry’s output was partially due to the 2011 strike in oil fields, and to a fall in external demand for raw materials. A significant increase occurred in the manufacturing sector. It increased output by 8.6%, with the growth rate accelerating in both machine-building and light industry. A considerable rise in trade and services suggests an increase in consumer demand in the private sector.

A rise in export prices in Q1 2012, mainly prices of raw material, which increased by 40% year-on-year, led to a significant surplus in trade and a current account balances of $3.8 billion, up from $2.3 billion in 2011. The dynamics of the export volume was influenced by the fall in external demand, and the production decline in the mining industry. Kazakhstan’s imports increased in the period, which was largely due to a rise in domestic demand and consumption. The financial account balance was determined by a net inflow of foreign investment and a net outflow of short-term capital. A $4-billion increase in the foreign assets of the government and the National Bank of Kazakhstan accounted for the overwhelming part of the outflow of portfolio investment, which totaled $4.1 billion.

The government pursued a tight and consistent fiscal policy, decreasing the level of the tax burden and containing the growth of public spending. That helped ensure a rapid increase in the volume of the National Fund, which is intended to be a safety cushion to reduce the impact of the global economic crisis. Government expenditure remained at a steadily low level, amounting to 16% to 19% of GDP. Q1 2012 saw a consolidated budget surplus equal to 13.1% of GDP. If the resources of the National Fund are not taken into account, the state budget had a deficit amounting to 1.2% of GDP.

Inflation slowed significantly by March 2012, with its annual rate falling to 4.6%. The slowdown in the rise in prices allowed the National Bank to gradually reduce the refinancing rate from 7.5% at the end of 2011 to 6% in June 2012. Lending grew at a slow but steady pace, increasing by 15 to 16% year-on-year. The National Bank’s restrictions contained the growth of foreign currency lending, which decreased by 4.1% compared with Q1 2011. Loans in the national currency increased in March by 30.9% year-on-year. “Other” loans, which included loans for consumer purposes, were the main contributor to the increase in lending. As of late March 2012, non-performing bank loans accounted for 33% of the total volume of loans issued by second-tier banks, down from 34.9% at the end of 2011.
Outlook

Kazakhstan: Uncertainty and likely economic slowdown

Amid a growth slowdown in the world economy and, in particular, the economy of China, Kazakhstan will see a continuation of the current trends and a certain slowdown of its economic growth. Petroleum products account for about 70% of the total volume of exports, and half of industrial output. A decline in external demand for these major export products will therefore lead to a lower growth rate in the mining industry. However, one can expect that non-oil sectors will continue growth, driven by domestic consumption and, to a certain extent, investment. Following a growth rate of 7.5% in 2011 last year, the International Monetary Fund forecasts the real GDP growth rate to fall to 6% in the next two years. In a joint statement issued in February, the government and the National Bank predicted the real economic growth rate to be 6% to 7%. Despite the poor preliminary results of the first half of the year, the EDB expects a growth rate of about 6.5%, provided there are no significant shocks that could change the external trade conditions for the country. Consumption will be the main driving force of such growth. If the situation in world financial markets calms down, one can expect an increase in investment activity provided that the real income of the private sector continues to rise. Given a low inflation rate, it is likely that domestic demand will continue to grow in the medium term, and that the government’s efforts to industrialize the economy will lead to the industrial sector’s increased contribution to Kazakhstan’s GDP.

The declared objective of the National Bank regarding inflation is to ensure that the 2012 inflation rate is within a range of 6% to 8%. There was some anxiety caused by the news that the annual inflation rate rose by 5% in May 2012, with the main contribution to the rise being made by an increase in utility tariffs. A certain effect may have been produced by the decision of the National Bank to lower its refinancing rate to 6% amid falling oil prices. The National Bank pointed out that the inflation rate remained below 6% after the increase in utility tariffs. If world oil prices continue to fall, one can expect the disinflation trend to continue provided the national currency’s exchange rate changes insignificantly.

The fiscal policy pursued by the government does not cause apprehension because public expenditures remain at the previous low level (16% to 19% of GDP). This makes it possible to preserve a consolidated budget surplus and build up international reserves. Relatively high oil prices in the first five months of 2012 allowed the National Bank to increase its foreign exchange reserves by 16%, while the reserves of the National Fund of Kazakhstan grew by 18%, which made a combined total of $85.8 billion.

However, given the growing risks in the world economy, a determining factor for the macroeconomic situation is the government’s exchange rate policy - a more flexible exchange rate system would help provide the economy with liquidity, and thereby support the stability of economic growth. The continued high level of non-performing loans remains a major impediment for the monetary policy and the proper functioning of the economy. Hopefully, the ongoing restructuring of problem banks, and the establishment of the Stress Assets Fund, will help improve the state of the banking sector in the medium term. It will allow banks to get rid of bad loans by writing them off, and transferring them to the Fund or other special institutions.
Kazakhstan

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

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)

Source: national agencies, IMF

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

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)

Source: national agencies

Figure 5.5. **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 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)

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

**Kyrgyzstan: Economic setback due to fall in gold production**

A poorer-than-expected performance of gold mining company Kumtor, which accounts for about 40% of Kyrgyzstan’s industrial output, led to a 6.8% year-on-year GDP drop in Q1 2012. The industrial sector’s contribution to the country’s real GDP decreased to 8.6%. If gold production is not taken into account, GDP increased by 4.5%, up from 2.1% in Q1 2011. Output increased in other sectors: construction - 12%, trade - 7.5%, and services - 5.9%. This partially compensated for the fall in industrial output. The aggregate contribution of the agricultural sector was 0.1%.

A 63% drop in Kumtor’s gold production led to a significant deterioration in Kyrgyzstan’s balance of payments. In Q1 2012, the country had a trade deficit of $762 million, 30% more than in Q1 2011. Although world gold prices rose by 22%, Kyrgyzstan’s exports decreased by 12% in nominal terms. Imports jumped by 40% as a result of a rise in the price of imported petroleum products. This accounted for 19% of the nominal increase in imports. An increase in the demand for imported cars contributed 12% to the increase.

These factors, coupled with a decline in nominal GDP, led to the trade deficit increasing to 62% of GDP. The deterioration of external imbalances was partly offset by an inflow of cash remittances from abroad - $314 million, and foreign investment - $118 million.

Despite the decrease in GDP, the country’s state budget revenues turned out to be higher than projected. An increase in budget revenue from the State Customs Service (SCS) is attributable to: the increase in imports; and to the transition to a new system of imports administration based on prices instead of weight. The collection by the State Tax Service (STS) of tax payments in excess of the targeted amount is linked by authorities to the improvement of tax administration. The higher-than-expected contributions to the Social Fund were in turn caused by a nominal wage rise, which increased by 38% year-on-year in Q1 2012. However, the state budget had a deficit of 1.9% of GDP compared with a surplus in Q1 2011.

The deterioration of the economic situation, coupled with a managed exchange rate policy and the continued fall in prices in the world food market, led to the intensification of the disinflation trend. In response the National Bank of Kyrgyzstan attempted to loosen its monetary and lending policy. The rate on the National Bank’s short-term notes was lowered from 13.6% at the end of 2011 to 9.6% in late March 2012, when the annual rise in consumer prices was 0.2%.

The banking sector’s lending to the economy grew by 17%. The highest increase was in consumer loans with 12% of total loans up from 9% in 2011. The situation in the banking sector can be described as generally positive. The financial indicators of profitability and capital adequacy remained at rather high levels. The share of non-performing loans was relatively small, making up 10% of the total loan volume.
Kyrgyzstan: Uncertainty in gold production leads to uncertainty regarding economic development prospects

The problems experienced in gold production at the Kumtor mine are responsible for a considerable part of the uncertainty regarding the short-term prospects of the economy. The government, which earlier projected GDP to increase by about 7.5% in 2012, preliminarily revised the projection downward to 1.8%. The International Monetary Fund and other international organizations left their initial GDP growth forecast for this year unchanged at 5%. Kumtor unveiled a new production schedule showing production continuing to decline up to the end of Q3 2012, but increasing by 95% year-on-year in Q4. Gold production in 2012 is expected to be 31% lower than in 2011. Gold production accounts for about one-fifth of the country’s GDP. If Kumtor’s forecasts are correct, then the revised projections of the government might be met, with trade, construction and services continuing to be the main driving forces of the economy. The lower-than-expected revenue from Kumtor has created a risk of failure to meet the target for state budget revenue. This has made the government reduce fixed capital expenditure by 0.8% of GDP. The fiscal authorities are considering a set of measures to stimulate and boost revenues from other sectors of the economies. These include the imposition of a moratorium on tax audits, and the simplification of a number of registration procedures. Re-orientation of some companies from the re-exporting of Chinese products to production of manufacturing goods may help accelerate growth in certain sectors such as the textile and food industries. However, all these measures cannot produce an immediate effect. That is why it is quite likely that the gap between government revenue and expenditure will exceed the projected level of 5.4% of GDP. This constitutes an additional impetus to the rise in prices. In this regard, the National Bank does not plan to loosen its monetary policy. The projections made by the monetary authorities for base inflation, and the existence of free liquidity in the banking sector, indicates the existence of inflation pressure.

The revision of the indicators of private companies’ non-guaranteed external debt should have been expected after the scope of statistics was expanded following the transition of debt compilation from the National Bank to the National Statistical Committee (NSC). According to updated data, the borrowings of the private sector, except the banking sector, grew to 26% of GDP and the gross external debt amounted to 91% of GDP by the end of 2011. An increase of 3.7% in this indicator during Q1 2012 constitutes another risk to the national economy.

Given all circumstances, pursuing a flexible exchange rate policy represents an important task for the National Bank. This would make it possible to reduce the impact of both the external and internal shocks that the economy faces.
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

**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

**Figure 6.5. 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 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 and the IMF
**Trends**

**Moldova: GDP growth slowdown amid crisis in Europe**

Moldova’s economic growth sharply decelerated in Q1 2012. The country had a 1% year-on-year GDP increase in the period compared with a 6.4% increase in Q1 2011. Major factors determining the trend included: a slowdown in both the growth of household consumption and the export of Moldovan products; and a decline in investment activity amid the deteriorating situation in the European economy. Public expenditure also decreased in real terms as a result of the government’s policy aimed at the consolidation of the state budget, the sustainability of which was seriously disturbed by the crisis 2008-2009. The fall in the growth rate affected economic sectors rather evenly. The extractive sector, the manufacturing sector, and the power and heat generation industry decreased output by 9, 1.8 and 2.6%, respectively. Agriculture and services saw their growth rates decline to 1.6 and 2.6% from 5.5 and 5.4% in 2011. Construction was the only sector that had a considerable rise in output in Q1 2012, posting a 9.8% year-on-year increase.

Inflation slowed slightly, with the annual inflation rate in March 2012 being 6.2% compared with 7.6% at the end of 2011. The inflation slowdown in Moldova was more moderate than, for instance, in Ukraine, as the National Bank of Moldova promptly responded to it by lowering the refinance rate in December 2011 and January 2012. A relatively flexible policy regarding the national currency’s exchange rate allowed the National Bank to adjust its monetary policy, adequately reacting to shocks affecting the economy.

Despite the government’s effort to strengthen its finances, the progress made in this area in Q1 2012 was not significant: the central government’s budget deficit amounted to 2.9% of GDP compared with 3% in Q1 2011. Although measures taken to improve the collection of taxes led to an increase in budget revenue as compared with GDP, the deteriorating economic situation complicated control of government expenditure.

The condition of Moldova’s balance of payments also did not change significantly. In Q1 2012, the country had a current account deficit equal to 13.4% of GDP. The deficit was the same in Q1 2011. Moldova’s income, transfer and financial account surpluses were not seriously affected by the deterioration of the economic situation in European countries. It should be noted that the inflow of cash remittances sent by Moldovan citizens employed abroad increased to 11.8% of GDP in Q1 2012 from 11.1% a year ago. This increase may have been caused by the fact that Russia’s economic growth rate did not fall. The banking sector’s lending continued to grow at the same rate as last year. As of late March, the annual lending growth rate was 21.5%, standing at the same level as in December 2011. The banking sector’s capital sufficiency and liquidity indicators fell in Q1 2012, but remained rather high: the ratio of capital to assets, and the share of liquid assets in the total volume of assets, shrank to 28.4 and 31.8% as of the end of March from 30.4 and 33.2% at the end of 2011, respectively.
Moldova: Danger of recession, uncertainty in second half of 2012

The nature of Moldova’s economic growth in the first quarter of the year, when most of the sectors had a sharp growth deceleration or negative growth and only construction continued to have a relatively high growth rate, make one believe that the country will face a recession in the short term. If, as should be expected, the construction sector’s growth slows after a slowdown in the overall investment activity, GDP will start to decline. The likelihood of this happening is rather high, although in Q2 2012 the Moldovan economy apparently continued to receive support because of the continued relatively favorable economic situation in Russia. As a result, additional negative phenomena in the Moldovan economy, if they take place, will not be of a large scale, especially considering that the satisfactory condition of the state budget, and the National Bank’s flexible exchange rate policy, provide a certain margin of safety against external shocks in the short term. A new series of negative developments in Europe and Russia in the second half of 2012 may have more serious consequences for the economy of Moldova. However, there is likelihood that the country will soon resume economic growth if the European authorities regain control of the situation in the Eurozone.

The inflation slowdown in Q1 2012 continued into the following months: the annual inflation rate declined to 5.4% in May.

Since there is a considerable slowdown in money growth – the annual growth rate of the M2 money supply fell from more than 20% in the middle of 2011 to 11.3% in May 2012 – inflation will continue to be low during the remaining part of 2012, unless the impact of negative external shocks leads to a dramatic depreciation of the national currency. It should be noted that the National Bank has a potential to loosen its policy in case the economic situation in the country changes for the worse.

Moldova’s balance of payments will remain in good condition while there is a steady inflow of remittances from labor migrants. Things may change if the debt crisis in Europe deepens and the economic situation in Russia deteriorates. Nonetheless, since the National Bank continues to pursue a flexible exchange rate policy, there are grounds to expect that the country will not lose its external sustainability in the foreseeable future.

The consolidation of public finances, which slowed in 2011, when the state budget deficit amounted to 2.4% in GDP against 2.5 percent in 2010, may end this year. An economic decline, even if it is not severe and long-lasting, will negatively affect the government’s revenue and require an increase in, at least, the social spending. This would lead to a rise in the budget deficit. Given the moderate size of the public debt, which amounted to 28% of GDP at the end of 2011, reducing the budget deficit under the current circumstances should not perhaps be a priority objective for the government, the need to continue structural reforms aimed at ensuring the sustainability of the public finances in the long term remains.
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

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

Source: national agencies, estimates by 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
Trends

Russia: Continued growth amid high prices of raw materials

In Q1 2012 the Russian economy retained the annual growth rate at the level reached in Q3 and Q4 2011. The country’s GDP rose by 4.9% year-on-year. The relatively high economic growth rate was due to a rise in private consumption, which increased by 7.2% amid a rise in real pay of 11.7%, and a 15% year-on-year increase in fixed capital expenditure. From the standpoint of supply, the highest increases occurred in retail and wholesale trade, which grew by 7.5 and 11.3%, respectively. The agricultural sector showed a rise of 4%, which was not bad for the beginning of a year. At the same time a downward trend in the industrial sector’s growth rate that began in mid-2011 continued into Q1 2012. Rather modest output increases occurred in the extractive sector, and in the utilities - 1.9 and 2.6%, respectively. The manufacturing sector’s output increased by 4.4% year-on-year against a rise of 10.6% in Q1 2011.

The annual inflation rate in the country continued to set new all-time lows, and stabilized at about 3.7% by the end of Q1 2012. This was mainly due to the government’s decision to shift the annual revision of administratively set tariffs from January to the middle of the year. In addition, inflation was held back by the policy of the Bank of Russia (central bank), which kept its refinance rate at 8%. Since the inflation rate is expected to be 5 to 6% this year, the refinance rate remains firmly in the positive, curbing the growth of lending and monetary aggregates.

The high prices of Russia’s major export items, and high economic activity in Q1 2012, ensured favorable fiscal results in the period, although public expenditure rose by 28% compared with Q1 2011. Russia’s consolidated budget had a surplus of 519.9 billion rubles, which amounted to 3 to 4% of the quarter’s GDP. These factors enabled an increase in the government’s reserves. The Reserve Fund of Russia grew to $60 billion.

Russia continued to have a current account surplus in Q1 2012, which amounted to $42.3 billion, up from $30.8 billion in Q1 2011. The outflow of capital from the country, which totaled about the same amount, mainly came from the private sector. In Q1 2012 the latter took as much as $35.1 billion out of Russia amid a very uncertain economic situation in the world, and increased political tension in the country during that period.

The banking sector’s lending continued to grow at a fast pace, increasing by 25.4% in March 2012 compared with March 2011, although the growth rate was lower than in 2011, when lending experienced a dramatic upturn, growing by 41.6% year-on-year in December 2011. The slowdown in lending growth had a positive effect on the sustainability of the banking system. In particular, the ratio of Russian banks’ capital to assets, which had been declining throughout the last year, and reached levels below 10% in Q4 2011, recovered by the end of Q1 2012 to more than 14%, which was about the same level as at the end of 2010.
Outlook

Russia: Growth due to low-base effect, uncertainty in second half of 2012

From the data that is already available data for Q2 2012, it is seen that the deterioration of the economic situation in the world, and the fall in the prices of raw materials in May and June, had a limited effect on the situation in the Russian economy. In particular, industrial output, poll-based purchasing managers’ indexes (PMIs), and business activity indexes indicate only a moderate slowdown in Russia’s economic growth. Since the results of Q2 2011 were poor, one can expect that the country will retain the annual GDP growth rate at 4.5 to 5% in Q2 2012. Economic trends in the second half of 2012 look much more uncertain. If the external environment does not deteriorate further, Russia’s economic growth may accelerate compared with the first half of 2012. Such developments took place in 2011, when a fall in prices of raw materials did not prevent the Russian economy from increasing its growth rate in Q3 and Q4. The main driving force of that acceleration was investment activity, the bulk of which shows up in the data in the last months of a year. If companies do not start to fundamentally revise their investment plans under the influence of unfavorable external developments, this trend will reappear this year, ensuring a GDP growth rate of about 5% in 2012. If the fall in the price of Russia’s major export items persists – under our negative scenario the price of Brent crude oil falls to $90 per barrel and remains at this level until the end of 2013 – we expect a decline in Russia’s rate of economic growth to 2 to 3% in 2012 and 2013.

July is a crucial month for the inflation outcomes of 2012 as the government is to raise administratively set tariffs, an event postponed from January. A seasonal drop in food prices, coupled with the current global fall in prices of raw materials, may reduce its effect. A contrary impact on inflation will be produced by the weakening of the ruble. This may be one of the reasons the Bank of Russia is not ready to loosen control over the exchange rate of the national currency by broadening the ruble’s allowed fluctuation band against the dollar/euro currency basket. Meanwhile, the relatively flexible policy regarding the ruble’s exchange rate is an important factor in the current situation – it enables the central bank to concentrate its effort on keeping the growth of money supply stable. The contraction of the money supply, when the ruble rate is de facto fixed at the upper limit of the band, may have a destabilizing effect on the national economy, as was the case during the crisis of 2008-2009.

The fall in energy prices in May and June prompted the Russian authorities to shift their preference to a more cautious fiscal policy. In particular, starting in 2013, federal budget expenditure will be based on the average oil price in the previous 5 year period, which is to increase to 10 years by 2018. In practice, that average is going to be $90 to $95 per barrel in the near future. Despite the fundamental importance of budget consolidation for the preservation of economic stability in the long run, the low level of public debt as a percentage of GDP, and the financial reserves at the disposal of the government, ensure a certain degree of protection for the country’s budget from the impact of the current twist of the debt crisis in Europe. In the short run, adequate monetary and exchange rate policies, and vigilance regarding risks in the banking sector are much more important for maintaining economic stability. The government should focus its attention on these matters in the next few months.
Russia

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

![GDP and output graph]

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)

![Foreign trade graph]

Source: national agencies, IMF

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

![Government sector graph]

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)

![Monetary sector graph]

Source: national agencies

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

![Economic growth graph]

Source: national agencies, estimates by 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)

![Savings and investments graph]

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

**Tajikistan: GDP growth amid significant external imbalance**

Tajikistan had a GDP growth rate of 7.2% in Q1 2012. A significant contribution to the growth was made by trade and services, which increased by 18.6% and 12.8%, respectively. Industrial sector production increased by 14.6%, which was driven by an 80% rise in the textile and garment industries, and a 7.3% increase in the food industry. Metallurgy production dropped by 9.8%. A considerable decrease occurred in the construction sector. Fixed capital investments fell by 35%, which is attributable to a slowdown in the construction of the Rogun Hydroelectric Power Plant. From the standpoint of demand, the main driver of the economy in the first months of 2012 was household consumption.

In Q1 2012 cotton fiber production grew by 20%. This led to an increase in the export of cotton fiber by 65.1% in real terms, but a decline in cotton prices in world markets caused an export decrease of 24.9% in nominal terms. Problems experienced in the import of coke and alumina led to a decline in the export of aluminum, another important export item for the Tajik economy. A 21% increase occurred in imports. This was caused by both a rise in the price of imported mineral products, and a rise in the demand for consumer goods, with the import of transport vehicles doubling. As in 2011, the impact of the increased trade deficit on the balance of payments was offset by an increased inflow of cash remittances from abroad. The country’s external debts did not exceed the certain limit of 40% of GDP, but they grew by 2% in Q1 2012 from 33.2% of GDP at the end of 2011.

Despite an improvement in tax administration, the rise in public expenditure outpaced revenue growth. The total volume of revenue, including grants, amounted to 32% of GDP. The main contributor was sales tax and VAT, the share of which decreased by 1% of GDP compared with the same period in 2011. Higher expenditure during the period led to the state budget surplus decreasing to 3.7% of GDP against 5.1% in Q1 2011.

A decline in the growth rate of consumer prices, which began in the middle of 2011, continued into Q1 2012. The period saw a gradual decrease in the impact of non-monetary factors on inflation amid a favorable fall in food prices in world markets. Disinflation continued although the National Bank of Tajikistan lowered its refinancing rate from 10% in November 2011 to 8% by April 2012. The IMF describes the stability of the national currency’s exchange rate as an anchor that helps reduce inflation expectations. It also warns that a sudden increase in the prices of utility tariffs, and imported goods, may lead to a return to double-digit inflation in 2012.

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 banking loans in the national currency. Despite authorities’ efforts and some apparent improvements, the country’s banking sector remains weak and vulnerable to shocks. This is because banks’ profitability rates are still low, and non-performing loans make up a large share of total loans.
Outlook

**Tajikistan: Slowdown in growth amid increased payments to service external debt**

International organizations’ forecasts for 2012 and 2013 predict that Tajikistan will have an inflation rate of 8% to 9% and a GDP growth rate of 5.6% in 2012. The fall in economic growth from 7.4% in 2011 will be a consequence of an economic slowdown in the key trading partners of Tajikistan. The forecasters expect that the country’s GDP growth rate will recover to 6% in 2013 if the situation in the global economy returns to normal. Tajikistan’s economic development model has remained unchanged in the last few years. Due to significant external imbalances, GDP grows through an increase in public investment and a rise in private consumption. Given the de-facto fixed exchange rate of the national currency, public investment is financed with external borrowings, and the inflow of cash remittances from abroad is accompanied with a rise in the consumption of imported goods. The external trade deficit in the first five months of 2012 amounted to more than half of the country’s GDP, but it was to a considerable extent offset by cash remittances, which, according to estimates from the Bank of Russia, amounted to 41% of GDP in Q1 2012. Various sources estimate that about 80% of the total volume of cash remittances from abroad goes for purchases by households of goods for their own consumption.

Starting in 2012, Tajikistan will have to repay the amortization of its external debt, which currently amounts to 32% of GDP. Given this circumstance, the most efficient approach to fiscal policy would be the consolidation of the budget through reducing non-priority capital expenditure and improving revenue administration. According to data from the World Bank, the volume of tax revenue as a percentage of GDP in Tajikistan is lower than in most of the other countries in Europe and Central Asia. The government expects that the enactment of a new tax code in 2013 will simplify the tax system, increase the efficiency of taxation, and give a boost to private sector development.

Transition to a more flexible exchange rate policy could be an important step in: preventing an excessive increase in the external debt; reducing the balance of payments imbalances; and generally assisting the economy. Apart from this, given the growing risks from the global economy, the flexibility of the national currency’s exchange rate would help to cushion the impact of negative external factors.

The weakness of the banking sector represents another significant risk for steady economic development. The National Bank of Tajikistan reports that the weighted average rate on bank loans in Q1 2012 was 2.9% lower than in Q1 2011, whereas the total volume of loans provided by banks grew by 7.4% year-on-year. Despite an apparent rise in demand for bank loans, it should be noted that the increase in lending to the private sector is due to the provision of loans in foreign currency and direct loans disbursed by the National Bank. The fixed exchange rate may also contribute to lending growth.

**International organizations expect a slowdown to 5.6% in 2012**

**The growing gap between exports and imports is offset by a rise in cash remittances from abroad**

**Given mounting external risks, reducing non-priority expenditure is the most efficient approach to fiscal policy**

**The weakness of the banking sector poses a risk for steady economic development**
Figure 9.1. **GDP and output**: GDP growth and output change by sectors, (in %, year-on-year)

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

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

Figure 9.5. **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 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 and the IMF
The economy of Turkmenistan continued to grow at a double-digit pace in Q1 2012. In Q1 the country had an annual GDP growth rate of 10.5% compared with 14.4% in Q1 2011. According to official data, in the first two months of 2012, the year-on-year growth rate was 12.6% in the industrial sector, 13.4% in construction, 5.6% in the transport and communications sector, 6.8% in trade, 6.5% in the services sector and 1.9% in agriculture.

The favorable situation in external trade was determined by an increased demand for the country’s key export items, including natural gas and cotton. This can be evidenced by a 19.1% rise in the production of natural gas, which is lower than Q1 2011 when gas production increased by 41% year-on-year. A marked slowdown occurred in the growth rate of exports, which fell to 50.4% from 91.8% in Q1 2011. Q1 2012 saw a 45.2% increase in imports compared with a 2.3% increase in Q1 2011. This rise is mainly attributable to the significant import of investment goods within the framework of the government’s program aimed at the modernization and diversification of the economy. In Q1 2012 the growth rate of fixed capital expenditure accelerated to 39.6% from 25.6% in Q1 2011.

In Q1 2012 government revenue rose by 68.5% year-on-year and exceeded the target by 13.5%. Expenditure grew by 31% and only reached 93.8% of the projected level. Measures relating to the implementation of the government’s social policy accounted for 70.5% of all expenditure. The “protected” state budget expenditure items (salaries, pensions, student allowances and social benefits) were financed fully and promptly. According to a report from the Asian Development Bank, the Turkmen government retains control over monetary policy and lending, which makes it possible to keep the rise in prices within the target band despite a relatively high growth rate of the money supply.

According to forecasts from international organizations, in the remaining part of 2012, the economy of Turkmenistan will continue to grow at a rate of 9%, with the main driver being government investment, amid high prices of natural gas. 2013 is expected to see a certain slowdown in economic growth because of general trends in the world economy, and a decline in external demand for Turkmen gas. The country is to significantly benefit in the medium term from the strengthening of cooperation with neighboring countries. In particular, the completion of the North-South Railroad project by 2014 should improve access to the markets of Kazakhstan, Russia and South Asian countries.

As was mentioned in previous reports, the non-diversified structure of exports, with natural gas accounting for about 90% of the total volume, makes the national economy vulnerable to external shocks. The diversification of export destinations, and the diversification of the economy in general, are a key condition for the country’s steady economic development. In order to diversify the economy, it is also necessary to carry out structural reforms. The government is taking appropriate steps under the National Program of Social and Economic Development, which places emphasis on the development of the agricultural sector and manufacturing industries.
Turkmenistan

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

Source: the CIS Statistics Committee and national agencies

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

Source: national agencies and IMF

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

Source: national agencies and ADB

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

Source: national agencies and ADB

Figure 10.5. 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 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)

Source: estimates and forecasts by national agencies and the IMF
Trends and outlook

Uzbekistan: Economic growth under the influence of demand-stimulating policy

In Q1 2012 the economy of Uzbekistan kept growing under the influence of a demand-stimulating policy. According to officially released statistical data, the country’s GDP grew by 7.5% year-on-year in the period, with the main drivers of the growth being the services sector - 12.5%, trade - 11%, and transport and communications. In the industrial sector, the highest growth rates were achieved in light industry - 10.9%, the building materials industry - 9.7%, and the non-ferrous metallurgy industry - 7.7%.

The production of consumer goods rose by 5.4%, while retail trade increased by 11%, and the volume of paid services grew by 20.1%. The resumed growth in the construction sector – 6.6% against 0.9% a year before – indicates the economy’s recovery from the 2008 - 2009 crisis.

A distinctive feature of Q1 2012 was a considerable increase in imports, which was driven by the government’s investment programs aimed at modernizing the industrial sector.

The country apparently retained a current account surplus, which led to an increase in its international reserves. According to an IMF report, the reserves amounted to the equivalent of 14 months’ worth of imports.

The fiscal outcome of the period turned out to be significantly better than earlier projected figures. In Q1 2012, Tajikistan had a budget surplus equal to 2.1% of GDP, which was somewhat higher than in 2011 and much higher than in the same period in 2010.

A fall in prices in world food markets did not have any impact on the dynamics of prices in the country. According to the IMF, its alternative inflation estimate is 13%. Despite some tightening of monetary policy and a slowdown in the growth of monetary aggregates, the high rise in prices is driven by the demand-stimulating policy, the weakening of the national currency and an increase in regulated prices. The country’s banking system keeps stable amid continued capitalization.

According to international organizations’ forecasts, if there continue to be high prices in world markets for Uzbekistan’s major export items, the country’s economic growth rate this year and in the medium term will remain high amid a rise in investment in the industrial sector and the infrastructure. International organizations’ current average GDP growth forecast is 7.7% for 2012, 7% for 2013 and 6.7% for 2014.

The IMF recommends the Uzbek authorities to focus on policies to lower inflation, eliminate distortions in the foreign exchange market, and enhance trust in banks by further strengthening banking supervision and improving cash management.
Uzbekistan

Figure 11.1. **GDP and output**: GDP growth and output change by sectors, (in %, year-on-year)

Source: the CIS Statistics Committee and national agencies

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

Source: national agencies

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

Source: national agencies and 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)

Source: national agencies and IMF

Figure 11.5. **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 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)

Source: estimates and forecasts by national agencies and the IMF
Trends

Ukraine: Slowdown in growth, low inflation, external imbalance

Ukraine’s economic growth slowed dramatically in Q1 2012 after a successful previous year, when the country had a growth rate of 5.2%. In Q1 2012 Ukraine’s GDP increased by 2% year-on-year against an annual growth rate of 5.4% in Q1 2011. The most significant slowdowns were experienced by the manufacturing sector with a 0.2% year-on-year increase against a 13.3% increase in Q1 2011, and the construction sector with a 3.1% fall compared with a 6.4% increase in Q1 2011.

The extractive industry, utilities, and the agricultural sector also experienced a slowdown, but it was less significant. From the standpoint of demand, a significant negative growth rate was shown by exports, which fell by 6.8% in real terms compared with Q1 2011, whereas households’ expense and fixed capital expenditure continued to grow at a decent pace, increasing by 9.8 and 7.6%, respectively. One can presume that the slowdown in Ukraine’s economic growth in Q1 2012 was largely due to a fall in external demand for products of the country’s iron and steel industry as a result of the deteriorating economic situation in Europe and China, as well as to the petering out of the stimulating effects from preparations for the 2012 UEFA European Football Championship, which apparently led to a fall in construction compared with 2011.

Amid the drop in Ukraine’s economic growth, the country’s inflation rate continued to decline: the annual consumer price index fell to 1.9% in March. That was due to the exchange rate policy pursued by the National Bank, which maintained an almost fixed exchange rate of the national currency against the US dollar. Amid a general capital outflow from emerging markets and the European debt crisis, the National Bank’s tough monetary policy led to a deceleration in the growth of monetary aggregates. In particular, the annual growth rate of M2 was 11.2% in March and continued to decline in April, reaching 9.7% compared with 25.5% in March 2011.

The country’s external balance did not show signs of improvement. Although the current account deficit decreased to $1,209 million - 3.3% of GDP in Q1 2012, against $1,340 million in Q1 2011, this decrease did not continue - the current account deficit in January through April was 50% larger than in the first four months of 2011 ($1,830 million against $1,410 million). An increase in the financial account deficit due to a capital outflow left the Ukrainian economy’s general balance of payments in the negative. The international reserves were shrinking, totaling $31.1 billion as of the end of March compared with $36.4 billion a year before.

The banking sector’s lending to the economy grew at a slower pace than in 2011 amid the capital outflow from the country, and an associated decline in the growth rate of money supply. The total volume of loans issued by banks to non-financial organizations increased by 10.7% year-on-year in March compared with a 15.1% year-on-year rise in March 2011 and a 14.9% increase in December 2011. The sustainability indicators of the banking sector did not change much compared with Q4 2011. The consolidation of the financial sector following a lending expansion in 2011 apparently was not a key factor behind the current slowdown in lending growth in Ukraine.
Outlook

Ukraine: Risk of external shocks, need for strengthening of balance of payments

The fall in Ukraine’s economic growth rate in Q1 2012 showed the economy’s relatively high vulnerability to the impact of negative external shocks. This means that uncertainty is high regarding the chance of economic growth in the remaining part of the year. The recovery of demand for Ukrainian exports in case the economic situation in Europe normalizes will lead to the resumption of economic growth in the country in the second half of 2012. Nonetheless, given the poor outcome of Q1, and the existence of signs suggesting that Q2 was even less favorable for the economy – industrial output in January through May increased by only 0.7% year-on-year – the GDP growth rate in 2012 will still be low. International organizations’ current forecasts for this year – the IMF expects a GDP increase of 3% and the World Bank puts it at 2.5% – which predict a significant slowdown in the Ukrainian economy’s growth compared with 2011, when the growth rate was 5.2%, are actually optimistic. They will only be realized if there are favorable economic developments outside the country in Q3 and Q4.

The deceleration of inflation in Ukraine continued into Q2 2012 - the annual consumer price index growth was 0.6% in April and minus 0.5% in May. The base inflation rate, i.e. the one cleared of the impact of volatile food prices and energy prices, remained close to zero since the beginning of the year. The country thus encountered deflation, which may turn out steady, especially if additional negative shocks impact the economy during the second half of the year. The rapid fall in inflation after chronically high price growth during previous years – 22.3% in 2008, 12.3% in 2009 and 9.1% in 2010 – is a success. On the other hand, we are afraid this success may be excessive. If price growth rates remain at zero or negative levels during a long period of time, this may affect economic growth in the country.

The slow GDP growth, a negative phenomenon in itself, is also a source of additional risk in the context of the country’s steady external imbalance. If a low economic growth rate leads to the deterioration of access to external financing for Ukraine, this may result in a significant depreciation of the national currency. This depreciation would be followed by a new surge in inflation, which would nullify the government’s achievements in its effort to ensure price stability in the country. The National Bank’s transition to a flexible policy regarding the exchange rate of the hryvnia, and the adoption of an inflation-targeting system, are the measures that would help ensure a smooth adjustment of the balance of payments and more steady dynamics of economic activity and prices. In the short term, this transition would make it possible to ease monetary policy. That may be warranted by the economic conditions in the country considering the fall in the growth rate of GDP, and the sharp deceleration in inflation, amid a slowdown in the growth of the money supply.
Figure 12.1. **GDP and output**: GDP growth and output change by sectors, (in %, year-on-year)

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

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)

![Graph showing foreign trade data for Ukraine](image)

Source: national agencies, IMF

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

![Graph showing government sector data for Ukraine](image)

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)

![Graph showing monetary sector data for Ukraine](image)

Source: national agencies

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

![Graph showing economic growth data for Ukraine](image)

Source: national agencies, estimates by 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)

![Graph showing savings and investments data for Ukraine](image)

Source: estimates and forecasts by national agencies and the IMF
Analytical insert
Budgetary policy and external balance of Russian economy: analysis of a structural relation

By Konstantin Fedorov

Introduction

The sustainability of the balance of payments of the Russian Federation, which generally was not questioned throughout the greater part of the 2000s, has again been a subject of discussion among economists. Many experts point out that a number of circumstances may lead to the evaporation of a current account surplus in Russia in the relatively close future. These circumstances include: the significantly looser budgetary policy in the country compared with the period preceding the 2008-2009 crisis; and the gradual decrease in the volume of exports as a percentage of GDP (due to the stabilization of the prices and physical volume of Russia’s exports, and gradual economic growth).

This opinion is shared by the Russian authorities and international organizations (see forecasts in Figure 1). In particular, the forecast for economic development in the country that was annexed to the draft Law on the Federal Budget for 2012 and the Planning Period of 2013 and 2014 predicts that the current account surplus will turn into a deficit as early as 2013. Some government officials suggest that such developments would increase the risk of instability in the foreign exchange market, noting that the forecast regarding the current account balance gives reasonable grounds to say that a significant depreciation of the Russian currency is inevitable within two years (see, for instance, RIA Novosti’s report dated September 15, 2011).

Figure 1. Current Account Balance, actual and predictions

The International Monetary Fund’s forecast is of a somewhat less radical nature in this respect. The IMF expects a smoother fall in the external balance of the Russian economy and does not offer conclusions regarding the impact of this process on the ruble’s exchange rate, but the Fund also expects the current account surplus to come close to zero relatively soon, in 2016.
Nonetheless, in the first months of 2012, the performance of the Russian economy did not match the above forecasts. Contrary to experts’ expectations, the economy’s current account balance rose significantly, amounting to $42.3 billion in the first quarter, which means $169.2 billion for the year. Many observers believe that a possible reason for this rise was the general outflow of capital from emerging markets amid the debt crisis of the Eurozone countries, which intensified in the fall of 2011, as well as the negative effect of political events connected with the elections for the State Duma and president on investors’ perception of Russia.

Despite the fact that the above factors probably had an impact on the dynamics of the country’s current account balance, we think it is hasty to use them to explain the difference between forecasts for the current account balance and its actual dynamics. In our opinion, before resorting to them, it is necessary to ascertain the correctness of the major assumptions determining the forecasts that predict the Russian economy’s current account balance will soon go into the negative. As we said earlier, there are two such assumptions: one of them is about the impact of budgetary policy on the external balance; the other one deals with the dynamics of Russia’s exports and imports in the foreseeable future. The present article focuses on the former assumption.

Analysis of interaction between budgetary policy and Russia’s external balance

Despite the fact that the Russian economy remained a net exporter of capital throughout 1990-2000, the roles of its state and private sectors in this process changed with time. For instance, the 1990s, at least the period preceding the 1998 default, were characterized by a situation where the outflow of capital through private sector channels was offset to a considerable extent, if not fully, by an inflow through the government channels. With a rise in export revenues, and the resumption of economic growth at the end of the 1990s and in the first half of the 2000s, both the state and the private sector began to repay debts and accumulate foreign assets. Their external balances went into the positive. The picture changed to some degree between 2006 and 2008: amid an economic boom, accompanied by an increased need for financing investment, the private sector reduced the export of capital, whereas the export of capital by the state remained significant. During this period the Russian government actively increased its international reserves. The 2008 crisis was accompanied by a fall in export proceeds, a “sudden stop” of capital

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1 By the term “state sector” we mean government bodies. Therefore the “private sector” includes public corporations and companies involving the state. The term “private” is certainly conventional in this case.
inflow from the international capital markets due to a discontinuation of their normal functioning for a period, which, fortunately, turned out to be short, and a decline in the economy. That made players in the Russian economy dramatically change their external balances. The private sector, which reduced its consumption and investment expenditure, brought its balance far into the positive; whereas the government started to have a budget deficit, using earlier accumulated reserves to finance it. The recovery of prices of Russia’s major export products, and the general recovery of the economy in 2011, made it possible for the state budget to resume a surplus. The private sector reduced the export of capital, but not to the degree that would lead to its balance becoming negative or at least close to zero. As a result, the aggregate export of capital from the country, measured by the current account balance, remained at the levels that prevailed during the second half of the 2000s.

One of the observations that can be made on the basis of the historical dynamics showed in Figure 2 is that: the private and state components of the external balance of the Russian economy negatively correlate with each other - the private external balance worsens when the state improves its external balance, and vice versa. This fact can have more than one explanation; and which of them can be rejected or accepted determines the conclusions that can be drawn from it, including with regard to the impact of the current relatively loose budget policy on the external balance of the private sector.

The negative correlation between the external balances of the private and state sectors can reflect the following phenomena:

1. There exist factors influencing both sectors. If the private and the state component of the external balance of the country react to these factors in a contrary manner, there should be a negative correlation between them. For instance, such a factor can be economic growth or a rise in prices of goods exported by the country. If an improvement in the economic situation provides grounds for the private sector to believe that, in the foreseeable future, it will become much richer than at present, its entities may resort to external financing in order to increase their consumption immediately. A result of this behavior will be deterioration in the private external balance, whereas the state balance may improve because of a rise in tax revenue compared with expenditure amid economic growth.

2. Changes in budgetary policy have a direct effect on the private external balance. When the government toughens its policy, it withdraws from the economy the resources that the private sector could invest abroad. Accordingly, the external balance of the private sector deteriorates because it does not have surplus resources. When the government loosens its budgetary policy, we find an opposite picture. Thus, there is a negative correlation between the state and private external balances.

3. Spontaneous changes (not connected with the impact of economic growth or trade conditions - as opposed to the situation described in point 1) in the preferences of the private sector regarding savings and investment directly influence the state external balance (a situation contrary to that described in point 2). This influence can take place, for instance, because an increase in private consumption, a factor behind a deterioration in the private external balance, leads to a rise in tax revenues and, consecutively, can lead to an improvement of the state external balance.

To all appearances, there can actually be effects attributable to all of the three groups described here. An evaluation of their strength and direction is not a trivial problem; and a visual analysis of the diagrams in Figure 2 is not enough to solve it. A usual method of analyzing such a situation is the identification of the structural vector autoregression, which involves variables describing the examined area of economic reality on the basis of an evaluation of a reduced form of this vector autoregression.

In our case, we include in the model the following variables: the state external balance as percentage of GDP; the private external balance as percentage of GDP; the percentage growth of real GDP; and the percentage rise in the
price of Brent crude oil. The latter variable is an approximate measure for changes in the prices of the raw materials exported by Russia. The form of vector autoregression that we use has the following appearance:

\[ x_t = Ax_{t-1} + bp_{oil} + u_t, \]  

where \( x_t = \{gr_t, gbalt_t, pbalt_t\}', gr_t \) is the growth rate of real GDP, \( gbalt_t \) is the ratio of the state external balance to GDP, \( pbalt_t \) is the ratio of the private external balance to GDP, and \( poilt_t \) is the rise in the average price of Brent oil within the period \( t \) (the model treats this variable as exogenous). Equations of the model are evaluated separately according to the method of least squares on the basis of data of annual frequency for the period between 1996 and 2011.

The problem of identifying the structural form of the model

\[ x_t = Ax_{t-1} + bp_{oil} + Ce_t, \]  

where the vector \( e_t \) consists of independent elements, to which it is possible to attach the role of exogenous “structural shocks” of one nature or another, requires the imposition of restrictions on the interdependence of the elements of the vector of residuals \( u_t \). We use a common approach, assuming the so-called recursive structure of residuals, within which \( e_t = \{egr_t, egbal_t, epbal_t\} \), where \( egr_t, egbal_t, epbal_t \) are exogenous shocks changing the values of the growth rates of the economy (shocks from demand and supply), the state external balance (shocks from fiscal policy) and the private external balance (fluctuations in private preferences regarding savings and investment), respectively. The matrix \( C \) has a low-triangle form, i.e. we assume that shocks from fiscal policy and shocks from the private external balance, which reflect the variables \( egbal_t \) and \( epbal_t \) do not have a direct effect (that is, within the period \( t \)) on economic growth, and that shocks from the private external balance (\( epbal_t \)) do not have a direct effect on the state balance. After making these assumptions, we can find the matrix \( C \) with the help of the Cholesky factorization of the sample correlation matrix of the vector of residuals \( u_t \).

The above-formulated assumptions are supported by certain reasons. The first of our assumptions – we should note that this particular assumption is not of fundamental importance for the results of this analysis and can be changed – implies that the response of the economy to shocks from fiscal policy and the private external balance takes some time for realization, which can really be true. Of fundamental importance to us is the second assumption, which implies that shocks from the private balance, not related directly to fluctuations in the economic growth rate or oil prices, do not have an immediate effect on the state balance, that is, the effects described in point 3 are absent. Strictly speaking, this is not the case. Exogenous changes in the private external balance as a result of a rise or decline in consumption, revenues or investment is accompanied by a change in the tax base. Nonetheless, this effect can probably be disregarded because it appears to be incommensurably lower than the effects produced on the state balance by other variables of the model, such as the economic growth rate, shocks changing this rate and, most importantly, oil prices.

After making these assumptions and receiving estimates for the structural form of vector autoregression (2), we can create functions of impulse response to structural shocks in the model (2). They are shown below in Figure 3. Of the greatest interest to us is the response of the private external balance to shocks from budgetary policy (“Response of PBAL to GBAL” in Figure 3). One can see that according to our estimates, the private external balance falls by approximately two percentage points on average in response to an exogenous increase in the state external balance that amounts to one standard deviation of the second equation of the model. The latter is equal to 1.96 (the results of the evaluation are available upon request). Thus, exogenous shocks from budgetary policy cause the private external balance to change in the opposite direction by approximately the same value. This response offsets the impact of such shocks on the aggregate current account balance of the country. Thus, the conclusions drawn from the evaluation of our model strictly correspond to the first visual impression from the diagrams in Figure 2.
If the results that we have received reflect the way the Russian economy behaves in reality, the continued significant outflow of capital through the channels of the state sector has two reasons: expensive oil and a much looser budgetary policy than in the pre-crisis period.

Conclusion

The econometric analysis of the interaction between budgetary policy and the external balance of the Russian economy that we have made shows that exogenous shocks of a fiscal nature cause an immediate response from the external balance of the private sector, which has an opposite direction and a similar value. If this result is true to reality, the fiscal policy pursued by the Russian authorities has a smaller effect on the country’s external balance than many observers believe. Given our analysis, a decrease in the degree of sterilization by the authorities of export revenues will lead to an increase in the outflow of capital from the country through the channels of the private sector. This response offsets to a considerable extent the impact of the loosening of the government’s budgetary policy on the aggregate current account balance.

Thus, the Russian economy has mechanisms that can, to a certain extent, maintain the stability of its external balance, and the outflow of private capital as a response to the loosening of budgetary policy is a key component of these mechanisms. The latter conclusion is important, as it means that the increase in this outflow, which can be
seen at present, does not necessarily represents an abnormal and/or negative phenomenon. If the increased export of capital from the country is a normal reaction to economic circumstances – the high level of energy prices and the authorities’ policy - it would be erroneous to view it as a reason to alter economic policy. Actually, it is hasty attempts to change the direction of capital flows either by granting generous concessions to investors or (more destructively) imposing administrative restrictions on the export of capital that could, if successful, undermine the stability of the country’s balance of payments under the current circumstances.

As it appears from above, not only an excessively loose budgetary policy, but also an excessively tough one can constitute a danger to the external stability of the Russian economy. It is evident that the current account balance is not the only factor that determines this stability. Balanced state and private components of the balance of payments are also important factors of external stability. From this standpoint, the intensive accumulation by the government of international reserves in the period preceding the 2008-2009 crisis, could have had a destabilizing effect on the economy because of its negative impact on the external balance of the private sector. One should not rule out that, strange as it may seem, the relatively loose current budgetary policy of the Russian authorities is more helpful for maintaining the stability of the country’s balance of payments because it more evenly ensures the stability of its state and private components.

Naturally, what is stated above should not be taken as either an assertion that a loose budgetary policy in Russia theoretically cannot have a negative impact on the aggregate external balance of the economy, or an argument in defense of such a policy irrespective of circumstances. Our conclusions are based on a specific 15-year period in the development of Russia, and pertain to the economic situation that exists in the country. The thoughts expressed above with regard to the impact of the ongoing expenditure expansion depend on the assumption that budgetary policy will, in general, be countercyclical as it was during the period under review, that is, the balance of public finances will improve as the economy recovers its former growth rate. The countercyclical nature of budgetary policy is confirmed by the results of our econometric analysis: Figure 3 shows that the state balance responds, in a statistically significant manner, to exogenous shocks from economic growth, improving in response to its acceleration (see “Response of GBAL to GR”). If the current loosening of budgetary policy is really permanent, these conclusions need to be adjusted.

References:


«Курс рубля завышен минимум на 10%, считает замглавы Минэкономразвития» (Ruble’s value is at least 15 % overrated, says deputy minister of economic development), RIA Novosti, September 15, 2011, see: http://ria.ru/economy/20110915/437737020.html

response of government and private expenditure in CIS countries to fluctuations in oil prices

by elvira kurmanalieva

in the 1980s, the average oil price was $36 per barrel, approximately the same as in 2004. by 2008, the price jumped to $97. after the mortgage lending crisis in the united states, accompanied by the bankruptcy of major financial companies, caused a dramatic fall in economic activity and collapses in stock and commodity markets. in 2008, oil prices decreased to $70 in 2008 and 2009. as a result, the world economy shrank by 0.6% in 2009. this affected international trade, which decreased by 11% following 8% growth between 2004 and 2008. however, the world economy and markets recovered to a considerable extent in 2010 and 2011 under the influence of vigorous stimulating fiscal and monetary measures taken by governments throughout the world. due to this, the oil price resumed its rise: according to the world bank, the average oil price reached a record high level in march 2012, when buyers started to pay $118 per barrel on average.

oil prices influence economic and political processes in the world, which determine: the value of companies’ stock; the pace of economic growth and the inflation rate; as well as the intensity of the centralization and concentration of production. oil prices serve as a reference point in the formation of prices of other raw materials. the macroeconomic situation in oil-exporting countries is especially sensitive to fluctuation in oil prices: economic activity declines and external and fiscal balances deteriorate, when oil decreases in price; and, on the contrary, there is an economic boom when oil prices set new record highs. on the other hand, for all other countries in the world, a rise in oil prices increases production costs and reduces companies’ revenues, thereby affecting economic activity. figure 1 shows that from the 1960s through the 1980s, there was negative interaction between oil prices and the world GDP growth rate.

figure 1. the growth of the world’s GDP and the rise in oil prices

1960-1980

y = -0.0099x + 4.9186
R² = 0.1766

1980-2011

y = 0.0246x + 2.6861
R² = 0.1773

however, in the last 20 years, the energy intensity of production in developed countries has decreased noticeably. this has reduced the share of the oil sector in these countries’ GDP and, consecutively, the impact of the oil shock on the aggregate supply. that is why we can see that the correlation between the oil price and the GDP growth rate changed from negative to positive after the 1980s. in its recent (2012) report, the IMF gives a another explanation:
the rise in oil prices in the last two decades was caused by the rapid growth of developing economies, which led to high oil prices; that is, in this case, the world’s economic growth influences the formation of prices of raw materials, and not the reverse.

In general, the impact of fluctuations in oil prices on an economy depends in the first instance on its structure. Theoretically, it should be different for the countries that receive high revenues from the export of oil as a share of their GDP, than for the oil-importing countries. During periods of high prices of energy resources, revenues shift from oil consumers (importers) to producers (exporters). Globally, this movement of revenues should not lead to a global change in GDPs. However, there is a common assertion that oil consumers are more inclined to spend than producers, and oil exporters are more inclined to save. As a result, a rise in oil prices may lead to a slowdown in domestic demand and, eventually, to a slowdown in the world’s GDP growth. Another group of researchers believe that oil producers use their savings for investment in other countries, contributing to a decrease in interest rates and a rise in prices of assets, and thereby stimulating economic growth. That is why, in the opinion of this group of researchers, the effect of the GDP growth slowdown cannot be unambiguous.

In any case, high oil prices create certain difficulties for the macroeconomic policies of the governments of both oil-exporting and oil-importing countries. This is because both of them should simultaneously achieve objectives that contradict each other, such as: smoothing consumption; ensuring equal incomes for different generations; and capital expenditure for ensuring economic growth. That is why, as a rule, during periods of high energy prices when there is uncertainty regarding export revenue, the governments of oil-exporters prefer to accumulate buffer reserves in the form of government national oil funds, and the central banks’ foreign exchange reserves. Oil-importers, on the contrary, show a deterioration in their external trade balances, which puts pressure on the national currency’s exchange rate, and eventually leads to a decrease in revenue. The impact of a rise in oil prices on inflation generally depends on: the macroeconomic policy pursued in the country; the ability of employees to demand compensation for their decreased income in the form of an increase in their salaries; and corporations’ intention to retain their profit margins. All these factors may lead to the untwisting of the “wage-prices” spiral in a situation where households and corporations have to reduce their expenses following declining incomes. This will lead to deflation.

It is an unambiguous and widely accepted fact that the growth of uncertainty and volatility in the economy influence the real economy through investment decisions. If a rise in oil prices becomes a more long-lasting phenomenon, economies go to new equilibrium levels. In particular, for oil-exporting countries, long-term changes in trade conditions lead to higher investment, which contributes to GDP growth. Oil-importing countries find themselves at lower levels of economic growth, which imply lower levels of both government and private expenditure.

From this standpoint, among the CIS member countries, there are energy exporters (Russia, Kazakhstan, Azerbaijan and Turkmenistan) and all other countries, which are net importers of hydrocarbons. Like other countries in the world, exporting countries are characterized by: a high proportion of exports as a percentage of GDP; a current account surplus; and a large share of oil revenues in the state budget. The latter group of countries is less homogeneous. In particular, the economies of Armenia, Moldova, Kyrgyzstan and Tajikistan have significant trade deficits, which depend on world energy prices. They are financed to a considerable extent by cash remittances from abroad. Despite the fact that most countries of this group possess certain resources for export, those resources are not large enough for the export sector to determine economic dynamics. The other countries of the group (Belarus, Uzbekistan and Ukraine) are distinguished by a significant share of products with a relatively high degree of processing; although all of them also export or re-export considerable amounts of raw materials. The state of their external balances is historically better than in the other countries of this group. The budgetary policies in these countries are also historically stronger than in most of the other countries of the group, but the stability of their public finances is still fragile. However, the CIS countries, apparently without exception, are exporters of primary
commodities (see Table 1). Since the price of other natural resources, and processed products, correlate to a considerable extent with oil prices, a rise in the price of energy resources is usually accompanied by an increase in the price of CIS countries’ non-energy export goods. That is why these countries were among the nations that benefited from a boom in the international energy market, and suffered losses from a fall in energy prices in late 2008 and in 2009.

Table 1. The CIS member countries’ indicators used to determine their grouping (data of 2010)

<table>
<thead>
<tr>
<th>Exporters of oil and natural gas</th>
<th>Share of mineral products in exports (in %)</th>
<th>Commodity groups accounting for more than 10 % of all exports</th>
<th>Current transfers (in % of GDP)</th>
<th>Cash remittances from Russia (in % of GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Azerbaijan</td>
<td>95</td>
<td>mineral products (95%)</td>
<td>1</td>
<td>1.5</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>76</td>
<td>mineral products (76%), metals (13%)</td>
<td>-0.3</td>
<td>0.3</td>
</tr>
<tr>
<td>Russia</td>
<td>66</td>
<td>mineral products (66%), metals (10%)</td>
<td>-0.2</td>
<td>-0.5</td>
</tr>
<tr>
<td>Turkmenistan</td>
<td>71</td>
<td>mineral products (71%), textiles (20%)</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Exporters of labor</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Armenia</td>
<td>31</td>
<td>mineral products (31%), metals (28%), food (17%), stone, cement and precious metals (16%), precious metals (46%), food (13%), textiles (11%), stone, cement, others (11%)</td>
<td>6</td>
<td>10.1</td>
</tr>
<tr>
<td>Kyrgyzstan</td>
<td>8</td>
<td>food (48%), textiles (19%), machinery and equipment (11%)</td>
<td>29.1</td>
<td>21</td>
</tr>
<tr>
<td>Moldova</td>
<td>1</td>
<td>metals (57%), food (18%), textiles (16%)</td>
<td>22.8</td>
<td>13.4</td>
</tr>
<tr>
<td>Tajikistan</td>
<td>4</td>
<td></td>
<td>26.8</td>
<td>38</td>
</tr>
<tr>
<td>Exporters with a diversified export structure</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Belarus</td>
<td>29</td>
<td>mineral products (29%), chemical products (16%), food (13%)</td>
<td>0.6</td>
<td>0.3</td>
</tr>
<tr>
<td>Uzbekistan</td>
<td>24</td>
<td>mineral products (24%), textiles (23%), chemical products (14%), metals (13%), food (10%)</td>
<td></td>
<td>6.7</td>
</tr>
<tr>
<td>Ukraine</td>
<td>13</td>
<td>metals (34%), food (19%), mineral products (13%), machinery and equipment (11%)</td>
<td>-6.1</td>
<td>1.4</td>
</tr>
</tbody>
</table>

Sources: Trademap, national agencies

In the December 2011 issue of the CIS Macromonitor, we explored the impact of oil prices on the balance of payments, inflation and GDP growth in the CIS economies. In our brief analytical insert, we confirmed that a rise in oil prices produces an unambiguously positive effect on the former group of countries, favorably influencing the revenues of mining companies, and the state of the public finances. Apart from this, a widespread subsidizing of the prices of energy resources leads to the emergence of direct fiscal, or quasi-fiscal, dependence on oil prices. There is the opposite picture in the case of oil-importing countries. The still existing close economic ties between countries help reduce the impact of energy prices. The ties diminish the dependence between the degree of the impact of the dynamics of oil prices on economic growth and the availability of oil in the country. In particular, according to our estimates, a 10% rise in oil prices leads to an increase of 0.4% to 2.7% of GDP in the current account balance in the CIS countries. This increase is more significant for the countries that export oil and gas, but there is still an increase for the other countries of the region as well. As for the impact of oil prices on GDP growth, the economy of Russia proves to be the most sensitive to this impact, and the economy of Uzbekistan is the least sensitive. Apart from Russia and Turkmenistan, the countries whose economic growth depends highly on the rise in oil prices include Ukraine, Armenia and Moldova. On the whole, a 10% increase in oil prices leads to an annual GDP rise of 0.008% to
Determining how the impact of oil prices is transmitted to the CIS countries will allow us to make an analysis of the interaction between the external balance and domestic private and government expenditure in the CIS economies. Figure 2 shows this interaction in the period between 2004 and 2008, which saw the highest rise in oil prices.

The diagram suggests that the CIS member countries in fact do not constitute an exception to general rules. The oil exporters, being on the right side of the axis X, had lower expenditure, preferring to save the greater part of export revenue and accumulate buffer reserves. At the same time, during the oil boom, the oil importers had aggregate expenditures equal to 100 and more percentage of their GDPs. While government expenditure depends on the macroeconomic policy pursued in the country, this interaction can be clearly seen in the case of private expenditure.

A regression analysis is another way of determining interactions. To evaluate the structural vector auto-regression we use: annual growth rates of oil prices due to a limited amount of available time-series data; as well as indicators of external balances (foreign trade in goods and services); government consumption expenditure and investment; and household consumption and private investment. Data is analyzed from nine CIS member countries (except Turkmenistan and Uzbekistan). Equations of the model are evaluated by the method of least squares in the period between 1996 and 2011. To identify the structural form of the model, we impose short-term restrictions implying that shocks from private expenditure do not have an immediate effect on government expenditure, and shocks from government expenditure do not have an immediate effect on the external balance.

Thus, the formulated assumptions regarding the structural model imply that an economy’s response to external exogenous shocks takes some time for realization. It is also important to note that government policy in this case is a connecting link that does not directly influence external trade, but has a certain effect on the private sector’s investment decisions. Of course, real interactions in the economy are much more complicated, but this simplification allows us to distinguish and examine separately the interactions that are of interest to us.

After making these assumptions and receiving estimates for the structural vector auto-regression (SVAR), we can create functions of impulse response to structural shocks in the model. In this analytical report, we state only the results for the response of investment and consumption to positive shocks from external trade. They are given in Figure 3.
The results reflect only statistically significant values. The response of government consumption turns out to be statistically significant for the Russian economy, whereas for all other economies, statistically significant are the responses of private expenditure (private investment in the case of the Armenian economy). Thus, one can see that according to earlier assumptions, expenditure decreases by 0.2 to 1% of GDP on average in response to a 1% exogenous increase in the external balance. Accordingly, exogenous shocks from external trade cause an immediate change in expenditure in the opposite direction. Thus, the conclusions drawn on the basis of the evaluation of the model correspond to a certain degree with the explanation that is widely spread in scientific circles. However, contrary to this hypothesis, the private sectors in Azerbaijan and Kazakhstan reduce their expenditure to a lesser degree than in oil-importing countries, thereby preferring to stimulate economic growth. A significant share of raw materials in the structure of exports of oil-importing countries can be an explanation. The prices of various raw materials correlate to a certain degree with oil prices.

Apart from the above-stated results, we found that in a number of economies - Azerbaijan, Russia, Armenia, Kyrgyzstan, Tajikistan and Belarus - there exists an effect of replacement of private expenditure by government expenditure, i.e. an increase in government expenditure replaces the private sector’s expenditure to a certain degree. In the case of Belarus, the positive effect of government expenditure on the external balance also proved to be statistically significant. This means that if the situation regarding external trade improves, there will be an increase in government expenditure and a considerable decrease in private expenditure; which declines not only under the influence of the external balance, but also as a result of substitution effect of a rise in government expenditure.

Given the current uncertainty, it is difficult to say how long the current oil prices will last. The fall in oil prices that has been seen lately cannot but cause concern about the development prospects of the CIS economies whose economic well-being directly depends on oil prices.

However, the hope that additional measures of support will be taken by the central banks in developed countries, and the debt situation in the Eurozone will stabilize amid emerging markets’ high demand for energy resources, quite probably implies the return of a scenario with high prices of energy resources.

If the outcome of our analysis is true to reality, it explains the slowdown in Russia’s economic growth and the higher GDP growth rates in other CIS countries in the last two years, when oil prices stood at a high level. It is quite likely that in the near future the Russian economy will grow at a higher rate than the economies of other CIS countries.

The question as to how correct one strategy or another can be is the subject of a separate discussion. In general, as previous years show, one can say that the region has a certain safety margin regarding the impact of exogenous shocks, and possesses mechanisms to smooth differences in consumption in different periods of time.

The most convincing conclusion seems to be that there exists a negative interaction between the external balance and government and private expenditure. Taking it into consideration, while evaluating the impact of oil prices on...
Given the fact that all economies in the region are net exporters of primary commodities, whose prices move in one direction with oil prices, the region in general corresponds with the common opinion that exporters of oil (or raw materials) are inclined to accumulate reserves during periods of high export prices, and reduce their expenditure.

Despite differences in the structure of the region’s economies, the CIS countries continue to be closely connected with each other. This enables them to share risks, and withstand shocks coming from the world economy. The fact that reductions in oil importers’ expenditure are smaller than changes in their external balances may suggest that they hope that high prices for their export goods will continue, or they view their close ties - the free movement of goods and labor - as buffer reserves that will help smooth consumption.

The existence of an effect of replacement of private investment by government expenditure makes it possible to recommend reducing government expenditure, and instead using incentives for the development of the private sector of the economy.

One should probably treat with caution the results of our analysis and the above-stated conclusions. From a technical standpoint, the econometric approach and statistical data on which these results are based need further improvement.

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