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INTRODUCTION

Macroeconomic Stability Tested

In 2018, the EDB member countries faced a number of challenges to regional macroeconomic stability. The main risks resulted from the global economic slowdown, growing protectionist trends in world trade and increased volatility in developing markets. Higher geopolitical tensions also had an impact on the regional macroeconomic situation.

Despite the growing external challenges, the macroeconomic situation remained stable in the region, with most EDB countries’ fiscal policies aimed at achieving more sustainable economic growth and a balanced monetary policy. The favorable oil price during most of 2018 was another factor behind the improvement in the region’s economy.

All the EDB member countries recorded positive growth rates in 2018, which we estimate at 2.0% overall. Inflation reached a record low and will stay within the central banks’ target ranges for 2018. The EDB member countries’ mutual trade grew by 12.5% versus January to September 2017.

The 2017 and 2018 economic growth in the region was significantly assisted by eased monetary policies. Yet the recovery cycle is ending, while the inflationary risks are high. These factors combine to limit monetary policy’s ability to continue stimulating the economy. With the external risks mounting, it is increasingly important to find new sources of sustainable growth, in particular, by means of reforms intended to raise the economies’ efficiency and improve the investment climate.

In the special report attached to this macro review, the team of authors of the Eurasian Fund for Stabilization and Development gives recommendations concerning economic policy measures that might help overcome an economy’s structural and institutional limitations, taking Armenia as an example. Analysis of the structural gaps existing in Armenia allows us to identify the areas of reform that are being successful – as well as those which are lagging. The tools used in the study are versatile and can be used for developing targeted recommendations on structural economic policy measures.

In 2018, some member-states’ authorities initiated structural reforms. The Government of the Russian Federation announced a package of structural changes intended to stimulate sustainable growth of investment activity and pursue long-term social objectives. In Kazakhstan, presidential initiatives announced in the spring and fall of 2018 are largely intended to enhance the population’s welfare by improving the business environment and developing human capital. Such reforms may help improve the quality of Kazakhstan’s economic growth in the long run by making it more sustainable and based on an inclusive model of economic development.
Structural changes are long lasting, and their economic and social effects only become manifest in the medium term. In the short run, the regional economies will remain affected by decisions taken at the tactical level in response to increased external risks. Thus, we expect Russia’s economic growth to slow to 1.6% in 2019. This will partly result from the monetary policy tightening by the Bank of Russia amid growing inflationary risks. The growth in the tax burden from January 2019 will probably have a short-term negative impact on business activity as the national projects enter their active implementation stage towards the middle of 2019. In Kazakhstan, slower growth in 2019 (3.3%) will result from the monetary policy measures taken and from the completion of large-scale investment projects while new ones have not yet entered the active phase. The projected 2019 slowdown of economic growth in Armenia (to 5.0%) and Belarus (to 1.6%) will be caused in particular by the completion of their economic recovery periods. Accelerated growth in the Kyrgyz Republic (to 3.9% in 2019) is expected to result from new production facilities to be commissioned. Tajik economic growth, projected at 7.0%, will largely hinge on the implementation of infrastructural projects.

The risks of accelerated inflation have increased with exchange rate volatility, and the favorable base effects in the food segment have run their course. In a number of regional countries, inflation may temporarily overshoot the established targets. In Russia, the VAT increase from 18% to 20% from 1 January 2019 poses additional risks of growing inflationary expectations. However, we estimate that the balanced monetary policy of the Central Bank of Russia will hold back further acceleration of inflation and keep it from settling above the target.

We see the growth of the integration processes in the medium term, with the expansion of both mutual trade as well as mutual cooperation with third countries, as an additional growth factor in the Eurasian region. In particular, a free trade agreement between the EAEU and Singapore is to come into force in 2019, which may become the first step towards a free trade area with the Association of Southeast Asian Nations (ASEAN).

EDB Team of Analysts
INFORMATION DISCLOSURE

This publication is a comprehensive macroeconomic review of the member states of the Eurasian development bank. The review provides a detailed description of the current internal and external macroeconomic conditions and a forecast that takes into account interlinks between the economies of the region and the external sector.

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

More detailed information about the structure of the integrated model system, its main components and its use within the framework of the analyzing and forecasting of the macroeconomic situation can be obtained from a joint report by the EDB Center for Integration Studies and the Eurasian Economic Commission, which is titled “The System of Analysis and Macroeconomic Forecasting” (the full text of the report is available at EDB’s website: http://eabr.org/r/research/centre/projectsCII/projects_cii/index.php?id_4=49198&linked_block_id=0).

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

World economy slowdown
The world economic activity indicators showed a decline in 3Q2018, which may indicate a slowdown in global demand. The IMF lowered its estimate of global GDP growth in 2018 and 2019 by 0.2 pp, to 3.7%. Protectionist measures and high geopolitical tension have a persistent negative impact on the global economy. Risks for the world economy are mainly a downward shifted and result from uncertain effects of trade restrictions, aggravation of geopolitical tensions and a possible outflow of capital from developing markets if financial conditions in developed countries are tightened more than expected.

U.S. economic activity remains high
A stimulative fiscal policy continues to support the U.S. economy. GDP growth in 3Q2018 was 3% YoY after 2.9% in the preceding quarter. Output growth was driven by trends in final household consumption expenditure and the State budget.

U.S. inflation slowdown
U.S. inflation slowed somewhat in 3Q2018. The consumer price index grew by 2.3% YoY in September 2018 (down from 2.9% YoY in June 2018). The slowdown in inflation is largely attributable to a gradual decrease in energy commodities’ contribution as the annual oil price growth decreased.

FRS continues its rate rise cycle
The inflation trends and a vigorous economic growth accompanied by a decrease in unemployment led the Fed to increase its target fund rate range by 25 bp, to 2–2.25%, in September 2018. We believe a further rate increase to be highly probable in December 2018.

Eurozone slowdown continues
The Eurozone economy grew by 1.6% YoY in 3Q2018 after 2.2% in the preceding quarter. The decline of GDP growth is partially attributable to temporary factors, such as a decrease in car sales in Germany due to the enactment of new environmental standards, and the oil prices remaining high. Economic activity is also being affected by growing uncertainty in the region’s trade relations with the USA and mounting risks within the Eurozone.

Core inflation stays low in Eurozone
Eurozone inflation was 2.1% YoY in 3Q2018, a little above June 2018 (2% YoY). The increase in inflation was due to a higher contribution of energy prices, that increased from 0.76 pp in June to 0.9 pp in September 2018. Excluding energy commodities, inflation remains low, at 1.3% YoY in September 2018.
With economic growth slowing and core inflation still low, the ECB left its interest rates for the main refinancing operations unchanged at its September meeting and confirmed its intention to keep them at the current level at least till the end of summer 2019. Therefore, the Eurozone’s monetary policy remains a stimulative one.

Brent oil continued to rise in July to September 2018, to reach USD 75.5 per barrel, 1.3% above the preceding quarter and 46% higher than in the same period of the 2017. The prices rose against the backdrop of the expansion of U.S. sanctions against Iran, a production decline in Venezuela, and the market’s doubts about the OPEC countries’ ability to promptly boost production. However, as early as the end of October 2018, oil prices began decreasing, due to the expected global economic slowdown as well as the fact that the anticipated risks did not materialize in full: sanctions against the Iranian oil industry were milder than expected, while Russia and Saudi Arabia increased production. In this situation, OPEC+ decided to cut production again in 2019.

The strengthening of the U.S. dollar in the world foreign exchange market in 3Q2018 was reflected in a gold price decrease, by 7.2% from the preceding quarter’s level and by 5.1% YoY.

Industrial metal prices were also affected by trends in the U.S. dollar exchange rate. This was compounded by increased tensions in world trade. The WB metal price index in July to September 2018 decreased by 9.6% from the preceding quarter’s level, and by 1.9% vs. the same period in 2017.

### Forecast for key external economic indicators

<table>
<thead>
<tr>
<th>Year</th>
<th>Average annual price of URALS oil, in U.S. dollars per barrel</th>
<th>Average annual price of gold, in U.S. dollars per ounce</th>
<th>Food price index, 2010=100</th>
<th>Average annual exchange rate of the euro to the U.S. dollar</th>
<th>Average annual Fed Funds rate, in percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>2018</td>
<td>71.0</td>
<td>1270</td>
<td>91.0</td>
<td>1.18</td>
<td>2.0</td>
</tr>
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<td>97.5</td>
<td>1.25</td>
<td>2.9</td>
</tr>
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<td>1306</td>
<td>99.3</td>
<td>1.26</td>
<td>3.0</td>
</tr>
</tbody>
</table>

**Source:** International Financial Institutions, calculations by the authors, EEC
EDB MACROREVIEW: REPUBLIC OF ARMENIA

TRENDS

GDP

Slowdown in economic growth

According to the Statistical Committee, in 3Q2018 GDP growth was 2.7% YoY, down from 7.5% YoY in the 2Q2018 and from 9.7% YoY in 1Q2018. In January to September 2018, economic growth was 6.0% compared to the same period of the previous year.

Decline in agriculture, construction and ore mining slows economic growth

The slowdown in GDP growth from its level of the first half of 2018 is mainly attributable to a fall in agricultural output by 10.8% YoY in the 3Q2018, caused by adverse weather conditions which affected the 2018 harvest. Other significant factors behind the economic growth deceleration included a decrease in the mining of ores due to tighter environmental standards’ enforcement and a halt in growth in the construction industry, that recorded a 0.4% YoY activity decline in 3Q2018 after 6.9% YoY growth a quarter before.

Positive contribution of trade to GDP growth in 3Q2018

Economic growth was still being supported by trade (wholesale and retail), that recorded a growth of volumes by 9.0% YoY in 3Q2018 (vs. 8.3% YoY a quarter before).

Among the main manufacturing industries, fast growth continued in the food industry (14% YoY in September 2018) and in the production of other non-metal mineral products (39% YoY in September).

Inflation

Food price growth speeds up inflation in 3Q2018

Inflation increased from 0.9% YoY in June 2018 to 3.5% YoY in September 2018. The main factor behind its acceleration was food price growth resulting from a smaller harvest than the previous year’s. Non-food product price growth slowed from 5.3% in June to 3.9% in September 2018, while service price growth decelerated from 1.4% YoY in June to 0.7% YoY in September.

Inflation decreases again in October and November 2018

In November 2018, inflation slowed again to 1.8% YoY as food inflation decreased and the prices of other components of the consumer basket showed a stable growth rate. The factors behind inflation’s decrease in October and November 2018 included the comparative base effect created by relatively fast food price growth in October and November 2017.
External Sector

Trade deficit widens In the first half of 2018, the balance of payments posted a current account deficit of USD 449 million, or 8.9% of GDP. In 3Q2018 the current account remained in deficit, as is indicated by the widening of the trade deficit in the 3Q2018 compared to the first half of 2018. One of the causes of the trade deficit growth was higher spending on energy imports as oil and gas prices increased.

Remittances decrease in dollar terms In 3Q2018 remittances sent by Armenians working abroad, a major source of external funding for the economy, decreased by 3.6% YoY in dollar terms. The decrease in remittances from Russia as the ruble to dollar exchange rate weakened was partly offset by the growth of remittances from other countries.

Gross external debt growth slows Despite the persistence of a considerable current account deficit, gross external debt stabilized as a share of GDP in the first half of 2018. Rapid economic growth reduced it from 91.2% of GDP in December 2017 to 86.9% in June 2018 (USD 10.6 billion).

Fiscal Policy

State budget deficit decrease In January to September 2018, the State budget posted a deficit of 15.0 billion drams, or 0.4% of GDP (vs. a deficit of 92.8 billion drams, or 2.5% of GDP, the year before). Public finance improved in particular due to the decrease in budget expenditure from 26% of GDP to 23.1%.
The 2019 budget aims to reduce the deficit to 152 billion drams, down from 161 billion in 2018. The Budget Law envisages 14% income growth and 12% expenditure growth over the 2018 levels.

Public debt stabilized as the State budget was better balanced. In 3Q2018, public debt was 3.2 trillion drams, or 55.1% of GDP, down from 3.3 trillion drams, or 58.7% of GDP, at the end of 2017.

The Central Bank of Armenia did not change its refinancing rate between July and November 2018. The monetary authority expects inflation to keep below its 4% target level for most of 2019–2021 and to reach the target level at the end of the projection period only.

In September 2018, the cumulative volume of commercial banks’ loans to residents exceeded the level of the same period in the previous year by 19.6% YoY. The portfolio of loans to corporate sector slowed its growth to 15.6% YoY in September, after 22.3% YoY in June. This slowdown was offset by accelerated growth in lending to individuals, to 25.6% YoY in September 2018, up from 19.7% YoY in June 2018.

The deposit base growth in 3Q2018 fell behind the growth in lending and continued to decelerate: the volume of residents’ deposits with commercial banks grew by 10.3% YoY in September 2018 after 14.2% YoY growth in June 2018.

Source: National statistical office, calculations by the authors, EEC
The dollarization level continued to decrease gradually: the share of deposits in foreign currency was down to 53.3% in September 2018 (from 57.2% the year before), while the share of foreign currency loans fell to 56.6% (62.3% the year before).

**FORECASTS**

**GDP growth projected at 5.6% in 2018 and 5% in medium term**

In 2018, GDP is forecast to have grown by 5.6%, supported by a partial recovery in economic growth after a slowdown in 3Q2018. In 2019, the economy will still be held back by fiscal policy dictated by the need to contain public debt. In the medium term, 5% economic growth is projected, which is in line with the economy’s potential as investment and remittances growth stabilize and the agricultural and food processing industries resume its progressive development.

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1 Here and elsewhere fan chart ranges correspond to 10%, 50% and 75% confidence intervals.
The rapid drop of inflation in October and November 2018 confirmed that its acceleration in 3Q2018 had been caused by short-term factors. 2018 inflation is projected at 2%. In the medium term, inflation is expected to gradually rise to its target levels, driven by increasing lending, consumer activity, and imported goods appreciation amid general acceleration of inflation in the region.

Inflation to return to target value

### Real exchange rate gap, AMD per U.S. dollar, percent

### Output gap, percent

Source: calculations by the authors, EEC

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**SUMMARY**

**Macroeconomic forecasts for the Republic of Armenia**

<table>
<thead>
<tr>
<th></th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
<th>2021</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>CPI (end of period, YoY percent change)</strong></td>
<td>2.0</td>
<td>3.4</td>
<td>4.1</td>
<td>4.0</td>
</tr>
<tr>
<td><strong>GDP in constant prices (YoY percent change)</strong></td>
<td>5.6</td>
<td>5.0</td>
<td>5.2</td>
<td>5.3</td>
</tr>
<tr>
<td><strong>Interbank repo rate (in percent per annum)</strong></td>
<td>6.1</td>
<td>7.2</td>
<td>7.8</td>
<td>7.9</td>
</tr>
<tr>
<td><strong>Exchange rate, the national currency against the U.S. dollar (average for the year)</strong></td>
<td>482</td>
<td>482</td>
<td>486</td>
<td>492</td>
</tr>
</tbody>
</table>

Source: calculations by the authors, EEC
Economic growth slowed to 2.3% YoY in 3Q2018, from 3.9% YoY a quarter before. The overall GDP growth in January to September 2018 was 3.7% YoY.

The main factor behind the economic activity slowdown was a decline in agricultural produce output of 4.7% YoY in 3Q2018. The fall of the sector’s output is mainly attributable to 2018 year’s adverse weather conditions and low harvest.

The industrial output growth rate remained fairly high, at 4.8% YoY, in the reporting quarter. However, some slowdown in production activity has been observed as the recovery period comes to an end.

Consumer demand remained strong in 3Q2018 as indicated by a 7.5% YoY increase in retail turnover. Consumer demand is still being supported by increasing real wages, that grew by 11.1% YoY in the 3Q2018.

The economic recovery in 2017–2018 led the S&P rating agency to keep the credit ratings of the Republic of Belarus for liabilities in foreign and national currency at the B/B level in October, with a ‘stable’ outlook.

In the 3Q2018 inflation accelerated to 5.6% YoY in September (vs. 4.1% YoY in June). Consumer price growth was driven by some foods, mainly meat and meat products, by fuel as well as higher inflation in Russia and high consumer activity.

According to the National Bank’s surveys, inflationary expectations remain high, which poses a major risk of the inflation targets being overshot in the medium term. In November 2018, the 12-month inflation level expected by the households was 12.6%, vs. 11.7% in August.
External Sector

Foreign exchange market switches to net demand
The weakening of the Russian ruble in the world currency market in the second half of August and September 2018 had a significant impact on the Belarusian foreign exchange market. While a net supply of foreign currency continued into July and August (some USD 430 million), there was net demand in September (some USD 180 million).

Exchange rate more volatile
The change in the Belarusian foreign exchange market affected movements in the nominal Belarusian ruble exchange rate. In 3Q2018 the price of the basket of foreign currencies calculated from their weighted average exchange rates decreased, mainly on account of the Belarusian ruble’s strengthening vs. the Russian ruble. The real effective exchange rate of the Belarusian ruble strengthened by 2.7% versus the preceding quarter (4.7% vs. 3Q 2017).

Foreign trade improved by price factor and services
The surplus of foreign trade in goods and services in 3Q2018 was USD 571.5 million, almost four times as much as in the same period the previous year. The main contributing factors behind the surplus’s expansion included higher prices for export goods and continued expansion of the trade surplus in services.

Reserve assets increase
In 3Q2018, international reserve assets increased by USD 95 million to reach USD 6,926.4 million on 1 October. The growth in reserve assets was driven by foreign exchange purchases by the National Bank on the currency exchanges in July and August, as well as the receipt of export duties and revenues from foreign currency bonds placed by the National Bank and Ministry of Finance in the domestic market. The growth of reserves was hindered by the repayment of foreign currency liabilities (some USD 1 billion in 3Q2018) by the National Bank and Government of Belarus.

Source: National statistical office, calculations by the authors, EEC
Fiscal Policy

External factors support budget surplus

The Republic’s budget posted a surplus of 3.4 billion Belarusian rubles, or 3.8% of GDP, in January to September 2018 (2.5 billion rubles, or 3.3% of GDP, the year before)\(^1\).

Budget income increased by 31.6% YoY in January to September 2018. The increase in world prices of the main Belarusian export commodities led to significant growth of export duty income, while high and persistent consumer activity promoted the growth of the VAT and excise receipts.

Budget expenditure increased by 18.6% in January to September 2018 compared to the same period in 2017. Furthermore, capital expenditure grew by 46.1% YoY in that period. The increase in capital expenses, if efficient, may promote further recovery of the potential growth rates in the Belarusian economy.

Credit ratings assigned by Chinese agency

In September the CCXI rating agency of China assigned credit ratings to the Republic of Belarus: AA+ with a ‘stable’ outlook on the Chinese scale and BBg on the international scale. Obtaining a Chinese national rating is a pre-condition for the Republic of Belarus to carry out a planned placement of its bonds in the Chinese stock market.

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

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\(^2\) Since 2018, the budget financing sources have included the costs of loans and borrowings minus repayments, so the 2018 budget surplus is not fully comparable with the 2017 surplus. According to the Ministry of Finance of Belarus, these costs amounted to 0.3% of GDP in January to September 2018: http://www.minfin.gov.by/upload/bp/doklad/2018/ys2018.pdf.
Monetary Policy

**Refinancing rate still at 10% level**

In the 3Q2018, the refinancing rate was kept at the 10% level. The regulator explained that it had suspended its refinancing rate reduction cycle due to increased inflationary pressure, mainly from the external sector.

**Lending slowdown**

The credit and deposit market rates were virtually the same in July to September 2018 as in the preceding quarter. Lending activity remains high, and accelerating inflation with the nominal interest rates unchanged may have a stimulative effect on lending in the short term.

**Dollarization of bank deposits decreasing**

The dollarization of bank deposits continued its decrease in the 3Q 2018. The share of foreign currency deposits in the total volume of deposits placed by residents with banks in September 2018 was 65.7%, versus 66.1% in June.

FORECASTS

**Economic growth to slow in late 2018 and 2019**

We lowered our estimate of 2018 Belarusian economic growth, mainly due to the agricultural decline that was deeper than expected. At the end of the 2018, economic growth is expected to be contained by investment demand against the previous year’s high base. Consumer demand driven by growing wages will continue its positive contribution to GDP till the end of 2018. 2018’s resultant GDP growth is thus estimated at 3.1%.

In 2019 to 2021, we project GDP growth of 1.6–2%, which we estimate to be in line with its potential growth. The economic slowdown results from the termination of the recovery phase with its high growth rates.

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

<table>
<thead>
<tr>
<th>15Q3</th>
<th>17Q3</th>
<th>19Q3</th>
<th>21Q3</th>
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<tbody>
<tr>
<td>4</td>
<td>3</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>0</td>
<td>-1</td>
<td>-2</td>
<td>-3</td>
</tr>
<tr>
<td>-4</td>
<td>-3</td>
<td>-2</td>
<td>-1</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>15Q3</th>
<th>17Q3</th>
<th>19Q3</th>
<th>21Q3</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.2</td>
<td>3.0</td>
<td>2.8</td>
<td>2.6</td>
</tr>
<tr>
<td>2.4</td>
<td>2.2</td>
<td>2.0</td>
<td>1.8</td>
</tr>
<tr>
<td>1.6</td>
<td>1.4</td>
<td>1.2</td>
<td>1.0</td>
</tr>
</tbody>
</table>

**Source:** Calculations by the authors, EEC
Inflation risks to increase

2018’s inflation is projected to be 5.4% YoY. Higher prices of fuel and some food items will accelerate inflation somewhat later in the year. In early 2019, the acceleration of inflation in Russia due to the VAT increase may exert additional inflationary pressure. The overall consumer price increase in 2019 is projected to be generally within the target set by the National Bank of the Republic of Belarus. However, high and persistent inflationary expectations, strong growth of wages and a possible further increase in domestic fuel prices caused by the tax maneuver in Russia all shift the risks to the pro-inflation side.

Interest rates to stay at current levels

The increase of the inflation risks will keep the refinancing rate at its 10% level in 4Q2018. The interbank loans rate is expected to be in the 10–11% range at the end of the year, which we estimate to be its neutral level. In 2019, the interbank loans rate is expected to remain in its neutral range, which is needed to prevent further growth of inflationary expectations amid increased inflation risks.

Source: Calculations by the authors, EEC
## SUMMARY

Macroeconomic forecasts for the Republic of Belarus

<table>
<thead>
<tr>
<th></th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
<th>2021</th>
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<tbody>
<tr>
<td>CPI (end of period, YoY percent change)</td>
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<td>5.1</td>
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<td>1.6</td>
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<tr>
<td>Interest rate on overnight interbank loans (in percent per annum)</td>
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<td>Exchange rate, the national currency against the U.S. dollar (average for the year)</td>
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<td>2.12</td>
<td>2.20</td>
<td>2.28</td>
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</tbody>
</table>

Source: Calculations by the authors, EEC
As estimated by the national statistical authority, in January to September 2018 the real growth of the country’s GDP averaged 4.1% YoY, with an increase of 4.2% YoY in the first half followed by some slowdown in the 3Q2018.

The main contributors to the economic slowdown in the 3Q2018 were agriculture and oil production, whose output growth slowed in the 3Q2018 to 2.0% YoY and 5.3% YoY, respectively, in January to September, after 4% and 6.2% YoY growth in the first half. The production slowdown in agriculture was caused by weather conditions that postponed grain harvesting and affected the harvest volume. Oil production growth slowed as the Kashagan deposit reached its plateau stage.

Among major industries, the highest production growth, at 32% YoY in September, was recorded in oil refining, as major enterprises completed their modernization and capacity expansion plans. Metallurgy (mainly, non-ferrous and precious metals production) also made a positive contribution to overall economic growth. High growth rates were observed in the production of transportation and electric equipment. Among the extractive industries, coal mining accelerated its growth.

The volumes of retail trade were more than 10% higher in 3Q2018 than in the same period last year (real sales growth in January to September was 6.7% YoY). Investment growth remained high, above 20% YoY, in September 2018. The strong trends in both consumer and investment demand in Kazakhstan were supported by increasing export revenues, development policy by the State, and increased growth of lending to individuals due to measures taken in 2017 to rehabilitate the banking sector.

Annual inflation grew somewhat over 3Q2018 as it reached 6.1% in September after registering 5.9% in June. Its acceleration was caused by food price growth (from 4.2% YoY in June to 5.7% in September 2018). On the other hand, non-food inflation continued to decrease in the 3Q2018, while core inflation remained virtually the same.
Inflation decreases in October

In October 2018, the inflation decrease to 5.3% YoY was recorded against a high comparison base (the acceleration of the motor fuel price growth in October 2017).

External Sector

Current account deficit decreases

According to the first estimates, the balance of payments posted a USD 855.9 million current account deficit in January to September 2018 (a USD 4,636 million deficit the year before). The current account deficit decreased on account of the trade balance surplus growth, that reached USD 7,027 million in the 3Q2018, driven by faster growth in exports.

Financial account balance in surplus

The financial account balance posted a surplus of USD 1,367 million in January to September 2018 (a USD 6,556 million deficit the year before). The positive trend reflects a switch from net capital inflow in 2017 to outflow in 2018. The outflow mostly represented a reduction in foreign liabilities by domestic nonfinancial corporations.

Fiscal Policy

Budget deficit down from 2017

In January to September 2018 the State budget posted a deficit of 125 billion tenge (1.1 trillion tenge the year before). The budget situation improved due to income growth as oil prices rose and the economy grew. The expenditure reduction largely resulted from the absence of need for banking sector support on the scale comparable to 2017.

Public and publicly guaranteed debt grew from 14.0 trillion tenge in late 2017 to 15.1 trillion tenge at the end of September 2018. Debt growth slowed compared to...
2017. Public debt as a share of GDP decreased from 26.3% to 26.1%. The issue of government bonds in the domestic market remained the main form of attracting domestic debt. The structure of foreign debt is dominated by Eurobonds and previous loans from international financial institutions, mainly the IBRD and ADB.

2019–2021 budget to reduce transfer from national fund

The law on the Republic’s budget for 2019–2021 provides for a phased reduction in the annual transfer from the National Fund to the State budget, from 2.6 trillion tenge (4.4% of GDP) in 2018 to 2.0 trillion tenge (2.7% of GDP) in 2021. Also, the law stipulates the reduction in budget expenditure from 16.9% of GDP in 2018 to 15.3% of GDP in 2021. The 2019–2021 budget is planned with a deficit of 1.3–1.5% of GDP.

Monetary Policy

National Bank leaves rate unchanged in 3Q and raises it in October

During the 3Q2018 the National Bank kept its base rate at 9%. The National Bank pointed to the increased inflation risks as domestic demand recovered, the tenge weakened versus developed countries’ currencies, mainly the dollar, and inflation accelerated in trade partner countries.

The rate was raised to 9.25% in mid-October 2018 amid increased foreign exchange market volatility. This move, combined with the National Bank’s interventions in support of the tenge, have helped stabilize the exchange rate and inflation since the second half of October.

Banks’ deposit base and credit portfolio stabilize

The restructuring of the banking sector is helping to stabilize Kazakh banks’ deposit base and credit portfolio. The volume of newly issued loans grew by 23% YoY in the 3Q2018, a little less than in the 2Q2018. Most new lending was in the national
Both external factors and domestic demand growth contributed to the acceleration of inflation in the second half of 2018. Barring additional external shocks, inflation pressure will weaken in 2019. Inflation will still be contained by an increased supply of oil products. Given this, we project annual inflation to stay within the 5.9–6.3% range in the first half and to decrease to 5.4% by the end of 2019. Under this scenario, inflation will stay within its 4.0–6.0% target range established by the National Bank for 2019, and conditions will be created for inflation to settle at its long-term target level of 4.0% by the end of 2020.

FORECASTS

**Inflation to slow gradually**

The relatively high GDP growth in 2018 reflects the influence of such factors as increased oil production, as the Kashagan oil field reached its full capacity in late 2017, increased lending to individuals as the banking sector had been restructured, and the continued fiscal stimulus. Our projection is that stabilization of oil production and the lending growth rate, as well as the fiscal consolidation, will reduce GDP growth to its potential rate, that we estimate at a maximum of 3.5% YoY. Growth in the projection period will be supported by the implementation of the infrastructure development plans and the Presidential social initiatives by the authorities.
SUMMARY

Macroeconomic forecasts for the Republic of Kazakhstan

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Source: Calculations by the authors, EEC
In 3Q2018, the annual rate of gold output decrease at the Kumtor mine slowed, thereby interrupting the downward trend in overall economic growth. While in 2Q2018 output decreased by 0.8% YoY, in 3Q2018 GDP grew by 2.6% YoY. In January to September 2018, GDP grew by 1.2% compared to the same period of 2017.

Turning to GDP by expenditure, consumption was a key factor behind growth in 2018. Consumer demand has been recovering as real household income grew. Investment is also supporting the economy. Net export trends limit economic activity, as real export volumes are decreasing and imports increasing.

The composite leading indicator calculated by the EEC heralds a recovery of economic activity in the short term. The upward trend in annual GDP growth is likely to continue into the 4Q2018. Against the previous year’s low base, faster growth of Kumtor mine output can be expected in 4Q2018. In other sectors of the economy, business activity will be somewhat higher compared to the situation in the first half of 2018, against the backdrop of the calendar factor and high and persistent consumer activity.

In 3Q2018 food deflation continued, which helped keep the consumer price index low. A weak price situation in the regional grain market and the world markets of sugar and vegetable oil contributed to deflation in the domestic food market. This was supported by 2018’s greater supply of fruit and vegetable produce than in the previous year. Despite accelerated growth in motor fuel prices as world oil prices increased, some strengthening of the som to U.S. dollar exchange rate during most of 2018 kept inflation low in the non-food sector. During the 3Q2018 the consumer price index was volatile, and at the end of September 2018 growth amounted to
1.2% YoY, with food prices decreasing by 2.8% YoY, 2.6% YoY growth in the non-food sector and 6.0% YoY growth in the service sector.

In first months of 4Q2018, inflation remained below its target range, kept down by still weak prices in foreign food markets.

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

### External Sector

#### Current account in deficit

The current account deficit in the first half of 2018 exceeded the previous year’s level. The wider trade balance deficit was caused by imports growing more rapidly than exports. The decrease in export results from declining gold shipments in nominal terms, despite an upward trend demonstrated by other exports. Import growth is mainly attributable to the volume of imported consumer goods, that increased as consumer demand recovered. The trends in net inflow of remittances is switching to stable growth. Capital inflow on the financial account is driven by other investments.

In 3Q2018 the appreciation of the real effective som exchange rate strengthened (+5.6% compared to 3Q2017). This is mainly due to som strengthening in real terms versus the Russian ruble (+8.7% YoY) and the Kazakh tenge (+2.4% YoY).

### Fiscal Policy

#### Fiscal position relatively balanced

In January to September 2018 the State budget posted a deficit of 0.02% of GDP. The year before, the budget deficit was 1.8% of GDP. Budget income was approximately at the level of January to September 2017. Tax income growth
(+15.4% from January to September 2017) was offset by a decrease in non-tax incomes (−20.1% YoY), while official transfers halved, and social allocations were reduced. Current expenses grew by 5.1% compared to January to September 2017, while expenses on the purchase of non-financial assets fell by 38.9% YoY. Total expenditures decreased by 5.1% compared to January to September 2017.

Public debt decreased by 4.1% compared to early 2018, to 56.2% of GDP as of end of September 2018. External public debt decreased (−7.7% compared to the beginning of the year), while domestic public debt grew by 34.4% during the same period. External public debt was reduced as the Russian Federation wrote off debt of USD 240.0 million. Domestic public debt growth was mainly due to State treasury bonds issued.

**Public debt**

*end of period, percent of GDP*

**State budget**

*percent of GDP*

**Monetary Policy**

**Policy rate left at 4.75%**

The National Bank’s policy rate was unchanged during 3Q2018, staying at 4.75%. Despite the current low inflation, mid-term risks in the external environment prompted the monetary authorities to keep the current stance of the monetary policy. The average money market rate was 1.7% in 3Q2018. The volume of credit resources issued by the National Bank was 580.2 million soms.

As the earlier observed trend of the appreciation of the som to the U.S. dollar reversed, the monetary authority intervened in the foreign exchange market selling a total of USD 38.7 million during the 3Q2018.

The average interest rate on newly accepted deposits in national currency was 2.4% in the 3Q2018 (compared to 2.7% the year before). The interest rate on bank
loans in national currency was 20.1% on average in 3Q2018 (opposed to 19.2% the year before).

The volume of newly issued loans grew by 3.2% compared to 3Q2017, mainly on account of the growth of loans issued in national currency (+4.0% YoY). Despite the lowered deposit interest rates, the volume of newly accepted deposits in national currency grew by 11.9% YoY in 3Q2018.

**FORECASTS**

**Inflation to rise to target**

Inflation will remain low till the end of 2018, as world food prices will stay low and the effect of the som’s strengthening versus the U.S. dollar in the first half of 2018 continues. In early 2019 inflation may accelerate as tobacco excises are raised, while in the medium term the expected food price recovery will compound the existing upward trend in energy prices to push inflation into its 5.0–7.0% target range.

**Economic growth to approach potential rate in medium term**

In the remainder of 2018, the economic growth rate can be expected to accelerate against the backdrop of the previous year’s low base in the production of major metals and the increase in the annual gold production target at the Kumtor mine to 490–510 thousand ounces. In the medium term economic growth will be near its potential level, as the budget deficit decreases gradually and the remittance inflow grows more moderately.
SUMMARY

Macroeconomic forecasts for the Kyrgyz Republic

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Source: Calculations by the authors, EEC
Growth slows in 3Q2018

According to Rosstat, in 3Q2018 GDP grew by 1.5% YoY, down from 1.9% a quarter before. In January to September, real GDP grew by 1.6% YoY.

The causes of the economic slowdown included an output decrease in agriculture that reached 11.7% YoY in September 2018, as the grain harvest was lower than in 2017.

Mineral resources production grows

Industrial output growth remained at a level comparable with that of 2Q2018, as growth accelerated in all the main extracting industries – oil and gas production and ore and coal mining. In contrast, output growth in the manufacturing industries slowed, and September 2018 saw output decline by 0.1% YoY. Output growth was held back by the chemical industry, transport machine building and metallurgy.

Consumer activity slowing

The trends in consumer demand also contributed to the economic growth slowdown in the 3Q2018, as is indicated by the retail sales deceleration from 3.3% YoY in June to 2.3% in September 2018 as the ruble depreciated and consumer price inflation accelerated. Against this backdrop, real household income decreased by 2.5% YoY in September 2018 (in January to September 2018 income growth was 0.9% YoY).

Investment growth accelerates

Real growth of fixed capital investments, which accelerated to 5.2% YoY from 2.8% YoY a quarter before, made a positive contribution to output trends in 3Q2018. In addition, external demand continued to support Russian exports, as indicated by the increase in the physical volume of export supplies of such goods as oil and oil products, gas, coal, iron and steel, copper and aluminum in 3Q2018.

Inflation

Inflation accelerates in 3Q2018

Annual inflation increased from 2.3% in June 2018 to 3.4% in September 2018. Both food and non-food price growth accelerated. The contributing factors included a relatively low comparison base, fuel price growth resulting from trends in world oil prices, and the weakening of the ruble versus the currencies of Russia’s main trade partner countries, that accelerated in August and September 2018.
Inflation and key interest rate

Inflation continued to increase in October and November 2018 to reach 3.8% YoY. Its acceleration was largely driven by food price growth after a harvest that was lower than in 2017.

Ruble weakening in August and September 2018 also made some contribution to the acceleration in inflation.

External trade and the real exchange rate

The balance of payments in 3Q2018 posted a current account surplus of USD 26.4 billion. Relative to GDP, at 6.4%, it was the highest in the last ten years. In January to September 2018, the surplus expanded to USD 75.8 billion, or 6.3% of GDP (USD 19.7 billion, or 1.7% of GDP, the year before).

The current account surplus expansion resulted from the increase in the foreign trade surplus against the backdrop of relatively high prices for the main Russian export goods.

In 3Q2018, net capital exports by the private sector, mainly non-financial corporations, reached USD 19.2 billion, the highest same quarter figure since 2010.

In 3Q2018 the Central Bank of Russia took a pause in foreign currency purchases, conducted on behalf of the Ministry of Finance under the budget rule. As a result, reserve assets only grew by USD 5 billion in the 3Q2018, despite the oil price growth in the period, while in 1Q2018 they had grown by as much as USD 19.3 billion (the highest increment since 2011).
Fiscal Policy

Budget moves into surplus in 2018 as oil and gas incomes grow

According to the Federal Treasury, in January to September 2018 the federal budget posted a surplus of 2.6 trillion rubles, or 3.5% of GDP (in the same period of 2017 there was a deficit of 229.8 million rubles, or 0.6% of GDP). The main factor behind the switch to surplus was the growth of the budget’s oil and gas incomes, which increased by 48.4% YoY in January to September 2018, while other budget income increased by 14.3% YoY. According to Government officials, in 2018 the surplus of the federal budget may amount to 2.5% of GDP.

2019–2021 federal budget planned in surplus

The law on the State budget for 2019 and the 2020–2021 planning period provides for a federal budget with a surplus of 0.8–1.8% of GDP during the projection period in the context of the budget rule implementation. Also, the budget law envisages federal expenditure growth within 0.5–1% of GDP compared to 2018, in particular, to fund the development and social policies specified by the Presidential ‘May Decrees’. The financing sources will include the VAT increase from 18% to 20% from January 2019 on.

Gross external debt decreases

Gross external debt decreased from USD 437 billion at the end of 2017 to USD 413 billion in September 2018. The biggest component of external debt, non-financial corporations’ debt, decreased from USD 345 billion to 317 billion.

Public external debt decreased in the same period, from USD 55.6 billion to USD 46.5 billion, or from 3.5% to 2.8% of GDP, in particular, as the need for debt financing decreased.

Source: National statistical office, calculations by the authors, EEC
Monetary Policy

On 14 September 2018, the Central Bank of the Russian Federation raised its key rate from 7.25% to 7.5% amid increasing inflation risks. In another move intended to stabilize the foreign exchange market and thus limit inflation, it discontinued foreign currency purchases in the market made in the interests of the Ministry of Finance under the budget rule. The purchases may be resumed in January 2019, according to the regulator.

Bank lending growth rate stable

In 3Q2018, the volumes of financing of the national economy by the banking sector continued to grow. The banks’ claims on other sectors of the economy (in the form of loans, bonds, etc.) amounted to 61.3 trillion rubles in September 2018, an increase of 10.5% YoY. Growth was fastest in claims on households, which accelerated to 21% YoY in September 2018. The banking sector’s deposit base grew at a similar rate: the volume of deposits included in the M2 money stock grew by 11.3% YoY in September 2018.

FORECASTS

GDP growth to slow in 1H2019

The projection of 2018 economic growth for Russia remains the same: 1.8% YoY. In 2019, growth is expected to slow to 1.6%. This will be partially due to the measures that the Central Bank took in the second half of 2018 to limit mid-term inflation risks. Growth in the tax burden from January 2019 is likely to have a short-term negative effect on economic activity, as the implementation of national projects enters the active phase towards the middle of next year.

In 2020–2021, Russia’s economic growth rate will be close to its potential level, that we estimate at about 1.8%.

As the structural changes planned by the Government are implemented, the potential growth rate may be adjusted upwards.

GDP in constant prices (YoY percent change)
We expect the Russian ruble to regain in 2019 some of the ground that it lost in 2018, assisted by lower volumes of capital outflow and the twin surpluses still in place.

We project 2018 annual inflation to be close to the Central Bank’s target (4%), and to overshoot it in 2019 as the value added tax is raised. From mid-2019, the favorable base effects and the Central Bank’s policy will reduce inflation back towards the target.
SUMMARY

Macroeconomic forecasts for the Russian Federation

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*Source: Calculations by the authors, EEC*
Annual economic growth slowed somewhat in the 3Q2018 compared to 2Q2018, which is largely due to the high base effect in construction and agriculture. Nevertheless, in 2018 the level of economic activity was higher than in 2017. In January to September 2018, GDP grew by 7.0% YoY (+6.8% in January to September 2017).

Although at the beginning of the second half of 2018 the contribution of investment to GDP growth decreased somewhat against the previous year’s high base, in January to September 2018 investment grew at a high rate, 15.8% YoY (+4.3% YoY in the same period of 2017).

The agricultural sector’s performance also limited economic growth due to this season’s cotton crop, that was lower than in January to September 2017, when output grew 1.5 fold in annual terms.

Industrial growth slowed from 16.9% in January to June 2018 to 13.5% in January to September 2018. The slowdown in annual growth in the industrial sector is partly due to a temporary output reduction in the mining industries and metallurgy.

The service sector has demonstrated overall turnover growth, spurred by an increase in hotel and restaurant services.

The State infrastructural development programs will support investment demand through the remainder of 2018. The growth of real wages and net inflow of remittances are conducive to the maintenance of the current level of consumer demand.

In 3Q2018, the inflation trend reversed: after four consecutive quarters of decrease, the consumer price growth rate began accelerating. While in July 2018 annual inflation was 2.3%, by September 2018 it had increased to 5.0%. In July and August 2018 air fares increased by 47.5% and 16.7%, respectively. The favorable base
effect of the previous year’s high supply of fruit and vegetable produce petered out in August 2018. The growth of flour, rice, and fuel and lubricant prices began to contribute positively to CPI trends. In September 2018 food prices grew by 4.8% YoY, while inflation was 5.7% in the non-food sector and 4.3% YoY in the service sector.

In 4Q2018, inflation trends will stabilize within the target range, partly assisted by the calm domestic foreign exchange market.

In 3Q2018, the real effective somoni exchange rate strengthened by 1.4% compared to 3Q2017. This was primarily due to somoni strengthening in real terms by 4.9% YoY versus the Russian ruble.
**Fiscal Policy**

**State budget in deficit**  In January to September 2018 the budget posted a deficit of 1.0% of GDP, while the year before it had a surplus of 0.6% of GDP. In the first eight months of 2018 the public finance sector had remained in surplus. In September 2018 the funding of the energy sector increased sharply. While in January to August 2018 public investment in this sector was 2.9 billion somoni, in January to September its volume rose to 4.2 billion somoni.

While the expenditure side spiked, the income trends remained stable. Budget income grew by 10.7% compared to January to September 2017, due to 12.9% YoY increase in tax revenues being along with other key drivers.

**Monetary Policy**

**Refinancing rate unchanged in 3Q2018**  In 3Q2018 the National Bank of Tajikistan kept its refinancing rate unchanged at 14.0%. The rate decisions during the quarter were based on expectations of inflation risks rising in the projection period and inflation approaching the target.

In 2018 the NBT increased the volume of notes in circulation to remove excessive liquidity from the banking system and keep the average interest rate on NBT notes at the refinancing rate level. The money market rates also reached the set interest range.

The interest rates on loans in national currency issued by commercial banks remained the same during the year, at 28.9% on average in 3Q2018. The rates on deposits in national currency were 0.6% on average in 3Q2018 (0.5% the year before).
In the financial area the key indicators still remain weak, despite the measures taken by the government and NBT to rehabilitate the banking sector. The share of nonperforming loans in the total volume of loans was 31.7% in September 2018 (41.8% the year before). The loan’s portfolio decreased by 6.0% compared to September 2017. Return on assets was 1.56% (0.19% in September 2017), and return on equity grew to 5.59% (0.71% in September 2017).

**FORECASTS**

**Economic growth to slow in medium term**

The investment momentum will support the economy in the remainder of 2018 and early 2019. The potential for further expansion of domestic consumer demand will be limited by the rebound inflation and by slower growth of remittance inflow. Additional economic growth potential may unfold as banking sector lending recovers and the level of nonperforming loans decreases. Long-term growth of the economy can be sustainable if debt sustainability balance is maintained, among other factors.

![GDP in constant prices (YoY percent change)](chart1)

![Nominal exchange rate, TJS per U.S. dollar](chart2)

**Inflation within target range of 7.0% (±2 pp)**

The monetary policy being pursued is conducive to the limitation of midterm inflation risks and to keeping inflation in the target range of 7.0% (±2 pp), established till the end of 2019. Higher energy prices and the planned increase in tariffs may generate inflation in the medium term. As the target range will be reduced to 6.0% (±2 pp) from 2020, the transition to a neutral monetary policy may take longer.

**Source:** Calculations by the authors
SUMMARY

Macroeconomic forecasts for the Republic of Tajikistan

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Source: Estimates by the authors
SPECIAL REPORT.

ASSESSMENT OF STRUCTURAL GAPS IN ARMENIA BASED ON THE GLOBAL COMPETITIVENESS INDEX (WITH A FOCUS ON STRUCTURAL LIMITATIONS AND POSSIBLE LABOR MARKET POLICY MEASURES)\(^1\)

P. A. Biryukov\(^2\)

Financial loans from the Eurasian Fund for Stabilization and Development (EFSD) are the key instruments for maintaining an efficient dialogue with borrowing countries on key economic policy measures. A prudent well-targeted matrix of policy measures coordinated with the authorities is essential to the success of budget support programs, and it requires a deep understanding of the macroeconomic, structural, and institutional limitations existing in the economy.

EFSD’s experience in implementing a budget support program for Armenia in 2015–2017 showed that, although the program attained its main objectives, some structural problems remained and represent a considerable hindrance to the economic growth potential, particularly as regards the labor market. Overcoming these problems requires a set of measures based upon a deeper understanding of both their nature and government’s capacity to implement them.

To better adapt recommendations on structural policy measures to the Armenian context, the EFSD experts used the methodology of the International Monetary Fund\(^3\), that helps assess the economy’s structural gaps by comparing the World Bank’s structural and institutional reform rating for Armenia with those of countries with comparable levels of income as well as with countries that have implemented reforms successfully.

The analysis of structural gaps in Armenia helped identify areas of reform that are successful and those that are lagging. Specifically, the comparison with Georgia, reveals underperformance in the fields of institutional development, infrastructure, and financial markets.

\(^1\) Disclaimer – the article reflects the authors’ personal opinion, which may not coincide with the official position of the Eurasian Development Bank, the manager of the Eurasian Fund for Stabilization and Development.

\(^2\) The author is especially grateful to Sergei Ulatov (Economic Advisor, EFSD) and Tigran Kostanyan (Acting Director for Financial Credit Department, EFSD) for their useful comments, recommendations and edits.

\(^3\) For details see (Funke et al, 2017).
Also, this analysis has helped to identify more targeted recommendations on policy measures to overcome the structural limitations in the labor market and reduce the lag with countries that advanced in reform implementation. Among these, the key measures might include:

- strengthening anti-monopoly legislation by broadening opportunities for the investigation of offences against economic competition; introducing an ‘affiliate’ detection methodology; implementing the assessment of draft laws’ regulatory impact, etc.; and
- broadening women’s economic involvement by amending the Government’s motherhood protection policy.

The analysis also helped detect bottlenecks in other areas of reform that are lagging in Armenia but which may have a considerable positive impact on the potential growth rate and the economy’s competitiveness, e.g.

- increasing labor productivity growth through the implementation of new approaches to vocational training; and
- improving corporate governance.

Although this analysis requires some fine-tuning (given the novel methodology used), it may be useful for improving the quality of dialogue and consultations with the Government of Armenia on future areas of reform and, consequently, for ensuring more efficient provision of financial loans for budget and balance of payments support, if needed.

**MOTIVATION AND METHODOLOGY**

It is increasingly understood that the implementation of structural reforms is a key factor of sustainable economic growth. Developing countries are obviously in need of structural reforms, for the process of transition to a market economy is not yet finished in many countries. On the other hand, after the 2009 crisis even developed economies faced the limited reach of the existing fiscal and monetary growth stimuli. In this situation, according to leading international financial organizations4, it is structural reform that becomes the key element of a successful economic policy. Its implementation helps accelerate economic growth, generate more income for the State budget and, consequently, reduce the debt burden.

Despite the successful completion of the EFSD budget support program in Armenia, significant structural imbalances remain in the country, mainly in the labor market, with low economic involvement of women and productivity growth problems. The persistence of the above imbalances after the successful implementation of an extensive matrix of structural policy measures points to the need to specify more accurately the main thrust of

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4 See
- (G20 Communiqué, 2015)
- (IMF, 2015)
the policy measures being developed. Hence, the main purpose of this research note was to address the following key questions:

1) What is the current status of the structural imbalances in the national economy?

2) What areas of reform will help achieve the most efficient convergence with countries that are successful in the structural reform area, including the labor market?

3) What policy measures by the authorities have had an effect on the change of structural imbalances?

4) Is it possible to complement the structural policy measures planned by the authorities in key areas of reform with those suggested by IFOs?

To answer the first two questions, we used an IMF pilot methodology (Funke et al., 2017)\(^5\). This innovative method uses panel regression on data of the WB Global Competitiveness Index (GCI) – a vast set of assessments of structural imbalances in economies participating in the WB World Economic Forum (WEF) (see Box 1). Panel regression assesses the dependence of the values of the WB Global Competitiveness Index and its subindexes on per capita income and a number of fixed effects (being a commodity exporter, geographical location, membership in economic and political blocs, etc.). The results obtained are used to calculate the deviations of the actual values of the global competitiveness subindexes for the countries under scrutiny from their panel assessments. Assessments exceeding actual CGI data indicate that the country lags behind others with a comparable level of incomes in structural reform implementation (see Box 2).

The answers to the third and fourth questions permit more thorough elaboration of potential structural policy measures. Hence, in addition to econometric evaluation of structural reform success indicators, this note examines the structural policy measures implemented by the authorities to explain the trends in the WB GCI subindexes observed. This made it possible to detect a number of changes in structural imbalance data that are unrelated to the authorities’ actions. Also, a detailed study of the measures and policies used helped prepare a more focused set of recommendations for discussion with the authorities.

### Box 1. Global Competitiveness Index of the World Bank

The WB concept of the assessment of an economy’s competitiveness builds on methods suggested by Professor K. Schwab in 1979\(^6\), that have laid a methodological basis for annual studies in the last 40 years. This approach hinges on the message that a certain set of institutions, authorities’ policies and economic productivity factors determines the potential level of the national economy’s well-being.

Since 2005, annual CGI studies have used quantifications whose methodology was proposed in (Sala-i-Martin, 2006). This approach was used to assess the aggregate GCI for 12 areas (pillars) of structural reform and macro stability. In turn, those assessments were similarly obtained as aggregates of 114 more detailed subindexes composed of the results of business community surveys and national economies’ statistics. The polls of businessmen are held under WB WEF auspices and cover 137 countries, or 98% of world GDP.

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\(^{5}\) (Funke et al., 2017).

\(^{6}\) (Schwab et al., 2017).
The structure of the aggregate GCI is directly dependent on the country’s economic development stage: with the growth of per capita GDP the weights of the innovation and sophistication related pillars increase while basic ones’ weights decrease.

**Table 1. Economy Development Stages and Parameter Weights**

<table>
<thead>
<tr>
<th>Stages of Development</th>
<th>GDP per capita (USD)</th>
<th>Stage 1: Factor-driven</th>
<th>Transition from Stage 1 to Stage 2</th>
<th>Stage 2: Efficiency-driven</th>
<th>Transition from Stage 2 to Stage 3</th>
<th>Stage 2: Innovation-driven</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Less than 2,000</td>
<td>2,000–2,999</td>
<td>3,000–8,999</td>
<td>9,000–17,000</td>
<td>More than 17,000</td>
<td></td>
</tr>
<tr>
<td>Weight for basic requirements</td>
<td>60%</td>
<td>40–60%</td>
<td>40%</td>
<td>20–40%</td>
<td>20%</td>
<td></td>
</tr>
<tr>
<td>Weight for efficiency enhancers</td>
<td>35%</td>
<td>35–50%</td>
<td>50%</td>
<td>50%</td>
<td>50%</td>
<td></td>
</tr>
<tr>
<td>Weight for innovation and sophistication factors</td>
<td>5%</td>
<td>5–10%</td>
<td>10%</td>
<td>10–30%</td>
<td>30%</td>
<td></td>
</tr>
</tbody>
</table>

**Source:** (Schwab et al., 2017)
1. CURRENT STATUS OF STRUCTURAL REFORM IN ARMENIA

The analysis of the current status of structural reform is based on identifying the difference between the WB GCI aggregate indicators (pillars) for Armenia and other countries with comparable levels of income (see Box 2 for details of the assessment methodology). Georgia was chosen as the latter as one of the most advanced post-Soviet countries in terms of structural reform.

Box 2. Econometric Assessment of Structural Reform Gap

The structural reform gap is assessed as the normalized difference between the actually observed values of indicators (indexes, subindexes, pillars, etc.) and estimates thereof. The latter were calculated from the results of panel regressions using the methodology suggested in (Funke et al., 2017). The difference was normalized for the value of the standard deviation of the respective regression’s residuals.

The variables being explained are indicator parameters that explain: per capita level of GDP in U.S. dollars at purchasing power parity based on 2010 prices, and a number of dummies. The latter include: location in the ECA region, OECD membership, the country’s location in Africa, the economy’s dependence on exports of natural resources, etc.

The above parameters are significant at a 10% significance level for all the aggregated pillars. The assessment of gaps in the disaggregated labor market indicators led to the exclusion of some dummies (most often, dependence on natural resources and OECD membership) as their statistical significance decreased.

The observation sample includes 2007–2017 data on 137 countries – 1,395 observations. The data were taken in natural logarithms.

In the case of comparison with an individual country’s indicators, the differences between the logarithms of those countries’ indicators were used, normalized for the standard deviation of those indicators from the respective panel regression.

The analysis focused on the Basic Requirements and Efficiency Enhancers category subindexes, for WB experts consider progress in these very areas to be the most important for developing countries7. Also, the macro stabilization, health, education and political science pillars were excluded from the remaining set of subindexes (for this study has a different mandate).

Diagram 1. Structural Reform Gaps in Armenia
(Compared to Countries with Comparable Incomes)

Source: authors’ calculations.

7 See (Sala-i-Martin, 2006).
The assessments obtained indicate that the structural reforms in the Republic of Armenia are ahead of similar reforms in the countries selected for comparison\(^8\), whose goods markets, institutions, infrastructure, and labor markets are often less developed. The development of its financial markets is generally in line with global trends or ahead. The implementation of some Institutions pillar reforms was supported by the EFSD program in the RA. In particular, EFSD funds were used to support the Government’s measures taken to develop and enact the RA’s first Tax Code; reduce financial risks in the energy sector by adapting the tariff methodology to potential energy generation and distribution shocks; reform the State finance system by increasing the share of electronic tenders in competitive State procurement; and raise the efficiency of social expenditures by creating territorial integrated social service centers.

\[
\text{Diagram 2. Structural Reform Gaps in Armenia (Compared to Georgia)}
\]

Source: authors’ calculations.

In comparison with the level of the structural reform implemented in Georgia (as the most advanced reformist country in the region), Armenian businessmen’s assessments point to the reforms being slow in three of the five areas (the Institutions, Infrastructure, and Financial Market pillars). Business considers the labor market reform to be equivalent to Georgia’s level, and the goods market reform to be above it\(^9\).

The analysis of the current structural reform situation in the country will be further supplemented with a review of the authorities’ policy and an assessment of its impact on the structural gap figures obtained.

Pillar 1. Institutions

A country’s institutional development includes a whole set of parameters, of which legislation quality and legal practices by both public and private agents are the most important. The State’s legislative and administrative system affects investment decisions and competitiveness. Besides, private institutions’ efficiency is important for sustainable development: both investors’ and consumers’ confidence is based on enterprises’ good and truthful reporting.

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\(^8\) The countries with comparable per capita income include some ten countries, of which Georgia, Indonesia and Mongolia are the most significant.

\(^9\) Mainly due to RA’s accession to the EAEU in 2015.
In comparison with comparable income countries (see Diagram 1) the Pillar 1 indicator is in positive territory – that means, above the level of institutional development in countries with comparable incomes. The 2013–2017 data showed a minor improvement on average. In 2016–2017, the indicator improves considerably after a marked setback.

In comparison with Georgia (see Diagram 2) the indicator is in negative territory, meaning that Armenia lags behind the Georgian level of institutional development. The 2013–2017 data showed an insignificant deterioration on average: in 2016–2017 the indicator improves after a deep setback.

The indicator’s movements were driven by a number of competing factors:

- ↓ The decrease in 2014–2015 was mainly on account of worsened assessments by business of public finance performance. This might presumably reflect the aggravation of corruption and favoritism as perceived by most businessmen. Those assessments are confirmed by an analysis using WB WGQI methodology: the aggregate government efficiency, corruption and rule of law indicators showed a decrease at the same time.

- ↑ The increase in 2016–2017 was largely on account of a better perception of the corruption situation by business, and improving protection of property rights and equality of rights. The better perception of the situation by business was due to accession to the EAEU in 2015, changes in electricity pricing in 2015–2016, reform of the public finance system in 2015–2017, enactment of the first Tax Code in 2018 and the effectiveness of social expenditures raised by creating integrated territorial social service centers.

**Pillar 2. Infrastructure**

Well-developed and efficient infrastructure is necessary for a sound economy. Efficient transportation facilitates both production processes and labor mobility; a modern economy cannot work without trouble-free power supply, and reliable communication systems are needed for prompt exchange of information, which is a basis for the growth of economic efficiency.

In comparison with comparable income countries (see Diagram 1) the Pillar 2 indicator is in positive territory – that means, above the level of infrastructural development in countries with comparable incomes. Comparison for 2013–2017 showed an insignificant deterioration, with a sharp worsening in 2015 not fully offset by the ensuing growth of the indicators.

In comparison with Georgia (see Diagram 2) the indicator is in negative territory, meaning that Armenia lags behind the Georgian level of infrastructural development. The 2013–2017 data showed an insignificant improvement on average: in 2016–2017 there was a visible improvement after a shallow recession. The indicator’s movements were driven by the following competing factors:

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10 Including the granting of demands for an independent audit of the situation in the country’s biggest power grid company.
11 Including the new public procurement law that approved the use of electronic tenders for competitive deals.
12 This measure should considerably reduce tax administration expenses for business, make tax payment assessment more transparent, establish equal terms of competition and increase the State budget’s income by legalizing economic agents.
• ↑ The ‘open skies’ policy introduced since 2014 has increased the number of airlines allowed to fly to Yerevan, which enhanced competition and reduced air fares considerably. In addition to the obvious benefit for the local population, two-digit rates of growth of international tourist traffic to Armenia were observed in 2015–2017, which made a positive contribution to economic growth.

• ↓ The paved motorway construction rate is insufficient to meet the country’s growing needs; the share of paved roads in satisfactory condition is decreasing despite their annual increase in length. As road transport accounts for some 82% of cargo traffic, its worsening quality affects the quality of all infrastructure.

• ↓ A temporary decrease in the number of seats available on flights was one of the causes behind the decrease in the aggregate transport index, although by 2017 their level already exceeded the 2014 level. The decrease was probably due to the weakening of the Russian ruble exchange rate; the resultant decrease in Armenian labor migrants’ dollar incomes cut down on air traffic. As noted in the media13, the passenger flow drop at that time (i.e. before the ‘open skies’ policy was started) led airlines to withdraw from Armenia.

• ↓ Power supply quality decreased temporarily in 2014–201514 due to temporary factors: water shortage and planned repairs on the nuclear power plant led to a decrease of electricity generation by 5%.

Pillar 6. Goods Markets

Efficient goods markets are a prerequisite for production growth with both demand and supply limited. Sound market competition is a pre-condition for their continued efficiency, for it preserves the most efficient enterprises.

In comparison with comparable income countries (see Diagram 1) the Pillar 6 indicator is in positive territory, meaning that the goods markets in the RA are more efficient than in other countries with comparable levels of income. The 2013–2017 data showed a considerable improvement.

In comparison with Georgia (see Diagram 2) the indicator is in positive territory, meaning that it is above the Georgian level of goods market efficiency. 2013–2017 data showed a considerable improvement on average, mainly due to growth in 2016–2017.

The indicator’s movements were driven by the following competing factors:

• ↑ Considerable improvement of anti-monopoly regulation resulting from consistent legislative reforms in this area. In particular, a package of amendments adopted to harmonize legislation with the EAEU in 2016 had a positive effect.

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14 Deteriorating poll answers to the question: “In your country, how reliable is the electricity supply (lack of interruptions and lack of voltage fluctuations)? [1 = extremely unreliable; 7 = extremely reliable]”.

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46
• The trade barriers were lowered as Armenia joined the EAEU and signed the Comprehensive and Enhanced Partnership Agreement with the EU in 2017.

• The tax burden on business was lowered sharply in 2014–2016 as an eased tax administration regime for small and medium-sized businesses was introduced in place of the old programs that included VAT.

**Pillar 7. Labor Markets**

For maximum labor productivity, the labor markets should be flexible enough to support low-cost inter-industry flows of labor and to prevent wage fluctuations from having any significant social consequences. Also, an efficient labor market should lead employers to respect meritocracy and gender equality, required for both reducing outbound labor migration and for attracting workers from abroad.

In comparison with comparable income countries (see Diagram 1) the Pillar 7 indicator is in positive territory, meaning that it is above the labor market efficiency level in the countries with comparable incomes. It should be noted that the high level of migration in Armenia is compatible with this statement, for the countries being compared are in a similar migration situation. The 2013–2017 data tended to worsen slightly: a sharp deterioration on 2014 was not fully offset by ensuing growth.

In comparison with Georgia (see Diagram 2) the indicator is roughly at the Georgian level of labor market development. 2013–2017 showed an insignificant overall improvement: in 2015–2017 it improved markedly after a strong setback.

This gap’s changes over time will be examined in more detail in Sections 2 and 3.

**Pillar 8. Financial Market**

An efficient financial sector redistributes both national savings and funding attracted from abroad in favor of projects with the highest expected rates of return. This feature of financial markets explains their influence on the growth of the economy’s productivity. To be the most effective in their role, banks should be reliable and transparent, and financial mechanisms should be duly regulated so that investors’ rights can be protected and legal compliance ensured.

In comparison with comparable income countries (see Diagram 1) the Pillar 8 indicator returned to positive territory in 2017. This means it is above the financial market development level in countries with comparable incomes. The 2013–2017 data showed a minor worsening on average: a sharp deterioration in 2014–2015 was not offset by ensuing growth of the indicators.

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15 E.g. wage reduction at local backbone enterprises during a crisis may lead to a significant fall in the regional population’s incomes.
In comparison with Georgia (see Diagram 2) the indicator is in negative territory, which means lagging behind the Georgian level of financial market development. The 2013–2017 data showed a deterioration on average: in 2016–2017 the indicator improved after a deep setback.

The indicator’s movements were driven by the following competing factors:

- ↓ A transition to a conservative monetary policy in 2014–2015 made loans less accessible for Armenian business. The monetary policy has been eased since 2016.

- ↓ A growing share of bad loans (NPLs) resulting from borrowers’ problems reduced the banking system’s strength and undermined businesses’ confidence in it.

- ↑ The RA CB consolidated the banking sector in response to its serious weakening after the 2014–2015 events. To enhance the banks’ stability, the regulator had their capital increased using their shareholders’ funds and facilitated mergers and acquisitions.

- ↑ Eased lending procedures had a positive impact on businessmen’s assessments of the development of the Armenian financial market.

2. ANALYSIS OF LABOR MARKET BREAKDOWNS

To identify current problems in the field of labor market reform, the approach described in the first section was applied to disaggregated indicators of this pillar. The methodology used (Funke et al., 2017) makes it possible to apply an econometric assessment of structural gaps not only to the aggregated indexes of GCI Pillars but to their components as well. This analysis excluded duplicate indicators, and the remaining ones were assembled into two groups: ‘Perception of State Policy by Business’ and ‘Business’s Perception of its own Situation’.

<table>
<thead>
<tr>
<th>Table 2. Detailed Indicators of the Labor Market</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Perception of State Policy by Business</strong></td>
</tr>
<tr>
<td>Hiring and firing practices</td>
</tr>
</tbody>
</table>
This indicator answers the question: ‘How flexibly does regulation allow you to hire and dismiss personnel?’ | This indicator answers the question: ‘Can your country create self-realization opportunities for the most productive workers?’ |
| Effect of taxation on incentives to work | Female participation in the labor force |
This indicator answers the question: ‘How much do taxes and benefits reduce the population’s economic involvement?’ [1 = strongly, 7 = no impact]. | This indicator answers the question: ‘What is the female to male workforce ratio?’ [percentage]. |
| Flexibility of wage determination | Reliance on professional management |
This indicator answers the question: ‘How are wages set?’ [1 = centrally, 7 = individually]. | This indicator answers the question: ‘Who occupies managerial posts in companies?’ [1 = relatives or friends, regardless of their abilities; 7 = professional managers in most cases]. |
| Pay and productivity | |
This indicator answers the question: ‘To what extent do wages reflect the employees’ productivity?’ | |

**Source:** (Schwab et al., 2017).
The assessments indicate that the labor market reform is relatively ahead of other countries with similar per capita incomes in nearly all areas. The only area of reform that lags behind is wage determination flexibility.

Source: authors’ calculations.

In comparison with the level of structural reform implemented in Georgia (as the most advanced reformist country in the region), Armenian businessmen assess the reforms to be slow in two of the seven areas (‘Impact of Taxes and Benefits on the Population’s Economic Involvement’ and ‘Wage Flexibility’). Also, business assesses the levels of reform in four areas to be equivalent to Georgia’s and ahead in one area (‘Correspondence between Wages and Productivity’).

Source: authors’ calculations.
The analysis of the labor market breakdowns pointed to a number of questions that require further study:

• What factors were behind the fall of the ‘Flexibility of the Hiring and Firing Process’ indicator in 2014?16

• In the ‘Correspondence between Wages and Productivity’ area, what factors spurred the excessive growth of wages – both as understood by business (2013–2017) and according to statistical analysis (in 2016)?

• What, besides productivity growth, might have raised the businessmen’s assessments of the opportunities for reducing labor emigration? On the contrary, the laws passed in that period and known to the Manager of Fund’s resources would either permit or facilitate continued labor migration within the EAEU.

• What events caused women’s involvement to grow as noted by the WB in 2015? What statistics did the WB rely upon in formulating this statement?

Now we go on to supplement the analysis of those labor market breakdowns with a review of the authorities’ policies, to assess their effect on the values obtained for the structural gaps in the labor market.

**Hiring and firing practices**

The ease of hiring and dismissing employees directly affects the ability of business to adapt quickly to changed market conditions. The liberalization of labor relations has reduced uncertainty for entrepreneurs, which is beneficial for the investment climate and job creation.

In comparison with comparable income countries (see Diagram 3) the indicator for this aspect of the labor market is in positive territory. This means a more flexible approach to hiring and firing in Armenia than in countries with comparable incomes. The 2013–2017 data showed deterioration on average, mainly due to a drop in 2014.

In comparison with Georgia (see Diagram 4) the indicator is equivalent to the Georgian level of hiring and firing flexibility. The 2013–2017 data showed no substantial changes.

The question of what factors caused the indicator to drop in 2014 remains open. That said, according to information available to the Manager of Fund’s resources, a number of labor laws were passed in 201517 that reduced businesses’ personnel hiring costs. The reforms in the countries taken for comparison have probably been even more effective than the Armenian legislative changes. However, the issue should be studied in more detail so that accurate conclusions can be made.

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16 According to information available to the Manager of Fund’s resources, in this area of labor legislation only some laws were adopted in 2015 that reduced businesses’ personnel hiring costs: RA Law No. ZR-120 of 24 November 2015 (which changes the start-of-employment notification procedure), RA Law No. ZR-96 of 14 July 2015 (which changes the terms of the calculation of, and payment for, overtime), and RA Law No. ZR-77 of 7 July 2015 (which institutes an arbitrator for the pre-judicial resolution of employment disputes).

17 RA Law No. ZR-120 of 24 November 2015 (which changes the start-of-employment notification procedure), RA Law No. ZR-96 of 14 July 2015 (which changes the terms of the calculation of, and payment for overtime), and RA Law No. ZR-77 of 7 July 2015 (which institutes an arbitrator for the pre-judicial resolution of employment disputes)
**Effect of taxation on incentives to work**

The State’s social policy largely shapes the labor market and has an impact on the population’s economic activity. A reduced ratio of unemployment benefit to the average wage will generally reduce the number of officially registered unemployed and increase supply in the labor market. The latter consequence may result in lower remuneration costs for business.

In comparison with *comparable income countries* (see Diagram 3) the indicator for this aspect of the labor market is in positive territory. This means a greater effect on economic involvement in the RA than in countries with comparable incomes. The 2013–2017 data showed considerable improvement, mainly on account of strong growth in 2016.

In comparison with Georgia (see Diagram 4) the indicator is in negative territory, which means lagging behind the Georgian scale of the effect of taxes and benefits on economic participation. The 2013–2017 data showed no substantial changes.

The indicator’s movements were driven by the following competing factors:

- ↓ Minimum wage growth by 43% in 2014: from 35 to 50 thousand drams.
- ↑ According to experts\(^{18}\), social support made more targeted as part of the social security reform in 2016–2017 improved the situation of the needy while reducing social security costs. The reform also increased labor supply.
- ↑ Adoption of the RA Law No. ZR-36 “On an Amendment and Addition to the Law of the Republic of Armenia ‘On Income Tax’” of 27 May 2015, that established a 13% income tax rate for RA citizens registered in the RA but employed abroad. For comparison: the RA income tax rate is 24.4–31% depending on the level of income.

**Flexibility of Wage Determination**

The State’s remuneration policy is reflected both in its legislation (e.g. the minimum wage established for the whole economy) and in individual segments of the labor market, including the education and health systems, where most workers are employed by State-funded entities. Conversely, the State’s influence on the wage level may be limited where there is a sizable informal sector.

In comparison with *comparable income countries* (see Diagram 3) the indicator for this aspect of the labor market in 2013–2016 fluctuates around zero, but falls into negative territory in 2017. This means that Armenia falls behind the countries with similar incomes in terms of wage flexibility. The indicator showed decreases in 2014 and 2017, followed by recovery.

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In comparison with Georgia (see Diagram 4) the indicator is constantly in negative territory, which means lagging behind wage determination flexibility in Georgia. The 2013–2017 data showed deterioration, mainly due to the fall in 2014.

The indicator’s movements were driven by the following competing factors:

- ↓ The Law of the Republic of Armenia No. ZR-157 ‘On Labor Compensation for Persons Occupying State Positions’ adopted on 28 December 2013 was intended to raise public servants’ salaries. It resulted in 17% salary growth in the public sector during the year vs. 2% growth in the private sector.
- ↓ 43% minimum wage growth in 2014: from 35 to 50 thousand drams.
- ↑ The Law of the Republic of Armenia No. ZR-152 ‘On Employment’ adopted on 28 December 2013 replaced unemployment benefit with active labor policy mechanisms. It was later amended in 2015 to diffuse its impact.

**Pay and productivity**

The relationship between labor productivity and remuneration is a universal method for assessing an economy’s competitiveness. The State’s policy resulting in wage increases in State-funded entities, benefit changes or revision of migration arrangements may have a considerable impact on this indicator of competitiveness.

In comparison with comparable income countries (see Diagram 3) the indicator decreased in the last five years to find itself in negative territory in 2017. This means that Armenia’s competitiveness is currently a little below the level of comparable income countries.

In comparison with Georgia (see Diagram 4) the indicator is constantly in positive territory, meaning that the business community considers the Armenian economy to be more competitive than the Georgian one. The 2013–2017 data showed an improvement, mainly on account of growth in 2016–2017.

However, any analysis of this index should take into account that it is based on business community surveys and may deviate from statistics. Thus, the statistical indicator of the observed ‘pay and productivity’ gap for Armenia showed growth for the first time in six years in 2016, which cancelled out the whole growth of Armenia’s economic competitiveness since 2012. The growth was caused by a 10% increase in real wages in 2016 against 7% productivity growth.

19 Opinion of the RA Minister of Justice, according to News of Armenia, October 2016: https://news.am/rus/news/350315.html
The question of which factors were behind the excessive growth of wages, both statistically and in the businessmen’s opinion, remains open.

**Diagram 5. Armenia’s Labor Resources and Temporary Labor Migrants in the Russian Federation**

![Diagram showing labor resources and temporary labor migrants in the Russian Federation]

**Source:** Armstat, Federal Migration Service of Russia, Customs Control of the Federal Security Service of Russia.

**Country capacity to retain talent**

The national economy’s ability to provide the best-trained personnel with self-realization opportunities and thus prevent their emigration is a key pre-condition for high involvement of the population in labor processes within the country.

In comparison with comparable income countries (see Diagram 3) this aspect’s indicator demonstrated stable growth in the last three years (2015–2017), staying in positive territory all the time. This means the Armenian economy fared better than the countries with similar incomes in terms of its ability to provide its citizens with domestic self-realization opportunities. The improvement of this index since 2014 was reflected in the statistically observed stabilization of the number of labor migrants in the Russian Federation during that period (see the diagram above).

In comparison with Georgia (see Diagram 4) the indicator is consistent with the Georgian labor migration propensity level. The 2013–2017 data showed a considerable improvement of the indicator, mainly due to its growth in 2015–2017.

Yet the question of what might have led the business community to improve their assessment of the possibility of reducing labor migration, besides natural productivity growth in the Armenian economy, remains open. On the contrary, the laws passed in that period were conducive to the growth of labor migration within the EAEU:

- the EAEU Treaty was ratified\(^20\), which actually preserved the pre-existing level of integration of Armenia’s and Russia’s labor markets; and
- the above-mentioned RA Law No. ZR-36 “On an Amendment and Addition to the Law of the Republic of Armenia ‘On Income Tax’” of 27 May 2015 was passed, that nearly halved the income tax rate for labor migrants, from 24.4–31% to 13%.

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\(^20\) The Treaty entered into force on 1 January 2015.
Female participation in the labor force

The growth of women’s participation in the workforce and the attainment of gender parity are considered essential to sustainable growth and social stability21.

In comparison with comparable income countries (see Diagram 3) this aspect’s indicator was in negative territory all the time, despite its sharp growth in 2015. This means a lower proportion of women in the structure of workforce than in countries with comparable levels of income.

In comparison with Georgia (see Diagram 4) the indicator is consistent with the Georgian level of women’s participation in economic activities. The 2013–2017 data showed no considerable change in the indicator.

Armenia is notable for the low participation of women in economic activities, traditionally attributed to a protracted child rearing period that has to be extended because kindergartens and crèches are scarce or unaffordable at market prices. It should be noted that the low economic involvement of women in Armenia is highly stratified22: among people with tertiary education, the share of women in the workforce is higher than men’s. Hence, women’s economic involvement can only increase if their access to education services is improved and measures are taken to broaden their access to child care services.

As regards Government action, the only significant legislative decision taken to guarantee equal rights to work in Armenia is the law of the same title, No. 57-N, adopted on 20 May 201323. It recodified24 women’s right to work, but had no effect on the index. The laws that support motherhood probably address demographic issues and have no decisive impact on the behavior of women as economic agents. Section 3 will show that IFOs’ recommendations focus on policy measures aiming to facilitate child rearing, which is partially reflected in the authorities’ new program of action.

Still, what events caused the growth of women’s economic involvement as noted by the WB remains an outstanding question.

Reliance on professional management

The approach to the selection of managerial staff based on their abilities rather than informal ties is an important factor of productivity growth in an economy. Meritocratic selection of executives in the corporate sector is a top priority for institutional reform during catching-up development.

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21 ‘Women’s full participation in labor relations could increase the world economy’s size by as much as 20% by 2025’, assessment by McKinsey consulting agency, according to Kommersant newspaper, September 2015: https://www.kommersant.ru/doc/2819437.
In comparison with comparable income countries (see Diagram 3) this aspect’s indicator is in positive territory. That means that Armenian corporate governance is generally more meritocratic than in countries with comparable incomes. The index data showed considerable improvement in five years, mainly due to strong growth in 2016–2017.

In comparison with Georgia (see Diagram 4) the index is zero, which means a meritocratic management level close to the Georgian one. The index data showed considerable improvement in five years, mainly due to strong growth in 2017, which shows the indicators of Georgia and other countries with similar incomes to be codirectional.

In our assessment, the growing complexity of the financial products used had the greatest impact on this indicator’s trends. After foreign demand shrank in 2014–2015 and the financial situation at the real sector enterprises deteriorated, the latter needed to attract more bank funding. This resulted in more complicated financing schemes and, consequently, higher qualifications required of the managing personnel and greater meritocracy in corporate management.

3. REVIEW OF THE POTENTIAL AREAS OF STRUCTURAL REFORM IN RESPECT OF THE LABOR MARKET

To identify the potential areas of reform that will facilitate institutional development convergence with more developed countries, we should apply higher per capita income criteria. In other words, the ‘current issues’ point to the difference between the country and other economies with similar levels of income, while ‘potential areas of reform’ show how different the country is from more developed economies. To this end, we applied an approach with a higher benchmark for the observable measures of the country’s current institutional development to the preceding section’s labor market subindexes. The Czech Republic was chosen for comparison, being a developed but land-locked EU country with a Soviet-era institutional background.

Source: authors’ calculations.
As seen from Diagram 6, a review of the structural gaps in the labor market compared to Czech per capita income shows Armenia to be behind in three areas out of seven. The areas most important for study are Meritocratic Management, Correspondence between Wages and Productivity, and Women’s Economic Involvement.

**Main Conclusions and Suggested Reforms**

The use of the leading IFOs’ innovative approaches to the analysis of structural reforms does much to enhance EFSD’s ability to assess the structural challenges faced by the economies under scrutiny. Although the methodology is a general one that cannot unambiguously identify causal links at this stage, its application is the first attempt to broadly diagnose structural imbalances in EFSD member countries using quantitative criteria. Moreover, the proposed methodology, enriched with EFSD expertise, helps overcome the weaknesses identified, suggest explanations for the observed status of the structural problems and define the range of outstanding issues that require further study.

Armenia exemplifies a country that makes better progress than generally expected of countries with similar incomes but which is far behind the regional leaders in terms of reform. Thus, structural gap assessments show that the country is still behind Georgia as regards the implementation of structural reforms. More specifically, RA businessmen’s assessments point to slow progress on three out of five areas of reform (Institutions, Infrastructure, and Financial Market). The labor market reform status was found by business to be equivalent to Georgia’s level, and goods market reform to be above it. Yet in comparison with other countries that have similar incomes, some successes of Armenia in the field of reform are visible.

As regards the detailed assessment of the labor market gaps, the situation is less optimistic. In this field, Armenia is behind the countries with comparable incomes in terms of Wage Flexibility and, compared to Georgia, is also behind in terms of Impact of Taxes and Benefits on the Population’s Economic Involvement.

The review of the authorities’ actions also showed legislative efforts to improve the institutional situation in the country and implement the reforms in the period under scrutiny. Yet there were outstanding questions formulated in respect of the Flexibility of the Hiring and Firing Process, Labor Migration Propensity, Women’s Economic Involvement, and Correspondence between Wages and Productivity, whose examination is of considerable practical interest for the preparation of further recommendations to the authorities.

The structural gaps in the labor market compared to advanced countries’ level of income help identify the promising areas of reform that lead to convergence with those countries. The assessment findings point to the potential of measures in the areas of corporate governance, labor productivity and women’s economic involvement growth. As the Armenian authorities have declared those areas of reform to be relevant for their country, their implementation may rely on IFOs’ suggestions (see Table 3).
### Table 3. Potential Measures to be implemented in Armenia

<table>
<thead>
<tr>
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<tbody>
<tr>
<td><strong>Meritocratic Management</strong></td>
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<tr>
<td>Combatting monopolism in domestic markets through the enhancement of competition and equality of all before the law.</td>
<td>Improvement of corporate governance:</td>
</tr>
<tr>
<td></td>
<td>• more transparent corporate reporting (including disclosure of financial and non-financial information);</td>
</tr>
<tr>
<td></td>
<td>• empowerment of the Boards of Directors;</td>
</tr>
<tr>
<td></td>
<td>• protection of investors’ rights.</td>
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<tr>
<td></td>
<td>Working to improve anti-monopoly legislation, including managerial decision-making:</td>
</tr>
<tr>
<td></td>
<td>• introduction of competitive principles in the assessment of draft laws’ regulatory impact;</td>
</tr>
<tr>
<td></td>
<td>• expanding the toolkit of the SCPEC (State Commission for the Protection of Economic Competition)26. The regulator needs better tools to combat anti-competitive conduct, instead of price controls;</td>
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<tr>
<td></td>
<td>• adjustments of fines;</td>
</tr>
<tr>
<td></td>
<td>• introduction of ‘affiliate’ detection machinery;</td>
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<tr>
<td></td>
<td>• more transparent public procurement procedures and introduction of electronic mechanisms.</td>
</tr>
<tr>
<td></td>
<td>Working on the ‘gaps’ in legislation to improve the business climate and the institutional environment (the WB Guillotine project).</td>
</tr>
<tr>
<td><strong>Correspondence between Wages and Productivity</strong></td>
<td>Introduction of a continuous vocational education system as an instrument for increasing labor productivity and reducing social stratification27.</td>
</tr>
<tr>
<td></td>
<td>Introduction of personnel retraining programs to address the mismatch between skills and requirements in the labor market.</td>
</tr>
<tr>
<td><strong>Women’s Economic Involvement</strong></td>
<td>Facilitation of women’s access to vocational and university-level education.</td>
</tr>
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<td></td>
<td>Taking measures to ease their child care responsibilities:</td>
</tr>
<tr>
<td></td>
<td>• expansion of the system of kindergartens, particularly in rural areas,</td>
</tr>
<tr>
<td></td>
<td>• introduction of benefits for students from rural areas.</td>
</tr>
<tr>
<td>IMF, 2017. Selected issues: the creation of specialized seasonal jobs can serve as a basis for women’s involvement. This approach enables them to combine participation in the workforce with their family responsibilities, for full-time employment may currently hinder women’s economic involvement.</td>
<td></td>
</tr>
</tbody>
</table>

*Source:* materials of the RA Government, World Bank, and International Monetary Fund.

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26 According to the study (World Bank, 2013).

27 (Coady et al., 2017) show that social stratification decreases with the increase of the population’s level of education. Hence, the growth of expenses on education reduces social stratification.
LIST OF ABBREVIATIONS IN THE SPECIAL REPORT

ECA – Central and Eastern Europe, Central Asia, and the Caucasus
EFSD – Eurasian Fund for Stabilization and Development
IFOs – International financial organizations
IMF – International Monetary Fund
OECD – Organization for Economic Cooperation and Development
RA – Republic of Armenia
RA CB – Central Bank of the Republic of Armenia
WB – World Bank
WB GCI – Global Competitiveness Index of the World Bank
WB WEF – WB World Economic Forum
WB WGQI – WB World Governance Quality Index

REFERENCES


Major macroeconomic indicators of the EDB member countries

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<td>CPI (end of period, YoY percent change)</td>
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<td>Interest rate on overnight interbank loans (in percent per annum)</td>
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<td>Interbank REPO rate 7d (in percent per annum)</td>
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<td>MIACR (in percent per annum)</td>
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<tr>
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<td>6.1</td>
<td>6.7</td>
<td>5.5</td>
<td>7.0</td>
<td>5.1</td>
<td>5.3</td>
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<tr>
<td>GDP in constant prices (YoY percent change)</td>
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<td>6.9</td>
<td>7.1</td>
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<td>Refinancing rate (in percent per annum)</td>
<td>8.0</td>
<td>9.8</td>
<td>15.1</td>
<td>14.2</td>
<td>15.1</td>
<td>13.9</td>
<td>12.4</td>
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<tr>
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<td>6.2</td>
<td>7.8</td>
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<td>9.2</td>
<td>9.8</td>
<td>10.4</td>
<td>10.9</td>
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</table>

Source: National agencies, estimates by the authors, EEC
GLOSSARY

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tbody>
<tr>
<td>ADB</td>
<td>Asian Development Bank</td>
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<tr>
<td>bp</td>
<td>basis point</td>
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<tr>
<td>CPI</td>
<td>Consumer Price Index</td>
</tr>
<tr>
<td>DSGE</td>
<td>Dynamic Stochastic General Equilibrium</td>
</tr>
<tr>
<td>EAEU</td>
<td>Eurasian Economic Union</td>
</tr>
<tr>
<td>ECB</td>
<td>European Central Bank</td>
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<td>EDB</td>
<td>Eurasian Development Bank</td>
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<td>EEC</td>
<td>Eurasian Economic Commission</td>
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<tr>
<td>FRS</td>
<td>Federal Reserve System of the United States</td>
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<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>IBRD</td>
<td>International Bank for Reconstruction and Development</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<td>NBT</td>
<td>National Bank of Tajikistan</td>
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<tr>
<td>OPEC</td>
<td>Organization of the Petroleum Exporting Countries</td>
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<tr>
<td>pp</td>
<td>percentage point</td>
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<tr>
<td>U.S. or USA</td>
<td>United States of America</td>
</tr>
<tr>
<td>USD</td>
<td>United States Dollar</td>
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<tr>
<td>VAT</td>
<td>value added tax</td>
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<td>WB</td>
<td>World Bank</td>
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<tr>
<td>% YoY</td>
<td>year-over-year growth rate</td>
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