*RESEARCH &
KNOWLEDGE MANAGEMENT*

Russia and Central Asia Macroeconomic Outlook 2017

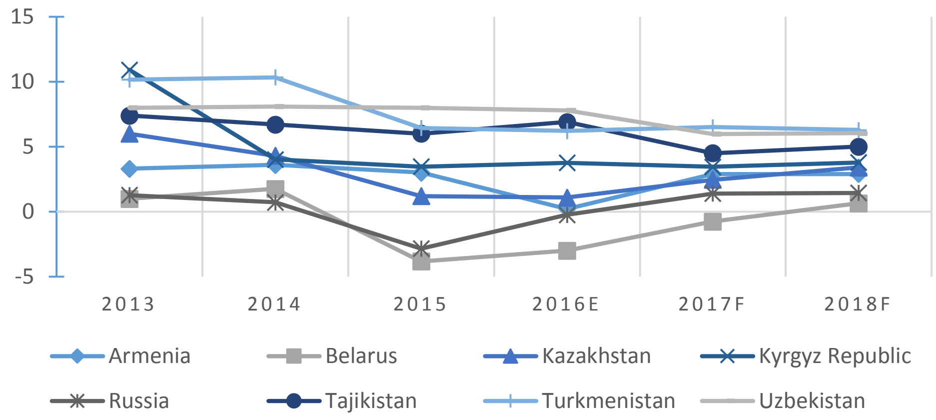
4 July 2017

Contents:

Key highlights:

- Central Asian economies have started recovering after a downturn in 2015 and 2016 due to unfavorable external conditions that have affected the countries of the region. Consequently, the majority of regional economies are expected to show stronger performance in 2017 and 2018, led by Armenia, Kazakhstan, Turkmenistan and Uzbekistan.

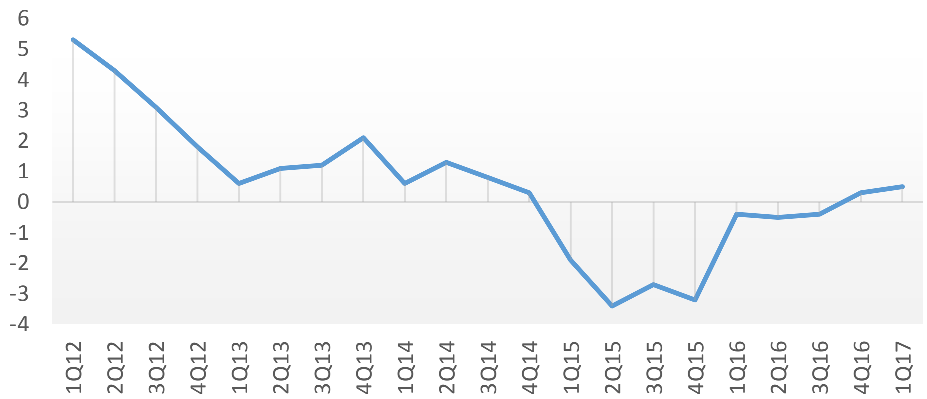
GDP growth, % (2013-2017f)



Source: IMF, Samruk Kazyna

- Growth in the region is supported by a rebound in commodity prices, as well as improved performance of the Russian economy and strong growth in China. Perspectives of the Russian economy have improved, the economy is expected to show growth of 1.4% in 2017 vs. -0.2% in 2016 and -2.8% in 2015. Russia is the key source of remittance flows and the largest trade partner for most of the economies of the Central Asian region.

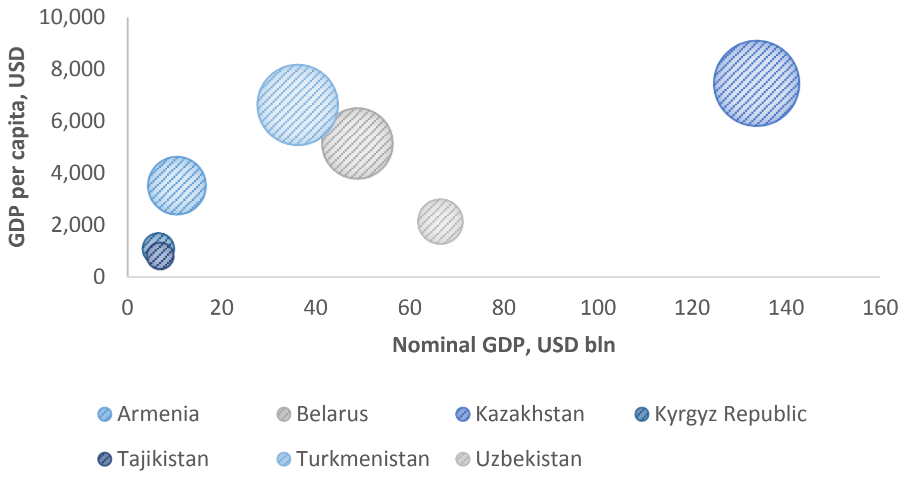
Real GDP growth in Russia, % (2012-2016)



Source: Federal State Statistics Office of Russia, Samruk-Kazyna

- At the same time, growth of the Chinese economy, a key investor and increasingly important trade partner for the region, is forecasted to remain strong. This positively affects growth perspectives of Central Asian countries through improved capital and trade flows, as well as through higher commodity prices. One of the most promising economic developments in the region is the Chinese One Belt One Road initiative, which will focus on strengthening connectivity and promoting infrastructure development. Integration of Armenia, Belarus, Kazakhstan, Kyrgyzstan and Russia within the Eurasian Economic Union will provide additional economic benefits through the expansion of trade and capital flows, as well as free movement of the labor force.

Nominal GDP and GDP per capita (2016e)



Source: IMF, Samruk Kazyna

- The IMF estimates economic growth in the Central Asian region at 2.4% in 2016, 0.8% lower than in 2015. In 2017, higher global commodity prices will support fiscal expansion in oil-exporting economies, while the devaluation of most regional currencies will support net exports. Overall growth in the region is projected to pick up to 3.1% in 2017 and further accelerate to 4.1% in 2018, although individual countries will grow at different rates. Inflation will be subdued in most of the regional economies due to a high base of 2016.

- Nevertheless, most economies of the region are faced with internal and external imbalances, which will require adequate response from the governments through monetary, fiscal and structural policy measures. Some countries would have to implement further fiscal consolidation, adopt more accommodative monetary policy and enforce institutional reforms to ensure a fast recovery and sustainable growth in the future.

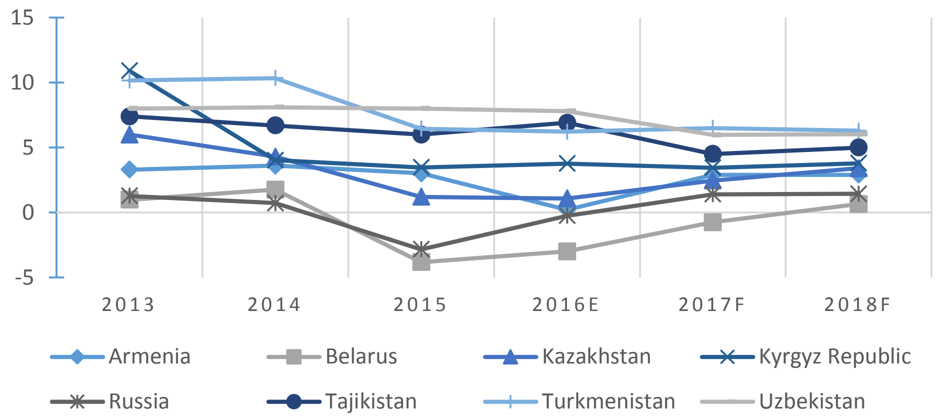
- Consequently, growth of several regional economies will remain subdued due to constrained internal demand and investment activity. At the same time, the respective governments have limited resources and instruments to resolve imbalances. Fiscal space in most of the countries has been diminishing and external debt has been growing as a result of stimulus packages implemented in 2015 and 2016 to offset the impact of external shocks. Current account deficits widened in most CA countries in 2016 as well, largely reflecting the effects of the various external shocks that have hit the region since 2014.

- Most of the Central Asian countries have devalued their currencies due to extensive external shocks and the devaluation of the Russian currency. This has triggered various fiscal and monetary shocks, increasing external debt and inflation. At the same time, financial sector vulnerabilities continue to increase, as dollarization remains high and some banks remain undercapitalized.

1. Introduction

Central Asian economies have started recovering after a downturn in 2015 and 2016 due to unfavorable external conditions that have affected the countries of the region. Growth is attributed to the rise in commodity prices and stronger performance of the largest regional economies. Stabilization of the current account balance in most of the countries is expected to improve consumer and business confidence, pick up investments and drive the growth of domestic demand. Consequently, the majority of regional economies are expected to show stronger performance in 2017 and 2018, led by Armenia, Kazakhstan, Turkmenistan and Uzbekistan.

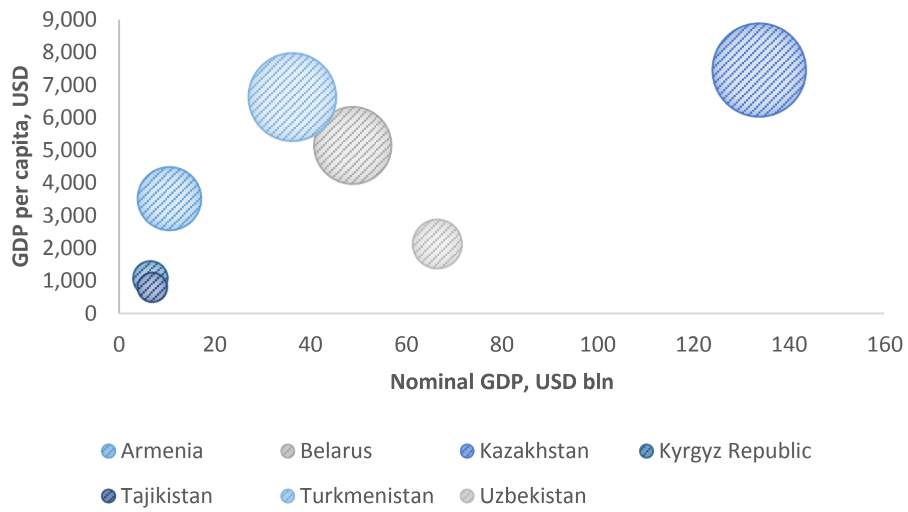
GDP growth, % (2013-2017f)



Source: IMF, Samruk Kazyna

The IMF estimates economic growth in the Central Asian region at 2.4% in 2016, 0.8% lower than in 2015. Overall growth in the region is projected to pick up to 3.1% in 2017 and further accelerate to 4.1% in 2018. Kazakhstan, the largest economy in Central Asia, is expected to be one of the faster growing countries in the region, benefitting from a rebound in commodity prices and further fiscal stimuli, which have been proposed by the government. A similar situation can be observed in both Turkmenistan and Uzbekistan. Other countries of the region, which are more dependent on remittances and capital inflows form the neighboring Russia and China, are expected to achieve a more stable external balance.

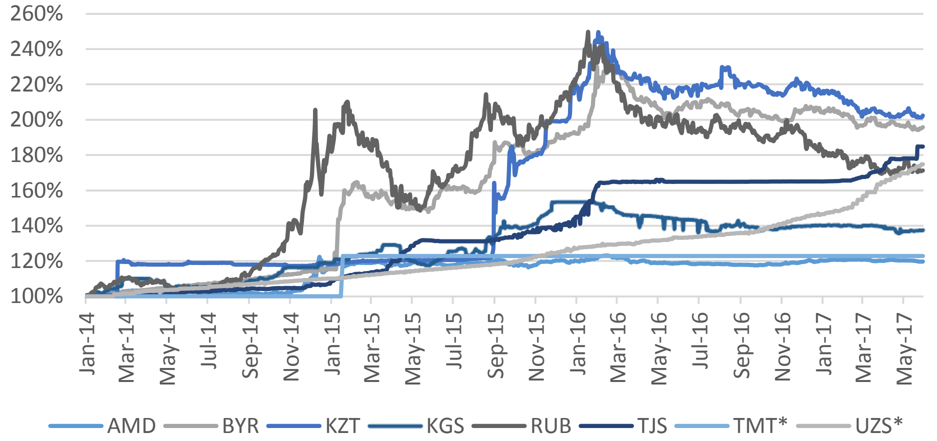
Nominal GDP and GDP per capita (2016e)



Source: IMF, Samruk Kazyna

In 2015 and 2016, most of the Central Asian countries have devalued their currencies due to extensive external shocks and the devaluation of the Russian currency, since Russia is a significant trading partner or a source of capital inflows for most of the region's economies. This has triggered various fiscal and monetary shocks, increasing external debt and inflation. As countries continue to move toward increased exchange rate flexibility, their respective economies adjust to the new environment, while weaker currencies boost competitiveness of local producers. Fiscal support and currency adjustment helped mitigate some of the impact of external shocks.

Exchange rates of regional currencies, % (Jan-2014 as 100%)

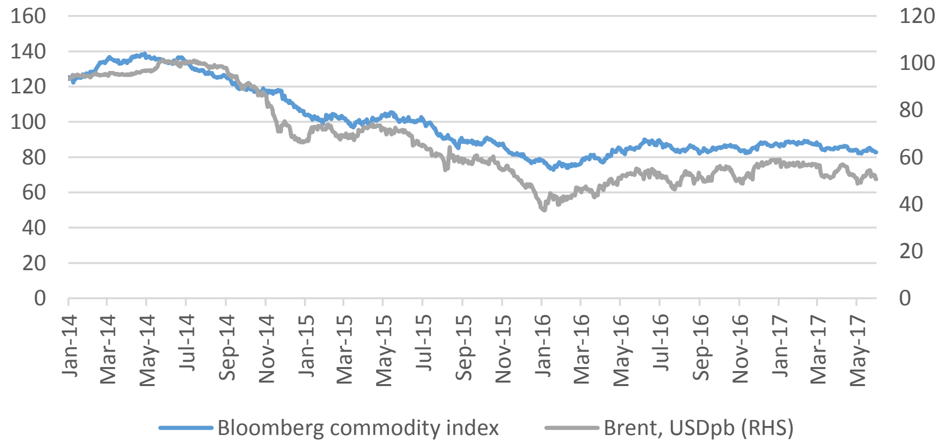


Source: Bloomberg, Samruk Kazyna

Note: Turkmenistan Manat and Uzbekistan Som are not traded at market value

Russia, Kazakhstan, Turkmenistan and Uzbekistan have commodity-oriented economies, which depend heavily on global prices. Oil, gas and several other commodities have seen a significant drop in prices since early 2015, which has put some pressure on current account balances of these countries. Oil prices, which are a major source of export revenue for Russia and Kazakhstan, starter to rebound slightly in 2Q16 and are poised for stabilization at around USD50-52pb in the medium-term. While such price levels are significantly below pre-2014 highs, they should support external balances of several Central Asian economies.

Bloomberg commodity index (Jan-2014 as 100%)

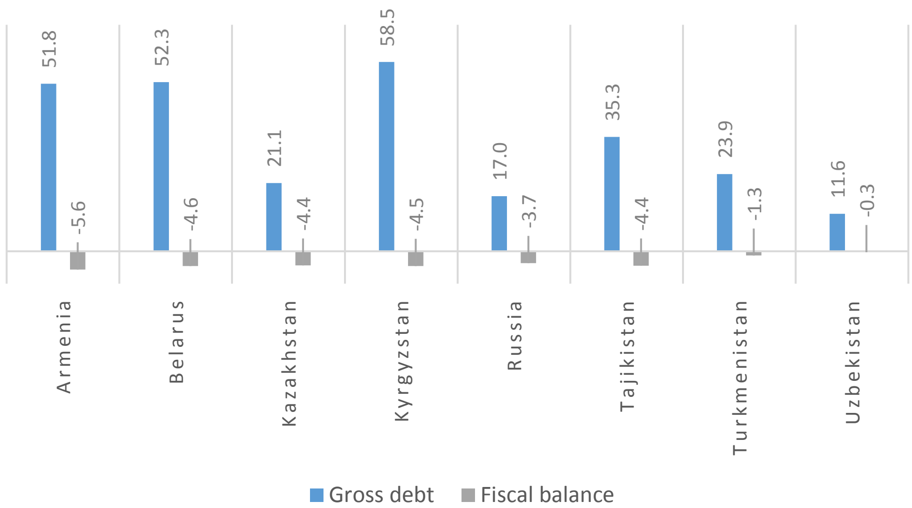


Source: Bloomberg, Samruk Kazyna

In addition, Central Asian economies are expected to benefit from higher growth in the region's largest economies. Perspectives of the Russian economy have improved, since the country is expected to resume growth in 2017. Russia is the key driver of remittance flows and the largest trade partner for most of the economies of the Central Asian region.

At the same time, growth of the Chinese economy, a key investor and increasingly important trade partner for the region, is forecasted to remain strong. This positively affects growth perspectives of Central Asian countries through improved capital and trade flows, as well as through higher commodity prices. One of the most promising economic developments in the region is the Chinese One Belt One Road initiative, which will focus on strengthening connectivity and promoting infrastructure development.

Gross government debt and fiscal balance, % of GDP (2016e)



Source: IMF, Samruk Kazyna

Nevertheless, most economies of the region are still facing internal and external imbalances, which require adequate response from the governments through monetary, fiscal and structural policy measures. One of the largest problems for the majority of the regional economies is rising government debt and diminishing fiscal space. With the exception of a few countries, the governments used fiscal stimuli to offset the impact of external shocks. While this provided some support to economic activity, fiscal space has declined and public debt is now higher. Some countries would have to implement further fiscal consolidation, adopt more accommodative monetary policy and enforce institutional reforms to ensure a fast recovery and sustainable growth in the future.

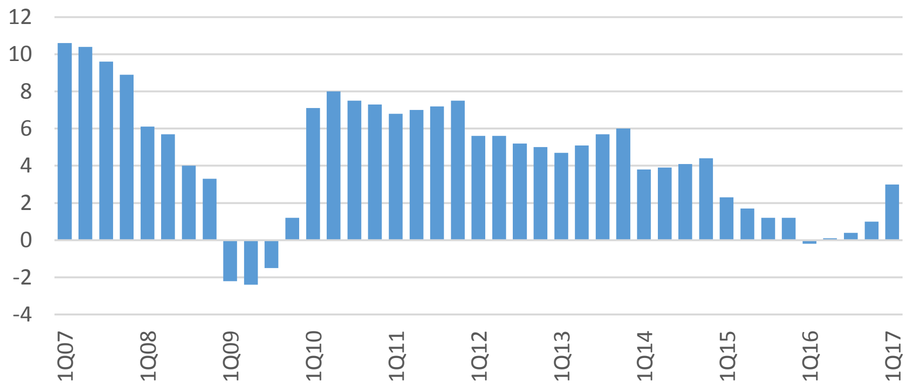
In addition, the economic slowdown, coupled with exchange rate depreciation, had an adverse impact on the heavily dollarized financial sectors of the Central Asian economies. Inefficient banking sector is a big impediment to future growth. Consequently, medium-term growth in the region is expected to remain below the historical average, reflecting a relatively subdued external outlook, and domestic structural problems.

2. Kazakhstan

Kazakhstan's economy remains resilient; it has withstood shocks from low oil prices, devaluation of the tenge and growth slowdown in key trading partners. The economy is gradually adapting to the "new normal" environment. For 2016, GDP growth stood at 1.0%, above official forecast of 0.5% and beating market expectations of as low as -1.0%, supported by gradual recovery in oil prices towards 4Q16, the resumption of oil output from Kashagan and infrastructure spending. The government's fiscal stimulus packages (transfers from the National Fund to the budget amounted to 6% of GDP in 2015 and 8% of GDP in 2016) had cushioned the declines in private sector consumption and investment.

For 2017, GDP growth is expected to strengthen up to 2.5%, supported by higher global oil prices, increase oil production, continued fiscal stimulus and improved economic performance in key trading partners. The government allocated KZT441.6bln for the implementation of Nurly Zhol program in 2017 with the possibility of an increase to KZT720bln subject to budget revision depending on the economic situation. These funds will be used for the construction and reconstruction of infrastructure including highways, railways and airports. Other measures include construction of affordable housing, as well as projects for the EXPO 2017. These measures are expected to have a multiplier effect on the economic growth. In the medium-term, GDP growth will hover at 3.1% and 3.5% between 2017 and 2022, in line with the Ministry of Economy's projections.

Quarterly GDP Growth Trend, % YoY
(2007-2016)



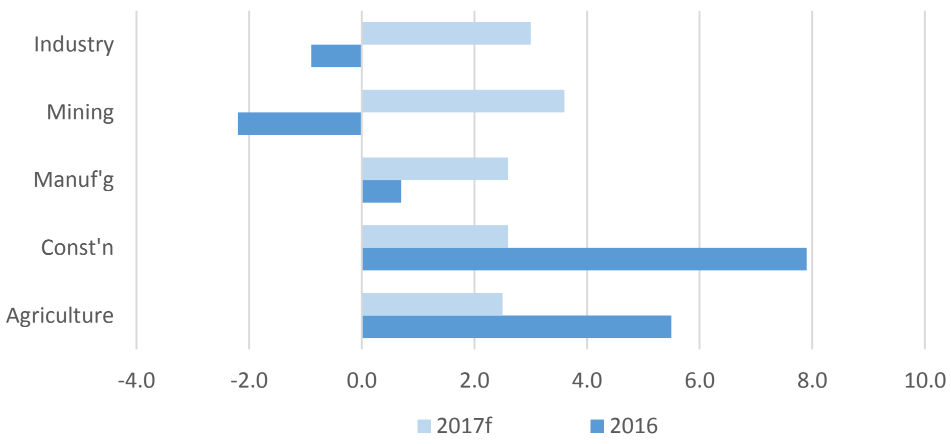
Source: Ministry of National Economy, Samruk Kazyna

A sectoral review of 2016 results showed that growth momentum was supported by construction (7.9%), agriculture (5.5%), transportation services (3.7%), as well as manufacturing (0.7%). At the same time, growth last year was dragged down by a slowdown in the mining (-2.7%), retail and wholesale trade (-1.4%) and communication (-2%) sectors. Overall volume of produced goods increased by 1.3%, while the volume of services grew by only 0.8%. Consequently, production of goods contributed more to GDP growth than services for the first time since 2010. Consequently, in 2016, Kazakhstan's economy became slightly less dependent on commodity sectors.

The slowdown in mining was due to the decreased production of crude oil (-1.8%), coal and lignite (-4.9%) and iron ores (-12.9%). The decline in iron ore output was due to a drop in Chinese demand for iron ore and pellets, decrease in exports of pellets to Russia, and decline in world prices for iron ore. The manufacturing sector recorded a growth rate of 0.7% in 2016, up slightly from 0.5% in 1H16. Metallurgy (6.6%) and production of food products (3.9%) contributed most to this output increase.

Investment in fixed assets provided some support for the economy, the physical volume of expenditures on construction, capital investments, as well as machinery and equipment grew by 5.1%. The total volume of investment in fixed assets in 2016 was estimated at KZT7.7tln.

GDP Growth Breakdown by Sectors, % (2016-2017)



Source: Ministry of National Economy, Samruk Kazyna

Economic growth in 2016 was higher than the official forecast of 0.5%, mainly attributed to the implementation of the state infrastructure development programs, as well as the construction of affordable housing within the Nurly Zhol initiative. Consequently, construction alone contributed more than 50% of the observed economic growth in 2016. At the same time, the commissioning of the Kashagan oilfield in 4Q16 alongside the recovery in global oil prices towards the fourth quarter also boosted growth for the year. External environment improved throughout the year, which helped stabilize the national currency. Decreasing inflationary pressure and the subsequent gradual reduction of the base rate from 17% to 12% by the NBK towards the end of last year helped accelerate economic growth. Consequently, growth in 1Q17 exceeded forecasts and amounted to 3%, but this attributable to a low base effect of 1Q16.

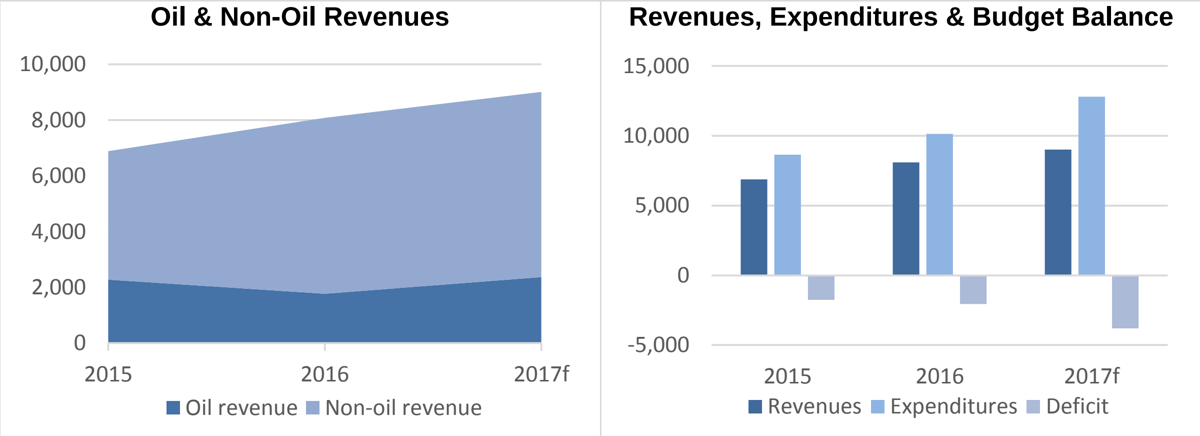
Fiscal position

Consolidated budget revenues are expected to increase in 2017 to KZT9tln or 18.1% of GDP vs. KZT8.1tln or 17.8% of GDP in 2016. The main increase in revenues is expected from corporate income tax and value-added tax due to an improvement in the overall economic performance. At the same time, budget oil revenues are also expected to increase to KZT2.4tln mainly due to an improvement in the oil price outlook from USD35pb to USD50pb and additional production at the Kashagan oilfield. Oil production forecast for 2017 was revised up to 81mln tons vs. 78mln tons in 2016.

Planned consolidated budget expenditures for 2017 amount to KZT12.8tln or 22.3% of GDP. One of the largest expenditure items is the rehabilitation of the banking sector, which will require as much as KZT2tln, of which the National Fund will finance KZT1.1tln. These expenditures are needed to support the largest banks and stimulate lending to the economy. KZT231bln are allocated for technological modernization of the economy and improving the business environment in specific sectors, including KZT60 billion for the development of the agricultural sector and KZT127bln for the development of transport and transit potential.

Consequent implementation of the government infrastructure development plans and additional anti-crisis measures in 2017 would require a target transfer from the National Fund in the amount of KZT1.5tln, previously KZT1.1tln. The target transfer in 2016 amounted to only KZT0.7tln. At the same time, the consolidated budget would receive KZT2.9tln in guaranteed transfers. As a result, planned budget deficit in 2017 was revised upwards by 2.7 times to (KZT3.8tln) or -7.6% of GDP vs. a deficit of (KZT2.1tln) or -4.5% of GDP in 2016. Non-oil deficit will further increase to (KZT6.2tln) or -12.4% of GDP from (KZT3.8tln) or -8.4% of GDP.

Consolidated Budget Position, KZT bln (2015-2017)



Source: Ministry of National Economy, Samruk Kazyna

Despite the unfavorable external environment and the overall economic slowdown, Kazakhstan's fiscal position remains strong enough to support fiscal stimulus programs. Resources of the National Oil Fund allow the government to execute massive infrastructure projects (assets of the National Fund stood at USD73.3bln or 53.7% of GDP as at end of 2016). According to official projections, with oil prices at a conservative level of USD50pb, National Fund assets are expected to remain robust at USD66.5bln or 44.1% of GDP by the end-2017. This provides some fiscal space, since government debt including government guaranteed debt remains relatively low at USD14bln or 10.5% of GDP as at end-3Q16.

Inflation and monetary policy

In line with our earlier expectations of monetary policy for stimulus, National Bank of Kazakhstan (NBK) cut its base rate four times by a total of 500bps last year, from 17% in February to 12% in December. In February 2017, the key interest rate was cut by another 100bps to 11%. The decisions on the base rate in 2016 and February 2017 were taken premised on the following factors:

- Inflation trends have corresponded to the expectations of NBK, with the risks of acceleration being minimal under current circumstances. In January 2017, inflation stood at 7.9% YoY, within the official target band of 6.0%-8.0% for 2017. In the absence of negative shocks, inflation is expected to reach 6.5%-7.0% towards December 2017, lowering to 5.0%-7.0% in 2018 and potentially heading below 4.0% by 2020.

- The USD-KZT exchange rate has stabilized since March 2016, reflecting the combination of an improved external and domestic environment, with the exception of the short-term turbulence in the global financial markets created by Brexit in June 2016. Global oil prices improved significantly since 4Q16, providing the added support needed by the tenge. Similarly on the domestic front, improved economic stability reduced the negative expectations on currency risks. These developments have contributed to the conversion of foreign currency denominated assets to tenge-denominated assets in both the foreign exchange cash market and the bank deposit market.

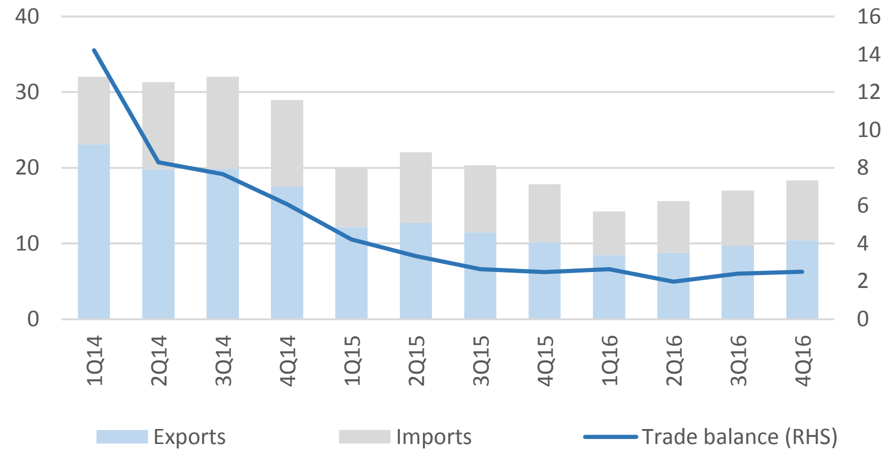
NBK highlighted that further actions on the base rate will depend on the dynamics of fundamental factors influencing domestic demand and stability of the financial sector. Amongst external factors that should also be monitored include volatility of global commodity prices, speed of economic recovery in key trade partners and the revision of budget expenditures.

External positions

On external trade, total trade turnover decreased by 19.2% YoY to USD65.05bln in 2016, whereby exports fell 19.9% YoY to USD37.25bln and imports contracted 17.8% YoY to USD27.80bln. The decline in exports was due to lower commodity prices while lower imports was driven by weaker purchasing power arising from slower growth, lower incomes and the devaluation of the tenge. Consequently, current account deficit was at USD8.17bln or 6.9% of GDP in 2016, a second year the country registers a current account deficit since 2009.

For 2017, total trade turnover is projected to improve by approximately 19.5% YoY to USD77.75bln, with exports and imports expected to increase by 21.0% YoY and 17.6% YoY respectively, underpinned by stronger global growth, gradual recovery in commodity prices and improved economic performance from key trading partners. As such, current account balance is anticipated to improve further to –USD5.91bln or -3.9% of GDP in 2017. Kazakhstan's total trade turnover is projected to increase moderately in the medium-term, potentially reaching USD90bln by 2021. Following this, current account balance is expected to improve gradually from -3.9% of GDP in 2017 to -1.6% of GDP in 2021.

External Trade Trend, USD bln (2014-2016)



Source: Ministry of National Economy, Samruk Kazyna

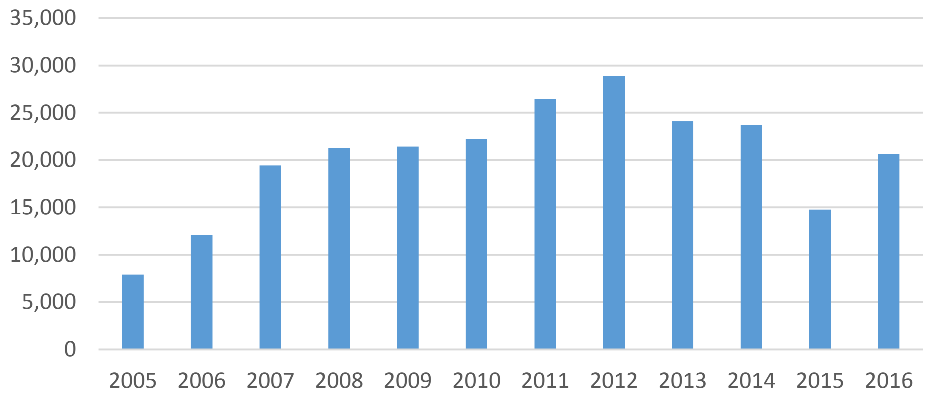
On reserves, Kazakhstan's official international reserves comprise of foreign-exchange assets at the NBK and in the National Oil Fund. Total international reserves stood at USD90.78 billion as at December 2016. This amount comprised of FX reserves of USD29.76bln at the NBK and USD61.02bln at the National Oil Fund. NBK's repayment of FX swaps to commercial banks in 2016 (at KZT600bln or approximately USD1.8bln) improved the quality of these reserves.

Foreign direct investment

Gross inflows of FDI picked up momentum in 2016, amounted to USD20.64bln, USD5.89bln or 39.9% higher than in 2015. Between 2005 and 2016, Kazakhstan attracted cumulative FDI of more than USD280bln.

Inflow of investments went to traditional sectors, such as mining with total investments of USD65.95bln or 27.1% (mainly in the extraction of crude petroleum and natural gas), as well as investments into professional, scientific and technical activities at USD86.95bln or 35.8% (majority relates to geological exploration and prospecting activities). The oil and gas, natural resources and extractive industries continue to remain the most attractive sectors for investments, comprising more than half of Kazakhstan's accumulated FDI inflows to-date. Nonetheless, the manufacturing, wholesale and retail trade, financial services, and construction attracted commendable investments of USD29.99bln (12.3%), USD21.60bln (8.9%), USD12.17bln (5.0%) and USD8.53bln (3.5%) respectively, reflecting relative success of Kazakhstan's efforts to diversify the economy.

Gross Inflows of FDI, USD mln (2005-2016)

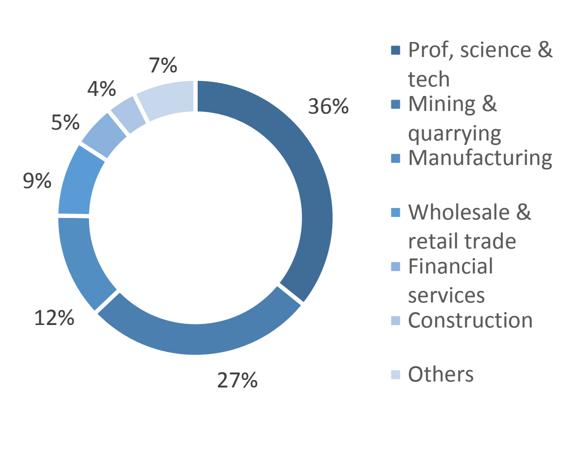


Source: National Bank of Kazakhstan, Samruk-Kazyna

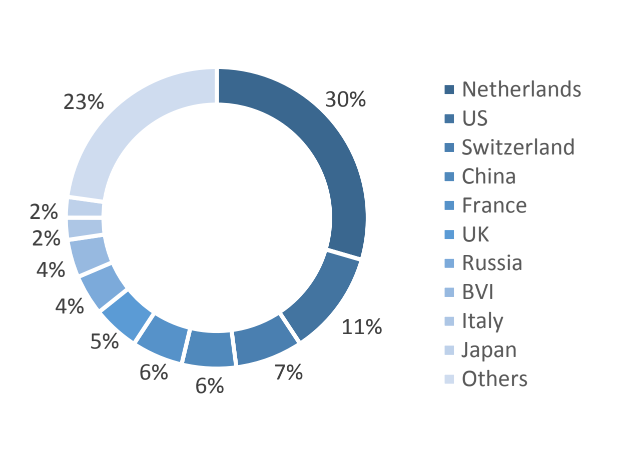
Netherlands remains the largest investor (domiciled by country) in Kazakhstan with investments amounted to USD71.67bln, while the US has USD27.22bln investments in the country. Other major investors include Switzerland, China, France, UK and Russia. Kazakhstan has increasingly been receiving FDI from China namely within the Chinese "One Belt, One Road" initiative.

New Asian partners such as China, India and even Iran are replacing Kazakhstan's traditional investment partners. However, they have not been able to fully substitute Russia and western investors, many of which have been deterred by lower oil prices, weakening domestic and regional economic cycles.

FDI by Sector (as at 2016)



FDI by Country (as at 2016)



Source: National Bank of Kazakhstan, Samruk Kazyna

2017 outlook

In summary, Kazakhstan's economy remains resilient and is gradually adapting to the "new normal" environment. GDP growth stood at 1.0% in 2016, above official forecast of 0.5% and beating market expectations of as low as -1.0%, supported by gradual recovery in oil prices towards 4Q16, the resumption of oil output from Kashagan and infrastructure spending. The government's fiscal stimulus packages had cushioned the declines in private sector consumption and investment.

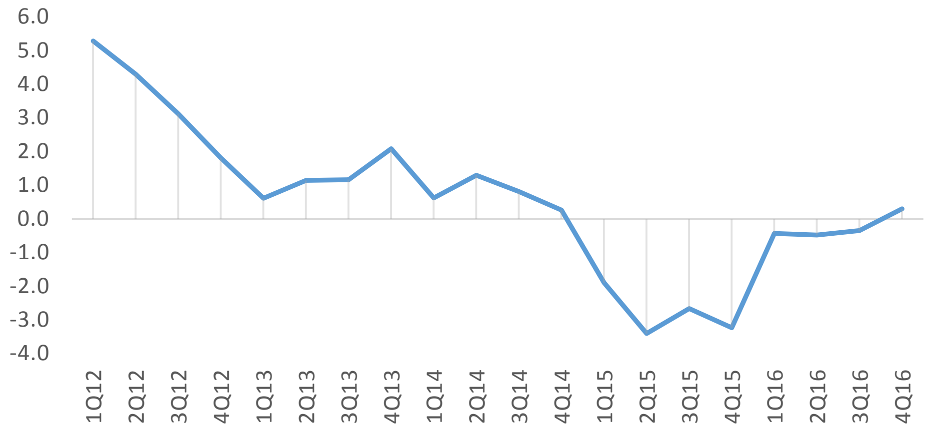
For 2017, GDP growth is expected to strengthen up to 2.5%, supported by higher global oil prices, increase oil production, continued fiscal stimulus and improved economic performance in key trading partners. The government allocated KZT441.6bln for the implementation of Nurly Zhol program in 2017 with the possibility of an increase to KZT720bln subject to budget revision depending on the economic situation. These funds will be used for the construction and reconstruction of infrastructure including highways, railways and airports. Other measures include construction of affordable housing, as well as projects for the EXPO 2017. These measures are expected to have a multiplier effect on the economic growth.

Future performance of China and Russia will have spillover effects to Kazakhstan through trade and commodity prices, as well as through the degree of confidence and volatility in financial markets. China and Russia account for 11% and 10% respectively of the country's total exports, and more-than-expected slowdown in China's economy and prolonged economic recession in Russia will put downward pressure on Kazakhstan's GDP growth. In addition, devaluation of the currencies of key trade partners especially the ruble will weigh on the competitiveness of the Kazakh exports and may result in downward pressure on the USD-KZT exchange rate with the risk of increased dollarization.

3. Russia

In 2016, Russian economy showed mixed results. The government tried to find balance between addressing economic problems and reaching social development goals. The dynamics of key indicators remained heterogeneous. On one hand, industrial production continued to grow, supported by an increase in external demand and the development of import substitution. Investment activity started to improve gradually. On the other hand, consumer demand continued to contract after a slight increase in the third quarter.

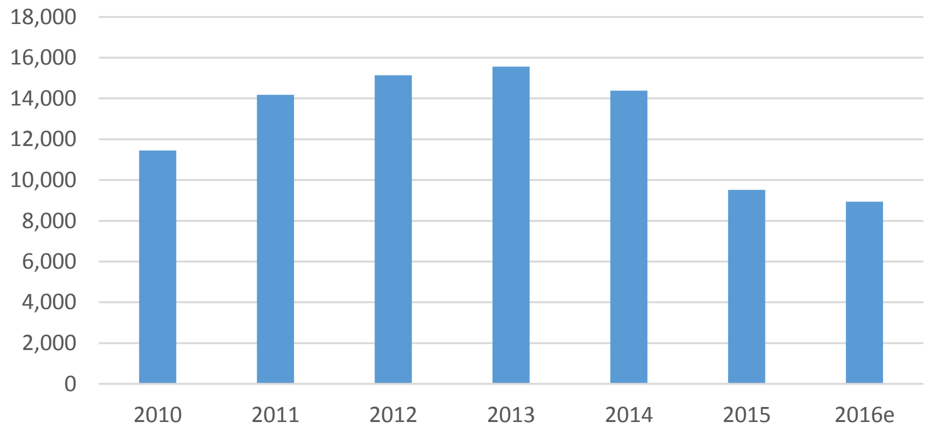
Real GDP growth, % (2012-2016)



Source: Federal State Statistics Office of Russia, Samruk-Kazyna

Most of the socio-economic indicators remain negative at the beginning of 2017 in continuation of the crisis that started in 2014. However, almost all negative trends in the economy seem to be showing signs of improvement, while some sectors show impressive growth. Consequently, the economy of Russia has adjusted to the negative external macroeconomic environment although internal structural imbalances remain.

GDP per capita, USD (2010-2016e)

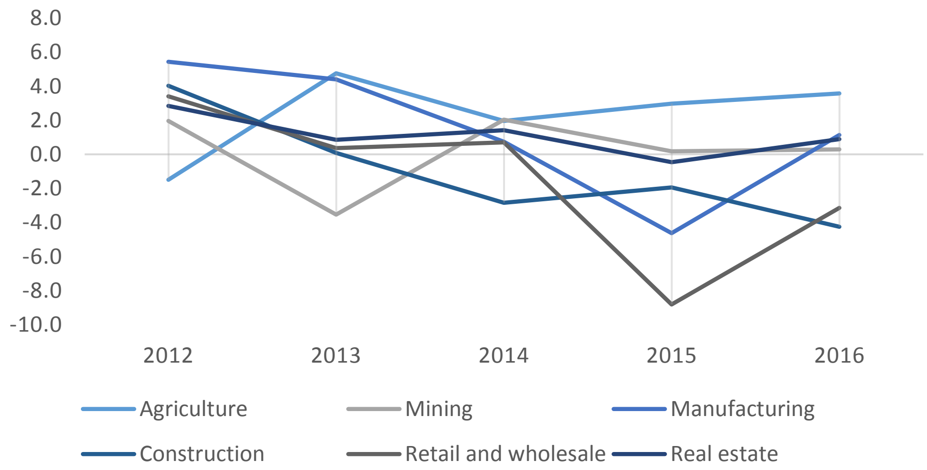


Source: IMF, Samruk-Kazyna

GDP grew 0.3% YoY in 4Q16, following 0.4% contraction in 3Q16. It was the first expansion in almost two years. Such growth can be attributed to an improvement in net external demand, as exports rose by 3.7% YoY while imports edged up 0.3% YoY. At the same time, household spending (-3.2% in 4Q16 vs. -4.8% in 3Q16) and investments (-0.3% in 4Q16 vs. -0.8% in 3Q16) contracted at a slower pace.

Meanwhile, government consumption fell by 0.5%. Despite the positive results in 4Q16, GDP for the entire 2016 shrank by 0.2% against -3.7% in 2015. Consequently, GDP in current prices amounted to RUB86.44tln.

Dynamics of the main sectors of the Russian economy, % (2012-2016)



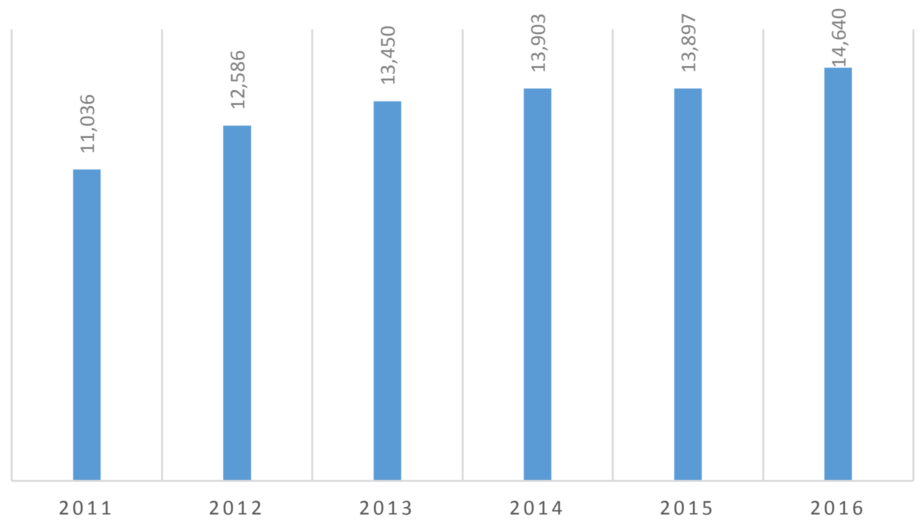
Source: Federal State Statistics Office of Russia, Samruk-Kazyna

A sectoral overview of the Russian economy shows that real estate and renting services grew by 1.2% vs. 0.7% in 3Q16; transport and communication expanded by 1.2% from 0.3% in 3Q16; financial services increased by 1.7% from -1.9% in the previous quarter while agriculture grew by a mere 3.2% vs. 5% in 3Q16. Output fell less in wholesale and retail trade (-0.6% from -4.8% in 3Q16) and construction (-1.9% vs. -3.5% in 3Q16). In contrast, manufacturing contracted by 0.6% (1.3% in 3Q16) and mining and quarrying edged down 0.1% (0.1% in 3Q16).

Russia's agriculture, forestry, light manufacturing and chemical industries, as well as production of machinery and equipment experienced growth in 2016, backed by large-scale state support measures and increased competitiveness of Russian producers due to the devaluation. The growth of output in manufacturing and agriculture contributed to an increase in transportation services, including through the expansion of exports.

The policy of import substitution, launched in 2014-2015, also contributed to the growth of the aforementioned sectors. Moreover, in 2016, the government put more emphasis on the development of the high-tech sector, including defense and aerospace subsectors. At the same time, traditional manufacturing sectors, such as metallurgy, were going through a difficult period due to declining domestic and external demand. Construction industry was also heavily affected by falling household income and lack of investments. As the economy adjusts to the new environment, growth is expected in more sectors in 2017 compared with last year.

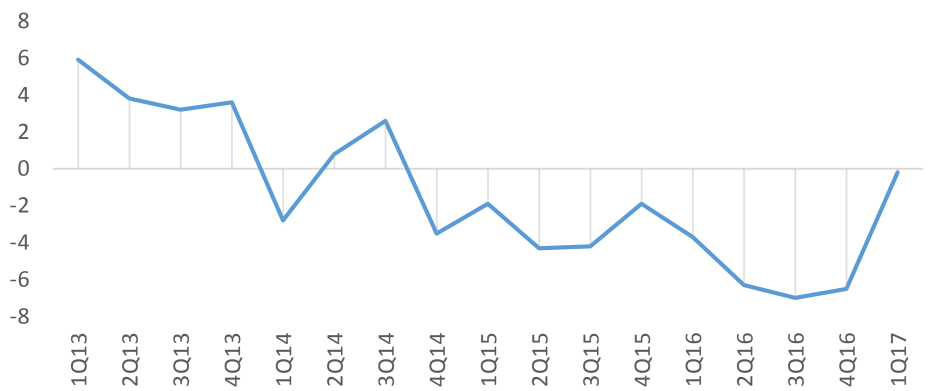
Investments in fixed assets, RUB bln (2011-2016)



Source: Federal State Statistics Office of Russia, Samruk-Kazyna

Retail and wholesale trade, as well as several other service industries continued to decline (-5.2%) in 2016 due to falling real incomes. The rate of decline, however, slowed – in 2015, the volume of retail and wholesale trade fell by 10% YoY. Wages and other income started to fall in 2014, this trend is still evident three years later, in 2016, despite an increase of 0.6% in real wages, real disposable income declined by 5.9% YoY due to a reduction in welfare and other social support. The falling of real incomes accelerated from 3.2% in 2015 and 0.7% in 2014. In 1Q17, real incomes declined by only 0.1% YoY, partially due to the low base effect of 2016. In these conditions, the population continued to shift towards savings rather than consumption. As a result, most service industries continued to decline or showed insignificant growth. Household spending on final consumption decreased by 4.5% in 2016, although the rate of decline slowed considerably from 9.6% in 2015.

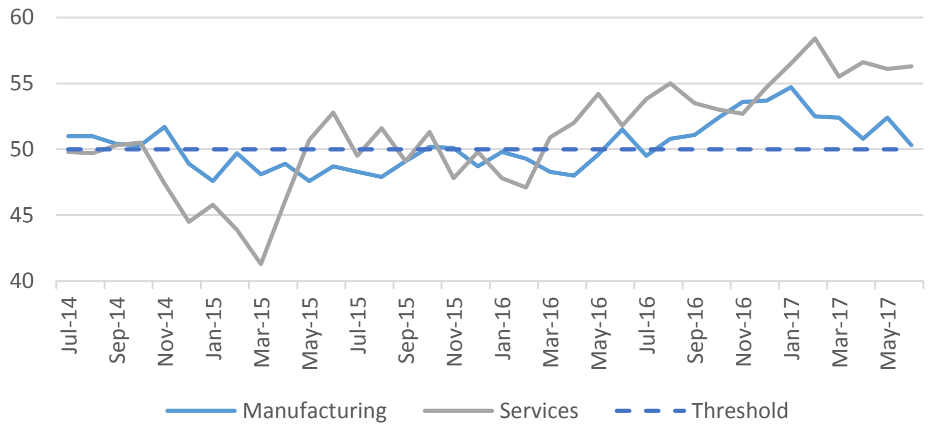
Real disposable income per capita, % YoY (2013-1Q17)



Source: Federal State Statistics Office of Russia, Samruk-Kazyna

Nevertheless services PMI in Russia indicated continuous expansion since February 2016, reaching 58.4 points in January 2017. Russia Services PMI for 1Q17 came in at 56.8, up on already significant growth in 4Q16 at 54.6 and significantly above the 1Q16 reading of 50. Such optimistic data shows that service industries may be on a path to recovery given consistent and sustainable increase in consumer demand. PMI in manufacturing indicated slower but continuous expansion since August 2016. Russia Manufacturing PMI averaged 53.2 in 1Q17, unchanged on 4Q16 and up on 49.1 average for 1Q16.

PMI in manufacturing and services (July 2014-May 2017)



Source: Bloomberg, Samruk-Kazyna

Several other macroeconomic indicators are suggesting that the Russian economy is on its path to recovery. Consumer and business confidence has been improving, standing at the highest level in the last five years. Consumer confidence in Russia rose to -15 in 1Q17 from -18 in 4Q16. It was the highest reading since 3Q14. Households showed less pessimism about Russia's economic situation over the next 12 months. The consumer sentiment in regards to personal financial situations and conditions for major purchases showed improvement in 1Q17.

Government policy

Recession in the Russian economy called for several structural reforms from the government. First of all, the authorities carried out several privatization initiatives that became the key source of funding for the state budget and ensured that the country would be able to overcome the negative effects of the Western financial and economic sanctions. The sale of 19.5% stake in Russia's energy giant Rosneft to foreign investors was one of the largest privatizations carried out in the last several years. Further privatization initiatives might be launched in 2017.

The government is making more steps to encourage competition on the domestic market, as well as support import substitution. Improvement of the business climate has positively affected businesses: despite the overall economic downturn the country's stock market is growing rapidly while the price of national companies' shares has grown by 27% in 2016.

Other anti-crisis measures included diversification of the economy via subsidies and targeted support of various sectors, such as automotive industry and several manufacturing subsectors. At the same time, the government allocated more than RUB300bln for the social development of regions and other social security programs. Total cost of the program amounted to about RUB700bln.

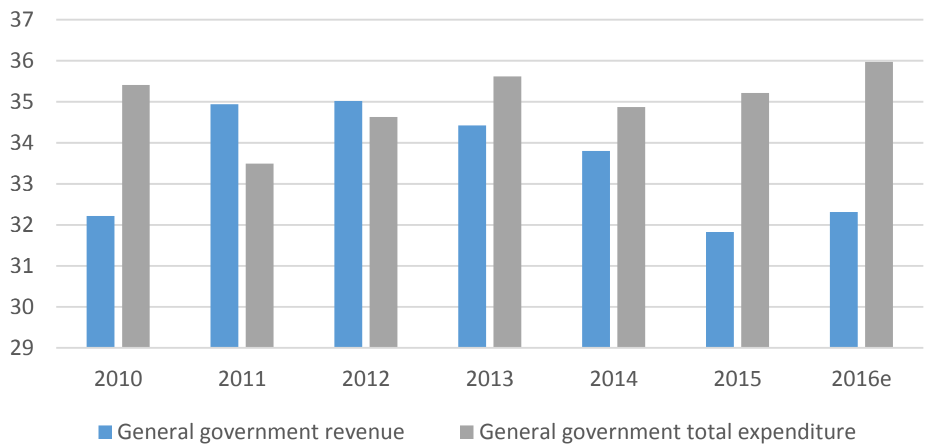
The anti-crisis program for 2017 is far smaller in scope (RUB110bln), but essentially it follows the same principles. The plan consists of 16 measures and focuses on supporting individual industries: the automotive industry, transportation, agriculture, construction, road and municipal engineering, machine building, as well as the food, light manufacturing and processing industries. Most of the funds are allocated to the automotive industry - more than RUB62bln. These funds will be directed on subsidies for automakers and auto loans to stimulate demand for domestically-produced vehicles.

However, experts argue that the government should prioritize structural reforms, aimed at improving competitiveness rather than subsidizing vulnerable industries. One of the key measures in this direction is the reduction of government support for inefficient enterprises with low labor productivity, which will create conditions for the reallocation of resources, capital and workforce into more efficient companies.

Fiscal policy

Since January 1 2017, the Russian government has shifted to a three-year budget planning. Previously, in 2016, the government used a one-year budget due to a high degree of uncertainty in regard to the external and internal macroeconomic conditions. Planned federal budget revenues in 2017 are estimated at RUB13.5tln, while expenses should amount to RUB16.2tln. Consequently, the deficit of the federal budget in 2017 is anticipated at RUB2.8tln (3.2% of the GDP), which is slightly lower than the RUB2.95tln deficit in 2016. The government plans to reduce this amount to RUB2tln in 2018 and just RUB1.1tln in 2019.

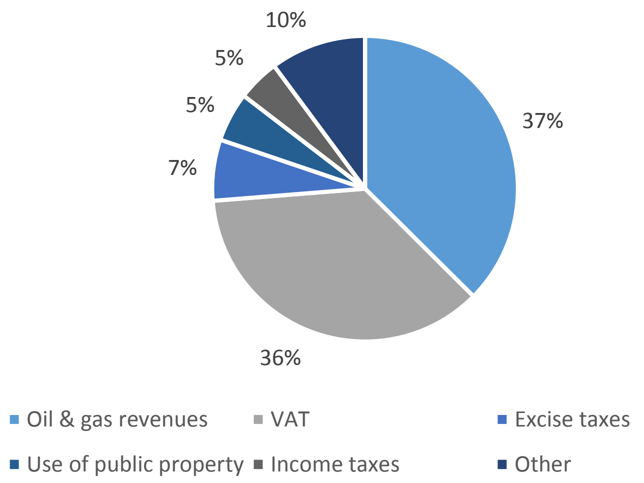
Government budget deficit, % of GDP (2010-2016e)



Source: IMF, Samruk-Kazyna

The budget was prepared using the base case scenario with an average annual oil price of USD40pb and inflation of no more than 4%. Exchange rate forecast stands at 67.5 rubles per US dollar in 2017, 68.7 rubles per US dollar in 2018 and 71.1 rubles per dollar in 2019. The ministry of finance estimates that if the average oil price in 2017 will be around USD55pb, exchange rate will stand at RUB66.3 per USD and the budget deficit will amount to just 1.5% of GDP.

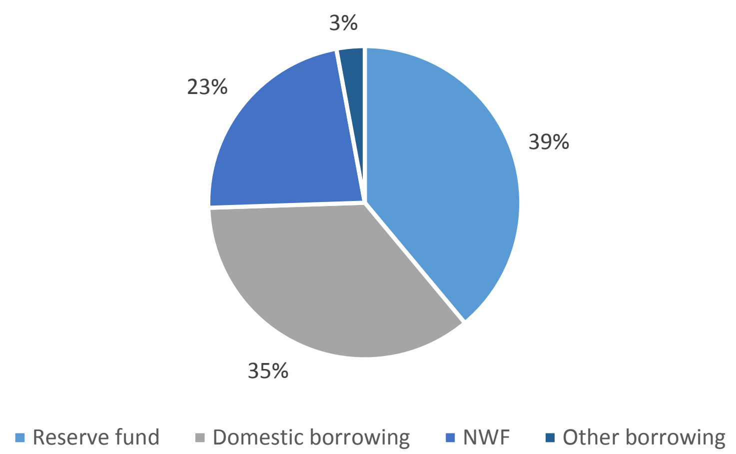
Structure of budget revenues, % (2016)



Source: Russian Ministry of Finance, Samruk-Kazyna

In 2016, the budget deficit was partially financed using the assets of the Reserve Fund, which have decreased to about RUB3tln by the end of 2016. However, in 2017 this fund is expected to be depleted, consequently, budget deficit in 2017 will be financed using the National Welfare Fund (NWF), whose assets are forecasted at RUB4.7tln as at the beginning of 2017, RUB4.2tln in 2018 and RUB3.1tln in 2019. In general, the government is planning to reduce external borrowing and switch to domestic borrowing.

Sources of budget deficit financing, % (2016)



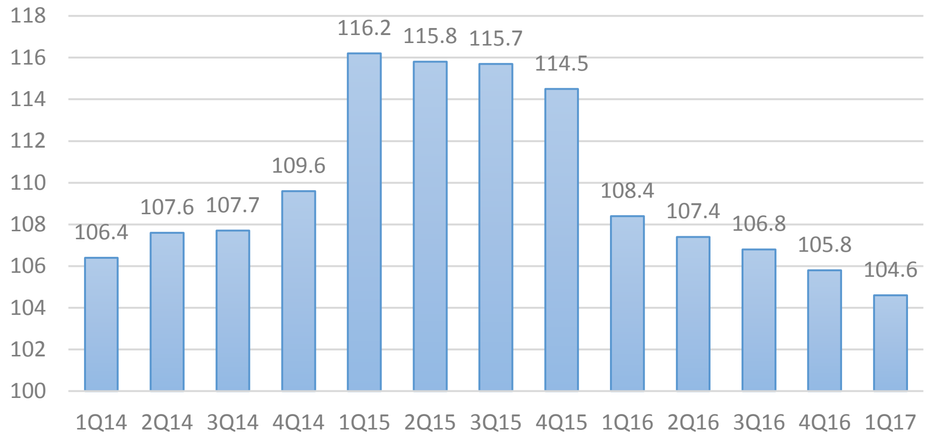
Source: Russian Ministry of Finance, Samruk-Kazyna

About 50% of the budget will be allocated on public administration, national security and the financing of the government's economic projects, as well as on subsidizing state entities, another 30% will be spent on pensions and social payments. Other expenditures include separate subsidies to the regional budgets to decrease regional disparities. Budget sequestration resulted in decreased financing of healthcare and education, their weight in total 2017 budget expenditures decreased to 2.3% and 3.5% respectively. The government has also decreased its military budget by 6% in real terms. Unlike the 2016 fiscal policy, newly adopted budget is more socially-oriented.

Inflation and monetary policy

Throughout 2016, the Bank of Russia has been carrying out a strict monetary policy that has helped to bring down the inflation. The key interest rate has been lowered from 11% at the beginning of the year to 10% by end-2016. Consequently, the inflation rate decreased from 14.5% YoY in 4Q15 to 4.6% YoY in 1Q17. April 2017's CPI growth was the lowest inflation rate since May 2012, as prices increased at a slower pace for housing and utilities, clothing and transport.

Quarterly inflation, % YoY (1Q14-1Q17)



Source: Federal State Statistics Office of Russia, Samruk-Kazyna

As the inflation approached the regulator's target, the central bank has lowered its benchmark one-week repo rate further by to 9.75% in March 2017 and 9.25% in April 2017. Policymakers signaled the possibility of further cuts in 3Q17 and 4Q17, as inflation continues to decline and is projected to reach 4% target before the end of 2017. Since the CBR shifted to a free-floating regime and inflation targeting, it emphasizes predictability, transparency and better communication as core principles. Given the favorable external conditions, Bank of Russia may decrease the key interest rate to the level of 6.5-6.75% to stimulate the domestic economy.

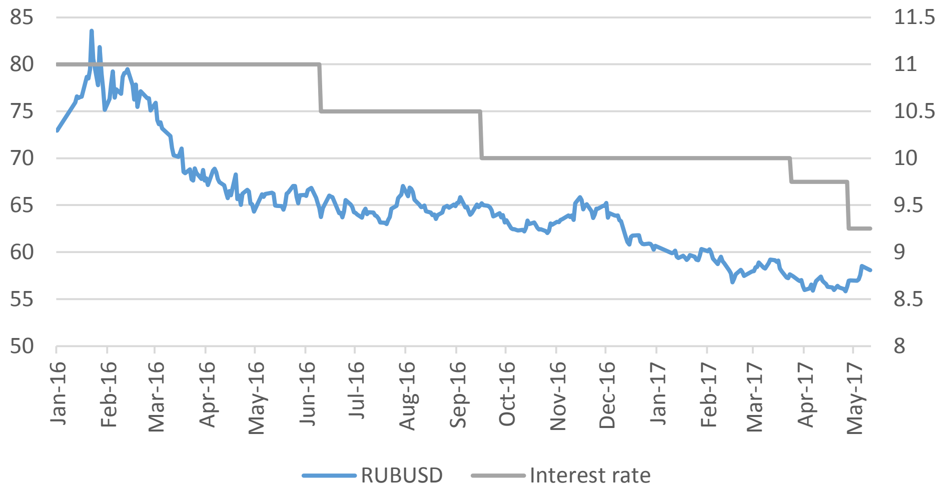
The Bank estimates that the economy continued to recover in the first quarter and expects fixed capital investments to increase. Industrial production is maintaining positive dynamics and unemployment is showing a downward trend. The labor market is adjusting to the new economic environment, with signs beginning to emerge that labor shortages are finding their way in individual segments. According to the estimates, the observed annual rise in real wages will foster gradual growth in consumer activity without posing additional pro-inflationary pressure amid increased supply of goods and services.

Among other measures undertaken by the regulator in 2016, the Bank of Russia revoked licenses from 95 banks, or about 10% of total, in order to stabilize the banking system and make it more resistant to various shocks.

External conditions: FX rates, reserves and trade

Russia's central bank maintained its free-float regime for the national currency throughout 2016 to help the economy adjust to external shocks, such as falling oil prices and Western sanctions. Improvement of the external environment has resulted in a 19% appreciation of the Russian currency as compared to the US dollar. The strengthening of the ruble on the back of a stable external economic environment has also contributed to the slowdown of inflation in Russia, holding back prices for non-food goods and services.

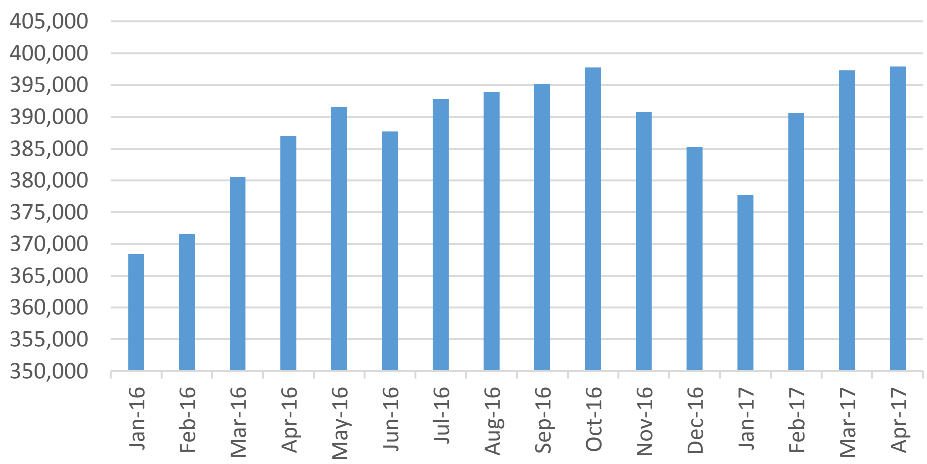
RUBUSD exchange rate vs. interest rate (January 2016 – May 2017)



Source: Bank of Russia, Samruk-Kazyna

After several unexpected spikes in 1Q16, Russian ruble's exchange rate remains stable at the level of 62-67 rubles per US dollar. The Russian ruble has also been among the best-performing emerging market currencies during 1Q17 with gains of about 9% after further growth of oil prices. However, it has depreciated by about 2% in April 2017.

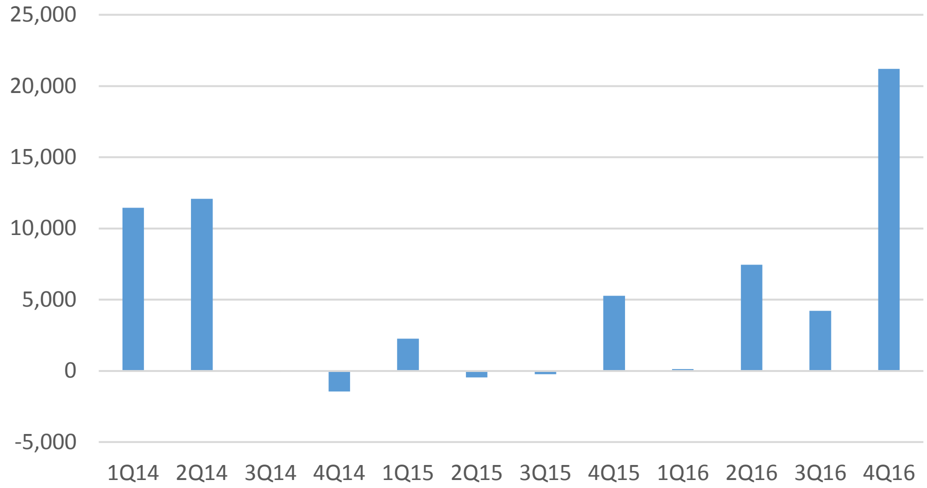
Foreign exchange reserves, USD mln (January 2016 – April 2017)



Source: Bank of Russia, Samruk-Kazyna

Russian financial markets posted a stellar performance in 2016 and ended up surprising most market participants. The Russian ruble also rose sharply, enhancing the profitability of local-currency investments in 2016. It also supported the inflow of money from non-residents, further increasing the attractiveness of Russian equities and bonds. Foreign investment in Russian equities stood at USD3bln in the first three quarters of 2016 as compared to an outflow of about USD0.3bln in the same period last year.

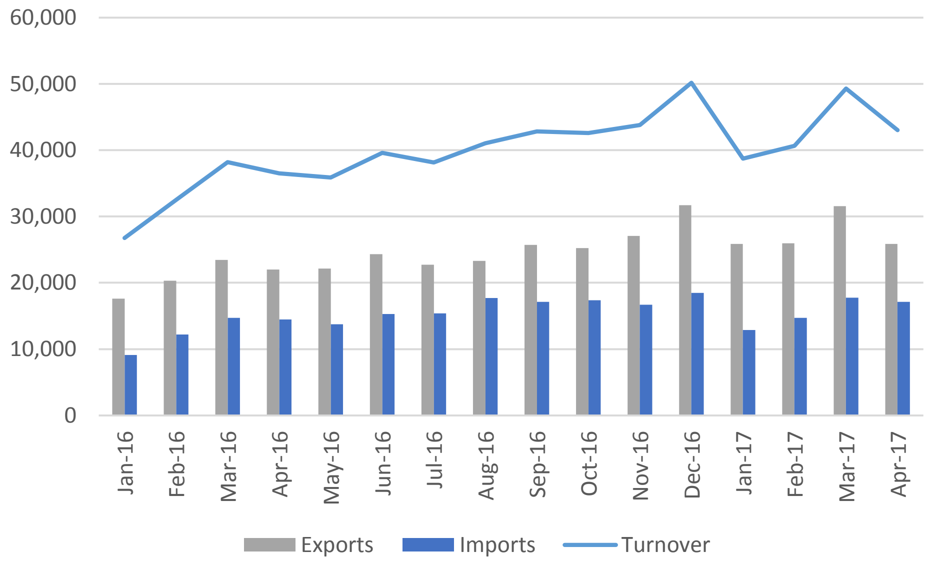
Gross inflow of FDI, USD mln (1Q14-4Q16)



Source: Bank of Russia, Samruk-Kazyna

The increase in FDI in Russia is principally attributed to investments associated with the privatization of state-owned assets: the government sold a 19.5% stake in the state-owned oil company Rosneft in a deal worth around USD11bln to a consortium led by Glencore (Switzerland) and the Qatari sovereign wealth fund

Exports and imports, USD mln (January 2016 – April 2017)



Source: Federal State Statistics Office of Russia, Samruk-Kazyna

The foreign trade turnover of Russia in 2016 amounted to USD471.2bln dollars. This is 11.2% less than in 2015. The devaluation of the ruble played a decisive role in the reduction of external trade. The exchange rate in the beginning of 2016 skyrocketed to 78 rubles per US dollar. This coincided with a seasonal decline in business activity in January, which is observed in Russia annually, as well as with a reduction of production in many manufacturing industries. As a result, volumes of trade in January reached record lows - exports fell by one third, while imports declined by 20%.

Over 2016, Russia's exports in declined by 17% to USD285.49bln. Such dynamics is due to lower oil and commodity prices. At the same time, exports in volume terms increased, consequently Russia increased exports abroad even in unfavorable conditions. As such, oil exports in 2016 increased by 6.6% to 236.2 mln tons, while revenues from exports of oil fell by 17.7% to USD73.67bln. Exports of other conditions followed the same trends. Russia has also increased exports of many food products, machinery and other manufacturing products to China, Asia and Europe. The devaluation of the ruble allowed Russian products to compete efficiently in external markets.

Unlike exports, both monetary and physical volumes of imports showed a decline. Imports of motor vehicles, electric generators, textiles, and foodstuffs have decreased due to the depreciation of the ruble, as well as lower consumer demand and a decline in industrial production in a number of industries.

The current account balance of Russia in 2016 declined to USD25bln (USD68.9bln in 2015). The net capital outflow by the private sector amounted to USD19.2bln, or one-third of the outflow in 2015. This was mostly due to a reduction in external debt repayments by banks, while the government continued external borrowing. The external debt as of January 1, 2017 amounted to USD513.5bln, declining by USD5.6bln or 1.1% over 2016.

Outlook for 2017

The IMF upgraded its forecast on Russia’s GDP growth from 1.1% to 1.4% in 2017 and from 1.2% to 1.4% in 2018. Improved outlook for the economy reflects firming oil prices and a recovery in domestic demand attributable to easing financial conditions and improved consumer confidence. Inflation is expected to slow down further in line with the central bank’s inflation target, providing the conditions for the central bank to gradually resume monetary policy easing to stimulate credit growth. However, Appreciation of the ruble that started after the rebound in global oil prices may limit the competitiveness of Russian producers and negatively affect growth prospects.

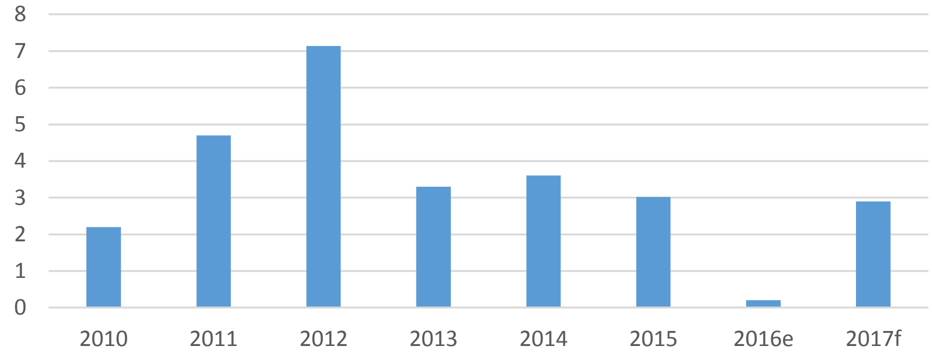
At the same time, the fiscal consolidation process in Russia is expected to continue to adjust to lower oil revenues and increased social obligations. This could limit the government’s fiscal space needed for the support of the economy. In the medium term, the growth potential of the economy will depend on the implementation of structural reforms. These reforms should be aimed at promoting competition in markets, modernizing production capacities.

Higher oil prices and the improved outlook for Russia will support activity in other countries of the region, given tight linkages through trade, investment, and remittances.

4. Armenia

According to official forecasts, GDP growth in Armenia slowed to 0.2% in 2016 due to falling agriculture (-5.8%), construction (-11.8%) and communication (-2.2%). On the other hand, such sectors as mining and manufacturing registered growth of 11.6% and 5% respectively. Such growth was not enough to outweigh the decline in agriculture, which is the largest sector of the Armenian economy with 15.9% of the GDP. Consequently marginal growth of the economy was supported by services and retail and wholesale trade which grew by 1.9% in total. Other factors that negatively affected growth in 2016 include a result of a significant reduction in government spending in the second half of the year, weak household demand and a deep contraction in investment. In early 2017, economic activity has shown signs of recovery, led by private sector credit growth supported by monetary policy easing.

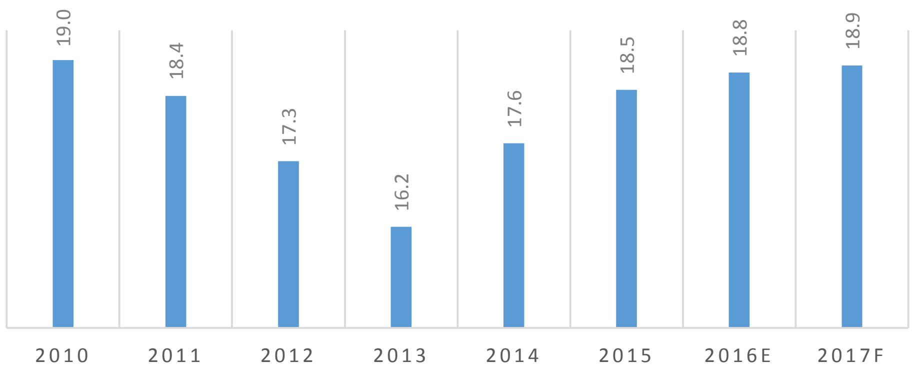
GDP growth of Armenia, % (2010-2017f)



Source: IMF, Samruk-Kazyna

Unemployment is one of the largest problems in Armenia, a large part of the population works on seasonal jobs in the agriculture industry. The unemployment rate in Armenia decreased to 17.4% in 4Q16 compared to 19.5% in the previous period. It was the lowest jobless rate since the third quarter of 2015 as the number of unemployed persons fell by 41.1 thousand to 212.3 thousand. Nevertheless, the level of unemployment in 2016 increased to 18.8% vs. 18.5% in 2015. The unemployment rate in Armenia is the highest among the CIS countries. In addition to unemployment, the wages in the country keep declining in both public and private sectors, pushing down the inflation in the country.

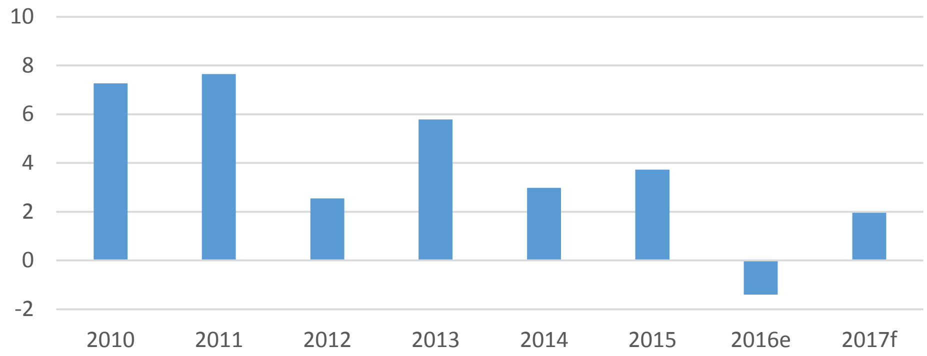
Unemployment rate in Armenia, % (2010-2017f)



Source: IMF, Samruk-Kazyna

Consumer prices in Armenia increased by 1.2% YoY in April 2017, following a 0.1% drop in the prior month. It was the first rise in consumer prices since November of 2015, driven by higher cost of food and non-alcoholic beverages (5.9% from 3.4% in March); transport (0.7% from -1% in the previous period). Despite the upward spike in inflation, the underlying factors remain. Overall CPI in 1Q17 declined by 0.3% YoY after a 1.4% YoY decrease in 2016. The deflation was due to subdued consumer demand, falling wages and lower imports prices for consumer goods. To stimulate economic growth and inflation, the Central bank of Armenia has made twelve rate cuts in the last 2 years from 10.5% to 6% as of February 2017. Policymakers expect economic activity to recover and inflation to accelerate to around 2% in 2017.

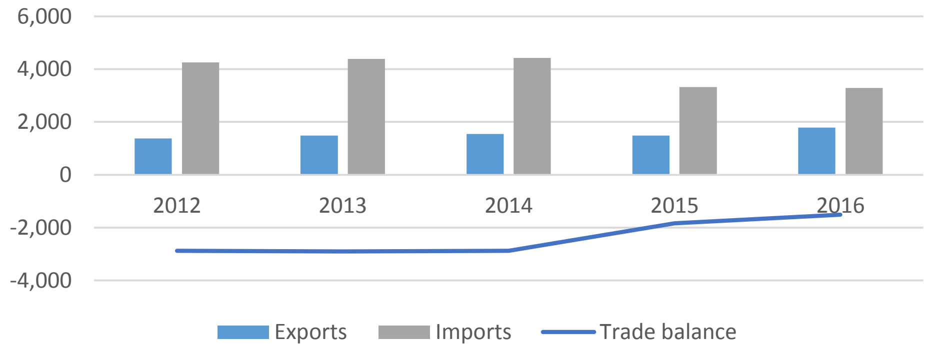
Inflation in Armenia, % (2010-2017f)



Source: IMF, Samruk-Kazyna

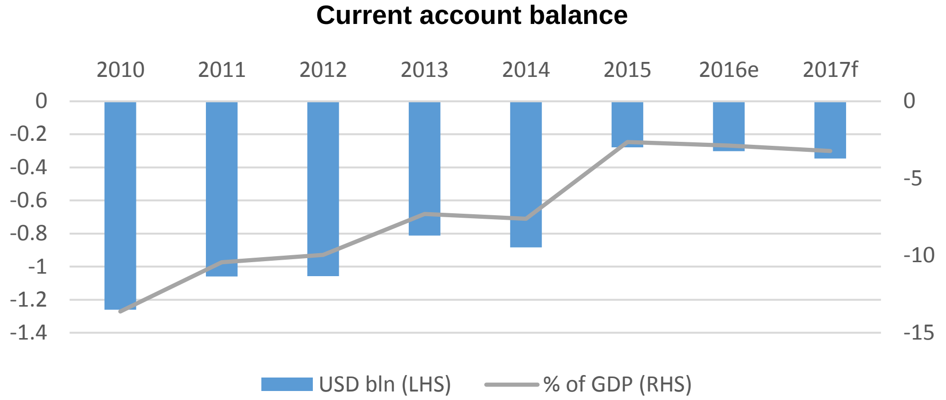
Armenian trade deficit declined from USD1.84bln in 2015 to 1.51bln in 2016 due to increased exports from 1.49bln in 2015 to USD1.78bln in 2016. Meanwhile, imports remained virtually unchanged due to subdued consumer demand. Nevertheless, the country holds a consistent trade deficit due to low export diversification and competitiveness. In 1Q17, trade deficit stood at USD360.6mln as exports went up by 16.5% to USD443.1mln while imports rose at a much faster pace of 17.9% to USD803.7mln.

Armenian trade balance, USD mln (2010-2016)



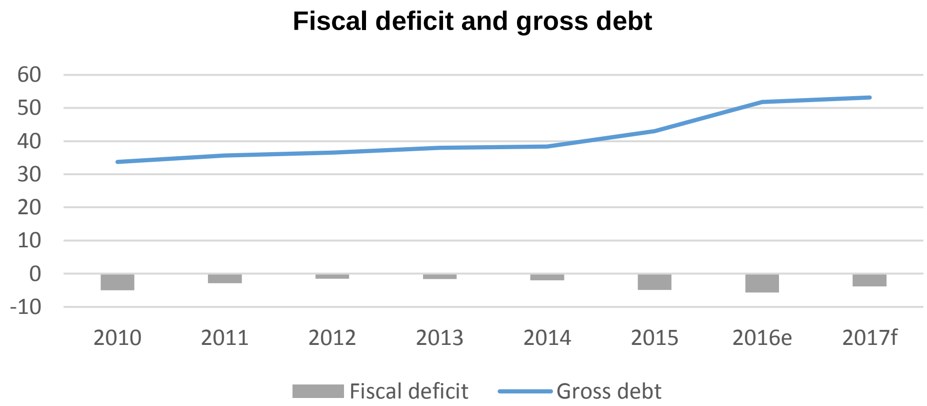
Source: Armenian Statistical Service, Samruk-Kazyna

About 80% of exports are provided by four sectors – mineral ores (26.4%), prepared foodstuffs (23.4%), precious and semi-precious stones/metals (18.9%), as well as non-precious metals (12.4%). Top ten importers of Armenian goods and services are: Russia (20.8%), Bulgaria (8.5%), Georgia (8.2%), Germany (7.8%), Canada (7.8%), Iraq (7.7%), China (5.4%), Iran (4.2%), Switzerland (4.2%) and the UAE (3.6%). In 2016, exports to Russia and Bulgaria rose by 51.5% and 93.1% respectively, while exports to the UAE grew seven-fold. Exports to China decreased by 41.7% last year.



Source: IMF, Samruk-Kazyna

As a result, Armenia holds a consistent current account deficit, in 4Q16 it increased to USD184mln vs. USD93.8mln gap in the same period a year ago. The surplus in primary income narrowed to USD132.1mln (from USD186.9mln surplus in 4Q15), mainly due to lower investment income, direct investments and remittances, which have declined as a result of the economic downturn in the neighboring countries. In contrast, secondary income surplus expanded to USD175.5mln (from USD171.8mln). Current account deficit is expected to widen in 2017 to USD347mln from USD302mln in 2016.



Source: IMF, Samruk-Kazyna

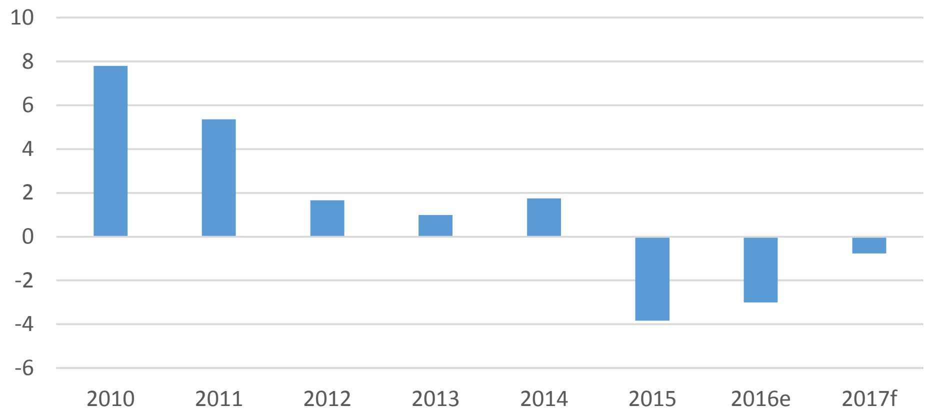
Gross government debt in Armenia increased to USD9,952mln at the end of 2016 from USD9,239mln in 3Q16. Consequently, gross debt to GDP ratio rose from 43% in 2015 to 51.8% in 2016. Armenian officials forecast that the gross public debt would continue increasing in 2017, reaching 53.1% of GDP, despite the government's measures to balance its fiscal stance and increase tax revenue. Nevertheless, Armenia's fiscal stance and external positions are supported by loans from international financial institutions.

The outlook for 2017 is positive mainly due to the recovery of regional economies, namely Russia, which is a major export market and source of investment. Remittances from Russia are expected to rebound, which should provide a modest boost to household income, and inflationary pressures are expected to remain relatively weak. On the other hand, Armenia is not likely to achieve high growth rates due to subdued investments, high financing costs, unfavorable business environment and limited access to international markets.

5. Belarus

In 2016, Belarus' GDP at current prices amounted to BYR94.3bln, showing a contraction of 2.6% or 3.0% vs. 2015 in real terms. This follows a contraction of 3.9% in 2015, taking the cumulative fall for the two years to 6.4%. Most of the sectors of Belarus' economy declined throughout 2016: the volume of industrial production decreased by 0.4% YoY to BYR79.4bln, while retail and wholesale trade decreased by 4.1% and 10.4% respectively. The only major sector that showed growth was agriculture, growing by 3.4% to BYR15.3bln. The economy of Belarus expanded 0.3% YoY in 1Q17, this was the first positive quarterly result in more than 2 years.

GDP growth in Belarus, % (2010-2017f)

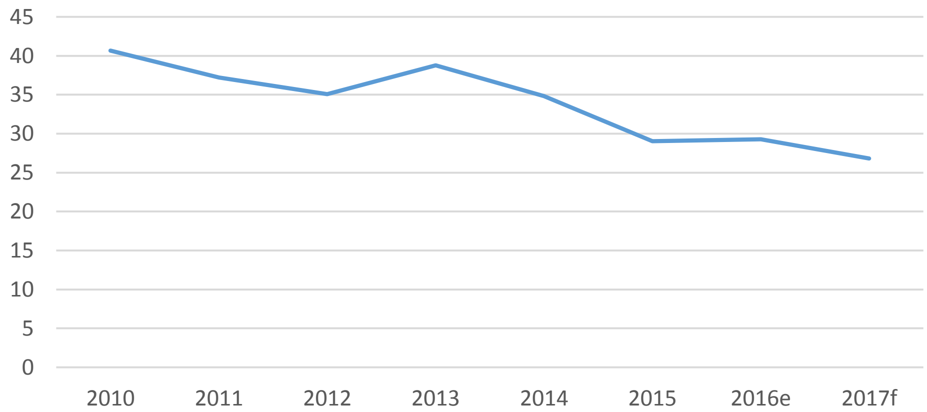


Source: IMF, Samruk-Kazyna

Note: official estimates differ from IMF estimates, which stand at -3.8% in 2015 and -3.0% in 2016

Although both GDP and industrial output fell at slower rates than in 2015, this does not ensure that the economy is on the road to recovery. Capital investment declined by 17.9% last year, on top of a fall of 17.5% in 2015. State-owned enterprises cut their investments by 17.1%, while private businesses decreased investments by 13.2%. In 2017, the decline is expected to continue, limiting potential growth.

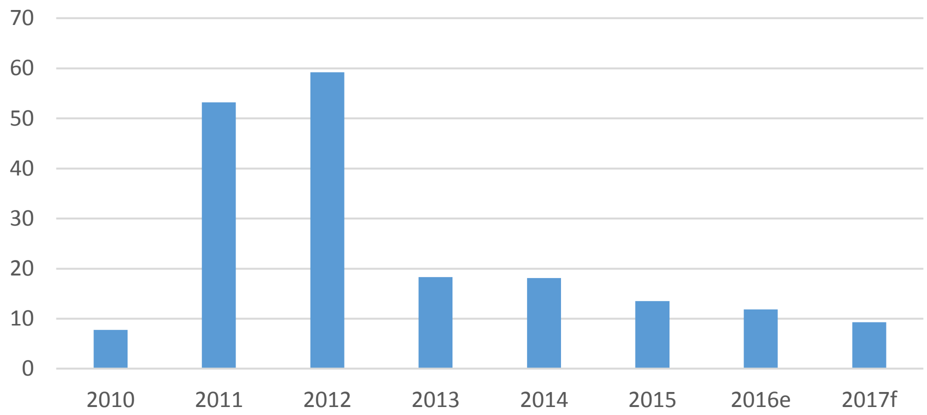
Total investments, % of GDP (2010-2017f)



Source: IMF, Samruk-Kazyna

In 2016, the index of consumer prices for goods and services in Belarus rose by 11.8% YoY compared to 13.5% YoY in 2015 and 18.1% YoY in 2014. Unlike the previous years, when the inflation was driven by continuous devaluation of the Belarus ruble, in 2016, was driven by internal factors. Food prices rose by 10.4% YoY, while non-food prices went up by 9.4% YoY, at the same time, prices in services industries rose by 19.7% YoY. Eroded by high inflation, real individual incomes declined by 7.5% in 2016, after a 5.5% drop in 2015. Real wages have been contracting since 2H14. The government has limited fiscal space to raise wages in the public sector.

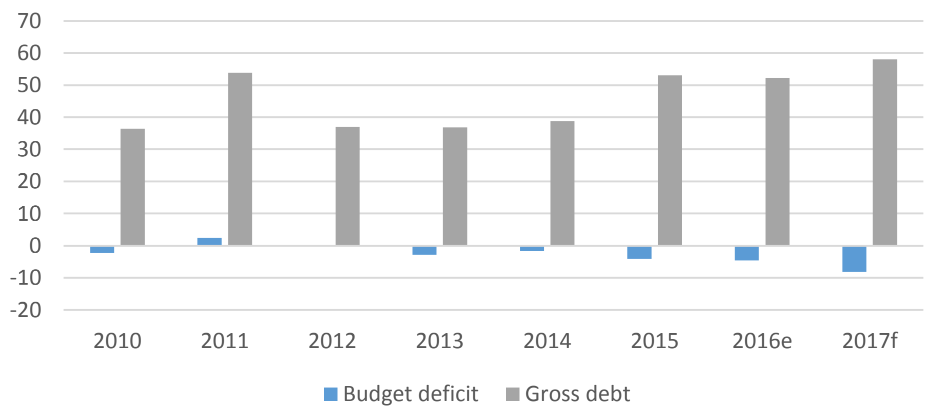
Inflation, % YoY (2010-2017f)



Source: IMF, Samruk-Kazyna

The government is undertaking some market reforms to attract financing from international financial institutions. The switch to a currency float has helped to absorb external shocks and raise reserves, which nevertheless remain low. In addition, the government has liberalized prices for some consumer goods, cut some subsidies and raised several tariffs. Price liberalization, privatization and implementation of private property legislation are among the most needed reforms that would boost competitiveness and innovation, raise export earnings and promote economic growth. They would also increase fiscal space and reserves, which will help reduce Belarus' exposure to external shocks. Gross government debt in Belarus decreased slightly to 52.3% of GDP from 53.4% of GDP in 2015. Despite the fact that Belarus officials plan a positive fiscal stance in 2017, government debt is forecasted to increase to an all-time high of 58% in 2017.

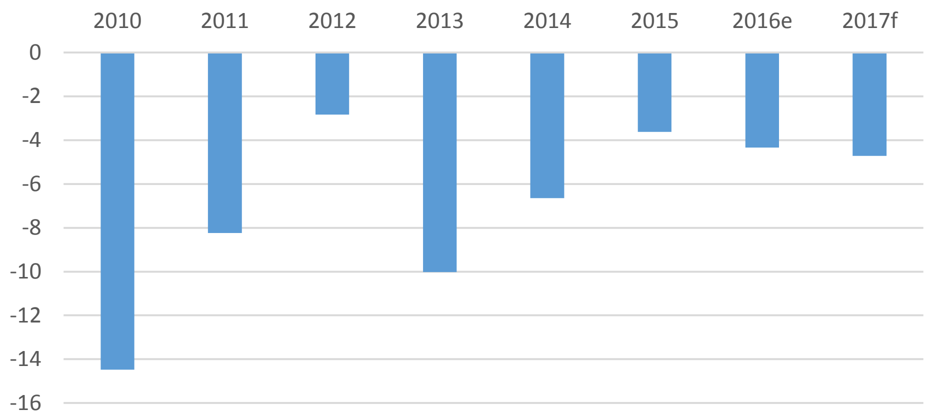
Budget deficit and gross debt, % of GDP (2010-2017f)



Source: IMF, Samruk-Kazyna

In 2016, the pace of the decline in trade slowed compared with 2015, but the trade deficit widened by USD450mln to USD2.6bln, since import revenues experienced a slower decrease compared to exports, by 9.7% vs/ 12.2% for exports. Export revenue from the EU fell by 33.7%, while exports to Russia began to grow YoY starting from August 2016. The reduction of Russian crude oil supplies to the refining capacities in Belarus contributed to a 10.8% fall in imports from Russia. Capital accounts also showed some deterioration in 2016 due to a continued recession in Russia, which is a major source for investments and remittances in Belarus. Consequently, the current-account gap widened to about -4.3% of GDP in 2016 from -3.6% of GDP in 2015.

Current account balance, % of GDP (2010-2017f)



Source: IMF, Samruk-Kazyna

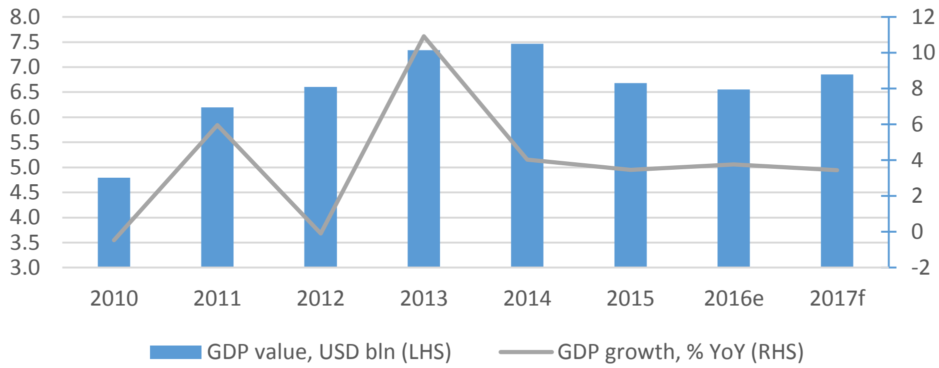
In 2017, external improvements in prices and demand will raise export earnings and increase capital inflow. Consequently, the economy might start recovering from a two-year recession, as evidenced by the 0.3% growth YoY in 1Q17. However, weak domestic demand, consolidation of budget expenditures, weak lending and lack of investments in fixed capital will restrain the economy from expanding in 2017. At the same time, lack of structural and institutional reforms will inhibit medium-term growth prospects. Weak external positions and high level of government debt also pose threat to medium-term potential of the Belarus economy.

6. Kyrgyz Republic

Real GDP of Kyrgyzstan grew by 3.8% YoY in 2016, recovering from a -2.3% contraction YoY in 1H16. Such growth was possible due to increased production on Kumtor gold mine, as well as increased remittances in the end of the year. The gold sector is an important element of the economy, accounting for 25% of industrial production and about 42% of exports in 2016. Overall industrial production in 2016 increased by 4.9%, driven by manufacturing industry (+5.0% YoY), which accounts for 78% of the industrial production. Services industries, such as retail and wholesale trade and hospitality rose by 7.2% and 9.5% respectively.

Positive economic dynamics continued into 2017 as growth in 1Q17 reached 7.8% YoY partially due to the low base effect of early 2016. GDP growth excluding production of gold at the Kumtor mine amounted to 3.9% YoY over the same period. At the same time, the volume of remittances has declined in early 2017 due to seasonal effects.

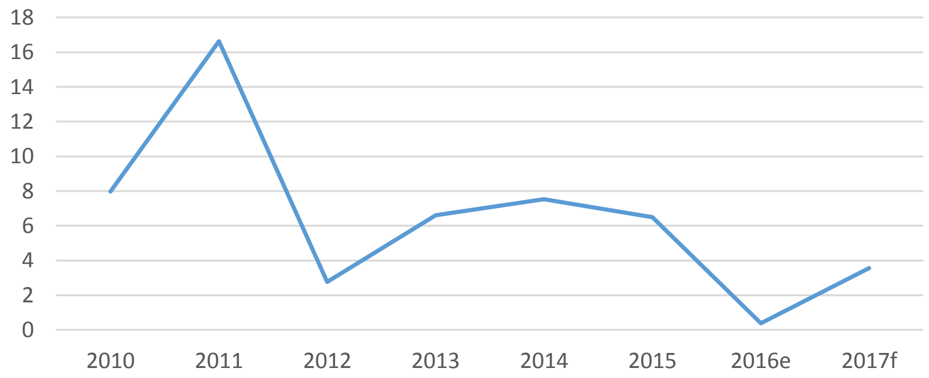
GDP value vs. growth rate in Kyrgyzstan, USD bln vs. % (2010-2017f)



Source: IMF, Samruk-Kazyna

The weakening of the national currency against the US dollar boosted inflation in the beginning of 2015, but inflationary pressures eased in 2016 due to low commodity and food prices, weak domestic demand and a slight appreciation of the currency on the back of the stabilization of the Russian ruble. Inflation stood at a historically low level of 0.4% YoY in 2016. Looking forward, higher remittances from neighboring countries will boost the money supply and may pose some inflationary pressure. Meanwhile, a modest recovery in some commodity prices will also drive import price pressures.

Inflation, % YoY (2010-2017f)

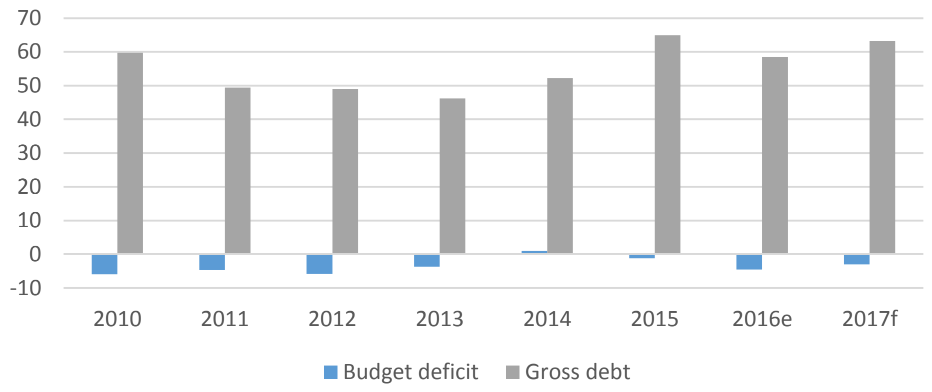


Source: IMF, Samruk-Kazyna

Weak household consumption and poor tax collectability negatively affected budget revenues in 2016, which grew by 1.9% YoY nevertheless. As a result, the budget deficit widened to an estimated 4.5% of GDP, from 1.2% of GDP in 2015. The government is targeting a deficit of 3% of GDP in 2017 as the economy starts to recover. The depreciation of the national currency in 2015 has led to a record increase in the gross government debt to 64.9% of GDP in 2015. Consequent appreciation of the currency eased the debt burden to 58.5% of GDP.

One of the main problems for the officials in Kyrgyzstan is the collectability of taxes. In 2016, tax revenues were KGS6.9bln (around USD100mln) less than planned, including KGS4.1bln in taxes and 2.1bln in customs duties. Such losses indicate a high level of the shadow economy, which is estimated to be from 50% to 70% of GDP. The government has to address these issues to ensure fiscal sustainability in the medium-term.

Budget deficit and gross debt, % of GDP (2010-2017f)

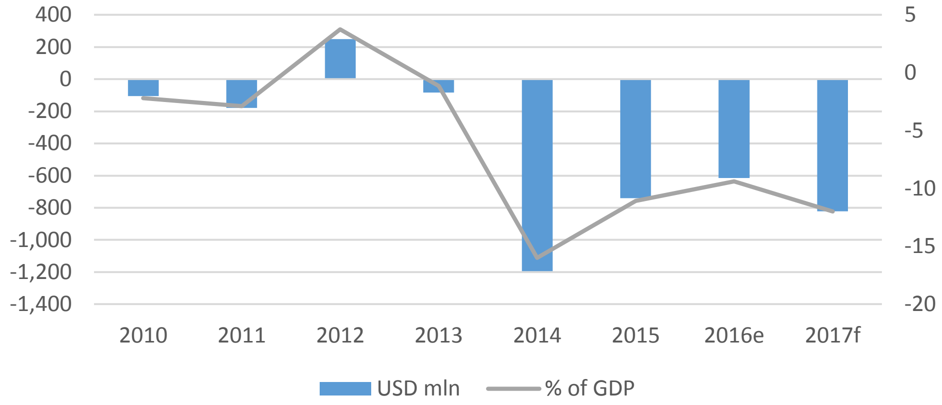


Source: IMF, Samruk-Kazyna

National Bank of the Kyrgyz Republic has lowered its rate by 200bps to 6% in May 2016, then further to 5% in November and to 5% in late December, as the pressure on the national currency eased due to appreciation of regional currencies. Adjustments to the base rate will have a limited impact on the money market as the high dollarization of the economy limits the regulator's ability to control interest rates and inflation through monetary policy. In addition, bank lending in Kyrgyzstan traditionally plays a limited role in financing investments in the economy.

As in many other Central Asian economies, the officials are taking measures to dedollarize the economy: in February 2016, the Central Bank banned new mortgages and consumer loans in foreign currency. The government has also converted some foreign-currency mortgages into the national currency, as well as reduced the interest rates on deposits in foreign currency to less than that offered in som. These measures have had limited effect in reducing the share of loans denominated in foreign currency, as they still accounted for 44.5% of total loans as at end-2016.

Current account balance, USD mln vs. % of GDP (2010-2017f)



Source: IMF, Samruk-Kazyna

The current-account deficit narrowed to 11.1% of GDP in 2015 from a record 16% in 2014. Currency depreciation and softer domestic demand as a result of weaker remittance flows significantly reduced imports in 2015, although exports also decreased due to weaker external demand. In 2016, current account deficit decreased further to 9.4% of GDP.

This was due to increased remittances, as well as an improvement in external trade. Exports in 2016 increased to USD1.54bln from USD1.47bln in 2015, while imports decreased to USD3.92bln in 2016 vs. USD4.07bln in 2015 despite the appreciation of the currency. Kyrgyzstan's external trade is highly dependent on the exports of gold and other precious metals and stones, which have accounted for almost a half of total exports. Other exports include textiles and agricultural products. Main export partners are Switzerland, Kazakhstan, Russia and Uzbekistan.

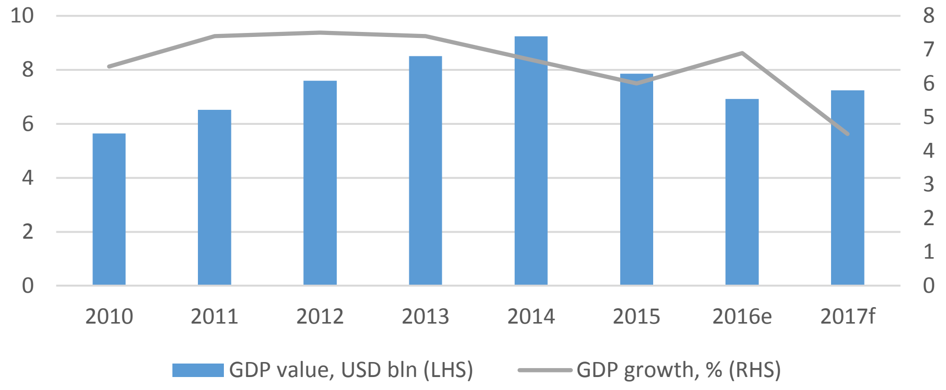
The Kyrgyz Republic recently joined the Eurasian Economic Union, which includes Kazakhstan, Russia, Armenia and Belarus. The main economic impact of this membership is through the simplification of procedures for Kyrgyz citizens to work in the EAEU member-countries, which are a major source of remittances and household income. Other benefits include expansion of trade and capital flows.

Looking forward, Kyrgyzstan's economy is expected to grow by about 3.5% in 2017 due to improved performance of the largest regional economies, Russia and Kazakhstan. However, private consumption and government spending are expected to remain subdued, holding back economic growth. Domestic investments will remain moderate, while the country might see an inflow of foreign investment into infrastructure under the Chinese One Belt One Road initiative.

7. Tajikistan

Tajikistan's GDP in real terms grew by 6% in 2015 and 6.9% in 2016 despite the devaluation of the national currency and the decline in remittances from Russia after the economic downturn in the country and the devaluation of the ruble. Growth was supported by mining, agriculture, manufacturing, as well as substantial government investments. Industrial production expanded by 16% YoY in 2016 vs. 11.2% in 2015, while capital investments, driven by government spending, grew by 17.4% YoY.

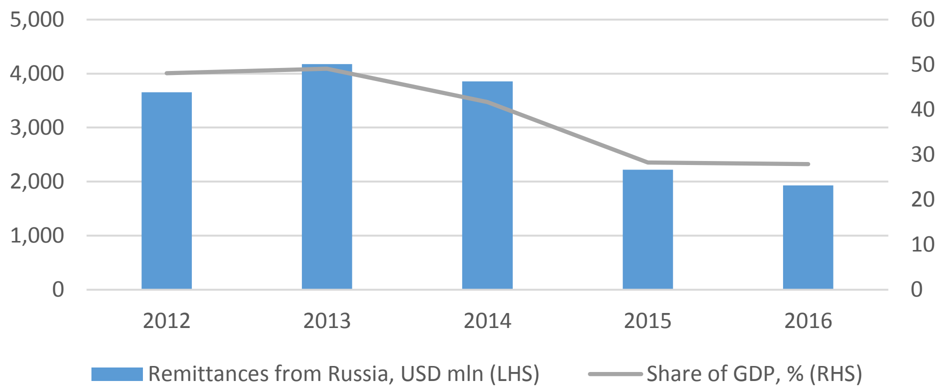
GDP value vs. growth rate in Tajikistan, USD bln vs. % (2010-2017f)



Source: IMF, Samruk-Kazyna

Meanwhile, weaker domestic demand and the decrease in in global prices for Tajikistan's two main export commodities, aluminum and cotton, constrained economic growth in 2015 and 2016. Weaker remittances negatively affected disposable incomes of the population, which resulted in a continuous decline in services (-0.3% in 2016 vs. -7.1% in 2015). Aluminum output fell to 129,300 tons in 2016, from 139,100 tons in 2015, as global prices for aluminum averaged USD1,400-1,700 per ton, while domestic production costs were as much as USD2,000 per ton. At the same time, banking sector problems constrained investment activity. Other factors that impeded economic growth include tightening of the fiscal space and the devaluation of the national currency. Nevertheless, GDP growth in 1Q17 amounted to 6.5%, while the government forecasts economic growth of 9.4% in 2017.

Remittances to Tajikistan from Russia, USD mln (2012-2016)



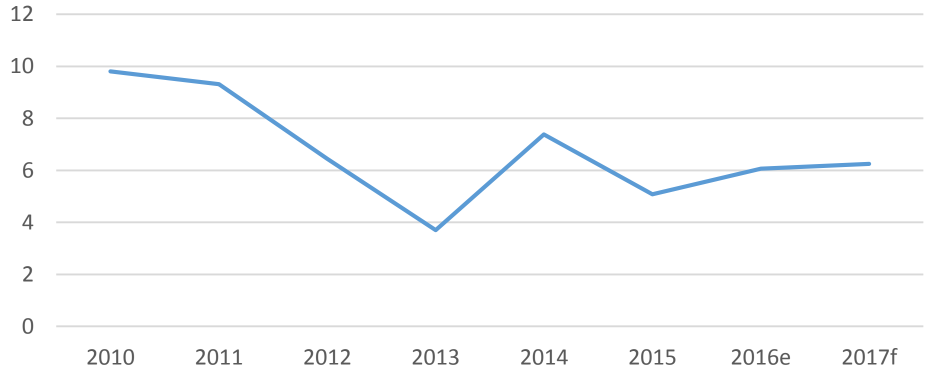
Source: Bank of Russia, Samruk-Kazyna

Historically, remittances from neighboring countries have been a major source of capital inflows, money transfers from Russia alone amounted for as much as 49% of the GDP in 2013. Economic recession in

Russia driven by lower commodity prices and Western sanctions resulted in a significant reduction of remittances to Tajikistan. The value of remittances fell by 42.4% in 2015 and 13.1% in 2016. Consequently, money transfers from Russia only totaled USD1.9bln in 2016, which is equivalent to almost 30% of the GDP of Tajikistan.

Worsening of the external conditions, resulted in a devaluation of the national currency in 2015 and early 2016. This, in turn, caused a slight increase in inflation, which accelerated to 6.1% from 5.1% in 2015. Prices rose by 6.8% for food, 5.7% for other goods, and 4.5% for services. Public sector wage increases of 10%–20% in July 2016 and a raise in electricity tariffs in November also fueled inflation. CPI growth reached 7.3% YoY in March 2017, slightly above the target rate of 7%.

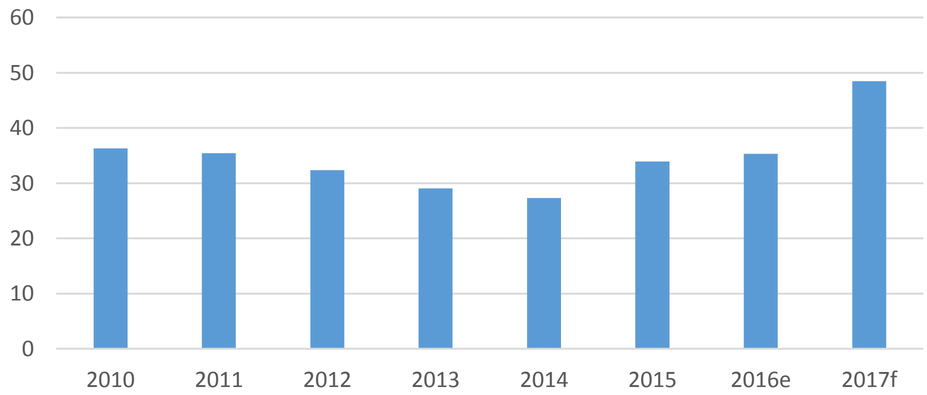
Yearly inflation, % (2010-2017f)



Source: IMF, Samruk-Kazyna

National Bank of Tajikistan's monetary policy in 2016 was aimed on maintaining currency stability and combating inflation. To limit depreciation, the regulator required from February 2016 that all remittances should be converted to the national currency and that banks immediately sell half of the foreign currency converted to the National Bank. Combined with tightened foreign exchange controls, these measures helped stabilize the exchange rate for the rest of the year and reduce the share of deposits in foreign currency from 71.5% as at end-2015 to 62.5% as at end-2016. To combat inflation, the central bank raised the refinancing rate from 8.0% to 9.0% in March 2016, then to 11.0% in July, to 12.5% in February 2017, and finally to 16.0% in March 2017. In addition, in March 2017, it increased reserve requirements.

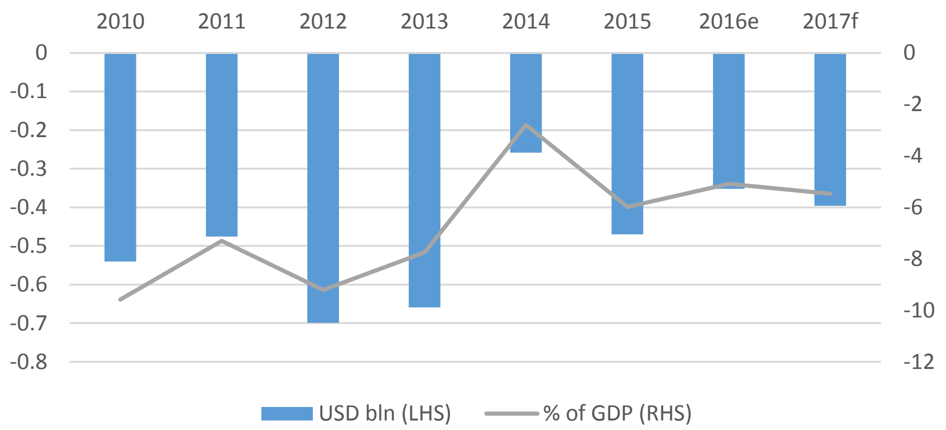
Gross government debt, % of GDP (2010-2017f)



Source: IMF, Samruk-Kazyna

Tajikistan's general government budget recorded a deficit equal to 1.7% of GDP, less than the 2.3% in 2015. Tax revenues were negatively affected by low trade and remittance flows, and weak domestic demand. Nevertheless, total revenues reached 32.1% of GDP vs. 30.1% in 2015, mainly due to improved administration and collection of taxes. Expenditures rose to 33.8% of GDP from 32.4% in 2015 as the government maintained social programs and used foreign financing to expand capital investment. The 2017 budget increases expenditures by 8.5%, of which about 40% will be allocated on social spending. The government projects a deficit equivalent to 0.5% of GDP, which will be financed using privatization revenue, domestic borrowing and international assistance. Public and publicly guaranteed debt climbed to 35.3% of GDP in 2016 from 33.9% a year earlier, mainly due to increased external borrowing and currency depreciation. As a result of increased government spending, gross government debt may reach 48.5% of GDP in 2017, according to IMF estimates.

Current account balance, USD bln vs. % of GDP (2010-2017f)



Source: IMF, Samruk-Kazyna

Tajikistan's current account deficit narrowed to about 5.1% of GDP in 2016 vs. 6% in 2015 despite a further decline in remittance inflows. Such dynamics was due to exports rising by 0.9% on the back of higher domestic output and despite lower global prices for the country's main exports. Meanwhile, imports fell by 11.8% mainly due to lower private consumption and subdued global food prices. Gross international reserves rose in the 9M16 by 50% as a result of the purchase of domestically produced gold, higher gold prices, and the conversion of private savings from foreign to local currency.

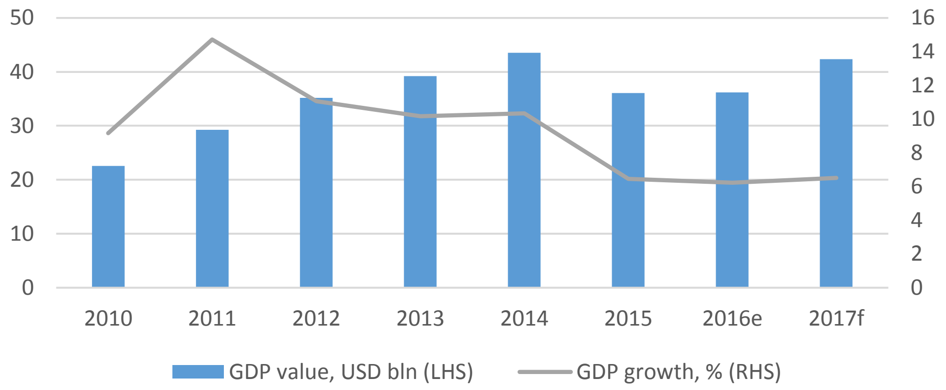
Economic growth is forecasted to slow down to 4.5%-4.8% in 2017, according to various estimates. Weaker GDP growth is primarily attributed to systemic problems in the country's financial sector, tightening monetary policy and lower remittances inflows despite the recovery in Russia and other regional partners. Economic activity in the private sector is expected to be subdued due to increased tax burden. Both monetary and fiscal policy would constrain private investments, which could inhibit medium-term growth prospects. Meanwhile, inflation is expected to remain higher than the official target. At the same time, the government may not be able to implement a wider fiscal stimulus in the coming years given the tight financing constraints, higher external debt and the need for external assistance.

8. Turkmenistan

Turkmenistan's economy grew at 6.2% in 2016 vs. 6.5% a year earlier, after four years of double-digit growth. The slowdown is attributed to lower global commodity prices, weaker demand for Turkmenistan's exports, namely oil & gas, from trade partners, worsening terms of trade and a slowing of investment. As a result, oil and gas industries expanded by only 2.8%, the same rate as in 2015. Consequently, economic growth was supported by non-hydrocarbon sectors, which expanded by 6.6% in 2016.

Expansion was slower than 8.5% in 2015 as industry, historically the country's key driver of growth, expanded by only 1.2% vs. 3.1% in 2015 and 11.4% in 2014 as the contraction in commodity sectors had spillover effects on other industries. Services grew by 11% vs. 10% in 2015, driven by increases of 14.2% in trade, 10.4% in transport and communications, 4.4% in construction services, and 9.7% in other services. Agriculture grew by 12% mostly due to increased production of cotton and wheat. As in other relatively closed regional economies, official statistics raises doubts regarding its accuracy.

GDP value vs. growth rate, USD bln vs. % (2010-2017f)

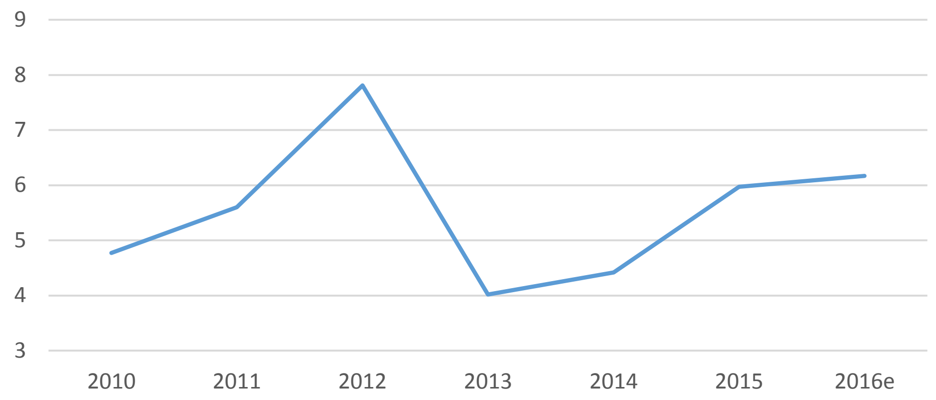


Source: IMF, Samruk-Kazyna

Growth was also driven by both government and foreign investments. Gross investments growth is estimated at 39% of GDP in 2016, including 13% through foreign direct investments. Official statistics shows that the volume of capital expenditures has increased by only 0.4% YoY in 2016, while the volume of foreign investments into fixed capital has declined by 27.6% YoY. Investments were allocated mostly into gas, oil, and chemical processing industries. Growth in consumption, especially private consumption expenditures, was less robust as inflation and currency depreciation caused a deterioration of real disposable incomes despite a 10% rise in salaries, pensions and other social security payments.

Official sources report that inflation in 2016 rose to 6.2% vs. 6% in 2015, although IMF estimates inflation rate in Turkmenistan at 7.4% in 2015 and 3.5% in 2016, while CIA's estimates are much higher at 16% in 2015 and 11% in 2016. High inflation was driven by the devaluation of the national currency in the beginning of 2015, higher utility tariffs and rising prices for imported consumer goods due to higher import duties. To keep inflation within projections, the government continued to regulate prices to stimulate import substitution, aiming to ensure that supplies of domestically produced consumer goods were sufficient and affordable.

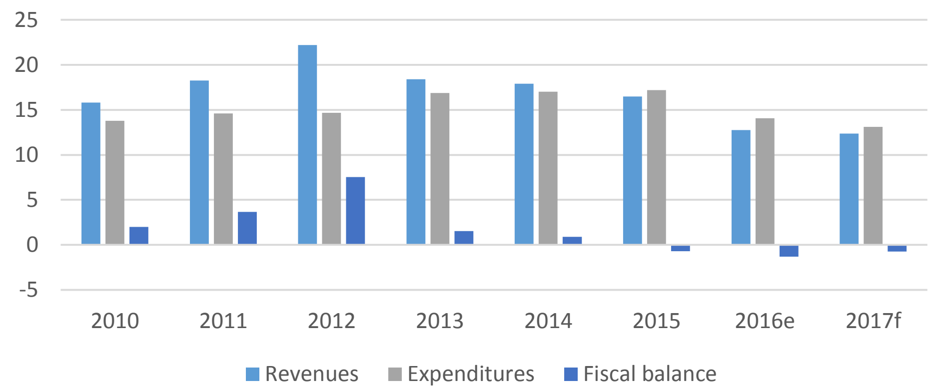
Yearly inflation, % (2010-2017f)



Source: IMF, Samruk-Kazyna

In addition, the Central Bank of Turkmenistan keeps strict control of cash in circulation by limiting foreign exchange conversion. Tight monetary policy, reduced bank lending and more increased regulation of financial operations resulted in a reduction of broad money growth to 7.2% in 2016 from 16.1% in 2015. Central Bank's strict monetary policy that includes a fixed exchange rate, price controls and foreign exchange regulations is expected to continue in 2017 and 2018.

Fiscal position, % of GDP (2010-2017f)

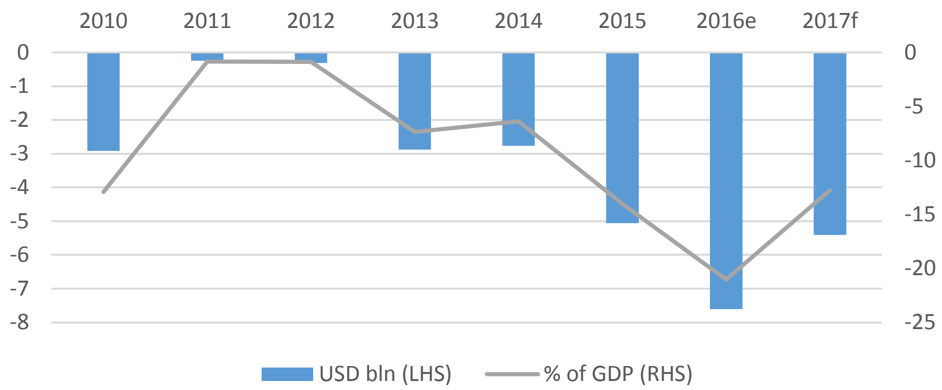


Source: IMF, Samruk-Kazyna

The government budget deficit is estimated to have increased to 1.3% of GDP in 2016 vs. 0.7% deficit in 2015. Revenues amounted to about 12.8% of GDP, decreasing from 16.5% of GDP in 2015 and 17.9% of GDP in 2014, while expenditures decreased to 14.1% of GDP in 2016 vs. 17.2% in 2015 and 17% in 2014. Over 80% of government spending went to social programs and social security payments, including a 10% rise in salaries. The government is starting to prioritize large investment programs in an attempt to rationalize budget expenditures. As non-oil and gas industries show impressive growth, Turkmenistan's non-hydrocarbon budget deficit gradually shrank from 11.2% of non-hydrocarbon GDP in 2014 to 8.2% in 2015 and 6.8% in 2016. Turkmenistan's Stabilization Fund provided resources to smooth revenue volatility and offset contraction from lower energy exports. The state budget does not take into account quasi-government operations, which are believed to be large.

The current account deficit is estimated to have widened to 21% of GDP vs. 14% in 2015 due to higher FDI-related imports of services combined with lower exports of commodities, which account for 85% of all exports. In 2016, exports of goods declined by 15.4% YoY while imports of goods contracted by 16.7% YoY. External debt, entirely public, has been increasing from 18% in 2014 to 19.4% in 2015 and 23.9% in 2016, although this level of debt is considered quite low and sustainable.

Current account balance, USD bln vs. % of GDP (2010-2017f)



Source: IMF, Samruk-Kazyna

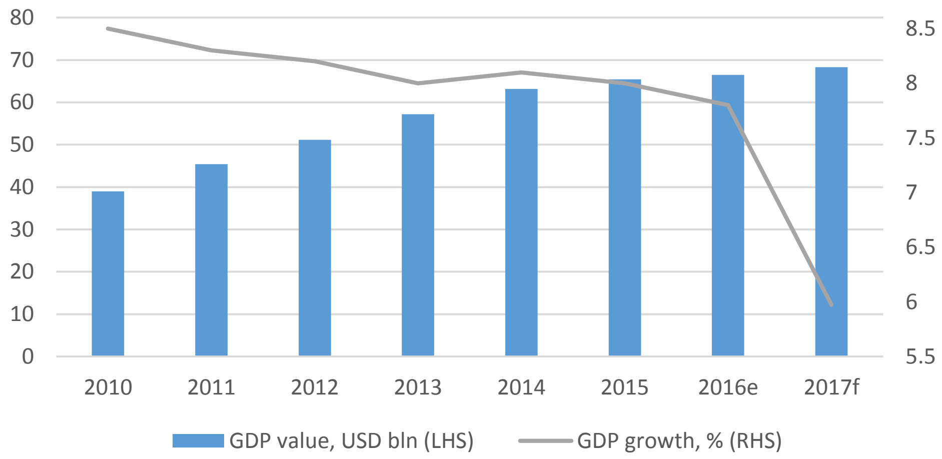
Economic growth is projected to rise slightly to 6.5% in 2017, driven by government investment, strong FDI inflow, as well as private and public consumption. Improvement in the external environment, including the recovery of global commodity prices should increase output in the mining industry, exports and fiscal revenue. Industrial production is projected to expand by 4%–5%, supported by growth in food processing, agro-industry, light industry, construction materials and chemicals. The government prioritizes these industries for the purposes of import substitution. Agriculture is another sector that would benefit from extensive government support, it is forecasted to grow by as much as 10% in 2017 and 2018. Demand for services is projected to grow by more than 10% due to increased real disposable incomes.

Government's policy will focus on controlling inflation by maintaining a tight monetary policy. However, high interest rates would constrict lending to businesses, so investment activity would depend on direct financing from the government. Fiscal policy in 2017 is expected to be more contractionary, as revenues remain virtually unchanged, while expenditures would decrease to 13.1% of GDP. Officials project a state budget deficit of 0.4% of GDP and a surplus of 0.5% in 2018 attributed to higher commodity prices and expansion of the non-commodity sectors of the economy. The government plans to continue supporting social programs and build industrial infrastructure to create jobs and raise incomes. Favorable external environment would decrease the current account deficit through increased exports, while external debt is forecasted to decrease to 21.9% of GDP.

9. Uzbekistan

GDP growth in Uzbekistan slowed slightly to 7.8% in 2016 vs. 8% in 2015, supported by government expenditures and investments. The economy was negatively affected by weaker than expected growth in Uzbekistan's key trading partners. Industry and agriculture in 2016 each grew by 6.6%, lower than 8.0% and 6.8% respectively in 2015, mainly due to the weak external environment. Services industries expanded by 10.7% vs. 9.8% in 2015, driven by finance, retail and wholesale trade, as well as telecommunications. Meanwhile, public investment in infrastructure and housing resulted in a 12.8% growth of the construction industry.

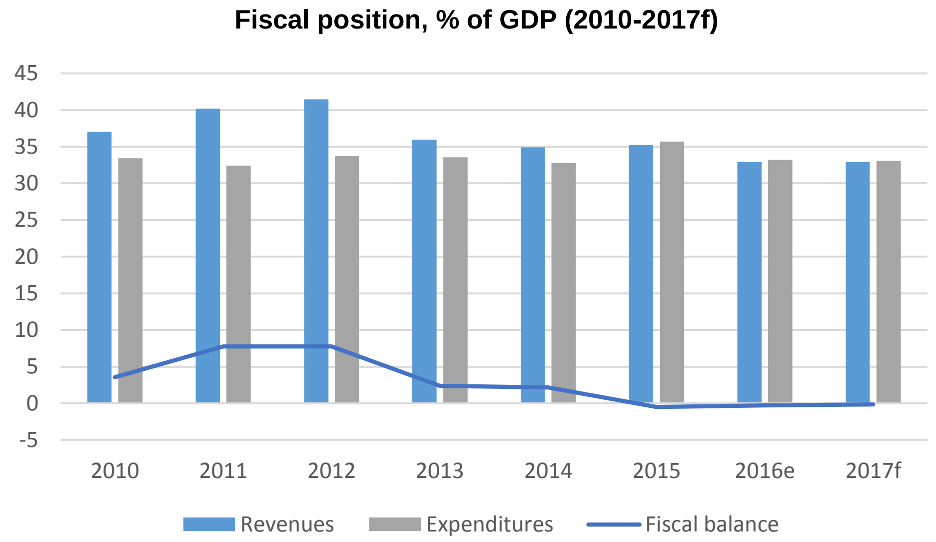
GDP value vs. growth rate, USD bln vs. % (2010-2017f)



Source: IMF, Samruk-Kazyna

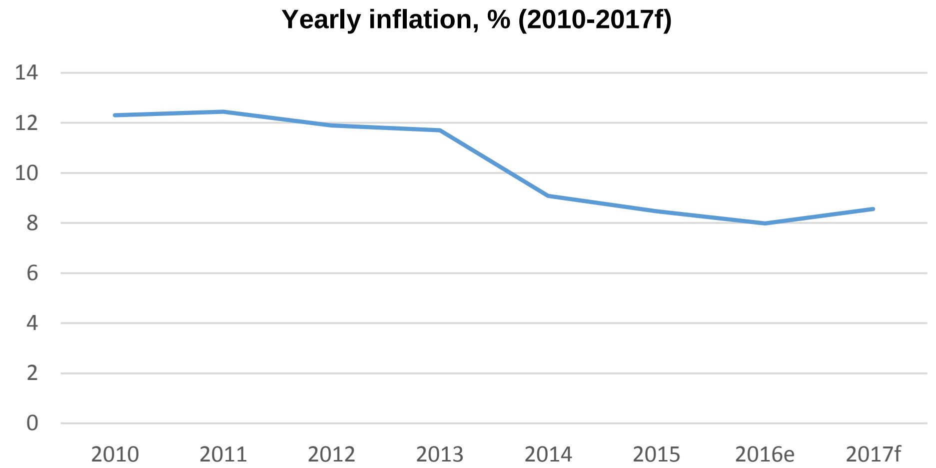
Investment was the main driver of growth in 2016, as capital expenditures increased by 9.4%, slightly below the 9.9% expansion in 2015. This is attributed to the decrease in financing from commercial banks and the Fund for Reconstruction and Development, Uzbekistan's sovereign wealth fund, and other government specialized funds, which focus on infrastructure development and social projects. Meanwhile, investments by private sector showed an increase. The share of foreign investments, which are concentrated in energy and petrochemicals, rose to 21.9% of total in 2016 vs. 20.4% in 2015.

Uzbekistan's fiscal stance is stable as officials reported the fiscal budget with a surplus of 0.1% of GDP in 2016. However, this data may not be accurate, since the country's reporting standards do not include a detailed breakdown of revenues and expenditures. The IMF estimates 2016 fiscal balance at -0.3% of GDP vs. -0.5% of GDP in 2015. Consolidated budget revenues declined from 35.2% of GDP in 2015 to 32.9% of GDP in 2016, mostly due to decreased income from exports of key commodities. Consolidated budget expenditures declined as well, from 35.7% of GDP in 2015 to an estimated 33.2% in 2016, partially due to decreased social spending. Salaries in the public sector and social security payments rose by 3.4% YoY in nominal terms, less than the nominal increase in GDP and the inflation. Government debt, rose to 11.6% of GDP in 2016 vs. 10.3% in 2015 as the government increased borrowing to finance infrastructure development.



Source: IMF, Samruk-Kazyna

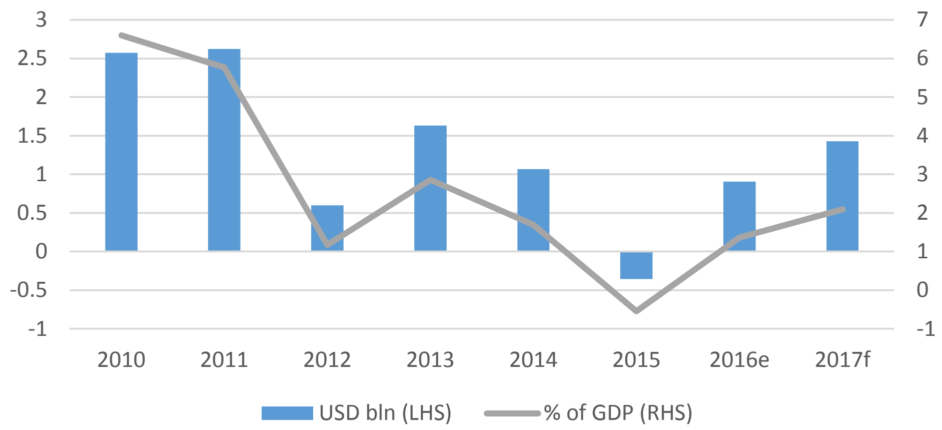
Official inflation estimate stood at 5.7% YoY in 2016, well within the target range. Independent estimates show a different picture, CPI growth in 2016 averaged at 8% YoY vs. 8.5% in 2015. Despite increased tariffs and the depreciation of the national currency, inflation slowed in 2016 partially due to global food price deflation and lower import costs. Uzbekistani sum (UZS) officially depreciated against the USD by 15% in 2016 vs. 16% in 2015. However, the national currency on the black market depreciated by 19% in 2016 vs. 60% in 2015.



Source: IMF, Samruk-Kazyna

The current account balance showed a 1.4% surplus in 2016, after a 0.5% deficit in 2015. Trade in goods showed a deficit of USD2bln vs. USD1.7bln in 2015. Exports of goods and services fell by 2.4% YoY in 2016, mainly because of the decline of global prices and weaker demand for natural gas, which is the largest export commodity in Uzbekistan. Imports of goods also declined by 1.2% YoY, partially due to tighter import controls and lower import costs, namely for food items and energy. Machinery and equipment remained the largest import good, amounting for 44% of all imports. Imports of services declined by 7.2% as well, due to demand for transportation and logistics services.

Current account balance, USD bln vs. % of GDP (2010-2017f)

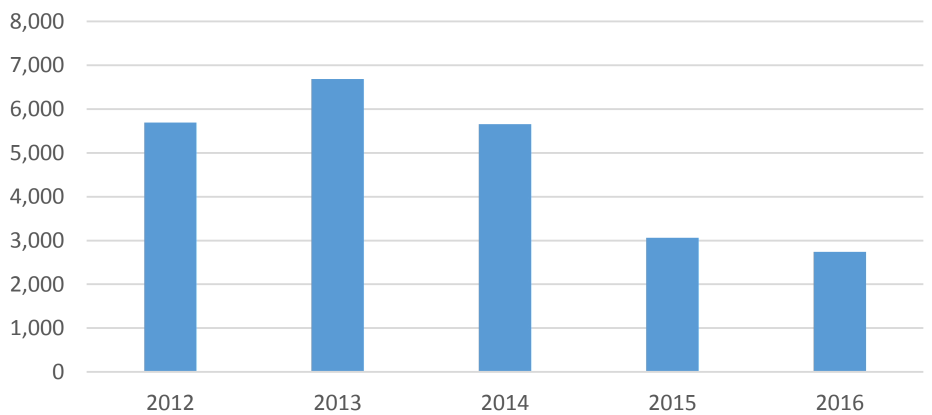


Source: IMF, Samruk-Kazyna

Slowing of the Chinese and Kazakh economies and the continued recession in Russia, Uzbekistan's main trading partners, continued to affect Uzbekistan's economy in 2016. Exports to China and Kazakhstan fell by 28% and 46%, respectively. Weak demand for labor force in Russia's construction, utilities and logistics sectors resulted in a sharp decrease of remittances since 2013. Money transfers from Russia into Uzbekistan declined by in 2016.

Growth of the Uzbekistan's economy is forecasted at 6% in 2017, driven by improved external conditions and higher investments, including those into infrastructure. The government plans to increase wages and social security benefits above the inflation rate, which should support private consumption and growth in services. Despite the improved economic performance of the main trading partners, remittance inflows are projected to remain subdued, limiting private consumption. Inflation is expected to speed up to 8.6%, mainly due to higher government spending and continued depreciation of the currency. The regulator has recently announced its plans to liberalize the exchange rate regime to allow the economy to adjust to external risks. Managing inflation will be the main challenge for the national bank that would require a close coordination of monetary and fiscal policies.

Volume of remittances to Uzbekistan from Russia, USD mln (2012-2016)



Source: Bank of Russia, Samruk-Kazyna

The government plans to raise expenditure to support a new national development strategy, which includes higher spending for health, education, and social security. Meanwhile, recovering global economy and a gradually improving economic situation in Russia and China should promote external trade and remittances. Import demand will come mostly from ongoing infrastructure spending and the industrial modernization program, as well as from the purchase of capital goods for the recently approved agriculture diversification program.

10. Conclusion

The IMF estimates economic growth in the Central Asian region at 2.4% in 2016, 0.8% lower than in 2015. In 2017, higher global commodity prices will support fiscal expansion in oil-exporting economies, while the devaluation of most regional currencies will support net exports. Overall growth in the region is projected to pick up to 3.1% in 2017 and further accelerate to 4.1% in 2018, although individual countries will grow at different rates. Inflation will be subdued in most of the regional economies due to a high base of 2016.

Russia, Kazakhstan, Turkmenistan and Uzbekistan have commodity-oriented economies, which depend heavily on global prices. Oil, gas and several other commodities have seen a significant drop in prices since early 2015, which has put some pressure on current account balances of these countries. Oil prices, which are a major source of export revenue for Russia and Kazakhstan, starter to rebound slightly in 2Q16 and are poised for stabilization at around USD50-52pb in the medium-term. While such price levels are significantly below pre-2014 highs, they should support external balances of several Central Asian economies.

Recovery in Russia and faster than expected growth in China are expected to play a crucial role for the economies of the region. In addition, Central Asia will benefit from the realization of the Chinese One Belt One Road initiative, which includes massive investments into the region's infrastructure. At the same time, Russian economy is expected to return to growth, which will intensify remittance flows into some of the Central Asian countries. Integration of Armenia, Belarus, Kazakhstan, Kyrgyzstan and Russia within the Eurasian Economic Union will provide additional economic benefits through the expansion of trade and capital flows, as well as free movement of the labor force.

Nevertheless, most economies of the region are still facing internal and external imbalances, which require adequate response from the governments through monetary, fiscal and structural policy measures. One of the largest problems for the majority of the regional economies is rising government debt and diminishing fiscal space. With the exception of a few countries, the governments used fiscal stimuli to offset the impact of external shocks. While this provided some support to economic activity, fiscal space has declined and public debt is now higher. Some countries would have to implement further fiscal consolidation, adopt more accommodative monetary policy and enforce institutional reforms to ensure a fast recovery and sustainable growth in the future.

In addition, the economic slowdown, coupled with exchange rate depreciation, had an adverse impact on the heavily dollarized financial sectors of the Central Asian economies. Inefficient banking sector is a big impediment to future growth. Consequently, medium-term growth in the region is expected to remain below the historical average, reflecting a relatively subdued external outlook, and domestic structural problems.

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