1 October 2024
EM macro and credit

Note: This is a non-investment research report and does not include the investment strategies and trade recommendations contained in the Global Markets Research version to be found on research.ing.com

CIS macro and credit

Fiscal side back in the spotlight

Contents

In line with our initial view at the start of last year, the CIS-4 countries continue to show signs of fiscal easing, which is leading to upward revisions in projected CPI and key rate trajectories and, in some cases, to deterioration in the FX rate views. In the sovereign credit space, we expect new Eurobond issuance will be met with strong investor demand.

Country views

- Economic activity **in Armenia** is moderating as the momentum related to high-skilled immigration in 2022 and higher participation in the external trade is wearing off. The role of domestic drivers of financing activity is increasing. Re-integration of refugees from Nagorno-Karabakh and continued tensions with Azerbaijan are likely to keep the fiscal deficit elevated. The resulting higher CPI risks should limit the scope for monetary policy easing. The Armenian dram, which has so far avoided depreciation, may come under pressure.
- Still sluggish on the core oil activity, **Azerbaijan's** economic activity is posting a recovery on the non-oil side, financed heavily by the domestic credit and public expenditure. The resulting price pressures mean that the monetary policy easing cycle is most likely over. The country's fiscal and external reserves are ample, but the gradually eroding trade surplus and growing current account breakeven, if not addressed, could create some pressure on the manat's dollar peg in the coming years.
- GDP growth in **Kazakhstan** has slowed owing to commodity sector, but the rest of the economy appears well supported by lending and public spending. Budget policy is becoming more generous, and at some point, the issue of US$100+/bbl breakeven oil price will need to be addressed. For now, it has added to CPI risks and caused the NBK to signal that the end of the rate easing cycle is near. KZT depreciation risks seem to have materialised, but the challenges of the budget and balance of payments are likely to keep the tenge under pressure in the medium term.
- **Uzbekistan** continues to show a fast and well-diversified economic growth rate. The tariff-related spike in CPI was somewhat lower than expected, allowing an improvement in key rate expectations for the coming quarters. Also, the soum depreciation rate slowed in 1H24, also helped by the strong gold market, but the pressure may increase in 2H24. Our concern is the continued widening in the consolidated budget deficit to 7% of GDP for the four quarters ending March 2024. Like its CIS-4 peers, consolidation might come onto the agenda at some point.

Sovereign credit views

- Valuations look reasonable for a region that has seen fundamentals improving over the past few years, while geopolitical risks also appear to be easing. At the same time, with fiscal policy generally loosening, the focus will be on expectations for more Eurobond issuance to come over the next year. Our preference in the region would be Armenia, while expectations for near-term issuance could push spreads in Kazakhstan wider from fairly rich levels.

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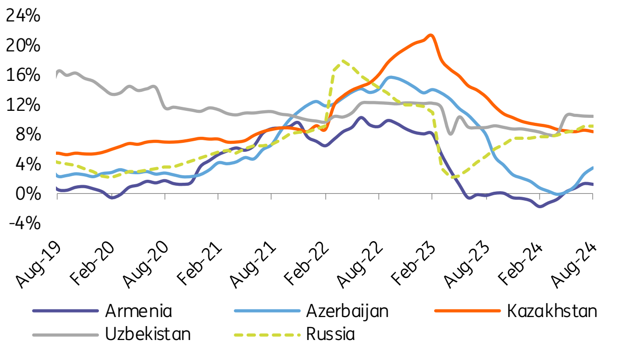
Selected macro indicators for 2022-24F

	Armenia			Azerbaijan			Kazakhstan			Uzbekistan		
	2023	2024F	2025F	2023	2024F	2025F	2023	2024F	2025F	2023	2024F	2025F
GDP												
Real GDP (%YoY)	8.3	6.0	5.0	1.1	3.5	2.6	5.1	3.7	5.5	6.0	5.7	5.7
Nominal GDP (US$bn)	22.3	23.5	24.9	72.4	75.8	81.3	264.3	284.0	312.0	90.9	97.7	107.7
GDP per capita (US$)	8053	8266	8835	7126	7370	7830	13277	14130	15372	2790	2610	2825
Fiscal balance												
Consolidated budget balance (% of GDP)	-1.9	-4.0	-5.5	8.2	4.1	2.3	-0.5	-1.4	-0.9	-6.2	-6.0	-5.3
Public debt (% of GDP)	50.5	52.6	54.7	18.4	16.6	17.4	22.5	22.4	21.4	36.3	37.5	38.6
Fiscal breakeven Brent (US$/bbl)	n/a	n/a	n/a	54	66	67	90	107	107	n/a	n/a	n/a
Balance of payments												
Current account (% of GDP)	-2.3	-2.7	-3.4	11.5	7.0	4.9	-3.3	-1.5	-1.7	-8.6	-7.8	-7.6
Trade balance (% of GDP)	-10.4	-8.0	-6.7	17.7	11.8	9.3	7.6	7.2	6.8	-16.6	-15.9	-15.0
Foreign debt (% of GDP)	64.2	62.3	61.9	23.2	22.8	21.9	61.6	59.0	55.3	66.7	69.2	67.4
Current account breakeven Brent (US$/bbl)	n/a	n/a	n/a	56	63	63	99	91	86	n/a	n/a	n/a
CPI, Interest & exchange rate												
CPI (year-end, %YoY)	-0.6	2.8	3.0	2.1	4.8	3.5	9.8	8.5	6.5	8.8	10.2	8.0
Central bank key rate (year-end, %)	9.25	7.25	7.00	8.00	7.25	7.25	15.75	14.00	12.00	14.00	13.50	12.50
Exchange rate vs USD (year-end)	405	393	408	1.70	1.70	1.70	455	485	490	12346	12964	13482

Source: National sources, CEIC, ING

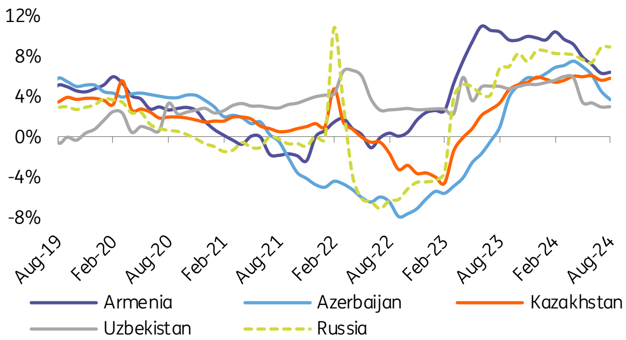
CIS cross-country overview charts

Fig 1 Inflation (% YoY)



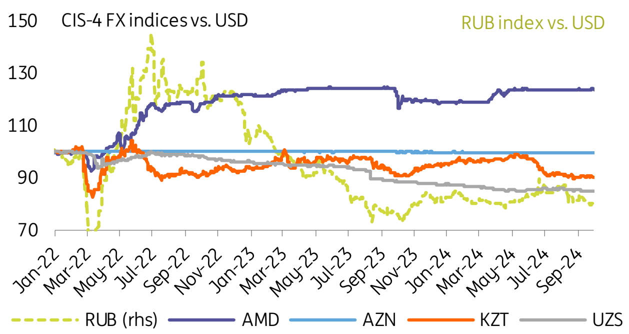
Source: National sources, CEIC

Fig 2 Real policy rates (%)



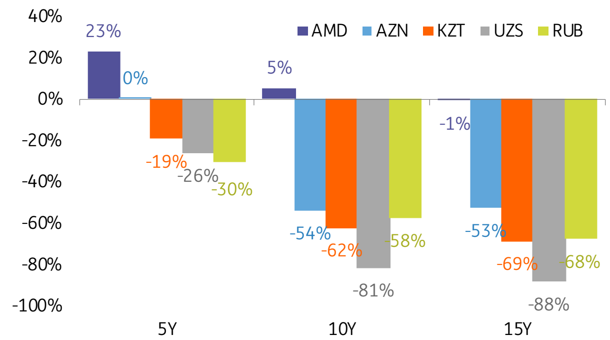
Source: National sources, CEIC, ING

Fig 3 CIS currencies vs USD, index, end-2021 = 100



Source: National sources, Refinitiv, CEIC, ING

Fig 4 Long-term performance of CIS currencies vs USD



Source: National sources, Refinitiv, CEIC, ING

Armenia

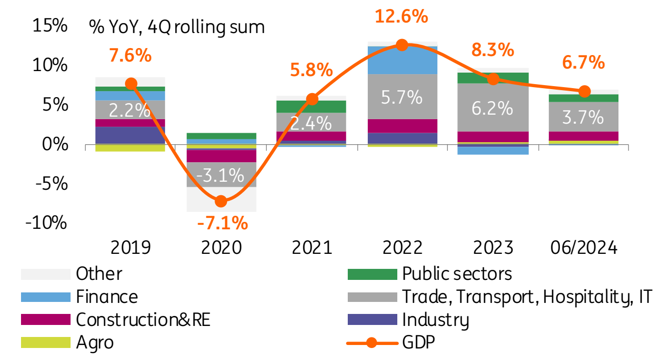
Economic overview

Economic activity is moderating as the momentum related to high-skilled immigration in 2022 and higher participation in the external trade is wearing off. The role of domestic drivers of financing activity, including local household savings, lending, and state spending is increasing. Re-integration of refugees from Nagorno-Karabakh and continued tensions with Azerbaijan are likely to keep the fiscal deficit elevated, in line with our initial view at the start of last year. The resulting elevated CPI risks should limit the scope for monetary policy easing from current levels. The Armenian dram, which has so far avoided depreciation, may come under pressure on normalisation of the balance of payments.

Economic activity. Armenian GDP growth decelerated to 6.4% YoY in 2Q24 (or 6.7% YoY on a 4Q rolling basis) after a brief pick-up in 1Q24. From the output-based angle, the main drag came from the trade, transportation, hospitality and IT sectors, which were the primary drivers during the high-skilled immigration boom of 2022-23. Their contribution to GDP growth has dropped from 5.7-6.2ppt in 2022-23 to 3.7ppt currently, which is closer to the historical range of 2.0-2.5ppt. From the GDP usage angle, we note the material slowdown in real export growth from a 100% YoY spike in 1Q24 to 60% YoY in 2Q24 amid a similar slowdown in imports, suggesting still substantial but somewhat lower benefits from elevated foreign trade in the region.

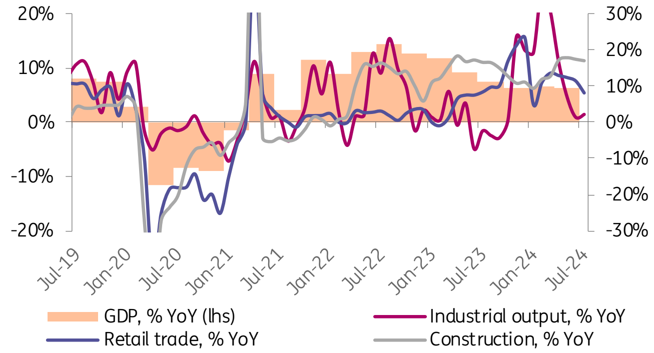
On the positive side, industrial and construction activity so far look solid and show continued improvement compared to previous years. However, historically, the country's industrial side has been more volatile and less reliable than the household-focused area.

Fig 5 Armenia: GDP growth components



Source: National sources, CEIC, ING

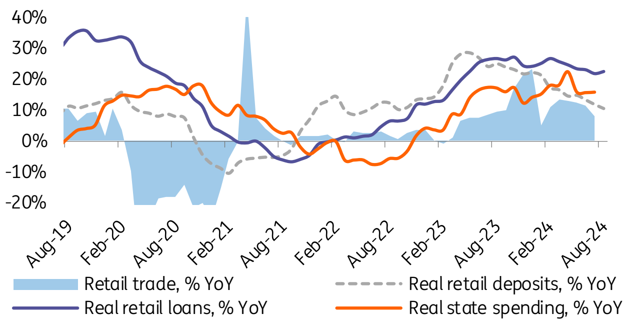
Fig 6 Armenia: Key activity indicators



Source: National sources, CEIC, ING

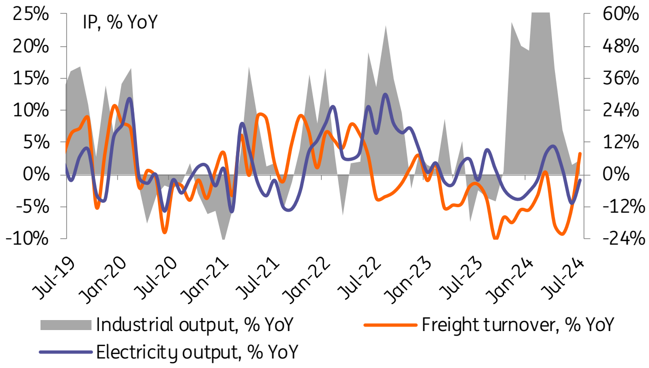
Domestic consumption has been strong since mid-2023, with retail trade posting double-digit growth in real terms. However, since 2Q24 it has been showing signs of slowdown to single digits (8.1% YoY in July) amid deceleration in retail lending and an even steeper slowdown in retail deposits, suggesting a potentially lower availability of savings. The arrival of c.100,000 refugees, or c.3% of population from Artsakh (Nagorno-Karabakh), has yet to translate into a wider labour force, which should eventually lead to better domestic income trends but, so far, it's been a cause of higher state spending amid still high unemployment of 15.5% (as of 1Q24). The mood on the industrial side is being supported by the expectations of new mining projects due to come online in 2025 and the country's still high participation in the regional foreign trade.

Fig 7 Armenia: Consumption activity indicators



Source: National sources, CEIC, ING

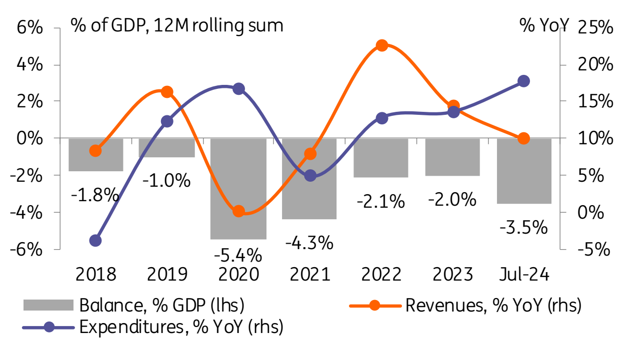
Fig 8 Armenia: Industrial activity indicators



Source: National sources, CEIC, ING

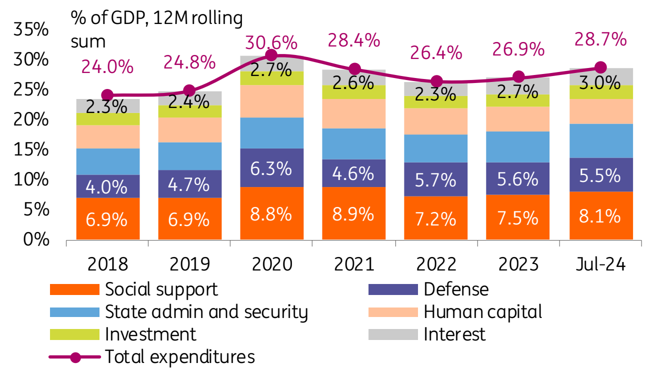
Budget policy is drawing more attention, in line with our initial concerns. The revenue side continues to underperform, reflecting the GDP slowdown, while spending volumes keep growing due to still elevated military spending, higher social support requirements and larger interest payments. Together, these lines account for around 58% of the total expenditures, which increased by 1.7ppt of GDP compared to year-end 2023. As a result, the budget deficit widened from c.2% of GDP in 2022-23 to 3.5% currently, and we do not exclude further widening to 4-5% of GDP in the next couple of years.

Fig 9 Armenia: Key budget parameters



Source: National sources, CEIC, ING

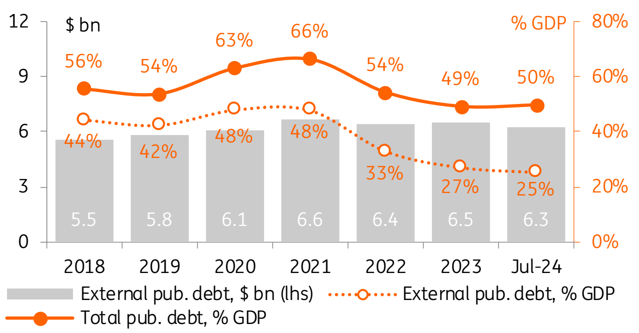
Fig 10 Armenia: Budget expenditure, 12M rolling basis



Source: National sources, CEIC, ING

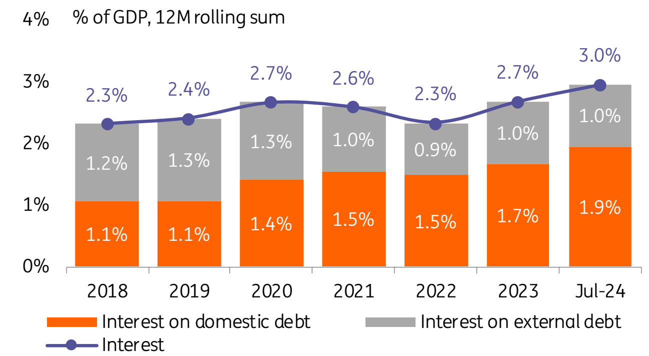
Wider fiscal deficit puts a bigger focus on Armenia's public debt, which may now be headed towards 55% of GDP in the coming years after brief stabilisation at 50%. On the positive side, the structure of the public debt improved, as external debt did not increase in absolute terms and nearly halved to 25% of GDP compared to 2021 amid AMD appreciation, GDP growth and higher reliance on domestic borrowing, as local public debt doubled to AMD2.4tr. On the negative side, Armenian public finances remain exposed to AMD depreciation risks, which remain significant in our view.

Fig 11 Armenia: Key public debt parameters



Source: National sources, CEIC, ING

Fig 12 Armenia: Interest payments on public debt

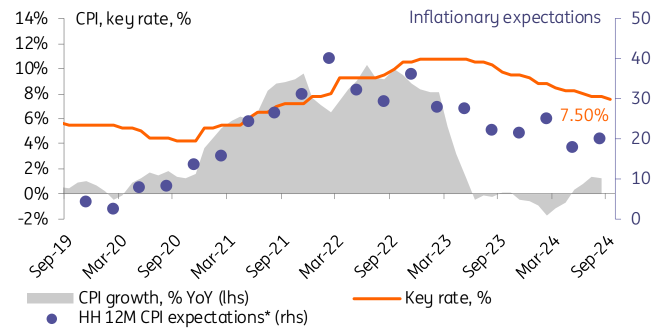


Source: National sources, CEIC, ING

Inflation and monetary policy. With current CPI growth of just 1.3% YoY, Armenia remains the country with the lowest inflation in our coverage space. In the meantime, the near-term outlook has somewhat worsened given the exhaustion of the previous disinflationary factors, such as inflow of high-skilled immigrants, AMD appreciation and global food price deflation. Most recently, the continued fast lending growth, further easing in the fiscal policy and the upcoming tariff indexation in January 2025 may facilitate a faster than previously believed return of CPI to the 4-5% YoY range. The labour market is an important variable in the equation, as the high unemployment is a sign of limited supply rather than low demand. An expedited re-integration of the refugees could potentially be a disinflationary factor, but such a scenario is on the optimistic side.

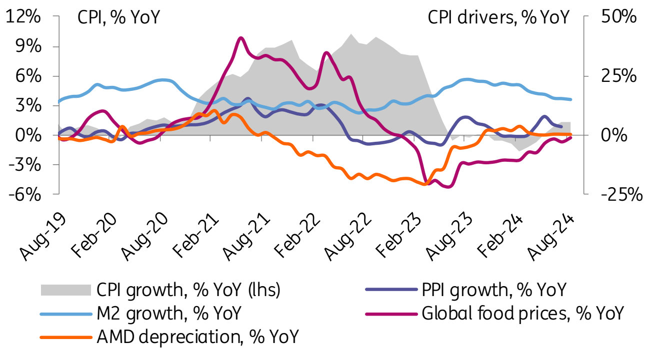
The abovementioned considerations are keeping the inflationary expectations elevated. The recent quarterly households survey suggests that while CPI expectations are off their 2022 peaks, they remain elevated. The central bank's actions and communication also chime with these concerns. Although the CBA continued lowering the key rate (to 7.50% in September) and is signalling the possibility of further cuts, the recent monetary policy report has a higher emphasis on pro-inflationary risks, particularly from the domestic fiscal side, and related to the worsening in the inflationary outlook in the main trade partner countries, all suggesting limited scope for further monetary policy easing. We raise the expected key rate floor for the next 2-3 years from the previous 6.50% to 7.00%.

Fig 13 Armenia: Inflation, expectations, and key rate



* % of households expecting fast to very fast price growth in the next 12M
Source: National sources, CEIC, ING

Fig 14 Armenia: Inflation drivers

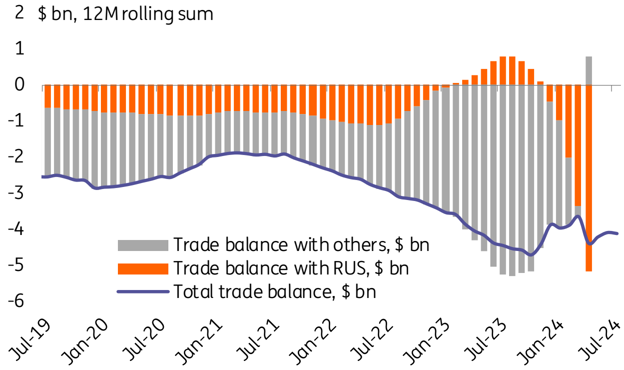


Source: National sources, CEIC, UN FAO, ING

Balance of payments and exchange rate. Judging by the volatile role of Russia in its trade balance, Armenia has been more actively involved in regional trade, including most recently – through re-exports of various goods, that led to the entire trade deficit over the last 12 months being Russia-related. That said, these re-exports are largely neutral for the overall trade deficit, which widened from US$3-4bn in 2020-21 to US$4.0-4.5bn currently, reflecting the country's own domestic consumption and investment needs. The widening trade deficit is still being offset by a higher surplus of services, which is related to more active involvement in regional trade and continued presence of foreign nationals in Armenia. At the same time, the overall current account balance has already returned to its normal deficit state of -US$0.5-1.0bn, and we do not exclude further widening in the coming quarters.

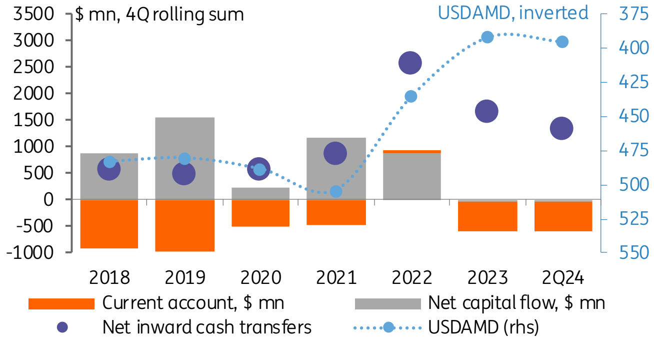
The only balance of payment item that remains supportive of the dram is the net inward cash transfers (remittances), which despite some moderation remain elevated at around US$1.4bn pa currently (versus pre-2022 US$0.5bn pa). As a percentage of GDP, the net remittances inflow is already back to the normal 5% versus the 2022 peak of 15%, suggesting limited downside from the current level. That said, compared to the overall balance of payment fundamentals, the Armenian dram appears overvalued and vulnerable to depreciation risks, especially if triggered by negative external developments.

Fig 15 Armenia: **Trade balance level and composition**



Source: National sources, CEIC, ING

Fig 16 Armenia: **Balance of payments vs AMD**



Source: National sources, CEIC, ING

Credit strategy

While macro fundamentals are generally normalising from the improvements seen in 2022, most metrics have stabilised at comfortable levels. Geopolitical risk from tensions with Azerbaijan remains a potential driver of volatility, although more recently some optimism has built about progress in improving relations at November's COP climate conference in Baku, meaning this is no longer a purely downside risk factor. Limited FX-reserve coverage and potential widening of the current account deficit are external vulnerabilities, but financing needs for commercial external debt are low outside of a small March 2025 (c.US$300m) Eurobond maturity.

Fig 17 Armenia: **Rating drivers/sensitivities, factors that could lead to an upgrade or downgrade**

Agency	Upgrade factors	Downgrade factors
Moody's Ba3 (STABLE)	• Recent inflows of capital and labour are sustained, driving productivity growth and fiscal strength. • A durable easing in geopolitical tensions with Azerbaijan, from a peace agreement.	• Reversal in the financial or labour inflows received from Russia. • Resurgence in inflation that is not contained by monetary policy. • Escalation of tensions with Azerbaijan into full-scale conflict.
S&P BB- (STABLE)	• Geopolitical risks are contained while strong growth continues. • Further strengthening of fiscal or external balance sheets.	• Material reversal in financial and labour inflows from Russia. • Macroeconomic fallout triggered by escalation of conflict with Azerbaijan, or geopolitical tensions with Russia.
Fitch BB- (STABLE)	• **Fiscal:** Fiscal consolidation and reduction in FX share of government debt. • **Macro:** Durable high growth rates that increase GDP per capita.	• **Fiscal:** Substantial increase in government debt/GDP from growth slowdown or fiscal loosening. • **External:** Increase in current account deficits or decline in international reserves. • **Structural:** Materialisation of geopolitical risks that hit financial stability.

Source: Moody's, S&P, Fitch, ING

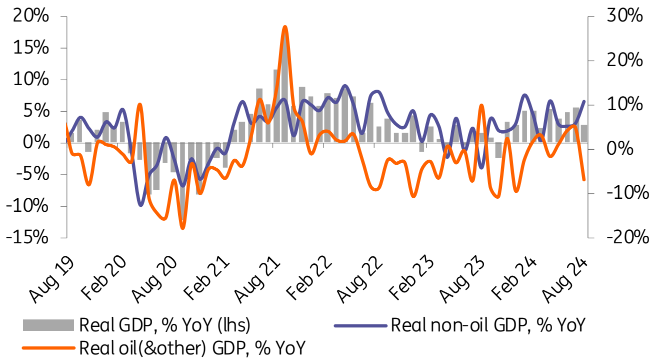
Azerbaijan

Economic overview

Still sluggish on the core oil activity, Azerbaijan's economic activity is posting a recovery on the non-oil side, financed heavily by the domestic credit and public expenditure. The resulting price pressures mean that the monetary policy easing cycle is most likely over. The country's fiscal and external reserves are ample, but the gradually eroding trade surplus and growing current account breakeven, if not addressed, could create some pressure on the manat's dollar peg in the coming years.

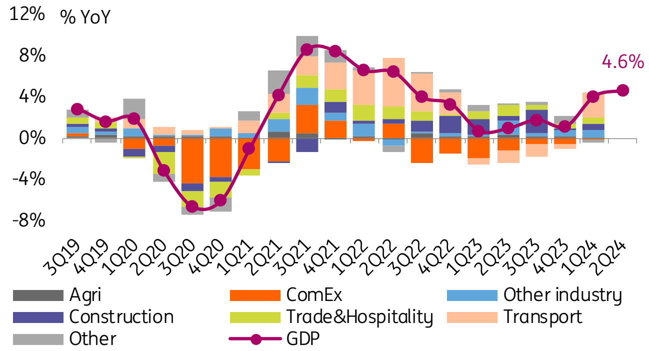
Economic activity. After a weak 1.1% GDP growth in 2023, Azerbaijan is on a rebound, showing a 4.3% YoY increase in 8M24, led by the 7.0% YoY spike in the value-added of the non-fuel sectors. Positive contributions from the construction, transport and retail-focused sectors suggest that, in addition, reconstruction of the recently re-integrated Nagorno-Karabakh, and bigger involvement in regional trade, the growth recovery is gaining a wider domestic base. Oil and gas, on the other hand, is stagnant, as the new projects, related to expanding hydrocarbon trade with the EU are so far only enough to offset the ageing of existing oil production. We expect 3.5% GDP growth this year with possible moderation to 2-3% in the coming years.

Fig 18 Azerbaijan: GDP growth by key contributors



Source: National sources, CEIC, ING

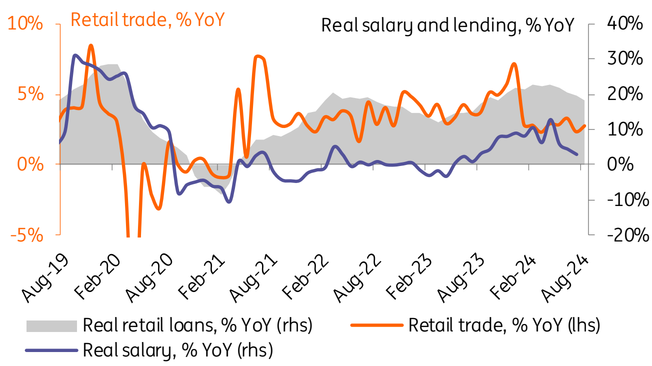
Fig 19 Azerbaijan: GDP growth by sectors



Source: National sources, CEIC, ING

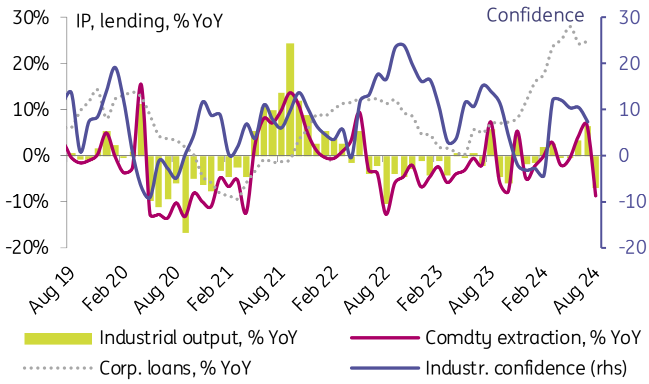
In terms of financing, the growing activity in the non-fuel sectors seems to be increasingly reliant on 20 percent growth in corporate and retail lending, as well as more modest but still steady growth in household income. The mood in the core industrial sectors remain heavily dependent on the volatile commodity extraction.

Fig 20 Azerbaijan: Consumption fundamentals



Source: National sources, CEIC, ING

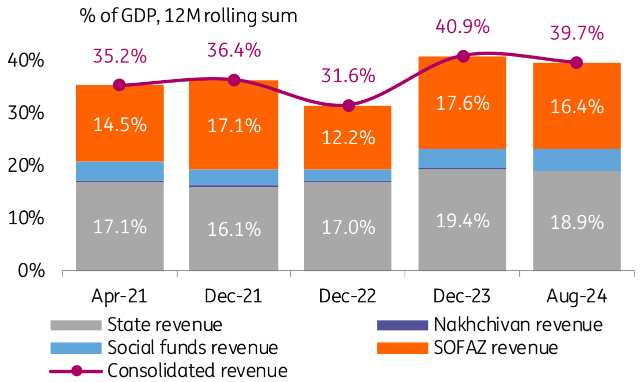
Fig 21 Azerbaijan: Key indicators of industrial activity



Source: National sources, CEIC, ING

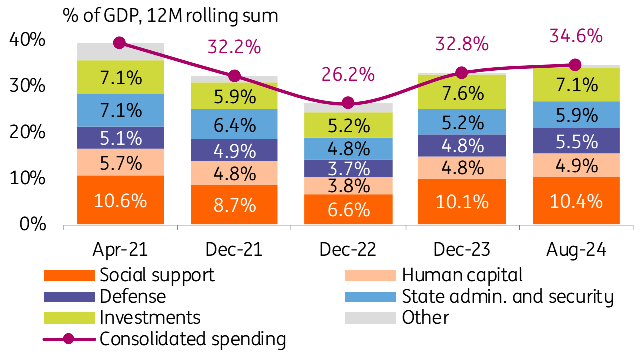
Budget policy. After posting a strong 8.2% GDP surplus in 2023, the consolidated budget is showing signs of easing. On the revenue side we see normalisation of oil revenues from an extremely high US$213m per US$1/bbl of Brent price last year to US$190m in the past 12 months, which is within the historical US$150-200m range for Azerbaijan and more in line with the overall declining volumes of production and exports. On the expenditure side there is a continued increase in spending, seen across the board, but primarily in social spending, defence and other state administration items, which is likely to continue given the country's current economic policy priorities.

Fig 22 Azerbaijan: Consolidated budget revenues



Source: National sources, CEIC, ING

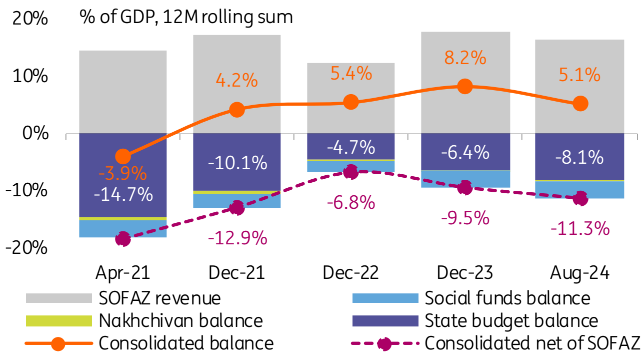
Fig 23 Azerbaijan: Consolidated budget spending



Source: National sources, CEIC, ING

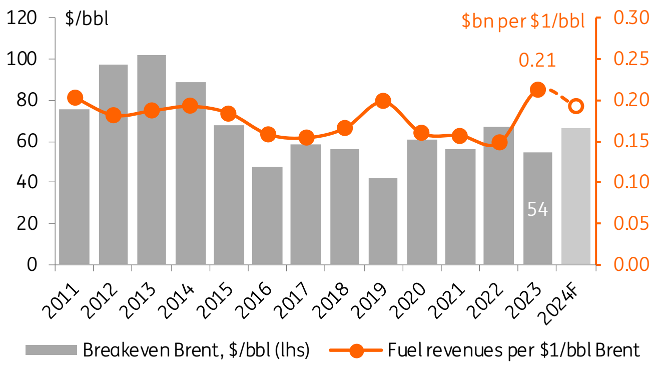
We believe that the reconstruction of Nagorno-Karabakh, other investment projects, and continued tensions with Armenia (even without escalation into open hostilities) should keep the fiscal policy generous in the coming years. We see the consolidated surplus shrinking to 4% of GDP this year and to around zero by 2027, corresponding to an increase in the breakeven oil price from US$54 in 2023 to US$65-70/bbl in the next three years. This will be an elevated level, but not dramatically so, compared to US$75-105/bbl seen in 2011-14. For the medium term, Azerbaijan's fiscal picture remains solid, with little need for borrowing, provided oil prices remain above the breakeven levels.

Fig 24 Azerbaijan: Consolidated budget balance



Source: National sources, CEIC, ING

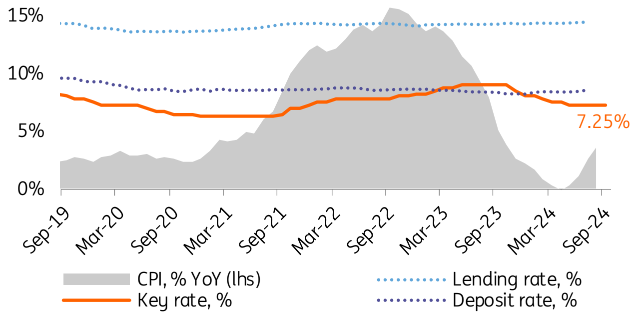
Fig 25 Azerbaijan: Budget sensitivities to oil prices



Source: National sources, CEIC, ING

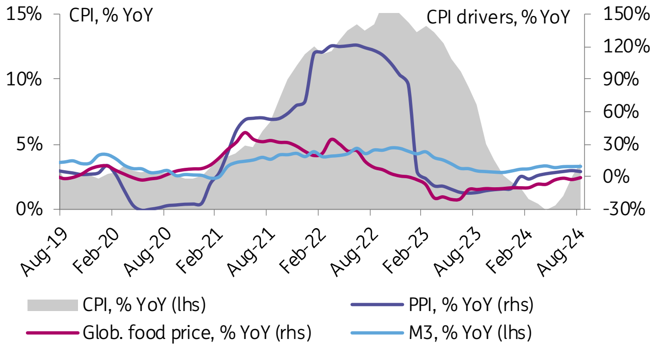
Inflation and monetary policy. Following a deceleration to zero in April 2024, inflation picked up again and reached 3.5% YoY in August, aided by exhaustion of global food price deflation and domestic indexation of regulated tariffs. Traditional precursors of CPI, including monetary aggregates and producer prices, have been looking up for some time and the reversal in the overall CPI was not a surprise. However, the scale of fiscal easing and lending acceleration somewhat exceeds expectations, resulting in an increase in our year-end CPI forecasts to 4.5-5.0% for 2024 and c.3.5% for 2025. Given this expected inflation trajectory, the current key rate of 7.25% is unlikely to have any downside for the foreseeable future.

Fig 26 **Azerbaijan: Inflation and key rate**



Source: National sources, CEIC, ING

Fig 27 **Azerbaijan: Inflation drivers**

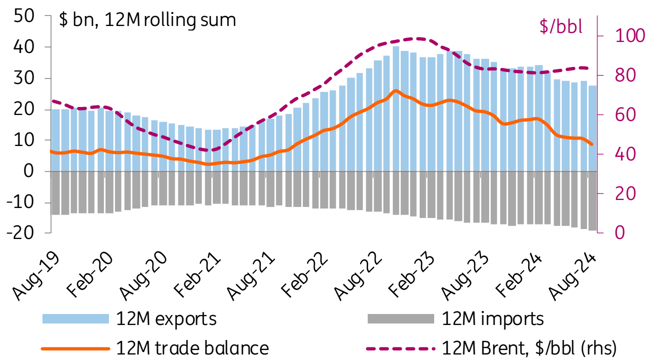


Source: National sources, CEIC, UN FAO, ING

Balance of payments and AZN. Azerbaijan's external balance continues to show signs of moderation following the extremely strong 2022, when the current account reached US$23.5bn, or nearly 30% of GDP. Since then, the trade side has come under a double pressure of falling exports and growing imports. The exports side suffers from both moderation in oil prices and decline in export volumes, as fuel exports dropped from US$380m per US$1/bbl Brent in 2022 to US$320m in 2023 and US$280m during the four quarters ending in mid-2024. In line with the fiscal side, the current proceeds per unit of oil price is in line with the historical range (US$250-300m) and is related with the moderation in physical volumes.

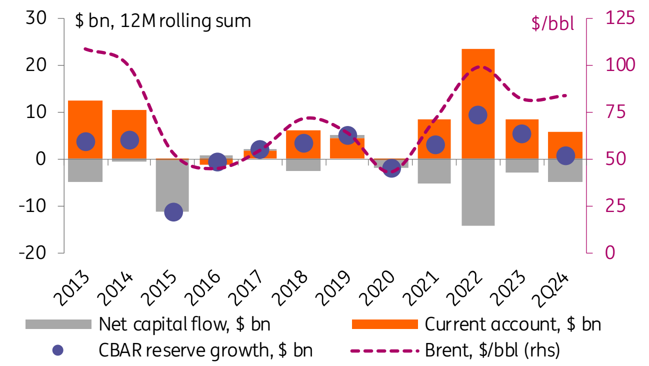
On the imports side, Azerbaijan is showing increased appetite for consumer and investment goods as per its core construction and pipeline projects as well as broad economic recovery. Having slowed from 20-30% YoY in 2022-23 to just 8% YoY in 2Q24, merchandise imports are again showing signs of acceleration in early 3Q24, forcing us to somewhat downgrade our 2024 current account surplus expectations to US$5.0-5.5bn (7% of GDP) with further shrinking forecast for 2025-27 unless Azerbaijan shows a reversal in the overall fuel production and exports trend.

Fig 28 **Azerbaijan: 12M trade balance composition**



Source: National sources, CEIC, ING

Fig 29 **Azerbaijan: 12M balance of payments composition**



Source: National sources, CEIC, ING

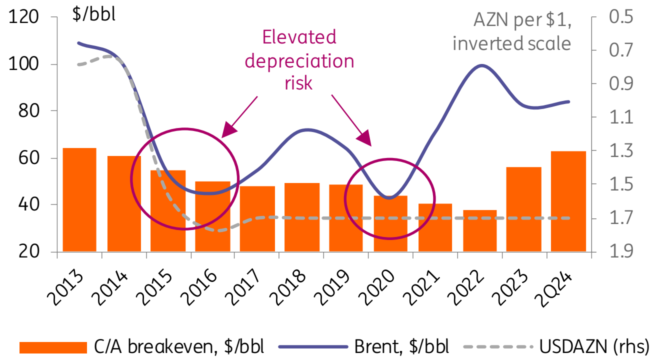
As result of the narrowing current account surplus and continued capital outflow the central bank (CBAR) had to stop its accumulation of reserves for the first time since 2020. This is not a direct threat to the manat's eight-year long 1.7/US$ peg, but the topic of FX stability deserves a closer look, especially given the recent increase in the current account breakeven level to a multi-year high of US$63/bbl in a softer oil price context. In our view, risks of AZN depreciation become serious when the oil price drops to or below the current breakeven level, as Azerbaijan's institutional and growth framework requires the current account to remain in surplus.

Over the past decade, such risks were encountered twice, during the period of declining oil prices of 2014-15 and 2020, and materialised only in the former case, when the declining oil prices at first led to CBAR spending half of its reserves on protecting the FX, but the deterioration in the long-term oil price expectations eventually forced it to shift the peg from 0.78/US$ to the current levels. In 2020, those risks did not materialise because the dip in the oil prices was too short-lived to create a lasting depreciation pressure.

Looking at those two examples, the current picture does not require us to put AZN on immediate devaluation watch, firstly, because the oil prices are still above the breakeven level and not showing signs of collapse. Secondly, the sovereign external asset position has recovered at the central bank level and materially improved on the government level. Thirdly, the authorities might be highly motivated to avoid devaluation to protect the nearly 10-year long gradual de-dollarisation: the shares of FX retail and corporate funding have only recently returned to pre-2015 levels of 35-40%.

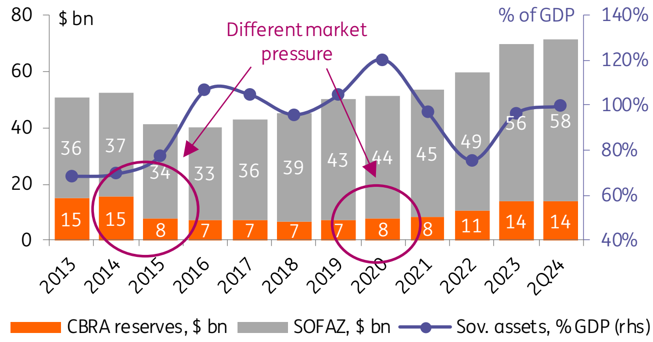
We therefore continue to see AZN at 1.7/US$ for the foreseeable future. That said, the growing breakeven level for the current account, if left unaddressed, may become a watch factor for AZN depreciation pressure in the coming years.

Fig 30 Azerbaijan: Current account breakeven



Source: National sources, CEIC, ING

Fig 31 Azerbaijan: External sovereign asset position



Source: National sources, CEIC, ING

Credit strategy

Credit fundamentals are strong given the significant FX assets and limited external financing needs, despite expectations for a moderation in the twin surpluses. Ratings are on the path to IG, with Fitch upgrading to BBB- in July and Moody's on positive outlook, which should bring official ratings in line with market perception and pricing.

Fig 32 Azerbaijan: Rating drivers/sensitivities, factors that could lead to an upgrade or downgrade

Agency	Upgrade factors	Downgrade factors
Moody's Ba1 (POS)	• Further progress in reforms to improve governance, transparency and policy predictability. • Economic diversification that reduces dependence on hydrocarbons.	• Signs of erosion in the credibility and effectiveness of the policy framework. • Banking sector weaknesses resurfacing, raising contingent liability risks. • Renewed geopolitical tensions with Armenia.
S&P BB+ (STABLE)	• Sustaining high external surpluses for further accumulation of external assets. • Reforms that improve diversification of economy and monetary policy effectiveness. • Regional geopolitical risks subside	• Declining oil production weighs on fiscal balances. • Falling hydrocarbon receipts weigh on GDP per capita growth. • Geopolitical tensions with Armenia escalate again.
Fitch BBB- (STABLE)	• **Macro/structural:** Continued strengthening of the economic policy framework and institutional capacity that enhance Azerbaijan's capacity to absorb shocks. • **External finance:** Significant additional strengthening of the sovereign balance sheet resulting from higher energy revenues and a prudent policy mix.	• **Fiscal/external:** Significant erosion of the sovereign balance sheet. • **Macro:** A deterioration in the economic policy mix that, for example, results in macroeconomic and financial stability risks and/or increases Azerbaijan's vulnerability to external shocks including oil price volatility.

Source: Moody's, S&P, Fitch, ING

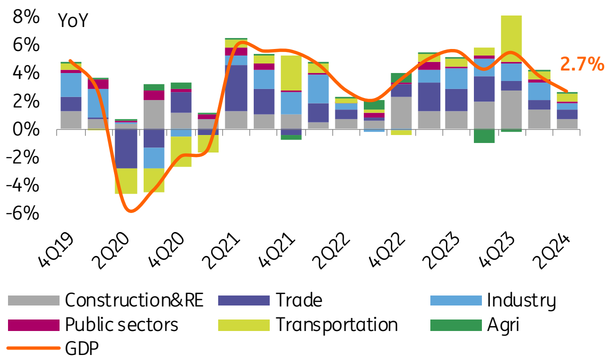
Kazakhstan

Economic overview

Economic momentum has slowed owing to commodity sector and other cyclical factors, but the rest of the economy, especially consumer-focused, appears robust and well supported by lending and public spending. Budget policy is becoming more generous, and at some point, the issue of US$100+/bbl fiscal breakeven oil price will need to be addressed. For now, it has added to pro-inflationary risks and caused the NBK to signal that the end of the rate easing cycle is near. In the meantime, KZT depreciation risks seem to have materialised, but the challenges of the budget and balance of payments are likely to keep the tenge under pressure in the medium term.

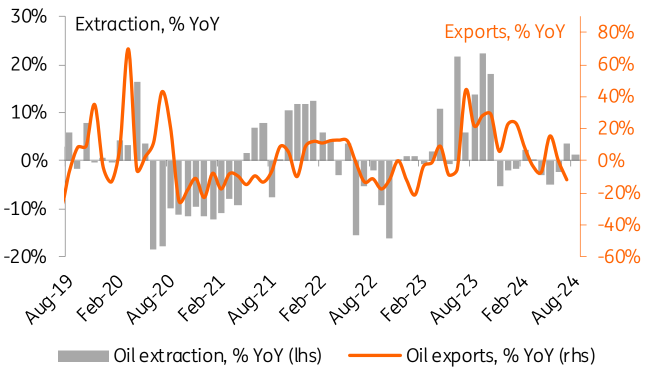
The concerns we expressed earlier this year regarding the potential slowdown in Kazakhstan's economic activity have received confirmation from recent official data. After strong 5.1% growth in 2023, GDP slowed to just 2.7% YoY in 2Q24, somewhat below expectations amid disappointing output in the commodity sectors and cyclical slowdown in the construction sector. Our initial 4% GDP growth expectation for 2024, already significantly below the government's 6% target, is now challenged and a 3.5-4.0% range appears more appropriate.

Fig 33 Kazakhstan: GDP growth dynamics and structure



Source: National sources, CEIC, ING

Fig 34 Kazakhstan: Key oil sector indicators

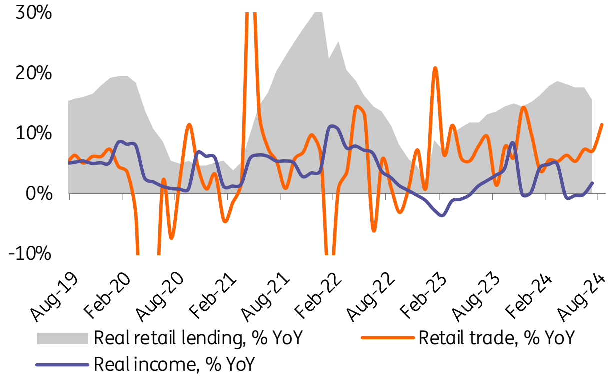


Source: National sources, CEIC, ING

Looking deeper into the composition of growth and sources of its financing, the picture does not look too grim, however. The consumption fundamentals appear robust, with retail trade showing steady growth amid continued growth in the number of employees (up 100,000 over the course of 1H24 to 7m), positive real income growth as well as a double-digit increase in retail lending. We also note that since 2022 Kazakhstan's private sector is enjoying an inflow of tourist and business travellers from Russia, which is also supportive for GDP and balance of payments.

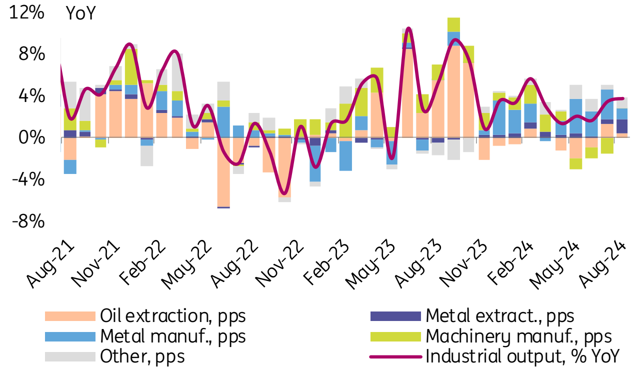
On the corporate side, industrial output outside of oil sector (mainly metals) is making a positive contribution, while oil sector performance should increase next year provided there are no further delays with Tengiz and extra pressure from Kazakhstan's OPEC+ commitments – the government expects oil production to grow by 12% in 2026 vs 2024. In terms of financing, the continued fast growth in corporate lending (14% YoY in nominal terms throughout 1H24) as well as growing public spending appear accommodative. We therefore expect GDP growth to reverse to 4.0-5.0% in the next couple of years.

Fig 35 **Kazakhstan:** Consumption fundamentals



Source: National sources, CEIC, ING

Fig 36 **Kazakhstan:** Industrial output composition

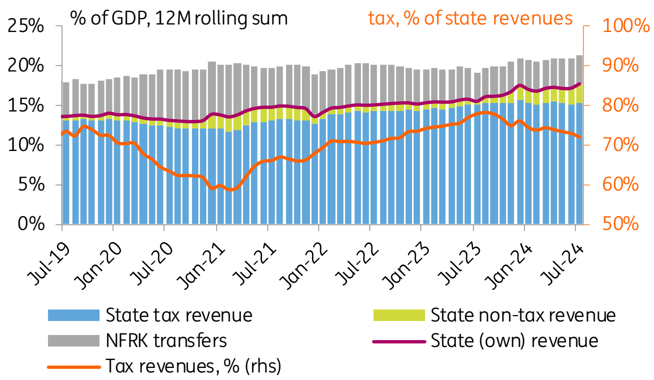


Source: National sources, CEIC, ING

Budget policy. Even though the headline fiscal performance appears solid in 7M24, we have several concerns when it comes to details. On the revenue side, flat consolidated revenues at around 21.2% of GDP and even some increase in the state level (mostly non-oil revenues of the central republican and local budgets) to 17.7% of GDP are assured by the growing non-tax, mainly asset sale proceeds, while the share of tax in the non-oil state-level revenues dropped from 76% to 72%. Also, the fuel revenues, which are the primary source of transfers out of NFRK, the sovereign oil fund, to the state budget, are weakening: annual oil revenues per US$1/bbl of oil price declined from US$183m in 2022 to US$165m in 2023 and US$155m currently amid sluggish oil production and exports. Given the historical experience, this will be difficult to boost without an increase of the tax burden on the oil producers.

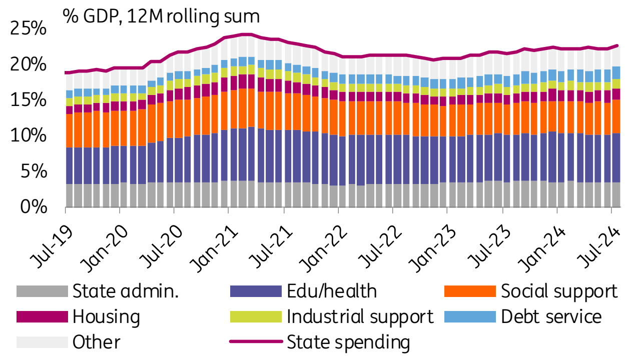
On the state expenditure side, we see continued upward pressure. Although this year some extra spending items were needed to address the consequences of the floods in April, we see a longer-term trend of growing state financing of various areas, including education, healthcare, social support, housing, sectoral investments, and debt servicing, all leading to a gradual increase of overall spending to 22.7% GDP currently vs 21-22% in the previous couple of years and 18-20% GDP in pre-Covid years. Unlike the revenue side, the state spending obligation may prove sticky.

Fig 37 **Kazakhstan:** State budget revenues



Source: National sources, CEIC, ING

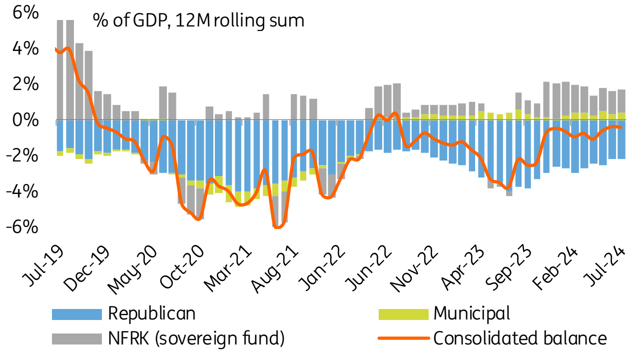
Fig 38 **Kazakhstan:** State budget spending



Source: National sources, CEIC, ING

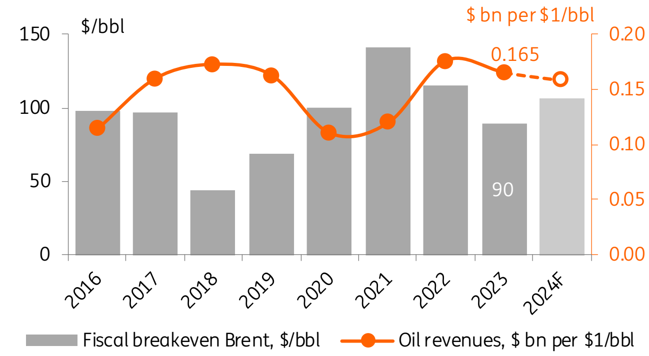
As a result, the headline picture of close to balanced consolidated budget and narrowing deficit of the republican budget (the key variable for the domestic borrowing) could be a bit misleading. In terms of fiscal impulse for the economy, the transfer out of NFRK is pivotal, and as of 7M24 already KZT3tr out of the full-year KZT4tr plan has been fulfilled, meaning that another year of overrun is likely. While we expect the consolidated deficit to remain within 0.5-1.5% GDP in the coming years, and stable at 2% GDP on the republican level, it would suggest high and out-of-the-money fiscal breakeven oil prices of US$80-110/bbl – requiring the matter of fiscal consolidation to appear on the government agenda in the medium- to long-term perspective.

Fig 39 Kazakhstan: Consolidated budget balance



Source: National sources, CEIC, ING

Fig 40 Kazakhstan: Budget sensitivities to oil prices

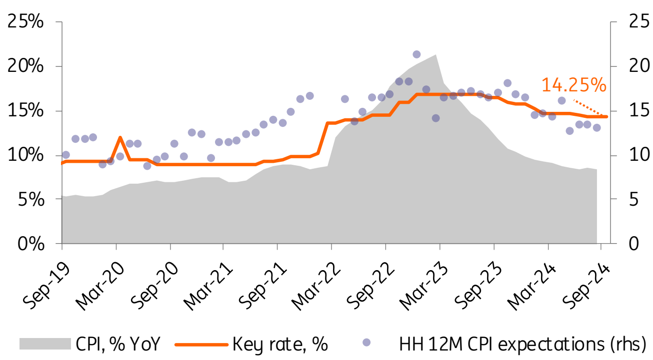


Source: National sources, CEIC, ING

Inflation and monetary policy. The recent floods, loosening in the fiscal policy and depreciation of the tenge have led to an increase in our expectation of the medium-term CPI trajectory by 0.5-1.0ppt. The CPI drivers, such as global food prices, local regulated tariffs, producer prices and banks' balance sheet growth, while not particularly pro-inflationary, still suggest that further disinflation would be difficult to achieve, at least in the near term. We now see inflation remaining at around 8.5% YoY until the year-end and see upside risks to our 6.5% expectations for 2025-26.

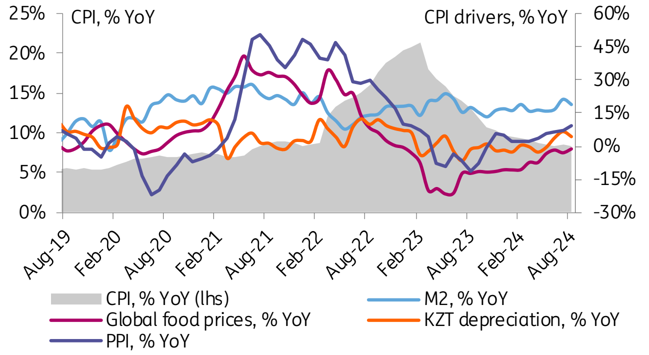
In this context, the scope for interest rate policy easing should be reduced as well. Given the recent communication from the NBK, we believe in just a 25bp cut of the key rate (currently at 14.25%) until the year-end. Further cuts in 2025 are possible if inflation shows signs of further deceleration towards the targeted 5%. Uncertainties regarding the fiscal policy and exchange rate remain the key watch factors.

Fig 41 Kazakhstan: Inflation, expectations, and key rate



Source: National sources, CEIC, ING

Fig 42 Kazakhstan: Inflation drivers

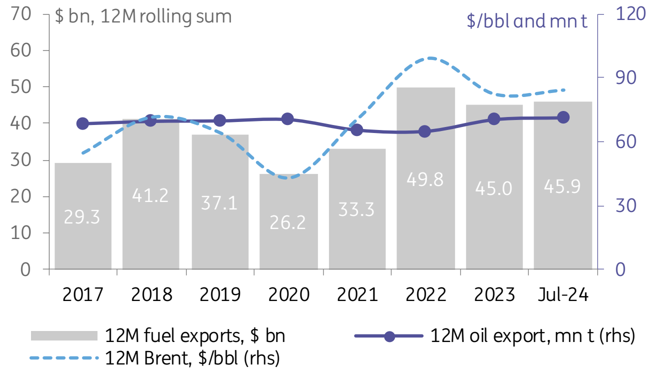


Source: National sources, CEIC, UN FAO, ING

Balance of payments and exchange rate. Our assessment of the trends in trade balance and current account somewhat improved recently. On the exports side, the picture is largely unchanged, as the upside here is limited by so far stagnant oil export volumes and recent downward pressure on price, while the potential for higher volumes in the coming years are offset by expectations of lower oil prices. So far, Kazakhstan's fuel exports are around US$550m per US$1/bbl, which is in the middle of the historical range of US$500-600m). On the import side, there are signs of a sharper-than-expected slowdown to zero from 21-22% pa growth in 2022-23, reflecting slower-than-expected economic activity as well as sharp KZT depreciation towards the end of 2Q24.

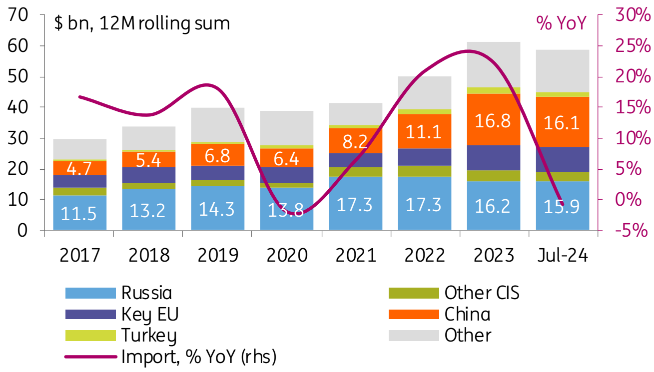
We now expect the current account deficit to narrow from US$8.7bn in 2023 to US$4-6bn in 2024-26, corresponding to 1.5-2.0% of GDP. Meanwhile, the risks of a wider-than-expected deficit remains and is related to potential further delays at Tengiz and high appetite for investment-related imports.

Fig 43 Kazakhstan: Fuel export volume and value



Source: National sources, CEIC, ING

Fig 44 Kazakhstan: Import growth and geography



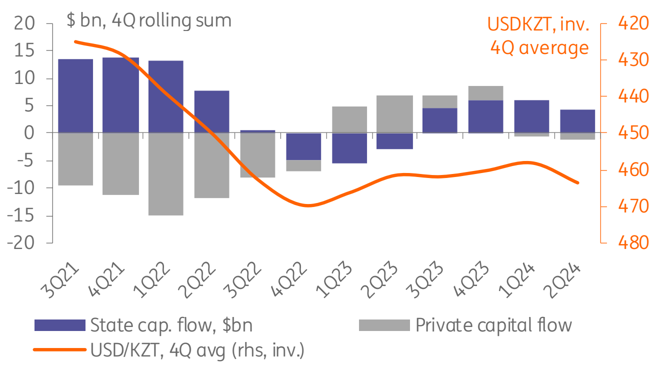
Source: National sources, CEIC, ING

As the current account picture improved, our near-term outlook for KZT is constructive: we believe the depreciation risks have largely materialised for this year. In the current macro scenario year-end USD/KZT should be in 480-485 range. At the same time, this does not mean that the tenge's long-term profile has materially improved, as the key uncertainties for the local FX market are related to the capital account, particularly to the budget-related domestic FX operations of the sovereign fund (NFRK).

Kazakhstan's balance of payment operates in a way that private capital flows act as a balancing item. This means that the improvement in the current account surplus is accompanied by accelerated private capital outflows, partially due to foreign participation in local oil projects. Thus, the state capital flows, including public debt (external liabilities side) and oil savings in NFRK (external assets) are a game-changer for the FX market, making KZT performance directly related to the fiscal policy.

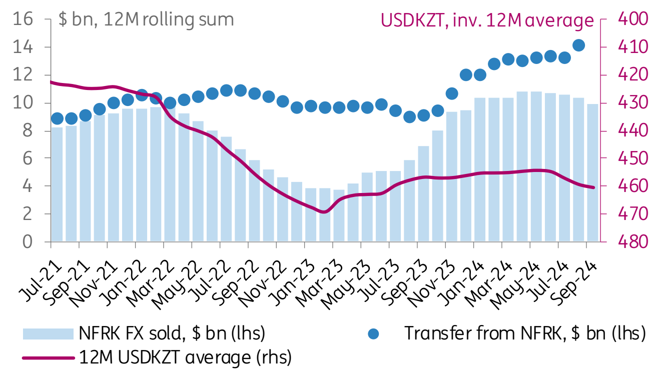
For the near term, the fiscal framework is KZT-supportive, as a further increase in the appetite for transfers out of the NFRK (which increased from US$12bn in 2023 to US$14bn in the 12m ending July 2024) may translate into higher FX sales by the state. Meanwhile, in the longer run, the state support to KZT should decline due to eventual fiscal consolidation and declared inclination to reduce the role of oil savings in the deficit financings in favour of higher accumulation of debt. The negative effect on KZT could be hypothetically offset through higher non-resident participation in the domestic public debt (recent increase in the sovereign rating by Moody's could be supportive of foreign appetite), provided the domestic market infrastructure becomes more accommodative. We therefore remain cautious on USD/KZT for the 2-3 year horizon and see it in a 480-500 range.

Fig 45 Kazakhstan: Capital account vs KZT



Source: National sources, CEIC, ING

Fig 46 Kazakhstan: NFRK FX sales and KZT



Source: National sources, CEIC, ING

Credit strategy

Some improvements in the external picture are balanced by modest fiscal weakening, leaving fundamentals overall fairly stable. We have seen a rating upgrade by Moody's, with all outlooks now stable and a composite rating of BBB, ranging across this tier (Baa1/BBB/BBB-). With an upcoming October US$1.5bn Eurobond maturity, Kazakhstan looks to be one of the few remaining likely sovereign issuers before the end of the year, while fiscal pressures could mean more regular activity in the primary market in the coming years.

Fig 47 Kazakhstan: Rating drivers/sensitivities, factors that could lead to an upgrade or downgrade

Agency	Upgrade factors	Downgrade factors
Moody's Baa1 (STABLE)	• Further reforms to strengthen institutional framework and policy credibility. • Accelerated process of economic diversification, to expand growth drivers.	• A structural fall in oil production or exports, perhaps driven by acceleration of in global carbon transition. • Crystallisation of domestic political risks, such as a re-emergence of social unrest, and external geopolitics, sanctions. • Slowdown in domestic reform momentum.
S&P BBB- (STABLE)	• Medium-term fiscal trajectory improves quicker than expected, reducing the pace of debt accumulation. • Monetary policy effectiveness improves through low inflation, exchange rate flexibility and reduced dollarisation. • Easing of geopolitical risks.	• A significant decline in oil exports due to disruption to the CPC pipeline, which could worsen external position and fiscal deficits. • Rising borrowing costs increase the government debt servicing burden. • Deteriorating domestic stability with severe civil unrest.
Fitch BBB (STABLE)	• **Structural/Macro:** Strengthening of economic policy framework and diversification. • **Fiscal:** Sustained improvement in fiscal performance leading to stronger sovereign balance sheet.	• **Structural**: Spillovers from Russia-related sanctions or domestic political instability. • **Fiscal:** Deterioration of sovereign balance sheet due to commodity price shock or contingent liabilities. • **Macro:** Deterioration of policy mix that undermines predictability of monetary policy.

Source: Moody's, S&P, Fitch, ING

Uzbekistan

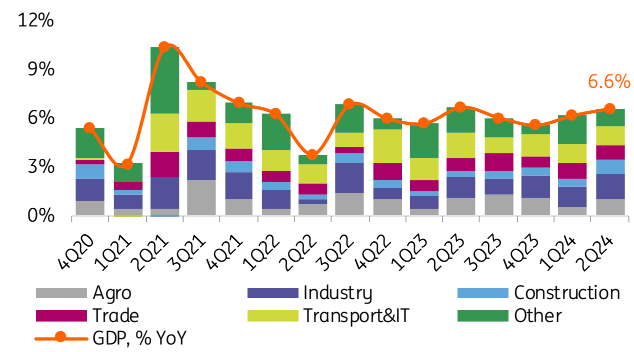
Economic overview

Uzbekistan continues to show a fast and well-diversified economic growth rate. Another positive is that the tariff-related spike in CPI was somewhat lower than expected, allowing an improvement in key rate easing expectations for the coming quarters. Also, the soum depreciation rate slowed in 1H24, in line with our view, also helped by the strong gold market, but the pressure may increase in 2H24. Our concern for the medium term is the continued widening in the consolidated budget deficit which reached 7% of GDP for the four quarters ending March 2024. Like its CIS-4 peers, consolidation might come onto the agenda at some point.

Economic activity. Uzbekistan's GDP has been accelerating for the second quarter in a row, with 2Q24 posting a 6.6% YoY increase on stronger industrial output. The most recent leading indicators of industrial activity, including a decline in the electricity output and slowdown in corporate lending growth to 9% YoY in nominal terms suggest a potential softening in 2H24, but the overall corporate mood should remain well supported by the state's investment-friendly approach.

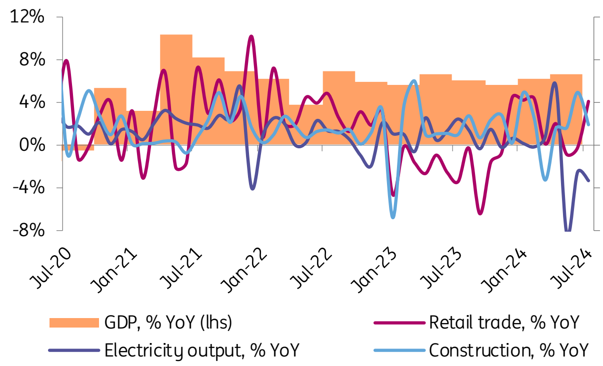
Consumption trends appear generally positive, however the recent spike in household tariffs and cooling in the retail lending growth from 47% YoY in 2023 to 30% YoY as of mid-2024 suggest that the momentum in retail trade might slow in the coming quarters, with the state budget being the only steady real income support factor. In any case, we see GDP growth remaining in a high range of 5.5-6.0% this year, as well as in 2025-26.

Fig 48 Uzbekistan: GDP growth composition



Source: National sources, CEIC, ING

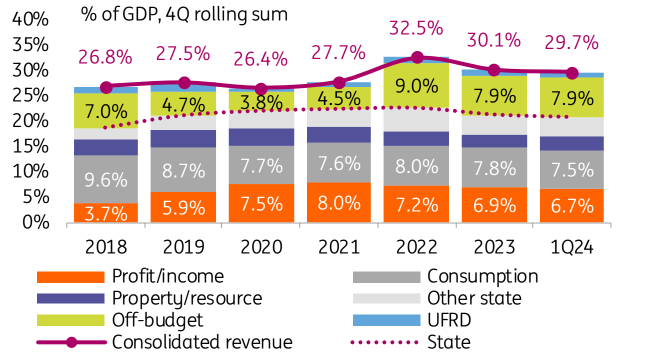
Fig 49 Uzbekistan: Key activity indicators



Source: National sources, CEIC, ING

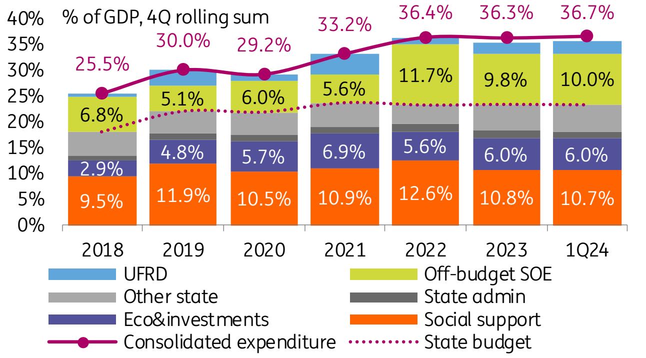
Fiscal policy. Following a brief hiatus in disclosure, Uzbekistan released consolidated budget performance for 2023 and 1Q24, revealing a higher than expected and growing deficit amid stagnant revenues and growth expenditures. At the state level, the deficit increased from 0.8% GDP in 2022 to 2.3% in 2023 and 2.7% in the four quarters ending in March 2024, while at the consolidated level the widening was from 3.9% to 6.2% and 7.0% of GDP, respectively. At the state level, the key contributors to expenditure growth include social and investment spending, which prove rather sticky and unlikely to be reduced especially given the need to offset the effects of tariff increase for low-income families and to continue with industrial development. At the consolidated level, the spending of state-owned enterprises (SOEs) is also proving sticky at around 10% of GDP and outperforming the revenue of around 8%. The overall revenue side is stagnant, largely in line with our expectations.

Fig 50 **Uzbekistan:** **Consolidated budget revenue**



Source: National sources, IMF, CEIC, ING

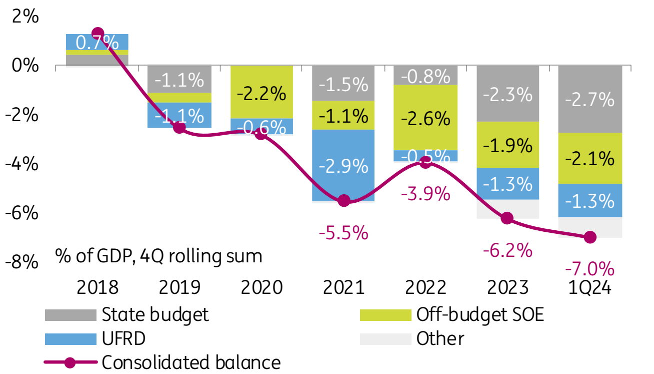
Fig 51 **Uzbekistan:** **Consolidated budget spending**



Source: National sources, IMF, CEIC, ING

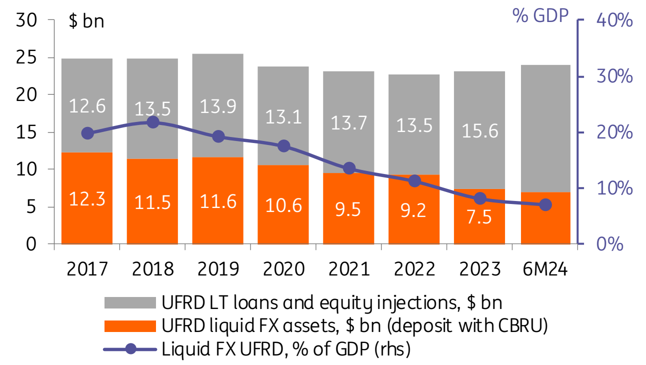
As a result, even if some fiscal consolidation is about to take place in the coming years, we still expect the consolidated budget deficit to remain in an elevated range of 4-6% GDP for 2024-2026. On the negative side, this means that the liquid FX savings in the sovereign fund (UFRD), which are already below 10% of GDP, are likely to remain under pressure in the medium term. On the positive side, however, this may potentially serve as an incentive for the government to proceed with the privatisation programme in addition to domestic and foreign borrowing, also a popular topic for the foreign investors.

Fig 52 **Uzbekistan:** **Consolidated budget balance**



Source: National sources, IMF, CEIC, ING

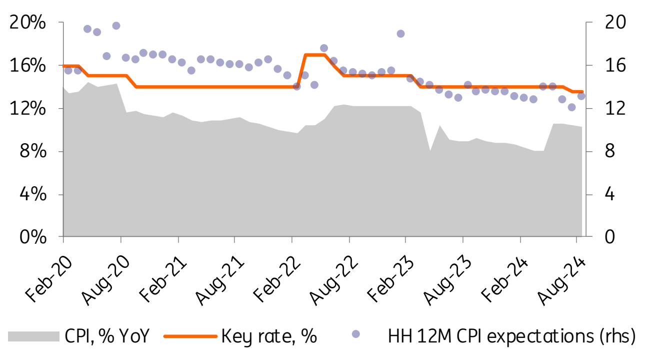
Fig 53 **Uzbekistan:** **Sovereign fund composition**



Source: National sources, IMF, Fitch, CEIC, ING

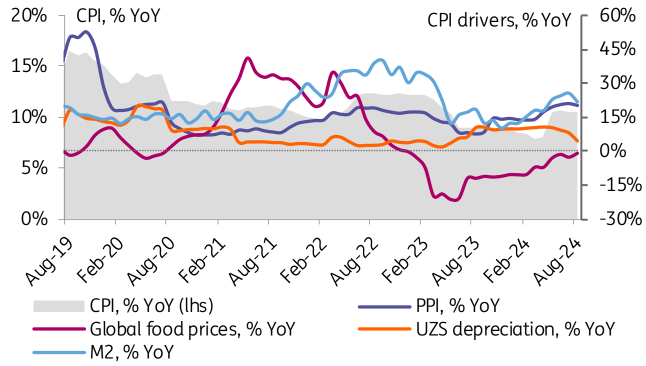
Inflation and monetary policy. Despite the widening fiscal gap and the recent spike in the regulated tariffs in May, the inflationary picture is turning out slightly better than expected, with CPI peaking at 10.6% YoY in May-Jule and slowing to 10.2% in August. That allowed the NBU to make a 50bp key rate cut to 13.50%. Our explanation is that the pro-inflationary factors are currently being counterbalanced by the slowdown of lending growth, and USZ depreciation amid easing in the supply-side constraints to the economic growth thanks to significant capex.

Fig 54 **Uzbekistan:** **Inflation, expectations, and key rate**



Source: National sources, CEIC, ING

Fig 55 **Uzbekistan:** **Inflation drivers**

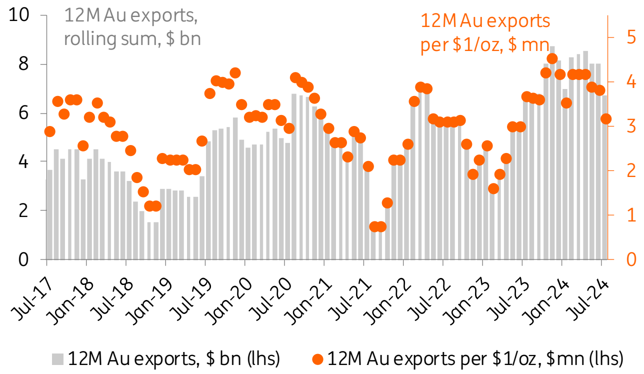


Source: National sources, CEIC, UN FAO, ING

For the rest of this year, the likelihood for a further slowdown in the inflation rate and key rate cuts appears low, especially given the still elevated inflationary expectations by households and still high PPI increase. However, we see further room for cuts to 12.50% by year-end 2025 and 11.00% by year-end 2026 provided CPI continues to decelerate towards the 6-8% range. To reiterate, uncertainties regarding the fiscal policy and FX stability remain the key watch factors and possible upward revisions in the CPI and key rate outlooks now.

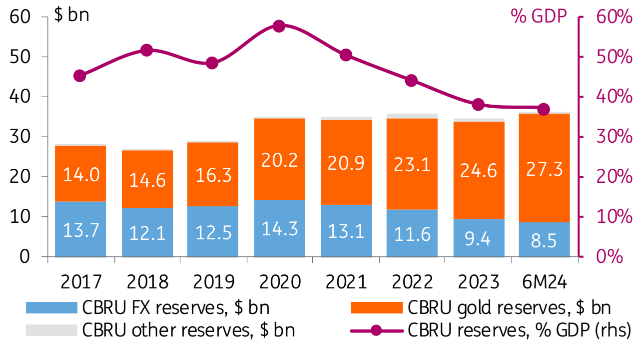
Balance of payments and exchange rate. Uzbekistan's external trade and currency had a favourable 1H24, mainly thanks to elevated gold exports, as higher global prices prompted the central bank to ramp up the export volumes. In January-June 2024 the country's gold exports continued to exceed production, leading to elevated proceeds of around US$4m per each US$1/oz of gold price. Meanwhile, the July data suggests that the intensity of gold sales somewhat eased. This, in our view, is in part due to the CBRU's need to accumulate monetary gold to offset the FX portion, which is a de-facto UFRD's FX deposit with the CBRU and is being sold to finance the fiscal deficit.

Fig 56 Uzbekistan: Export sensitivity to gold price



Source: National sources, CEIC, media, Statista, ING

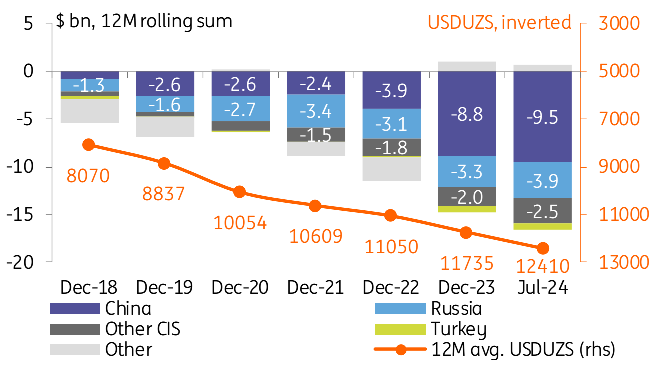
Fig 57 Uzbekistan: CBRU reserve composition



Source: National sources, CEIC, ING

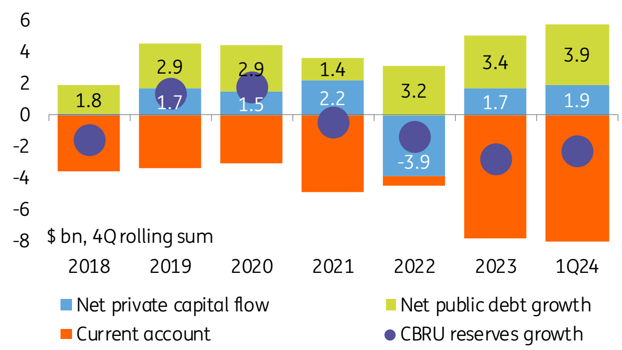
Improvement in the export dynamics has somewhat slowed the pace of USZ depreciation, in line with our initial expectations. At the same time, the broader balance of trade picture at the beginning of 2H24 is pointing to a renewed pressure, as 12m rolling exports have slowed down to just 1% YoY as of July, while imports continued growing at around 18% YoY, reflecting the country's persistently high appetite for consumer and investment imports. As a result, the current account deficit is likely to remain at around US$7-8 bn in 2024-25, with state and private capital inflows only partially covering the gap and exerting further pressure on USZ. We continue to expect the pace of USD/USZ to slow to around 2-4% in the medium term, but this year it should be around 5% YoY (to 12,900-13,000), in our view.

Fig 58 Uzbekistan: Balance of trade and services vs UZS



Source: National sources, CEIC, ING

Fig 59 Uzbekistan: Balance of payments composition



Source: National sources, CEIC, ING

Credit strategy

In terms of fundamentals, Uzbekistan's strong balance sheet (low government debt and strong reserve coverage) is slightly weakened by widening twin deficits, although the sovereign remains in a comfortable position. We believe Eurobond supply is set to continue to finance the nation's investment needs on its development path, although refinancing needs are low until 2027. As a positive, direct geopolitical risk appears lower than for Uzbekistan's regional peers.

Fig 60 Uzbekistan: Rating drivers/sensitivities, factors that could lead to an upgrade or downgrade

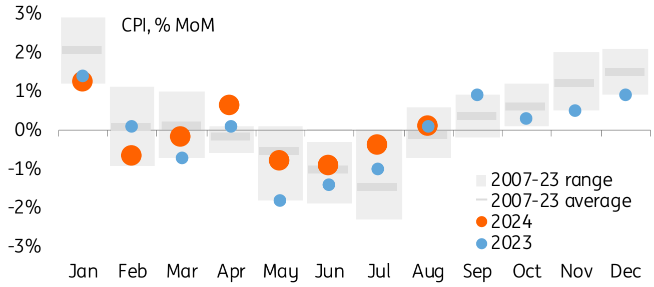
Agency	Upgrade factors	Downgrade factors
Moody's Ba3 (STABLE)	• Further progress in structural reforms to improve competitiveness. • Deepening of domestic capital markets to reduce reliance on foreign currency debt.	• Permanent weakening in real GDP growth and worse fiscal metrics. • Persistent widening in current account deficits without increased foreign investment. • Domestic political instability hinders the pace of reforms.
S&P BB- (STABLE)	• Economic reforms result in stronger growth potential and increased fiscal revenue. • Increased integration with the global economy drives diversification of export receipts.	• Negative spillovers from the Russia-Ukraine conflict drive weaker fiscal and external positions. • External and public debt continue to increase rapidly. • Weaker financial performance of SOEs leads to the transfer of contingent liabilities to the government balance sheet.
Fitch BB- (STABLE)	• **Fiscal:** Consolidation that enhances medium-term debt sustainability. • **Macro:** Structural reforms that boost GDP growth prospects. • **Structural:** Improvement in governance standards and easing in geopolitical risk.	• **Fiscal:** Marked rise in government debt due to period of low growth, loose fiscal stance, sharp UZS depreciation, or crystallisation of contingent liabilities. • **External:** Worsening in external position due to large drop in remittances or widening in the trade deficit.

Source: Moody's, S&P, Fitch, ING

Appendix 1

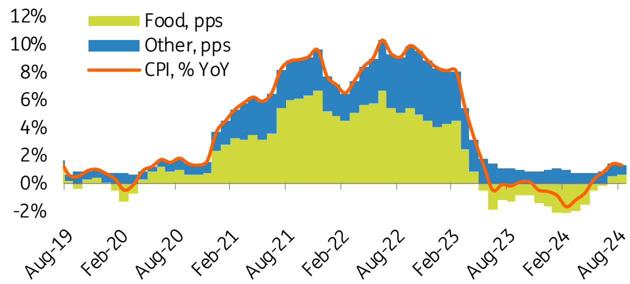
CIS-4 Inflation: Seasonality and composition

Fig 61 Armenia: Monthly price growth seasonality



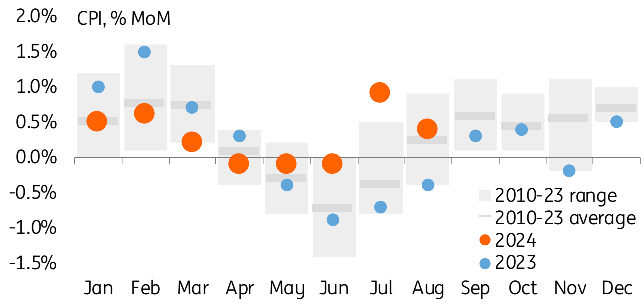
Source: National sources, CEIC, ING

Fig 62 Armenia: Annual CPI growth composition



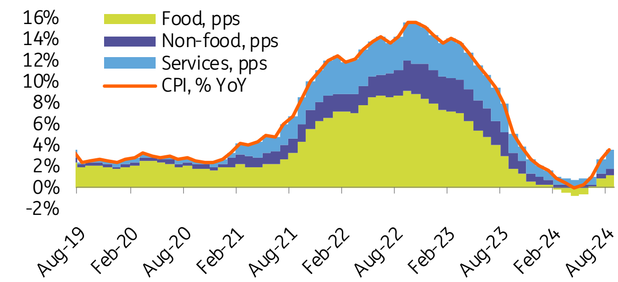
Source: National sources, CEIC, ING

Fig 63 Azerbaijan: Monthly price growth seasonality



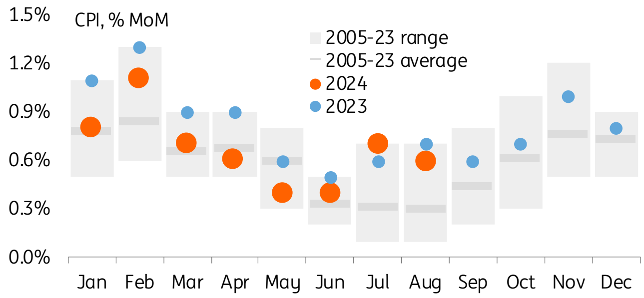
Source: National sources, CEIC, ING

Fig 64 Azerbaijan: Annual CPI growth composition



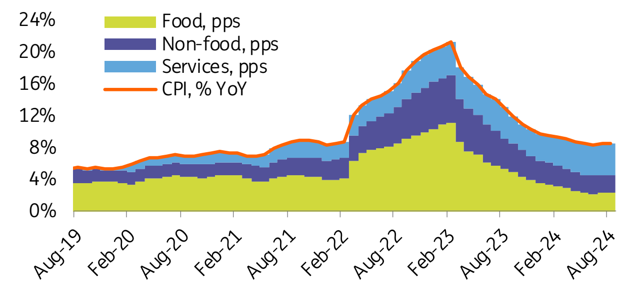
Source: National sources, CEIC, ING

Fig 65 Kazakhstan: Monthly price growth seasonality



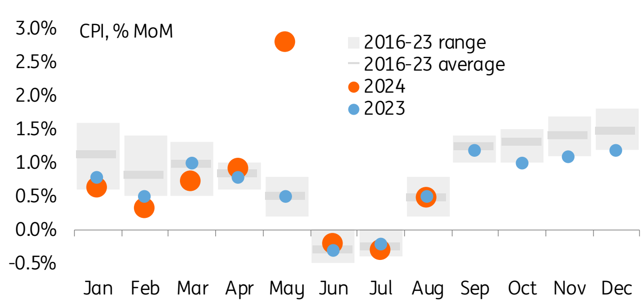
Source: National sources, CEIC, ING

Fig 66 Kazakhstan: Annual CPI growth composition



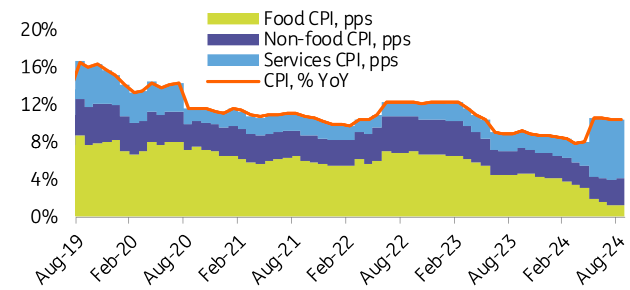
Source: National sources, CEIC, ING

Fig 67 Uzbekistan: Monthly price growth seasonality



Source: National sources, CEIC, ING

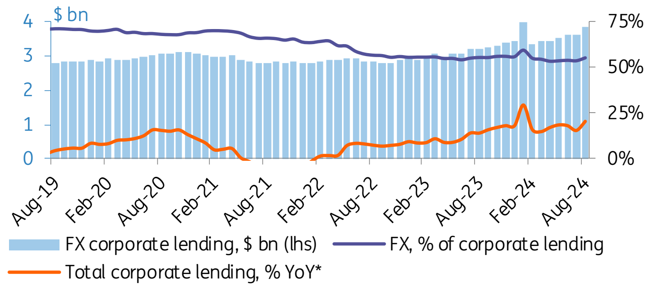
Fig 68 Uzbekistan: Annual CPI growth composition



Source: National sources, CEIC, ING

Appendix 2
CIS-4 banking sector lending trends

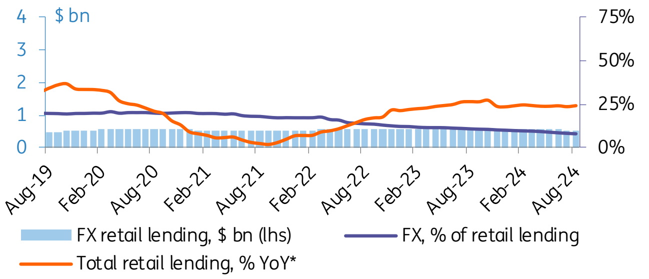
Fig 69 Armenia: Corporate lending (27% of GDP)



*Adjusted for FX revaluation effect

Source: National sources, CEIC, ING

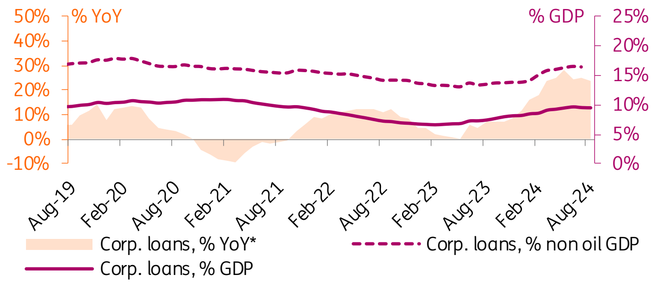
Fig 70 Armenia: Retail lending (25% of GDP)



*Adjusted for FX revaluation effect

Source: National sources, CEIC, ING

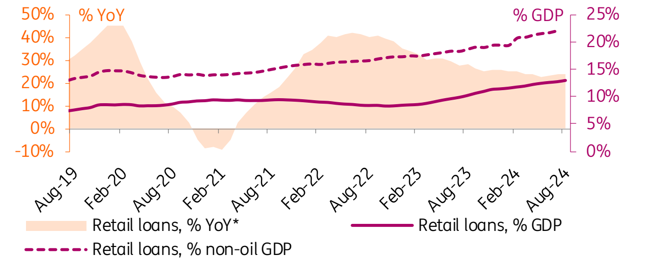
Fig 71 Azerbaijan: Corporate lending (9% of GDP)



*Adjusted for FX revaluation effect

Source: National sources, CEIC, ING

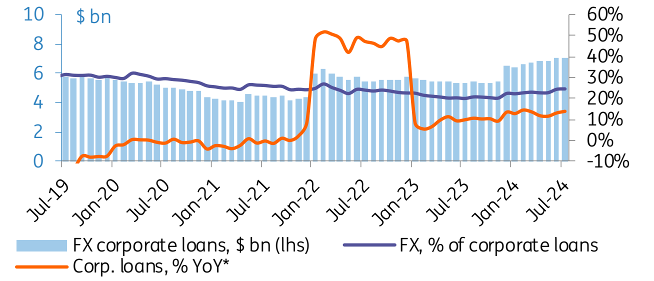
Fig 72 Azerbaijan: Retail lending (13% of GDP)



*Adjusted for FX revaluation effect

Source: National sources, CEIC, ING

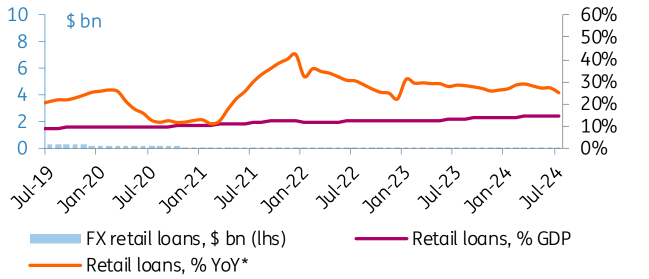
Fig 73 Kazakhstan: Corporate lending (11% of GDP)



*Adjusted for FX revaluation effect

Source: National sources, CEIC, ING

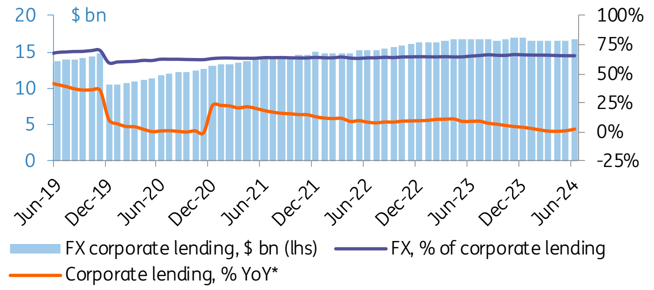
Fig 74 Kazakhstan: Retail lending (15% of GDP)



*Adjusted for FX revaluation effect

Source: National sources, CEIC, ING

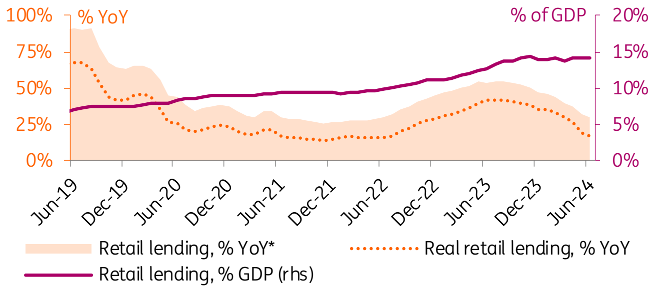
Fig 75 Uzbekistan: Corporate lending (30% of GDP)



*Adjusted for FX revaluation effect

Source: National sources, CEIC, ING

Fig 76 Uzbekistan: Retail lending (14% of GDP)

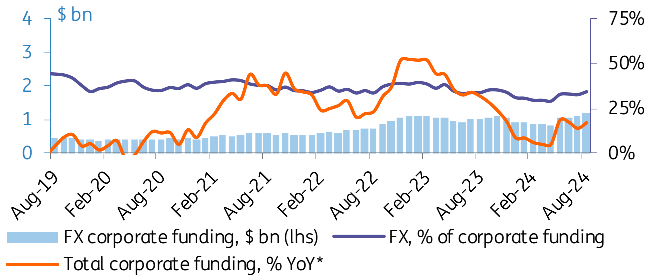


*Adjusted for FX revaluation effect

Source: National sources, CEIC, ING

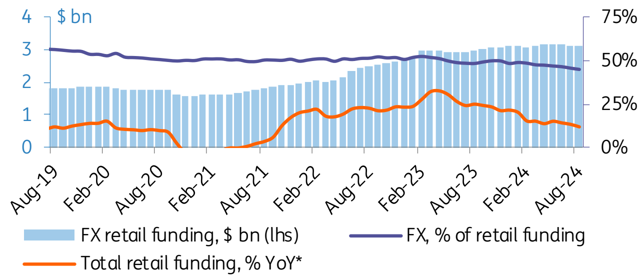
Appendix 3
CIS-4 banking sector funding trends

Fig 77 Armenia: Corporate funding (14% of GDP)



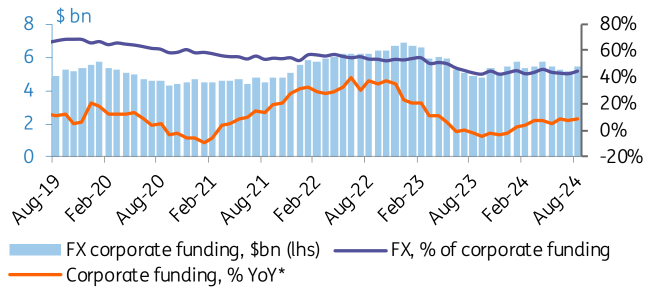
*Adjusted for FX revaluation effect
Source: National sources, CEIC, ING

Fig 78 Armenia: Retail funding (27% of GDP)



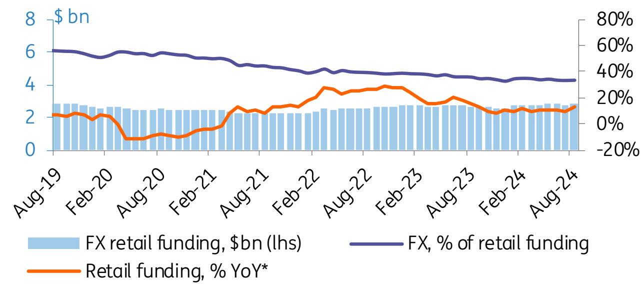
*Adjusted for FX revaluation effect
Source: National sources, CEIC, ING

Fig 79 Azerbaijan: Corporate funding (17% of GDP)



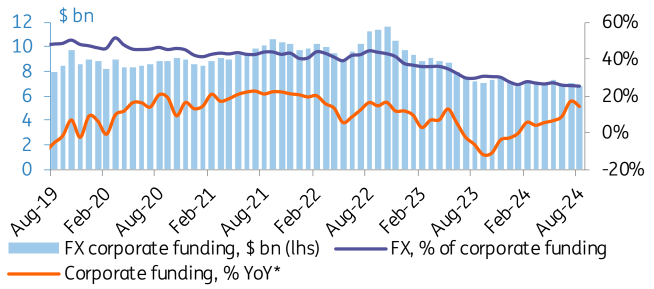
*Adjusted for FX revaluation effect
Source: National sources, CEIC, ING

Fig 80 Azerbaijan: Retail funding (11% of GDP)



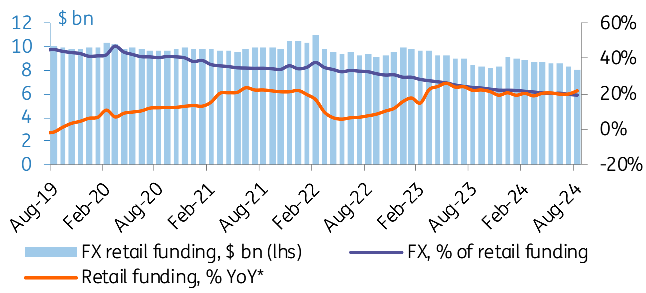
*Adjusted for FX revaluation effect
Source: National sources, CEIC, ING

Fig 81 Kazakhstan: Corporate funding (13% of GDP)



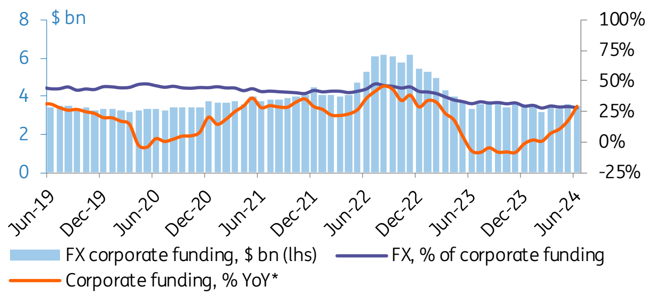
*Adjusted for FX revaluation effect
Source: National sources, CEIC, ING

Fig 82 Kazakhstan: Retail funding (19% of GDP)



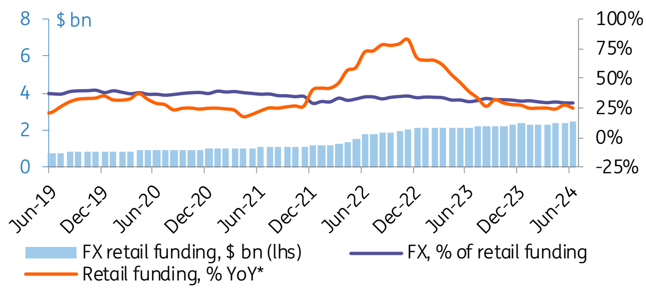
*Adjusted for FX revaluation effect
Source: National sources, CEIC, ING

Fig 83 Uzbekistan: Corporate funding (18% of GDP)



*Adjusted for FX revaluation effect
Source: National sources, CEIC, ING

Fig 84 Uzbekistan: Retail funding (12% of GDP)



*Adjusted for FX revaluation effect
Source: National sources, CEIC, ING

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