4 October 2023
EM Macro

Contents

CIS macro

Budget policy matters

We initiate regular coverage of four countries of the CIS (Commonwealth of Independent States): Armenia, Azerbaijan, Kazakhstan and Uzbekistan. In this report, we take a broad look at what the recent geopolitical shift in the region as well as domestic developments mean for each country's economic activity, fiscal and monetary policy, interest, and exchange rates. We also take a snapshot of what bank sector lending looks like.

Country views

- **Armenia,** the smallest of the CIS-4, is exposed to external forces, benefiting from the influx of Russian immigrants, but facing risks from incoming refugees from Nagorno-Karabakh. The dram is now reversing following more than a year of strength.
- **Azerbaijan,** the most financially solid of the four, is enjoying some recovery despite an otherwise lagging economic growth rate, aided by new gas contracts with the EU and upcoming state investments into reintegrated Karabakh.
- **Kazakhstan,** the largest among the CIS-4, is showing solid growth momentum but there are concerns on the fiscal side. The deficit is widening with higher savings in the oil fund, meaning more active borrowing and lower support to the tenge, which is pressured by growing imports and depreciation of trading partners' currencies. However, with positive real rates, the domestic debt might be attractive to portfolio investors.
- **Uzbekistan** is also posting solid economic growth rates and is increasingly affected by fiscal policy, which is showing signs of easing in 2023. The key focus is on the soum, which has been the worst performing currency in the CIS space. We do not exclude the possibility that the next couple of quarters could bring some temporary relief.

Macro themes

- In terms of **economic growth**, Armenia is the leader in 2023, for the second year in a row, but growth in Uzbekistan and, to some extent, Kazakhstan appears more diversified and therefore more sustainable. Azerbaijan is lagging given the mature oilfield base but may show some recovery related to gas and construction sectors.
- **Budget policy** is showing signs of easing across the region. Governments are becoming more socially focused. In addition, Armenia and Azerbaijan are likely to maintain elevated military spending, while Uzbekistan is on a public investment spree. Azerbaijan's state finances appear the most solid, while Armenia's require attention.
- **Monetary policy and rates** are turning downward against a backdrop of global disinflation. However, apart from Kazakhstan, downside for the key rates is modest because of region-wide fiscal easing and credit expansion, Armenia's FX depreciation risks and Uzbekistan's tariff liberalisation.
- **Exchange rates** are showing a mixed picture. Azerbaijani manat's peg to the US dollar seems secure given the country's strong external balance. The Armenian dram seems the most vulnerable to depreciation given the domestic political risks and moderation of the Russia-related external inflows. Uzbeki soum's downside appears relatively limited, while the Kazakh tenge, entangled in domestic fiscal policy and external influences from China and Russia, may stabilise in the coming quarters.

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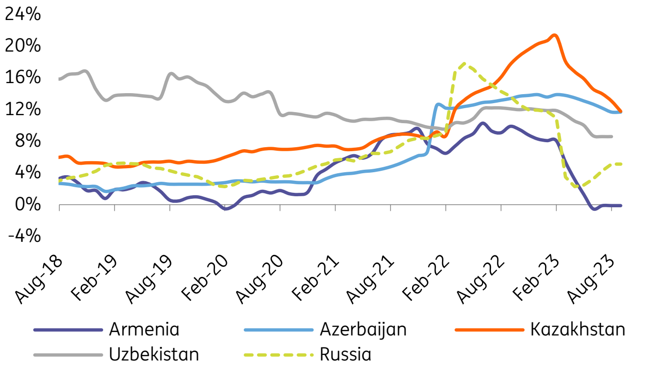
Select macro indicators for 2022-24F

	Armenia			Azerbaijan			Kazakhstan			Uzbekistan		
	2022	2023F	2024F	2022	2023F	2024F	2022	2023F	2024F	2022	2023F	2024F
GDP												
Real GDP (%YoY)	12.6	8.0	4.7	4.6	1.2	2.5	3.3	5.0	4.5	5.7	6.0	5.5
Nominal GDP (US$bn)	18.4	21.9	20.3	78.7	84.6	89.8	225.5	262.5	284.9	80.4	87.6	95.7
GDP per capita (US$)	6572	7543	7265	7798	8055	8476	11484	13533	14684	2255	2386	2557
Fiscal balance												
Consolidated budget balance (% of GDP)	-2.2	-2.4	-2.8	5.4	4.8	3.8	-1.3	-2.7	-1.1	-4.0	-5.3	-4.2
Public debt (% of GDP)	49.2	48.1	49.7	20.7	22.3	23.7	24.4	25.4	26.7	34.3	36.9	38.3
Fiscal breakeven Brent (US$/bbl)	n/a	n/a	n/a	70	64	72	116	125	107	n/a	n/a	n/a
Balance of payments												
Current account (% of GDP)	0.8	-2.0	-2.6	29.8	19.4	19.2	3.5	-1.6	-1.2	-0.8	-4.6	-6.7
Trade balance (% of GDP)	-9.5	-9.5	-10.2	34.8	22.9	23.8	15.8	8.0	8.7	-13.9	-16.0	-15.0
Foreign debt (% of GDP)	78.2	68.2	73.1	19.1	17.1	16.1	71.2	63.0	59.1	63.2	60.3	58.3
Current account breakeven Brent (US$/bbl)	n/a	n/a	n/a	38	40	45	83	93	97	n/a	n/a	n/a
CPI, Interest & exchange rate												
CPI (year-end, %YoY)	8.3	0.9	5.6	14.4	3.1	7.0	20.3	10.0	7.5	12.3	8.7	12.2
Central bank key rate (year-end, %)	10.75	8.75	7.50	8.25	8.50	8.00	16.75	15.50	11.50	15.00	14.00	14.00
Exchange rate vs USD (year-end)	394	440	471	1.70	1.70	1.70	463	470	485	11229	12352	12970

Source: National sources, CEIC, ING

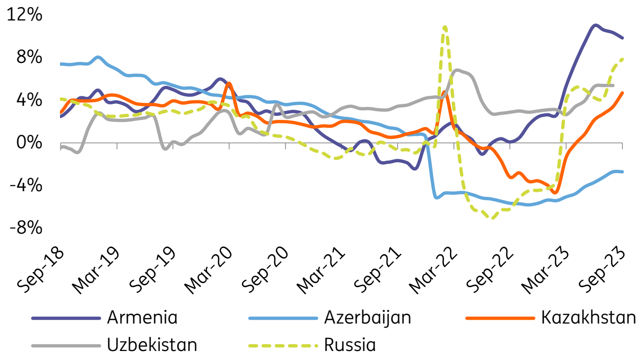
Cross-country overview charts

Fig 1 Inflation (% YoY)



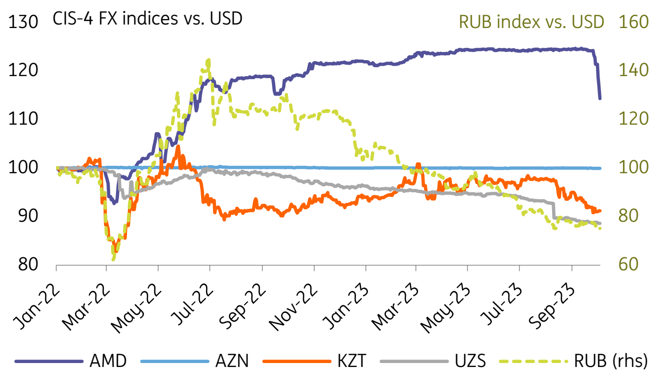
Source: National sources, CEIC

Fig 2 Real policy rates (%)



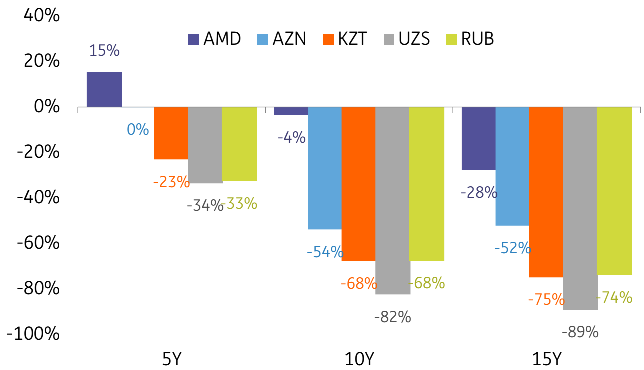
Source: National sources, CEIC, ING

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

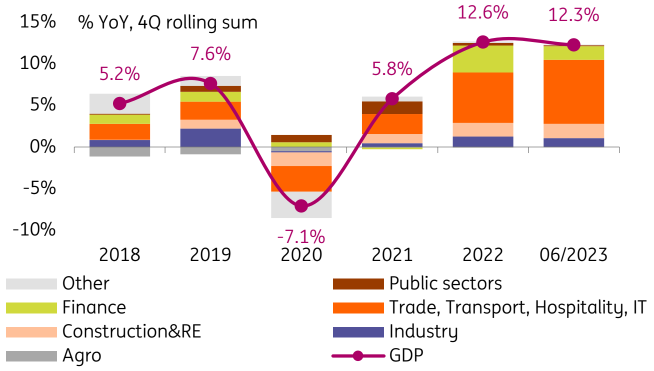
Armenia

Economic overview

The dissolution of Nagorno-Karabakh (Artsakh), a breakaway state within Azerbaijan with an ethnic Armenian majority, is a big event for Armenia. While a full-scale war with Azerbaijan seems to have been avoided, the tensions are likely to remain. The domestic political cost of the event and the upcoming inflow of 100-120 thousand ethnic Armenian refugees means upside risk to budget spending and the deficit. Outside of tensions with Azerbaijan, the spillovers from the Russia-Ukraine conflict remain mostly positive, with GDP growth continuing to be above trend, despite some recent moderation. The flipside is elevated inflation risks and limited downside to the key rate. Meanwhile, the exchange rate appears overvalued relative to peers, and the recent political event is a trigger for correction. The country's balance of payments seems to be gradually returning to normal following large inflows in 2022, but the recent ratings upgrade could potentially be favourable to portfolio flows after the correction.

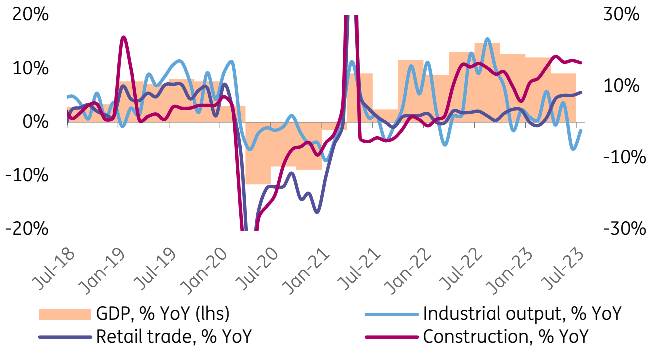
Economic activity in Armenia is above-trend for the second year in a row, decelerating only modestly from 12.6% in 2022 to 12.3% YoY during 4Q ending mid-2023. 90% of this growth is assured by construction, IT, trade and banking sectors, supported by the continued presence of Russian immigrants. Activity is financed by still elevated remittances of 10% GDP and accelerating retail lending (+40% YoY in July, 13.5% of GDP). We see GDP growth at 8% this year and around 6% next year. However, the sense of defeat in the Karabakh story and influx of refugees may raise the risks to growth if there were to be social unrest and political instability.

Fig 5 Armenia: GDP growth components



Source: National sources, CEIC, ING

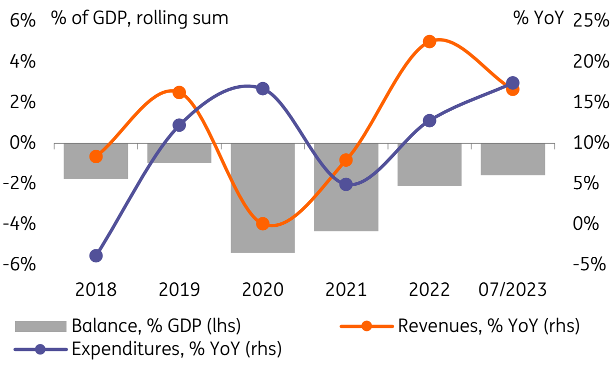
Fig 6 Armenia: Key activity indicators



Source: National sources, CEIC, ING

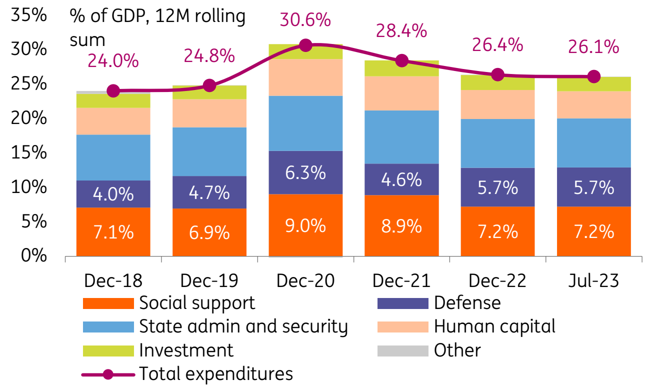
Budget policy, which has been showing signs of restraint in 2022 amid windfall revenues, may now be on the verge of loosening. The July data points to moderating revenue growth being outstripped by spending, which may be further pushed up by the upcoming inflow of as many as 120 thousand ethnic Armenians (4% of Armenia's permanent population) from Nagorno-Karabakh, which has now been reintegrated into Azerbaijan after c.30 years of breakaway status. Currently, Armenian spending on defence and social support account for 13% of GDP and 50% of total spending. We estimate that additional social spending because of the refugees could total at least 1% of GDP, while military spending will have to remain elevated given Azerbaijan's pressure to create a land bridge to its Nakhchivan exclave through Armenian territory. We expect Armenia's fiscal deficit widening from 2.2% GDP in 2022 to 2.5-3.0% in 2023-25F, to be financed via both local and foreign debt. With public debt at 49% of GDP, the country has some room for new borrowing, but the FX-heavy debt is sensitive to depreciation risks.

Fig 7 Armenia: Key budget parameters



Source: National sources, CEIC, ING

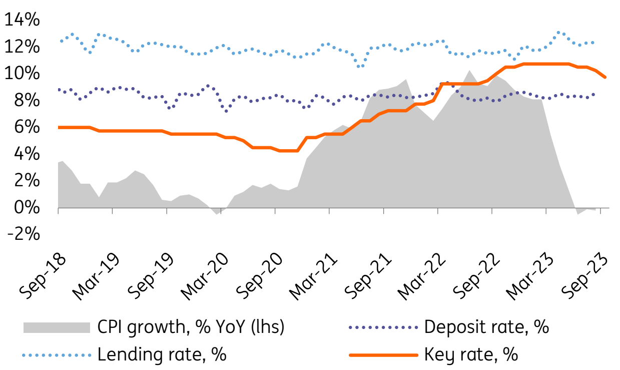
Fig 8 Armenia: Budget expenditure, 12M rolling basis



Source: National sources, CEIC, ING

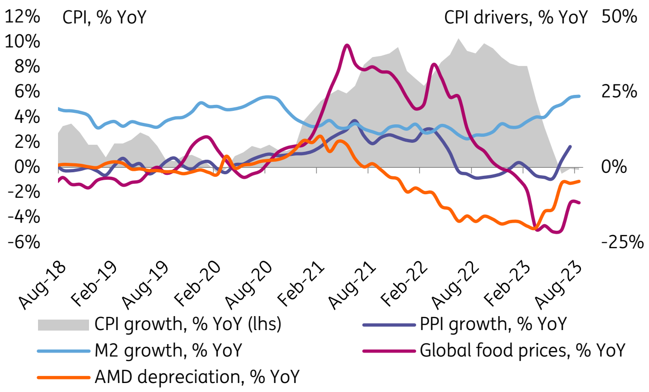
Inflation and monetary policy: The flipside to the positive view on economic growth and the greater role of the budget policy in it, is elevated inflationary risks. So far, Armenia's CPI has enjoyed a rapid deceleration thanks to global food price deflation, stronger domestic currency, muted lending growth and fiscal consolidation. We see average inflation bottoming at 2.0-2.5% in 2023, but the reversal of the most disinflationary factors should lead to a subsequent acceleration to 4.0-4.5% in 2024-25, ie, above the long-term target of 4.0%, which limits the downside to the key rate. The window for a key rate cut will be the next couple of months when annual CPI will be pushed down by the high base effect. We see the key rate at 9.0% at the end of 2023 and 7.0-7.5% in 2024. This is still a decent downside from the current 9.75% but risks to our rates view are tilted up.

Fig 9 Armenia: Inflation and key rate



Source: National sources, CEIC, ING

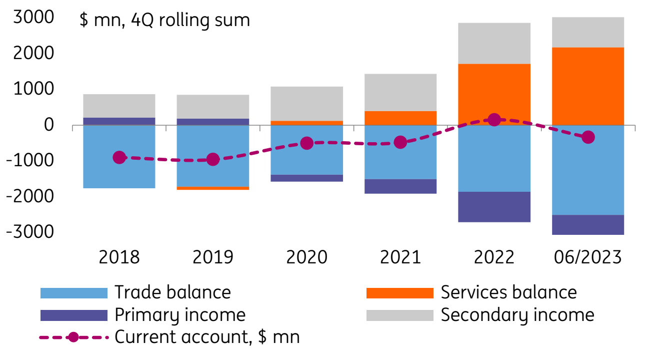
Fig 10 Armenia: Inflation drivers



Source: National sources, CEIC, UN FAO, ING

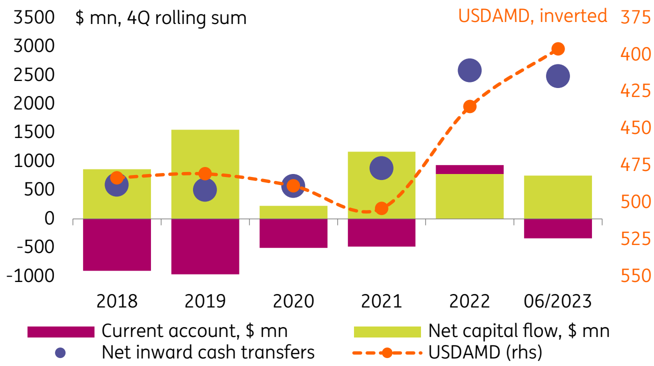
Balance of payments and exchange rate: Armenia's balance of payments is normalising after the Russia-related 'disruption' of 2022. The current account balance is back to negative territory as of mid-2023 (both on a YTD and 4Q rolling basis), but the deficit so far is still much narrower than the usual 3.5-7.0% of GDP as it is still supported by the presence of Russian immigrants in two channels. Firstly, net remittances inflows are still higher than usual at US$1.0bn but have moderated to US$2.5bn on a 12M rolling basis in July 2023 vs the peak US$3.0bn as of end-2022. Secondly, the services exports (hotels) are benefiting from the inflow of people. The private capital flow balance appears positive, and the recent upgrade in the ratings to BB- by S&P and Fitch and improved outlook by Moody's to stable (Ba3) should be supportive. However, the flare-up of tensions with Azerbaijan is a factor of concern.

Fig 11 Armenia: Current account evolution + composition



Source: National sources, CEIC, ING

Fig 12 Armenia: Balance of payments vs AMD



Source: National sources, CEIC, ING

Given the gradual normalisation of the balance of payments the AMD's scope for appreciation seems exhausted. The dram was already an outlier in the CIS space after the 26% rally vs USD between February 2022 and mid-September 2023. We do not exclude a 10% USD/AMD drop in 4Q23 and a continued decline in 2024. We view Armenia's defeat over the Nagorno Karabakh state as a trigger but not the fundamental reason for the reversal in the AMD trend.

Fig 13 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	• 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 • Fiscal, balance of payments, and financial stability risks lessen over and above current expectations	• Material reversal in financial and labour inflows from Russia • Macroeconomic fallout triggered by escalation of conflict with Azerbaijan
Fitch BB- (STABLE)	• **Fiscal:** Fiscal consolidation and reduction in FX share of government debt • **Macro:** Durable high growth rates that increase GDP per capita. • **Structural:** A reduction in geopolitical risk	• **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

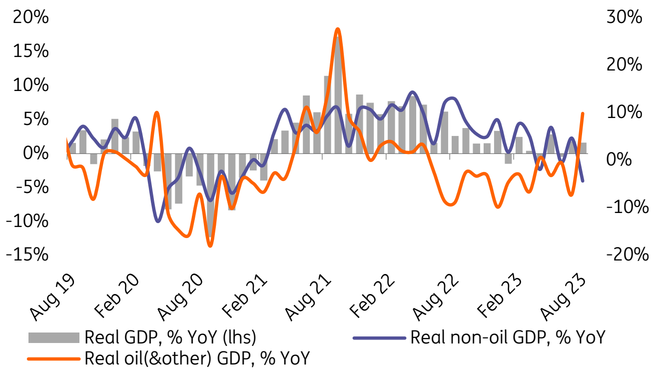
Azerbaijan

Economic overview

Following the reintegration of the breakaway Nagorno-Karabakh state, Azerbaijan is at an inflection point. Economic activity seems to be picking up cautiously amid a recovery in the oil and gas output, fiscal policy is on the verge of easing, and inflation is about to show a material (though temporary) slowdown. The potential increase in state investments should be the key watch factor in the coming months. The risk of further tensions with Armenia, which seem low now, may remain on the agenda, preventing a decline in defence spending. A low-risk financial powerhouse, Azerbaijan would be an attractive borrower, if it were to need the money.

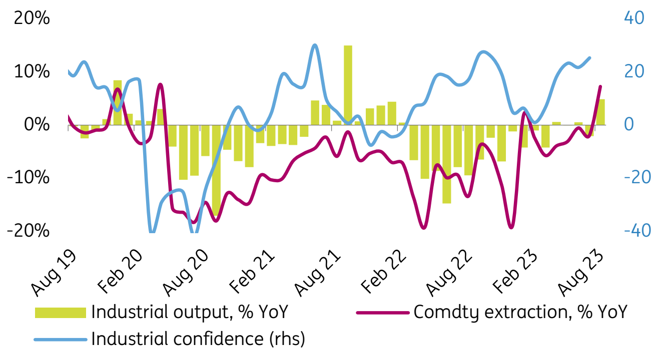
Economic activity for Azerbaijan is on a cautious recovery track. Having slowed from 4.6% in 2022 to just 0.5% YoY in 1H23, GDP growth was 1.6-1.8% YoY and, in August, industrial production turned positive at 4.9% YoY thanks to a 7.3% YoY spike in commodity extraction. The oil GDP (40% of total) has been the main drag lately, due to disruptions in oil production, exports and transportation, but this seems to be improving. Non-oil GDP appears to be resilient, especially on construction and trade, although positive spillovers from the Russia-Ukraine conflict reflected in elevated transportation may be receding. Overall, we see 2023 GDP posting a modest 1.2% increase this year. However, the 2024 result should be 2.5%, closer to normal, thanks to the removal of some transportation bottlenecks, higher gas output (thanks to the substitution of Russian gas by the EU) and potential public investments into the recently reintegrated Nagorno-Karabakh.

Fig 14 Azerbaijan: GDP growth dynamics and composition



Source: National sources, CEIC, ING

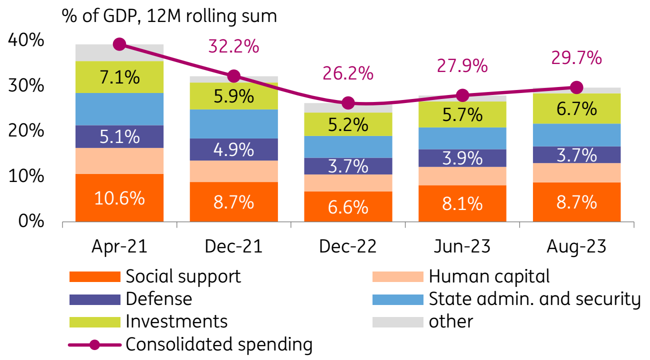
Fig 15 Azerbaijan: Key indicators of industrial production



Source: National sources, CEIC, ING

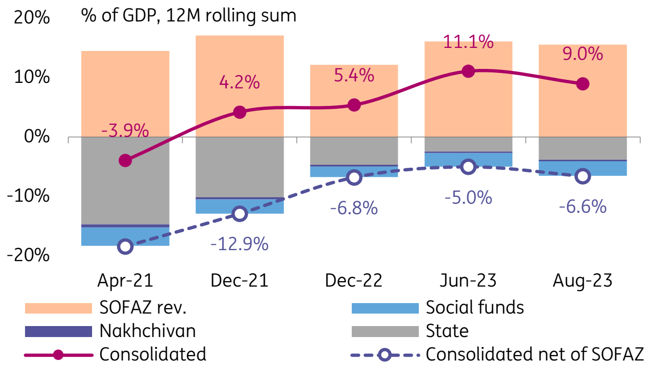
Budget policy remains Azerbaijan's key strength. Azerbaijan's consolidated surplus reached an impressive 11.1% of GDP (12M rolling basis) as of June 2023. Fuel revenues, accounting for 60% of total and comprised of the state budget's corporate profit tax and the SOFAZ (state sovereign oil fund) proceeds from fuel trade and asset management have strengthened. Annual revenues collected per US$1/bbl of Brent increased from the traditional US$150-160m to US$210-220m in 2022-23 despite lower physical volumes of extraction and exports. Meanwhile, starting in 2H23, we observe an inflection point, related to some moderation in fuel and non-fuel revenues amid some pickup in spending. Expenditures have been growing in 2023 in real terms due to higher social support and public investments, and there is further appetite to maintain economic momentum and to develop Nagorno-Karabakh. Also, defence spending is likely to remain elevated given the continued tensions with Armenia. Azerbaijan's desire to create a land connection with its Nackhchivan exclave over Armenian territory will be a watch factor. We see Azerbaijan's consolidated surplus narrowing to 3.8-4.8% of GDP in 2023-24. With a fiscal configuration like that, Azerbaijan does not appear to require any new borrowing.

Fig 16 Azerbaijan: Consolidated budget spending



Source: National sources, CEIC, ING

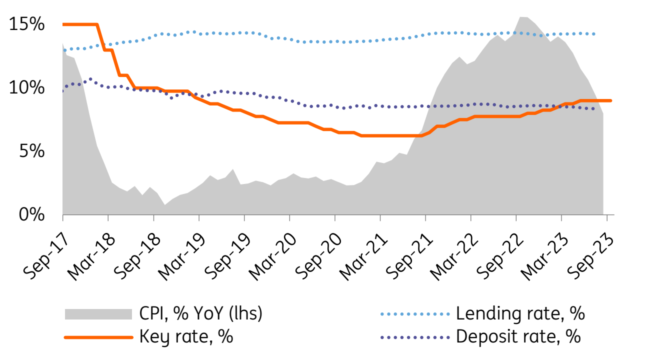
Fig 17 Azerbaijan: Components of consolidated budget balance



Source: National sources, CEIC, ING

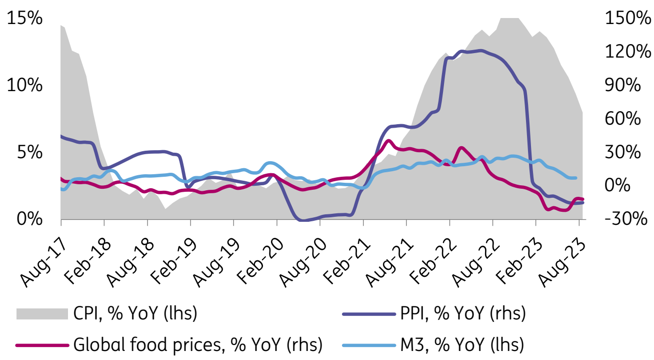
Inflation and monetary policy: Azerbaijan's inflation is on a cautious deceleration path thanks to global price disinflation. As of August, local CPI growth decelerated to 8.0% YoY vs the 15.6% YoY peak recorded in September last year. The favourable base effect combined with actual easing in the inflationary pressure may lead to a temporary decline in the CPI rate to around 3% YoY in 1H24. At the same time, sustainability of this slowdown will be challenged by the recovery in economic activity and potential easing in the fiscal policy. As a result, the central bank is likely to remain cautious and any downside to the key rate, currently at 9.0%, may start materialising only by this year-end. We see the year-end 2024 key rate at 8.0%. This means that the monetary policy is unlikely to provide material support to the economic growth in the medium term.

Fig 18 Azerbaijan: Inflation and key rate



Source: National sources, CEIC, ING

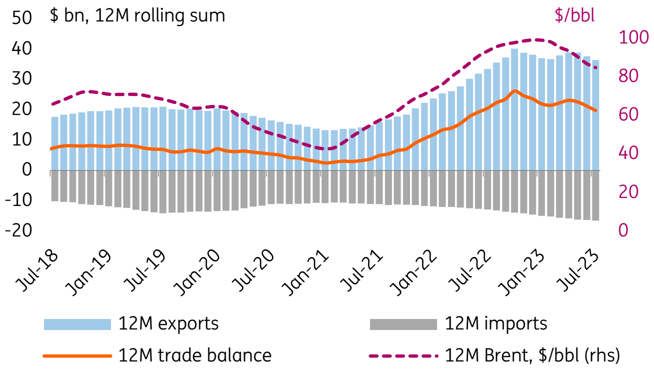
Fig 19 Azerbaijan: Inflation drivers



Source: National sources, CEIC, UN FAO, ING

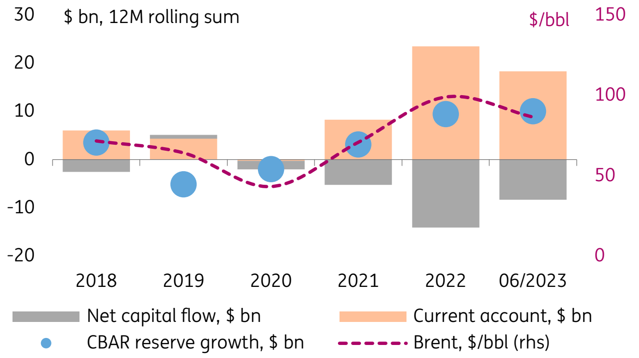
Balance of payments: Azerbaijan's external position remains strong. In 2022, annual fuel exports per US$1/bbl of oil price shot up from a normal US$250-280m to US$380m, and as of mid-2023 (4Q rolling basis) reached US$390m, presumably thanks to higher gas supplies. At the same time, imports are catching up, limiting the expansion of the trade balance and the current account. As a result, we see the current account surplus narrowing from 30% GDP in 2022 to 19% GDP in 2023. This means a relatively stable breakeven at a comfortable level of around US$40/bbl. At this point, the risk of devaluation of AZN, currently pegged to USD at 1.70, seems quite low.

Fig 20 Azerbaijan: 12M trade balance composition



Source: National sources, CEIC, ING

Fig 21 Azerbaijan: 12M balance of payments composition



Source: National sources, CEIC, ING

Fig 22 Azerbaijan: Rating drivers/sensitivities, factors that could lead to an upgrade or downgrade

Agency	Upgrade factors	Downgrade factors
Moody's Ba1 (STABLE)	• 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 or significant spillovers from the Russia-Ukraine conflict
S&P BB+ (STABLE) *(next review date 8 December 2023)*	• Sustaining high external surpluses for further accumulation of external assets • Reforms that improve diversification of economy and monetary policy effectiveness	• Declining oil production weighs on fiscal balances • Falling hydrocarbon receipts weigh on GDP per capita growth • Geopolitical tensions with Armenia escalate again
Fitch BB+ (POS)	• **Fiscal:** Continued expenditure restraint, in line with fiscal rule, or sustained high energy prices • **External:** Further strengthening of external balance sheet, eg, through energy exports • **Macro**: Improvements in policy predictability and framework	• **Fiscal:** Significant fiscal loosening or additional material contingent liabilities • **External:** Lower energy prices that could significantly reduce exports • **Macro:** Reduced confidence in policy framework

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

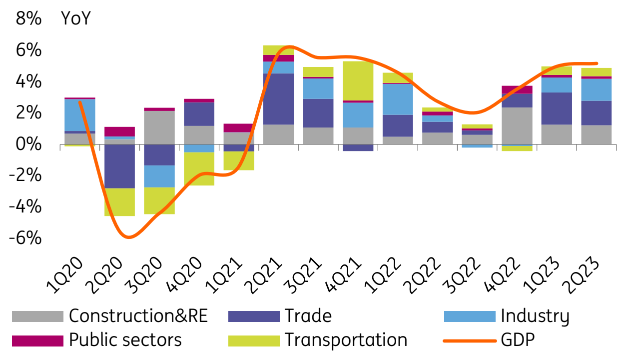
Kazakhstan

Economic overview

Fiscal policy is a key watch factor for the country's financial market. The budget deficit is widening but, at the same time, the government is building up savings in the sovereign oil fund. This means higher borrowing at generous rates. On the negative side, it means elevated breakeven Brent at US$115-125/bbl in the coming couple of years as well as growing public debt and interest expense. Also, in the longer run, lower disbursement of FX out of the oil fund might limit the government's ability to support the tenge, which is currently under pressure of growing imports and depreciation of trading partners' currencies. On the positive side, it is growth-supportive for the medium term, while the growing local debt amid positive real rates could draw the attention of foreign portfolio investors.

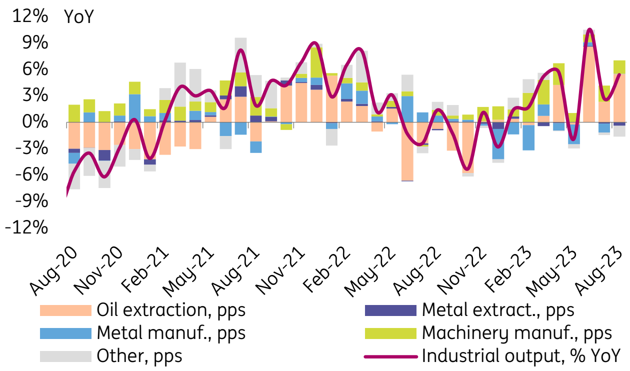
Economic activity in Kazakhstan is currently on a recovery path as, after the trough in 3Q22, GDP growth is back to a normal 5.0-5.2% YoY in 1H23. While the non-oil GDP (70% of total) has been largely upbeat the whole time and benefited from Russian immigration in 2022, the oil sector has been volatile. After some disruption in production and exports in 2022, the situation in 2023 appears to be more solid now, with oil extraction showing confidently double-digit growth rates YoY since June this year, contributing to the significant improvement in overall industrial production growth. We see GDP growth remaining at 5% in 2023 and we raise our expectations to 4.5% for 2024 given the recent signs of renewed easing in the fiscal policy.

Fig 23 Kazakhstan: GDP growth dynamics and structure



Source: National sources, CEIC, ING

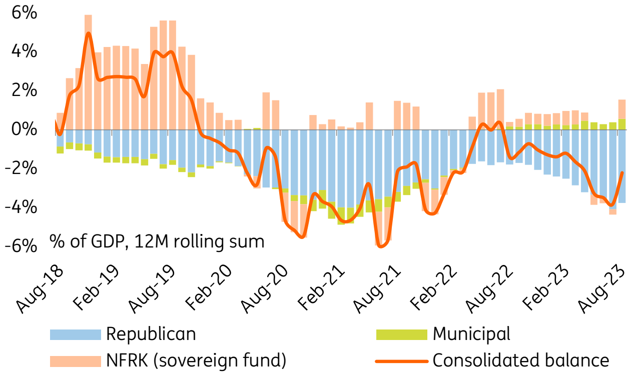
Fig 24 Kazakhstan: Industrial production growth and structure



Source: National sources, CEIC, ING

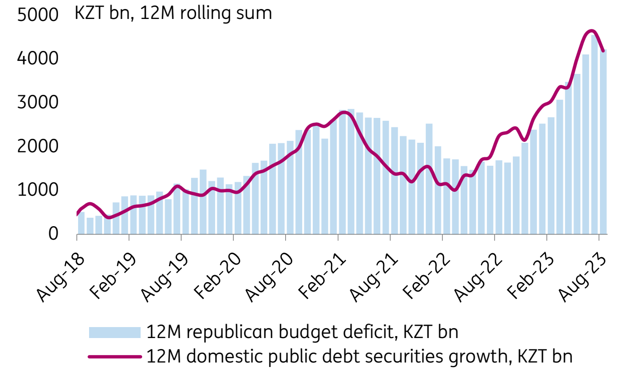
Budget policy is leaning towards easing, as expenditures showed a broad-based increase of 1 percentage point of GDP during 8M23. In the meantime, the revenue side is under pressure from lower fuel revenue collection, which is down from US$180m per annum to US$170m per US$1/bbl of Brent because of slightly and temporarily lower production and export volumes. Despite this, the deficit widened by 0.9ppt of GDP to 2.2% of GDP in 8M23. We expect a consolidated deficit at 2.7% of GDP for FY23, with some moderation in 2024. Meanwhile, the announced tightening of the fiscal rule means a higher preference to save fuel revenues in the sovereign fund (NFRK) rather than use them to finance current expenditures of the republican budget. This leads to higher borrowing requirements. We see the 2023-24 republican budget deficit at 3-4% of GDP (KZT4.5-5.0tr) per annum and already, as of August 2023, the domestic public debt securities market is growing at a pace of KZT4.2tr YoY amid elevated rates, leading to higher interest expense. In the case of a wider deficit, some additional external borrowing might be required.

Fig 25 Kazakhstan: Consolidated budget balance composition, 12M



Source: National sources, CEIC, ING

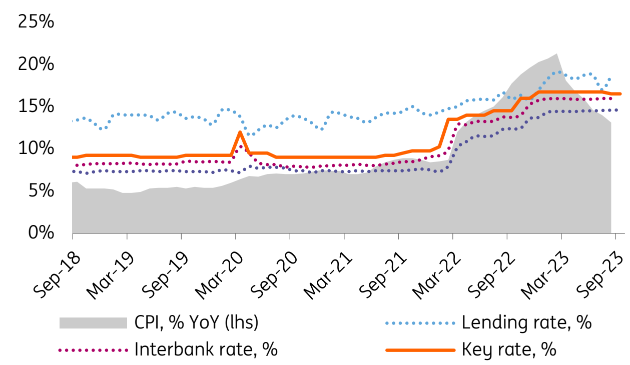
Fig 26 Kazakhstan: Republican deficit and domestic debt growth



Source: National sources, CEIC, ING

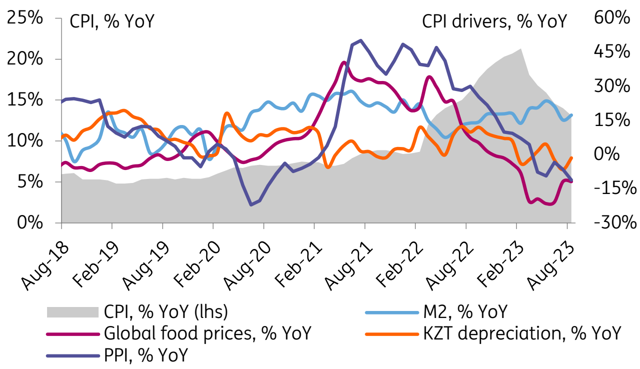
Inflation and monetary policy: CPI and the key rate are on a cautious downward path, but risks remain. Having peaked at 21.3% YoY in February 2023, CPI has crawled down to 13.1% YoY currently amid normalisation of the global food prices and other commodities as well adjustment to the newly arrived Russian immigrants. This enabled the NBK to make a first cautious 25bp cut in August to 16.50%, while indicating that the fiscal easing and elevated domestic inflationary expectations may be clouding the outlook. We expect CPI to continue decelerating to 10.0% YoY at year-end 2023 and to 7.5% YoY at year-end 2024, allowing the central bank to cut the rate to 15.50% and 11.50%, respectively. That said, the recent tenge depreciation may create an upside risk to this path.

Fig 27 Kazakhstan: Inflation and key rate



Source: National sources, CEIC, ING

Fig 28 Kazakhstan: Inflation drivers

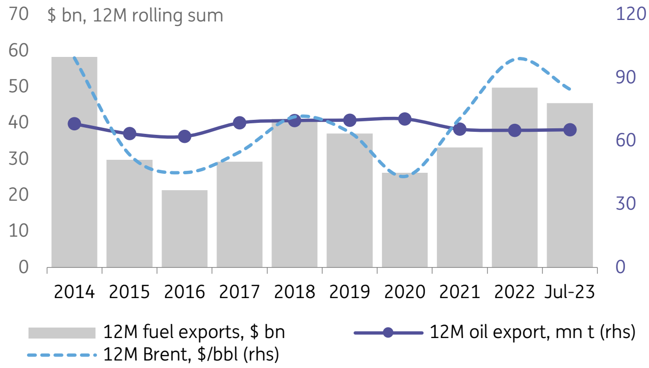


Source: National sources, CEIC, UN FAO, ING

Balance of payments and exchange rate: Following the geopolitically driven collapse of 1H22, the tenge has been on a gradual recovery path for four quarters. The abrupt end to this recovery in 3Q23 despite the strength in Brent prices may seem surprising even considering lower support to KZT from the state-owned enterprises. However, the evolution of balance of payments sheds some light on the issue.

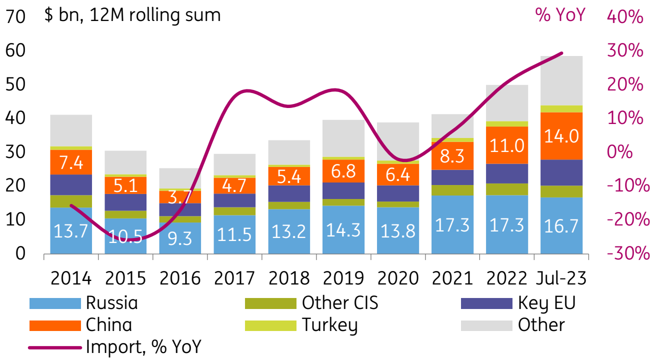
Looking at the foreign trade evolution, it appears that the FX market is losing the temporary support of the current account, which showed a brief surplus in 2022 amid elevated oil prices and is now coming back to its usual deficit state. While Kazakhstan's oil-heavy exports (55-60% of total) are stable in physical terms and slightly down in dollar terms, imports are growing rapidly at 30% YoY, primarily from China, reflecting the country's growing investment needs amid recovery in industrial output and efforts to diversify oil exports away from the Russia-related CPC pipeline (80% of oil exports). We expect the current account to slide into a 1.6% GDP deficit in 2023 and remain in a 1-2% range in the subsequent couple of years.

Fig 29 Kazakhstan: Fuel export volume and value



Source: National sources, CEIC, ING

Fig 30 Kazakhstan: Import growth and geographical composition

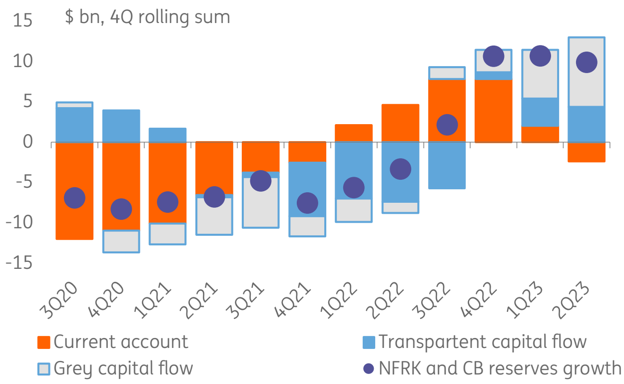


Source: National sources, CEIC, ING

Looking more broadly at the balance of payments, it could be argued that the weakness in the current account should not be a big problem for the tenge because it seems to be offset by the capital inflow. Indeed, as of mid-2023, the current account deficit of US$2.4bn (4Q rolling sum) appears to be overwhelmed by the net private (banks, companies and households) capital inflow of US$13bn. However, we see two major issues with that inflow. First, the quality and sustainability of the inflow are under question, as two-thirds of this inflow is 'errors and omissions', which became large and positive in 3Q22 following the Russia-related geopolitical turmoil. The transparent and sustainable capital inflows are much more modest, providing much smaller support to the local FX market.

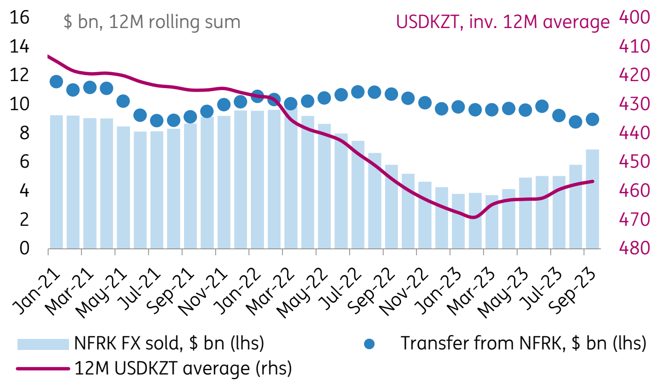
The second issue is that the private capital inflows are actively sterilised by the accumulation of FX assets by the central bank and NFRK, the state oil fund. The FX interventions by the sovereign fund – which must convert a portion of its FX oil revenues into KZT to finance the current spending of the budget – is a game changer for the exchange rate. Looking at the past 12 months, the period of deepest KZT weakness corresponds to a decline in the NFRK FX sales. Although the overall transfers from the NFRK to the republican budget remained roughly unchanged at US$10bn in 2022, the share of conversion into KZT dropped materially from 90% in 2021 to 44% (US$4.3bn) in 2022, reducing support to the tenge. In 2023, the situation improved, as with the planned decline in the annual transfer by KZT1tr to c.US$8bn, the intensity of FX conversion recovered, suggesting an increase in the annual FX sales from NFRK this year and guiding for some support to tenge by this year-end. At the same time, the planned reduction of NFRK transfers by KZT200bn (c.US$0.6bn per year) in 2024-26 suggests lower support to tenge in the longer run.

Fig 31 Kazakhstan: Balance of payments composition, 4Q rolling sum



Source: National sources, CEIC, ING

Fig 32 Kazakhstan: FX sales out of sovereign fund and USD/KZT



Source: National sources, CEIC, ING

To sum up, the recent round of KZT weakness in 3Q23, which may have been amplified by the weaker RUB and CNY, the currencies of Kazakhstan's major trade partners, may pause in the coming quarter assuming the expected normalisation in the global risk mood, continued private capital inflows to Kazakhstan and potential interest of portfolio investors (who can no longer invest into Russia) to Kazakhstan's public debt against a backdrop of positive real rates, as well as more active FX conversion out of the NFRK. However, the weakening trend may resume in 2024 with a continued deterioration of the trade balance, evaporation of the Russia-related capital inflows, and an expected lower participation of NFRK in support to the domestic FX market.

Fig 33 Kazakhstan: Rating drivers/sensitivities, factors that could lead to an upgrade or downgrade

Agency	Upgrade factors	Downgrade factors
Moody's Baa2 (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
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 dollarization	• 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) *(next review date 17 November 2023)*	• **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

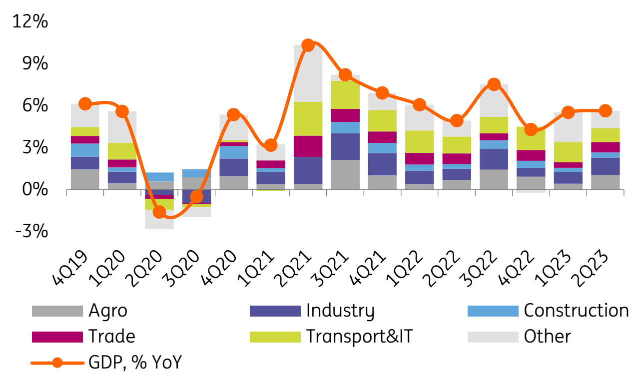
Uzbekistan

Economic overview

Uzbekistan is being strongly affected by the fiscal policy as well. The active state investments and expanding social safety net amid tax easing are supportive of economic growth and social development but lead to a wider fiscal deficit and higher borrowing requirements. The monetary policy is cautious, targeting highly positive real rates to limit the monetary inflation risks coming from credit- and fiscally-sponsored demand, weaker domestic currency and an expected inflationary effect of retail energy tariff liberalisation in May next year. The key rate currently has very little downside in 2024. Meanwhile the soum, which has been on a depreciation path for some time, may find some temporary relief in the coming couple of quarters thanks to some stabilisation in the trade and services balance, higher foreign borrowing by the government, highly positive real domestic rates, weaker dollar on the global market, and some possible stabilisation of the currencies of Uzbekistan's major trading partners.

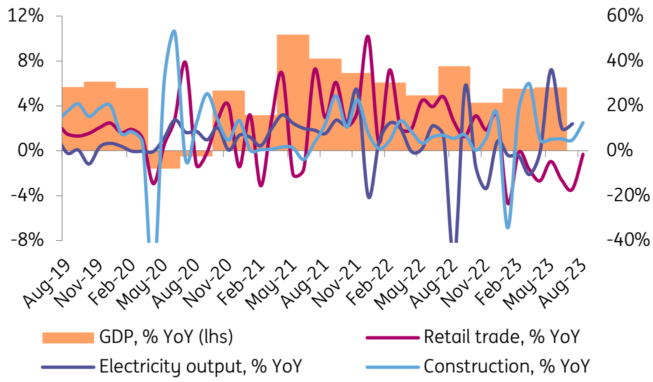
Economic activity is back on an acceleration path in Uzbekistan following a slight hiccup at the beginning of the year when activity was disrupted by power outages. GDP growth is up 5.5-5.7% YoY in 1H23, as output in agriculture and heavy industries normalised. Domestic demand appears well supported by credit expansion, with retail lending up 40% YoY in real terms, continued remittances inflow and other spillover effects of the Russia-Ukraine conflict, continued export growth, and – most recently – by the fiscal side, as contrary to our initial expectations the consolidated budget deficit widened by almost 1ppt of GDP over the course of 1H23. We see GDP growth picking up 0.3ppt to 6.0% in 2023 and stabilising in the normal 5.5-6.0% range in 2024-25.

Fig 34 Uzbekistan: GDP growth dynamics + composition



Source: National sources, CEIC, ING

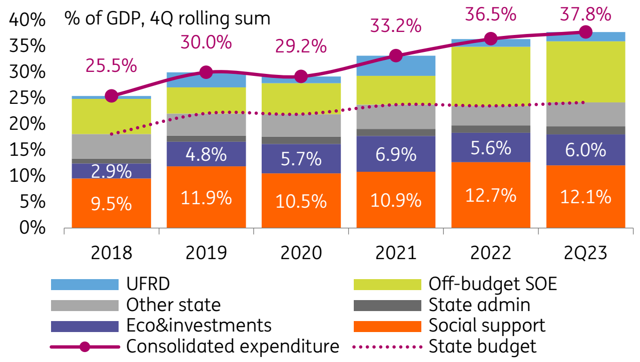
Fig 35 Uzbekistan: Key economic activity indicators



Source: National sources, CEIC, ING

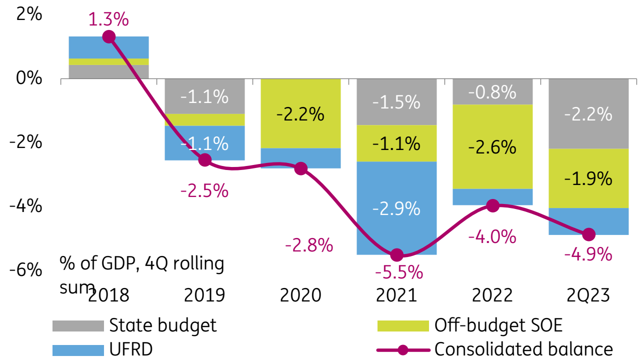
Budget policy is growth-supportive as, after consolidating from 5.5% to 4.0% of GDP in 2022, the consolidated budget deficit (comprising of state budget, sovereign fund and budget SOEs) widened again to 4.9% of GDP on a 4Q rolling basis as of mid-2023. This was caused by the continued expansion of expenditures (which are up from 25.5% of GDP in 2018 to 37.8% of GDP as of mid-2023) amid a much more modest revenue performance (these are up from 26.8% in 2018 to 32.9% currently). The spending increase seems to be driven by the social sphere (12-13% of GDP) including energy subsidies to low-income families and families with children, as well as state investments (6% of GDP). In the meantime, revenues under pressure of a reduction in VAT are negatively affected by the lower prices of Uzbekistan's commodity exports (export-driven revenues account for around 20% of the consolidated budget). As a result, we see the consolidated budget deficit widening to 5.0-5.5% of GDP this year with some stabilisation in the 3-4% range possible within the next two years. With only 10% of GDP of liquid state savings in the UFRD, the sovereign fund, borrowing seems to be the primary source of the deficit. Most of Uzbekistan's public debt is external, however we do not exclude an attempt to boost domestic borrowing as well. The public debt, at 34% of GDP in 2022, may increase by around 5ppt by the end of 2025.

Fig 36 Uzbekistan: Consolidated budget expenditure composition



Source: National sources, CEIC, ING

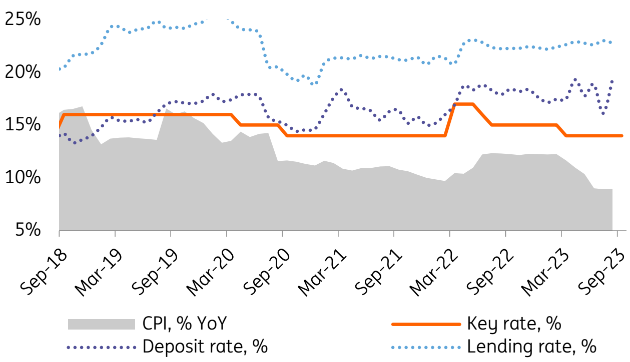
Fig 37 Uzbekistan: Consolidated budget balance composition



Source: National sources, CEIC, ING

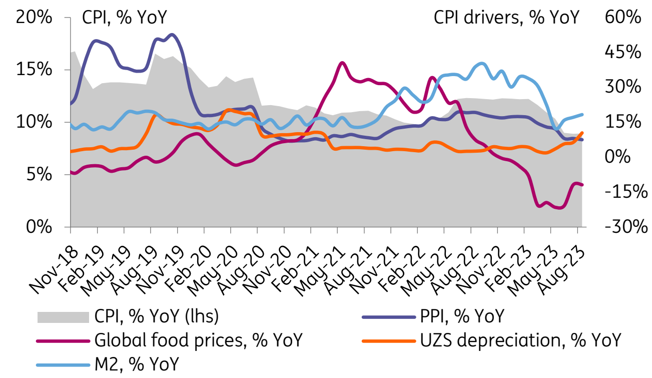
Inflation and monetary policy: Inflation appears to be on a downward path, in line with global and regional trends, with the CPI rate down to 8.9% YoY in August from the 2022 peak of 12.3%. In the meantime, the central bank is reluctant to cut the key rate of 14.0% (in place since March this year) citing elevated consumption, strong credit growth, fiscal easing, a weakening soum and uncertainty over the impact of upcoming energy price liberalisation scheduled for next May. CPI may stay in the 8.0-8.5% YoY territory until May 2024, after which, if the government proceeds with the spike in the tariffs, inflation may pick up again. In this environment, the NBU's key rate of 14.0% may well have to be kept unchanged until the beginning of 2025, when the dust from the higher services inflation settles.

Fig 38 Uzbekistan: Inflation and key rate



Source: National sources, CEIC, ING

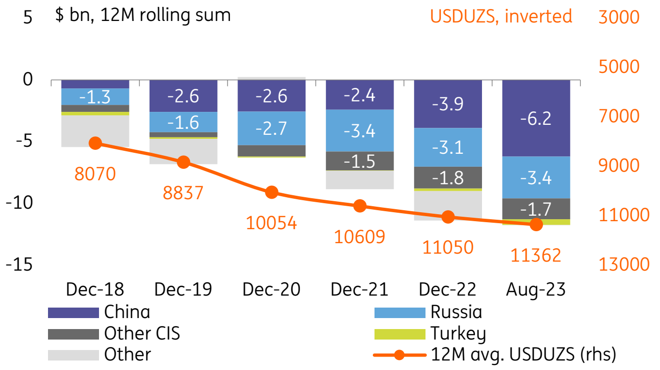
Fig 39 Uzbekistan: Inflation drivers



Source: National sources, CEIC, UN FAO, ING

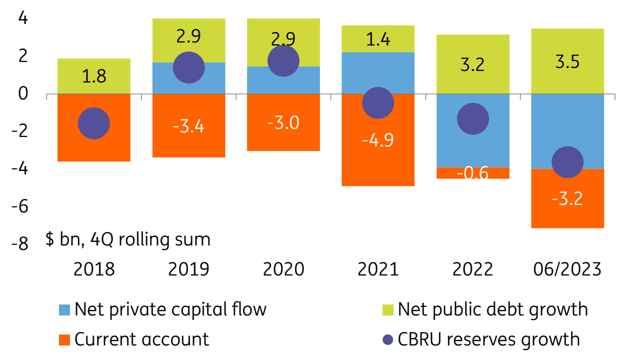
Balance of payments and exchange rate: UZS is the worst-performing currency in our covered CIS space. From a current account perspective, the balance of trade of goods and services continues to deteriorate due to elevated imports from China (probably related to the large state investment programme), but the pace of deterioration somewhat slowed. Exports are also expanding, but not to Russia, which is positive from the perspective of secondary sanctions risk. On the remittances side, which is the main link with Russia and ruble exchange rate, the flow has moderated but remains elevated. As a result, the current account, having shown a minimal deficit of US$0.6bn in 2022, has widened to a more standard US$3.2bn as of mid-2023 (4Q rolling basis). In terms of capital flows, the private sector remains a large exporter of capital (US$4.0bn outflow over the past four quarters) for the second year in a row through purchases of foreign assets. Only the state sector is supporting the balance of payments, through continued attraction of foreign debt (up US$3.5bn YoY) and the sale of international reserves.

Fig 40 Uzbekistan: Balance of goods and services vs USD/UZS



Source: National sources, CEIC, ING

Fig 41 Uzbekistan: Balance of payments composition



Source: National sources, CEIC, ING

We expect Uzbekistan to remain on a depreciation path in the long term. However, we do not exclude a slowdown of the pace or even a pause in the coming couple of quarters based on expectations of intensified foreign borrowing by Uzbekistan's government, normalisation of private capital flows after the Russia-related geopolitical shock, as well on our global view on risk assets which assumes stabilisation of USD vs Uzbekistan's major trade partners.

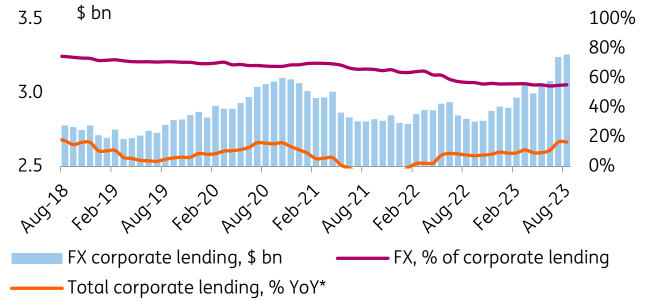
Fig 42 Uzbekistan: Rating drivers/sensitivities, factors that could lead to an upgrade or downgrade

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) *(next review date 1 December 2023)*	• 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 • 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 or crystallisation of contingent liabilities • **External:** Worsening in external position due to large drop in remittances or widening in trade deficit

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

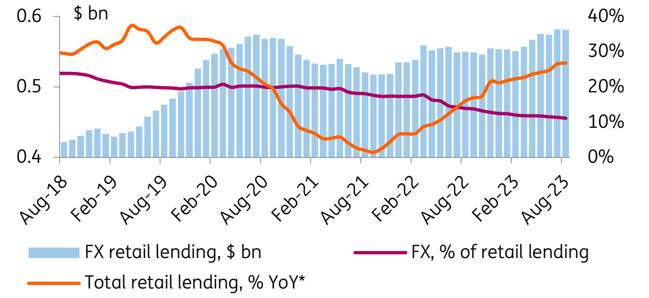
Appendix
CIS-4 banking sector lending chart book

Fig 43 Armenia: Corporate lending (25% of GDP)



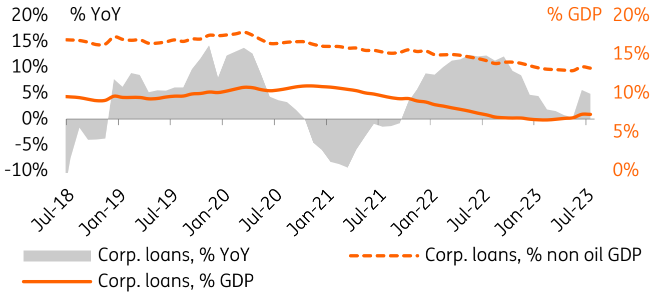
*Adjusted for FX revaluation effect
Source: National sources, CEIC, ING

Fig 44 Armenia: Retail lending (22% of GDP)



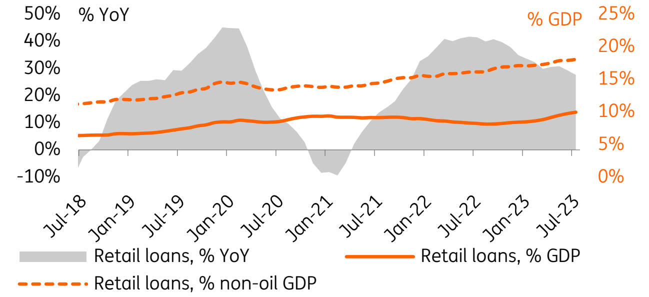
*Adjusted for FX revaluation effect
Source: National sources, CEIC, ING

Fig 45 Azerbaijan: Corporate lending (7% of GDP)



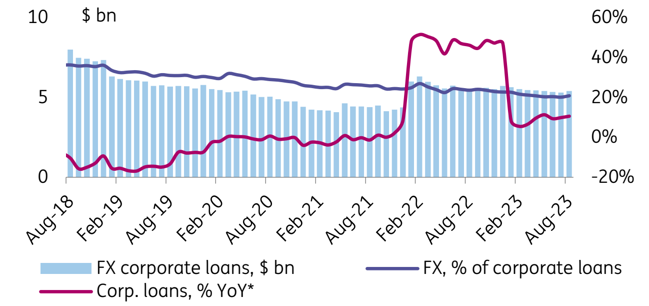
Source: National sources, CEIC, ING

Fig 46 Azerbaijan: Retail lending (10% of GDP)



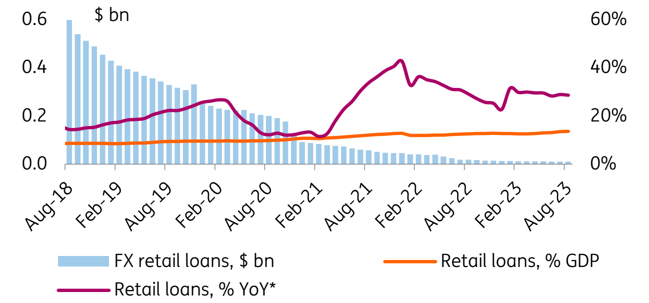
Source: National sources, CEIC, ING

Fig 47 Kazakhstan: Corporate lending (8% of GDP)



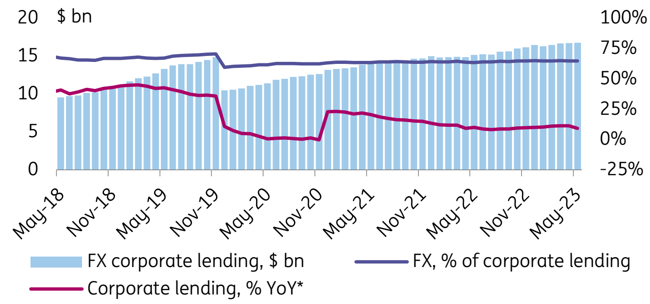
*Adjusted for FX revaluation effect
Source: National sources, CEIC, ING

Fig 48 Kazakhstan: Retail lending (14% of GDP)



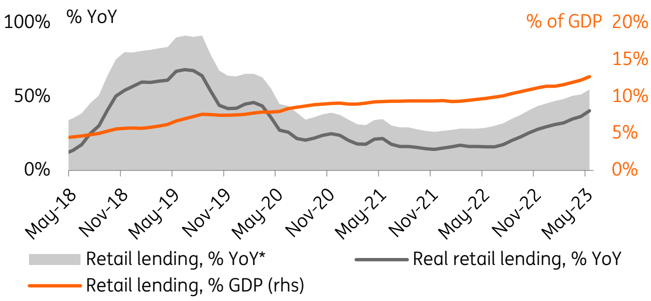
*Adjusted for FX revaluation effect
Source: National sources, CEIC, ING

Fig 49 Uzbekistan: Corporate lending (31% of GDP)



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

Fig 50 Uzbekistan: Retail lending (13% of GDP)



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

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