Special Report

Central Asia– Strong real GDP growth momentum in 2018, but structural vulnerabilities to remain

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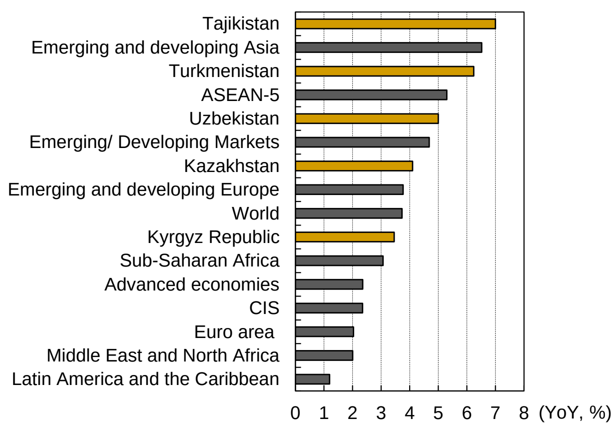
1. Introduction

Central Asia, which covers Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan and Uzbekistan, outpaced most other regions on a real GDP growth basis last year. In Tajikistan, Turkmenistan and Uzbekistan, some of the highest rates of real GDP growth in the world were reported, according to the IMF (Chart 1). The expansion has been driven by external demand for the region's commodity exports and its emigrant labour force, which in turn has driven domestic household demand via remittance inflows.

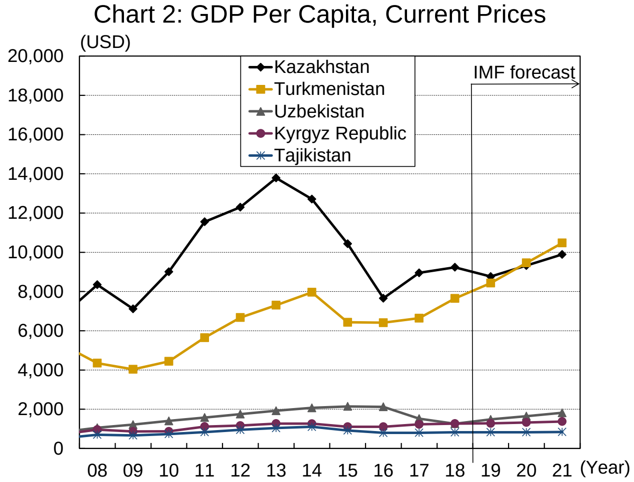
A constructive policy backdrop, as evidenced by various development policies, has also been a positive signal for both foreign and domestic investment. However, these robust real GDP growth rates are accompanied by various structural vulnerabilities which arise from the countries' economic models. These include high commodity dependence and reliance on remittance inflows, as well as high government debt levels in the Kyrgyz Republic and Tajikistan. Three of the five central Asian countries also suffer from very low levels of GDP per capita (Chart 2), on top of wider regional pressures such as strong population growth.

Chart 1: Real GDP Growth, 2018



Source: IMF, MUFG Bank Economic Research Office

Chart 2: GDP Per Capita, Current Prices



Source: IMF, MUFG Bank Economic Research Office

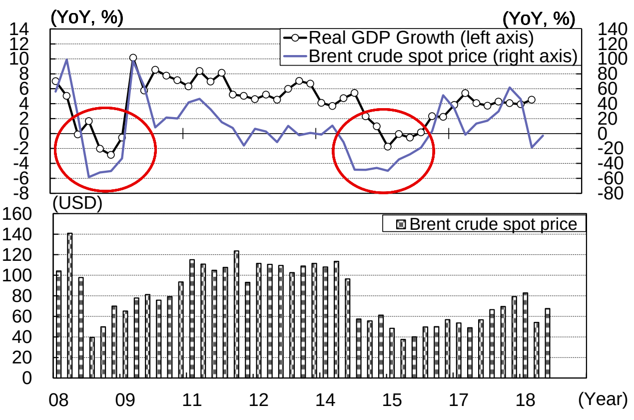
2. Real GDP Growth Drivers & Vulnerabilities

(1) Commodity exports

The export of commodities is both an important source of external demand that supports real GDP growth and a source of vulnerability when commodity prices fall. A high degree of export concentration to a few specific countries exacerbates this. Figures are hard to come by for all five countries but a useful metric exists for Kazakhstan and Uzbekistan, which looks at commodity dependence levels. The metric takes total non-manufactured exports, as a proportion of current account receipts (CXR). In 2018, this figure stood at 77.1% in Kazakhstan and 45.8% in Uzbekistan, and with CXR at USD 71.1 billion and USD 17.7 billion in the two countries, this equated to a significant 38.6% and 40.9% of GDP, respectively.

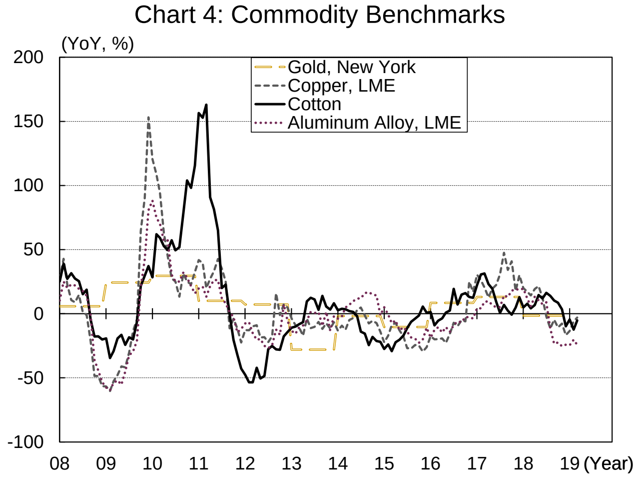
In Kazakhstan, the region's largest economy, there is a clear reliance on the main commodity export, oil. This is shown by the relationship between the country's real GDP growth rate and the Brent Crude oil price (Chart 3). Since the start of the global financial crisis (GFC), there have been two recessions, one from Q1 to Q3 2009, and one more recently, from Q3 2015 to Q1 2016. On both occasions, oil price declines of more than 40% led to a decline in real GDP in Kazakhstan. The more recent YoY fall in the oil price in the second half of 2018 was not as sharp, but is still expected to weigh on real GDP growth in 2019. The wider region is also affected by commodity price volatility as seen in Chart 4. This had both a negative effect on real GDP growth in Uzbekistan, and across the central Asian region. In Uzbekistan's case, the main exports are gold, petroleum gas and cotton. Copper and aluminium are also major commodity exports from the wider region. In the aftermath of the GFC, these commodities saw greater price swings than oil prices, in YoY terms.

Chart 3: Kazakhstan Real GDP Growth, Brent Oil Prices



Source: Macrobond, MUFG Bank Economic Research Office

Chart 4: Commodity Benchmarks



Source: Macrobond, MUFG Bank Economic Research Office

Vulnerabilities also stem from the region's high export concentration to key trade partners. Switzerland is particularly important to both the Kyrgyz Republic and Uzbekistan due to large gold exports, while China is more central to Turkmenistan, Kazakhstan and Tajikistan due to exports of gas and petroleum. The demand for Turkmenistan's gas exports has been robust in recent years as a result of China's strategy to switch to natural gas. This can be expected to continue despite the gradual decline in China's real GDP growth rate. We note that exports to China in the other three countries remain low and stable at under 10% of total exports. Russia is also a key commodity export destination, sitting in the top ten across the board (Table 1).

Table 1: 2017 Exports (USD million)

Kazakhstan		Krygyz Rep		Tajikistan		Uzbekistan		Turkmenistan	
Italy	8,670.2	Switzerland	489	Turkey	262.8	Switzerland	3,486.0	China	6,202.9
China	5,773.4	Kazakhstan	295	Russia	199.0	China	1,391.1	Turkey	380.7
Netherlands	4,748.2	Russia	262	China	169.0	Russia	967.3	Afghanistan	335.3
Russia	4,479.3	UK	191	Switzerland	119.7	Turkey	776.7	Italy	127.7
Switzerland	3,100.7	Uzbekistan	146	Iran	104.9	Kazakhstan	693.4	Georgia	112.5
France	2,861.1	Turkey	131	Algeria	78.0	Afghanistan	419.6	Bangladesh	112.5
Spain	1,444.3	China	97	Afghanistan	54.0	Bangladesh	319.6	Russia	79.5
Turkey	1,145.2	U.A.E	31	Kazakhstan	31.1	Iran	140.8	Romania	46.9
Romania	925.6	Tajikistan	24	Italy	12.9	Tajikistan	67.7	Kazakhstan	41.7
Austria	3.5	Belgium	21	Pakistan	11.5	France	46.7	UK	24.1

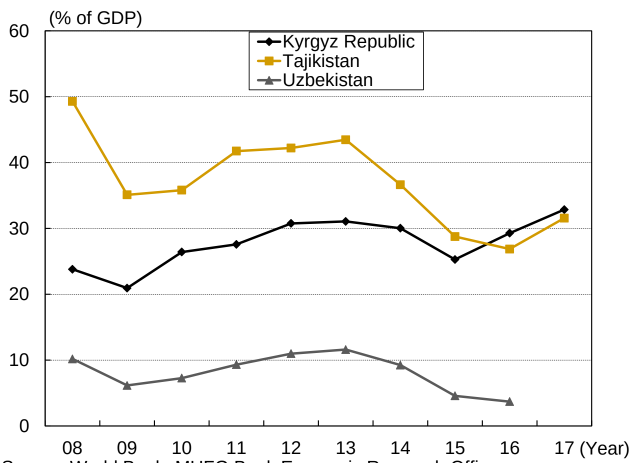
Source: Asian Development Bank, MUFG Bank Economic Research Office

(2) Remittance inflows

Remittances are an important source of external funds, a major support to real GDP growth but are also vulnerable to Russian real GDP growth shocks. Russia hosts the greatest number of migrants from the central Asian region with the Kyrgyz Republic and Tajikistan the main beneficiaries, with a substantial 32.9% and 31.6% of GDP of remittance inflows in 2017 respectively. The ratio is much lower in Uzbekistan (3.7% of GDP) against much larger nominal GDP levels (Chart 5).

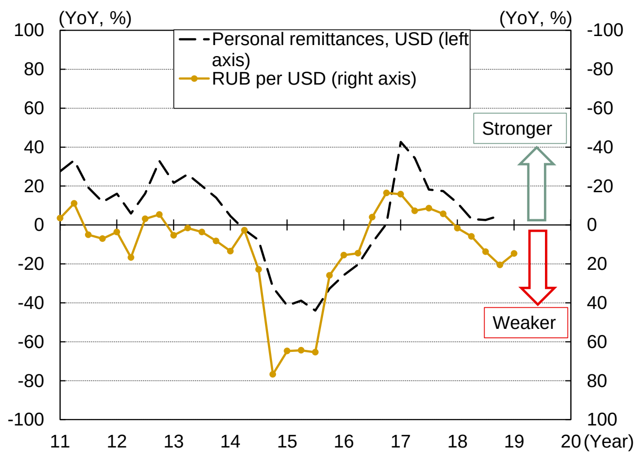
Risks can be highlighted by the recent Russian recession which took place over 2015 and 2016, mainly due to a drop in oil prices. This, together with the completion of the Sochi Olympics, led to a sharp fall in remittance inflows in Tajikistan to 28.8% of GDP in 2015 from 43.5% of GDP in 2013, and more than halved inflows to Uzbekistan (Chart 5). The recession could also be seen in the Russian rouble (RUB) per the US dollar (USD) exchange rate, which closely trended with Russian remittance outflows and has also acted as a useful predictor. The economic recession in Russia together with the significantly weaker rouble, over 2014 to 2016, led to a sharp drop of remittance outflows in USD terms (Chart 6).

Chart 5: Remittance Inflows



Source: World Bank, MUFG Bank Economic Research Office

Chart 6: Rouble and Russian Remittances



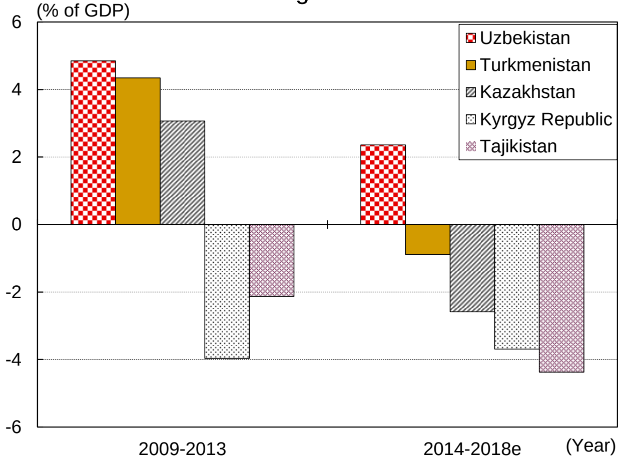
Source: Macrobond, MUFG Bank Economic Research Office

More recently, since January 2018, the RUB per USD exchange rate has continued to depreciate on YoY terms. However, the rate of depreciation slowed in Q1 2019, which suggests a better outlook for remittances in 2019 if this trend continues. The current real GDP growth rate in Russia is moderate and stable, and with a more benign external environment than at the start of 2019, the recent improvement can be expected to continue, but the central Asian region will remain susceptible to shocks to Russian real GDP growth and wider global downside risks.

(3) Expansionary fiscal policy

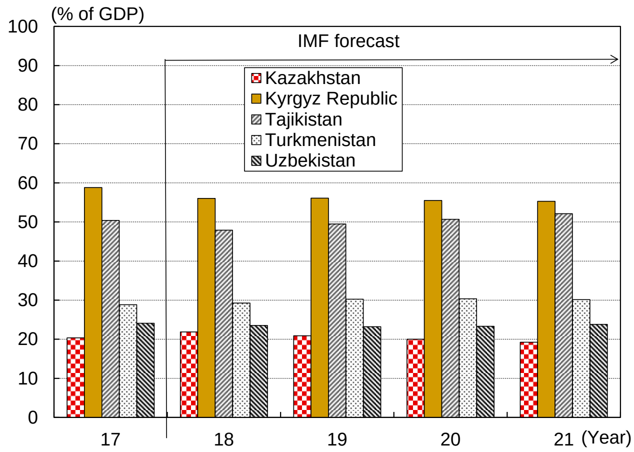
Government expenditures in the region have supported real GDP growth, including at a time of lower oil prices, through current and capital expenditures (capex). The recent five-year average highlights this (Chart 7). From 2014 to 2018, fiscal deficits averaged 5.2% of GDP in Tajikistan, 4.0% in the Kyrgyz Republic, 2.8% in Kazakhstan, and 1.2% in Turkmenistan, versus a surplus in Uzbekistan. Over a similar timeframe, capex, which is important to potential real GDP growth rates, has averaged over 25% of total government expenditures in Turkmenistan, the Kyrgyz Republic and Tajikistan, and in some cases far higher due to large one-off infrastructure projects. However, the use of further fiscal policy to support growth will be limited in the Kyrgyz Republic and Tajikistan. Here, government debt levels are high, and in 2017, stood at 58.8% of GDP and 50.4% of GDP (Chart 8) versus far lower figures in Uzbekistan, Kazakhstan and Turkmenistan.

Chart 7: Average Fiscal Balance



Source: IMF, MUFG Bank Economic Research Office

Chart 8: Government Debt



Source: IMF, MUFG Bank Economic Research Office

Despite high government debt levels, fiscal risks in the Kyrgyz Republic and Tajikistan are moderate. This is thanks to the largely concessional nature of government debt and relatively long debt maturity. These are predominantly owed to multilateral development banks and bilaterally, for example, to China. Together, this leads to low interest payments, as a per cent of GDP, at 1.1% in the Kyrgyz Republic and 1.3% in Tajikistan in 2017.

Box 1: Population continues to increase as nominal GDP recovers

The region's total population has increased, despite large migration outflows, and stood at 72.4 million people in 2018. This has supported the rise in nominal GDP levels since 2000, despite a dip in nominal GDP from 2013 to 2016 (due to the decline in price of oil), and nominal GDP finally picked up to a combined USD 271.5 billion in 2018. Kazakhstan accounts for 62.8% of the region's total GDP, though its share has declined since 2009. Over the same period, Uzbekistan and Turkmenistan have increased their share. These trends can be expected to continue.

Chart A: Population

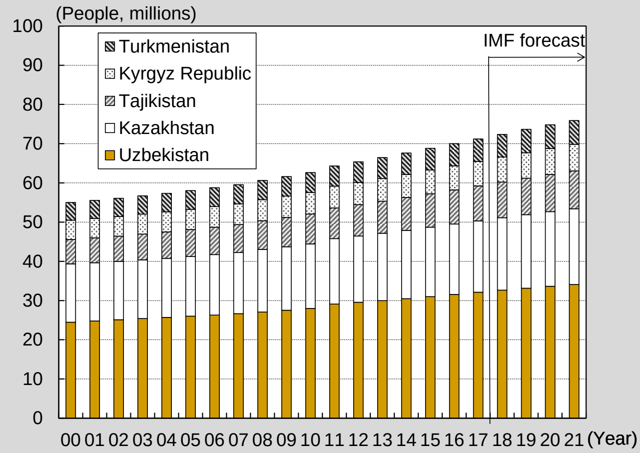
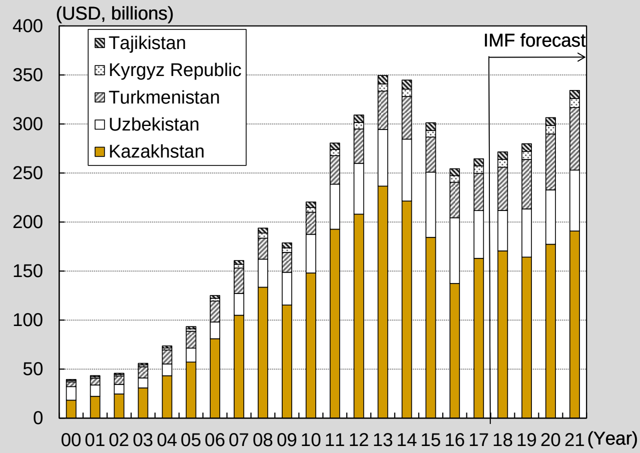


Chart B: Nominal GDP



3. Development Policies

The successful implementation of development polices and reforms could boost levels of GDP per capita in the region as well as alleviate pressures from high population growth, which over the last ten years has averaged 1.8% YoY. There has been a significant increase in the working-age population in the five countries over this period. Growth has been in double digits in four of the five countries, and high single-digits in Kazakhstan. Taken together with a median age for the region of just 26.7 years in 2017, this supports a dynamic labour market but also creates challenges. Development policies differ, ranging from economic diversification, development of infrastructure, improvements of the business environment to the reduction of external vulnerabilities and commodity dependence of the region.

Uzbekistan has embarked upon an ambitious agenda of economic and political reform since President Shavkat Mirziyoyev came to power in September 2016. The agenda includes reforms to the judiciary, public administration, education, health and social protection. Uzbekistan has also focused on the reduction of previous tensions with its neighbours to increase trade and investment flows. The FX market was liberalised in 2017 and the government has also signed a number of investment agreements, and issued its first Eurobond in February 2019. The longer term benefits are expected to be a better macro-economic policy framework and reduction of corruption that will lead to stronger real GDP growth.

In Kazakhstan, development policies include economic diversification, improved governance and an anti-corruption strategy. However, we note that the benefits of most of these policies will only be felt over the longer term, as with Uzbekistan. Private sector involvement and effective implementation will be important to the size of the resultant economic boost.

Turkmenistan's development policy revolves around its vast energy resources and strategic location. The Asian Development Bank (ADB) has a partnership strategy with Turkmenistan to develop ways to diversify Turkmenistan's export base, and enhance its position as a trade and transit hub. For instance, the ADB has focused on the development of the country's transport and has worked with Turkmenistan since 2003. In the Kyrgyz Republic, the authorities have produced a development strategy called 'Strategy 2020' which has a core goal of 'poverty reduction through inclusive economic growth'. In order to achieve this, the approach focuses on the reduction of bottlenecks, improved infrastructure and a better investment environment. Similarly, the ADB strategy in Tajikistan also focuses on infrastructure investment, the business environment and better food security.

4. Strong Growth Momentum but Vulnerabilities to Remain

Regional growth momentum leading into 2019 has been strong and real GDP growth forecasts remain encouraging. Real GDP growth will continue to be driven by commodity exports and private consumption. Turkmenistan is forecasted to grow by 6.3% YoY in 2019, 5.0% in both Tajikistan and Uzbekistan, 3.8% in the Kyrgyz Republic and 3.2% in Kazakhstan, according to latest Consensus Forecasts. Commodity exports could be affected by the weaker global economic sentiment, whereas private consumption is vulnerable to a slowdown in remittance inflows, as well as higher inflationary pressures, which could both act as dampeners on household consumption.

Development policies will be a driver of the region's longer term real GDP growth rates, GDP per capita and job creation. These include initiatives to promote economic diversification, development of infrastructure, improvements of the business environment and the reduction of external vulnerabilities. We note Uzbekistan's ambitious agenda of economic and political reforms under President Mirziyoyev are encouraging.

Despite this, the region's reliance on external demand makes it vulnerable to changes in global economic sentiment and real GDP growth. Over the last five years, as the price of oil and other commodities have fluctuated, the governments of the five central Asian countries have used fiscal policy to smooth real GDP growth fluctuations. As a result, there has been an increase of government debt levels in the Kyrgyz Republic and Tajikistan, which could limit the future opportunities to use fiscal policy to support growth.