Central Asia: Real GDP trajectory could be bumpy as region faces multiple near-term risks

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The economies of Central Asia (Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan) all suffered from the COVID-19 shock last year. This was driven by especially severe recessions in Kyrgyzstan and Kazakhstan, with real GDP falling by 8.0% and 2.6% respectively. The Kyrgyz economy suffered from the shutdown of its main gold processing plant in Q1 2020, a sharp decline in remittances (which represent around 30% of GDP) and the effects of political crisis on confidence. In Kazakhstan, the first annual decrease in GDP in over two decades was largely driven by the global decline in demand for oil.

Annual growth rates in the other three countries remained positive, but still fell markedly from the pre-pandemic five-year averages as lockdown measures weighed on domestic demand. There were muted growth rates in Uzbekistan (1.7% in 2020, despite support from the agricultural sector) and Turkmenistan (0.8%). The economy of Tajikistan, while supported by robust demand for gold exports, was affected by a fall in remittances from abroad which caused growth to fall from 7.5% in 2019 to 4.5% in 2020.

Recent Activity Has Picked-up

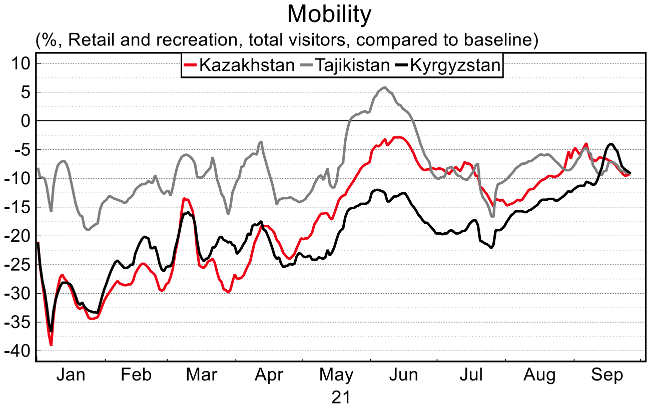
There are promising signs more recently regarding the region's recovery from the COVID-19 shock. In Q2 2021, real GDP in Uzbekistan is estimated to have grown at its highest rate since Q3 2016, while Kazakhstan, the largest economy in the region, experienced real GDP growth of 2.3% YoY in Q2 2021 after a decline of 1.4% the previous quarter. This was in fact the first quarterly expansion in Kazakhstan since the onset of the pandemic. Elsewhere, there has also been a rebound of sorts in Turkmenistan over H1 2021, but economic indicators have been more mixed as a result of further COVID-19 waves and resulting lockdown restrictions which were in place from mid-July to early-August.

Generally, the return to stronger momentum has been driven by improved retail trade and robust industrial production as now less stringent lockdown restrictions have led to increased footfall across the region. Public mobility has clearly improved since the start of the year in both Tajikistan and Kyrgyzstan.

In Kazakhstan, retail sales grew by 7.1% YoY in 2Q 2021, after a decline of 2.9% in 1Q 2021. Retail trade is likely to have benefitted from stronger wage growth in some countries (including a real rise of 11.2% in Kazakhstan). This trend, which comes despite the disruptions of last year, is likely to have supported the build-up of precautionary savings. In turn, savings are set to support the consumer recovery through to 2022, even if wage growth loses some steam.

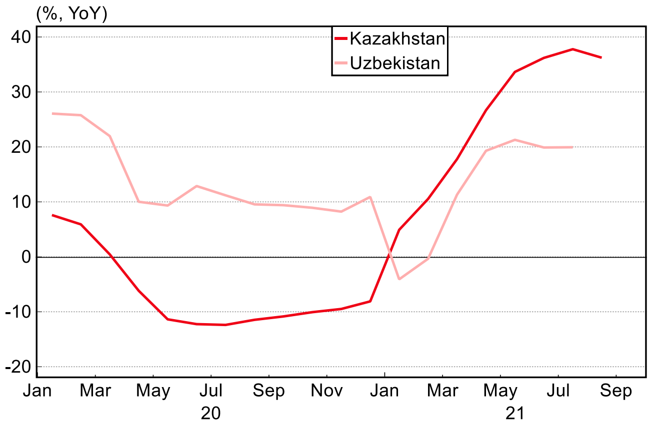
Another boost to real GDP growth has come in the form of improved external demand for the region's exports which followed the roll-out of vaccination programs in developed economies. This has led to a sharp rebound effect, particularly in commodity-exporting countries. In Kazakhstan, exports surged by 36.0% YoY in Q1 2021 on the back of a recovery in oil demand (after falling by 19.0% across 2020 as a whole). There were also signs of increased demand for manufactured goods with industrial production also recovering after slipping back last year.

Mobility



Source: Google LLC "Google COVID-19 Community Mobility Reports". https://www.google.com/covid19/mobility/ Accessed: 7th September, Macrobond, MUFG Bank Economic Research Office

Industrial Production



Source: National Sources, Macrobond, MUFG Bank Economic Research Office

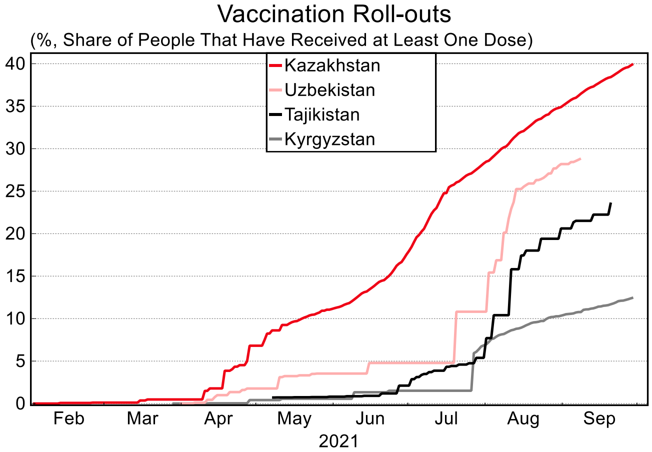
Real GDP growth is likely to remain fairly strong in H2 2021, given the continued rebound in domestic and external demand (even if the rebound effect starts to fade), while some countries in the region will continue to benefit from ongoing structural reform efforts, increasing levels of regional cooperation and longer-term foreign investment inflows.

But Plenty of Downside Risks In Short-term

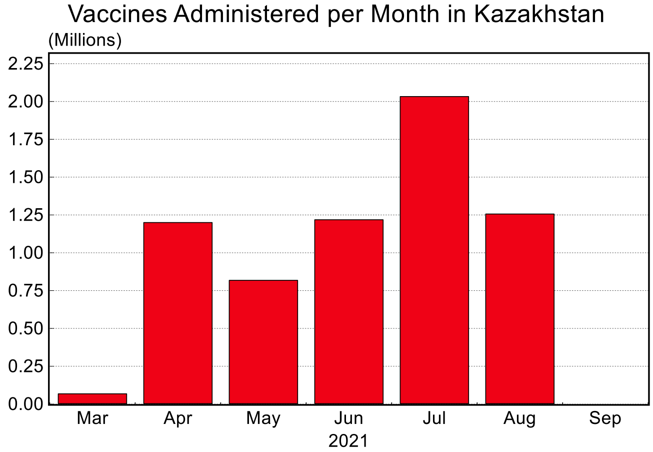
However, there will be some key downside risks over the rest of 2021 and through 2022.

First, as was the case in most developing economies, there was a slow start to vaccination programmes in Central Asia. Vaccine coverage in Kyrgyzstan remains particularly low, with just 10% of the population having had at least one dose. Recently other countries have seen the pace improve, with the trajectories of doses administered now looking broadly similar to those of developed countries with a lag of four to five months. As a result, the region now looks set to exceed the (not-especially-optimistic) targets set by the World Bank earlier in the year for low and middle income countries to fully vaccinate more than 20% of people by end-2021. This rate is well short of any immunity threshold, however, and the region looks vulnerable to COVID-19 waves as it enters the colder winter months.

Further vaccination gains may also become increasingly difficult. Vaccine deliveries in coming months are set to be hampered by various factors which include manufacturing problems, delays in the approval of new shots and India's recent export ban. These sorts of supply issues have prompted Covax to cut its forecasts for vaccine deliveries to developing countries by around 25% this year. There could be further downward revisions to delivery estimates if there is a sharp rise in demand for 'booster jabs' from governments in developed countries. For Central Asia, we worry that vaccination coverage of anything close to immunity thresholds may start to seem a long way if supply problems persist, especially if there are any signs of waning effectiveness of the vaccines for those that have already been fully vaccinated.



Source: Our World in Data, Macrobond, MUFG Bank Economic Research Office



Source: Our World in Data, Macrobond, MUFG Bank Economic Research Office

Secondly, the Taliban's rapid takeover of Afghanistan has also increased geopolitical risk for the region. Three Central Asian countries share a border with Afghanistan (Tajikistan, Turkmenistan, and Uzbekistan). This proximity may concern foreign investors to the region. The Taliban has indicated that it has no ambitions beyond ruling Afghanistan. This may or may not be the case, but other militant Islamic groups may not feel so constrained by historical borders. Indeed, acknowledging that there is risk of militant extremism, the governments of Turkmenistan and Uzbekistan have so far refused to accept Afghan refugees in permanently[1].

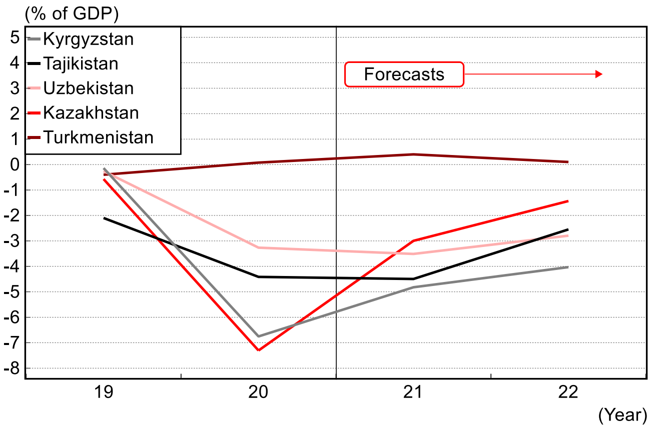
Fiscal and Monetary Policy Anti-Crisis Measures Effects Also Fading

During the acute phase of the COVID-19 shock, governments introduced fiscal packages to prevent a sharper drop of real GDP, while central banks cut their main policy rates in order to alleviate pressures on the private sector and stimulate activity. These policies were broadly successful at preventing a more serious economic downturn.

However, the effects from fiscal measures are now fading. Four of the five countries in the region will have narrower fiscal deficits relative to GDP in 2021 as extraordinary policy measures are being phased out (only some of the reduction in headline deficits can be attributed to the denominator effect from growing economies). This change in the fiscal stance might be problematic for the recovery if not met by a rebound in private demand, especially if governments feel compelled to cut down on investment expenditure in order to protect fiscal space. Government debt loads increased from 2019 to 2020 in all the region's countries apart from Turkmenistan, with the figure in Kyrgyzstan (74.3% of GDP, from 54.1% in 2019) especially concerning. While Kyrgyzstan and Tajikistan had to ask to restructure some of their debts last year, we would note that government debt in both countries is largely on concessional terms with relatively long maturity.

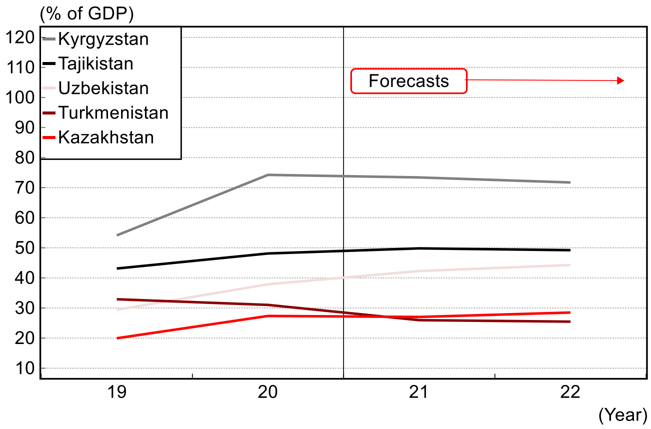
[1] Historically, the majority of Afghan refugees have travelled to Iran and Pakistan rather than Central Asian countries, so social pressures relating to a sudden, large influx of people may not be that relevant.

Government Fiscal Balance



Source: IMF, Macrobond, MUFG Bank Economic Research Office

General Government Gross Debt

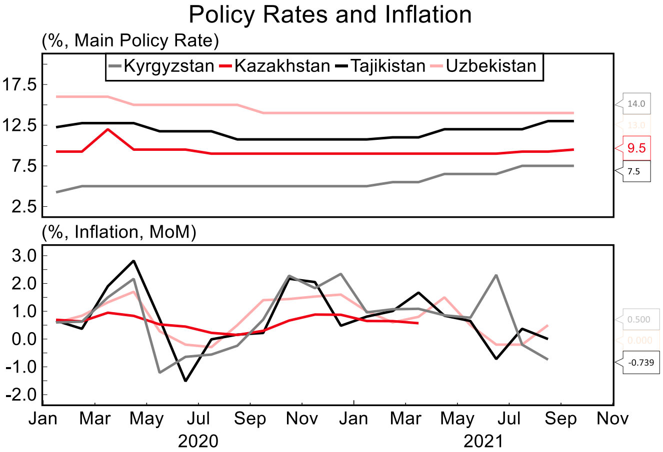


Source: IMF, Macrobond, MUFG Bank Economic Research Office

Meanwhile, on the monetary policy side, higher inflation across the region (as well as globally) due to reopening effects and supply-side problems means that some central banks in Central Asia have already moved to increase policy rates. The National Bank of the Kyrgyz Republic has gone the furthest so far and has raised its policy rate three times from 5.0% in January to 7.5% at present. The National Bank of Tajikistan has raised rates twice since the start of the year (from 10.75% in January to the current rate of 12.0%).

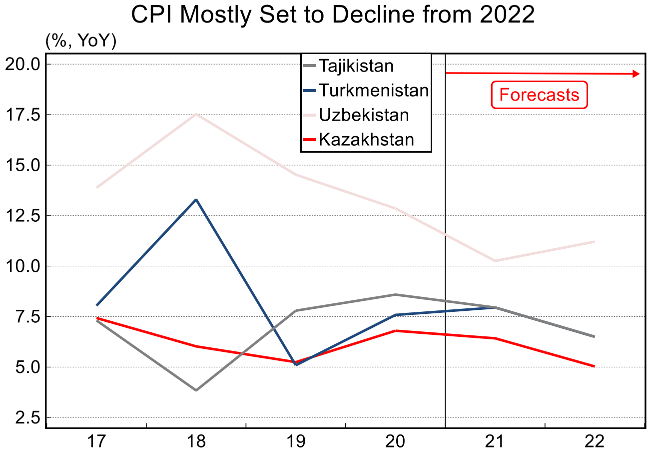
Tighter monetary policy will make it tougher for the private sector recovery – and there could be further rises to come if central banks feel compelled to respond to any shift towards tighter policy from the US Fed in order to support capital flows to the region. We note, an expected decline in CPI next year should help ease the current trade-off between higher rates and economic growth, yet central banks in central Asia are likely face a difficult set of circumstances[2] for some time given the uncertain external backdrop. Inflation is expected to decline in 2022, as higher inflation in 2021 sets up some negative base effects for 2022, while global commodity prices are expected to moderate.

Policy Rates and Inflation



Source: Macrobond, MUFG Bank Economic Research Office

CPI Mostly Set to Decline from 2022



Source: IMF, Macrobond, MUFG Bank Economic Research Office

[2] Central banks face a tough quandary given the need to balance real GDP growth (alongside a backdrop of raised rates of unemployment, and higher poverty levels) against rising inflationary pressures caused by exchange rate pressures, stronger private consumption and global supply-chain issues.

Post-pandemic Recovery Could be Bumpy

The IMF's latest forecasts suggest that no economy in the region will manage real GDP growth rates comparable to the five years before the pandemic. While recent activity has been better than expected in some cases, we think that the recovery path will be bumpy and the higher growth rates of pre-pandemic years will be hard to achieve. There will be multiple risks such as further possible vaccination supply-side issues, reduced policy support, possible US Fed tapering and geopolitical tensions could all emerge as headwinds for the region over coming years. At the same time, as ever, the region's growth remains tightly linked to the external backdrop. The region will remain dependent on Chinese demand for exports, remittances from Russia, while the outlook for foreign investor flows will be reliant on US Fed policy.