KAZAKHSTAN

Highlights

- **Growth is accelerating.** GDP growth accelerated to 4.3 per cent year-on-year in the first nine months of 2017, from 1.1 per cent in 2016, primarily supported by the recovery in oil exports and stronger activity in the construction, agriculture and transport sectors.
- **Banking sector consolidation is advancing.** In July 2017, Halyk Savings Bank, Kazakhstan's largest bank, finalised the purchase of Kazkommertsbank (KKB), the second largest, after the state allocated US$ 6.4 billion to clean the balance sheets of banks with large shares of non-performing loans (NPLs). The merger of two other large banks, Tsesnabank and Bank CenterCredit is expected.
- **The Kashagan oilfield restarted in September 2016.** Production reached 180,000 barrels per day as of June 2017, about 10 per cent of Kazakhstan's total production. This is a marked development for the field, which had suffered from long delays and cost overruns owing to logistical and technical challenges.

Key priorities for 2018

- **Implementation of the government's structural reform agenda is a key priority.** Priorities include continuing efforts for a successful privatisation of state-owned entities, tariff reform in regulated sectors, development of the Astana International Financial Center (AIFC), banking sector reforms and the establishment of the framework for a green economy transition.
- **The role of the state in the economy should be further reduced.** Work needs to continue towards a better balance between the respective roles of the public and the private sectors, by supporting the growth of private enterprises, including small and medium-sized enterprises (SMEs), in agribusiness and other non-extractive sectors, as well as public sector reform and the commercialisation and privatisation of state-owned enterprises (SoEs).
- **The banking sector should be further strengthened.** The National Bank of the Republic of Kazakhstan (NBK) should continue its work on the reduction of legacy problem loans, as well as to further strengthen banking sector regulation and supervision, by taking more robust action regarding banks that fail to adjust their activities.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	6.0	4.3	1.2	1.1	3.8
Inflation (average)	5.8	6.7	6.7	14.6	7.3
Government balance/GDP	4.8	1.7	-2.2	-0.3	-2.9
Current account balance/GDP	0.5	2.8	-2.8	-6.5	-5.3
Net FDI/GDP [neg. sign = inflows]	-3.4	-2.1	-1.5	-9.8	-5.8
External debt/GDP	63.4	71.2	83.2	119.3	110.1
Gross reserves/GDP	10.4	13.2	15.1	21.5	n.a.
Credit to private sector/GDP	31.4	30.5	31.0	27.1	n.a.

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Macroeconomic performance

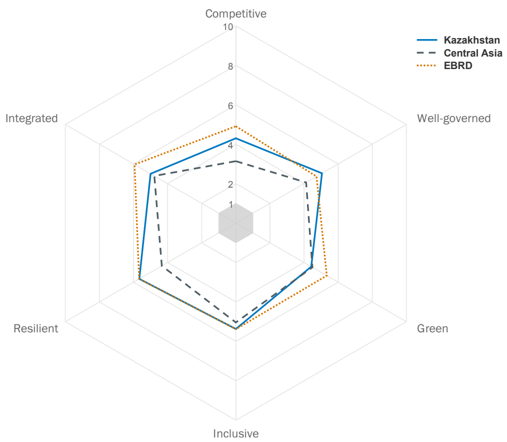
The economy is recovering. Real GDP growth accelerated to 4.3 per cent year-on-year in the first nine months of 2017, primarily driven by the rebound in oil exports and strong performance in the agriculture, construction and transport sectors. This follows a significant slow-down during 2014-16, due to the plunge in oil prices, weaker domestic demand and the recession in Russia. Exports rose by 32.2 per cent in the first eight months of 2017 in US dollar terms, mainly due to higher metal and stable oil prices, after falling 20 per cent in 2016 and 42 per cent in 2015. Imports increased by 17.9 per cent in the same period of 2017 after a drop of 17 per cent in 2016 and 26 per cent in 2015. Foreign exchange buffers have remained strong at combined net international reserves of the NBK and National Oil Fund foreign assets of about US$ 90 billion in September 2017, or 27 months of imports of goods and services.

Monetary conditions have normalised. Monetary policy has been effective at anchoring inflation expectations despite inflation spikes following the abrupt change in the exchange rate regime back in 2015. Inflation has returned to the 6.0 to 8.0 per cent NBK target corridor, reaching 7.1 per cent in September 2017 year-on-year. Following 46 per cent depreciation in 2015, the tenge has stabilised since March 2016. The NBK has gradually lowered its monetary policy rate from a high of 17.00 per cent at the beginning of 2016 to 10.25 per cent in August 2017. After lack of liquidity in the period of exchange rate pressure, there is excess short-term liquidity in tenge now, which is being sterilised by the central bank. However, sources of long-term tenge remain concentrated in a few institutions such as the Unified Pension Accumulation Fund that is managed by the central bank.

NPLs continue to weigh on the banking sector, but there is a new momentum towards resolution. The NPL ratio increased to 10.7 per cent in June 2017, from 6.7 per cent at the end of 2016, partly as a result of growth in overdue accrued interest. While this is around the 30 per cent level that persisted over 2008-13, the underlying asset quality remains a concern given the presence of not fully transparent off-balance sheet structures. However, steps have been taken to strengthen the NBK's supervisory mandate, dollarisation is declining, and banking sector consolidation is taking place with the injection of state funds.

Growth is expected to reach 3.8 per cent in 2017 and remain strong at 3.5 per cent in 2018, driven by increasing crude production, including from the restarted Kashagan oilfield, favourable oil prices and a recovery in real incomes growth, which turned negative in the second quarter of 2017. Inflation is expected to remain within the 6.0 to 8.0 per cent range set by the NBK currently, but might be shifted to 5.0 to 7.0 per cent in 2018.

Assessment of transition qualities (1-10)



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Major structural reform developments

Key structural reforms are moving forward gradually. The country's policy response to the oil price drop and the difficult economic environment in 2014-16, which focused mainly on counter-cyclical government spending and the move to a flexible exchange rate and inflation targeting regime, has created a more conducive environment for economic growth and further structural reforms. Key reforms include the development of the AIFC, which is taking shape. The Astana International Exchange is to be launched in early 2018. In June 2017, the Shanghai Exchange and the AIFC signed an agreement under which the Shanghai Exchange became a strategic cooperation partner of the AIFC and owns 25.1 per cent of the Astana Exchange. In other developments, the government amended the regulatory framework governing renewable energy development in 2017 in order to reduce the foreign exchange risk for investors. A framework for tariff reform in regulated sectors has been developed, although social issues make the immediate application challenging. Legislation concerning subsoil use is being amended with the objective to implement international standards for minerals and hydrocarbons extraction.

Kazakhstan ranks 36th of 190 countries in terms of ease of doing business according to the World Bank *Doing Business 2018* report. The country made progress in three components of ease of doing business: the transfer of a property was streamlined by improving registration transparency and the land administration system's dispute resolution mechanisms; investor protection was improved by strengthening minority shareholder rights and their role in major corporate decision making, by requiring greater corporate transparency and allowing better access to corporate information during trial; enforcing contracts was made easier by introducing tighter time standards for key court events – they are respected in the majority of cases.

A new development strategy has been unveiled. In January 2017 the President announced the new development strategy, "Third Modernization: Global Competitiveness". It aims to accelerate the modernisation and digitalisation of key sectors of the economy, increase productivity, diversify the economy away from hydrocarbons (in particular by boosting manufacturing), address banking sector weaknesses, reduce impediments to the private sector, increase the effectiveness of the civil service and reduce the role of the state in the economy by accelerating privatisation efforts.

Banking system consolidation and recapitalisation is taking place. In July 2017, Halyk Savings Bank, Kazakhstan's largest bank, finalised the purchase of Kazkommertsbank (KKB), the second largest, after the state allocated US$ 6.4 billion to clean the balance sheet of banks with the largest shares of the sector's NPLs. It is assumed that large banks will be the major recipient of the government fund injection, while the smaller banks will be expected to rely mostly on capital injections from their shareholders. In February 2017 the NBK also supported KKB via its liquidity line to repay its sizeable €400 million Eurobond in a timely manner. The merger of two other large banks, Tsesnabank and Bank CenterCredit is expected.

Steps are being taken to strengthen NBK's supervisory mandate. More robust actions against banks that fail to adjust their activities have been taken. The banking licence of Kazinvestbank was suspended due to the systematic failures to fulfil payment obligations. On 22 May 2017 NBK repeatedly suspended Delta bank's licences for accepting deposits from individuals and legal entities until November 2017. There are upcoming stress tests and an Asset Quality Review (AQR) of large banks planned for late 2017. In August 2017, the NBK adopted a programme to improve the financial stability of the banking sector and introduce a risk-oriented approach to the financial supervision process. The NBK will spend around tenge 500 billion (US$ 1.5 billion) on the implementation of the programme.

Fiscal policy is being stepwise adjusted to the continued lower level of oil prices. The draft 2018 budget envisages further adjustment through reduction of stimulus spending and higher non-oil revenues from growth and improved administration. A new draft tax code has been prepared, which focuses on changes in natural resources taxation and VAT improvements and making the tax system more progressive. An expansion of public-private partnerships (PPPs) is also being considered.

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The government is making progress with its ambitious privatisation programme. Between mid-2016 and mid-2017, 53 small companies owned by the state-holding-company Samruk-Kazyna (SK) were sold. SK has been actively working on the pre-privatisation preparation of blue-chip companies, and it mobilised international advisers with the objective to attract strategic investors that can bring know-how and improve governance. SK also held a privatisation workshop at the London Stock Exchange in April 2017, showcasing initial public offering candidates, particularly Air Astana. Under the privatisation programme 2016-20, adopted in December 2015, assets singled out for privatisation include 782 entities in total, with 216 assets under the SK umbrella representing the most important strategic part. The SK assets have been divided into two parts, with 44 core assets and 172 smaller assets. The plan is to privatise the small non-core assets during 2016-17 and the large blue-chip companies during 2018-20. Air Astana and KazAtomProm are expected to be privatised in 2018-19.

The Kashagan oilfield restarted in September 2016. In November 2016 the field achieved a commercially viable level of production with sustained output at 75,000 barrels per day (b/d). In June 2017, production reached 180,000 b/d. The government expects that Kashagan will reach its first-stage full output capacity of 370,000 b/d before the end of 2017, with overall annual oil output at around 8.9 million tonnes. This will mark a milestone in the development of the field, which has suffered from long delays and cost overruns owing to logistical and technical challenges, and will help it meet its growth targets.

KYRGYZ REPUBLIC

Highlights

- **The economy is growing strongly.** Real GDP growth reached 5.0 per cent year-on-year in the first nine months of 2017, reflecting partly the low base effect as well as strong gold production and the stabilisation of remittances inflows.
- **The currency has stabilised after significant depreciation during 2014-15.** The som appreciated by around 10.8 per cent from the beginning of 2016 to the end of October 2017, reflecting the rebound in remittances and improvements in the external environment.
- **Banking sector vulnerabilities remain significant.** The weakening of the currency and overall economic slow-down in 2015 and the first half of 2016 contributed to an increase in classified loans to 8.8 per cent by the end of 2016, up from 4.5 per cent in 2014. Dollarisation in the banking sector remains high, but is declining as a result of the National Bank of the Kyrgyz Republic (NBKR)'s policies.

Key priorities for 2018

- **Simplifying tax administration and other interaction with the government for small and medium-sized enterprises through more efficient public services continues to be of high importance to improve the business climate.** This would also help to move more businesses from the informal to the formal sector.
- **Efforts to strengthen the banking sector should continue for a more resilient financing base for the economy.** Prudential banking rules should be enforced more rigorously.
- **Public utilities should be strengthened through commercialisation and stronger private sector participation.** This would help municipal utilities improve their financial standing, operating practices and governance, and enhance the reliability of the power sector by rehabilitating assets and developing a more attractive institutional framework for private investment.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	10.5	4.0	3.9	3.8	4.4
Inflation (average)	6.6	7.5	6.5	0.4	3.1
Government balance/GDP	-3.7	1.0	-1.2	-4.5	-3.0
Current account balance/GDP	-13.3	-16.0	-16.0	-9.7	-11.6
Net FDI/GDP [neg. sign = inflows]	-8.5	-3.1	-15.1	-6.6	-6.7
External debt/GDP	71.9	75.6	85.2	84.4	73.1
Gross reserves/GDP	30.5	26.2	26.6	30.0	n.a.
Credit to private sector/GDP	15.4	19.6	21.8	20.4	n.a.

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Macroeconomic performance

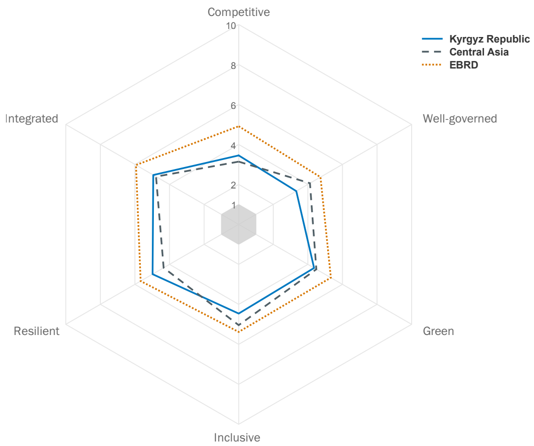
The economy is growing strongly. GDP growth reached 5.0 per cent year-on-year in the first nine months of 2017, continuing the strong rebound in the second half of 2016. Excluding the Kumtor gold mine, GDP growth reached 3.6 per cent, slightly lower compared with 2016, when the economy grew by 3.8 per cent. The better 2017 GDP figures not only reflect the significant increase in gold production, but also the low base effect and strong remittances inflows, which increased by 25.4 per cent in US dollar terms and 22.5 per cent in local currency terms year-on-year in the first eight months of 2017.

The currency has stabilised since 2016. The som appreciated by around 10.8 per cent from the beginning of 2016 to mid-October 2017, reflecting the rebound in remittances and the stabilisation of the external environment. Currency appreciation and lower fuel prices reduced inflation to only 0.4 per cent in 2016, but the rate accelerated to 3.3 per cent year-on-year in September 2017, mainly due to higher services prices. The NBKR gradually lowered its refinancing rate from 10.0 per cent in 2015 to 5.0 per cent in December 2016. Gross international reserves remained stable, close to US$ 2.1 billion (covering five months of imports of goods and services) as of September 2017.

External and fiscal positions remain under pressure. The fiscal deficit widened to 4.5 per cent of GDP in 2016 from 1.2 per cent in 2015 as a result of weak budget revenues and large infrastructure spending. The government is targeting a deficit of 3.0 per cent of GDP in 2017 as the economy has begun to recover. The current account deficit narrowed to around 9.7 per cent of GDP in 2016 from 16.0 per cent in 2015, reflecting the recovery in external transfers in the second half of the year and a further decline in imports as a result of weak investment and household demand. The deficit will likely further decline this year, but nevertheless remain sizeable.

Real GDP growth is expected to reach 4.4 per cent in 2017 and 4.2 per cent in 2018, on the back of strong growth in mining and higher gold exports, as well as continued growth in remittances, boosting household demand. Infrastructure spending from China will likely remain significant. However, the fiscal loosening in the run-up to the presidential election will have to be reversed in order to continue with the IMF programme.

Assessment of transition qualities (1-10)



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Major structural reform developments

Business environment and investment climate challenges remain despite improvements in recent years. The Kyrgyz Republic ranked 77th out of 190 countries in terms of ease of doing business, according to the World Bank *Doing Business 2018* report. The country performs well in areas such as starting a business, registering property, getting credit and dealing with construction permits, but poorly in paying taxes, resolving insolvency, getting electricity, enforcing contracts and trading across borders. Efforts to boost investment are hindered by low state capacity, political volatility and concerns over foreign ownership of economic assets.

Progress has been made to resolve the long-standing Kumtor gold mine dispute. At the beginning of September 2017 Canadian mining company Centerra Gold Inc. announced that an agreement had been reached with the Kyrgyz authorities to settle all disputes over the Kumtor gold mine. As a result all environmental claims and court orders against Kumtor will be dropped and Centerra will be able to freely transfer its funds worth US$ 299 million out of the country, which earlier had been frozen by the Kyrgyz government. Following the deal, there will be no restrictions on Kumtor's ability to distribute funds to Centerra and all restrictions of movement on Kumtor's employees will be lifted. The settlement follows a dispute during which Centerra took the Kyrgyz government to international arbitration in 2016 over a disagreement on profit sharing.

Banking sector vulnerabilities remain, but are not so significant to sharply constrain credit growth. The weakening of the currency and the overall economic slow-down in 2015 and the first half of 2016 contributed to an increase in classified loans (overdue and non-performing loans) to 8.8 per cent by the end of 2016 from 4.5 per cent in 2014, falling only marginally to 8.4 per cent as of June 2017. The dollarisation in the banking sector has remained rather high at 48 per cent in deposits and 42 per cent in loans as of June 2017. However, as economic growth has accelerated the banking sector has begun to show signs of recovery with credit to the private sector increasing.

The Kyrgyz Republic again needs to find a new partner for the Naryn project. The government approved a contract in August 2017, under which Liglass Trading, a Czech photovoltaic and hydropower investment company, agrees to construct and operate two large hydropower plants in the Upper Naryn cascade and 10 other smaller plants with a capacity of 280 MW. However, after Liglass announced in September 2017 that it would be unable to fulfil obligations to pay US$ 37 million to RusHydro, the government decided to cancel the contract with the company. The contract for the development of these hydropower plants had previously been awarded to RusHydro, a Russian hydroelectric company. The contract with the Russian company was terminated in 2015 because of the government's concerns regarding the ability of the Russian government to follow through on proposed investments in the project. The successful completion of the Upper Naryn project would be a good sign for other significant endeavours such as the proposed Karambata-1 dam, which will require investment on an even larger scale.

MONGOLIA

Highlights

- **The economy is recovering well.** Growth reached 5.3 per cent in the first half of 2017, significantly up from 1.0 per cent in 2016, largely reflecting the base effect, high fixed investment in the mining sector and a recovery in household consumption.
- **A new IMF programme is in place.** This is part of a broader US$ 5.5 billion package supported by China, Japan, Korea, the Asian Development Bank (ADB) and the World Bank. Disbursements are conditional on fiscal consolidation, monetary policy and banking sector reforms as set out in the new programme.
- **Significant fiscal reforms have been passed.** Progress has been made on legislation that strengthens tax administration, tax policy and budgetary controls, including through the establishment of a fiscal council.

Key priorities for 2018

- **Reforms under the IMF programme need to be implemented effectively.** Critical pillars of the programme are fiscal consolidation, strengthening the banking system, financial market reform, restoring debt sustainability and rebuilding international reserves.
- **Banking sector reforms need to advance.** A forthcoming Asset Quality Review should be followed by recapitalisation and restructuring of banks as needed. It will be key to improve the supervisory and regulatory framework, and strengthen the governance and independence of the Bank of Mongolia.
- **An environment conducive to large mining sector projects needs to be secured.** The natural resources sector requires further reform, including the promotion of transparency of the licensing process, further improving the effectiveness of the implementation of existing legislation, and strengthening the independence and technical capacity of the regulatory bodies.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	11.6	7.9	2.4	1.0	2.6
Inflation (average)	8.6	12.9	5.9	0.6	4.5
Government balance/GDP	-6.8	-1.2	-5.0	-15.4	-10.4
Current account balance/GDP	-25.4	-11.5	-4.8	-6.3	-4.9
Net FDI/GDP [neg. sign = inflows]	-16.7	-2.3	-0.9	37.8	-8.8
External debt/GDP	151.2	171.7	184.4	248.3	247.4
Gross reserves/GDP	17.8	13.5	11.3	11.8	n.a.
Credit to private sector/GDP	56.2	56.2	50.5	52.0	n.a.

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Macroeconomic performance

Mongolia's economy is recovering. Economic growth slowed to just 1.0 per cent in 2016, as domestic demand declined and investment struggled to recover from the downturn in previous years. However, a strong recovery has taken hold since late 2016 thanks to growing investment in the mining sector and higher coal prices and exports. Real GDP growth reached 5.3 per cent year-on-year in the first half of 2017, following a 9.8 per cent rise in the fourth quarter of 2016. Household consumption also improved. External trade turnover increased by 33.4 per cent year-on-year in the first nine months of 2017. Exports rose by 37.5 per cent year-on-year in US dollar terms, led by coal exports, while imports rose by 27.9 per cent in the same period.

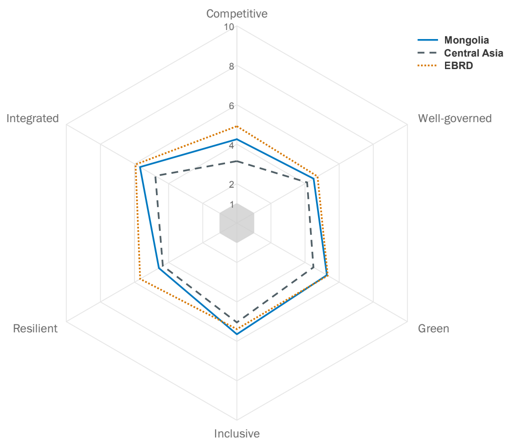
Currency pressures eased in 2017. This reflects the effect of the new IMF programme, the accompanying fiscal reforms, and higher exports. The tugrik modestly appreciated against the US dollar in the first 10 months of 2017, following a 20 per cent depreciation over 2016. This allowed the central bank of Mongolia (BOM) to lower its policy rate to 12.0 per cent in June 2017 from the 14.0 per cent rate established earlier. Upward pressure on inflation has been gradually building from low levels in 2016. Inflation reached 5.8 per cent in September 2017 year-on-year, after averaging 0.6 per cent in 2016.

Public finances have remained a challenge, although liquidity pressures have been overcome. The budget deficit widened to 15.4 per cent of GDP in 2016, versus an initially budgeted 4.0 per cent, partly as a result of including into the budget spending programmes previously undertaken by the central bank. For 2017, the budget deficit is expected to narrow to a still-significant 10.4 per cent of GDP, reflecting substantial reductions in the spending on state-funded programmes. Short-term liquidity pressures have abated since the government refinanced an external bond due in March 2017 by issuing a new seven-year maturity bond. This demonstrated solid market access in light of the new programme with the IMF, which unlocks a US$ 5.5 billion financial package from multilateral and bilateral lenders over the next three years to maintain the economic stability of the country.

In October 2017 the government of Mongolia issued US$ 800 million in a 5.5-year bond with a 5.625 per cent coupon. Proceeds from the bond will be used to repay debts from the government's previous bonds, including the Chinggis and Dim Sum bonds. Major public debt repayments will thus not be due before 2021.

The economy is projected to grow by 2.6 per cent in 2017, rising to 3.0 per cent in 2018, as mining investment and exports accelerate driven by the expansion of the second phase of the Oyu Tolgoi mine. Public spending will by contrast remain subdued in 2017-18, given the government has remained committed to the significant fiscal tightening envisaged under the IMF programme.

Assessment of transition qualities (1-10)



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Major structural reform developments

Mongolia is quite advanced towards its transition to a market economy. The country has the highest average transition quality score compared with other Central Asian countries and ranks 23rd among the 37 EBRD countries. Mongolia ranked 62nd out of 190 countries in terms of ease of doing business according to the World Bank *Doing Business 2018* report, with large gaps remaining in the areas such as getting electricity and trading across borders. In the mining sector, issues surrounding the share of state ownership, the rules governing the allocation of risks and rewards between the state and private investors, and the tax regime have all been subject to change and uncertainty.

Structural reforms are anchored within the new IMF programme. The programme – a three year US$ 434 million extended fund facility signed in May 2017 – focuses on economic reforms to: (i) tighten fiscal policy; (ii) improve the central bank's independence, governance and focus on core responsibilities; (iii) strengthen the financial sector; (iv) foster economic diversification and inclusive growth; and (v) protect the most vulnerable in society. The approval of the programme unlocked an additional US$ 5.2 billion financial support package, with the ADB, the World Bank, Japan and Korea, providing around US$ 3 billion budgetary and project support, and China extending an around US$ 2.2 billion swap line to BOM for the next three years.

The structural reform agenda has advanced. Staff-level agreement on the first and second review of the IMF programme was reached in October 2017. The rehabilitation and strengthening of the banking system is under way: the results of the comprehensive Asset Quality Review are expected in mid-December; important legal reforms are being drafted to strengthen the financial system; and improvements to the regulatory and supervisory framework are under way. On the fiscal side, progress has been made in strengthening the tax administration, tax policy and budgetary controls including through the establishment of a fiscal council and a high-level working group on tax policy.

Significant fiscal reforms have been passed. Legislation passed in April 2017 focused heavily on revenue-side reforms. Changes include a progressive personal income schedule that replaces the flat rate of 10 per cent applied previously and the taxation of interest on personal savings. Under the new progressive schedule, individuals with earnings exceeding tugrik 1.5 million (US$ 70,000) will be liable to additional marginal tax rates of 15 to 25 per cent. Other important amendments include the raising of retirement ages, which will be increased by six months every year from 2018 to reach the target pension-drawing ages of 65 years for men and women by 2028 and 2038, respectively. A 10 per cent tax will be levied on all savings accounts, effective from May 2017. Also, increases were adopted on fuel taxes, a vehicle tax schedule targeting larger vehicle engine capacities. Tariffs on imported cigarettes were also increased from 5 to 30 per cent, and higher excise taxes were imposed on alcoholic beverages and cigarettes, to be phased in during 2018-20. Mandatory social insurance fund contributions will also be increased gradually from 2018.

The strategic Oyu Tolgoi II mining project is gathering pace. Rio Tinto, the operator of Mongolia's biggest mine, Oyu Tolgoi (OT), is making progress on the second phase of the project, which was launched in 2016. A sum of US$ 6 billion has been invested so far in OT, and another US$ 5 billion could be invested under the new phase. Significant structural changes were made earlier to support mining activities in the country, which included the amendments to the Foreign Investment Law that clarified applicable tax regimes and permitted most foreign private investors to invest in a range of strategic sectors without seeking government approval. The amendments also stipulated that foreign-invested projects are governed by the rules in place when the contracts were signed. However, restrictions remain on foreign state-owned enterprises acquiring control of key mining assets.

TAJIKISTAN

Highlights

- **Economic growth remains strong but fiscal pressures are building.** The economy grew by 6.9 per cent in 2016 according to official data and 6.8 per cent (year-on-year) in the first nine months of 2017. However, fiscal pressures are rising as a result of the challenges in the financial sector.
- **The banking sector is still in a challenging state.** The government had to bail-out major banks in December 2016, and is trying to secure international support for a fundamental reform of the sector.
- **Construction of the Rogun dam was launched in October 2016.** In September 2017 Tajikistan successfully placed its debut sovereign Eurobond of US$ 500 million to finance the Rogun dam construction. On 28 August 2017, Standard & Poor's (S&P) and Moody's assigned first-time sovereign ratings for Tajikistan as follows: B- (S&P) and B3 (Moody's), both with stable outlooks.

Key priorities for 2018

- **Banking sector weaknesses need to be tackled vigorously.** It will be essential to make a comprehensive assessment of the financial situation of the largest systemic banks, to recapitalise them and restore their liquidity, and to improve their management. The regulatory framework needs to be enhanced, including through the stronger supervision and introduction of an improved non-performing loan (NPL) resolution framework.
- **Reforms need to continue to improve the business environment.** A particular focus is needed on improving tax administration practices and easing currency restrictions, two of the most important constraints for businesses.
- **Efforts should be further accelerated to restructure the vertically integrated electricity company Barki Tojik and rationalise the tariff-setting in the sector.** Cost transparency for electricity generation, transmission and distribution needs to be enhanced, and ultimately the three parts should be unbundled and tariffs adjusted gradually over time, while related social issues need to be addressed. Securing the completion of CASA-1000 and more transparency in the management of the Rogun project will also be important going forward.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	7.4	6.7	6.0	6.9	6.5
Inflation (average)	5.0	6.1	5.8	5.9	8.2
Government balance/GDP	-0.8	0.0	-1.9	-10.6	-6.5
Current account balance/GDP	-7.8	-2.8	-6.0	-3.8	-6.3
Net FDI/GDP [neg. sign = inflows]	-1.5	-3.3	-5.4	-5.0	-3.0
External debt/GDP	47.4	43.0	48.6	57.8	59.5
Gross reserves/GDP	5.6	5.5	6.3	9.4	n.a.
Credit to private sector/GDP	18.6	21.5	23.4	18.2	n.a.

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Macroeconomic performance

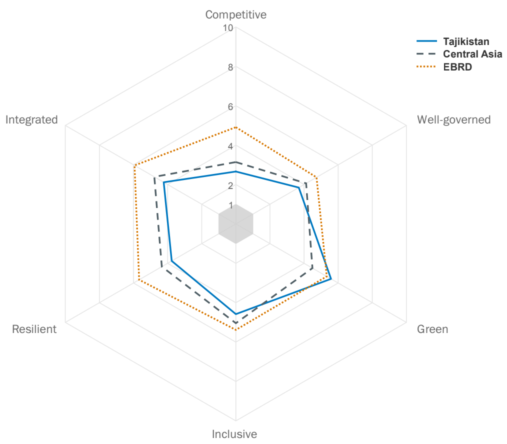
Economic growth remains strong. GDP growth was 6.9 per cent in 2016 and 6.8 per cent (year-on-year) in the first nine months of 2017 according to official figures. However, the headline figures mask the build-up of structural disruptions, reflected in the fragility of the banking sector. The fall in global prices for aluminium and cotton, Tajikistan's main export commodities, impeded the economic performance of the country in 2015 and early 2016. Remittances from Russia declined by 42.4 per cent in US dollar terms in 2015 year-on-year. However, the decline eased to 13.1 per cent in 2016, and the first half of 2017 saw a significant rebound by 22.4 per cent year-on-year, positively affecting domestic demand.

Currency controls kept the somoni broadly stable in 2016, but exchange rate pressures intensified in 2017. The somoni depreciated by 10.5 per cent against the US dollar in the first 10 months of 2017. The National Bank of Tajikistan (NBT) gradually increased its refinancing rate from 4.8 per cent in early 2014 to 16.0 per cent in March 2017. Measures introduced by the authorities in 2015 aimed at preventing sharp currency depreciation have remained in place. They include controls to restrict households' and companies' access to foreign exchange and the banning of all currency exchanges in the country. Foreign exchange and gold reserves have increased recently, to US$ 1.3 billion at the end of September 2017 (an import cover of around five months) mainly due to the Eurobond issuance proceeds. Inflation averaged 5.9 per cent in 2016 and increased to 6.7 per cent in September 2017 year-on-year.

Tajikistan's banking sector has been facing significant challenges since 2015. The fundamental problems in banks, including the longstanding weaknesses in governance and lending to related parties, were aggravated by the significant currency depreciation in the country. Overdue and NPLs, mostly concentrated in the two large banks, rose to around 54.0 per cent in the fourth quarter of 2016 from 29.9 per cent in 2015, according to NBT data and decreased only by 3.7 percentage points between December 2016 and June 2017. Fiscal risks stemming from the government's need to shore up the banking system are substantial. Public external debt rose to US$ 2.3 billion in 2016 (33 per cent of GDP), the issuance of the US$ 500 million Eurobond added an additional 7 per cent of GDP. Domestic public debt stood at the equivalent of US$ 700 million (12 per cent of GDP) at the end of 2016, including US$ 422 million in special government debt securities guaranteed by the NBT issued under the bank bail-out programme.

Officially reported real GDP growth is expected to reach 6.5 per cent in 2017 and slow to around 5.0 per cent in 2018. Significant downside risks remain in light of the possibility of further banking sector turbulence and in view of the difficult fiscal position of the country.

Assessment of transition qualities (1-10)



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Major structural reform developments

The investment climate and business environment deteriorated further over 2016-17. Heavy-handed tax administration practices have become more intrusive and arbitrary in the past two years as a result of increased fiscal pressures and, along with currency controls and the difficult access to finance, are negatively affecting businesses and limiting their ability to carry out their operations. The delays in structural reforms to resolve banking sector challenges, as well as to improve the business environment, with a particular focus on tax administration practices and easing currency restrictions, are likely to allow vulnerabilities to accumulate further. Tajikistan ranks 123rd out of 190 countries in the World Bank's *Doing Business 2018* report, with large gaps remaining in most areas, in particular in getting electricity, getting credit, trading across borders, paying taxes and resolving insolvency.

Large parts of the banking sector have been bailed out. The second largest bank, Tojiksodirotbank (TSB), was put into temporary administration in May 2016 and a number of other banks face solvency and liquidity problems. In December 2016, the government announced a US$ 422 million bail-out programme for the two largest banks, Agroinvestbank (AIB) and TSB, and two smaller banks, Tojprombank and Fononbank. The bail-out was funded through the issuance of special government debt securities guaranteed by the NBT. In January 2017, the NBT announced the withdrawal of somoni 1.6 billion (US$ 200 million) from AIB and TSB, which was followed by the revocation of the licences of Fononbank and Tojprombank in February 2017. The government is now considering a fundamental reform of the sector and is working on securing international financial institution financial and policy support.

Currency controls introduced in 2015 have mostly remained in place. These include measures to restrict households' and companies' access to foreign exchange and banning all private currency exchange offices in the country. In January 2017, the NBT started a gradual depreciation against the US dollar, with the currency weakening by 10.5 per cent against the US dollar in the first 10 months of 2017. In May 2017, the AIB reduced its daily withdrawal limit to somoni 500, from Somoni 1,000, while at TSB the limit has remained at somoni 200.

Tajikistan tapped the international bond market with a debut Eurobond issuance. The US$ 500 million 10-year sovereign bond, yielding 7.125 per cent, was successfully placed at the beginning of September 2017. The proceeds of the bond will be used to finance the Rogun dam, construction of which was officially launched in October 2016. In April 2017, the parliament also approved the government's plan to reallocate somoni 530 million (US$ 62.5 million) in bail-out funds for Fononbank and Tojprombank (both of which are liquidated) to the construction of the dam. However, given its struggle to attract investment in the past and with investors facing significant economic risks, securing financing for such a large project remains a challenge.

Tajikistan intensifies exploring Eurasian Economic Union (EEU) membership. In July 2017 the head of the customs service in Tajikistan announced that an expert committee had completed its study of Tajikistan's potential EEU accession. The results have not been made public. Negotiations for Tajikistan's accession to the EEU have been slow. However, the difficult situation in the banking sector and the broader economy might motivate Tajikistan to seek closer ties with the EEU to request financial support.

TURKMENISTAN

Highlights

- **Growth has changed little.** Officially reported real GDP growth was 6.4 per cent year-on-year in the first half of 2017, after 6.2 per cent in 2016 and 6.5 per cent in 2015.
- **The local currency remains significantly overvalued.** The black market rate reached around 6.6 manat to one US dollar by September 2017 compared with the official peg rate of 3.5 manat to one US dollar. The government has responded by introducing harsher currency restrictions. Information on foreign currency reserves is not disclosed.
- **The government terminated social transfers for electricity, gas and water in June 2017.** Exceptions are made for socially vulnerable groups. This indicates that the country has begun to better target budget expenditures, adjusting to lower revenues as the dollar value of gas exports has remained 40 per cent below its peak in 2014.

Key priorities for 2018

- **The authorities need to address currency convertibility issues and move towards unifying the black and official exchange rates.** The harsh currency controls and the significantly overvalued peg are distorting the economy and holding back private sector development.
- **The banking sector needs to be reformed.** Necessary measures include a gradual reduction in state-directed lending and state lending programmes through commercial banks, and a move to a more market-based financial intermediation.
- **Efforts to improve the business environment need to accelerate.** It is important to advance structural reforms, with particular focus on the commercialisation of state-owned companies and their gradual privatisation, and the liberalisation of cross-border trade, which would strengthen the country's integration into regional and global markets.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	10.2	10.3	6.5	6.2	5.7
Inflation (average)	6.8	6.0	7.4	3.6	6.0
Government balance/GDP	1.5	0.9	-0.7	-1.3	-1.1
Current account balance/GDP	-7.3	-6.4	-14.0	-21.0	-15.4
Net FDI/GDP [neg. sign = inflows]	-7.3	-8.8	-8.5	-6.2	-6.1
External debt/GDP	22.1	18.0	19.4	23.9	25.9
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	n.a.	n.a.	n.a.	n.a.	n.a.

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Macroeconomic performance

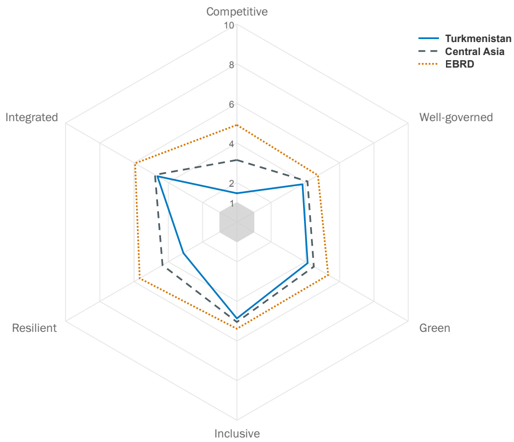
Growth remained little changed in early 2017. Officially reported real GDP growth reached 6.4 per cent year-on-year in the first half of 2017, after 6.2 per cent in 2016 and 6.5 per cent in 2015. This is substantially below the growth rates achieved in 2011-14, when gas exports were increasing rapidly. Recent growth has been supported by rising domestic consumption and import substitution. Retail trade turnover expanded by 16.9 per cent year-on-year in 2016 and by 17.2 per cent in the first half of 2017. However, fixed investment stalled in 2016 and early 2017 despite the preparation of the Asian Indoor and Martial Arts Games, which took place in September 2017. The halt of gas exports to Russia since 2016 and gas disputes with Iran, leaving China as the sole major gas recipient for the country, combined with the fall in global energy prices reduced exports to US$ 7.5 billion in 2016 from its peak of US$ 11.3 billion in 2014, according to the IMF.

The gap between the official and unofficial exchange rates has widened significantly, suggesting that the manat is significantly overvalued. The black market rate depreciated to 6.6 manat per US dollar in September 2017 from 4.4 manat per US dollar, while the official peg of 3.5 manat per US dollar has been maintained since January 2015. The government responds by continuously introducing harsher currency restrictions, severely disrupting trade.

Despite some recovery in revenues, state finances have remained under pressure. The budget slipped into a marginal deficit in 2015. In 2016 the deficit widened to 1.3 per cent of GDP, even though budget expenditures remained 13 per cent below plan, not least due to public wages arrears and cuts and lay-offs of public sector workers. Revenues decreased by 11 per cent year-on-year, and expenditures by 18 per cent, in 2016. In the first half of 2017, revenues began to recover and rose 18 per cent from a year earlier, with expenditures up by a moderate 3 per cent. The end of social transfers for electricity, gas and water from June 2017 will put a further cap on spending growth. Turkmenistan nevertheless spent significant amounts on preparation for the September 2017 Asian Indoor and Martial Art Games (for example, a new sports complex for US$ 6 billion and a new airport for US$ 2 billion), at least in part from off-budget funds.

Real GDP growth can be expected to slow to an average of 5.7 per cent in 2017 and 5.1 per cent in 2018, due to fiscal tightening measures and continuing currency depreciation that eats into real household income and spending. Relatively meagre export growth and the failure to introduce much-needed reforms to enhance the country's competitiveness and attract investment will also weigh on growth.

Assessment of transition qualities (1-10)



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Major structural reform developments

Turkmenistan remains in a very early stage of transition. The country has the lowest assessment of transition quality (ATQ) score among the EBRD's countries of operations. Significant gaps remain across all qualities, in particular in competitiveness, resilience and governance. Competitiveness of the private sector is low due to the challenging business environment and the significant state presence in the economy.

A "National Development plan for 2018-2024" was adopted in October 2017. It aims to create job opportunities in all provinces of Turkmenistan; facilitating self-sufficiency up to province level and where possible up to district level; fast-track measures to reduce imports and boost exports; nurturing the small and medium-sized enterprises to serve as the backbone of the economy; creating conditions for the emergence of private farmers as the primary guarantors of food security. It foresees also major industrial projects in the mining, chemical, metallurgical industries and in logistics. The government also passed several legislative reforms, including the amendments to the law on free economic zones, labour code, land code and tax code of Turkmenistan.

The government ended social transfers for electricity, gas and water in June 2017. Exceptions are made for socially vulnerable groups. This termination of transfers suggests better targeting but also that the government faces significant shortages in revenues as a result of low commodity prices. Turkmen citizens had enjoyed such benefits since late 1992, although limits were later imposed on the amounts that citizens could use for free. The government is also pushing to eliminate cash transactions in favour of bank cards, which suggests there is a serious shortage of hard currency.

Customs stamps have been reintroduced. The measure was implemented in June 2017, requiring importer companies to obtain a stamp for the State Commodity and Raw Materials Exchange before customs clearance. This has therefore increased non-tariff barriers to trade. Such a rule had existed from the time of Turkmenistan's independence in 1991 until 2008, when the government ended the requirement for imports valued below US$ 1 million after the official manat exchange rate was harmonised with the market rate.

The construction of a new gas pipeline has been postponed. In March 2017 it was decided to indefinitely postpone work on Line D of the Central Asia-China gas pipeline. Line D is the fourth branch of this pipeline, which was launched in 2009. Line D was particularly important for Turkmenistan as it would have enabled the country to raise its total gas exports to China to 65 billion cubic metres by 2020 from an estimated 30 billion cubic metres in 2016. Turkmenistan's economy is left particularly exposed by this decision, as it is entirely dependent on China as its only gas export market, after gas exports to Russia and Iran were halted in 2016-17. The construction of the Turkmenistan-Afghanistan-Pakistan-India (TAPI) pipeline is progressing slowly, owing to diplomatic, financial, security and technical challenges.

UZBEKISTAN

Highlights

- **Officially reported GDP growth slowed to 5.3 per cent in the first nine months of 2017,** from 7.0 per cent in the first half of 2017 and 7.8 per cent in 2016, however this likely reflects more accurate accounting rather than a sharp contraction in the third quarter.
- **A series of market-oriented reforms have been initiated.** In addition to the liberalisation of the foreign exchange regime (see below), there have been measures to improve the business and investment climate, a reduction of the state presence in the economy, and judicial reforms.
- **Major steps were made to liberalise the foreign exchange regime.** Since 5 September 2017 the sum has been allowed to float freely and currency controls have been loosened, representing the most important economic reform for the country to date. A comprehensive plan for monetary policy reforms for 2017-21 has also been approved, which includes the gradual move to an inflation targeting regime.

Key priorities for 2018

- **Further deep structural reforms need to be launched.** Fiscal and tax reforms, customs reform, financial market reform, and others are crucial for successful competition with intensified imports after the opening up of the country. Foreign investments need to be encouraged and remaining legal and administrative obstacles need to be removed.
- **Banking sector reforms need to deepen and state-directed lending should be phased out.** The underdeveloped banking system with high state ownership hinders the development of a resilient and competitive economy. Strengthening of the banking sector is needed through stricter enforcement of prudential banking rules and better risk and credit management, and the reduction of state-directed lending at preferential terms is critical.
- **Efforts to improve the business and investment climate need to continue and deepen.** The authorities should carry on with the ongoing work to address excessive regulations, improve business registration and the licensing regime, and reform the complex and distortive tax system.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	8.0	8.1	8.0	7.8	5.4
Inflation (average)	11.7	9.1	8.5	8.0	13.2
Government balance/GDP	2.4	3.4	0.8	0.4	0.6
Current account balance/GDP	2.9	1.7	0.7	0.7	0.9
Net FDI/GDP [neg. sign = inflows]	-1.1	-1.2	-0.1	-0.2	-0.2
External debt/GDP	13.4	14.5	18.1	20.2	22.2
Gross reserves/GDP	39.4	38.2	38.7	37.8	n.a.
Credit to private sector/GDP	n.a.	n.a.	n.a.	n.a.	n.a.

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Macroeconomic performance

Officially reported GDP growth slowed to 5.3 per cent in the first nine months of 2017 year-on-year, from 7.0 per cent in the first half of the year and 7.8 per cent in 2016. However, the lower reported growth figure is likely to be due to more accurate accounting rather than reflecting a sharp contraction in the third quarter. Growth was driven by an increase in exports of 25.6 per cent year-on-year and a strong performance in the industry, construction and services sectors.

The sum has been allowed to float freely. Since 5 September 2017 the Central Bank of the Republic of Uzbekistan (CBU) stopped administratively setting the exchange rate and devalued the official rate by 48 per cent to Sum 8,100 to 1 US dollar from Sum 4,210 to 1 US dollar set previously. Interventions serve only to prevent large fluctuations.

Inflation has accelerated in 2017. Consumer prices were 5.2 per cent higher in June 2017 than in December 2016 mainly reflecting the increases in food prices. This compares with 2.5 per cent a year earlier and 8.0 per cent for 2016 overall. Some further acceleration in inflation might take place when prices, currently partially frozen, will be adjusted. The liberalisation of exports of some goods previously supplied only to the domestic market also contributes to higher inflation, whereas the pass-through from the devaluation of the official exchange rate has been limited thanks to the wide use of the unofficial exchange rate before the currency reform.

Monetary policy was fairly accommodative until mid-2017, but has been tightened since. The central bank increased its monetary policy rate from 9 per cent to 14 per cent in June 2017 in a move to halt credit expansion during the run-up to exchange rate convertibility. At the same time the central bank opened emergency liquidity lines to banks – up to three months. After significant growth in the first half of 2017, banks have halted credit growth to conserve liquidity and manage capitalisation, as well as reflecting the shift in government policies towards restricting monetary growth during the transition to the new exchange rate regime. Banks had received significant liquidity and capitalisation support from the central bank and a state fund earlier in 2017 as measures to prepare for currency liberalisation.

Fiscal and external positions remain in surplus. The officially reported fiscal balance remained in surplus at 0.4 per cent of GDP in 2016 and in marginal surplus also in early 2017. At the same time the government has kept up significant off-budget investment spending, permitted by the large cash buffer available. The current account balance has been maintained at near balance in recent years, turning out at an estimated 0.7 per cent of GDP deficit in 2016. The inflow of foreign direct investment (FDI) and investment loans totalled Sum 6.6 trillion in the first half of 2017 according to official data, with 68 per cent invested in the oil and gas sector and 10 per cent in telecommunications.

Real GDP growth is projected to reach 5.4 per cent in 2017 and increase moderately to 6.2 per cent in 2018, supported by continued robust domestic investment and the stepwise implementation of economic reforms. Export growth will be supported by the improved economic relations with neighbouring countries. Furthermore, the better economic prospects for Russia and Kazakhstan, the main destinations for Uzbek migrant workers, will support remittance inflows. There is however significant forecast risk with regard to the headline figures, as statistical methods might significantly change during the reform process.

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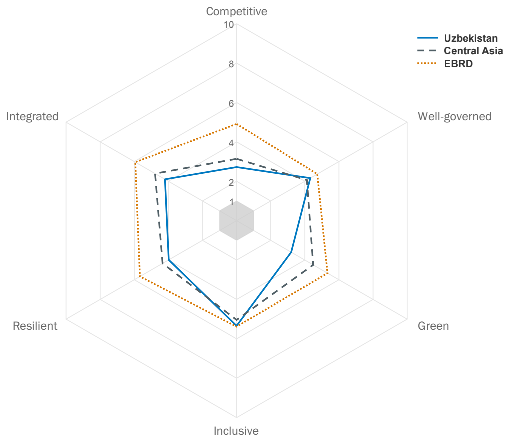
Assessment of transition qualities (1-10)



Major structural reform developments

A series of reforms were announced after the 2016 presidential election. The government's development strategy, approved in February 2017, includes five priority areas: (i) improving public administration and state buildings; (ii) ensuring the supremacy of law and reforming the judicial system; (iii) maintaining solid economic growth and liberalising the economy; (iv) improving the social safety net; and (v) ensuring security. Alongside these reforms the government plans to implement investment projects worth US$ 40 billion over the next five years in energy, infrastructure, chemicals, pharmaceuticals and other sectors. In order to attract the required foreign investment and advanced technologies, the government also plans to open four additional Free Economic Zones in the Samarkand, Bukhara, Fergana and Khorezm regions.

Uzbekistan showed one of the most notable improvements in the World Bank's *Doing Business 2018* report. With five implemented reforms, Uzbekistan has become the regional leader in the total number of reforms in the Europe and Central Asia region and is among the 10 economies improving most in 2016-17. Uzbekistan's rank was 74th out of 190 countries, up from 87th in the previous year's report. Areas reformed were the starting of businesses, access to electricity, paying taxes, dealing with construction permits and protecting minority investors. The largest improvements were made in two areas: paying taxes was made easier and less costly by introducing an electronic system for filing and paying VAT, land tax, unified social payments, CIT, infrastructure development tax, environmental tax, personal pension fund contributions and cumulative pension contributions, while the process of getting an electricity connection was streamlined by introducing a turnkey service at the utility that fulfils all connection-related services, including the design and completion of the external connection.

Steps have been taken to liberalise the currency regime. The reform was launched by the presidential decree issued on 2 September ordering the exchange rate to be decided by market mechanisms. Since 5 September CBU stopped administratively setting the exchange rate and devalued the official rate by 48 per cent. Interbank currency exchange trading sessions are held daily. CBU interventions are intended to prevent large fluctuations. The official central bank rate continues to be published weekly (every Monday), from now on equal to the average value of the rates fixed at the trades of the currency exchange in the previous week. The official rate applies for accounting purposes, statistical and other reporting, as well as for calculating customs and other mandatory payments on the territory of the Republic of Uzbekistan. The decree relaxed some stringent capital controls on foreign currency for businesses and individuals. Legal entities, as well as individual entrepreneurs and farmers with foreign exchange income can now purchase unlimited foreign currency for use in international payment operations. Individuals can receive foreign exchange on payment cards and use it abroad.

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Further steps to improve monetary policy and introduce inflation targeting are being developed. On 13 September the President advised CBU, the Ministry of Finance and the Ministry of Economy to outline a plan for monetary policy reforms for 2017-21 including measures for the coordination of economic, fiscal and monetary policies; the introduction of monetary policy instruments for liquidity management; increasing transparency and improving communication on monetary policy decisions between CBU and the public; and developing the domestic capital markets in the medium term. Monetary policy will be guided by inflation targeting. CBU has been ordered to present a medium-term road map for the implementation of the 2017-21 monetary policy reforms by March 2018. A new law "On foreign exchange regulation" will be introduced by July 2018.

The business environment has significantly improved. Non-scheduled inspections of companies have been limited by law. The state's influence in non-strategic companies has been reduced (whereas previously the state had special rights even if it had a small shareholding, those rights are proportional now). The government is working on the development of e-services to limit face-to-face interactions of the regulator and private sector representatives. The government established the State Committee for Investments in March 2017, responsible for coordinating the formulation and implementation of a unified state investment policy and attracting foreign investments. The government is also working on public-private partnership (PPP) legislation, a renewables framework and a law on state procurement.

The government has adopted a resolution to revise tax legislation. The legislation was adopted in June 2017, and specifying amendments are to follow in the coming months. The structure of the tax system is impeding the creation of specialised businesses (as part of the production value chain) because the taxation of turnover instead of value-added constrains tax deductibility for smaller businesses. The tax system also disincentivises larger businesses and thus discourages companies from growing beyond a certain size. The government is also working to align definitions of micro-, small- and medium-sized enterprises with international practices.

Cross-border integration is being enhanced. Two new border crossings opened between Uzbekistan and Kazakhstan in July 2017 on a section of the Tashkent-Samarkand road passing through Kazakhstan, which had been closed for more than a decade. A new railway link between Samarkand and Astana via Tashkent was launched in June 2017. Uzbekistan is trying to resolve tensions in its relationships with Tajikistan and the Kyrgyz Republic over issues including territorial disputes and access to water resources. In April 2017, a commercial flight between Uzbekistan and Tajikistan was carried out for the first time in 25 years. Efforts are being made to establish bilateral contacts with Turkmenistan.

A new business district and a technopark are planned to be built in Tashkent. In July 2017 Toshkentboshplan, the state-owned company in charge of urban planning and construction in Tashkent, announced that a 70-hectare district, called Tashkent City, will be constructed at a cost of US$ 1 billion in Tashkent in 2018. The project is part of the President's programme aimed at infrastructure development, modernising the economy and positioning the country as investor-friendly.