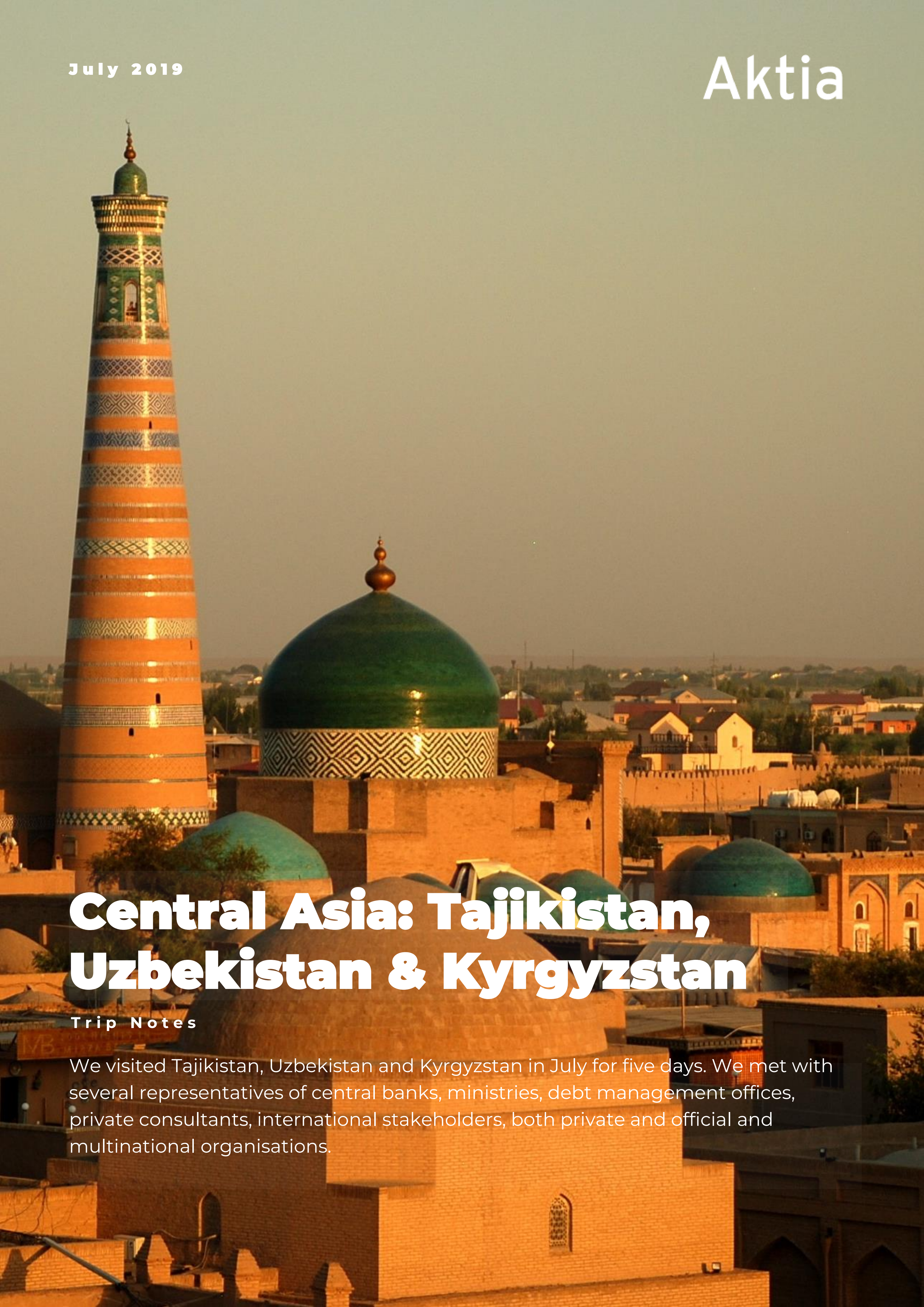
July 2019

Aktia



Central Asia: Tajikistan, Uzbekistan & Kyrgyzstan

Trip Notes

We visited Tajikistan, Uzbekistan and Kyrgyzstan in July for five days. We met with several representatives of central banks, ministries, debt management offices, private consultants, international stakeholders, both private and official and multinational organisations.

Tajikistan, Uzbekistan & Kyrgyzstan

▶ These Central Asian countries have much in common. Mineral mining and remittances play central roles in all of the three economies. Also, energy prices and cost of labour are low in a global context. Demographic trends are supportive for long-term growth, especially if the business environment can be developed to be more conducive for further job creation. The financial markets are still under development and the small sizes of the banking sectors are impediments for faster private sector growth.

▶ One central theme has lately been the economic and political opening up of the largest Central Asian country, Uzbekistan. Bilateral trade has grown considerably after borders have been reopened and in the long term, it is possible that the culturally similar countries could strengthen their political and economic relationships, e.g. in the form of a customs union.

▶ At the same time, the reform momentum in Uzbekistan could increase the pressure for further reforms in the neighbouring countries as well, especially if Uzbekistan's reforms increase the country's competitiveness and its large domestic market attracts international companies at the expense of its neighbours. The reforms are especially followed in Tajikistan, which lags behind its neighbours in political and economic reforms. Kyrgyzstan is the most advanced democracy in the area and so far, safety and stability have been one of its key strengths, appreciated by both international corporations and tourists.

Tajikistan

	2014	2015	2016	2017	2018	2019F	2020F
Real GDP (%, end of period)	6.7	6.0	6.9	7.1	7.0	5.0	4.5
Inflation (%, end of period)	7.4	5.1	6.1	6.7	5.4	6.2	6.2
GDP Per Capita (USD)	1105	919	796	801	826	828	827
GDP Per Capita (USD, PPP)	2691	2820	2982	3187	3416	3578	3743
Current Account Balance (% of GDP)	-2.8	-6.0	-5.2	2.1	-5.3	-7.0	-6.8
General Government Gross Debt (% of GDP)	27.7	34.7	42.0	50.4	47.9	49.5	50.7
Population (million)	8.4	8.5	8.7	8.9	9.1	9.3	9.5
Population growth (%)	2.3 %	2.2 %	2.2 %	2.1 %	2.1 %	2.0 %	2.0 %

Uzbekistan

	2014	2015	2016	2017	2018	2019F	2020F
Real GDP (%, end of period)	8.0	7.9	9.0	8.9	5.0	5.0	5.5
Inflation (%, end of period)	9.2	8.4	7.9	18.9	14.4	15.7	10.5
GDP Per Capita (USD)	2070	2143	2124	1520	1263	1483	1648
GDP Per Capita (USD, PPP)	5736	6147	6656	7259	7665	8065	8561
Current Account Balance (% of GDP)	1.7	0.7	0.3	1.4	-7.8	-5.6	-4.7
General Government Gross Debt (% of GDP)	7.8	8.7	10.5	24.1	23.5	23.2	23.3
Population (million)	30.5	31.0	31.6	32.1	32.7	33.2	33.7
Population growth (%)	1.7 %	1.7 %	1.8 %	1.7 %	1.7 %	1.6 %	1.5 %

Kyrgyzstan

	2014	2015	2016	2017	2018	2019F	2020F
Real GDP (%, end of period)	4.0	3.9	4.3	4.7	3.5	3.8	3.4
Inflation (%, end of period)	10.5	3.4	-0.5	3.7	0.5	4.7	5.1
GDP Per Capita (USD)	1267	1109	1110	1231	1268	1280	1324
GDP Per Capita (USD, PPP)	3328	3422	3538	3706	3844	3979	4122
Current Account Balance (% of GDP)	-16.0	-16.0	-11.6	-6.2	-9.8	-10.9	-8.6
General Government Gross Debt (% of GDP)	53.6	67.1	59.1	58.8	56.0	56.1	55.5
Population (million)	5.9	6.0	6.1	6.3	6.4	6.5	6.6
Population growth (%)	2.0 %	2.1 %	2.0 %	1.9 %	2.0 %	2.0 %	1.9 %

Tajikistan

- We continue to be of the view that the current risk premia in USD-denominated debt do not compensate for the risks stemming from the lack of clarity around the future fiscal situation, the substantial contingent liabilities and a growth model based too much on electricity production from Rogun.
- Local rates, however, are still attractive, underpinned by a stable currency and good reserves. There are also very few international investors involved in the market, further decreasing potential volatility. We are currently invested in currency derivatives and AAA-instruments and are in the process of discussing with the IFC about future projects. We are willing to increase our investments in local currency with current rate levels.

Our visit to Tajikistan further confirmed many of our views articulated in our report from the IMF spring meetings in April 2019. The funding and completion of the mega-dam project at Rogun is still one of the pivotal questions affecting the future of the country's state finances and external balance. The country might very well be in need of an IMF-sponsored funding program in the coming years, but so far Rogun has been the biggest issue between the authorities and the fund. Even though they are closer to a program than ever before and there is an agreement on almost all points, there is still disagreement on two points, the budget deficit (ultimately Rogun driven) and the reduction of tax exemptions, and thus discussions are currently on hold. The IMF fears that the Rogun project will prove to be too big for the country, as Tajikistan is already classified as being in high risk of debt distress. The authorities had apparently hoped for further Chinese support in the form of loans, but recent comments by President Xi do not support this. Chinese or Russian capital injections might be more probable, but it is uncertain if the authorities are prepared to accept one of its giant neighbours as a co-investor. A potential IMF-program could be around USD 300 million, and it would simultaneously unlock funding from other IFI's adding up to USD 1,5 bn. These funds would, however, come with quite a few caveats.

The current situation of the construction of the dam has not improved very much since April. The second turbine is expected during the end of the year, and the first turbine is also only a temporary one. The dam is delayed not only by construction problems, but incompetent project management and unclear division of labour between different ministries. There are still no power purchasing agreements and the dam might not bring in any income for the next years. We also understood that Pakistan might have reduced electricity needs with new Belt and Road projects in the future. This might diminish the future returns of CASA 1000, a network of transmission lines and converters designed to supply Tajiki and Kyrgyz hydropower south, where there is an energy shortage, in Afghanistan and Pakistan. Some of the slack could, however, be picked up by local demand, like the Tajikistan Aluminium Company. To be able to further other reforms as well, the government could spend still USD 1,1 billion on the dam during the next three years, according to the IMF. The potential of the project is still enormous, as, according to the IMF, the annual revenue potential still exceeds the remaining investment needs.

Another large energy-related project is a potential gas pipe transporting gas from Turkmenistan to China through 400 kilometres in Tajikistan, which could provide further long-term budget support for the government and a temporary uplift to economic growth.

Rogun represents only a fraction of the enormous total hydropower potential, but the country is also endowed with significant mineral wealth; the country has one of the largest silver deposits in the world and it is one of only two countries in the world (Kyrgyzstan being the other one) with proven deposits of every element in the periodic table. The mining sector is, however, in dire need of further investments. The authorities are actively trying to encourage moving away from only exporting concentrates, but to start enriching the ore locally. The country needs further reforms especially to amend current structural impediments and inconsistencies in the rule of law have, to increase foreign and local investments, e.g. there are very few small companies in the country and the economy is essentially dominated by large conglomerates. The World Bank has a few projects in the country e.g. related to agriculture (milk exports) and eco-tourism. They are prepared to invest further into energy, mining and telecommunications if there were signs of clear reforms.

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Tajikistan

The authorities bailed out two systematically important banks in 2016, which was one of the preconditions for an IMF-program, but the banking sector still needs a structural overhaul, with NPL's close to 40 percent, political connections and lending to SOE's. The banking sector contingent liabilities to the sovereign can be significant.

The dam project has helped increase the stock public debt, which is currently mostly external, China being the biggest debtor. The government is currently looking into ways of increasing the proportion of domestic debt. Even though the debt stock has risen during the last years, the debt servicing cost remains low, due to the structure of the debt, with a high share of concessional loans. The current deficit is reasonable, but much depends on the completion and capitalisation of the Rogun dam. Growth is on a good level in the country according to the authorities, although from a low base, with industrial production and retail being the biggest contributors last year. Some doubt was cast upon these figures, however, as public statistics have not yet reached international standards. Also, a large proportion of activity is still in the informal sector and are difficult to measure accurately.

The National Bank of Tajikistan has currently adequate foreign exchange reserves, covering around five months of imports, but most of this is gold, exposing the country to risks from volatility in gold prices. However, there is some element of a hedge in this, as the economy is very much dependent on remittances from the 1,5 million Tajiks who live in Russia and are mostly employed in the oil-price sensitive Russian construction sector. If the oil price was to decrease due to a global slowdown, gold might work as a safe have asset at the same time. At the same time gold also works as an inflation hedge and can be positively correlated to oil prices as well, so the hedge is somewhat dubious.

Inflation is to some extent seasonal due to the large portion of citizens living abroad returning home during holidays in March-April and September-October, apart from that, inflation is mostly import-inflation as 70% of food is imported, making FX-passthrough very high. As the government has low fiscal flexibility and cannot increase salaries in public sector, it is important to keep inflation low and therefore keep the somoni stable. This has led to some shortages in foreign currency and a formation of a black-market price that prices the local somoni around 5% lower than the official rate. One of the preconditions for an IMF-program would be a devaluation.

Since the 2015 death of neighbouring Uzbekistan leader Karimov, uncertainty around political successions has been a central issue in the area. At the same time, the situation in Uzbekistan has also increased the pressure in neighbouring countries to take the last steps away from a Soviet-style economic model. Tajikistan is holding presidential elections in 2020, and it is not clear if the long serving leader, Emomali Rahmon, will be up for re-election, or if his son, Rustam, who was appointed mayor of Dushanbe in 2017 and has been groomed for a while to be the next leader, will inherit his father's position. There is, however, a feeling that it is "end of term" for the current cabinet, and that the son could bring in younger people with skills to commence structural reforms. Job creation is paramount for the authorities, as currently they are geopolitically dependent on Russia, who could potentially leverage the Tajiks working there by e.g. instituting targeted immigration laws and thus sending 1,5 million unemployed Tajiks home. Tajiks already pay higher fees than e.g. Kyrgyzstan nationals, as Kyrgyzstan has agreed to join the Russian-led Eurasian Union.

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Uzbekistan

- We are very positive on the country's future possibilities, due to the strong reform drive, implemented in cooperation with international agencies, the low indebtedness, large reserves and healthy demographics that support long-term growth.
- We are invested in soum-denominated AAA bonds and FX derivatives on the local currency side and we are prepared to invest in government bonds were they made accessible to international investors. We have increased our exposure on the external side after the meetings in Uzbekistan.
- We have increased our exposure in USD-denominated government bonds after our visit.

Uzbekistan is currently in the midst of far reaching reforms in order to leave the previous post-Soviet growth model. President Shavkat Mirziyoyev, who succeeded the late president Karimov in 2016, has kickstarted a broad economic and social reform agenda, where the administration itself has broadly been renewed with central positions having been restaffed within government agencies and government owned corporations. One of the goals of the reforms is to increase the market orientation of the economy, the size of the private sector (currently the government's role is especially large in the financial, mining and energy sector and in cotton production) and to attract foreign direct investments. The agricultural sector (particularly fruits) and the textile industry are currently export sectors that the country especially focuses on.

The economic reforms are still rapidly advancing, based on our meetings in the country, which will support the long-term growth potential in Uzbekistan, along with domestic public investments (the IMF is expecting growth to average 5% during the next few years). The government is currently accelerating the pace of the restructuring of sovereign owned enterprises, where management and corporate governance are improved, and the energy and transport sectors are partly privatised. Also, the phasing out of regulated prices is going to be continued. The government has commenced a broad tax reform in 2019, which will simplify the system and lighten the tax burden of private companies and employees.

The current reforms are very broad based and planned and implemented together with international financial institutions; e.g. the World Bank has financed investments with four billion dollars – one of the largest lending programs in Europe and Central Asia. Even if the country is only in the beginning of its reforms, concrete results are already visible e.g. in the newest (2018) World Bank Ease of Doing Business-index, where the country was one of the top climbers (rising to the 74th position out of 190 countries).

The pace of reforms is generally considered to continue to stay strong, although there seems to be a lack of coordination from time to time. Furthermore, we got the impression from some of our meetings that the authorities currently lack a sense of priority between the different projects. The most progress has so far been made in the mining sector: gold mining has been opened up to the private sector, financial reporting has been updated to international standards and statistics around gold production have been opened up to the public. One central reform has been the outsourcing of management in government owned companies, which has quickly increased the production capacity and profitability of the mining companies. The mining sector is central for government revenues, and therefore the current production capacity increasing investments (e.g. Almalyk MMC is planning to double their production within the next five years) will in the future strengthen budget revenues. Mining sector profitability has good prerequisites in Uzbekistan, as the country has an inexpensive workforce (average wage between USD 50-80 per month), electricity is cheap, and the excavation costs are low for several minerals.

The government is planning a public offering in three of the biggest state-owned mining companies (Navoi Mining and Metallurgical Company, Uzbek Metallurgical Company and Almalyk MMC) before 2023, as part of the process of increasing the role of the private sector and opening up local markets to international investors. The planned IPO's are not confined only to the mining sector, but there are also plans of listing part of the financial sector (there are plans to make it possible for foreigners to own up to 10% of local banks).

Reforms are also advancing in the energy sector, even though the pace is a bit slower compared to the mining sector. Increasing electricity production through the building of a nuclear power plant is a central project, currently scheduled to be completed around 2030. One of the most visible changes in the agricultural sector has been the dismantling of regulated prices and currently cotton farmers receive the global market price for their crops.

”Even if the country is only in the beginning of its reforms, concrete results are already visible”

Uzbekistan

Financial markets are still relatively closed and underdeveloped in the country. The authorities are planning to open up these markets to international investors and developing the conditions needed for local corporations accessing financial markets. Currently, the banking sector is mostly servicing public investment projects, as 85% of banking sector assets are within government owned banks, whose main function is to support government projects. Furthermore, the banking sector remains small compared to the overall economy, as assets are only 30% of GDP. The banking sector is considered to be healthy; even though NPL's are on the rise, the levels are still very low at 1,5% of total loans, according to central bank data. Extensive growth in lending (+54% in 2018) is a worry according to the central bank but does still not constitute a broad-based credit expansion as it is almost fully explained by government led investment projects.

The post-independence, Soviet-style economic model had the advantage that the country was left with very few external liabilities and has instead large foreign exchange reserves. These are currently at very good levels (~USD 28 billion, covering around 13 months of imports), providing a healthy buffer for external shocks during the opening up of the economy. Public debt – mostly foreign currency denominated – is still very low (~20 % of GDP) and even though there has been a nominal increase in debt levels, strong growth will ensure that debt stays stable. The need for public investments will strain public finances in the coming years, as will the growth in social spending, which among other things help to compensate lower-income families for potential negative effects of the reforms (e.g. like in the case for deregulation of bread prices). The public sector wage bill is also growing, as increases in the minimum wage will reflect also on other public sector pay grades. The budget deficit is still however expected to remain moderate in the coming years (~1 – 1.5% of GDP).

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Although inflation has moderated from 2017 peak levels, caused by the currency devaluation, price pressures are still relatively strong. The central bank has tightened monetary policy, but inflation has stayed stubbornly high, as inflation expectations haven't meaningfully adjusted lower (due to limited experience of flexible prices and FX) and the removal of price regulations has made some products more expensive. According to the government's plans, the price liberation of energy prices (petrol, gas and electricity) is set to continue, but the lack of a clear time table has increased uncertainty to the central bank's inflation projections (expecting +13.5 – 14.5% at the end year without any major surprises). Given that the inflation adjustment has been gradual, the government will most likely carry out new price liberation measures more cautiously than in previous rounds. The central bank's gold purchases from local producers (in local currency) has a role in FX intervention policies, as the central bank can choose the timing when it sells the gold to international markets. According to the tighter monetary policy stance, the central bank has sterilised the liquidity increase of som followed by gold transactions in order to prevent weakening pressure of the local currency.

Kyrgyzstan

- We remain positive on Kyrgyzstan local currency investments, that are underpinned by the moderating inflation, a stable currency, a transparent central bank with ample reserves and the minimal foreign participation.
- We are currently invested in AAA-supras and FX-derivatives and we are prepared to diversify these investments into government bonds given the opportunity in the future.
- Kyrgyzstan does not currently have any Eurobonds, but we would be prepared to look at such opportunities were they to arise.

Post-Soviet politics in Kyrgyzstan have differed very much from the rest of Central Asia, where most countries have been governed by single-party systems, whereas Kyrgyzstan has been able to develop a vibrant, multi-party parliamentary system. The country has transitioned towards a more parliamentary system from a presidential one in the last ten years and the current parliamentary majority built around the Social Democratic Party will be challenged in the next elections in 2020. Politics have, however, been quite volatile in the country and it has had around 20 prime ministers in less than 30 years of independence, slowing down investments and potential economic growth. Nevertheless, we understood that the current political situation is stable.

Geopolitically Russia is the clear primary partner, both historically and currently; Kyrgyzstan has joined the Eurasian Union, there has been large emigration to Russia and Russia maintains a military base in the country. China is the second most important partner; Kyrgyzstan is ready to benefit from the Belt and Road project, but at the same time views Chinese expansionist policies with age old suspicion. The opening up of Uzbekistan, the largest country in Central Asia, might have geopolitical repercussions as well, as regional cooperation is a top priority for Uzbek president Mirziyoyev, and e.g. a customs union of around 70 million people would give the area a possibility for a more coherent voice against its larger neighbours of China and Russia.

The close ties to Russia are also very much visible in the economy. There are between 1-1.5 million Kyrgyzstani nationals working in Russia and their labour rights are the same as for Russians thanks to the Eurasian Union. Most are employed in the service sector, due to their comparatively high education level and good language skill. The service sector generally enjoys higher wages and provides less cyclical and less seasonal employment compared to construction work, the traditional form of employment for immigrants from ex-Soviet countries. The high proportion of emigrants and higher wages abroad result in very large remittance flows, above 30 % of GDP, around the same size as the state budget. Textiles constitute around 8 % of exports and are mostly destined for Russian markets further strengthening the links to the Russian economy. Kazakhstan and China are other important exports markets, along with Switzerland for gold exports.

The main export product is still gold, and it is the second most important source of hard currency after remittances. The largest gold mine in the country, Kumtor, provides a large share of current government income, but is set to be shut down in 2026. There are however, a few other mines that are under development, but the reserves are smaller, currently about 10 years of Kumtor-like production. We understood that there is very high potential mining sector, but the concessions would need to be made more attractive for international investors.

Like Tajikistan, the country has huge potential in hydro energy, only a fraction of hydro potential is currently in use and yet as much as 90 % of energy is produced using hydro power. A long-term challenge for the industry is the low price at the moment, which has not been high enough to attract further investments for adding capacity. There are, however, already projects for small and medium sized hydro plants, with less concentrated risks compared to mega dams. These can also be spread around the country, decreasing the amount of grid needed. The Casa 1000 transmission lines are almost ready and contracts for selling electricity for five times the domestic price are apparently already in place. Apart from hydro power, there is large potential for thermal power production due to very large coal deposits.

Kyrgyzstan

The education budget to GDP is on par with the Nordic countries in Kyrgyzstan and this has, as a side-effect, created a thriving education business. There are around one hundred thousand foreign students in the country, mostly from India and Pakistan, 90% of them in medical studies. Already the tuitions paid by these students constitute 2.5% of GDP, plus lodging and other expenditure. Tourism also has large potential, due to the cooler mountain climate compared to the larger neighbours. Last year, the country also received 200 000 tourists from Europe, mostly hikers and mountain climbers. The country has also functioned as a hub for many international companies in the area, thanks to its safety and stable policies. However, to increase future growth potential and attract further investments, structural reforms should be continued: cost of finance should be reduced as real lending rates are still an impediment to investments and the rule of law should still be improved.

Kyrgyzstan's public debt relative to GDP is at a higher level than in Tajikistan and Uzbekistan. The majority of this debt is denominated in foreign currency (~80%), so the weakening of the currency during 2014–2015 had a negative impact on the debt burden. However, even if the debt level is relatively high at the moment, Kyrgyzstan's debt servicing costs are very small compared to peers as maturities are long and interest rates are low. The IMF projects the debt ratio to remain stable in coming years with budget deficits expected to be around 3% of GDP, which is in line with the draft fiscal rule considered by the parliament (caps deficit at 3% of GDP and debt at 70%). However, there are some risks related to budget spending as general elections, held in 2020, are approaching. In terms of long-term fiscal strength, the IMF has urged the government to reduce tax exemptions, decrease the wage bill, improve investment management and raise energy tariffs, but so far the progress has been very modest. On a general level Kyrgyzstan's budget spending was described as somewhat rigid, as public wage bill takes a big share of revenues and often any excess revenues are allocated to education at the cost of development investments. Like in Tajikistan and Uzbekistan, the substantial size of the informal economy (especially in the service sector) makes it harder to increase tax revenues which, in turn, limits public expenditure.

Internal inflation pressures are expected to remain moderate with growth seen stable but below the estimated potential (~4%). Currently inflation is clearly below the central bank's target of 5–7%, as food prices, which represents around 40 % of the CPI basket, have declined due to cyclical factors and the opening of Uzbekistan which means that imported food is now much cheaper. As a significant share of Kyrgyzstan's consumer goods are imported from Kazakhstan, Uzbekistan and Russia, the inflation is sensitive to FX fluctuations.

The central bank sees that the current FX valuation is at a neutral level. The IMF, on the other hand, estimates that the Kyrgyzstani som is overvalued, but even so, external pressures have been moderate and the central bank's intervention frequency has decreased meaningfully. During this year the central bank has intervened in the foreign exchange market only three times (central bank's communication has been very transparent also related to interventions), but if USD/KGS is to go above 70 that would likely prompt the central bank to act more frequently. Over the last two years, the som has been fairly stable against the USD, but the currency has appreciated around 15% from the beginning of 2015 in real terms. In terms of external buffers, the central bank has plenty of ammunition, as FX reserves have been increasing steadily from 2015, now covering four months of imports. Compared to Tajikistan, Kyrgyzstan's reserves have less exposure to gold prices, owing to a smaller share of gold (around one quarter of total). Despite the fact that Kyrgyzstan has a fairly significant current account deficit, the IMF didn't seem to be too worried about external vulnerability in the short term, as the deficit is being financed by aid and foreign direct investments especially in the gold sector. However, over the longer term, one clear risk is if the expected slowdown of Kumtor gold mine (by 2026) cannot be offset by new gold mines that could generate sufficiently export revenues.

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