



**European Bank**  
for Reconstruction and Development

# **Regional Economic Prospects in the EBRD Regions November 2018**

## **In the shadow of trade conflicts**

### **Sustained growth amidst tighter financing conditions**

*In the first half of 2018, average growth in the EBRD regions remained unchanged from 2017, at 3.8 per cent. The composition of growth has shifted, with a higher contribution of private consumption and lower, but significant, contributions from investment and exports.*

*Growth is expected to average 3.2 per cent in 2018 and 2.6 per cent in 2019. This represents a downward revision of 0.1 percentage points in 2018 and 0.6 percentage points in 2019 compared with the May 2018 forecast, primarily on account of slower expected growth in Turkey, where a sharp deceleration in the second half of the year is expected to bring the 2018 growth rate down to 3.6 per cent, as the weak lira and interest rate hikes negatively impact private consumption and investment. A growth rate of around 1 per cent is expected in 2019.*

*Excluding Turkey, the projection for the region's average growth in 2018 has been revised upwards by 0.1 percentage points, reflecting strong economic performance in the first half of the year, and is unchanged for 2019. Spillovers from the expected deceleration in Turkey to other economies in the EBRD regions are expected to be very limited.*

*Three major trends have affected the external economic environment for the EBRD regions: tightening of financing conditions for emerging markets; escalating trade conflicts; and higher oil prices.*

*The recent increase in average interest rates faced by emerging markets is the fifth largest in the last 20 years, yet interest rates remain low in historical perspective, comparable to those prevailing during 2003-07 and 2013-15. As a result, the moderate tightening of financing conditions has so far primarily affected capital flows to economies with underlying weaknesses, notably Argentina and Turkey. In addition, countries with high stocks of external debt and domestic debt denominated in foreign currency are more vulnerable to further tightening of financing conditions for emerging markets.*

*If trade conflicts remain confined mainly to bilateral China-US trade, economies in the EBRD regions will be relatively little affected, as most of the region's trade takes place within or with the European Union. For some countries in the region, a reduction in bilateral trade between US and China may open new opportunities to increase exports of finished goods to the American or Chinese markets.*

*In contrast, a scenario in which trade tensions escalate globally and international supply chains become severely disrupted entails high risks for the region's economies that are strongly integrated into global value chains. The economies' ability to flexibly reconfigure supply chains will likely depend on the extent of innovation capabilities, quality of management and the size of domestic markets. In the past, growth in domestic value added of exports in the EBRD regions has been more innovation-light than in other emerging markets. In particular, it has been accompanied by smaller increases in patenting activity.*

*Oil price increases provided a boost to growth in Russia, Central Asia and Azerbaijan and underpinned continued recovery in remittances from Russia to Central Asia, Moldova and the Caucasus. At the same time, growth in Central Asia is expected to moderate to around 4.6 per cent in 2018, reflecting the need for fiscal consolidation, and further to 4.2 per cent in 2019 in light of lower growth in mining output. Growth in Russia is projected to remain around 1.5 per cent.*

*Growth in central and south-eastern Europe is projected to gradually moderate in 2018-19 from high levels seen in 2017, reflecting shortages of skilled labour. Growth in Eastern Europe and the Caucasus is projected to increase to 3.1 per cent in 2018 and 3.2 per cent in 2019 as the recovery in Ukraine gains momentum. Growth in the southern and eastern Mediterranean is projected to increase from 3.8 per cent in 2017 to around 4.4 per cent in 2018 and 4.7 per cent in 2019 on higher tourist arrivals and improved external competitiveness in Egypt and Tunisia.*

*Escalation of trade conflicts is a major risk to the outlook. Other risks include disruption to cross-border supply chains in the case of a no-deal Brexit, high levels of corporate indebtedness and geopolitical instability.*

Table 1. Real GDP growth

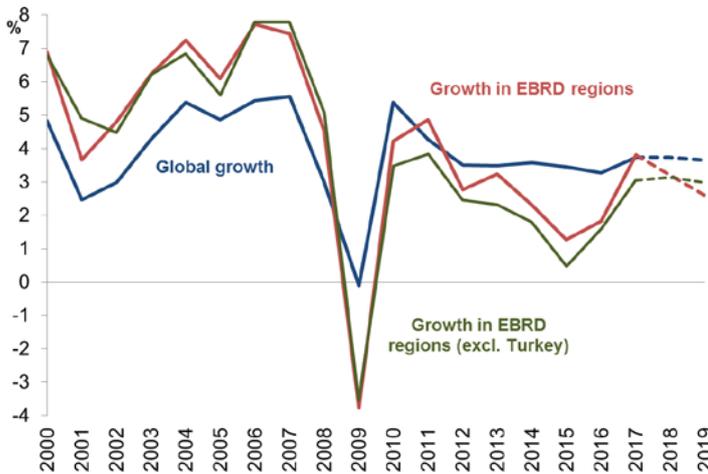
	Actual			Forecast (as of 1 Nov '18)		Difference from REP May '18	
	2016	2017	H1 2018	2018	2019	2018	2019
	<b>EBRD regions<sup>1</sup></b>	<b>1.9</b>	<b>3.8</b>	<b>3.8</b>	<b>3.2</b>	<b>2.6</b>	<b>-0.1</b>
<b>Central Europe and the Baltic states</b>	<b>3.0</b>	<b>4.4</b>	<b>4.7</b>	<b>4.3</b>	<b>3.5</b>	<b>0.5</b>	<b>0.2</b>
Croatia	3.5	2.9	2.7	2.7	2.5	0.0	0.0
Estonia	3.5	4.9	3.5	3.6	3.0	-0.2	0.0
Hungary	2.3	4.1	4.7	4.3	3.3	0.5	0.3
Latvia	2.1	4.5	4.7	3.9	3.5	0.4	0.0
Lithuania	2.4	4.1	3.8	3.4	2.8	0.2	0.0
Poland	3.1	4.8	5.1	4.7	3.6	0.7	0.3
Slovak Republic	3.1	3.2	3.9	3.9	4.0	0.0	-0.2
Slovenia	3.1	4.9	4.2	4.2	3.3	0.2	0.0
<b>South-eastern Europe</b>	<b>3.1</b>	<b>4.4</b>	<b>3.5</b>	<b>3.5</b>	<b>3.2</b>	<b>-0.1</b>	<b>-0.3</b>
Albania	3.4	3.8	4.4	4.0	3.9	0.2	0.0
Bosnia and Herzegovina	3.1	3.0	2.9	3.0	3.5	-0.3	0.0
Bulgaria	3.9	3.8	3.4	3.6	3.4	0.0	0.0
Cyprus	4.8	4.2	3.9	3.9	3.5	0.7	0.5
FYR Macedonia	2.9	0.0	1.6	2.0	3.0	-0.5	0.0
Greece	-0.2	1.5	2.2	2.2	2.3	0.0	0.0
Kosovo	4.1	3.7	4.2	4.0	4.0	0.3	0.0
Montenegro	2.9	4.7	4.8	4.2	3.0	0.9	0.3
Romania	4.8	7.3	4.0	4.2	3.6	-0.4	-0.6
Serbia	2.8	1.9	4.9	4.2	3.5	1.3	0.0
<b>Eastern Europe and the Caucasus</b>	<b>0.1</b>	<b>2.3</b>	<b>3.6</b>	<b>3.1</b>	<b>3.2</b>	<b>0.1</b>	<b>-0.1</b>
Armenia	0.2	7.5	8.3	5.5	5.0	2.0	0.5
Azerbaijan	-3.1	0.1	1.3	1.5	3.5	-1.0	0.0
Belarus	-2.5	2.4	4.6	3.0	2.5	0.0	-0.5
Georgia	2.8	5.0	5.4	4.5	4.5	0.0	0.0
Moldova	4.3	4.5	4.5	4.0	4.0	0.5	0.0
Ukraine	2.4	2.5	3.5	3.5	3.0	0.5	0.0
<b>Turkey</b>	<b>3.2</b>	<b>7.4</b>	<b>6.2</b>	<b>3.6</b>	<b>1.0</b>	<b>-0.8</b>	<b>-3.2</b>
<b>Russia</b>	<b>-0.2</b>	<b>1.5</b>	<b>1.6</b>	<b>1.5</b>	<b>1.5</b>	<b>0.0</b>	<b>0.0</b>
<b>Central Asia</b>	<b>3.6</b>	<b>4.8</b>	<b>4.6</b>	<b>4.6</b>	<b>4.2</b>	<b>0.2</b>	<b>-0.3</b>
Kazakhstan	1.1	4.1	4.1	4.0	3.5	0.1	-0.3
Kyrgyz Republic	3.8	4.6	0.1	2.7	3.2	-1.0	-0.8
Mongolia	1.2	5.1	6.3	6.1	6.0	0.9	0.1
Tajikistan	6.9	7.1	7.2	6.1	5.0	1.1	-0.5
Turkmenistan	6.2	6.5	6.2	6.2	5.6	1.2	0.6
Uzbekistan	7.8	5.3	4.9	5.0	4.5	-0.1	-0.8
<b>Southern and eastern Mediterranean<sup>2</sup></b>	<b>3.3</b>	<b>3.8</b>	<b>4.5</b>	<b>4.4</b>	<b>4.7</b>	<b>0.0</b>	<b>-0.1</b>
Egypt	4.3	4.2	5.6	5.3	5.5	0.0	0.0
Jordan	2.0	2.0	2.0	2.2	2.4	-0.3	-0.3
Lebanon	1.0	1.5	1.1	1.1	1.5	-0.9	-1.0
Morocco	1.2	4.0	2.8	3.0	3.5	0.0	-0.5
Tunisia	1.0	1.9	2.7	2.8	3.0	0.1	0.0
<b>EBRD regions excluding Turkey</b>	<b>1.7</b>	<b>3.1</b>	<b>3.3</b>	<b>3.1</b>	<b>3.0</b>	<b>0.1</b>	<b>0.0</b>

<sup>1</sup> Weighted averages, based on the countries' nominal GDP values in PPP US dollars.

<sup>2</sup> EBRD figures and forecasts for Egypt's real GDP reflect the country's fiscal year (July to June). The figure for Lebanon in H1 2018 is an unofficial estimate.

**Average growth in EBRD regions is projected to moderate**

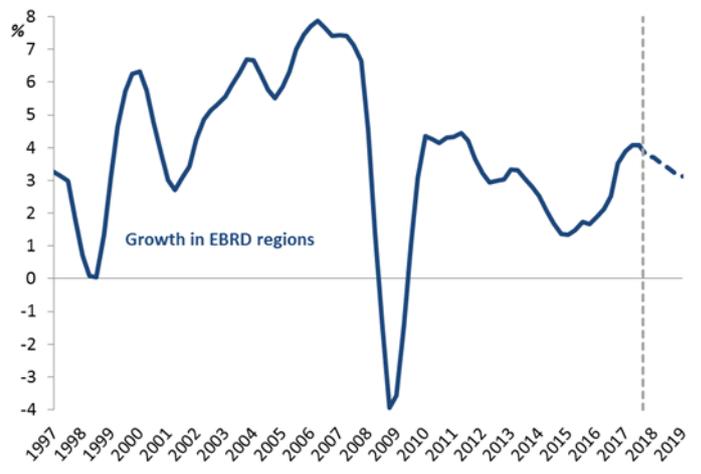
Chart 1. Average growth, %



Source: IMF, EBRD and authors' calculations, PPP-weighted.

**Growth in EBRD regions reached 4.1% in 12m to Jun-18**

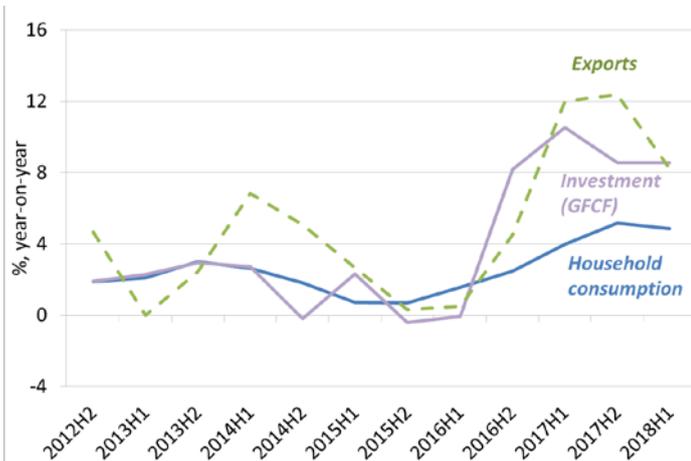
Chart 2. Real GDP growth rate in EBRD regions, %



Source: CEIC, national authorities, IMF and author's calculations.

**Composition of growth shifted towards consumption**

Chart 3. Growth of consumption, investment, exports



Source: CEIC national authorities and authors' calculations.

**Financing conditions for emerging markets tightened**

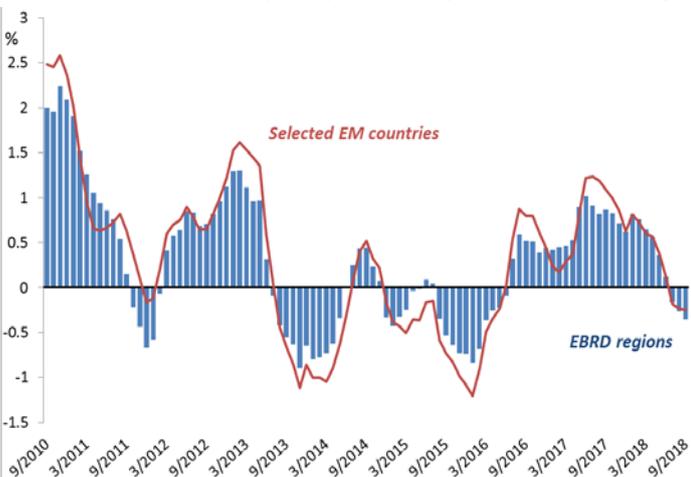
Chart 4. Bond yields



Source: Bloomberg.

**Capital flows to emerging markets have moderated**

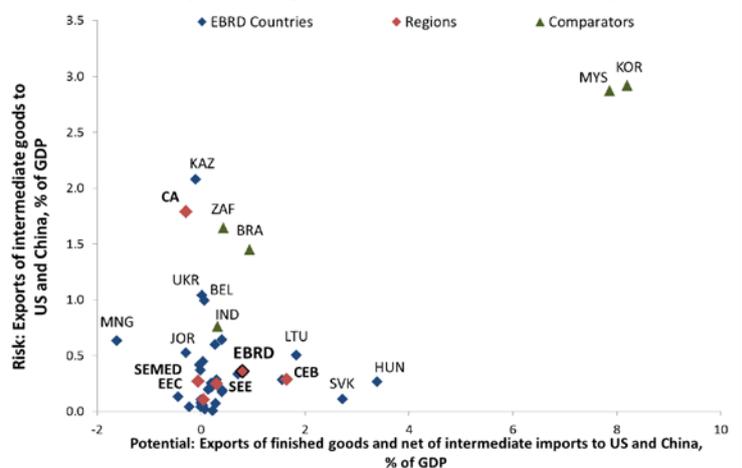
Chart 5. Net mutual fund flows, % of assets under mng.



Source: EPFR Global and authors' calculations.

**Direct exports to China and US tend to be limited**

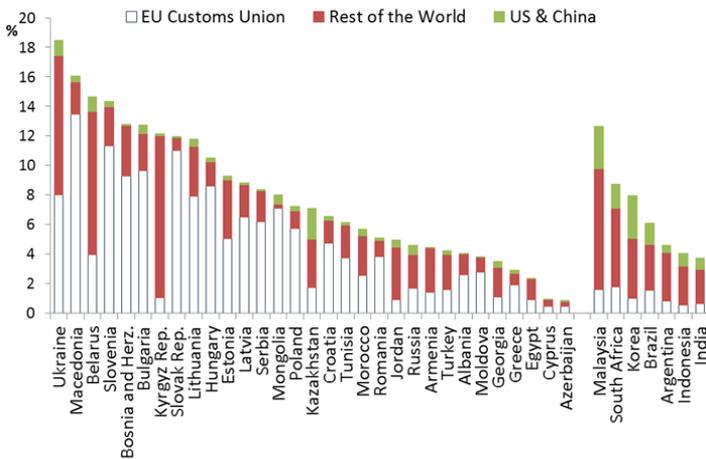
Chart 6. Exports of goods to China and US, % of GDP



Source: WITS, World Bank, IMF and authors' calculations.

**Region's economies are strongly integrated in GVCs**

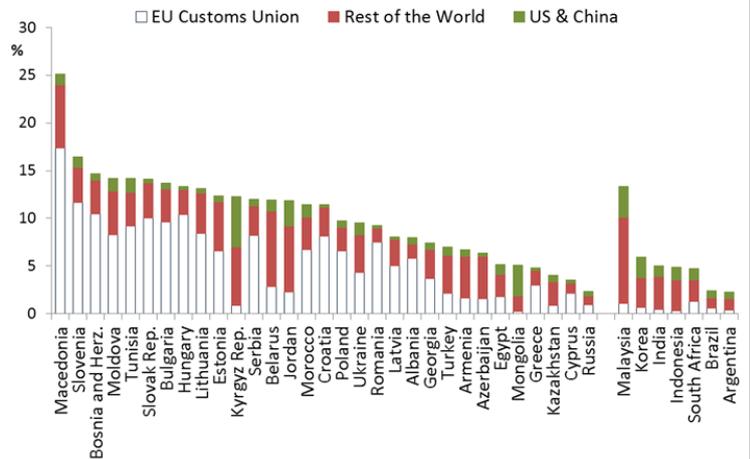
*Chart 7. Exports of intermediate goods, % of GDP*



Source: WITS, World Bank, IMF and author's calculations.

**Mostly trading intermediate goods with/within the EU**

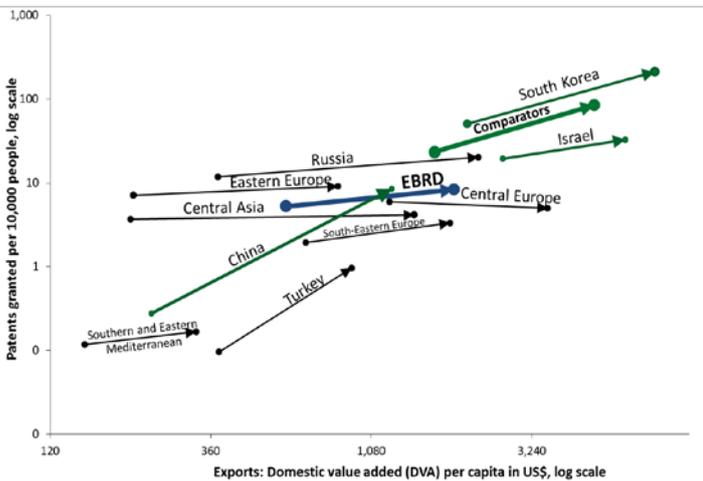
*Chart 8. Imports of intermediate goods, % of GDP*



Source: WITS, World Bank, IMF and author's calculations.

**Fast growth in exports has been innovation-light**

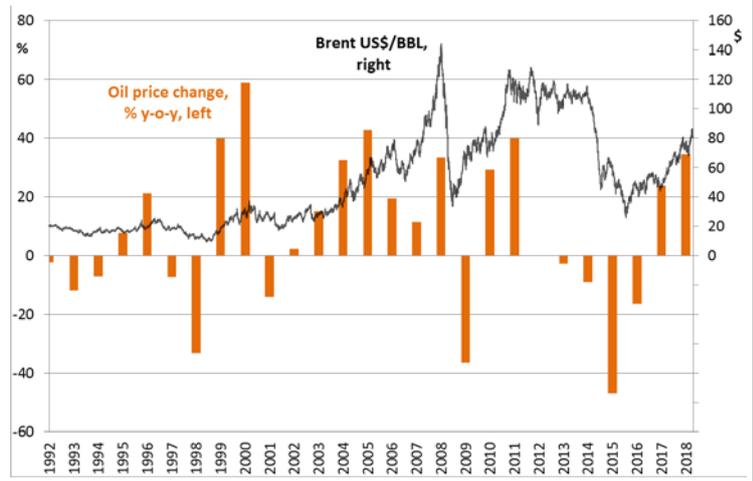
*Chart 9. Domestic value added in exports and patents*



Source: WITS, World Bank, PATSTAT and authors' calculations.

**Brent oil price rose by 40% year-on-year in Jan-Oct 2018**

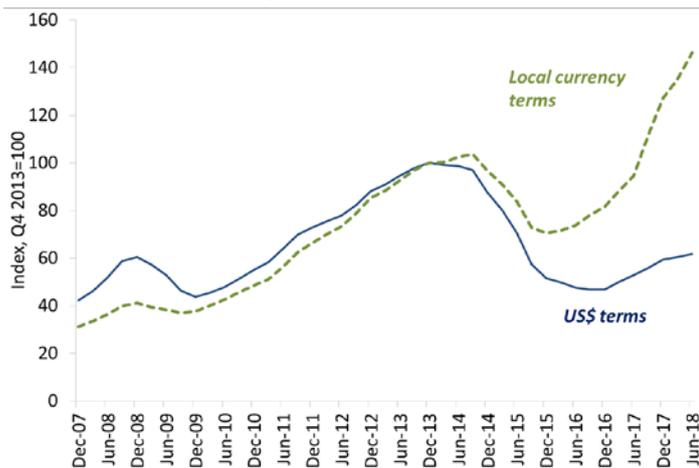
*Chart 10. Brent oil price*



Source: Reuters and authors' calculations.

**Higher oil prices led to higher remittances from Russia**

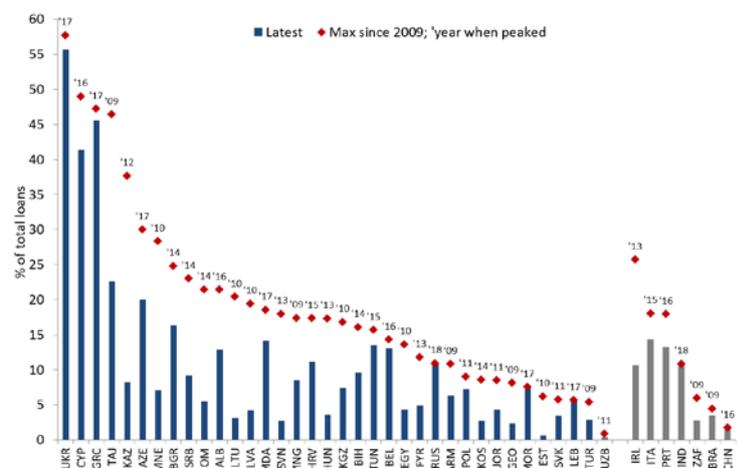
*Chart 11. Remittances from Russia to CA+EEC, Q4 2013=100*



Source: Central Bank of Russia and authors' calculations.

**NPL ratio in a median economy dropped by 10pp since peak**

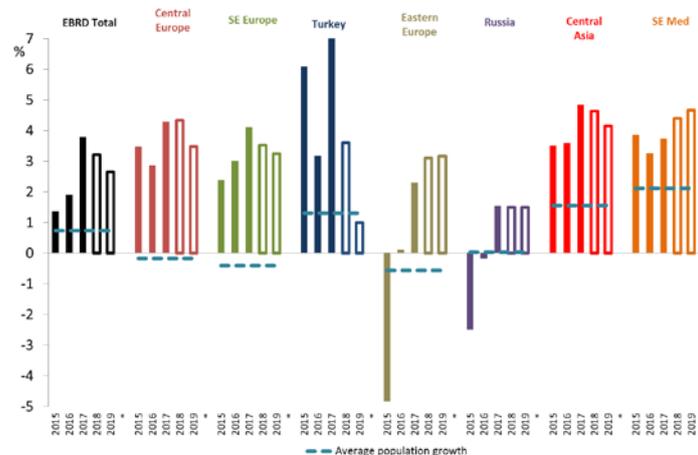
*Chart 12. Non-performing loans, % of total loans*



Source: CEIC, national authorities and World Bank.

## Turkey's economy is expected to slow down considerably

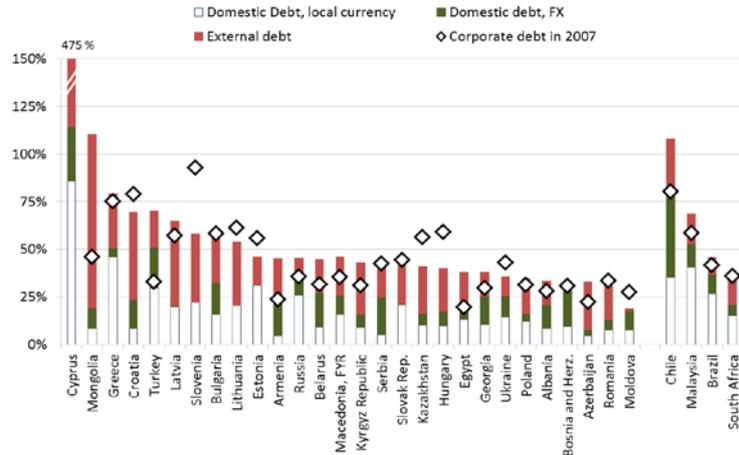
Chart 13. Average growth, %



Source: IMF, EBRD and authors' calculations, PPP-weighted.

## Much of corporate debt is in foreign currency or external

Chart 14. Corporate debt, % of GDP



Source: IMF, EBRD and authors' calculations

### Average growth has been stable at around 3.8 per cent

Growth in the EBRD regions averaged 3.8 per cent in the first half of 2018, unchanged from 2017 (see Table 1 and Chart 1; averages are weighted using the values of countries' gross domestic product [GDP] at purchasing power parity [PPP]). On a twelve-month rolling basis, average growth accelerated to 4.1 per cent at end-June 2018 (see Chart 2).

The composition of growth has shifted towards consumption. Investment and exports still made a large contribution to growth in the first half of 2018, but this contribution was smaller than in 2017 while the contribution of private consumption has increased (see Chart 3). A shift from investment to consumption-led growth is typical of late stages in an economic cycle.

Recent economic performance in the EBRD regions has broadly mirrored global trends. The world economy is projected to expand by 3.7 per cent in 2018-19 (in PPP-weighted terms), unchanged from 2017, according to the latest projections published in the *World Economic Outlook* of the International Monetary Fund (IMF).

Growth in the EBRD regions showed signs of deceleration in the second half of 2018. The latest economic indicators such as retail sales, exports and imports point towards a further moderation of growth (see Chart 2), based on estimates derived using a principal-component-based nowcasting model.<sup>1</sup> This deceleration reflects slower growth of global trade and weaker economic data from advanced European economies.

Three major trends have affected the external economic environment for the EBRD regions: tightening of financing conditions for emerging markets, escalating trade conflicts and higher oil prices.

<sup>1</sup> See the November 2017 edition of the *Regional Economic Prospects* for a discussion of the model.

## Emerging markets financing conditions: from favourable to neutral

Financing conditions in emerging markets have started tightening, following several quarters of exceptionally favourable environment. The average yield on high-risk emerging market bonds edged up from the low of 5.8 per cent in April to 8 per cent in September. This is the fifth largest increase in average interest rates faced by emerging markets in the last 20 years, the others being the immediate aftermath of the 2008 global financial crisis, an episode in 2001, the Eurozone debt crisis of 2011 and an episode in 2015 (see Chart 4). Rising interest rates in emerging markets currently reflect tighter monetary policy in the United States where the US Federal Reserve has raised its benchmark rate to the range of 2 to 2.25 per cent.

Notwithstanding recent tightening, financing conditions can be characterised as neutral-to-favourable in historical perspective. Interest rates remain at the lowest levels seen in the last 20 years, comparable to the rates prevailing during 2003-07 and 2013-15 (see Chart 4).

As a result, the moderate tightening of financing conditions has so far primarily affected capital flows to economies with underlying weaknesses, notably Argentina and Turkey. The Turkish Lira depreciated by 36 per cent in January-October 2018, hit by a crisis of confidence among investors reflecting concerns about domestic policy and geopolitical risks.

More broadly, capital flows to emerging markets, and to economies in the EBRD regions specifically, have moderated to around zero in net terms (see Chart 5). The region's currencies have weakened against the US dollar by 8 per cent on average over the period May-October 2018. Stock market indices in Emerging Europe declined by 11 per cent over the same period and equity valuations returned to the levels of mid-2017. The downward correction, also experienced in other emerging markets, reflects concerns about further tightening of financing conditions and escalating trade wars (see below). In Russia, a likelihood of further sanctions being imposed by the US also appears to have been priced in.

## Escalating trade conflicts

Amidst escalating trade tensions, the US has imposed a 10 per cent tariff on around 45 per cent of its imports from China (more than US\$ 230 billion by value). The tariff is due to rise to 25 per cent on 1 January 2019. China has responded by imposing tariffs on US\$ 60 billion worth of imports from the US and has threatened to ban exports of certain raw materials. In parallel, the US, Mexico and Canada renegotiated the North Atlantic Free Trade Agreement (NAFTA), pending its ratification. The new US Mexico Canada Agreement (USMCA) includes stricter rules of origin for cars and foresees regular reviews, among other changes. Earlier in March 2018, the US imposed additional tariffs on imports of steel (25 per cent) and aluminium (10 per cent), including from the EU. Meanwhile, there is a risk that the UK will leave the EU without any special arrangements governing future trade and investment links with the union. And in recent public interventions, President Trump encouraged US companies to re-shore the production of items such as smartphones.

If trade conflicts remain confined mainly to bilateral China-US trade, economies in the EBRD regions will be relatively little affected as most of the region's trade takes place within or with the European Union. The region's economies export few intermediate goods to China or the US (see Chart 6). Such intermediate goods may in turn be used as inputs into US or Chinese exports. If those exports are affected by trade disputes, demand for intermediate inputs imported from other countries may also weaken. Kazakhstan and other Central Asian economies export the highest volumes of intermediate goods to China and the US relative to their GDP – mostly metals and chemical products. For the rest of the EBRD regions such exposure is lower than for comparator emerging markets such as Brazil, Malaysia or South Africa (see Chart 6).

For some countries in the region, a reduction in bilateral trade between the US and China may open new opportunities to increase exports of finished goods to the American or Chinese markets. For instance, the Slovak Republic and Hungary export around 3 per cent of GDP worth of finished goods to the US and China (calculated in terms of domestic value added of these exports, netting out the value of imported production inputs). These exports are concentrated in the automotive and machinery sectors and could be potentially scaled up if exports from China lose access to the US market, and vice versa. The potential to benefit from such trade diversion, however, appears to be higher for economies in Emerging Asia, where domestic value added of exports of finished goods to China and the US reaches 10 per cent of GDP.

In another scenario, trade tensions may escalate globally with trade restrictions applied universally rather than targeted at specific countries. In this scenario, complex international supply chains would become severely disrupted. In the longer term, escalating protectionism threatens complex global supply chains. For instance, three-quarters of US imports from China that are now subject to higher tariffs are intermediate and capital goods. As intermediate goods cross borders multiple times before final consumer goods are exported, tariff costs multiply. In an international supply chain, a 25 per cent average tariff may increase the cost of final goods by significantly more than 25 per cent.

Undoing global supply chains will be painful for businesses and costly for consumers, but may technically be possible to achieve. In a scenario of a major rise in protectionism not limited to China-US bilateral trade, global aggregate demand will take a major hit, negatively impacting economies across the board, albeit to a varying degree.

In this scenario, the risks are highest for countries that are strongly integrated into global production chains – those where exports of intermediate goods are highest as a percentage of GDP. In this regard, many economies in the EBRD regions have higher exports of intermediate goods than Korea, Brazil and other emerging markets (see Chart 7). The risk of fallout from global trade wars is particularly high for these economies. A mitigating factor is the fact that for many economies in the region trade in intermediate goods occurs within the EU customs union (which, in addition to the European Economic Area economies includes Turkey; see Chart 8) – assuming that trade tensions do not escalate within the EU customs bloc.

Commodity exporters are least likely to be affected by trade conflicts. While intermediate goods are often tailored to the needs of specific purchasers, new buyers of commodity products are relatively easy to find while demand for oil and gas and basic agricultural crops is likely to remain robust.

When it comes to recreating supply chains domestically in the long run, economies with higher innovation capabilities, better management practices and larger domestic markets will have the upper hand. It is easier to build an integrated national or regional smartphone supply chain on the basis of a design facility than based on system chip factories.

While the EBRD regions enjoyed fast growth in domestic value added of exports over the last two decades, this growth has not been mirrored in growth in patenting and innovation – unlike in China, Korea or Israel (see Chart 9; Turkey is a notable exception). To gain competitive advantage in reconfiguring and recreating supply chains, economies in the region would need to strengthen innovation capabilities and the quality of management. The latter tends to be weak across the region, as discussed in the EBRD *Transition Report 2014*.

In sum, if trade conflicts remain primarily focused on bilateral China-US trade, economies in the EBRD regions will be relatively little affected. In contrast, a scenario in which trade tensions escalate globally and international supply chains become severely disrupted entails high risks for the region's economies that are exceptionally strongly integrated into the global value chains. Box 1 further discusses potential implications of Brexit for the regions' economies.

### **Second year of rising oil prices**

The average price of Brent oil was 40 per cent higher in January-October 2018 than in the same period of 2017, following a 24 per cent increase in 2017 (see Chart 10). In September 2018 the price of Brent surpassed US\$ 80 per barrel, returning to levels last seen in the first half of 2014.

Higher oil prices reflect stronger demand, lower supply from Venezuela and some other producers as well as production caps agreed by the members of the Organisation of Petroleum Exporting Countries (OPEC) and Russia. Infrastructure bottlenecks, on the other hand, limit the ability of producers of shale oil in the United States to put downward pressure on the oil price.

Oil price increases provided a further boost to growth in Russia, Central Asia and Azerbaijan. In addition, remittances from Russia to Central Asia, Moldova and the Caucasus picked up by 19 per cent in US dollar terms in the first half of 2018. Yet on current trends, remittances are unlikely to surpass this year the 2013 peak (in US dollar terms adjusted for US inflation; see Chart 11).

## Sustained growth momentum across the EBRD regions

Growth in **central Europe and the Baltic States** accelerated further from an average of 4.4 per cent in 2017 to 4.7 per cent year-on-year in the first half of 2018 (see Chart 2), driven by faster consumption on the back of recent wage increases.

In contrast, growth in **south-eastern Europe** moderated from 4.4 per cent in 2017 to 3.5 per cent year-on-year in the first half of 2018, in line with estimates of long-term potential growth. In Romania, growth rate moderated from 7.3 per cent in 2017 to 4 per cent year-on-year in the first half of the year. Recovery momentum has been sustained in Greece where output expanded at the rate of 2.2 per cent year-on-year in the first half of 2018 following modest growth of 1.5 per cent in 2017.

Growth in **Eastern Europe and the Caucasus** picked up from 2.3 per cent in 2017 to 3.6 per cent year-on-year in the first half of 2018, with a stronger growth momentum in all six economies.

In **Turkey**, growth moderated from 7.4 per cent in 2017 to 6.2 per cent year-on-year in the first half of 2018 as credit growth started slowing down. Various economic indicators point to a sharper slowdown in the third quarter of 2018. The weak lira has led to a significant shift in the external trade position, reducing the current account deficit to 6.5 per cent of GDP by the second quarter of 2018. However, the short-term external financing requirement remains high, in excess of 25 per cent of GDP.

**Russia's** economy expanded at the rate of 1.6 per cent year-on-year in the first half of 2018 following growth of 1.5 per cent in 2017, with GDP on track to recover to its 2014 level by the end of the year (in constant prices).

Growth in **Central Asia** marginally moderated from 4.8 per cent in 2017 to 4.6 per cent year-on-year in the first half of 2018. While many economies in the region continue to benefit from favourable commodity prices and recovering remittances from Russia, growth in the Kyrgyz Republic came to a virtual standstill as a result of lower output of gold.

Growth in the **southern and eastern Mediterranean** picked up from 3.8 per cent in 2017 to 4.5 per cent in the first half of 2018 as the region recorded the best tourist season since 2010 and investor confidence strengthened in Egypt.

## Policy actions and economic recovery led to lower non-performing loan ratios

Further progress has been made in terms of reducing the levels of non-performing loans (NPL) in the region, as policy actions leading to NPL reductions and the economic upswing reinforced each other in a virtuous loop. A typical (median) country saw the ratio of NPLs to total loans decline by close to 10 percentage points from the post-2008-09 crisis peaks (see Chart 12). At the same time, NPL ratios remain high in several economies in the region.

A banking scandal in Estonia served as another reminder of challenges in terms of banking regulation and supervision in the region, following the liquidation of the third-largest bank in

Latvia earlier in the year. Allegations of large-scale money-laundering through Estonian branch of Danske Bank emerged in September 2018 and the Chief Executive Officer of the banking group resigned.

### **Outlook: growth is projected to remain robust but it may now have peaked**

Average growth in the EBRD regions is expected to moderate from 3.8 per cent in 2017 to 3.2 per cent in 2018 and 2.6 per cent in 2019 (see Chart 1 and Table 1). The new projections represent a downward revision compared with the May 2018 forecast (of 0.1 percentage points in 2018 and 0.6 percentage points in 2019), primarily on account of slower expected growth in **Turkey**, where a sharp deceleration in the second half of the year is expected to bring the 2018 growth down to 3.6 per cent, as the weaker lira and interest rate hikes negatively impact private consumption and investment. On the other hand, the weaker lira is expected to provide a boost to net exports and thus GDP growth. For the first time in three years a monthly surplus was recorded on the Turkish current account in August 2018, compared with a deficit of 6.5 per cent of GDP in the twelve months to June 2018. Growth of around 1 per cent is expected in 2019 (see Chart 13).

### **Limited spillovers from the expected deceleration in Turkey**

Excluding Turkey, the projection for the region's average growth rate in 2018 has been revised upwards by 0.1 percentage points reflecting strong economic performance in the first half of the year (see Table 1). The projection for the average growth rate in 2019, again excluding Turkey, is unchanged from May 2018.

Spillovers from the projected deceleration of growth in Turkey to the economies in the EBRD regions are expected to be limited owing to the relatively modest extent of economic linkages via trade, cross-border investment and remittances. For instance, Bulgaria exports 2 per cent of GDP worth of finished goods to Turkey and Hungary exports around 1.4 per cent of GDP worth, while exports of finished goods from other economies in the EBRD regions to Turkey do not exceed one per cent of GDP. By way of comparison, Bulgaria exports around 19 per cent of GDP worth of goods finished to other EU member states. Exports of intermediate goods from the economies of the EBRD regions to Turkey are also modest and are less likely to be impacted to the extent that they serve as inputs into the production of goods in turn exported by Turkey.

Direct investment from Turkey in January-August 2018 did not exceed 0.1 per cent of GDP of recipient economies in the EBRD regions. The only exception is Montenegro, where Turkish direct investment amounted to (a still modest) 0.3 per cent of GDP. And unlike Russia, Turkey, with its young population and rapidly growing labour force is not a significant source of migrant remittances (see the discussion in the forthcoming EBRD *Transition Report 2018-19*).

## Growth outlook across the EBRD regions

Growth in **central Europe and the Baltic States** is projected to normalise in 2019 from visible overheating, slowing from 4.3 per cent in 2018 to 3.5 per cent in 2019. The dynamism of household consumption is likely to offset the negative growth impact of shortages of skilled labour, slower growth of global trade and a softening EU business climate.

**In south-eastern Europe**, growth momentum is also expected to subside, averaging 3.5 per cent in 2018 and 3.2 per cent in 2019. Growth in Romania is expected to gradually moderate from 7.3 per cent in 2017 to 4.2 per cent in 2018 and 3.6 per cent in 2019, more in line with the economy's long-term potential growth. Recovery in Greece, on the other hand, is expected to gradually take hold, with growth projected to exceed the 2 per cent mark in 2018 and 2019.

The economies of **Eastern Europe and the Caucasus** are projected to continue gaining growth momentum in 2018 and 2019, with average growth accelerating from 2.3 per cent in 2017 to 3.1 per cent in 2018 and further to 3.2 per cent in 2019. Ukraine's economy continues to recover from a major output contraction in 2014-15 and growth is projected to pick up in Azerbaijan next year.

**Russia's** growth is projected to remain around 1.5 per cent in 2018 and 2019, in line with the estimated medium-term growth potential, as the supporting effect of higher oil prices is expected to be offset by the negative economic impact of the sanctions imposed by the US and the EU.

Growth is expected to moderate in **Central Asia**, from 4.8 per cent in 2017 to 4.6 per cent in 2018 reflecting the need for fiscal consolidation and a sharp fall in gold output in the Kyrgyz Republic. Growth is expected to moderate further in 2019, to 4.2 per cent, in light of lower gains in mining output and higher inflation, which will limit growth in real incomes and private consumption.

Growth in **the southern and eastern Mediterranean** is projected to increase from 3.8 per cent in 2017 to 4.4 per cent in 2018 and 4.7 per cent in 2019 on higher tourist arrivals, improved external competitiveness following currency depreciations in Egypt and Tunisia and sustained export growth. In Jordan and Lebanon, however, the projected growth in 2018 remains below the average growth rate of population observed in recent years, implying a likely decline in real per capita incomes.

## Risks to the outlook: Indebtedness, trade conflicts, geopolitics

In the light of trade tensions between the United States and its major trading partners, a widespread escalation of protectionism is a major concern. A no-deal Brexit may lead to a disruption of cross-border supply chains in the short term and affect the region through a number of other channels (see Box 1.1). The security situation in the Middle East and geopolitical tensions remain key sources of risk for the region's economies.

Corporate indebtedness (discussed in greater detail in the May 2018 *Regional Economic Prospects*) has shown no sign of declining. Countries with high stocks of external debt and domestic debt denominated in foreign currency are more vulnerable to tightening of financing conditions for emerging markets, as illustrated by the recent experience of Turkey (see Chart 14).

### **Box 1. The impact of Brexit on the EBRD regions**

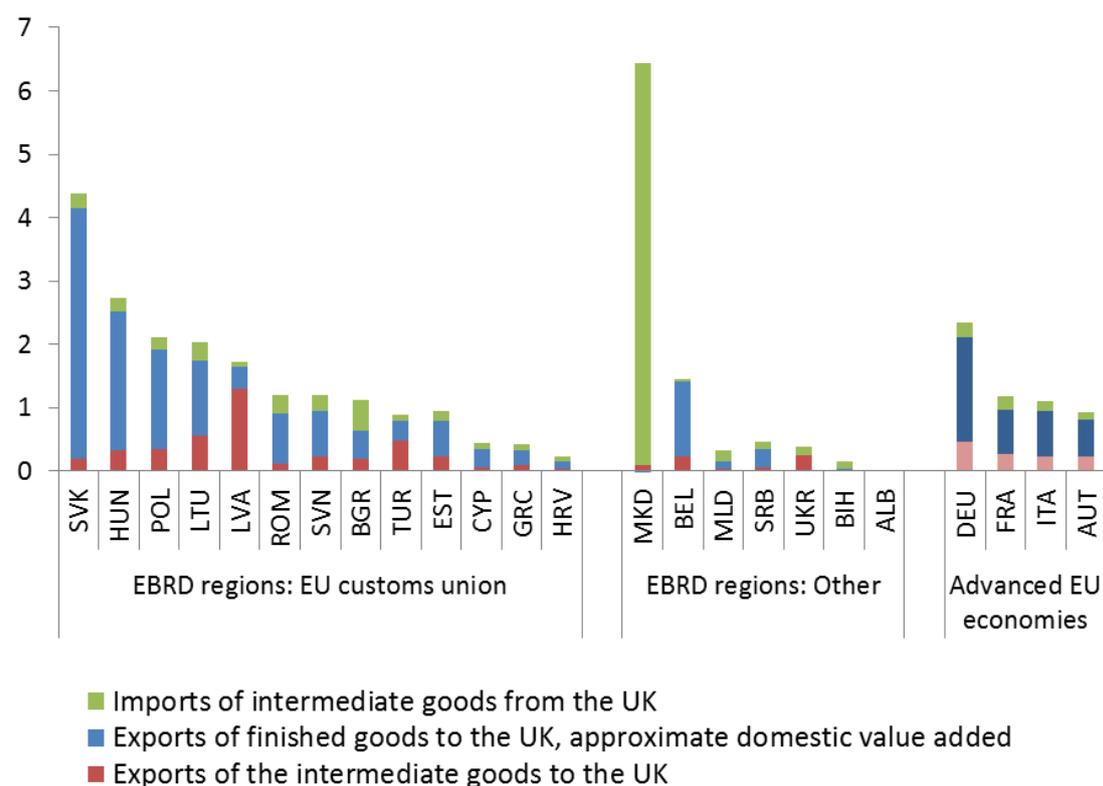
This box updates an earlier analysis of the implications of Brexit, UK's departure from the European Union, for the EBRD regions.<sup>2</sup> The modalities of Brexit remain to be determined as of late October 2018. Scenarios range from the UK staying in the EU customs union to the UK departing the EU with no special agreement governing trade, investment and other aspects of bilateral relations (the no-deal scenario). In the no-deal scenario, the UK may also remain outside many of the agreements of the World Trade Organization (WTO) in the short-to-medium term. UK's bid to rejoin the Government Procurement Agreement (GPA), for instance, is being blocked by Moldova over issues related to UK's visa issuance practices.

In a no-deal-Brexit scenario, the cross-border supply chains encompassing the UK and the EU-27 economies may be severely disrupted in the short term. In the longer term, some of the UK's inputs into production in other EU economies may be replaced with inputs sourced from elsewhere as UK suppliers no longer benefit from borderless trade with the European continent. Currently, direct exports of intermediate goods to the UK are sizable only for Latvia (of an order of 1.5 per cent of GDP, see Chart 1.1, primarily wood products) while direct imports of intermediate goods from the UK are only sizable for FYR Macedonia (around 6 per cent of GDP, mainly stone and glass products). An additional impact may arise due to disruption in value chains that link the EBRD regions' economies with advanced economies in Europe, which are in turn linked to the UK although the extent of such links between the UK and advanced economies in Europe is relatively limited (see Chart 1.1).

In other aspects, a no-deal scenario is likely to be similar to a hard Brexit scenario analysed earlier. Unless other member states increase their contributions, Brexit will lead to a 10 to 15 per cent decline in structural and accession funds available to countries in central and south-eastern Europe, amounting to a reduction of up to 0.4 percentage points of GDP in EU-supported investment. Brexit may also weaken the (perceived) prospects of EU accession for candidate and potential candidate countries. A slower reform momentum in these countries will then weigh on growth.

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<sup>2</sup> See Box 2 in the November 2016 issue of the *Regional Economic Prospects* by Peter Tabak and Emir Zildzovic.

**Chart 1.1 Trade between the UK and selected economies, per cent of GDP**

Source: WITS, IMF and authors' calculations.

The reintroduction of customs border with the EU will lower the demand for EU exports of finished goods to the UK. The Slovak Republic and Hungary have exports to the UK with an estimated domestic value added of 1.5 to 3 per cent of GDP mainly in the automotive and machinery sectors. Poland and Lithuania also have sizable exports of food products, worth 1 to 2 per cent of GDP. Indirectly, lower exports from Europe's advanced economies to the UK will, in turn, affect demand for imports of intermediate goods from the EBRD regions. Lower purchasing power in the UK will further affect the UK's demand for imports (the National Institute of Social and Economic Research, NIESR, estimated annual real incomes in the UK to be around GBP 800 per person lower than in a no-Brexit scenario).<sup>3</sup>

Cumulatively, the economic impact of a no-deal Brexit is projected to be largest for economies of south-eastern Europe, mainly through disruption to trade linkages encompassing the UK and other advanced economies in Europe, the impact on the EU accession reform momentum and a reduction in the EU structural and cohesion funds. Several years after a no-deal Brexit the level of GDP in this region is projected to be around five percentage points lower than in a no-Brexit scenario. For the Southern and Eastern Mediterranean, on the other hand, the impact of a no-deal Brexit is estimated to be limited to one percentage point of GDP, mainly on account of the trading partners in Europe being

<sup>3</sup> See NIESR (2018), "How much would a 'White Paper Brexit' cost the UK economy?" 1 August.

negatively impacted. The estimated impacts are smaller in a scenario where the UK remains within the EU customs union.

## Regional updates

### Central Europe and the Baltic States (CEB)

The CEB region remains at risk of overheating. During the first half of 2018, economic expansion accelerated to 4.7 per cent year-on-year growth, mostly driven by persistently robust private consumption, further recovered investment and the strongest European business climate in years. Labour shortages, in particular in the low productivity sectors, have induced strong growth in wages, which has negatively affected the region's international competitiveness. A solution to that could be greater automatization in the industry sector, which effectively could push companies to rethink their business models and ultimately lead to a positive shift towards higher value added production. Rising trade protectionism also constitutes a direct risk for export-oriented economies, in particular in the Slovak Republic and Hungary. GDP growth in the region is projected to normalise from visible overheating in 2019, slowing from 4.3 to 3.5 per cent, respectively. The dynamism of household consumption is likely to offset the negative growth impact of shortages of skilled labour, slower growth of global trade and softening EU business climate.

#### Croatia

The economic recovery has continued in 2018 but at a somewhat slower pace than in 2017. The Croatian economy expanded by 2.7 per cent year-on-year in the first half of 2018, on the back of stronger domestic demand, primarily that of households, while net exports contributed negatively due to a faster rise in imports than exports. Fiscal adjustment has continued but public debt remains high at 76 per cent of GDP (end-June 2018). Growth is projected to slow to 2.7 per cent in 2018 and 2.5 per cent in 2019. Risks to the projection are relatively balanced, with upside ones being the stronger than expected tourism revenues (with 2018 set to be another record high year) and faster utilisation of EU funds, and the downside ones relating to skilled labour shortages and the country's ailing food and retail giant, Agrokor. Despite high unemployment, labour is scarce in sectors such as tourism and construction, which might act as a drag on growth. In July 2018, Agrokor creditors approved a debt settlement, but there are still uncertainties surrounding the restructuring of the company, and negative spillovers to the rest of the economy cannot be excluded.

#### Estonia

Following the investment-led strong GDP growth recovery of 4.9 per cent in 2017, economic growth in Estonia slowed down to 3.5 per cent year-on-year in the first half of 2018. This growth deceleration has been largely induced by poor corporate investment, which was only marginally offset by higher investment expenditures of the public sector and households. At the same time, private consumption accelerated, presumably as the positive impact of the higher personal income tax exemption introduced in 2018 started to take effect earlier than expected. The favourable external environment has helped exports, but its positive net effect on GDP was effectively offset by the strong growth in domestic demand-driven imports. Economic growth is expected to decelerate to 3.6 per cent in 2018 and further to

3.0 per cent in 2019. Labour shortages have been increasingly seen as a major constraint on business investment and exports, in particular in relatively less productive sectors. In contrast, rising wages will likely further underpin strong household consumption, which will be only fractionally offset by the expected rise in inflation.

### **Hungary**

In the first half of 2018, economic expansion in Hungary accelerated further to 4.7 per cent year-on-year, fuelled by the continuously strong domestic demand and double-digit investment growth. Despite strong exports, the net contribution of trade has been negative, as the recovery in investment has required a major increase in imports. Following almost eight years of contraction, credit growth to the private sector started to recover in mid-2017. In the first half of 2018, corporate credit grew by a healthy 10 per cent year-on-year. At the same time, household borrowing also went up, although by just 1.0 per cent year-on-year. The output gap is now fully closed and growth is expected to further remain above its potential and reach 4.3 per cent in 2018, before it slows down to 3.3 per cent in 2019. Strengthening credit to the private sector will further boost investment over the forecast horizon. Household consumption will also remain strong, although a rise in inflation may somewhat offset the ongoing increase in disposable incomes. The shrinking labour supply and potential turmoil in global trade constitute the main risks to the outlook, especially in the automotive industry. The government's gradual withdrawal from the public works scheme is expected to shift more workers towards the private sector, although more active labour market policies are required to bring more disabled, Roma and elderly people back to employment.

### **Latvia**

GDP growth in Latvia accelerated further, to 4.7 per cent in the first half of 2018, underpinned by a rebound in investment and still-solid household consumption. Following two consecutive years of contraction, investment growth turned positive and registered double-digit growth in 2017 and in the first half of 2018. The surge in investment coincides with improved EU funds utilisation, as well as a recovery in private sector investment. The latter is mainly financed by companies' own funds, rather than credit growth, which remains subdued, partly because of the government's ambition to decrease the foreign share of deposits in Latvia's banking sector. New legislation to reduce transactions between Latvian banks and shell companies was approved in April 2018 as fallout of the ABLV bank failing after being accused of money laundering by the US authorities. Consequently, the share of foreign deposits dropped from 30 per cent in March to a record-low level at 20.5 per cent in August, while the aim of the government is to cut it to only 5 per cent of all deposits. While the law will likely have a negative impact on GDP growth in the short term, it is aimed at strengthening the resilience of the banking sector. GDP growth is expected to slow down to 3.9 per cent and 3.5 per cent, this and next year, respectively. In the short term, household consumption is forecast to remain solid, backed by higher wages and lower unemployment.

## Lithuania

Real GDP growth in Lithuania slowed down to 3.8 per cent year-on-year in the first half of 2018. Robust private consumption has been accompanied by an 8 per cent expansion in investment, which is expected to improve further, in line with the accelerated absorption of EU funds and a greater need for capacity expansion among manufacturers. Exports also showed a robust recovery, although their positive effect on GDP has been largely offset by an investment-led strong rise in imports. Rapid wage growth and a further tightening of the labour market will continue supporting robust private consumption. GDP growth is forecast to decelerate to 3.4 per cent in 2018, before it reaches 2.8 per cent in 2019. The expected weakening in external demand from Lithuania's major trading partners, amid an investment-led surge in imports, will result in a negative trade balance, and thus will weigh on GDP growth in the forecast horizon. The shrinking working-age population is expected to hurt businesses increasingly, which in turn may defer investment decisions, as the lack of skilled labour may not be easily replaced by machines. In contrast, the accelerated utilisation of EU funds will likely propel a rise in public investment. Strong wage expansion will have a diminishing effect on consumption, as a result of the savings' rate recovery after a slump of the latter from the already low level in 2016.

## Poland

The Polish economy grew by 5.1 per cent year-on-year in the first half of 2018, amid continuously robust household consumption and improved investment, the latter growing at 6.0 per cent year-on-year. Public investment has been expanding for some years, while private sector investment has finally showed early signs of recovery since the second quarter of 2018, driven mainly by foreign-owned companies and in sectors such as machinery, technical equipment, tools and transport. The expansionary fiscal policy and improving labour conditions underpinned the solid household consumption growth. GDP growth may have peaked in mid-2018, but it is expected to remain robust over the forecast horizon. Amid increasing inflation, household consumption will likely soften to some extent, but the tightening labour market, noticeable largely in rising wages, will keep it at a high level. Investment is expected to continue its recovery, in particular in the public sector. The labour market is undergoing a major structural shift. Labour supply is falling due to aging, a decreased retirement age, and lower participation of women because of higher social benefits. A counter-balancing factor is a surge in immigration, mostly from Ukraine and Asia. On a net basis, labour issues constitute a limiting factor for almost 50 per cent of companies in Poland, according to the third quarter of 2018 European Commission business survey. While difficulties in employing new workers may be a factor in favour of greater automatization in about 16 per cent of companies, according to a local employment agency, the shortage of workers has already delayed investment plans. This is especially visible in the construction sector. A possible delay in the recovery in private investment of domestic companies constitutes a downside risk to GDP growth. Global trade disruptions contribute also to that uncertainty. As a result, GDP growth in 2018 is forecast to reach 4.7 per cent in 2018 before it slows down to 3.6 per cent in 2019.

## Slovak Republic

The economic expansion in the Slovak Republic accelerated to 3.9 per cent year-on-year growth in the first half of 2018. While household consumption remained strong, it was investment, at a double-digit growth rate, that made the largest positive contribution to GDP growth. Exports are benefiting from strong external demand and extended production capacity in the car industry. While the unemployment rate has been below 7 per cent since mid-2018, the share of long-term unemployed still stands at 63 per cent of the total unemployed, which is one of the highest rates in the EU. The high levels of structural unemployment and skills mismatch exacerbate the already-persisting labour shortages, which have ballooned over time, largely triggered by significant gaps in the quality of education. GDP growth is forecast to reach 3.9 per cent this year and 4.0 per cent in 2019. Investment is expected to remain solid, underpinned by the accelerated EU funds utilisation and a further expansion of production capacities in the car industry. Labour shortages will contribute to rising nominal wages and, as a result, household consumption will remain strong, only slightly held back by growing inflation. On the downside, rising trade protectionism in the global economy constitutes a direct risk for the export-oriented Slovak economy. Long-term growth will strongly depend on ultimate solutions to structural challenges, in particular in the labour market.

## Slovenia

The economy continued to expand strongly in the first half of 2018 (by 4.2 per cent year-on-year), although a bit slower than in 2017 (4.9 per cent). The growth was driven by domestic demand, underpinned by both higher investment and private consumption. While export performance remained strong, imports continued to catch up. Stronger growth led to a fall in the unemployment rate to below 6.0 per cent in the first half of 2018 and to labour shortages becoming more prevalent. This year Slovenia has exited the Macroeconomic Imbalances Procedure and the improvement in the general government balance has continued. However, public debt remains high at 73 per cent of GDP (end-June 2018), and there is a need for structural reforms in areas such as a sustainable public wage system motivating employees, and also in others linked to the ageing of the society, including pensions, health care, long-term care and education (especially life-long learning). Economic growth is likely to moderate in the short term, to 4.2 per cent in 2018 and 3.3 per cent in 2019, as the temporary effects of the new EU funding cycle subside and the economy reaches its potential. While downside risks come from possibly weaker demand from Slovenia's main trading partners, as well as slow pace of structural reforms and privatisation, a stronger than envisaged government investment cycle and growth in private consumption could push up growth rates above projections.

## South-Eastern Europe (SEE)

The south-eastern European region is showing robust growth so far in 2018. A modest recovery is occurring in FYR Macedonia, the one country that failed to show any growth in 2017. Neighbouring Serbia is showing its strongest growth rate for some years while other economies in the Western Balkans are also expanding at a healthy rate. Confidence and investment are returning to the Greek economy following the successful conclusion of the economic adjustment programme in August 2018, and growth in the first half of the year exceeded 2 per cent. The Cypriot economy is also continuing its strong post-crisis recovery, and Bulgaria and Romania are also performing well though signs of overheating are becoming apparent in the latter. Overall, the SEE region is projected to grow at 3.5 per cent in 2018 and 3.2 per cent in 2019.

### **Albania**

Robust economic growth has continued into 2018. GDP growth accelerated in the first half of 2018 to 4.4 per cent year-on-year, driven primarily by private consumption. Investment also made a positive contribution to growth, although the construction of the major energy projects, namely the Norwegian investment in hydropower plants on the river Devoll and the Trans Adriatic Gas Pipeline (TAP), continued to slow down following a peak in the first half of 2017. Electricity production was strong, fuelled by heavy rainfall particularly during the second quarter, following a prolonged drought in the second half of 2017, which triggered high electricity imports. Further monetary easing has occurred amid a strengthening currency. Inflation has stayed below the central bank's target of 3 per cent, averaging 2.1 per cent in the first eight months of 2018. In response, the Bank of Albania made another cut to its key policy rate by 0.25 percentage points in June 2018 to 1.0 per cent, a new historical low. Meanwhile the lek has been appreciating against the euro in recent years, and particularly during 2018, providing a further justification for the policy rate cut. This reflects the ongoing de-euroisation policy initiative of the central bank in the financial sector, as well as the capital conversion of some banks. Some unrecorded cross-border activities may also be contributing to the appreciation pressures. In early June 2018 the Bank of Albania intervened in the market to dampen these pressures. The short-term outlook remains positive but risks remain. We expect growth of 4.0 per cent in 2018 and 3.9 per cent in 2019, with private consumption and investment being the main drivers of growth.

### **Bosnia and Herzegovina**

Moderate growth has continued into 2018 as the economy grew in the first half by 2.9 per cent year-on-year. Services, and particularly domestic trade, continued to be the main growth driver, supported by private consumption. Industry also performed well, following the good performance of the previous year. Investment levels recovered after a slowdown in 2017, as adoption of the law on an increase of the fuel excise duties in late-2017 paved the way for a resumption of infrastructure financing. However, reforms have slowed down in 2018 in advance of the general elections held in early October, and the latest review of the International Monetary Fund (IMF) programme has been on hold because of concerns over

new spending proposals in both entities. Further growth is expected in the short term, but downside risks are significant. The economy is projected to grow by 3.0 per cent in 2018 and 3.5 per cent in 2019. Investment in public roads is expected to play a more growth-supportive role in the coming period. Nevertheless, uncertainty associated with the aftermath of the general elections in October 2018 and the stalling, or even possible reversal, of reforms remain important downside risks.

### **Bulgaria**

The Bulgarian economy has been growing robustly at 3.8 per cent in 2017 and 3.4 per cent in the first half of 2018. Household consumption has been the main source of growth over this period, driven by a tightening labour market. Growth was also supported by rising investment, helped by the growing disbursement of EU funds since the second half of 2017. Meanwhile, net exports have weighed on growth as strong private consumption has pushed up imports. Government spending has remained constrained as the government posted a budget surplus in 2017 and in the first three quarters of 2018. Household consumption and investment are expected to drive growth over the next two years, while prudent fiscal policy will limit the contribution from government spending. GDP growth is projected at 3.6 per cent in 2018 and 3.4 per cent in 2019. Key risks to the outlook are: prolonged weakness in major trade partners, not least Turkey; a possible exacerbation of current labour shortages; and worsening of investor sentiments towards emerging markets.

### **Cyprus**

A major economic recovery in Cyprus is continuing. After GDP growth in 2017 of 4.2 per cent, the positive trend has continued into 2018 with growth in the first half of 2018 estimated at 3.9 per cent year-on-year, mainly driven by private consumption and net exports. After double-digit rises in the previous two years, tourist arrivals in the first eight months of 2018 increased by 8 per cent, as Cyprus is continuing to benefit from instability elsewhere. Meanwhile, unemployment has dropped to single-digit levels, reaching 7.3 per cent in June 2018. After a few years of declining prices, inflation returned to the economy, averaging 0.7 per cent in 2017 (HICP) and 0.4 per cent in the first eight months of 2018. Fiscal performance has remained strong and the government reached an overall surplus in 2017 of 1.8 per cent of GDP, helping to drive down general public debt to below 100 per cent of GDP by the end of 2017. Cyprus's credit ratings have further improved with the latest upgrade by Standard & Poor's in September 2018 from BB+ to BBB-, lifting the country back to investment grade for the first time since the crisis. We expect strong growth to continue in the short term, and we have upgraded our growth forecast for 2018 to 3.9 per cent, moderating slightly to 3.5 per cent in 2019.

### **FYR Macedonia**

Following a period of economic stagnation, GDP began to recover in the second quarter of 2018. Overall GDP growth in the first half of 2018 was 1.6 per cent year-on-year. Economic activity was mainly driven by services, and particularly domestic trade, but an extremely poor performance of the construction sector was again a significant drag on growth,

reflected in another drop in gross capital formation compared to the same period of the previous year. Private consumption and net exports both increased, with gross exports rising by 26 per cent, helping to keep the current account deficit at just 1.0 per cent of GDP in 2017. The central bank cut its long-term policy rate by 0.25 percentage points to 3.0 per cent in March 2018. Inflation turned positive in 2017 after three years of price declines and averaged 1.5 per cent in the first eight months of 2018. A further rise in exports is also expected in the short term, following last year's strong performance, in light of the improved economic prospects in the European Union (EU), the country's key trading partner. As a result, the 2018 forecast for growth is 2.0 per cent, with a moderate increase to 3.0 per cent in 2019. However, the forecast has a significant downside risk, which is the possibility of a resumption of political turbulence and uncertainty if progress in resolving the name dispute is not maintained.

### **Greece**

The economic recovery that began in 2017 has continued into 2018. GDP growth in 2017 of 1.5 per cent has been followed this year by an acceleration in growth in the first half of 2018 of 2.2 per cent year-on-year, with continued improvements in exports, by far the main driver of growth. Private consumption has also had a positive contribution to growth during 2018, but government spending has declined in the first half of the year, as has investment. Nevertheless, investor confidence has been boosted by Greece's successful exit on schedule in August 2018 from its economic adjustment programme, following a sustained period of reforms. Further debt relief measures have been granted to help ensure debt sustainability over the medium term. Financial sector stability is improving but asset quality remains a concern as the banking system is still burdened by an exceptionally high level of non-performing loans (NPLs). The systemic banks are addressing the problem using a variety of tools and according to targets agreed with the Bank of Greece. Unemployment has fallen to 19.1 per cent as of June 2018, the lowest level since mid-2011. Short-term growth is projected at 2.2 per cent in 2018 and 2.3 per cent in 2019. The economic recovery is conditional on sustained reforms through the post-programme period. Any backtracking in reforms or increased uncertainty about the policy direction of the country could damage investor confidence and lower growth prospects.

### **Kosovo**

Robust growth has continued into 2018 with overall output rising 4.2 per cent year-on-year in the first half of the year. Growth was mainly investment driven, as construction of some of the key transport infrastructure progressed, although private and government consumption were also positive contributors to growth. Inflation averaged 0.6 per cent in the first eight months of 2018, while fiscal policy has remained moderate, as the government has stuck to a prudent fiscal path. Public debt also remains exceptionally low by regional standards at just 17 per cent of GDP by the end of 2017 (excluding debt related to the Yugoslav era). Further growth is likely in the short term. We are slightly increasing our 2018 GDP growth forecast to 4.0 per cent (from 3.7 per cent), with the same projection also in 2019. Growth will be supported by a more favourable external environment and hence higher remittances and exports, as well as an anticipated continuation of investment, including in public

infrastructure. Future growth may also depend on the pace of implementation of the planned new 500 MW thermal power plant, which would represent the biggest investment project in the country.

### **Montenegro**

After exceeding expectations in 2017 and growing by an estimated 4.7 per cent, the Montenegrin economy has continued to power ahead in 2018, with growth in the first half of 2018 estimated at 4.8 per cent year-on-year. This growth was mainly driven by investment, particularly in the priority section of the highway connecting the Montenegrin coast with Serbia (financed by the Chinese Exim Bank and implemented by the Chinese CRBC), as well as in some flagship tourism developments on the coast. Private consumption has also grown strongly, driven by a relatively high rate of lending. However, high imports, as a component of both investment and private consumption, have been fuelling a large trade deficit (of almost 19 per cent of GDP in 2017) and acts as a drag on growth. Tourist arrivals in the first eight months of 2018 were up by 12 per cent year-on-year, with a continued rise of visitors from the EU, boosted by new airline connections. The government has begun implementing a medium-term fiscal adjustment strategy in order to address the sustainability of the public finances, which is seen as one of the country's biggest risks. In April 2018 the government placed a seven-year, €500 million Eurobond at 3.375 per cent, a record low rate for the country, implying a positive reaction from the financial markets for the recent fiscal consolidation measures. However, further financing will be needed in the coming years to meet significant Eurobond redemptions in the period 2019-21. We are increasing our 2018 growth forecast to 4.2 per cent, with a slightly moderation to 3.0 per cent in 2019 mainly on the grounds of the further investment in the main highway. The main risks include the high level of public debt and limited fiscal space.

### **Romania**

Following a growth rate of 7.3 per cent in 2017, one of the highest rates in the EU, the economy is slowing down in 2018 with GDP growing by 4.0 per cent year-on-year in the first half of the year. Private consumption has been making the highest contribution to growth, driven by the tightening labour market and continuing loose fiscal policies. Investment growth has also increased as a result of increased absorption of EU funds. Signs of overheating have appeared in the form of a widening trade deficit, pushing the current account deficit to 3.4 per cent of GDP at the end of 2017, and inflation which peaked at a 5-year high of 5.4 per cent in June 2018. A fiscal stimulus has pushed the budget deficit to 2.9 per cent of GDP in 2017, with a further deficit recorded so far in 2018. GDP growth is projected to moderate to 4.2 per cent in 2018 and 3.6 per cent in 2019, due to weakening impact of the policy stimulus and tighter monetary policy, although it will continue to be supported by investment linked to EU funds and consumption linked to the tightening labour market. Downside risks to the outlook include further worsening of labour shortages, domestic political and reform uncertainty and changing global investor sentiment towards emerging markets.

**Serbia**

After a modest growth in 2017 (of almost 2 per cent), the economy expanded by 4.9 per cent year-on-year in the first half of 2018 on the back of stronger domestic demand, primarily higher investment. Private consumption also kept recovering, while imports, on the other hand, continued outpacing exports. Fiscal performance has remained strong. The budget stayed in surplus in the first half of the year and public debt kept falling (to around 60 per cent of GDP at end-June). In July 2018, Serbia signed a 30-month Policy Coordination Instrument (PCI, a new non-financing instrument) with the IMF, focusing on fiscal, structural and institutional reforms, and monetary and financial sector policies, all of which are key to sustaining the current high growth rates. The economy is projected to expand by 4.2 per cent this year and to slow down to 3.5 per cent in 2019. Faster growth is to be supported by further strengthening of consumption and investment. The risks to the projection are balanced and mainly relate to the implementation of reforms envisaged under the IMF's PCI and the further pace of Eurozone growth.

<b>Turkey</b>
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The Turkish economy grew by 7.4 per cent in 2017 and 6.2 per cent year-on-year in the first half of 2018, on the back of various stimuli provided by the government, including an expansion of the Credit Guarantee Fund (CGF) and several major public infrastructure projects. However, leading indicators suggest that the overheated economy has entered a sharp slowdown in the second half of 2018.

The Turkish lira has been extremely volatile over the past year. A lack of domestic policy clarity and geopolitical tensions, in the context of tightening of the US monetary policy and a stronger US dollar, saw the lira at one point lose over 40 per cent of its value against the dollar since the start of 2018. A series of sharp interest hikes by the Central Bank of Turkey, alongside the adoption of the New Economic Programme (NEP) and a recent rapprochement in relations with the US, seem to have stabilised the lira. Nevertheless, the economy's heavy dependence on foreign capital means that the lira remains vulnerable. Meanwhile, the pass-through effect from the lira's depreciation and stimulus-driven consumption growth pushed inflation to a 15-year high of almost 25 per cent in September 2018.

Economic rebalancing forced by the weak lira should help reduce large external imbalances, which arose as consumption-driven growth resulted in a rapid growth in imports, driving the current account deficit to 6.5 per cent of GDP by Q2 2018. Lately, the weak lira has led to a significant improvement in the external trade position, in turn reducing the current account deficit. However, the short term external financing requirement remains high, in excess of 25 per cent of GDP.

The banking system, often considered a key anchor of the economy, is under growing stress. The depreciation of the lira has hit banks' capital, and their asset quality may be impacted by both their exposure to corporates with large FX liabilities, and the effect of increased interest rates on corporate and household balance sheets, particularly as the economy slows. The Banking Regulatory and Supervisory Authority has introduced several measures to address the issues faced by banks, but there are concerns about the impact of these measures on balance sheet transparency, and confidence in the system.

The lira's depreciation and interest rate hikes will continue to impact consumption and investment in the short term, although rebalancing should see net exports make an increasing contribution to growth. A sharp slow-down in the second half of the year is expected to bring annual growth in 2018 down to around 3.6 per cent, with a growth rate of around 1.0 per cent expected in 2019. The key risk to the outlook is uncertainty regarding the banking sector but other risks include the direction of economic policy and further depreciation of the lira.

## Eastern Europe and the Caucasus (EEC)

The EEC region as a whole remains on the course of economic recovery, despite signs of growth moderation in some of the economies. On balance, the external economic environment remains conducive for the EEC countries. Strong export receipts and foreign exchange capital inflows are supporting the regional currencies which have remained broadly stable in the first ten months of the ongoing year. Consumption is expanding, backed by strong inflows of remittances and growth in real wages, among other factors. Thanks to deft monetary policy management, inflationary pressures remained under control even in the face of growing consumption spending in most of the regional peers. The EEC region is forecast to grow by 3.1 per cent in 2018 and 3.2 per cent in 2019, contingent on a non-intensification of geopolitical and political tensions, a continued positive regional economic backdrop and other country-specific factors.

### Armenia

Armenia's economy is growing rapidly. Following a near stagnation in 2016, real GDP growth accelerated from 7.5 per cent in 2017 to an estimated 8.3 per cent year-on-year in the first half of 2018. Household consumption, capital investment and exports all contributed strongly to economic growth. Capital investments increased by 7.7 per cent in 2017 after eight years of decline (with the exception of 2015) and picked up further to an estimated 14.7 per cent year-on-year growth in the first half of 2018. The growth of money transfers from abroad continued in the first eight months of 2018, although at a more moderate rate of 4.9 per cent year-on-year. Inflation has been gradually accelerating closer to the central bank's inflation target, standing at 2.6 per cent in the first nine months of 2018. Meanwhile, the Central Bank of Armenia has been able to maintain the policy rate at the lowest level since the beginning of 2010. The loan portfolio of commercial banks expanded by 10.2 per cent in 2017 and by a further 11.3 per cent in January-September 2018. Thus far, the pace of growth has been largely unaffected by the political uncertainty, while governance reforms initiated after the "Velvet Revolution" are expected to provide a stimulus to the economy. We forecast Armenia's real GDP to grow by 5.5 per cent in 2018 and by 5.0 per cent in 2019. At the same time, weak agricultural outturns might weigh down growth this year. The volume of agricultural output contracted by 4.8 per cent year-on-year in the first nine months of 2018. Conflict in the Nagorno-Karabakh region poses a risk to the growth outlook.

### Azerbaijan

The ongoing slow economic recovery in Azerbaijan is supported by the higher oil price and macroeconomic stabilization measures. GDP grew by 0.8 per cent year-on-year in the first nine months of 2018 following 0.1 per cent growth in 2017. Non-oil GDP expanded by 1.0 per cent year-on-year in the first nine months of 2018 with the help of output growth in non-oil industry, agriculture, transportation, retail trade and information and communication services. Overall capital investment is in the fifth consecutive year of decline, although in the non-oil sector investment in fixed assets has posted growth in the first nine months of 2018. External balances are improving due to the recovery in the oil price. In the first half of 2018, the current account surplus was driven by a 41.1 per cent year-on-year

increase in export receipts from the oil and gas sector. As of the third quarter of 2018, the combined assets of the State Oil Fund of Azerbaijan (SOFAZ) and of the foreign exchange reserves of the Central Bank of Azerbaijan stood at US\$ 44.5 billion, up by 8.2 per cent compared to the end-2017 level. The manat exchange rate against the US dollar has been stable since April 2017 despite the positive oil price trend. Inflation decelerated from 12.9 per cent in 2017 to 2.6 per cent year-on-year in the first nine months of 2018, paving the way for looser monetary policy. The refinancing rate was lowered three consecutive times, from 15 per cent in the beginning of the year to 10 per cent in June 2018. The new fiscal rule is expected to reduce pro-cyclicality and further improve fiscal discipline starting from the next year. Strategic energy projects are reportedly on track with a number of milestones achieved in 2018. The ongoing expansion of gas production and export capacity is supportive of the growth outlook, which is projected at 1.5 per cent in 2018 and 3.5 per cent in 2019. On the other hand, the remaining vulnerabilities in the banking sector are a drag on the economic recovery. Conflict in the Nagorno-Karabakh region also poses a risk to the growth outlook.

### **Belarus**

In Belarus, economic growth gained pace at the start of 2018 but moderated somewhat in the following months. After a 2.4 per cent growth in 2017, real GDP growth accelerated to 5.2 per cent year-on-year in the first quarter of 2018. By the end of the third quarter the rate of growth slowed, although it remained relatively brisk at 3.7 per cent year-on-year. Strong external demand and expanding household consumption contributed to broad-based growth. In the first nine months of 2018, output increased in all production sectors except agriculture where it declined by 1.6 per cent year-on-year. Services accounted for around 60 per cent of gross value added as of the first half of 2018, with the ICT and hospitality sectors demonstrating above-10 per cent real growth rates in this period. Real wages and disposable incomes increased by 12.6 per cent year-on-year and 7.8 per cent year-on-year respectively in the first eight months of 2018. In the same period, export of goods from Belarus went up 18.3 per cent in US dollar terms, with flows to the EU market increasing by 43.0 per cent year-on-year and representing 31.4 per cent of total. Inflation declined further to 4.8 per cent year-on-year in the first nine months of 2018 from an average of 6.0 per cent last year. The exchange rate has remained stable. The National Bank of the Republic of Belarus lowered the refinancing rate further from 11 per cent at the end of 2017 to 10 per cent in June 2018. We forecast Belarus's real GDP to grow by 3.0 per cent in 2018 and by 2.5 per cent in 2019. Growth prospects continue to depend on the extent of structural reforms and on the ability to expand the private sector's role in value creation.

### **Georgia**

Georgia's growth momentum has been generally vigorous since 2017 but is showing early signs of a slowdown in recent months. The economy grew by 5.0 per cent in 2017, rising to an estimated 5.4 per cent year-on-year in the first half of 2018. Preliminary estimates by the statistical authorities suggest that real GDP growth slowed to 4.8 per cent year-on-year in first eight months of 2018, including 2.0 per cent year-on-year growth in August. Growth in the first half of 2018 was driven by trade, real estate activities, manufacturing and financial

intermediation. By contrast, construction output nearly stagnated in this period. The hospitality sector continued to perform well. The number of international visitor trips to Georgia increased by 12.9 per cent year-on-year in the first nine months of 2018. In the first half of 2018, international tourism receipts increased by 28.9 per cent year-on-year, export of goods by 28.4 per cent year-on-year and money transfers by 18.3 per cent, all in US dollar terms. FDI inflows to Georgia also remained sizable despite a 9.8 per cent year-on-year drop in this period. The Georgian lari was broadly stable against the US dollar in the first ten months of 2018, despite some volatility in this time stretch. We forecast Georgia's real GDP to grow by 4.5 per cent in both 2018 and 2019, but the growth outlook depends to a large extent on economic trends in Georgia's main trading partners.

### **Moldova**

The economy of Moldova is generating steady growth. Real GDP is estimated to have grown by 4.5 per cent in 2017 and by the same rate year-on-year in the first half of 2018. Economic growth was supported by favourable external economic conditions and capital investment which returned to growth after contributing negatively to GDP growth in 2015-16. In the same period, rising remittances and real wages bolstered household consumption which, in turn, increased by 3.8 per cent in real terms. A widening of the current account deficit in the first half of 2018 reflected consumption- and investment-driven import growth. However, it was more than offset by foreign exchange capital inflows. Against the backdrop of a small appreciation of Moldovan leu, inflation slowed from an average of 6.6 per cent in 2017 to 3.7 per cent year-on-year in the first nine months of 2018. Official reserve assets increased from US\$ 2.8 billion in December 2017 to US\$ 3.0 billion in August 2018, providing approximately six months of import coverage. Significant progress has been achieved in restoring shareholder transparency at the two systemically-important banks, following the entry of international investors into the ownership structure of these banks. However, structural and demographic challenges remain. We forecast Moldova's real GDP to grow by 4.0 per cent in 2018 and by 4.0 per cent in 2019. The existing IMF programme is an important anchor of reforms and macroeconomic stability, and its implementation needs to continue without delays.

### **Ukraine**

Growth of the Ukrainian economy has gained some momentum in 2018 but remains modest. Economic output growth accelerated from an average of 2.5 per cent in 2016-17 to an estimated 3.5 per cent year-on-year in the first half of 2018. Fast-growing real wages and remittances have stimulated household consumption. Real wages grew by 12.8 per cent year-on-year in the first eight months of 2018 while remittances in US dollar terms increased by 31.5 per cent year-on-year in the first six months of the year. Gross fixed capital formation continued to grow apace in the first two quarters of 2018, albeit at a slower rate compared to the same period of the previous year. In the first half of 2018, exports of goods and services contracted in real volume terms but growth in the US dollar value of export receipts was positive due to favourable terms of trade. Headline inflation remained elevated at 11.4 per cent year-on-year in the first nine months of 2018, well above the medium-term inflation target of 5 per cent plus-minus one percentage point, although the rate of inflation

slid into high single digits between June and September. To counter the inflationary pressures, the National Bank of Ukraine raised its key policy rate four consecutive times from 14.5 per cent in January 2017 to 18 per cent in September 2018. Exchange rate volatility has remained under control in the year to date, despite seasonal variations. Since April 2018 international reserves have been on a declining path, falling from US\$ 18.4 billion to US\$ 16.6 billion (covering approx. 2.9 months of imports) as of September 2018, although this trend is expected to be reversed upon renewal of cooperation with the IMF. In October 2018, the authorities and the IMF reached a staff level agreement on a new 14-month Stand-By Arrangement for US\$ 3.9 billion. If approved by the IMF Executive Board and duly implemented, this programme will help to address Ukraine's near-term external financing needs and to maintain macroeconomic stability throughout the electoral cycle next year. We forecast the Ukrainian economy to grow by 3.5 per cent in 2018 and by 3.0 per cent in 2019. Large foreign exchange public debt liabilities falling due in 2018-19 pose downside risks to the outlook.

## Russia

After a two-year recession, Russia's economy has returned to moderate growth. GDP grew by 1.5 per cent in 2017 and 1.6 per cent year-on-year in the first half of 2018. On the expenditure side, growth was primarily driven by recovering household consumption. Investment also saw a relatively solid recovery in 2017 (rising by over 4 per cent), boosted by the temporary increase in public investment related to the 2018 FIFA World Cup. However, investment growth in the first six months of 2018, while still positive, has subsided. Exports have continued to grow in 2018, supported by higher oil prices while import growth has slowed significantly from the year before.

The recovery of oil prices was accompanied by the rouble's 15 per cent appreciation against the US dollar in 2017, and a further rise in early 2018. However, foreign exchange interventions set by the new fiscal rule, together with the new round of US sanctions against Russia (which triggered a sell-off of Russian financial assets), have exerted downward pressure on the exchange rate since April 2018. In September 2018 the rouble was 16 per cent weaker than six months earlier.

Rouble depreciation has been followed by increasing inflation. However, at 3.4 per cent in September 2018, the inflation rate is still below the central bank target (4.0 per cent). Still, perceiving heightened inflationary risks, the Central Bank of Russia (CBR) raised the key policy rate in September by 0.25 percentage points, to 7.5 per cent.

Recovering growth and oil prices have supported the fiscal position of the country. The budget balance shifted from a deficit of 1.5 per cent of GDP in 2017 to a surplus of over 3 per cent of GDP in the first half of 2018. The country has also embarked on tax and pension reform. In July 2018, the parliament approved a VAT rate hike (to 20 per cent, from 18 per cent) and the reform of oil sector taxation, providing for the gradual elimination of the oil export duty (from 30 per cent currently) and its replacement by a higher natural resource tax, shifting (and effectively widening) the tax base from oil exports to oil production. The pension reform envisages a hike in the retirement age.

The CBR has continued to close banks that have weak performance and poor corporate governance. In August 2018, there were around 510 banks in Russia, around 445 fewer than in mid-2013. As a result of bank closures and new resolution rules from mid-2017, the share of state-controlled banks (including those under rehabilitation) in total bank assets was over 70 per cent at the beginning of 2018, up from around 50 per cent in 2013.

The growth rate of Russian economy in 2018 and 2019 is expected to stay at the same level as in 2017 (1.5 per cent). It will be driven by recovering private consumption and investments, and supported by higher oil prices, with a negative effect from the US and EU sanctions. Without significant reforms, however, Russia's long-term economic growth may remain stuck at around 1 to 2 per cent annually due to outdated production capacities and low investments, as well as unfavourable internal structural factors (weak demographics, obsolete infrastructure and discouraging institutional characteristics of the economy).

## Central Asia

GDP growth in Central Asia fell marginally to 4.6 per cent year-on-year in the first half of 2018 from 4.8 per cent in 2017. Growth in Kazakhstan and Mongolia was driven by favourable commodity prices, higher production in the extractive sector and stronger fixed investment in the sector. In contrast, GDP growth weakened in the Kyrgyz Republic as a result of lower than anticipated gold output and exports, and in Uzbekistan due to a slowdown in private consumption growth and a widening trade deficit. The Kyrgyz Republic, Tajikistan and Uzbekistan continued to benefit from a recovery in remittances, though they remain below pre-crisis levels of 2013-2014. Exchange rates have come under some pressure in several countries, most evidently in Kazakhstan. Inflation stayed within or below central bank targets in most Central Asian countries, but significantly accelerated in Uzbekistan and Turkmenistan, and to some extent also in Kazakhstan. The rising inflationary pressures prompted interest rate hikes in Kazakhstan and Uzbekistan. The weak banking sector and deteriorating fiscal outlook in Tajikistan and foreign exchange scarcity and reduction in public investment in Turkmenistan continue to weigh on their economic performance. The economies of Central Asia as a whole are forecasted to expand on average by 4.6 per cent in 2018 and a more moderate 4.2 per cent in 2019 on the back of slower gains in the extractive sectors and fiscal consolidation efforts.

### **Kazakhstan**

In Kazakhstan real GDP growth accelerated to 4.1 per cent both in 2017 and in the first three quarters of 2018 from 1 per cent in 2018. The economy grew strongly due to increased oil production and favourable oil prices. Oil output expanded by 10.5 per cent in 2017 and by 6.6 per cent year-on-year in January-September 2018. A recovery in real wages and higher lending to households led to a 4.5 per cent growth year-on-year in private consumption in the first half of 2018, after a meagre 1.5 per cent in 2017. Fixed investment growth was 5.3 per cent year-on-year in the first half of 2018, up from 4.0 per cent in 2017. The exchange rate appreciated in 2017, supported by the rebound in oil prices. However, the tenge came under some pressure in 2018 despite further rising oil prices, resulting in a weakening against the US\$ by 8.5 per cent during the first nine months of 2018. This contributed to some acceleration of inflation in the third quarter of 2018. At 6.1 per cent in September 2018, inflation is still within the central bank's target of 5.0-7.0 per cent. In response, the central bank intervened in the foreign exchange market in September 2018 and also raised the base rate from 9.0 per cent to 9.25 per cent in October 2018, reversing a series of rate cuts since May 2016. Banking sector imbalances surfaced as the central bank deprived three smaller banks of their licenses and provided liquidity support to the second largest bank in September 2018. The economy's growth rate is projected to decelerate somewhat to 4.0 per cent in 2018 and 3.5 per cent in 2019 due to slower additional gains from oil output and a weak average real income growth due to inflation. However, the foreseen substantial increase in the minimum wage will underpin private consumption to some degree. Ongoing fixed investment in the oil and gas sector will also likely support economic growth.

## **Kyrgyz Republic**

After strong growth momentum in 2017 (4.6 per cent), the Kyrgyz economy has significantly decelerated in 2018 to 1.2 per cent growth year-on-year in the first three quarters of 2018, as gold production at Kumtor, the largest mine, has contracted. Stronger gains in mining in the fourth quarter of 2018 are expected to help lift GDP growth to 2.8 per cent in 2018 as a whole. While the foreign trade deficit widened due to falling gold exports and a rise in imports, remittance inflows strengthened (8 per cent year-on-year growth in US dollar terms) in the first eight months of 2018. There were some minor fluctuations of the exchange rate, but it has remained broadly stable, which has resulted in effective appreciation against the rouble and the tenge. Credit continued to expand at a high pace in 2018. Inflation nevertheless has been moderating and reached 1.2 per cent in September 2018, significantly below the target band of 5-7 per cent. The central bank reduced its policy rate from 5.0 per cent in 2017 to 4.75 per cent in May 2018 and has kept it there since. Fiscal consolidation efforts are ongoing, the budget deficit is targeted at 2.5-2.6 per cent of GDP in 2018 and 1.6 per cent of GDP in 2019, lower than the 3.3 per cent of GDP achieved in 2017. GDP growth is expected to reach 3.2 per cent in 2019, marginally higher than in 2018 as non-mineral exports are expected to grow, thanks to further Eurasian Economic Union integration, and as remittances rise further. The main risks to the outlook are a slower-than-assumed recovery in mining and a weaker-than-assumed growth of the Russian economy.

## **Mongolia**

Economic growth in Mongolia remains solid after a strong recovery in 2017 of 5.1 per cent growth, up from just 1.2 per cent in 2016. In the first half of 2018, GDP growth accelerated to 6.3 per cent year-on-year, boosted by stronger investment in mining and a pick-up in household consumption. Exports increased by 27.2 per cent year-on-year in January-September 2018 but imports grew more strongly at 45.8 per cent year-on-year in the same period reflecting growing domestic demand and imports associated with rising FDI flows. The economic recovery has resulted in an acceleration of inflation, which rose to 5.7 per cent year-on-year in September 2018 from an average 4.6 per cent in 2017, still below the central bank's target of 8 per cent. The central bank has maintained the policy rate at 10.0 per cent. External buffers have improved with gross international reserves reaching around US\$ 2.9 billion in August 2018, up from US\$ 1.6 billion a year ago. Fiscal accounts have also strengthened in compliance with the IMF programme, but also owing to the improved economic performance. The general government budget turned out at a deficit of 1.9 per cent of GDP in 2017, substantially below the 17 per cent deficit in 2016, and was in surplus in 2018 as of September due to the growth in tax receipts. Continued growth of mineral exports and strong FDI inflows are expected to result in GDP growth of 6.1 per cent in 2018 and 6.0 per cent in 2019.

## **Tajikistan**

Headline growth of the Tajik economy continued to exceed 7 per cent in the first half of 2018 after reaching 7.1 per cent growth in 2017. Growth has been supported by higher fixed investment and a continuing recovery in remittances. Tajikistan's foreign trade deficit

widened to US\$ 1.5 billion in the first nine months of 2018 from around US\$ 1 billion the year before, with exports contracting by 10 per cent year-on-year and imports rising by 18 per cent year-on-year. The ensuing pressure on the somoni has led the central bank to allow the official exchange rate to depreciate marginally since April 2018 to keep it within the 2 per cent range of the parallel market rate. In the first ten months of 2018 the somoni depreciated by around 6 per cent. With annual inflation at 5 per cent in September 2018, down from 6.8 per cent a year ago, the central bank has kept its key rate at 14.0 per cent since March 2018. Notwithstanding high GDP growth rates reported since 2010 (of at least 6 per cent), the economy faces major fiscal challenges, a deteriorating public debt, still unresolved financial sector weaknesses and significant business environment constraints. These tensions result in less favourable economic prospects in the coming years with officially reported GDP growth projected to slow to 6.1 per cent in 2018 and 5.0 per cent in 2019.

### **Turkmenistan**

In Turkmenistan, officially reported GDP grew 6.5 per cent in 2017 and 6.2 per cent year-on-year in the first three quarters of 2018. While exports rose in the first half of 2018 by 43.4 per cent year-on-year, they still remain well below their peak levels in 2014. Import substitution policies and foreign exchange rationing led to a reduction of imports by 43.5 per cent in the same period. Fixed investment continued to decline in 2018 after falling by 8.8 per cent in 2017, from high levels related to ambitious government projects though. The current account deficit is projected to narrow from IMF estimated 11.5 per cent of GDP in 2017, but has remained sizable, resulting in continued foreign exchange pressures. The parallel market exchange rate rose to 16-17 manats per US dollar in September 2018 versus the official peg of 3.5 manats to the US dollar. Barring major structural reforms, economic growth is forecasted at 6.2 per cent in 2018 and will likely slow to 5.6 per cent in 2019 reflecting persistent macroeconomic imbalances. Contributions to GDP growth from public spending will be limited in light of the fiscal consolidation efforts. Growth may be also dragged down by a further contraction of domestic consumption and the scarcity of foreign exchange that makes it difficult to conduct business.

### **Uzbekistan**

Economic growth slightly decelerated in 2018 following a decline to 5.3 per cent growth in 2017 from the official rate of 7.8 per cent in 2016. GDP growth was 5.2 per cent year-on-year in the first three quarters of 2018. The slowdown was caused by a deterioration of the trade balance, with exports declining by 0.3 per cent year-on-year in January-September 2018 and imports expanding by 33.3 per cent year-on-year in the same period. In addition, growth of domestic consumption eased in response to price increases. While Uzbekistan's reform push lays the ground for solid growth in the years to come, the price and exchange rate liberalisation and the reduction of subsidies has led to the adjustment of relative prices and double-digit inflation (15.7 per cent year-on-year in August 2018) The liberalisation of foreign trade led to higher exports of meat and some other goods, and price increases in response to the higher overall demand. The high inflation and some exchange rate weakening prompted the central bank to tighten monetary policy in September 2018 and

hike the policy rate hike from 14.0 per cent, were it stood since June 2017, to 16.0 per cent. The current account was in deficit by around US\$ 1 billion in the first half of 2018, although the growing trade balance deficit was partially offset by remittances inflows. The exchange rate started appreciating at the beginning of 2018 until September 2018, when mild depreciation pressures set in. Overall, the som strengthened by 2 per cent in the first nine months of 2018. GDP growth may slow somewhat to 5.0 per cent in 2018 as a whole and to 4.5 per cent next year as a consequence of a deceleration in real income growth due to inflation and a further widening of the trade deficit.

## Southern and Eastern Mediterranean (SEMED)

In the SEMED region, real GDP growth is set to pick up in 2018 to 4.4 per cent compared with 3.8 per cent in 2017, owing to the best tourism season since 2010 in most countries in terms of arrivals and receipts, and improved competitiveness as a result of currency depreciations in Egypt and Tunisia, combined with the implementation of reforms. However, delays in implementing reforms in Jordan and Lebanon, the result of social unrest and political instability, have driven the downgrade in their growth forecasts relative to May 2018. Economic activity in SEMED is expected to grow modestly in 2019 by 4.7 per cent, supported by the recovery in the traditional drivers of growth, higher exports, the implementation of business environment reforms to attract foreign direct investment, stronger private consumption from refugees, and greater political certainty – both domestic and regional. However, growth will continue to be, in the medium term, lower than pre-2011 levels.

### **Egypt**

In Egypt, growth continued to accelerate to reach 5.3 per cent in FY2017/18, the highest rate in a decade, amid still-high inflation, which exceeded 20 per cent on average. Continuing the trend which had started in FY2016/17, net exports and investment were the main drivers of growth, benefitting from gains in competitiveness and confidence. The non-oil private sector is showing early signs of recovery, as indicated by a rise in the purchasing managers index (PMI). A modest pick-up in growth to 5.5 per cent is expected in FY2018/19 supported by a number of factors. These include the continued boost in confidence, recovery in tourism, increase in foreign direct investment, improved competitiveness, continued strengthening of exports, the start of natural gas production from the Zohr field, the implementation of business environment reforms and prudent macroeconomic policies.

### **Jordan**

Economic growth in Jordan remained subdued in 2017 and the first half of 2018, at 2 per cent, amid continued regional turmoil, and following social unrest. Growth was driven by services, notably transportation and financial services. Tourism arrivals increased for the first time since 2010, by 7.8 per cent, signalling the best tourism season since the Arab uprising, and the increase continued in the first half of 2018, with tourist receipts increasing by 14.9 per cent y-o-y. Growth is expected to rise only modestly to 2.2 per cent in 2018 and 2.4 per cent in 2019, supported by stronger private consumption from the higher refugee population, foreign investment, and greater certainty and confidence stemming from fiscal consolidation. Moreover, exports will benefit from higher mining output, higher phosphate prices, and the re-opening of the border with Syria and Iraq.

### **Lebanon**

In 2017, growth in Lebanon decreased from 1.7 to 1.5 per cent. The economy is driven mainly by private consumption – sustained by remittances from the Lebanese diaspora – and exports. Positive political development and renewed stability boosted confidence, and the

reform momentum also supported growth in 2017. In 2018, growth was negatively impacted by the slowdown in the real estate sector, a major driver of growth, following the phasing out of subsidised lending. Economic activity was also impacted by recent political developments after the May 2018 elections and delays in forming the government, and remained in a protracted period of low growth since the start of the Syrian conflict in 2011. Growth is expected to decrease further to 1.1 per cent in 2018, then pick up to a range between 1.5 and 1.9 per cent in 2019 depending on the recovery in the construction and financial sectors and the extent of reconstruction in Syria.

### **Morocco**

In Morocco, growth in the first half of 2018 stood at 2.8 per cent year-on-year, compared with 4.0 per cent in the same period of 2017. The slowdown was driven by falling agricultural output. The non-agricultural sector grew by 3.1 per cent growth in the same period. Growth is expected to slow down in 2018 to 3.0 per cent, influenced by the negative base effect following favourable weather conditions for agriculture in 2017. In 2019, growth is forecast to rise to 3.5 per cent, supported by the continued recovery in tourist arrivals, an increase in foreign direct investment, greater competitiveness from the move to a more flexible exchange rate regime, a rebound in services and manufacturing, stronger export growth – especially in the automotive and aeronautics industries –, and expanded mining capacity. The sustained growth is predicated on continuing the implementation of reforms to improve the business environment and boost productivity, and diversifying the economy away from agriculture.

### **Tunisia**

In Tunisia, economic activity picked up in the first half of 2018, registering growth of 2.7 per cent year-on-year compared with 1.8 per cent in the same period of 2017, the fastest growth since 2014. Economic growth is projected at 2.8 per cent for the year, up from 1.9 per cent in 2017, supported by the continued rebound in agriculture, which in turn supported agribusiness and food production industries, and consequently manufacturing. Strong growth in the tourism sector and a rebound in exports and investment on the back of the dinar depreciation, which boosted competitiveness, have also boosted the economy. Meanwhile, inflation reached a 26-year high in June, recording 7.8 per cent y-o-y, driven by higher consumption as a result of wage increases, subsidy reforms, and the impact of the depreciation, before moderating to 7.4 per cent in September. Growth is expected to pick up in 2019 to 3.0 per cent, against the backdrop of continued recovery in tourism and investment, stronger growth in major export markets in Europe, and the implementation of structural reforms, in the run up to the elections in November 2019.

## About this report

*Regional Economic Prospects* are published twice a year. The report is prepared by the Office of the Chief Economist and the Department of Economics, Policy and Governance and contains a summary of regional economic developments and outlook alongside the EBRD's growth forecasts for the economies where it invests.

For more comprehensive coverage of economic policies and structural changes, the reader is referred to country strategies and updates, as well as the *Transition Report 2018-19*, which are all available on the EBRD's website ([www.ebrd.com](http://www.ebrd.com)).

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Regional updates were edited by Peter Sanfey ([sanfey@ebrd.com](mailto:sanfey@ebrd.com)). The writing teams covering individual countries and regions were:

- **Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine:** Konstantine Kintsurashvili and Ana Kresic
- **Bulgaria, Romania and Turkey:** Roger Kelly and Ali Sokmen
- **Kazakhstan, the Kyrgyz Republic, Mongolia, Tajikistan, Turkmenistan and Uzbekistan:** Hans Holzacker and Dana Skakova
- **Croatia, Russia, Serbia and Slovenia:** Peter Tabak and Sanja Borkovic
- **Estonia, Hungary, Latvia, Lithuania, Poland and the Slovak Republic:** Mateusz Szczurek and Marcin Tomaszewski
- **Egypt, Jordan, Lebanon, Morocco and Tunisia:** Bassem Kamar and Rafik Selim
- **Albania, Bosnia and Herzegovina, Cyprus, Greece, Kosovo, FYR Macedonia and Montenegro:** Peter Sanfey and Jakov Milatovic

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