



European Bank
for Reconstruction and Development

Regional Economic Prospects in EBRD Countries of Operations November 2015

Economic outlook split by conflicting forces

The outlook for growth in the EBRD region in 2015 and 2016 has remained broadly unchanged since our last forecast in May.¹ On current projections, 2015 will be the fifth year of consecutive slowdown in average growth – from 4.6 per cent in 2010-11 to 0.2 per cent in 2015. Growth is expected to pick up modestly in 2016, recovering to 1.6 per cent.

These numbers reflect divergent trends in different sub-regions. The sharp drop in the price of oil and other commodities and a recession in Russia, where output is projected to contract by 4.2 per cent in 2015 and 1.2 per cent in 2016, weigh on the growth outlook in the Eastern Europe and the Caucasus (EEC) and Central Asia regions. Ukraine's economy will suffer a double-digit contraction this year but is expected to return to growth in 2016.

In contrast, growth in the rest of the region (Central Europe and the Baltic States (CEB), South-Eastern Europe (SEE), Turkey and southern and eastern Mediterranean (SEMED)) is projected to pick up from 2.5 per cent in 2014 to 3 per cent in 2015 and remain at around that level in 2016, as economies benefit from lower commodity prices and a recovery in the Eurozone supported by the quantitative easing programme launched by the European Central Bank (ECB). Greece's economy, however, is projected to experience a new recession in 2015, and GDP is likely to fall further in 2016.

The balance of risks in the forecast is tilted towards the downside. In particular, a stronger-than-expected impact of the tightening of US monetary policy could result in capital outflows from emerging markets globally, accompanied by steeper rises in borrowing costs for corporates and governments in the EBRD region. In addition, geopolitical risks remain high.

¹ The regional average growth rates in 2015 and 2016 are based on new weights. These weights correspond to countries' projected nominal GDP values in US dollars in 2015, measured at purchasing power parity. Weights used in the May 2015 issue of the *Regional Economic Prospects* were based on the 2014 nominal GDP values.

Since May 2015, the outlook for the region as a whole has remained broadly unchanged, but this masks very different sub-regional trends. The key drivers of the economic outlook are:

- Concerns about growth prospects in China and in emerging markets more broadly
- Expectations of monetary policy tightening in the US versus quantitative easing in the eurozone
- A further drop in the price of oil (from around US\$ 60 to around US\$ 50 per barrel of Brent) and softening of prices of other commodities
- The elevated geopolitical risks related to the conflicts in Ukraine and in the Middle East, and
- A slowdown in global trade flows.

Global economic environment

Increased concerns about the prospects of China's economy sparked a sell-off in global equity markets in late-August 2015. In the course of three trading days, China's equities lost 27 per cent of their value, and the VIX measure of global market volatility spiked sharply. Equity markets in advanced countries have experienced downward corrections (Chart 1).

Faced with increased market turbulence since the end of August, the Federal Reserve left interest rates at their record low levels. The markets now expect monetary policy in the US to be tightened from December 2015, or possibly even later (Chart 2). In contrast, prior to the "Black Monday" of 24 August 2015, markets had priced in an interest rate hike in September.

In fact, broadly-shared expectations of higher interest rates in the United States have led to increased volatility of capital flows into emerging markets, with lower net inflows recorded in the second and third quarters of the year, according to preliminary data from the Institute of International Finance (IIF). These data suggest that net capital flows into emerging markets this year may be at their weakest point in more than two decades.

Concerns about China's economy have contributed to a further drop in oil prices. The price of Brent crude briefly dropped below US\$ 43 per barrel in late-August before recovering to around US\$ 50, still about 10 to 20 per cent below the prices that prevailed in the summer (Chart 3). Lower oil prices reflect high stocks, stronger-than-expected resilience of supply of shale oil in the United States, expectations of weaker demand from China and other emerging markets, and the prospects of Iran's oil gradually returning to international markets following the envisaged phasing out of economic sanctions.

Growth in emerging markets has also been affected by slower growth in international trade, as a wave of expansion of global supply chains and the associated increase in cross-border shipment of intermediate goods appear to have come to an end at the same time as the global economy continued slowing.

After lengthy negotiations in July 2015, Greece and its official creditors reached an agreement on a new bailout programme. The agreement enabled Greece to clear its arrears with the International Monetary Fund (IMF) and re-open banks that had been closed for several weeks. However, capital controls remain in place. Syriza, the party in power since January, won the September 2015 elections and leads a new coalition government, but its commitment to implementing the new bailout programme remains largely untested.

Implications for EBRD countries of operations

Within the region where the EBRD invests, the economies of Russia, Central Asia and Eastern Europe and the Caucasus (EEC) have been most affected by the weaker external environment. Commodity exporters have been directly hit by a further drop in prices of oil, gas and metals. On 20 August 2015, Kazakhstan switched from a US dollar peg to a floating exchange rate regime in anticipation of lower oil prices. Kazakhstan's currency, the tenge, has depreciated by around 30 per cent since then. The rouble also weakened and the Russian economy remained in recession, adding to the pressure on currencies in Eastern Europe and the Caucasus (EEC) and Central Asia, given these regions' strong trade, investment and financial sector linkages with Russia.

High levels of dollarization of debt in the region also make economies more vulnerable to spikes in global market volatility and changes in investor sentiment towards emerging markets. Economies can flexibly adjust to changes in external environment through exchange rate movements. However, the exchange rate depreciations needed to equilibrate inflows and outflows of foreign funds may exacerbate the burden of debt service in economies where debt is highly dollarized (that is, denominated in dollars or any other foreign currency).

Countries in the region tend to have much higher levels of dollarization of debt than other emerging markets or advanced economies, as discussed in the forthcoming *Transition Report 2015-16*.² Foreign currency-denominated debt (both external and domestic) in many countries totals between 40 and 130 per cent of GDP (Chart 4). In some countries, the adverse impact of currency depreciations on the cost of debt may to a significant extent be offset by appreciation of assets (including international reserves of the Central Bank), while liabilities are naturally hedged by exports of goods prices in US dollars (although prices of many commodities have recently declined). The impact also depends on the currency composition of liabilities – those denominated in US dollars have become particularly costly to service. In this respect, high levels of dollar-denominated debt may further complicate policy adjustment to the new environment of lower commodity prices and weaker external demand in EEC and Central Asia.

Turkey is highly vulnerable to increased volatility of capital flows into emerging markets. The situation in Turkey has been compounded by political uncertainty, and the lira depreciated by around 30 per cent against the US dollar in the first 9 months of 2015. The

² *Rebalancing Finance*, forthcoming on 10 November 2015, Chapter 1.

beneficial effect of lower oil prices has been more than offset by deteriorating investor sentiment towards emerging markets. Given the large current account deficits (around 6 per cent of GDP last year, financed by non-FDI portfolio inflows), substantial refinancing needs and significant external corporate debt denominated in US dollars, Turkey's economy is particularly vulnerable to capital outflows.

In contrast, countries in CEB, SEE and SEMED stand to benefit from lower commodity prices and the quantitative easing in the Eurozone, as discussed in the May issue of *Regional Economic Prospects*. This accounts for the continued divergence of economic developments and the outlook in different parts of the region where the EBRD invests.

The slowdown in international trade has had limited impact on growth in the region so far. The negative impact of this trend on exports has been offset by slowing imports. Most countries' direct non-commodity exports to China are modest as a percentage of GDP. At the same time, a number of countries in CEB are integrated into the European global value chains exporting capital goods and other merchandise to China. If China's demand for investment goods were to decline considerably over time, net exports of these economies may be affected to a greater extent.

Countries across the region have been affected by the refugee crisis. The extent of impact is sizeable in some cases (see Box 1).

Country-specific factors have also played an important role in shaping economic outlook of individual countries. These are discussed in detail in the *Regional Updates* section.

Recent growth performance in the region

- In **CEB**, domestic demand continues to be the main driver of growth, in most cases reflecting a combination of strong private consumption, recovering investments (helped by the acceleration of EU funds utilisation) and savings on fuel expenditures. Growth has been picking up faster than expected in **Croatia** on the back of a good tourist season, stronger external demand and lower oil prices.
- The first nine months of 2015 have been a period of gradual improvement in most of the economies of **south-eastern Europe (SEE)**. The main exception is **Greece**, which is likely to fall back into recession for the year as a whole (after a modest upturn of 0.7 per cent in 2014) as a result of political uncertainty, the imposition of capital controls and widespread fears about the country's future in the Eurozone. To date, however, contagion effects from Greece on the rest of the region have been largely contained. **Bulgaria** has weathered the financial crisis better than expected and recovery has been accelerating in **Serbia** as infrastructure is rebuilt after last year's floods and exports are picking up on stronger EU demand.
- The recession in **Ukraine** has deepened. Ukraine's GDP fell by 17.2 per cent and 14.6 per cent year-on-year in the first and second quarters of 2015. Recent data suggest that the economy may have bottomed out in mid-year and may now be on the way

to gradual recovery. The IMF programme in Ukraine remains broadly on track. **Belarus's** economy has been strongly affected by the recession in Russia and the depreciation of the Russian rouble. In **Moldova**, large-scale banking sector fraud, governance challenges and the low level of external financial assistance have all created significant risks. **Armenia** posted stronger than expected growth in the first half of 2015 on the back of a strong performance of agriculture and mining.

- **Turkey's** economy grew 3.4 per cent year-on-year in the first half of 2015, with growth drivers shifting towards domestic demand. Consumption and investments rose, partly as a result of falling oil prices boosting disposable income for non-oil goods.
- The recession in **Russia** appears to have deepened as oil prices declined further in the third quarter of 2015. Growth in **Central Asia** has also been slowing down, given the region's strong dependence on Russia and commodity exports.
- Lower oil prices, stronger external demand from the US and the Eurozone and economic reforms supported growth in the **SEMED** region. At the same time, the economies of **Jordan** and **Tunisia** have been negatively affected by the deteriorating regional and domestic security conditions, respectively.

Capital flows and remittances

Capital outflows have intensified in the second and third quarters of the year, according to recent (partial) data (see Chart 5 showing net mutual fund flows into selected countries as recorded by EPFR Global). These trends reflect increased expectations of monetary tightening in the United States as well as a reassessment of prospects for emerging markets in light of lower commodity prices and a more uncertain outlook for growth of the Chinese economy. At the same time, capital flows to the CEB and SEE regions appear to have been affected to a lesser extent than those to many other emerging markets. Balance of payments data for the first half of the year indicate net capital inflows of around 0.8 per cent of GDP, compared with net inflows of around 1.2 per cent in 2014. Net private capital outflows from Russia have moderated somewhat (see Box 2).

Remittances from Russia to Central Asia and the EEC continued to decline at rates close to 40 per cent year-on-year in US dollar terms, as predicted in the previous issue of *Regional Economic Prospects*. Depreciating currencies of the recipient countries, however, meant that the value of remittances declined substantially less dramatically when expressed in local currency terms, or as a share of nominal GDP.

Currency movements

The weakening of the region's currencies against the US dollar continued, mirroring broader trends in emerging markets and reflecting cross-border movements of capital and lower export receipts of commodity-rich economies. Kazakhstan was the last major commodity exporter in the region to revise or abandon the peg against the US dollar.

Currencies in the EEC region and Central Asia, on average, depreciated most. This reflects a combination of lower remittance inflows from Russia, weaker export demand and lower prices of commodities.

Credit conditions

Firms in the region continue facing credit crunch conditions, in particular in CEB and SEE, as discussed in the forthcoming *Transition Report 2015-16* (see Chapter 2). Recent surveys of lending conditions indicate that the supply of funding in the region has been tightening even as the demand for loans has picked up somewhat. This is in contrast with post-crisis trends, when demand and supply conditions tended to move in the same direction, although the magnitude of fluctuations in supply conditions has been smaller than in recent years (Chart 6).

Credit growth remains constrained by persistently high levels of non-performing loans in the region. The latest data show that, out of 25 countries with the highest ratios of non-performing loans to GDP world-wide, 16 are from the region where the EBRD invests. Even though cross-country comparisons of NPL levels are notoriously problematic due to differences in definitions and reporting standards, the figures highlight the urgency of dealing with the overhang of NPLs.

Inflation

A decline in oil price of around 40 per cent in year-on-year terms contributed to further disinflation in most commodity-importing countries. In several CEB and SEE countries consumer prices declined over the last 12 months. Low domestic inflation can foster local currency and capital market development, but deflation increases the real debt burden - a particular problem in countries with high corporate or household debt.

In contrast, inflation in Russia stood at around 16 per cent year-on-year at end-September, owing to a large extent to, first, the pass-through of import prices following the depreciation of the rouble, and second, the impact of self-imposed counter-sanctions banning food imports from sanctioning countries. Similarly, currency depreciations led to a significant acceleration of inflation in Belarus, the Kyrgyz Republic, Tajikistan and Ukraine. In Turkey, despite the fall in oil prices, currency pressures kept inflation elevated, well above the central bank's target for the fourth consecutive year.

Outlook

In our baseline scenario, growth in the transition region is expected to average 0.2 per cent in 2015 and to pick up to 1.6 per cent in 2016 (Table 1). The forecast for 2015 has been broadly unchanged compared with May. The sharp decline in the average rate of growth in 2015 largely reflects Russia's recession and strong negative spillovers to neighbouring countries in the EEC and Central Asia regions, as well as a major slowdown in other commodity exporters. Growth in the rest of the region is expected to accelerate compared with 2014, reaching 3 per cent in 2015 and remaining around this level in 2016.

- In **CEB**, the economic outlook remains relatively strong, as QE in the Eurozone and lower commodity prices provide for more accommodating monetary conditions in the region. The expected average growth rate of around 3 per cent in 2015 and 2016 provides for continued, albeit slow, convergence of income levels with those of advanced economies (projected by the IMF to grow at around 2 per cent).
- QE in Europe, the weaker euro and lower oil prices are also benefitting the economies in **SEE**. Growth in most economies in the region is expected to pick up in 2015 and be maintained in 2016. Greece's economy, however, is projected to decline in both 2015 and 2016.
- The 2015 economic outlook in the **EEC** has worsened, affected by spillovers from the recession in Russia and due to deeper recession in Ukraine and Belarus. Ukraine's economy is expected to contract by 11.5 per cent in 2015 before growth finally returns in 2016, as increased regional geopolitical risk-aversion continues to undermine confidence. Armenia, Azerbaijan and Georgia are expected to post low single-digit growth.
- Growth in **Turkey** will remain broadly unchanged at 3 per cent in 2015 and 2.8 per cent in 2016, below the country's long-term potential. Constrained domestic demand will be partly offset by improved net exports, as recovery in the Eurozone supports exports while weaker domestic demand and lower commodity prices reduce import bills.
- In **Russia**, output is expected to contract by 4.2 per cent in 2015 and 1.2 per cent in 2016, as consumption and real incomes decline in the face of significantly lower oil prices, which compound structural problems and the effect of economic sanctions. The recession is expected to ease in 2016 as the economy adjusts to lower oil prices.
- Growth in **Central Asia** is expected to decelerate significantly in 2015-16 compared with 2014 on account of lower commodity prices and the region's strong economic ties with Russia.
- In the **SEMED** region, growth momentum in Egypt is expected to be stronger than previously forecast, while in Tunisia and Jordan the growth outlook has weakened due to deteriorating domestic and regional security conditions. Growth in the region is expected to reach 4 per cent in 2015 and 2016.

The projections assume a gradual tightening of monetary policy in the United States, accommodating policies in the Eurozone and decelerating growth in emerging markets. Lower commodity prices that reduce inflationary pressures may further moderate the pace of monetary tightening in the US.

Risks to the outlook

The outlook is subject to major risks.

- **A sharper-than-expected deceleration in China** would spark renewed volatility and a loss of confidence in emerging markets more broadly, and increase downward pressures on commodity prices. This will directly affect the EBRD region. A significant further decline in oil prices would intensify pressures on the Russian economy, with negative spill-overs for the economies in EEC and Central Asia.
- **On the other hand, capital flows to emerging markets may also be negatively affected by stronger-than-expected increases in interest rates in the United States.** A combination of weaker demand from China and tightening financing conditions on the back of strong recovery in the United States may become particularly challenging for emerging markets, including countries in emerging Europe and Central Asia.
- **Political instability and geopolitical tensions are a major, and rising, source of risk.** Any escalation of the conflict in the east of Ukraine, leading to further economic sanctions, would have significant negative spill-overs for the economies in the region. The conflict in Syria and the threat posed by Islamic State are also important sources of risk for the region – particularly the economies of the SEMED region and Turkey – through their impact on trade, investment, tourism and inflows of refugees.
- **Uncertainty also surrounds domestic politics in Greece.** If a new bailout programme agreed between Greece and its official creditors in July 2015 were to go off track, the Eurozone would enter a new period of economic turbulence. Deterioration in the economic outlook for the Eurozone may in turn lead to intensified withdrawal of funds by European parent banks operating in CEB and SEE, exacerbating the contraction of credit.

Box 1. The refugee crisis

The refugee crisis has affected the region's economies in a number of ways. The “frontline” countries – those immediately bordering the conflict zone in Syria and Iraq – saw a massive influx of refugees. Turkey is estimated to be hosting 2.5 million refugees, while in Jordan they account for almost one-fifth of the population. This massive influx has strained public services, government finances and labour markets.

Recent analysis of Turkey's labour markets finds that the inflow of refugees, who overwhelmingly do not have work permits, results in a displacement of informal, low-educated, mostly female Turkish workers, primarily in agriculture.³ As low-income Turkish workers drop out of the formal labour force, the average wage recorded in the formal sector seems to rise. The influx of refugees seems to have also bolstered the school attendance, particularly among young women, who dropped out of the labour force.

The longer-term macroeconomic impact of refugee influx on the recipient economies may depend on their contribution to productive activities. If refugees contribute productively to the labour market, their impact might be growth-positive, albeit challenging for certain cohorts of domestic workers, as labour competition rises. If, however, refugees do not productively contribute to labour market, they are likely to put a burden on public expenditure, while at the same time dent public revenues through a rise in informal employment. In addition, their prolonged absence from the labour market will further diminish their existing labour skills.

Several countries in SEE saw large numbers of refugees transiting their territories. For instance, more than 145,000 migrants, mainly of Syrian origin, are estimated to have transited through Serbia since January 2015, a ten-fold increase on the number of transits in 2014. This presented logistical and fiscal challenges for the countries' governments, which have provided medical and social care, food, water, and accommodation. United Nations agencies, the European Union, the Red Cross and non-governmental organisations have been supporting the region's governments in providing urgent humanitarian aid.

In addition, Albania and Kosovo are important countries of origin in Europe's migration wave. In 2015, more than 20 per cent of asylum requests in Germany were filed by Albanians and Kosovars. Under EU proposals these countries will be declared 'safe'. Asylum is therefore unlikely to be granted and large numbers of migrants may be repatriated, straining local economies.

³ See Del Carpio, Ximena, and Mathis Wagner, 2015, “The impact of Syrian refugees on the Turkish labor market”, World Bank Policy Research Working Paper 7402.

Box 2. Sensitivity of capital flows to global and local shocks: a tale of two countries

In recent years, ample global liquidity has enabled emerging market countries (EMs) with weak fundamentals to receive large capital inflows. An increasing share of these flows, however, has been portfolio inflows, which are more volatile and prone to reversal. The expected tightening of US monetary policy may change the intensity and direction of these flows. EM economic policies have to prepare for this shift in order to avoid “sudden stops”, which may have negative implications for exchange rates, external financing and, ultimately, economic growth.

Russia and Turkey have traditionally faced high volatility of capital flows, but the structure of these flows and the resulting shocks differ substantially. Both countries currently face a challenging external environment due to increased political uncertainty (Turkey) and geopolitical uncertainty (Russia). While net holdings of foreign assets are positive for Russia, Turkey accumulated a large stock of foreign liabilities after 2008 (see Chart 2.1). Another difference is that Turkey attracted significant debt flows (portfolio, bank and corporate loans) while in Russia equity liabilities have been prominent.

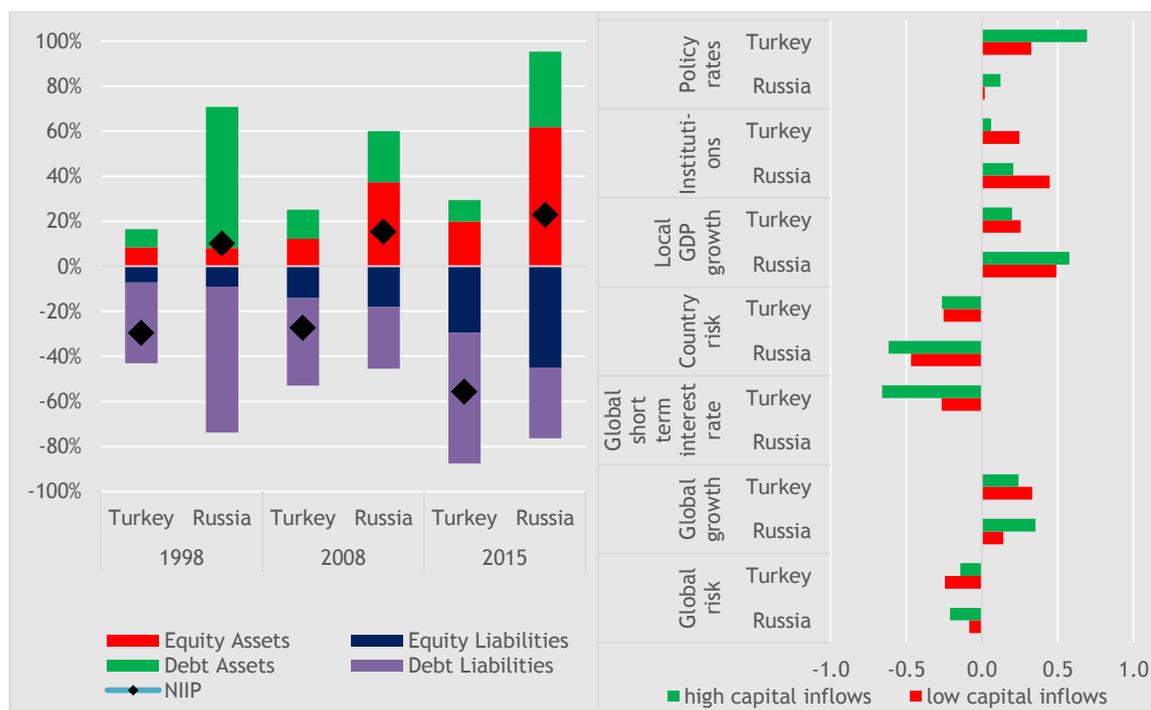
Turkey is more sensitive to changes in global sentiment, but monetary policy, operating through interest rates, is more effective in tackling capital flows, according to quantile regression analysis.⁴ This is due to the fact that global factors (including, prominently, interest rate differentials) are the most important drivers of capital flows in Turkey. In contrast, local fundamentals play a key role in Russia (see Chart 2.2), including the economy’s rate of growth, the country risk perception and the quality of institutions. This can be explained by the fact that Russian inward investment is mostly equity (also, in large part, Russian “round-tripping” capital) whose return is highly dependent on local economic factors. Finally, while the impact of the policy rate on capital flows declines in outflow periods in both countries, the same rate hike tends to reduce outflows from Turkey significantly more than in the case of Russia.

The findings suggest that institutions and monetary policy transmission matter in both countries. Countries with high portfolio flows like Turkey, however, have to focus strongly on changes in global interest rates and risk perception and adjust policies accordingly. On the other hand, countries with high equity-type flows like Russia should pay particular attention to the level and stability of economic growth and the business environment. In the case of Russia, increasing policy credibility and transmission efficiency would help monetary policy better control capital outflows. Nevertheless, it is measures aimed at enhancing

⁴ The sensitivity of capital flows to changes in global and local factors is estimated using quantile regression techniques. This allows for the distinction among the impact of the determinants in periods of high, moderate and low capital inflows. The determinants are selected in line with the global vs. local (push vs. pull) framework typically used in the literature (e.g. *Koepke: What Drives Capital Flows to Emerging Markets? A Survey of the Empirical Literature, IIF Working Paper, April 2015*). Local factors represent the local business environment, while global factors show the role of opportunity costs (e.g. interest rates in the countries of origin of capital flows).

institutional and economic stability that support capital inflows most and reduce their volatility. Finally, high levels of foreign liabilities (even if they are domestic “round-tripping” capital in case of Russia) in both countries imply risks related to interest payments and refinancing (in case of debt) and profit repatriations (in case of equity) which may negatively affect investor perception and sovereign credit ratings.

Chart 2.1: Net international investment position (% of GDP) **Chart 2.2: Determinants of capital flows**



Source: IMF Balance of Payments statistics. Net international investment position is the value of overseas assets owned by a nation (including international reserves of the Central Bank) minus the value of domestic assets owned by foreigners.

Source: Author’s calculations. Sample: 2005Q1-2015Q1 for Turkey, 2006Q1-2015Q1 for Russia. The estimates show the impact of a one standard deviation change in a given variable on capital flows (measured as a share of standard deviation of capital flows). Periods of low capital flows are those when capital flows were below the 25th percentile of their distribution; periods of high capital flows are those when capital flows were above the 75th percentile.

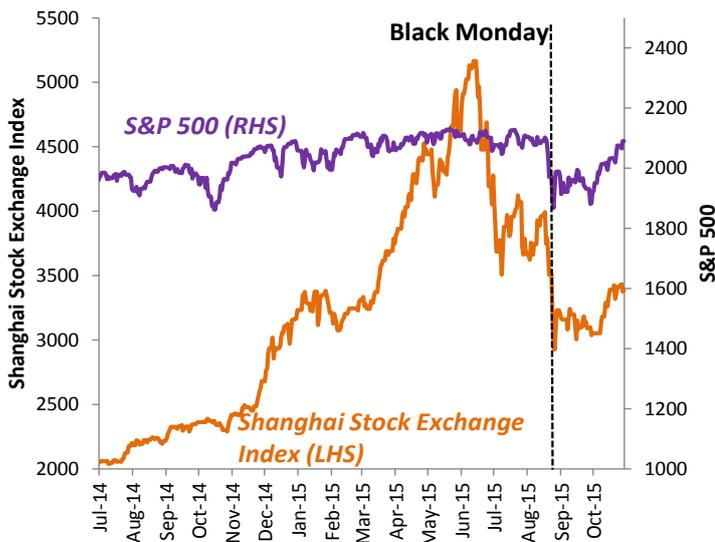
Table 1: Real GDP Growth*(In per cent; EBRD forecasts as of 5 November 2015)*

	Actual			Current forecast		EBRD Forecast in May 2015		EBRD Forecast in May 2015	
	2014	2015	2016	2015	2016	2015	Change May-Nov.	2016	Change May-Nov.
EBRD Region¹	1.8	0.2	1.6	0.2	0.0	1.6	0.0	1.6	0.0
Central Europe and the Baltic states¹	3.1	3.0	2.9	3.0	0.0	3.0	0.0	3.0	-0.1
Croatia	-0.4	0.9	0.5	0.5	0.4	0.5	0.0	0.5	0.0
Estonia	2.9	2.0	2.8	2.2	-0.2	3.0	-0.2	3.0	-0.2
Hungary	3.7	2.9	2.1	2.6	0.3	2.3	0.3	2.3	-0.2
Latvia	2.4	2.3	3.1	2.3	0.0	3.1	0.0	3.1	0.0
Lithuania	3.0	1.7	3.0	2.7	-1.0	3.2	-1.0	3.2	-0.2
Poland	3.3	3.4	3.3	3.4	0.0	3.4	0.0	3.4	-0.1
Slovak Republic	2.5	3.1	3.2	2.8	0.3	3.3	0.3	3.3	-0.1
Slovenia	3.0	2.3	2.0	2.0	0.3	2.3	0.3	2.3	-0.3
South-eastern Europe¹	1.4	1.6	1.6	1.6	0.0	2.5	0.0	2.5	-0.9
Albania	2.2	2.3	3.3	2.5	-0.2	3.0	-0.2	3.0	0.3
Bosnia and Herzegovina	1.0	2.8	3.0	2.5	0.3	3.0	0.3	3.0	0.0
Bulgaria	1.5	1.8	2.0	1.0	0.8	1.5	0.8	1.5	0.5
Cyprus	-2.5	1.0	1.7	0.5	0.5	1.5	0.5	1.5	0.2
FYR Macedonia	3.5	3.5	3.5	3.5	0.0	3.7	0.0	3.7	-0.2
Greece	0.7	-1.5	-2.4	0.0	-1.5	2.0	-1.5	2.0	-4.4
Kosovo	0.9	2.0	3.0	2.5	-0.5	3.5	-0.5	3.5	-0.5
Montenegro	1.8	3.0	4.0	3.0	0.0	3.7	0.0	3.7	0.3
Romania	2.8	3.5	3.7	3.0	0.5	3.2	0.5	3.2	0.5
Serbia	-1.8	0.5	1.8	0.3	0.2	1.8	0.2	1.8	0.0
Eastern Europe and the Caucasus¹	-1.9	-5.1	1.4	-3.5	-1.6	1.9	-1.6	1.9	-0.5
Armenia	3.5	2.3	2.0	-1.5	3.8	1.0	3.8	1.0	1.0
Azerbaijan	2.8	3.0	2.5	1.5	1.5	1.5	1.5	1.5	1.0
Belarus	1.6	-3.5	-1.0	-2.5	-1.0	0.0	-1.0	0.0	-1.0
Georgia	4.8	2.5	2.6	2.3	0.2	2.6	0.2	2.6	0.0
Moldova	4.6	-2.0	0.0	-2.0	0.0	1.5	0.0	1.5	-1.5
Ukraine	-6.8	-11.5	2.0	-7.5	-4.0	3.0	-4.0	3.0	-1.0
Turkey	2.9	3.0	2.8	3.0	0.0	3.0	0.0	3.0	-0.2
Russia	0.6	-4.2	-1.2	-4.5	0.3	-1.8	0.3	-1.8	0.6
Central Asia¹	6.0	3.8	3.9	3.9	-0.1	4.3	-0.1	4.3	-0.4
Kazakhstan	4.3	1.2	1.5	1.5	-0.3	2.0	-0.3	2.0	-0.5
Kyrgyz Republic	3.6	5.0	3.9	3.0	2.0	3.1	2.0	3.1	0.8
Mongolia	7.8	3.3	5.0	4.0	-0.7	3.0	-0.7	3.0	2.0
Tajikistan	6.7	5.0	4.5	3.8	1.2	3.8	1.2	3.8	0.7
Turkmenistan	10.3	8.5	8.5	9.5	-1.0	10.0	-1.0	10.0	-1.5
Uzbekistan	8.1	7.5	7.2	7.0	0.5	7.2	0.5	7.2	0.0
Southern and Eastern Mediterranean^{1,2}	2.3	4.0	4.0	4.0	0.0	4.3	0.0	4.3	-0.3
Egypt	2.2	4.2	4.3	4.0	0.2	4.2	0.2	4.2	0.1
Jordan	3.1	2.8	3.5	3.6	-0.8	3.9	-0.8	3.9	-0.4
Morocco	2.4	4.9	3.8	4.6	0.3	5.0	0.3	5.0	-1.2
Tunisia	2.3	1.0	3.0	2.8	-1.8	3.6	-1.8	3.6	-0.6
Average EEC, CA, Russia	1.1	-3.1	0.0	-3.0	-0.1	-0.3	-0.1	-0.3	0.3
Average CEB, SEE, SEMED, Turkey	2.5	3.0	2.9	3.0	0.0	3.2	0.0	3.2	-0.3

¹ Weighted averages. The regional average growth rates in 2015 and 2016 are based on new weights. These weights correspond to countries' nominal GDP values in PPP US dollars in 2015. Weights used in the May 2015 issue of the Regional Economic Prospects were based on the 2014 nominal GDP values in US dollars.

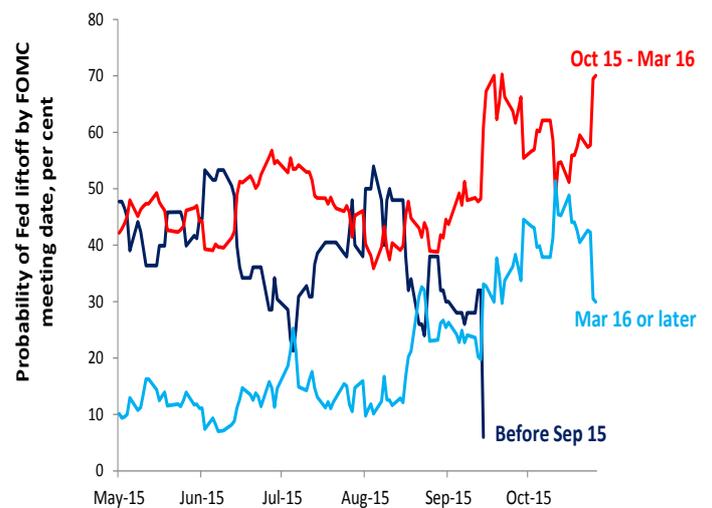
² EBRD figures and forecasts for Egypt's real GDP reflect the fiscal year, which runs from July to June. These are also used in the regional averages.

Chart 1. Stock markets



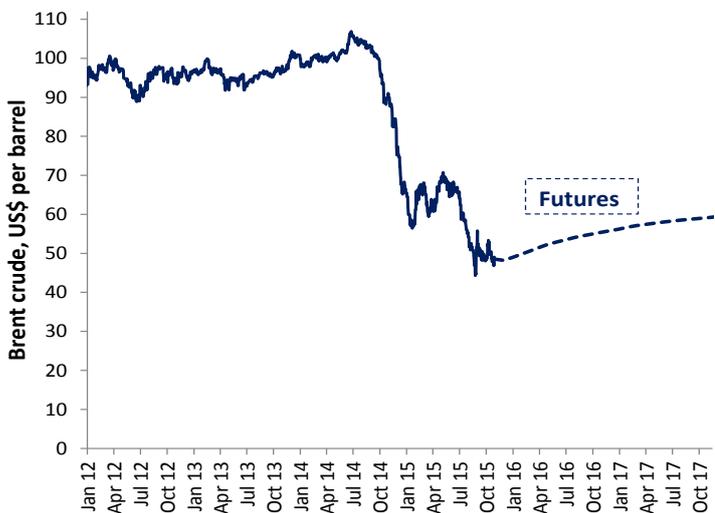
Source: Bloomberg

Chart 2. Probability of the first US interest rate hike



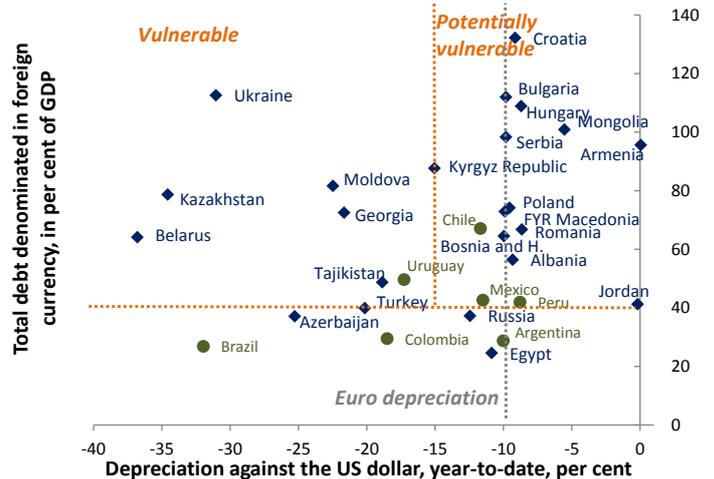
Source: Bloomberg; EBRD calculations

Chart 3. Brent crude, US\$ per barrel



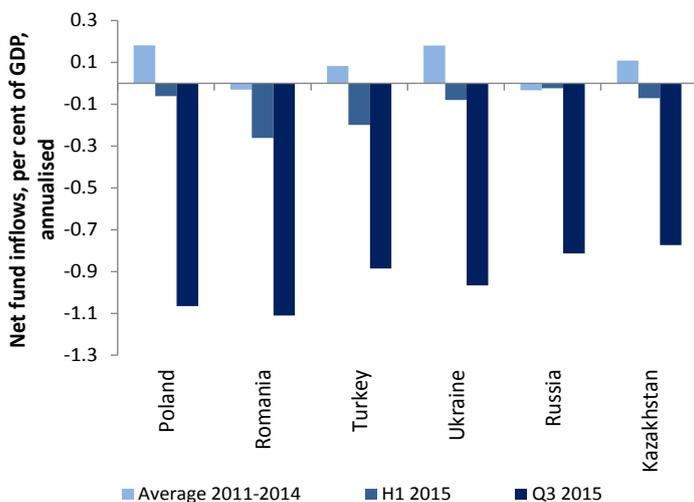
Source: Bloomberg

Chart 4. Foreign currency denominated debt



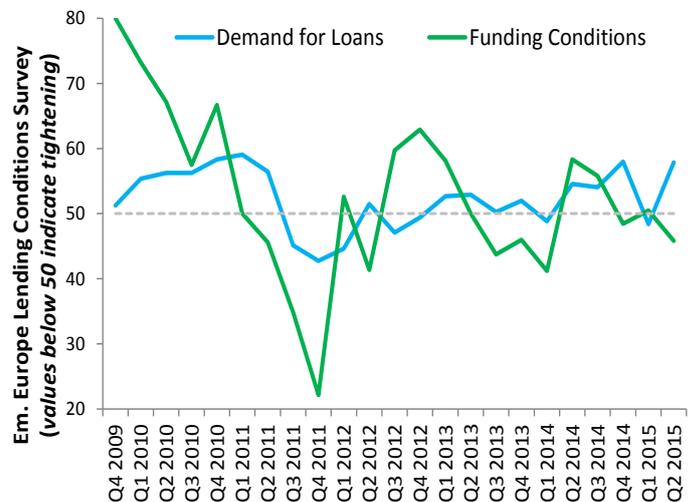
Source: Bloomberg; National authorities; BIS; World Bank; IMF; EBRD calculations. Debt as of end-2014 or latest.

Chart 5. Net mutual fund inflows



Source: EPFR Global; EBRD calculations

Chart 6. Lending conditions



Source: IIF Lending Conditions Survey

Regional updates

Central Europe and the Baltic States (CEB)

Central Europe and the Baltic states (CEB) have so far weathered the unfolding withdrawal of liquidity from emerging markets well, and we only marginally revise our growth forecasts to 3 per cent this year, and 2.9 per cent next year. There are vulnerabilities – such as high public debt in Hungary and Croatia or the legacy of foreign-currency-denominated retail loans in Poland and Croatia – though few of the large and ongoing financing requirements that have plagued other emerging markets. Hungary and the Slovak Republic are exposed to a slowdown of demand in emerging markets, including through indirect trade channels, though so far strengthening demand within the Eurozone has compensated for this.

- Growth in **Poland** has surprised positively in the first half of 2015. Strong real wage and consumption trends, on the back of a buoyant labour market, and government spending of a fiscal over-performance are likely to have bolstered growth in the remainder of the year. On current projection, a 3.4 per cent expansion in 2015 will remain the strongest in the region. Exposure to weakening emerging markets demand is limited, and Poland does not suffer from significant external vulnerabilities that could expose it to rapid liquidity withdrawals. We expect that delays in the implementation of EU structural funds may lead to a slight weakness in public investment in 2016, though growth should stay at a similar level next year.
- **Hungary** will register growth of about 2.9 per cent in 2015, to slightly above the forecast made earlier in the year. This upgrade primarily reflects greater-than-anticipated strengthening of the household consumption, backed by improvements in the labour market and rising disposable incomes. Yet, investment has increased only marginally in the first half of the year. More broadly, the effects of the central bank's Funding for Growth scheme are beginning to wane. The stimulus to public investment from the new phase of EU structural funds has been delayed as implementation encountered some administrative hurdles. Hungary is highly exposed to a global trade slowdown, with 25 per cent of exports directed to Germany, and has a considerable exposure to final demand in emerging markets. Stimulus from the budget will be increasingly constrained, as the government seeks to restore its investment grade sovereign rating. We therefore expect a slowdown in growth next year to 2.1 per cent.
- **The Slovak Republic** has this year benefitted from stronger Eurozone growth, and our expectation for GDP growth was upgraded to 3.1 per cent. Solid investment growth of 8.8 per cent in the first half of 2015 mirrors an acceleration of utilisation of EU structural funds in the final year of disbursements. As an economy that is highly dependent on exports (which account for 80 per cent of GDP), the Slovak Republic is exposed to a global trade slowdown. The concentrated export structure in the automotive sector and electronics could be an additional vulnerability if significant investors or certain technologies undergo adjustment. A major new

investment by Jaguar-Land Rover, will boost investment from 2017, further entrenching this concentration. Reductions in the VAT rate on selected food products, minimum wage increases and cuts in healthcare contributions for low-income employees have already supported household consumption, and will continue to do in 2016, for which we expect a similar growth rate.

- The **Baltic** countries have broadly sustained growth despite the recession in Russia and economic stagnation in Finland. Lithuania suffered a temporary disruption in external trade in the first half of 2015, and we reduced growth expectations to only 1.7 per cent. On the whole, exporters appear to have been adept in shifting to new markets and upgrading products further. In 2016, growth is expected to be more uniform at around 3 per cent. All three economies show strong real wage growth, though also more binding constraints in labour markets. The initiation of the new EU funding of public investment has been relatively smooth, though all three economies increasingly try to mobilize private funding in conjunction with the structural funds.
- **Slovenia's** economy grew by 3 per cent year-on-year in 2014 and 2.7 per cent year-on-year in the first half of 2015, driven by net exports and build-up of stocks. In the second half of 2015 and 2016, domestic demand is expected to drive growth. Consumption will be supported by falling lending rates, rising consumer confidence and higher disposable income, as real wages gradually rise and the unemployment rate falls. Higher business confidence and lower cost of funding will support private investments. Government investments are expected to increase slightly in the second half of 2015, to absorb more EU funds as the 2007-2013 programming period ends as of end-2015, but they are then expected to decline in 2016, with the beginning of 2014-2020 EU programming period, leading to a slightly more moderate growth next year. Growth is thus expected at 2.3 per cent in 2015 and 2.0 per cent in 2016.
- The **Croatian** economy saw a cumulative 12 per cent contraction between 2009 and 2014, the second largest in the EU after Greece, but the recession came to an end in 2015. We are revising our growth forecast for this year to 0.9 per cent (up from 0.5 per cent in May), as a result of a better-than-expected tourist season, stronger external demand and lower oil prices. Despite a certain improvement in business sentiment, investment is expected to remain weak, pointing to remaining structural weaknesses. We expect only marginal growth in 2016, of 0.5 per cent, due to strong pressure for fiscal adjustment under the EU's excessive deficit procedure together with a weaker contribution from external factors, as well as slow implementation of reforms aimed at improving the business environment.

South-Eastern Europe (SEE)

The first nine months of 2015 have been a period of gradual improvement in most of the economies of south-eastern Europe (SEE). The main exception is Greece, which is likely to fall back into recession for the year as a whole (after a modest upturn of 0.8 per cent in 2014) as a result of political uncertainty, the imposition of capital controls and widespread fears about the country's future in the Eurozone. To date, however, contagion effects from Greece on the rest of the region have been largely contained. Most countries in the region are expected to maintain growth rates in 2016 at close to or above those recorded this year.

Greece

- The Greek economy has undergone significant turbulence in 2015 as a result of high political uncertainty, the imposition of capital controls in June and ongoing fears about the long-term solvency of the country. On the positive side, the economy grew by 0.1 per cent (quarter-on-quarter, seasonally adjusted) in the first quarter of 2015, and by a surprisingly high 0.9 per cent in the second quarter. The latter result was driven by consumption, especially of durable goods, possibly driven by people's fears of a "Grexit" and/or confiscation of bank deposits. Tourism numbers have held up well and may reach record levels in 2015. Net exports also rose in the second quarter of 2015 as imports fell by nearly 5 per cent, reflecting trading difficulties faced by many importers. However, gross fixed capital formation fell in the second quarter by nearly 11 per cent. GDP growth in the third quarter was almost certainly strongly negative (pending the release of data in November) after the uncertainty caused by the temporary bank closure (in late-June/first half of July) and the imposition of capital controls. Following the September elections, stability and confidence are being restored and the government is moving ahead on commitments agreed with the European Commission and other institutions in August. However, real GDP is likely to fall in 2015 by -1.5 per cent. The carry-over effect implies a further drop in 2016, but growth is likely to return (on a quarter-on-quarter basis) perhaps by the second quarter of the year provided investment picks up and reforms are implemented.

Cyprus

- Economic activity in Cyprus in the first half of 2015 has been better than expected. After 14 quarters of negative growth, the economy grew 1.2 percent q/q in Q1 2015, and further growth occurred in Q2 of 0.5 per cent. Private consumption and investment were main drivers of growth, while confidence indicators are on a steadily rising path. Tourist arrivals in the first eight months are up by more than 6 per cent with respect to the same period of the previous year. In July 2015, the Central Bank of Cyprus (CBC) began purchases of Cypriot government bonds as part of the ECB's quantitative easing programme, following a positive assessment from the IMF and other Institutions on the review of the country's bailout programme. We have therefore upgraded our 2015 forecast from 0.5 to 1 per cent, with a further

rise to 1.7 per cent in 2016. The main risks stem from the elevated level of public debt and the still exceptionally high amount of NPLs in the banking system.

Bulgaria and Romania

- The **Bulgarian** economy grew by 2.2 per cent year-on-year in the first half of 2015, with net exports taking over as the main driver of growth. The declining country risk premium and lower domestic lending rates, after credible steps to improve confidence in the financial sector, contributed to higher-than-expected domestic demand. Weakening of the euro, to which domestic currency is pegged, led to slight gains in competitiveness, contributing to higher net exports. In the second half of 2015 and 2016, domestic demand will continue to support growth, helped by higher disposable income on the back of low inflation, and a lower than previously expected country risk premium and thus cost of funding. Fiscal policy is expected to remain tight, while improving growth prospects in the Eurozone will help boost net exports. We therefore revise up our growth expectation to 1.8 per cent in 2015 and to 2.0 per cent in 2016.
- **Romania's** economy grew by 3.8 per cent year-on-year in the first half of 2015, as a rise in wages and low inflation led to higher disposable income and supported consumption. The lower cost of funding, following improved investor confidence and the NBR's policy rate cut in May to a historically low level of 1.75 per cent, contributed to a rise of investments, which have reached their strongest level in the last five years. In the remainder of 2015 and 2016, growth will continue to be supported by stronger domestic demand. Consumption will be boosted by higher disposable income, as a consequence of the recent VAT cut on food products from 24 per cent to 9 per cent, as well as introduced and planned public wage hikes. Private investments will continue to recover on the back of improved investor sentiments and previous decline in the cost of funding, while government investment is expected to rise in the second half of 2015 as the country absorbs more EU funds. Overall, we expect Romania to grow at 3.5 per cent in 2015 and 3.7 per cent in 2016, with average inflation remaining negative in 2015, on the back of recent and planned VAT cuts, low oil prices and low inflation expectations.

Western Balkans

- The **Albanian** economy has performed steadily in 2015, successfully withstanding the impact of severe flooding in the south of the country in February. However, fiscal challenges remain significant and the government is struggling to reach targets agreed under the IMF programme. The government has stepped up its efforts to reduce informality in the economy, and these efforts should yield benefits over the medium term. In the meantime, growth in 2015 is likely to be around 2.3 per cent, slightly lower than our May forecast, but rising to 3.3 per cent in 2016 on the back of an improved external environment (in the Eurozone) and the start of the major construction work on the Trans-Adriatic gas Pipeline (TAP).

- **Bosnia and Herzegovina** has continued to show considerable resilience in 2015. In the first quarter, GDP grew strongly at 2.1 per cent year-on-year, with particularly robust growth in wholesale and retail trade, public administration and construction, while growth in the second quarter accelerated to 4.4 per cent year-on-year (helped by a low base effect from last year's floods). The authorities are currently negotiating on a new agreement with the IMF which, if agreed, would be supportive of macroeconomic stability. Governments at all levels in Bosnia and Herzegovina have committed to a new "Reform Agenda" which should lead to important and long-delayed structural reforms. We expect growth of around 2.8 per cent in 2015 and 3 per cent in 2016. However, fiscal risks and possible political paralysis remain significant downside risks.
- The economy of **FYR Macedonia** continues to grow at a robust rate in 2015, with quarterly growth rates of 0.9 and 1 per cent respectively in the first two quarters of the year. Exports are continuing to perform well and were up significantly in the first half of the year. We expect growth to be 3.5 per cent in 2015 and 2016. However, downside risks have increased as a result of political uncertainties, and the sharp increase in public debt in recent years is another source of risk.
- Economic growth in **Kosovo** dropped significantly in 2014 relative to previous years and there are few signs in 2015 of any bounce-back. We have therefore lowered our forecast for the year to 2 per cent (from 2.5 per cent in May), rising to 3 per cent in 2016. The country has entered into a 22-month €185 million stand-by agreement with the IMF, which should help the country in cutting unproductive current spending while increasing space for critical investment in transport and energy infrastructure. The authorities are also targeting improved competitiveness and a reduction in corruption and informality. The IMF programme will require the implementation of new fiscal rules.
- In **Montenegro**, growth in 2014 was disappointing at around 1.8 per cent, but a pick-up is under way, primarily driven by a major Chinese-financed highway project. The tourism sector has also performed well in 2015, as a drop in Russian tourists has been more than compensated by an increase from other countries, particularly in the SEE region. We expect growth this year to be around 3 per cent, rising to 4 per cent next year when the highway project will be in full swing. However, a major downside risk lies in the fiscal side, and the worrying rise in public debt in recent years may necessitate painful austerity measures elsewhere, especially if economic growth rates were to falter.
- **Serbia** underwent three recessions in the last six years, but a modest recovery is under way in 2015. The economy contracted by 1.8 per cent in 2014, largely due to severe floods. We forecast a slow recovery of 0.5 per cent in 2015 as stronger external demand and lower oil prices may offset the short-term negative effects from the fiscal consolidation under the IMF programme. Exports will continue to be the main growth driver, supported by supply-side effects – the re-launch of operations of a major steel plant as well as normalization of coal extraction and

power generation in the second half of the year after the damage caused by last year's floods. Despite the improvement in industrial production, declining car production and a worse-than-expected agricultural season weigh on this year's growth. Growth is anticipated to accelerate from 2016 in line with expected stronger EU growth, and a pick-up in domestic investment. As high NPLs are likely to be resolved only gradually, credit growth may remain moderate. Medium-term prospects are favourable provided the reform programme envisaged in the IMF agreement is implemented. There is room for further monetary easing, speeding-up major infrastructure projects, making progress with NPL resolution and improving the business environment.

Turkey

The Turkish economy grew by 3.4 per cent year-on-year in the first half of 2015, with growth drivers shifting towards domestic demand. Consumption and investment rose, partly as a result of falling oil prices boosting disposable income for non-oil goods, and partly due to frontloading to avoid expected price hikes of imported goods, machinery and equipment, as the recent weakening of the lira gradually passes through to prices. The contribution of net exports to growth remained subdued despite the currency weakening, as export demand remained limited amidst rising tensions in the Middle East and recession in Russia.

The pressure on the lira increased in 2015 as expected monetary tightening in the US, diverging monetary policies between the Fed and ECB, deteriorating investor sentiment towards emerging markets and elevated regional and domestic political uncertainty amidst the inconclusive June parliamentary elections pushed up the country risk premium. As a consequence, in 2015 the lira weakened 31 per cent against the dollar and 21 per cent against the euro by the end of September. Meanwhile, on the back of currency weakening and persistent rises in food prices, average annual inflation rose to 7.9 per cent in September 2015, remaining above the central bank's target of 5 per cent for the fourth consecutive year.

The cost of funding in both lira and foreign currency will remain elevated in the remainder of 2015 and in 2016. Inflationary pressures, expected monetary tightening of the Fed and moderation in global liquidity, as well as elevated financial market volatility due to domestic and regional political uncertainties, have already increased pressure on the central bank to hike interest rates. The higher cost of funding and base effects will constrain consumption and investments in 2016. Government spending is expected to remain moderate, given the budget deficit target of 0.7 per cent of GDP in 2016. Constrained domestic demand will be partly offset by improved net exports, as growth prospects in the Eurozone support exports, and constrained domestic demand coupled with lower global oil and commodity prices lower imports. Overall, the economy is expected to grow by 3.0 per cent in 2015 and to moderate to 2.8 per cent in 2016, below the country's long-term potential. The main downside risks to this outlook are a larger-than-expected fall in net capital inflows (as a consequence of moderation in global liquidity) and worsening investor sentiments towards emerging markets. In mitigation, the banking sector remains well capitalized with low non-performing loan ratios, and public finances remain stable, with government debt standing at around 36.8 per cent of rolling GDP in August 2015.

Eastern Europe and the Caucasus (EEC)
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The EEC region contracted by 1.9 per cent in 2014, driven by severely negative growth in Ukraine. In 2015, a further contraction of 5.1 per cent is expected as the economies of Belarus, Moldova and Ukraine, which collectively represent approximately two-thirds of the combined GDP of the EEC region, are all forecast to decline. Low single-digit growth is expected in Armenia, Azerbaijan and Georgia. National currencies and foreign exchange reserves came under pressure in all EEC countries as remittances and export proceeds declined. Weaker exchange rates have facilitated external adjustment, while at the same time affecting disposable incomes and public and private sector balance sheets. A mild recovery is projected for 2016 but is contingent on an improvement in the regional economic environment, a reduction in geopolitical risks and on other country-specific factors.

- **Armenia** posted an estimated 4 per cent growth in the first half of 2015 (after 3.5 per cent growth in 2014), driven *inter alia* by the agriculture, mining and hospitality sectors. Following significant depreciation pressure at the end of 2014, the exchange rate stabilised in 2015 amid tight monetary conditions, central bank interventions in the beginning of the year and adjustment of the current account. Gross international reserves were on a downward path for most of 2014 and in January -February 2015 before increasing to close to four months of imports by September 2015. Public finances remained generally sound amid limited fiscal space. The budget deficit is expected to widen to between 3 and 4 per cent of GDP in 2015 on account of higher capital expenditures and revenues shortfall. Public debt is estimated at around 45 per cent of GDP in the first half of 2015. The regional economic slowdown has resulted in lower remittances to Armenia, including from Russia, lower imports and negative credit growth in the first eight months of 2015. We upgrade our Armenia GDP growth forecast to 2.3 per cent in 2015 and 2 per cent in 2016.
- **In Azerbaijan**, growth slowed from 5.8 per cent in 2013 to 2.8 per cent in 2014, affected by the decline in oil output. In 2014, a negative real growth contribution of agriculture and mining was offset by the positive contribution from construction, trade, transport, storage and communications. In January-September of 2015, the economy expanded by 3.7 per cent year-on-year, with non-oil GDP expanding by 6.4 per cent. Amid low oil prices, Azerbaijan's foreign currency reserves (in convertible currencies) decreased from US\$ 13.2 billion in November 2014 to approximately US\$ 5.3 billion in August 2015. Nevertheless, Azerbaijan's liquidity position is strong: assets of the State Oil Fund and the central bank's foreign exchange reserves collectively represented approximately 56 per cent of the 2014 nominal GDP and 26 months of imports at the end of the first half of 2015. By end-2014, public and publicly guaranteed debt was low at around 15 per cent of GDP. In February 2015, after almost two decades of stable exchange rate, the central bank devalued the manat against the US dollar by 25 per cent. This helped to contain pressure on the fiscal and external balance, but led to balance sheet concerns in the banking sector.

We upgrade our Azerbaijan GDP growth forecast to 3 per cent in 2015 and 2.5 per cent in 2016.

- **Belarus's** growth turned negative in 2015 for the first time after 19 consecutive years of positive growth in 1996-2014. While the economy grew by 1.6 per cent in 2014, in the first nine months of 2015 it shrank by an estimated 3.7 per cent year-on-year, affected significantly by the recession in Russia. Foreign currency reserves declined from US\$ 3.9 billion in November 2014 to US\$ 2.1 billion at end-September 2015, providing just one month of import coverage. To mitigate external imbalances, the authorities attempted external and internal adjustments tools. The general government balance posted a surplus in January-June 2015, with the surplus earmarked mainly towards the repayment of foreign exchange liabilities. Despite initial heavy administrative measures, in December 2014 the central bank abandoned its crawling peg in the context of depreciation of the Russian rouble. In January-October 2015, the Belarus rouble depreciated against the US dollar by approximately 30 per cent, with a resulting impact on real and financial sector balance sheets. The current account deficit declined from 6.7 per cent of GDP in 2014 to an estimated 1.9 per cent of GDP in the first half of 2015. General government gross debt increased to approximately 40 per cent of GDP in 2014. We downgrade our Belarus GDP growth forecast to -3.5 per cent in 2015 and -1 per cent in 2016.
- **Moldova's** economy expanded by 4.6 per cent in 2014 and by 3.6 per cent year-on-year in the first half of 2015. Risks for the remainder of 2015 are clearly tilted to the downside due to many factors, including: significant vulnerabilities in the financial sector, lower remittances, tight monetary policy, higher inflation, weak performance of agriculture, regional economic downturn, challenges in budget execution due to lower external financial assistance, volatile domestic politics and substantial governance challenges. In the first half of 2015, remittances, which amounted to approximately 20 per cent of GDP in 2014, fell in US dollar terms by approximately 30 per cent year-on-year, and export proceeds dropped by approximately 16 per cent. The leu depreciated against the US dollar by 16 per cent in 2014 and by close to 20 per cent in January-October of 2015. In the period October 2014 to August 2015, Moldova's official reserve assets decreased from US\$ 2.65 billion to US\$ 1.8 billion (approximately four months of imports). Annual inflation accelerated to 12.6 per cent in September 2015, and the central bank increased its base rate five times in 2015, from 6.5 per cent to 19.5 per cent. Public debt is expected to increase from approximately 30 per cent of GDP in 2014 to up to 50 per cent in 2015, mainly due to the emergency support to the three failed banks (although end-2014 public and publicly guaranteed foreign exchange-denominated debt, mainly owed to multilateral official creditors, was relatively moderate at 22 per cent of GDP). We retain our Moldova GDP growth forecast at -2 per cent in 2015 and downgrade it to zero per cent in 2016.

- Ukraine's** GDP fell by 6.8 per cent in 2014 and by 17.2 per cent and 14.6 per cent year-on-year in the first and second quarters of 2015. Inflation stood at 51.9 per cent year-on-year in September 2015. The current account deficit decreased sharply from 9.2 per cent of GDP in 2013 to approximately 4.7 per cent in 2014, and is expected to shrink further to less than 2 per cent of GDP in 2015. The disruptions to productive and export capacities in Donbas and significant net outflows registered in the financial account put pressure on the currency and reserves. The hryvnia lost approximately 63 per cent of its value against the US dollar from January 2014 to mid-October 2015, with depreciation from January to mid-October 2015 at 26 per cent. The official exchange rate has stabilised at 21-23 hryvnias per US dollar since April 2015 on the back of administrative restrictions on the foreign exchange market deployed by the central bank. Official reserve assets of the central bank fell from US\$ 17.8 billion in January 2014 to US\$ 5.6 billion in February 2015 (approximately one month of import coverage) before recovering to approximately US\$ 12.8 billion in September 2015, largely on account of inflows of international assistance. In 2014, the sum of the general government and Naftogaz deficits increased to approximately 10 per cent of GDP (from 6.7 per cent in 2013), with Naftogaz's deficit accounting for more than half of this. This overall deficit is expected to decrease to approximately 7 per cent of GDP in 2015, driven by an expected reduction in both the general government and Naftogaz deficits. Ukraine's public and publicly guaranteed debt increased steeply as a percentage of GDP, from 41 per cent in 2013 to 71 per cent in 2014, and is projected to increase further to up to 90-100 per cent of GDP at the end of 2015 due to exchange rate effects, the economic contraction and inflows of official loans. The four-year Extended Arrangement with IMF is on track. The government moved fast to carry out the IMF's prior actions which led to approval of the Extended Arrangement. To close Ukraine's external funding gap, the IMF programme envisages restructuring Ukraine's sovereign Eurobonds to generate cash flow savings of approximately US\$ 15 billion from 2015 to 2018 and to improve Ukraine's public debt sustainability. According to the Ministry of Finance of Ukraine, on 14 October 2015 all sovereign and sovereign guaranteed bondholders, with the exception of the December 2015 US\$ 3 billion bond, passed an Extraordinary Resolution approving the debt restructuring. Ukraine's short-term outlook depends on domestic and external factors. Seasonally adjusted quarter-on-quarter contraction slowed from -3.8 per cent in the first quarter of 2015 to -0.5 per cent in the second quarter of 2015. There is cautious hope that the economy has bottomed out in mid-2015 and that the output level will stabilise in the second half of the year amid domestic and regional risks which remain material. We downgrade our Ukraine GDP growth forecast to -11.5 per cent in 2015 and to 2 per cent in 2016.
- Growth in **Georgia** is expected to decline to 2.5 per cent in 2015 from 4.8 per cent in 2014, reflecting mainly a deteriorating external environment, with remittances and exports negatively affected by recession in Russia and a sharp slowdown in regional trading partners. Domestic political uncertainty is also weighing on consumer and business confidence and growth. The lari has depreciated significantly by more than 20 per cent since the start of the year, due to the deteriorating external

environment as well as domestic political uncertainty, which is contributing to erosion of trust in the local currency. Given the significant dollarization in the economy, depreciation of currency can be expected to lead to an increase in NPLs. In 2016, growth is expected to remain subdued at 2.6 per cent, affected by the negative external environment and a likely further increase in NPLs, as the effects of the slide of lari in 2014-15 and downturn in economy begin to crystalize.

Russia

Economic growth in Russia slowed significantly due to both structural and cyclical factors. GDP declined by 2.2 per cent (year-on-year) in the first quarter of 2015 and by 4.6 per cent (year-on-year) in the second quarter, as sanctions restrict access to foreign financing and declining oil prices weighed on economic activity. Household demand contracted sharply, as inflation has been cutting into real incomes. Although capital outflows moderated in the first half of 2015, the deleveraging may surpass US\$ 100 billion (8.5 per cent of GDP) in 2015 as banks and corporates remain unable to roll over maturing debts.

In the third quarter of 2015, lower oil prices and exchange rate depreciation continued to weigh on domestic demand. Retail sales declined by 10.4 per cent in September 2015 compared to August 2014, while real wages were down by 9.7 per cent.

Despite a large depreciation of the real exchange rate, import substitution has been limited to a few industries, mostly to those affected by the food import ban. High growth volatility, uncertainty over future growth prospects, as well as the increased cost of domestic borrowing and restricted access to external funding, are discouraging investments, while inventories have also continued to decline.

The scope for fiscal support to the economy is limited, as the government has been facing financing constraints in the domestic market and foreign markets remain closed. The consolidated fiscal deficit is expected to increase to 5.7 per cent of GDP in 2015, from 1.2 per cent in 2014, reflecting declining revenues due to lower oil prices and weaker economic activity as well as increasing expenditures, most notably defence and social spending. Pressures on regional budgets have also increased, as regional governments find it increasingly difficult to finance commitments given lower revenues and high interest rates.

Monetary policy has to balance the twin objectives of disinflation and economic growth. As inflationary pressures subsided after the large exchange rate shocks last year, the Central Bank of Russia (CBR) cut the policy rate by a cumulative 600 basis points this year, from 17 to 11 per cent. However, the utility price increase in July 2015 and the depreciation in August resulted in inflation accelerating again to 15.8 per cent in August. This has halted the easing cycle.

The rouble has remained volatile, on the back of oil price and geopolitical developments. In the first half of 2015 the lower intensity of the geopolitical crisis, together with some recovery in the oil price, helped the rouble to strengthen, allowing the CBR to replenish its reserves by US 10 billion. As oil prices declined further and the rouble weakened, reserve accumulation has stopped.

We are revising our growth forecast for 2015 from -4.5 to -4.2 per cent, with sharply falling imports limiting the decline in GDP. Next year's growth is likely to stay negative at -1.2 per cent, as oil prices may remain subdued, the geopolitical crisis may not be resolved soon and structural reforms may progress slowly. In addition, limited any short-term effects of supportive fiscal and monetary policies could be offset by supply-side constraints due to low

investment and outdated production capacities. The long-term growth rate – without significant supply-side reforms – may stay low, at around 1 to 2 per cent.

Central Asia

Growth and financial stability in Central Asia in 2015 have been significantly affected by the recession and currency depreciation in Russia and lower prices of oil and other commodities. At the same time, FDI and financial support from China and Russia, and to a lesser extent Western investors and IFIs, are increasingly contributing to growth and financial stability in the region. Growth in Kazakhstan, the largest economy in the region, is sharply lower, due to the collapse of the oil price, and to a much lesser extent, the negative effect of an influx of cheap imports from Russia on domestic industries and spillovers of negative investment sentiment from the Russia/Ukraine crisis. Tajikistan, the Kyrgyz Republic and, to a lesser extent, Uzbekistan, have been hit by sharply declining remittances from Russia, with growth supported by FDI and financial assistance from China and Russia. Growth in Mongolia remains subdued due to sharply lower FDI and weak commodity prices, and, to a lesser extent, a slowdown in China. The currencies across Central Asia have weakened significantly, with double-digit depreciation in all countries during the course of 2015. Kazakhstan has switched from a peg to the US dollar to a flexible exchange rate regime with inflation targeting. Central banks have supported currencies through foreign exchange market interventions (at times, very significant ones), tighter monetary policies and, in some cases, administrative measures. The growth in the region is expected to remain subdued in 2016, compared to recently observed growth levels, due to low oil and other commodity prices and continued recession in Russia, and to a lesser extent due to slower growth in China.

- In **Kazakhstan** GDP growth is projected to slow to 1.2 per cent in 2015, compared with 4.3 per cent in 2014, reflecting the plunge in oil prices, recession in Russia, depreciation of the rouble – which, particularly in the late 2014 and H1 2015, resulted in an influx of cheap imports from Russia, putting pressure on domestic industries and weaker exports – and weakening investor sentiment as a result of the Russia/Ukraine crisis. The slump in oil prices is significantly affecting profitability of the extractive sector and government revenues, which in 2015 is expected to lead to a budget deficit of around 3 per cent of GDP, with the government relying significantly on funding from the Wealth Fund and the National Pension Fund. The government has reacted with an acceleration of reforms and fiscal stimulus, which is providing a boost to growth. On August 20th, Kazakhstan switched from an exchange rate regime of a peg to the USD to a floating exchange rate regime with inflation targeting. The switch was expected but the timing was brought forward considerably, reflecting the government's and National Bank of Kazakhstan's view of an expected further decline in oil prices. By mid-October, the tenge had depreciated by more than 30 per cent against the US dollar. In the short run the depreciation is having a significant effect on some sectors and consumers, but overall its impact on growth is neutral. The difficult external environment and increasing pressures domestically will continue to affecting Kazakhstan in 2016, with growth expected to remain subdued and reach only 1.5 per cent. Inflation is expected to average 6.8 per cent in 2015.

- GDP growth in the **Kyrgyz Republic** jumped in the first half of 2015 to 7.3 per cent, around double the 3.6 per cent rate recorded in 2014. The increase in growth came despite the significant downward pressure coming from sharply lower remittances from Russia and the more difficult export environment due to recession in Russia, depreciation of the Russian rouble and sharply slower growth in Kazakhstan. The increase was mainly driven by robust performance in gold production and the base effect from back-loaded production in the previous year. It was also supported by investment and financial assistance provided by Russia as part of the accession to the EEU. Sharply lower oil prices are also providing a boost to consumption and growth, since the country is a significant net oil/petroleum importer. GDP growth for the full year is expected to reach 5.0 per cent. The som has depreciated significantly in 2014 and 2015, notwithstanding the National Bank's heavy interventions and gradual tightening of monetary policy; however, international reserves have declined to US\$ 1.8 billion as of end-September 2015, covering around three months of imports. Inflation is expected to remain elevated at around 8.5 per cent in 2015 reflecting the exchange rate pass through. In 2016, growth is expected to decline to 3.9 per cent, reflecting the continued challenging external environment. Macro vulnerabilities, including from increasing NPLs, and fiscal and social pressures can be expected to increase, reflecting the legacy from lower remittances and returning migrants in 2015 and softer exports to Russia and Kazakhstan. The investment and financial assistance provided by Russia can be expected to remain an important factor affecting growth.
- Growth in **Mongolia** slowed from double-digit levels in 2011-13 to 7.8 per cent in 2014 and is projected to decelerate to 3.3 per cent in 2015, as a result of lower FDI in the mining sector (due to the delays in several large mining projects, including the second phase of the Oyu Tolgoy (OT) project), lower commodity prices and weaker demand for commodities from China. Domestically, a slow-down in the real estate sector is also contributing to more subdued growth. The tugrik has depreciated significantly in 2014 and 2015, notwithstanding significant interventions of the National Bank in the foreign exchange market and gradually tightening monetary policy. Inflation is expected to remain relatively high, at around 8.2 per cent. The likely re-starting of the second phase of OT in late-2015, with significant investment expected in 2016 (and thereafter), can be expected to push up growth to a projected 5 per cent in 2016. The potential loosening of fiscal policy in 2016 in the wake of parliamentary elections that will take place in June 2016 could give a further short-term boost to growth.
- In **Tajikistan**, GDP growth is expected to decline to 5 per cent in 2015, compared with 6.7 per cent in 2014, reflecting a sharp contraction in remittances from Russia as well as the return of many migrants. The negative effects of lower remittances are being mitigated by increased investment from China and, to a lesser extent, investment from other countries. The somoni has depreciated significantly in 2014 and 2015, contributing to a rise in NPLs, given the very high level of dollarization in the country. The Central Bank's interventions in the foreign exchange market, as

well as administrative measures, have helped to limit depreciation, but that has come at the expense of losing a significant part of international reserves, which now stand at a very low level. Overall, the reduction in remittances, returning migrants and overall weakness of the economy heighten social security risks in the country. Inflation is expected to reach 6.4 per cent in 2015. Notwithstanding the fact that remittance flows from Russia might stabilise in 2016, the legacy of sharply lower remittances and returning migrants in 2015 as well as increasing NPLs can be expected to continue to weigh down on growth. GDP growth in 2016 is projected at 4.5 per cent, supported by expected strong FDI from China.

- In **Turkmenistan**, officially recorded GDP growth is expected to decline to 8.5 per cent in 2015 from 10.3 per cent in 2014, reflecting lower oil and gas prices and an economic slowdown of the trading partners in the region. Turkmenistan has increased gas exports to China, mitigating the negative effect of Russia's Gazprom decision, announced in the beginning of 2015, to cut gas imports from Turkmenistan. The Manat was devalued by 19 per cent at the beginning of 2015, which is helping to improve competitiveness, whilst also pushing up inflation to 6.9 per cent in 2015. In 2016, growth can be expected to remain at 8.5 per cent, supported by FDI both in the extractive and non-extractive sectors, as well as continued domestic investment into such sectors are real estate. Plans related to the Turkmenistan-Afghanistan-Pakistan-India pipeline are being finalised, with the work on the Turkmen part of the pipeline expected to start in late-2015 or early-2016, resulting in increased investment. Expected low oil and gas prices will continue put pressure on Turkmenistan's fiscal balance and growth.
- **Uzbekistan's** GDP growth is expected to decline to 7.5 per cent in 2015, compared with 8.1 per cent in 2014, reflecting a sharp drop in remittances from Russia and slowdown of economies of some of the main trading partners. The som has depreciated significantly over 2014 and 2015. Inflation is expected to reach 8.8 per cent in 2015, up from 8.4 per cent in 2014. In 2016, growth can be expected to reach 7.2 per cent, as external factors continue to weigh on remittances and trade. Macroeconomic vulnerabilities from the prolonged challenging external environment are increasing.

Southern and Eastern Mediterranean (SEMED)

The forecast for the SEMED region's growth in 2015 remains unchanged from May at 4 per cent, with upgrades in Egypt and Morocco (reflecting a strong investment rebound and better-than-expected agricultural growth, respectively) offsetting downgrades in Tunisia and Jordan (due to deteriorating domestic and regional security conditions, respectively). However, the region's growth is now expected to remain at 4 per cent in 2016, largely owing to the more challenging regional environment. Risks to the outlook are skewed to the downside and relate to further worsening of regional turmoil, reform implementation delays and slower-than expected growth in the Eurozone.

- Growth in **Egypt** accelerated to 5.5 per cent in the first half of the fiscal year 2014/15 – up from 1.2 per cent a year earlier. Private consumption remains resilient and the rebound in investment since the beginning of 2014 has been maintained, aided by significant policy reforms and a more stable political situation. However, net exports continue to drag on growth, reflecting structural problems in Egypt's energy sector and eroding competitiveness. Poor export performance, along with falling net official transfers, have led to a widening of the current account deficit. This has put pressure on international reserves, which were barely sufficient to cover three months of imports as of October 2015. Importers are increasingly affected by foreign exchange shortages as a result of measures to clamp down on the parallel market for foreign exchange. Growth is expected at 4.2 per cent in FY2014/15, rising slightly to 4.3 per cent in FY2015/16.
- Regional instability is adversely affecting **Jordan's** economic performance, with growth dropping from 3.1 per cent in 2014 to 2.2 per cent in the first half of 2015. The worsening turmoil in neighbouring Syria and Iraq has weighed on goods exports (Syria and Iraq together account for around 20 per cent of Jordan's export markets, and other important export destinations rely on transit routes through these countries) and tourism. Exports contracted by over 8 per cent on the year in the first half of 2015, and tourist arrivals were down by over 13 per cent over the same period. Moreover, the number of Syrian refugees hosted in Jordan has risen to an estimated 1.5 million – accounting for over 15 per cent of the population. This influx has strained labour markets, government finances and public infrastructure and services. The deteriorating regional situation is expected to continue to weigh on the Jordanian economy and the growth forecast for 2015 has been downgraded from 3.6 per cent in May to 2.8 per cent. Growth is expected to improve moderately to 3.5 per cent in 2016, with risks skewed to the downside. Nevertheless, low global energy prices should continue to benefit Jordan given its high energy import dependency.
- Annual growth in **Morocco** picked up to 4.2 per cent in the first half of 2015, though this was primarily driven by a rebound in agricultural output. While growth in the agricultural sector reached 13.5 per cent over the period, non-agricultural growth was disappointingly sluggish overall at just 1.8 per cent on the year, with a mixed

sectoral performance. On the positive side, Morocco's export performance in high-value added sectors has been strong, with automobile exports rising by 12 per cent in the first half of 2015. On the other hand, output in the hotel and restaurant sector contracted by 2 per cent on the year over the same period as the tourism sector struggled amidst regional security problems. Nevertheless, the strong agricultural performance is expected to boost overall growth to 4.9 per cent in 2015. Growth is expected to slow to 3.8 per cent in 2016 as agricultural output normalises, with a modest pickup of non-agricultural activity, aided by low oil prices and a recovery in Europe.

- **Tunisia's** economic performance has deteriorated markedly, with the country entering a technical recession in the first half of 2015. Terrorist attacks in March and June have hit the tourism sector hard, with year-to-date tourist arrivals plummeting by over 20 per cent as of the end of June relative to one year previously. As a result, output in the tourism and transport sectors contracted in the first half of the year. In addition, mining, phosphate and energy production fell over the same period as labour strikes in these sectors continued. As a result, year-on-year growth slowed to just 1.2 per cent in the first half of the year (down from 2.3 per cent in 2014) and the unemployment rate in the second quarter rose to 15.2 per cent. Meanwhile, the financial sector remains fragile with limited reform progress on bank recapitalisation but significant delays on dealing with toxic assets. As a result, the flow of credit to business remains restricted. The growth forecasts for 2015 and 2016 have been downgraded to 1 per cent and 3 per cent, respectively, from 2.8 per cent and 3.6 per cent in May.

About this report

This report is prepared by the Office of the Chief Economist and Vice-Presidency for Policy and Partnerships.

It is provided as a companion to the EBRD's growth forecasts for its countries of operations, which are released three times a year.

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 2015-16*, which are all available on the EBRD's website (www.ebrd.com).

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