Regional Economic Prospects in

EBRD Countries of Operations: September 2014[1]

EBRD Office of the Chief Economist

Overview

In the Heavy Shadow of the Ukraine/Russia Crisis

Since our forecast in May 2014, the Ukraine/Russia crisis has intensified and new rounds of economic sanctions on Russia have been introduced in July and September. Several countries in southern-eastern Europe were hit by floods in early summer. And the recovery in the Eurozone, benefitting countries with close economic ties to it, remains fragile.

As a net result of these developments, the growth outlook in the transition region has weakened further, though with significant country variations. Growth prospects are gradually improving in Central Europe and Turkey, remain relatively strong in parts of Central Asia, but are weakening in several other sub-regions. Russia's growth is expected to come to a standstill, after a slightly better than expected, though still weak, first half of the year, as new economic sanctions are impacting the already weak economy. In response, Russia has introduced counter-sanctions, targeting food imports from sanctioning countries, which include several EBRD countries of operations. Though their impact on exports and growth of these countries is expected to be limited, the overall uncertainty may start weighing on business confidence in Europe.

Our central scenario is that growth in the transition region will slow to 1.3 per cent in 2014 from 2.3 per cent in 2013, and will thus be slightly weaker than forecast in May. A modest pickup to 1.7 per cent is expected in 2015, also less than in our May forecast, though the volatile security situation in Ukraine makes the forecast exceptionally uncertain. And permanently higher military spending in the transition region over the medium term, in response to the renewed geopolitical risks, could erode the peace dividend from the dissolution of the Soviet Union.

Regional overview

Since our May forecast, the Russia/Ukraine crisis has intensified. In May 2014 Ukraine elected a new President and subsequently formed a new government, continuing broadly the course of economic reforms supported by the IMF Stand-by Arrangement. Yet, fighting in the East of the country has not stopped completely despite a ceasefire, military expenditure has risen and the death toll has mounted.

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[1] This document is provided as a companion to the EBRD's growth forecasts for its countries of operations, which are released four times a year. For more comprehensive coverage of economic policies and structural changes, the reader is referred to country strategies and updates and statistical series on economic and structural reform variables, as well as the EBRD's Transition Report 2013, which are all available on the EBRD's website (www.ebrd.com).

Sanctions have escalated. In July 2014, Russia was subjected to additional set of sanctions beyond those imposed in March-April 2014 (Box 1). In response, Russia introduced a one-year ban on imports of selected foods from sanctioning countries (the EU, US and several others). In mid-September, the EU introduced further sanctions, targeting directly, for the first time, the financing of the state-owned oil sector, which is at the core of the Russian economy. Similarly, the US strengthened its sanctions, including towards state-owned financial institutions and oil companies.

This crisis has continued to weigh on the economies of Ukraine and Russia. The Western sanctions, combined with uncertainty about their possible escalation in the future, have negatively affected business confidence in Russia, constrained the ability of corporates and banks to access international debt markets, and contributed to capital flight. Capital outflows from Russia continued in the second quarter of 2014, although at a significantly slower pace than in the first quarter. Cumulative net private capital outflow reached US$ 75 billion in the first six months of the year. As of early September, Ukraine and Russia have not reached a deal on future gas supplies. Gas imports from Russia have been suspended since June. Ukraine would face formidable difficulties without Russian gas supplies as the winter season nears. So far the transit flow of gas to Europe has not been affected.

Recovery in the Eurozone remains fragile. Growth in the Eurozone as a whole was modest in the first quarter of 2014 and stalled in the second quarter. The European Central Bank (ECB) further eased monetary policy in early September, in view of the risk to the growth momentum including from geopolitical risks, while inflation expectations remained low.

At the same time, investment growth turned positive in the Eurozone for the first time in three years as southern economies saw the return of investment inflows. Globally, the VIX (a measure of stock market volatility) has remained low, though market volatility has started to edge up on the back of developments in Iraq and Russia/Ukraine, and overall concerns about the divergence of global monetary policy cycles.

Recovery in the Eurozone, albeit hesitant, did support stronger growth in Central Europe and the Baltics (CEB). Hungary and Poland, in particular, recorded strong growth in the first half of 2014. Hungary's growth was driven in part by exports and in part by a number of government-sponsored temporary measures such as public expenditure through EU grants and de facto transfers to households in the form of administrative price cuts and mortgage debt relief. Poland has seen a more balanced and private sector-led growth. Growth was respectable in many other economies closely integrated with the Eurozone, with the notable exception of Estonia, where output contracted (in year-on-year terms) due to weaker exports to key markets (Finland, Russia and Sweden) and lower transhipments of goods from and to Russia through the country’s ports.

In south-eastern Europe (SEE), developments have been mixed. The region also benefited from recovering demand in the Eurozone. At the same time, Bosnia and Herzegovina and Serbia have been hit hard by floods in May 2014, with a negative effect on growth this year. Bulgaria’s recent banking sector stress, which has led to the liquidation of a major locally owned bank, may have impacted market confidence, though the longer-term impact is likely to be contained, thanks to the authorities’ rapid response. The latter included Bulgaria's announcement of its intention to opt into the Single Supervisory Mechanism (SSM) under Europe's banking union project. Acceptance is not automatic but, if implemented, this would put the European Central Bank (ECB) in charge of supervision of the key banks in the country in the future. In **Cyprus** – a new country of operations for the EBRD – the crisis-hit economy continued contracting in the first half of 2014, albeit at a slower pace, thanks to a gradually improving external environment and rigorous implementation of the authorities' adjustment programme, supported by the Troika.

Growth in the Eastern Europe and the Caucasus (EEC) region accelerated towards the end-2013, but has weakened considerably in 2014 so far, for a number of country-specific reasons as well as the impact of the Ukraine/Russia crisis. At the same time, in Belarus growth picked up to 1.6 per cent year-on-year in the first seven months of 2014 owing to the recovery of potash exports and a strong performance of agriculture. In June 2014, Moldova, Georgia and Ukraine signed Association Agreements with the EU, including Deep and Comprehensive Free Trade Agreements (AA/DCFTA), which should help increase exports and improve the business environment over the medium term, though in the short term may bring volatility to trade with Russia.

Growth remained quite strong in Central Asia, supported by a number of large extractive industry projects. At the same time, growth slowed down somewhat in lower-income countries dependent on remittances from Russia, and in Kazakhstan, the region's largest economy, where the impact of oil project delays was compounded by the Russia/Ukraine crisis.

Growth in Turkey slowed to 2.1 per cent year-on-year in the second quarter from a revised 4.7 per cent in the first quarter of 2014. The slowdown was driven by domestic demand, and reflected tighter monetary and international borrowing conditions from early 2014. Exports did however cushion a further slowdown, contributing over half of output expansion. Since April 2014, the Central Bank has cut interest rates by 1.75 percentage points, although inflation remained well above the central bank's target of 5 per cent, limiting the scope for stronger accommodative policies. Political uncertainty has largely subsided, with former Prime Minister Erdogan taking over as President at the end of August.

Recovery in the South and Eastern Mediterranean (SEMED) has remained slow. In Egypt, Tunisia and Morocco economic performance was weaker than expected in the first quarter of 2014, due to contracting exports in Egypt and Tunisia, and reduced agricultural activities in Morocco. In Egypt, exports declined as petroleum products exports were cut to make up for domestic energy shortages. In Tunisia, continued labour strikes in the mining and manufacturing sectors started to weigh on economic activity more generally.

Remittances

Remittances from Russia to Central Asia and EEC contracted in the first quarter of 2014 (in year-on-year terms), for the first time since 2009 (Chart 2), primarily due to the slowdown in Russia. Uzbekistan and Moldova have been affected the most, while remittances to Armenia slowed down significantly. The reduction in the US dollar volumes of remittances has been partly offset by the rising purchasing power of remitted dollars following weakening of the currencies in several recipient countries. A further drop in remittances from Russia may significantly dampen consumer demand in lower-income countries in the region.

In addition, countries in EEC and Central Asia are exposed to a slowdown in Russia through trade, investment, and remittance channels, as discussed in the May 2014 issue of *Regional Economic Prospects*. The overall exposure through various channels is summarized in a composite exposure index developed and presented here in Chart 3. The chart shows that Belarus, Armenia and Tajikistan (the latter predominantly through remittance flows) have the highest overall economic exposure to Russia. Such exposures are also significant for the Kyrgyz Republic, Moldova and Ukraine.

Capital flows and currency movements

Private capital flows to the transition region remained modest. Capital inflows into Turkey weakened in the first quarter, but picked up in the second as domestic political uncertainty moderated and investors diverted some funds from Russia to Turkey and some other large emerging markets. Mongolia saw a continued drop in inward foreign direct investment, the key source of financing of its large current account deficit in recent years, reflecting lowering investor confidence. As noted, net private capital outflows from Russia continued in the second quarter, albeit at a slower pace; anecdotal evidence points to some repatriation of funds as a reaction to Western sanctions. The volume of syndicated lending in the EBRD region contracted by 58 per cent year-on-year in the first half of 2014, driven by lower volumes in Russia and Turkey, in sharp contrast to globally increasing syndicated lending during the same period (by 7 percent).

Pressures on the region's currencies have moderated. While a number of currencies, including the Russian rouble, the Ukrainian hryvnia, the Kazakh tenge and the Kyrgyz som experienced sizable depreciations against the US dollar in the first quarter of the year, regional currencies have been broadly stable in recent months, with partial reversals of the earlier depreciations. At the same time, the Ukrainian hryvnia and the Mongolian togrog experienced continued downward pressures.

Faced with pressures on international reserves and the currency, in early-September the National Bank of Ukraine intensified restrictions on foreign currency transactions, including the 100 per cent surrender requirement for foreign exchange inflows from abroad and limits on daily purchases of foreign currency.

Credit conditions

Credit growth remains constrained by continued cross-border deleveraging and persistently high levels of non-performing loans (NPLs).

- **Foreign banks continued reducing their exposure to the CEB and SEE regions, albeit at a moderate pace**. The scale of reductions continued to vary among countries, with Slovenia, Latvia and Croatia experiencing the largest reductions in the first quarter of 2014. Since the third quarter of 2008 (the beginning of the global financial crisis), the CEB and SEE regions have lost cross-border funding of a total of US$184 billion, equivalent to 10.6 per cent of 2013 regional GDP.

- **Non-performing loans have remained high for a long time in many countries**. NPL ratios are close to or above 20 per cent in Ukraine and most SEE countries, and between 30 and 50 per cent in Kazakhstan and Cyprus (Chart 4). In Ukraine NPL ratios may rise further significantly, adding to the recapitalisation needs of affected banks.
- **Overall credit growth remained subdued outside Turkey and the CIS countries** and Slovenia, in particular, is experiencing large contractions in corporate credit.

Inflation

Inflation rates remained low in most countries, in line with global trends. In several countries consumer prices declined over the preceding 12-month period (Chart 5). In countries with high private sector debt levels, such as Hungary, deflation can lead to weaknesses in spending as the real value of debt rises. At the same time, inflation remains high in Belarus, Egypt, Mongolia, Russia, Turkey as well as in Ukraine, fuelled in part by higher prices of imports following currency depreciations.

Outlook

In our baseline scenario, growth in the transition region is expected to slow down significantly from 2.3 per cent in 2013 to 1.3 per cent in 2014, a downward revision compared with the May 2014 projection, as better growth prospects in Central Europe and Turkey are being offset by lower growth elsewhere. Growth is then expected to pick up moderately, to 1.7 per cent in 2015, also below our May projection (Table 1). This would mark the fourth consecutive year of regional growth below 3 per cent.

- **Ukraine's** economy is expected to continue undergoing the necessary adjustments with the support of an IMF programme, complemented by assistance from multilateral and bilateral donors and international financial institutions. However, the escalation of military turbulence in eastern Ukraine is weighing heavily on the economy and its external financing needs. In addition to disruptions in production and trade, there has been a partial military mobilisation. Output contraction is expected to be severe at around 9 per cent in 2014 though less so in 2015, as growth may resume in late 2015.

- **In Russia**, investor confidence and economic activity are likely to remain weak, reflecting the effect of EU/US sanctions and Russian counter-sanctions on an already feeble economy. We expect growth to be flat in 2014 and a mild recession in 2015. These forecasts assume fiscal and quasi-fiscal expenditures to give some limited boost to the economy and a contribution from investments related to the planned expansion of oil and gas export capacity. Stubbornly high inflation (temporarily also accelerated by the aforementioned ban on food imports) and supply-side constraints in a low-investment environment will continue to constrain the long-term effects of any major fiscal or monetary policy response.

- Recovery in the **CEB** and **SEE** regions will continue at a moderate pace, with some acceleration in certain cases. A lift from the Eurozone economy - particularly if quantitative easing in the single currency zone proves effective - will be only partially offset by the weaker demand from Russia and the impact of the ban on food exports to Russia. Banned food exports amount to up to 0.4 per cent of GDP in CEB countries (Chart 6), with the exception of Lithuania, where they reach 2.7 per cent of GDP, but mostly represent re-exports of food from elsewhere. Some of these exports can be expected to be redirected to other markets. However, permanently higher military spending over the medium term in response to increased geopolitical risks behind the eastern borders could erode the piece dividend from the dissolution of the Soviet Union. Conditions in **Cyprus** are gradually improving but output is still expected to fall further this year with a bottoming out in 2015.

- Growth in the **EEC** region (excluding Ukraine) and **Central Asia** is expected to decelerate on account of the region's strong economic ties with Russia, as well as a number of country-specific factors. Countries that rely heavily on Russian remittances are in particular at risk of a sharper economic slowdown should deceleration in Russia deepen.
- **Turkey's** economy is expected to grow at the rate of 3.0 per cent in 2014 as the impetus from the lower cost of finance may be partly offset by weaker export performance in light of tensions in Iraq.
- The forecast for the **SEMED** region has been revised down following the weaker-than-expected performance in the first months of the year reflecting sluggish exports. SEMED countries have taken steps to reduce price subsidies and bring prices closer to cost recovery levels in the energy and utilities sectors, which should help fiscal sustainability over the medium term.

The projections assume a challenging but slowly improving external environment (outside Ukraine/Russia). The positive effects of the recovery in the United States and in the Eurozone, though still fragile, will be partly offset by a slower and more volatile growth in emerging markets, including China, where property markets have shown signs of cooling. In addition, cross-border bank deleveraging pressures in the region may again intensify should the Eurozone-wide stress tests reveal significant recapitalisation needs of major banking groups operating in the CEB and SEE countries.

Risks to the outlook

The forecasts are subject to an exceptional degree of uncertainty and downside risks to the economic outlook are high.

- The single most important source of risk remains the further escalation of the crisis in Ukraine/Russia with a direct negative impact on the two countries and significant spill-over effects for the region as a whole, as discussed in the May 2014 issue of *Regional Economic Prospects*. Such a scenario would have far-reaching implications for investor confidence in the region, trade, flows of remittances from Russia to lower-income countries in EEC and Central Asia, and possibly energy and food security in the region.

- An additional risk is an oil price shock from further escalation of the security crisis in Iraq.

- Finally, there is a small but rising risk from monetary policy in both already expanding advanced economies as well as the Eurozone, where growth is nascent. In advanced countries where growth has become self-sustained, protracted monetary easing (or too gradual tapering), could lead to abrupt corrections in both interest rates as well as the current record high level of asset prices. At the same time, the case for quantitative easing (QE) has become compelling to support the still fragile recovery in the Eurozone, to which much of the CEB and SEE regions are strongly linked. An effective Eurozone QE may help lessen the risk of setbacks in the recovery of those regions.

If military spending over the medium term permanently rises as a result of the renewed geopolitical risks, the peace dividend from the dissolution of the Soviet Union is at risk of being eroded.

Box 1. How will Western sanctions and Russian counteractions affect Russia?

Western countries (EU, USA, Norway, Japan, Canada, Australia, and Switzerland) have been implementing sanctions against Russia since March 2014. The September round of EU sanctions is particularly strong as they now target the oil sector (in the case of the latest US sanctions, Gazprom is also included), the core of the Russian economy. Sectoral sanctions in July aimed at state-owned banks that can fund themselves through deposits and liquidity provided by the central bank as well.

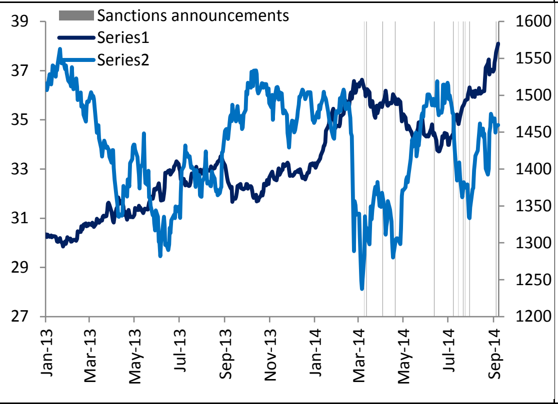
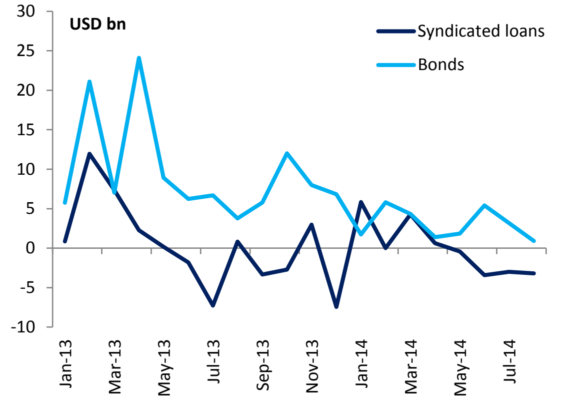
Sectoral sanctions in general have a greater economic effect than previous ones on certain individuals. Financial sanctions against the oil sector are even more effective as a quarter of budgetary revenues and a half of exports are oil-related. The introduction of EU sanctions is not immediate and can be reversed if “clear evidence” is found that Russia is helping a political solution in the Russia-Ukraine crisis.

Russia retaliated to Western sanctions in July by introducing a one-year ban on import of most food items from sanctioning countries from August and it contemplates closing its airspace for Western transcontinental flights and also with a selective ban on Western (used) car and clothing imports. The potential flight ban may cost Aeroflot in lost royalties for the overflights and Western airlines due to longer routes some hundred million dollars.

Both Russian and Western sanctions are expected to weigh on Russian growth. As major Russian corporates need to make repayments of around US$ 190 billion on foreign debt by end-2015 and they may not be able to borrow externally, international reserves - at US$ 465 billion in September - may become under pressure and domestic interest rates will go further up. Sanctions weaken business confidence leading to a reduction in private investment. Meanwhile households’ precautionary savings will increase, dampening consumption. External trade may also suffer as it takes time to restructure existing trade and financial links. These are likely to be gradually reoriented from the West to the East and Latin America.

Russia's ban on food imports from sanctioning countries may drive inflation up by 1-2 percentage points as items covered by sanctions constitute about 60 per cent of food basket and 20 per cent of consumer basket, and their prices are expected to rise between by 5-10 per cent (taking into account also any increased supply of domestic or imported substitutes).

The potential ban on transcontinental flights may cost Aeroflot an annual USD 300 million in revenues while European airlines may have to face cost increases of several hundred million dollars.

Financial markets	**Net monthly syndicated lending and bond issuance, Russian borrowers**
	
Source: Bloomberg	Source: Bloomberg

Timeline of major sanctions and countersanctions

Date	*Sanctions introduced*
17 March	**USA**: Ban on travel and transactions, asset freeze for 11 Russian and Ukrainian politicians
Further in March	**EU**: Ban on travel and transactions, asset freeze for 21 Russian and Ukrainian politicians **G7**: Russia's G8 membership suspended **USA**: Ban on travel and transactions, asset freeze for 19 Russian politicians and businessmen, US dollar transactions ban with Bank Rossiya
April	**USA**: Ban on travel and transactions, asset freeze for 18 Russian politicians, US dollar transactions ban with Chernomorneftegaz and 15 other companies
June	**USA**: Ban on travel and transactions, asset freeze for 7 Russian politicians and Ukrainian separatists
July	**USA**: Ban on travel and transactions, asset freeze for 5 Russian politicians and Ukrainian separatists and 2 entities, US dollar transactions ban with 6 military, oil, and Crimea-based companies; new equity or debt transactions over 90 days for Bank of Moscow, Gazprombank, Russian Agricultural Bank, VEB, VTB, Novatek and Rosneft, prohibited **EU**: Ban on travel and transactions, asset freeze for 23 Russian politicians, Ukrainian separatists, 9 political and military entities, 9 Crimean enterprises, and 3 Russian enterprises; new equity or debt securities transactions over 90 days for Gazprombank, Rosselhozbank, Sberbank, VEB and VTB prohibited
1 August	**EU**: Embargo on military and dual-use equipment trade **Russia:** One-year ban on imports of a wide range of food products from Canada, Australia, EU, Norway and USA
12 September	**EU:** Ban on travel and transactions, asset freeze for further persons involved in the Russia-Ukraine crisis; new equity or debt transactions over 30 days for Gazprombank, Rosselhozbank, Sberbank, VEB, VTB, Rosneft, Gazpromneft and Transneft prohibited (previously allowed syndicated lending banned and allowable maturity reduced, ban to oil companies extended); trade ban on dual-use technologies extended; provision of services for deep water oil exploration and production, arctic oil exploration and production or shale oil projects prohibited **USA**: New equity or debt transactions over 30 days for Bank of Moscow, Gazprombank, Russian Agricultural Bank, Sberbank, VEB and VTB; new debt transactions over 90 days with Gazprom, Gazprom Neft, Rosneft, Novatek, Transneft; new debt transactions over 30 days with Rostec; transactions in goods, services or technology for deepwater, Arctic offshore and shale projects with Gazprom, Gazprom Neft, Lukoil, Rosneft, Surgutneftegaz are prohibited

Table 1: Real GDP Growth

(In per cent; EBRD forecasts as of 16 Septembe

	Actual		Current forecast		EBRD Forecast in May 2014	
	2012	2013	2014	2015	2014	Change May-September
Central Europe and the Baltic states						
Croatia	-2.2	-0.9	-0.5	0.5	-0.5	0.0
Estonia	3.9	0.8	1.0	2.5	2.0	-1.0
Hungary	-1.7	1.1	2.8	2.2	1.6	1.2
Latvia	5.2	4.1	3.2	3.7	3.8	-0.6
Lithuania	3.7	3.3	3.0	3.4	3.0	0.0
Poland	1.9	1.6	3.0	3.3	2.8	0.2
Slovak Republic	1.8	0.9	2.3	3.0	2.0	0.3
Slovenia	-2.5	...	0.7	1.0	0.0	0.7
Average [1,2]	**1.2**	**1.3**	**2.5**	**2.8**	**2.2**	**0.3**
South-eastern Europe						
Albania	1.0	1.4	1.7	2.5	1.7	0.0
Bosnia and Herzegovina	-1.2	2.1	0.2	2.7	1.8	-1.6
Bulgaria	0.6	0.9	1.5	2.0	1.9	-0.4
Cyprus	-2.4	-5.4	-3.5	0.0	…	…
FYR Macedonia	-0.4	2.9	3.0	3.0	3.0	0.0
Kosovo	2.5	2.5	3.5	3.5	3.5	0.0
Montenegro	-2.6	3.5	3.0	2.5	3.0	0.0
Romania	0.7	3.5	2.6	2.8	2.6	0.0
Serbia	-1.5	2.5	-0.5	2.0	1.0	-1.5
Average (excl. Cyprus) [1]	**0.3**	**2.7**	**1.9**	**2.6**	**2.2**	**-0.3**
Eastern Europe and the Caucasus						
Armenia	7.1	3.5	3.0	3.5	3.0	0.0
Azerbaijan	2.3	5.8	3.0	3.0	3.5	-0.5
Belarus	1.7	0.9	0.7	0.5	0.0	0.7
Georgia	6.2	3.2	4.0	4.0	4.0	0.0
Moldova	-0.7	8.9	2.0	4.0	2.0	0.0
Ukraine	0.3	0.0	-9.0	-3.0	-7.0	-2.0
Average [1]	**1.4**	**1.8**	**-3.6**	**-0.5**	**-2.6**	**-1.0**
Turkey	2.1	4.0	3.0	3.2	2.5	0.5
Russia	3.4	1.3	0.0	-0.2	0.0	0.0
Central Asia						
Kazakhstan	5.0	6.0	5.0	5.1	5.0	0.0
Kyrgyz Republic	-0.9	10.5	4.5	4.8	4.5	0.0
Mongolia	12.4	11.7	5.0	5.5	12.5	-7.5
Tajikistan	7.5	7.4	4.4	4.4	4.4	0.0
Turkmenistan	11.1	10.2	10.0	10.0	10.0	0.0
Uzbekistan	8.2	8.0	7.5	7.6	7.5	0.0
Average [1]	**6.4**	**7.1**	**6.0**	**6.0**	**6.2**	**-0.2**
Southern and Eastern Mediterranean						
Egypt	2.2	2.1	2.2	3.2	2.5	-0.3
Jordan	2.7	2.8	3.4	4.1	3.4	0.0
Morocco	2.7	4.4	3.5	4.7	4.2	-0.7
Tunisia	3.7	2.3	2.9	4.2	3.4	-0.5
Average [1,3]	**2.5**	**2.7**	**2.6**	**3.7**	**3.0**	**-0.4**
Average EBRD region (incl. Cyprus) [1]	**2.6**	**2.3**	**1.3**	**1.7**	**1.4**	**-0.1**

[1] Weighted averages. The weights used for the growth rates are WEO estimates of nominal dollar-GDP for 2012.

[2] Weighted averages do not include the Czech Republic, for which EBRD no longer produces a forecast.

[3] As of January 2014, EBRD figures and forecasts for Egypt's real GDP reflect the fiscal year, which runs from July to June.

Chart 1. Market Volatility Index (VIX)

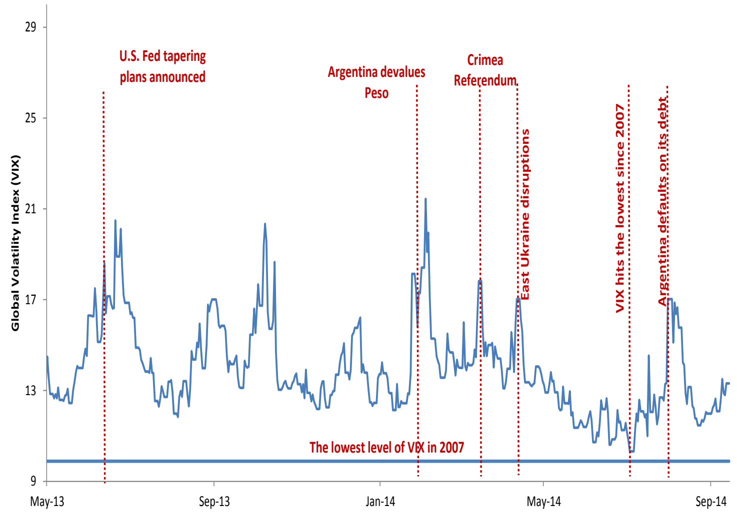


Chart 2: YoY growth of Russian cross-border remittances

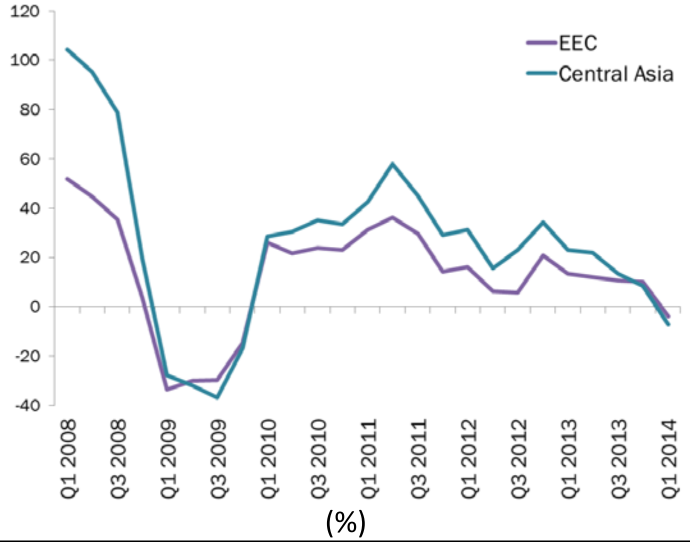


Chart 3. Exposure to Russia, (% of GDP)

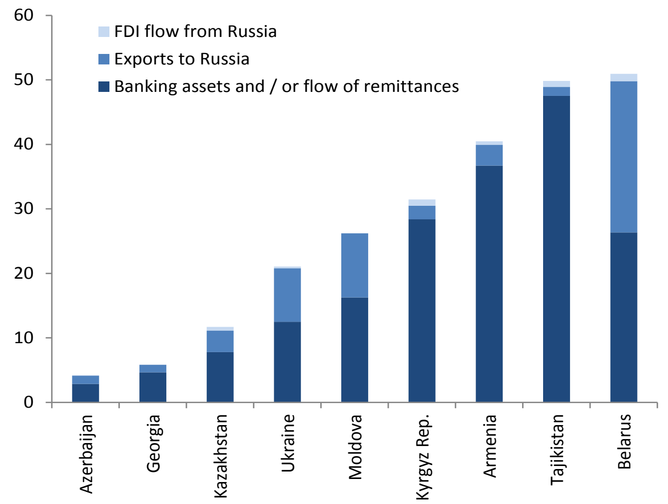


Chart 4. The latest NPLs, (%)

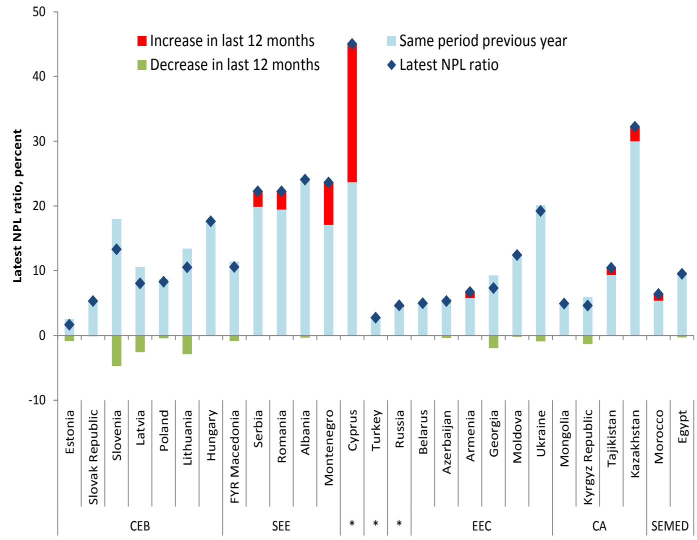


Chart 5. Inflation YoY, (%)

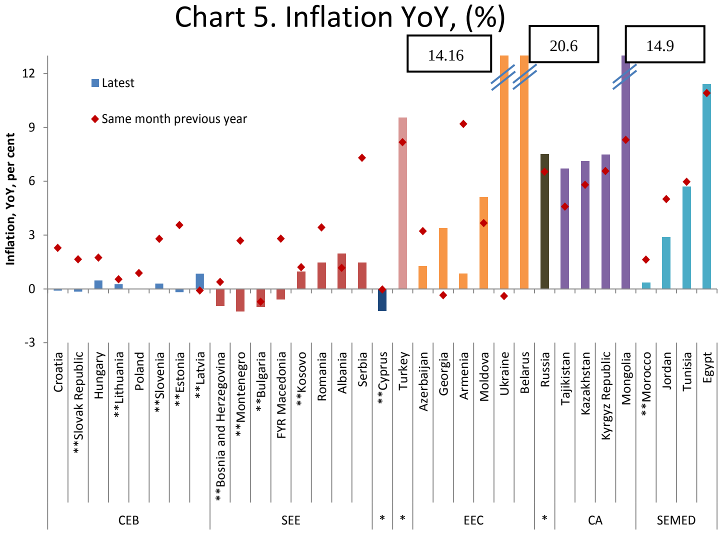
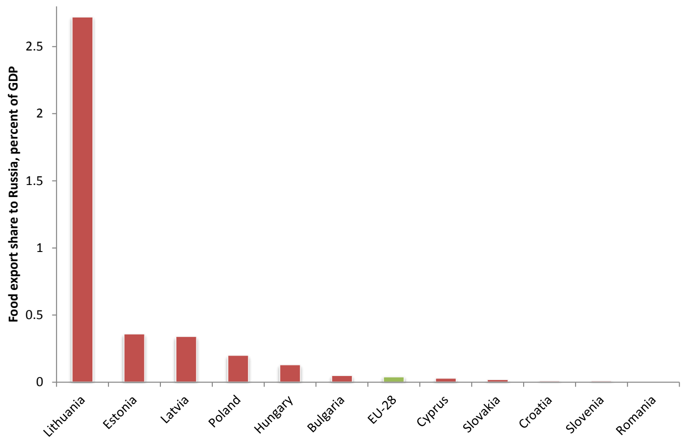


Chart 6. Food export shares to Russia (2013), (%)



Regional updates

Central Europe and the Baltic States (CEB)

Compared to the May forecast the growth outlook in the central Europe region has improved, with an average growth of 2.5 per cent expected this year and 2.8 per cent in 2015. This positive revision is largely attributed to the re-invigorated domestic demand, though the external environment may weigh on growth as the Russian ban on EU food imports will have an impact on CEB countries. The direct impact, through restricted trade with Russia, will be amplified by the indirect impact through the Eurozone where the deterioration in economic relations with Russia will weigh on business sentiment and growth.

Poland's growth in particular has been upgraded to 3.0 in 2014 and 3.3 per cent in the next year, as export sales soared amid strengthening industrial production in the first half of the year. The food ban will weigh somewhat on Polish growth, though food exports to Russia account for only 0.2 per cent of GDP. **Hungary**, where the effect from sanctions has been even more limited, saw the largest upgrade for 2014, due to good exports but also a number of temporary effects, including public infrastructure spending funded through EU grants and de facto transfers to households in the form of administrative price cuts and mortgage debt relief at the expense of banks. By contrast, the three **Baltic States** have been more directly impacted by the sanctions and the significant slowdown in Russia. In addition to agricultural firms with large export exposure to Russia, transport firms shipping goods between European countries and Russia may also be severely affected. Estonia's GDP showed a contraction in the first two quarters of this year, primarily explained by adverse trends in domestic services sectors. The **Slovak Republic** saw a strong recovery in household consumption. However, weakening export demand from Germany and a drop in exports to Russia and Ukraine (by 7 and 33 per cent, respectively in January-June) may be a drag on further growth this year.

In **Slovenia**, the restructuring of corporate sector that is necessary to sustain long-term growth has been somewhat slower than expected though it will hopefully accelerate once the new government is formed in September. The growth in 2014 is, however, revised up to 0.7 per cent from 0 per cent, following better than expected growth in the first and second quarters and robust export performance. With the exception of **Croatia**, where contraction continues and the forecast remains unchanged, the whole region is now seeing positive investment growth in annual terms, albeit predominantly in the public sector. This trend is expected to strengthen as countries have started utilising the EU structural funds made available under the new EU budget.

South-Eastern Europe (SEE)

Since our May 2014 forecasts, the outlook for growth in SEE in 2014 has changed negatively in several countries, leading the overall weighted average to drop to 1.9 per cent relative to 2.2 per cent in May. The main downward forecast revisions are in **Bosnia and Herzegovina** and **Serbia**, both of which suffered extensive flood-related damage in late-May that has badly affected vital sectors such as energy and agriculture. Growth in Bosnia is forecast at just 0.2 per cent, while Serbia is expected to be in recession (-0.5 per cent). We have also downgraded our forecast for **Bulgaria** from 1.9 to 1.5 per cent, due mainly to the negative impact of political uncertainty and recent turmoil in the banking sector. In contrast, for 2015 average growth in SEE is now expected to be 2.6 per cent, up from 2.4 per cent in May. We expect a modest reconstruction-related rebound in the Bosnian and Serbian economies in 2015, while prospects for **Albania**, **FYR Macedonia** and **Montenegro** also look better now than two months ago because of expected spillover effects from the progress in clearing arrears in Albania and improved prospects for major public infrastructure projects in FYR Macedonia and Montenegro.

The **Cyprus** economy remains in deep recession, but signs of confidence and optimism are becoming increasingly apparent. The output drop in 2013 of 5.4 per cent was less severe than expected and the seasonally adjusted quarter-on-quarter result for the second quarter of 2014 (-0.3 per cent) was also an improvement on previous quarters. Nevertheless, the economy faces severe problems, not least in the banking sector where most lending has dried up and non-performing loans are around a staggering 50 per cent of the total. For 2014 as a whole, we expect GDP to fall by 3.5 per cent, which is slightly better than the current Troika expectations (-4.2 per cent). There is more than usual uncertainty surrounding the 2015 forecast but we expect a bottoming out of the economy by then, with zero growth for the year.

Turkey

Amidst political uncertainty and rising geopolitical risks, the **Turkish** economy decelerated to 2.1 per cent year-on-year in the second quarter down from a revised 4.7 per cent in the first quarter of 2014. The slowdown was driven by domestic demand, and reflected tighter monetary and international borrowing conditions from early 2014. Nevertheless, exports remained an important driver of growth, contributing to more than half of output expansion in Q2. In addition, the rapid recovery in the country risk premium, driven by moderated domestic political uncertainty and international funds substituting away from Russia, prompted the central bank to cut the interest rate by 175 basis points to 8.25 per cent since May, which will somewhat contain the expected slowdown in domestic demand and help revive investment spending in the second half of the year. We thus revise our growth expectation slightly up to 3.0 per cent in 2014, and keep it at 3.2 per cent for 2015.

The export-driven growth may, however, be muted later in the year on the back of increased tensions in Iraq, which is Turkey's second largest export partner, and the still shaky growth in the EU. The central bank's easing cycle will likely continue with caution, if at all, as inflation in July remained high at 9.5 per cent, much above the targeted 5 per cent for the third consecutive year. External vulnerability and large exposure to global liquidity conditions remain the largest risks ahead, although the country fared resiliently through past such turbulences.

Eastern Europe and the Caucasus (EEC)

Since May, **Ukraine's** economy has continued to deteriorate, in line with our forecast of significant negative growth for the year. Military turmoil in Eastern Ukraine intensified into the third quarter of 2014, leading to damages to infrastructure and productive capacities, and to disruption of economic activity. Economic relations with Russia soured, resulting in gas supply cut-offs in June and other trade restrictions.

Financial sector instability led to continued deposit outflows, failure of several banks and use of currency restrictions. Under the IMF supported programme, systemic banks are undergoing independent diagnostic audits (including asset quality reviews) to foster contingency planning. On the positive side, the authorities are persevering with the difficult structural adjustment programme. The first review of the IMF-supported programmed was successfully completed on August 29 and international financial assistance has flowed into Ukraine.

Looking to 2015, the situation in Eastern Ukraine remains the biggest source of uncertainty, prompting the revision of the growth forecast from 0 to -3 per cent. There are significant downside risks to the outlook stemming from protracted and intensified fighting and from further breakdown of trade linkages with Russia. On the upside, eventual stabilization in the East may pave the way for infrastructure rehabilitation and for confidence recovery, although the timeline is highly uncertain. The signed Association Agreement with the EU can serve as an anchor for reforms which, if implemented, could stimulate investment activity and exports. The recently agreed delay in application of the DCFTA until the end of 2015, with unilateral extension by the EU of autonomous trade preferences for Ukraine for the same period, could reduce risks of retaliatory trade measures from Russia and may benefit Ukraine's domestic producers and the budget. On the other hand, this may lead to the postponement of necessary reforms.

Since our May forecasts, the average growth outlook in the EEC region, excluding Ukraine, did not change significantly, as our forecast already factored in much of the fallout from the Ukraine/Russia crisis. Due to the better than expected performance of **Belarus's** economy in the first half of the year, we upgrade our outlook to a still weak 0.7 per cent for 2014. **Azerbaijan** slowed down more than was foreseen due to what is believed to be a temporary decline in oil extraction, prompting a downgrade in the forecast to 3.0 per cent. **Armenia**'s and **Moldova**'s economies slowed down expectedly, reflecting moderation of remittances inflow and repercussions from the Ukraine/Russia crisis. **Georgia**'s growth rebound from the end of last year continued.

Russia

Economic growth has slowed further in the first and second quarter of 2014 reaching 0.9 and 0.8 per cent, respectively, relative to the same period of 2013 after 1.3 per cent growth in 2013. Sanctions have further worsened business confidence and slowed down investment. Private capital outflows slowed to US$ 26 billion in the second quarter from the high of US$ 49 billion in the first quarter of 2014. Anecdotal evidence shows that financing constraints of Russian companies and legislative efforts may also force owners to repatriate some of their off-shore funds to ensure funding.

The geopolitical crisis has already had a particularly strong effect on investment (falling by 2.6 per cent in January-July 2014 compared to the same period of 2013). Consumption has also decelerated (retail sales rose by 2.4 per cent in January-July 2014 compared to the same period of 2013 vs. 4 per cent in January-July 2013) on the back of slower retail lending (21 per cent year-on-year in June 2014 vs. 34 per cent in 2014). Still strong real (although slowing) wage growth (3.1 per cent in January-July 2014 compared to the same period of 2013) may offset some of the slow-down for the rest of the year. Net exports (mostly through slower import growth) have gained significance as the main driver of growth from 2013 helped by lower investment and consumer demand, as well as high oil prices and demand also due to the security crisis in Iraq.

We keep our growth projection for 2014 at 0 per cent, reflecting that a better-than-expected growth in the first six months will be reversed due to the new sanctions, partially mitigated by some increase in fiscal and quasi-fiscal spending later this year. At the same time, we are revising the 2015 growth forecast to a mild contraction of -0.2 per cent, as sanctions take effect, while fiscal room is limited and high capacity utilisation limits the long term effects from any fiscal or monetary stimuli. In the medium term, fast and peaceful resolution of the geopolitical crisis would be necessary to revive growth. Recovery after the potential lifting of the sanctions will be protracted as investor confidence and business relationships will have to be rebuilt while financing may be hindered by lower corporate financial buffers.

In the long term, Russia will have to continue improving the business climate both at the federal and the regional level to attract highly needed advanced technologies. Only consistent implementation of these policies can support productivity improvements, reduce dependence on commodities, and alleviate the drag from the ageing population, necessary to revive Russia's growth potential.

Central Asia

The growth in the Central Asia region has dropped from 7.4 per cent in the first quarter of 2013 to 6.9 per cent in the first quarter of 2014, largely driven by slowdown in Russia, as a result of the Russia-Ukraine crisis. Particularly vulnerable are **Kyrgyz Republic** and **Tajikistan**, where even a small drop in remittances from Russia is substantive, as remittances make up 29 per cent and 49 per cent of GDP respectively. Recent introduction of further sanctions by the EU and US, with further dampening growth in Russia, will negatively affect growth in the Central Asian countries; however, some of the negative effect with be offset, particularly in **Kazakhstan**, by increased exports to Russia resulting from the Russia counter-sanctions banning food and agricultural imports from the EU, US and a number of other countries. Internal vulnerabilities associated with the weak banking sector in the countries of the region and high level of NPLs, particularly in Kazakhstan and Tajikistan, also continue to be a drag on growth.

Growth in **Mongolia** is expected to decelerate due to lower prices of key export commodities, delays in the second phase of Oyu Tolgoi and weaker investment activity. The growth forecasts for other countries remain unchanged from the May issue of the *Regional Economic Prospects*.

Southern and Eastern Mediterranean (SEMED)

The growth forecast for 2014 for SEMED countries has been revised downwards to 2.6 per cent compared with 3.0 per cent in May's forecast. The downward revisions are in **Egypt**, **Tunisia** and **Morocco**, where economic performance during the first quarter of 2014 was weaker than expected. In Egypt, exports contracted in the first three months of 2014, which implied a larger drag on growth than envisioned in May. This mainly reflects a sharp contraction in petroleum exports as the country faces growing energy shortfalls. Similarly, the recovery in Tunisia has been timid, reflecting sluggish growth of the industry and poor performance of phosphate and energy exports. In Morocco, economic activity in the first quarter was significantly weaker than previously estimated, with agricultural activities contracting and non-agricultural output underperforming as construction and industrial activities struggled. In Jordan, growth was driven by stronger performance in agriculture, mining and utilities, though the recovery in exports remains modest amidst regional turmoil and weak external demand. Meanwhile, in 2015, output growth in the region is expected to improve to 3.7 per cent, supported by the recovery in the Eurozone, political progress in some countries and the economic reform measures across the region particularly in reducing energy subsidies.

Table 2. Transition Region: Real Sector and Financial Indicators [1]

	Nominal GDP	Inflation, average		Unem-ployment	Bank deposits	Private FX loan stocks				Loans-to-deposits	NPLs [2]	Sovereign Ratings	
	US$ billion	% change, y-o-y		%, latest	% GDP, latest	(% GDP, latest)			% total	%, latest	%, latest	latest	
	2013	2013	2014f			Total	Corp.	HH				S&P	Fitch
Central Europe and Baltics													
Croatia	58.1	2.3	0.5	18.8	52.8	53.2	24.3	28.9	74.8	134.2	16.1	BB	BB
Estonia*	24.5	3.2	1.0	7.3	50.6	…	…	…	…	144.0	1.7	AA-	A+
Hungary	132.4	1.7	0.4	8.1	39.2	24.0	11.5	12.5	52.1	118.4	14.4	BB	BB+
Latvia*	31.0	0.0	0.9	10.8	50.1	…	…	…	…	142.2	7.8	A-	A-
Lithuania	47.6	1.2	0.9	11.5	37.0	30.8	16.1	14.7	72.3	115.2	10.5	A-	A-
Poland	516.1	0.8	0.4	9.0	47.7	14.7	4.1	10.6	28.6	107.7	8.3	A-	A-
Slovak Republic*	95.8	1.5	0.4	13.8	50.7	…	…	…	…	97.7	5.3	A	A+
Slovenia*	46.9	1.9	1.1	9.8	56.1	…	…	…	…	111.2	14.6	A-	BBB+
South-Eastern Europe													
Albania	12.9	1.9	2.0	18.3	69.2	23.7	18.1	5.6	59.8	56.8	24.1	B	…
Bosnia and Herzegovina	17.8	0.1	0.5	27.5	46.0	39.9	21.3	18.6	66.1	130.7	14.9	B	…
Bulgaria	53.0	0.4	-0.5	13.0	68.6	41.4	32.6	8.8	59.3	101.9	22.2	BBB-	BBB-
Cyprus*	21.8	0.4	0.4	16.4	351.1	…	…	…	…	85.9	42.6	B	B-
FYR Macedonia	10.2	2.8	1.5	28.4	53.2	24.2	14.7	9.5	47.4	95.9	10.6	BB-	BB+
Kosovo*	6.8	1.8	2.0	30.0	43.0	…	…	…	…	85.7	8.5	…	…
Montenegro*	4.4	2.2	0.4	19.1	57.6	…	…	…	…	100.4	17.5	BB-	…
Romania	189.7	3.2	2.3	7.0	34.1	19.2	9.2	10.0	57.5	99.9	22.2	BBB-	BBB-
Serbia	42.5	7.7	3.0	20.1	41.2	32.6	20.7	11.9	71.0	115.4	22.3	BB-	B+
Eastern Europe and the Caucasus													
Armenia	10.5	5.8	2.9	17.8	25.7	25.4	19.6	5.8	62.6	157.8	6.7	…	BB-
Azerbaijan	73.5	2.5	1.6	5.2	17.2	7.1	3.9	3.2	27.0	153.9	5.3	BBB-	BBB-
Belarus	71.7	18.3	19.1	0.5	28.0	22.6	22.4	0.0	51.0	157.8	5.0	B-	…
Georgia	16.2	-0.5	4.0	14.6	40.7	24.0	12.2	11.8	59.6	109.4	7.3	BB-	BB-
Moldova	7.9	4.4	5.4	3.6	55.7	16.2	16.0	0.3	37.3	77.1	12.4	…	…
Ukraine	177.8	-0.3	11.8	8.8	42.7	27.6	21.6	6.0	44.6	144.9	14.6	…	CCC
Turkey	827.2	7.5	9.0	10.1	44.8	20.9	20.9	0.0	28.8	110.7	2.8	BB+	BBB-
Russia	2,118.0	6.8	7.2	5.2	44.0	9.7	9.4	0.3	17.7	125.1	4.6	BBB-	BBB
Central Asia													
Kazakhstan	220.3	5.9	7.9	5.1	35.8	12.0	10.2	1.8	33.3	101.7	31.6	BBB+	BBB+
Kyrgyz Republic	7.2	6.6	6.5	7.6	…	9.4	7.4	1.9	51.3	…	4.6	…	…
Mongolia	11.5	12.5	10.5	8.4	…	19.5	17.9	1.6	31.2	…	4.9	B+	B+
Tajikistan	8.5	5.0	5.1	2.5	…	…	…	…	59.2	…	9.8	…	…
Turkmenistan	40.6	6.6	5.3	…	…	…	…	…	…	…	...	…	…
Uzbekistan	56.5	11.2	11.4	…	…	…	…	…	…	…	...	…	…
Southern and Eastern Mediterranean						…	…	…					
Egypt	271.4	6.9	10.1	13.3	78.9	8.0	7.9	0.1	…	43.8	9.8	B-	B-
Jordan	33.9	5.6	3.3	12.0	133.0	10.5	…	…	…	67.4	7.4	BB-	…
Morocco	105.1	1.9	1.3	9.3	66.0	…	…	…	…	103.6	6.7	BBB-	BBB-
Tunisia	47.4	6.1	5.6	15.2	59.0	…	…	…	…	…	14.9	NR	BB-

1/ National sources based on CEIC and IMF WEO.
2/ Nonperforming loans.
* Euro area members, Kosovo and Monetnegro use the Euro as legal tender.

Table 3. Transition Region: Fiscal and External Indicators

end-2013, unless otherwise specified	General Gov't Fiscal Balance[1] (% of GDP)	Primary fiscal balance[1] (% of GDP)	General Gov't Debt [1] (% GDP)	External Debt[1] (% GDP): Total	Private	Short-term	Current Account (% of GDP)	Net FDI (% of GDP)	Total reserves (excl. gold)[2]: $ bn, latest	in % of: GDP	Sh term ext. debt	mo. of imports
Central Europe and Baltics												
Croatia	-5.5	-2.4	59.8	103.4	82.9	32.8	1.2	2.1	17.7	30.5	93.1	8.9
Estonia*	-0.2	0.7	10.0	85.1	78.6	46.0	-1.0	2.4	0.5	1.8	4.0	0.7
Hungary	-2.2	2.1	79.2	115.9	66.6	29.4	3.0	0.6	49.2	37.2	126.5	5.2
Latvia*	-1.0	0.7	38.1	134.8	104.5	68.8	-0.9	1.5	3.3	10.6	15.4	2.1
Lithuania	-2.2	-0.5	39.4	64.4	32.7	27.5	1.5	0.9	7.9	16.5	60.0	3.2
Poland	-4.3	-1.7	57.0	71.1	41.8	19.0	-1.3	-2.1	98.2	19.0	100.2	5.2
Slovak Republic*	-2.8	-0.8	55.4	…	…	…	2.1	1.1	1.0	1.0	…	0.0
Slovenia*	-14.7	-12.1	71.7	108.9	52.0	17.2	6.3	-1.6	1.0	2.2	…	0.0
South-Eastern Europe												
Albania	-6.2	-2.9	70.5	39.7	10.7	3.2	-9.1	7.7	2.6	20.6	636.5	6.3
Bosnia and Herzegovina	-2.2	-1.5	42.7	52.1	22.8	15.6	-5.6	2.6	4.9	27.4	175.5	6.2
Bulgaria	-1.9	-1.0	17.6	95.9	87.5	32.6	2.1	2.8	17.2	32.4	99.3	5.5
Cyprus*	-4.7	-1.7	112.0	348.0	…	…	-1.5	1.5	…	…	…	…
FYR Macedonia	-4.0	-3.2	35.8	64.9	41.5	26.5	-1.8	3.2	2.3	22.8	86.1	3.8
Kosovo*	-2.5	...	…	…	…	…	-6.8	...	1.1	15.7	…	3.7
Montenegro*	-2.4	-0.2	56.8	120.4	…	…	-15.0	9.8	0.5	11.3	…	2.1
Romania	-2.5	-0.8	39.3	69.7	45.1	25.2	-1.1	1.8	41.8	22.0	87.5	6.2
Serbia	-5.7	-3.1	65.8	87.4	40.6	17.2	-5.0	2.4	13.7	32.3	188.4	6.9
Eastern Europe and the Caucasus												
Armenia	-2.5	-1.3	41.9	79.3	41.0	9.4	-8.4	5.2	1.9	17.7	187.6	4.5
Azerbaijan	0.8	1.1	13.8	13.4	…	…	19.7	-0.9	16.7	22.8	…	11.5
Belarus	-0.9	0.1	36.7	50.1	28.6	25.6	-9.8	3.0	3.6	5.0	19.6	1.0
Georgia	-2.7	-0.3	34.7	82.0	54.0	18.1	-5.9	5.6	2.5	15.8	94.6	3.3
Moldova	-1.8	-1.2	24.4	80.4	57.7	30.8	-4.8	2.9	2.8	34.8	112.9	5.1
Ukraine	-4.5	-1.1	41.0	76.6	60.1	34.8	-9.2	1.8	16.3	9.2	26.3	1.9
Turkey	-1.5	1.6	35.8	45.8	32.3	20.6	-7.9	1.2	110.3	13.3	64.7	5.0
Russia	-1.3	-0.6	13.4	34.3	25.5	7.7	1.6	-0.3	423.8	20.0	261.2	10.7
Central Asia												
Kazakhstan	5.0	5.5	13.5	67.0	64.5	8.1	0.1	3.7	21.3	9.7	119.4	4.2
Kyrgyz Republic	-3.8	-2.9	47.7	74.2	29.3	5.6	-12.6	7.6	2.0	27.5	492.9	3.5
Mongolia	-7.7	-6.8	…	119.9	76.6	…	-27.9	19.9	1.8	16.0	…	2.9
Tajikistan	-0.8	0.1	29.2	43.2	19.1	1.1	-1.9	1.8	0.4	4.2	379.7	0.8
Turkmenistan	0.2	...	20.6	20.6	0.0	4.5	-3.3	7.5	…	…	…	0.0
Uzbekistan	1.3	1.4	8.6	13.0	4.9	0.7	1.7	1.2	…	…	…	…
Southern and Eastern Mediterranean												
Egypt	-14.1	-6.4	89.2	14.5	0.7	4.6	-2.1	1.0	13.8	5.1	109.8	2.5
Jordan	-5.3	-1.8	87.7	24.5	0.0	1.5	-11.1	5.2	14.0	41.4	…	7.8
Morocco	-7.5	-2.9	61.9	30.9	4.1	2.0	-7.4	2.9	20.4	19.4	993.6	4.9
Tunisia	-5.9	-4.1	44.4	52.0	16.0	15.3	-8.4	2.2	6.9	14.6	95.5	3.2

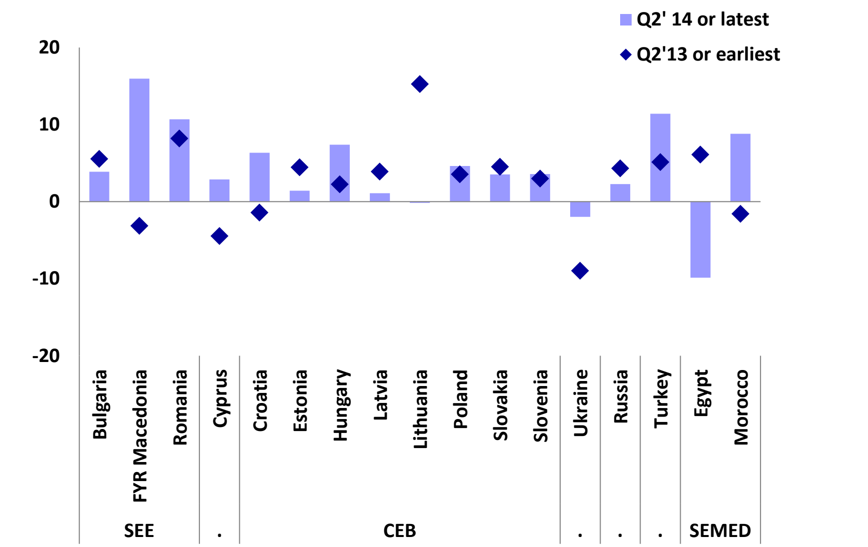
Source: WEO April 2014, IFS, and national authorities. Figures for the CEB countries (excl. Croatia) are sourced from Eurostat.

1/ Figures for Egypt reflect the fiscal year, w hich runs from July to June. For Slovenia, fiscal balance includes bank recapitalisation package of 10.3 per cent of GDP.

* Euro area members, Kosovo and Monetnegro use the Euro as legal tender.

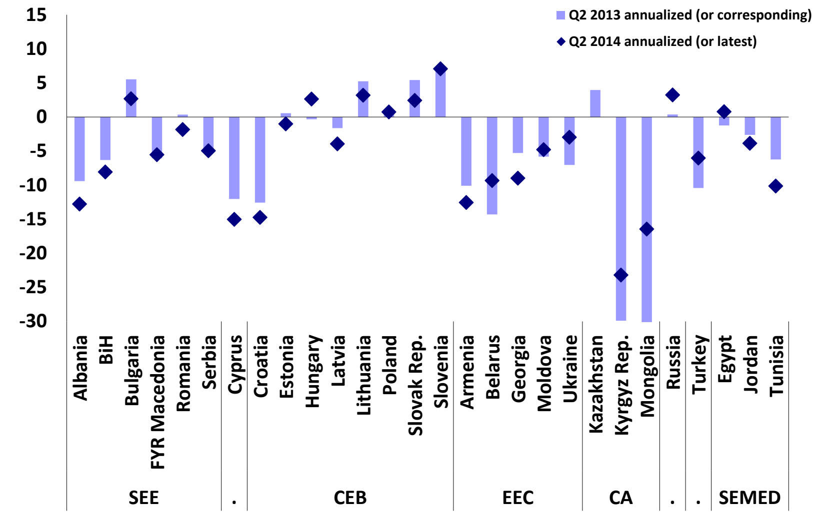
Figure 1. External environment

Export volumes, y-o-y, %



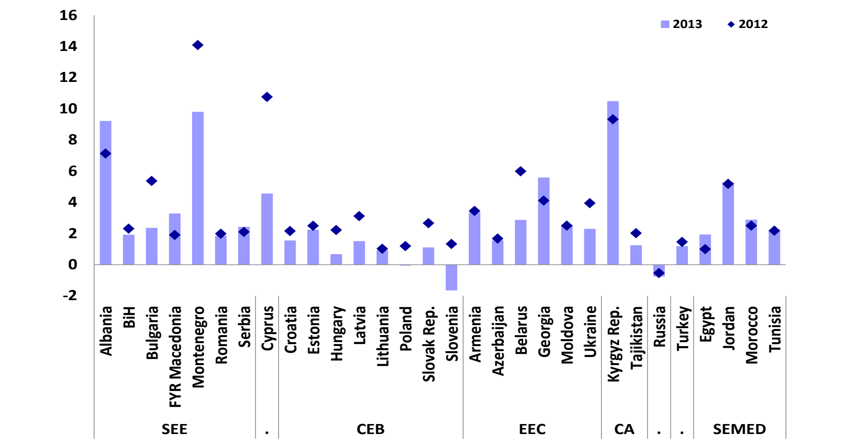
Source: National authorities via CEIC data service.

Current account, % of GDP



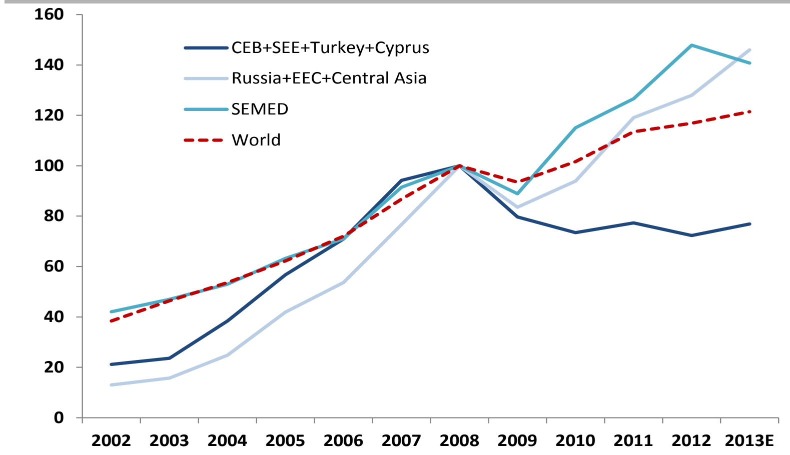
Source: National authorities via CEIC data service.

FDI net inflows, % of GDP



Source: National authorities via CEIC data service.

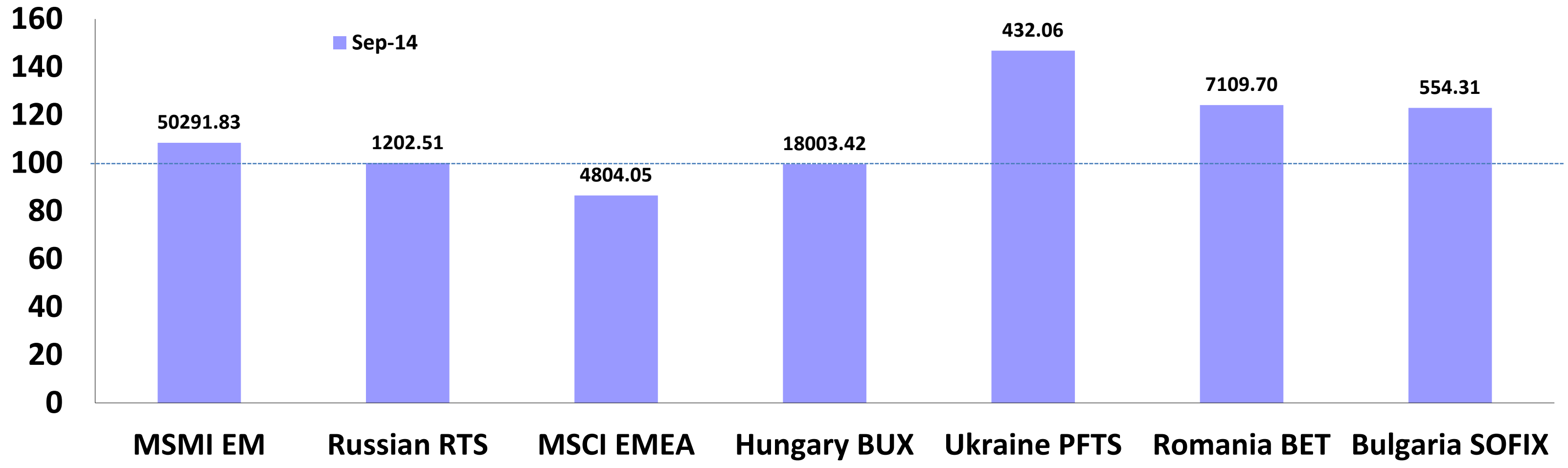
Migrant remittance inflows, Index 2008=100



Source: World Bank

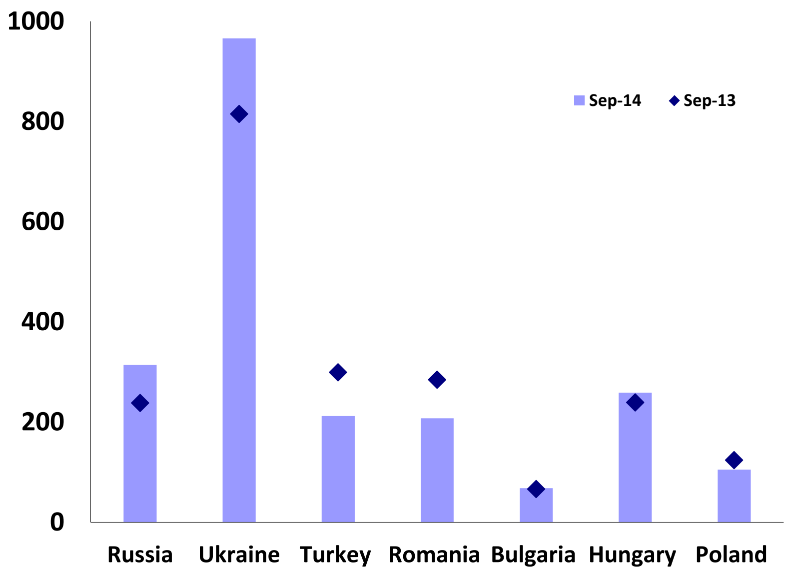
Figure 2. Financial market indicators (daily frequency)

Stock markets (January 2011=100)



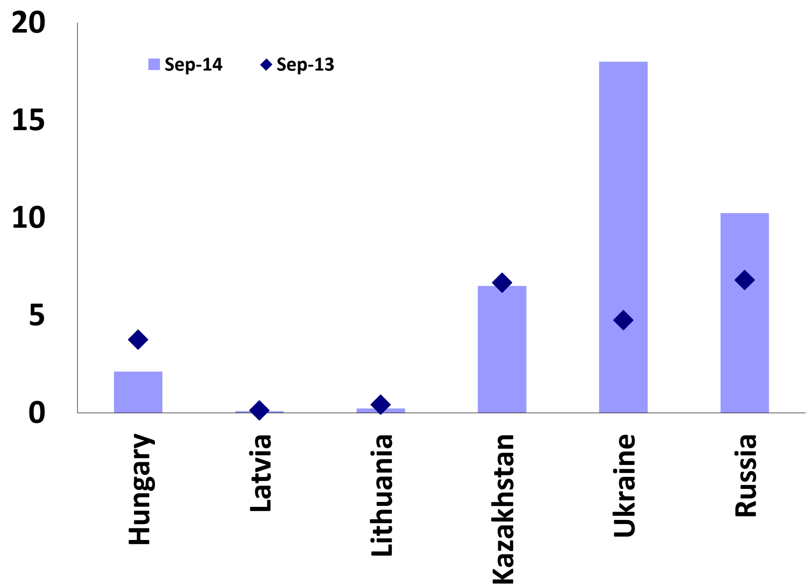
Source: Bloomberg.

Sovereign risk (EMBI spreads, bps)



Source: Bloomberg

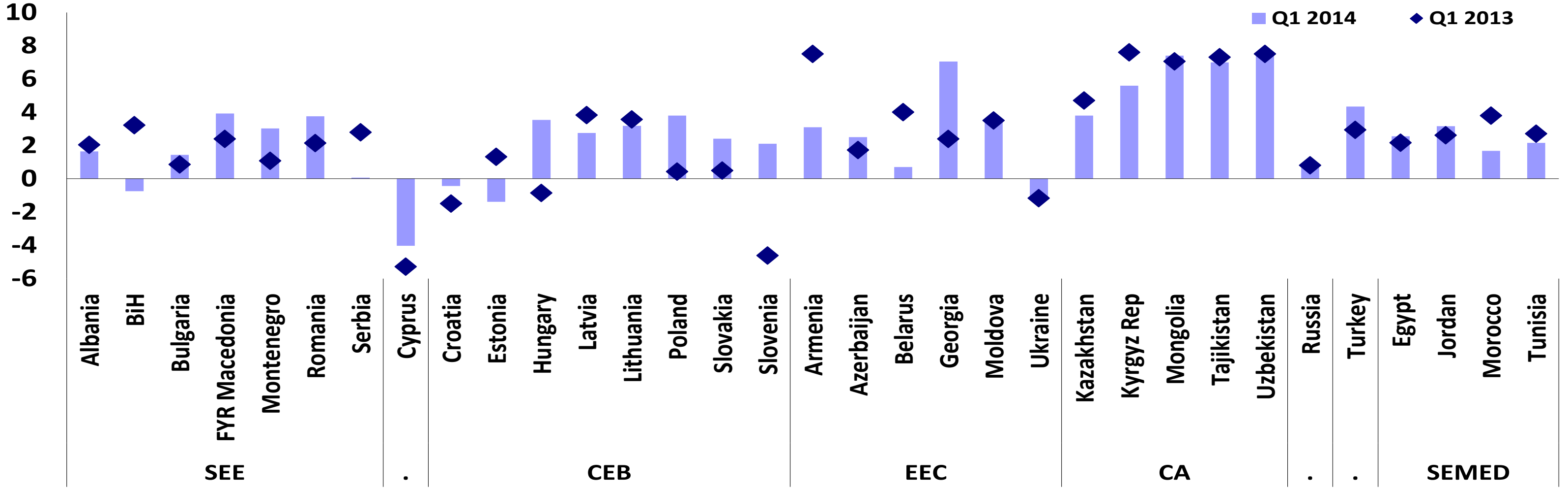
Interbank rates (%)



Source: Bloomberg

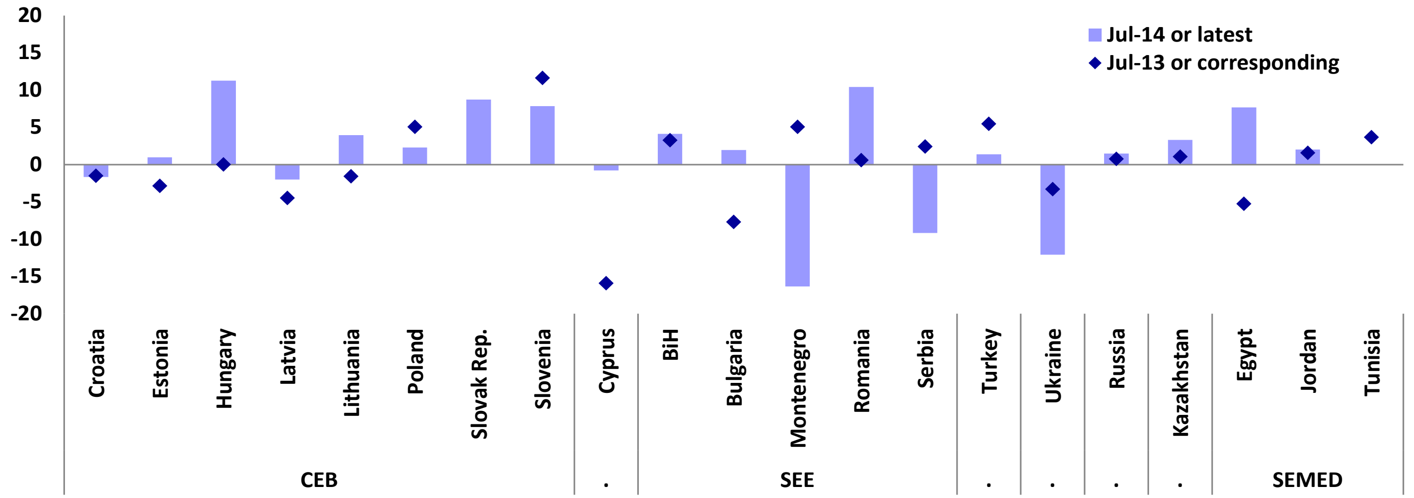
Figure 3. Indicators of real activity

Real GDP, y-o-y change, %



Source: National authorities via CEIC data service.

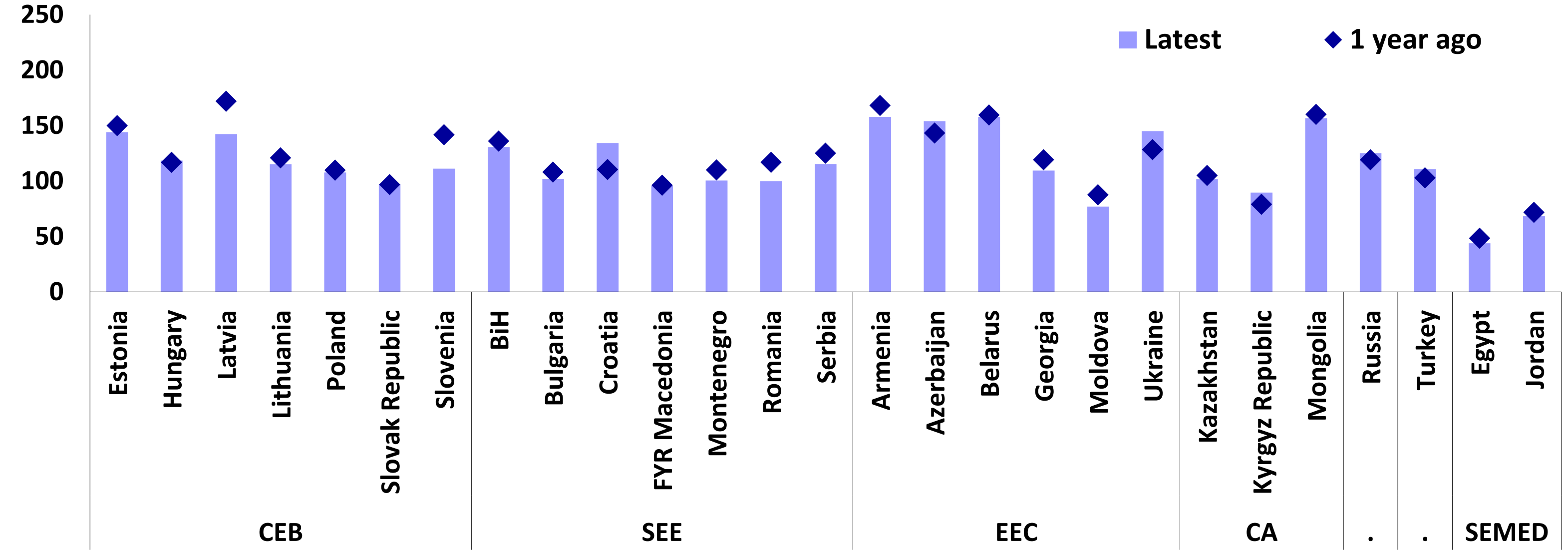
Industrial production, monthly y-o-y change, %



Source: National authorities via CEIC data service.

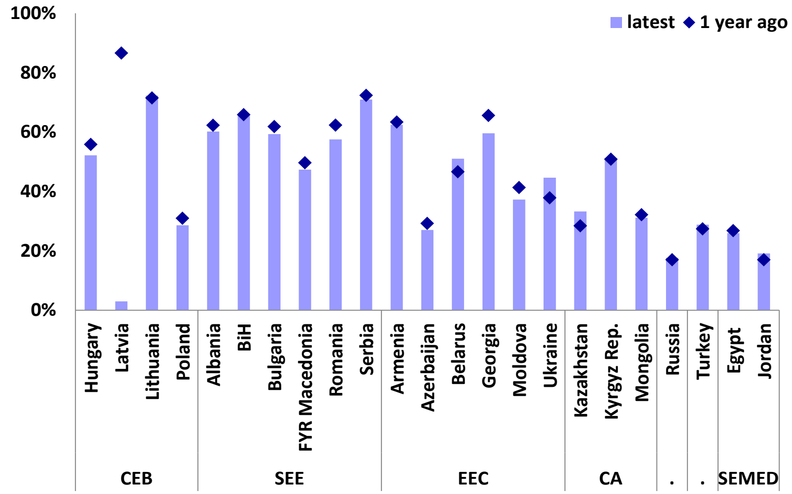
Figure 4: Financial sector indicators: loans and deposits

Loan to deposit ratio, (%)



Source: National authorities via CEIC data service.

Foreign currency loans to total loans ratio, (%)



ource: National authorities via CEIC data service

Foreign currency deposits to total deposits ratio, (%)

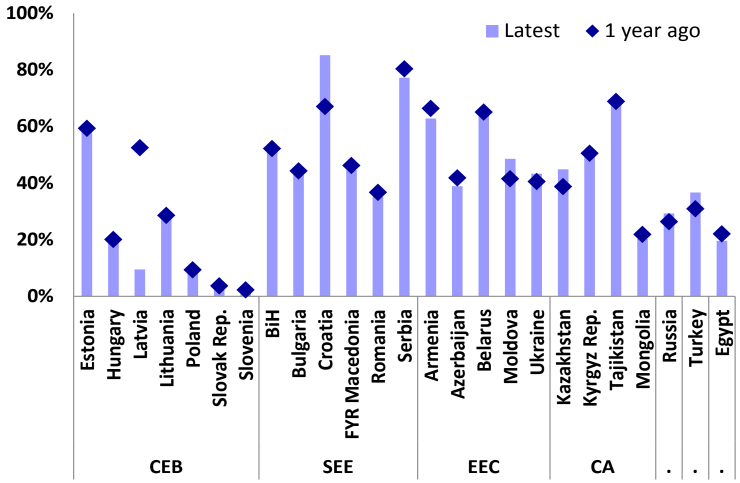
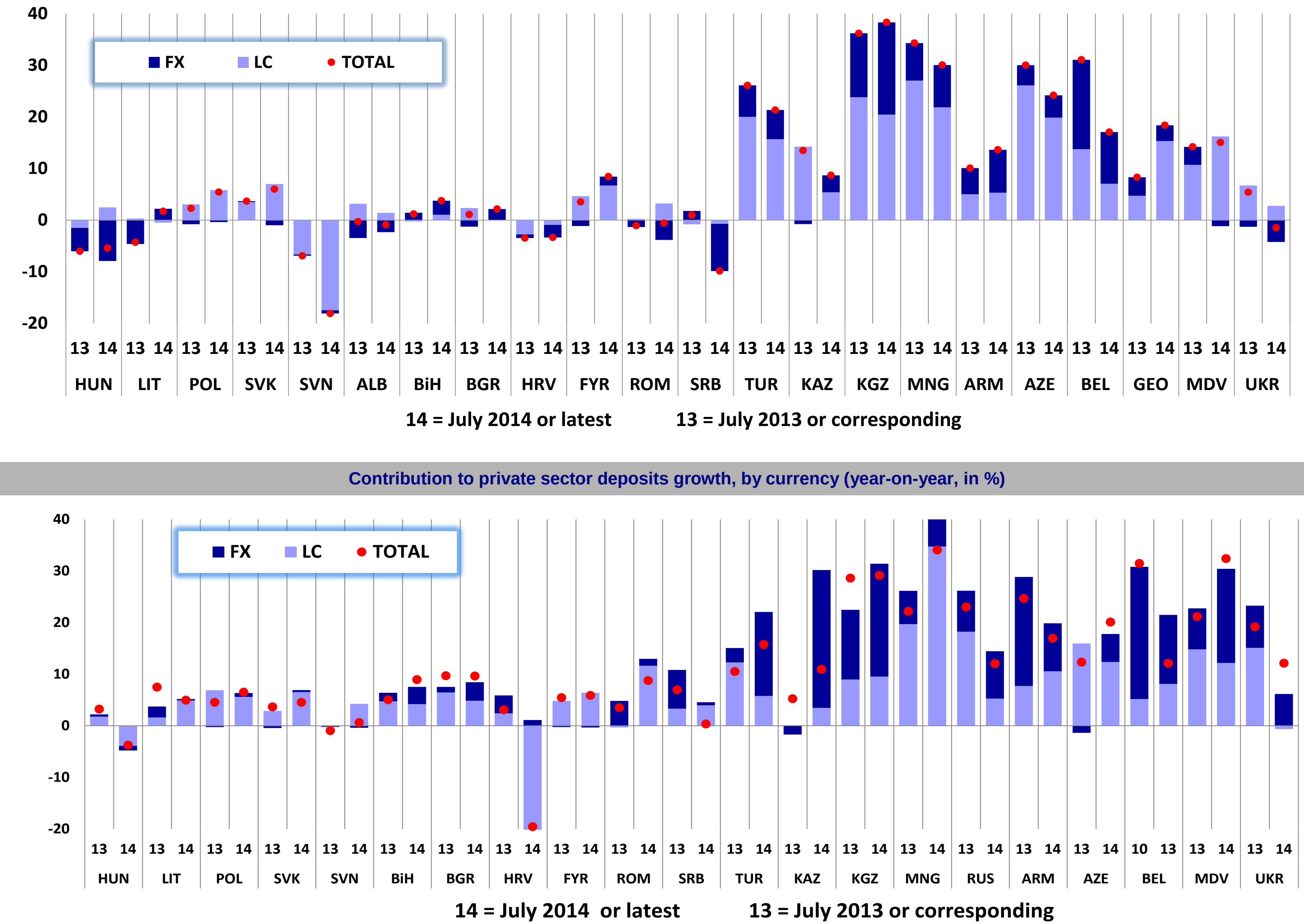


Figure 5. Financial sector indicators: foreign and local currency lending and deposits

Contribution to private sector credit growth, by currency (year-on-year, in %)



Source: National authorities via CEIC data service