European Bank
for Reconstruction and Development

Regional Economic Prospects in EBRD Countries of Operations

May 2016

Modest pick-up amid continued uncertainty

After five years of continued deceleration, average growth in the region is expected to pick up modestly, from 0.5 per cent in 2015 to 1.4 per cent in 2016. This momentum is expected to be sustained in 2017 as average growth reaches 2.5 per cent. At the same time, the outlook for growth in the EBRD region in 2016 has weakened slightly since our last forecast in November.[1]

Low commodity prices and the continued recession in Russia, where output is projected to contract by 1.2 per cent in 2016 (following a decline of 3.7 per cent in 2015) are weighing on the economic performance of Central Asia and Eastern Europe and the Caucasus (EEC). In contrast, lower energy import bills benefit Central Europe and the Baltic States (CEB) and south-eastern Europe (SEE) where growth momentum is expected to be sustained.

CEB and SEE economies also benefit from accommodative monetary policies in the eurozone. In contrast, monetary policy in the United States is being tightened gradually, negatively affecting net capital flows to the region and to emerging markets more broadly.

Weaker tourism receipts partly due to security concerns and the slowdown in global trade are clouding the outlook in southern and eastern Mediterranean (SEMED) as well as Turkey. Growth in Turkey is projected to moderate to around 3.2 per cent following stronger-than-expected economic performance in 2015 partly caused by several one-off factors.

Ukraine's economy is expected to return to growth in 2016 and 2017 after contracting by close to 10 per cent in 2015, as structural reforms are gradually implemented.

These projections are subject to major risks related to geopolitical tensions in and around the region and a general weakening of investor confidence with respect to emerging markets.

[1] The regional average growth rates in 2016-17 are based on new weights corresponding to countries' projected nominal GDP values in US dollars in 2016, measured at purchasing power parity.

Since November 2015, the outlook for the region as a whole has weakened slightly. It is shaped by several key trends:

- A further drop in the price of oil, followed by a partial recovery in commodity prices
- Increased volatility in global financial markets and lower capital flows to emerging market economies world-wide
- Weakness of global trade
- Elevated geopolitical risks, as the situation in the Middle East and Eastern Ukraine remain highly volatile

Global economic environment

The oil price dropped further, from around US$ 50 per barrel of Brent at the time of our previous forecast to US$ 28 per barrel in late January 2016, before recovering to US$ 40-45 per barrel of Brent as of late April. The drop reflected a continued deceleration of global growth and strong supply, including from Saudi Arabia and other OPEC members, as well as an expected scaling-up of oil supply from Iran, which was previously subject to sanctions. Expectations of a continued decline in oil production in the United States, on the other hand, have led to gradual increases in the oil price since February.

Volatility in the global financial markets rose substantially in the first months of 2016. A new downward correction in China's equity markets at the start of the year sparked a reassessment of global prospects among investors. Bank shares, in particular in Europe, came under strong pressure as investors took account of the impact of new regulations on bail-in as well as high ratios of non-performing loans. Global markets have subsequently recovered the losses recorded at the start of the year.

Since the November forecast, the US Federal Reserve (Fed) raised its funding rate by 0.25 per cent. The move was widely expected and largely priced in by the markets. Markets expect the Fed to raise the interest rate further in 2016 but only slightly, given the sell-off in global markets early in the year and the decline in valuations of banks.

Given the expected tightening of monetary policy in the US, capital inflows into emerging markets are expected to be lower than in recent years. The Institute for International Finance (IIF) estimates 2015 net portfolio capital inflows to emerging markets at around US$ 30 billion, the lowest reading since 2008 (around 90 per cent below the 2010-14 average). China experienced significant capital outflows in 2015-16.

In contrast, the European Central Bank (ECB) expanded its quantitative easing programme in March 2016. Monthly purchases of assets have been scaled up to €80 billion and now also cover selected corporate bonds. The deposit rate has been cut to -0.4 per cent, and banks were made eligible to receive long-term funding at negative interest rates under TLTRO II (targeted long-term refinancing operations). At the same time, a lack of cheap bank capital and already high cash holdings of corporates (23 per cent of GDP in the eurozone versus 8 per cent in the United States) are reducing the effectiveness of these measures.

Growth of global trade remained subdued, reflecting weaker demand from advanced economies, the gradual shift in China's economy towards a greater contribution of services to value added compared with manufacturing and lower investment activity, which is mirrored in lower shipments of capital goods. In volume terms, global trade grew at a rate of 2.5 per cent in 2015, compared with an annual average of 5 per cent over the previous two decades.

Geopolitical tensions remain a major source of risk for the global economy. A number of countries across the region where the EBRD operates continue to be affected by the refugee crisis. The extent of impact varies from country to country, as discussed in the November 2015 issue of the *Regional Economic Prospects*, with Jordan and Turkey affected the most. In addition, geopolitical tensions, terrorism and the refugee crisis are likely to have a significant negative impact on tourism receipts in Egypt, Tunisia and (to a lesser extent) Turkey and Greece. Croatia and Montenegro may benefit from tourists looking for alternative destinations during the summer season.

Implications for EBRD countries of operations

The economic outlook remains weak in Russia, Central Asia and Eastern Europe and the Caucasus (EEC). Commodity exporters have been negatively affected by a further drop in the price of oil while other economies in the region are suffering because of the recession in Russia, which is a major source of remittances and an important trading partner. In terms of the combined economic significance of trade, investment and remittances, Russia remains a leading economic partner for many economies in EEC and Central Asia, followed by the eurozone. Although the weight of China as an economic partner has been rising, it remains considerably lower for most economies (Chart 1; see also Box 1 for estimates of the spillover effects of slower growth in Russia and China).

Countries in Central Europe and the Baltic States (CEB), south-eastern Europe (SEE), Turkey and southern and eastern Mediterranean (SEMED), in contrast, are continuing to benefit from low commodity prices and accommodative monetary policy in the eurozone. Most of these economies have been affected to a lesser extent by the reversal of capital flows into emerging markets as they had previously benefited less from the upturn in inflows than emerging markets in Asia and Latin America. Turkey, a notable exception in this regard, benefited from a reduction in its fuel import bill which has partially offset the impact of lower net capital inflows on its external position.

The regional updates section further discusses country-specific factors that have been shaping the economic outlook in individual countries.

Recent growth performance in the region

Growth in the region as a whole slowed sharply, from 1.9 per cent in 2014 to 0.5 per cent in 2015, broadly in line with the projections published in the November 2015 issue of the *Regional Economic Prospects.*

- Growth in **CEB** averaged around 3 per cent in 2015, virtually unchanged from 2014, supported, in most cases, by a combination of strong private consumption, recovering investments (helped by the acceleration of EU funds utilisation) and lower fuel import bills. **Croatia's** economy expanded for the first time in seven years on the back of a good tourist season, stronger external demand and lower oil prices.

- Average growth in **south-eastern Europe (SEE)** accelerated from 1.5 per cent to more than 2 per cent, despite a slowdown in **Greece**. The economies of **Serbia** and **Cyprus** returned to positive growth, aided by stronger EU demand.

- **Ukraine's** economy appears to have bottomed out in the second half of 2015 but the contraction for the year as a whole reached almost 10 per cent. Growth slowed down in all other **EEC** economies and turned negative in **Belarus** and **Moldova**.

- **Turkey**'s economy grew by 4 per cent in 2015 as consumption was propped up by a strong influx of refugees, increased purchases of durable goods against the background of the lira's weakening and supportive fiscal conditions.

- In **Russia,** output contracted by an estimated 3.7 per cent in 2015 as household consumption dropped by more than 9 per cent and investment activity remained weak. A sharp drop in imports, on the other hand, was a supportive factor.

- Growth in **Central Asia** slowed down from 6 per cent in 2014 to less than 4 per cent in 2015, reflecting given the region's strong dependence on Russia and commodity exports.

- Implementation of reforms as well as lower oil prices supported economic activity in the **SEMED** region where growth accelerated from 2.3 per cent in 2014 to almost 4 per cent in 2015. At the same time, growth slowed down in **Jordan** and **Tunisia**, reflecting deteriorating regional and domestic security conditions, respectively.

Capital flows

Net capital outflows into the region have declined, but less dramatically than in the case of emerging markets as a whole (see Box 2)**.** In CEB and SEE, balance of payments data indicate net capital outflows of around 0.3 per cent of GDP in 2015, compared with new inflows of 1.2 per cent of GDP in 2014 (Chart 2). Net private capital outflows from Russia have moderated further as a significant portion of the external debt owed by banks and corporates had been repaid during earlier quarters.

In line with global trends, FDI inflows into commodity-dependent economies have declined significantly, as major projects have been put on hold and investors have been reassessing the medium-term prospects of these economies. In contrast, FDI flows to Turkey increased (partly due to two large-scale transactions), to some extent offsetting the reduction in non-FDI flows.

Remittances

Remittances from Russia to Central Asia and the EEC declined by around 40 per cent in US dollar terms in 2015 and continued declining in year-on-year terms in the first quarter of 2016, according to partial data. Expressed in rouble terms, remittances declined only marginally (by 3 per cent), suggesting that the drop in US dollar terms is to a large degree explained by exchange rate movements.

Expressed in the local currencies of the recipient countries, remittances declined on average by around 20 per cent in 2015 as in most cases national currencies weakened against the US dollar but strengthened against the Russian rouble (Chart 3). This suggests that lower remittances are likely to exert continued pressures on the external balances of these economies.[2]

Currency movements

The weakening of the region's currencies against the US dollar continued, mirroring broader trends in emerging markets and reflecting lower inflows of capital into emerging markets as well as subdued demand for emerging market exports (in many cases, commodities).

Russia, the EEC region and Central Asia, on average, saw the largest depreciations. The currencies of the region's major oil exporters (Azerbaijan, Kazakhstan and Russia) have adjusted in a way that broadly preserved, or restored, the local-currency price of a barrel of oil (Chart 4), thus supporting budget revenues (in nominal terms). In oil-importing countries energy has become significantly cheaper in local currency terms.

Credit conditions

Recent surveys of lenders indicate that credit conditions in the region have tightened further, albeit less so than in other emerging markets. Credit growth remained subdued in most countries in the CEB and SEE regions. High levels of non-performing loans continued to constrain the ability and willingness of banks to provide fresh credit. Some countries have made progress in terms of removing non-performing loans from banks' balance sheets, although in some cases these assets may remain on the books of special vehicles fully owned by the originating banks.

In Turkey, EEC and Central Asia credit growth has slowed down markedly (Chart 5, corresponding dots lie well below the 45-degree line). In some instances it turned sharply negative in inflation-adjusted terms after years of rapid credit expansion.

[2] Based on Central Bank of Russia (CBR) data. Discrepancies between remittances as reported by the CBR and the authorities of the recipient countries have widened, possibly reflecting increased use of informal channels for sending money between the countries.

Inflation

A continued decline in oil prices over the past 12 months contributed to disinflation in most commodity-importing countries. In several CEB and SEE countries consumer prices have been declining, on average, since 2012.

In contrast, countries where currencies weakened substantially saw increases in inflation, largely due to higher prices of imported goods. In Russia, annual inflation moderated to 7.3 per cent in March 2016 after peaking at 17 per cent, reflecting weak domestic demand. In Turkey, the impact of weaker currency outweighed the effect of lower commodity prices, with inflation remaining well above the Central Bank's target.

Outlook

In our baseline scenario, growth in the transition region is expected to increase to 1.4 per cent in 2016, up from 0.5 per cent in 2015 (Table 1). This pick-up in growth reflects sustained momentum in CEB and SEE. The acceleration is nonetheless slightly weaker than projected in November 2015 (Chart 6) on account of headwinds faced by the economies in EEC and Central Asia, as well as a weaker outlook for the SEMED region, while the forecast for Turkey has been revised upwards.

The moderate recovery is expected to be sustained in 2017, with average growth reaching 2.5 per cent as economic growth resumes in Greece, Russia and several EEC economies and growth in the SEMED region and Central Asia accelerates.

- The economic outlook in the **CEB** region remains relatively strong, on the back of accommodative policies in the eurozone and sustained low commodity prices. Income convergence is set to continue as the region's growth averages above 3 per cent in 2016 and 2017.

- Similarly, growth in **SEE** is expected to reach 2.4 per cent in 2016 and 2.9 per cent in 2017. Output in Greece, however, is expected to fall slightly in 2016, as investor and consumer confidence remains weak.

- Ukraine's economy is expected to return to growth in 2016 on the back of the earlier macroeconomic adjustment and rebalancing supported by structural reforms, although investor confidence remains weak. With the exception of Georgia, which is expected to benefit from a strong tourist season and increased investor confidence, growth in the rest of the **EEC** is projected to remain subdued given the headwinds from the recession in Russia and a number of country-specific factors, including low oil prices in the case of Azerbaijan.

- Following a stronger-than-expected economic performance in 2015 partly reflecting one-off factors, growth in **Turkey** is projected to moderate to 3.2 in 2016 and to 3.4 per cent in 2017, as the outlook for tourist arrivals has been weakened by the terrorist attacks and Russian sanctions.

- **In Russia**, recession is expected to continue in 2016, reflecting low oil prices and reduced availability of investment funding. Modest growth is expected to return in 2017.

- Low commodity prices and recession in Russia will continue to weigh on growth in **Central Asia**, with further deceleration expected in 2016. At the same time, growth is expected to accelerate in Mongolia, supported by the implementation of the second phase of Oyu Tolgoi, a major copper mining project.

- The near-term outlook for the **SEMED** region has weakened significantly since our November forecast, reflecting the negative impact of terrorist attacks on tourist arrivals and a slowdown in global trade.

The projections assume gradual, albeit relatively slow, upward movement of commodity prices, cautious moves towards normalisation of monetary policy in the United States and a continued rebalancing of China's economy towards consumption and services-driven growth.

Risks to the outlook

Geopolitical tensions in and around the region are a rising source of risk. The conflict in Syria and the threat posed by Islamic State risk exacerbating the refugee crisis, with potentially negative longer-term implications for economic integration within Europe. The economies of the SEMED region and Turkey may be particularly strongly affected by the instability in the Middle East. In addition, the situation in Eastern Ukraine remains volatile.

A sharp deceleration in China's growth may further exacerbate loss of confidence among investors and amplify volatility in global markets. This trend could be further compounded by concerns about the health and profitability of global banks in the low interest rate environment. Although growth in China has already slowed down perceptibly, China's contribution to global demand remains broadly unchanged compared with the mid-2000s as China's economy has become significantly larger in nominal US dollar terms. However, a "hard landing" in China could result in a notable drop in global demand. A "leave" vote in the UK referendum on the membership of the European Union in June 2016 may result in increased volatility in the financial markets with negative spillovers for the CEB and SEE regions in particular.

Prolonged weakness in commodity prices, and a possible new drop in the price of oil, could exacerbate pressures on the economies of Russia and other commodity exporters as well as countries in Central Asia and the EEC region with close economic links with Russia.

Box 1. Spillovers from slower growth in China and Russia

In recent quarters the region has been exposed to the effects of prolonged recession in Russia, aggravated by Western sanctions and declining oil prices, as China's economy has been rebalancing towards new growth model based on consumption and services.

This box estimates the effects of growth shocks in China and Russia on EEC, Central Asia and the Baltic States using a global vector autoregression model (GVAR). GVAR estimates dependencies between growth and various domestic and external economic variables, where external variables represent weighted averages of estimates for other countries. The weights are based on a combination of exports, remittances and investment (with a higher weight given to FDI-to-GDP ratios to reflect larger multiplier effects of investment spending). Estimates are obtained based on quarterly data for the period from 2007 to mid-2015 and thus reflect recent trends.

Economic links with China are strongest in Central Asia and reflect primarily investment flows as well as exports (in particular in the case of Mongolia). Trade links with Russia are strong for most economies in EEC, Central Asia as well as the Baltic countries. In addition, several EEC and Central Asian economies receive large flows of remittances from Russia, while Armenia, Belarus and Moldova also receive significant Russian FDI.

Negative growth shocks in both Russia and China are estimated to affect regional growth, but the spill-overs from Russia are stronger (see Table 1.1). A one percentage point decline in Russia's growth translates, over a period of a year, into a 0.55 pp deceleration in the Baltic States and a 0.2 pp lower growth in Central Asia and EEC. The effects are strongest in the case of Armenia and weakest in the case of Azerbaijan and Mongolia.

A similar deceleration in China is estimated to translate into a decline in growth of 0.2 pp in the Baltic States and 0.4 pp in Central Asia excluding Kazakhstan. The effect is strongest for Mongolia and weakest for Azerbaijan, Belarus and Kazakhstan. Spillovers from China may in fact be larger than the model suggests. First, the estimates are backward looking while economic linkages with China have been growing rapidly. Second, they do not take into account the second-order effects of deceleration in China via its impact on commodity prices or global growth.

While the projected recovery of the Russian economy in the coming years will likely have positive effect on growth in EEC, Central Asia and the Baltics, the expected slowdown of Chinese economy will weigh on regional growth, in particular in Central Asia. At the same time, rebalancing towards consumption and services in China may create more export opportunities for countries in the region.

Table 1.1. Estimated impact of a one percentage point drop in growth in Russia or China, cumulative impact over 4 quarters, percentage points

	Russia	China
The Baltics	-0.55	-0.16
Ukraine	-0.22	-0.11
EEC ex. Ukraine	-0.19	-0.02
Kazakhstan	-0.19	0.00
Other Central Asia	-0.25	-0.41

Source: Authors' calculations.

Box 2. Capital flows to emerging markets: Europe versus Asia

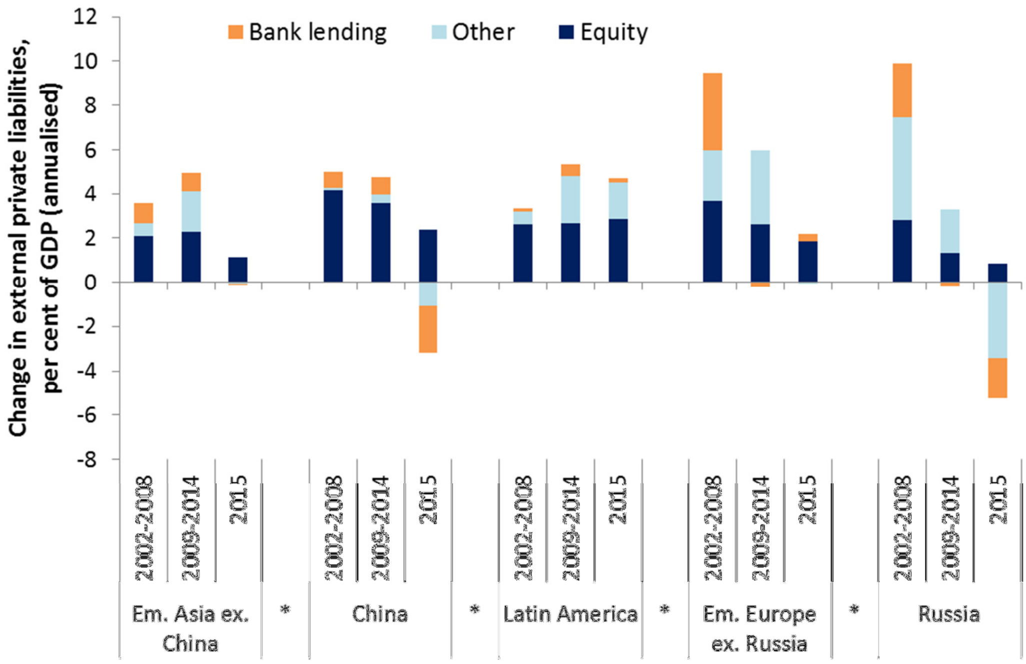
As the US Fed started tightening monetary policy, capital inflows into emerging markets declined across the board. The Institute for International Finance (IIF) estimates 2015 net portfolio capital inflows to emerging markets at around US$ 30 billion, the lowest reading since 2008 (around 90 per cent below the 2010-14 average). China experienced renewed volatility in the stock markets in early 2016 and significant capital outflows in 2015-16.

The ups and downs of capital flows were more pronounced in Emerging Asia and Latin America, while Emerging Europe saw continuation of a downward trend. During the period of loose monetary policy in the advanced economies and quantitative easing in the United States, inflows of capital into emerging markets in Asia averaged around 5 per cent of GDP (Chart 2.1) and were around 1.5 percentage points of GDP higher than before the 2008-09 financial crisis.

While inflows into Emerging Europe were of similar size when measured relative to recipient countries' GDP, that represents only around half of the levels experienced during the pre-crisis boom of the 2000s (when inflows into Emerging Europe were to a significant extent driven by cross-border bank lending).

In contrast with non-FDI inflows, FDI inflows into emerging markets increased by 1.5 per cent in 2015, according to preliminary estimates by the United Nations Conference on Trade and Development (UNCTAD). At the same time, this increase has been driven primarily by the economies in Emerging Asia.

Chart 2.1. Average net non-resident private capital inflows, in per cent of GDP



Source: IIF and authors' calculations.

Table 1: Real GDP Growth

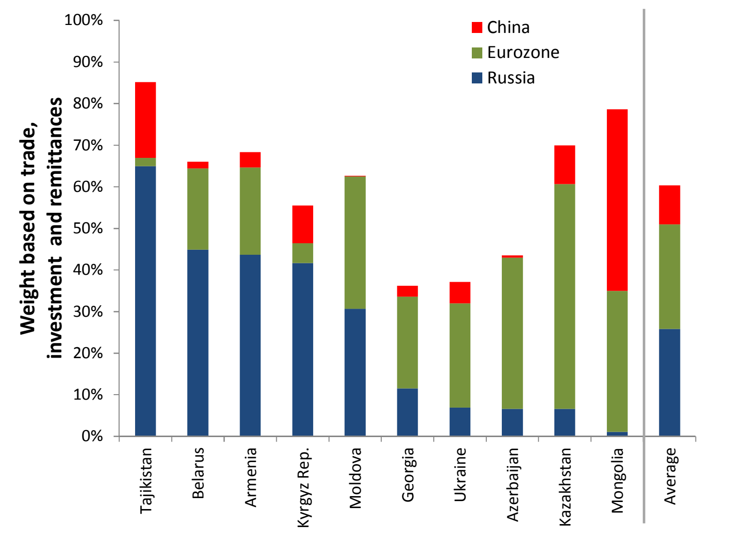
(In per cent; EBRD forecasts as of 5 May 2016)

	Actual		Current forecast		EBRD Forecast in Nov. 2015	
	2014	2015	2016	2017	2016	Change Nov.-May
EBRD Region[1]	**1.9**	**0.5**	**1.4**	**2.5**	**1.6**	***-0.2***
Central Europe and the Baltic states[1]	**3.1**	**3.2**	**3.1**	**3.1**	**2.9**	***0.2***
Croatia	-0.4	1.6	1.5	1.5	0.5	*1.0*
Estonia	2.9	1.1	2.2	2.6	2.8	*-0.6*
Hungary	3.7	2.9	2.1	2.4	2.1	*0.0*
Latvia	2.4	2.7	3.1	3.3	3.1	*0.0*
Lithuania	3.0	1.6	3.0	3.1	3.0	*0.0*
Poland	3.3	3.6	3.6	3.4	3.3	*0.3*
Slovak Republic	2.5	3.6	3.2	3.2	3.2	*0.0*
Slovenia	3.0	2.9	2.0	2.3	2.0	*0.0*
South-eastern Europe[1]	**1.5**	**2.2**	**2.4**	**2.9**	**1.7**	***0.7***
Albania	2.0	2.6	3.3	3.5	3.3	*0.0*
Bosnia and Herzegovina	1.1	3.2	3.0	3.0	3.0	*0.0*
Bulgaria	1.5	3.0	2.5	2.5	2.0	*0.5*
Cyprus	-2.5	1.6	1.7	2.0	1.7	*0.0*
FYR Macedonia	3.8	3.7	3.2	3.5	3.5	*-0.3*
Greece	0.7	-0.2	-0.2	2.4	-2.4	*2.2*
Kosovo	1.2	3.0	3.0	3.5	3.0	*0.0*
Montenegro	1.8	3.1	4.0	3.0	4.0	*0.0*
Romania	3.0	3.8	4.0	3.5	3.7	*0.3*
Serbia	-1.8	0.7	1.8	2.3	1.8	*0.0*
Eastern Europe and the Caucasus[1]	**-1.7**	**-4.8**	**-0.2**	**1.7**	**1.4**	***-1.6***
Armenia	3.5	3.0	2.0	2.0	2.0	*0.0*
Azerbaijan	2.8	1.1	-3.0	1.0	2.5	*-5.5*
Belarus	1.7	-3.9	-3.0	1.0	-1.0	*-2.0*
Georgia	4.6	2.8	3.4	3.9	2.6	*0.8*
Moldova	4.8	-0.5	0.0	2.0	0.0	*0.0*
Ukraine	-6.6	-9.9	2.0	2.0	2.0	*0.0*
Turkey	3.0	4.0	3.2	3.4	2.8	*0.4*
Russia	0.7	-3.7	-1.2	1.0	-1.2	*0.0*
Central Asia[1]	**6.0**	**3.6**	**3.3**	**4.0**	**4.0**	***-0.7***
Kazakhstan	4.3	1.2	1.1	2.4	1.5	*-0.4*
Kyrgyz Republic	3.6	3.5	1.0	2.6	3.9	*-2.9*
Mongolia	8.1	2.4	3.9	5.1	5.0	*-1.1*
Tajikistan	6.7	6.0	4.5	4.1	4.5	*0.0*
Turkmenistan	10.3	6.5	6.5	7.1	8.5	*-2.0*
Uzbekistan	8.1	8.0	6.5	6.2	7.2	*-0.7*
Southern and Eastern Mediterranean[1,2]	**2.3**	**3.9**	**2.9**	**4.0**	**4.1**	***-1.2***
Egypt	2.2	4.2	3.3	4.2	4.3	*-1.0*
Jordan	3.1	2.4	3.0	3.3	3.5	*-0.5*
Morocco	2.4	4.5	2.3	4.0	3.8	*-1.5*
Tunisia	2.3	0.8	1.6	2.5	3.0	*-1.4*
Average EEC, CA, Russia	1.1	-2.8	-0.4	1.6	0.0	*-0.4*
Average CEB, SEE, SEMED, Turkey	2.6	3.4	3.0	3.4	2.9	*0.1*

[1] Weighted averages, based on the countries' nominal GDP values in PPP US dollars.

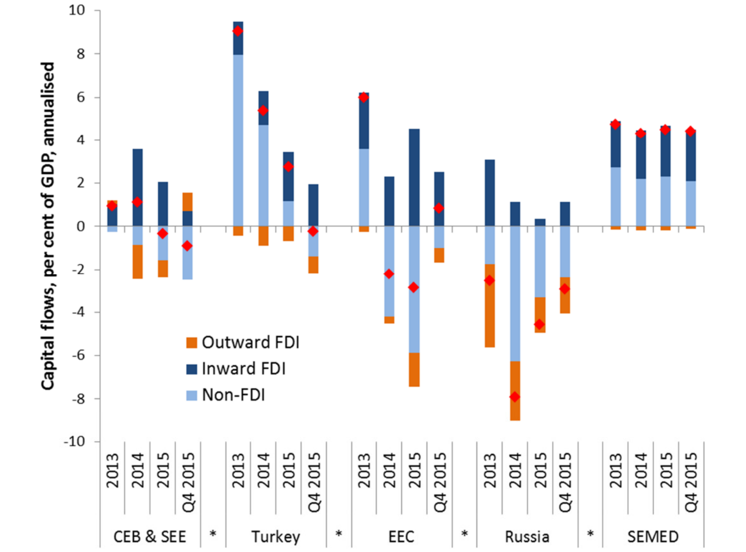
[2] EBRD figures and forecasts for Egypt's real GDP reflect the fiscal year, which runs from July to June. These are also used in the regional averages.

Chart 1. Weight of Russia, the Eurozone and China



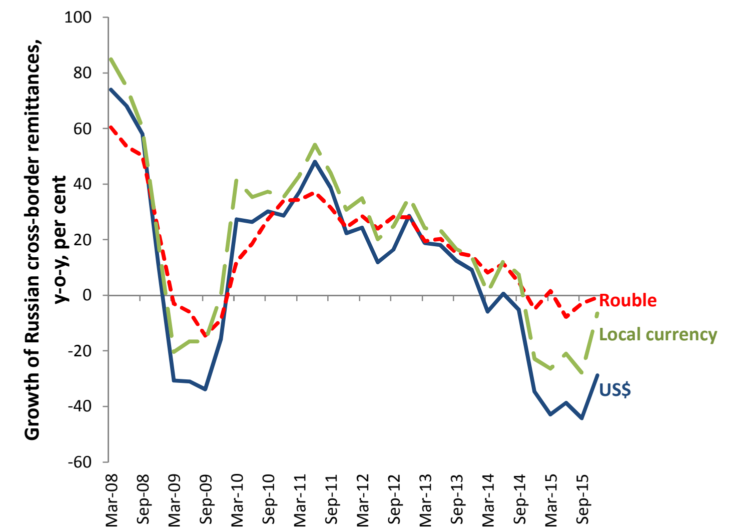
Source: UN Comtrade; IMF; CBR; national authorities; EBRD calculations

Chart 2. Capital flows in the EBRD region



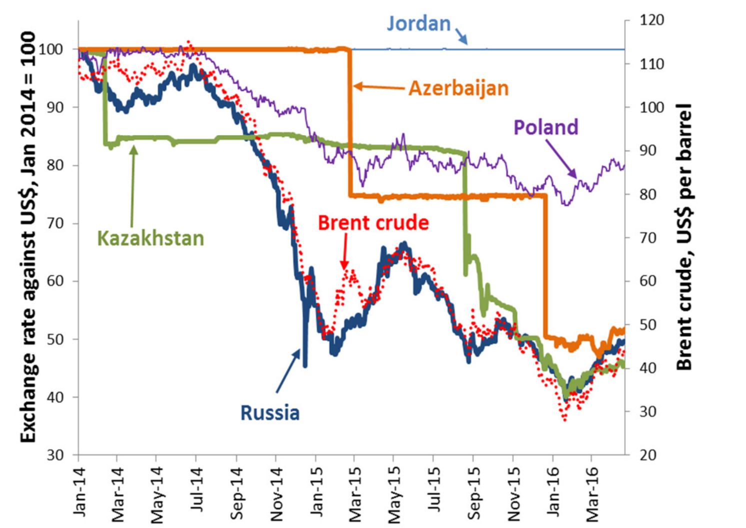
Source: National authorities via CEIC; EBRD calculations

Chart 3. Growth rate of Russian cross-border remittances



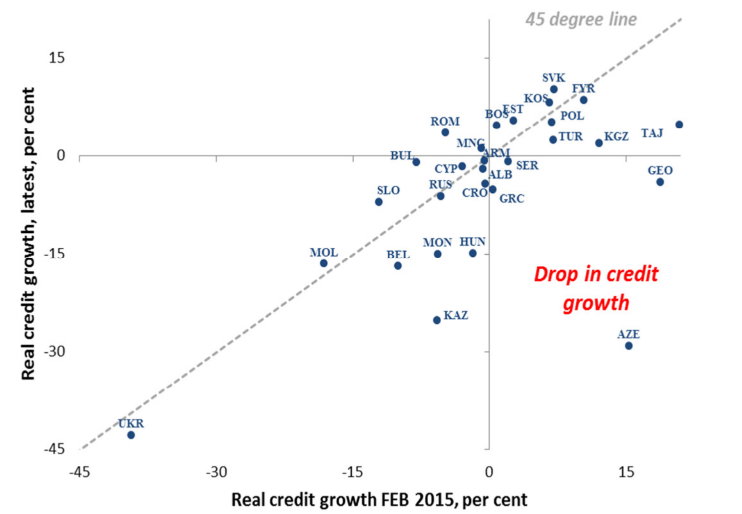
Source: CBR, CEIC, Bloomberg and EBRD calculations

Chart 4. Oil price and exchange rate developments



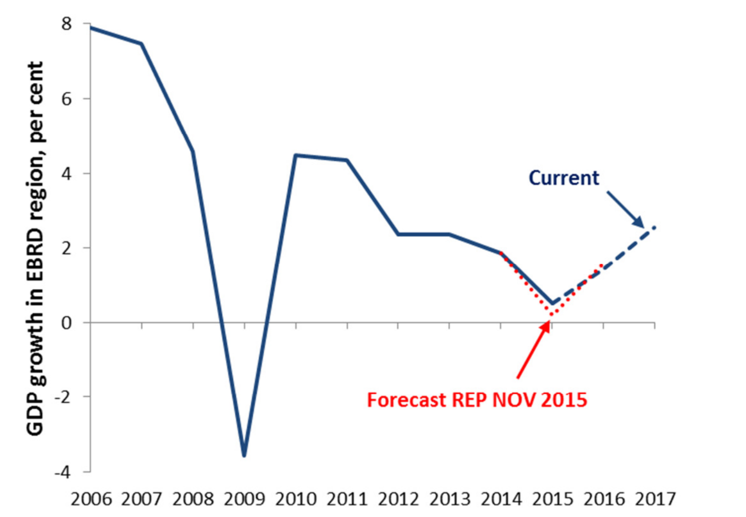
Source: Bloomberg

Chart 5. Real credit growth



Source: National authorities via CEIC; EBRD calculations

Chart 6. GDP growth and forecasts for the ERBD region



Source: IMF WEO; EBRD forecasts

Regional updates

Central Europe and the Baltic States (CEB)

The CEB region grew by 3.2 per cent in 2015, slightly exceeding our expectations from last year's autumn forecasts. Domestic demand continued to serve as a key driver of GDP growth, to a large extent benefitting from accommodative monetary policies, historically low oil prices and improving labour market conditions. Household consumption strengthened in the entire region. Public investment intensified in those economies which sought to accelerate absorption ahead of the expiry of funds at the end of 2015, such as in the Slovak Republic. Overall the exposure to other emerging markets is limited in the region. Our growth expectations for this year remain broadly unchanged, at 3.1 per cent, with similar growth projected in 2017.

- GDP growth in **Poland** accelerated to 3.6 per cent in 2015, underpinned by strong household consumption and investment, with the latter heavily reliant on the final disbursements of EU funds from the expiring budget period. Growth in 2016 is expected to remain at a similar level, as disposable income benefits from a generous injection form of the government's pro-family fiscal programme, which amounts to roughly 1 per cent of GDP. Private investment will remain robust and will be further boosted from 2017, when the government's new Development Plan generates its first projects. Co-financing by state and private banks is likely to result in greater capital formation by domestic small and medium-sized enterprises (SMEs). At the same time, fiscal risks and tightening capital market conditions could increasingly weigh on funding terms. This could result in a slight deceleration in 2017.

- Registering a growth rate of 2.9 per cent in 2015, **Hungary**'s real GDP finally surpassed its pre-crisis peak of 2008. Domestic demand continued to be the principal driver of growth, underpinned by strong increases in household disposable income. Growth in private investment, on the other hand, has remained depleted compared to the pre-crisis period. Despite several central bank initiatives that provided subsidized credit to SMEs, the corporate credit contraction continued in the first quarter of 2016. The approval by the European Commission in February 2016 for a new public asset management company aimed at distressed corporate real estate assets could assist the banks in reducing their NPL burden. We are maintaining our forecast of 2.1 per cent growth for this year and expect a slight acceleration to 2.4 per cent in 2017, supported by higher public investment and exports.

- Growth in **the Slovak Republic** accelerated to 3.6 per cent in 2015, primarily driven by impressively high investment, including in foreign-owned enterprises, as well as household consumption. Investment expenditures grew by 14 per cent last year, at a similar rate as at the beginning of the country's EU membership almost 12 years ago. Even though the spike in public investment clearly mirrors an acceleration of utilisation of the EU structural funds from the previous budgetary period, the Slovak

Republic only manged to absorb less than 90 per cent of the committed funds by end-2015. Further falling unemployment, deflation and the now rapidly expanding consumer credit further stimulated household consumption. We expect this trend to persist, in part due to the reduction in the VAT rates for selected food products and the hike in the minimum wage that came into effect this year. Substantial domestic private investments should underpin growth this year and next. Several large investment projects are about to get under way, such as the Bratislava ring road, as well as the Jaguar car plant, which is expected to start operating by end-2016.

- The economic contraction in Russia continued to weigh on growth in **the Baltics** in 2015. Growth in Estonia and Lithuania, at 1.1 and 1.6 per cent respectively, came in below our expectations, in large part due to the exposure to the contraction in Russia. In all three Baltic economies, GDP growth in 2015 was primarily supported by domestic demand, especially household consumption, where growth accelerated to 4.4 per cent. Over the coming two years growth should gradually gain momentum in all three countries, as easy monetary and credit conditions and stabilization in external markets take hold.

- **Slovenia's** economy grew at the rate of 2.9 per cent year-on-year in 2015, driven by net exports and private consumption. In 2016 and 2017, domestic demand will be the main driver of growth, mainly on the back of improved labour market conditions and a recovering housing market. This will be more than offset by moderating public spending due to fiscal consolidation and termination of the previous EU funding period by end-2015. The contribution of net exports to growth is also expected to decline significantly, as imports will rise on the back of rising domestic demand, albeit with still strong exports. Overall, the economy is expected to grow by 2.0 per cent in 2016 and by 2.3 per cent in 2017.

- In **Croatia,** the six-year recession came to an end in 2015 and the economy expanded by 1.6 per cent. The recovery has been underpinned by a better-than-expected tourist season, stronger external demand and lower oil prices. The EBRD is forecasting growth of 1.5 per cent in both 2016 and 2017. Recovering private consumption will be supported by lower oil prices and continuing disinflation, and exports will grow on further integration of Croatian companies in the EU market and higher tourist inflows due to perceived security risks in competing tourist destinations. Public investments may pick up gradually as the absorption capacity of EU funds rises. Despite some improvement in business sentiment, private investment is expected to remain subdued, pointing to remaining structural weaknesses. The 2015 general government deficit was smaller than expected by many analysts but further fiscal adjustment is needed to put the public debt on a sustainable path, which may weigh on short-term growth prospects. Long-term growth may remain weak in the absence of further reforms in the business environment, resolving high level of (corporate) non-performing loans as well as reducing household and corporate leverage.

South-Eastern Europe (SEE)

Economic growth in south-eastern Europe (SEE) in 2015 was modest, with a weighted average of 2.2 per cent, but with significant divergence across individual countries. All countries recorded positive growth apart from Greece, where the drop in GDP was just 0.2 per cent, well above expectations in mid-2015 when capital controls were introduced and banks were temporarily shut. For 2016, the weighted average for SEE is projected to rise slightly to 2.4 per cent, with a further rise to around 3 per cent in 2017 fuelled by broad-based growth across the region, including in Greece.

Greece

- The economic situation remains very difficult in Greece, but the economy has been more resilient than expected. GDP growth in 2015 was -0.2 per cent, significantly better than projected mid-year. Private consumption held up well, the vital tourism sector had a record year, and most businesses have managed to adjust to capital controls, which have been progressively relaxed since they were introduced. However, major uncertainties remain in the short term. Investment is being held back by delays in the negotiations between Greece and the creditor Institutions (EC, ECB, ESM and IMF) on the first programme review. The refugee crisis is a significant added burden on Greece's public finances and may adversely affect tourism figures this year. On balance, however, we expect modest growth to resume in the second half of 2016 once clarity on the future direction of economic policy and on Greece's debt sustainability is obtained, and provided debt repayments to international creditors are made on time. This would still leave GDP growth slightly negative in 2016, largely because of base effects, but more robust growth (2.4 per cent) is projected for 2017 as investment picks up and confidence returns to the economy.

Cyprus

- Cyprus has made an impressive recovery after being hit by a deep crisis in April 2013. The country exited its adjustment programme in March 2016, two months ahead of schedule, having drawn €7.3 billion of the €10 billion available. Economic growth returned in 2015 at 1.6 per cent after three years of contraction. The government has met or out-performed fiscal targets amid widespread acceptance of the need for initial painful austerity measures. However, the privatisation programme is lagging behind as the proposed sale of key assets has encountered significant internal resistance. Further growth is expected in 2016 and 2017 but is likely to remain low (1.7 and 2 per cent respectively) as banks remain burdened by high NPLs and the elevated level of public debt constrains fiscal spending.

Bulgaria and Romania

- **Bulgaria's** economy grew by 3.0 per cent year-on-year in 2015. Net exports emerged as the main driver of growth, partly on the back of weakening of the euro, to which the domestic currency is pegged, and also due to expanding exports of investment goods to the EU. The contribution of private consumption to growth was higher than expected due to low inflation and improved economic sentiments. In 2016 and 2017, domestic demand will take over as the main driver of growth, supported by higher disposable income on the back of a 10.5 per cent hike in the minimum wage as of January 2016 and improving labour market conditions. Rising consumption will limit the contribution of net exports to growth. Alongside fiscal consolidation and spending discipline, this will keep growth at 2.5 per cent in 2016 and in 2017.

- The **Romanian** economy grew by 3.8 per cent in 2015, supported by domestic demand. While private consumption was the major driver of growth, in a low-inflation environment and helped by a rise in income, investments grew on the back of the lower cost of funding, due to improved investor confidence and historically low lending rates. In 2016 and 2017, strong domestic demand will continue to support growth. Consumption will be pushed up by a cut in the VAT rate to 20 per cent from 24 per cent as of January 2016, a 19 per cent hike in the minimum wage as of May 2016, planned wage hikes in the public sector, improved economic sentiment and a low inflation environment. Private investments will continue to grow on the back of the lower cost of funding and an abolition of the construction tax as of 2017. However, growth is expected to come in at a slower pace amidst uncertainty around 2016 elections. Although public investment might decline due to the end of the previous EU-funding period, public consumption will likely rise on the back of wage rises in the public sector, thus putting some pressure on the fiscal balance. Overall, growth is expected at 4.0 per cent in 2016 and 3.5 per cent in 2017.

Western Balkans

- The **Albanian** economy performed steadily in 2015, successfully withstanding the impact of severe flooding in the south of the country in February and recording 2.6 per cent growth for the year as a whole. In September 2015 the government initiated a high-profile campaign to reduce informality in the economy, and some results are already evident in terms of increased business registration. Fiscal challenges remain significant but the IMF programme remains on track and agreement at staff level on the seventh review was reached in March 2016. GDP growth is likely to accelerate to 3.3 per cent in 2016 on the back of a revived investment cycle, in particular in the energy sector, including the start of major construction work on the Trans-Adriatic gas Pipeline (TAP). A further slight increase to 3.5 per cent is expected in 2017.

- **Bosnia and Herzegovina**'s economy has continued to show considerable resilience in 2015, with the strongest level of growth (estimated at 3.2 per cent) since 2008, helped by a strong performance of manufacturing and a recovery of agriculture after flood damage in 2014. The authorities are currently negotiating a new agreement with the IMF which, if agreed, would be supportive of macroeconomic stability. In July 2015 governments at all levels committed to a new “Reform Agenda” which should lead to important and long-delayed structural reforms. We expect growth of

3 per cent in 2016 and 2017. However, fiscal risks and possible political paralysis remain significant downside risks.

- The economy of **FYR Macedonia** continued to grow at a robust rate in 2015, with GDP growth for the year as a whole reaching 3.7 per cent, helped by household spending, public investment and a strong export performance. We expect growth to remain above 3 per cent in 2016 and 2017. However, downside risks have increased as a result of a political crisis, while the sharp increase in public debt in recent years is another source of risk.

- After a difficult year in 2014, the **Kosovo** economy bounced back in 2015 with growth of around 3 per cent, according to preliminary estimates. Growth was boosted by strong domestic demand and an increase in investment. During the year Kosovo entered into a 22-month €185 million stand-by agreement with the IMF, which is helping the country in cutting unproductive current spending while increasing space for critical investment in transport and energy infrastructure, improving competitiveness, and reducing corruption and informality. The government has also adopted a new National Development Strategy. We expect growth to remain at around 3 per cent in 2016, rising to 3.5 per cent in 2017 as reforms take hold and investment increases further.

- In **Montenegro**, growth picked up in 2015 to an estimated 3.1 per cent (from 1.8 per cent in 2014), with the increase primarily driven on strong FDI inflows and progress on a major Chinese-financed highway project. The tourism sector also performed well in 2015, as a drop in Russian tourists was more than compensated by an increase from other countries, particularly in the Western Balkan region. We expect growth in 2016 to rise further to 4 per cent, as the construction of the highway enters the full swing, another well-booked tourism season, as well as increase private consumption supported by the recent increase in public sector wages, pensions, and social benefits, before falling back to around 3 per cent in 2017 as post-election government spending is tightened. More generally, a major downside risk lies in the fiscal side, and the worrying rise in public debt in recent years may necessitate austerity measures elsewhere, especially if economic growth rates were to falter.

- **Serbia** returned to growth in 2015 despite a programme of fiscal adjustment. GDP grew by 0.7 per cent on the back of a low base after the floods in 2014, increasing private investment and pick-up in exports. Lower oil prices and monetary easing have also supported the recovery. We forecast an acceleration of growth to 1.8 per cent in 2016 and 2.3 per cent in 2017. Private investment will continue to be the main growth driver, supported by a gradual recovery of consumption. Upside risk for the projection (potentially adding 1.0-1.5 percentage points to growth in 2017) comes from potential upscaling of production in the recently privatised large steel mill, with the new Chinese owner announcing ambitious investment and production plans. Medium-term prospects are favourable, but will depend on the pace of reforms needed to further improve the investment climate, support NPL resolution and corporate restructuring with a view to unlocking credit growth, and speed up the implementation of major infrastructure projects.

Turkey

Turkey's economy grew by 4.0 per cent in 2015, surprising on the upside on the back of private consumption. Three reasons for stronger-than-expected private consumption include: (i) stronger refugee influx and their spending; (ii) frontloading of durable goods, such as cars, in expectation of higher prices of imported goods following currency weakening, and (iii) somewhat stronger government transfers amidst recurring elections and refugee influx. Public investment in construction also rose; while the contribution of net exports to growth remained negative due to contraction in exports, on the back of limited external demand and rising geopolitical tensions in the Middle East.

The lira was under pressure in 2015 amid expected monetary tightening in the US, worsening investor sentiment toward emerging markets, elevated regional tensions and domestic political uncertainty between two Parliamentary elections. Consequently, the lira weakened against the US dollar by a cumulative 25 per cent in 2015, while the weakening versus the euro – the currency of Turkey's major trading partner – was 12 per cent, implying a limited improvement in trade competitiveness. Currency weakening, combined with persistently high food prices, kept inflation at 8.8 per cent at end-2015, well above the central bank's target of 5 per cent for the fourth consecutive year. By March 2016, inflation moderated to 7.5 per cent, on the back of a decline in food prices.

Low oil prices and a 30 per cent hike in the minimum wage will support growth in 2016. While still strongly positive, the contribution of consumption may moderate somewhat, as some of the one-off factors boosting consumption last year fade away. In addition, the cost of funding is likely to remain elevated in 2016 and 2017, due to inflationary pressures, monetary tightening by the Fed, as well as elevated volatility in emerging markets. Positive contribution of domestic demand to growth will be partly offset by a negative contribution of net exports due to a sharp decline in tourism receipts following terrorist attacks, Russian sanctions, and still challenging external environment amidst subdued growth in Europe and continuing tensions in the Middle East, although exports might benefit slightly from the lifting of sanctions on Iran.

Overall, the Turkish economy is expected to grow by 3.2 per cent in 2016 and by 3.4 per cent in 2017. The downside risks to the outlook are worsening domestic or regional uncertainties, a large decline in capital inflows due to elevated volatility in the global financial markets, or a bounce back in oil prices. Nevertheless, the banking sector and fiscal balances remain stable, with low non-performing loan ratio and public debt standing at around 35 per cent of GDP at end-2015.

Eastern Europe and the Caucasus (EEC)

The EEC region contracted at the rate of 4.8 per cent in 2015 on the back of negative growth in Ukraine, Belarus and Moldova. Geopolitical tensions, low oil prices and recession in Russia influenced regional trade, investment and financial linkages and remittances. National currencies and foreign exchange reserves came under pressure. Weaker exchange rates facilitated external adjustment, but at the same time affecting disposable incomes and public and private sector balance sheets. The rate of output decline in the EEC region is expected to moderate to 0.2 per cent in 2016, with such outlook contingent on a better regional economic environment, a reduction in geopolitical risks and other country-specific factors. The stabilization of output in Ukraine and growth in Armenia and Georgia are expected to help offset the negative growth forecasts for Azerbaijan and Belarus.

- **Armenia** grew by close to 3 per cent in 2015 despite economic spill-overs from Russia, regional currency adjustments and lower remittances. Growth in 2015 was supported by a positive contribution from agriculture and mining and was driven by government consumption and an improvement in net exports. However, gross capital formation and household consumption decreased. Inflation has been contained by the stability of the dram, a tight monetary policy and low commodity import prices. The dram-US$ exchange rate has been predominantly stable on the back of central bank interventions early in 2015 and, more recently, the large adjustment of the current account. Gross international reserves were at close to four months of imports in the first quarter of 2016, helped by the issuance of a sovereign Eurobond in March 2015. Public finances remained generally sound, although fiscal space is limited, as general government gross debt is expected to increase to close to 50 per cent of GDP in 2016. Growth and currency stability in the first quarter of 2016 were helped by positive dynamics in industry, agriculture and services, and an increase in exports and fall in imports. The banking sector loan book remained flat in line with a consolidation in the financial sector. The conflict in the Nagorno-Karabakh region represents a risk to the growth outlook. We have left our 2016 Armenia GDP growth forecast unchanged at 2 per cent and we are forecasting growth of 2 per cent for 2017.

- **Azerbaijan's** economy grew by 1.1 per cent in 2015. Stronger growth of 5.7 per cent in the first half of the year was partly due to significant construction projects and to the lower oil production base of 2014. Growth decelerated considerably in the second half of 2015, with the drop in oil prices leading to a contraction of Azerbaijan's export receipts. Following year-on-year growth of 3.7 per cent in the first half of 2015, capital investment fell by 11.1 per cent year-on-year in 2015. In December 2015, Azerbaijan devalued its currency by 33 per cent (the second devaluation in 2015) and shifted to a more flexible exchange rate regime, with the manat losing almost 50 per cent of its value against the US dollar during the year as a whole. The devaluations led to balance sheet pressures in the real and financial sectors. In the context of the low oil price, the current account balance worsened from a surplus of 13.9 per cent of GDP in 2014 to a deficit of 0.4 per cent of GDP in

2015. In the first quarter of 2016, real GDP fell by 3.5 per cent, with non-oil GDP contracting by 5.7 per cent. Investment in fixed assets – an important contributor to growth in previous years – dropped by close to 34 per cent year-on-year. Liquidity buffers declined but remain sizable. At the end of 2015, the combined assets of the State Oil Fund (SOFAZ) and of the Central Bank's foreign exchange reserves stood at US$ 38.5 billion, approximately 70 per cent of 2015 GDP and 25 months of imports, providing a safety cushion against liquidity and refinancing risks. Official foreign reserves of the Central Bank fell from US$ 15 billion in November 2014 to US$ 4.1 billion in March 2016. We expect Azerbaijan's economy to shrink by 3 per cent in 2016 and to grow by 1 per cent in 2017. The conflict in the Nagorno-Karabakh region represents a risk to the growth outlook.

- **Belarus**'s economy shrank by 3.9 per cent in 2015 after 19 years of positive growth. All main sectors contracted – mining, manufacturing, construction and agriculture. Recession in Russia and the depreciation of regional currencies exacerbated Belarus's external imbalances. International reserves declined from US$ 3.9 billion in October 2014 to US$ 2 billion in March 2016 (approximately 1.5 months of imports). Against a backdrop of low international reserves and limited borrowing options, the authorities attempted external and internal adjustments. The Belarus rouble depreciated against the US dollar by 36 per cent in 2015 and by a further 8 per cent in the first quarter of 2016. General government fiscal policy is reasonably tight, although there are contingent fiscal liabilities related to state banks and state-owned enterprises. In the first quarter of 2016, GDP contracted by 3.6 per cent year-on-year, with gross value added in manufacturing – the largest sector of the economy – falling by 4.4 per cent and with construction output falling by 23.6 per cent year-on-year. In March 2016, the Eurasian Fund for Stabilisation and Development approved a US$ 2 billion loan for Belarus, to be disbursed in tranches in 2016-2018 (a first tranche of US$ 0.5 billion was disbursed in March). Taking Belarus's trade linkages with Russia into account, as well as the structure of the economy, imbalances and refinancing risks, we expect Belarus's economy to shrink by 3 per cent in 2016 before growing by 1 per cent in 2017.

- Growth in **Georgia** is expected to improve to 3.4 per cent in 2016, compared with 2.8 per cent in 2015. While the external environment remains challenging, with remittances and exports negatively affected by recession in Russia and a sharp slowdown in regional trading partners, the country is likely to enjoy a strong tourism season – helped by constraints on other tourism destinations, such as Turkey – and increased investor confidence supported by the business-friendly policies of the government and the National Bank of Georgia. Trust in the Lari and in Central Bank policies is also increasing. This factor can also be expected to reduce dollarization in the economy, which currently stands at 68 per cent on the deposit side and 66 per cent on the loan side. Following a 21 per cent decline of the Lari in 2015, which given the high level of dollarization is increasingly affecting NPLs, the current account deficit can be expected to stabilise and dollarization to start gradually declining in 2016. This will reduce downward pressure on the Lari. In 2017, growth is expected to increase further to 3.9 per cent, supported by an increasing impact of the Deep and Comprehensive Free Trade Area (DCFTA) implementation and increased competitiveness, as well as strong domestic and foreign direct investment in infrastructure and other sectors.

- **Moldova**'s GDP contracted by 0.5 per cent in 2015, driven in part by a drop in agriculture production. In 2015, exports of goods and services fell by 15 per cent year-on-year and remittances, which amounted to 17 per cent of GDP in 2015, fell by 30 per cent year-on-year (both in US dollar terms). Inflation accelerated to 13.6 per cent year-on-year in December 2015 and then slowed to 9.4 per cent year-on-year in March 2016 amid tight monetary policy conditions. Following a 21 per cent depreciation against the US dollar in 2015, the leu exchange rate remained stable in the first quarter of 2016. Official reserves decreased significantly between November 2014 and February 2015 and then stabilised in March-December 2015 at approximately US$ 1.8 billion (4 months of imports). A tight monetary stance in the wake of large-scale banking sector fraud helped to contain exchange rate and inflation pressures, although the flow of credit has been severely disrupted and domestic public borrowing has become prohibitively expensive. International budget support has been suspended and fiscal planning is short-term, lacking an adequate planning horizon. In January-February 2016, exports, imports and remittances fell respectively by 18.5 per cent year-on-year, 13.8 per cent year-on-year and 12 per cent year-on-year. The economic outturn for 2016 depends largely on the agricultural performance and on the situation in the banking sector. Monetary and fiscal space is limited. We are retaining our 2016 growth forecast for Moldova at zero per cent and project growth of 2 per cent in 2017.

- **Ukraine**'s economy contracted by 9.9 per cent in 2015 after a 6.6 per cent contraction in 2014. In US dollar terms, GDP decreased from approximately US$ 180 billion in 2013 to US$ 90 billion in 2015. In the second half of 2015, the economy likely bottomed out, posting positive quarter on quarter growth rates. Consumer price inflation averaged 48.7 per cent in 2015, having slowed down to 43.3 per cent year-on-year in December 2015 from 60.9 per cent year-on-year in April 2015. On the back of a stabilising exchange rate, weak domestic demand, low global commodity prices and prudent fiscal and monetary policies, inflationary pressures are expected to decrease in the next 12 months. The hryvnia depreciated against the US dollar by a total of 67 per cent in 2014-2015 and by a further 10 per cent in the first quarter of 2016, stretching the real, financial and public sector balance sheets. Tight capital controls introduced in 2014-2015 remain in place. External and fiscal adjustment continued. The current account deficit decreased significantly from close to 9 per cent of GDP in 2013 to almost zero in 2015. The volume of net private inflows depends on the resumption of disbursements under the IMF programme, on political stability and on a continued momentum for reform in crucial areas such as banking and energy, privatisation, the rule of law and the administration of justice. The transformation of the banking sector continued, although the flow of credit to the real sector remains highly constrained. The number of licensed banks decreased from 180 in January 2014 to 116 in February 2016. Ownership transparency has improved, controls over related party lending have been tightened and the independence of the National Bank of Ukraine has been strengthened. Official funding remains essential for a further build-up of international reserves which in March 2016 stood at US$ 12.7 billion (approximately 3 months of imports). Fiscal consolidation was significant, with the combined general government and Naftogaz deficit decreasing from close to 10 per cent of GDP in 2014 to close to 3 per cent in 2015. Influenced by the hryvnia depreciation, the public debt-to-GDP ratio increased from 40 per cent in 2013 to close to 80 per cent in 2015, although the Eurobond debt restructuring implemented in 2015 helps to mitigate repayment risks. We are retaining our 2016 growth forecast for Ukraine at 2 per cent and project growth of 2 per cent in 2017.

Russia

In **Russia**, GDP declined by 3.7 per cent in 2015 after five years of growth. Economic data point to a sharp contraction in both household demand (10.1 per cent) and corporate investments (7.6 per cent) in 2015, as inflation has been cutting into real incomes, while sanctions and high interest rates dampened business and consumer confidence and also made access to financing more difficult and costly. Export volume expanded by 3.7 per cent, reflecting mostly an increase in exports of commodities despite decreasing prices. Private sector capital outflows continued in 2015, but at a slower pace (US$ 57 billion in 2015 versus US$ 153 billion in 2014), mostly reflecting private sector deleveraging. A further drop in oil prices at the beginning of 2016 continued to weigh on domestic demand, depressing retail trade (-5.9 per cent year-on-year in February 2016).

Fiscal policy has acted counter-cyclically, with a high deficit recorded in 2015 (-3.5 per cent vs -1.1 per cent in 2014), but, assuming permanently lower oil prices, fiscal outlook is challenging. The 2016 budget aims to reduce the deficit by limiting the growth of certain social payments (pension and wage indexation) and foresees a real cut in other expenditures. Given sustained low oil prices, the deficit is likely to widen further and may accelerate the exhaustion of reserve funds. The scope for further fiscal support is limited, as the government has been facing financing constraints on the domestic market and foreign markets may remain closed for longer.

Monetary policy has tried to support disinflation and avoid excessive exchange rate volatility. The key policy rate has been unchanged since August 2015. Depreciation pressures eased following the most recent increase in the oil price, while weak demand and base effects supported disinflation (CPI dropped to 7.3 per cent in March 2016 from the peak of 15.9 per cent in February 2015).

Financial sanctions are taking a toll on Russian banks. In order to clean up and consolidate the banking system, the Central Bank of Russia (CBR) has closed some 190 banks with weak financial performance and poor corporate governance since 2014. Household loan growth has remained negative in 2016, while NPLs have been increasing in both the corporate and the household sector.

We are keeping our growth forecast for 2016 unchanged at -1.2 per cent, as oil prices remain subdued, sanctions may not be removed soon and structural reforms are progressing slowly. In addition, limited short-term effects of supportive fiscal and monetary policies could be offset by supply-side constraints due to low investment and outdated production capacities. In 2017 growth is expected to pick-up to 1 per cent supported by recovering oil prices, private consumption and investment, while long-term growth, without significant reforms, may stay at around 1 to 2 per cent annually.

Central Asia

Growth in Central Asia in 2016 is projected to decrease to 3.3 per cent, compared to 3.6 per cent in 2015 and 6.0 per cent in 2014, reflecting expectations of a continuing negative external environment. The countries with the strongest economic links to Russia – the Kyrgyz Republic, Tajikistan and Uzbekistan – are being particularly negatively affected. In Kazakhstan, the largest economy in the region, growth and broader economic conditions, including the exchange rate regime, are expected to stabilize in 2016, following a very challenging period in the last quarter of 2015 and the first two months of this year. Growth is expected to reach 1.1 per cent this year, only slightly below the 1.2 per cent achieved in 2015. The economy is being supported by a combination of a gradual return of investor confidence, stabilisation of the exchange regime internally, private and (especially) public investment and more benign commodity prices. FDI from China, including as part of the development of the Silk Road Economic Belt, is providing a significant anchor for growth in some of the countries in the region, and the importance of this source of FDI is likely to increase. Support and investment from Russia also plays an important role.

In 2017, growth in the region is projected to increase to 4 per cent, driven by a positive trend in Kazakhstan in particular, where growth is projected to accelerate to 2.4 per cent. Growth in Mongolia and Turkmenistan, significant commodity exporters, is also likely to improve in 2017. However, a build-up of structural problems over the past two years, resulting from such factors as slowing growth and significant currency depreciation, can be expected to continue to depress growth in the Kyrgyz Republic, Tajikistan and Uzbekistan in 2017.

Overall, there remain significant risks to growth in the region in 2016-17 associated with external events (such as a possible hard landing in the Chinese economy or an increase in the intensity of the Russia-Ukraine crisis) as well as internal regional vulnerabilities. While the likelihood of these risks materialising is small, if they do materialise, growth in the region could be considerably lower.

- Growth in **Kazakhstan** can be expected to start recovering in 2016 and 2017, following a challenging period. The last quarter of 2015 and January-February 2016 were particularly difficult, with external pressures resulting in a contraction of the economy, a dramatic drop of the Tenge (after the introduction of a flexible exchange rate regime with inflation targeting), high inflation (reaching 15.7 per cent year-on-year in March 2016), and limited availability of Tenge liquidity. However, steps taken by the Government and the NBK in response to the crisis since early 2014 – including the introduction of the US$ 3billion a year counter-cyclical investment programme Nurly Zhol, and a series of structural reforms across sectors – are beginning to create a more positive environment, which combined with stabilisation of oil prices, are beginning to provide a basis for recovery. Growth in 2016 is seen at 1.1 per cent, and is projected to improve further to 2.4 per cent in 2017, as the external environment and investor confidence improve, resulting in stronger exports of oil, higher FDI and increased investment domestically, although downside risks to growth remain significant. In terms of FDI, a significant expected increase of investment from China, including the development of the Silk Road Economic Belt, combined with expected recovery of FDI from EU and other countries, can be expected to boost growth and, more broadly, provide platform for creating better connectivity and growth (including in the non-infrastructure sectors) in the country. In addition to trade and investment links to traditional partners, links with such newly-open markets as Iran can also provide a boost to growth. Internally, the banking sector remains a concern, as the sector faces lack of long-term Tenge liquidity, a high level of dollarization and increasing NPLs; there is also a need to improve the capitalisation of in the sector. As a result of the steps taken by the NBK, combined with a more benign external environment, the exchange rate is beginning to stabilise and (short-term) Tenge liquidity is returning to the market. These positive developments will provide a good basis for further normalisation of Tenge liquidity and a reduction of dollarization in the banking sector. Whilst, average annual inflation for 2016 can be expected to reach 13.2 per cent, it is projected to return 7.5 per cent in 2017, within the 6-8 per cent range set by the NBK, and decline further in subsequent years.

- Growth in the **Kyrgyz Republic** is expected to decline significantly to 1.0 per cent in 2016, compared to 3.5 per cent in 2015, reflecting continued external challenges, following major challenges in 2014 and 2015. Remittances from Russia have declined significantly in 2015 (25 per cent year-on-year in US dollar terms, 10 per cent in Som terms); overall exports were down by 12 per cent in 2015 and are expected to remain subdued. The Som depreciated 22 per cent (against the US dollar) in 2015, despite tight monetary policy and interventions on the currency market by the National Bank of Kyrgyz Republic. Change of the tariff structure enacted as part of the accession to the Eurasian Economic Union (EEU) has negatively affected trade with countries outside of the EEU, whilst potential benefits to Kyrgyz companies from access to the larger (EEU) market are not fully accruing as a result of an insufficient quality of production and a lack of quality standard certification facilities (needed for the certification of exports within the EEU). Financial support and FDI from Russia and China in particular have helped to counter the effects of the negative external environment, and the role of this support and investment can be expected to remain important in 2016-17. Growth in 2017 can be expected to improve, projected at 2.6 per cent, reflecting an expected gradual improvement in the external environment in 2017; however, a build-up of challenges over 2014-16 will continue to weigh on the outlook on prospects.

- Growth in **Mongolia** slowed from double-digit levels in 2011-13 to 8.1 per cent in 2014 and 2.4 per cent in 2015, reflecting lower prices of commodities and slower exports to China, which constitute around 33 per cent of GDP. Domestically, a slow-down in the real estate sector is also putting negative pressure on growth, and the Tugrik depreciated by 16.8 per cent (against the US dollar) over 2014-15. Growth in 2016, however, is projected to increase to 3.9 per cent. While the challenging external environment will continue to weigh on growth, the signing of the Oyu Tolgoi second phase (a project worth close to US$ 6 billion) will increase FDI and should lead to an improvement in the investment climate and in consumer confidence. The potential loosening of fiscal policy in 2016 in the wake of parliamentary elections in June 2016 could give a further short-term boost to growth. Growth in 2017 is projected to increase to 5.1 per cent, reflecting strong FDI, an improvement in investor confidence and a gradual expected improvement in commodity prices.

- Growth in **Tajikistan** in 2016 is projected to decline to 4.5 per cent, compared to 6.0 per cent in 2015. The external environment remains particularly challenging, with remittances from Russia declining by 42 per cent in US dollar terms and 33.3 per cent in Somoni terms in 2015 year-on-year. The somoni depreciated 24 per cent (against the US dollar) in 2015, which is putting pressure on NPLs and the performance of the banking sector generally. Whilst headline economic growth in the country in 2014 and 2015 has been resilient to these external shocks – helped by financial support and FDI from China in particular – and notwithstanding the fact that remittance flows from Russia may stabilise in 2016, the legacy of sharply lower remittances and returning migrants in 2014-15 as well as increasing NPLs can be expected to continue to weigh on growth in 2016, and in 2017 in particular. Growth in 2017 is projected to decline further and reach 4.1 per cent, with significant downside risks to achieving this level of growth, reflecting a risk of negative external events and internal structural vulnerabilities.

- A significant drop in oil and gas prices and a slowdown in the economies of regional trading partners have put pressure on growth in **Turkmenistan**, with officially recorded GDP growth down to 6.5 per cent in 2015, compared to 10.3 per cent in 2014. The Manat was devalued by 19 per cent (against the US dollar) at the beginning of 2015, which is helping to improve competitiveness with regional peers. Pressure on the Manat has continued, and the authorities have responded by introducing stringent FX regulations, which have mitigated pressure on the currency, whilst at the same time negatively affecting the ability of businesses in the country to carry out import-export operations. Growth in 2016 is expected to remain at the level of 2015, reaching 6.5 per cent, supported by FDI both in the extractive and non-extractive sectors and a gradual improvement in the external environment, offset by negative effects of the currency restrictions on the real economy. Plans related to the Turkmenistan-Afghanistan-Pakistan-India pipeline have been finalised, with the work on the Turkmen part of the pipeline already underway, resulting in increased investment. In 2017, growth can be expected to recover slightly to 7.1 per cent, reflecting expected gradual improvements in commodity prices and inward FDI.

- Growth in **Uzbekistan** is expected to decline to 6.5 per cent in 2016, compared with 8.0 per cent in 2015, reflecting a build-up of weaknesses in the economy resulting from a sharp drop in remittances from Russia and a slowdown in some of the main trading partners over 2014-15. The Som has depreciated by 21 per cent (against the US dollar) over 2014-15, which has helped increase competitiveness, whilst putting pressure on NPLs in the banking sector. Inflation is expected to remain high at 9.0 per cent in 2016. In 2017, growth can be expected to decline further to 6.2 per cent, as external factors continue to weigh on remittances and trade, and to crystalize internal macroeconomic vulnerabilities, increasing risks to growth.

Southern and Eastern Mediterranean (SEMED)

Growth in SEMED has been revised downwards across the board. The region as a whole is now expected to grow at 2.9 per cent in 2016, down from 4.1 per cent in the November forecast. A key challenge for the region is the contraction in tourism receipts – which has been particularly severe in Egypt and Tunisia, both of which experienced terrorist attacks in 2015. Exports are contracting across the region – with the notable exception of Morocco, which is reaping the rewards of successful policies to promote high-value added exports. In addition to the global slowdown in growth and international trade, some country-specific factors have contributed to the weak export performance, ranging from weak competitiveness in Egypt to border closures in Jordan and labour strikes in Tunisia. Regional growth is expected to pick up to 4 per cent in 2017.

- After a strong expansion of 4.2 per cent on the year in FY2014/15, growth in **Egypt** slowed to 3 per cent in the first quarter of FY2015/16, driven by a sharp contraction of exports of over 25 per cent. This was the result of: a fall in tourism receipts; declining Suez Canal earnings reflecting a slowdown in global trade; and weak competitiveness. Several domestic and external headwinds are expected to hold growth to 3.3 per cent for FY2015/16 as a whole. Domestically, foreign exchange shortages have constrained manufacturing activity given its high dependence on imported inputs – though a 13 per cent devaluation of the EGP in March should ease foreign exchange and competitiveness pressures. Moreover, tourist arrivals have fallen by over 45 per cent on the year in the aftermath of the downing of a Russian airplane over Sinai in October 2015 and will likely take time to recover. Externally, the continued slowdown in world trade is expected to weigh on Suez Canal receipts. A rebound to growth of 4.2 per cent is expected in FY2016/17, helped by improved competitiveness.

- In **Jordan**, growth slowed to 2.4 per cent in 2015 from 3.1 per cent in 2014 as conflicts in neighbouring Iraq and Syria adversely affected trade and tourism and deterred investment. The weakening growth performance was driven by a contraction in the restaurant and hotel and construction sectors, despite strong growth in mining and utilities. Tourism arrivals contracted by 8 per cent compared to 2014 (marking five consecutive years of decline). Regional turmoil also adversely impacted exports, which contracted by 8 per cent while FDI plunged by 37 per cent. Given the difficult regional environment and slowing global trade, growth is expected to rise only modestly to 3 per cent in 2016 and 3.3 per cent in 2017. Private consumption – supported by higher demand from rising numbers of refugees – is expected to drive the modest improvement in growth.

- Growth in **Tunisia** decelerated significantly in 2015 to 0.8 per cent from 2.3 per cent in 2014, driven by the adverse impact of terrorist attacks and continued industrial disputes. The tourism sector was severely affected by three deadly terrorist attacks – in March, June and November 2015 – resulting in a decline in tourist receipts of over 35 per cent in 2015. Ongoing industrial disputes in the mining sector as well as cutbacks in investment by foreign oil companies in the energy sector led to contractions in output of over 6 per cent on the year. Strong agricultural growth of 9.1 per cent in 2015 – in olive oil production in particular – only partially offset the downward pressures on overall growth. While the three major public banks have been recapitalised, financial vulnerabilities remain. The Tunisian banking system has the highest non-performing loan (NPL) ratio in SEMED, at 16 per cent at the end of 2015, with NPLs on the rise due to the exposure of banks to the tourism sector. Growth is expected to slow down to 1.6 per cent in 2016 and gradually pick up to 2.5 per cent in 2017.

- **Morocco**'s GDP growth in 2015 reached 4.5 per cent, up from 2.4 per cent in 2014. This was driven primarily by a strong agricultural sector rebound of 14.1 per cent, and a modest non-agricultural growth of 2.0 per cent. Morocco's industrial strategy of developing high-value added sectors such as automotive and aeronautics industries is showing positive results and is counter balancing the decline in more traditional sectors such as textiles or tourism; in particular, exports in the automobile sector grew by 20.9 per cent over 2015 above total exports growth of 6.7 per cent, while aerospace exports increased by 4.5 per cent. Regional security concerns are still adversely affecting the tourism sector, which saw a contraction of 1.4 per cent over 2015 and a decline in the number of arrivals – excluding Moroccan residents abroad – of 5.2 per cent over the same period. Growth is expected to decelerate in 2016 to 2.3 per cent, as the drought in the winter weighs on agricultural output, sluggish growth in Europe – Morocco's main trade partner – and continued modest non-agricultural growth.

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 twice 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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