European Bank
for Reconstruction and Development

# Regional Economic Prospects in EBRD Countries of Operations

# May 2017

## Growth picking up despite political uncertainty

*Growth in the EBRD region averaged 1.8 per cent in 2016, broadly in line with projections made as far back as May 2015. Average growth is expected to pick up to 2.4 per cent in 2017 and 2.8 per cent in 2018. The outlook for growth in 2017 is largely unchanged compared with our last forecast in November 2016.*

*Russia's economy is projected to return to moderate growth after a cumulative output decline of 3 per cent in 2015-16. Growth is also expected to pick up slightly in Central Asia and Eastern Europe and the Caucasus (EEC) reflecting a stabilisation of commodity prices and resumed growth in Russia. The gap between growth rates in these regions and the rest of the EBRD countries is estimated to have narrowed in the first half of 2017.*

*Growth in Central Europe and the Baltic States (CEB) and south-eastern Europe (SEE) is also projected to strengthen, reflecting a pick-up in investment after a dip in 2016 and a number of country-specific drivers.*

*In contrast, weaker tourism receipts, partly due to security concerns and geopolitical risks, continue to cloud the outlook in the southern and eastern Mediterranean (SEMED) and Turkey where projections have been downgraded, largely accounting for the slight downward revision for the EBRD region as a whole. Growth in Turkey is now projected to moderate to 2.6 per cent in 2017 from 2.9 per cent in 2016, reflecting increased capital outflows and a weaker outlook for investment on the back of political uncertainty. Growth in SEMED in 2017 is projected at around 3.7 per cent on average, as a drop in purchasing power of Egypt's consumers owing to high inflation will only be partially offset by stronger investment activity.*

*These projections are subject to major risks related to geopolitical tensions in and around the region. In addition, the global environment is characterized by increased political uncertainty and a number of conundrums, notably the substantial improvement in economic confidence indicators that have not been reflected in hard economic data.*

## Table 1: Real GDP Growth

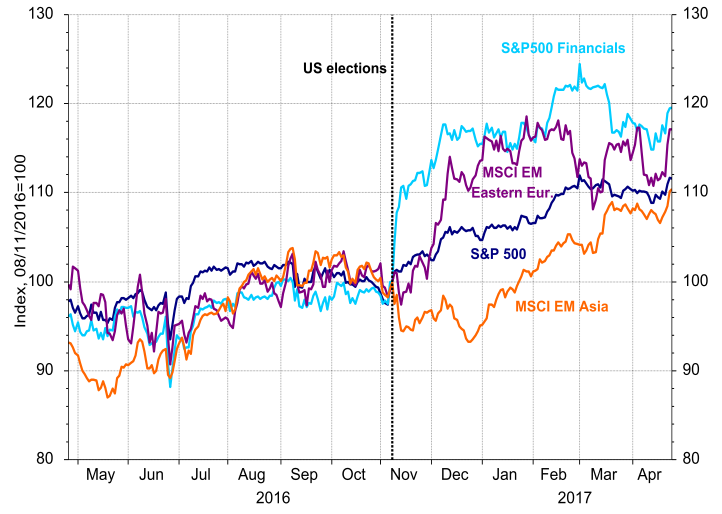
*(In per cent; EBRD forecasts as of 10 May 2017)*

| | Actual | Estimate | Current forecast | | EBRD Forecast in November 2016 | |
|---|---|---|---|---|---|---|
| | 2015 | 2016 | 2017 | 2018 | 2017 | Change Nov.-May. |
| **EBRD Region[1]** | **1.3** | **1.8** | **2.4** | **2.8** | **2.5** | ***-0.1*** |
| **Central Europe and the Baltic states** | **3.4** | **2.6** | **3.1** | **3.1** | **3.0** | ***0.1*** |
| Croatia | 16 | 2.9 | 2.9 | 2.6 | 2.0 | *0.9* |
| Estonia | 14 | 16 | 2.4 | 2.7 | 2.4 | *0.0* |
| Hungary | 3.1 | 2.0 | 3.0 | 3.0 | 2.4 | *0.6* |
| Latvia | 2.7 | 2.0 | 3.1 | 3.2 | 3.1 | *0.0* |
| Lithuania | 18 | 2.3 | 2.9 | 3.0 | 2.9 | *0.0* |
| Poland | 3.8 | 2.7 | 3.2 | 3.2 | 3.2 | *0.0* |
| Slovak Republic | 3.8 | 3.3 | 3.2 | 3.5 | 3.2 | *0.0* |
| Slovenia | 2.3 | 2.5 | 2.5 | 2.2 | 2.3 | *0.2* |
| **South-eastern Europe** | **2.4** | **2.9** | **3.1** | **3.0** | **3.0** | ***0.1*** |
| Albania | 2.6 | 3.5 | 3.5 | 3.7 | 3.5 | *0.0* |
| Bosnia and Herzegovina | 3.0 | 2.0 | 2.5 | 3.0 | 3.0 | *-0.5* |
| Bulgaria | 3.6 | 3.4 | 3.2 | 3.0 | 2.8 | *0.4* |
| Cyprus | 17 | 2.8 | 2.5 | 2.2 | 2.2 | *0.3* |
| FYR Macedonia | 3.8 | 2.4 | 2.4 | 3.0 | 3.0 | *-0.6* |
| Greece | -0.2 | 0.0 | 2.0 | 2.2 | 2.0 | *0.0* |
| Kosovo | 4.0 | 3.4 | 3.5 | 3.5 | 3.5 | *0.0* |
| Montenegro | 3.4 | 2.5 | 3.0 | 3.3 | 3.5 | *-0.5* |
| Romania | 3.9 | 4.8 | 4.0 | 3.5 | 3.7 | *0.3* |
| Serbia | 0.8 | 2.8 | 2.9 | 3.0 | 2.7 | *0.2* |
| **Eastern Europe and the Caucasus** | **-4.8** | **0.0** | **1.1** | **2.4** | **1.7** | ***-0.6*** |
| Armenia | 3.0 | 0.2 | 2.5 | 3.0 | 2.0 | *0.5* |
| Azerbaijan | 11 | -3.1 | -0.5 | 2.0 | 10 | *-15* |
| Belarus | -3.8 | -2.6 | -0.5 | 10 | 10 | *-15* |
| Georgia | 2.9 | 2.7 | 3.9 | 4.2 | 3.9 | *0.0* |
| Moldova | -0.5 | 4.1 | 3.0 | 3.5 | 2.5 | *0.5* |
| Ukraine | -9.8 | 2.3 | 2.0 | 3.0 | 2.0 | *0.0* |
| **Turkey** | **6.1** | **2.9** | **2.6** | **3.0** | **3.0** | ***-0.4*** |
| **Russia** | **-2.8** | **-0.2** | **1.2** | **1.4** | **1.2** | ***0.0*** |
| **Central Asia** | **3.7** | **3.5** | **3.8** | **4.6** | **3.9** | ***-0.1*** |
| Kazakhstan | 12 | 10 | 2.4 | 3.5 | 2.4 | *0.0* |
| Kyrgyz Republic | 3.9 | 3.8 | 3.9 | 4.1 | 2.6 | *13* |
| Mongolia | 2.4 | 10 | 14 | 2.8 | 3.2 | *-18* |
| Tajikistan | 6.0 | 6.9 | 3.8 | 4.0 | 4.1 | *-0.3* |
| Turkmenistan | 6.5 | 6.2 | 5.7 | 6.0 | 7.1 | *-14* |
| Uzbekistan | 8.0 | 7.8 | 6.2 | 6.5 | 6.2 | *0.0* |
| **Southern and Eastern Mediterranean[2]** | **4.0** | **3.4** | **3.7** | **4.1** | **4.0** | ***-0.3*** |
| Egypt | 4.4 | 4.3 | 3.8 | 4.5 | 4.0 | *-0.2* |
| Jordan | 2.4 | 2.0 | 2.3 | 2.5 | 2.8 | *-0.5* |
| Morocco | 4.5 | 15 | 4.2 | 3.8 | 4.8 | *-0.6* |
| Tunisia | 11 | 10 | 2.2 | 2.7 | 2.5 | *-0.3* |
| **Average "East": EEC, CA, Russia** | **-2.1** | **0.4** | **1.6** | **2.1** | **1.7** | ***-0.1*** |
| **Average "West": CEB, SEE, SEMED, Turkey** | **4.2** | **2.9** | **3.1** | **3.3** | **3.2** | ***-0.1*** |

[1] All averaged use weights corresponding to countries' nominal GDP values in US dollars at PPP.

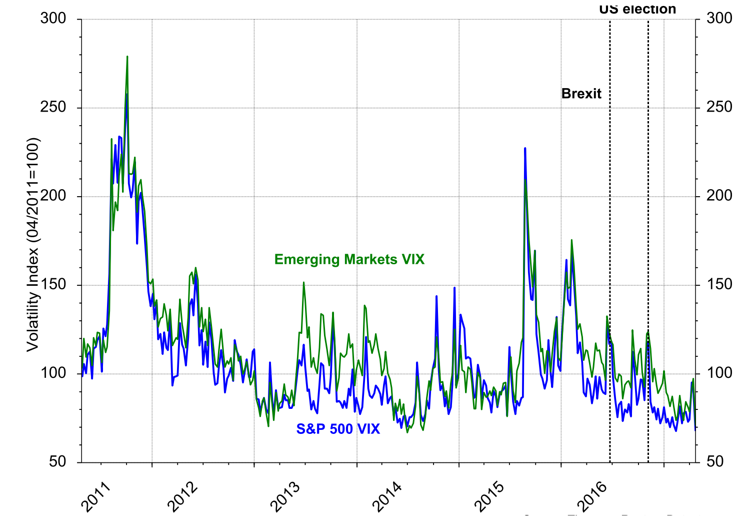
[2] Egypt's growth numbers are for the fiscal years ending June.

Chart 1. Equity indices, 08 Nov 2016 = 100



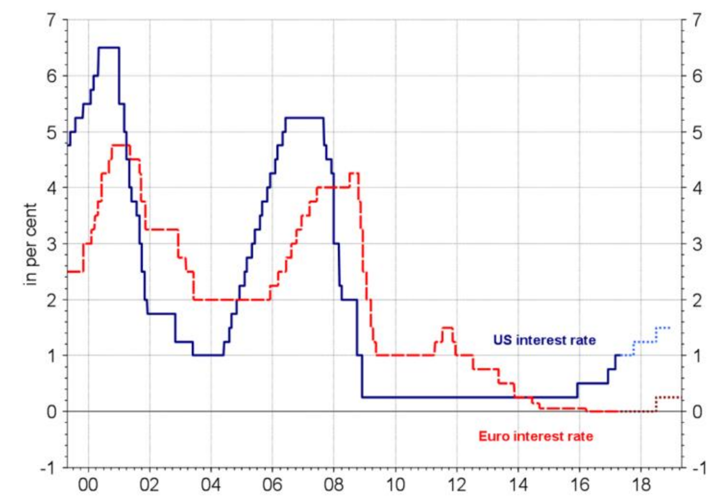

*Source: Thomson Reuters, EBRD calculations*

Chart 2. Stock market volatility



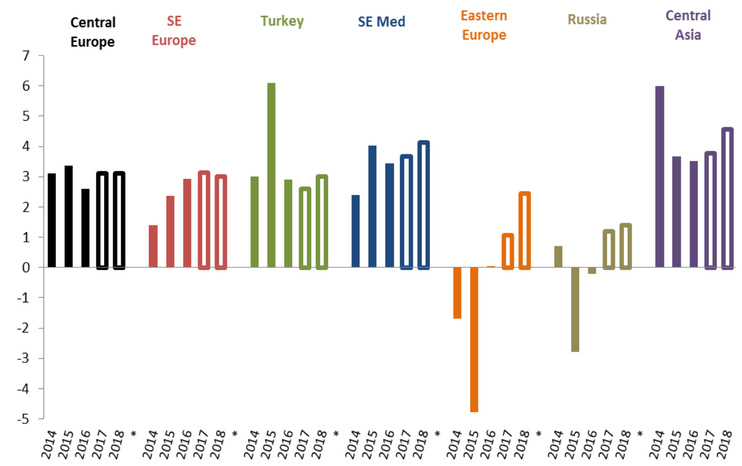

*Source: Thomson Reuters, EBRD calculations*

Chart 3. US and ECB policy rates, historical and expected



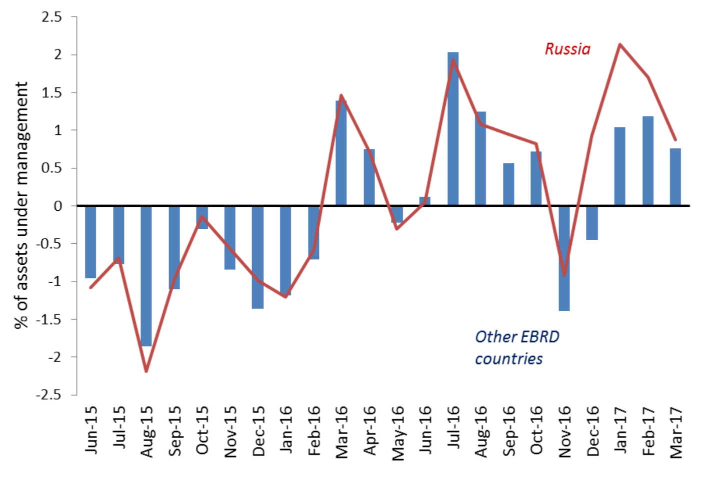

*Source: Thomson Reuters, EBRD calculations*

Chart 4. Economic growth in individual regions, %



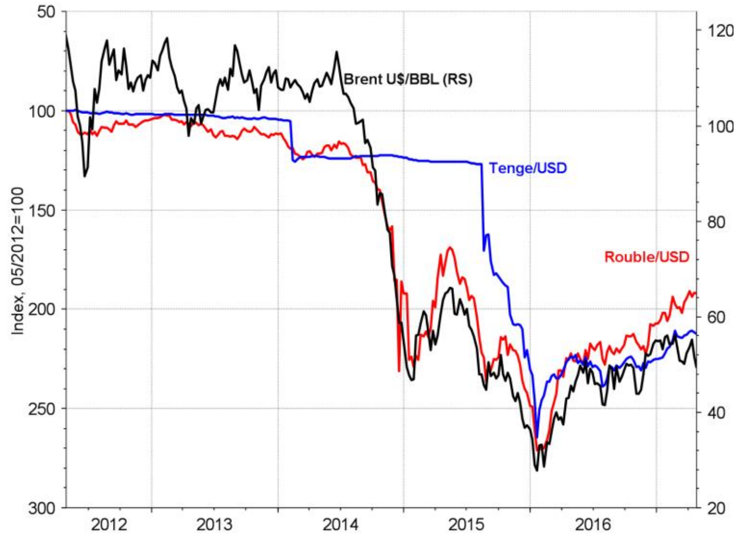

*Source: National authorities, EBRD*

Chart 5. Net mutual fund flows to EBRD countries



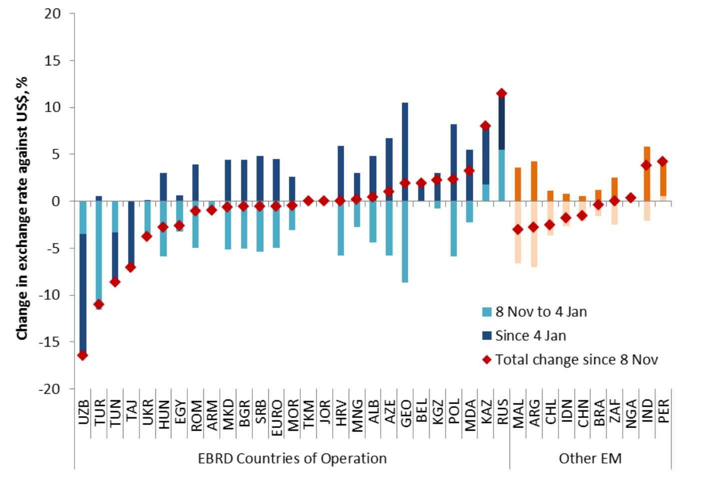

*Source: EPFR, EBRD calculations*

Chart 6. Selected currencies against US dollar and oil price



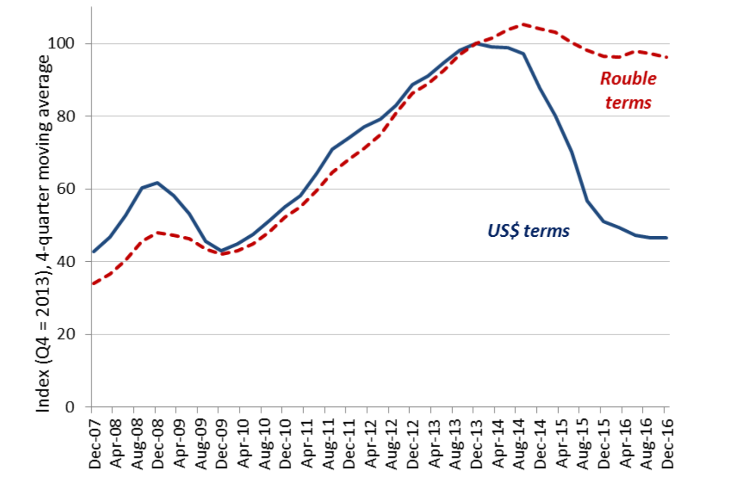

*Source: Thomson Reuters, EBRD calculations*

Chart 7. Exchange rate movements against the US dollar



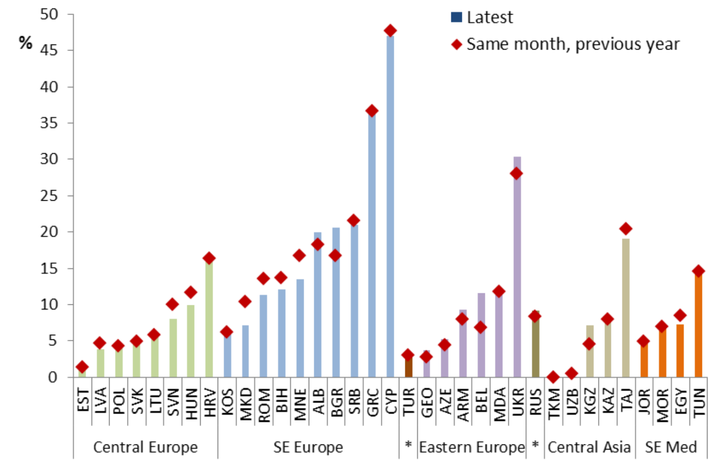

*Source: Thomson Reuters, EBRD calculations*

Chart 8. Remittances from Russia to Central Asia and EEC



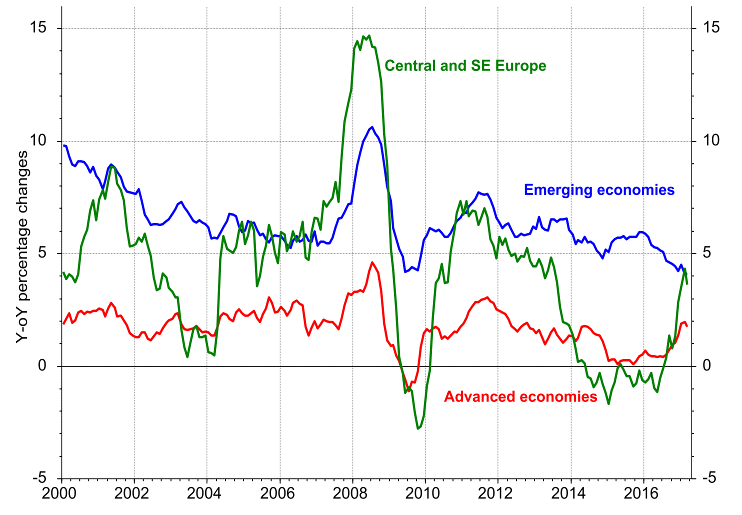

*Source: Central Bank of Russia*

Chart 9. Non-performing loan ratios



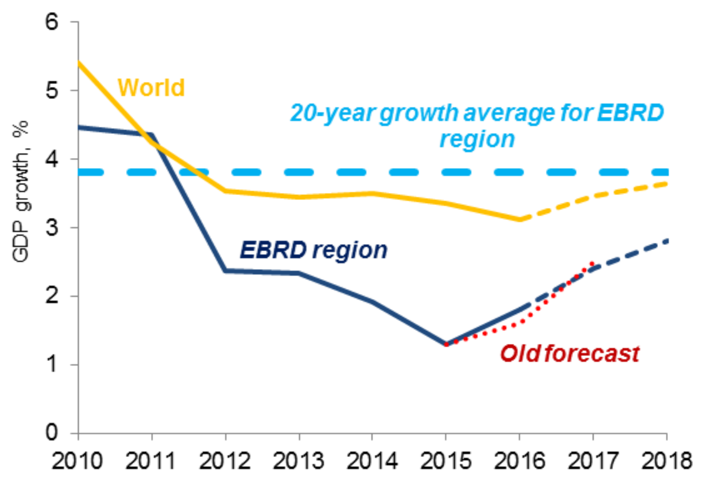

*Source: National authorities via CEIC, EBRD calculations*

Chart 10. Average inflation rates



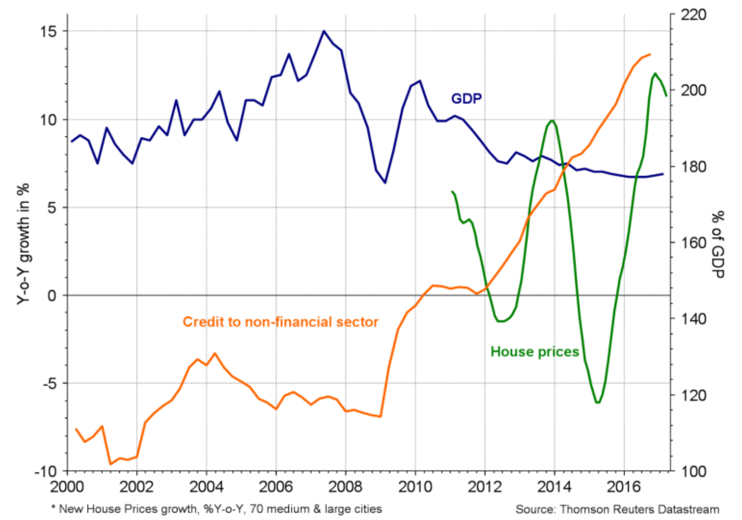

*Source: Thomson Reuters, EBRD calculations*

Chart 11. GDP growth and forecasts for the ERBD region




*Source: IMF WEO, EBRD calculations*

Chart 12. GDP growth and forecasts for the ERBD region




*Source: IMF WEO ,Thomson Reuters, BIS, EBRD calculations*

**The outlook for growth in the EBRD region has not changed since early November 2016.**

- In a global environment characterized by increased political uncertainty, the growth outlook for central and south-eastern Europe remains broadly unchanged.
- As oil prices have stabilized at levels well above those seen in the first half of 2016 and the Russian economy has emerged from a two-year recession, growth in the East of the region (Eastern Europe and the Caucasus, EEC; Russia; and Central Asia) is projected to pick up gradually.
- The outlook for Turkey and Southern and Eastern Mediterranean (SEMED) has weakened somewhat reflecting, in part, security and geopolitical risks and a resulting drop in tourism receipts and investment.

## Global economic environment

In recent months, the global economic environment has been characterized by increased political uncertainty and a number of conundrums:

- Volatility in terms of stated economic policy priorities following the US presidential elections has contrasted with the relative calm in the financial markets.
- While hard economic data have shown little change, the "soft" indicators of business confidence and expectations have recorded a remarkable improvement, both in the United States and elsewhere.
- Tightening of monetary policy in the United States has been accompanied by unchanged or improved external financing conditions in emerging markets.

*Economic policies versus market reactions*

**Economic policy uncertainty increased** as the new administration took office in the United States following the November 2016 presidential elections and the United Kingdom served the official notice of intention to exit from the European Union ("Brexit"), with a two-year countdown starting on 29 March 2017. Across major economies, the key areas of policy uncertainty include deregulation, taxation, international trade and climate change.

**At the same time, financial markets have remained broadly sanguine.** Equities have performed strongly both in advanced and in emerging market economies as markets priced in the expected benefits of future tax reform in the United States and the positive impact of a stronger US economy on the rest of the world. Equities in emerging Europe have been among the top performers recently, ahead of Emerging Asia and the advanced economies (Chart 1). Financial stocks in advanced economies initially experienced an even stronger post-US-election rally but these gains have been partially reversed as the prospects of comprehensive financial deregulation have been reassessed in light of the impasse over health care reform in the United States.

**Stock market volatility has stayed low for the longest period since 2013**, both in advanced markets and in the EBRD region (Chart 2).

*Soft versus hard indicators*

**Indicators of business and consumer confidence and purchase managers indices (PMI) have recorded marked improvements even as "hard" data on value added (GDP), sales volumes or industrial production have changed little to date.** The disconnect has been strongest in the United States where businesses and consumers appear to take positive views of the new administration's expected future policies, including tax cuts, boosts to infrastructure spending and deregulation in finance and a number of other sectors.

**This surge in confidence has not translated into a change in output indicators.** The nowcasting model for the EBRD region, which takes into account over a 100 concurrent indicators capturing the external environment, yields a virtually unchanged estimate of the region's GDP growth in the first half of the year compared with a similar calculation done late last year (see Box 1). More broadly, the growth of global GDP has remained modest by historical standards, coupled with the continued weakness of investment spending and international trade. Moreover, credit growth in the United States has decelerated markedly.

*Monetary tightening in advanced economies versus lower emerging market spreads*

**The announcement of the US election results on 9 November 2016 ended a period of lower interest rates in advanced markets that had prevailed since the Brexit vote** in June 2016. Markets swiftly priced in the expected impact of a looser fiscal stance and tighter monetary policy in the United States. In line with market expectations, the US Federal Reserve System (FRS) raised its policy rate by 0.25 of a percentage point in December 2016 and in March 2017, to the range of 0.75 to 1 per cent. Markets expect a gradual pace of tightening going forward as the US economy benefits from the anticipated fiscal stimulus.

**At the same time, the yields on debt of higher-risk emerging market borrowers continued to decline** as investors' search for yield intensified and capital flows to emerging markets strengthened. This suggests that monetary tightening to date, if anything, has proceeded slower than previously anticipated by investors. Only one interest hike per year is currently expected in the next three years (Chart 3) as analysts have reassessed the odds of stimulus measures being fully implemented. As a result, emerging market currencies have partially or fully recovered their post-US-election losses against the US dollar, with the notable exceptions of Mexico and Turkey. Several countries in the EBRD region, including Egypt, took advantage of these trends by issuing sovereign bonds at favourable terms.

**The European Central Bank (ECB) has maintained an accommodative stance for the time being.** Its quantitative easing (QE) programme has been extended by 9 months till end-2017, although monthly asset purchases have been scaled back to €60 billion.

*Other developments*

**Oil prices have remained broadly stable.** The price of Brent oil has fluctuated around the level that prevailed at the time of our previous forecast in November 2016 (US$ 52 per barrel). This level is expected to prevail in the next couple of years as it appears sufficient to sustain profitability of some shale oil producers in the US. At the same time, an agreement in principle to cut production reached by the members of the Organisation of Petroleum Exporting Countries (OPEC) in late 2016, on the other hand, reduced downward pressure on oil prices.

**The economic outlook for the region remains materially affected by terrorism, geopolitical tensions and the refugee crisis.** Over the last six months Egypt, Jordan, Russia and Turkey saw several terrorist attacks while Syria remains in a humanitarian crisis.

## Recent growth performance in the region

**The differences in economic outlook between the East and in the West of the EBRD region have narrowed.** The increase in the price of oil since the first quarter of 2016 has been a positive development for Russia, other commodity exporters and countries in Central Asia and EEC that rely on Russia as a major source of remittances and/or export demand. In contrast, growth in Central Europe and the SEMED region dipped somewhat in 2016 (Chart 4).

**On balance, growth in the region as a whole picked up from 1.3 per cent in 2015 (according to the latest data revisions) to 1.8 per cent in 2016,** broadly in line with expectations and our forecast (see Box 2). This moderate upward trend appears to have continued in the first months of 2017.

- Growth in **CEB** picked up slightly in the second half of 2016 and averaged 2.6 per cent in the year as a whole, down from 3.4 per cent growth in 2015. The deceleration is mainly due to weaknesses in private and public investment, while consumption has been expanding at a steady pace.

- Growth across **south-eastern Europe** maintained a steady momentum, averaging 2.9 per cent in 2016. In **Greece**, output stagnated in 2016 as a whole with little sign of an upturn in the first months of 2017.

- Modest recoveries in **Ukraine** and **Moldova** continue. At the same time, recessions in **Azerbaijan** and **Belarus** meant that output in the EEC region as a whole stagnated in 2016.

- **Turkey**'s growth more than halved in 2016, from 6.1 per cent a year earlier to 2.9 per cent (according to the revised data). While increased disposable income on the back of a 30 per cent hike in the minimum wage in January 2016 resulted in an increase in private consumption, growth was hit by a sharp fall in tourism receipts, Russian sanctions, and geopolitical tensions in the Middle East. Weak consumption and investment following the attempted military coup in July 2016 compounded these problems and contributed to a weakening of the lira.

- **Russia's** economy has returned to growth, after a cumulative contraction of around 3 per cent in 2015-16. At the same time, investment activity has remained constrained by economic uncertainty and relatively high financing costs.

- Growth in **Central Asia** has recently shown signs of greater dynamism after weakening in 2016. The renewed growth momentum comes on the back of the stronger economic outlook in Russia and higher commodity prices.

- Growth in the **SEMED** region slowed down to 3.4 per cent in 2016 as high inflation adversely affected consumption in **Egypt**, tourism receipts declined in **Jordan**, **Morocco** experienced a weak harvest, and the implementation of reforms was delayed in **Tunisia**.

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

## Capital flows

**Capital flows to emerging markets, including the EBRD region, strengthened in the first months of 2017**, despite the gradual tightening of monetary policy in the United States. This likely reflects the fact that the rate hikes to date have been fully priced in by the markets and, if anything, the pace of expected tightening is slower than previously anticipated. Bond and equity inflows into the EBRD region also strengthened in recent months in line with global trends. Russia has been among the main beneficiaries, as reflected in the mutual funds flow data (Chart 5).

## Currency movements

**In the aftermath of the November 2016 elections in the US, the region's currencies initially weakened against the US dollar, by about 3 per cent on average**. The direction of currency movements changed around the start of 2017 and by April 2017 the post-US-election decline has been fully undone in most countries. These fluctuations mirrored broader trends for the euro and the currencies of other advanced economies and emerging markets.

**The currencies of commodity exporters – Azerbaijan, Kazakhstan and Russia – strengthened** on balance as oil prices stabilized at around US$ 50-55 per barrel of Brent. While the Kazakh Tenge moved broadly in line with the price of Brent, the appreciation of the Russian rouble, in particular, has been stronger than oil prices alone would suggest (Chart 6) despite the concurrent replenishment of Russia's international reserves. This in part reflects strong inflows of capital into Russia's bond and equity markets. In contrast, the Turkish Lira depreciated by 11 per cent against the US dollar between early November 2016 and late April 2017 (Chart 7). The Tunisian Dinar and the Tajik Somoni depreciated by around 7 per cent over the same period. The gap between the official and unofficial exchange rates has widened in Tajikistan and Turkmenistan and remained large in Uzbekistan. Following the exchange rate liberalisation and step devaluation in early November 2016, the Egyptian pound has been broadly stable against the US dollar.

### Remittances

**Remittances from Russia to Central Asia and the EEC stabilised in US dollar terms towards the end of 2016** (a year earlier, remittances were contracting at the rate of 32 per cent). Yet after three years of decline, the level of remittances in the last quarter of 2016 was less than 45 per cent of the level reached three years earlier. The remittances may have started growing again in the first half of 2017, as the Russian economy returned to growth and the rouble has appreciated in line with the oil price.

### Credit conditions

**Credit conditions in the region remained broadly unchanged compared with those a year ago.** In most countries credit growth in real terms (adjusted for inflation and exchange rate movements) has been modest or negative, with the notable exception of Georgia, the Slovak Republic and Turkey where credit growth has been sustained at around 10 per cent per annum. Credit contraction continued in Azerbaijan, Cyprus, Greece, Moldova, Ukraine and Tajikistan, among other countries, reflecting weaknesses of bank balance sheets in these economies.

**The levels of non-performing loans (NPLs) have declined slightly in south-eastern Europe** but remain elevated across much of the EBRD region (Chart 9). Improving asset quality in the banking sector is recognized as a policy priority in many countries in the region, from Central Europe to Central Asia (see Box 3 for a discussion of the corporate restructuring angle).

### Inflation

**Inflation has turned positive in countries in central and south-eastern Europe that had experienced periods of deflation in recent years** (Chart 10)**.** While inflation in these countries historically moved broadly in line with the emerging market average, in 2014-16 the trajectory of inflation was more akin to that of advanced economies, with inflation rates hovering around the zero mark. In recent months inflation has picked up again towards the emerging market average on the back of higher oil and energy prices compared with a year ago as well as a gradual reduction in unemployment. In Russia, inflation moderated towards the Central Bank target of 4 per cent as the rouble strengthened while economic activity remained weak. In contrast, in Azerbaijan, Egypt, Ukraine and Turkey inflation is in double-digits, largely reflecting recent depreciations of the respective currencies.

## Outlook

**The projections assume** slowly rising prices of oil and other commodities, gradual interest rate increases in the United States combined with a moderately expansionary fiscal stance, continuation of accommodative monetary policies in the Eurozone, and a modestly-paced rebalancing of China's economy towards consumption-driven growth.

**The average rate of growth in the EBRD region is expected to increase from 1.8 per cent in 2016 to 2.4 per cent in 2017** in the baseline scenario (Table 1). This pick-up in growth reflects sustained momentum in south-eastern Europe, continued recovery in Russia and Ukraine as well as a somewhat improved outlook in countries with strong economic links with Russia.

**The acceleration is slightly weaker than projected in November 2016** (a downward revision of 0.1 percentage points) on account of increased headwinds to growth in Turkey and the SEMED region reflecting weakening outlook for tourist arrivals amidst widespread security concerns and a number of country-specific factors.

**Growth is expected to pick up further in 2018, reaching 2.8 per cent** (still short of both the world average growth, as projected by the International Monetary Fund, and the EBRD's region long-term average growth, see Chart 11). The expected gradual acceleration in both 2017 and 2018 is broad-based:

- Growth is **central Europe and the Baltic states** is expected to accelerate slightly in 2017 and to return to around 3 per cent following an investment-driven dip in 2016. It is expected to remain around that mark in 2018. The economic outlook has improved in **Hungary** on the back of cuts in the rates of personal income tax and social security contributions.

- In **south-eastern Europe**, average growth is also expected to reach the 3 per cent mark. **Greece** is expected to return to growth as reforms advance further and business confidence gradually improves.

- Growth in **the Eastern Europe and the Caucasus** region as a whole is expected to turn positive in 2017 as headwinds from low commodity prices and the earlier recession in Russia subside, although **Azerbaijan** and **Belarus** are projected to remain in recession. A gradual recovery in the region is set to continue in 2018.

- Growth in **Turkey** is projected to moderate to 2.6 per cent in 2017 reflecting worsening investor sentiment compounded by the downgrade of the sovereign rating to sub-investment-grade level. Growth is expected to pick up to 3 per cent in 2018.

- **Russia's** economy is expected to grow modestly in 2017 and 2018, supported by a gradual recovery in oil prices and in line with the estimated longer-term potential growth rate of 1 to 2 per cent per annum.

- In **Central Asia**, the average growth is expected to return to around 3.8 per cent in 2017 and 4.6 per cent in 2018 after a weaker 2016, reflecting expectations of an improved external environment. Construction work on the second phase of Oyu Tolgoi, a large copper mine, is expected to support growth in **Mongolia,** offsetting the economic impact of the expected fiscal consolidation.

- Growth in the **southern and eastern Mediterranean** is expected to gradually recover to around 4 per cent by 2018 as agricultural output normalizes after a year of poor rainfall and **Egypt** enjoys gains in competitiveness. In the near term, a drop in purchasing power of Egypt's consumers owing to high inflation is expected to be only partially offset by stronger investment activity.

## Risks to the outlook

The outlook is subject to numerous risks.

**Geopolitical tensions** and security threats in and around the region continue to rise, with uncertain impact on tourist arrivals and investor confidence.

Significant uncertainties remain with respect to the **economic policies of the new US** administration and the possibility of a rapid escalation of protectionism globally. The nature of the negotiated **Brexit,** likely to remain unclear for months to come, may further affect investor sentiment in Europe and beyond.

**China** faces considerable challenges in managing the growth trajectory of the economy, including in terms of moderating the growth of credit (with credit to households and enterprises well in excess of 200 per cent of GDP and house prices rising fast, see Chart 12) as well as reducing excess capacity in certain mining and manufacturing sectors and in narrowly-specialised towns. Low levels of public and foreign-currency-denominated debt are among the key mitigating factors.

A reversal of the recent recovery in **oil prices** is a major source of risk for Russia's economy as well as for countries in Central Asia and the EEC region with close economic links with Russia.

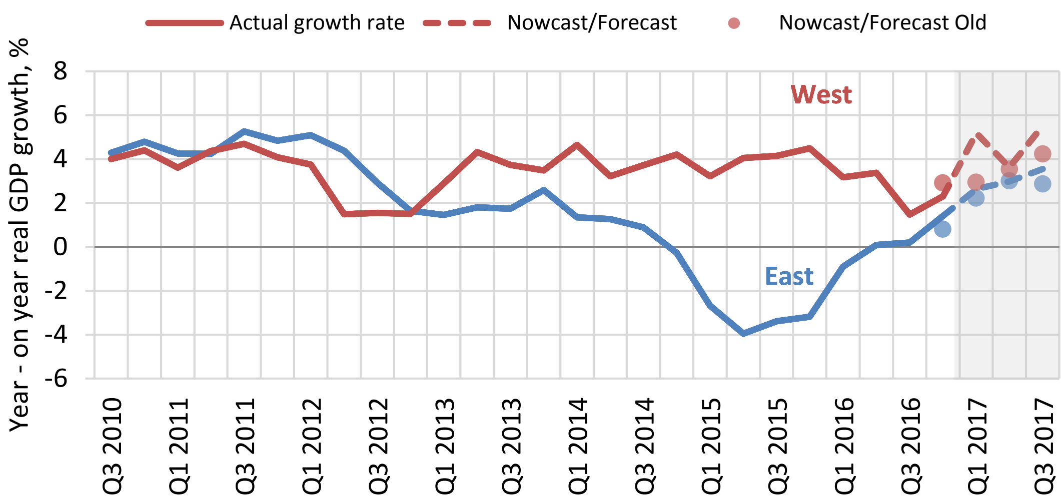
## Box 1. Nowcasting: The EBRD Region's growth in the second quarter of 2017

**Average growth in the EBRD region is estimated to have accelerated to 3.2 per cent (year-on-year) in the first half of 2017** from 1.9 per cent in the last quarter of 2016, according to the March nowcast. The underlying model is based on principal component analysis and takes into account the latest data for 107 economic indicators, as well as GDP growth in previous quarters.[1] Economic indicators include global series such as commodity prices or US imports, as well as indicators specific to the region, for example, Russia's industrial production.

**The nowcast for the first half of 2017 is broadly unchanged compared with the one from December 2016,** with an upward revision of only 0.1 percentage points, as key external variables have been broadly stable over recent months.

**The gap between growth in the West and the East of the region is estimated to have narrowed in the second quarter of the year.** Prior to end-2012, growth rates in the East (Eastern Europe, the Caucasus, Russia and Central Asia) and in the West (the rest of the economies) moved largely together (Chart 1.1). The gap opened in early 2013 and widened further in 2014-15, before narrowing again in recent quarters. The acceleration in the "East" reflects a combination of Russia's recovery from the crisis, higher oil prices (compared with the first half of 2016), as well as stronger external demand (including higher imports by China and the eurozone). On current forecasts, however, the growth differential between the West and the East is expected to persist throughout 2017 and 2018 (Table 1).

**Chart 1.1. Nowcast for the EBRD region**




Sources: Authors' calculations based on 107 data series from the national authorities, CEIC, IMF World Economic Outlook, Bloomberg.

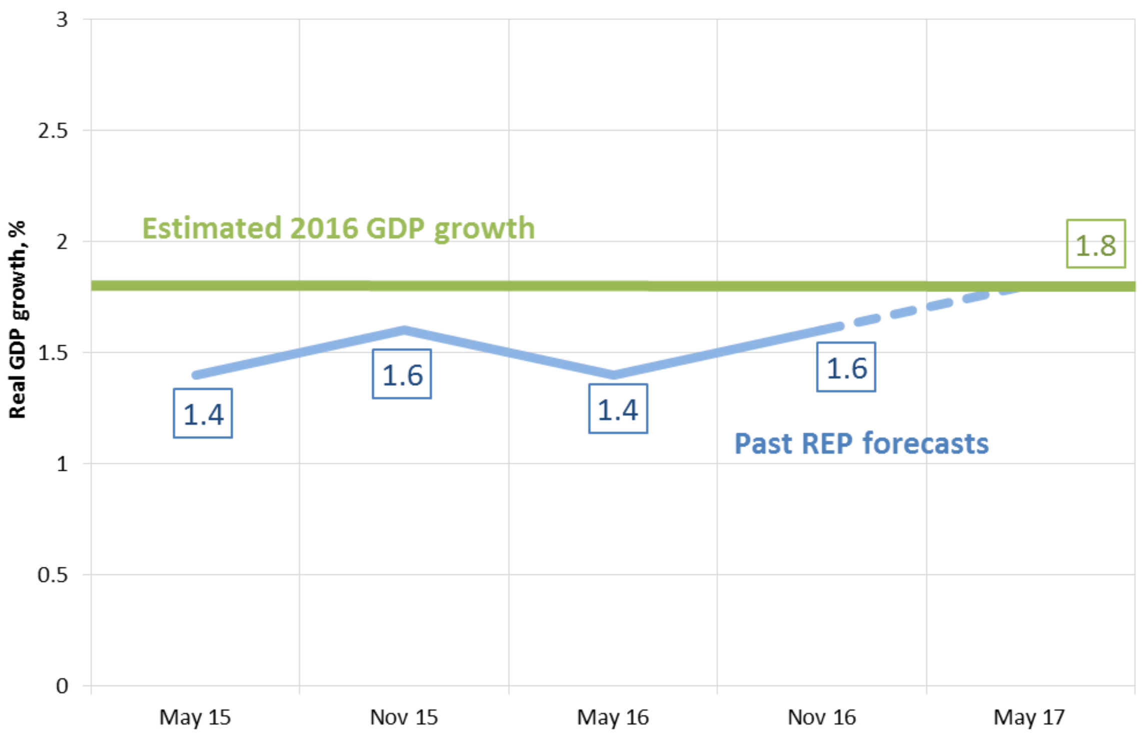
[1] See description in the November 2016 issue of the Regional Economic Prospects.

## Box 2. How well did we forecast 2016?

**Our first growth forecast for 2016 published in May 2015 suggested a recovery in the region's average growth to 1.4 per cent** (see Chart 2.1). The forecast understated the recovery momentum relative to what the data tell us today (1.8 per cent) but by a relatively small margin, one smaller than in the case of most other forecasters. Subsequently the forecast was adjusted by 0.2 percentage points, on average, upwards and downwards, broadly following the trajectory of the oil prices, which reached their lows in between the November 2015 and the May 2016 forecasting rounds.

**The flat trajectory of the forecasts for 2016 points towards the by-and-large stable, and predictable, external environment that the region has been facing over the past two years.** Positive new developments, including the recovery in the oil prices, have been offset by negative ones, including the escalation of conflict and the rise of terrorism in and around the region (globally, the death toll from conflicts has now reached the highest level since the early 1980s according to the analysis in the IMF's April 2017 *World Economic Outlook*).

**Chart 2.1. Average 2016 growth, as projected at different points in time**




Sources: REP, National authorities.

## Box 3. Deeply indebted: Corporate over-indebtedness and potential consequences in Croatia, Serbia and Slovenia

**Non-performing loans have long been on the radar screen of economic policy and financial regulation given their well-known negative real and financial effects**.[2] Although still high, NPL ratios have started to decline in many countries in south-eastern Europe owing to a combination of regulatory actions, improving conditions for NPL sales on the back of higher provisioning and faster loan growth.

**Yet while corporate over-indebtedness receives less attention, it seems to be more persistent, and can have equally large negative effects on the economy,** as over-indebted companies**:**

- may be restricted in terms of ability to raise financing and choose suppliers – with adverse implications on their efficiency;
- can also create negative spill-overs for other companies, including suppliers that may face liquidity problems due to late payments and off-takers that may be incur the cost of switching suppliers;
- may raise problems at banks due to potential late payment or default on their debt; ultimately leading to higher NPLs.

**The recent case of Agrokor (Croatia's largest privately-owned company), with a debt of close to 15 per cent of the country's GDP, illustrates all these potential spill-overs** and has prompted actions from governments of Croatia and Slovenia aiming at achieving an orderly restructuring.

**Besides Croatia, two other former Yugoslav countries, Serbia and Slovenia, also stand out in terms of corporate over-indebtedness[3] in the CESEE region** (Chart 3.1). In Slovenia, the debt level of over-indebted companies peaked in 2012 and has dropped by around 7 percentage points since, to 13 per cent of GDP. However, in Croatia and Serbia high over-indebtedness has persisted at above 35 and close to 25 per cent of GDP, respectively.[4]

**The reduction of the debt level in these countries could result in significant growth dividend in the medium term**. According to a recent study on central and south-eastern

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[2] See Balgova, M., M. Nies and A. Plekhanov, 2016, "The economic impact of reducing non-performing loans", EBRD Working Paper 193.

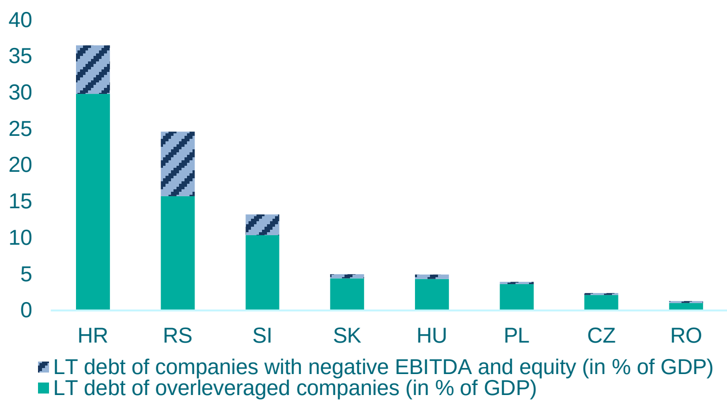
[3] For the purposes of this box, a company is considered over-indebted if its long-term debt-to-EBITDA ratio is higher than 10. In order to better capture the level of over-indebtedness in a country, the debt of over-indebted companies is augmented for the long-term debt of companies with negative EBITDA and equity.

[4] In Croatia, debt worth around 12 per cent of GDP is owed by six (mostly state-owned) motorway and railway companies. On the other hand, the debt of Agrokor is not included in the overall over-indebtedness as official data from 2015 show that its LT-debt-to-EBITDA ratio is below 10.

Europe (CESEE)[5], a 10 percentage point decline in excessive debt (defined as debt of companies with net debt-to-EBITDA ratio above 4) can raise a Croatian company's (total factor) productivity by around 0.5 per cent.

**Debt reduction would require more efficient corporate restructuring procedures[6] and improved corporate governance**. Corporate governance is important as it influences a firm's choice of financing**.** Economic research documents an inverse relationship between governance quality and leverage as well as preference of firms with weak governance for debt over equity financing.[7] In fact, higher leverage may act as a substitute for corporate governance mechanisms in mitigating agency costs (conflicts between shareholders and management). The relatively low scores of the Croatia, Serbia and Slovenia in terms of corporate governance[8], including on structure and functioning of Boards in EBRD assessments[9], and overreliance of owners of relatively large (family) enterprises on debt appears to support these conclusions.

**Chart 3.1. Long-term debt of overleveraged companies in 2014, per cent of GDP**




Note: Overleveraged companies have a positive EBITDA and their debt is greater than 10 *EBITDA

Source: EBRD calculations based on ORBIS.

[5] See Damijan, J., 2016, "Corporate NPL portfolios in CESEE countries: how corporate leverage and debt spillovers affect firm performance", EBRD Working paper 191.

[6] See Laryea, T. (2010), "Approaches to Corporate Debt Restructuring in the Wake of Financial Crises", IMF Staff Position Note SPN/10/02.

[7] See Jiraporn, P., J. Kim, Y. Kim and P. Kitsabunnarat (2011), "Capital Structure and Corporate Governance Quality: Evidence from the Institutional Shareholder Services"; Mande, V., Y. Park, and M. Son (2012), "Equity or Debt Financing: Does Good Corporate Governance Matter?" *Corporate Governance: An International Review*, Vol. 20, pp. 195–211.

[8] The average ranking of Croatia, Serbia and Slovenia in the World Economic Forum Global Competitiveness Indicator for efficacy of corporate boards is 92 vs. 69 for the Czech Republic, Hungary, Poland, Romania and the Slovak Republic. The average rankings of the two groups in terms of reliance on professional management are 97.3 vs. 68.6.

[9] See http://www.ebrd.com/what-we-do/sectors/legal-reform/corporate-governance/sector-assessment.html

# Regional updates

## Central Europe and the Baltic States (CEB)

GDP growth in 2016 in the Central Europe and the Baltic States region came in slightly below our expectations from the previous Regional Economic Prospects, at 2.6 per cent. This significant deceleration from 3.4 per cent in 2015 can be largely attributed to a dramatic contraction in investment, on average by 6.6 per cent in all eight CEB economies. The reason behind the investment collapse, especially in the public sector, was a much deeper decline in EU fund transfers and their absorption than in the previous beginnings of the EU programming periods. At the same time, strengthening household consumption remained the key growth engine, underpinned by benign labour markets and substantial wage growth. On the downside, the shrinking working age population and intensifying skill-mismatches have started weighting on the pace of employment growth, which has been dwarfed by the fast-mounting number of job vacancies.

An anticipated acceleration in investment and further improvements in household consumption should strengthen GDP growth to 3.1 per cent in 2017, a rate that will likely remain at the same level in 2018.

### Poland

In Poland, GDP growth slowed down sharply from 3.8 per cent in 2015 to 2.7 per cent in 2016. Last year's growth deceleration was mainly induced by contracting investment, which fell by 7.9 per cent. General government investment saw the lowest such level in the past 10 years, while local government investment, at only 1.3 per cent of GDP, was the lowest since the early transition years of mid 1990s. In contrast, household consumption has remained the key growth driver, supported by good labour market conditions and increased child benefits.

While the tightening labour market will likely continue putting pressure on wages, thus providing a further boost to consumption, the positive impact of the child benefit programme on growth is largely over. Public sector investment will likely rebound, starting from the second half of 2017, though private investment still constitutes a higher risk to growth. According to the central bank's recent enterprise survey, only one in three private companies is expected to start investment in 2017, which has been the worst such indication since the 2008/09 financial crisis. The recovering public investment and the still strong household consumption will likely boost growth to 3.2 per cent this year and next. Nevertheless, the generous social spending and rebounding public capital expenditure coupled with a lower retirement age may lead to the breach of the 55 per cent public debt ceiling by 2019, in which case the public finance law effectively mandates a very significant fiscal tightening.

### Hungary

Economic expansion in Hungary saw the second consecutive year of deceleration in 2016. Last year's GDP growth, at 2 per cent, was curbed by a dramatic fall in investment, which dropped by 15.5 per cent. As in most other EU new member states, public investment has been decreasing since the beginning of 2016. This can be attributed to the slow start of the new EU 2014-20 programmes. Amid still contracting (though at a slower pace) corporate credit, private investment growth also remained negative. In contrast, household consumption saw an increase of 5 per cent. Household disposable incomes were driven by 6 per cent real wage growth and unemployment falling to just 4.2 per cent in January 2017. In 2017, cuts in social security contributions and the minimum wage increase will keep consumption strong. The emerging skill-mismatches and worsening demographic trends are expected to put further pressure on earnings, thus weighing on Hungary's international competitiveness. At the same time, the reduction of the corporate income tax to 9 per cent, the lowest such level in the EU, is expected to positively stimulate corporate investment, including from abroad. On balance, we revise upwards our GDP growth forecast to 3 per cent in 2017, and expect the growth rate to remain at the same level in 2018.

### Slovak Republic

The Slovak Republic was the fastest growing economy in the CEB region in 2016. Last year's GDP grew by 3.3 per cent, largely propelled by strong household consumption and net exports. Admittedly, the latter was effectively a result of relatively weak imports, which came from poor public sector investment demand, mostly affected by the slow start of the EU funds utilisation from the new EU budget. In 2017, investment growth will likely accelerate, underpinned by strong corporate credit growth and high firms' capacity utilisation rates. The expansion of production plants in the automotive industry, with the new Jaguar car plant planned to be operational from 2018, is expected to positively affect exports, including outside the EU. The tightening labour market, together with rising wages, will provide an additional boost to domestic demand, though emerging skill-mismatches and continued aging are expected to weigh on growth potential in the medium term. In 2017, GDP growth is forecast to reach 3.2 per cent, accelerating to 3.5 per cent in 2018.

### Baltic economies

In the Baltic States region, GDP growth improved only marginally in 2016, when compared to its performance in the previous year. Lithuania's economy expanded by 2.3 per cent, followed by Latvia and Estonia, which saw growth rates of 2 per cent and 1.6 per cent, respectively. Similarly to other CEB economies, investment registered a negative growth, but the contraction was the most severe in Latvia, by 11.7 per cent. Strong household consumption, which continued to be the main engine of growth, resulted in relatively high imports, thus effectively neutralising the positive impact on GDP from recovering exports. Rising earnings will continue supporting household consumption, but the tightening labour markets, amid decreasing working-age populations (particularly in Latvia and Lithuania), ageing and persistent skill mismatches, have started weighing on the three economies' international competitiveness. Since 2013, unit labour costs have been growing faster than labour productivity. This contributed to falling world export market shares in 2015. In all three countries we anticipate a gradual recovery over the forecast horizon, largely driven by rebounding investment.

### Croatia

The Croatian economy continued to expand in 2016 (2.9 per cent), underpinned by a good tourist season, strong external demand and, on average, lower oil prices. The growth momentum may stay at 2.9 per cent in 2017, while in 2018 we project a slight slowdown to 2.6 per cent, due partly to the high base effect. Growth will be mainly driven by domestic demand – consumption supported by tax cuts, strong tourism revenues and falling unemployment, as well as investment which is benefiting from favourable financial conditions, lower corporate tax and expected improvements in the absorption capacity of EU funds. The contribution from net exports is unlikely to be significant due to rising imports from higher domestic demand. The short-term outlook may be negatively affected by potential spill-overs from Agrokor's financial troubles on its subsidiaries and suppliers, but medium-term growth prospects also remain weak due to long-standing structural weaknesses, including high corporate over-indebtedness, still limited business environment reforms, and slow EU fund absorption – all of which need to be addressed consistently.

### Slovenia

After posting a growth rate of 2.5 per cent in 2016, Slovenia’s economy is expected to grow by 2.5 per cent in 2017 and by 2.2 per cent in 2018. Domestic demand will be the main growth driver, mainly on the back of improved labour market conditions, previously announced large investment projects and an expected recovery in EU fund absorption. The contribution of net exports is expected to be negligible, as imports will catch up with exports on the back of rising domestic demand. Risks to the projection relate to high corporate over-indebtedness, and the slow pace of business environment reforms and privatisation.

## South-Eastern Europe (SEE)

Economic growth in SEE varied significantly by country in 2016, ranging from 0 per cent in Greece to nearly 5 per cent in Romania. On average, growth in the region reached 2.9 per cent, up from 2.4 per cent in 2015 and fuelled mainly by the strong Romanian growth but also by robust growth in Bulgaria and a significant improvement in Serbia. The Cypriot economy also performed well in 2016, with GDP rising by 2.8 per cent. Performance in the Western Balkans was somewhat mixed, as continued robust growth in Albania and Kosovo was balanced by a slowdown in Bosnia and Herzegovina, FYR Macedonia and Montenegro. All economies in the region are forecast to grow in 2017 and 2018, but major uncertainties remain, associated in some cases with internal political problems.

### Greece

After negative growth (-0.2 per cent) in 2015, the Greek economy continued to decline on a year-on-year basis in the first half of 2016 (-0.4 per cent), influenced by high base effects from the equivalent period in 2015, but quarterly growth resumed in the second quarter, with output rising 0.3 per cent quarter-on-quarter. Further growth was achieved in Q3, helped by another excellent tourism season, but the economy turned down again in Q4 (-1.2 per cent q/q), leaving growth for the year as a whole at around 0 per cent. There are few signs of recovery yet in 2017 and confidence has been damaged by lengthy delays to the completion of the second review of the ESM-funded Economic Adjustment Programme. However, fiscal discipline has continued to improve in the past year and the primary surplus in 2016 was nearly 4 per cent of GDP, well above the programme's target. At the same time, public debt remains exceptionally high at around 180 per cent of GDP amid ongoing concerns about long-run debt sustainability. We expect growth to pick up in the second half of 2017, once the second review is completed, with overall growth of 2 per cent for the year, rising to 2.2 per cent in 2018, but major downside risks to the forecast remain.

### Cyprus

After the return to growth in 2015 (1.7 per cent), the economy continued to perform well in 2016, with GDP growth reaching 2.8 per cent, above expectations. Tourism was one of the main drivers of the economy, with arrivals last year up by around 20 per cent and virtually all hotels at full occupancy, while other sectors such as construction and professional services are also contributing to the ongoing recovery. Levels of consumer confidence in Cyprus are currently higher than the EU average. The country's long-term sovereign rating was raised by S&P in March 2017 from BB to BB+. The government is maintaining a prudent fiscal stance and delivered an overall budget surplus for 2016. The challenge now, in light of the still high levels of public debt (exceeding 100 per cent of GDP), will be to maintain strong fiscal discipline fiscal in the run-up to elections in 2018. Overall growth is likely to continue in 2017 and 2018 at between 2 and 2.5 per cent, but significant headwinds remain, including the very high levels of indebtedness in the economy, and the large legacy of NPLs which still account for nearly half of all loans.

### Bulgaria

After growing 3.6 per cent in 2015, the Bulgarian economy expanded by 3.4 per cent in 2016. While private consumption grew on the back of a 10.5 per cent hike in the minimum wage and improved labour market conditions, government spending remained subdued due to the transition to the new EU funds programming period and budgetary tightening, resulting in a budget surplus for the first time since 2008. There was also strong growth in private investment, offsetting the low public investment resulting from fiscal tightening. Driven by increasing growth prospects of the main trading partners, net exports also had a positive impact on growth in 2016. In 2017 and 2018, growth will be driven by private consumption and investment, as fiscal consolidation continues and the contribution of net exports to growth tapers off due to strong domestic demand. Overall, growth is expected to stand at 3.2 per cent in 2017 and 3.0 in 2018.

### Romania

Having grown by 3.9 per cent in 2015, Romania's economy grew by 4.8 per cent in 2016, supported by strong domestic demand. Private consumption emerged as the main driver of growth over this period, on the back of higher disposable income (boosted by cuts in VAT and a rise in wages), improvements in the labour market and low inflation. Consumption will continue to drive growth in 2017 and 2018, supported by a further increase in minimum and public sector wages, which formed part of the governing PSD's election promise. The latter will mean that government spending is likely to remain elevated in 2017, with a risk that the 3 per cent of GDP deficit limit under the fiscal compact will be breached. Private investment will be boosted by the abolition of the construction tax and historically low cost of funding. Meanwhile, a slight improvement in net exports will be driven by better economic prospects of Romania's trading partners, though higher domestic consumption will offset some of this. GDP growth of around 4.0 per cent is expected in 2017, moderating to 3.5 per cent in 2018.

### Albania

Economic performance continued to improve in Albania in 2016. Overall GDP growth reached 3.5 per cent, compared to 2.6 per cent in 2015, on the back of strong growth in private consumption and investment. Government spending increased moderately after levelling off the year before. Net exports also had a positive contribution to growth (although small), mostly because of a good performance of services exports, such as tourism. Several major energy sector projects are advancing, contributing to the overall growth rate, while the state-owned power producer company, KESH, and electricity distribution company, OSHEE, are undergoing a restructuring process, which should boost long-term growth prospects in the sector. Fiscal policy has been prudent within the framework of a three-year IMF programme, which was concluded successfully in February 2017. With an inflation rate of just 1.3 per cent in 2016 (below the central bank's target of 3 per cent), monetary policy remains accommodative and the policy rate has stayed at its historic low of 1.25 per cent since May 2016. The short-term outlook remains positive but downside risks are significant. Growth of 3.5 per cent is expected in 2017, rising to 3.7 per cent in 2018, on the back of private domestic demand and further major construction work on large energy-related FDI, such as the Trans-Adriatic (gas) Pipeline (TAP).

### Bosnia and Herzegovina

The economy of Bosnia and Herzegovina continued to grow in 2016 but at a slower rate than in the previous year. Growth for the year as a whole is estimated at 2 per cent, compared to 3 per cent in 2015. The slowdown of growth was driven by a levelling off in the wholesale and retail sector, and a small decline in public sector spending. However, the industry sector continued to grow at a robust rate and was a major driver of GDP growth. Also, the economy has been boosted by several major projects in the transport and energy sectors (in particular the Corridor Vc motorway project). Some positive trends have been recorded in high-frequency data in the first months of 2017, notably in exports, but completion of the first review of the 3-year IMF programme has been held up for several months, delaying implementation of some key infrastructure projects and jeopardising their funding. We have thus lowered our projection for 2017 to 2.5 per cent, rising to 3 per cent in 2018. Downside risks to this forecast are significant if the IMF programme remains delayed or goes off track and if important structural reforms are postponed.

### FYR Macedonia

In FYR Macedonia, the prolonged political crisis is starting to have a measurable negative impact on economic performance. The economy grew by just 2.4 per cent in 2016, well below the rates recorded in the previous two years (of 3.6 and 3.8 per cent respectively). Private consumption has remained relatively robust, and remained as a main growth driver. Net exports also made a positive contribution to growth, as exports increased by more than 10 per cent in real terms, mainly those associated with some of the large foreign investments. On the other hand, gross capital formation declined due to weak investment levels, with capital spending falling to exceptionally low levels. Both public and private investments are being held up by uncertainty about the political situation and when it might be resolved. As a result, we are lowering our forecast for growth in 2017 to 2.4 per cent, with a modest increase to 3 per cent growth in 2018 on the assumption that the current crisis is resolved, unblocking further reforms and bringing much-needed investments. However, in the current climate there are major downside risks to these forecasts.

### Kosovo

Kosovo’s economy continued to perform well in 2016, although the rate of growth slowed down slightly from 4 per cent in 2015 to 3.4 per cent in 2016. The drivers of growth in Kosovo continue to be robust private consumption, helped by major inflows of remittances, and strong investment figures, including public investments in infrastructure. On the other hand, government consumption and net exports made negative contributions to growth with the latter reflecting the country’s weak production base and low competitiveness. Public debt remains low by regional standards, at around 15 per cent of GDP, and fiscal discipline has been maintained within the framework of the 22-month IMF Standby Arrangement (signed in July 2015), which in March 2017 was extended by several months to

August 2017. We maintain our forecast of 3.5 per cent growth for 2017 and the same figure for 2018, as growth is expected to be supported by further remittance inflows, which should continue to fuel private consumption and investment, as well as by critical public investment in transport and energy infrastructure.

### Montenegro

In Montenegro, 2016 economic growth, estimated at 2.5 per cent (compared to 3.4 per cent in 2015) was lower than expected. Investment in the major highway project, which is being mainly financed by loans from China, is among the key drivers of this growth. However, high imports related to the project fuelled the trade deficit and made a significant drag on growth, almost offsetting the positive gross capital contribution. At the same time, concerns about fiscal discipline grew in 2016, especially in the run-up to elections when there were significant increases in public sector wages and social benefits. However, steps have since been taken by the authorities since then to chart a path for fiscal consolidation. As electricity output grows following the production from the newly commissioned Krnovo wind power plants, and as the tourism sector is likely to be boosted by the newly operational airline connections with the EU countries, we expect growth in 2017 to rise to 3 per cent, and further to 3.3 per cent in 2018. However, the worrying rise in public debt in recent years, projected to exceed 80 per cent of GDP by 2018, may necessitate painful austerity measures elsewhere, especially if economic growth rates were to falter.

### Serbia

After a strong momentum in 2016 (2.8 per cent growth), the Serbian economy is expected to grow by 2.9 per cent in 2017 and by 3.0 per cent in 2018. The main growth driver will be domestic demand, with investment growth supported by an improved business climate based on successful fiscal consolidation and on-going structural reforms. Rising employment and wages will support a further consumption recovery. On the other hand, the contribution of net exports may be negligible as exports growth may be offset to a large extent by higher imports due to stronger domestic demand. The main risks for the projection are tilted to the downside due to a high base from an extraordinary agricultural output in 2016, and a possible slow-down in fiscal and structural reforms (including SOE restructuring). Medium-term prospects are favourable, but will depend on the pace of reforms envisaged in the current IMF programme, further improvements in the investment climate, support for NPL resolution and corporate restructuring to unlock credit growth, and acceleration of the implementation of major infrastructure projects.

## Turkey

After domestic demand-driven growth of 6.1 per cent in 2015, the Turkish economy grew by only 2.9 per cent in 2016. While increased disposable income on the back of a 30 per cent hike in the minimum wage in January 2016 resulted in an increase in private consumption, growth was hit by a sharp fall in tourism receipts, Russian sanctions, and geopolitical tensions in the Middle East. Weak consumer and investor sentiment following the attempted military coup in July 2016 compounded these problems with the result that the economy contracted for the first time since 2009 during the third quarter by 1.3 per cent. Significant fiscal stimulus helped a consumption-driven rebound to 3.5 per cent in the fourth quarter, though investment was slow to pick up.

Worsening investor sentiment, compounded by various factors including a downgrade of the sovereign to sub-investment grade, the ongoing State of Emergency and a general movement of investors away from emerging markets due to expected monetary tightening in the US, resulted in a weakening of the lira by 17 per cent against the dollar in 2016. This depreciation passed through to inflation, which reached double digits for the first time in five years in February 2017, well above the 5 per cent target set by the Central Bank.

Turkey's external situation remains a challenge. Although the current account deficit declined to 3.8 per cent of GDP at end-2016 from 6.7 per cent at end-2013, on the back of lower oil prices and depreciation of the lira, it still remains large. Meanwhile, gross external financing needs are almost 25 per cent of GDP, leaving the country exposed to global liquidity conditions.

On the positive side, past reforms continue to pay dividends in the area of public finance and the banking sector. With a budget deficit of 1.1 per cent of GDP and public debt below 30 per cent of GDP, the government has significant buffers. Furthermore, the banking system remains well capitalized, with low levels of NPLs at 3.3 per cent.

Consumption will be the main driver of growth in 2017 and 2018, supported by fiscal expansion and measures such as a VAT reduction for household goods. The recovery in tourism is likely to be slow while the domestic political and geopolitical situation remains fragile. Increasing levels of public investment will be partly offset by sluggish private investment growth, due to the rising cost of production on the back of a higher wage bill, rising cost of imports and raised cost of funding following the rating downgrades.

Overall, the economy is expected to grow around 2.6 per cent in 2017 and 3.0 per cent in 2018. The downside risks to this outlook for the next two years are investor uncertainty in the context of the unstable geopolitical environment and perceived deterioration of institutional independence; faster than expected monetary tightening by the US Fed and moderation in global liquidity; and failure of the government to restart structural reforms efforts which are required to enable the country to reach its longer term growth potential.

## Eastern Europe and the Caucasus (EEC)

Economic output in the EEC region was stable on average in 2016, after a decline of 4.8 per cent in 2015. The economies of Ukraine and Moldova recorded positive growth following recessions in 2015, GDP growth in Georgia remained flat, Armenia's growth slowed in 2016 to the lowest rate since 2009 and the economies of Azerbaijan and Belarus contracted. The EEC region is forecast to grow by 1.1 per cent in 2017 and 2.4 per cent in 2018, contingent on a non-intensification of geopolitical tensions and on other country-specific factors. In 2017, small economic contractions in Azerbaijan and Belarus are expected to be outweighed by growth in the other economies of the region. All EEC economies are forecast to grow in 2018.

### Armenia

GDP growth in Armenia slowed from 3 per cent in 2015 to 0.2 per cent in 2016, driven by a decline in construction and agriculture. In the first quarter of 2017, economic indicators pointed to growth in industrial output, external trade and services, while agriculture and construction performance remained weak. Inflation of consumer prices remains slightly negative, allowing for further monetary easing. External adjustment helped to maintain a stable dram-US$ exchange rate, with the current account deficit stable at 2.7 per cent of GDP in 2016. Remittances, which account for approximately 13 per cent of GDP, fell further by 7 per cent in 2016, but the pace of reduction was mitigated by a recovery in money transfers from Russia. A sizable fiscal consolidation is planned in 2017 to curtail the public debt-to-GDP ratio, which increased to an estimated 57 per cent of GDP at the end of 2016. The conflict in the Nagorno-Karabakh region presents a risk to the growth outlook. We forecast Armenia's economy to grow by 2.5 per cent in 2017 and 3.0 per cent in 2018.

### Azerbaijan

Azerbaijan's economy contracted by 3.1 per cent in 2016, with non-oil GDP declining by 4.4 per cent. In 2016, capital investment fell for the third consecutive year after growing rapidly in the previous years. Output declined by further 0.9 per cent year-on-year in the first quarter of 2017, although non-oil GDP returned to mild growth of 2.4 per cent year-on-year in the same period. Macroeconomic policies have remained tight to safeguard liquidity buffers, defuse foreign exchange pressures and curb inflation, which picked up to 13.2 per cent year-on-year in the first quarter of 2017. After a brief period of volatility in the beginning of 2017, the manat-US dollar exchange rate has stabilized. Bank lending contracted in 2016 and credit activity is expected to remain subdued in 2017 owing to the ongoing consolidation of the banking sector, restrictive monetary policy, tight management of manat liquidity and a generally challenging economic backdrop. However, liquidity buffers remain sizeable despite oil price fluctuations, with reserves (central bank reserves plus State Oil Fund assets ) of US$ 37.1 billion at end-2016, approximately equivalent to Azerbaijan's nominal GDP in 2016. The conflict in the Nagorno-Karabakh region presents a risk to the growth outlook. We forecast Azerbaijan's economy to contract by 0.5 per cent in 2017 followed by 2.0 per cent growth in 2018.

### Belarus

Following a recession in 2015, Belarus's economy contracted further by 2.6 per cent in 2016 with negative growth in manufacturing, trade and construction. In the first quarter of 2017, GDP is estimated to have grown by 0.3 per cent year-on-year. Moderation in wage growth and generally tight monetary and fiscal policies brought the inflation down to 11.8 per cent in 2016 and further to 6.4 per cent year-on-year in March 2017, the lowest level since March 2010. The National Bank of Belarus has lowered the refinancing rate four times since the beginning of 2017, from 18 per cent in January to 14 per cent in April. The current account deficit fell from 6.6 per cent of GDP in 2014 to 3.6 per cent of GDP in 2016, but international reserve assets of the National Bank of Belarus remain low, covering approximately two months of imports. The banking sector continued to face challenges. Non-performing loans were reported at 13.3 per cent as of 1 March 2017, although subsidised and directed lending programmes, which accounted for approximately 40 per cent of all loans, made monitoring of the problem loans difficult. Reported ratio of the banks' regulatory capital to risk-weighted assets remained sound at 18 per cent as of 1 October 2016. In light of these challenges we forecast the economy of Belarus to contract further by 0.5 per cent in 2017 and return to growth of 1.0 per cent in 2018.

### Georgia

Real GDP growth in Georgia slowed slightly to 2.7 per cent in 2016 compared to 2.9 per cent in 2015, due partly to the weak external environment, but the economy picked up in the second half of year, with a rebound in exports and remittances flows. Exports were down by 23 per cent in 2015 and another 4 per cent in 2016, while remittances in US dollar terms expanded by 6.6 per cent in 2016, after shrinking by 25 per cent in 2015. The soundness of the highly dollarized banking sector was maintained amid significant depreciation of the currency over 2014-2016, with the level of NPLs reaching just 3.8 per cent in September 2016. The fiscal deficit widened to 4.2 per cent of GDP in 2016 and is planned to reach 4.1 per cent in 2017 reflecting high infrastructure spending, which is mainly supported by borrowing from the IFIs. GDP growth is projected to improve to 3.9 per cent in 2017 and further to 4.2 per cent in 2018, supported by a recovery in consumption and strong domestic and foreign direct investment in infrastructure and other sectors, as well as strong tourism inflows. The Deep and Comprehensive Free Trade Area (DCFTA) and now the EU visa free regime, granted in March 2017, are contributing to improved investor confidence and providing better access to the EU market. The economic outlook is subject to risks stemming from a slower global and regional recovery.

### Moldova

Moldova's GDP grew by 4.1 per cent in 2016, supported by 18.2 per cent real growth in agriculture. In 2016, household consumption increased by an estimated 3.6 per cent in real terms and exports of goods and services recovered by an estimated 8.8 per cent in real terms mainly on the account of increased export volumes to the European Union. This was partly offset by capital investment which fell by an estimated 3.0 per cent in real terms. External and inflationary pressures have eased. Amid tight monetary conditions, inflation decelerated from 13.6 per cent year-on-year in December 2015 to 5.1 per cent year-on-year in March 2017. Decline in money transfers from abroad (which accounted for approximately 16 per cent of GDP in 2016) flattened out in the second half of 2016. The current account deficit fell from 6.4 per cent of GDP in 2015 to an estimated 4.1 per cent of GDP in 2016. The leu remained stable against the US dollar in 2016 after depreciating by 34 per cent in 2014-2015. A new IMF programme, approved in November 2016, reduced funding pressures by unlocking international budget support and by providing access to tranche disbursements under the programme. Major banking sector challenges remain despite the recent overhaul of the banking supervision and regulatory framework. Moldova's narrow economic base is concentrated in agriculture, which can lead to volatile growth rates. We forecast Moldova's economy to grow by 3.0 per cent in 2017 and 3.5 per cent in 2018.

### Ukraine

Ukraine's economy stabilized in 2016 and embarked on a moderately-paced recovery. GDP grew by 2.3 per cent for the year as a whole, driven by a rebound in domestic demand from the low base of the previous two years. In 2016, household consumption grew by 1.8 per cent in real terms. Investment in fixed assets, which increased by approximately 20 per cent in real terms in 2016, was funded mostly from enterprises' own earnings while FDI, bank lending and public infrastructure spending remained weak. Commodities still account for a significant share of Ukraine's exports, exposing the economy to volatility in commodity markets. In 2016, export of goods and services declined by 1.6 per cent in real volume terms. In the first quarter of 2017, Ukraine's industrial production contracted by 0.7 per cent year-on-year, affected by the cargo transportation blockade of the area that is currently beyond the control of the Government of Ukraine. The blockade will weigh down on GDP growth and balance of payments in the near term.

Consumer price inflation picked up from an average of 13.9 per cent year-on-year in 2016 to 15.1 per cent year-on-year in March 2017. The National Bank of Ukraine expects to bring it down to single digits by the end of 2017. The current account deficit widened from almost zero in 2015 to 4.1 per cent of GDP in 2016, reflecting the recovery of domestic demand and weak exports. PrivatBank, the largest bank in Ukraine, was declared insolvent and nationalized in December 2016 without major disruptions to the broader economy. The hryvnia exchange rate remained predominantly stable in the wake of the nationalization. The combined general government and Naftogaz deficit stood at an estimated 2.3 per cent of GDP in 2016, below the initially planned deficit target of 3.7 per cent of GDP. In 2017, it is planned to widen somewhat to 3.0 per cent of GDP. We forecast the Ukrainian economy to grow by 2.0 per cent in 2017 and 3.0 per cent in 2018.

## Russia

After contracting by 2.8 per cent in 2015, the Russian economy experienced another year of recession in 2016. The contraction in 2015 was milder than initially estimated and the output drop in 2016 was smaller than expected (0.2 per cent) owing to a methodological change implemented by Rosstat, the statistics agency.

Consumption and investment continued falling though to a lesser extent than in 2015, given the recovery in real wages. Investment activity remains constrained by economic uncertainty and relatively high financing costs. The contribution of net exports to GDP growth stayed positive as imports continued to fall in 2016 albeit at a slower pace than in 2015.

Private sector capital outflows continued in 2016 (around US$ 20 billion), but at a significantly slower pace than in 2014 (US$ 152 billion) and 2015 (US$ 58 billion). Eurobond issuances and syndicated borrowing (close to US$ 32 billion in 2016 and US$ 1.75 billion sovereign borrowing vs. US$ 12 billion in the whole of 2015) increased significantly but still remain well below pre-2014 levels.

Monetary policy has been cautious, with the central bank keeping its hard-earned credibility by supporting disinflation and avoiding excessive exchange rate volatility. Weak demand and base effects have supported disinflation; the annual change in the consumer price index dropped to 4.3 per cent in March 2017 (from a peak of 16.9 per cent in March 2015), coming close to the Bank of Russia's target of 4.0 per cent. Meanwhile, fiscal policy has acted counter-cyclically with the general government deficit surging to 3.7 per cent of GDP in 2016, from 1.1 per cent in 2014. Although budgetary plans for 2017-2019 set out fiscal consolidation at 1.0 percentage point of GDP annually, its pace is somewhat uncertain due to the government's conservative oil price assumption of US$ 40 per barrel on the one hand (upside risk) and need to sustain social spending in the run-up to the elections on the other (downside risk). The new fiscal rule, still under discussion and scheduled to be in effect from 2019, is supposed to reduce the effect of oil prices on the federal budget.

Financial stability is supported by the central bank's policy of closing weaker banks. Household loan growth turned positive only in the last quarter of 2016, while NPLs have increased in both the corporate (6.2 per cent) and the household sector (8.2 per cent) as of February 2017, but are still moderate compared to average rates in CESEE.

Domestic demand remained weak in 2016, but recovering household income and the stronger rouble may reduce the trade surplus and support imports. Increasing oil prices will underpin the economic recovery. In 2017 and 2018 growth is expected to pick up to 1.2 and 1.4 per cent, respectively, on the back of higher oil prices, recovering private consumption and investments. The main risks for the projection come from the oil price developments, lack of business environment reforms supporting investment, geopolitical tensions and prolongation of sanctions. Without significant reforms, long-term growth will remain at around 1 to 2 per cent annually due to low investment.

## Central Asia

Growth in Central Asia in 2017 is expected to rise slightly to 3.8 per cent, compared with 3.5 per cent in 2016, reflecting the improved external environment. Commodity exporting countries will benefit from the pick-up in oil prices and other key commodities, while countries with strong economic links with Russia are expected to be supported by a rebound in remittances, leading to a recovery in domestic demand. Notwithstanding the more stable external environment, the region continued to experience a build-up of structural challenges over 2014-2016 with increased fiscal, external and financial sector vulnerabilities. Currencies have stabilised and inflationary pressures have eased in 2016, but tight currency controls and dual exchange rates weigh heavily in some countries. In 2018 real GDP growth in the region is expected to increase to 4.6 per cent, driven mainly by a stronger performance in commodity-exporting countries. FDI from China, including as part of the Belt and Road Initiative, is expected to provide significant support for growth in most Central Asian economies. However, the region remains exposed to future adverse risks, such as a further drop in oil prices and slower than anticipated growth in Russia and China, which, together with internal structural challenges, could hold back growth.

### Kazakhstan

The slowdown in Kazakhstan bottomed out in 2016 and growth rate is projected to increase to 2.4 per cent in 2017 (after 1.0 per cent in 2016), supported by stronger exports from the improved oil price outlook, targeted public investments and higher FDI inflows. Monetary conditions have been eased, the exchange rate has stabilised and inflation is on a downward trend (inflation decreased from 17.7 per cent year-on-year in July 2016 to 7.7 per cent in March 2017). The legacy of high non-performing loans (around US$ 9.6 billion, or 16.4 per cent of the loan portfolio as of end-March 2017) continues to weigh on the banking sector, given the presence of off-balance sheet structures that have absorbed the legacy NPLs. The government has allocated US$ 6.5 billion to support banks facing insolvency risks, and a possible merger of several banks is being discussed. Continued implementation of the government’s reform agenda is likely to lead to further improvements in the country's institutional capacity and its business climate. Growth is expected to increase to 3.5 per cent in 2018, driven by accelerated production at the Kashagan oil field, boosting oil exports, and higher FDI from China and other countries. Large state support programmes, backed by significant fiscal buffers, will continue to drive growth. Inflation is expected to remain within the 6-8 per cent range set by the NBK in 2017, and decline further in subsequent years.

### Kyrgyz Republic

Growth in the Kyrgyz Republic remained broadly stable at 3.8 per cent in 2016, compared to 3.9 per cent in 2015, and represented a marked recovery after the contraction of 2.3 per cent in the first half of the year. The improvement largely reflected strong output growth at the Kumtor gold mine, after the owner, Centerra Gold, received approval for its mining plan in the middle of the year. Currency pressures eased, with the Som appreciating by 9.6 per cent over 2016, helped by a rebound in remittances from Russia, up by 19 per cent (in US dollar terms) in 2016. The economy is expected to grow by 3.9 per cent and 4.1 per cent in 2017 and 2018 respectively, supported by further recovery in Russia, rising remittances, enhanced trade and financial support for the country, and strong mining production output. Large public investment in the infrastructure and energy sectors, mainly financed by China, is expected to remain significant in coming years. However, a build-up of structural reform challenges over 2014-16 will, if not addressed, continue to weigh on growth prospects.

### Mongolia

Mongolia's economic growth has been decelerating markedly in recent years. From a peak of 17.3 per cent in 2011, economic growth slowed to 1.0 per cent in 2016, as domestic demand declined and investment struggled to recover from the downturn in previous years. Growth rebounded significantly in the last quarter of 2016, up by 9.9 per cent year-on-year in real terms, primarily as a result of large fixed investments in mining sector, with gross fixed capital formation expanding by 36.6 per cent in this period year on year. Short-term liquidity pressures have abated, as the government refinanced an external bond due in March 2017 by issuing a new seven-year maturity note. This demonstrated solid market access in light of the new programme with the IMF, which is expected to unlock a US$ 5.5 billion financial package from multilateral and bilateral lenders over the next three years to maintain the economic stability of the country. Growth in 2017 is expected to improve to 1.4 per cent and further to 2.8 per cent in 2018, reflecting the increased investment in the second phase of Oyu Tolgoi (OT) mine, and improvements in the investment climate and consumer confidence, reflecting the improved economic environment. A gradual increase in mining production, combined with expected improvements in commodity prices, will support both exports and government revenues. However, a range of fiscal consolidation measures and tight monetary policy under the new IMF programme are expected to weigh on public and private consumption in the short term.

### Tajikistan

Growth in Tajikistan in 2017 is projected to decline to 3.8 per cent, after reaching 6.9 per cent in 2016 according to official figures. The headline growth rate masks the fragile economic situation and the build-up of structural disruptions, such as overdependence on remittances, returning migrants since 2014 and unresolved challenges in banking sector, all of which have translated into significant pressure on the population and businesses. Growth in 2017 will be supported by a rebound in remittances inflow from Russia. The Somoni remained broadly stable in 2016 reflecting the effects of currency controls, but it started weakening again in the first quarter of 2017 depreciating by 7 per cent, leading to tighter monetary policy with the base rate being increased to 16 per cent in March 2017 compared to 11 per cent at the end of 2016. The banking sector has been in crisis since the collapse of remittances inflows from Russia, resulting in a sharp increase in NPLs to around 42 per cent in 2016 compared to 9.9 per cent in 2013. The government has made efforts to support the banking sector via an injection of state funding and IFI financial support, but significant challenges remain. In 2018 only a modest improvement in economic performance is expected Growth is projected at around 4.0 per cent, with significant downside risks to achieving this level of growth, reflecting ongoing fiscal and financial sector challenges.

### Turkmenistan

In Turkmenistan, the officially reported GDP growth slowed to 6.2 per cent in 2016, following double-digit growth rates over 2011-2014, as a result of a significant drop in energy prices and a slowdown in the economies of regional trading partners. The halt of gas exports to Russia in 2016 and to Iran at the beginning of 2017 has left China as Turkmenistan's sole gas export destination. Measures have been introduced to reduce pressure on the currency and maintain the peg to the US dollar (established in January 2015), which are disrupting trade activity. The black market rate has continued to weaken, reaching close to 8 manats per US dollar at the end of 2016, compared to the official peg of 3.5 to US dollar. In 2017 growth is expected to slow to 5.7 per cent and recover slightly to 6.0 per cent in 2018, reflecting the dislocations in the economy, such as impaired trade activity and production caused by tight currency controls and dual exchange rate. Fiscal revenues could be severely affected by the fall in energy prices. Strong public and FDI investments in both in the extractive and non-extractive sectors and a gradual improvement in the external environment will support economic growth.

### Uzbekistan

The officially reported growth in Uzbekistan in 2016 remained strong at 7.8 per cent, mainly internally driven, supported by a rise in the government's social and infrastructure spending as well as a good performance in agriculture, construction retail trade and services sectors. Growth in 2017 is expecting to moderate to 6.2 per cent, negatively affected by dislocations in the domestic economy as a result of tight currency controls and dual exchange rates, which constrain the development of more competitive industries and discourage FDI. Growth will be supported by higher energy export prices, recovery in Russia and a rebound in remittances inflows, supporting private consumption. The government has announced a series of reforms to improve the investment climate, including plans to liberalize the exchange rate regime, which would be a significant policy development. While the currency has yet to be allowed to float freely, the pace of Sum depreciation has accelerated in the first four months of 2017, with the official rate weakening by 13 per cent and the black market rate hitting around Sum 7,800 per US dollar versus an official rate of Sum 3,706 per US dollar at the end of April 2017. In 2018 the economy can be expected to grow by 6.5 per cent, supported by a more positive investment environment.

# Southern and Eastern Mediterranean (SEMED)

In the SEMED region, growth forecast for 2017 has been revised downwards slightly to 3.7 per cent, owing to a worse-than-expected recent performance across all the countries of the region, albeit with different magnitudes. In Egypt, higher-than-expected inflation has adversely affected consumption, historically the main driver of growth. In Jordan, weaker-than-expected exports and tourism owing to the regional turmoil have contributed to the downward revision of the growth forecast by 0.2 percentage points. In Morocco, subdued non-agricultural growth has led to a downgrade of growth forecast by 0.6 percentage points. In Tunisia, delays in the implementation of reforms continue to weigh on growth. Key factors underlying forecasted growth are: a rebound in agricultural output in both Tunisia and Morocco; higher domestic demand in Jordan driven by the refugee influx; and the improvement in competitiveness and the business climate in Egypt. As a result, average growth in SEMED is expected to reach 4.1 per cent in 2018. Downside risks to the outlook relate mainly to regional turmoil and delays in the implementation of tough structural reforms.

## Egypt

In Egypt, investment is becoming a more prominent driver of growth in fiscal year (FY) 2016/17, following significant recent reforms, notably the reform of subsidies and the liberalisation of the exchange rate. Investment picked up, following the liberalization of the exchange rate in November 2016. In the first half of FY2016/2017, FDI increased by more than 20 per cent compared to the same period last year. Private consumption however was adversely affected by high inflation, which eroded purchasing power and outweighed the boost in investment. As a result, growth moderated to 3.4 per cent in the first quarter of FY2016/17 compared to 5.1 per cent in the same period of FY2015/16. Economic activity is expected to grow at 3.8 per cent for FY2016/17. Inflation, which reached record high levels, will continue to weigh on consumption. A pick-up in growth momentum of 4.5 per cent is expected in FY2017/18, helped by improved competitiveness and continued strengthening of investment, following the implementation of reforms.

## Jordan

Instability in Iraq and Syria and the large influx of Syrian refugees continue to weigh on growth in Jordan. The rate of growth slowed to 2 per cent in 2016 from 2.4 per cent in 2015 as conflicts in neighbouring Iraq and Syria adversely affected trade, tourism, and investment. The weakening growth performance was driven in particular by a contraction in the mining and restaurants and hotel sectors, despite strong growth in services. Given the difficult regional environment, growth is expected to rise only modestly to 2.3 per cent in 2017 and 2.5 per cent in 2018, supported by stronger private consumption from the higher refugee population.

### Morocco

In Morocco, economic growth decelerated in 2016 owing to a sharp contraction in agricultural output and subdued non-agricultural activity. GDP growth dropped to 1.6 per cent in 2016, from 4.5 per cent in 2015. This was driven primarily by a sharp contraction in the agricultural sector of 10.9 per cent, and a modest non-agricultural growth of 2 per cent. Morocco's industrial strategy of developing high value-added sectors, such as automotive and aeronautics industries is showing positive results and is offsetting the more modest growth in traditional sectors such as mining and quarrying. Growth is expected to accelerate in 2017 to 4.2 per cent, as agricultural output rebounds following strong rainfall, and non-agricultural growth remains subdued. In 2018, growth will stabilize at 3.8 per cent as agricultural activities normalize.

### Tunisia

In Tunisia, economic growth remained sluggish. Economic activity was subdued in 2016 at 1 per cent, compared to 1.1 per cent in 2015. The modest growth was driven by a recovery in services, offsetting contractions in agriculture owing to low rain levels and in oil and gas extraction and refining due to cutbacks in investment by international oil companies. Growth is expected to increase to 2.2 per cent in 2017 and gradually pick up to 2.7 per cent in 2018, driven by a rebound in agricultural output following strong rainfall, and a continued recovery in tourism and investment.

# About this report

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

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 2016-17*, which are all available on the EBRD's website (www.ebrd.com).

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