Regional Economic Prospects
in the EBRD Regions
May 2019

Facing global slowdown: More exposed, better prepared?

Growth to pick up in 2020 after a weaker 2019

Growth in the EBRD regions averaged 3.4 per cent in 2018, down from 3.8 per cent in 2017. This deceleration was driven by a very sharp slowdown in Turkey and weaker export growth across the regions’ economies, mirroring the global trade slowdown.

Having tightened throughout 2018, financing conditions faced by the EBRD regions’ economies started easing from January 2019, with interest rates remaining low in historical perspective. The oil price dropped sharply at the end of 2018 but has since rebounded significantly, supporting growth in oil exporters and in countries that receive large flows of remittances from Russia and the Gulf Cooperation Council economies.

Turkey’s economy entered recession in the second half of 2018 on the back of tighter monetary policy and deteriorating consumer and investor sentiment. Elsewhere in the EBRD regions deceleration in the second half of 2018 has been modest. Robust domestic demand continued to support growth in central Europe and the Baltic states. South-eastern Europe and eastern Europe and the Caucasus also experienced robust growth, though with some growth moderation in countries with previously high growth rates. Rising oil prices supported economic growth in Kazakhstan and Russia as well as higher remittances from Russia to Central Asia, the Caucasus and Moldova. Growth in the southern and eastern Mediterranean picked up owing to a combination of higher tourist arrivals, improved competitiveness and reforms in some countries, partially offset by the impact of political instability in parts of the region.

Average growth in the EBRD regions is expected to moderate to 2.3 per cent in 2019 before picking up to 2.6 per cent in 2020. In line with slowing global growth, moderations are expected almost across the board, with the exception of the southern and eastern Mediterranean. Following the output drop in 2019, growth in Turkey is expected to return to positive territory in 2020. Growth pick-ups in Russia and Ukraine and a further acceleration of already-high growth in the southern and eastern Mediterranean are also expected to contribute to higher overall growth in 2020.
In recent years growth in the EBRD regions has become more dependent on global economic conditions than it was prior to 2008. This reflects the region’s deep integration in the global value chains as well as the fact that economies of emerging Europe and Central Asia can no longer rely on transition-related productivity catch-up as a major source of growth. In this regard, the sensitivity of EBRD regions’ growth to changes in external conditions is now similar to that observed for other emerging markets.

This highlights the significant risks to the outlook for growth in the EBRD regions stemming from trade tensions between the United States and its major trading partners. A widespread escalation of global protectionism remains a major concern. The modalities of Brexit are still unclear, and global uncertainty remains high. The security situation in the Middle East and geopolitcal tensions are also key sources of risk for the regions’ economies.

On the other hand, many economies in the EBRD regions have strong macroeconomic frameworks and some fiscal space that could facilitate an appropriate policy response to external shocks. In fact, economies in the EBRD regions have been increasingly making good use of flexible exchange rates and inflation targeting to respond to external and domestic shocks. Fiscal policy has also been used as a counter-cyclical tool: on average countries built fiscal buffers during the periods of stronger economic growth and used them at times of adverse economic shocks. Similar trends have been observed among emerging market economies globally.
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Growth is projected to bottom out in mid-2019

**Chart 3. Average real GDP growth rates, 12-month rolling, %**

- Growth slowest in mid-2019
- Export growth slowed in most economies of EBRD regions

**Chart 4. Exports (goods and services), % change in Euro terms**

- Financial tightening episode of 2018 ended in Jan-2019
- Less variation in spread increases than in earlier episodes

**Chart 5. Yields, %**

- Volatility of capital flows has also declined since 2005
- Higher oil prices supported partial recovery in remittances

**Chart 7. S.d. of net mutual fund flows, 12-month, % of AUM**

- Sources: CEIC, EBRD model forecasts and authors’ calculations.
- Sources: National authorities via CEIC and authors’ calculations.
- Sources: Bloomberg.
- Sources: Bloomberg. 24 other emerging markets.
- Sources: EPFR Global. EM based on 9 selected EM countries.
- Sources: Central Bank of Russia and authors’ calculations. The peak in quarterly remittances was within two quarters of 2014 Q1 in all countries.
Greater use of flexible exchange rates as shock absorbers

Chart 9. Exchange rate volatility rel. to advanced economies

In most countries in the region, inflation is close to targets

Chart 10. Inflation targets and latest inflation rates

Sources: Thomson Reuters. 3-month moving average of the standard deviation of nominal effective exchange rates.

Sources: Thomson Reuters and author’s calculation.

Most countries have adequate levels of int. reserves

Chart 11. External financing needs and reserves, % of GDP

Most countries have some fiscal policy space

Chart 12. Stock burdens and flow burdens

Sources: World Bank and author’s calculation. External financing needs are the sum of current account deficits and short-term external debt.

Sources: Bloomberg, CEIC and author’s calculation.

External conditions matter more for growth than before

Chart 13. Share of variation in manufacturing growth explained by external conditions, %

Sources: World Bank, IMF WEO, based on 14 other EMs.

Risks: Global uncertainty high and rising

Chart 14. World Uncertainty Index and US Trade Policy

Uncertainty, 1996-2010 mean = 100

Sources: Baker, Bloom and Davis (2016) and World Uncertainty Index.
Average growth in the EBRD regions fell to 3.4 per cent in 2018, weighed down by Turkey

Growth in the EBRD regions slowed in the second half of 2018 and averaged 3.4 per cent in the year as a whole, down from 3.8 per cent in 2017 (see Table 1 and Chart 1; averages are weighted using the values of countries’ gross domestic product [GDP] at purchasing power parity [PPP]). The averages largely reflect a very sharp slowdown in Turkey, from 7.4 per cent growth in 2017 to 2.6 per cent in 2018 (see Chart 2), but they also mirror broader global trends.

Following almost two years of strong and broad-based growth, the global economy slowed from 3.8 per cent in 2017 to 3.6 per cent in 2018, with a pronounced deceleration in the second half of the year. Activity softened amid an increase in trade tensions between the United States and China, higher policy uncertainty across many economies, a tightening in financial conditions, slower growth of global trade and a resulting decline in business confidence.

Mirroring global trends, growth slowed in about 70 per cent of countries in the EBRD regions in the second half of 2018, relative to the first half of the year. The latest economic indicators such as retail sales, exports and imports point towards a further moderation of growth in the first half of 2019, based on estimates derived using a principal-component-based model that takes into account more than 150 global indicators as well as estimates of economies’ medium-term potential growth (see Chart 3). For the EBRD regions excluding Turkey, this moderation is estimated to be relatively muted.

Weaker external demand and slowing trade growth weigh on the region

Global trade growth slowed considerably towards the end of 2018, from the high rates seen in late 2017. Increased trade tensions between the United States and China contributed to the slowdown. Industrial production also decelerated across advanced economies, except in the United States. This deceleration was driven by a combination of waning cyclical factors, high policy uncertainty and worsening market sentiment.

Slower growth of global trade weighed on export demand in the EBRD regions. Export growth slowed in almost all countries, to an average of 10 per cent year-on-year in euro terms in the latest 6 months compared with 24 per cent in the same period a year earlier (see Chart 4).

In contrast, domestic demand held up in most economies. A notable exception is Turkey, where domestic demand collapsed in the second half of 2018 amid tighter monetary policy, private sector deleveraging and deteriorating consumer and investor sentiment.

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1 See the November 2017 edition of the Regional Economic Prospects for a discussion of the model.
Over the past decade and a half, growth in many economies of the EBRD regions has been mostly driven by capital formation and automation, reflecting the increasing scarcity of labour (see Box 1). The contribution from total factor productivity has been small since the Global Financial Crisis. While this is captured here simply as a residual, this finding is consistent with the low level of innovation in these economies, as documented in the 2017-18 EBRD Transition Report and November 2018 Regional Economic Prospects. On average over the period 2003-2015 falling employment weighed on growth. The negative effects of shrinking working-age populations due to migration and aging were just about offset by rising employment rates (especially among older workers). However, shifts in the skill-composition of employment, in particular falling demand for middle-skilled labour, also constituted a drag on growth during most of this period, though these effects are small compared to the large positive contribution of capital formation.

**Episode of tightening of financing conditions ended in January 2019**

Financing conditions for emerging markets tightened in 2018, following several quarters of an exceptionally favourable environment. The average yield on high-risk emerging market bonds edged up from a low of 5.8 per cent in April 2018 to 8.2 per cent at the end of the year. This was the fifth largest increase in average interest rates faced by emerging markets in the last 20 years - the others being an episode in 2001, the immediate aftermath of the 2008 Global Financial Crisis, the Eurozone debt crisis of 2011 and an episode in 2015 (see Chart 5).

The tightening ended in January 2019, with financing conditions easing since. Interest rates remain at the lowest levels seen in the last 20 years, comparable to the rates prevailing during 2003-07 and 2013-15 (see Chart 5). The tightening primarily affected capital flows to economies with underlying weaknesses, notably Argentina and Turkey.

**Lower differentiation among emerging markets benefited higher-risk economies**

The latest tightening episode saw less variance in terms of spread increases than earlier episodes, as measured by the difference between the increases in the cost of debt faced by borrowers at the 10th and 90th percentiles of distribution of cost increases (see Chart 6). The lower extent of differentiation among different markets could be explained by investors anticipating a normalisation of conditions and engaging earlier in the opposite trades, buying assets, including government bonds, as they become cheaper. This trend benefited most those countries where risks are perceived to be higher, such as Ukraine; in these economies increases in interest rates were more modest than during previous episodes. Broad trends have been similar in emerging markets at large, although the reduction in differentiation among emerging markets in general occurred somewhat earlier, and notable outliers (outside the 90th percentile) remain.
The volatility of capital flows has also declined over time, consistent with investors’ increased confidence in the countries’ macroeconomic policy frameworks (see Chart 7). As in other emerging markets, capital flows to the EBRD regions have been recovering in recent months.

Markets now expect looser financial conditions in 2019. The US Fed has signalled a more accommodative monetary policy stance in light of slowing economic activity. Interest rates are also expected to remain on hold for longer in the euro zone, while fiscal policy is easing there for the first time in a decade.

**Recovering stock market valuations and exchange rates**

Emerging market currencies in general, as well as those in the EBRD regions, have been broadly stable or strengthened slightly against the US dollar in January-April 2019, having weakened over the course of 2018. The Turkish lira, which depreciated by 29 per cent against the dollar in 2018, has recovered some of its losses in the first months of 2019, though it remains highly vulnerable to changing investor sentiment. Tighter monetary policy and an increase in the price of oil have helped bolster the Russian rouble in the first part of 2019.

Stock market valuations in emerging Europe have also been recovering in the first months of 2019 after a weaker 2018. These trends mirror broader developments in emerging markets where a downward correction in 2018 reflected escalating trade wars, a weaker global outlook and ongoing concerns about tightening financing conditions.

**Oil prices are rising again following a sharp drop**


The oil price has rebounded somewhat since the beginning of 2019. It exceeded US$ 70 by April, driven by production cuts in oil exporting countries. This price recovery notwithstanding, the average price of Brent in January-April 2019 was 5 per cent lower than in the same period of 2018.

**Stronger recovery in remittances to EAEU member countries**

The higher oil price has supported growth momentum in commodity exporters and a continued recovery in remittances from Russia to eastern Europe, the Caucasus and Central Asia. The recovery in remittances has, however, been uneven across countries (see Chart 8).

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2 The measure of capital flow volatility is based on monthly net mutual fund flows to a given country, expressed in per cent of assets under management. The standard deviation of flows to all countries over a 12-month window is used to gauge volatility.
In particular, remittances are on average 1.4 percentage points of GDP below their peak in members of the Eurasian Economic Union, but remain at 4.6 percentage points of GDP below their peak level in other countries in Eastern Europe, the Caucasus and Central Asia. This could reflect differences in access to the Russian labour market, including differences in the quality of jobs available to migrants once there.

At over 7 per cent of GDP on average, remittances in the EBRD regions remain about 3.3 percentage points higher than in other countries at a similar level of development.³ Looking at the cost of remitting through formal channels it is also cheaper to send money from Russia than to make remittances along most other major remittance corridors (for instance from Germany to south-eastern Europe, from Saudi Arabia to South Asia and from the United States to Central America). The cost of sending remittances from Russia has further halved since 2011, according to World Bank data.

Better prepared: Flexible exchange rates and counter-cyclical fiscal policy increasingly acting as shock absorbers

Over the last two decades, emerging market economies globally as well as in the EBRD regions have been making greater use of flexible exchange rates and inflation targeting to respond to external and domestic shocks. Correspondingly, their exchange rates have become more volatile relative to those of advanced economies. In such relative terms, emerging market exchange rate volatility is at its highest level since 2001 (see Chart 9). This, of course, reflects the combination of emerging markets’ choice of policy tool as well as the frequency and intensity of external shocks affecting them. By now 70 per cent of economies in the EBRD regions are inflation targeters and, with the exception of Egypt, Ukraine and Turkey, inflation does not exceed the target by more than 2 percentage points (see Chart 10).

Most countries in the EBRD regions have comfortable levels of international reserves in relation to their short-term external financing needs as discussed in the previous issues of Regional Economic Prospects. In only seven countries in the region do reserves cover less than a year of external financing requirements (the sum of current account deficit and short-term external debt), and only two of these maintain currency pegs (see Chart 11).

At the same time, high levels of debt denominated in foreign currency limit the effectiveness of flexible exchange rates as shock absorbers. As documented in the November 2018 Regional Economic Prospects, much of corporate debt in the EBRD regions is in foreign currency or external. In these cases, a weaker currency still supports exports, makes imports more expensive and renders local assets more attractive to foreign investors, but it also makes debt of corporates, households and the government more expensive to service.

Fiscal policy has also been used as a counter-cyclical tool, mitigating the impact of economic shocks (see Box 2 for a detailed analysis). On average, countries in the region built fiscal

³ The numbers refer to unweighted averages among recipient countries.
buffers during times of stronger economic growth and increased government spending at times of adverse shocks. Similar to advanced economies, countries in central Europe and the Baltic States, south-eastern Europe and Turkey implemented fiscal stimulus packages in response to the Global Financial Crisis. Other economies in the region used fiscal policy to respond to the drops in commodity prices in the mid-2010s (and the consequent drops in remittances from commodity exporters) – a pattern also seen in many emerging markets.

Such counter-cyclical fiscal policies, however, appear to complement the use of flexible exchange rates rather than be used as an alternative policy response to external shocks, as discussed in Box 2, possibly reflecting the strength of countries’ macroeconomic frameworks.

Owing to a relatively low cost of servicing government debt in recent years, most countries in the regions have some available fiscal space that can facilitate a fiscal response to an adverse economic shock. Like in advanced economies, in many economies in the EBRD regions debt levels are moderate-to-high but interest rates on government debt are below the growth rate of nominal GDP (the sum of real economic growth and inflation). In these economies, located in the bottom right quadrant of Chart 12, debt can be expected to decline as a percentage of GDP over time provided government revenues cover non-interest spending. In contrast, in Turkey and Ukraine (and, to a lesser extent, Azerbaijan), debt levels are moderate but the current financing terms are relatively unfavourable, requiring governments to run sizable primary fiscal surpluses to keep debt-to-GDP ratios stable (top left quadrant of the chart). Lebanon and Jordan, as well as Tunisia, face both high levels of debt and a relatively high cost of debt service.

**Broadly sustained growth momentum, with the exception of Turkey**

Growth in 2018 was faster than in 2017 in most economies in the EBRD regions, with the notable exception of Turkey and south-eastern Europe.

Growth in **central Europe and the Baltic states** exceeded expectations and reached 4.7 per cent in 2018, up from 4.4 per cent in 2017 (see Chart 2), owing to strong domestic demand on the back of rising wages, favourable financing conditions and improved absorption of European Union (EU) structural funds.

Growth in **south-eastern Europe** moderated from 4.3 per cent in 2017 to 3.4 per cent in 2018, with significant variation across countries. At 1.9 per cent, growth in Greece was slightly below expectations, but confidence, investment and employment have been picking up. Growth in Bulgaria and Romania remained relatively strong, though signs of a slowdown are apparent in the latter. Growth picked up in the Western Balkans, primarily as a result of faster growth in Serbia, the region’s largest economy, and recovery in North Macedonia. The composition of growth shifted to private consumption, with a larger drag from net exports than in 2017.

Growth in **eastern Europe and the Caucasus** picked up from 2.4 per cent in 2017 to 3.0 per cent in 2018, though with some growth moderation from the previously-high growth rates in...
Armenia, Georgia and Moldova. Recovery took hold in Ukraine, with growth accelerating to 3.3 per cent in 2018 on the back of robust consumption, recovery in investment and rising remittances from Poland.

In Turkey, growth slowed sharply from 7.4 per cent in 2017 to 2.6 per cent in 2018. The economy entered a recession in the second half of 2018 amid tighter monetary policy and private sector deleveraging. As the lira depreciated, net exports have made a stronger contribution to growth. After a sharp slowdown in the last months of 2018, credit growth picked up in the first quarter of 2019 as lending by state banks increased.

Russia’s economy expanded at the rate of 2.3 per cent in 2018, up from 1.5 per cent in 2017. Rising oil prices and oil production boosted government revenues and export receipts. The central bank hiked its policy rate to contain inflation and the currency depreciation resulting from the new round of sanctions.

Growth in Central Asia accelerated slightly from 4.7 per cent in 2017 to 4.8 per cent in 2018. On balance the external economic environment remained conducive to growth, with strong export receipts and higher remittance inflows. Mongolia, Uzbekistan and Tajikistan also benefitted from a significant expansion of fixed investment, primarily public and foreign.

Growth in the southern and eastern Mediterranean picked up from 3.8 per cent in 2017 to 4.4 per cent in 2018, corresponding to around 2 per cent in per capita terms. Social unrest and political instability delayed the implementation of reforms in Jordan and Lebanon. Receipts from tourism, however, were higher in most countries, competitiveness in Tunisia improved as a result of currency depreciation and reforms helped Egypt achieve the highest growth rate in a decade.

**Growth is projected to moderate, in line with global trends**

Average growth in the EBRD regions is expected to moderate from 3.8 per cent in 2017 and 3.4 per cent in 2018 to 2.3 per cent in 2019 (see Table 1). This mirrors a slowdown in global growth, projected at 3.3 per cent in 2019 (in PPP-weighted terms), according to the latest World Economic Outlook of the International Monetary Fund (IMF). The new projections for the EBRD regions represent a downward revision of 0.3 percentage points compared with the November 2018 Regional Economic Prospects forecast, primarily on account of slower expected growth in Turkey. Excluding Turkey, growth in the EBRD regions is expected to moderate to 3.0 per cent in 2019, a forecast unchanged from November 2018 (see Table 1).

Growth in central Europe and the Baltic States is projected to slow from 4.7 per cent in 2018 to 3.8 per cent in 2019 and 3.2 per cent in 2020, with key risks tilted to the downside in the light of the slowing growth in advanced Europe.

Growth momentum is also expected to moderate in south-eastern Europe, to around 3.0 per cent in both 2019 and 2020. Growth in Romania is expected to moderate from close to 7 per cent in 2017 and 4.1 per cent in 2018 to 3.2 per cent in 2019 and 2020 on account of increased perceived investment risk, tighter monetary policy and growing external
imbalances. Recovery in Greece, on the other hand, is expected to continue, with growth projected to rise to 2.2 per cent in both 2019 and 2020.

A slowdown is also projected in most of eastern Europe and the Caucasus, with average growth falling from 3.0 per cent in 2018 to 2.8 per cent in 2019. In Ukraine a deceleration of growth in the main trading partners and domestic political uncertainties due to the twin elections are expected to cause a temporary slowdown in growth to 2.5 per cent in 2019. Reforms and monetary policy easing are expected to support growth increasing to 3.0 per cent in 2020.

Russia’s growth is projected at 1.5 per cent in 2019, as higher interest rates, the increase in the rate of the value added tax (VAT) and rising inflation hold down household consumption growth, while a stricter sanctions regime constrains private investment. In addition, an agreement with OPEC foresees reduced oil exports. Growth is expected to start picking up in 2020, driven partly by an ambitious investment plan announced for the period 2019-2024.

Growth in Central Asia is also forecast to slow, from 4.8 per cent in 2018 to 4.4 per cent in 2019 and 4.2 per cent in 2020 due to smaller gains in oil and gas production, but is expected to stay above 4 per cent contingent on continued supportive external conditions, advancement in regional integration and barring increases in political uncertainty.

In contrast, growth in the southern and eastern Mediterranean region is projected to pick up from 4.4 per cent in 2018 to 4.6 per cent in 2019, supported by the implementation of reforms aimed at improving the business environment and boosting domestic and foreign investment. Robust economic growth in Egypt is expected to continue, supported by the sustained recovery in tourist arrivals and exports, large public construction projects, higher natural gas production and various reforms.

**Spillovers from Turkey are likely to be limited**

Recovery from the ongoing slowdown in Turkey is likely to be gradual. High interest rates will continue to dampen consumption and investment, although higher net exports on the back of the weaker lira are expected to continue to contribute to growth. A contraction of around 1.0 per cent in expected in 2019, with a gradual recovery of growth to around 2.5 per cent in 2020. Box 3 examines post-recession recoveries in the EBRD regions over the last two decades.

Spillovers from the sharp deceleration of growth in Turkey to the economies in the EBRD regions are expected to be limited. As documented in the 2018 November Regional Economic Prospects, economic linkages via trade, cross-border investment and remittances are relatively modest. Goods exports to Turkey do not exceed 2 per cent of the exporter’s GDP anywhere in the EBRD regions. Exposures are highest in Bulgaria (mostly consumer goods) and Hungary (mostly capital goods). In addition, exports of intermediate goods are less likely to be impacted by the domestic slowdown in Turkey to the extent that they serve as inputs into the production of goods exported by Turkey.
Turkey accounts for only 0.5 per cent of total FDI inflows into the EBRD regions, although its share of Azerbaijan’s FDI is 9 per cent. And with its young population and rapidly growing labour force, Turkey is not a significant source of migrant remittances (as documented in the EBRD Transition Report 2018-19). Remittances from Turkey account for at most 1.9 per cent of recipient countries’ GDP (in the case of Bulgaria).

More exposed: increased vulnerability to external shocks

The EBRD regions are deeply integrated in regional value chains. As documented in the November 2018 Regional Economic Prospects, the import content of exports in emerging Europe (a proxy for integration in value chains), at 43 per cent, is high by the standards of advanced economies and emerging economies. While deepening economic integration has benefited the EBRD regions, providing access to capital, generating employment, facilitating knowledge spillovers and boosting productivity growth, it has also increased economies’ sensitivities to changes in external demand conditions. This was exemplified by spillovers to the EBRD regions from the recent slowdown in manufacturing growth (especially in the automotive sector) in Germany.

The importance of external conditions for the regions’ growth rates has increased significantly, converging to the levels commonly observed in emerging markets (see Chart 13). Before 2008, growth in the EBRD regions was to a greater extent driven by sources specific to the region, namely transition catch-up in the levels of total factor productivity facilitated by gradual integration into European and global value chains. In 2000-2007, variation in manufacturing growth in the euro area accounted for about 14 per cent of the variation in manufacturing growth in central Europe. After 2010, this ratio increased to around 50 per cent. Spillovers from China’s growth have also increased sharply and now explain around a third of the variation in manufacturing growth across EBRD regions. In some cases, these linkages can be indirect. A strong association between Russia’s growth and China’s, for instance, is likely driven by the impact of China’s demand on prices of Russia’s commodity exports.

In sum, a slowdown in global growth presents significant risks to the outlook for growth in the EBRD regions. In light of the trade tensions between the United States and its major trading partners, a widespread escalation of protectionism remains a major concern. Notwithstanding recent moderation, US trade policy uncertainty remains at historically high levels (see Chart 14), with the cost of the ongoing trade tensions estimated at 0.2 percentage points of global GDP, according to the IMF. The security situation in the Middle East and geopolitical tensions remain key sources of risk for the region’s economies.

Furthermore, the modalities of the UK’s exit from the EU (“Brexit”) remain unclear. After the Draft Withdrawal Agreement was repeatedly rejected by the UK House of Commons, the date of the UK’s departure from the EU has been moved forward to 31 October 2019, with the option to leave earlier if the UK Parliament passes the withdrawal agreement. In a no-deal-Brexit scenario or other scenarios where the UK does not remain in a customs union with the EU, cross-border supply chains involving the UK may be severely disrupted. Lower exports from Europe’s advanced economies to the UK will affect demand for imports of
intermediate goods from the EBRD regions. When such value-added-chain effects are taken into account, up to 7 per cent of exports from the region (by their domestic value) are at risk.
Box 1. The impact of structural shifts in the labour market on growth

Countries in emerging Europe are faced with shrinking labour forces. Scarcity of labour led to rising employment rates and rapid automation of production, and with it, a change in the skill composition of employment. How have these changes affected growth so far? Consistent with rapid automation, growth has been overwhelmingly driven by capital formation, with a modest contribution from improvements in total factor productivity (TFP). Shrinking working-age populations exerted a drag on growth that could not be fully offset by rising employment rates. Shifts in the skill-composition of employment also weighed on growth, though these effects are relatively modest compared to the positive contribution of capital formation.

The 2018-19 Transition Report and previous Regional Economic Prospects pointed to ways in which shrinking labour forces in emerging Europe have been reshaping labour markets. Population aging, compounded by out-migration (primarily to the EU-15), has led to greater use of automation and rising employment rates, especially among older workers. Rapid technological change has been transforming the nature of jobs and demand for skills. As routine cognitive tasks (such as processing invoices or insurance claims) tend to be easier to automate than manual work (such as cleaning) or creative work (such as software development), the share of middle-skilled occupations has been declining in most economies while the shares of low- and high-skilled

Chart 1.1 Growth contributions

1. Production function decomposition

<table>
<thead>
<tr>
<th>Year</th>
<th>TFP</th>
<th>Capital stock</th>
<th>Employment</th>
<th>GDP growth</th>
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2. Decomposition of labour's contribution

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<thead>
<tr>
<th>Year</th>
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<th>Changes in skill composition</th>
<th>Employment rate</th>
<th>GDP growth (right scale)</th>
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<td>-0.7</td>
<td>-0.7</td>
<td>-0.7</td>
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</tbody>
</table>

Sources: OECD and authors’ calculations.

Note: Panel 1 shows a simple production function decomposition into the contributions of the changes in employment, capital stock and TFP. Panel 2 further decomposes the employment contribution into the contributions of changes in the employment rate, changes in the working-age population and changes in the skill composition. Low-, middle- and high-skilled are defined based on the ISCO-88 classification: high-skilled occupations include legislators, senior officials and managers, professionals, technicians and associate professionals; medium-skilled occupations include clerks, craft workers and related tradespersons, plant and machine operators and assemblers; low-skilled occupations include service and sales workers and elementary occupations. Simple averages across HRV, HUN, LTU, LVA and POL.
occupations have been on the rise.\(^4\)

How have these changes affected growth so far? To examine this question we first rely on a simple production function decomposition of growth, which examines how much changes in each of the factors of production (capital, labour and total factor productivity) contributed to growth in Croatia, Hungary, Latvia, Lithuania and Poland, which averaged 2.8 per cent per annum over the period 2003-14 (see Chart 1.1 panel 1).\(^5\)

Consistent with fast automation, growth has been overwhelmingly driven by capital formation. The 44 per cent increase in capital stocks over 2003-2015 contributed 2.4 percentage points to annual growth. The relatively large estimated coefficient on capital (of around 0.6) could also be a reflection of technological change making production more capital-intensive. In contrast, TFP growth contributed about 0.5 percentage points per annum, consistent with limited innovation in these economies, as documented in the 2017-18 Transition Report.

The overall change in employment constituted a -0.06 per cent drag on growth. To look at the impact of various forces behind the overall change in employment, we rely on an augmented production function, which now assumes that low-skilled, middle-skilled and high-skilled labour are all complementary inputs needed to produce the economy’s final output. One can be substituted for the other, albeit imperfectly. We use this assumption to estimate the impact of changes in the employment shares of low-, middle- and high-skilled occupations. We also separate out changes in the working-age population due to aging and migration, and changes in the employment rate (the share of employed in the working-age population; see Chart 1.1 panel 2).

The drag from shrinking working-age populations was just about offset by rising employment rates. A decline in working-age populations (on average by 3.6 per cent) due to aging and outmigration resulted in a -0.44 percentage point drag on growth, while employment rates increased by 4 percentage points and contributed 0.48 percentage points to growth.\(^6\)

Shifts in the skill-composition of employment also weighed on growth, though these effects are small compared to the large positive contribution of capital formation. Changes in the skill composition of employment resulted in a -0.09 percentage point drag on growth, likely

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\(^4\) On skill-biased technological progress see, for instance, Karabarbounis and Neiman (2014). On wage and employment polarization see, for instance, Autor and Dorn (2013) and Goos, Manning and Salomons (2014).

\(^5\) Due to data limitations on employment by educational attainment and occupations examined below, the focus throughout is on five countries in emerging Europe.

\(^6\) In the Baltic states, outmigration of those of working-age accounted for most of this drag, while in Croatia, Hungary and Poland it was a combination of aging and outmigration.
reflecting a combination of falling demand for middle-skilled labour and selective outmigration.\(^7\)\(^8\)

Changing demand for different skill levels could, however, affect social cohesion, inequality and levels of life satisfaction (insofar as more workers feel overqualified for the jobs they hold). While the growth effect of the changing skill composition of employment so far appears to be relatively small, these shifts impose disproportionate costs on some occupations, sectors, and regions, while benefiting others, calling for policies to mitigate the impact of technological change on social cohesion and equality of opportunity.

References


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\(^7\) Migrants from most emerging European countries are more likely to have completed tertiary education than their home populations (with the notable exception of the Baltic states; Eurostat 2017).

\(^8\) Results are qualitatively similar when defining skills by educational attainment rather than occupation, with an even smaller -0.04 percentage point drag on growth from changing skill composition.
Box 2. The use of counter-cyclical fiscal policy in the EBRD regions

Countries in the EBRD regions have been making greater use of flexible exchange rates and monetary policy to respond to economic shocks. What about fiscal policy? Fiscal policy has also been used as a counter-cyclical policy tool, with economies on average building fiscal buffers during good times and using them at times of adverse shocks. Similar to advanced economies, countries in central Europe and the Baltic states, south-eastern Europe and Turkey implemented fiscal stimulus packages in response to the Global Financial Crisis of 2008-09. Other economies in the region used expansionary fiscal policy to respond to the drops in commodity prices (and the consequent drop in remittances from commodity exporters) – a pattern akin to the average profile of fiscal policy in other emerging markets. In theory, countries with non-flexible exchange rates regimes may be more dependent on the use of fiscal policy to respond to changes in economic conditions. However, the analysis reveals that countries with flexible exchange rates have made greater use of counter-cyclical fiscal policy than those with fixed exchange rates. This suggests that both counter-cyclicality of fiscal policy and the use of flexible exchange rates and inflation targeting may reflect the overall strength of macroeconomic frameworks rather than a choice of one policy instrument over the other.

This box looks at the use of fiscal policy to manage business cycles in the EBRD regions, with particular reference to the countries’ choice of exchange rate regimes. The main text showed that emerging market economies globally, as well as economies in the EBRD regions, have been making greater use of flexible exchange rates and monetary policy to respond to economic shocks. What about fiscal policy? This box first provides an overview of the evolution of revenues, expenditures, government balances and gross debt as a share of GDP since 2000. It then examines whether the observed patterns correspond to counter-cyclical fiscal policies, namely, economies building buffers during good times and using them at times of adverse shocks. Finally, the analysis looks at whether countries with fixed exchange rate regimes are more dependent on fiscal policy to mitigate adverse changes in economic conditions.

The evolution of fiscal policies in the regions mirrors the timing of key shocks hitting the economies. Broadly speaking, government deficits in central and south-eastern Europe (CEB and SEE) as well as Turkey became smaller, as a percentage of GDP, in the boom years of the 2000s before deteriorating sharply in 2008-2009 as countries implemented fiscal impulses in response to the Global Financial Crisis of 2008-09. The large deficits of the crisis years have been reined in since then, through fiscal consolidation relying primarily on expenditure restraint (with government spending declining as a percentage of GDP). Spending has, however, drifted back up more recently, resulting in some deterioration of fiscal balances (see Chart 2.1, panels 1 and 3). This pattern broadly mirrors fiscal trends in advanced economies.

In contrast, fiscal policies in the rest of the EBRD regions - Central Asia (CA), eastern Europe and the Caucasus (EEC), the southern and eastern Mediterranean (SEMED) and Russia - followed trajectories similar to those observed on average in other emerging markets. As in the former group, fiscal balances improved in the boom years in the early 2000s and
worsened as a result of the Global Financial Crisis, though to a lesser extent than in advanced economies or CEB and SEE. Having subsequently improved, fiscal balances in this group worsened again after 2013 as countries used fiscal policy to respond to the drops in commodity prices or remittances from commodity exporters. Balances have, however, improved somewhat since 2016, driven by the pick-up in government revenues as a share of GDP (see Chart 2.1, panels 2 and 4).

**Chart 2.1 Revenues, expenditures and overall balances (Percent of GDP)**

<table>
<thead>
<tr>
<th>1. Baltics, Central and South-eastern Europe and Turkey</th>
<th>2. Caucasus, Central Asia, Eastern Europe, Southern and Eastern Mediterranean and Russia</th>
</tr>
</thead>
<tbody>
<tr>
<td>![Chart 1]</td>
<td>![Chart 2]</td>
</tr>
</tbody>
</table>

Sources: IMF World Economic Outlook database and authors’ calculations.
Note: Simple averages across countries; balanced samples over time. Kosovo excluded due to the short time series.

Debt increased as a share of GDP in both groups of economies. The increase occurred earlier in CEB and SEE and later in Central Asia, EEC and SEMED - in line with the different timing of major episodes of fiscal stimulus deployed in response to different shocks hitting these economies (see Chart 2.2). Russia and Turkey stand out as economies where public debt as a percentage of GDP declined sharply over the period. In Russia, the rapid decline in the debt-to-GDP ratio until 2007 reflected rapidly growing revenues on the back of increasing oil prices; the level of debt has increased somewhat post-crisis. In Turkey, high rates of nominal GDP growth helped to reduce public debt as a share of GDP, though here, too,
debt has resumed growing recently.

At first sight, these patterns broadly correspond to counter-cyclical fiscal policies, where fiscal buffers are built in good times (as spending falls as a share of GDP or tax revenues as a share of GDP increase) to be used at times of adverse shocks (as spending is increased and taxes are cut). In order to examine the cyclicality of fiscal policy in a more systematic way, we estimate the elasticity of government expenditures with respect to changes in real GDP. This measure captures the responsiveness of spending to economic conditions: counter-cyclical fiscal policy leans against changes in real income and thus tends to be characterised by low or negative elasticity of government spending with respect to real GDP. We estimate elasticities separately for positive and negative shocks to economic growth, to account for the possibility that governments may provide fiscal stimulus during bad times but fail to generate savings during good times, or (less likely) vice versa.

Our estimates suggest that fiscal policy was counter-cyclical in the EBRD regions as a whole. We find that on average the elasticity of spending to growth was smaller than one (estimates larger than one would correspond to pro-cyclical fiscal policy). Expenditures increased more slowly than GDP in good years, and kept up better than GDP in bad years, thus mitigating some of the effects of adverse economic shocks (see Chart 2.3, panel 1).

Do countries with non-flexible exchange rates make more use of counter-cyclical fiscal policy since their ability to use flexible exchange rates and monetary policy in response to adverse economic shocks? Some evidence points in this direction, as shown in Chart 2.3. Chart 2.3 shows the expenditure response to change in log real GDP for different regions and exchange rate regimes. The bars represent the estimated elasticities, with positive and negative values indicating pro-cyclical and counter-cyclical fiscal policy, respectively. The chart also includes a legend with two axes: one for expenditure response to positive change in log real GDP and another for negative change. The data points are colour-coded to differentiate between different regions and exchange rate regimes.

Sources: Ilzetzki, Reinhart and Rogoff (2019), IMF World Economic Outlook database and authors’ calculations. Note: Coefficient estimates from regressions of the change in log real expenditure on the change in log real GDP, including country fixed effects. ‘Positive’ and ‘negative’ bars examine asymmetric responses to positive and negative GDP shocks. Exchange rate classifications are based on Ilzetzki, Reinhart and Rogoff (2019), classifying the coarse categories 1 and 2 (no separate legal tender, peg, currency board, band or crawling band narrower or equal to +/-2 per cent, crawling peg) as fixed and categories 3 and 4 (pre-announced crawling band wider than +/-2 per cent, de facto crawling band, moving band, managed floating and freely floating) as floating.
economic shocks is severely restricted? In contrast, countries with flexible exchange rates can rely on exchange rate movements and inflation targeting frameworks as the primary shock absorbers and may choose to run a less active fiscal policy. In order to examine whether this has been the case, we estimate elasticities of government spending separately for countries with flexible exchange rate regimes and those with fixed or heavily-managed exchange rate regimes.

On average, fiscal policy is estimated to have been more counter-cyclical in countries with flexible exchange rates, both in the EBRD regions and among emerging markets elsewhere. In particular, countries with fixed exchange rates tend to spend more in good years than those with flexible exchange rates (see Chart 2.3, panel 2). This difference between the two groups is statistically significant in the EBRD regions (albeit not for the other emerging markets). Overall, fiscal policy in the EBRD regions and in emerging markets has been somewhat less counter-cyclical than in advanced economies—in particular in terms of generating savings during the good years.⁹

This finding highlights the importance of strong macroeconomic frameworks for managing economies’ response to adverse shocks. The estimations suggest that both the use of counter-cyclical fiscal policy and the use of flexible exchange rates appear to reflect the strength of macroeconomic frameworks and the quality of economic institutions rather than the choice of one counter-cyclical instrument over the other.

References


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⁹ Alesina *et al.* (2008) argued that overspending in good years could be explained by voters being concerned that budget surpluses may be misappropriated. They would thus push for increased expenditures during good times, resulting in more pro-cyclical policies when economic institutions are perceived as weak.
Box 3. Forecasting recoveries from recessions

This box examines recoveries following recessions in economies in the EBRD regions over the past two decades. We use quarterly data and define recessions as situations when GDP over a 12-month period was lower than over the preceding 12 months. More conventionally, recessions are defined as two consecutive quarters of negative growth in seasonally adjusted quarter-on-quarter terms. Most economies in the EBRD regions, however, do not publish official estimates of seasonally adjusted quarter-on-quarter growth rates, hence the use of an alternative approach building on year-on-year quarterly data.

How common are recessions in the EBRD regions? By this metric the median country had two recession episodes over two decades, though some countries (for instance Poland, Jordan and Morocco) did not have any, while some countries experienced as many as four. The incidence of recessions was highest following the Asian and Russian crises of 1997-98, the Global Financial Crisis of 2008-09 and the subsequent European sovereign debt crisis. There were very few recessions in the boom years of 2000-2007 as well as in the second half of 2017 and 2018 (see Chart 3.1, panel 1).

Chart 3.1 Frequency and distribution of recessions in the EBRD regions

How long are typical recessions in the EBRD regions? The median episode over this period was one year long, though with considerable heterogeneity (see Chart 3.1, panel 2). The shortest episodes lasted a single quarter; while the longest, in Croatia and Greece, lasted 6 years (see Chart 3.2, panel 1). The median country in the EBRD regions spent 2.5 years out of 20 in recession.

How long does it take to recover to medium-term potential growth? We measure time to recovery as the number of quarters from the first recession quarter until the quarter where growth reaches or exceeds the estimated medium-term potential growth. The latter is estimated based on annual data for more than 120 economies world-wide and takes into account countries demographic profiles, the quality of economic institutions, the skills base, the rate of investment and various other economic, social and financial variables.

10 12-month rolling GDP growth and year-on-year changes are used here given uncertainties about seasonal adjustments in quarterly growth paths.
The median recovery in the EBRD regions took seven quarters, though with significant heterogeneity (see Chart 3.2, panel 2). Some recessions were followed by rapid ("V-shaped") recoveries, with medium-term potential growth reached within half a year, while in other cases recovery took almost eight years. Furthermore, in 12 recession episodes growth had not recovered to medium-term potential until the next recession (or to date).

The length of recession does not appear to be a strong predictor of the length of recovery. Recessions without full recovery were no longer than the rest, with the median duration of one year.

Once recovery is achieved, does growth overshoot the estimated medium-term potential? We also examine whether growth overshoots the estimated medium-term potential after recoveries – possibly on account of a widened output gap during recessions. The extent of such overshooting is the difference between the highest growth (on a 12-month rolling basis) observed in the year after a recovery has been achieved and the estimated medium-term potential growth.

In the median economy, growth overshoots by 0.6 percentage points. This suggests that most recessions reflect prior overheating of the economy, or the output gap (if any) takes a long time to close once growth returns to its normal levels. The median, again, hides significant heterogeneity across episodes, ranging from no overshooting to growth exceeding medium-term potential by as much as 4.7 percentage points following recovery from a recession. Countries with shorter recessions and recoveries typically overshoot medium-term potential growth by more (see Chart 3.3), hinting at sharp V-shaped patterns. On the other hand, countries with long recessions and recoveries overshoot much less or may not even recover, in line with flat V recoveries or even L-shaped non-recoveries.

Prior to the latest episode (which, using our recession metric, starts in the second quarter of 2019), Turkey experienced three recessions over the last two decades: in 1999-2000, 2001-2002 and 2009. All of these lasted for one year and recoveries took five quarters. Growth meaningfully overshot the estimated medium-term potential (by more than two percentage points) only following the recovery after the 2001-02 episode. These “stylised facts” are broadly consistent with the forecast for Turkey’s growth in 2019 and 2020.
Chart 3.3. Length of recoveries and extent of overshooting

Sources: CEIC, national authorities and authors' calculations.
Regional updates

Central Europe and the Baltic States (CEB)

GDP growth in the CEB region exceeded our expectations and reached 4.7 per cent in 2018. Similar to in previous years, domestic demand proved to be the core driver of growth. Increased disposable incomes, mainly thanks to rising wages, boosted household consumption. At the same time, the persistent low interest rate environment and improved absorption of EU funds enhanced investment, largely by private corporates, and led to high levels of capacity utilisation. In addition, companies have started to invest more heavily in machines as they more often struggle with finding employees for their labour-intensive production. Key risks to the outlook are tilted to the downside, related to the worsening environment in western Europe, uncertainties about Brexit and global trade tensions.

Croatia

Economic expansion moderated from the post-recession high of 3.5 per cent in 2016 to 2.6 per cent in 2018, following a 2.9 per cent growth rate in 2017. Private consumption remained the main driver of growth, fuelled by increased earnings, a higher employment rate and increasing pace of household lending. The unemployment rate in December 2018 was 8.6 per cent, down from 18.3 per cent in December 2014 (the last year of recession). However, higher private consumption led to increased imports, and as exports did not increase by as much, the negative contribution from net exports was higher in 2018 compared to the years before. Fiscal adjustment continued in 2018 albeit at a slower pace. The 2018 budget surplus is estimated at 0.4 per cent of GDP, following a budget surplus of 0.9 per cent in 2017 (the first surplus since the country’s independence). The strong fiscal performance and continued economic expansion led to a decreasing public debt ratio, from a peak of 86 per cent of GDP in 2014 to an estimated 74 per cent in 2018. Investment continued along its recovery path from 2015, rising about 4-5 per cent per year on average ever since, and thus contributing almost 1 percentage point to growth per year, as economic sentiment kept on rising (and is now at its post-crisis maximum). In addition, Croatia is back to investment grade, thanks to S&P’s upgrade to BBB- in March 2019. We expect growth of 2.5 per cent in 2019 and 2020. Risks to the projection are relatively balanced. On the upside there is a chance of another improvement of the tourism revenues and faster utilisation of the EU funds, while the downside relates to the negative spillovers from the country’s ailing food and retail giant, Agrokor, although risks related to the latter have decreased following the debt settlement reached in 2018.

Estonia

GDP growth slowed down to 3.9 per cent in Estonia in 2018. Household consumption was the key contributor to growth, underpinned by rising disposable incomes, to some extent supported by a substantial rise in the tax-free threshold for personal income tax in 2018. Investment growth decreased somewhat but remained robust, aided by increasing construction of residential buildings amid buoyant labour markets and favourable lending
conditions for households. As Estonia’s main trading partners, particularly in the Nordic region, see falling growth rates, the economic expansion in Estonia is also likely to lose speed. Besides, labour shortages remain one of the largest problems for Estonian companies, and for the less productive ones a further wage increase may translate into a damaging loss of competitiveness. While domestic demand will likely remain the main driver of growth in the short-term, the uncertainty related to global developments constitutes a key negative risk. We anticipate GDP growth to slow down to 3.2 per cent and 2.6 per cent in 2019 and 2020, respectively.

**Hungary**

Economic growth in Hungary reached 4.9 per cent in 2018 and remained driven by domestic demand. Total investment (public and private) registered an impressive growth rate of 16.5 per cent, the highest among CEB economies. Household consumption remained buoyant, underpinned by strong gross nominal wage growth (above 10 per cent in annual terms), mostly in the private sector. While the average growth rate of household consumption has been the highest in the CEB region since 2015, its share in GDP remains the lowest, at only 47.2 per cent, substantially below the regional average of 54.1 per cent. Starting from 2019, the economic expansion is expected to decelerate, mainly due to weakening external demand in the main trading partners. This slowdown will be partially offset by domestic demand, powered by a double-digit recovery in corporate credit and still strong wage hikes. The latter is largely a result of tightening labour markets, induced by the falling working-age population and mounting skill-mismatches. Taking all these factors into account, GDP growth in 2019 is anticipated to reach 3.7 per cent, before slowing down to 2.9 per cent in 2020.

**Latvia**

GDP growth in Latvia accelerated to 4.8 per cent in 2018, mainly supported by investment and household consumption. Investment registered an impressive growth rate of 16.4 per cent, fuelled by improved absorption of EU funds. Following several years of stagnation, strong GDP growth supported employment growth, particularly in the construction sector. Household consumption will likely remain solid and at the core of economic growth in the short term but, together with investment, will slow down somewhat once EU fund inflows reach their peak. Exports, particularly of financial services, will remain subdued, driven by the ongoing reduction of the banking sector’s exposure to non-EU clients. As a result, GDP growth in 2019 is estimated to drop to 3.3 per cent and then to 2.7 per cent in 2020.

**Lithuania**

Economic growth in Lithuania in 2018 reached 3.4 per cent and was in line with our expectations from November 2018. Similar to its regional peers, GDP growth was driven by investment and household consumption. Besides, Lithuania was the only CEB country that saw positive net exports last year amid strong investment-driven imports. As Lithuania closed its output gap years ago, economic expansion is expected to moderate as capacity constraints, including labour, start to bite. The ongoing fight for employees between companies induces rising wages and household consumption. Weaker demand from the
eurozone will weigh on exports, but the depreciated euro should help exporting companies to reach countries outside the common currency area. As a result, GDP growth rates in 2019 and 2020 are expected to moderate to 3.1 per cent and 2.5 per cent, respectively.

**Poland**

GDP growth in Poland accelerated to 5.1 per cent in 2018, propelled, as elsewhere in the CEB region, by strong domestic demand. The recovery in investment was the highest since 2015, driven by robust investment expenditures by local governments and (less so) by corporates. The latter was observed in larger companies and in sectors that significantly depend on EU funding, such as construction, utilities and transport. Household consumption remained strong as real disposable incomes continue improving, with average real wage growth exceeding 6 per cent in 2018. Amid a deteriorating external environment, domestic demand is expected to remain the key engine of growth, additionally boosted by generous government spending, starting from 2019, which is a double election year in Poland (EU and general elections). In February 2019, the ruling Law and Justice party announced a massive fiscal package, which is likely to total about 1 per cent of GDP in 2019 and some 2 per cent in 2020. The package includes expansion of child subsidies, a one-off pension payout, a liquidation of PIT for those under 26 years old, and an increase in the tax-free allowance. This fiscal expansion comes at the peak of the business cycle and it uses up much of whatever fiscal space was left, constituting a permanent upward shift in the structural budget deficit. Both the national expenditure rule and the EU Stability and Growth Pact will be exceedingly difficult to meet already in 2019. Overall, GDP growth this year will likely decelerate to 4.1 per cent and further to 3.5 per cent in 2020.

**Slovak Republic**

Economic expansion accelerated to 4.1 per cent in the Slovak Republic in 2018, boosted primarily by investment and household consumption. In particular, private investment saw a significant improvement, largely due to the finalisation of the construction of Jaguar’s car plant, which started its operations in October 2018. In contrast, public investment remained subdued, in line with the still slow absorption of EU funds from the current budget, at below 20 per cent as of end-2018. Tightening labour markets, especially driven by the increasing shortages of qualified labour, resulted in significant wage hikes in the industry sector and ultimately further underpinned private consumption. Yet, the anticipated slowdown in western Europe, the key trading partner of the Slovak Republic, constitutes a significant negative risk to GDP growth in the short term. Mounting labour shortages and uncertainty related to Brexit are other risks; according to our estimates, the trade volume of the Slovak Republic’s exports potentially affected by a hard Brexit amounts to 1.9 per cent of the total domestic output, mainly in the automotive and machinery sectors. As a result, we forecast that GDP growth will decelerate to 3.6 per cent and 3.3 per cent in 2019 and 2020, respectively.

**Slovenia**

A major economic expansion in Slovenia continued in 2018 as the economy grew by an estimated 4.5 per cent, following growth of 4.9 per cent in 2017. Growth was broad-based,
with investment being the largest contributor in both years. Investment grew by more than 10 per cent in 2018, following a similar growth rate in 2017, as the capacity utilisation rate almost reached the pre-crisis levels of 85 per cent. Meanwhile, unemployment has dropped to a long-time minimum of 4.4 per cent in December 2018, while the employment rate is on the rise, and stood at 56 per cent. Combined with 3-4 per cent earnings growth in both 2017 and 2018, the strong labour market contributes to rising private consumption. Fiscal performance has remained solid and the government is estimated to have reached an overall surplus in 2018 of 0.8 per cent of GDP, driving down general government debt to about 70 per cent of GDP as of end-2018, more than 10 percentage points lower compared to the post-crisis peak of 83 per cent in 2015. Exports continued their strong performance, and grew by more than 7 per cent in 2018, helping net exports contribute positively to growth, despite domestic demand expansion. We expect growth to moderate slightly in the short term to 3.3 per cent in 2019 and 2.8 per cent in 2020.
South-Eastern Europe (SEE)

The south-eastern European region grew robustly in 2018, albeit with significant variation across a diverse region. The lowest rate of growth was in Greece, where an expansion of 1.9 per cent was slightly below expectations. However, the country is moving in the right direction having successfully completed the third adjustment programme in August 2018 and with confidence, investment and employment all picking up. The Cypriot economy has continued to show strong post-crisis growth. Bulgaria and Romania are both performing well although signs of a slowdown are apparent in both cases. In the Western Balkans, the highest growth rates in 2018 were recorded in Montenegro and Serbia, with both countries enjoying strong investment flows. Other countries in this region also grew robustly, with North Macedonia bouncing back after near-zero growth the previous year. The resolution of the country’s name dispute is expected to boost EU accession progress and thus contribute to better prospects for investment and growth. Overall, the SEE region is projected to grow at 3.0 per cent in 2019 and 2020.

Albania

Growth stepped up to 4.1 per cent in 2018, on the back of a better industrial performance, primarily as a result of good hydrological conditions last year and, consequently, higher electricity production. Unemployment continued to decline, but at 12 per cent is still high, while inflation (at 2 per cent) stayed below the central bank target of 3 per cent for the seventh consecutive year, contributing to a further easing of monetary policy. The key policy rate is now at a record low of 1 per cent. Bank lending is expected to rise gradually, in line with the pass-through from lower interest rates and ongoing efforts to tackle non-performing loans in the banking sector. In 2019 and 2020, the economy is projected to expand by 3.9 per cent in both years, a slightly slower pace than in 2018, driven mainly by private consumption. However, downside risks remain, associated with the economic slowdown in Albania’s main economic partner, the eurozone, and internal risks (high public debt with contingent liabilities stemming from controversial public-private partnership programmes, and the ongoing political crisis).

Bosnia and Herzegovina

The economy has once again proved to be resilient to a slow-down of reforms and continued political uncertainty. In 2018, GDP grew by 3.1 per cent, a similar rate as in the past three years, driven mainly by domestic demand (contributing 2.5 percentage points). Although growth of private consumption, investments and exports slowed from the year before, the deceleration was largely compensated for by lower imports, resulting in another year of positive net exports (0.6 percentage points). Unemployment went down by 2 percentage points, but at above 18 per cent remains high, especially for the youth (close to 40 per cent). Mainly as a consequence of rising fuel prices and excise duties on cigarettes, inflation jumped in the first half of 2018 (from 0.3 to 1.8 per cent year-on-year), but is trending down from early 2019 (falling below 1 per cent in February). The consolidated budget turned into deficit of 0.8 per cent of GDP in 2018 (from a 1 per cent surplus in 2017), on the back of higher public spending. The economy is expected to continue growing in 2019 and 2020 at
3.0 per cent annually in both years, a similar pace as in recent years. The 2019 projection has been revised downwards by 0.5 percentage points from November 2018 report due to delays in the formation of new governments after the October 2018 elections and with the IMF programme. Risks to the projection are mainly related to uncertainty about Eurozone growth and about the country's reform agenda related to improvements in the business climate and standards of governance, as well as advancement of the country's EU approximation agenda.

**Bulgaria**

The economy grew by an estimated 3.1 per cent in 2018, following a growth rate of 3.8 per cent in 2017. Private consumption has been the main driver of growth, as the tightening labour market is pushing wages up and unemployment down (to below 5 per cent as of end-2018). Investment has also been strong and it grew by almost 7 per cent in 2018, helped by the growing disbursement of EU funds. Meanwhile, net exports have weighed on growth as strong private consumption has pushed up imports, while exports experienced a small decline (not least because of a prolonged weakness in Turkey, an important trading partner). A long period of fiscal tightening with strong revenue performance and decreasing expenditures resulted in three consecutive years of budget surpluses, reaching 0.8 per cent of GDP. In this environment, public debt continues to decline and stands at around 23 per cent of GDP, one of the lowest levels in the EU. Inflation rose to a five-year high of 3.5 per cent in August 2018, and averaged 2.6 per cent in 2018. We expect growth to remain solid, mainly underpinned by private consumption. We project growth of 3.4 per cent in 2019 and 3.0 per cent in 2020. Public and private investment will also contribute positively to growth, as the absorption of EU funds will continue.

**Cyprus**

GDP growth remained solid in 2018 at 3.9 per cent. Investment was one of the main drivers, as the construction sector continued to grow. The increase of private consumption was another significant factor, thanks to improving labour market conditions and wage increases. Unemployment continued on a downward trend, reaching 7.4 per cent in January 2019. Net exports also made a small positive contribution to growth, helped by a strong tourist season. The health of the banking sector continues to improve, as the resolution of Cyprus Cooperative Bank (CCB) in 2018, the establishment of the Cyprus Asset Management Company, and the sale of non-performing loan portfolios by Bank of Cyprus and Hellenic Bank should all help to bring NPL levels down from their current highly elevated rate. Due to the sale and winding down of CCB, the second largest bank in the country, the public debt burden remains large at around 102.5 per cent of GDP. However, strong GDP growth and primary surpluses should allow the debt-to-GDP ratio to resume its downward path from this year onwards. Looking ahead, a less favourable external environment and persistent uncertainties will weigh on the construction sector and economic activity linked to foreign companies. Capacity constraints on the tourism sector might also hold back GDP growth. On the other hand, rising employment and higher wages are expected to boost disposable income and support private consumption. Public consumption is also expected to grow.
Taking into account all the relevant factors, we expect growth to slow down moderately in 2019 and 2020 to 3.4 per cent and 3.0 per cent respectively.

**Greece**

The economic recovery, which began in 2017, continued in 2018, although at a slightly slower pace than expected with a 1.9 per cent GDP growth rate for the year as a whole. The main driver of growth was, similarly to 2017, exports of goods and services. Private consumption continued to have a positive impact of growth and unemployment has declined further, reaching 18.7 percent in the last quarter of 2018. More generally, the economic recovery is broad-based, with services the main driver. Investment and government consumption continue to weigh negatively on growth. The exit of Greece from the ESM-financed third adjustment programme in August 2018 and the adoption of debt relief measures by the Eurogroup, as well as recent rating upgrades and successful market emissions, provide some limited leeway for government spending. These improved conditions have boosted market and investors’ confidence and could ultimately lead to a sustained increase in business investment. Looking ahead, the main drivers of growth are likely to remain exports and private consumption. Non-performing exposure (NPE) reduction should accelerate as targets of reduction increase and the implementation of new schemes for NPE reduction advance further. Short-term growth is projected at 2.2 per cent in both 2019 and 2020. In terms of risks, the negative effects of the global slowdown could affect exports growth. Moreover, any backtracking in reforms or increased uncertainty about the policy direction of the country could damage investor confidence and lead to lower growth prospects.

**Kosovo**

Relatively strong economic growth continued in 2018 for the fourth year in a row. After 3.7 per cent growth in 2017, GDP grew by 3.9 per cent in 2018, driven by investment and consumption. Higher domestic demand contributed to an increase in imports and widening of the current account deficit to over 8 per cent of GDP. Inflation remained subdued for a year as a whole (at around 1 per cent), but it has gone up since the second half of 2018, reaching 3.3 per cent in March 2019. The surge in inflation has been mainly driven by food price increases (reaching 8 per cent year-on-year in March), possibly also related to the imposition in November 2018 of 100 per cent taxes on goods imported from Serbia and Bosnia and Herzegovina. Higher growth has not yet translated into more jobs, as the employment rate fell in 2018 by one percentage point, to 29 per cent. Similarly, the unemployment rate went down only slightly, staying close to 30 per cent, and at 55 per cent for youth. Although the budget deficit increased to 2.7 per cent of GDP (from 1 per cent in 2017), the public debt remains exceptionally low by regional standards, at just 17 per cent of GDP at end-2018. Growth in 2019 and 2020 is expected to stay at 4.0 per cent annually, with domestic demand continuing to be the main growth driver. The risks to the projection are balanced. While upside risks relate to the possible start of the construction of a major new power plant and faster reform progress, weaknesses in public investment management, the economic slowdown in the EU and domestic political uncertainty represent the main downside risks.
Montenegro

Growth in 2018 surprised on the upside. The economy expanded by close to 5 per cent, on the back of the highway construction, some flagship real estate projects at the coast, an exceptionally strong tourist season and a further rise in private consumption. Intense investment activity and consequently higher imports caused the current account deficit to widen to over 17 per cent of GDP. At the same time, net FDI declined to 7 per cent of GDP (from 11 per cent a year before), partly because of the government’s repurchase of the shares of the power utility company. Gradual fiscal consolidation has started to yield results. In 2018, the budget deficit narrowed to 3.5 per cent of GDP (from 5.5 per cent in 2017) and the public debt, at 71 per cent of GDP at end-2018, is expected to start declining this year, also helped by the highway-related spending coming to an end. However, contingent liabilities and spending overruns may threaten the results so far. The unemployment rate decreased by one percentage point in 2018, but at 15 per cent stayed high, especially that of youth (about double the national rate). With the completion of large investment projects and ongoing fiscal consolidation, growth is expected to moderate significantly, to 2.8 per cent in 2019 and 2.6 per cent in 2020. The risks to the projections are on the downside and mainly relate to weaker growth in the EU, possible further motorway cost overruns and domestic political uncertainty. Besides improving public finance management, risks to the growth could be mitigated by reforming the labour market and public administration and strengthening economic institutions.

North Macedonia

After almost zero growth in 2017, the economy expanded by 2.7 per cent on the back of strong growth in exports and recovery of consumption, both private and public. Robust export performance came as a result of stronger activity of both FDI-related and traditional industries (machinery and transport equipment, chemicals, iron and steel, furniture), helping to reduce the current account deficit to 0.4 per cent of GDP. Net FDI also strengthened (to 5.8 per cent of GDP) thanks to foreign capital inflows in manufacturing and services, but total investment recorded a decline due to the postponement of large infrastructure projects and stagnating construction. Lower capital spending by the government also narrowed the budget deficit to below 2 per cent of GDP. On the other hand, public and publicly guaranteed debt continued to grow, reaching 49 per cent of GDP at end-2018, and further fiscal adjustment would be needed to stabilise its level. The unemployment rate, although declining, remains high at 21 per cent, especially for the youth (45 per cent). Growth is expected to pick up slightly in 2019 to 3.0 per cent on the back of the expected recovery in investment, and continue at the same pace in 2020. The risks to the projection are more on the downside. While the resolution of the name issue with Greece might speed up the EU accession progress, thus strengthening investor confidence and growth, less favourable external developments, primarily in the eurozone, and a slower than expected recovery of investments, especially public ones, may act as a strong drag on growth.
Romania

Following a growth peak of 7 per cent in 2017, the economy slowed down to an estimated 4.1 per cent growth rate in 2018. Private consumption has been the main driver of growth over the past two years (although at a slower pace in 2018), supported by a pro-cyclical fiscal policy, including salary hikes, and cuts in consumption and income taxes. Fuelled by increased absorption of EU funds, the contribution of investment to growth was also positive. The unemployment rate, at just below 4 per cent, is the lowest in a decade, making recruitment difficult and driving wage growth. In late-December 2018, the government abruptly introduced a set of measures with a potentially significant negative impact on certain sectors, including banking, pension funds, energy and telecommunications. Although in late March 2019 the government has softened some of the measures announced, and primarily those regarding the banking sector, investor sentiment has been damaged, with an expected negative impact on overall economic activity. Meanwhile, macroeconomic imbalances have widened, with the current account deficit rising to 4.6 per cent of GDP in 2018 (up from 3.2 per cent in 2017) and the budget deficit reaching 3 per cent of GDP on the back of looser fiscal policies. Inflation has also been a concern, reaching a five-year high of 5.4 per cent in June 2018, well above the central bank’s upper target of 2.5 per cent +/- 1 percentage point, before receding to 3.3 per cent by end-year. On the positive side, general government debt is still low by regional standards, at around 37 per cent of GDP. We are downgrading our 2019 growth forecast from 3.6 per cent (as per our November 2018 edition) to 3.2 per cent, with the same rate in 2020, due to an increased investment risk, but also tighter monetary policy (the central bank’s policy rate was raised three times in 2018 from 1.75 to 2.5 per cent) and increased external imbalances. Key risks include the exacerbation of the current labour shortages, prolonged weakness in the eurozone, and negative changes in global investor sentiment.

Serbia

After just 2.0 per cent growth in 2017, the Serbian economy stepped up to 4.3 per cent growth in 2018, as a result of further recovery of domestic demand and strong exports. Higher domestic demand, however, translated into a fast, double-digit rise in imports, resulting in a negative contribution from net exports to GDP. The current account deficit stayed relatively high, at above 5 per cent of GDP, but continued to be fully covered by net FDI inflows (over 7 per cent of GDP in 2018). The majority of the foreign capital was invested into manufacturing, transportation and storage, the financial sector and construction. Unemployment kept trending down, but remains high (13 per cent), especially for the youth (30 per cent). Fiscal over-performance continued, with 2018 being the second year in a row of fiscal surplus (at 0.6 per cent of GDP). The public debt continued to fall, helped also by upward GDP revisions, and ended the year at around 55 per cent of GDP. Growth is expected to slow down to 3.5 per cent in 2019, inching up to 3.8 per cent in 2020. The main growth drivers (private consumption, investment and exports) should remain the same, with offsetting effects coming from higher imports. The risks to the projection are skewed to the downside and relate to the possibility of slower implementation of the reform agenda envisaged by the new IMF programme, a faster than expected slowdown of external
demand from the eurozone and a continuing fall in mining and electricity production (present since mid-2018). In addition, short-term economic prospects may be negatively affected by the introduction of steel import quotas by the EU and the 100 per cent import tariffs by Kosovo.
The Turkish economy as a whole grew by 2.6 per cent in 2018, but this was driven by strong growth in the first half of the year, and the economy entered recession in the second half of 2018. Tighter monetary policy and deteriorating consumer and investor sentiment resulted in a cumulative contraction of 4 per cent in the second half of the year. While leading indicators suggest that the slowdown may have bottomed out in the first quarter of 2019, this may in part be driven by temporary counter-cyclical measures introduced in advance of the municipal elections in March 2019.

While the lira has stabilised following a period of high volatility in 2018, it remains highly vulnerable to fragile investor sentiment. Having depreciated by an average 29 per cent against the dollar in 2018, the lira has recovered part of its losses since the last quarter of the year. Nevertheless, it remains highly vulnerable to changing investor sentiment. The continuing dollarisation of bank deposits and volatility of the exchange rate in recent months indicate that confidence in the economy has not improved sufficiently to rule out another bout of currency depreciation. Meanwhile, the means employed to support the currency in the run-up to the municipal elections have done little to support investor confidence.

While the rapid rise in inflation has partly reversed since late 2018, inflation is likely to remain elevated throughout the first half of 2019. Having surged rapidly as a result of the lira’s depreciation and overheating of the economy, annual inflation hit a 15-year high of 25 per cent in October 2018. It has started to decline since November, as the economic slowdown has constrained consumer demand. At the same time, although several counter-inflationary measures introduced by the authorities have helped tame headline inflation, it remains elevated, at around 20 per cent. Inflation is likely to start to decline gradually in the second half of 2019 as the pass-through effect of last year’s lira depreciation recedes.

The sharp contraction in domestic demand has resulted in a significant reduction in the current account deficit. Depreciation of the lira and contracting domestic demand have resulted in a significant decline in imports in the second half of 2018, and it is likely that the current account balance will be close to zero by mid-2019, from 6.5 per cent of GDP a year earlier. Still, the short-term external financing requirement remains high, at around 25 per cent of GDP.

The economic slowdown and weakness of the lira have led to concerns about bank asset quality and capitalization. Asset quality has been affected both by exposure to corporates with large foreign-currency-denominated liabilities, and by the effect of increased domestic interest rates on corporate and household balance sheets, particularly as the economy slows. This has reduced bank capital ratios, with some banks going to the market to raise capital. These challenges have resulted in a significant contraction in credit growth, albeit with a small reversal in the first quarter of 2019 driven by state banks.

Fiscal policies have been tightened, although there has been some slippage. While the 2018 budget deficit was realised as planned at 1.9 per cent of GDP, the target deficit of 1.8 per cent for 2019 will be difficult to meet, particularly in light of the counter-cyclical policies
adopted in the period leading up to the municipal elections in March. Public finances are robust overall, with a low public debt of around 30 per cent of GDP. However, the long-term impact of growing contingent liabilities in the form of revenue guarantees to PPP projects and credit guarantees under the Credit Guarantee Fund (CGF) is unclear.

Recovery from the ongoing slowdown is likely to be gradual. The lira’s depreciation and high interest rates will continue to dampen consumption and investment, although net exports should make a positive contribution to growth. Deleveraging by the private sector means that the economic recovery will be slower than in past crises, when credit growth stimulated recovery. A contraction of around 1.0 per cent is expected in 2019, while 2020 will likely see a gradual recovery of growth to around 2.5 per cent.
Most of the eastern Europe and the Caucasus (EEC) region is entering a period of growth moderation in the face of a gradually deteriorating external economic environment and resurfacing political uncertainties in some countries. A slowdown in the economic performance of major trading partners is affecting regional economies through trade, remittances and investments channels. In most EEC economies growth continues to be driven by domestic demand on the back of increasing disposable incomes. Improved macroeconomic policy management is supporting a reduction in public debt levels and keeping inflation at bay in all countries of the region. At the same time, Azerbaijan is benefitting from the ongoing expansion of hydrocarbon production and export capacity as well as favourable oil price dynamics. The EEC region is forecast to grow by 2.8 per cent in 2019 and 3.0 per cent in 2020. The main risks to this forecast arise from geopolitical and political tensions, as well as a possible slowdown in the reform agenda.

Armenia

Real GDP expanded by an estimated 8.5 per cent in the first half of 2018 before slowing down to an estimated 3.0 per cent in the second half of the year, giving an overall growth rate for the year of 5.2 per cent. A contraction in production in the agriculture and mining and quarrying sectors weighed on the growth of exports and economic output in the second half of the year. At 28.5 per cent, capital investments were the largest contributor to growth. However, this impressive growth is largely explained by one-off methodological changes; the increase in gross fixed capital formation was 5 per cent. Household consumption and exports both grew, albeit at lower rates than a year earlier. A strong expansion in consumer loans and a steady inflow of money transfers from abroad supported private consumption growth. The current account deficit widened significantly from 2.4 per cent of GDP in 2017 to 9.1 per cent in 2018, in part financed by foreign investments and increased bank deposits in foreign currency. The dram remained relatively stable against the US dollar. According to preliminary estimates, economic output grew by 6.5 per cent year-on-year in the first two months of 2019. We expect this positive growth trend to continue with real GDP growth of 4.5 per cent in both 2019 and 2020. In February 2019, the authorities reached a staff-level agreement with the IMF on a three-year Precautionary Stand-By Arrangement (SBA). Subject to approval by the IMF Executive Board, the SBA aims to support the new government programme, which is focused on achieving stronger and more inclusive growth, while at the same time preserving macroeconomic and financial stability.

Azerbaijan

Azerbaijan’s economy started reviving in 2018 after decline and near stagnation in the previous two years. GDP expanded by 1.4 per cent in 2018, supported by an increase in the oil price and rises in gas production and exports. The non-oil sector recorded 1.9 per cent growth. Output in transport, real estate, non-oil industry, trade, agriculture, and information and communication services all increased. The loan portfolio contraction levelled off in February 2018 and grew by 12.2 per cent in nominal terms in the following year. Loan and deposit dollarisation has been declining, but remains high at 37.1 per cent and 65.0 per cent
respectively, as of February 2019. External and fiscal balances recovered on the back of rising oil prices. The current account surplus widened from 4.1 per cent of GDP in 2017 to 12.9 per cent in 2018, as receipts from the oil and gas sectors increased by 37.3 per cent. The consolidated budget moved from a deficit of 1.5 per cent of GDP in 2017 to a 5.9 per cent surplus in 2018. On the back of a stable exchange rate, supported by growing oil prices and tight management of manat against the US dollar, inflation declined from an average of 12.9 per cent in 2017 to 2.3 per cent in 2018, allowing for further monetary policy relaxation. According to preliminary estimates, GDP grew by 3 per cent year-on-year in the first two months of 2019. The outlook in the near term is shaped by the expected increase in the output of the combined oil and gas sectors. We forecast the economy to grow by 3.5 per cent in 2019 and 3.3 per cent in 2020.

**Belarus**

Real GDP growth in Belarus rose from 2.5 per cent in 2017 to 3.0 per cent in 2018. Growth was driven by an expansion of domestic demand and exports, although net exports were actually negative. A strong increase in real disposable income, underpinned by 11.6 per cent growth of real wages, boosted the acceleration of private consumption growth to 8.3 per cent. Fixed capital formation grew by a solid 4.9 per cent, slightly below the previous year’s rate. Exports and imports continued to recover from the slump in 2016, though both remain substantially below pre-crisis level. At the same time, strong net improvements in exports of goods and services as well as secondary income, the latter due to rising transfers of duties on energy resources in line with the agreement with Russia, brought the current account nearly to balance in 2018. As a result, the exchange rate remained stable and average inflation was 4.9 per cent in 2018. According to preliminary estimates, the economy grew by 0.8 per cent in the first two months of 2019. Without profound structural reforms, the economy has limited potential to build up on the recovery in the last two years and on the stable environment created by prudent macroeconomic policies. Having in mind such developments, GDP growth is forecast to slow down to 2.0 per cent in 2019 and further to 1.8 per cent in 2020. Risks to the outlook have increased. The new energy taxation system being introduced by Russia, the so-called “tax manoeuvre”, could significantly reduce revenues of Belarus’ oil refining industry, thus affecting the fiscal balance and reducing economic and export growth.

**Georgia**

The Georgian economy remains on the path of strong economic growth. Economic output expanded by 4.7 per cent in 2018, driven largely by growth in trade, real estate, transport and financial intermediation. The hospitality sector continued to boom, supporting overall economic performance; the share of tourism-related services in the whole economy increased from an average of 7.3 per cent in 2015-17 to 8.1 per cent in 2018. However, output of the construction sector declined by 3.1 per cent, marking the first contraction in the sector since 2013. Supported by a growing network of free trade agreements, exports of goods increased by 22.6 per cent in 2018 and by 13.2 per cent in the first two months of 2019, both in nominal US dollar terms. In 2018, inflows of remittances increased by 13.1 per cent, amounting to 10.9 per cent of GDP and supporting household consumption. Combined
with thriving tourism and rising exports of goods, this caused a narrowing of the current account deficit to 7.7 per cent of GDP in 2018. At the same time, foreign investment into Georgia decreased by 34.9 per cent compared to 2017, hitting a five-year low at 7.3 per cent of GDP. This came on the back of completion of the South Caucasus Pipeline Expansion (SCPX – the gas pipeline connecting Azerbaijan and Turkey), the transfer of several enterprises to domestic ownership and debt repayments between connected companies. Despite the decline, FDI remained the main source of currency inflows, nearly offsetting the current account deficit. Balance of payments dynamics supported the currency which, while subject to seasonal variations, remained resilient to negative developments in regional economies. High-frequency indicators point to economic growth of 4.1 per cent year-on-year in the first two months of 2019. We forecast Georgia’s real GDP to grow by 4.5 per cent in 2019 and by the same rate in 2020.

Moldova

The Moldovan economy maintained robust growth of 4.0 per cent in 2018, supported by expanding household consumption and exports, albeit at lower rates compared to the previous year, and strong capital investments. A further increase in remittances and a 9.9 per cent rise in real wages helped uphold disposable incomes and, consequently, household consumption. Growth of gross fixed capital formation accelerated from 8 per cent in 2017 to 14 per cent in 2018. It was accompanied by 16 per cent growth in construction output. Alongside trade and industry, the construction sector was one of the main drivers of growth on the production side. On the back of rising investments and private consumption, the growth of import volume outpaced that of exports. The current account deficit almost doubled to 10.5 per cent of GDP in 2018 from a year earlier and was mostly financed by an increase in foreign currency household deposits in the banking sector. As a result, the Moldovan leu remained relatively stable during the course of 2018 and foreign reserves were sustained at US$ 3.0 billion, covering 5.6 months of imports. Inflation slowed from an average of 6.6 per cent in 2017 to 3.0 per cent in 2018 and further to 2.5 per cent year-on-year in the first three months of 2019. In March 2019, a 63.9 per cent stake of Moldinconbank, the second largest bank in Moldova, was acquired by a strategic foreign investor. This marks the completion of the clean-up of the banking sector, as non-transparent shareholders have now been replaced by fit and proper foreign strategic investors in all three systemic banks. However, long-standing structural and demographic challenges are compounded by current uncertainties regarding the inconclusive outcome of parliamentary elections in February 2019 and delays in disbursements of funds from international partners. We forecast Moldova’s real GDP to grow by 3.5 per cent in 2019 and by 3.8 per cent in 2020.

Ukraine

Economic recovery accelerated to 3.3 per cent in 2018 on the back of robust domestic demand. Private consumption increased by 8.9 per cent, benefiting from the 12.5 per cent growth of real wages which came on top of a cumulative 30 per cent growth in 2016-17. An increase in average pensions, rising inflows of remittances and strong consumer credit growth of 24.2 per cent also helped to boost private consumption. Remittances increased by
17.5 per cent in nominal US dollars in 2018, reaching 8.3 per cent of GDP. Inflows from Poland, amounting to one-third of all remittances in 2018, nearly doubled in the period 2016-18. Recovery in investment continued, with fixed capital formation growing at the rate of 14 per cent. After a modest recovery in 2017, the growth rate of exports of goods and services turned negative in 2018, while imports rose by just 3.2 per cent, in spite of strong domestic demand, partly because of a substantial reduction of gas imports. Credible monetary policy has helped maintain a relatively stable exchange rate and a gradual reduction of inflation to 8.8 per cent year-on-year in February 2019. In December 2018, the IMF Executive Board approved a new 14-month Stand-By Arrangement for US$ 3.9 billion. With US$ 1.4 billion made available upon the approval of the IMF programme, as well as funds received under the EU’s Macro-Financial Assistance (MFA) and the World Bank’s Policy-Based Guarantee (PBG), international reserves of the National Bank of Ukraine reached a five-year high by end-2018. A deceleration of growth in the main trading partners and domestic political uncertainties arising from the twin elections are expected to cause a temporary slowdown of real growth to 2.5 per cent in 2019. Reinvigorated pursuance of the reform agenda in the aftermath of the elections, combined with monetary easing, would facilitate sturdier corporate activity, with real growth strengthening to 3.0 per cent in 2020. With large foreign debt repayments in 2019-2020 posing a major downside risk, maintaining cooperation with official creditors remains vital for a continuation of the economic recovery.
Russia

The Russian economy grew by 2.3 per cent in 2018. Growth was mainly driven by household consumption and exports, the former supported by low inflation and rapid credit growth, and the latter due to an increase in extractive industries output and rising oil prices. Meanwhile, construction activities, such as those related to the Yamal LNG field project, also made a significant contribution to GDP during the second half of the year.

Fiscal consolidation has continued as the government implemented the fiscal rule. Fiscal measures taken since 2016, such as the adoption of a fiscal rule, VAT increases and a pension reform, resulted in a budget surplus of 2.7 per cent of GDP in 2018, versus a deficit of 3.7 per cent two years earlier. While the fiscal rule adopted in 2017 has been slightly softened, tight fiscal policies are foreseen to continue under the government’s budget plan for 2019-21.

The rouble depreciated against the dollar last year while the external position has improved. Driven by the imposition of new US sanctions, the rouble fell by an average of 7.5 per cent against the dollar in 2018 compared to the previous year, leading the Central Bank to temporarily suspend foreign exchange purchases associated with the fiscal rule. Higher oil prices and the depreciating currency helped increase the external surplus, with the current account surplus rising from 2.1 per cent of GDP in 2017 to around 6.5 per cent of GDP in 2018.

Monetary policy has been tightened to counter increasing inflationary pressures and the depreciation of the rouble. The Central Bank of Russia (CBR) increased its policy rate by 25 basis points to 7.75 per cent in December 2018 to counter the expected inflationary impact of the VAT hike and to bolster the currency, following the decision to resume fiscal rule-related foreign exchange purchases in January 2019. Meanwhile, higher food prices due to a weak harvest, and the weaker currency drove inflation to 5.3 per cent in March 2019, from 2.3 per cent a year earlier.

The banking sector remains a key source of risk for the economy. The sector is highly fragmented and suffering from asset quality and governance problems. While the share of non-performing loans has started to decline slightly from a peak of 11 per cent in the second quarter of 2018, this is in part due to rapid credit expansion, averaging 8 per cent year-on-year in the second half of the year. The sector is currently undergoing a consolidation, with 77 banks having their licenses revoked in 2018. Meanwhile, the central bank continues to provide funding to the private banks it took over in 2017.

Economic growth is expected at 1.5 per cent in 2019 and 1.8 per cent in 2020. In 2019, higher interest rates, the value added tax increase and rising inflation will slow down household consumption growth, while tightening international sanctions will constrain private investment. An agreement with the Organisation of Petroleum Exporting Countries (OPEC) to reduce oil production is likely to reduce export revenues from oil. Growth is likely to start picking up in 2020, driven partly by an ambitious investment plan announced for the
period 2019-2024. Key risks to the outlook include the possibility of more severe sanctions affecting the oil and gas sector, and a sharp fall in oil prices.
Central Asia

Average GDP growth in Central Asia slightly accelerated to 4.8 per cent in 2018 from 4.7 per cent in 2017, thanks to higher growth in Uzbekistan and Mongolia. On balance, the external economic environment remained conducive for growth in the Central Asian countries, with strong export receipts and higher remittance inflows. In particular, net exports rose significantly in Kazakhstan, bringing the current account close to balance. In Turkmenistan, higher gas export earnings and import substitution policies led to the narrowing of external imbalances. Mongolia, Uzbekistan and Tajikistan benefitted from a significant expansion of fixed investment, primarily public and foreign. Dollar strength combined with rouble weakness put regional currencies under some depreciation pressure despite rising exports, although it was not fully reflected everywhere in official exchange rates. Resulting inflation fears led to monetary policy tightening in some countries, with the exception of the Kyrgyz Republic where very low inflation prompted a monetary stimulus. In April 2019, Kazakhstan also reversed its monetary policy stance in an accommodative direction to stimulate growth of lending. The Central Asian region is forecast to grow by 4.4 per cent in 2019 and 4.2 per cent in 2020, contingent on continued supportive external conditions, advancement in regional integration and only moderate political uncertainty.

Kazakhstan

The economy grew by 4.1 per cent in 2018 supported by rising net exports and private consumption, with the latter helped by positive real income growth after three consecutive years of decline. As a result of higher oil prices in 2018, the current account came almost to balance after a deficit of 3.3 per cent of GDP in 2017. Notwithstanding the improved external accounts, capital outflows and rouble depreciation weakened the tenge against the US dollar by 14 per cent over the course of 2018. Food price increases were moderate last year and average annual inflation fell to 6.0 per cent in 2018 from 7.4 per cent in 2017. The deceleration of inflation at the beginning of 2019 coupled with policies to stimulate credit growth prompted the central bank to reduce the base rate by 25 basis points to 9.0 per cent in April 2019, reversing the rate hike in October 2018. On the fiscal side, higher tax revenues supported the narrowing of the state budget deficit to 2.1 per cent of GDP in 2018 from 2.8 per cent in 2017. However, from 2019 the guaranteed transfer from the National Oil Fund has been increased to finance various social support programmes, which led to a revision of the state budget deficit target to 2.1 per cent of GDP, up from 1.5 per cent. With minimum wages increasing since January 2019, growth in real incomes, along with higher consumer lending, will continue to drive private consumption. GDP growth is nevertheless projected to ease slightly to 3.5 per cent in 2019 and 3.2 per cent in 2020, as a result of slower increases in oil production than in the previous two years.

Kyrgyz Republic

Growth in the Kyrgyz Republic slowed to 3.5 per cent in 2018 from 4.7 per cent in 2017 as industrial production, in particular mining, expanded at a lower rate. Excluding the Kumtor gold mine, real GDP increased by the same amount (3.5 per cent) as in the previous year. While export growth virtually stalled in 2018, imports rose by around 9 per cent. Net
remittances increased by 5.5 per cent (in US dollar terms) in 2018 and continued to support private consumption, although the growth in remittances was less than in 2017. Inflation decreased to 0.5 per cent by December 2018 from an average 3.2 per cent in 2017 and turned negative in February 2019 due to falling food prices. The low inflation rate allowed the central bank to cut its policy rate by 25 basis points to 4.5 per cent in February 2019. The exchange rate remained broadly stable in 2018 as the central bank intervened to smooth excessive fluctuations and was a net seller of foreign exchange. Exports from the Kumtor gold mine, more evenly distributed over the year than in 2018, and private consumption, supported by further increases in real wages and remittances, are expected to be major contributors to economic growth in the short term. The scope for fiscal expansion is, by contrast, very limited. Real GDP is projected to grow by 3.6 per cent both in 2019 and in 2020.

**Mongolia**

Growth in Mongolia accelerated significantly to 6.9 per cent in 2018 from 5.3 per cent a year earlier. This was enabled by a continued surge in fixed investment and a rebound in private consumption. The contribution of net exports was negative due to increasing mining-related imports, and the current account deficit widened to 15 per cent of GDP in 2018, from 10 per cent in 2017. In the second half of 2018, the tugrik came under pressure, depreciating overall by 8 per cent in 2018. Average annual inflation accelerated to 6.8 per cent in 2018 from 4.3 per cent in 2017. In response to these developments the Bank of Mongolia tightened monetary policy by raising the policy rate from 10.0 per cent to 11.0 per cent in November 2018 and by restricting the growth of consumer lending through a ceiling on the household debt-to-income ratio. Fiscal accounts have improved in the past year, with the fiscal deficit of 2017 turning into a small surplus in 2018. The economy is projected to grow by a still high 6.2 per cent in 2019, slowing down somewhat to 5.0 per cent in 2020, aided by further investment in the underground expansion of Oyu Tolgoi. Private consumption is also projected to support GDP growth as real incomes rise, thanks in part to an increase in public workers’ salaries. Downside risks include a possible slowdown in China and the stalling of reforms due to political uncertainty in the run-up to the parliamentary elections scheduled for 2020.

**Tajikistan**

The Tajik economy has continued to grow rapidly in the past year. Real GDP growth reached 7.3 per cent growth in 2018, according to official data. Growth was driven by fixed investment (primarily due to public expenditure in the energy sector), which increased by 7.8 per cent year-on-year. Private consumption, aided by growing remittances and increases in public sector wages and pensions, also supported the expansion. However, exports declined by 10 per cent year-on-year in US dollar terms, while imports rose by 14 per cent, pushing the current account into deficit in the first three quarters of 2018 from a surplus a year earlier. The significant growth in imports largely reflects the purchase of equipment for the construction of the Roghun hydropower plant (HPP). The somoni depreciated by 7 per cent in 2018. Inflation decelerated to 5.4 per cent in December 2018 from 6.7 per cent in December 2017, but started rising again in early 2019. To contain inflation, the central bank
raised the policy rate from 14.0 per cent to 14.75 per cent in February 2019. The fiscal deficit narrowed in 2017 and 2018 but significant fiscal pressures remain, related mainly to financing the Roghun HPP and contingent liability risks from the banking sector and state-owned enterprises. Fiscal challenges, combined with a difficult business environment, are likely to continue to weigh on economic activity. However, growth in 2019 and 2020 is expected at 5.0 per cent and 4.5 per cent, respectively, driven by remittances, electricity exports from the Roghun HPP and improving bilateral ties with Uzbekistan. An agreement on an IMF programme, which is currently under negotiation, would support economic stability by enabling banking sector resolution, building fiscal and external buffers and improving the investment climate.

**Turkmenistan**

Economic growth slowed marginally to 6.2 per cent in 2018 from 6.5 per cent in 2017, according to official figures. Fixed investment continued to contract (by 22 per cent year-on-year) as public spending decreased. Higher gas demand from China enabled strong growth of exports (by 49.6 per cent year-on-year in US dollar terms). In contrast, registered imports declined by 47.8 per cent. However, foreign exchange scarcity has remained severe. The depreciation of the parallel market exchange rate to 18-19 manats per US dollar by April 2019 (while the official rate is 3.5 manats) exerts strong pressure on prices of imported goods. Officially reported inflation fell to 7.25 per cent in December 2018 from 10.4 per cent a year earlier despite the removal of subsidies and increases in public sector wages and pensions; unrecorded inflation is believed to be substantially higher. The resumption of gas exports to Russia following a three-year interruption is expected to improve growth prospects. However, in the short term, growth will be weighed down by fiscal restraint, restricted access to foreign exchange except for priority projects, a difficult business environment and limited FDI inflows. Real GDP growth is projected at 6.3 per cent in 2019 and 6.0 per cent in 2020, provided the external demand for gas remains favourable. The forecast risk is high due partly to the difficult access to reliable data.

**Uzbekistan**

The economy expanded by 5.1 per cent in 2018, up from a revised 4.5 per cent a year earlier, and enabled mainly by high fixed investment growth. On the supply side, industry and construction were the primary drivers of growth. At the same time, Uzbekistan’s external position moved into deficit as imports grew 40 per cent in US dollar terms in 2018, strongly exceeding exports growth of 14 per cent. The current account turned into a deficit of around 7 per cent of GDP in 2018 from a surplus in 2017 as a result. After a major devaluation in 2017, the exchange rate weakened further by 2.6 per cent in 2018. Price liberalisation and the resulting adjustment of relative prices, and rapidly increasing credit and money supply, pushed average annual inflation to 17.9 per cent in 2018 from 12.5 per cent in 2017. To contain inflation, the central bank raised the policy rate from 14.0 to 16.0 per cent in September 2018. The augmented fiscal deficit (taking into account lending by the Uzbek Fund for Reconstruction and Development) increased to 2.5 per cent of GDP in 2018 from 2.1 per cent in 2017, reflecting higher public outlays on social programmes and infrastructure. The economy is predicted to grow by 5.0 per cent in 2019 and 5.2 per cent in
2020, driven by further expansion of fixed investment, including FDI. Wage increases and remittances should also support private consumption growth.
In the southern and eastern Mediterranean (SEMED) region, growth in 2018 averaged 4.4 per cent. While social unrest and political instability in Jordan and Lebanon delayed implementation of various reforms, tourism continued to strengthen in most countries, competitiveness in Tunisia improved as a result of currency depreciation, and the sound implementation of reforms helped achieve the highest growth rate in a decade in Egypt. Economic activity in SEMED is expected to grow robustly by 4.6 per cent in 2019 and 5.1 per cent in 2020, supported by the implementation of economic reforms and improvements in the business environment aimed at promoting domestic and foreign investment. Growth will also benefit from the recovery in the traditional drivers of growth and emergence of new ones, and greater political certainty – both domestic and regional. However, growth will continue to be lower than pre-2011 levels.

**Egypt**

In Egypt, growth has continued to accelerate in the past year, reaching 5.4 per cent year-on-year in the first half of fiscal year 2018-19, the highest rate in a decade, after having recorded 5.3 per cent in fiscal year 2017-18. The strong growth was driven by tourism, natural gas production, telecommunications, construction and Suez Canal revenues. At the same time, the rebalancing of drivers of growth from the demand (expenditure) side continued, with exports and investment contributing the most to growth. Robust economic growth is expected to continue in fiscal year 2018-19 (5.5 per cent) and fiscal year 2019-20 (5.9 per cent), supported by the continued recovery in tourism and strengthening of exports, large public construction projects including the new capital, natural gas production from the Zohr field, the implementation of business environment reforms and prudent macroeconomic policies. The main risks to the outlook arise from a persistent wait-and-see approach taken by foreign investors and the erosion of competitiveness as a result of the recent appreciation of the pound and the stubbornly-high inflation. The risks are partially mitigated by the authorities’ strong commitment to the implementation of structural reforms.

**Jordan**

The rate of growth in Jordan remained subdued in 2018 at 1.9 per cent, below the average of 2.5 per cent recorded since the start of instability in Syria and Iraq in 2010, and average growth of 6.5 per cent in the preceding decade. The modest growth was driven by financial services, manufacturing, and transport. Tourism arrivals continued to increase for the second consecutive year, by 7.7 per cent, although they remain at only 65 per cent of the peak levels achieved prior to the Arab uprising in 2011. The outlook remains broadly unchanged. Growth is expected to remain subdued in 2019 (2.2 per cent) and 2020 (2.4 per cent), supported by various factors: the implementation of structural reforms, domestic and foreign investment, the lower cost of imported energy, increased finance provided to SMEs under various schemes from the Central Bank of Jordan (CBJ), greater certainty and confidence stemming from the commitments of the London Conference in February 2019, and the increase in exports resulting from the re-opening of the border with Iraq. Risks to
the outlook include the eroding real competitiveness stemming from higher inflation and the strengthening of the dinar in the light of the peg to the US dollar, slow progress in implementing reforms, and protracted conflict in Syria and Iraq. On the upside, the capacity of Jordanian companies to comply with the relaxation of the rules of origin requirements by the European Union could boost exports of agriculture, pharmaceuticals and textiles.

**Lebanon**

Growth averaged 1.6 per cent between 2011 and 2017, and is estimated to have slowed down to 0.2 per cent in 2018, compared to an annual average of 5.6 per cent in the decade before. In 2018, internal and regional factors, the wait-and-see approach after the CEDRE conference, and uncertainty following the parliamentary elections in May 2018, slowed down investment and private consumption. The latter was also dampened by tighter liquidity due to a decline in foreign capital inflows. Lebanon’s outlook remains uncertain, and growth is expected to remain low at 1.3 per cent in 2019 and 2.0 per cent in 2020. This weak performance is a result of lack of clarity regarding sources of economic growth, political and security risks, both domestic and regional, and subdued growth in the traditional drivers – tourism, real estate, and construction, all of which depend on confidence and consumer sentiment. Any amelioration remains contingent on the successful implementation of the reforms to which the government has committed in the context of the CEDRE Conference. Lebanon is also well placed to benefit from the reconstruction efforts in Syria, should the situation stabilise in that country.

**Morocco**

The economy slowed down in 2018 in Morocco, with the rate of growth declining to 3.1 per cent (versus 4.1 per cent the previous year), mainly due to a slowdown in the non-agricultural sector. Growth is expected to improve to reach 3.2 per cent in 2019 and 3.8 per cent in 2020 driven by stronger non-agriculture growth. This is a result of improved fiscal management and economic diversification away from agriculture, the continued recovery in tourist arrivals, strong foreign direct investment, rapid expansion of the automotive and aeronautics industries, and expanded mining capacity. Downside risks include lower growth in Europe, lower commodity prices, and the vulnerability of agricultural activity to weather and price developments, since a drop in harvest adversely impacts exports, growth, and private consumption, given that two-fifths of the population work in agriculture.

**Tunisia**

Economic growth in 2018 accelerated in Tunisia from 1.9 per cent in 2017 to 2.5 per cent, the fastest growth since 2012, but remains below pre-2011 levels. Amid favourable weather conditions, agriculture witnessed a significant rebound, contributing with tourism and banking to sustaining growth. Meanwhile, non-manufacturing industries (oil and gas extraction, and mining) contracted. Investment and exports will remain the main drivers of growth in the short term, supported by the boost to competitiveness due to the depreciation of the dinar. Growth in 2019 is forecast to remain broadly unchanged, at 2.7 per cent, however, held back by the delay in the implementation of structural reforms,
notably due to uncertainty in the run-up to the 2019 parliamentary elections in October and presidential election in November 2019. In 2020, we expect a recovery in foreign investors’ confidence in the reform momentum in Tunisia once the elections are over. This will result in significant improvements in both domestic and foreign investment, pushing growth to above 4.0 per cent. Risks stem from the possibility that socioeconomic protests will disrupt production in the phosphate and hydrocarbon sectors. These risks will be mitigated by likely improvements 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 the EBRD’s growth forecasts for the economies where it invests.

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

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