Regional Economic Prospects
in the EBRD Regions

November 2019

Stalling engines of growth
Growth to pick up in 2020 after a weaker 2019

Growth in the EBRD regions averaged 2.1 per cent year on year in the first half of 2019, down from 3.4 per cent in 2018 and 3.8 per cent in 2017. This deceleration reflects continued weakness in Turkey, a slowdown in Russia and slower growth in global trade and the world economy.

Global industrial production slowed, led by a contraction in the automotive sector. Given its deep integration in ‘factory Europe’ and the importance of the automotive industry for the regions’ economies, emerging Europe is highly vulnerable to weakness in the automotive sector and a further slowdown in Germany. Growth in China also decelerated, affecting global demand for commodities and the outlook for commodity exporters.

Technological change weighed on inflows of foreign direct investment (FDI) and the expansion of global value chains, even before trade conflicts had escalated, as automation reduced the value of relocating production to lower-wage economies. FDI inflows to the EBRD regions have continued to moderate in recent years.

On the upside, financing conditions faced by the EBRD regions’ economies and by emerging markets more generally remain favourable relative to historical trends. As emerging markets have strengthened their economic policy frameworks, including more widespread use of flexible exchange rates and inflation targeting, episodes of acute financial tightening have become less common and less pronounced.

The deceleration in the first half of 2019 has been modest in the EBRD regions as a whole. Growth in central Europe and the Baltic States was supported by high wage growth and strong absorption of the European Union structural and cohesion funds. In contrast, growth has weakened in most of south-eastern Europe, weighed down by slowing growth in the eurozone. Slower growth in Russia reflected a hike in value-added tax, a lower average oil price in 2019 and weak investment. Growth remained broadly stable across Central Asia and eastern Europe and the Caucasus. Turkey’s economy entered a recession in the second half of 2018 amid tighter monetary policy and private sector deleveraging. It contracted by almost 2 per cent year on year
in the first half of 2019. In the southern and eastern Mediterranean region, robust growth in Egypt contrasted with slow growth elsewhere, in particular when measured in per capita terms.

Average growth in the EBRD regions is expected to moderate from 3.4 per cent in 2018 to 2.4 per cent in 2019 before picking up to 2.9 per cent in 2020. This represents a downwards revision compared with the previous forecast published in May 2019 (of 0.1 percentage point in 2020). Growth is expected to slow in most of central Europe and the Baltic States and south-eastern Europe in line with weakening growth in the euro area and a global contraction in car production. Growth is forecast to pick up in Russia in 2019 and 2020, boosted by higher levels of public investment. A pickup in growth in Russia is expected to support growth momentum in eastern Europe and the Caucasus and Central Asia. Turkey is projected to return to growth in the second half of 2019, although a mild contraction is expected for the year as a whole. In the southern and eastern Mediterranean region, growth in 2019 and 2020 should remain broadly at 2018 levels, supported by strong momentum in Egypt.
### Table 1. Real GDP growth

<table>
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<th>Actual</th>
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<th>Change from May 2019 REP</th>
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¹ 'e' indicates that figures for H1 2019 are unofficial estimates.

² Weighted averages, based on countries’ nominal GDP values in PPP US dollars. Weights for 2020 have been updated since the May 2019 REP.

³ EBRD figures and forecasts for Egypt’s real GDP reflects the country’s fiscal year (July to June).
Growth in the EBRD regions slowed to 2.1 per cent year on year in the first half of 2019

Growth in the EBRD regions averaged 2.1 per cent year on year in the first half of 2019, down from 3.4 per cent in 2018 and 3.8 per cent in 2017 (see Table 1 and Chart 1).

This deceleration reflects continued weakness in Turkey (where output contracted by close to 2 per cent year on year in the first half of 2019), a slowdown in Russia (from 2.3 per cent in 2018 to 0.7 per cent in the first half of 2019) and weaker export growth across the region, mirroring the global trade slowdown.

Global growth and global trade growth slowed further

The global economy has been experiencing a synchronised slowdown. Global growth in 2019 is forecast to be the slowest since the global financial crisis of 2008-09, according to the World Economic Outlook of the International Monetary Fund (see IMF (2019)). Forecasts for the eurozone economies have also been repeatedly revised downwards, to their lowest levels since 2013 (see Chart 2).

1 Averages are weighted using the values of countries’ gross domestic product (GDP) at purchasing power parity (PPP).
Industrial production slowed

Chart 3. Industrial production growth (year-on-year change, per cent)

Sources: CEIC and authors’ calculations.
Note: Three-month moving average.

Contraction in the automotive sector

This slowdown in industrial production has been led by a reduction in the global output of passenger vehicles (so far, sales of commercial vehicles have held up). Global car production fell in 2018 – a drop previously seen only in the run-up to the dot-com crisis and during the global financial crisis. The contraction in the automotive industry continued into 2019 (see Chart 4). Job growth in Germany’s automotive industry stalled in 2018 for the first time since 2013. Prior to that, direct employment in the automotive sector in Germany (excluding those employed by suppliers of goods and services to car producers) increased from 2.4 per cent of total employment in 2000 to 2.9 per cent in 2017.

The car industry slump reflects a number of one-off factors, including the rollout of new euro-wide emission tests in the third quarter of 2018\(^2\), a drop in demand after the expiration of tax incentives in China\(^3\) (Chart 5) and falling demand for diesel-powered vehicles (in the EU, the market share of diesel passenger cars fell by 16 per cent between 2015 and 2018 as consumers switched to petrol, electric and hybrid vehicles).

Global car production contracted

Chart 4. Motor vehicle production (1997=100)

Sources: CEIC Data, Eurostat, International Organization of Motor Vehicle Manufacturers and authors’ calculations.
Note: Projections for 2019 are based on partial data for the period January to September. ‘Selected economies in the EBRD regions’ includes Hungary, Morocco, Poland, Romania, Serbia, Slovak Republic, Slovenia and Turkey.

Weak demand for cars is likely also to be a reflection of longer-term trends as consumers need to replace higher-quality cars less frequently, while younger consumers also shift away from ownership of manufactured goods and of cars in particular. In Europe, new restrictions on emissions, such as the introduction of an ultra-low-emission zone in London, may also have contributed to weaker demand for cars.

In the first nine months of the year, car production in China, Germany, Japan and the United States of America declined by almost 8 per cent. Car production in emerging Europe

\(^2\) The large number of models requiring certification led to bottlenecks at testing agencies and car producers had to adjust production schedules to avoid unwanted inventory accumulation. German car production was down by 8 per cent quarter-on-quarter in the third quarter of 2018.

\(^3\) Tax breaks have been used in China to encourage vehicle ownership. The purchase tax was lowered to 5 per cent in 2016 before increasing to 7.5 per cent in 2017 and 10 per cent in 2018. The lower tax rate in 2016 is estimated to have brought sales forward by 20 per cent of production, with a subsequent decline in sales in 2018-2019.
increased in year-on-year terms in the first half of 2019, but early data indicate that production growth has turned negative in recent months.

**Falling production in China weighed on global car production**

*Chart 5. Motor vehicle production (contributions to percentage changes)*

Sources: IMF and authors’ calculations. Note: EBRD economies included in ‘Rest of the world’ account for 5 per cent of global car production, with a growth contribution of around 0.1 percentage point in 2018.

**Emerging Europe highly vulnerable to weakness in the automotive sector and a further slowdown in Germany**

Relative to its population, the Slovak Republic is the world’s largest car producer (Chart 6). The sector accounts for over a quarter of the economy’s exports and almost 15 per cent of gross output (Chart 7).

Other economies in central and south-eastern Europe, such as Hungary, Poland, Romania and Slovenia, are also highly dependent on the automotive industry. A single Audi plant in Győr, in the north-west of Hungary, accounts for 9 per cent of Hungarian exports.

**The Slovak Republic is the top producer of cars per capita**

*Chart 6. Motor vehicle production, 2018 (units per 1,000 population)*

Sources: CEIC Data, Eurostat, International Organization of Motor Vehicle Manufacturers and authors’ calculations.

**Central and south-eastern Europe are also highly dependent on the automotive sector**

*Chart 7. Importance of automotive industry, 2015 (percentages of country’s total exports and gross output)*

Sources: CEIC Data, Eurostat, International Organization of Motor Vehicle Manufacturers, OECD-WTO Trade in Value Added (TiVA) and authors’ calculations.

Direct employment in car production (excluding those employed by suppliers of goods and services to the automotive sector) accounts for 3 to 5 per cent of employment in the Slovak Republic, Hungary, Slovenia and Romania –
exceeding the share observed in Germany (see Chart 8).

The automotive industry accounts for a higher share of employment than in Germany

*Chart 8. Direct employment in the automotive industry, 2018 (percentage of total employment)*

![Chart 8](image)

Sources: Eurostat and authors’ calculations.

Furthermore, while overall manufacturing employment in the region has declined since 2010 or remained broadly flat (see Box 1), employment in the automotive sector has been growing rapidly (Chart 9), often at double-digit rates.

*Employment in the automotive sector far outpaced employment growth in manufacturing

*Chart 9. Employment growth by sector, 2010-18 (per cent)*

![Chart 9](image)

Sources: Eurostat and authors’ calculations.

Given that the region’s economies are deeply integrated within ‘factory Europe’ and depend on the car industry, the exports of central European countries tend to follow strongly the export trends of Germany (Chart 10), with correlations reaching 70-80 per cent in Hungary, the Slovak Republic and Slovenia (see also Leal et al. (2019) for estimates of the impact on central Europe of the contraction in Germany’s automotive sector).

*High dependence on Germany

*Chart 10. Global value chain (GVC) integration and export correlation with Germany, 2009-19*

![Chart 10](image)

Sources: International Trade Centre (ITC), OECD-WTO Trade in Value Added (TiVA) and authors’ calculations.

In 2018, employment growth in the automotive sector in central Europe fell to its lowest level since 2010. Daimler has recently postponed the expansion of its compact-car plant in Kecskemét, central Hungary. Data on new orders and business confidence indices point to a further slowdown in the second half of 2019, with an adverse impact on demand for metal products.

A further slowdown in the German car industry and potential near-term disruptions from the imposition of tariffs on importing EU cars into the USA are thus key risks to the outlook for central European economies. Tariffs on EU car imports under consideration in the USA could affect US$ 19 billion worth of German exports and US$ 3 billion worth of passenger car exports from the Slovak Republic.
Slowdown in China weighs on outlook for commodity exporters

Growth in China slowed from an average of 10.6 per cent in 2001-10 to 6.6 per cent in 2018 and is expected to slow further (Chart 11). The outlook is weaker in a scenario of sustained trade tensions with the USA, in which case the IMF estimates that China’s growth would be 2 percentage points weaker in the near term compared with the scenario of no trade tensions (the estimates assume slower productivity growth due to a slower diffusion of technology and a lower rate of innovation). Forecasts incorporating the latest global data in a principal-component-based framework also point to a weaker outlook in a trade-conflict scenario (Chart 11).

Growth has been slowing in China
Chart 11. China’s real GDP growth and forecasts (per cent)

Slower growth in China is expected to weigh on growth in Central Asian countries. China is the main export destination for Mongolia and Turkmenistan, accounting for over three-quarters of goods exports from these countries. It is also an important trade partner for Uzbekistan, Kazakhstan, Armenia and Russia, primarily due to commodity purchases (Chart 12).

Central Asia and Russia are vulnerable to a slowdown in China
Chart 13. Export share and export correlation with China, 2009-19

For Kazakhstan, Russia and a number of other commodity exporters, export correlations with China are as high as those between countries in central Europe and Germany (Chart 13). These correlations are driven primarily by exports of coal, copper, gas, minerals and oil. On the other hand, linkages in the manufacturing value chain account for high export correlations between China and other Asian economies such as South Korea.
Technological change has been weighing on FDI inflows and global value chain linkages — even before trade conflicts began

The gradual decline in foreign direct investment flows and trade in intermediate goods relative to global output predates recent trade tensions. While the tensions have exacerbated these trends and brought them into the spotlight, longer-term structural forces have been at play.

Automation reduced the importance of labour costs in manufacturing and hence the value of moving production from higher-wage to lower-wage economies. In addition, wage differentials between emerging markets and advanced economies have narrowed. Rising geopolitical tensions and policy uncertainty with respect to cross-border trade have made offshoring even less attractive.

The EBRD regions have benefited more from integration into global value chains than most other emerging markets have. FDI inflows, in particular to the new EU member states, rose sharply in the boom years before the global financial crisis (see Chart 14).

Trade in intermediate goods as a share of GDP also increased rapidly in the early 2000s and is higher in the EBRD regions — in particular, in emerging Europe — than in many other emerging market economies, such as Malaysia or South Africa (see Chart 15).

In line with trends seen in other emerging markets, FDI inflows to the EBRD regions as a share of GDP have been modest in recent years (see Chart 14)\(^4\), with the notable exception of the Western Balkans, a region that has continued to benefit from its proximity to advanced European economies, skilled labour forces and lower wages compared with those in central Europe.

FDI inflows have been falling as a share of GDP

Chart 14. Foreign direct investment (inflows, percentage of GDP)

Sources: IMF, OECD, UNCTAD and authors’ calculations.
Notes: Figures for 2019 predicted using quarterly data available for a subset of countries.

Trade in intermediate goods has been declining globally

Chart 15. Trade in intermediate goods (exports + imports, percentage of GDP)

Sources: IMF, World Integrated Trade Solutions (WITS) and authors’ calculations.
Note: In Chart 15 the EBRD regions exclude Bulgaria due to data limitations.

Trade in intermediate goods has also started to decline as a share of GDP in emerging markets. In the EBRD regions it has plateaued. While a slight pickup has been observed recently, due to large exchange-rate depreciations in Egypt and Turkey (see Chart 15), in two-thirds of these economies

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\(^4\) FDI inflows to the EBRD regions have declined in nominal US dollar terms since 2008. In other emerging markets, including China, they have increased in nominal terms but have been growing more slowly than GDP.
trade in intermediate goods is now below the 2011 levels (measured as percentages of GDP).

**Financing conditions remain favourable**

Having tightened throughout 2018, the financing conditions faced by the EBRD regions’ economies started to ease from January 2019, with interest rates remaining low in historical terms (see Chart 16).

**Episodes of financial tightening less frequent**

More generally, episodes of acute financial tightening have become less common and less pronounced. Previously, such episodes often accompanied external, fiscal or banking crises in emerging markets (see Box 2). As macroeconomic frameworks in emerging markets have improved (see also the discussion in the May 2019 Regional Economic Prospects), business cycles have also become more akin to those in advanced economies, characterised by longer spells of more moderate growth.

**Central Europe has been outperforming similar emerging markets by 1.6 percentage points a year**

Growth in the EBRD regions decelerated from 3.4 per cent in 2018 to 2.1 per cent in the first half of 2019.

Growth in **central Europe and the Baltic states** continued to surpass that observed in other emerging markets at similar levels of development (Chart 17)\(^5\). Over the period 2014-19, GDP growth per capita in central Europe and the Baltic states was about 1.6 percentage points higher than in emerging markets with comparable levels of income. This outperformance is larger than the level seen during the pre-crisis boom of the 2000s, when the region’s per capita incomes were lower and the growth rates of comparator economies, notably in Asia, were higher (at the time, the region’s outperformance averaged around 1 percentage point).

**Central Europe and the Baltic states continued to outperform similar emerging markets**

Relative to the boom years of the 2000s, the composition of growth shifted from investment (including FDI) towards consumption. While in the 2000s the difference between high levels of investment and moderate savings drove large current-account deficits, external imbalances have recently been smaller as savings have been rising.

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\(^5\) For a discussion of the methodology underlying such estimates see EBRD (2017), Plekhanov and Stostad (2018) and Box 3.
slightly as populations in these economies age (Chart 18).

Recent outperformance in new EU member states has been underpinned by consumption rather than investment

Chart 18. Savings, investment and FDI flows (percentage of GDP)

Consumption has been boosted by high wage growth in tight labour markets. Wage growth that far exceeds labour productivity growth has not yet translated into significant inflationary pressures (see Chart 19) – possibly explained by a combination of well-anchored inflation expectations and high demand for real estate assets (house prices in the capital cities of central Europe have been rising particularly fast).

GDP growth in central Europe and the Baltic states in the first half of 2019 averaged 4.2 per cent, representing a deceleration of 0.6 percentage point compared with the outcome of 2018. Growth was supported by strong wage growth and high absorption of the EU structural and cohesion funds in late 2018 and early 2019.

Growth decelerating in 2019

High-frequency indicators, however, point to a slowdown in the second half of the year. Car exports have begun to fall in Hungary and the Slovak Republic (despite an offsetting contribution from the new Jaguar Land Rover plant in the Slovak Republic). Monthly indicators of new car orders have been falling in most countries since mid-2019.

In contrast, growth was already weak in the first half of 2019 in the Western Balkans, weighed down by slowing eurozone growth. Growth disappointed in Serbia, with weak industrial production; exports from Fiat’s Serbian car plant have been falling. While the region has benefited from FDI, the local supplier base remains small, limiting the positive spillovers from FDI to the local economy.
Slower growth in Russia in the first half of 2019 reflected a hike in the rate of the value added tax, weak investment, including slower-than-expected implementation of government projects, and a lower average oil price in 2019.

The oil price spiked only briefly following attacks on Saudi Arabia’s energy infrastructure in mid-September. In January-October 2019, the Brent oil price averaged US$ 65 per barrel, 10 per cent less than in the same period of 2018 (see Chart 20).

Average oil price in 2019 is down compared with the 2018 average

Chart 20. Oil price and change in oil price

Source: Thomson Reuters.

Growth in the first half of 2019 exceeded expectations in most of Central Asia as well as eastern Europe and the Caucasus. Remittances remained stable in US dollar terms and continued to increase in local currency terms (see Chart 21). In Kazakhstan, growth in early 2019 was supported by public spending on social programmes. Meanwhile, growth exceeded expectations in Ukraine, driven by booming construction. In Azerbaijan, growth was disappointing, reflecting delays in the implementation of oil and gas projects.

Turkey entered a recession in the second half of 2018, amid tighter monetary policy and private sector deleveraging following earlier overheating, with strong credit growth, high inflation and growth peaking in double digits in mid-2017. Growth in Turkey turned positive in quarter-on-quarter terms in early 2019 owing to expansionary fiscal policy and an increase in credit driven by state banks. In year-on-year terms, however, the economy contracted by 1.9 per cent in the first half of 2019.

While growth momentum in Egypt has remained strong on the back of high tourism receipts and the implementation of the Tourism Reform Programme, elsewhere in the southern and eastern Mediterranean growth has remained low, in particular when measured in per capita terms.

Growth in 2019 as a whole is projected to moderate, in line with global trends

The latest economic indicators such as retail sales, exports and imports point towards further moderation, based on estimates derived using a principal-component-based model that takes into account more than 150 global indicators as well as
estimates of the medium-term potential growth of economies (see Chart 1).  

Average growth in the EBRD regions is expected to moderate in 2019 as a whole relative to 2018 (see Charts 22 and 23), in line with weakening eurozone growth and global trade headwinds. For the region as a whole, growth is then expected to recover somewhat in 2020 as the economy gains momentum in Turkey and Russia.

Growth is expected to moderate in 2019 before picking up somewhat in 2020

Chart 22. Average real GDP growth (per cent)

Growth is expected to moderate in 2019 in most of the EBRD regions

Chart 23. Average real GDP growth rates (per cent)

Forecasts have repeatedly been revised downwards in most of the EBRD regions, with the notable exception of Central Europe where domestic demand held up better than expected (see Chart 24).

Forecasts have repeatedly been revised downwards

Chart 24. Real GDP growth forecasts for 2019

Growth is expected to moderate in most of central Europe and the Baltic states and south-eastern Europe, in line with weakening eurozone growth and headwinds to global trade.

Growth is expected to pick up in Russia in 2019 and 2020 on account of increased public-investment spending and a more accommodative monetary policy. Stronger growth momentum in Russia will support growth in eastern Europe and the Caucasus and in Central Asia.

Output is still expected to contract in Turkey in 2019 as a whole, although the contraction is likely to be smaller than previously expected, due to credit growth, a fiscal stimulus and rising consumer confidence. The economy is expected to return to growth in 2020.

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6 See the November 2017 edition of the Regional Economic Prospects for a discussion of this model.
In the **southern and eastern Mediterranean region**, growth is expected to remain broadly unchanged compared with 2018 levels. Continued high growth in Egypt is likely to be driven by high levels of investment and a strong tourist season on the back of reforms in that sector. Lebanon’s already bleak outlook is subject to significant downside risks given the rising political tension and the economy’s significant need for external financing.

**Risks**

Given the EBRD regions’ deep integration into global supply chains, a further escalation of trade tensions and rising global uncertainty about policy (including with regard to Brexit – see Box 3) are major risks to the outlook. The World Trade Organization is expected to rule in the first quarter of 2020 in a dispute relating to subsidies to Boeing, a US aircraft manufacturer, following an earlier ruling in a case involving Airbus, an EU-based aircraft manufacturer. Meanwhile, levies on imports of cars from the EU remain under consideration in the USA.

Economies in the EBRD regions are particularly vulnerable to a further slowdown in the eurozone, a deeper-than-anticipated slowdown in China and protracted weakness in the automotive sector globally.
Box 1: Vulnerabilities in emerging Europe

Emerging Europe has experienced rapid growth over the past two decades, outperforming other emerging markets at similar levels of development. Much of this growth was, however, driven by high inflows of FDI and by heavy reliance on foreign-owned, capital-intensive manufacturing, in particular in the automotive sector, making the region vulnerable to changing external conditions.

Manufacturing employment as a share of total employment in the EBRD regions, and particularly in emerging Europe, tends to be higher than in other countries at similar levels of development (see Chart 1.1).

**Employment in industry is high in the EBRD regions relative to other emerging markets**

*Chart 1.1. Employment in industry as a share of total employment, by level of development, 2018 (per cent)*

The share of manufacturing employment has been falling on average in EBRD regions. While the trend has not been as stark as in advanced economies, it contrasts strongly with the still-increasing manufacturing employment in many other emerging markets (Chart 1.2).

Most of the decline occurred in the 1990s and 2000s. More recently, employment by foreign-owned enterprises, and rapid employment growth in the automotive sector in particular, have leaned against the secular decline in manufacturing employment as a share of total employment.

**Employment in industry has been declining**

*Chart 1.2. Employment in industry as a share of total employment, by level of economic development (1997 and 2018, per cent)*

Large FDI by leading multinationals, especially to the new EU member states, has placed a number of EBRD countries among the leading car producers in the world when measured in per capita terms.

This integration has, however, been accompanied by only limited ‘learning’ so far. As economies participate in global value chains and companies learn from their suppliers, customers and competitors, economies tend to develop capabilities to produce higher value-added components domestically.

In the EBRD regions, however, reliance on imported inputs has remained broadly constant. Despite strong export growth in the automotive sector, foreign value-added has accounted for a broadly constant share of the value of exports (an average of 40 per cent in the EBRD regions – see Chart 1.3 – and up to 60 per cent in Hungary and the Slovak Republic).
Limited ‘learning’ from GVC integration

Chart 1.3. Foreign value-added as a share of total exports (per cent)

Sources: OECD and authors’ calculations.
Note: Based on data for 17 economies in the EBRD regions (the twelve members of the EU, as well as Kazakhstan, Morocco, Russia, Tunisia and Turkey).

Foreign affiliates account for almost a quarter of manufacturing output in the EBRD regions. Foreign-owned multinationals from the EU dominate car manufacturing and, to a lesser extent, electronics (see Chart 1.4).

Foreign affiliates dominate the automotive sector

Chart 1.4. Gross output share of foreign-owned multinational enterprises, 2016 (percentage of industry output)

Sources: OECD and authors’ calculations.
Note: Based on data for 15 economies in the EBRD regions (EU-12, as well as Morocco, Russia and Turkey).

In the short term, higher reliance on imports may cushion the blow from the contraction in the global automotive industry as lower exports will be, to a larger extent, offset by lower imports. In the long term, however, the relatively low domestic content of exports is a reflection of the difficulties that economies face in moving up the value-added chain.
Box 2: Financial and real cycles in emerging markets

This box examines the frequency and severity of episodes of financial tightening and recessions in emerging markets and advanced economies. Episodes of acute financial tightening have become less common and less pronounced in emerging markets. Business cycles have also become more similar to those in advanced economies, characterised by longer spells of more moderate growth.

Financial cycles have become less pronounced in emerging markets. Chart 2.1 examines the average increase in interest rates during financial tightening episodes, defined as episodes where interest rates increase by at least 1.5 percentage points relative to the previous year. On this measure, episodes of acute financial tightening, historically associated with external, fiscal or banking crises in emerging markets, have become less common and less pronounced.

Financial cycles have become less pronounced in emerging markets. Chart 2.1. Average increase in interest rates during episodes of financial tightening

However, as economic cycles in emerging markets have lengthened, the average annual growth during upswings has declined to the levels seen in advanced economies (see Chart 2.3).

Average growth during upswings has declined
Chart 2.3. Average annual growth during upswings (per cent)
In other words, as macroeconomic frameworks in emerging markets have improved (see also the discussion in the May 2019 Regional Economic Prospects), business cycles have become more akin to those seen in advanced economies, characterised by longer spells of more moderate growth. The performance of advanced economies and emerging markets has also become more synchronised over time.

Reflecting stronger macroeconomic frameworks, episodes of tightening in financial conditions are now less likely to coincide with declines in output. Indeed, emerging markets have been experiencing fewer instances of real and financial crises (see Chart 2.4). It should be noted that the tendency for economic cycles in emerging markets to becoming more akin to those in advanced economies does not imply anything about the severity of any particular crisis that may occur in the future.

Real and financial cycles are less likely to coincide

Chart 2.4. Share of countries facing a recession and/or financial tightening (per cent)

Sources: CEIC Data, IFS and authors’ calculations.
Notes: Unbalanced sample of 49 countries. Recessions are defined as negative growth over two consecutive quarters (or annual average). Financial tightening is defined as an increase in interest rates of 1.5 percentage points or more relative to the previous year.
Box 3. The economic impact of Brexit-related uncertainty

This box estimates the effects of Brexit-related uncertainty since the 2016 referendum. In the United Kingdom, this uncertainty appears to have cost the economy about 1 percentage point in terms of annual per capita GDP growth. The direct impact of a ‘soft’ Brexit on most economies in the EBRD regions is expected to be limited. The indirect effects of a ‘hard’ Brexit are estimated to be largest for economies in south-eastern Europe.

The recent performance of the UK economy in terms of per capita GDP growth can be evaluated against a ‘synthetic comparator’, a weighted average of GDP per capita growth rates observed in the same year in other countries at a similar level of development. Countries with larger populations and countries that are most similar to the UK in terms of GDP per capita receive larger weights when the synthetic comparator is constructed.

The United Kingdom underperformed relative to comparable economies in the period preceding its accession to the European Communities in 1973 (see Chart 3.1). In contrast, its performance improved by more than 2 percentage points over the period 1975-2016. Since 2016, the economy has underperformed relative to its comparators by an average of 0.6 percentage point a year, a difference of around 1 percentage point relative to the 1975-2015 average.

7 For a detailed discussion of the methodology see EBRD (2017) and Plekhanov and Stostad (2018).

As of late October 2019, the modalities of Brexit remain unclear. The direct impact of a ‘soft’ Brexit (which assumes a relatively smooth exit for the UK, with trade relationships being kept close to their present levels) on most of economies in the EBRD regions is expected to be limited, as discussed in the November 2016 and November 2018 issues of the Regional Economic Prospects. Exports of final or intermediate goods to the United Kingdom are largest for the Slovak Republic and Hungary (mostly in the automotive and machinery sectors), and for Poland, Latvia and Lithuania (wood and food products), but are relatively modest. Direct imports of intermediate goods from the UK are only sizeable for North Macedonia.

A closer look at the automotive sector shows that a tariff regime between the UK and the rest of the EU would weigh on the profitability of automotive plants in the UK. Given the current outlook for the automotive industry, however, it is far from certain that the Japanese car-makers operating in the UK (Honda, Nissan, and Toyota) or other manufacturers would consider moving production to economies in central or south-eastern Europe.
Indirect effects – through weaker growth in the eurozone – are estimated to be much larger, in particular in the event of a ‘hard’ Brexit, where the existing value chains encompassing the UK and the rest of the EU are significantly disrupted, while progress on new trade agreements between the UK and its trading partners is slow (see Chart 3.2).

Cumulatively, the economic impact of a ‘hard’ Brexit of this kind is projected to be largest in south-eastern Europe, mainly through disruption to trade linkages encompassing the UK and other advanced economies in Europe and through lower reform momentum on account of more uncertain prospects for EU membership, which could have a negative effect on investor sentiment and growth. The slowing momentum in the approximation with the European Union – highlighted as a risk in the 2016 November Regional Economic Prospects – has been observed to some extent, though it is a matter of judgement whether a reduced appetite for EU expansion in certain EU member countries is related to Brexit.

EU structural and cohesion funds available to economies in south-eastern and central Europe may also be reduced in the period 2021-27, to the extent that the EU does not introduce compensatory revenues to make up for the UK’s budget contributions. These funds averaged 3.3 per cent of GDP of EBRD-EU economies over the period 2014-19, implying a potential one-off impact on growth of around 0.4 percentage points.

**Indirect effects of Brexit are estimated to be largest for economies in south-eastern Europe**

*Chart 3.2. Difference in levels of GDP relative to a no-Brexit baseline over a five-year period (per cent)*

Sources: EBRD calculations, based on a GVAR model (see Transition Report 2016-2017 and November 2016 Regional Economic Prospects). A ‘hard’ Brexit scenario assumes that EU transfers are cut by 10 per cent as the withdrawal of the UK contribution is not compensated by other countries.
Regional updates

Central Europe and the Baltic States

Central Europe and the Baltic states (CEB) has mostly managed to maintain its very strong growth momentum longer than Western Europe has done. EU-financed investments, wage growth driven by tight labour markets, and government-supported initiatives have all helped. Unfortunately, the slowdown in western Europe has already started to weigh on exports from CEB, thus weakening business sentiment and industrial production. An employment slowdown could follow, especially in the areas affected by substantial minimum wage increases. But public investment will play a stabilising role, given the EU funds cycle.

Croatia

The economic recovery has continued in 2019, following four consecutive years of solid growth averaging 3.1 per cent, after a six-year recession from 2009-14. The economy expanded by 3.1 per cent year on year in the first half of 2019, on the back of broad-based domestic demand. Growth was equally supported by private consumption and investments. Private consumption was fuelled by increased earnings and higher employment, with the unemployment rate as of June 2019 at just 7 per cent (compared with 18 per cent in 2014), and an increased pace of household lending (which grew by 6 per cent in the first half of 2019). Investment continued along its recovery path from 2015, helped by the growing disbursement of funds from the EU, rising economic sentiment and low interest rates. In line with previous years, net exports contributed negatively to growth, although to a somewhat larger extent in the first half of 2019. Fiscal adjustment has continued, although at a slower pace, as government spending contributed positively to growth. A balanced budget is expected in 2019, following a small budget surplus of 0.3 per cent of GDP in 2018. The government’s commitment to joining the European Exchange Rate Mechanism II, as part of the euro adoption strategy, should serve as an anchor for prudent fiscal policy in the coming years. Standard & Poor’s and Fitch raised Croatia’s credit rating to investment grade (BBB-) in March and June 2019 respectively. GDP growth of 3.0 per cent is expected in 2019, followed by a light moderation to 2.5 per cent in 2020, broadly in line with the country’s current growth potential, as supply-side constraints for the tourism sector become more apparent. Growth is likely to be mainly driven by private consumption, which is supported by positive labour market developments and low inflation. Risks to the projection come from possibly weaker demand from Croatia’s main economic partners, such as the eurozone.

Estonia

Buoyant growth in Estonia’s GDP is starting to face capacity constraints. Nominal wage growth reached an average of almost 8.0 per cent year on year in the first half of 2019, causing unit labour costs to grow faster than labour productivity. This reflects a shrinking labour market and raises concerns about Estonia’s future competitiveness. While consumption stayed strong in 2018, an increasing part of demand was directed towards imports, resulting in growth deceleration to 4.8 per cent. In the first half of 2019, moderating household consumption slowed growth further, to 4.2 per cent year on year. However, these remain impressive numbers and short-term GDP growth will remain robust, at 3.2 per cent and 2.6 per cent in 2019 and 2020 respectively. Negative risks to the outlook come from the intensification of trade tensions and from weaker export demand in advanced economies, especially in the Nordic region.

Hungary

Investment acceleration and continuously strong household consumption have been the key drivers
of the recent strong economic growth. Following the 5.1 per cent GDP growth rate in 2018, the Hungarian economy continued to grow at a similar pace in the first half of 2019. Consumption was fuelled by strong nominal wage growth (above 10 per cent in annual terms) in both the private and public sectors. Salaries of employees in the central public administration were raised on average by 30 per cent from January 2019. With such a strong start, growth for 2019 as a whole is expected to remain very solid at 4.6 per cent, notwithstanding concerns about the car industry in Germany, to which Hungary is vulnerable. In 2020, it is anticipated that GDP growth will moderate to 3.1 per cent. This slowdown will be partially offset by domestic demand, powered by a double-digit recovery in corporate credit and in wage hikes that remain strong. The latter is largely a result of the tightening labour market, caused by the fall in the working-age population and mounting skill-mismatches. The absorption of EU funds will be likely to further underpin investment in 2019, but reduced EU fund inflows will create a drag on public investment from 2020 onwards. Trade disputes and the economic performance of Hungary’s main trading partners, such as Germany, are negative risks to that scenario.

Latvia

After reaching 4.8 per cent in 2018, GDP growth slowed substantially to 2.4 per cent in the first half of 2019. In 2018, investment-driven imports robustly outperformed weak exports, but in the first half of 2019, all domestic demand components slowed. Labour shortages and restrained bank financing will continue to weigh on growth. GDP growth is projected to decelerate to 2.6 per cent in 2019 and then further to 2.2 per cent in 2020. The slowdown is due to a combination of factors, including decelerating economic growth in advanced European countries, adverse demographics and the reduced availability of sources of finance, such as EU funds and bank credit. However, additional rises in wages will continue to support consumption growth.

Lithuania

GDP growth, at 3.6 per cent in 2018 and 4.0 per cent year on year in the first half of 2019, continues to be supported by vibrant household consumption, investment and exports. Recent labour tax reforms have effectively reduced the tax wedge in 2019 and, amid rising wages and low unemployment rates, have provided an additional boost to household spending. Investment growth is strong as a result of better utilisation of EU funds. Net exports have also positively contributed to growth, especially in the first half of 2019, despite the weaker external environment and a strong base effect. Structural factors and demographics are the main risks over the medium term. In the short term, GDP growth is expected to reach 3.6 per cent in 2019 and 2.3 per cent in 2020. Domestic demand will likely remain the key growth engine, driven by strong household consumption and investment, as companies continue to invest in automation amid mounting labour shortages. Greater investment in productivity could partially offset negative demographic trends associated with ageing and emigration.

Poland

Poland’s economy grew by 5.1 per cent in 2018, the highest growth rate in central Europe and the Baltic states, then slowed to 4.4 per cent year on year in the first half of 2019. Domestic demand was the principal engine of growth, driven by recovered investment, continuously robust household consumption and especially by strong government consumption, at 4.7 per cent growth in the first half of 2019. Significant wage increases in the economy, averaging 6.7 per cent year on year in the first half of 2019, substantial government transfers and favourable labour market trends have all contributed to sustaining household disposable incomes and consumer
confidence. Robust growth will continue but the weakening external environment constitutes a negative risk. The Polish economy is forecast to grow by 3.9 and 3.5 per cent in 2019 and 2020, respectively. Rising household disposable incomes will drive further strong consumption, although the expected generous hikes in minimum wages will be likely to induce higher inflation, boosted by the anticipated rise in energy prices from next year. In addition, if plans to raise the minimum wage to 70 per cent of the average wage within the next five years were to materialise, employment could be hit, especially in small and medium-sized enterprises (SMEs). For the time being, investment will remain supported by substantial inflows of funds from the EU and government-led investments, including those financed by savings in the occupational pension scheme. Nevertheless, the approaching slowdown in Poland’s key trading partners in the EU represents an important risk to that scenario.

**Slovak Republic**

Domestic demand, particularly household consumption and investment, continued to underpin GDP growth of 4.0 per cent in 2018. However, a slowdown was evident in the first half of 2019, with the economy growing by just 3.0 per cent year on year. Amid weakening external demand in western Europe, export growth lost momentum and reached 3.9 per cent in the first half of the year. Inflation accelerated to 2.5 per cent in 2018, and further to 3.0 per cent in July 2019. Service price inflation saw the greatest hikes, in line with expectations of rapidly rising wages and positive consumer confidence. External uncertainties are the main risks to further economic growth, especially for the automotive industry, including its SME-led supply base. GDP growth is likely to continue to be driven by domestic demand, although its strength will moderate. We expect growth to slow to 2.5 per cent in both 2019 and 2020, representing a large downward revision (of 1.1 percentage points in 2019 and 0.8 percentage point in 2020). Key negative risks include the possibility of a hard Brexit and the eurozone’s economic slowdown. By contrast, improved absorption of EU funds provides potential for an upside.

**Slovenia**

The economic recovery has continued in 2019 but at a somewhat slower pace than in the previous two years, in which growth averaged 4.5 per cent, among the fastest growth rates in the EU. The economy expanded by 2.9 per cent year on year in the first half of 2019. The growth was driven by domestic demand, underpinned by both higher investment and private consumption. The strong labour market (with unemployment at just 4.0 per cent as of June 2019), combined with earnings growth (driven also by an increase in the minimum wage), contributed to rising private consumption. Increased growth in corporate loans, amid favourable financing conditions, as well as a better rate of capacity utilisation, supported investments, while economic sentiment was above its long-term average. Exports continued their strong performance and grew by almost 9 per cent in the first half of 2019, but the growth of imports outpaced that of exports. The declining trend of public debt is expected to continue, as the fiscal position has improved significantly in recent years. The budget was in surplus in 2018 for the first time since independence which, combined with strong nominal GDP growth, led to a decline in the public debt-to-GDP ratio from a peak of 83 per cent in 2015 to an expected 66 per cent as of end-2019. The economy is projected to grow at 3.0 per cent in 2019, dropping slightly to 2.8 per cent in 2020. The risks to the downside come from weaker demand from main trading partners, as the country’s economy, which is highly integrated into eurozone supply chains, relies significantly on exports.
Growth remains fairly robust in most of this region, with private consumption driving growth in Bulgaria, Cyprus and Romania. In Greece, the gradual recovery of recent years has continued at a slow pace in 2019, but short-term prospects are favourable given the strong fiscal performance, improved prospects for medium-term debt sustainability and a new momentum for reform.

**Bulgaria**

The Bulgarian economy grew robustly at 4.2 per cent year-on-year in the first half of 2019. Household consumption continued to be the main source of growth, fuelled by strong lending activity, increased earnings and a higher employment rate amid the tightening labour market. Unemployment was down to almost 4.0 per cent as of June 2019, while nominal wages kept growing at high single-digit rates. The government raised the monthly minimum wage by 10 per cent in January 2019, to €286. Investment also continued to contribute positively to growth, although at a slower pace than in 2018. Meanwhile, net exports also boosted growth, as exports grew at a faster rate than imports, which almost stagnated. Government spending rose in 2019, mainly due to a one-off large army-related expense, and the budget may be in deficit after three consecutive years of budget surpluses. Public debt stands at around 21.0 per cent of GDP, one of the lowest percentages in the EU. The economy is expected to grow by a solid 3.7 per cent in 2019 and 3.0 per cent in 2020, broadly in line with the country’s current growth potential. Growth is likely to be underpinned by private consumption, which typically fuels economic activity. Investment should also contribute positively to growth, as the absorption of EU funds is accelerated towards the end of the 2014-20 funding period and the government embarks on a major energy investment cycle. Key risks to the outlook are: prolonged weakness of major trading partners, particularly that of the eurozone, and an exacerbation of current labour shortages.

**Cyprus**

In 2018, GDP growth remained strong at 3.9 per cent. Economic growth slowed in the first quarter of 2019 to 3.4 per cent year on year, mainly reflecting weaker exports. Investment continues to be one of the main drivers of growth. The increase of private consumption is another significant driver, with a robust labour market recovery and wage increases. Unemployment continued its uninterrupted downward trend since 2013, reaching 6.8 per cent in August 2019. In 2018, net exports made a small positive contribution to growth, helped by a strong tourism season, but in 2019 the sector is showing signs of a slowdown, with a decrease in tourist arrivals of 1.1 percent over the first five months of 2019. Public debt was still above 100 per cent of GDP at end-2018, but strong GDP growth and primary surpluses should allow the debt-to-GDP ratio to resume its downward path from this year onwards. Cyprus has returned to investment grade status, but levels of non-performing loans are still among the highest in the EU. Looking ahead, a less favourable external environment and persistent uncertainties will weigh on the construction sector and economic activity linked to foreign companies. A sharper-than-expected slowdown in the euro area or a hard Brexit could also harm the prospects of the Cypriot economy. However, 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 moderately in 2019 and 2020 to 3.2 per cent and 2.8 per cent respectively.

**Greece**

The economic recovery that began in 2017 continued in 2018 and the first half of 2019, although at a slightly slower pace than expected
with 1.9 per cent GDP growth in 2018, and 1.5 per cent growth year on year in the first half of 2019. Exports of goods and services remain by far the key driver of growth, private consumption retains a positive impact on growth, and unemployment continues to decline, down to 17 per cent in August 2019. The general government primary surplus was 4.4 per cent of GDP in 2018, well above the 3.5 per cent target, and is on track to achieve this target in 2019. Capital controls have been fully lifted as of 1 September 2019. These improved conditions have boosted market and investor confidence, reflected in a sharp decline in 2019 of bond yields, and could ultimately lead to an increase in business investment, with the economic sentiment indicator reaching a 12-year record high level of 108.4 in August 2019. Looking ahead, the main drivers of growth in the short term will continue to be exports and private consumption. Investment is the key to a full economic recovery and is expected to rise as the health of the financial sector improves. Non-performing exposures⁸ remain exceptionally high but should lower significantly over time, an expectation helped by the October 2019 approval by the European Commission of a new asset protection scheme. Short-term growth is projected at 2.0 per cent in 2019 and 2.4 per cent in 2020. However, economic growth depends on many factors, including the magnitude and pace of the reduction in non-performing exposures, as well as the capacity of the government to implement reforms.

Romania

The economy is estimated to have accelerated from an already strong 4.0 per cent growth in 2018 to 4.6 per cent year on year in the first half of 2019. Private consumption has made the highest contribution to growth, supported by the tightening labour market, pro-cyclical fiscal policy, including hikes in public sector salaries, pensions and the minimum wage, and an increased pace of retail lending. The unemployment rate, at about 4 per cent as of June 2019, is the lowest in a decade, making recruitment difficult and further driving up wages. Fuelled by increased absorption of EU funds, as well as corporate lending, the contribution of investment to growth has also been positive. Twin deficits have increased in the wake of government pro-cyclical stimulus measures. Despite growing exports, the trade deficit has been widening since 2015, as rising domestic demand has driven up imports even more. The nominal budget deficit reached 3 per cent of GDP in 2018 (second-highest in the EU) and is expected to exceed that level in 2019. On the positive side, general government debt is still low by regional standards, at around 35 per cent of GDP, and has been stable for some time, thanks to high nominal growth. Although inflation gradually receded to 3.3 per cent in December 2018, following three consecutive policy rate rises, it has risen to an average of 3.9 per cent in the first half of 2019, again above the central bank's upper target. Growth is expected at 4.0 per cent in 2019, moderating to 3.2 per cent in 2020 because of higher perceived investment risks and growing external imbalances. Key risks to the outlook are linked to weakness in major trading partners, not least the eurozone, rising labour shortages and domestic political and reform uncertainty.

⁸ Non-performing exposures include loans more than 90 days past due and loans whose debtor is assessed as unlikely to pay its credit obligations in full without realization of collateral, regardless of the existence of any past due amount or of the number of days past due. It is thus a broader measure than non-performing loans, which are loans more than 90 days due only.
Western Balkans

Growth in the Western Balkans region slowed in the first half of 2019 to 2.9 per cent year on year (down by more than 1 percentage point from 2018). The deceleration was recorded in all economies, with the exceptions of Kosovo and North Macedonia. Despite the eurozone slowdown, FDI inflows to the region remain strong, with these economies benefiting from their favourable geographical location, skilled labour force and lower wage costs than those in central Europe.

Albania

After accelerating to 4.1 per cent in 2018, growth has slowed in 2019. During the first half of 2019, the economy expanded by 2.4 per cent year on year. The slowdown was mainly a consequence of weaker power generation, combined with the high base effect from 2018, while tourism remained an important contributor. On the expenditure side, investment and export growth decelerated too. Unemployment continued to decline gradually but remained at double-digit levels, averaging 11.8 per cent in the first half of the year. At the same time, inflation decreased to 1.5 per cent on average, staying below the central bank’s target of 3.0 per cent for the eighth consecutive year. As a result, the central bank’s key policy rate has remained at a record low of 1.0 per cent since June 2018. Despite primary surpluses in recent years, public debt remains high (66.9 per cent of GDP in June 2019, excluding arrears). The economy is projected to expand by 2.8 per cent in 2019, driven mainly by private consumption, and to accelerate to 3.5 per cent in 2020. The moderation in growth relative to the most recent years is due mainly to a combination of the economic slowdown of Italy and the rest of the eurozone, the further delay in starting EU membership talks, and internal risks associated with both contingent liabilities stemming from unsolicited public-private partnership programmes (lacking transparency and accountability) and the ongoing political instability.

Bosnia and Herzegovina

The economy has decelerated in 2019. In the first half of the year, GDP growth was 2.7 per cent year on year, down from 3.6 per cent in 2018, primarily due to a slowdown in exports and increase in import growth. At the same time, private consumption growth picked up to 3 per cent year on year, twice the growth rate seen in the previous two years. In the first quarter of 2019, the unemployment rate was lower by 2.7 percentage points than in the year before, but at 15.7 per cent it remained high, especially for young people (34 per cent). The inflation rate decelerated from 1.6 per cent year on year at the end of 2018 to 0.3 per cent in August 2019. This decline was primarily led by the slowdown in the growth of transport prices. GDP is expected to expand by 3.0 per cent annually in both 2019 and 2020. Risks to the projection lie on the downside and relate mainly to uncertainty about reforms (primarily in terms of improving the business climate and standards of governance, and advancing the country’s EU approximation agenda) and to the economic slowdown in the European Union.

Kosovo

Relatively strong economic growth has continued in 2019. After 3.8 per cent GDP growth in 2018, the economy expanded by 4.2 per cent year on year in the first half of 2019. Growth was primarily driven by investment, but private consumption was also an important contributor. However, economic growth is translating very slowly into higher employment. In the second quarter of 2019, the employment rate stood at 30 per cent, around 1 percentage point higher than a year before. Meanwhile, the unemployment rate fell by 4 percentage points year on year, but at 25 per cent it remained high, especially for young people.
(close to 50 per cent). Inflation, which started to increase in the second half of 2018 (possibly also in relation to the imposition in November 2018 of a 100 per cent tax on goods imported from Serbia and Bosnia and Herzegovina), peaked in May 2019 at 3.4 per cent, sliding to 2.4 per cent in September 2019. GDP growth in 2019 and 2020 is expected to stand at 4.0 per cent annually, with domestic demand remaining the key driver of growth. The risks to the projection are balanced. While upside risks relate to the possible start of construction of a major new power plant and to faster reform progress, weaknesses in public investment management, the economic slowdown in the European Union, domestic political uncertainty and deteriorating relations with neighbours represent the main downside risks.

Montenegro

The economy’s growth rate has slowed in 2019. In the first half of the year, GDP growth fell to 3.1 per cent year on year, from 5.1 per cent in 2018. The deceleration is primarily due to large investment projects (the Bar-Boljare highway and the power link to Italy) approaching completion. The first half of 2019 was also marked by poor industrial performance, due to declines in electricity production and manufacturing sector output. On the other hand, the tourism sector has continued to perform well. The current account deficit is expected to remain large and at a similar level to that seen in 2018, at around 17 per cent of GDP. Price growth has slowed since the second half of 2018, primarily on the back of falling prices for tobacco, clothing and footwear, but also due to decreasing (oil price-related) transport prices. The average year-on-year inflation rate decreased from 2.6 per cent in 2018 to 0.3 per cent in the first nine months of 2019. The period from June to September 2019 has even been marked by deflation (-0.2 per cent monthly, on average). With the completion of large investment projects and ongoing fiscal consolidation, growth is projected to moderate significantly, to 2.8 per cent in 2019 and 2.6 per cent in 2020. However, private investment in tourism and energy is likely to stay high. The risks to the projections mainly relate to weaker growth in the European Union.

North Macedonia

The economy has continued to recover after the resolution of the political crisis in 2017. Following a 2.7 per cent increase in 2018, the growth rate accelerated to 3.6 per cent year on year in the first half of 2019. Growth was driven by domestic demand, primarily the recovery of investment. The rates of total and youth unemployment went down, although they were still high at 18 and 35 per cent in the second quarter of 2019, respectively (down from 21 and 48 per cent in the same quarter of 2018). Inflation remained subdued at 1 per cent in the first nine months of 2019. Growth is projected to pick up to 3.2 per cent in both 2019 and 2020, supported primarily by the rebound in investment. The resolution of the name issue with Greece has helped to strengthen investor confidence, as confirmed by Fitch’s upgrade in June 2019 of the country’s sovereign rating to BB+. However, current risks to the projection are more on the downside. These are mainly related to the delayed start of EU accession talks, which may weaken reform momentum within the country, and the economic slowdown of the European Union.

Serbia

Growth has subsided during 2019. Unfavourable trends in industrial production continued in the first half of 2019, with industrial output declining by 2.0 per cent year on year on the back of falling production in mining and manufacturing, while utilities and agricultural output stagnated. As a consequence, the overall GDP growth rate slowed to 2.8 per cent year on year in the first half of 2019, from 4.4 per cent in 2018. The 2019 budget envisages a small deficit (0.5 per cent of GDP), while public debt stood at 54 per cent of GDP at
Inflationary pressures have been low, also thanks to the strong exchange rate. Inflation initially picked up in 2019, reaching 3.0 per cent year-on-year in April, but then fell back to 1.1 per cent in September, undershooting the lower bound of the central bank’s target band (3 ± 1.5 per cent). After keeping the policy rate unchanged at 3.0 per cent for more than a year, the central bank cut the rate again in the third quarter of 2019, to 2.5 per cent. GDP is expected to expand by 3.2 per cent in 2019 and 3.5 per cent in 2020. Domestic demand should remain the main growth driver, while net exports are most likely to continue their negative contribution. The economic slowdown of the main trading partner, the European Union, and the slow pace of reforms within the country might act as a drag on growth in the near term and make it more volatile. While Kosovo’s introduction of a 100 per cent tariff on Serbian products may have a negative effect on exports of up to €400 million a year, reliable assessments of this effect are not yet available.

Armenia

GDP grew by an estimated 6.8 per cent year on year in the first half of 2019, driven by strengthened household consumption which is benefiting from a stronger inflow of money transfers (up 9.3 per cent in the first seven months of 2019). Exports and capital investments both grew in the first half of 2019, albeit at somewhat lower rates than those seen in 2018. Preliminary indicators of economic activity point to further growth acceleration in July and August. Fiscal balances continued to improve. Improved tax compliance supported a steep increase in tax revenues in 2019, with accrued tax revenues and state duties rising by 21.3 per cent year on year in the first eight months of 2019, bringing the fiscal balance to a surplus of 1.5 per cent of forecasted 2019 GDP in the same period. Inflation declined from 2.5 per cent in 2018 to 1.6 per cent in the first nine months of 2019 (0.5 per cent in September), affected by the contractionary fiscal policy and deflationary pressures stemming from the external sector. This prompted the Central Bank of Armenia to lower its refinancing rate twice consecutively, from 6 per cent in January 2019 to 5.5 per cent in September 2019, bringing the policy rate to its lowest level since the beginning of 2010. The mining and quarrying sectors, the largest contributors to exports, are expected to boost overall GDP in the second half of 2019 due to the base effect from the strong output contraction in the second half of 2018. Armenia’s GDP is expected to grow by 6.0 per cent in 2019 and by 5.0 per cent in 2020.

Azerbaijan

The economic recovery that began in 2018 continues in 2019. GDP growth accelerated from 1.4 per cent in 2018 to 2.4 per cent year on year in the first eight months of 2019, supported by the strengthening of sectors other than hydrocarbons. The non-oil and gas areas of the economy grew by 3.0 per cent year on year in the

**Eastern Europe and the Caucasus**

Economic growth in eastern Europe and the Caucasus (EEC) averaged 3.0 per cent in the first half of 2019, on a par with the previous year, albeit with significant variation across the region. Private consumption continued to be the core driver of growth, supported by rising real disposable incomes that have been converging to the pre-crisis level. Thanks to improved management of public finance, fiscal deficits remained at bay and public-debt levels continued to decline. A benign inflation environment and stable exchange rates in most countries enabled the start of a loosening cycle of monetary policy (with the exceptions of Georgia and Moldova). Economic growth in the EEC region is projected to stabilise at 2.9 per cent in both 2019 and 2020.
same period, up from 1.9 per cent in 2018. Indicators of output growth in non-oil and gas industries, agriculture and services are all positive so far in 2019. The current account remains in surplus, though the trend of its widening halted in the first half of 2019 due to weak exports of services and to near-stagnation in the oil and gas-sector balance. Credit activity is also recovering and inflation was low at 2.6 per cent year on year in the period January-September 2019, allowing the central bank to cut the policy rate by 200 basis points from January to October. However, the percentage of overdue loans and the level of dollarisation in the economy remain significant, constraining credit activity and the effectiveness of monetary policy. GDP is likely to expand by 2.8 per cent in 2019 and by 2.4 per cent in 2020. The economy’s resilience to external shocks is supported by significant liquidity buffers, as the combined official foreign exchange reserves of the Central Bank of Azerbaijan and assets of the State Oil Fund of Azerbaijan are approximately equal to the country’s GDP.

Belarus

The GDP growth rate decelerated to an estimated 0.9 per cent year on year in the first half of 2019. Disruptions in the supply of oil from Russia to Belarusian refineries in the second quarter of 2019 caused stagnation in the manufacturing sector and negatively affected the volume of exports. The growth of private consumption slowed but remains solid at close to 6 per cent year on year, driven by the continued robust growth of disposable income (up by 7 per cent in the same period). The current account deficit increased slightly in the first half of 2019 but remained relatively low at around 1.3 per cent of the estimated annualised GDP. The trade balance surplus shrank as a consequence of a deepening deficit in the goods balance that was only partially offset by a rising surplus in the balance of services. Substantial improvements in debt finance inflows contributed to an increase in international reserves during 2019 by US$ 1.7 billion to US$ 8.8 billion as of 1 October 2019, but coverage remains relatively low at just 2.6 months of imports. These developments led to a broadly stable exchange rate in the first nine months of the year. Inflation fell below 5 per cent in 2018 for the first time since independence but has since risen to 5.3 per cent in September 2019 on the back of increases in regulated prices and tariffs. Economic growth is expected to slow to 1.3 per cent in 2019 and 1.2 per cent in 2020, but the growth outlook depends on the prospects for Belarus to receive compensation for the new taxation system being introduced by Russia, known as the “tax manoeuvre”, the implications of which remain unclear.

Georgia

GDP grew by an estimated 4.7 per cent year on year in the first half of 2019. Inflows of money transfers are growing for the fourth consecutive year and credit growth remains robust, supporting private consumption. Exports of goods (in nominal US dollar terms) increased by 12.4 per cent year on year in the first eight months of 2019. The tourism sector remains strong despite the Russian ban, in force since July 2019, on direct flights to and from Georgia. The overall number of international visitors increased by 5.9 per cent in the first nine months of 2019, compared with a rise of 11.1 per cent in 2018. However, these events, coupled with domestic political uncertainties, have increased pressure on the domestic currency. The Georgian lari depreciated by 9.4 per cent in the period January to September 2019. Inflation has increased from 2.6 per cent in 2018 to 6.4 per cent in September 2019 on the back of the currency depreciation and an increase in excise taxes earlier in the year. This prompted the National Bank of Georgia to intervene on the foreign exchange market, and it has raised the monetary policy rate by 200 basis points, reaching 8.5 per cent in October. Official international reserves increased by 9.5 per cent
relative to the beginning of the year and stood at US$ 3.6 billion in September 2019, providing around four months of import coverage. The Georgian economy is forecast to grow by 4.5 per cent in both 2019 and 2020.

**Moldova**

GDP growth accelerated from 4.0 per cent in 2018 to 5.2 per cent year on year in the first half of 2019. The broad-based growth on the production side was led by construction, while agriculture was the only major sector with negative dynamics. Fixed capital investments, growing at 20.3 per cent, remained the main driver to economic growth on the expenditure side. Meanwhile, the growth of household consumption decelerated to just 1.8 per cent year on year. Strengthening growth of exports and weakening growth of imports have reduced the negative contribution of net exports to GDP growth. Nevertheless, the current account deficit has widened amid a slight increase in the trade deficit, an improving primary income surplus and a declining surplus of secondary income. A large part of the deficit has been financed by increased FDI inflows and, to a lesser extent, by debt financing. Official reserve assets remained almost unchanged at US$ 2.9 billion as of September 2019, providing more than five months of imports coverage. Annual inflation slowed to 0.9 per cent in December 2018, but then accelerated to 6.3 per cent in September 2019, driven by rising regulated prices and imported-food prices. This development prompted the National Bank of Moldova to react by raising the main policy rate twice, in June and July, from 6.5 to 7.5 per cent. IMF support remains crucial for anchoring the macroeconomic stability of Moldova. After disagreements between the IMF and the previous government, staff-level agreement on the fourth and fifth reviews of the current programme was reached in July 2019, subsequently resulting in the allocation of a new US$ 46.1 million tranche. Moldova’s economy is forecast to grow by 3.8 per cent in 2019 and 4.0 per cent in 2020.

**Ukraine**

Economic growth remained resilient, despite the risks coming from the twin election cycle. After gaining momentum in 2018, Ukraine’s real GDP growth accelerated from 3.3 per cent in 2018 to 3.6 per cent year on year in the first half of 2019. The economy continued to benefit from robust private consumption, which grew at 11.3 per cent on the back of strong real growth of disposable income. Fixed capital formation increased by 12.0 per cent year on year in the first half of 2019, driven by the booming construction sector. Meanwhile, real export growth is up by 5.6 per cent and imports by 7.8 per cent year on year in the same period. This has led to a widening trade deficit, but the current account remains stable, helped by substantial increases in services and primary income surpluses. Significant private capital inflows on the domestic government securities market led to a 15.0 per cent appreciation of the local currency (relative to the US dollar) in the period January to September 2019. The abundance of foreign portfolio capital inflows helped to increase Ukraine’s official reserve assets to US$ 21.4 billion as of 1 October 2019, covering 3.5 months of imports, despite large debt repayments in the same period. Inflation slowed to 7.5 per cent in September 2019 but remains above the 5 per cent target of the National Bank of Ukraine. The key policy rate has come down from 18.0 per cent in April to 15.5 per cent in October. Bearing in mind the large public sector foreign exchange debt repayments that will fall due in the next two years, the new IMF reform-oriented programme is crucially important for anchoring investors’ expectations and supporting macroeconomic stability. Ukraine’s economic growth is forecast to stay at 3.3 per cent in 2019 and slightly accelerate to 3.5 per cent in 2020.
Turkey

The Turkish economy exited recession at the beginning of 2019, as the policy tightening that had ushered in a recession during the second half of 2018 gave way to stimulus in the period before the municipal elections. Leading indicators suggest that some of this momentum has subsequently been sustained.

At the same time, there has been a significant improvement in macroeconomic stability. The current account evolved from a deficit of 6.5 per cent of GDP in mid-2018 to record a small surplus by mid-2019, largely driven by import compression linked to the sharp slowdown in the economy. This adjustment, combined with a supportive global backdrop as central banks in advanced economies moved into easing mode, and the failure of several geopolitical concerns to materialise, helped bring some stability to the lira.

The stabilisation of the lira, combined with high real policy rates and the impact of base effects, have resulted in a sharp decline in inflation in recent months. A substantial rate hike and consequent sharp slowing of the economy helped bring down inflation from its 15-year high of 25 per cent in October 2018 to single-digit levels in September 2019. The central bank has cut rates significantly, by a total of 1,000 basis points since August, but it needs to moderate the pace of future rate cuts in order to avoid a resurgence of inflation.

The municipal elections saw a significant loosening of fiscal policy, and the recent release of the latest New Economic Programme has relaxed deficit targets for 2019 and 2020, now foreseeing a budget deficit of 2.9 per cent of GDP in both 2019 and 2020, significantly higher than the previously forecast 1.8 per cent. Although public finances are robust, with a low public debt of around 30 per cent of GDP, the long-term impact of growing contingent liabilities in the form of revenue guarantees to public-private partnership projects and credit guarantees under the Credit Guarantee Fund is unknown.

The risk of a banking crisis has eased with the stabilisation of the lira. Bank capitalisation is adequate, helped by capital-raising exercises conducted by several banks. However, asset-quality issues are holding back private banks from lending, despite several government schemes that seek to restart the credit cycle in order to boost growth. In response to this problem, the banking regulator recently introduced measures requiring banks to recognise problem assets that will increase the ratio of non-performing loans to around 6.3 per cent. But a more wide-ranging response is needed to deal with the issue.

Despite some stabilisation in recent months, the economic situation remains fragile. The response to Turkey’s recent incursion into Syria serves as a reminder that geopolitical tensions are never far from the surface. With reserves remaining low and external financing requirements still high, despite the current-account rebalancing, such tensions can have a significant impact on the economy. Recovery from the ongoing slowdown is likely to be gradual. A contraction of around 0.2 per cent is expected in 2019 and the economy should return to a growth rate of 2.5 per cent in 2020, although given the unpredictable domestic and geopolitical environment, significant uncertainty remains around this forecast.

Russia

The Russian economy grew by 0.7 per cent year on year during the first half of 2019, following growth of 2.3 per cent in 2018. Household consumption continued to drive growth but was subdued on account of stagnant real wages and a 2 percentage point increase in VAT introduced in January 2019. Weaker external demand, lower oil prices and a stronger rouble since the start of the year have negatively affected net exports, while
sanctions and continued tight fiscal policy have constrained public and private investment.

Tight economic policies that helped secure macroeconomic stability have recently turned more neutral, in recognition of their negative impact on growth. The authorities continue to follow the fiscal rule adopted in 2017, which mandates the transfer of oil revenues in excess of a US$ 40 per barrel threshold to the National Wealth Fund, but recently the rule was relaxed to allow a 0.5 per cent deficit at this threshold. There will soon be scope to start investing part of the National Wealth Fund, although how this can be done without sparking inflation remains subject to debate.

Monetary policy has also turned more neutral in recent months. The inflationary impact of a 2 percentage point VAT increase introduced in January 2019 was more modest than expected, and inflation has been declining from a peak of 5.3 per cent in March 2019 as a result of falling real household incomes and a stronger rouble. Declining inflation and weaker-than-expected output has led the central bank to cut its policy rate three times by a total of 75 basis points since June 2019.

The banking sector remains a source of risk for the economy. While the system-wide capital adequacy ratio is stable at around 12 per cent, asset quality remains a problem, with the non-performing loan ratio standing at 10.4 per cent in March 2019. The fast growth of unsecured household credit has raised concerns and the Central Bank of the Russian Federation has introduced macro-prudential measures to address this. In the past year, the government has continued the process of banking sector consolidation, with more than 500 banks having been closed down since 2013. However, this has led to an increasing concentration of the banking sector in state hands, with over 70 per cent of bank assets now owned by state-owned or state-controlled banks.

The growth outlook is expected to improve slightly, starting with the second half of 2019, thanks to more supportive monetary policy and the implementation of the 13 national projects. However, private investment is likely to remain weak, given the continuing negative impact of sanctions imposed by the European Union and the United States of America, and exports are likely to be held back by the weaker global trade environment. A growth rate of 1.1 per cent is expected for 2019, followed by 1.7 per cent in 2020. Key risks to the outlook include the possibility of more severe sanctions and a sharp fall in oil prices, which would lead to currency depreciation, impacting the already weak asset quality of the banking sector.

Central Asia

Economic growth in Central Asia accelerated slightly in the first nine months of 2019. Uzbekistan leads the region in corporate credit growth, investment and export expansion, but trade performance improved in all countries, except Kazakhstan, where exports temporarily declined due to repair works in major oilfields. Remittances from Russia contracted by 2 per cent in the first half of 2019, mostly to the Kyrgyz Republic and Tajikistan. This did not significantly affect domestic demand, thanks to increased consumer lending. Exchange rate depreciations have been limited in most countries, partly due to central bank interventions. A lack of diversification, governance issues and weak banking sectors are key vulnerabilities that continue to constrain growth throughout Central Asia. Barring major adverse developments, the region as a whole is forecast to expand on average by 4.9 per cent in 2019 and 4.7 per cent in 2020.
Kazakhstan

Real GDP growth accelerated slightly to 4.3 per cent year on year in the first nine months of 2019, from 4.1 per cent in the same period of 2018, enabled by expansions in construction, trade and transport. Gains in oil production moderated due to planned repair works at the Kashagan oilfield. Coupled with lower oil prices, this has led to a decline in exports in the first eight months of 2019. Fixed investment increased by 9.7 per cent in the first nine months of 2019, partly related to the construction of the Saryarka gas pipeline. Rising real wages, fuelled by increases in minimum wages and public sector salaries, continue to support private consumption and increased imports. Despite market pressures, the depreciation of the exchange rate in the first three quarters of 2019 has been limited. Rising inflationary pressures prompted the central bank to increase the base rate by 25 basis points to 9.25 per cent in September 2019. Inflation reached 5.5 per cent in October 2019. Credit growth remains slow (up 15 per cent year on year in September 2019). Annual inflation nevertheless remained low in September 2019 at 2.3 per cent, significantly below the target band of 5-7 per cent. The low inflationary environment prompted the central bank to cut the policy rate twice in 2019, by 25 basis points each time – in February and May – to 4.50 per cent and 4.25 per cent, respectively. The exchange rate remained stable in nominal terms in 2018 and 2019 but continued to appreciate in real effective terms. GDP growth is expected to reach 3.9 per cent in 2019, driven by increased gold production. In 2020, economic growth is projected to ease to 3.7 per cent due to slower gains in mining. Public investment and private consumption are expected to support growth in the short term.

Kyrgyz Republic

GDP growth reached 6.1 per cent year on year in the first three quarters of 2019, significantly up from 3.5 per cent in 2018, reflecting strong gains in mining and manufacturing and the low base effect. Excluding the Kumtor gold mine, GDP growth in the first three quarters of 2019 was 3.2 per cent year on year, slightly higher compared with same period of 2018, when the economy grew by 2.8 per cent. Growth was supported by an acceleration in fixed investment growth (6.8 per cent in the first three quarters of 2019 from 0.8 per cent a year earlier). Exports increased by 11 per cent in US dollar terms in the first eight months of 2019, mainly due to higher levels of gold shipments, while imports declined by 9 per cent and remittance inflows weakened by 12 per cent year on year. Credit continued to expand at a high pace (up 15 per cent year on year in September 2019). Annual inflation nevertheless remained low in September 2019 at 2.3 per cent, significantly below the target band of 5-7 per cent. The low inflationary environment prompted the central bank to cut the policy rate twice in 2019, by 25 basis points each time – in February and May – to 4.50 per cent and 4.25 per cent, respectively. The exchange rate remained stable in nominal terms in 2018 and 2019 but continued to appreciate in real effective terms. GDP growth is expected to reach 4.3 per cent in 2019, driven by increased gold production. In 2020, economic growth is projected to ease to 3.7 per cent due to slower gains in mining. Public investment and private consumption are expected to support growth in the short term.

Mongolia

Strong growth rates are continuing in Mongolia, with the economy growing 7.3 per cent year on year in the first half of 2019 as compared to 6.9 per cent in the first half of 2018. Growth was enabled by increases in exports (primarily coal) and fixed investment. Propelled by rapid growth of credit, private consumption continued to rise in the first half of 2019. Inflation accelerated to 9 per cent in September 2019, above the central bank’s 8.0 per cent target, reflecting growing domestic demand and higher food prices. The central bank has maintained its policy rate at 11.0 per cent since November 2018. Exchange rate pressures eased in the first half of 2019 on the back of a
narrowing current account as the growth of exports outpaced that of imports. This, coupled with central bank interventions, has stabilised the exchange rate. Gross international reserves continued to rise and reached US$ 3.2 billion in June 2019 (including a US$ 2.2 billion currency swap with China). On the fiscal side, the overall balance was in surplus in 2018 and in the first half of 2019 (compared with a deficit of 3.8 per cent of GDP in 2017). This was achieved by improved economic performance and fiscal adjustment policies. Public debt decreased to 73.3 per cent of GDP in 2018 from 84.6 per cent in 2017, according to the IMF. The IMF programme, initiated in early 2017, has been suspended since December 2018 partly due to delays in financial sector reforms relating to the capitalisation of banks. Following the asset quality review, five banks raised most of their required capital but a forensic review was launched in July 2019 to ensure that the additional capital contributed by shareholders is derived from legitimate sources. GDP growth is projected at 6.8 per cent in 2019 and 5.4 per cent in 2020 on the back of sustained domestic demand and further FDI in the underground expansion of the Oyu Tolgoi mine. Mineral exports will support growth in the short term, but their contribution will diminish in 2020, as China’s growth is expected to moderate.

**Tajikistan**

In the first half of 2019, officially reported real GDP growth was 7.5 per cent year on year, following 7.3 per cent growth in 2018. Growth was driven by gains in services and industry. This led to an increase in exports (8 per cent year on year in US dollar terms), particularly of metals and precious stones. Remittances declined by 4 per cent year on year in US dollar terms in the first half of 2019, constraining private consumption. Fixed investment contracted by 8.6 per cent in the same period, mainly due to lower public investment in the energy sector, which also contributed to a slowdown in import growth. As the growth of exports exceeded that of imports, the current account deficit narrowed slightly in the first half of 2019 to 3.1 per cent of GDP from 5.0 per cent of GDP in 2018. Credit growth began to pick up in 2019, reaching 7 per cent year on year in September 2019 (versus a contraction of 7 per cent a year ago). This trend, along with rising food prices, has led to acceleration of inflation, which neared the upper bound of the central bank’s targeted inflation corridor of 5-9 per cent in August. Nevertheless, the central bank reduced its refinancing rate to 13.25 per cent in June 2019 from the 14.75 per cent set in February 2019, with the expectation that inflationary pressures would subside in the second half of 2019. In August 2019, exchange rate pressures prompted the central bank to devalue the currency by 2.7 per cent, bringing the official exchange rate closer to the unofficial rate. The second unit of six units of the Rogun hydropower plant was put into operation in September 2019. However, there are challenges with the full implementation of the project, primarily related to financing. While Tajikistan used proceeds from the sale of Eurobonds to finance the initial stages of the project, further funding options remain unclear given the constrained fiscal space and weak investment climate. The economy continues to face structural challenges stemming from solvency and liquidity issues in the banking sector, as well as a significant debt overhang, which will drag down future growth. GDP growth is projected to be 7.0 per cent in 2019 and 6.3 per cent in 2020.

**Turkmenistan**

Officially reported GDP expanded by 6.3 per cent year on year in the first three quarters of 2019, following the 6.2 per cent growth reported in 2018. This was enabled by an acceleration of growth in industry (6.9 per cent versus 4.6 per cent a year earlier). Exports are reported to have risen by 7.5 per cent year on year in the first three quarters of 2019, helped by a resumption of gas
exports to Russia. Imports continued to contract (5 per cent year on year) in the same period due to import substitution policies and foreign currency restrictions. The parallel market exchange rate stayed at around 17 to 19 manat per US dollar in the first three quarters of 2019 (well above the official rate of 3.5 manat), with pressures easing since the beginning of the year. Inflation remains elevated due to high import prices and the termination of social transfers for electricity, gas and water in January 2019. GDP growth is projected at 6.3 per cent in 2019, slightly decelerating to 6.0 per cent in 2020, but external imbalances are likely to continue in the absence of exchange rate adjustment. Turkmenistan is particularly vulnerable to any slowdown in China and Russia, effectively its only export markets.

Uzbekistan

The economy continued growing steadily in the first three quarters of 2019 at 5.7 per cent year on year on the back of strong performance in industry and construction. Exports increased by 45 per cent year on year in US dollar terms in the first eight months of 2019, and imports by 33 per cent, reflecting trade liberalisation policies. Credit expansion remains high at 60.4 per cent year on year in August 2019, supporting the growth of infrastructure investment and surging imports. Average inflation decelerated to 14.1 per cent in the first three quarters months of 2019 from 18.2 per cent during the same period in 2018. This stems mostly from slower growth in food prices, which has compensated for an increase in services inflation. The central bank has kept the policy rate unchanged at 16.0 per cent since September 2018. As of August 2019, the monetary authorities removed the five per cent limit on daily exchange rate fluctuations, allowing the rate to be determined by the market. In addition, the sale of foreign currency by commercial banks is now allowed for purposes other than business or tourist travel, including in cash form, which was not previously possible. This is part of a wider set of measures to further liberalise the foreign exchange market. As a result, the exchange rate depreciated by around 12 per cent relative to the beginning of the year. GDP is expected to grow by 5.5 per cent in 2019 and 5.8 per cent in 2020 due to sustained growth in investment, both domestic and foreign, helped by rapid credit expansion.

Southern and eastern Mediterranean

In the southern and eastern Mediterranean (SEMED) region, the average real GDP growth forecast was revised downwards in 2019 to 4.4 per cent, around the same level seen in 2018, owing to domestic and regional political and security uncertainties in Lebanon and Tunisia, the contraction in agriculture in Morocco and delays in the implementation of reforms in Jordan. Growth will be driven by the robust performance in Egypt and by a strong tourism sector across the region. Economic activity in SEMED is expected to grow modestly in 2020 by 4.8 per cent, supported by the recovery in the traditional drivers of growth, higher exports, the implementation of business environment reforms to attract foreign direct investment, and greater political certainty – both domestic and regional. However, in the medium term, growth will continue to be lower than the pre-2011 levels.

Egypt

Real GDP growth continued to increase, reaching its highest level in 11 years (5.6 per cent) in the fiscal year 2018-19, mainly driven by higher net exports and investments. Tourism revenues recorded historically high levels thanks to the successful implementation of the tourism reform programme (see Box 4). This sector, together with the gas, trade and construction sectors were the main contributors to the strong GDP growth. Annual inflation has decreased to its lowest rate in almost seven years – 4.8 per cent in September 2019 – from a record high level of 33.0 per cent in
July 2017, mainly due to currency appreciation and a slowdown in food inflation. In the fiscal year 2019-20, GDP is expected to rise by 5.9 per cent, driven by the continued strengthening of the tourism sector and of exports, by large public construction projects such as the building of the New Administrative Capital, natural gas production from the Zohr field and other new discoveries, the re-engagement of private investors – domestic and foreign – following the recent trend of interest rate cuts, and the continued 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, the erosion of competitiveness due to the recent appreciation of the Egyptian pound, and the negative outlook for the economy on account of the stagnation in the European Union, Egypt’s main trading partner. The risks are partially mitigated by the authorities’ demonstrated commitment to the implementation of structural reforms.

**Jordan**

The pace of economic growth in Jordan was restrained in the first half of 2019, with a sluggish growth rate of 1.9 per cent year on year. Financial services – including insurance, real estate and the business services sector – were the major drivers of growth, followed by the transport, storage and communications, and manufacturing sectors. Tourist arrivals continued to increase for the third consecutive year, but remained at just 75 per cent of the record levels achieved in 2010. Inflation declined from its peak of 5.7 per cent in July 2018 to -0.3 per cent in September 2019. GDP growth is expected to remain subdued in 2019 (2.1 per cent) and 2020 (2.3 per cent), supported by various factors. These include rising domestic and foreign investment, the lower cost of imported energy, increased finance provided to SMEs under various schemes from the Central Bank of Jordan, greater certainty and confidence stemming from the commitments of the London conference in February 2019, and an increase in exports resulting from the re-opening of the border with Iraq. Risks to the outlook include an erosion of real competitiveness stemming from the strengthening of the dinar (in light of the peg to the US dollar), slow progress in implementing reforms, and regional instability. On the upside, significant fiscal and structural reform progress would raise the growth forecast, improving private sector-led growth.

**Lebanon**

In 2018, Lebanon’s GDP grew by a mere 0.2 per cent, mainly driven by private consumption, tourism and exports. The removal of the travel ban to Lebanon in a number of Gulf countries led to an improved performance in the tourism sector, which subsequently benefited private consumption. Furthermore, exports also rose, driven by the opening of land routes with Syria. Meanwhile, domestic and regional political uncertainty continued to negatively affect confidence and hold back growth. Non-resident deposit flows, which finance Lebanon’s twin deficits, reversed in 2019, with a net outflow of 2.4 per cent of GDP in the first eight months, compared to a net inflow of 0.4 per cent of GDP in the same period of 2018. Foreign currency reserves also declined to their lowest level in seven years, although they remain high at US$ 30.6 billion in August 2019, covering more than nine months of imports. Inflation moderated to 1.2 per cent in August 2019, down from a peak of 7.6 per cent in June 2018, due to an easing in food-price inflation. The economy is expected to remain in stagnation during 2019, before falling into negative territory in 2020. However, the outlook remains uncertain, with significant downward risks, given the political instability and recent social uprisings, which are undermining the timely implementation of crucial fiscal, energy and structural reforms.
Morocco

In Morocco, economic growth slowed in the first half of 2019 to 2.6 per cent year on year, driven by a 3 per cent contraction in the agricultural sector due to poor rainfall. This was balanced by strong growth of 3.5 per cent in non-agricultural activities. Inflation remained low at 0.3 per cent in September 2019, due to lower prices of food, oil and lubricants, with average inflation in the first nine months of the year standing at only 0.2 per cent. GDP growth is expected to reach 2.7 per cent in 2019, improving gradually to 3.3 per cent in 2020. The increase in 2020 is expected to be driven by stronger non-agricultural growth – particularly in the mining, automotive and aeronautical industries – a rebound in agriculture, continued recovery of tourist arrivals, an improvement in fiscal management and an increase in foreign direct investment. Downside risks include falling growth in Europe, lower commodity prices, rising social discontent and the vulnerability of agricultural production to weather and price developments.

Tunisia

The economy grew at a slower pace in the first half of 2019, achieving 1.2 per cent growth year on year. The slowdown was driven mainly by the fall in manufacturing industries and the decline in extraction industries, despite the expansion in commercial services – mainly in tourism, communication and financial services – and agriculture. Inflation has slowed, but remained high in September 2019 at 6.7 per cent, compared with a peak of 7.7 per cent in June 2018. Food and tobacco prices remain the main drivers of inflation, while the appreciation of the Tunisian dinar and monetary tightening by the Central Bank of Tunisia helped keep inflationary pressures in check. For 2019 as a whole, growth is expected to slow to 1.5 per cent because of a delay in the implementation of structural reforms, notably due to uncertainty in the run-up to the presidential and parliamentary elections in September and October 2019, respectively. In 2020, we expect a recovery in foreign investors’ confidence and 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 2.6 per cent. Risks stem from the possibility that socio-economic protests will disrupt production and slow progress on reforms, given the new political structure and falling growth in Europe. Upsides include the improvements in tourism and investment and the restoration of confidence following the successful democratic transition, which should be reflected in an increase in productivity and growth.
**Box 4. Tourism reform programme in Egypt: lessons for the SEMED region**

In SEMED, the tourism sector is particularly important as it is dominated by private investment and, if it achieves its potential, could provide employment and income to a large percentage of the population.

After a sharp decline since the Arab Spring, the tourism sector was among the main sources of growth in SEMED during 2018 and is expected to remain so in 2019 and 2020. Despite the high growth of tourism receipts in SEMED in general, and in Egypt and Tunisia in particular, the sector still seems to be operating below its potential, with an average of 6.8 per cent of GDP in 2018 compared with 7.9 per cent of GDP in 2010.

Recent performance of the tourism sector has been impressive in Egypt, where receipts increased by 27.6 per cent in the financial year 2018-19 to reach a historical record. This was mainly due to the implementation of Egypt’s Tourism Reform Programme (E-TRP), a comprehensive programme by the Ministry of Tourism. The country gained the fourth-highest performance improvement in the World Economic Forum’s Travel and Tourism Competitiveness Index 2019, and received a 2019 Global Champion Award from the World Travel and Tourism Council for promoting resilience in the tourism sector.

The E-TRP is built around five pillars:

**Institutional reforms** to modernise the Ministry’s organisational structure; improve the skillset of the workforce; strengthen strategic partnerships with international institutions to work towards achieving the UN Sustainable Development Goals; and improve the measurement of tourism’s contribution to the national economy.

**Legislative reforms** to ensure inclusive representation of the private tourism sector in federations and chambers to help guarantee the implementation of the legislative reform process.

**Promotion and marketing** to highlight Egypt’s contemporary dimension using competitive promotion and marketing tools consistent with international trends and increase the sector’s resilience by tapping new markets. It also aims to modernise the Ministry’s presence at international travel exhibitions.

**Infrastructure and tourism development** projects to raise investment in 67 tourist areas and to implement a strategy for sustainable tourism development until 2030, aiming at diversifying Egypt’s tourism, increasing the number of tourist nights, and creating direct and indirect employment with better community integration. The E-TRP also updates hotel classification criteria to international standards, in collaboration with the World Tourism Organization, and improves the international health and food-safety standards of hotels. Lastly, it establishes a private equity fund aimed at restructuring financially impaired hotels and other tourist establishments.

**A global tourism-trends programme** focused on branding Egypt as a destination with recognised environmental and social sensitivities that is able to meet future demand for green tourism products. The programme promotes the economic empowerment of women by increasing their participation in the tourism sector, and encourages innovative and digital solutions to enhance the sector’s competitiveness.

Other SEMED economies also have strong tourism potential, and lessons from the E-TRP can therefore be replicated throughout the region, helping to generate important gains in income and employment.
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About this report

The *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, see the EBRD’s country strategies and updates, as well as the *Transition Report 2019-20*, which are all available on the Bank’s website at www.ebrd.com.

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