

# Regional Economic Prospects in EBRD Countries of Operations: May 2015<sup>1</sup>

## **In the Cross-currents of Diverging Monetary Policies and Russia's Recession**

*Outlook is improving for Central and South Eastern Europe but remains challenging further East*

*The 2015 outlook for the EBRD region has remained broadly unchanged since our last forecast in January<sup>2</sup> and we still expect overall stagnation, with however increasingly diverging sub-regional trends. Growth in 2015 is expected to reach almost 3 per cent in Central Europe and the Baltics (CEB) and also improve in South-Eastern Europe (SEE) thanks to the European Central Bank (ECB)'s quantitative easing programme. This more positive financial environment has added to the earlier lift from declining oil prices. The outlook is also slightly brighter for countries in the southern and eastern Mediterranean region (SEMED) on the back of terms of trade gains linked to the lower oil price, some reforms and improving confidence in the region's largest economy, Egypt. We expect Turkey to grow by 3 per cent, the same level as last year, as the positive impact of lower oil prices is being offset by lower external demand and less space for monetary policy rate cuts.*

*At the same time, deep recession in the Russian economy, which we now project to contract by 4.5 per cent in 2015, is having larger-than expected negative spill-over effects on countries that have strong economic links with Russia. While the Minsk 2 accord relating to the Ukraine/Russia conflict so far has held, the recession in Ukraine will likely be deeper than projected in January, with some spill-overs to smaller neighbouring countries.*

*The overall outlook should improve in 2016 as average growth turns positive, though still at a meagre 1.4 per cent. The ECB's QE will continue to deliver benefits to central and southern-eastern Europe. However, tightening monetary conditions in the US, now expected for early next year, will likely put increasing pressure on emerging markets that are dependent on capital inflows and have high dollar denominated refinancing needs. In particular, Turkey can be caught in the cross currents of diverging monetary policies as its competitiveness with the Eurozone will be squeezed while its borrowing costs and pressures for capital outflows will increase as US*

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<sup>1</sup> This document is prepared by the Office of the Chief Economist and Vice-Presidency for Policy and Partnerships. It is provided as a companion to the EBRD's growth forecasts for its countries of operations, which are released three times a year. For more comprehensive coverage of economic policies and structural changes, the reader is referred to country strategies and updates, as well as the *Transition Report 2014*, which are all available on the EBRD's website ([www.ebrd.com](http://www.ebrd.com)).

<sup>2</sup> The GDP weights used to calculate the regional weighted average growth rate have been updated with the latest nominal GDP data. The January forecast for average growth in 2015 is -0.1 per cent using new weights, compared with -0.3 per cent published in January (based on old weights).

*monetary policy tightens. Russia's recession is expected to ease to -1.8 per cent as oil prices stabilise in the region of US\$ 60 per barrel and prudent macroeconomic shock management continues, but with deep-rooted structural issues likely to remain unsolved.*

*The balance of risks in the forecast has improved somewhat, but is still tilted towards the downside. In particular, the Eurozone's prospects could be dented by higher volatility in case of a more adverse Greek scenario, and a stronger-than-expected impact of the tightening of US monetary policy could result in steeper rises in borrowing costs and larger capital outflows. On the more positive side, geopolitical risks related to Ukraine/Russia remain contained though at a high level; and a faster Eurozone recovery would deliver a larger boost to growth in CESEE.*

**Since January 2015, the outlook for the region as a whole has remained broadly unchanged and will improve somewhat in 2016, but this masks very different sub-regional trends.** The key drivers are (i) the European Central Bank (ECB)'s quantitative easing (QE) programme; (ii) monetary policy tightening in the US, which is now more widely expected to happen around early 2016; (iii) oil price stabilisation at around US\$ 60 per barrel of Brent; and (iv) the still elevated though broadly contained geopolitical risks related to the conflict in Ukraine. Domestic policy factors will play particularly important roles in Ukraine that is undergoing historic if painful reforms, as well as some other neighbouring countries under macroeconomic or financial pressure (Belarus and Moldova primarily).

**Faced with a weak outlook for growth in the eurozone and falling inflation, in late January 2015 the ECB finally announced a QE programme that has positively surprised markets by its large size and open-ended nature.** The programme envisages monthly asset purchases of €60 billion until at least September 2016, targeting, for the first time, public sector debt directly. Following the announcement, stock markets in the eurozone have rallied, the yields on sovereign bonds have declined, in some cases entering negative territory, and the euro has depreciated further against the US dollar. A weaker euro has the potential to boost eurozone's exports while at the same time nudging inflation upwards (due to higher inflation expectations and the pass-through of the euro's depreciation into import prices – the so-called “exchange rate channel”).

**In the wake of the ECB's QE, monetary conditions in countries with close economic links to the eurozone have eased.** The Baltic States, Slovenia, the Slovak Republic (and soon Cyprus, after an important Troika conditionality has now been met) are directly covered by the ECB QE programme, and quite a few other economies in the Central Europe and the Baltics (CEB) and South-eastern Europe (SEE) also use the euro as legal tender or monetary policy anchor. The QE has also enabled countries with flexible exchange rates to ease their monetary policies, other things being equal (Poland, Hungary, Romania, and Serbia).

**Interest rates in many CEB and SEE countries have consequently declined alongside interest rates in the eurozone,** including in flexible exchange rate countries. In addition, most currencies in the region have weakened against the US dollar alongside the euro (Chart 1; see Box 1 for further discussion).

**Weaker currencies (on a trade-weighted basis) and more accommodating monetary conditions should help competitiveness of these economies but can increase debt service in US dollars.** A boost to competitiveness is a particularly welcome development at a time when the contribution of exports to growth has been small or negative in many countries recently. On the other hand, these countries may also see an increase in cost of servicing foreign-currency denominated debts, as their value in euro or national currency terms rises. To mitigate this risk, countries can consider proactive refinancing with moving debt into euros.

**Stock markets in large CEB economies have also started to see significant gains.** For instance, equities in Hungary and Poland have outperformed both the S&P benchmark and emerging markets global benchmark since the start of the ECB quantitative easing programme (Chart 2). This is in contrast with the performance in preceding quarters, when equities in the region generally underperformed relative to other emerging markets.

**While the economic outlook of the eurozone as a whole has improved, Greece, a new country of operations of the EBRD, is still facing high economic uncertainty.** As of May 7, agreement on some core reforms that are a precondition to further international support to Greece are yet to be reached, though recent news indicate more chances of success for at least a temporary deal. Yet nominal public debt, owed now mainly to the international official sector, continues to be seen by markets as very high at over 170 per cent of GDP, even though it is somewhat less onerous in net present value (NPV) terms due to concessional terms such as grace periods and below-market interest rates secured in the context of the international support.

**Brent oil prices have stabilised in the range of US\$ 55-65 per barrel,** having touched lows of US\$ 45-50 in late January 2015. Thus the overall outlook for commodity exporters and importers remains broadly unchanged compared with our January forecast.

**Geopolitical risks related to the conflict in Ukraine have been broadly contained, albeit at a high level, following the signing of the Minsk 2 accord in February.** While the intensity of fighting has decreased, situation in the East of Ukraine remains volatile. The sanctions imposed on the Russian economy by the United States and the EU and the Russian counter-sanctions (ban on selected food imports) remain in place.

### **Recent growth performance**

**Central Europe and the Baltic states (CEB) are starting to benefit from the nascent recovery in the eurozone, and more importantly the ECB's quantitative easing.** The main impact thus far has been through "importing" the QE and firming inflation expectations as evidenced by higher nominal wage growth in Poland and Hungary, for example. In Poland, the region's largest economy, household consumption has been supported by a further fall in the unemployment rate to a level last seen in 2009, accompanied by a rise in real disposable incomes. Domestic demand continues to be the main engine of growth in the subregion though exports have also picked up in some countries (Chart 3). And we have seen sizable growth in public investment ahead of the deadline for disbursement under the previous EU structural funds programme.

**Growth performance in south-eastern Europe (SEE) has been mixed against an improving external environment, reflecting the importance of domestic policy factors.** The final outcome in 2014 of 1.9 per cent growth in SEE (excluding Cyprus and Greece) was slightly better than we expected in January as the region showed considerable resilience to country-specific shocks such as the severe mid-year floods in Bosnia and Herzegovina and Serbia. Looking forward, the SEE region is benefiting from lower commodity prices and the eurozone QE, but domestic factors will constrain growth in Serbia and Bulgaria. Although Cyprus's economy remained in recession in 2014, the pace of decline was much lower than in 2013. Greece recorded positive growth in 2014 after six years of deep recession, but growth turned negative in the last quarter of the year and high-frequency indicators for the first three months of 2015 suggest that the economy is now back in recession amidst great uncertainty about the government's reform programme and related international support and fears of a possible default on sovereign debt payments.

**Growth in the Eastern Europe and Caucasus (EEC) region and Central Asia decelerated considerably towards the end of 2014 and in the first quarter of 2015 mainly due to external shocks.** Lower export demand and remittances from Russia and the decline in consumer and investor confidence weighed on the growth in many economies in the region. Preliminary data points to much weaker economic activity in Ukraine in the first quarter of 2015, against the background of painful but necessary reforms with tightening fiscal and monetary policies, earlier sharp depreciation of the local currency, energy tariff hikes, bank restructuring and continued massive credit contraction. Structural economic bottlenecks, challenges in the financial sector and/or persistent governance issues exacerbate the impact of external shocks in Belarus and Moldova.

**Turkey, a country caught in the cross currents of diverging monetary policies in the eurozone and the US, has seen a moderation of its growth rate to 2.9 per cent in 2014, and we see similar trends going forward.** The positive impact of lower oil prices on growth will likely be offset by continuing weakness in external demand and developments in the euro-dollar exchange rate. The lira weakened against the dollar by 13 per cent in January-April 2015, as expectations of US monetary policy tightening resulted in a reduction in capital inflows that finance Turkey's large and persistent current account deficit (of 5.7 per cent in 2014). But the weakening against the dollar did not lead to significant gains in trade competitiveness, since Turkey's main trading partner is the eurozone, and the lira weakened against the euro at a more moderate rate of 6 per cent, despite a sizeable inflation differential. Consequently, in the first three months of 2015 Turkey's exports contracted by 7 per cent compared with the same period of 2014, while net capital inflows in the first two months averaged US\$ 2.6 billion versus a monthly average of US\$ 3.6 billion in 2014. Diverging monetary policy in the two currency areas will likely continue to add to currency volatility in Turkey, although perceived domestic policy volatility may also play a role.

**Recession in Russia has been deepening, though Russia still has significant reserve buffers to mitigate the recession.** Retail sales and real wages have been declining at a rate of close to 10 per cent year-on-year in recent months. At the same time, pressure on the rouble has subsided as oil prices have edged upwards, the current account is in surplus because of a contraction in imports and geopolitical

tensions appear to have lessened somewhat. Capital outflows continued but at a reduced rate and international reserves reduced at a lower rate. Overall reserves dropped by about 30 per cent from over US\$ 500 billion at the beginning of 2014 to US\$ 353 billion by end-April 2015. As the situation stabilised, the Bank of Russia cut its refinancing rate by a cumulative 450 to basis points to 12.5 per cent, reversing a large part of the massive hikes in December, and it has continued to provide liquidity support to large banks. Fiscal policy is set to loosen appropriately to allow automatic stabilisers to work through accommodating revenue losses, while spending is reallocated towards stability programme priorities and public sector wages are frozen. The fiscal deficit aims to widen to 3.7 per cent of GDP in 2015. However, while budget spending plans have been cautious, actual federal government spending increased by as much as 27 per cent in the first quarter of 2015. This may indicate competing views in the government on the extent of a viable – sustainable financeable - fiscal stimulus.

**Recovery in the South and Eastern Mediterranean (SEMED) has firmed up.**

Growth momentum has been strong in Egypt, which has benefited from policy reforms but also some fiscal loosening, supported by financing from the Gulf Cooperation Council (GCC) and a more stable political environment. In the first half of fiscal year 2014/15, Egypt's growth accelerated to 5.5 per cent from 1.2 per cent a year earlier, driven primarily by higher private consumption and investment. The pace of recovery has been slower in the rest of the region and unemployment rates remain high at levels between 10 and 15 per cent. And the region continues to suffer from extremist attacks originating in Libya and Syria.

**Remittances and capital flows**

**Remittances from Russia to Central Asia and the EEC continued to decline at an alarming rate.** Partial data for the first quarter of 2015 suggest that remittances may now be declining at rates similar to, or higher than, those observed at the height of the crisis in 2009 (Chart 4). This trend is likely to continue in the following three quarters (in year-on-year terms) before moderating as the base effect of sharp depreciation of the rouble is no longer present.

**The decline in remittances reflects not only the weaker rouble but also return of a significant number of migrants to their home countries.** For instance, hundreds of thousands of migrant workers are reported to have returned to Tajikistan and Uzbekistan. Returns may be significant in the Kyrgyz Republic, too (including from Kazakhstan where growth has also slowed following the oil price decline). Migration on this scale poses the significant challenge of how to absorb the returning workers into the domestic economy. In the short term, this requires additional government resources for health care, social protection and law and order, although returning migrants may bring some savings back with them. In medium term, the challenge is to tailor education and skills mix in a way that supports the effective use of labour resources at home. This can become an urgent matter in a geopolitically sensitive region.

**Private capital flows to the transition region remained modest.** CEB and SEE regions saw net capital outflows of around 1 per cent of GDP in 2014 (they continued in the first quarter of 2015, according to very preliminary, partial data). Cross border deleveraging in CESEE continued in the last quarter of 2014. Net private capital

outflows from Russia continued in the first quarter of 2015, albeit at a lower rate (US\$ 33 billion, as compared to US\$ 48 in the first quarter of last year). These outflows to a significant extent reflect repayment of external debt, which declined from US\$ 732 billion in mid-2014 to US\$ 559 billion by 1 April 2015.

### **Currency movements**

**The region's currencies continued weakening against the US dollar.** Currencies in CEB and SEE regions weakened alongside the euro following the launch of QE in the eurozone (by around 10-15 per cent against the US dollar since the start of the year, Chart 1). The weakening of currencies of commodity exporters (Azerbaijan, Russia, and Turkmenistan) reflects pressures emanating from lower commodity export receipts. The exception is Kazakhstan where the exchange rate has remained broadly stable since February 2014. In Russia, the exchange rate has strengthened over the last quarter, following the rapid depreciation over the preceding months. Overall, by end-April the rouble was still around 20 per cent weaker against the policy basket of the US dollar and the euro than in early September 2015.

**Sharply lower remittance inflows from Russia, compounded by weaker export demand and investment inflows, put pressures on the currencies of economies in EEC and Central Asia.** Belarus, Georgia and Moldova experienced the largest depreciations since the start of the year, of around 15 to 25 per cent against the US dollar (and around 5 to 15 per cent in trade-weighted terms). A number of countries in the region, including Armenia, Georgia and Moldova, hiked interest rates and / or intervened extensively in foreign exchange markets to limit currency depreciations.

### **Credit conditions**

**Credit growth has remained subdued in CEB and SEE regions.** The rate at which parent banks are reducing their exposure to these regions appears to have increased again in recent months, and this reduction has not been fully offset by an expansion in the domestic deposit base. Greece continues to face particularly severe credit and liquidity constraints. Corporate bond issuance in the region has been slowly growing (as percentage of GDP) since the 2008-09 crisis, but the overall volumes of bonds outstanding of around 2 per cent of GDP still represent only a small fraction of the stock of corporate bank credit (Chart 5).

**Credit recovery remains constrained by high non-performing loan (NPL) ratios.** NPL levels have recently declined markedly in Kazakhstan (from very high levels) and Romania, following strong policy steps by the regulators. In contrast, in Ukraine NPL levels have been rising rapidly, approaching 30 per cent. NPLs are estimated to be close to or in excess of 40 per cent in Greece and Cyprus, and 20 per cent in many SEE countries, with corporate loan NPLs hitting 30 per cent in many countries.

### **Inflation**

**A decline in oil price of around 40 per cent in year-on-year terms contributed to further disinflation in most commodity importing countries.** In several CEB and SEE countries consumer prices declined over the last 12 months. Low domestic inflation can foster local currency and capital market development, but deflation increases the real debt burden - a particular problem in countries with high corporate

or household debt. In contrast, in Russia inflation accelerated to around 17 per cent year-on-year, owing to a large extent to the pass-through of import prices following the depreciation of the rouble and the impact of self-imposed counter-sanctions banning food imports from sanctioning countries. Similarly, currency depreciations led to a significant acceleration of inflation in Belarus, the Kyrgyz Republic, Tajikistan and Ukraine. In Turkey, despite the fall in oil prices, currency pressures kept inflation elevated, well above the central bank's target for the fourth consecutive year.

## Outlook

**In our baseline scenario, growth in the transition region is expected to average zero in 2015 and to pick up to 1.4 per cent in 2016** (Table 1). The forecast for 2015 has been broadly unchanged compared with January, on account of improved outlook for the CESEE and SEMED regions and worsening outlook in the East. The latter largely reflects Russia's recession and strong negative spillovers to neighbouring countries, as well as a major slowdown in other commodity exporters. Growth in commodity importing countries is expected to accelerate compared with 2014, reaching 2.3 per cent in 2015 and 3.1 per cent in 2016.

- In **CEB**, the economic outlook has strengthened, as QE in the eurozone translates into more accommodating monetary conditions in the region. Growth is expected to average around 3 per cent in 2015 and 2016. Convergence is set to continue in earnest.
- QE in Europe, the weaker euro and lower oil prices are also benefitting the economies in **SEE**. Growth in this region is expected to pick up in 2015 and further in 2016, limited mainly by domestic policy factors - adjustment in Serbia, weaker confidence in Bulgaria, and the legacy of high NPLs region-wide.
- Business confidence in **Greece** has been badly hit by fears that the country may default on its external debt obligations and even exit from the eurozone. Our base case scenario is that Greece "muddles through", avoiding drastic policy moves and with just enough reforms to start growing and securing the continued support of the international community. Further debt relief would be most beneficial to bring debt to sustainable levels (though this is not in our base case). All this should help improve the currently low business confidence and could pave the way for a return to modest growth later this year and in 2016.
- **Ukraine** is experiencing a deep recession, with GDP contracting by 7.5 per cent this year before growth finally returns in 2016. The outlook in **EEC** has generally worsened owing to damaging negative spill-overs from Russia, a deeper recession in Ukraine and increasing geopolitical risk-aversion affecting investor, lender, depositor and consumer confidence. In addition, currency depreciation in the region is exacerbating the risks associated with currency mismatches on corporate and public sector balance sheets. Given the challenging external environment and some domestic political uncertainty,

growth in **Georgia** is expected to decelerate to 2.3 per cent in 2015 and 2.6 per cent in 2016.

- Growth in **Turkey** will remain broadly unchanged at 3 per cent in 2015 and 2016, significantly below the country's long-term potential. The positive effect of lower oil prices is expected to be offset by weaker external demand and limited room to cut interest rates, due to pressures on country risk premium and the exchange rate.
- In **Russia**, output is expected to contract by 4.5 per cent in 2015 and 1.8 per cent in 2016, as consumption and real incomes decline in the face of significantly lower oil prices, which compound deeply rooted structural problems and the effect of economic sanctions. The recession is expected to ease in 2016 because of base-year effects and some targeting stabilisation programme spending with effects materialising mainly next year. It is hard to see a rebound going forward without the reversal of the ongoing-de-coupling of Russia's economy from the rest of the world and major structural reforms.
- Growth in **Central Asia** is expected to decelerate significantly on account of the region's strong economic ties with Russia. In addition, growth prospects in Kazakhstan and Turkmenistan are negatively affected by lower commodity prices.
- Lower oil prices, growth in the US, improved prospects in the eurozone and a number of economic reform measures will continue supporting growth in the **SEMED** region. It is expected to reach 4 per cent in 2015 and improve further to 4.3 per cent in 2016.

**The projections assume continued divergence of monetary policies in advanced markets and a gradual deceleration of growth in emerging market economies.** Monetary policy in the United States is expected to be gradually tightened, although the timing and pace of tightening may be moderated by lower oil prices and thus lower inflationary pressures. The tightening is thus likely to have greater impact on global economic outcomes in 2016. In contrast, monetary conditions in the eurozone and Japan are expected to be accommodating for a longer period of time. Growth in emerging markets, including China, is expected to continue to decelerate gradually, as emerging market income levels converge towards those of advanced economies. Deceleration also reflects lower contribution to growth from commodity-rich emerging markets (the latter account for around a quarter of emerging markets' total GDP globally).

## **Risks to the outlook**

**There are three major risks to this outlook.**

- **First, major volatility from Greece that undermines the "muddling through" scenario and the improving eurozone outlook.** Failure of Greece and its official creditors to reach an agreement could impact consumer and

investor confidence in the eurozone and result in intensified capital outflows from CEB and SEE region and weaker export demand from the eurozone.

- **Second, a larger than-expected impact of tightening of monetary policy in the United States early next year**, resulting in steeper increases in external financing costs and larger capital outflows from emerging markets. Fund flow data compiled by EPFR Global suggest that inflows and outflows of funds are very strongly correlated across emerging markets, including in Europe, as they tend to be driven primarily by the US monetary conditions. The volatility of monthly flows to emerging markets (measured as the average standard deviation of monthly flows to various countries, expressed in per cent of GDP, over a six-month period) spiked upon the initial announcement of forthcoming tapering of quantitative easing in June 2013. Although the tapering was considered to be largely priced in by the markets well before it started, the volatility of emerging market flows spiked again, albeit less dramatically, when the Fed actually started reducing its monthly purchases of assets (Chart 6). This episode suggests that capital flows to emerging markets are likely to become significantly more volatile once interest rates start rising. In addition, a significant further appreciation of the US dollar could substantially raise the burden of servicing foreign currency debt, in particular in Turkey, where corporate foreign currency debt has been expanding rapidly in recent years. At the same time, lower oil prices make faster-than-expected normalisation of monetary policy in the US less likely.
- **Third, high geopolitical risks related to the situation in Ukraine/Russia.** An escalation of the conflict would have significant spill-over effects for the entire region and lead to extension and expansion of the economic sanctions regime. In the extreme scenario, this regional risk can become a global threat.

**Global economic outlook is a source of both downside and upside risks.** A more pronounced deceleration of growth in China, and in emerging markets more generally, is a source of downside risk. At the same time, the recovery in the eurozone could gain a stronger momentum on the back of QE programme, in particular if policy uncertainty surrounding the situation in Greece is materially reduced.

### **Box: QE in the eurozone and its implications for the EBRD countries**

Quantitative easing can work through a variety of channels. In terms of spillovers of QE in the eurozone for countries in the CEB and SEE regions – those with the closest links to the eurozone via trade and financial linkages - similar channels have been at work:

**Exchange rate channel.** Currency depreciation can boost exports and limit demand for imported goods, while higher import prices contribute to higher inflation. As euro acts as legal tender or monetary policy anchor in many countries in CEB and SEE, exchange rates in these countries weakened alongside the euro. The competitiveness boost for these economies will be limited by the fact that the currency of their main trading partner, the euro, also depreciates. However, on a trade-weighted basis, these economies will nonetheless see some gains (vis-à-vis other trading partners).

**Interest rate channel.** QE injects additional liquidity into the markets and raises demand for eligible bonds. This pushes bond prices up and bond yields down. Indeed, interest rates in the eurozone declined following the start of the QE, turning negative in some cases, and bond yields in many CEB and SEE countries also declined. Lower interest rates in the eurozone allow, ceteris paribus, lower interest rates in countries with close ties to the zone. Lower interest rates have the potential to stimulate credit growth to the real economy – this is believed to have been the main channel of transmission of QE in the United States. However, low demand for loans, high levels of non-performing loans and continued withdrawal of cross-border funding by parent banks may limit the effectiveness of this channel in CEB and SEE.

**Portfolio re-balancing channel.** As QE pushes down yields on government bonds, investors engage in “search for yield”, which drives down interest rates in adjacent asset classes (corporate bonds, equity) and regions, benefiting CEB and SEE economies.

**Wealth channel.** As additional liquidity in the markets leads to increase in asset prices, households and companies may respond to the increases in their wealth by raising consumption and investment. As discussed in the main text, stock markets rallied in the both the eurozone and CEB countries following the launch of the QE. However, as stock markets tend to be smaller in CEB and SEE economies, the impact of the wealth effect on economic activity would also be smaller than was the case in the United States.

**Second-round real sector effects.** Provided that QE is effective in stimulating growth in the eurozone, the economies with strong economic ties to the single currency area would also benefit through stronger demand for exports and higher investment flows.

**Balance sheet effect.** Working in the opposite direction is the balance sheet effect. As regional currencies depreciate against the US dollar, the cost of servicing non-euro foreign-currency denominated debt rises and currency mismatch risks for unhedged borrowers increase.

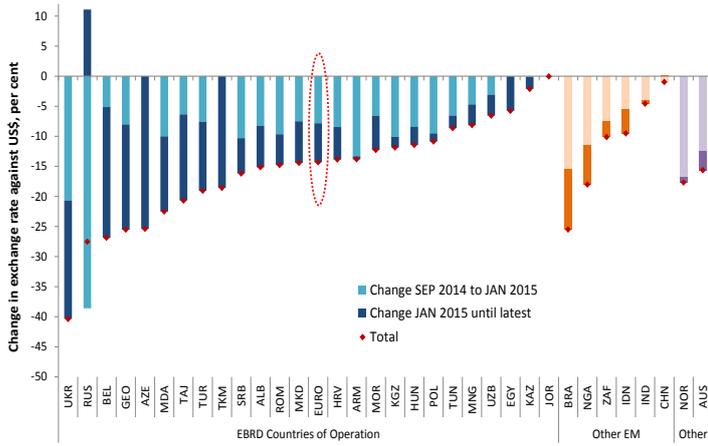
At the same time, prolonged periods of very low interest rates may have negative “unintended consequences.” They reduce incentives to pursue fiscal consolidations and repair balance sheets; they may push asset prices above levels justified by economic fundamentals; and they can also discourage saving and question the viability of business models of insurance companies, pension funds and other financial intermediaries.

**Table 1: Real GDP Growth***(In per cent; EBRD forecasts as of 30 April 2015)*

	Actual		Current forecast		EBRD Forecast in January 2015	
	2014	2015	2016	2015	Change Jan.-April.	
<b>Central Europe and the Baltic states</b>						
Croatia	-0.4	0.5	0.5	0.5	0.0	
Estonia	2.1	2.2	3.0	2.2	0.0	
Hungary	3.6	2.6	2.3	2.4	0.2	
Latvia	2.4	2.3	3.1	3.0	-0.7	
Lithuania	2.9	2.7	3.2	3.2	-0.5	
Poland	3.4	3.4	3.4	3.0	0.4	
Slovak Republic	2.4	2.8	3.3	2.6	0.2	
Slovenia	2.6	2.0	2.3	1.6	0.4	
<b>Average</b> <sup>1,2</sup>	<b>3.0</b>	<b>2.9</b>	<b>3.0</b>	<b>2.6</b>	<b>0.3</b>	
<b>South-eastern Europe</b>						
Albania	1.9	2.5	3.0	2.5	0.0	
Bosnia and Herzegovina	1.3	2.5	3.0	2.7	-0.2	
Bulgaria	1.7	1.0	1.5	0.8	0.2	
Cyprus	-2.3	0.5	1.5	0.7	-0.2	
FYR Macedonia	3.8	3.5	3.7	3.5	0.0	
Greece	0.8	0.0	2.0	...	...	
Kosovo	1.0	2.5	3.5	3.5	-1.0	
Montenegro	1.5	3.0	3.7	3.0	0.0	
Romania	2.8	3.0	3.2	2.8	0.2	
Serbia	-1.8	0.3	1.8	0.5	-0.2	
<b>Average (excl. Cyprus and Greece)</b> <sup>1</sup>	<b>1.9</b>	<b>2.3</b>	<b>2.8</b>	<b>2.2</b>	<b>0.1</b>	
<b>Average (incl. Cyprus and Greece)</b> <sup>1</sup>	<b>1.3</b>	<b>1.3</b>	<b>2.4</b>	...	...	
<b>Eastern Europe and the Caucasus</b>						
Armenia	3.4	-1.5	1.0	0.0	-1.5	
Azerbaijan	2.8	1.5	1.5	1.5	0.0	
Belarus	1.6	-2.5	0.0	-1.5	-1.0	
Georgia	4.8	2.3	2.6	4.2	-1.9	
Moldova	4.6	-2.0	1.5	0.0	-2.0	
Ukraine	-6.8	-7.5	3.0	-5.0	-2.5	
<b>Average</b> <sup>1</sup>	<b>-1.3</b>	<b>-3.3</b>	<b>1.8</b>	<b>-1.8</b>	<b>-1.5</b>	
<b>Turkey</b>	2.9	3.0	3.0	3.0	0.0	
<b>Russia</b>	0.6	-4.5	-1.8	-4.8	0.3	
<b>Central Asia</b>						
Kazakhstan	4.3	1.5	2.0	1.5	0.0	
Kyrgyz Republic	3.6	3.0	3.1	3.2	-0.2	
Mongolia	7.8	4.0	3.0	3.5	0.5	
Tajikistan	6.7	3.8	3.8	4.4	-0.6	
Turkmenistan	10.3	9.5	10.0	9.7	-0.2	
Uzbekistan	8.1	7.0	7.2	7.8	-0.8	
<b>Average</b> <sup>1</sup>	<b>5.9</b>	<b>3.7</b>	<b>4.1</b>	<b>3.9</b>	<b>-0.2</b>	
<b>Southern and Eastern Mediterranean</b>						
Egypt	2.2	4.0	4.2	3.8	0.2	
Jordan	3.1	3.6	3.9	3.7	-0.1	
Morocco	2.1	4.6	5.0	4.6	0.0	
Tunisia	2.3	2.8	3.6	3.0	-0.2	
<b>Average</b> <sup>1,3</sup>	<b>2.2</b>	<b>4.0</b>	<b>4.3</b>	<b>3.9</b>	<b>0.1</b>	
<b>Average EBRD region (excl. Cyprus and Greece)</b> <sup>1</sup>	<b>1.9</b>	<b>0.0</b>	<b>1.4</b>	<b>-0.1</b>	<b>0.1</b>	
<b>Average EBRD region (incl. Cyprus and Greece)</b> <sup>1</sup>	<b>1.9</b>	<b>0.0</b>	<b>1.4</b>	...	...	
<b>Average commodity exporters</b> <sup>4</sup>	1.3	-3.3	-1.0	-3.6	0.3	
<b>Average commodity importers excl. Greece</b>	2.2	2.3	3.1	2.6	-0.3	

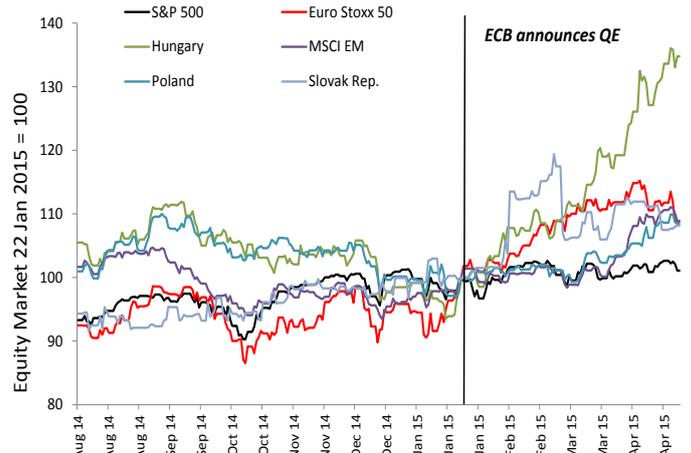
<sup>1</sup> Weighted averages. The weights used are WEO estimates of nominal dollar-GDP for 2014 which have been rebased compared to our last publication.<sup>2</sup> Weighted averages do not include the Czech Republic, for which EBRD no longer produces a forecast.<sup>3</sup> EBRD figures and forecasts for Egypt's real GDP reflect the fiscal year, which runs from July to June. These are also used in the regional averages.<sup>4</sup> Commodity exporters include: Azerbaijan, Russia, Kazakhstan, Mongolia and Turkmenistan.

Chart 1. Exchange rate development since SEP 2014



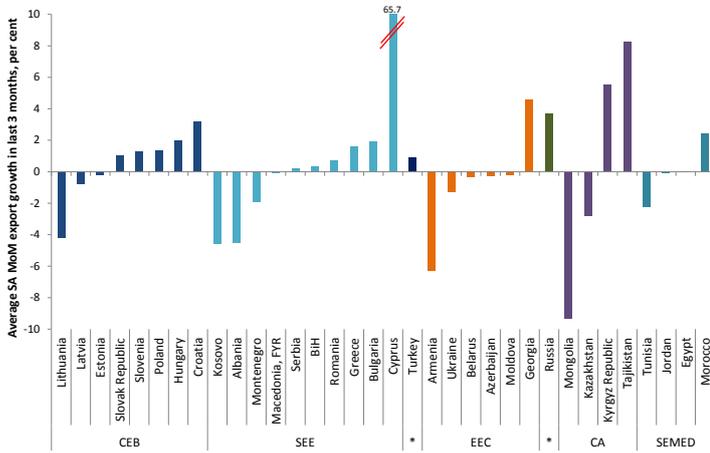
Note: EBRD countries using EURO are Cyprus, Estonia, Greece, Kosovo, Latvia, Lithuania, Montenegro, Slovakia and Slovenia  
Source: Bloomberg

Chart 2. Stock market indices



Source: Bloomberg

Chart 3. Real export growth, per cent



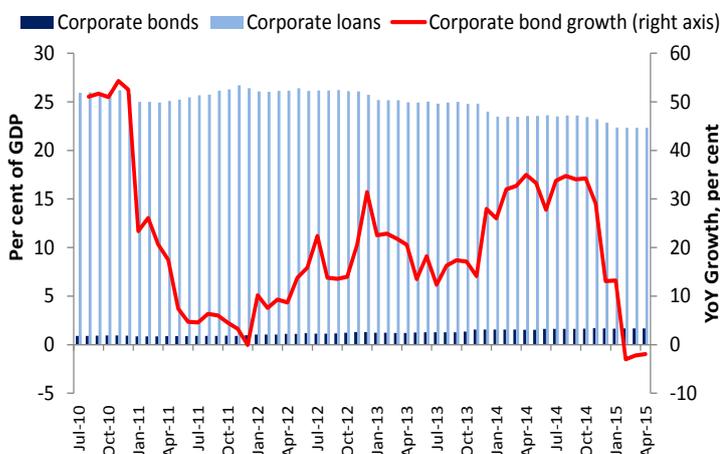
Note: Estimates using export deflators for EU-member countries and producer price based deflators for other countries  
Source: National authorities, Eurostat and IMF via CEIC

Chart 4. Remittances from Russia to EEC and Central Asia



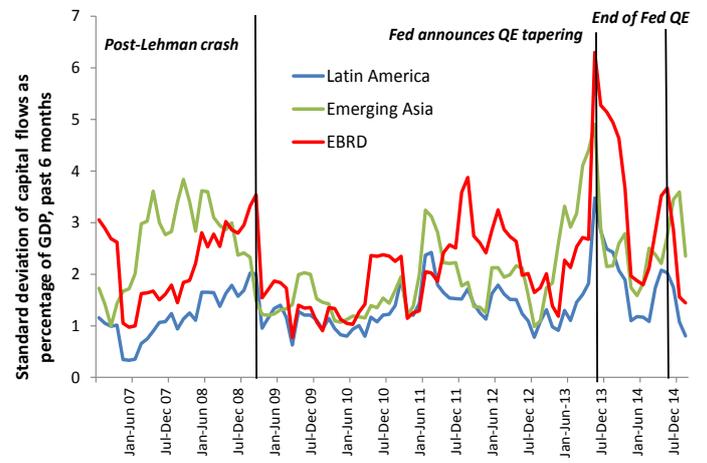
Source: Central Bank of Russia; National sources; EBRD calculations

Chart 5. Corporate bonds and loans in per cent of GDP



Source: National authorities via CEIC; IMF WEO; Bloomberg

Chart 6. Volatility of fund flows



Note: GDP-weighted averages  
Source: EPFR Global and EBRD calculations

## Regional updates

## Central Europe and the Baltic States (CEB)

The CEB region is the group of transition countries most directly benefiting from the further recovery in the eurozone, which will now add to support from lower oil prices. Quantitative easing by the ECB has the potential to moderate funding withdrawals from the foreign-dominated bank systems, though as yet aggregate real credit growth for the region remains near zero. Exports from the region have withstood the contraction in Russia and other CIS economies better than earlier expected. Some economies have seen sizable growth in public investment as disbursement under the previous EU structural funds came to an end. Private investment growth is as yet more tentative, and the now-improved sentiment remains vulnerable to regional tensions. Relative to our January forecast, average growth in the eight countries in 2015 has been upgraded by 0.3 per cent to 2.9 per cent. Average growth is expected to increase slightly in 2016 to 3 per cent.

- Growth in **Poland** doubled last year to 3.4 per cent, and remains well-balanced between investment and consumption. Fixed capital formation saw the first solid growth in three years on the back of an improving financial situation of enterprises and some recovery in corporate lending. Household consumption was supported by a further fall in the unemployment rate to a level last seen in 2009, and rising real disposable incomes. In contrast, the external sector represented a drag on growth throughout most of 2014, though may now provide an additional boost to activity as the eurozone recovers. Industrial production and confidence indicators in the first quarter of the year have been promising, and the central bank is intent on preventing appreciation pressures from undermining competitiveness, and indeed has reduced policy interest rates. Overall, we expect growth of 3.4 per cent both this year and next, a tangible upgrade from earlier this year.
- For **Hungary** we continue to expect a deceleration in growth from the high 3.6 per cent rate achieved last year, to about a still respectable 2.5 per cent on average in each 2015 and 2016. Temporary factors last year, such as the rapid disbursement of EU funds towards the end of their availability, no longer boost growth. Given the long history of weak investment, these rates are still in excess of estimates for trend growth. In 2014 industrial output and export volumes grew markedly (up by 7.1 per cent and 4 per cent, respectively), though there has been a clear deceleration late in the year, and now in the first quarter of 2015. Nevertheless, further gains in employment, and strong real wage growth now underpin growth in domestic consumption. Inflation has remained in negative territory since the third quarter of last year, and has given further room for manoeuvre to the central bank, which has again cut interest rates. In addition, the central bank has expanded the programme of subsidized lending to smaller SMEs. This programme will likely contribute 3 per cent of GDP in funding to the corporate sector.
- After a significant slowdown in 2013, growth in the **Slovak Republic** last year recovered to 2.4 per cent. As in the other economies in the region household consumption, buoyed by real wage growth (up by 2.9 per cent over the year), and a further slight drop in unemployment (to 12.3 per cent in February 2015),

accounted for the largest contribution to growth. This year the depreciation in the euro should boost exports (for which growth had fallen to a five year low of 4.6 per cent last year), and prospects for exports have further brightened with the announcement of capacity expansion in the car industry. The Slovak Republic has not managed to disburse a large share of EU structural funds allocated to the country. Unless paid out to final beneficiaries, funds previously committed by the EU will need to be paid back at end-2015. The government has therefore markedly stepped up its investment programme this year. Against this background, we expect a pickup in growth to 2.8 and 3.3 per cent in 2015 and 2016, respectively.

- The projected 2015 GDP growth rates in **Latvia** and **Lithuania** have been trimmed down to 2.3 and 2.7 per cent, respectively. For **Estonia** the projection remains unchanged at 2.2 per cent in 2015. Next year, all three Baltic economies are expected to see more rapid GDP growth, above 3 per cent in all cases. In 2014, regional tensions weighed on investor confidence and exports. Reflecting the impact of Russia's counter-sanctions, short shelf-life food products, especially unprocessed vegetables and meat products showed a sharp drop in all the economies but in particular in Lithuania. Compared to the same period in early 2014, the value of exports to Russia in the first two months of 2015 dropped by between 30 and 50 per cent in the three countries. Domestic demand continues to be the main engine of growth, supported by improving labour markets and historically low euro area inflation. Last year, investment trends diverged across the Baltic economies, with Lithuania registering growth of 8 per cent, though by contrast a drop of 2.8 per cent was observed in Estonia. The eurozone QE programme, improved credit availability together with the fresh disbursements of the EU structural funds are expected to boost investment expenditures further.
- Driven by both domestic demand and net exports, **Slovenia's** economy grew by 2.6 per cent in 2014, while inflation remained low at 0.2 per cent, on the back of lower food and oil prices. In 2015 and 2016, private consumption is expected to increase, on the back of low inflation, easier monetary stance, and revival of delayed purchases of durable goods, along with an increase in private investments amidst low interest rate environment. Fiscal consolidation and deceleration of EU-funded investments will continue to limit public investments over the same period. Somewhat stronger growth in eurozone, Slovenia's main trading partners, and somewhat higher competitiveness, due to lower labour costs and the weakening of the euro, will result in a continuing positive contribution of net exports to growth. Overall, we expect growth to moderate to 2 per cent in 2015 and edge up to 2.3 per cent in 2016.
- The recession in **Croatia** continued for the sixth year in 2014, with GDP growth estimated at -0.4 per cent, marginally better than expected. Domestic demand remains subdued with investment being the largest negative contribution to growth in 2014. We keep our forecast for 2015 at a timid 0.5 per cent, as Croatia should benefit from reduced oil prices and some improvement in eurozone demand. The necessary fiscal adjustment will most likely be postponed for after the elections due later this year. Owing to the lack of large-scale reforms improving the business environment, strong pressure for

fiscal adjustment under the EU's excessive deficit procedure together with weaker contribution from external factors we expect again only marginal growth in 2016 at 0.5 per cent.

### **South-Eastern Europe (SEE)**

After a difficult 2014, when growth in the SEE region was a mere 1.9 per cent, prospects for 2015 are looking somewhat improved, allowing growth to pick up to 2.3 per cent. The key drivers are the ECB's QE and terms of trade gains from lower commodity prices. Nevertheless the downside risks remain considerable. As of early May it is unclear if or when the impasse between the Greek government and its main creditors will be resolved, though some progress is being reported. Our central scenario is that of a "muddling through," under which a minimum set of reforms are agreed between Greece and its official sector creditors, allowing the latter to roll over their funding. For 2016, we expect growth in SEE to rise further, as the current uncertainties surrounding Greece are reduced, as well as on the back of improved prospects in the eurozone and rising confidence and investment in domestic economies.

#### **Greece**

- As **Greece** became an EBRD country of operations in March 2015, we are providing forecasts for the country for the first time. The situation is highly uncertain as of early May. In 2014, the economy showed positive (seasonally adjusted) quarter-on-quarter growth in each of the first three quarters of the year, contributing to overall growth for the year of 0.8 per cent. However, quarterly growth turned negative in the final quarter of 2014 and high-frequency indicators for the first three months of 2015 suggest that the economy is back in recession. Business confidence has been badly hit by widespread fears that Greece may default on its external debt obligations and perhaps, in an extreme scenario, even exit from the eurozone. Nevertheless, our baseline assumption is that an agreement will be reached between Greece and the lending institutions, helping confidence and stability and could pave the way for a return to modest growth in the second half of the year. Overall, therefore, we expect zero economic growth in Greece in 2015, rising to around 2 per cent in 2016 as Greece starts to benefit from the ECB's QE, investment begins to pick up and consumer confidence strengthens. However, these forecasts would be rendered completely invalid in a negative scenario of missed sovereign debt payments, capital controls, limits on deposit withdrawals and the possible introduction of IOUs ("pseudo euros") or equivalent instruments to pay domestic obligations. In this case, Greece would likely fall back to a major recession, the size and duration of which are difficult to quantify now.

#### **Cyprus**

- The performance of **Cyprus** under its bailout programme, in place since April 2013, continues to be favourable, although the pace of economic recovery remains sluggish. Quarterly growth rates were negative throughout 2014, with

GDP falling by 2.3 per cent for the year as a whole. The high level of NPLs – still close to 50 per cent of total loans – is a major drag on the recovery. However, the banking sector should benefit from the implementation of new foreclosure legislation (passed in April 2015) as it lays the groundwork for large-scale loan restructurings and improves the banks' recovery prospects. It should also help secure the conclusion of the fifth review of the bailout programme, which would allow the country to access the ECB's QE programme. In 2015, Cyprus, which imports all its oil (40 per cent of its trade deficit in goods), also benefits from lower oil prices. But the economy is vulnerable to negative spillovers from the Greek crisis and regional instability in the Middle East, as well as a likely reduction in tourists from Russia (which account for 25 per cent of total tourist arrivals) because of the economic contraction in that country. Overall, therefore, we expect growth this year to be 0.5 per cent, slightly down on our January forecast (0.7 per cent), rising to 1.5 per cent in 2016 as the gradual recovery continues.

### **Bulgaria and Romania**

- Despite difficulties in the banking sector in June 2014, **Bulgaria's** economy grew at 1.7 per cent year-on-year in 2014, driven by domestic demand. Consumption was supported by rising wages and declining inflation, while fiscal deficit came larger than planned at 3.7 per cent of GDP, as a result of banking bailouts and costs of summer floods. In 2015 and 2016, contribution of domestic demand to growth will moderate, partly due to base effect and partly to somewhat higher country risk premium weighing on credit growth and consumption. At the same time, fiscal policy is expected to tighten, while the contribution of net exports will increase on the back of better growth prospects in eurozone, Bulgaria's main trading partner, following the recent weakening of the euro to which the local currency is tied through a currency board arrangement. Overall, we expect growth to moderate to 1.0 per cent in 2015 and remain subdued at 1.5 per cent in 2016, unless structural reforms revive and business environment improves.
- **Romania's** economy grew by 2.8 per cent in 2014, on the back of strong private consumption, boosted by a rise in minimum wage in mid-2014, while contribution of net exports remained low and investments subdued. Recent and prospective interest rate cuts, enabled by inflation falling on the back of energy and food prices, will continue to boost domestic demand in 2015 and 2016. Rising industrial confidence and the deprivation of inventories may lead to a rise in investments after two years of fall. A recent reduction in NPLs following proactive provisioning policies by the central bank – a first in the region - should help the credit supply. Government expenditure is expected to rise in order to absorb more EU funds, as absorption rate still remains the lowest in EU. Overall, these should enable domestic demand to edge up. Somewhat stronger growth in eurozone, albeit still moderate, may push up Romania's net exports in the near term, keeping growth at around 3.0 per cent in 2015 and 3.2 per cent in 2016, among the highest in emerging Europe. Meanwhile, annual average inflation is expected to remain at an average of 0.5 per cent in 2015, on the back of June cuts in VAT on food products, as well as low inflation expectations and lower commodity prices.

## Western Balkans

- **Albania's** macroeconomic performance has improved within the framework of the IMF arrangement. In particular, the gradual clearance of public sector arrears is providing a boost to suppliers, while efforts are being made to tackle the problem of high NPLs in the banking sector, which is among the highest in the sub-region. Monetary policy of the Bank of Albania has continued to be accommodating, with the policy rate cut to a new record low of 2 per cent in January 2015 as inflation remained low and in order to support the weakened economy. However, fiscal space remains limited by the high level of public sector debt, while negative spillovers from Greece – an important trading partner and source of remittances – remain a key risk to growth. The severe floods that hit Albania in February 2015 have also negatively affected the economic outlook. We maintain our January forecast of 2.5 per cent growth in 2015, rising to 3 per cent in 2016 on the back of an improved external environment (in the eurozone), the start of the major construction work on the Trans-Adriatic gas Pipeline (TAP), and expected policy moves to reduce the high level of NPLs.
- **Bosnia and Herzegovina** showed considerable resilience in 2014 in the face of major flooding mid-year in spite of a negative contribution from agriculture and energy production. Some high-frequency indicators (exports, industrial production) turned down in the first months of 2015, but we expect this to be temporary, as the country should benefit from lower oil prices. We have lowered our growth forecast for this year by just 0.2 percentage points to 2.5 per cent. Rebuilding of flood-damaged areas should also be growth-supportive this year and next. The growth rate is forecast to increase to 3 per cent in 2016, with large projects in the transport and energy sectors in the pipeline and a more positive eurozone and regional outlook as the main growth drivers.
- The economy of **FYR Macedonia** continued to grow strongly in 2014 at nearly 4 per cent, the highest in the region by some distance. The construction sector was the largest contributor to growth, with the “Skopje 2014” project being among the most visible manifestation of this. As macroeconomic conditions are stable and production from several high-profile foreign investments remains strong, we have maintained our forecast for 3.5 per cent in 2015, and we expect this to rise to 3.7 per cent in 2016. Downside risks mainly stem from internal political disputes.
- **Kosovo's** growth rate slowed down markedly in 2014 to around 1 per cent as an accident (explosion in the country's largest thermal power producer) temporarily halted electricity output as well as the output of the sector's main supplier, the mining industry. The six-month political stalemate after the general elections also negatively affected economic sentiment last year. Prospects for 2015 are somewhat better as the political uncertainty that dominated most of last year has been resolved, and the new government is in place. Nevertheless, confidence and investment remain subdued, and we have lowered our forecast for growth this year by a percentage point to 2.5 per cent. We expect higher growth to return in 2016 (3.5 per cent) as investment picks up and public sector projects advance.

- In **Montenegro**, growth in 2014 was disappointing at around 1.5 per cent, but a pick-up is expected this year and next, primarily driven by a major Chinese-financed highway project. However, the tourism sector, a major sector of economic activity for the country, could suffer if visits from recession-hit Russia decline, as arrivals from Russia make up around 25 per cent of total tourist arrivals in Montenegro. We therefore expect growth of around 3 per cent this year, but rising to 3.7 per cent in 2016 as progress on the highway project accelerates and tourism receipts rise again.
- Economic conditions in **Serbia** in 2014 were challenging, exacerbated by the severe floods, pushing the economy back into recession of an estimated 1.8 per cent, marginally better than expected. Vital sectors, including energy production and mining, were significantly affected, with a major negative contribution to growth. Front-loaded necessary fiscal adjustment under the new IMF programme has dragged down domestic demand also in 2015. The ongoing fiscal adjustment and eurozone quantitative easing together with sub-target inflation, reinforced by lower oil prices and subdued domestic demand, will allow monetary easing. This, together with the low base in 2014, will help revive growth, although credit growth may still be held back by high NPL ratios. We expect a modest recovery in 2015, with a growth of 0.3 per cent, accelerating to just below 2 per cent in 2016 with the successful implementation of the macroeconomic programme; further monetary easing; and improvements in the business environment. The construction of major infrastructure projects may also speed up.

### Turkey

Turkish economic growth moderated to 2.9 per cent year-on-year in 2014, following 4.2 per cent in 2013, but the growth drivers have become more favourable, with net exports taking over as the main driver. Nevertheless, contribution of net exports moderated towards the end of 2014, amidst continuing weakness in eurozone, geopolitical tension in Middle East, and recession in Russia. Domestic demand was constrained mainly by lower growth of private consumption, on the back of a slowdown in strong household credit growth and a hike in interest rates early in the year. The moderation in public spending and low growth of private investments also contributed to subdued domestic demand.

In 2015, declining commodity and oil prices are expected to contribute to growth, although their benefit may remain limited since central bank's space to cut interest rate will remain constrained by ongoing currency pressure on inflation. Lira weakened against the dollar by around 13 per cent in the first four months of 2015, as market-expected rise in US interest rate somewhat reduced capital inflows and led to a rise in the risk premium of the country. Diverging monetary policy expectations between the US and eurozone meant that the weakening of the lira against the euro, the currency of the major trading partner, was much more moderate at around 6 per cent in the same period, implying very limited improvement in Turkish trade competitiveness. Meanwhile, pass-through of the currency pressures and persistent food inflation resulted in an annual inflation of 7.6 per cent year-on-year in March, well above the central bank's inflation target of 5 per cent for the fourth consecutive year. Although inflation is expected to moderate in the remainder of 2015, on the back of lower food

inflation in the second half of the year, it is likely to remain elevated above the target, as the past currency weakening is passing through to inflation. The higher-than-target inflation and moderation in global liquidity as the Federal Reserve (Fed) tightens its policy, will keep both lira and foreign currency cost of financing high throughout 2015 and 2016. The higher cost of financing will constrain private consumption, weighing on growth. While investment activity may somewhat edge up as Turkey enters four year of election-free period later in the year, its pace and sustainability will largely depend on whether this period is used to implement a series of structural reforms. Meanwhile, net exports may benefit from better-than-expected growth in the eurozone, resulting in economic growth of 3 per cent in 2015 and in 2016.

Although weaker currency boosting net exports, weaker domestic demand growth containing imports, and declining energy import bill towards the end of the year eased the current account deficit to 5.7 per cent of GDP in 2014 from 7.9 per cent in 2013, the country continues to rely on volatile portfolio inflows to meet its large external financing needs. The volatility of capital flows as a consequence of Fed tightening and diverging monetary policies between the US and eurozone, is a downside risk to the Turkish economic outlook in 2015 and 2016. Further risks may come if a recovery in eurozone does not take hold, or in a case of further worsening of the geopolitical tensions in the Middle East and Ukraine, as well as deterioration of business sentiment in case of perceived weakening of regulatory and press independence following summer elections. On a positive note, the public finances of the country remain strong and banking sector is well capitalized, with low NPL ratios.

### Eastern Europe and the Caucasus (EEC)

In late 2014 – early 2015, the EEC region experienced major negative external shocks stemming from the Ukraine-Russia crisis and the downturn in Russian economy, the Russian rouble depreciation and, on the positive side with the exception of oil producer Azerbaijan, oil price decline. To contain spill-overs and to adjust to the new external context, most countries tightened their economic policies and let their currencies depreciate faster. This added to the stress by affecting the domestic demand. EEC region's 2015 growth outlook is subdued, with four out of six EEC countries expected to shrink. Recovery in 2016 is expected to be generally weak and subject to improvement in external conditions and to easing of geopolitical risks. Country-specific vulnerabilities and policy actions differ and they will continue to drive variation in growth trajectories across the EEC.

- **Armenia's** economy slowed down significantly in early 2015, driven by plummeting remittances and shrinking exports. Real GDP growth is likely to be negative in 2015. After rapid but mild devaluation in late-2014, Armenian dram stabilized, helped by tight monetary policy and central bank interventions. Contagion from the currency to the banking sector has been contained, but the credit activity grounded to a halt. Despite a successful Eurobond placement in March, end-March foreign currency reserves were 25 per cent lower than a year ago, at around 3.5 months of imports. Fiscal space is limited by an increased public debt-to-GDP ratio. Prospects of quick economic recovery in 2016 will depend on the external environment, mainly

in Russia. We forecast GDP growth at -1.5 per cent in 2015 and +1 per cent in 2016.

- **Azerbaijan** posted sound growth in the first quarter, according to official estimates. Real GDP increased by 5.3 per cent year-on-year in January-March 2015 (up from 2.8 per cent annual GDP growth in 2014). The 25 per cent step devaluation of the manat in February 2015 affected domestic demand and banks negatively, but helped buttress the fiscal revenue impact of declining oil revenues and competitiveness. Higher growth was due to the lower base of the last year, when oil extraction disruptions caused growth to slow, but also due to elevated capital spending on landmark infrastructure projects. As oil prices remained low, trade balance deteriorated and still-high international reserves remained under pressure, declining by 14 per cent month-on-month in March to the lowest level since late-2011. Overall, the growth forecast for 2015 remains unchanged at 1.5 per cent and we expect the same moderate level of growth in 2016.
- In the first quarter of 2015, **Belarus**'s economy contracted by 2 per cent year-on-year. Significant economic and trade exposure to the crisis-hit Russian economy led to the decline in exports and industrial production. Currency depreciation in early-2015 affected consumer demand. After the authorities tightened monetary and fiscal policies, the exchange rate stabilized, allowing the reversal of currency and price controls imposed in late-2014. Currency pressure abated and the international reserves remained broadly stable in February-March, although external risks remain very high, stemming, in particular, from significant public foreign exchange refinancing needs and still unfavourable terms of trade in respect of main trade partners. The 2015 growth forecast is slightly downgraded to -2.5 per cent on current policies. Without significant domestic reforms, improvements in the external environment, and mitigation of Belarus's material external liquidity and refinancing risks, growth in 2016 is likely to be nil.
- Growth in **Georgia** is expected to halve to 2.3 per cent in 2015 from 4.8 per cent in 2014, reflecting mainly a deteriorating external environment, with recession in Russia and sharp slowdown of regional trading partners. The resulting lower exports and remittances have negatively affected growth and the external balance of payments. The lari has depreciated significantly by 18 per cent since the start of the year, which, given the significant dollarization in the economy, is leading to increase in NPLs. Domestic political uncertainty is also weighing on confidence and growth. In 2016, growth is expected to remain still subdued at 2.6 per cent, affected by negative external environment, and increasing NPLs, as effects of the slide of lari in 2014-15 and downturn in economy will begin to crystalize.
- **Moldova**'s economy grew by 4.6 per cent in 2014, but the outlook has deteriorated recently. Remittances and exports proceeds have been contracting reflecting challenges to redirect trade away from Russia to the EU, with which Moldova completed last year a deep and comprehensive free trade agreement as part of the association agreement with the EU. Financial sector has been mired in scandals, with three large banks under special administration.

Political risks increased with formation of a new minority government and with elections of a governor in Gagauzia, Moldova's autonomous region. The Moldovan lei depreciated in the beginning of the year in line with regional currencies trends, but stabilized by March after major tightening of monetary policy and central bank interventions. The outlook for Moldova is increasingly uncertain, with significant downside risks. The economy is expected to contract by 2 per cent in 2015 (down from zero per cent growth forecast) and to grow by 1.5 per cent in 2016.

- In **Ukraine**, economic disruptions in Donbas that accounted for a major share of industrial production and exports before the conflict, negative balance sheet implications from the hryvnia depreciation, necessarily tight economic policies, energy tariffs hikes and continued credit contraction are expected to maintain massive pressures on the economy this year. Preliminary data points to further deterioration of economic activity in the first quarter of 2015 on the back of the very fragile though more stable situation in Donbas following the Minsk 2 agreement. The banking sector suffers from the adverse balance sheet impact of the macroeconomic turbulence but also from credit risks relating to the heavy legacy of related-party lending. The hryvnia lost almost two-thirds of its value since the beginning of 2014 due to both fundamental and confidence-driven factors. The most recent hryvnia exchange rate stabilisation has happened in the context of tightened monetary policies and significant currency and capital controls. The external adjustment is incomplete, with both current and capital accounts of the balance of payment likely to remain negative in 2015. Closure of Ukraine's external funding gap in 2015-2018 (IMF program period) will depend on the outcome of Ukraine's debt re-profiling and restructuring negotiations with private bondholders and creditors. We now expect real GDP to contract in 2015 by 7.5 per cent compared to -5 per cent forecasted in January 2015. Assuming that the security situation does not deteriorate and the IMF program remains on track, Ukraine is likely to register a recovery of around 3 per cent in 2016. Faster and successful reforms and abatement of the geopolitical risks may improve the growth outlook.

## Russia

Russia is expected to go through a significant recession in 2015 (-4.5 per cent) and next year (close to -2 per cent) and may face a protracted period of slow growth or stagnation. Low oil prices and Western sanctions have taken their toll on an already weak economy with deep-seated structural problems. Lower export revenues and constrained access to financing amid weak business confidence led to a trend economic slowdown and ultimately recession. Capital flight reached a record US\$ 154 billion in 2014 and late 2014 Russia experienced significant financial stress with massive rouble depreciation, ensuing surge in inflation, and interest rates increases.

Russia still has significant buffers and the authorities acted to protect the economy from potentially more severe consequences. Following the turbulence in the foreign currency market in mid-December, the central bank hiked interest rates in one step by 650 basis points to 17 per cent. A bank recapitalisation programme of 1 trillion

roubles followed, along with regulatory forbearance measures on bank capital ratios for a limited time period. The government introduced a Stabilisation Programme.

Economic policy seeks to strike a balance among several objectives: preventing a large drop in international reserves through a flexible exchange rate, allowing a cautious countercyclical fiscal easing without putting at risk the remaining reserves, and supporting the banking sector's key players in the face of worsening balance sheets including from the rouble depreciation. Real wages will fall sharply this year (they declined by 8.3 per cent in the first quarter) due to a freeze on nominal public sector wages and a surge in inflation – itself the result of the devaluation and self-imposed import ban of food from sanctioning countries - driving a large decline in consumption. As a result, retail sales have dropped by 8.7 per cent in March 2015, comparable to the sharp drop after the financial crisis in September 2009 (-9.7 per cent). Declining real income and increased level of household debt in the wake of the fast credit growth underpinning consumption in previous years have contributed to the rise in non-performing loans, which hiked to 6.9 per cent as of April 1 from 5.9 per cent at the beginning of the year.

Despite the large depreciation of the real exchange rate, import substitution – a stated policy goal in reaction to the sanctions - has proved challenging. While imports, particularly food due to the import ban, declined sharply, industrial production has failed to pick up the slack. High exchange rate volatility and recent strengthening of the rouble (together with the fast adjustment of rouble prices) may discourage investments into import substitution projects, while the large real wage drop may support its profitability.

After reaching its lowest point of 80 roubles per US dollar in mid-December 2014, the rouble appreciated to 50 roubles per US dollar by end-April 2015, driven by multiple factors. First, the stabilisation of the geopolitical crisis at a lower intensity has significantly reduced Russia's risk premium: CDS spreads have gone down from 630 at end-January to 350 by end-April and private sector capital outflow has lessened. Second, oil prices have also increased (from US\$ 45 in January to above US\$ 60 per barrel in April) and their volatility declined somewhat. Furthermore, the central bank extended US\$ 30 billion in foreign currency repos to banks, helping them to deal with foreign debt repayments (US\$ 24.3 billion in the first quarter of 2015). The stabilisation of the rouble has also led households and corporations to reconvert some of the foreign currency purchases made in December: in the first quarter they were the net sellers of foreign currency.

Financing conditions overall will remain tight, as is documented by still weak syndicated lending, which continued declining in the first quarter of 2015 (by 11 per cent year-on-year) after falling by 80 per cent in 2014. This market is basically closed. The Ministry of Finance, however, has started considering a Eurobond placement in 2015, given the recent decline in yields on Russian sovereign bonds.

The government is preparing the revised budget plan. The federal deficit is allowed to widen to 3.7 per cent of GDP this year, reflecting the revenue decline and virtually no change on overall spending, i.e., freezing wages and cutting to make room for higher military and Stabilisation Programme spending. In the meantime, federal spending jumped by 27 per cent year-on-year in the first quarter of 2015, mostly on military expenditure, limiting the depth of the recession.

We revise our growth forecast for 2015 to -4.5 from -4.8 per cent due to lower risk perception, stabilisation in financial markets and increased budgetary spending in the first quarter of 2015. The fundamentals for long-term growth - high economic volatility, geopolitical conflict, low investment, demographic constraints -, however, remain weak, reflected in the -1.8 per cent forecast for 2016. It is hard to see a rebound going forward without the reversal of the ongoing-de-coupling of Russia's economy from the rest of the world and major structural reforms. Upside risks may come from further recovery in the oil price and gradual improvement in the geopolitical crisis in 2016. These positive factors would have a lagged positive impact. A negative scenario with lower oil prices and/or intensification of the geopolitical crisis, on the other hand, can result in larger contraction in 2016.

### Central Asia

Growth in Central Asia in 2015 has been significantly affected by the recession and currency depreciation in Russia and the oil price collapse. Growth in Kazakhstan is sharply lower, due to the collapse of the oil price, and to a much lesser extent, negative effect of influx of cheap imports from Russia on domestic industries and spillovers of negative investment sentiment from the Russia/Ukraine crisis. Tajikistan, Kyrgyz Republic and, to a lesser extent, Uzbekistan, have been hit by sharply declining remittances from Russia. In Kyrgyz Republic and Mongolia there is considerable uncertainty around growth forecasts, due to uncertainty surrounding operations of large extractive projects (Kumtor and Oyu Tolgoi, respectively). The currencies across the Central Asia have weakened significantly, with double digit depreciation in Tajikistan, Kyrgyz Republic, Mongolia and Uzbekistan, and 19 per cent devaluation in Turkmenistan over the last 6 months. Central banks have supported currencies through foreign exchange market interventions and in some cases administrative constraints. The growth in the region is expected to remain subdued in 2016 due to low oil prices, recession in Russia and elevated, though contained, tensions in Russia/Ukraine.

- In commodity exporting **Kazakhstan**, GDP growth is projected to slow to 1.5 per cent in 2015, compared with 4.3 per cent in 2014, reflecting the plunge in oil prices, recession in Russia, depreciation of the rouble – which is resulting in influx of cheap imports from Russia, putting pressure on domestic industries and weaker exports – and weakening investor sentiment as a result of the Russia/Ukraine crisis. The slump in oil prices is significantly affecting Government's revenues, which in 2015 is expected to lead to budget deficit of around 3 per cent of GDP. The government has reacted with an acceleration of reforms and fiscal stimulus, drawing on resources from the National Fund. In particular, “Nurly Zhol”, a (largely) infrastructure investment based stimulus programme was launched in November 2014 that should provide a material boost to growth. Notably, pressure from cheap imports from Russia has hit some regions and sectors disproportionately, and therefore, notwithstanding the relatively stable overall growth environment and successful efforts of National Bank of Kazakhstan to reduce the level of legacy NPLs in banks, material increase in new NPLs and social pressure can be expected. Difficult external environment will continue affecting Kazakhstan going forward, with growth in 2016 expected to remain subdued and reach only 2 per cent. Tenge

has remained pegged to US dollar, but it is widely expected to depreciate during 2015. Inflation is expected to average around 7 per cent in 2015 without the impact of a devaluation.

- GDP growth in the **Kyrgyz Republic** is expected to decline to 3.0 per cent in 2015 from 3.6 per cent in 2014. The slowdown reflects sharply lower remittances from Russia and more difficult export environment due to recession, depreciation of the Russian rouble and sharply slower growth in Kazakhstan, the country's main trading partner and a source of remittances. Increased investment carried out using financing provided by Russia and Kazakhstan as part of the accession to the Eurasian Economic Union will help partially mitigate negative impact of external factors. Sharply lower oil prices are also expected to provide a boost to consumption and growth, since the country is a significant net oil/petroleum importer. However, lack of permanent solution to the issues surrounding the Kumtor gold mine remains material downside risk to growth. The som has depreciated significantly in 2014 and 2015, notwithstanding the National Bank's heavy interventions. However, international reserves remain comparatively high. Inflation is expected to remain elevated at around 10 per cent in 2015 reflecting the exchange rate pass through. In 2016, growth is expected to remain subdued, projected at 3.1 per cent, and there are likely to be increasing fiscal and social pressures, reflecting legacy from lower remittances and returning migrants in 2015, and negative effects of continued recession in Russia and sluggish growth in Kazakhstan in 2016.
- Growth in **Mongolia** remained strong in 2014, estimated at 7.8 per cent, driven mainly by consumption on the back of loose monetary and fiscal policies. Although strong performance in the second half of 2014 creates a strong base effect for average growth in 2015, growth is likely to decelerate significantly this year and next on account of lower foreign direct investment, continued delays with the second phase of Oyu Tolgoi, a large mining project, China's weaker demand for commodities, as well as policy tightening. Inflation moderated somewhat but remained relatively high, at around 9 per cent, reflecting demand pressures in the economy.
- In **Tajikistan**, GDP growth is expected to decline to 3.8 per cent in 2015, compared with 6.7 per cent in 2014, reflecting sharp contraction in remittances from Russia (in the last quarter of 2014, remittances from Russia dropped by 27 per cent year-on-year in US dollar terms) as well as reported return of migrants. The negative effects of lower remittances can be expected to be partially mitigated by increased investment from China, and to a lesser extent, investment from other countries. The depreciation can be expected to contribute to increases in NPLs, given the very high level of dollarization in the country. Central Bank's interventions in the foreign exchange market, as well as administrative measures, have helped to limit depreciation, but that has come at the expense of losing significant part of international reserves, which now stand at a very low level. Overall, reduction in remittances, returning migrants and overall weakness of the economies heighten social security risks in the country. Inflation is expected to increase to 7.5 per cent in 2015. Notwithstanding the fact that remittances flows from Russia might stabilise in

2016, the legacy of sharply lower remittances and returning migrants in 2015 as well as increasing NPLs can be expected to continue to weigh down on growth. The growth in 2016 is projected at 3.8 per cent.

- In **Turkmenistan**, officially recorded GDP growth is expected to be dented only slightly, notwithstanding the commodity price decline. Growth would decelerate to 9.5 per cent in 2015 from 10.3 per cent in 2014, reflecting lower gas and oil prices and economic slowdown of the trading partners in the region. Manat was devalued by 19 per cent in the beginning of 2015, which will help improve competitiveness, whilst also pushing up inflation to close to 7 per cent in 2015. In 2016, growth can be expected to recover, reaching 10 per cent, supported by FDI and domestic investment into such sectors as real estate.
- **Uzbekistan's** GDP growth is expected to decline to 7 per cent in 2015, compared with 8.1 per cent in 2014, reflecting sharp drop in remittances from Russia and slowdown of economies of some of the main trading partners. The som has depreciated significantly in 2014 and the first months of 2015, and it is expected to weaken further in the course of 2015. Inflation is expected to reach 9.8 per cent in 2015, up from 8.4 per cent in 2014. In 2016, growth can be expected to remain around 7 per cent, as external factors continue to weigh on remittances and trade.

#### Southern and Eastern Mediterranean (SEMED)

The 2015 growth projections for SEMED have been revised slightly upward from 3.9 to 4 per cent thanks to a stronger than expected pick-up in economic activity in Egypt, which more than outweighs modest downward revisions to the growth forecasts for Jordan and Tunisia. Growth in the region continues to be supported by lower oil prices, good growth in the US and a number of domestic economic reform measures. Growth momentum is expected to improve modestly further for the SEMED region in 2016 to 4.3 per cent, constrained by a challenging regional environment and reform implementation delays in some countries (notably Tunisia). Downside risks to the outlook relate mainly to regional turmoil and a slower-than-expected eurozone recovery.

- Economic activity has picked up in **Egypt**, thanks to policy reforms, a more stable political situation and financial support from the GCC. Growth accelerated to 5.5 per cent in the first half of the fiscal year 2014/15 - up from just 1.2 per cent a year earlier – driven by private consumption and investment. The recovery in investment was supported by significant steps to reduce macroeconomic imbalances and improve the business environment. However, net exports continue to be a drag on growth, reflecting structural problems in Egypt's energy sector and eroding competitiveness. The recent Egypt Economic Development Conference garnered strong financial support, both from GCC countries (which have pledged an additional US\$12.5bn financial support) and from investors, with prominent deals signed in the energy and housing sectors in particular. As a result of better-than-expected economic performance and improved business confidence, the forecast for

FY2014/15 has been revised upwards to 4.0 per cent, from 3.8 per cent in January. Downside risks to the forecast relate to macroeconomic vulnerabilities: the fiscal deficit remains elevated and Egypt has relied on GCC support to bolster its international reserve position.

- **Jordan's** economic recovery continues to be constrained by a difficult regional environment. GDP is expected to modestly grow from 3.1 per cent in 2014 to 3.6 per cent in 2015 remaining well below the average growth rates of 6 per cent over the last decade. Conflict in neighbouring Iraq and especially Syria has disrupted exports, not just bilaterally, but also more widely with Turkey and Lebanon. The influx of Syrian refugees into Jordan – who now comprise nearly one tenth of the population – has also strained public services and government finances and negatively impacted labour markets. Although Jordan's currency is pegged to the appreciating US dollar, the adverse impact of the stronger dinar on Jordan's export performance has been mitigated by Jordan's trade linkages: over 45 per cent of Jordan's exports are destined for the US or dollar-pegged economies. On the other hand, Jordan stands to benefit significantly from low global oil prices, given its position as a major energy importer, both through lower import costs and reduced losses for the National Electricity Company. Risks to the forecast relate predominantly to regional political developments.
- **Morocco's** growth momentum is projected to pick up to 4.6 per cent in 2015, up from 2.1 per cent in 2014, underpinned by a rebound in agricultural activities, strong growth in high value-added exports (in newly developed sectors such as automobiles, aerospace and electronics) and lower oil prices. Successful implementation of planned reforms to taxation, the investment climate and the pension system are also likely to further reduce macroeconomic imbalances and improve the economic outlook. While risks have decreased thanks to improved policy buffers, protracted slow growth in the eurozone would adversely affect Morocco through exports, FDI and remittance flows.
- Growth in **Tunisia** is projected to improve gradually from a sluggish 2.3 per cent in 2014 to 2.8 per cent in 2015 and 3.6 per cent in 2016. The recovery will be supported by the successful political transition and lower oil prices. However, economic performance continues to be constrained by delays in economic and financial reforms, a slow recovery in the eurozone, regional and domestic security tensions and persistent industrial unrest. The new 2015 forecast represents a downgrade of 0.2 percentage points from our forecast in January, owing to a worsening in the security environment in recent months, which is expected to adversely impact tourism and investment. Widening external imbalances and increased financial sector vulnerabilities tilt the risks to the downside.