

# Macroeconomic overview



Growth in the transition region slowed significantly in 2012 and has failed to recover in 2013. While the effects of the eurozone crisis on trade and capital flows have gradually abated, there has been a downturn in key emerging markets and in the three largest economies of the transition region: Russia, Turkey and Poland. As a result, countries initially less exposed to the crisis have suffered weaker trade and remittances and declining growth.

## FACTS AT A GLANCE

IN  
**27**  
countries out of 34 in the transition region GDP growth slowed in 2012.

ABOVE  
**20%**  
Remittances as a share of GDP in Tajikistan, Kyrgyz Republic, and Moldova.

ABOVE  
**50%**  
Youth unemployment rates in parts of south-eastern Europe.

ABOVE  
**15%**  
Loss of foreign bank funding as a share of GDP in countries most affected by deleveraging since the third quarter of 2011.

# Macroeconomic developments and outlook

Economic activity remains weak across most of the transition region. The current slow-down started in the second half of 2011 as the eurozone crisis intensified. Growth continued to decelerate in 2012, reaching low single-digit levels everywhere except in Central Asia (CA), where growth remained resilient, and in south-eastern Europe (SEE), where it contracted (see Chart M.1). Other than a modest recovery in SEE and Turkey, growth across the transition region was flat or even lower in the first half of 2013.

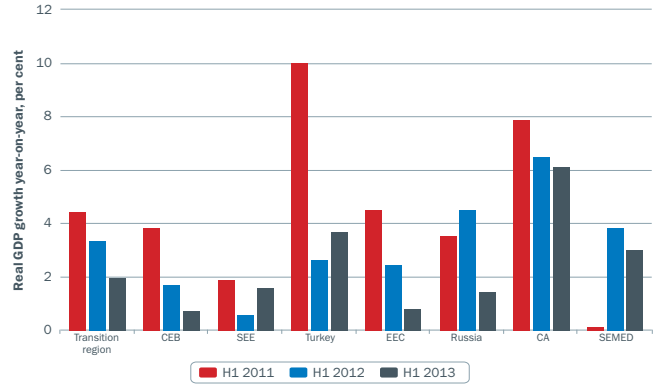
Compared to last year, the external drivers, composition and regional distribution of growth have shifted. Economic weakness has spread eastwards from the western transition countries and has shifted from external to domestic factors. Although the eurozone recession ended in the second quarter of 2013, there has been a slow-down in key emerging markets, including China and India. The largest transition economies – Russia, Turkey and Poland – have similarly slowed, with wider regional repercussions. In Central European and Baltic (CEB) and SEE countries, exports have recovered and cross-border deleveraging has moderated. Yet growth in these economies has continued to decelerate as domestic consumption and investment have weakened.

## SLOW-DOWN IN DOMESTIC DEMAND

Most transition economies – 27 out of 34 – saw lower growth in 2012 than in 2011 (see Chart M.2). This slow-down encompassed all regions, with the exception of the southern and eastern Mediterranean (SEMED) countries, where a slight increase reflected weak growth during the political turmoil of 2011, rather than any significant acceleration. In the majority of countries this decline can be attributed to weaker domestic demand. Consumption stalled across the region and contracted in real terms in the recession-hit economies of Bosnia and Herzegovina, Croatia, FYR Macedonia, Hungary and Slovenia. The end of the credit boom in Turkey triggered a sharp reduction in consumption, which played a significant role in the deceleration of the economy in 2012.

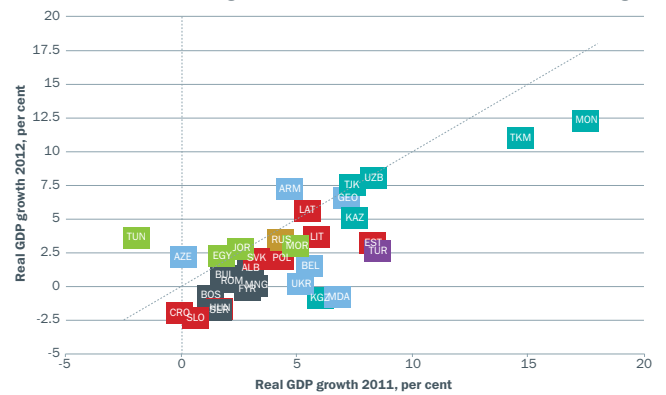
The weakening of investment has also been a major factor in the slow-down (see Chart M.3). In the CEB countries 2012 was the fifth successive year of weak or negative investment growth, due to fiscal austerity (which constrains public investment), low foreign direct investment (FDI) and investor uncertainty amid the eurozone crisis. In Russia fixed investment had come to a standstill by the end of 2012. This was due, in part, to faltering global commodity prices and the ensuing stagnation of export revenues. Weaker domestic demand and supply-side

Chart M.1. Growth in transition countries has slowed since 2011



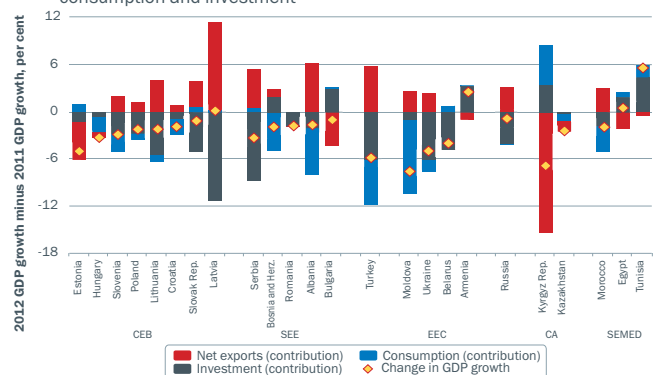
Source: National authorities via CEIC Data.  
 Note: The chart shows year-on-year growth rates. Regional averages are weighted by nominal US dollar GDP in 2011.

Chart M.2. In 2012 growth slowed in 27 countries in the transition region

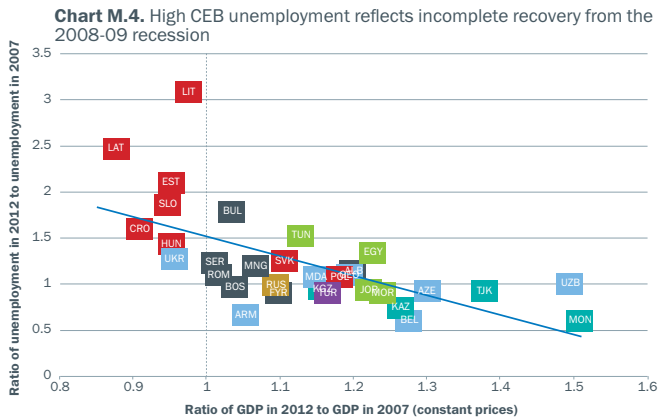


Source: International Monetary Fund World Economic Outlook (IMF WEO) database.  
 Note: The chart plots annual growth rates of real GDP in the years 2011 and 2012. Countries below the 45-degree line experienced a slow-down in 2012.

Chart M.3. The slow-down in 2012 was driven by weaker consumption and investment



Source: IMF WEO database.  
 Note: The chart shows changes in annual GDP growth rates from 2011 to 2012. Contributions are calculated as changes in the various components' growth rates weighted by their respective shares in 2011 GDP.



**Chart M.4.** High CEB unemployment reflects incomplete recovery from the 2008-09 recession  
**Source:** National authorities via CEIC Data and IMF WEO database.  
**Note:** The chart shows the ratio of real GDP in 2012 to real GDP in 2007 and the ratio of the unemployment rate in 2012 to the unemployment rate in 2007. Unemployment rates are end-of-period.

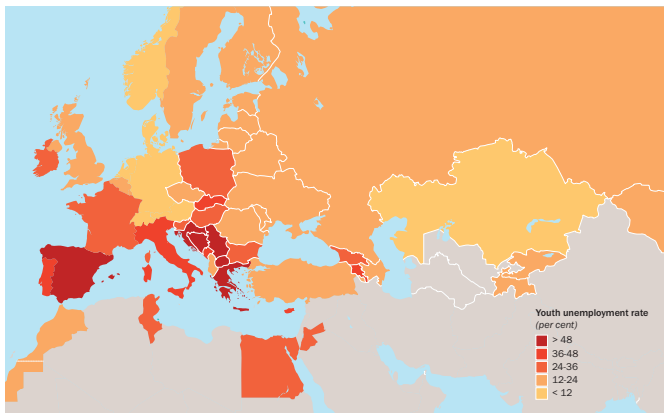
constraints – high capacity utilisation and low unemployment – have resulted in a rapid deceleration of growth. Investment has also been the principal driver behind the slow-down in Ukraine, contracting by over 10 per cent in real terms.

### PERSISTENT HIGH UNEMPLOYMENT

Continuing high rates of unemployment – in double digits in most CEB and SEE countries – are mostly a legacy of deep recessions in 2008-09. Output remains below pre-crisis levels in six CEB countries (as well as in Ukraine) and the persistence of high unemployment reflects this incomplete recovery (see Chart M.4). As a consequence, long-term unemployment has risen steadily in all CEB countries, Bulgaria and Romania – potentially resulting in declining labour-force participation and a loss of skills. Unemployment has been falling in the Baltic states – albeit from very high levels – but has increased in Croatia and Slovenia as their economies have re-entered recession, and has also risen in Egypt, Jordan and Morocco. Insufficient job creation is a long-term structural problem in SEMED countries that has become particularly pressing amid political unrest in recent years.

Most transition countries continue to see high levels of youth unemployment. In several Western Balkan states youth unemployment rates are in the region of 50 per cent or higher, comparable with the most extreme cases in the eurozone periphery (namely Greece and Spain; see Chart M.5). Youth unemployment is also a concern in some CEB and SEMED countries, as well as in Armenia and Georgia. In the SEMED region the problem is magnified by demographics, as young people account for a large and rising share of the population (see Box S.1).

**Chart M.5.** Youth unemployment in SEE, the Caucasus, SEMED and the eurozone periphery

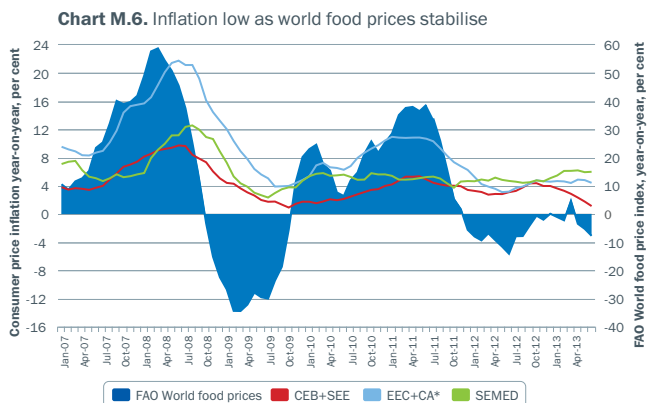


**Source:** National authorities, Eurostat, World Bank Development Indicators and International Labour Organization.  
**Note:** The chart is based on the latest data for the youth unemployment rate, defined as unemployment among individuals aged 15 to 24. No estimates are available for Turkmenistan or Uzbekistan. For country legends see the regional map in the Country Assessments section of the online *Transition Report*, at [www.tr.ebrd.com](http://www.tr.ebrd.com).

### STABLE INFLATION

Consistent with an environment of depressed demand, inflation has continued to fall in most CEB and SEE countries, dipping below two per cent in the first half of 2013. The exception was Serbia, where prices spiked due to a poor harvest, pre-election fiscal loosening and an increase in value-added tax. Inflation also edged up in some countries in eastern Europe and the Caucasus (EEC) and Central Asia – particularly Armenia and the Kyrgyz Republic – but remains low by historical standards. Supply shortages and the removal of subsidies have contributed to rising inflation in the SEMED region. Egypt, in particular, experienced a sharp increase in prices in the first half of 2013 as the depreciation of its currency continued to raise the cost of imports.

World food prices have been an important determinant of headline inflation in many transition countries in recent years (see Chart M.6). The recent moderation of inflation in EEC and Central Asian economies, where food constitutes a large share of the consumer price index (CPI) basket, is partly attributable to relative stability in global prices.



**Chart M.6.** Inflation low as world food prices stabilise  
**Source:** National authorities via CEIC Data, and the Food and Agriculture Organization of the United Nations (FAO).  
**Note:** The chart shows year-on-year growth rates for the FAO world food price index and consumer price indices. Regional averages are unweighted. \*The EEC+CA average excludes Belarus, which saw inflation exceed 100 per cent in 2011.

### TRADE REVERSAL

After the eurozone crisis intensified in late 2011 and the first half of 2012, exports from CEB and SEE countries fell significantly. This trend has reversed over the past year, as exports grew in all countries apart from Estonia. This recovery has lost some momentum in the CEB region in 2013, but has accelerated in certain SEE countries, notably Albania, Bosnia and Herzegovina, Montenegro and Serbia.

Countries further east in the transition region are less exposed to the eurozone, but are more vulnerable to developments in Russia. Weakening domestic demand in Russia has depressed exports from some EEC countries. Similarly, Central Asian economies have been impacted by the Russian slow-down, and also by China's deceleration, which has particularly affected Mongolia and Tajikistan. Exports from these countries still grew in the past year, but at a slower pace than they had previously.

By the first half of 2013, improving supply prospects and weak demand in emerging markets had led to falls in the prices of all major commodities. Azerbaijan, Kazakhstan and Russia experienced a dip in export revenues as the oil price dropped in early 2013 (oil production also declined in Azerbaijan). Prolonged stagnation in global commodity prices could constrain growth in Russia and other commodity exporting nations, while also endangering the recovery in transition economies that depend on Russia.

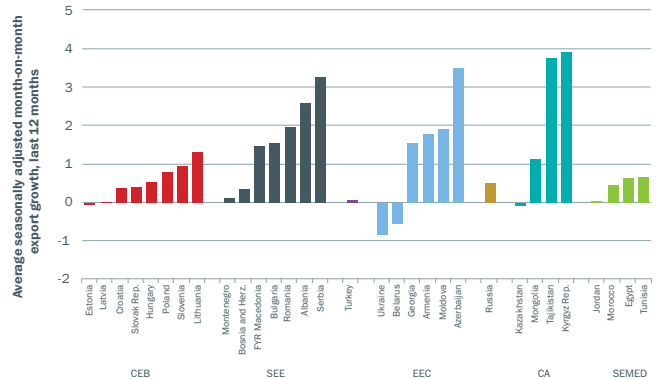
### CAPITAL FLOWS BELOW PRE-CRISIS LEVELS

Private capital has continued to flow into the transition region, but at modest rates. Emerging markets globally received significant inflows in the second half of 2012 and the first quarter of 2013, as low interest rates in advanced economies prompted investors to seek higher yields elsewhere. However, with the exception of Turkey, these inflows largely bypassed emerging Europe and Central Asia (see Chart M.8). The level of net flows into CEB and SEE countries – mainly FDI flows – was only about one-third of the levels seen prior to the crisis of 2008-09. Croatia, Hungary, Slovak Republic and Slovenia all experienced net outflows in the second half of 2012 and the first quarter of 2013. In Russia outflows slowed during the second half of 2012, but picked up again in early 2013, coinciding with the slow-down in the economy and the Cypriot banking crisis.<sup>1</sup>

Chart M.8 shows that net capital flows to the SEMED region remain very low. In part, this is a reflection of developments in Egypt, where the ongoing political crisis has prompted net outflows for that country. However, weak investor confidence has also affected foreign investment across the SEMED region, as FDI remained stagnant in all countries apart from Morocco.

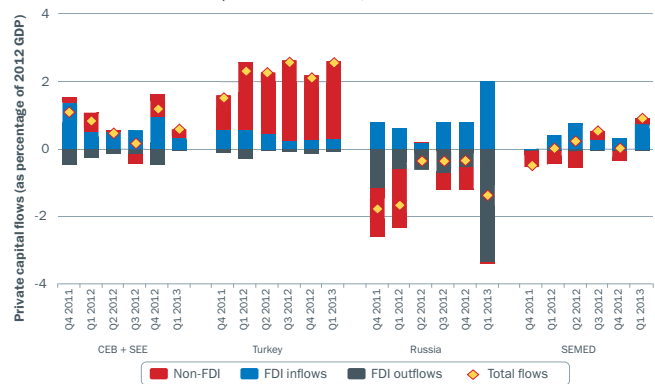
In May and June of 2013, concerns over the eventual tapering of quantitative easing in the United States sparked a period of heightened volatility in financial markets. Emerging markets in particular were hit by falling equity prices, rising yields and capital outflows.<sup>2</sup> Markets have since calmed, but future US monetary

Chart M.7. Export recovery in CEB and SEE since mid-2012



Source: National authorities via CEIC Data, and IMF International Financial Statistics (IFS).  
 Note: The chart shows the average of seasonally adjusted month-on-month export growth in the last 12 months. Exports are in US dollar values, adjusted using a US export deflator to correct for exchange rate movements.

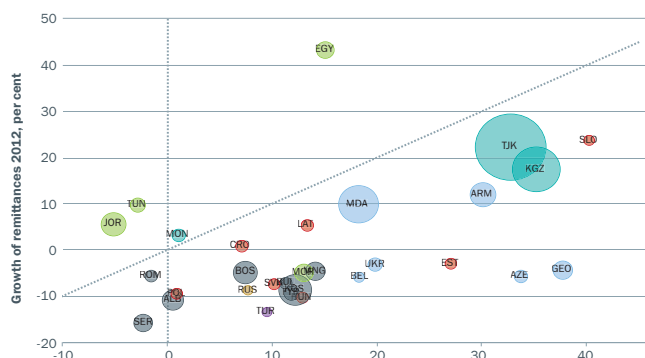
Chart M.8. Weak capital flows to CEB, SEE and SEMED



Source: National authorities via CEIC Data.  
 Note: Data are from the capital and financial accounts of individual EBRD countries. Private non-FDI flows are the sum of the capital account, portfolio investment, other investment and net errors and omissions. Net errors and omissions are included as this can be a significant channel for current account deficit financing or a major channel for capital flight in some countries.

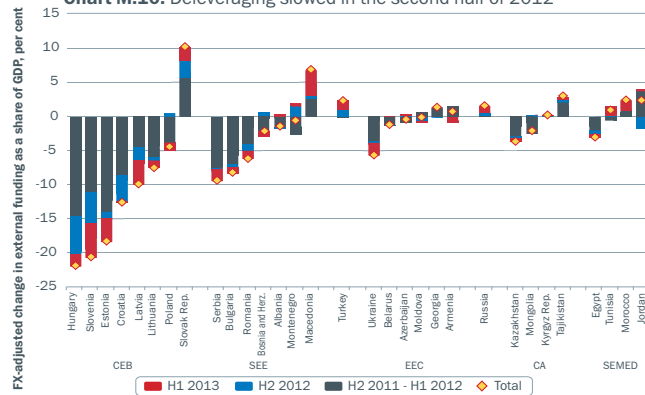
<sup>1</sup> The exceptionally large outflows and inflows of FDI for Russia in the first quarter of 2013 reflect transactions related to Rosneft's takeover of TNK-BP. From the perspective of the balance of payments, these transactions broadly offset each other and are unlikely to have significantly affected net capital flows.

<sup>2</sup> As measured by EPFR Global fund flows (www.epfr.com).

**Chart M.9. Remittance growth has slowed**

Source: World Bank.

Note: The chart plots the annual growth of remittance inflows in 2011 and 2012. The size of the bubble indicates the share of remittances in GDP.

**Chart M.10. Deleveraging slowed in the second half of 2012**

Source: Bank for International Settlements (BIS).

Note: The chart shows foreign exchange (FX)-adjusted changes in BIS reporting banks' external positions in relation to all sectors, as a percentage of 2012 GDP.

policy will remain an important determinant of capital flows for emerging economies. The transition region may be less exposed to these developments, due to the lack of more volatile non-FDI inflows in recent years. Turkey, however, is vulnerable to a reversal, given that portfolio inflows financed 85 per cent of its current account deficit in 2012.

## SLOWING REMITTANCE GROWTH

Remittances are the single largest source of international payments for several Central Asian, SEE and SEMED countries. However, in 2012 the annual growth rate of remittances declined in all but four countries (see Chart M.9). Egypt, Jordan and Tunisia were among the exceptions, which is consistent with past evidence that migrants from SEMED countries remit more in times of economic hardship.<sup>3</sup>

Remittances are most important for the economies of Tajikistan, Kyrgyz Republic and Moldova, where their shares of GDP are 46 per cent, 29 per cent and 23 per cent respectively. Remittance growth slowed in all three countries in 2012, but still remained relatively high. The collapse of remittances from Russia was one of the principal channels through which the 2008-09 crisis affected these and other EEC and Central Asian countries. Consequently, a Russian economic slow-down poses a significant risk. However, higher-frequency data show no evidence that remittances from Russia to EEC and Central Asian countries weakened in the first half of 2013.<sup>4</sup>

In the SEE region remittances have yet to return to pre-crisis levels and the year to mid-2013 saw further contractions. The negative growth in all SEE countries reflects the large percentage of remittances which come from the eurozone periphery. Outflows from Greece, Italy and Spain have dropped substantially since their economies went into recession. Albania has been especially vulnerable, given its dependence on remittances from Greece, which saw a 19 per cent decline in 2012 alone.

## CROSS-BORDER DELEVERAGING CONSTRAINS CREDIT

Foreign banks have continued to withdraw funding from the transition region, but the pace of deleveraging has moderated. The eurozone crisis triggered a sharp reduction in international bank claims in the second half of 2011. Outflows slowed in 2012 as ample global liquidity and the European Central Bank's monetary policy helped to improve funding conditions for banks, although they picked up temporarily in the first quarter of 2013.<sup>5</sup> According to a Bank for International Settlements (BIS) study,<sup>6</sup> the main reason for the withdrawal of cross-border funding has been pressure on parent banks. It has also increasingly reflected domestic factors, as the reduction of exposures has been largely confined to countries in recession. Hungary, Slovenia and Ukraine have seen no respite from outflows, while deleveraging has abated elsewhere (see Chart M.10). Compared to the first wave of funding withdrawals that followed the global financial

<sup>3</sup> See Bouhga-Hagbe (2006).

<sup>4</sup> Based on bilateral data from the Central Bank of Russia on remittances from Russia to EEC and Central Asian countries through money transfer operators.

<sup>5</sup> See Vienna Initiative 2.0, Deleveraging Monitor, 24 July 2013 ([www.vienna-initiative.com](http://www.vienna-initiative.com)).

<sup>6</sup> See Avdjiev et al. (2012).

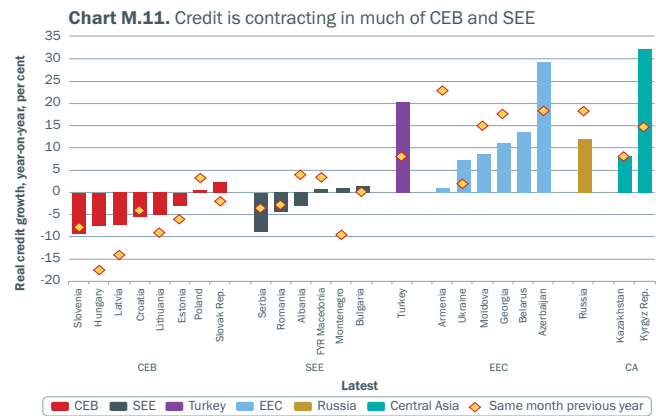
crisis in 2008-09, foreign banks appear to have adopted a more discriminating approach to deleveraging, as funding reductions have been more closely aligned with domestic vulnerabilities. In Ukraine international banking groups are not just reducing their exposures, but are exiting the country entirely, which may make the banking system more vulnerable to external shocks in the future.

Accumulated external funding losses continue to affect credit conditions in transition economies, even though banks have made significant efforts to raise domestic deposits. Real credit growth remains depressed in virtually all CEB and SEE countries (see Chart M.11). In the SEE countries a significant drop in credit growth has coincided with an increase in non-performing loans (NPLs). By mid-2013 credit was contracting in real terms in Albania, Romania and Serbia, and continued to contract in Croatia, Hungary and Slovenia. In countries less affected by foreign banks' deleveraging, the expansion of credit has slowed, in line with weakening domestic demand. Armenia, Georgia, Moldova and Russia have all seen decelerations of between 5 and 20 percentage points. Credit growth has accelerated in Turkey, but remains well below the rates seen in the boom years of 2010 and 2011.

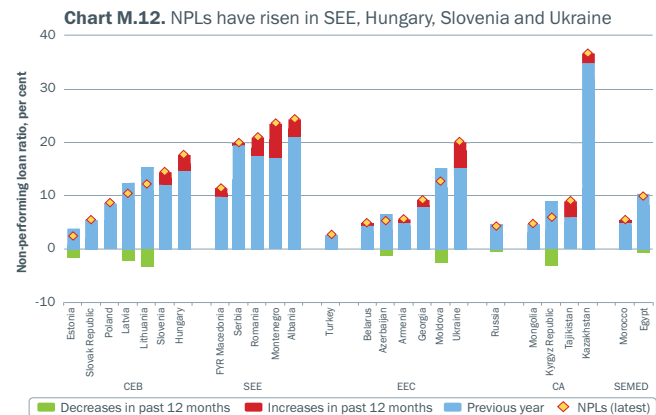
In a number of transition economies credit growth remains dampened by balance sheet constraints – an ongoing legacy of the 2008-09 financial crisis. The share of NPLs remains above pre-crisis levels across most of the region, including all CEB and SEE countries. Efforts to resolve bad loans are showing success in the Baltic states and the Kyrgyz Republic, where NPL ratios have declined steadily since 2010. However, they have continued to rise in many of the countries most affected by the downturn, including Hungary, Slovenia and Ukraine, as well as in the SEE region where the average NPL ratio has risen continually since 2007 and now exceeds 17 per cent. Kazakhstan has the highest reported share of NPLs, as continued attempts at resolution have so far failed to address balance sheet weaknesses in one of its largest banks.

## MACROECONOMIC POLICY

Monetary policy has remained accommodative in much of the transition region, reflecting the economic downturn and the relative lack of inflationary pressures. Central banks in the CEB and SEE regions have continued to cut interest rates, which have dropped to historic lows in the majority of countries.<sup>7</sup> Hungary has also tried to use unconventional monetary policy tools to revive credit to the private sector. By early 2013 monetary policy had begun to ease in Serbia, after a sharp rise in inflation prompted a tightening in the second half of 2012. Monetary policy was also broadly accommodative in EEC countries, with the exception of Belarus and Ukraine, where private sector credit conditions remain restrictive due to latent exchange rate pressures. The Central Bank of Russia has resisted calls to provide monetary stimulus to the weakening economy while inflation remains above the target range of 5 to 6 per cent. ▶



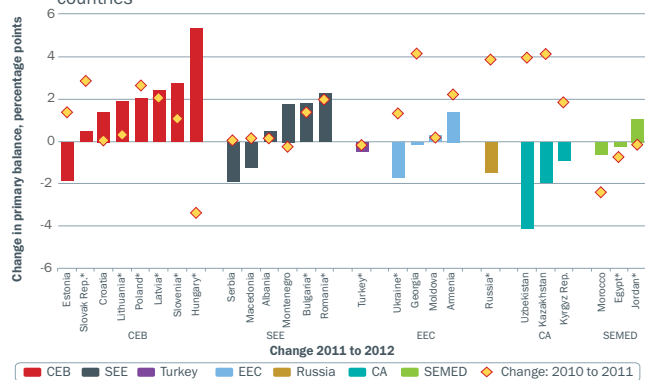
**Source:** National authorities via CEIC Data  
**Note:** The chart shows the year-on-year growth rate of credit adjusted for foreign exchange movements and inflation.



**Source:** National authorities via CEIC Data.  
**Note:** The definition of non-performing loans can vary across countries. As a result, the levels shown in the chart are comparable across time, but may not be perfectly comparable across countries.

<sup>7</sup> In the CEB and SEE regions interest rates have reached all-time lows in Albania, Bulgaria, Hungary, Latvia, Lithuania, Poland and Romania.

**Chart M.13.** Fiscal balances have deteriorated in most non-EU transition countries



Source: IMF IFS.

Note: Data from IFS only include cyclically adjusted balances for some countries (denoted with a \*). Where the data are available, the chart shows the change in the cyclically adjusted balance.

◉ In the SEMED region, interest rates rose in Egypt, Jordan and Tunisia in response to rising pressure on prices and exchange rates, but stayed low in Morocco where inflation remains low and stable.

Fiscal consolidation efforts continue in virtually all EU member countries, with the aim of achieving deficit and debt targets. However, an increasing number of transition economies have seen their primary balances deteriorate as the economic slow-down has hit revenues.

Fiscal policy tightened in all CEB countries in 2012 – except in Estonia, which has low public debt and registered a small deficit, after running a surplus in the previous two years.<sup>8</sup> This consolidation has contributed to the downturn. Poland, in particular, has been unable to maintain government investment, given its constitutional debt limits<sup>9</sup> and the EU fiscal rules. Fiscal policies have varied in other regions, with primary balances worsening in a number of countries (see Chart M.13). In Azerbaijan, Serbia and Ukraine this has partially reflected higher expenditure in the run-up to elections. In Russia and the commodity exporting nations of Central Asia the economic slow-down and weakening global commodity prices have led to slower growth in revenues.

There was a further widening of deficits across the SEMED region in 2012 as governments continued to increase spending on wages, social benefits and subsidies. Ongoing attempts to reform subsidies, in addition to budget support from the Gulf Cooperation Council for Egypt and Jordan, have contributed to a slower rate of fiscal deterioration compared with 2011.

## OUTLOOK AND RISKS

Growth in the transition region is expected to slow, from 2.7 per cent in 2012 to 2 per cent in 2013 as a whole. This reflects continued deceleration – of the Russian economy in particular – in the first half of the year. However, coinciding with the return to growth of the eurozone, early signs of recovery had begun to emerge by mid-2013.

CEB and SEE countries have seen gradual export growth and a pick-up in consumer and investor confidence. On a quarterly basis, Hungary, Croatia and Ukraine are expected to exit their recessions by the end of the year, although the latter two will still see contractions in annual terms. The majority of CEB, SEE and EEC countries will record weak growth – below 2 per cent – in 2013. Exceptions include Latvia and Lithuania, where gains in competitiveness continue to support a faster rate of expansion, and Azerbaijan, which has benefited from an increase in oil production. Growth also remains higher in Turkey and parts of the SEMED region, as well as in Central Asian countries, which continue to see significantly faster growth, ranging from 5 to 13 per cent.

In 2014 the region is expected to face a moderately improved, but still weak, external environment. Recovery in the eurozone is likely to be slow and uneven, and may be offset by the continued

<sup>8</sup> Slovenia's fiscal deficit has widened significantly in 2013, mainly reflecting the recapitalisation of ailing state-owned banks.

<sup>9</sup> Until this year, public expenditure in Poland was constrained by a law prohibiting increases in the budget deficit while public debt exceeds 50 per cent of GDP (and according to the domestic definition, it reached 52.7 per cent in 2012). However, this limit was suspended in July 2013, leading to a revision of the 2013 budget.

deceleration of major emerging economies. Market volatility in recent months has shown that the possible tightening of monetary policy in the United States could have significant consequences for the more vulnerable economies, including some countries in the transition region.

As a result of the gradual improvement of external demand – and in some countries, domestic demand – regional growth is projected to accelerate modestly in 2014, to 2.8 per cent. While better than the previous two years, this would mark the first time since the mid-1990s that the transition region had grown by less than 3 per cent in three consecutive years.

The recovery is expected to gain momentum slowly in most CEB and SEE countries, with only Slovenia remaining in recession. Supported by more accommodative fiscal policy, including increased spending on public infrastructure projects, Russian growth is expected to increase from 1.3 per cent in 2013 to 2.5 per cent in 2014. This partial recovery will benefit countries in the EEC region and Central Asia, whose economies have been negatively affected by weak Russian demand and slow remittance growth. In the absence of renewed political turmoil, the SEMED region is also expected to see somewhat faster growth in the coming year.

Downside risks to this outlook stem mainly from external sources. The most significant risk to growth in the CEB and SEE regions remains a return to crisis in the eurozone. In the worst scenario, a eurozone crisis would engulf larger members of the single currency area, leading to the insolvencies of several major banks in Europe. In response to such events, parent banks would accelerate withdrawal of funding from the region, exacerbating the contraction of credit and triggering recession in much of eastern Europe.

While the likelihood of this scenario has receded in recent quarters, other risks have increased. A faster deceleration of growth in China, or emerging markets more generally, would have substantial negative spillovers for the global economy. As yet unresolved disagreements over the extent and composition of fiscal adjustment in the United States pose a further risk. Given the global importance of US Treasury securities, a fiscal impasse could have a profound effect on world financial markets.

## References

**S. Avdjiev, Z. Kuti and E. Takáts (2012)**

“The euro area crisis and cross-border bank lending to emerging markets”, *BIS Quarterly Review*, December.

**J. Bouhga-Hagbe (2006)**

“Altruism and workers’ remittances: evidence from selected countries in the Middle East and Central Asia”, IMF Working Paper 06/130, Washington, DC.

**Vienna Initiative 2.0**

*Deleveraging Monitor*, 24 July 2013 ([www.vienna-initiative.com](http://www.vienna-initiative.com)).