20% ratio of non-performing loans to total loans in Cyprus, Kazakhstan and many South-Eastern European countries

16% average long-term unemployment rate in South-Eastern Europe

4 consecutive years of growth below 3 per cent on current projections through 2015
Average annual growth in the transition region has slowed further. Indeed, 2014 is likely to see the region’s annual growth rate standing below 3 per cent for the third consecutive year. Two major developments have negatively affected the performance of the region’s economies. First, growth has been hampered by the political tensions observed in Ukraine since late 2013. Second, like other emerging markets, countries in the region have been affected by expectations of monetary tightening in the United States.

Introduction

Growth has remained relatively weak across most of the transition region over the past year. Following the initial recovery after the 2008-09 global financial crisis, growth began slowing in the second half of 2011, against the backdrop of the intensification of the sovereign debt crisis in the eurozone. While a recovery started to take hold in the single currency area in the second half of 2013, two other major developments have had a negative impact on the economic outlook for the region.

First, growth in the region has been negatively affected by the geopolitical events observed in Ukraine since late 2013, so the outlook for growth has become significantly more uncertain. Second, prior to that, some countries in the EBRD region were (like other emerging markets) affected by expectations that quantitative easing would be tapered in the United States and monetary policy would be tightened in advanced economies more generally, which prompted outflows of capital.

The region as a whole grew at an annual rate of 2.3 per cent in 2013, compared with 2.6 per cent in 2012. Stronger growth in south-eastern Europe (SEE) and Turkey was more than offset by decelerating growth in Russia. Average growth in the southern and eastern Mediterranean (SEMED) region picked up only slightly, mainly on account of a strengthening in the performance of Morocco’s economy. Morocco benefited from a strong harvest, as well as increased foreign direct investment (FDI), on account of a more favourable policy environment.

Thus, the average annual growth rate in the region has now declined every year since 2011, and current projections suggest that 2014 will see it standing below 3 per cent for the third consecutive year. Growth has not been this weak over a three-year period since the transition recession of the early 1990s. This episode of moderate growth is likely to extend into 2015 and underscores the need to address structural impediments to growth across the region.

External conditions

Over the past year, modest improvements in the external economic environment have been more than offset by the crisis in Ukraine. The recovery in the eurozone took hold in the second half of 2013, with seasonally adjusted quarterly data suggesting that the single currency area returned to positive growth as early as the second quarter of that year, and by the first quarter of 2014 the crisis-hit economies of the eurozone’s periphery – including Portugal, Greece and Ireland – were able to return to the international bond markets, borrowing at relatively favourable interest rates.

The recovery in the eurozone has benefited the transition region, particularly central Europe and the Baltic states (CEB) and south-eastern Europe. In most of these countries the recovery has been underpinned by renewed growth in exports (see Chart M.1), following a significant contraction in 2011-12 at the height of the eurozone crisis. Supported by an increase in exports, Bosnia and Herzegovina, FYR Macedonia, Hungary, etc.
Montenegro and Serbia all returned to positive growth in 2013. Growth remained negative in Slovenia, however, while in Croatia the recession continued into 2014.

An economic recovery has also taken hold in the United States, prompting the Federal Reserve to start tapering its quantitative easing programme by reducing its monthly asset purchases. The Federal Reserve first alluded to the increased likelihood of such tapering in May 2013. Expectations of tighter monetary policy led to a gradual increase in US long-term interest rates (see Chart M.2). This made risk-adjusted returns on emerging market assets less attractive in relative terms and led to a sharp decline in capital flows to emerging markets in the summer of 2013. As a result, the stock markets and currencies of those countries came under pressure (see Chart M.3).

In the second half of 2013 the CEB region and most SEE countries were less strongly affected by expectations of tapering than emerging markets in Asia and Latin America (see Chart M.3). In part, this reflected smaller inflows of capital prior to May 2013. It was also a sign of stronger investor confidence in the region, boosted by the news of a recovery in the eurozone. Improvements in economic fundamentals following the 2008-09 crisis – such as smaller current account deficits (or larger surpluses) and larger primary fiscal balances, particularly in the new EU member states – also helped to mitigate the impact that the tapering of quantitative easing had on capital flows to the region (see Chart M.4).

When the Federal Reserve actually started reducing its monthly purchases of assets in December 2013 (initially from US$ 85 billion to US$ 75 billion per month), emerging market currencies and interest rates in mature economies largely stabilised. By then, expectations of future monetary tightening had largely been priced in by the markets. Moreover, the low investment levels that have generally characterised the post-crisis recovery in mature markets gave indications that long-term interest rates could remain low for longer than had initially been anticipated. Although emerging markets may be negatively affected by higher interest rates in the United States, the strong growth in advanced economies which underpins that monetary tightening will translate into increased demand for emerging market exports and thus benefit their economies.1

By contrast with trends observed in the second half of 2013, the currencies of a number of countries in the EBRD region came under stronger pressure in the first few months of 2014, while emerging markets in Asia and Latin America saw their currencies stabilising and appreciating somewhat. In a number of countries – including Hungary, Mongolia, Russia and Ukraine (see Chart M.3) – this largely reflected country-specific developments.

**Increased economic uncertainty**

Events in Ukraine have sharply increased economic uncertainty in the region, dashing hopes that the continuous decline seen in the region’s growth rate since 2011 would be reversed. As the events in Crimea developed in late February and early March 2014, Ukraine’s currency lost around 30 per cent of its value against

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1 See IMF (2014) for a comparative analysis of these various factors.
the US dollar between January and May 2014. At the same time, credit default swap spreads on government bonds widened sharply, while net private capital inflows turned sharply negative. In late March it was announced that an IMF programme had been agreed, but this brought only temporary respite, as disturbing news from eastern Ukraine further unsettled markets. A two-year IMF stand-by agreement was approved to assist Ukraine with the macroeconomic adjustments and structural reforms necessary to improve the country’s external position.

In Russia, equity markets and the currency also came under substantial pressure. This partly reflected the impact of the various waves of economic sanctions that the United States and the European Union had introduced since March 2014. Those sanctions, combined with uncertainty about their possible escalation in the future, negatively affected business confidence, limited the ability of companies and banks to access international debt markets and contributed to an increase in private capital outflow.

Net private capital outflows, which have persisted for several years, increased to around US$ 75 billion in the first half of 2014, as investor confidence weakened and Russian companies postponed or cancelled plans to borrow in international markets. This affected the annual growth rate of the Russian economy, which had already fallen to 1.3 per cent in 2013, down from between 3.0 and 5.0 per cent in 2010-12. Growth then slowed further to stand at 0.9 per cent year-on-year in the first quarter of 2014, while fixed capital investment contracted by 7.0 per cent over the same period.

Economic linkages in the region

Events in Ukraine have had a negative impact on investor confidence and growth prospects for the transition region more broadly. Various mechanisms play a role in this regard.

First, as tensions have escalated, concerns about energy security have been mounting in a number of countries in the region. Many countries – particularly CEB and SEE countries and those of eastern Europe and the Caucasus (EEC) – rely heavily on imports of Russian gas, with gas playing a major role in their overall energy mix and Russian supplies accounting for a large percentage of their total gas consumption (see Chart M.5). Furthermore, Russia and Ukraine also account for a large percentage of Egypt’s wheat imports.

Second, Russia is also an important source of export demand for many countries (see Chart M.6), and weaker growth in Russia affects those countries through the trade channel, as well as through reductions in inward foreign direct investment.

Third, a number of countries in the EEC region and Central Asia are vulnerable to a slow-down in remittances from Russia. In the case of Tajikistan annual remittances account for over 45 per cent of GDP, with the vast majority coming from Russia. Growth in remittances from Russia to Central Asia and the EEC region turned negative in the first quarter of 2014, the first time this had been observed since 2009 (see Chart M.7). However, the reduced volumes of US dollar-denominated remittances
Inflation and unemployment

Inflation rates have declined further in most countries (see Chart M.9). This reflects a combination of: (i) slower growth, and hence weaker demand pressures; (ii) broadly stable or falling prices for energy and metal commodities; and (iii) a decline in food prices, following one of the best harvests on record in 2013, coupled with expectations of a strong harvest in 2014.

In a number of countries in the CEB, SEE and EEC regions – predominantly those that use the euro as legal tender or as an anchor for their exchange rate peg – inflation has turned negative (in year-on-year terms). In some cases (in Hungary, for instance), administrative measures aimed at lowering regulated tariffs have temporarily contributed to lower inflation. At the same time, inflation has been persistently high in Belarus, Egypt, Mongolia, Russia and Turkey, where currency depreciation and resulting increases in import prices have contributed to upward price pressures. In Egypt bottlenecks in the food supply chain have further exacerbated food price inflation.

Unemployment remains persistently high in a number of countries, particularly in the CEB, SEE and SEMED regions. Of particular concern are the persistent (and in many cases rising) levels of long-term unemployment – the percentage of people in the labour force who have been unemployed for more than 12 months. Long-term unemployment now averages around 6 per cent in CEB countries and 16 per cent in SEE countries. The Baltic states are a notable exception: their long-term unemployment

\[\text{Notes:} \text{The index is calculated as the sum of FDI flows from Russia as a percentage of GDP, exports to Russia as a percentage of GDP, assets of Russian banks as a percentage of GDP and remittance flows as a percentage of GDP, all based on available data for 2012.}\]

\[\text{Source:} \text{International Trade Centre’s TradeMap database, Central Bank of Russia, national authorities and authors’ calculations.}\]

\[\text{Note: The rates shown are year-on-year figures based on consumer price indices. ** denotes a country that uses the euro either as legal tender or as a reference currency for the exchange rate peg.}\]

\[\text{Source:} \text{National authorities via CEIC Data.}\]

\[\text{Note: The rates shown are year-on-year figures based on consumer price indices. ** denotes a country that uses the euro either as legal tender or as a reference currency for the exchange rate peg.}\]
rate has been declining since 2011, testimony to the strength of their post-crisis recovery and their more flexible labour markets.

Youth unemployment (that is to say, unemployment among people aged between 15 and 24) remains particularly high in the SEE and SEMED regions. In the SEMED region the problem of youth unemployment is amplified by demographic trends, as young labour market entrants account for a large and rising share of the population.

Capital flows
Net capital flows to the EBRD region have been volatile, reflecting both the general volatility of capital flows to emerging markets and regional factors such as the crisis in Ukraine. Net capital inflows declined in the third quarter of 2013, following increased expectations that quantitative easing would be tapered. Turkey – where non-FDI capital inflows finance a major part of the persistently large current account deficit – was one of the emerging markets that was most significantly affected by that fall in capital inflows. The impact of that tapering moderated in subsequent quarters, but in early 2014 the outflows increased again, particularly for Russia and the EEC region, as tensions in Ukraine escalated (see Chart M.10). In the first half of 2014, syndicated lending to the region declined by 58 per cent year on year in volume terms, driven by declines in Russia and Turkey, while globally the volume of syndicated lending increased by 7 per cent over the same period.

Persistent non-performing loans
Cross-border bank deleveraging has continued, albeit at a slower rate overall, with foreign banks continuing to withdraw funds from the EBRD region. The pace of such deleveraging picked up in the third quarter of 2013, following the announcement of the forthcoming tapering of quantitative easing, as well as a number of interest rate cuts in the region, but it then moderated somewhat. Sustained deleveraging over a number of years has delayed the resumption of credit growth, particularly in the CEB and SEE regions, despite various credit surveys indicating that demand for loans has picked up in 2014.

In Bulgaria the banking sector came under stress in the summer of 2014, with runs on two major locally owned banks. The authorities took prompt action, putting one of the banks into administration and securing emergency liquidity support for the banking system as a whole, with the approval (under state aid rules) of the European Commission. The authorities’ response has helped to ease the situation, but the episode has raised concerns about supervisory standards. The Bulgarian authorities have subsequently signalled their intention to opt into the Single Supervisory Mechanism under the European Union’s banking union project.

On the positive side, deleveraging in the region has tended to be accompanied by a reduction in the percentage of credit which is denominated in foreign currency. New lending has increasingly been denominated in local currency, reflecting a greater...
Macroeconomic Overview

Kyrgyz Rep.

Bulgaria

Slovenia

Belgium

Serbia

Latvia

Montenegro

Romania

Poland

Mongolia

Azerbaijan

Ukraine

Tunisia

FYR Macedonia

Armenia

Egypt

Belarus

Nepal

Ratio (per cent)

Decrease in last 12 months

Increase in last 12 months

June 2014 or latest available

Table M.12. Persistently high levels of non-performing loans

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

Table M.13. Primary fiscal balances

Source: National authorities via CEIC Data, and IMF World Economic Outlook.
Note: Data for Mongolia do not include operations by the Development Bank of Mongolia.

Reliance on domestic funding, while in countries where credit has continued to contract in real terms, the contraction has been largely at the expense of foreign currency-denominated loans (see Chart M.11). A number of other factors have also contributed to this trend, including reduced interest rate differentials between loans denominated in local and foreign currencies (owing to lower levels of inflation) and stricter standards for lending to unhedged borrowers (for instance in Poland). In certain cases subsidised lending programmes (such as the Funding for Growth programme in Hungary) have also played a role.

Non-performing loans (NPLs) continue to account for a large percentage of total loans, and that ratio has even increased further in a number of countries, limiting the post-crisis recovery. In Hungary, Croatia, Ukraine and most SEE countries the ratio of NPLs to total loans is close to or in excess of 15 per cent (see Chart M.12). In Kazakhstan the NPL ratio has remained close to 30 per cent since mid-2009. The highest rate is in Cyprus, where NPLs account for more than 40 per cent of total loans and a significant contraction is still being observed for GDP. In Slovenia estimates of banks’ NPLs were revised upwards in late 2013 in the context of an asset quality review conducted by independent assessors at the request of national and EU authorities, while the subsequent recapitalisation of banks led to a reduction in NPL levels. Similar upward revisions of NPL ratios may follow in other countries conducting asset quality reviews.

Macroeconomic policy

The macroeconomic policies of countries in the EBRD region have generally been characterised by fiscal tightening, combined with accommodative monetary policies. A number of countries in the CEB and SEE regions (including Albania, Hungary, Romania and Serbia) have implemented further interest rate cuts to stimulate aggregate demand. These cuts have been facilitated by lower levels of inflation and moderating inflation expectations. Hungary and Mongolia have continued using unconventional monetary policy tools (including subsidised lending programmes) to boost credit to the private sector.

At the same time, central banks in a number of countries (including Turkey and Ukraine) have raised interest rates in response to capital outflows. However, the Central Bank of Turkey has subsequently reversed some of those interest rate increases. Moreover, the Central Bank of Russia increased its policy rate by 150 basis points (to 7 per cent) with effect from 3 March 2014 against the background of events in Crimea, stronger net capital outflows and persistently high inflation. Further rate increases followed in April and July 2014.

In January 2014, Latvia became the fifth country in the region to join the eurozone, following in the footsteps of Slovenia, Cyprus, the Slovak Republic and Estonia. Lithuania has been given the green light to follow suit in January 2015.

Primary fiscal deficits (that is to say, fiscal deficits net of the cost of servicing public debt) generally declined in 2013 relative to 2012, reflecting a slight tightening of fiscal policy (see Chart M.13). In some countries, notably in the SEE region, stronger economic growth contributed to increases in government revenues. SEMED countries continued to run sizeable primary fiscal deficits, partly reflecting the high fiscal cost of fuel subsidies. At the same time, all countries in the SEMED region adopted measures aimed at reducing energy subsidies, which should help to improve fiscal sustainability over the medium term. In Slovenia the general government deficit more than tripled compared with the previous year, owing to the considerable cost of recapitalising banks.

Looking ahead, countries in the region may find that they have less scope to combine fiscal tightening with accommodative monetary policies. In particular, when interest rates in advanced markets start to rise, there will be less scope for monetary policy easing, and monetary authorities may need to tighten policies in response to changes in cross-border capital flows.
Outlook and risks
The annual growth rate in the transition region is expected to decline from 2.3 per cent in 2013 to 1.3 per cent in 2014. This reflects the impact that the crisis in Ukraine has had on the economies of Ukraine, Russia and neighbouring countries, as well as a number of country-specific factors (including the damaging floods seen in Serbia and Bosnia and Herzegovina in May 2014).

Recovery in CEB and SEE countries will continue at a moderate pace. The lift provided by recovery in the single currency area will be only partly offset by weaker demand from Russia and the impact of the ban on selected food exports to Russia. Growth is expected to decelerate in Central Asia, due to the region’s strong economic ties with Russia, as well as various country-specific factors. Countries that rely heavily on remittances from Russia are at particular risk of a sharper economic slow-down. Growth is expected to remain robust in the SEMED region, where countries have taken steps to reduce energy price subsidies and improve fiscal sustainability over the medium term.

The transition region’s annual growth rate is projected to strengthen somewhat in 2015, increasing to 1.7 per cent. Output contraction in Ukraine is likely to be less severe in 2015. Growth may resume towards the end of the year, if the necessary macroeconomic adjustments and structural reforms are implemented and tensions do not escalate further. Russia is expected to experience a mild recession in 2015, reflecting increased uncertainty and the impact of economic sanctions. This slowdown is expected to constrain growth in the EEC region and Central Asia, where many economies rely heavily on export demand and remittance flows from Russia. Growth in the SEMED countries is also projected to strengthen on account of a more stable political environment.

The outlook for growth is subject to an exceptional degree of uncertainty related to geopolitical developments, with significant downside risks. Any further deepening of the crisis in Ukraine and Western sanctions on Russia will have direct implications for the two economies and a significant impact on investor confidence and growth in the transition region. In particular, a recession in Russia would reduce demand for the exports of many regional trade partners and weaken growth in remittance flows to EEC and Central Asian countries. A major economic slowdown in China or an abrupt correction in interest rates and asset prices in advanced markets could lead to a deterioration in the global economic outlook, potentially encouraging European parent banks to withdraw more funds from the region. This, in turn, would exacerbate the contraction of credit in the region, negatively affecting investment and consumption.

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