European Bank
for Reconstruction and Development

Regional Economic Prospects in EBRD Countries of Operations

November 2016

Return to modest growth

Average growth in the region is expected to pick up from 0.5 per cent in 2015 to 1.6 per cent in 2016 and 2.5 per cent in 2017. The outlook for growth in the EBRD region has thus strengthened slightly since May (an upward revision of 0.2 percentage points in 2016).[1]

Notwithstanding an upward adjustment since the first quarter of 2016, low commodity prices weigh on economic performance in Russia, where output is projected to contract by 0.6 per cent in 2016 (following a decline of 3.7 per cent in 2015) as well as that of other commodity exporters in Central Asia and Eastern Europe and the Caucasus (EEC).

In contrast, lower energy import bills, coupled with accommodative monetary policy in the eurozone, benefit Central Europe and the Baltic States (CEB) and south-eastern Europe (SEE). Strong tourist season gave additional boost to SEE economies, while the 2016 projections in CEB have been revised down somewhat on account of weak investment.

Weaker tourism receipts, partly due to security concerns, continue to cloud the outlook in the southern and eastern Mediterranean (SEMED) and Turkey. Growth in Turkey is projected to moderate to around 3 per cent in 2016-17, from around 4 per cent in the first half of 2016, as a result of weaker outlook for investment.

The direct impact on the EBRD region of the June 2016 Brexit vote in the UK is expected to be limited. In the short-term, more accommodative monetary policy in advanced countries in the aftermath of the vote contributed to recovery of capital flows to emerging markets, including the EBRD region.

The projections are subject to major risks related to geopolitical tensions in and around the region as well as economic developments in China.

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[1] The regional average growth rates in 2016-17 are based on weights corresponding to countries' projected nominal GDP values in US dollars in 2016, measured at purchasing power parity.

Broad trends

Since May 2016, the outlook for the region has improved at the margin, reflecting a number of global and regional trends:

- A modest recovery of oil prices from the lows seen in the first quarter of 2016 contributed to a stronger outlook in Russia and parts of Central Asia and EEC
- Capital flows into emerging markets have partially recovered in the aftermath of the UK referendum on EU membership
- On the other hand, weakness of global trade has persisted and the recovery in advanced economies has remained slow
- Geopolitical risks, both external and domestic, have remained elevated, with the situation in the Middle East and Eastern Ukraine being volatile

The slight improvement in the outlook is also consistent with EBRD's new economic model providing flash estimates (nowcasts) of economic growth in the region (see Box 1 for a discussion of the nowcast for the third quarter of 2016).

Global economic environment

The oil price has recovered further, from US$ 43 per barrel of Brent at the time of our previous forecast to US$ 52 per barrel as of mid-October 2016. This modest upward correction reflects expectations of a continued decline in oil production in the United States, where producers need prices of around US$ 60-65 per barrel to maintain sufficient profitability and justify investment costs, as well as the apparent willingness of Saudi Arabia to participate in a coordinated oil production freeze or production cuts.

The outlook for global growth remains relatively weak. Productivity in the advanced markets has been declining since the mid-2000s (Chart 1). Coupled with aging populations, this points towards lower medium-term growth. Growth of global trade has remained weak, below global GDP growth, to a large extent reflecting subdued investment activity in advanced economies and many emerging markets as well as a lower share of spending on machinery and equipment within investment outlays.

Since the May forecast, the US Federal Reserve System (FRS) and the European Central Bank (ECB) have left their funding rates unchanged. Markets expect the Fed to raise the interest rate in late 2016 and adopt a slow approach to monetary tightening in the view of the perceived weakness of the global recovery. The ECB has also maintained an accommodative stance. Monthly purchases of assets have been scaled up to €80 billion and now also cover selected corporate bonds.

The volatility in the European and global financial markets increased temporarily following the referendum held in the UK on 23 June 2016, where 52 per cent of voters backed leaving the European Union ("Brexit"). By mid-October, the British pound has weakened to the lowest level in decades, on a trade-weighted basis. The terms and timing of UK's departure from the EU are uncertain and will be subject to complex negotiations. In the short term, the vote has had a temporary positive impact on capital flows to emerging markets, as discussed below.

The medium-term impact of a potential slowdown in the United Kingdom on the EBRD region may materialize predominantly through indirect channels, such as lower growth in the eurozone, based on the analysis in the forthcoming *Transition Report 2016-17* employing a global vector auto-regression model (Chart 2; see also box 2 for a discussion of the longer-term impact in various scenarios). The direct impact on the EBRD region is likely to be limited as the weight of the UK in countries' trade, investment and remittances flows is relatively modest.

Significant numbers of nationals of new EU member states currently reside in the UK (up to 4 per cent of the total population of countries of origin in the case of Lithuania and Latvia). Some of these migrants may relocate back home or elsewhere in the EU in the medium term, depending on the nature and timing of UK's exit from the union.

A greater impact on the region's economic performance may materialise through the potential adverse impact of UK's exit on other EU economies, which in turn may depend on the impact of the UK referendum on domestic politics and the reform momentum in individual member states. In the longer term, a lower EU budget following the UK's departure may result in reductions in the EU structural funds available to the new EU member states, and in pre-accession funds to candidate and potential candidate countries.

Geopolitical tensions, terrorism and the refugee crisis continue to have a considerable impact on the economies of the region, including through their impact on tourist arrivals. Egypt, Tunisia and Turkey have seen considerable drops in tourism revenues while Croatia, Montenegro, Cyprus and, more recently, Greece have benefitted from tourists looking for alternative options for the summer season.

Recent growth performance in the region

The differences in economic outlook in the East and the West of the region, which have been apparent for the last two years, are persisting. Russia and other commodity exporters were negatively affected by a further drop in the price of oil in the first half of 2016 while the increase in the price of oil since the first quarter of 2016 has been a positive development for these economies. Most other countries in Central Asia and EEC have been negatively impacted by the continued recession in Russia, an important trading partner and a major source of remittances for these economies. Elsewhere, economies continue to benefit from low commodity prices and accommodative monetary policy in the eurozone. At the same time, security concerns weigh heavily on the tourism industries of SEMED economies and Turkey.

On balance, growth in the region as a whole picked up from 0.5 per cent in 2015 (the lowest since 2009) to 1.5 per cent (year-on-year) in the first half of 2016, according to preliminary data. This acceleration is broadly in line with the projections made in the May 2016 issue of the *Regional Economic Prospects.*

- Growth in **CEB** averaged around 2.6 per cent in the first half of 2016, below expectations and short of the 3.4 per cent growth in 2015. The slowdown primarily reflects weaker private investment and slower inflow of EU investment funds while consumption growth has remained robust.

- Growth across **south-eastern Europe (SEE)** averaged 2.9 per cent in the first half of 2016, maintaining the momentum gained in 2015. A notable exception is **Greece** where output contracted at a rate of 0.7 per cent in the first half of the year.

- Growth remained subdued throughout the **EEC** region, close to zero on average (in year-on-year terms) in the first six months of 2016. At the same time, **Ukraine's** economy has returned to growth in the first half of 2016 following a cumulative fall in output of around 16 per cent over the previous two years.

- **Turkey**'s economy grew by 3.9 per cent in the first half of 2016, following a 4 per cent expansion in 2015. Domestic demand was pushed up by private consumption due to increased disposable income, on the back of a 30 per cent hike in minimum wage as of January 2016, and somewhat larger government spending. After a relatively stable first half of 2016, the volatility of the lira increased in the third quarter in the aftermath of the failed coup on 15 July, amidst the introduction of the State of Emergency and its extension, rating downgrades by S&P and Moody's, as well as elevated regional tensions.

- In **Russia,** recession appears to have bottomed out, although in year-on-year terms output continued contracting in the first half of the year (by 0.9 per cent) as inflation cut into real incomes and household demand weakened further. Corporate investments also continued falling.

- Growth in **Central Asia** slowed down further in the first half of 2016, reflecting the region's strong dependence on commodity exports and close economic ties with Russia. Non-performing loans have been rising in several countries while fiscal pressures have increased.

- Security concerns and poor rainfall weighed on the economies of the **SEMED** region. Nonetheless, Egypt's economy performed better than expected in the first three quarters of fiscal year 2016 (4.3 per cent growth) on the back of strong private consumption growth (5.5 per cent) and recovery in investment (5.6 per cent).

The regional updates section further discusses country-specific factors that have been shaping the economic outlook in individual countries.

Capital flows

In the short term, emerging markets have come out as unlikely beneficiaries of the Brexit vote. In the aftermath of the UK's vote to leave the EU, investors reassessed the prospects of monetary tightening as major central banks indicated their readiness to keep low rates for longer while the Bank of England lowered its policy rate by 0.25 percentage points. As bond yields in advanced markets fell (turning negative in some cases), the search for yield led to higher inflows into emerging markets. As a result, capital inflows in 2016 are now expected to be higher than in 2015, albeit still considerably below the levels seen in 2010-14.

In CEB and SEE, balance of payments data indicate net capital inflows of around 1.4 per cent of GDP in the first half of 2016, compared with 0.1 per cent of GDP in 2015 (Chart 3). Net private capital outflows from Russia have moderated further as a significant portion of the external debt owed by banks and corporates had been repaid during earlier quarters.

Foreign direct investment has remained broadly stable, with some variation in terms of regional trends. It declined somewhat in central and south-eastern Europe and increased in the EEC region.

Remittances

Remittances from Russia to Central Asia and the EEC have stabilised in local currency terms in the first half of 2016, albeit at lower levels compared with 2014. In US dollar terms remittances in the first half of 2016 were around half the level recorded during the same period of 2014 and they continued declining. These trends reflect a somewhat better economic outlook in Russia following a negative growth of -3.7 per cent in 2015 coupled with relative weakness of the rouble in the early months of 2016.

Currency movements

The region's currencies have weakened slightly against the US dollar since April 2016, mirroring a moderate depreciation of the euro against the US dollar in the aftermath of the Brexit vote in June 2016 as well as broader trends in emerging markets. Mongolia's and Turkey's currencies weakened somewhat more in the aftermath of the general elections and attempted coup, respectively. In contrast, the Russian rouble has strengthened since April as oil prices have recovered from the lows seen at the start of 2016.

More broadly, currencies of major oil producers in the region continued to move in line with the oil price developments. This policy approach contrasts with that pursued by the Gulf Cooperation Council (GCC) member countries and some other major oil producers which maintained fixed or heavily managed exchange rate regimes while using fiscal policy (and running much higher budget deficits) to manage the economic adjustment to lower oil prices.

Credit conditions

Lending conditions eased slightly over the past six months, according to recent lender surveys. In line with broader trends in emerging markets, the IIF bank lending survey for Emerging Europe showed an improvement of overall conditions from 50.3 in the first quarter of 2016 to 51.9 in the third quarter of 2016 (on a 0 to 100 scale where values above 50 correspond to easing of lending conditions). Notwithstanding this easing, credit growth remained subdued in most countries in the CEB and SEE regions.

The levels of non-performing loans (NPLs) have been increasing in EEC and Central Asia, reflecting weaker economic outlook in these countries and, in some instances, weakness in governance of banks. In Tajikistan, for instance, the NPL ratio increased to 32 per cent at end-August 2016 compared with 16 per cent a year earlier; in Ukraine NPLs rose from 24 to 30 per cent of total loans between June 2015 and June 2016 while Belarus saw an increase in the NPL ratio from 6 to 13 per cent over the same period. NPL ratios remain high in many SEE countries, albeit declining. A recent EBRD study shows that persistently high ratios of NPLs are associated with substantial economic costs in terms of foregone growth, to the tune of more than 2 percentage points a year.[2]

Inflation

By mid-2016, 23 countries in the region had adopted some form of inflation targeting (of which seven did so by virtue of joining the eurozone). Of the remaining countries in the region around half currently peg their currencies to the euro or the US dollar.

In all but four countries with some form of inflation targeting the rates of consumer price inflation were below target at end-September 2016, as demand pressures have been weak and economies adjusted to lower commodity prices. In most of these countries Central Banks lowered their policy rates over the past 12 months (Chart 4). In countries with inflation rates above the target Central Bank policies varied depending on local circumstances. In Turkey, the policy rate remained unchanged despite persistent above-target inflation (consumer prices rose at the rate of 7.3 per cent in 12 months to September 2016). In Russia, the Central Bank started loosening its policy stance as inflation has been coming down towards the indicative target of 4 per cent for 2017 (it stood at 6 per cent at end-September).

Outlook

The projections assume a continued but low upward movement of prices of oil and other commodities, gradual moves towards normalisation of monetary policy in the United States, accommodative policies in the Eurozone and a continued rebalancing of China’s economy towards consumption and services-driven growth.

[2] See Balgova, Maria, Michel Nies and Alexander Plekhanov (2016), “The economic impact of reducing non-performing loans”, EBRD Working Paper 193.

In our baseline scenario, growth in the transition region is expected to increase from 0.5 per cent in 2015 to 1.6 per cent in 2016 (Table 1). This pick-up in growth reflects sustained momentum in south-eastern Europe, improved outlook in Russia where recession is coming to an end and a modest recovery in Ukraine.

The acceleration is slightly stronger than projected in May 2016 (an upward revision of 0.2 percentage points, Chart 5) on account of recovery in commodity prices, stronger capital flows and sustained import demand from China.

Growth is expected to pick up further in 2017, reaching 2.5 per cent (unchanged compared with the May 2016 projections)**.** The expected acceleration in both 2016-17 is broad-based:

- Growth expectations for 2016 have been revised downward to 2.7 per cent in **CEB** region reflecting weaker outcome in the first half of the year. Growth is expected to accelerate slightly in 2017, to exceed 3 per cent.

- Growth in **SEE** is expected to reach to 2.8 per cent in 2016, helped by significantly improved prospects in **Serbia** and robust growth in **Romania**. The second half of the year is likely to see a return to positive growth in **Greece**, helped by another strong tourism season and a gradual upturn in business confidence. The region is expected to see a further broad-based acceleration in 2017, to 3 per cent on average.

- Growth in **EEC** region as a whole is expected to remain negative in 2016 reflecting headwinds from the recession in Russia, geopolitical tensions and, in the case of Azerbaijan, low oil prices. While Ukraine returns to growth, Azerbaijan and Belarus are projected to be in recession. All economies are expected to return to growth in 2017 as external environment improves.

- Growth in **Turkey** is projected to moderate to around 3 per cent in 2016 and 2017 on lower expected private investments owing to higher wage bill costs and the country credit rating downgrade as well as sustained weakness of the outlook for tourist arrivals.

- **Russia's** economy is expected to return to modest growth in late 2016 and 2017 after another year of recession in 2016, as oil prices gradually recover. In quarter-on-quarter terms, recession is expected to end already towards the end of 2016.

- Growth in **Central Asia**, a region with close links to Russia and high dependence on commodities, is expected to decelerate further in 2016 before recovering in 2017, to reach 4 per cent (the level recorded in 2015). Mongolia's economy is expected to benefit from the implementation of the second phase of Oyu Tolgoi, a major copper mining project.

- Growth in the **SEMED** region is expected to moderate to 3.1 per cent in 2016 as lower agricultural output due to poor rainfall in Tunisia and Morocco compounds the weakness in the tourism sector. Growth is expected to recover to 4 per cent in 2017 as agricultural output normalizes and Egypt sees further improvements in competitiveness.

Risks to the outlook

The outlook is subject to numerous risks.

Geopolitical tensions and security threats in and around the region continue rising. This may have further impact on the refugee flows, tourist arrivals as well as broader investor confidence.

A build-up of debt in **China's** corporate and household sectors (Chart 6) as well as excess capacity in selected sectors and in narrowly-specialised towns remains a source of concern, although low levels of public debt and the low share of corporate debt denominated in foreign currency are viewed as mitigating factors. China has become an increasingly important trading and investment partner for the region as discussed in the May 2016 *Regional Economic Prospects* as well as the macroeconomic overview section of the forthcoming *Transition Report 2016-17*.

A renewed weakness **in commodity prices** is a key source of risk for Russia's economy as well as countries in Central Asia and the EEC region with close economic links with Russia.

The way **Brexit** talks unfold may materially affect investor sentiment, in Europe and beyond.

Box 1. Nowcasting: An estimate of region's growth in the third quarter

Since quarterly GDP numbers are published with a significant time lag, typically 2 to 4 months, policymakers, analysts and investors are interested in indicators that track economic growth in real time. Models that use such indicators to construct estimates of GDP growth are termed nowcasting. These models estimate growth in the recent past and project it for the near future. Amid a wealth of indicators that track economic performance in advanced economies, relatively few indicators have been developed for Emerging Markets.

This box presents a nowcast for economic growth in the EBRD region in the third quarter of 2016. The estimate is based on a factor model using principal components.[3] The model takes into account the latest data for 107 economic indicators, both global (such as the oil price) and specific to the region (such as Russia's industrial production a month ago). The indicators are selected based on the availability of data (with a maximum lag of 8 weeks) and their relevance for the region's economic performance. The model is estimated using seasonally adjusted quarterly data for the period 2009-2016 to capture the latest (post-crisis) relationship between various indicators and the region's GDP growth (quarter-on-quarter).

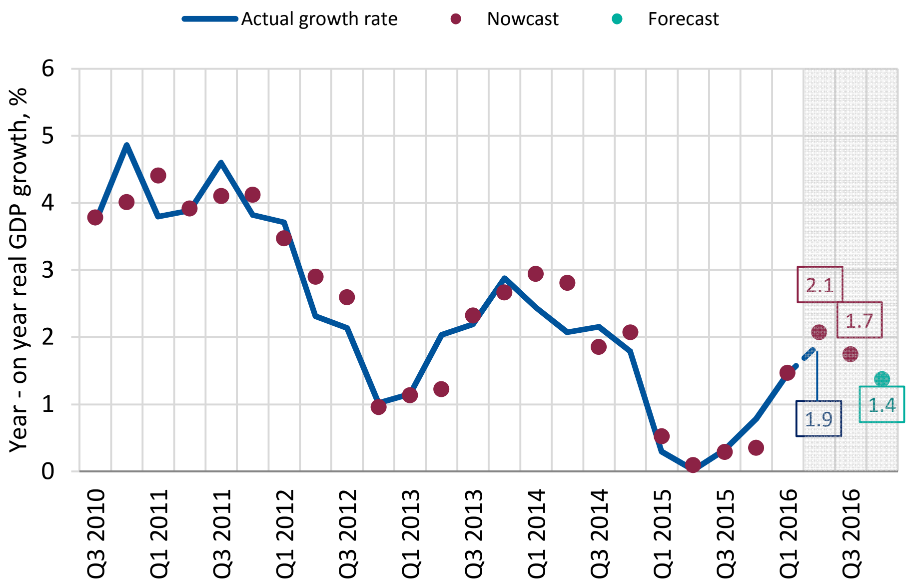
The October flash estimate of the nowcasting model points towards stronger growth in the second and third quarter compared to the first quarter of 2016 and the previous year. Chart 1.1 expresses the nowcasts in terms of year-on-year quarterly growth numbers – the format commonly reported by the region's statistical offices. While the majority of countries have published flash or final growth figures for the second quarter, the model complements missing growth data (notably for Egypt) with a country nowcast and predicts a year-on-year growth rate of 1.9 per cent in the second quarter (corresponding to 2.7 per cent quarter-on-quarter in seasonally adjusted annualized terms).

The growth in the third quarter is estimated to have moderated to 1.7 per cent year-on-year (or 1.6 per cent quarter-on-quarter, annualised). This is above the rate observed in the first quarter but below the second quarter estimate. The acceleration in the second and the third quarter primarily reflects a combination of higher prices of oil and other commodities and stronger external demand on the back of higher imports to China and the United States. These effects were stronger in the second quarter and moderated somewhat in the third (oil price, in particular, declined by 6 per cent in quarter-on-quarter terms but stood 26 per cent above the first quarter reading).

For the year as a whole, the model predicts a growth rate of 1.7 per cent, reflecting a further expected slowdown in the last quarter of the year, to 1.4 per cent year-on-year (1.5 per cent quarter-on-quarter). This nowcast is broadly in line with the average growth for the region derived from country-by-country forecasts presented in Table 1.

[3]For a detailed description of the model applied, see: Stock, James H., and Mark W. Watson, 2002, "Forecasting using principal components from a large number of predictors*." Journal of the American Statistical Association,* Vol, 97, pp. 1167-1179*.*

Chart 1.1. EBRD region's growth and October Flash Nowcast



Source: Authors' calculations based on a principal component factor model with 107 input variables.

Note: Year-on-year growth rates are transformed from quarterly seasonal adjusted figures for nowcasts.

How do nowcasts compare with the estimates that could be obtained if the model were run in April 2016, at the time of writing of the previous issue of the Regional Economic Prospects? The model run today suggests a 0.4 percentage point higher growth reflecting strong performance in the second and the third quarters. This is also consistent with the upward direction of revision of country-by-country forecasts in Table 1.

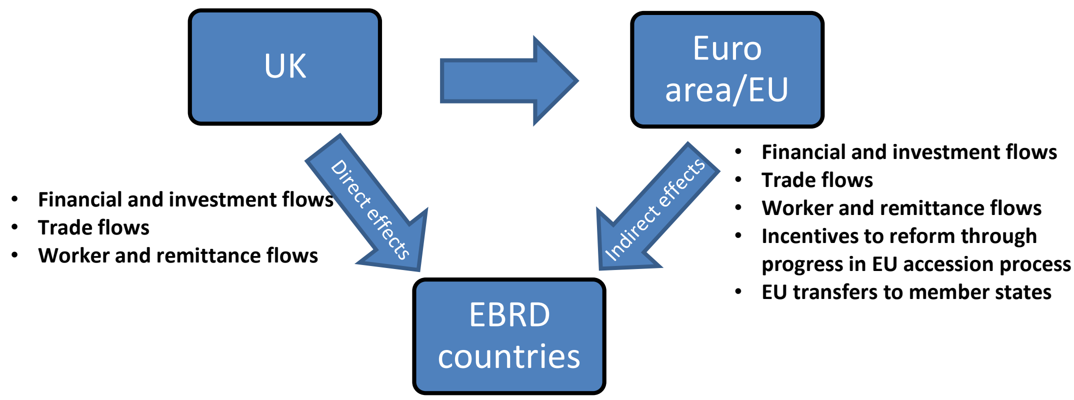
Box 2. Assessing the potential effects of Brexit on the EBRD region

The United Kingdom's (UK) decision to leave the European Union (EU) may have a significant effect not only on the UK economy but also on EU economies and thus on countries with strong ties to the EU. Following the referendum on 23 June, most analysts adjusted downwards their forecasts for the UK.[4] But how big will the impact on other economies be, and to what extent do these impacts depend on the Brexit model that eventually emerges from the negotiations, expected to begin next year, between the UK and the rest of the EU?

The estimates of the impact of Brexit on economic growth in EBRD region depend on the assumed scenarios, ranging from negligible to very substantial. The estimates take into account the following channels of transmission of the Brexit shock (Chart 2.1):

a) Direct impact of a slowdown in economic activity in the UK through financial, trade and labour linkages, estimated based on the newly-developed EBRD global vector autoregressive model (GVAR)[5];
b) Indirect Brexit effects (through financial, trade and labour linkages with the euro area whereby potential poorer performance in the euro area further affects the EBRD region);
c) The impact on growth from the potential slow-down in structural reforms in the EU accession countries results, estimated based on the empirical studies of the pre-accession reforms and growth performance of the new member states[6];
d) The growth effects from a potential reduction in EU transfers, estimated based on the European Commission's QUEST model

Chart 2.1. Main transmission channels of the UK exit from the EU



[4] See IMF World Economic Outlook Update, July 2016: Uncertainty in the Aftermath of the UK Referendum.

[5] See Transition Report 2016-17.

[6] See Falcetti, Elisabetta, Tatiana Lysenko, and Peter Sanfey (2006) "Reforms and growth in transition: Re-examining the evidence," *Journal of Comparative Economics,* Vol. 34, pp.421-445.

The "soft" Brexit scenario (taken from the October 2016 IMF WEO) assumes a relatively smooth exit for the UK, with trade relationships being kept at close to the present level. Under this scenario, EU transfers to the new member states are not affected as other members cover for the missing UK contributions.

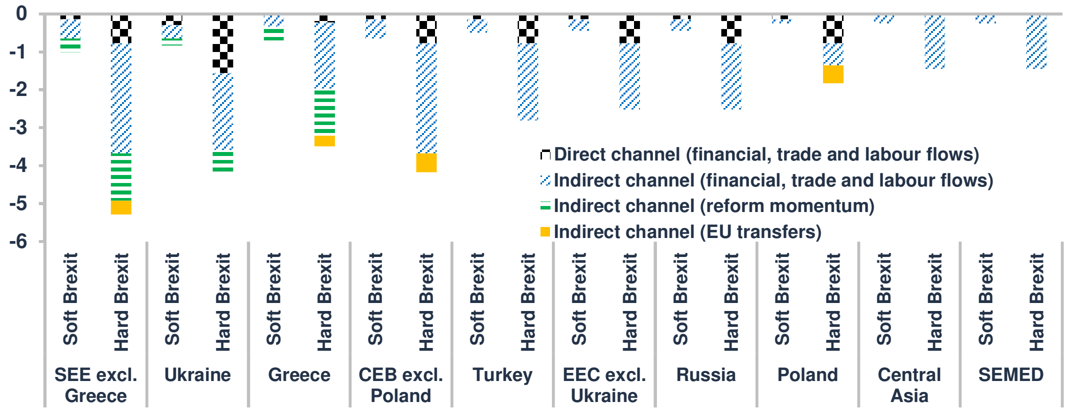
The "hard" Brexit scenario presumes trade relationships between the UK and the EU are significantly disrupted, while new trade agreements for the UK progress only slowly. UK and EU growth is markedly weaker than in the no-Brexit baseline because of the trade disruptions and the relocation of large companies and banks outside the UK. In this scenario EU transfers are cut by 10 per cent as the withdrawal of the UK contribution is not compensated by other countries. The EU accession process is also assumed to slow down, negatively affecting reform momentum and long-term growth in candidate and potential candidate countries, as well as in other countries trying to strengthen links with the EU. All estimates are reported with respect to a no-Brexit baseline scenario, which uses growth assumptions from the April 2016 IMF World Economic Outlook (WEO).

The results show that the indirect channels are more important that the direct ones under both scenarios (Chart 2.2).[7] The "soft" Brexit would have relatively mild negative effects: the level of GDP in 2021 is expected to be 0 to 1 per cent lower than in the scenario that has no Brexit.

Under the "hard" Brexit scenario, the impact is much more severe, especially in south-eastern Europe where the estimates of the foregone GDP growth (the difference between projected GDP in 2021 and that in the no-Brexit scenario) range from 3.5 per cent in Greece to nearly 6 per cent in the rest of SEE. The impact will also be felt in Ukraine and central Europe and the Baltic states with a reduction of around 4.2 per cent (excluding Poland, where the impact is less strong). In SEE, weaker reform momentum plays an important role while Central Europe and the Baltics States are to a greater extent affected by a drop in EU transfers.

[7] The highest share of UK in exports, according to UNCOMTRADE data from 2015, was in Belarus (11 per cent), Cyprus (10 per cent), Turkey (7 per cent), Moldova (7 per cent) and Poland (6 per cent) while share of exports to the EU for the EBRD region was 38 per cent.

Chart 2.2. Difference in GDP level compared to the no-Brexit baseline by 2021



Source: EBRD calculations based on a GVAR model – see Transition Report 2016-2017.

Table 1: Real GDP Growth

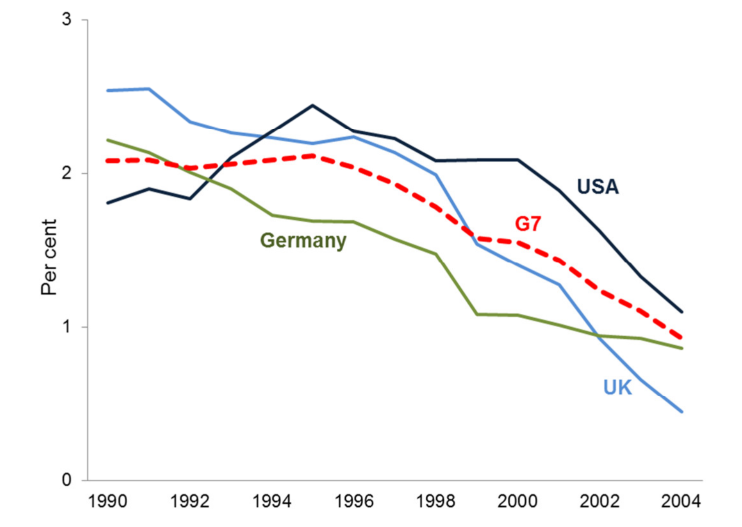
(In per cent; EBRD forecasts as of 3 November 2016)

	Actual		Current forecast		EBRD Forecast Change May-Nov.	
	2014	2015	2016	2017	2016	2017
EBRD Region[1]	**1.9**	**0.5**	**1.6**	**2.5**	**0.2**	***0.0***
Central Europe and the Baltic states[1]	**3.1**	**3.4**	**2.7**	**3.0**	**-0.4**	***-0.1***
Croatia	-0.5	1.6	2.3	2.0	0.8	*0.5*
Estonia	2.8	1.4	1.6	2.4	-0.6	*-0.2*
Hungary	4.0	3.1	2.0	2.4	-0.1	*0.0*
Latvia	2.1	2.7	2.2	3.1	-0.9	*-0.2*
Lithuania	3.5	1.8	2.6	2.9	-0.4	*-0.2*
Poland	3.3	3.9	3.0	3.2	-0.6	*-0.2*
Slovak Republic	2.6	3.8	3.2	3.2	0.0	*0.0*
Slovenia	3.1	2.3	2.2	2.3	0.2	*0.0*
South-eastern Europe[1]	**1.4**	**2.3**	**2.8**	**3.0**	**0.4**	***0.1***
Albania	1.8	2.8	3.3	3.5	0.0	*0.0*
Bosnia and Herzegovina	1.1	3.0	2.7	3.0	-0.3	*0.0*
Bulgaria	1.3	3.6	2.8	2.8	0.3	*0.3*
Cyprus	-1.5	1.7	2.7	2.2	1.0	*0.2*
FYR Macedonia	3.6	3.8	2.1	3.0	-1.1	*-0.5*
Greece	0.4	-0.2	0.0	2.0	0.2	*-0.4*
Kosovo	1.2	4.0	3.5	3.5	0.5	*0.0*
Montenegro	1.8	3.4	4.0	3.5	0.0	*0.5*
Romania	3.1	3.7	4.8	3.7	0.8	*0.2*
Serbia	-1.8	0.8	2.5	2.7	0.7	*0.4*
Eastern Europe and the Caucasus[1]	**-1.7**	**-4.8**	**-0.4**	**1.7**	**-0.2**	***0.0***
Armenia	3.6	3.0	2.0	2.0	0.0	*0.0*
Azerbaijan	2.8	1.1	-3.0	1.0	0.0	*0.0*
Belarus	1.7	-3.9	-3.0	1.0	0.0	*0.0*
Georgia	4.6	2.8	3.4	3.9	0.0	*0.0*
Moldova	4.8	-0.5	1.5	2.5	1.5	*0.5*
Ukraine	-6.6	-9.9	1.5	2.0	-0.5	*0.0*
Turkey	3.0	4.0	3.0	3.0	-0.2	*-0.4*
Russia	0.7	-3.7	-0.6	1.2	0.6	*0.2*
Central Asia[1]	**6.0**	**3.6**	**2.9**	**3.9**	**-0.4**	***-0.1***
Kazakhstan	4.3	1.2	0.7	2.4	-0.4	*0.0*
Kyrgyz Republic	3.6	3.5	1.6	2.6	0.6	*0.0*
Mongolia	8.1	2.4	1.7	3.2	-2.2	*-1.9*
Tajikistan	6.7	6.0	4.5	4.1	0.0	*0.0*
Turkmenistan	10.3	6.5	6.5	7.1	0.0	*0.0*
Uzbekistan	8.1	8.0	6.5	6.2	0.0	*0.0*
Southern and Eastern Mediterranean[1,2]	**2.4**	**3.9**	**3.1**	**4.0**	**0.2**	***0.0***
Egypt	2.2	4.2	3.8	4.0	0.5	*-0.2*
Jordan	3.1	2.4	2.4	2.8	-0.6	*-0.5*
Morocco	2.6	4.5	1.5	4.8	-0.8	*0.8*
Tunisia	2.3	0.8	1.5	2.5	-0.1	*0.0*
Average EEC, CA, Russia	1.1	-2.8	0.0	1.7	0.4	*0.1*
Average CEB, SEE, SEMED, Turkey	2.6	3.5	2.9	3.2	-0.1	*-0.2*

[1] Weighted averages, based on the countries' nominal GDP values in PPP US dollars.

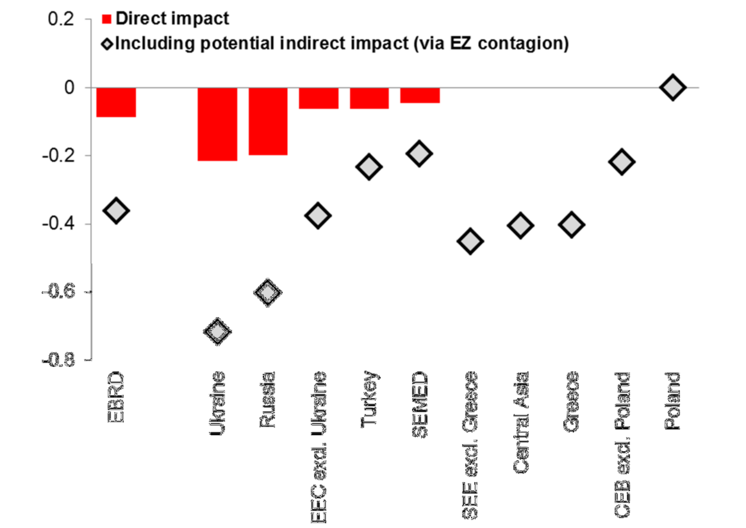
[2] EBRD figures and forecasts for Egypt's real GDP reflect the fiscal year, which runs from July to June. These are also used in the regional averages.

Chart 1. Labour productivity growth , 10-year moving average



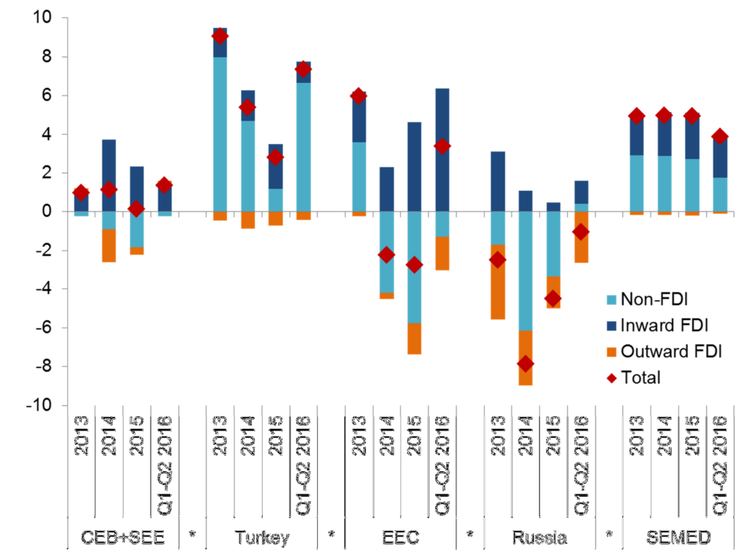
Source: OECD; EBRD calculations

Chart 2. Estimated impact of 1pp decline in UK GDP growth



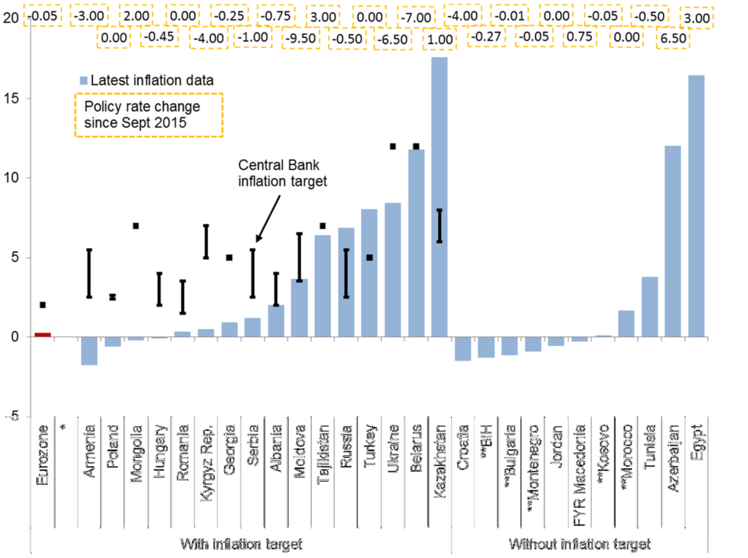
Source: EBRD calculations

Chart 3. Capital flows in the EBRD region



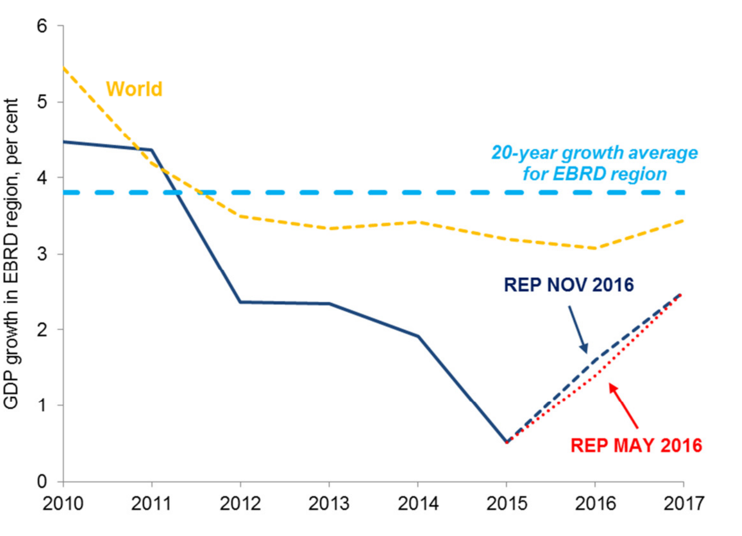
Source: National authorities via CEIC; EBRD calculations

Chart 4. Current rate of inflation versus inflation targets



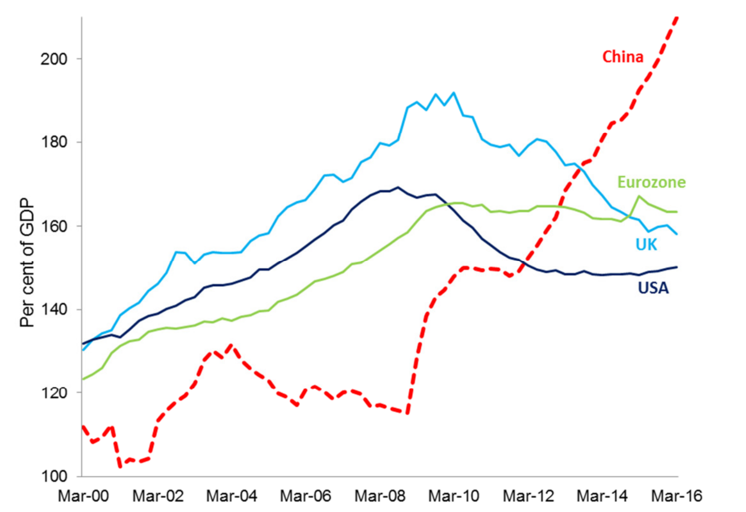
Source: National authorities via CEIC; EBRD calculations

Chart 5. GDP growth and forecasts for the ERBD region



Source: IMF WEO; EBRD forecasts

Chart 6. Household and corporate credit, % of GDP



Source: Bank of International Settlements

Regional updates

Central Europe and the Baltic States (CEB)

Following a GDP growth of 3.4 per cent in 2015, the CEB region saw some deceleration in economic expansion, to 2.6 per cent, in the first half of 2016. Amid further strengthening household consumption, underpinned by improving labour market conditions and rising real wages, investment performance disappointed. This substantial drop, on an average by 4.6 per cent, was broad based. On one hand, the slow start of EU funds inflow from the current budget dramatically affected public investment, while, on the other hand, private sector projects have been persistently delayed for various reasons, such us regulatory uncertainty in Poland or difficulties in credit financing, such us in Latvia or Slovenia. Our growth expectations for this year have been revised downward to 2.7 per cent, while in 2017 growth should pick up slightly, to 3 per cent. Nevertheless, risks related to the UK leaving the EU, which may materialise through significant trade links with the eurozone, may weigh on these developments.

- In **Poland**, GDP growth in the first half of 2016 came below our expectations, mostly affected by shrinking investment. That development was broad based. Firstly, the EU co-financed public investments are expected to accelerate only from 2017, which, in turn, have dramatically affected the construction sector thus far. Secondly, regulatory uncertainty related to sectoral taxes, and sweeping changes in the management of state-owned enterprises management have held back companies from launching new projects. In contrast, private consumption remained the key driver for growth, supported by a 5 per cent growth in real wages, record-low unemployment and new child cash benefits. Such strong consumption translates into worsening net exports. Due to poor investment performance we expect GDP growth to reach 3.0 per cent this year, before it accelerates somewhat to 3.2 per cent in 2017. Consumption is likely to remain the key driver, while net exports and investment pose a risk to that outlook.

- Following some deceleration in 2015, economic growth in **Hungary** saw a further slowdown in 2016. In annual terms, investment dropped by over 15 per cent by mid-2016, largely affected by weak EU funds inflows from the new budget. Private consumption strengthened further, particularly underpinned by decent growth in real wages, which soared by about 7 per cent in June, and improving labour market conditions. In volume terms, export growth remained robust, though its net contribution to GDP growth was largely offset by strong private consumption-driven imports. Growth in investment will likely gain momentum next year, owing to government fiscal stimuli, higher expected FDI inflows (partially linked to factory expansion projects of Audi and Mercedes) and accelerated disbursement of EU funds. We expect GDP growth at 2 per cent this year, before it accelerates to 2.4 per cent in 2017.

- The **Slovak Republic** has registered the highest GDP growth in the CEB region, at 3.6 per cent, over the first six months of this year. In contrast to its regional neighbours, investment growth remained positive, which was partially driven by robust private sector investment, such as the starting of projects in the automotive industry. Strong household consumption is expected to remain the key engine of growth, supported by rising disposable incomes and improvements in the labour market. Public investment is expected to accelerate only from next year, though it is conditioned on the rate of EU funds absorption, which saw some delays during the execution of the past budget. Our growth expectations for this year and next remain unchanged, at 3.2 per cent in both years.

- During the first half of 2016, GDP growth rates in the three **Baltic economies** remained below expectations. Amid tightening labour market conditions, which resulted in continuously rising real wages (above 7 per cent in Estonia and Lithuania), household consumption remained the key driver for growth. In contrast, investment growth disappointed in particular in Latvia, which saw a contraction in investment expenditures of about 22 per cent in the first half of this year, amidst the still weak absorption of EU funds from the new budget and persistent negative credit growth. Exports have marginally recovered, though the services' component has remained subdued, largely due to a continuous deterioration in transit trade with Russia. This year's growth rates have been revised down in all three countries, whereas the anticipated faster eurozone recovery and a greater number of investments co-financed by the EU will likely provide an additional boost for growth in 2017.

- The **Croatian** economy continued to expand in the first half of 2016, underpinned by strong consumption and the pick-up in investments. The EBRD forecast foresees 2.3 per cent growth in 2016 supported by recovering private consumption due to lower oil prices and continuing disinflation. Export growth is likely to remain strong on further trade integration in the EU market and higher tourist inflows due to sustained security issues in competing tourist destinations. In 2017, growth may slow to 2 per cent reflecting a lower contribution of net exports as consumption and investments continue to recover, and continuing fiscal adjustment to put the public debt on a sustainable path. Despite some improvement in business sentiment, private investments are expected to remain weak, pointing to persistent structural weaknesses. Public investments may pick up gradually along expected improvements in the absorption capacity of EU funds. Long-term growth prospects may improve if the government consistently implements major structural reforms envisaged in the National Reform Programme and focuses on resolving the high level of non-performing (corporate) loans as well as reducing household and corporate leverage.

- **Slovenia**'s economy is expected to grow by 2.2 per cent in 2016 and by 2.3 per cent in 2017. Domestic demand will be the main growth driver, mainly on the back of improved labour market conditions and the recovering housing market, while the termination of availability of funds from the previous EU funding period will weigh on investments. In 2017, growth will be supported by domestic demand, including the recovery of investments and consumption. While exports growth is to remain robust, the contribution of net exports is expected to decline significantly, as imports will catch up on the back of rising domestic demand.

South-Eastern Europe (SEE)

Economic growth in south-eastern Europe (SEE) in the first half of 2016 has held up well, following the improved performance in 2015 and the rise in average growth across the region to 2.3 per cent (versus 1.4 per cent in 2014). All countries recorded positive growth in the first half of 2016 aside from Greece, where GDP fell by 0.7 per cent year-on-year. The second half of the year is likely to see a return to positive growth in Greece, helped by another strong tourism season and a gradual upturn in business confidence. For 2016, the weighted average growth rate in the region is projected to rise slightly to 2.8 per cent, helped by significantly improved prospects in Serbia and robust growth in Romania, with a further rise to 3 per cent in 2017 fuelled by broad-based growth across the region, including in Greece.

Greece

The Greek economy experienced a drop of -0.7 per cent year on year in the first half of 2016, partly as a result of base effects from the upturn in consumer spending in the first half of 2015. One encouraging sign this year has been the positive contribution of gross fixed capital formation to growth, but other parts of the national accounts, including private consumption, government consumption and net exports, turned downwards again. Early indications are that 2016 will be another record year for tourism, with international arrivals at the country's main airports in the first nine months of the year up 7.6 per cent year-on-year. Business confidence is also rising gradually, helped by the government's progress in completing milestones under the current European Stability Mechanism (ESM)-funded economic adjustment programme. As a result, economic growth is likely to be positive in the second half of 2016, delivering zero growth for the year as a whole. For 2017, the outlook is more favourable as confidence and investment continue to pick up, but ongoing capital controls (albeit partially relaxed in recent months), further fiscal austerity measures and weaknesses in the financial sector, where non-performing loans remain substantial, will likely constrain growth to around 2 per cent.

Cyprus

Economic growth returned to Cyprus in 2015 after three years of contraction, with the economy expanding by 1.7 per cent. Growth accelerated in the first half of 2016 to 2.7 per cent year-on-year, and consumer confidence has risen sharply, exceeding the EU average in recent months and supporting strong private consumption growth. Gross fixed capital formation was also a major positive contributor, although this was to some extent neutralized by the negative contribution from the change in inventories. The more dynamic economy had positive spillovers on the labour market, as the unemployment rate has begun to fall, reaching 12.0 per cent in mid-2016 compared with the 2014 peak of 16.3 per cent. Fiscal performance has also been strong, with the fiscal deficit falling to just 1 per cent of GDP in 2015. Nevertheless, general government debt is still high, exceeding 100 per cent of GDP at the end of 2015. Overall growth in 2016 is likely to be around 2.7 per cent, moderating somewhat to 2.2 per cent in 2017, as high levels of public and private debt, and a large overhang of non-performing loans in the banking sector, continue to constrain growth.

Bulgaria

Following a 3.6 per cent growth in 2015, driven by net exports, the Bulgarian economy grew by 3 per cent in the first half of 2016, with a shift of growth drivers towards domestic demand. While private consumption grew on the back of 10.5 per cent hike in minimum wage as of January 2016 and better labour market conditions, government spending remained subdued due to transition to the new EU funds programming period. In 2016 and 2017, domestic demand will remain as the driver of growth, supported by improved income prospects, on the back of almost 9.5 per cent hike in minimum wages and wage improvement for teachers as of 2017, as well as lower cost of funding, on the back of financial sector stabilisation. However, the contribution of net exports to growth will remain limited due to strong domestic demand. Overall, growth is expected to stand at 2.8 per cent in 2016 and in 2017.

Romania

Economic growth in Romania accelerated further, from 3.7 per cent in 2015 to 5.2 per cent in the first half of 2016, on the back of domestic demand. The contribution of private consumption to growth was higher than expected, on the back of improved income prospects driven by low inflation and wage hikes, as well as fiscal easing. Consumption will be pushed further up by the wage hike for the entire health sector as of August 2016 and cut in employees' social security contribution by 2017. Private investments had a positive contribution to growth, on the back of historically low cost of funding and improved industrial confidence and this is likely to continue into 2017. Government spending is likely to remain subdued due to the end of the previous EU-funding period, despite higher staff costs. Meanwhile, slightly improved economic prospects of Romania's trade partners should support net exports. Overall, growth is expected to reach 4.8 per cent in 2016, before moderating to 3.7 per cent in 2017.

Western Balkans

- In **Albania**, GDP growth in 2015 was 2.8 per cent, an improvement of one percentage point compared to 2014. This increase in growth was mainly driven by investment as well as net exports to some extent. Growth continued in the first half of 2016 at 3.1 per cent year-on-year. The expansionary monetary policy of the central bank has brought the policy rate to a historic low of 1.25 per cent which has led to the lowering of interest rates. Government spending has been relatively contained in recent years and is expected to remain so as the government pursues a prudent fiscal policy in line with the aims of the IMF programme. The 2016 budget aims for a primary surplus of 0.3 per cent of GDP. The growth momentum is expected to be sustained in the short term, with GDP growth expected to rise to 3.3 per cent in 2016, with a further increase to 3.5 per cent in 2017. We expect growth to remain mainly investment-driven as TAP construction enters its full extent in

2016-2017 with a total investment of about 1.5 per cent of GDP per year in each of these two years.

- **Bosnia and Herzegovina**'s GDP grew by 3 per cent in 2015, the strongest level of growth since 2008. This was driven by a good performance of wholesale and retail trade, manufacturing and agriculture. Growth in the first half of 2016 slowed down somewhat to 1.7 per cent year-on-year, although the industry sector continued to grow at a robust rate. In September 2016 the IMF and the Bosnian authorities signed a three-year €553 million Extended Fund Facility (EFF). The new programme will help the governments of the two entities to fill their financing gaps. IMF financing is combined with an economic programme aiming to improve the business environment, create private sector jobs and raise the economy's growth potential. The country's reform agenda, introduced in mid-2015, is also advancing, with new labour laws adopted in both entities in the past year. Major infrastructure projects are also being rolled out, helping to boost growth. We expect GDP growth to fall slightly for 2016 as a whole to 2.7 per cent, before rising again to 3 per cent in 2017. Downside risks come from political uncertainties and ongoing weaknesses in the business environment.

- In **FYR Macedonia**, the robust economic performance of 2014 continued into 2015, as the economy grew by 3.8 per cent, helped by household spending, public investment and a strong export performance, especially of products associated with some of the large foreign investments in the car and car components sector. However, the political crisis has had some impact on economic growth, which fell to 2.1 per cent year-on-year in the first half of 2016, although private consumption remained relatively robust. On 4 May 2016, the central bank raised its key policy rate from 3.25 to 4 per cent due to pressures on the deposit base and higher demand for foreign currency as a consequence of the political situation. Fiscal policy has loosened in recent years and in July 2016 the parliament adopted revisions to the 2016 budget raising the deficit target to 3.6 per cent of projected GDP from the previous 3.2 per cent of GDP. The year 2016 as a whole is likely to see a significant drop in GDP growth to 2.1 per cent, but with a likely rebound to 3 per cent in 2017 on the back of continued robust consumption and investment. The political situation in the country continues to pose a significant downside risk to this growth outlook.

- After a difficult year in 2014, the **Kosovo** economy bounced back in 2015 with growth of 4 per cent, the best performance since 2011. Growth was driven by robust private consumption and strong investment figures. Private investment was supported by an increase in FDI (at around 5 per cent of GDP, it was at the highest level in the last four years), while public investment was mostly directed at the 65 km section of the highway connecting the capital, Pristina, to the Macedonian border. Government consumption contributed negatively to growth as the country has been implementing cost savings under the IMF programme. Growth in the first half of 2016 was 3.5 per cent year-on-year, with similar growth drivers as in 2015. We expect 3.5 per cent growth to be maintained for the rest of the year and through

2017, but with significant uncertainty depending on the future of potentially large investment projects.

- In **Montenegro**, growth picked up significantly in 2015 to 3.4 per cent (from 1.8 per cent in 2014), with the increase primarily driven on strong FDI inflows and progress on a major Chinese-financed highway project. The tourism sector also performed well in 2015, as a drop in Russian tourists was more than compensated by an increase from other countries, particularly in the Western Balkan region. In the first half of 2016 growth slowed down to 1.9 per cent, but the rate is likely to rise sharply in the second half of the year as a result of an increased pace of spending on the highway project, another strong tourism season, and the impact of pre-election spending and increases in social benefits. We therefore expect growth for 2016 as a whole to rise further to 4 per cent, remaining strong at 3.5 per cent in 2017. However, a major downside risk in the short- to medium-term lies on the fiscal side, and the worrying rise in public debt in recent years may necessitate painful austerity measures elsewhere, especially if economic growth rates were to falter.

- After a strong momentum (2.9 per cent year-on-year) in the first half of 2016, the **Serbian** economy is expected to grow by 2.5 per cent in 2016 and by 2.7 per cent in 2017. Private investments will continue to be the main growth driver, supported by the recovery of consumption, partially offset by declining contribution from net exports. The main upside risk for the projection comes from the potential upscaling of production in the recently privatised large steel mill where the Chinese owner announced ambitious investment and production plans while future oil price developments and possible weak external demand, in particular for the automobile sector, may be a drag on growth next year. Medium-term prospects are favourable, but will depend on the pace of reforms envisaged in the IMF programme, further improving the investment climate, supporting NPL resolution and corporate restructuring to unlock credit growth, and accelerating the implementation of major infrastructure projects.

Turkey

Following the domestic demand driven 4.0 per cent growth in 2015, the Turkish economy grew by 3.9 per cent year-on-year in the first half of 2016. Domestic demand was pushed up by private consumption due to increased disposable income, on the back of a 30 per cent hike in the minimum wage as of January 2016, and somewhat larger government spending. Meanwhile, despite lower oil prices and thus energy import bill, the contribution of exports to growth remained subdued due to a sharp fall in tourism receipts, Russian sanctions, and rising geopolitical tensions in the Middle East.

After a relatively stable first half of 2016, the volatility of the lira increased in the third quarter in the aftermath of the failed coup on 15 July, amidst the introduction of the State of Emergency and its extension, rating downgrades by S&P and Moody's, as well as elevated regional tensions. The lira has weakened by another 6 per cent year-on-year against the dollar since the failed coup, while equity markets fell by around 7 per cent. Although the current account deficit declined to 4.3 per cent of GDP in August 2016, from 5.7 per cent at end-2014, on the back of lower oil prices, it still remains large. Meanwhile, gross external financing needs are estimated to be at around 25 per cent of GDP in 2016. Moreover, inflation remained above the central bank's target of 5 per cent for the fifth consecutive year and stood at 7.3 per cent in September 2016.

In the remainder of 2016 and 2017, growth will continue to be driven by consumption, supported by recently introduced macroprudential measures such as the easing of regulations with respect to credit cards and some recovery in tourism, following the resumption of charter flights from Russia as of September 2016. But this will be offset by lower private investments due to the rising cost of production on the back of a higher wage bill, the raised cost of funding following the rating downgrades, and slightly higher oil prices. Overall, the economy is expected to moderate to around 3.0 per cent in both 2016 and 2017.

The downside risks to this outlook of the next two years stem from a larger than expected rise in oil prices, stalling of the renewed structural reforms efforts, a larger than expected capital outflow following the rating downgrade, or worsening of regional tensions. If preserved, the political consensus on structural reforms would help attenuate some of these risks, thus enabling convergence to the higher long-term growth potential of the country. While the banking sector and public finances remain stable, with a non-performing loans ratio of 3.3 per cent in August 2016, and public debt of around 35 per cent of rolling GDP in August 2016, external imbalances still remain a key vulnerability for the country.

Eastern Europe and the Caucasus (EEC)

The pace of output decline in the EEC region is expected to moderate in 2016, following two consecutive years of contraction. National currencies and foreign exchange reserves relatively stabilised in the first nine months of 2016, after major external adjustments in the past two years. Inflationary pressures abated in most countries of the region against the backdrop of generally tight macroeconomic policies. Domestic demand remained subdued owing to devaluation related shocks to real disposable incomes. Financial intermediation challenges affected credit flows in the regional economies. Monetary authorities embarked on monetary policy easing as stabilisation in consumer prices and in foreign exchange markets gained traction, except for Azerbaijan where monetary policy moved in the opposite direction. Geopolitical tensions, low commodity prices and recession in Russia continue to pose challenges for the region's economic recovery. The EEC region is forecasted to contract by 0.4 per cent in 2016 and to grow by 1.7 per cent in 2017, subject to containment of geopolitical risks and to other country-specific factors. In 2016, resumption of growth in Ukraine and Moldova as well as growth in Armenia and Georgia are expected to partly offset the negative growth forecasts for Azerbaijan and Belarus. All EEC economies are expected to generate positive growth in 2017.

- **Armenia**'s economy made a good start in 2016 but growth slowed in the second quarter; GDP growth decelerated from 4.5 per cent year-on-year in the first quarter to 1.5 per cent year-on-year in the second quarter of the year. In the first half of 2016, growth in exports and government consumption was offset, in part, by contraction in gross fixed capital formation and household consumption. Deflation in the first eight months of 2016 reflected weak domestic demand and low import prices. Armenia's economy remained exposed to spill-overs from the recession in Russia. In the first half of 2016, net FDI inflow was low and remittances declined, albeit at a lower rate than in 2015. The current account deficit remained contained in the first half of 2016 after sizable adjustment in 2015 which was driven by a reduction in imports. In the first nine months of 2016, the dram was mostly stable vis-à-vis the US dollar. International reserves provided approximately five months of import coverage as of September 2016. Tax and customs revenues were affected by deflation and by decreased nominal value of import flows. The fiscal deficit is expected to widen in 2016 on the account of revenue shortfall, followed by fiscal consolidation in 2017. In response to slowing growth, negative inflation and a stabilizing exchange rate, the Central Bank of Armenia gradually lowered refinancing rate from 10.50 per cent in August 2015 to 6.75 per cent in September 2016. In the first seven months of 2016, commercial bank lending remained mostly flat in the context of weak domestic demand and continued consolidation in the banking sector. The conflict in the Nagorno-Karabakh region presents a risk to the growth outlook. Our growth forecast for Armenia is unchanged at 2.0 per cent in 2016 and 2.0 per cent in 2017.

- **Azerbaijan**'s economy contracted by 3.9 per cent year-on-year in the first nine months of 2016. In the same period, non-oil GDP declined by 6.1 per cent year-on-year. Capital investment, an important driver of growth in the previous years, dropped significantly in January-September 2016. External and fiscal surpluses changed swiftly into twin deficits on the back of falling hydrocarbon revenues. After two step-devaluations in 2015, currency pressures lingered in the first nine months of 2016 despite efforts to bolster confidence in the manat. Inflation increased from 4.0 per cent in 2015 to 11.2 per cent in the first nine months of 2016 reflecting the earlier depreciation of the manat. In reaction to rising inflation and exchange rate pressures, the Central Bank of Azerbaijan raised the refinancing rate five times from 3.0 per cent in February 2016 to 15.0 per cent in September 2016, although the monetary impact of the hike is dampened by the high level of dollarization and an insufficiently developed money market. The share of foreign exchange deposits as total deposits increased from approximately 50 per cent in the beginning of 2015 to approximately 80 per cent in August 2016. At the end of the third quarter of 2016, the combined assets of the State Oil Fund (SOFAZ) and of the Central Bank's foreign exchange reserves stood at approximately US$ 40 billion (75 per cent of 2015 GDP), providing adequate safeguards against foreign exchange liquidity risks. Official foreign reserves of the Central Bank of Azerbaijan decreased by approximately US$ 11 billion since the fourth quarter of 2014, before stabilising at around US$ 4.2 billion in April-September 2016. SOFAZ provided liquidity for the Central Bank's foreign exchange auctions, preventing further drain of Central Bank's foreign reserves in the second and third quarters of 2016. The conflict in the Nagorno-Karabakh region presents a risk to the growth outlook. We leave our growth forecast for Azerbaijan's economy unchanged at -3.0 per cent in 2016 and +1.0 per cent in 2017.

- **Belarus**'s GDP contracted by 2.9 per cent year-on-year in the first nine months of 2016, with negative growth in major sectors of the economy, including manufacturing, construction and trade. Recession in Russia continued to expose the Belarus economy to headwinds through trade and financial linkages. Inflation was on a declining path amid moderation in wage growth and generally tight monetary and fiscal policies. In the first quarter of 2016, the Belarus rouble depreciated against the US dollar by 8 per cent against the backdrop of a widened current account deficit. The exchange rate stabilised in the second and third quarters of the year. Foreign currency reserves increased somewhat in the first nine months of 2016 but remained low, providing approximately one month of import coverage. From the second quarter of 2016, the National Bank of Belarus started to ease monetary policy by reducing the refinancing rate from 25 per cent to 18 per cent between April and August 2016. The general government balance was in surplus in the first eight months of 2016, with the surpluses earmarked for repayment of foreign exchange liabilities and payment under the government's guarantees to banks. The devaluation of the Belarus rouble in 2015 and in the first quarter of 2016 had a knock-on impact on the financial sector balance sheets. As of the end of the second quarter of 2016, dollarization of the financial sector liabilities increased to 75.0 per cent and the National Bank of Belarus reported a ratio of NPLs to total gross loans of 13.4 per cent, up from 4.4 per cent in the beginning of 2015. Directed and subsidised lending programmes continued to represent a tool of the government's economic policy. As in our previous REP, we expect Belarus's economy to contract by 3.0 per cent in 2016 before growing by 1.0 per cent in 2017.

- Growth in **Georgia** is expected to improve to 3.4 per cent in 2016, compared with 2.8 per cent in 2015. Trust in monetary policy and in the Lari is increasing, which can also be expected to reduce dollarization in the economy, which currently stands at 67 per cent on the deposit side and 64 per cent on the loan side. The Deep and Comprehensive Free Trade Area (DCFTA) and now the prospect of EU visa free regime is contributing to improved investor confidence. While the external environment remains challenging, with remittances and exports negatively affected by recession in Russia and a sharp slowdown in regional trading partners, in 2016 the country is enjoying a strong tourism season – helped by constraints on other tourism destinations earlier in the year – and increased investor confidence supported by the business-friendly policies of the government and the National Bank of Georgia. In 2017, growth is expected to increase further to 3.9 per cent, supported by an increasing impact of the DCFTA implementation and increased competitiveness, as well as strong domestic and foreign direct investment in infrastructure and other sectors.

- **Moldova**'s economy returned to moderate growth in the first half of 2016: GDP increased by 1.3 per cent year-on-year, supported by growth in household consumption. Gross fixed capital formation and exports of goods and services declined in real volume terms. The decline in the US dollar value of exports and remittances slowed in the first half of 2016, contributing to the current account deficit reduction. Fiscal and monetary tightening helped to bring inflation back to single digits and to keep official reserves steady at close to six months of imports coverage. Abatement of inflation pressures paved the way for gradual monetary policy loosening, starting from February 2016. Public debt is expected to rise significantly, mainly on the account of the liquidity support provided to the three banks affected by the fraud and liquidated in 2015. As of August 2016, Moldova's three largest banks remained under the NBM's special supervision, amid concerns about opaque ownership, related lending, weak corporate governance and low portfolio quality. In July 2016, the authorities reached a staff-level agreement on a new IMF programme (in the amount of approximately US$ 180 million equivalent to 3 per cent of GDP), approval of which is contingent on fulfilment of prior actions by the authorities. This was followed by a release of the first loan tranche (€60 million) of Romania's budget support to Moldova in August 2016. Approval and implementation of the IMF programme is expected to unlock international budget assistance from other donors. We increase our Moldova GDP growth forecast to 1.5 per cent in 2016 and to 2.5 per cent in 2017.

- **Ukraine**'s economy experienced growth in the first half of 2016 after around 16 per cent cumulative real GDP contraction in the past two years. However, the pace of recovery was slower than anticipated amid weak reform momentum in the aftermath of a government reshuffle as well as lack of foreign investment. Helped by a low comparison base of the previous year, GDP grew by an estimated 0.8 per cent year-on-year in the first half of 2016. Growth accelerated from 0.1 per cent year-on-year in the first quarter to 1.4 per cent year-on-year in the second quarter of 2016, driven by increase in household consumption for the first time since the first quarter of 2014 and capital investment financed predominantly from domestic sources. Inflation declined (from 48.7 per cent year-on-year in 2015 to 7.9 per cent year-on-year in September 2016) on the back of exchange rate stabilisation, subdued domestic demand and prudent fiscal and monetary policies. The Hryvnia depreciated against the US dollar in the first quarter of 2016, then regained some of the lost ground and stabilised, before currency pressures re-emerged again in August. After a year-long delay, the IMF completed the second programme review on 14 September 2016 and released a US$ 1 billion tranche. This helped to restore calm in the foreign exchange market and cleared the way for international assistance from other donors. On 22 September 2016, Ukraine placed the third 5-year US$ 1 billion bond under the US guarantee. Official reserve assets increased to US$ 15.6 billion in September 2016 (close to four months of imports). The National Bank of Ukraine lowered the key policy rate five consecutive times between April and September 2016. Tight capital controls introduced in 2014-2015 remain mostly in place, although the National Bank of Ukraine continued their gradual relaxation. The authorities plan to reduce the fiscal deficit from the projected 3.7 per cent of GDP in 2016 to projected 3.0 per cent of GDP in 2017, in line with the IMF programme framework. Consolidation of the banking sector has been underway, with the number of licensed banks falling from 180 in January 2014 to 100 in August 2016. We lower Ukraine GDP growth forecast to 1.5 per cent in 2016 and leave growth forecast for 2017 unchanged at 2.0 per cent.

Russia

The **Russian** economy has been undergoing a second year of recession with a GDP contraction of 0.9 per cent year-on-year in the first half of 2016 as oil prices fell to their lowest levels since 2003. A sharp contraction in both household demand (4.7 per cent) and corporate investments (7.1 per cent) continued in 2016, as inflation was still cutting into real incomes, while sanctions and high interest rates made access to financing more difficult and costly. Net exports contributed positively to the growth in the first half of 2016 as the drop in exports on lower commodity prices was more than offset by imports contraction. Unemployment has remained low at around 5 to 6 per cent as corporations generally prefer to cut wages first instead of shedding labour. Despite the improvement in price competitiveness resulting from the sharp depreciation, export and production gains were limited to a few sectors, mostly agriculture, food (also benefiting from the imports ban), chemicals, rubber and plastics.

Private sector capital outflows continue in 2016 (US$ 10 billion in the first three quarters of the year), but at a significantly slower pace than in 2014 (US$ 153 billion) and 2015 (US$ 57 billion). Increased Eurobond issuances and syndicated borrowing (US$ 22 billion in the first three quarters of 2016, including US$ 1.75 billion sovereign borrowing vs. US$ 12 billion in the whole of 2015) signal increased market demand for Russian assets but external funding is still well below pre-2014 levels.

Monetary policy has been focusing on supporting disinflation and avoiding excessive exchange rate volatility, while fiscal policy has been countercyclical. Weak demand and base effects have supported disinflation; the annual change in the consumer price index dropped to 6.8 per cent in August 2016 from a peak of 15.9 per cent in February 2015. This allowed the Central Bank of Russia (CBR) to cut its key policy rate by 0.5 percentage points in June 2016 for the first time since August 2015. Meanwhile, the fiscal policy has aimed to reduce the deficit to 3.0 per cent of GDP (from 3.5 per cent in 2015) by limiting the growth of certain social payments (pension and wage indexation) and foresees a real cut in other expenditures.

Financial sanctions are taking a toll on Russian banks. In order to clean up and consolidate the banking system, the CBR has continued to close banks (264 since 2014) with weak financial performance and poor corporate governance. Household loan growth remains negative in 2016, while NPLs are increasing in both the corporate and the household sector.

Domestic demand remains weak in 2016, but the stronger rouble will continue to support imports and reduce the trade surplus. Increasing oil prices underpin the economic recovery in the second half of 2016; resulting in a GDP growth of -0.6 per cent. In 2017 growth is expected to pick up to 1.2 per cent, supported by higher oil prices, recovering private consumption and investments. Long-term growth, without significant reforms, may remain at around 1 to 2 per cent annually due to low investments and outdated production capacities.

Central Asia

Growth in Central Asia in 2016 is projected to decrease to 2.9 per cent, compared to 3.6 per cent in 2015. The build-up of structural challenges over 2014-16 arising from lower commodity prices, remittances and exports as well as declining local currencies are increasingly depressing growth, creating fiscal pressures and increasing risks in the region, notwithstanding the fact that external environment is beginning to normalise. Countries are also seeing higher NPLs, increases in fiscal pressures and continued strain on local currencies. There is growing risk that economic or financial sector challenges can spill over across the Central Asian countries, even if economic linkages between most of the countries remain limited. The spillover risk, combined with the global and regional security incidents observed over 2016, are increasingly negatively affecting consumer, business and investor confidence in the region, including in the largest economy – Kazakhstan. In 2017, growth in the region is projected to increase to 3.9 per cent, driven by a positive trend in commodity exporting countries, however, material downside risks to growth will remain.

- Growth in **Kazakhstan** in 2016 is projected at 0.7 per cent, compared to 1.2 per cent in 2015. Monetary conditions in Kazakhstan have improved, the exchange rate has stabilised and inflation is on a downward trend, albeit from a high level (inflation decreased from 17.7 per cent year-on-year in July 2016 to 16.6 per cent in September). However, low oil prices, subdued growth in Russia and economic challenges in China continue to depress growth, which is exaggerated by the negative impact of regional risks and global and domestic security incidents on consumer, business and investor confidence. In the short run, the country will continue to largely rely on the State support programmes and state-owned and quasi-state-owned enterprises to drive growth. In 2017, growth is projected to improve to 2.4 per cent, as the external environment improves, resulting in stronger exports of oil, higher FDI and increased investment domestically. Average annual inflation for 2016 can be expected to reach 14.8 per cent, and decline to 7.5 per cent in 2017.

- Growth in the **Kyrgyz Republic** is expected to decline to 1.6 per cent in 2016, compared to 3.5 per cent in 2015. Lower growth reflects a build-up of structural challenges from declining remittances (down 17.4 per cent in US dollar terms, in the first half of 2016 compared with the same period of 2014), as well as sharply lower production in Kumtor gold mine (36 per cent decline in the first half of 2016 year-on-year). The disruptions of gold production were a result of delay with agreeing the 2016 mining plan between the Government of the Kyrgyz Republic and Centerra Gold, a situation that was resolved in June 2016. Financial support and FDI from China and Russia in particular have helped to support growth, and the role of this support and investment (and increasingly trade) can be expected to remain important in coming years. Growth in 2017 is projected at 2.6 per cent, reflecting an expected gradual improvement in the external environment in 2017. However, a build-up of challenges over 2014-16 will continue to weigh on growth prospects.

- Growth in **Mongolia** is projected to slow to 1.7 per cent in 2016, compared to 2.4 per cent in 2015 and 8.1 per cent in 2014, reflecting lower prices of commodities and slower exports to China, with exports to China in the first three quarters of 2016 24 per cent down year-on-year. A slow-down in the real estate sector and declining house prices are also putting negative pressure on growth. Tugrik depreciated by 27.5 per cent (against the US dollar) between 2014 and September 2016, and budget deficit for 2016 has been increased to around 18 per cent, partly as a result of bringing on the balance sheet unbudgeted spending programs that were previously undertaken by the Bank of Mongolia. Large repayment volumes of external bonds due in March 2017 at US$ 580 million and in January 2018 at US$ 500 million (around 9.4 per cent of GDP in total), combined with high current level of government debt, which stands at US$ 23.5 billion or 200 per cent of GDP as of June 2016 (US$ 16.7 billion or 142 per cent of GDP excluding intercompany lending), can be expected to limit the government's ability to stimulate economy. The signing of the Oyu Tolgoi 2nd phase (a project worth close to US$ 6 billion) in 2015 will increase FDI and should lead to an improvement in the investment climate and in consumer confidence, as the effects of the project start to materialise. Growth in 2017 is projected to increase to 3.2 per cent, reflecting strong FDI and expected improvement in commodity prices.

- After increasing by a reported 6.0 per cent in 2015, officially reported growth in **Tajikistan** is expected to decline to 4.5 per cent in 2016, reflecting sharply lower remittances and returning migrants since 2014. A significant decline of the Tajik Somoni (35 per cent against US$ in 2015 and the first half of 2016) combined with the declining household income are contributing to sharply rising NPL levels and broader liquidity and solvency problems in the banking sector. The reported NPL level has reached 32.3 per cent of total loans at end-March 2016 (approximately 7.5 per cent of GDP) compared with 9.9 per cent of total loans at the end of 2013. The external and internal challenges, combined with difficult business environment, can be expected to continue to suppress economic activity, with growth in 2017 expected to decline to 4.1 per cent. Moreover, there is downside risk to achieving this level of growth that can arise from possible further deterioration in the banking sector and challenging fiscal position of the country. External financial support and investment from the bilateral partners and IFIs will be key to ensuring economic stability.

- A significant drop in oil and gas prices and a slowdown in the economies of regional trading partners have put pressure on growth in **Turkmenistan**, with officially recorded GDP growth in 2016 projected at 6.5 per cent, compared to 10.3 per cent in 2014. Pressure on the local currency (which is pegged to the US dollar) is increasing; the stringent FX regulations that have been introduced in the country in 2015-16, whilst mitigating pressure on the currency, are creating constraints to accessing foreign currency, which is negatively affecting ability of businesses to carry out import-export operations. In 2017, officially reported growth can be expected to recover slightly to 7.1 per cent, supported by FDI both in the extractive and non-extractive sectors and a gradual improvement in the external environment.

- The officially reported growth in **Uzbekistan** is expected to decline to 6.5 per cent in 2016, compared with 8.0 per cent in 2015. Build-up of structural challenges continues with resulting from a sharp drop in remittances from Russia and a slowdown of growth in the main trading partners. The official Som exchange rate has depreciated by around 21 per cent (against the US dollar) over 2014-15; gap between the official rate and black market rate has widened. Inflation is expected to remain high at 9.0 per cent in 2016. In 2017, growth can be expected to decline further to 6.2 per cent, as external factors continue to weigh and to crystalize internal macroeconomic vulnerabilities, increasing risks to growth.

Southern and Eastern Mediterranean (SEMED)

In the SEMED region, growth in 2016 has been revised upwards slightly to 3.1 per cent, thanks to a better-than-expected performance in Egypt. This outweighs downwards revisions to the other SEMED countries in 2016. Poor rainfall adversely affected agricultural output in both Tunisia and Morocco; domestic and regional security issues have constrained economic activity in Tunisia and Jordan, respectively; and tourism has struggled across the board. In 2017, a pick-up to various extents is expected across the region. Key factors underlying this projected improvement include a normalisation in agricultural output in both Tunisia and Morocco; higher domestic demand in Jordan driven by the refugee influx; and an expected improvement in competitiveness in Egypt. As a result, average growth in SEMED is expected to reach 4 per cent in 2017.

- In **Egypt**, growth in FY2015/16 is estimated to have decelerated to 3.8 per cent, down from 4.2 per cent in the previous fiscal year. Whilst private consumption has remained strong and investment is recovering, net exports continue to drag on growth. Tourist arrivals have fallen by around 50 per cent year-on-year; Suez Canal receipts have declined and problems in the petroleum sector have constrained oil exports. Inflation is well above regional peers and rising, reaching 14 per cent at the end of FY2015/16. A modest pick-up in growth to 4 per cent is expected in FY2016/17 as competitiveness improves and investment continues to gradually recover. The approval and implementation of the IMF staff-level agreement on a three-year US$ 12 billion Extended Fund Facility is expected to boost investor confidence and improve the functioning of foreign exchange markets. General government fiscal deficit remains high at 11.7 per cent.

- Growth in **Jordan** is expected to remain flat at 2.4 per cent in 2016 as a difficult regional situation continues to constrain economic activity. In the first half of the year, growth averaged just 2.2 per cent. Struggling sectors include tourism and manufacturing, which registered a contraction of 1 percent and growth of 0.8 per cent, respectively; whilst utilities, financial activities and logistics have remained resilient, supported by higher demand. Nevertheless, sluggish economic activity has weighed on unemployment, which reached 14.7 per cent in the second quarter of 2016. A modest pickup in growth to 2.8 per cent is expected in 2017, driven by domestic demand. Monetary policy and oil prices are expected to remain accommodative, and some recovery in investment is expected. Downside risks to the forecast include a deterioration in the regional security situation; a worsening outlook in the Gulf Cooperation Council countries with an adverse impact on exports, remittances and official grants; and shortfalls in donor funding. The swelling of the refugee population (over 13 per cent of the total population) further adds to fiscal strains and is estimated to have cost Jordan over US$ 2.5 billion a year (6 percent of GDP). In February 2016, Jordan secured US$ 1.7 billion in financial aid (grants and grant equivalents) for its Refugee Response Plan but remains insufficiently funded.

- Growth in **Morocco** is expected to slow down to 1.5 per cent in 2016, due to a sharp decline in agricultural performance. Growth in the three first quarters of 2016 stood at 1.1 per cent. Agricultural activity contracted by 11.5 per cent over the same period due to a drought in the winter, while non-agricultural sectors grew modestly at 2 per cent. Regional security concerns remain a drag on the tourism sector; the number of tourist arrivals declined by 2.6 per cent over the first half of 2016 compared to the previous year. Unemployment declined marginally to a year-to-date average of 9.3 per cent in 2016 compared to a 2015 average of 9.7 per cent. Youth unemployment, however, remains very high at about 21 per cent. Growth is expected to rebound strongly to 4.8 per cent in 2017 mainly due to an expected normalisation of agricultural activity, while also supported by continued expansion of high value-added sectors due to the positive effect of the country's industrial strategy, and further progress with structural reforms.

- In **Tunisia**, growth is expected to marginally pick up to 1.5 per cent compared to 0.8 per cent in 2015. This is supported by manufacturing and phosphate sectors (as some of the mines resumed production) outweighing a contraction in agricultural output (owing to low rain levels), a decline in tourism sector activity (still suffering from the impact of the 2015 terrorist attacks), and a drop in oil and gas production (due to industrial action, a decline of older fields and of exploration investment). The improvement in economic activity did not however make a dent in unemployment which remains high at 15.6 per cent at the end of the second quarter of 2016. Growth is expected to pick up in 2017 to 2.5 per cent as agricultural output recovers, and as economic activity improves helped by subsiding social unrest and an accelerated pace of structural reforms.

About this report

This report is prepared by the Office of the Chief Economist and the Department of Economics, Policy and Governance. It is provided as a companion to the EBRD's growth forecasts for its countries of operations, which are released twice 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 forthcoming *Transition Report 2016-17*, which are all available on the EBRD's website (www.ebrd.com).

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The report was prepared under the general guidance of Sergei Guriev (Chief Economist), Mattia Romani (Managing Director, Economics, Policy and Governance), Ralph de Haas (Director of Research) and Artur Radziwill (Director of Country Strategy and Policy).

Yordan Georgiev (georgiey@ebrd.com), Lukas Boeckelmann and Fadel Jaoui provided research assistance.

The writing teams covering individual countries and regions are:

- Armenia, Azerbaijan, Belarus, Moldova and Ukraine: Konstantine Kintsurashvili and Ana Kresic
- Bulgaria, Romania and Turkey: Bojan Markovic and Idil Bilgic Alpaslan
- Central Asia and Georgia: Agris Preimanis and Nino Shanshiashvili
- Croatia, Russia, Serbia and Slovenia: Peter Tabak and Emir Zildzovic
- Hungary, Poland, the Slovak Republic and the Baltic states: Mateusz Szczurek and Marcin Tomaszewski
- Southern and eastern Mediterranean: Hanan Morsy, Rand Fakhoury and Fadel Jaoui.
- Albania, Bosnia and Herzegovina, Cyprus, Greece, Kosovo, Macedonia FYR and Montenegro: Peter Sanfey and Jakov Milatovic

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