



European Bank
for Reconstruction and Development

Regional Economic Prospects in EBRD Countries of Operations

November 2017

Accelerating in sync

Growth in the EBRD regions averaged 3.3 per cent year-on-year in the first half of 2017, up from 1.9 per cent in 2016. The acceleration has been broad-based, with contributions from higher exports and stronger investment activity. The upswing is perhaps more remarkable in terms of its breadth than its depth: growth picked up in 27 out of 36 countries reporting quarterly data, the first such occurrence since 2010.

Average growth is expected to pick up to 3.3 per cent in 2017 before moderating to 3 per cent in 2018. This represents an upward revision of 0.9 percentage points in 2017 and 0.2 percentage points in 2018 compared with our last forecast in May 2017. Notwithstanding this acceleration, the average growth in the region is expected to remain slightly below that of emerging markets elsewhere with comparable per capita incomes.

Russia's economy is projected to return to moderate growth after a cumulative output decline of 3 per cent in 2015-16. Growth is also expected to pick up slightly in Central Asia and Eastern Europe and the Caucasus reflecting a stabilisation of commodity prices and resumed growth in Russia. The gap between growth rates in these regions and the rest of the EBRD countries is expected to narrow further in 2017 and 2018.

Growth in Central and South-Eastern Europe and Turkey is also projected to strengthen in 2017 reflecting a pick-up in investment and stronger wage growth. Growth is then expected to moderate somewhat in 2018 as fiscal stimulus wears off in Turkey, the one-off impact of higher social payments in Poland fades away and shortages of skilled labour constrain medium-term growth potential in Central Europe.

Growth in Southern and Eastern Mediterranean is projected to increase to around 4 per cent in 2017 and 2018, as a drop in purchasing power of Egypt's consumers owing to high inflation is offset by stronger investment and exports and agriculture rebounds in Morocco and Tunisia.

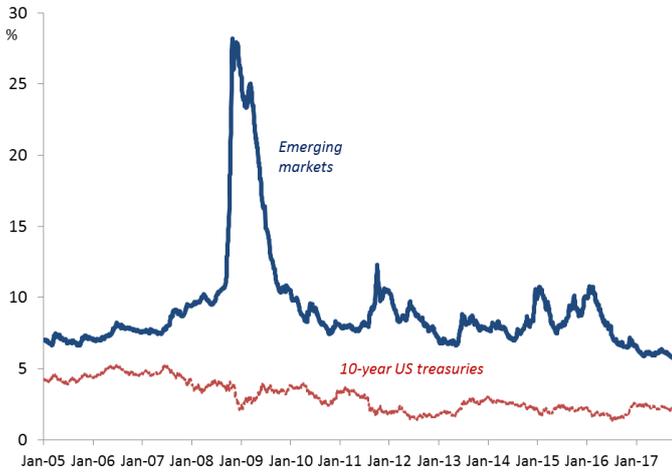
Table 1. Real GDP Growth

	Actual		Forecast (as of 7 Nov 17)		Change in forecast since May 2017	
	2015	2016	2017	2018	2017	2018
EBRD Region¹	1.3	1.9	3.3	3.0	0.9	0.2
Central Europe and the Baltic states	3.5	2.8	3.9	3.4	0.8	0.3
Croatia	2.3	3.0	2.9	2.6	0.0	0.0
Estonia	1.7	2.1	3.7	3.4	1.3	0.7
Hungary	3.4	2.2	3.8	3.4	0.8	0.4
Latvia	2.8	2.1	4.7	4.1	1.6	0.9
Lithuania	2.0	2.3	3.6	3.5	0.7	0.5
Poland	3.8	2.9	4.1	3.4	0.9	0.2
Slovak Republic	3.9	3.3	3.3	3.5	0.1	0.0
Slovenia	2.3	3.1	4.0	2.9	1.5	0.7
South-eastern Europe	2.4	2.9	3.6	3.3	0.5	0.3
Albania	2.2	3.4	3.7	3.7	0.2	0.0
Bosnia and Herzegovina	3.1	3.2	2.5	3.0	0.0	0.0
Bulgaria	3.6	3.9	3.5	3.2	0.3	0.2
Cyprus	2.0	3.0	3.5	2.5	1.0	0.3
FYR Macedonia	3.8	2.4	1.5	2.5	-0.9	-0.5
Greece	-0.3	-0.2	2.0	2.2	0.0	0.0
Kosovo	4.0	3.4	3.7	3.5	0.2	0.0
Montenegro	3.4	2.9	3.7	3.3	0.7	0.0
Romania	4.0	4.6	5.3	4.2	1.3	0.7
Serbia	0.8	2.8	1.8	2.9	-1.1	-0.1
Eastern Europe and the Caucasus	-4.8	0.1	1.6	2.7	0.5	0.2
Armenia	3.2	0.2	3.5	3.5	1.0	0.5
Azerbaijan	1.1	-3.1	-0.5	2.0	0.0	0.0
Belarus	-3.8	-2.6	1.5	2.0	2.0	1.0
Georgia	2.9	2.7	4.5	4.5	0.6	0.3
Moldova	-0.4	4.3	3.0	3.5	0.0	0.0
Ukraine	-9.8	2.3	2.0	3.0	0.0	0.0
Turkey	6.1	3.2	5.1	3.5	2.5	0.5
Russia	-2.8	-0.2	1.8	1.7	0.6	0.3
Central Asia	3.7	3.6	4.5	4.4	0.7	-0.1
Kazakhstan	1.2	1.1	3.8	3.5	1.4	0.0
Kyrgyz Republic	3.9	3.8	4.4	4.2	0.5	0.1
Mongolia	2.4	1.0	2.6	3.0	1.2	0.2
Tajikistan	6.0	6.9	6.5	5.0	2.7	1.0
Turkmenistan	6.5	6.2	5.7	5.1	0.0	-0.9
Uzbekistan	8.0	7.8	5.4	6.2	-0.8	-0.3
Southern and Eastern Mediterranean²	3.9	3.3	3.8	4.0	0.1	-0.1
Egypt	4.4	4.3	4.1	4.5	0.3	0.0
Jordan	2.4	2.0	2.3	2.5	0.0	0.0
Lebanon	0.8	1.0	2.3	2.5		
Morocco	4.6	1.2	4.2	3.5	0.0	-0.3
Tunisia	1.1	1.0	2.2	2.7	0.0	0.0
"East": EEC, CA, Russia	-2.1	0.4	2.2	2.3	0.6	0.2
"West": CEB, SEE, SEM ED, Turkey	4.2	3.1	4.2	3.6	1.1	0.2

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

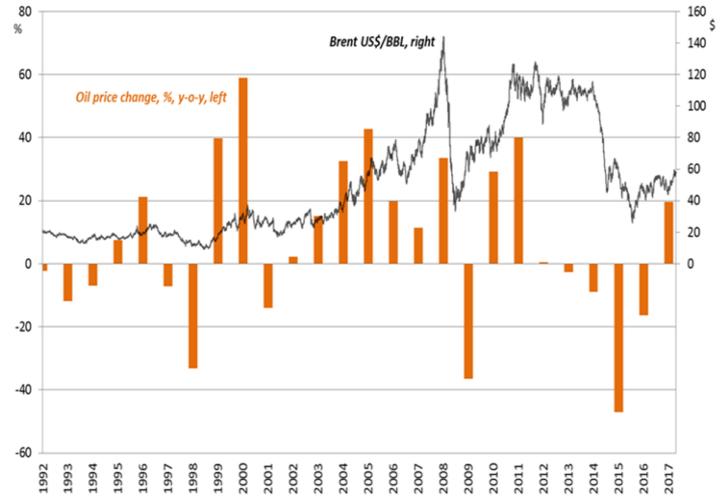
² EBRD figures and forecasts for Egypt's real GDP reflect the fiscal year, which runs from July to June.

Chart 1. Bond yields



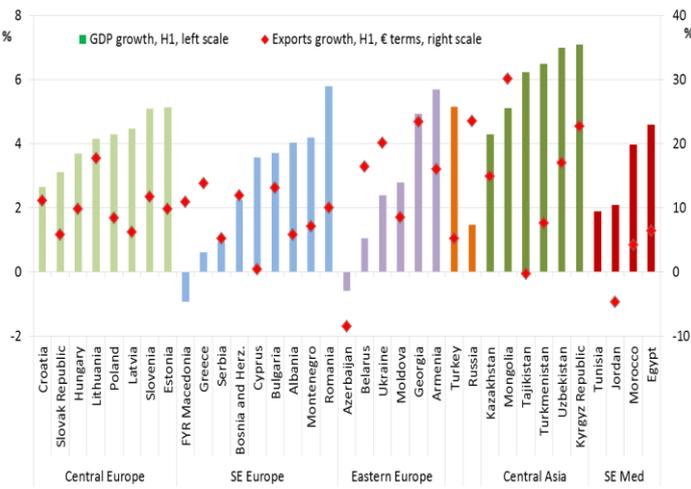
Source: Bloomberg

Chart 2. Brent oil price change, year-on-year



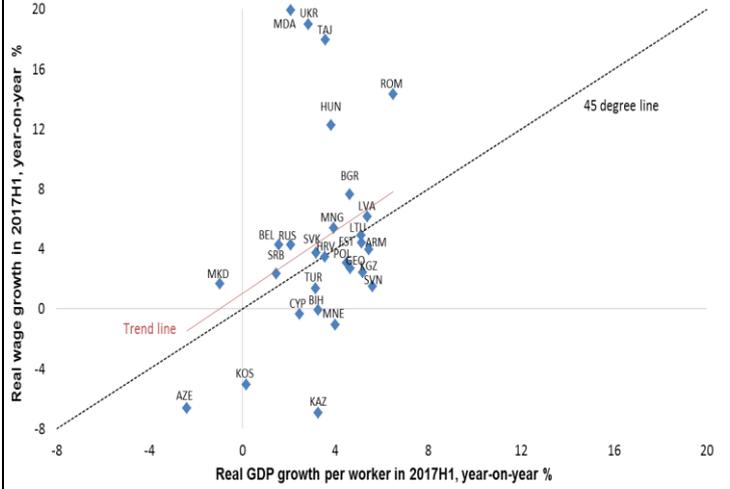
Source: Thomson Reuters, EBRD calculations. Jan-Oct for 2017.

Chart 3. Export and GDP growth H1 2017, % year-on-year



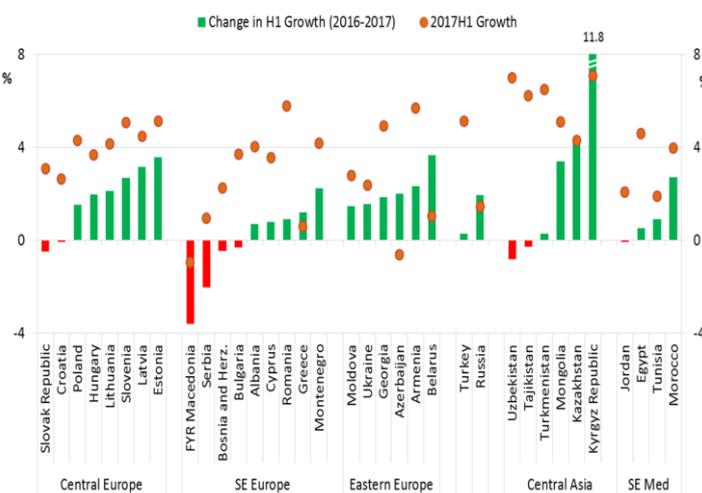
Source: CEIC, national authorities. Exports in nominal euro terms.

Chart 4. Growth in real wages and output per worker



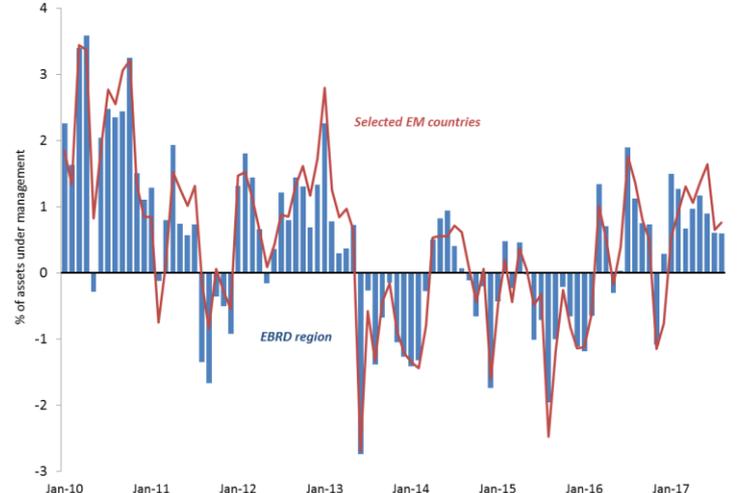
Source: CEIC, national authorities and authors' calculations

Chart 5. Growth in H1 2017, year-on-year



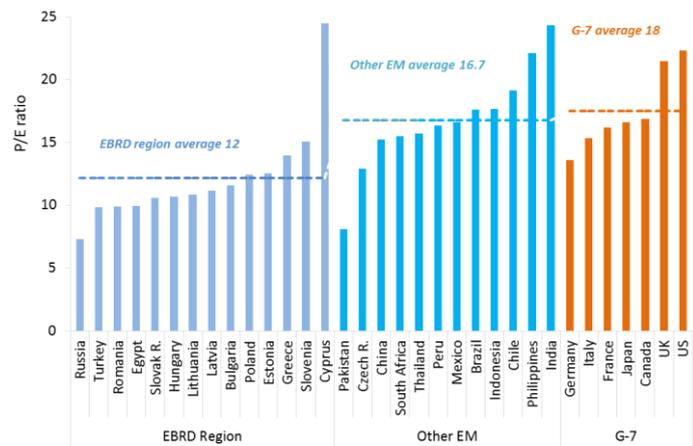
Source: CEIC, national authorities and authors' calculations

Chart 6. Mutual fund capital flows to emerging markets



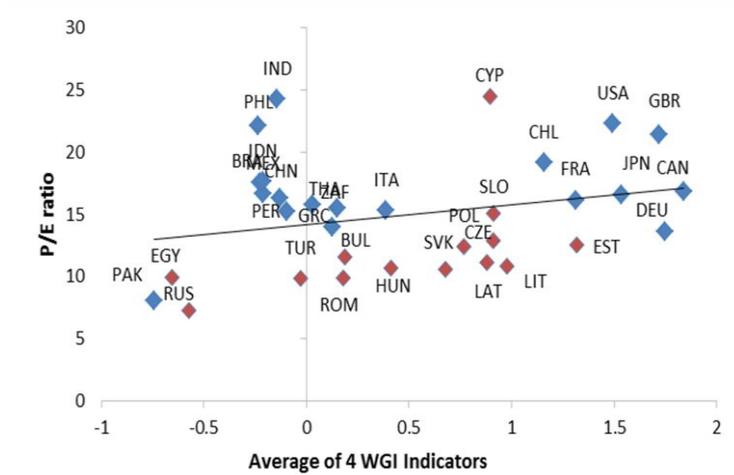
Source: EPFR Global

Chart 7. Price-to-earnings ratios



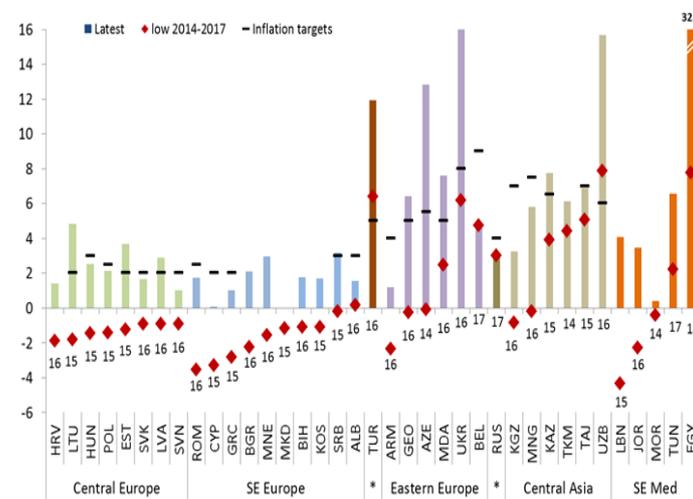
Source: Thomson Reuters. As of September 2017.

Chart 8. P/E ratios depending on economic institutions



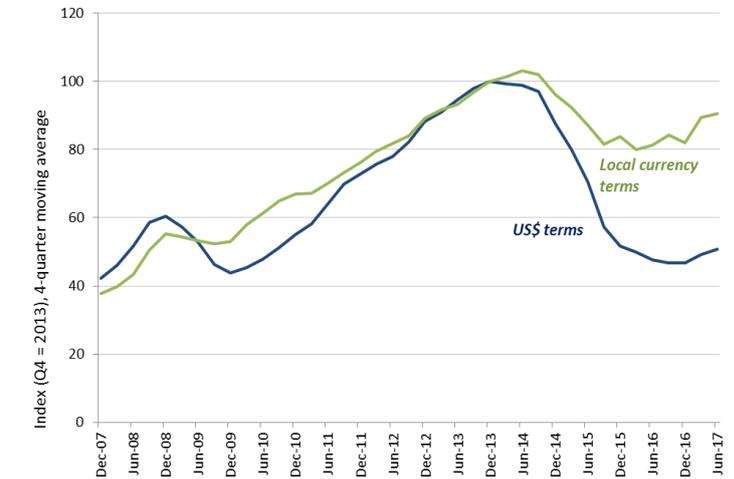
Source: Thomson Reuters and authors' calculations

Chart 9. Consumer price inflation, %, year-on-year



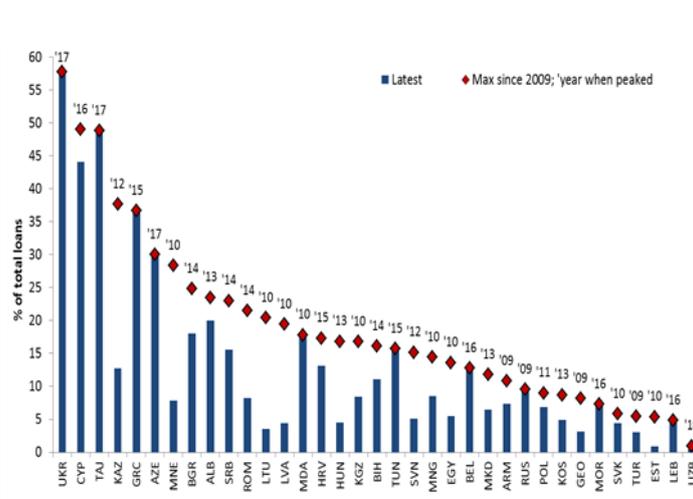
Source: Thomson Reuters and authors' calculations

Chart 10. Remittances from Russia to EEC/CA, inflation-adj.



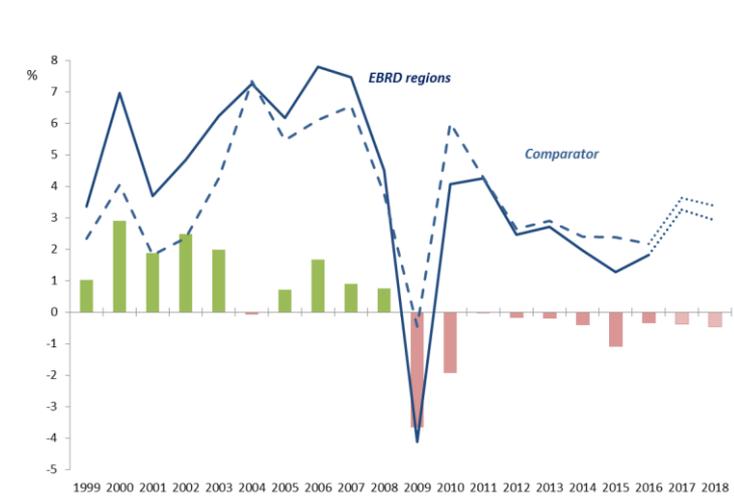
Source: Central Bank fo Russia, Bloomberg and authors' calculations.

Chart 11. Non-performing loans, % of total



Source: CEIC, national authorities, World Bank, Moody's

Chart 12. Growth in the EBRD regions and comparators



Source: EBRD, IMF and authors' calculations

Stronger growth momentum globally

The global economic outlook has strengthened in recent months. The recovery in the eurozone gained a stronger-than-forecast momentum, while growth in the United States has been somewhat weaker than projected in April-May 2017 (Box 2 looks at the potential implications of this change in growth mix for the EBRD regions).

On balance, the IMF expects global growth to accelerate by 0.4 percentage points in 2017, to 3.6 per cent, and further to 3.7 per cent in 2018. The recovery momentum has been broadly shared across countries. Investment activity has shown signs of recovery and global trade growth has picked up somewhat and is expected to exceed 4 per cent in volume terms for 2017 as a whole, broadly in line with global growth measured at purchasing power parity (PPP).

Favourable financing conditions

The global cycle in terms of financing conditions has run ahead of the global economic cycle, with particularly favourable financing conditions for emerging markets. As monetary conditions in advanced economies remained accommodating and interest rates in advanced economies low, the search for yield created exceptionally favourable financing conditions in emerging markets (Chart 1). Both Argentina's 100-year old bond placement in June 2017 and Ukraine's US\$ 3 billion bond placed in June were oversubscribed several times.

A number of other economies with relatively weak credit ratings took advantage of favourable financing conditions. Tajikistan, rated B- by S&P, issued a 10-year bond in September 2017 with a yield of 7.1 per cent. The US\$ 500 million placement, equivalent to 7 per cent of GDP, was oversubscribed more than 6 times. Three months prior, Belarus placed 10-year bonds yielding 7.6 per cent (the 5-year and 10-year issues jointly totalled US\$ 1.4 billion, or 3 per cent of GDP).

ECB expected to taper asset purchases

Stock market volatility has stayed low for the longest period since 2013, both in advanced markets and in the EBRD regions and equity market continued their strong performance.

The European Central Bank (ECB) is expected to taper its asset purchases further in the context of its quantitative easing (QE) programme. The current phase of QE, in place until September 2018, involves monthly asset purchases of €60 billion reduced to €30 billion from January 2018 onwards. More broadly, monetary conditions across the advanced and emerging market economies are expected to tighten gradually as global economy gain momentum.

Higher oil prices

The oil prices fluctuated in the range of US\$ 45 to 60 per barrel of Brent. This level is significantly above the lows of US\$ 28 per barrel reached in the first quarter of 2016. In September 2017, oil prices edged up reaching their highest level since the summer of 2015,

in part owing to a weaker US dollar and stronger global demand for oil. The average oil price in the first 10 months of 2017 was 19 per cent higher than in the same period of 2016 (the highest year-on-year increase since 2011, see Chart 2). This differential provided a substantial boost to year-on-year growth in Russia and Central Asia in the first three quarters of the year. The price of Brent oil is expected to remain around US\$ 55-65 per barrel in the medium term as long as increases in demand can be met by scaled up production of shale oil in the United States.

Growth picking up in the EBRD regions

Growth in the EBRD regions averaged 3.3 per cent year-on-year in the first half of 2017, up from 1.9 per cent in 2016. The broad upward trend is estimated to have continued into November (see Box 1 presenting the latest nowcast of growth in the region).

Broad-based acceleration

The acceleration has been broad-based, with contributions from higher exports (Chart 3) and, in some countries, from stronger investment activity. After several years of moderate wage increases, real wage growth picked up in many economies. On average wages grew in line with productivity (output per worker in real terms). In several countries, notably, Hungary, Romania and Ukraine, wage growth has been leading the recovery, significantly outpacing productivity growth (Chart 4). In Hungary, the increase in the cost of labour has been partly offset by lower social security contributions.

All economies in the region, except Azerbaijan and FYR Macedonia, recorded positive growth in the first half of 2017. Several countries, notably Romania and Turkey, enjoyed rates of growth comparable to those in the mid-2000s.

The recovery momentum is perhaps more notable for its breadth than its strength. In year-on-year terms, in the first half of 2017 growth picked up in 27 out of 36 countries reporting quarterly data, the first such occurrence since 2010 (the comparison is with the same period of the previous year, see Chart 5). The increase in the price of oil since the first quarter of 2016 has been a positive development for Russia, other commodity exporters and countries in Central Asia, Eastern Europe and the Caucasus that rely on Russia as a major source of remittances or export demand. Growth in Central Europe and the Baltic States was boosted by stronger exports and investment.

Across all regions

- Growth in **Central Europe and the Baltic States** (CEB) picked up to around 4 per cent year-on-year in the first half of 2017 (compared with 2.8 per cent in 2016) on the back of a strong performance by the CEB region's largest economy, Poland, where output growth was boosted by stronger investment activity and an increase in social welfare payments. The Baltic states, Hungary and Slovenia also saw stronger economic growth in the first half of 2017.

- Growth in **South-Eastern Europe** region has remained steady, averaging 2.9 per cent in 2016 and 3.3 per cent year on year in the first half of 2017. In Romania, however, the annual growth rate rose to more than 5 per cent in the first half of this year driven by private consumption and an accommodative fiscal stance. Growth has also picked up in the Western Balkans, supported by a gradual resumption of credit growth and a number of major infrastructure projects. In Greece, however, growth has remained sluggish following stagnation in 2016 and FYR Macedonia experienced negative growth in the first half of the year as the political crisis of the past two years has taken a toll on investment and growth.
- Growth in **Eastern Europe and the Caucasus** rose to around 1.5 per cent year on year in the first half of 2017, with growth turning positive in Belarus and the recovery in Ukraine gaining further momentum. Azerbaijan, is one of the only two economies in the EBRD regions that recorded a recession in the first half of 2017 owing to modest oil prices, lower oil production and stress in the financial sector.
- The introduction of various stimulus measures towards the end of 2016, including a TRY 250 billion (US\$ 71 billion equivalent) Credit Guarantee Fund for small and medium-sized enterprises and various tax incentives, helped growth in **Turkey** to recover to around 5 per cent year-on-year in the first half of 2017, from 3.2 per cent in 2016.
- **Russia's** economy has now returned to growth, following a cumulative contraction of around 3 per cent in 2015-16, with output expanding at a rate of 1.5 per cent year-on-year in the first half of 2017. At the same time, investment activity remains constrained by economic uncertainty and signs of stress appeared in the financial sector where two large private banks have been rescued and effectively nationalised following reports of weak asset quality in these banks and large withdrawals by the bank's depositors over the summer months.
- Growth in **Central Asia** showed signs of picking up again, averaging around 5 per cent year-on-year in the first half of 2017. The acceleration reflects higher commodity prices (relative to the first half of 2016) and the improved economic outlook in Russia. Uzbekistan embarked on a programme of structural reform, including the unification of exchange rates.
- In the first half of 2017, growth in the **Southern and Eastern Mediterranean** picked up to around 4 per cent year-on-year compared with 3.3 per cent in 2016, as a drop in purchasing power of Egypt's consumers owing to high inflation has been offset by stronger investment and exports and agriculture rebounded in Morocco and Tunisia. Starting from this issue of the REP, SEMED regional averages include Lebanon which in September 2017 became EBRD's latest country of operations (its weight in the regional total is around 5 per cent).

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

Resilient capital flows

Capital flows to emerging markets have been broadly resilient. The gross inflows peaked at US\$ 1.4 trillion in 2013 and then bottomed out at US\$ 325 billion in 2015 following tapering of quantitative easing in the United States. A gradual recovery in 2016 has continued throughout 2016-17, despite the gradual tightening of US monetary policy. This reflects the fact that the earlier interest hikes have been fully priced in by the markets and the pace of monetary tightening has, if anything, been slower than expected.

Bond and equity inflows in the EBRD regions have also strengthened in line with global trends, before moderating over the summer (Chart 6). The flows into the region traced closely flows to other major emerging markets.

Stock market have performed better in countries with strong economic institutions

Notwithstanding capital inflows, price to earnings (P/E) ratios in the EBRD regions on average remain below the levels seen in advanced economies and large emerging markets (Chart 7). In Croatia, Bulgaria and Slovenia P/E ratios are currently comparable to those in Western Europe. In contrast, in Russia P/E ratios are among the lowest among emerging markets reflecting in part the volatile nature of commodity prices and respective currencies and in part concerns about the quality of economic institutions and the rights of minority shareholders, as discussed in the *Transition Report 2015-16*.

Indeed, P/E ratios tend to be higher in countries with higher quality of economic institutions, as reflected in the average of World Governance Indicators tracing rule of law, control of corruption, government effectiveness and regulatory quality (Chart 8).

Currency movements

In the aftermath of the November 2016 elections in the US, the region's currencies initially weakened against the US dollar, by about 3 per cent on average. The direction of currency movements changed around the start of 2017 and by April 2017 the post-US-election decline has been fully undone in most countries. These fluctuations mirrored broader trends for the euro and the currencies of other advanced economies and emerging markets.

In September 2017 Uzbekistan moved towards unifying the exchange rates, resulting in a 48 per cent depreciation of the som against the US dollar. Prior to that, the unofficial exchange rate exceeded the official one by a factor of two or more, impeding investment and serving as a disguised tax on exporters (required to sell hard currency at the official exchange rate). The policy shift should support investment and development of the private sector in the medium term. In contrast, the wedge between the official and unofficial exchange rates remains wide in Turkmenistan.

Inflation: predominantly on-target

Inflation in most countries in the region has been in line with the targets established by Central Banks (Chart 9). A recent pickup in inflation in Central and South-Eastern Europe has

brought the values closer to targets while in Azerbaijan, Egypt, Turkey and Ukraine, however, inflation rates are in double digits, reflecting earlier depreciations of the respective currencies. Similarly, inflation is expected to rise in Uzbekistan where the Central Bank raised its policy rate by five percentage points following exchange rate liberalisation.

Remittances: growth resumed but levels remain modest

Remittances from Russia to Central Asia, Moldova and the Caucasus stabilised in US dollar terms towards end-2016 as the Russian economy returned to growth and the rouble appreciated in line with oil prices. Remittances rebounded by 21 per cent year-on-year in the first half of 2017 (in US dollar terms adjusted for US inflation) but remained around 50 per cent of the value recorded 4 years earlier. In local currency terms (adjusted for local inflation), remittances are only 9 percentage points below their peak levels of 2013 (Chart 10) reflecting cumulative depreciations in recipient countries in recent years.

Credit growth yet to pick up

Credit growth has been gradually picking up as growth momentum strengthened. Nonetheless, in real terms (adjusted for inflation and exchange rate fluctuations), credit growth averaged only 0.4 per cent year-on-year in the first half of 2017 as Azerbaijan, Belarus, Egypt, Ukraine and several other countries experienced considerable contraction of credit in real terms.

Modest progress with non-performing loans

In about two-thirds of the countries in the EBRD regions the ratios of non-performing loans (NPLs) peaked in double digits after the 2008-09 global financial crisis. In half of the economies NPL peaked at levels close to or above 20 per cent. In most countries, NPL ratios continued rising for several years after the crisis before peaking and starting to decline. A few exceptions include the Baltic States where NPLs peaked early and by now have declined to levels around or below 5 per cent. In contrast, in several economies in Eastern Europe and Caucasus and Central Asia NPL ratios are yet to start declining.

The declines in NPL ratios from their peaks have on average been modest and NPL levels remain elevated across much of the EBRD regions. Among countries with high NPL ratios, the median decline from the peak has been that of 3 percentage points, compared with the median peak ratio of around 16.5 per cent. Countries that reduced their NPL ratios by a third or more include the Baltic States, Egypt, Hungary, Kazakhstan, the Kyrgyz Republic and Romania (Chart 11).

Outlook

Growth to pick up faster than previously projected

The average rate of growth in the EBRD regions is expected to increase from 1.9 per cent in 2016 to 3.3 per cent in 2017 (Table 1). This pick-up in growth reflects acceleration in Central Europe, sustained growth momentum in south-eastern Europe, continued recovery in Russia

and Ukraine as well as a somewhat improved outlook in countries with strong economic links with Russia.

This acceleration is stronger than projected in May 2017 (an upward revision of 0.9 percentage points) on account of stronger expected performance in Turkey, Central Europe Central Asia and Russia. Growth projections for South-Eastern Europe, Eastern Europe and the Caucasus and Southern and Eastern Mediterranean have been also revised up, albeit the differences in forecasts for these regions are smaller.

Growth is expected to moderate somewhat in 2018, to 3 per cent, in line with views of the medium-term growth potential of the region's economies and reflecting a number of country-specific factors discussed below. This forecast represents an upward revision of 0.2 percentage points.

Average expected growth to remain below that of comparators

Notwithstanding this acceleration, the average growth in the region is expected to remain slightly below that of emerging markets elsewhere with comparable per capita incomes. The analysis in the forthcoming *Transition Report 2017-18* shows that average annual growth in the EBRD regions has consistently been below the average for a group of countries with comparable income per capita since 2009. By 2016, the region's GDP was around 9 per cent lower than could be expected based on performance of the comparator group of similar economies. The underlying calculation constructs a synthetic comparator for each country as a weighted average of the growth rates of similar economies in that year. For example, the economies with the largest weights in Egypt's reference group today include Indonesia, Peru and Sri Lanka. Weights based on GDP at PPP are then applied to calculate aggregate growth rates for the EBRD regions and their synthetic comparators.

Based on the current EBRD and IMF projections, the gap between the EBRD regions and the comparator economies is expected to remain narrow in 2017 and 2018, but not disappear completely (Chart 12). The remaining gap reflects the expected acceleration in comparator markets that benefit from the same global trends as the EBRD regions as well as modest growth in several large economies in the region including Russia and Ukraine.

Stronger outlook across regions

The expected acceleration in both 2017, followed by a slight moderation of growth in 2018, is broad-based:

- Following an investment-driven dip in 2016, growth is **Central Europe and the Baltic States** is expected to accelerate to close to 4 per cent in 2017, before moderating to around 3.5 per cent in 2018 as shortages of skilled labour constrain region's potential growth in the medium term and the one-off impact of increased social payments in Poland fades away. The near-term economic outlook has improved in **Hungary** on the back of cuts in the rates of corporate income tax and social security

contributions as well as increases in minimum wages for skilled and unskilled workers.

- In **South-Eastern Europe**, average growth is also expected to accelerate reaching 3.6 per cent in 2017 before moderating to 3.3 per cent in 2018. **Greece** is expected to return to growth as reforms advance further and business confidence gradually improves.
- Growth in **Eastern Europe and the Caucasus** as a whole is expected to pick up from near zero to close to 1.5 per cent in 2017 as headwinds from low commodity prices and the earlier recession in Russia subside, although **Azerbaijan's** economy is projected to remain in recession. A gradual recovery in the region is set to continue in 2018.
- Growth in **Turkey** is projected to accelerate to 5.1 per cent in 2017 on the back of government stimulus before moderating to 3.5 per cent in 2018 as the impact of the fiscal stimulus wears out.
- **Russia's** economy is expected to grow by around 1.8 per cent in 2017 supported by a gradual recovery in oil prices. In 2018 growth is projected to decelerate slightly as oil price increases moderate. These projections are broadly in line with the estimated longer-term potential growth rate of 1 to 2 per cent per annum.
- In **Central Asia**, the average growth is expected to return to around 4.5 per cent in 2017 and 2018 after a weaker 2016, reflecting higher average price of oil, increased output of crude oil in **Kazakhstan** and expectations of an improved external environment. Construction work on the second phase of Oyu Tolgoi, a large copper mine, is expected to support growth in **Mongolia**, offsetting the economic impact of the expected fiscal consolidation.
- Growth in the **Southern and Eastern Mediterranean** is expected Economic activity in SEMED is expected to recover to around 4 per cent by 2018 supported by reform implementation and continued recovery in the tourism sector across countries and export rebound in **Egypt** and **Jordan**. **Morocco's** growth, however, is expected to slow down to 3.5 per cent in 2018 as agricultural activity normalises following the 2017 strong rebound from drought-driven contraction in 2016..

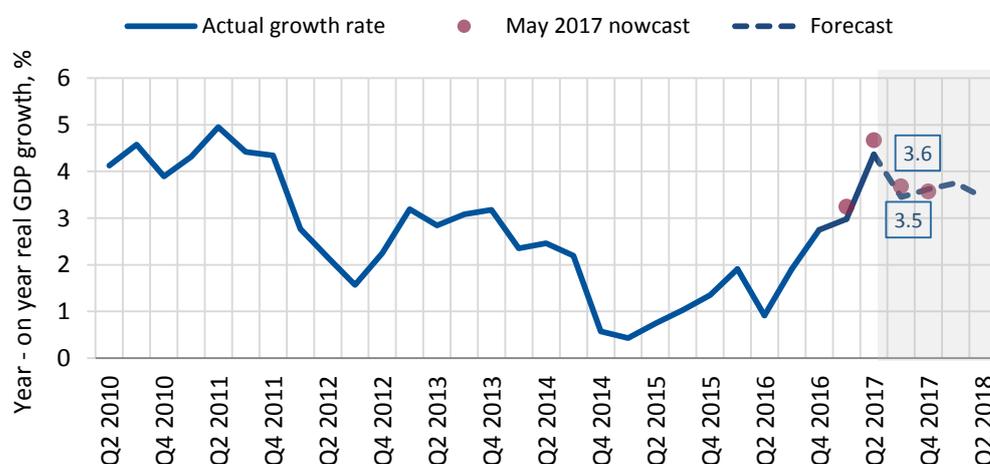
Significant risks to the outlook

The outlook is subject to numerous risks, including growing geopolitical tensions, persistent security threats, the growing appeal of populist anti-globalisation policies in advanced economies and high degree of concentration of sources of global growth, with China accounting for up to half of the total as discussed in the forthcoming *Transition Report 2017-18*.

Box 1. Nowcasting: Stronger growth continued in the second half of 2017

The nowcasting model estimates average growth in the EBRD regions at **3.6 per cent (year-on-year) in the second half of 2017** compared with 3.3 per cent in the first half of the year (see Chart 1.1). The nowcast for July-December 2017 is largely unchanged compared with the forecast for this period made based on data available as of May 2017 (an overall downward revision of 0.1 percentage points). A slower growth of China's imports compared with the growth rate observed at the time of the previous nowcasting round has been largely offset by the positive impact of higher prices of metals and other commodities, while dynamics of oil prices has remained largely unchanged.

Chart 1.1. Nowcast for the EBRD regions



Sources: Authors' calculations.

About nowcasting

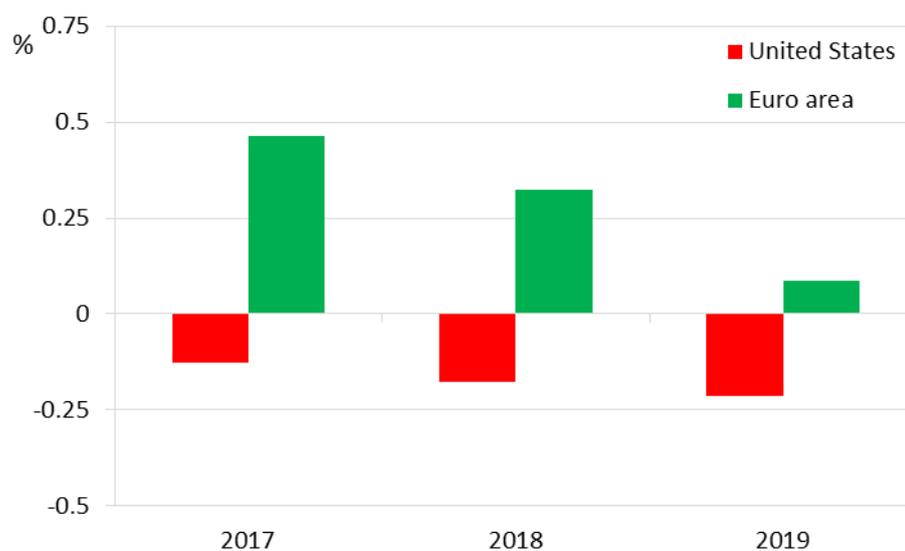
The nowcasting model is based on principal component analysis and takes into account the latest data for 152 economic and financial indicators, as well as GDP growth in previous quarters. Economic indicators include global series such as commodity prices or US imports, as well as indicators specific to the region, for example, Russia's industrial production. The model is estimated using quarterly data for 2009-2017. Relative to the previous issue of the Regional Economic Prospects, the model has been augmented with a number of additional financial variables in line with the recent findings regarding significant relationship between higher leverage and GDP growth over the short and medium term (see IMF's Global Financial Stability Report, October 2017).

Box 2. Does composition of global growth matter for the performance of the EBRD regions?

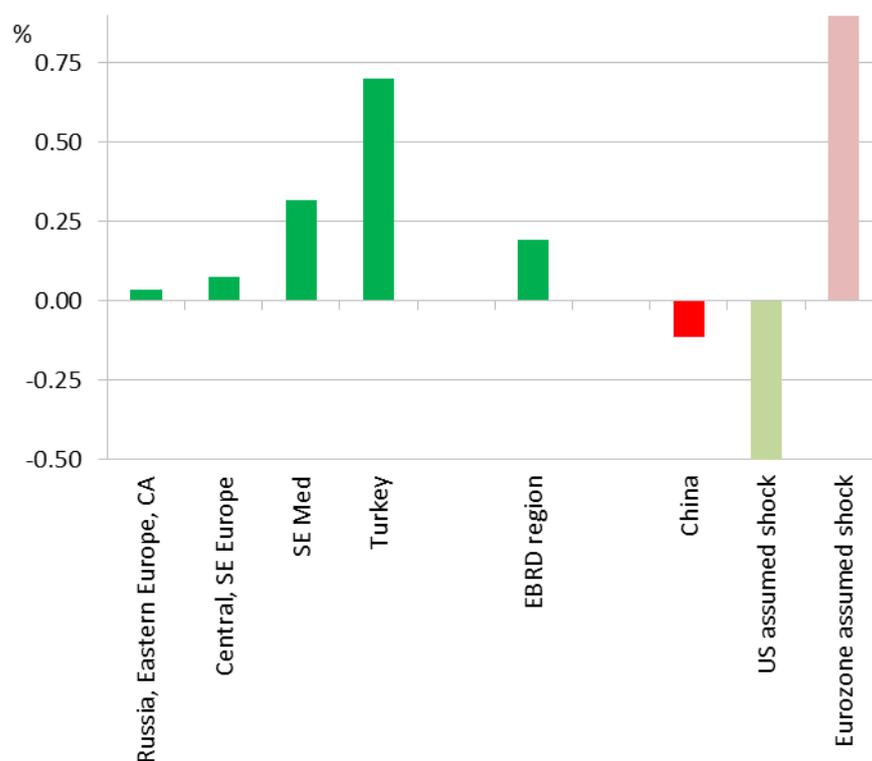
While the growth momentum in the Eurozone has recently picked up, the US economy has performed below expectations. The two developments have largely offset each other in terms of their contributions to changes in expected global growth. The latest World Economic Outlook of the IMF downgraded US economy projections for 2017-19 cumulatively by 0.5 percentage points while upgrading the Eurozone by 0.9 percentage points, compared to May 2017 forecast (Chart 2.1).

Have such shifts in composition of global growth historically mattered for the performance of the EBRD regions? To answer this question we use the global vector autoregression model. It includes countries accounting for more than 90 per cent of global GDP and captures cross-border economic spillovers through international trade, financial markets and global commodity prices, both directly and through third-party economies. For each country, Domestic variables include GDP, inflation, exchange rates, equity market indices and both short and long-term interest rates. The external variables include weighted averages of estimates of domestic variables for other countries, whereby weights are based on bilateral links in terms of trade, investment and remittances.

The growth impact of the slowdown in the US combined with an upswing in the Eurozone is estimated to be largely neutral for the EBRD region as a whole. While region's economic links with Europe are stronger than with the US, the US economy historically has had a greater impact on other regions, including large emerging markets such as China. As a result, for Central, South-Eastern and Eastern Europe as well as Russia and Central Asia, the combined direct and indirect effect of a slowdown in the US almost offsets the effect of faster growth in the eurozone even though the revision to the expected eurozone growth is larger in magnitude (Chart 2.2). For Turkey and Southern and Eastern Mediterranean, the positive eurozone effect dominates, based on historical patterns.

Chart 2.1. Changes in IMF growth forecasts, May-October 2017

Source: IMF World Economic Outlook, April and October 2017.

Chart 2.2. Impact of potential changes in the US and the eurozone growth on the EBRD regions

Source: Authors' calculations.

Regional updates

Central Europe and the Baltic States (CEB)

The GDP growth rate in the CEB region accelerated to around 4 per cent during the first half of 2017, after reaching 2.8 per cent in 2016. The key factor behind this improvement is the long-awaited recovery in investment. After dropping by 8 per cent in 2016, investment increased by 5.1 per cent in the first half of this year, primarily in the public sector as the weak EU funds utilisation is finally improving in a number of new EU member states. However, in economies such as Poland or the Slovak Republic, investment is still set to rebound. While private consumption will likely continue to remain a significant engine of growth in the CEB region, its positive effect will be gradually superseded by strongly recovering exports and investment, including in the private sector. The main downside risk to the latter, however, is the shrinking availability of skilled labour, which has been increasingly as one of the key business obstacles for companies to growth. Overall, we anticipate an average growth rate in this region of close to 4 per cent this year and close to 3.5 per cent in 2018

Croatia

After a strong growth momentum in 2016 (3.0 per cent), the Croatian economy is expected to grow at similar pace in 2017 (2.9 per cent) and slow down slightly in 2018, to 2.6 per cent. Growth in 2017 will be driven by domestic demand. The consumption recovery is supported by tax cuts, falling unemployment and record-breaking tourism revenues, while investments are underpinned by favourable financial conditions and lower corporate tax. Both exports and imports are expected to speed up moderately, resulting in a negligible impact of net exports to GDP developments in 2017. GDP growth may slow somewhat next year as a consequence of the possible slow-down in consumption growth due to the fading out of the effects of the tax reform and lower probability of another record tourist year. The risks of the projection are slightly tilted to the downside because of the potential for spill-overs from Agrokor's financial troubles on its subsidiaries and suppliers. The medium-term growth prospects remain weak due to long-standing structural weaknesses, including high corporate over-indebtedness, still weak business environment reforms, and slow EU fund absorption – all of which need to be addressed consistently.

Estonia, Latvia and Lithuania

In 2016, shrinking investment weighed on GDP performance in all three Baltic States, whereas private consumption remained the key growth engine. In 2017, investment growth in Estonia has turned positive for the first time since 2013. In Latvia, subsequent to a dramatic drop of 15 per cent in 2016, investment growth recovered to 18 per cent during the first half of 2017. At the same time, Lithuania saw a recovery in investment at 6 per cent. Two factors are behind these improvements. First, the already substantially delayed investments co-financed by the EU funds have started to materialise, although still slow in Latvia. Second, the recovering credit to non-financial corporates indicates that private

investment is also picking up, supported by positive expectations regarding external demand. Private consumption will likely remain strong, underpinned by improving labour markets and recovering domestic credit. Overall, we are substantially revising upwards our GDP growth forecasts for all three economies in 2017 and 2018. The main downside risks are associated with a lower-than-expected EU funds absorption and/or recovery in neighbouring Finland and Russia as well as, in the case of Estonia, low shale oil prices.

Hungary

In Hungary, GDP growth slowed to 2.2 per cent in 2016 as investment collapsed by 11 per cent, mostly explained by the low utilisation of EU funds. In contrast, private consumption remained strong, underpinned by rising employment and wages. Household disposable incomes were driven by rising real wages and falling unemployment. In the first half of 2017, GDP growth accelerated to 3.6 per cent year-on-year, driven by a solid rebound in public investment and robust private consumption. Investment is up by 24 per cent year-on-year in the first half of 2017, backed by accelerated EU fund transfers as well as a return to positive credit growth (after seven years of negative credit growth) to the private sector. Accelerated EU funds absorption and recovering credit to the private sector are set to support growth over the short term. The expected increases in wages, driven by agreements with the state-owned companies and car manufacturers, a higher minimum wage and social security contribution cuts will all further support strong consumption, despite rising inflation. On balance, GDP growth is expected to accelerate to 3.8 this year and to 3.4 per cent in 2018.

Poland

In 2016 economic growth in Poland decelerated to 2.9 per cent, largely dragged down by a sharp decrease in investment. The slow start of the EU 2014-20 funds utilisation and persistent regulatory uncertainty were the key reasons behind the weak investment, which dropped by 7.9 per cent in 2016. In contrast, household spending remained strong, and its dynamics strengthened even further at the beginning of 2017, backed by vigorous wage growth and deferred effects of higher social spending. As a result, GDP growth accelerated to 4.3 per cent year-on-year in the first half of 2017. Public sector investment is set to rebound from the second half of 2017, additionally boosted by the approaching local government elections in 2018. Private investment is fragile and still constitutes a higher risk to growth. Also, the tight labour market, amid shrinking labour supply and rising wages, constitutes an additional factor that hampers new investment. Overall, the investment-to-GDP ratio, which dipped below 18 per cent in mid-2017, has registered its lowest level since 1996. Household consumption, boosted by accommodative policies and the improving labour market, along with recovering investment, are expected to accelerate GDP growth to 4.1 per cent this year. In 2018, GDP growth will likely slow down to 3.4 per cent, in line with rising consumer prices which may weaken the currently strong private consumption.

Slovak Republic

Economic growth in the Slovak Republic slowed somewhat from 3.9 per cent in 2015 to 3.3 per cent in 2016, but still remained the strongest in central Europe and the Baltic states in

2016. Solid employment growth, rising disposable incomes and double-digit growth in credit to households supported strong private consumption. In contrast, investment expenditures declined by 8 per cent in 2016 and continued to fall over the first six months of 2017 (declining by 3.4 per cent), as the drawing of EU funds has been sluggish. During the first half of 2017, economic growth reached 3.2 per cent year-on-year. Shortages of qualified labour have been a problem for some time in the automotive industry and are now slowing the development of the IT industry, which is located in the eastern part of the country and where the unemployment rate remains high, at 13.2 per cent in 2016. Overall, the national unemployment rate fell to 7.5 per cent in August 2017, but increasing labour shortages are putting more and more pressure on wages, which increased year-on-year by 4.2 per cent in nominal terms in the first half of 2017. A rapidly declining working-age population is also a threat to the Slovak Republic's development model. In 2017 GDP growth is forecast to reach 3.3 per cent, rising to 3.5 per cent in 2018. Risks to the outlook constitute a weaker-than-anticipated recovery in the Eurozone as well as slow absorption of EU funds.

Slovenia

Slovenia's growth has surprised on the upside in 2017, and is projected to reach 4 per cent, which is 0.9 percentage points higher than a year before and 1.5 percentage points above the projection published in May. The growth is being led by domestic demand, which benefits from strong consumption momentum and strong recovery in investments with the start of the new EU funding cycle. The contribution of net exports is likely to be negligible, as imports and exports should keep rising on the back of higher domestic and favourable external demand, respectively. Growth is expected to slow down to 2.9 per cent in 2018, still led by domestic demand. Risks to the projection relate to high corporate over-indebtedness, and the slow pace of business environment reforms and privatisation.

South-Eastern Europe (SEE)

Economic growth has been positive in all SEE countries during the first half of 2017, with the exception of FYR Macedonia where the political crisis of the past two years has taken a toll on investment and growth. However, all countries in this region are projected to grow in 2017 as a whole and in 2018, with a particularly strong performance in Romania and in several Western Balkan countries. Prospects for the Greek economy have improved this year, and the Cypriot economy has once again out-performed expectations.

Albania

Economic activity in Albania continues to be on an accelerating trend. After broad-based growth in 2016 of 3.4 per cent, the rate of increase of GDP rose further to 4 per cent year-on-year in the first half of 2017. Growth is being driven by strong investment, primarily linked with construction of the gas Trans Adriatic Pipeline (TAP). The short-term outlook remains positive, and we have therefore increased our forecast for overall 2017 growth, based on this strong performance in the first half of 2017, from 3.5 to 3.7 per cent, staying at that level in 2018, on the back of private domestic demand and further major construction work on large energy-related foreign direct investment, including the TAP.

Bosnia and Herzegovina

The economy in Bosnia and Herzegovina has once again proved resilient to negative shocks, including the marked slowdown in reforms in the past year. Economic growth estimates for 2016 have been revised upwards recently to 3.2 per cent, and the economy continued to grow in the first half of 2017 albeit at a slower rate, estimated at 2.2 per cent year-on-year. The slowdown was driven by a weaker performance of the agricultural and construction sectors compared to the same period of last year, as well as a levelling off of the industry sector. The first review of the IMF programme is still on hold, pending the completion of several prior actions and, as a result, implementation of some key infrastructure projects, including Corridor Vc, is delayed. We are therefore leaving our growth projections for 2017 and 2018 unchanged relative to May, at 2.5 and 3 per cent respectively, while noting the significant downside risks if the country's reform agenda remains stuck.

Bulgaria

After growing 3.9 per cent in 2016, the economy expanded by 3.6 per cent and 3.9 per cent in the first two quarters of 2017. Private consumption became the main driver of growth in 2017 as a result of the tight labour market, a 10 per cent year-on-year increase in average wages and growing consumer confidence. Government spending remained subdued due to budgetary tightening and the transition to the new EU funds programming period, resulting in budget surpluses in 2016 and the first three quarters of 2017. Following three consecutive years of decline, investment grew in 2016-17, driven by the private sector. As a result of growing domestic demand driving imports, the contribution of net exports to growth turned negative in the first half of 2017. In 2017 and 2018, growth will be driven by private consumption and investment, as fiscal consolidation continues and the contribution of net

exports to growth remains negative due to strong domestic demand. Overall, growth is expected to stand at 3.5 per cent in 2017 and 3.2 per cent in 2018.

Cyprus

Economic activity has speeded up in 2017, building on the robust recovery of the past couple of years. GDP growth is estimated at 3.6 per cent year on year in H1 2017, driven by strong performances in retail and wholesale trade, construction and manufacturing. Leading indicators point to another exceptional year for tourism, which is continuing to benefit from instability elsewhere (in the first nine months of 2017, the number of tourist arrivals was nearly 15 per cent higher than in the same period in 2016). In light of these trends, we are upgrading our annual GDP growth forecast for 2017 from 2.5 to 3.5 per cent. We also expect the solid economic recovery to continue in 2018, at a moderated rate of 2.5 per cent. Nevertheless, significant headwinds remain, including the very high levels of indebtedness in the economy, and the large legacy of NPLs which still account for nearly half of all loans and are being dealt with only slowly.

FYR Macedonia

Political uncertainty during 2016 and the first part of 2017 had a strong negative impact on economic performance. Recorded GDP growth in 2016 of 2.4 per cent was well below the level in the previous two years (3.6 and 3.8 per cent respectively), mainly due to a negative contribution from investment. This trend was intensified in the first half of 2017 when the economy declined by 0.9 per cent year-on-year. However, private consumption has remained relatively robust, and investment is likely to pick up in the second half of the year and in 2018 in line with the resolution of the political crisis and formation of a new government in mid-2017. We expect growth in the second half of 2017 to bring the overall GDP rise in 2017 to 1.5 per cent, increasing to 2.5 per cent in 2018 on the assumption that the country maintains a stable political environment and unblocks further reforms, which can attract much-needed investments.

Greece

The Greek economy has seen modest growth and declining unemployment in 2017, and confidence is rising on the back of progress in the country's economic adjustment programme and completion of the second review of the programme in June 2017. Growth in H1 2017 was 0.6 per cent year on year, boosted by good performances in the industrial and export sectors. Quarterly growth in both Q1 and Q2 was 0.5 per cent. We expect to see a pick-up in growth in the second half of the year, boosted by another record year for tourism, and we thus maintain our forecast of 2 per cent growth for 2017 as a whole. We also keep our 2018 growth forecast at 2.2 per cent. However, major downside risks to the forecast remain as the economy is still in a difficult position, with current levels of investment well below depreciation, implying a constant deterioration of the capital stock. Further short-term austerity measures are in the pipeline, including tax rises and pension cuts, and the primary fiscal surplus is still targeted at 3.5 per cent of GDP in 2018.

Kosovo

The economy has continued to perform well in 2017, accelerating from the rate of growth it experienced in 2016. In H1 2017 the economy grew by 4.2 per cent year-on-year, primarily driven by rising investment but with positive contributions also from net exports and private consumption. Fiscal discipline has remained strong within the IMF programme, which expired in August 2017. As a result of the economy's strong performance, we are increasing our growth forecast slightly to 3.7 per cent in 2017, followed by 3.5 per cent in 2018. However, downside risks include possible delays to key infrastructure projects, which are crucial for the long-term sustainability of the economy.

Montenegro

After a somewhat disappointing growth rate of 2.9 per cent in 2016, the economy has accelerated in the first half of 2017, with an estimated rate of growth of 4.2 per cent year-on-year. This was mainly due to robust private consumption growth, helped to some extent by rising government consumption, while both investment and net exports had negative contributions to growth. Leading indicators, such as foreign tourist arrivals (up 20 per cent year-on-year in the third quarter of 2017) point to continued robust growth since mid-year. We are therefore increasing our forecast for GDP growth in 2017 to 3.7 per cent, while keeping our 2018 forecast at 3.3 per cent. Downside risks include a possible adverse impact of the rapidly rising public debt, which may necessitate painful austerity measures in future to keep it under control.

Romania

Romania's economy grew by 4.6 per cent in 2016 and by 5.8 per cent in the first half of 2017, driven by strong domestic demand. Private consumption surged on the back of higher disposable income (boosted by cuts in VAT and a rise in wages), improvements in the labour market and a strongly pro-cyclical fiscal policy. Consumption will continue to drive growth in 2017 and 2018, supported by a further increase in minimum and public sector wages, which formed part of the governing PSD's election promise. The latter will mean that government spending is likely to remain elevated, with a risk that the 3 per cent of GDP deficit limit under the fiscal compact will be breached in 2017. While overall investment has been weak, public investment will be boosted by the increased absorption of EU funds. Meanwhile, better economic prospects of Romania's trading partners mean that exports will offset part of the growing import bill resulting from higher domestic consumption. GDP growth of around 5.3 per cent is expected in 2017, moderating to 4.2 per cent in 2018.

Serbia

After recording a 2.8 per cent growth in 2016, the Serbian economy is expected to slow to 1.8 per cent in 2017. The slow-down is a consequence both of the summer drought which badly affected the agriculture sector, and difficulties in the mining and electricity generation, sectors which are dominated by state-owned companies. On the expenditure side, household consumption continues to recover on the back of rising employment and a pick-up in retail lending. Despite somewhat slower investment growth, domestic demand will still

be the main GDP driver. Exports of goods and services are likely to repeat the double-digit growth from previous years but higher import growth due to stronger domestic demand may result in negative contribution of net exports. Growth is projected to accelerate to 2.9 per cent in 2018. Faster growth should be supported by the low base, stronger consumption and investments, with offsetting effects from higher imports. Although fiscal performance has continued to be better than envisaged (with a budget surplus in January-August 2017), the slow-down of fiscal as well as structural reforms are the main downside risks to the projection.

Turkey

After growing at a below-average rate of 3.2 per cent in 2016, the Turkish economy grew by 5.1 per cent in the first half of 2017. The government has adopted a significant fiscal stimulus in 2017, notably the temporary VAT cuts in durable consumer goods and the TRY 250 billion (US\$ 70 billion) Credit Guarantee Fund, which have led to a surge in domestic demand in 2017. At the same time, the adoption of a new National Accounts methodology in December 2016 served to enhance the country's growth figures.

While the lira depreciated by 27 per cent against the dollar from July 2016 until end-January 2017, it has subsequently recovered some of its losses, reflecting both measures undertaken by the Central Bank to tighten monetary policy, and increased portfolio inflows in common with the overall trend in emerging markets. However, Turkey's large current account deficit, extensive foreign-exchange-denominated corporate debt and investor concerns over geopolitical risks mean that the lira remains vulnerable.

This depreciation passed through to inflation, which reached double digits for the first time in five years in February 2017, well above the 5 per cent target set by the Central Bank. The Central Bank tightened monetary policy by widening its interest rate corridor and resorting to lending through its punitive late liquidity window, rather than raising the policy rate. As a result of the tightening, inflation started to decline in May 2017.

Large external imbalances remain a major vulnerability. The current account deficit has been decreasing, from 6.7 per cent of GDP at end-2013 to around 4.1 per cent of GDP at Q2 2017, due to the depreciation of lira and the declining energy import bill, on the back of lower oil prices. However, gross external financing needs are estimated to be at around 25 per cent of GDP in 2017, leaving the country exposed to global liquidity conditions.

Strong public finances and a stable banking system remain the key anchors of the economy, despite the recent loosening of fiscal policies and increase of contingent liabilities. The banking system remains well capitalized, with low levels of non-performing loans (3.1 per cent). A significant strength of Turkey is its low public debt of 28 per cent of GDP at end 2016, and low budget deficit, which stood at 1.1 per cent of GDP in 2016. However, expansionary fiscal policies adopted since the end of 2016 have rapidly expanded the budget deficit, and the government passed an act to increase the borrowing limits of the Treasury this year.

Thanks to an uptick in exports and the exceptional stimulus provided by the government, growth is expected to recover to around 5.1 per cent in 2017 before declining to 3.5 per cent in 2018. The contribution of private consumption on growth will decline due to the phasing out of stimulus measures. Increasing levels of public investment will be partly offset by sluggish private investment growth, linked to a deterioration of the business environment. Net exports are likely to increase due to the competitive exchange rate and increasing demand in key export markets.

The downside risks to this outlook for the next two years are: investor uncertainty in the context of the unstable geopolitical environment and perceived deterioration of institutional independence; faster-than-expected monetary tightening by the US Federal Reserve and moderation in global liquidity; and failure of the government to pursue structural reforms efforts which are required to enable the country to reach its long-term growth potential. On the upside, if the government introduces new stimulus with the 2019 elections in mind, this could result in growth exceeding our forecast, albeit with associated negative consequences for other macroeconomic indicators.

Eastern Europe and the Caucasus (EEC)

Economic growth in the EEC region has been picking up, supported by a recovery in exports and remittances as well as favorable commodity price trends. In the first three quarters of 2017, the GDP contraction in Azerbaijan slowed and the economy of Belarus returned to growth after two years of recession. Ukraine and Moldova maintained positive growth momentum in the first half of 2017 despite downside risks, while economic growth in Armenia and Georgia accelerated. The EEC region is forecast to grow by 1.6 per cent in 2017 and 2.7 per cent in 2018, contingent on a non-intensification of geopolitical tensions, continued improvement in the regional economic context and other country-specific factors.

Armenia

In Armenia, economic growth has regained momentum in the first half of 2017, after coming almost to a standstill in 2016. GDP expanded by 6.5 per cent year-on-year in the first quarter of 2017 and by a further 5.5 per cent year-on-year in the second quarter. The rebound was supported by strong export performance and a recovery in money transfers to Armenia, which followed three years of contraction. On the other hand, contraction in the agricultural output and construction continued in the first nine months of 2017. Consumer price inflation slowly increased to 0.6 per cent year-on-year in the first nine months of 2017 amid monetary policy relaxation and recovering household consumption. Ongoing fiscal consolidation aims to put public debt on a declining trajectory. The budget deficit is planned to go down from 5.6 per cent in 2016 to around 3.0 per cent of GDP in 2017, mainly through lower public investment. The banking sector is well-positioned to expand lending to the economy following a successful recapitalization. Economic recovery in the main trading partners is expected to bolster growth in Armenia, but the economy remains exposed to several risks, including volatility in the commodity markets. The conflict in the Nagorno-Karabakh region presents a risk to the growth outlook. We forecast Armenia's economy to grow by 3.5 per cent in both 2017 and 2018.

Azerbaijan

The pace of economic recession in Azerbaijan has slowed on the back of the moderate recovery in the oil price and macroeconomic stabilization policies. GDP contraction moderated to 0.6 per cent year-on-year in the first nine months of 2017. The drop in capital investment has levelled off in the first eight months of 2017. Inflation has picked up to 13.9 per cent year-on-year in the first nine months of 2017. Azerbaijan's current account moved from a deficit of 3.6 per cent of GDP in 2016 to a small surplus in the first half of 2017, enabled by the oil price recovery. Macroeconomic policies have remained relatively tight to curb inflation, defuse foreign exchange pressures and safeguard liquidity buffers. Completion of landmark gas infrastructure projects is expected to provide stimulus to growth from 2018 onwards, although downside risks remain, associated mainly with the dependence on the resource sector and banking sector challenges. The conflict in the Nagorno-Karabakh region presents a risk to the growth outlook. We forecast Azerbaijan's economy to contract by 0.5 per cent in 2017 followed by 2.0 per cent growth in 2018.

Belarus

Belarus's economy is growing again after two years of recession. In the first nine months of 2017, GDP grew by 1.7 per cent year-on-year, driven by a recovery in external demand. Output in manufacturing, the economy's largest sector, grew by 6.6 per cent year-on-year. Stabilisation of the exchange rate, weak domestic demand, moderation in wage growth as well as generally conservative macroeconomic policies have all helped to bring the inflation rate down to 4.9 per cent year-on-year in September 2017, which is the lowest level in recent years. The near-term economic outlook has improved due to resolution of the gas price dispute with Russia, agreement to restore crude oil supplies to Belarus to ordinary annual volumes, resumption of disbursements by the Eurasian Fund for Stabilisation and Development and successful placement by Belarus of sovereign Eurobonds for the principal amount of US\$ 1.4 billion in June 2017. These developments have helped to mitigate short-term funding pressures. However, downside risks remain and the growth prospects continue to depend on the extent of structural reforms. We forecast the economy of Belarus to grow by 1.5 per cent in 2017 and 2.0 per cent in 2018.

Georgia

The economy of Georgia is accelerating on the back of strong export performance and burgeoning tourism. In the first half of 2017, GDP growth picked up to an estimated 4.5 per cent year-on-year following two years of below-3 per cent growth in 2015-16. The Georgian lari appreciated by approximately 6.7 per cent against the US dollar until mid-October 2017, supported by foreign exchange inflows from increased exports, tourism receipts, tightening of monetary policy, and a recovery in remittances which increased by approximately 19.7 per cent in the first nine months of 2017. Inflation gained pace to 6.2 per cent year-on-year in September 2017 from an average of 2.1 per cent in 2016. The fiscal deficit is planned at around 4.1 per cent of GDP in 2017, reflecting relatively high infrastructure spending financed mostly by borrowing from international financial institutions on favourable terms. A recovery in consumption, investment in infrastructure and strong performance of the hospitality sector are expected to contribute to growth. Weaker-than-expected regional recovery and geopolitical tensions could, however, affect growth on the downside. We forecast Georgia's economy to grow by 4.5 per cent in both 2017 and 2018.

Moldova

Moldova's GDP grew by 2.8 per cent year-on-year in the first half of 2017. In the first eight months of 2017, inbound money transfers resumed growth of 9.5 per cent year-on-year after a decline in the previous two years. Supported by strong export performance and recovering remittances, the leu appreciated by 14.5 per cent in relation to the US dollar until mid-October 2017. Amid monetary tightening and a stable leu, inflation decelerated to 6.3 per cent year-on-year in the first nine months of 2017. Official reserve assets remained adequately high at US\$ 2.5 billion in end-August 2017, providing approximately six months of import coverage. In April 2017, the IMF completed the first programme review and released a US\$ 21.5 million tranche. Macroeconomic stabilisation and an improved external environment underpin near-term growth outlook. However, vulnerabilities in the financial

sector remain despite recently taken steps to improve banking supervision and the regulatory framework. We forecast Moldova's economy to grow by 3 per cent in 2017 and 3.5 per cent in 2018. The forecast is subject to uncertainty due to a narrow economic base concentrated in agriculture.

Ukraine

Ukraine's economy sustained a moderately-paced recovery in the first half of 2017, growing by 2.5 per cent year-on-year in the first quarter and by an estimated 2.3 per cent year-on-year in the second quarter. Household consumption is picking up this year on the back of increasing real wages and improving confidence. After a protracted downturn, gross fixed capital formation continued robust growth of approximately 20 per cent year-on-year (in real terms) in the first half of 2017. The real volume of exports of goods and services declined by 0.4 per cent year-on-year in the first quarter and by 2.1 per cent year-on-year in the second quarter of the ongoing year, dragging down headline GDP growth. In the first eight months of 2017, industrial production contracted by 0.4 per cent year-on-year on account of the economic blockade of the area that is beyond the control of the government of Ukraine. Consumer price inflation has slowed but remains elevated at 16.4 per cent year-on-year in September 2017. Successful issuance of sovereign 15-year Eurobonds in September 2017 for the principal amount of US\$ 3 billion marked Ukraine's return to international capital markets. It was accompanied by a liability management operation to buy back Eurobonds maturing in 2019 and 2020. Ukraine's official reserve assets increased to approximately US\$ 18.6 billion (close to four months of imports) as of September 2017. The banking system has been stabilising but lending activity remained weak on the back of prevailing risk-aversion, deleveraging, lack of progress in creditor rights' protection and high (albeit decreasing) interest rates. The IMF completed the third programme review in April 2017 although continuation of the IMF programme is uncertain due to weak reform momentum. We forecast the Ukrainian economy to grow by 2 per cent in 2017 and 3 per cent in 2018.

Russia

After falling by 0.2 per cent in 2016, the Russian economy has returned to growth in 2017. In the first half of the year, GDP rose by 1.5 per cent year-on-year on the back of stronger activity in the trade, mining and transport sectors. On the expenditure side, the recovery was driven by domestic demand, i.e., consumption and investment, while the contribution of net exports turned negative as imports outpaced exports.

Private sector capital outflows in January-September 2017 reached the 2016 annual level (around US\$ 20 billion), this time driven by banking sector outflows. In the same period, Eurobond issuances increased almost threefold, to US\$ 29 billion, while syndicated borrowing declined by one-third, to US\$ 9.4 billion.

With inflation falling, monetary policy has been easing further. Over the past six months, the CBR cut the key policy rate by a cumulative 1.25 percentage points, to 8.5 per cent in September 2017. Disinflation was supported by the strengthening rouble, a strong food harvest and base effects. At 3 per cent year-on-year, inflation in September 2017 was below the CBR target (4 per cent). Meanwhile, fiscal policy has tightened with the deficit falling to 2.5 per cent of GDP in 2017, from 3.7 per cent a year before. The budgetary plans for 2017-19 set out fiscal consolidation at one percentage point of GDP annually, but the pace is somewhat uncertain due to both upside (the government's conservative oil price assumption of US\$ 40 per barrel) and downside risks (the need to sustain social spending in the run-up to the presidential elections). In addition, in July 2017 the new fiscal rule was adopted, with the intention to reduce the effect of oil prices on the federal budget.

Financial stability is supported by the central bank's policy of closing weakly performing banks with poor corporate governance. In September 2017 there were 574 banks operating in Russia, around 380 fewer than in mid-2013. The new bank resolution framework is effective from mid-June 2017, entrusting the Central Bank of Russia to operate the framework instead of the Deposit Insurance Agency (DIA). At 6.1 per cent in the corporate sector and 7.5 per cent in the household sector in September 2017, the non-performing loans ratios remain moderate compared with the average rates in central and south-eastern Europe.

Economic growth in 2017 is expected to be at 1.8 per cent and stay at similar level (1.7 per cent) in 2018. Growth will be led by the recovery in consumption and investment, and also supported by higher oil prices and macroeconomic stabilisation. The contribution of net exports in 2017 is likely to be negative, given the strong catch-up in imports that will most likely outpace the export growth. The main risks for the projection come from the oil price, lack of business environment reforms to support investment, geopolitical tensions and the prolongation of sanctions. Without significant reforms, long-term growth may remain at around 1 to 2 per cent annually due to low investments, outdated production capacities and less favourable internal structural factors such as weak demographics, outdated infrastructure and unfavourable institutional characteristics of the economy.

Central Asia

Economic growth in Central Asia has picked up significantly in the first nine months of 2017, following a slowdown in 2014-2016. In commodity-exporting countries growth was driven by the increased production in the extractive sector and stable commodity prices, leading to a stronger export performance. Countries dependent on remittance flows from Russia benefitted from the rebound of these. National currencies and foreign exchange reserves stabilised and inflationary pressures eased in most of the countries in the first nine months of 2017, following significant adjustments in previous years. Major steps were taken in Uzbekistan to liberalize the foreign exchange rate regime. Tight currency controls and dual exchange rates combined with banking sector weakness and fiscal pressures to weigh heavily on businesses in Tajikistan and Turkmenistan. The economies of Central Asia as a whole are forecasted to expand on average by 4.5 per cent in 2017. The upgrade from the May 2017 forecast results mainly from higher than expected growth in Kazakhstan, Central Asia's largest economy. Real GDP growth in the region is expected to moderate only marginally, to 4.4 per cent, in 2018 under the assumption of sustained growth in Russia and China and broadly stable commodity prices.

Kazakhstan

Following a significant slowdown over 2014-2016, real GDP growth in Kazakhstan accelerated to 4.3 per cent year-on-year in the first nine months of 2017 from 1.1 per cent in 2016, supported by the recovery in oil exports and stronger activity in construction, agriculture and transportation. Exports rose by 32 per cent in the first 8 months of 2017 in US dollar terms, after falling by 20 per cent in 2016 and 42 per cent in 2015. Imports were up 18 per cent in the same period. Monetary conditions have normalised and inflation has returned into the National Bank's established corridor, reaching 7.1 per cent in September 2017 year-on-year. Fiscal strength remains high, with National Oil Fund reserves remaining sizeable. Legacy NPLs continue to weigh on the banking sector, but there is a new momentum towards resolution. Banking sector consolidation is ongoing with the mergers of the largest banks and the injections of the state funds, to clean the balance sheet of banks with the largest shares of the NPLs. Growth is expected to reach 3.8 per cent in 2017 and remain strong at 3.5 per cent in 2018, driven by increasing crude production, including from the restarted Kashagan oil field, favourable oil prices and a recovery in real incomes growth, which turned negative in the second quarter of 2017. Inflation is expected to remain within the 6-8 per cent range set by the NBK in 2017-2018.

Kyrgyz Republic

Growth in the Kyrgyz Republic reached 5.0 per cent year-on-year in the first nine months of 2017, reflecting strong gold production. Excluding the Kumtor gold mine, GDP growth was 3.6 per cent year-on-year, broadly unchanged from 2016. The Kyrgyz som remained broadly stable over 2017, with foreign exchange reserves close to US\$ 2 billion or five months of import cover as of September 2017. Growth is expected to reach 4.4 per cent in 2017 and 4.2 per cent in 2018, on the back of strong growth in mining and higher gold exports, as well as continued growth in remittances, boosting household demand. in the first eight months of

2017, remittances from Russia increased by 26.8 per cent in US dollar terms. Infrastructure spending from China will likely remain significant. However, the fiscal loosening in the up-run to the presidential election will have to be reversed in order to continue with the IMF programme. This will weigh on GDP growth and keep it below 5 per cent in the medium term.

Mongolia

Mongolia's economy is recovering from the sluggish growth of previous years. Real GDP growth accelerated to 5.3 per cent year-on-year in the first half of 2017, significantly up from 1.0 per cent in 2016, reflecting the base effect, growing investment in the mining sector, stronger coal exports and a recovery in household consumption. Exports rose by 38 per cent year-on-year in the first nine months of 2017, led by coal exports to China, while imports expanded by 28 per cent. Currency pressures eased in 2017, an effect also of the new IMF programme. Stronger demand and the pass through from earlier currency depreciation caused inflation to accelerate to 5.8 per cent in September 2017 year-on-year, after averaging only 0.6 per cent in 2016. Mongolia's external position remains vulnerable, with total external debt at around 229 per cent of GDP (160 per cent excluding intercompany lending) as of June 2017. However, the IMF-led support package and the extension of the currency swap agreement with China will allow the country to meet its repayment obligations in the forecast period. We expect real GDP to rise by 2.6 per cent in 2017 and by 3.0 per cent in 2018, as mining investment and exports accelerate driven by the expansion of the second phase of the Oyi Tolgoi mine. Public spending will by contrast remain subdued in 2017-2018, given the government has remained committed to the significant fiscal tightening envisaged under the IMF programme.

Tajikistan

According to the official figures, real GDP grew by 6.8 per cent in Tajikistan in the first nine months of 2017 year-on-year, after 6.9 per cent in 2016. The strong headline growth is however in stark contrast with the difficult situation in the banking sector and rising fiscal and currency pressures. The banking sector remains in a challenging state, with overdue and non-performing loans, mostly concentrated in the two largest banks, at around 50 per cent as of June 2017. Fiscal risks, stemming from the government's need to shore up the banking system, are substantial. Remittances from Russia have recovered in the first half of 2017, rising by 22.4 per cent in US dollar terms in year-on-year in this period, which will support household consumption. The Tajik somoni came under pressure in 2017, depreciating by 10.5 per cent in the first nine months of the year, prompting the central bank to increase the monetary policy rate to 16 per cent in March 2017. Officially reported real GDP growth is expected to reach 6.5 per cent in 2017 year-on-year, decelerating to 5 per cent in 2018. These forecasts reflect the significant downside risks, given the possibility of further banking sector turbulences and the difficult fiscal position of the country.

Turkmenistan

In Turkmenistan officially reported real GDP growth was 6.4 per cent year-on-year in the first half of 2017, little changed from 6.2 per cent in 2016 and 6.5 per cent in 2015. Notwithstanding the strong headline figures, the economy is under significant pressure. The

gap between the official and unofficial exchange rates has continued to widen, suggesting that the manat is significantly overvalued. The black market rate depreciated to 6.6 manats per US dollar in September 2017 from 4.4 manats per US dollar, while the official peg of 3.5 manats per US dollar has been maintained since January 2015. The government responds to the scarcity of hard currency by continuously introducing harsher convertibility restrictions, which severely disrupt foreign trade and investment. The halt of gas exports to Russia in 2016 and gas dispute with Iran in 2016, leaving China as the major gas recipient for the country, combined with the fall in global energy prices to reduce exports to US\$ 7.5 billion in 2016 from its peak of US\$ 11.3 billion in 2014, according to the IMF. The government's decisions to cease free electricity, gas and water benefits in 2017 suggests that the countries fiscal position has been severely affected by reduced revenue and high spending on large projects such as the Asian Martial Games. Real GDP growth can be expected to slow, possibly to average 5.7 per cent in 2017 and 5.1 per cent in 2018, due to fiscal tightening measures and continuing currency depreciation that eats into real household income and spending.

Uzbekistan

Officially reported growth slowed to 5.3 per cent in the first nine months of 2017 in Uzbekistan, compared with 7.0 per cent in the first half of the year. This is the lowest growth rate reported since 2003. However, it likely reflects more accurate accounting rather than a sharp contraction in the third quarter. Growth was driven by strong performance in exports, increasing by 25.6 per cent year-on-year, as well as growth in the industrial, construction and services sectors. Major steps were made to liberalise the foreign exchange regime, representing the most important economic reform for the country to date. Since 5 September 2017 the central bank has stopped administratively setting the exchange rate. The official rate was devalued by 48 per cent to sum 8,100 per US dollar from sum 4,210 per US dollar on 5 September and has marginally appreciated against the US dollar since. The central bank intervenes only to smooth volatility. It had done so in the third quarter 2017 mostly to prevent appreciation, which could later reverse. The currency liberalisation resulted in some inflationary pressures, relatively moderately though, thanks to the pervasive use of the black market rate before the currency liberalisation. Real GDP growth is projected to reach 5.4 per cent in 2017 and increase moderately to 6.2 per cent in 2018, supported by continued robust domestic investment and the stepwise implementation of economic reforms. Export growth will be supported by the improved economic relations with the neighbouring countries. Furthermore, the better economic prospects for Russia and Kazakhstan, the main destinations for Uzbek migrant workers, will support remittance inflows. There is however significant forecast risk with regard to the headline figures, as statistical methods might significantly change during the reform process.

Southern and Eastern Mediterranean (SEMED)

In the SEMED region, growth momentum has picked up in 2017 with real GDP growth at 3.8 per cent compared with 3.3 per cent in 2016, owing to a pick-up in the tourism sector in most countries, strong rebound of the agricultural sector for Tunisia and Morocco, and improved sentiment following recent positive political developments in the case of Lebanon. Economic activity in SEMED is expected to modestly grow in 2018, at a rate of 4.0 per cent, supported by reform implementation and continued recovery in the tourism across countries and export rebound in Egypt, Jordan. Morocco's growth, however, is expected to slow down to 3.5 per cent in 2018 reflecting a slower growth in the agricultural sector (agricultural activity normalises following the 2017 strong rebound from drought-driven contraction in 2016) and a modest growth of the non-agricultural sector.

Egypt

In Egypt, GDP growth remained at 4.1 per cent in the fiscal year 2016/17, similar to previous year, amid rising inflation which exceeded 23 per cent on average. In the first three quarters of fiscal year FY2016/17, there was a rebalancing in the drivers of growth towards exports and investment, while the contribution of private consumption decreased. Tourist arrivals rebounded strongly in the first seven months of 2017, growing by 52 per cent, compared to a 42-per-cent decline in 2016. Suez Canal receipts have been stagnant since 2012, following a decade of 10 per cent growth on average. Since 2011, growth in Suez Canal receipts has been muted at 1 per cent on average, the same rate seen in the first 8 months of 2017. Oil exports rebounded in the second half of FY2016/2017, following three years of contraction. A modest pick-up in growth to 4.5 per cent is expected in FY2017/18 supported by strong reform implementation, foreign investment, exports growth, and increased competitiveness supported by the exchange rate depreciation.

Jordan

Economic performance in Jordan remains weak amid continued regional turmoil, with growth averaging 2.6 per cent since 2010, well below the average growth rate of 6.5 per cent over the 2000s. The conflict in Syria and Iraq has disrupted trade routes, and strained public infrastructure, service provision, and public finances. Tourism arrivals picked up in the first half of 2017 by 11 per cent after declining for six consecutive years between 2011 and 2016. Unemployment increased to 17.9 per cent in the second quarter of 2017. A modest pickup in growth to 2.3 per cent is expected in 2017 and to 2.5 per cent in 2018, driven by a slow recovery in exports and a rebalancing towards new markets, along with some reform progress. Downside risks to the forecast include deterioration in the regional security situation, lower-than-expected aid flows, and the effect of fiscal consolidation on consumption.

Lebanon

Lebanon has been in a protracted period of low growth since the start of the Syrian conflict in 2011, with the annual growth rate averaging 1.7 per cent, after a decade of 5.5 per cent

growth per year on average. However, in 2017, positive political developments, renewed stability, boosted confidence, and the reform momentum are expected to revive growth, as traditional drivers of growth – construction, tourism, real estate, and the financial sectors – recover, and inflows increase. Growth is expected to increase to 2.3 per cent in 2017 and 2.5 per cent in 2018, still low by historical standards and too weak to improve living conditions. Lebanon runs large twin fiscal and external deficit, and has the third largest debt to GDP ratio in the world, further straining public finances and limiting space for capital and social spending.

Morocco

In Morocco, growth in the first half of 2017 stood at 4 per cent, driven by a 16 per cent rebound in agriculture, while non-agricultural sectors continued to be subdued and grew at 2.6 per cent. Tourism picked up by 8.1 per cent, after three years of volatile growth averaging 1 per cent per year. Economic growth is expected to rebound for the whole year to 4.2 per cent in 2017, due to strong cyclical growth in agricultural, benefitting from a positive base effect following the 2016 drought and contraction. Unemployment remained broadly unchanged at 9.3 per cent. In 2018, growth is expected to slow down to 3.5 per cent, owing to the normalization of activities in the agricultural sector as well as continued modest growth in non-agricultural sector.

Tunisia

In Tunisia, economic activities picked up in the first half of 2017 registering growth of 1.9 per cent compared to 1.0 per cent in the same period of 2016. Economic growth is projected at 2.2 per cent for the year up from 1.0 per cent in 2016, supported by a rebound in agriculture, after the low levels of rain witnessed in 2016, and strong growth in the tourism sector, which grew by 8 per cent in the first half of 2017, after four years of decline. The recent dinar depreciation is expected to boost competitiveness. However, inflation has risen to 5.0 per cent during the first nine months of 2017, driven by higher consumption as a result of wage increases and the impact of the depreciation. Unemployment remains high at 15.3 per cent at the end of the second quarter of 2017. Growth is expected to pick up in 2018 to 2.7 per cent, against the backdrop of continued legislative, financial sector, public sector, and structural reforms.

About this report

Regional Economic Prospects are published twice a year. The report is prepared by the Office of the Chief Economist and the Department of Economics, Policy and Governance and contains a summary of regional economic developments and outlook alongside EBRD's growth forecasts for its countries of operations.

For more comprehensive coverage of economic policies and structural changes, the reader is referred to country strategies and updates, as well as the *Transition Report 2017-18*, which are all available on the EBRD's website (www.ebrd.com).

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Regional updates were edited by Peter Sanfey (sanfey@ebrd.com). The writing teams covering individual countries and regions are:

- Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine: Konstantine Kintsurashvili and Ana Kresic
- Bulgaria, Romania and Turkey: Roger Kelly and Ali Sokmen
- Central Asia: Hans Holzhaecker and Nino Shanshiashvili
- Croatia, Russia, Serbia and Slovenia: Peter Tabak and Sanja Borkovic
- Estonia, Hungary, Latvia, Lithuania, Poland and the Slovak Republic: Mateusz Szczurek and Marcin Tomaszewski
- Southern and eastern Mediterranean: Hanan Morsy, Cherry Khalil and Rafik Selim
- Albania, Bosnia and Herzegovina, Cyprus, Greece, Kosovo, FYR Macedonia and Montenegro: Peter Sanfey and Jakov Milatovic

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