

**Regional Economic Prospects in
EBRD Countries of Operations: January 2015¹
EBRD Office of the Chief Economist**

Overview

Oil-driven Russia downturn adds to weakness in EBRD economies

Country prospects reflect terms of trade changes as well as economic ties to Russia

The price of oil has halved since mid-2014 and other commodity prices have also softened, with a double-edged sword effect for the EBRD region and overall driving the region's growth down. Commodity exporters are impacted negatively, particularly the largest country in the region, Russia, where the oil price collapse is compounding the impact of already poor investor confidence, long-run structural problems and increasingly biting economic sanctions. The ensuing negative spill-overs will be significant in many economies in Eastern Europe, the Caucasus and Central Asia that have strong economic ties with Russia as well as other commodity exporters.

On the upside, commodity importers stand to benefit from significant terms of trade gains and some additional space for macroeconomic policy that can boost growth. The economies of central and south-eastern Europe (CESEE) and Southern and Eastern Mediterranean (SEMED) will be the main beneficiaries. However, CESEE countries continue to suffer from weak external demand from the Eurozone, their key trade and financial partner. The SEMED region may also see some negative, though limited, impact from weakening growth in the Gulf countries.

Geopolitical risks from the Ukraine/Russia crisis remain significant, although they are contained for the time being.

On balance, our central scenario for the EBRD region foresees a materially weaker overall economic outlook compared with the September 2014 forecast, primarily reflecting the high economic weight of Russia along with other commodity exporters in the EBRD region, but with major differentiation among regions. Growth in the transition region as a whole is estimated to have slowed to 1.6 per cent in 2014 from 2.3 per cent in 2013, a slightly milder deceleration than in our September forecast. Growth in 2015 is expected to become negative for the EBRD region (-0.3 per cent, compared with our forecast of +1.7 per cent in September). Russia is projected to slip into recession, with GDP contracting by close to 5 per cent. Growth rates in other commodity exporting economies will also drop significantly. Nonetheless, commodity-importing countries will see a modest pickup in growth from 2.1 per cent in 2014 to 2.4 per cent in 2015.

¹ This document is provided as a companion to the EBRD's growth forecasts for its countries of operations, which are released four times a year. For more comprehensive coverage of economic policies and structural changes, the reader is referred to country strategies and updates and statistical series on economic and structural reform variables, as well as the *Transition Report 2014*, which are all available on the EBRD's website (www.ebrd.com).

The forecast is subject to considerable risks that dominate on the downside. Further significant drops in the oil price would intensify liquidity and financial sector pressures in the Russian economy, with significant spill-over effects for Eastern Europe, the Caucasus and Central Asia. In addition, increased uncertainty in the Eurozone, including in the light of elections in Greece on January 25, can lead to heightened uncertainty for the CESEE region in particular. On the upside, terms of trade gains may give a larger-than-foreseen boost to the world economy and can help smooth the impact of the eventual normalisation of US monetary policy.

Lower oil prices redraw the economic outlook for the region

Oil prices have declined sharply since September, primarily reflecting a supply glut. The Brent price dropped to below US\$ 50 per barrel, from an average of US\$ 105-110 in previous quarters. The downward movement primarily reflects an oversupply in the wake of high production of oil, including shale oil, in the United States, but also weak global demand. Prices of metals (excluding gold) have also declined, albeit less dramatically. If the decrease in oil prices is sustained, gas prices may adjust downwards with some lag.

The decline in the price of oil has significantly weakened the economic outlook for major oil and gas exporters, in particular Russia. In Russia, lower oil prices have compounded the effect of deep-seated structural problems, increased uncertainty and low investor confidence, along with the increasing impact of economic sanctions imposed since March 2014. In the first three quarters of 2014 investment continued to decline, consumption growth decelerated to below 1 per cent, and imports dropped by 6 per cent in real terms. Capital outflows more than doubled to an estimated US\$ 151 billion in 2014. As a result, the rouble has lost almost half of its value in 2014 vis-à-vis the US dollar and Russia lost about a quarter of its international reserves, ending the year at around US\$ 380 billion (including the less liquid National Welfare Fund). Markets were particularly shaken in late November/early December 2014, and the central bank had to raise its policy rate to 17 per cent to stem pressure on the currency. The government provided additional capital to a number of banks, temporarily relaxed certain prudential requirements for banks, and introduced measures to increase the supply on the foreign exchange markets by state-owned companies and put in place additional incentives for de-offshorisation.

Most countries in the region are net importers of oil and gas and stand to benefit from lower energy prices, with improved terms of trade and related policy space:

- Economies that should benefit most from a reduction in the price of hydrocarbons through lower import bills include Jordan, Morocco, the Kyrgyz Republic, Cyprus and Turkey (Chart 1). Lower import commodity prices help consumers directly and imply lower input costs.
- Some policy space is being created in the fiscal and/or monetary areas, other things being equal. Fiscal space in high subsidy-provider commodity-importing countries could be used at least in part to reduce subsidies and the fiscal deficit (Chart 2). Countries in the SEMED region will face a more favourable environment for the continued implementation of subsidy reforms. The increased monetary policy space could be particularly valuable as a rapid

normalisation of US monetary policy may abruptly push borrowing costs higher and reduce net capital inflows to emerging markets. Lower oil prices may push back, or smooth, the timetable for normalisation/interest rate increases in the US, allowing emerging markets to use some of their own enhanced room for monetary policy (as a result of lower oil prices) and ease domestic interest rates in support of growth. Lastly, countries with still significant inflation volatility can use this window to anchor inflation at a lower level.

- Lower inflation volatility and monetary easing in countries with still significant financial dollarisation can lead to a shift to local currency assets and liabilities, thus helping sustainability in the banking sector and households.

At the same time, for a number of countries in Eastern Europe and the Caucasus (EEC) and Central Asia these gains are likely to be more than offset by a reduction in export demand as well as remittances and investment from Russia.

In a number of countries with strong economic links to Russia, for instance Armenia and Belarus, currencies came under pressure in December 2014 as the rouble tumbled. These pressures have been contained so far but may resume if low oil prices persist. Similarly, though to a lesser extent, in SEMED economies the gains from lower oil prices may be partially offset by lower export demand, investment and remittances from the oil-rich Gulf Cooperation Council (GCC) countries.

Ukraine's economy remains in a precarious state. The death toll in the East of Ukraine has been rising despite the ceasefire. International reserves have declined to one month of imports, despite capital controls, and external financing needs are higher than estimated earlier. Government debt has been rising rapidly as a share of GDP and fiscal and quasi-fiscal pressures remain significant. Banking sector balance sheets have been subject to deposit outflows and currency depreciation. The authorities are dealing with multiple banking sector restructuring issues. Energy security remains a serious issue due to shortages of coal and uncertain longer term prospects of Russian gas deliveries beyond the October 2014 "winter package" deal. So far, the transit flow of gas to Europe through Ukraine has not been disrupted but a possible interruption of supplies during the winter season remains a source of concern.

Diverging advanced economies

The performances of advanced markets have been increasingly divergent. In the United States, growth has been relatively strong, unemployment continues to decline, and lower commodity prices may provide a further boost to consumption. Price developments might also allow the Federal Reserve to push back interest rate hikes. In contrast, in the Eurozone growth is anaemic, unemployment is high and consumer prices are declining also as energy prices drop, bringing closer the time when the European Central Bank (ECB) may launch its own quantitative easing (QE) programme. This divergent performance leaves much of the transition region exposed to the weaknesses of both Russia's and the Eurozone's economies, while, alongside other emerging markets, they face the prospect of tighter financial conditions with lower capital inflows as the United States is expected to tighten monetary policy further.

Recent growth performance

Recovery in central Europe and the Baltic states (CEB) has continued. Across this sub-region, stronger domestic demand has been supported by favourable labour market dynamics (Chart 3). Coupled with low inflation translating into higher disposable income, this has helped to offset poorer export performance related to the weak demand from the eurozone. In Hungary, growth has also been supported by one-off factors, namely, accelerated disbursement of EU funds at the end of the EU financial cycle and a boost to household disposable income from cuts in utility tariffs. In Slovenia, growth has surprised on the upside partly due to temporary factors, such as investments financed by EU funds and higher consumption due to somewhat delayed corporate restructuring, but also due to longer-term positive developments as reflected in increased business confidence and a persistently lower country risk premium.

Domestic demand also supported growth in parts of south-eastern Europe (SEE), although developments in the region have been more mixed. Serbia entered a recession in 2014 as widespread damage from the floods in May 2014 compounded existing economic weaknesses, and growth slowed down significantly in Montenegro towards the end of the year partly on account of a delayed investment agenda. In contrast, sustained export expansion supported further growth in FYR Macedonia and a better than expected performance in Bosnia and Herzegovina, which also suffered major flood damage in May. Although Cyprus remained in recession, key sectors such as tourism and legal and accounting services have started to record positive growth rates again, and the country's overall economic performance has continued to surprise on the upside.

Growth in the Eastern Europe and the Caucasus (EEC) region and Central Asia decelerated considerably towards the end of 2014. Commodity exporting countries (Kazakhstan and, to some extent, Azerbaijan and Turkmenistan) have been adversely impacted by the drop in oil prices. At the same time, lower export demand and remittances from Russia and the decline in consumer and investor confidence weighed on the growth rates of many commodity importers. Georgia, whose economy relies to a lesser extent on either Russia or commodities, was the only country in EEC and Central Asia where growth is estimated to have accelerated markedly in 2014, to 5 per cent.

Growth in Turkey slowed to 1.7 per cent year-on-year in the third quarter of 2014 and is estimated to have reached 2.9 per cent in 2014 as a whole as a boost from net exports and government expenditure was offset by constrained domestic demand due to tight monetary conditions, which were necessary to tame high inflation pressures.

Recovery in the South and Eastern Mediterranean (SEMED) has proceeded slower than expected. Increased regional geopolitical tensions and necessary fiscal retrenchment constrained growth in Jordan, the contraction in agricultural output weighed on Morocco's performance, and in Tunisia strikes negatively affected overall economic activity. In contrast, growth picked up in Egypt where investment growth resumed thanks to policy reforms and a more stable political situation. Unemployment in the region remains elevated at 12.4 per cent (and 15.2 per cent in Tunisia) according to the latest available data.

Remittances

Remittances from Russia to Central Asia and the EEC continued to decline (Chart 4). Partial data for the fourth quarter in 2014 suggest that the decline is likely to have accelerated in recent months, entering two-digit percentage rate territory, as the Russian economy weakened and the sharp drop in the value of the rouble reduced the US dollar (and also local currency) value of the remitted earnings. Lower remittances inflows will affect consumption adversely and likely add to downward pressures on a number of currencies in EEC and Central Asia, which also face reduced export demand and investment flows from Russia.²

Capital flows and currency movements

Private capital flows to the transition region remained modest. In net terms, the CEB and SEE regions saw a capital outflow of around 0.5 per cent of GDP on average in the first three quarters of 2014 (annualised). Net private capital outflow from Russia continued in the third quarter, bringing the total to US\$ 85 billion (more than 6 per cent of GDP) in the first nine months of the year. Preliminary data suggest that outflows further accelerated in the fourth quarter, bringing the total amount to around US\$ 151 billion.

The region's currencies have weakened somewhat against the US dollar, beyond broader trends in emerging markets (Chart 5). The rouble lost more than 40 per cent of its value against the US dollar between mid-September 2014 and early January 2015. Various capital controls and administrative restriction were introduced in Ukraine to arrest further depreciation of the hryvnia. This has led to the emergence of a de facto dual exchange rate market.

The depreciation of the rouble increased pressures on the currencies of economies with strong trade, investment and remittances ties to Russia. A number of currencies in Central Asia and EEC depreciated by 10 to 35 per cent against the US dollar, with the most significant downward movements observed in Belarus, Turkmenistan and Armenia. Kazakhstan has thus far refrained from devaluation.

Credit conditions

Credit growth remained subdued in CEB and SEE regions. Parent banks continued reducing their exposure to the CEB and SEE regions, although this contraction was largely offset by the growth of the domestic deposit base, and credit standards kept being tightened, according to surveys of lending conditions. Growth of credit to the corporate sector has remained particularly low and in many cases negative.

Non-performing loans (NPLs) have been high for a long time in many countries and are a major obstacle to sustained credit recovery. The current levels are close to 20 per cent in most SEE countries and Ukraine. In Kazakhstan they exceed 30 per

² See *Transition Report 2014* and September 2014 *Regional Economic Prospects* for a discussion of regional economies' overall exposure to Russia.

cent while in Cyprus they are around 50 per cent. Impediments to resolution of NPLs vary from country to country, ranging from regulatory and tax disincentives to issues related to treatment of different loans to the same borrower to regulatory forbearance. Mirroring bad loans on bank balance sheets, corporate balance sheets also need to be cleansed of liabilities that are no longer performing.

Inflation

Inflation rates have remained predominantly low across the region, but deflation is not a policy problem in most countries. Lower energy prices have further dampened inflation and in several countries consumer prices continued declining while consumption grew, signalling that inflationary expectations have not been re-anchored to lower prices. However, countries with a high private or public debt burden are vulnerable to rising real interest rates if deflation sets in. In contrast, in Belarus, Egypt, Mongolia, Russia, Turkey and Ukraine, inflation has remained high, fuelled to a significant extent by higher prices of imports following currency depreciations. In Russia, the partial ban on imports of food from the EU and a number of other countries exacerbated inflationary pressures. In Egypt, the recent increase in inflation in part reflects the impact of the energy subsidy reform.

Outlook

In our baseline scenario, growth in the transition region is estimated to have slowed down from 2.3 per cent in 2013 to 1.6 per cent in 2014 and is expected to turn negative in 2015. The estimated 2014 outcome is slightly better than projected in September 2014, on account of stronger growth performance in Central Europe and a more moderate deceleration in Russia than expected (Table 1). In contrast, the forecast for 2015 has been revised down significantly from September.

The downward revision reflects divergent prospects of commodity exporters and commodity importers. Weaker commodity prices have significantly weakened the economic outlook for Russia and other oil and gas exporters (Chart 6) as well as a number of countries with particularly strong ties to the Russian economy. At the same time, the overall growth rate in commodity importing economies is expected to strengthen in 2015, from 2.1 to 2.4 per cent (Table 1 and Chart 6).

- **In Russia**, output is expected to contract by close to 5 per cent in 2015 due to a combination of sharply lower oil prices, deeply rooted structural problems, low investor and consumer confidence and economic sanctions. Investment is projected to contract at a double-digit rate as local borrowing costs are soaring and external funding is constrained by sanctions. Consumption will contract as real incomes are eroded and fiscal transfers are more constrained under the budget's adjustment to lower oil revenue. Any major fiscal stimulus using reserve funds may not be effective, given the aging production structure, already high inflation, and the acute risk that rouble funding will put additional pressure on the currency. Net exports will likely increase because of the sharp drop in imports as domestic demand contracts and external funding is constrained. Inflation is expected to edge up further in double digit territory, reflecting a partial pass-through from the deep currency depreciation.

- **Ukraine's** economy is expected to continue undergoing necessary, if painful, adjustments with the support of an IMF programme, but material external refinancing risks, uncertainty about the volume and timing of international financial assistance, and the damage to infrastructure and production capacities in Donbas will all weigh on growth in 2015, resulting in continued recession.
- Growth momentum in the **CEB** and **SEE** regions is expected to be sustained, supported by domestic demand and lower commodity import bills. Growth is also expected to resume in Cyprus, where economic conditions have been gradually improving.
- Growth in the **EEC** region (excluding Ukraine) and **Central Asia** is expected to decelerate significantly on account of the region's strong economic ties with Russia. In Armenia and Moldova growth is projected to come to a halt while Belarus is forecast to enter recession. The economies of Azerbaijan, Kazakhstan and Turkmenistan will be negatively affected by declining commodity prices.
- **Turkey's** economy is expected to grow at the rate of 3 per cent in 2015, as the impetus from the lower oil import bill and potential monetary easing against the background of lower inflation is partly offset by continued weakness in external demand and lower spending by tourists from Russia and Ukraine.
- Growth in the **SEMED** region is expected to pick up to 3.9 per cent in 2015, supported by lower oil prices as well as economic reform measures across the region. Subsidy reforms are being facilitated by the oil price drop. At the same time, regional geopolitical risks remain very significant with conflicts in Libya and Syria/Iraq.

The projections assume a challenging external environment. It reflects a combination of expectations of tightening of monetary policy in the US (though possibly eased by the oil price drop), continued weakness in the Eurozone, a recession in Russia as the economy adjusts to lower oil prices and sanctions, and ongoing tensions in Ukraine. Furthermore, continued cross-border bank deleveraging limits scope for credit growth, in particular in the CEB and SEE countries.

Risks to the outlook

The forecast remains subject to high uncertainty. The key downside risk is a significant further drop in oil prices, which would intensify pressures on the Russian economy, its banking system and the rouble, in particular in light of the significant external debt repayments in 2015 (estimated at around US\$ 150 billion), the declining (though still significant) level of reserves, and the highly constrained access to international capital markets. A deepening liquidity crunch in Russia would in turn have significant contagion effects for the economies in EEC and Central Asia, as seen already in December 2014.

A continued high risk is geopolitical, related to a possibility of further escalation of the crisis in Ukraine/Russia, with significant spill-over effects for the entire region. Although a tri-lateral deal on gas supplies between Ukraine, Russia and the EU has been reached, possible disruptions in supply of gas during the winter season

remain a source of concern. Similarly, an escalation of geopolitical turmoil in the Middle East and North Africa would pose a significant downside risk for SEMED countries and Turkey.

A prolonged divergence between the performance of the US and the Eurozone, coupled with weaker demand from China, is another source of risk, with particular concerns regarding the eurozone's economy. The outcome of the Greek elections on 25 January may substantially increase economic uncertainty in the Eurozone, sending jitters throughout the financial markets. Important national elections in the coming months in the EU, including in the UK, may also bring about heightened uncertainty. A scenario of renewed turbulence in the Eurozone would have the strongest adverse impact on the economies of CEB and SEE, which have the closest trade and financial links with the single currency area.

There are however some upside to the forecast, too. Terms of trade gains may give a larger-than-foreseen boost to the world economy and could smooth the impact of the eventual normalisation of US monetary policy.

Table 1: Real GDP Growth*(In per cent; EBRD forecasts as of 16 January 2015)*

	Actual		Current forecast		EBRD Forecast in September 2014	
	2013	2014	2015	2015	Change Sept.-Jan.	
Central Europe and the Baltic states						
Croatia	-0.9	-0.5	0.5	0.5	0.0	
Estonia	1.6	1.7	2.2	2.5	-0.3	
Hungary	1.5	3.2	2.4	2.2	0.2	
Latvia	4.2	2.5	3.0	3.7	-0.7	
Lithuania	3.3	2.9	3.2	3.4	-0.2	
Poland	1.7	3.2	3.0	3.3	-0.3	
Slovak Republic	1.4	2.4	2.6	3.0	-0.4	
Slovenia	-1.0	2.7	1.6	1.0	0.6	
Average ^{1,2}	1.5	2.8	2.6	2.8	-0.2	
South-eastern Europe						
Albania	1.4	1.5	2.5	2.5	0.0	
Bosnia and Herzegovina	2.5	0.9	2.7	2.7	0.0	
Bulgaria	1.1	1.5	0.8	2.0	-1.2	
Cyprus	-5.4	-2.1	0.7	0.0	0.7	
FYR Macedonia	2.7	3.8	3.5	3.0	0.5	
Kosovo	3.4	2.5	3.5	3.5	0.0	
Montenegro	3.3	1.3	3.0	2.5	0.5	
Romania	3.5	2.6	2.8	2.8	0.0	
Serbia	2.6	-2.0	0.5	2.0	-1.5	
Average (excl. Cyprus) ¹	2.8	1.7	2.2	2.6	-0.4	
Eastern Europe and the Caucasus						
Armenia	3.5	3.0	0.0	3.5	-3.5	
Azerbaijan	5.7	2.8	1.5	3.0	-1.5	
Belarus	1.0	1.5	-1.5	0.5	-2.0	
Georgia	3.3	5.0	4.2	4.0	0.2	
Moldova	9.4	3.0	0.0	4.0	-4.0	
Ukraine	0.0	-7.5	-5.0	-3.0	-2.0	
Average ¹	1.8	-2.6	-2.3	-0.5	-1.8	
Turkey	4.1	2.9	3.0	3.2	-0.2	
Russia	1.3	0.4	-4.8	-0.2	-4.6	
Central Asia						
Kazakhstan	6.0	4.3	1.5	5.1	-3.6	
Kyrgyz Republic	10.5	3.6	3.2	4.8	-1.6	
Mongolia	11.7	6.0	3.5	5.5	-2.0	
Tajikistan	7.4	6.7	4.4	4.4	0.0	
Turkmenistan	10.2	10.2	9.7	10.0	-0.3	
Uzbekistan	8.0	8.0	7.8	7.6	0.2	
Average ¹	7.1	5.6	3.5	6.0	-2.5	
Southern and Eastern Mediterranean						
Egypt	2.1	2.2	3.8	3.2	0.6	
Jordan	2.8	3.1	3.7	4.1	-0.4	
Morocco	4.4	2.4	4.6	4.7	-0.1	
Tunisia	2.4	2.3	3.0	4.2	-1.2	
Average ^{1,3}	2.7	2.3	3.9	3.7	0.2	
Average EBRD region (incl. Cyprus) ¹	2.3	1.6	-0.3	1.7	-2.0	
Average commodity exporters ⁴	2.0	1.0	-3.8	0.5	-4.3	
Average commodity importers	2.6	2.1	2.4	2.7	-0.3	

¹ Weighted averages. The weights used for the growth rates are WEO estimates of nominal dollar-GDP for 2012.² Weighted averages do not include the Czech Republic, for which EBRD no longer produces a forecast.³ 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.⁴ Commodity exporters include: Azerbaijan, Russia, Kazakhstan, Mongolia and Turkmenistan.

Chart 1. Net oil imports in 2013, per cent of GDP

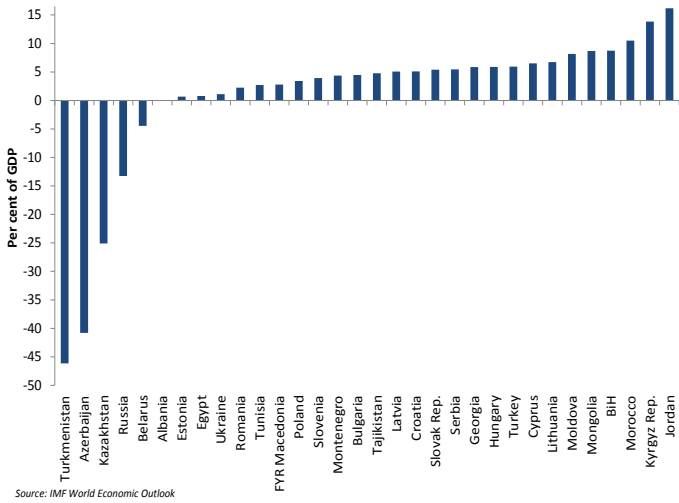


Chart 2. Subsidies and fiscal deficits in SEMED, 2013

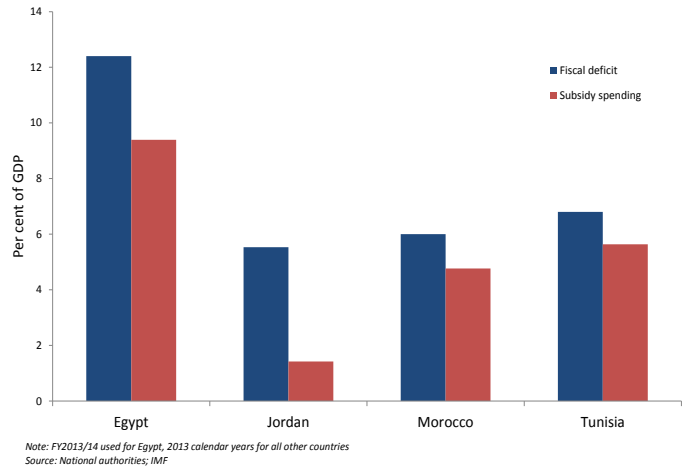


Chart 3. Unemployment rate in the region, per cent

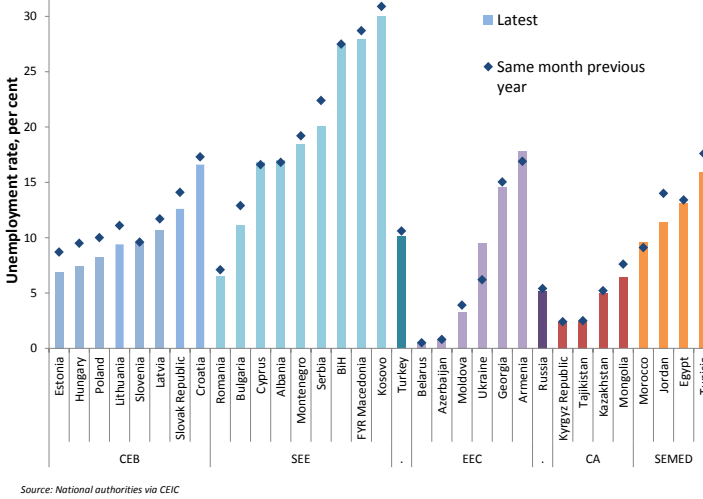


Chart 4. Remittances from Russia to EEC and Central Asia

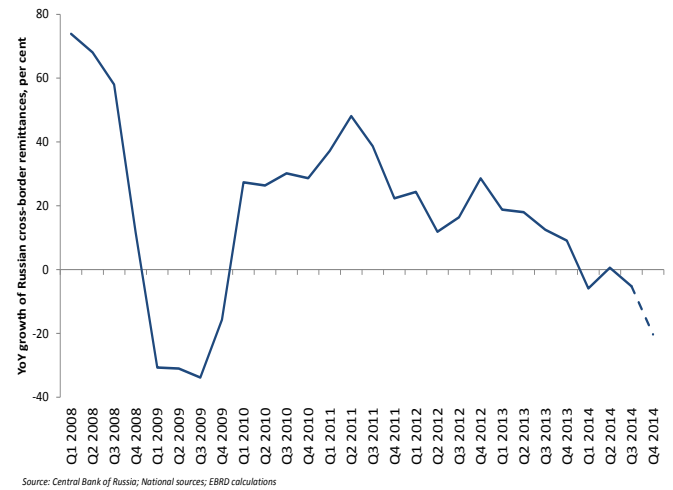


Chart 5. Exchange rate development since July 2014

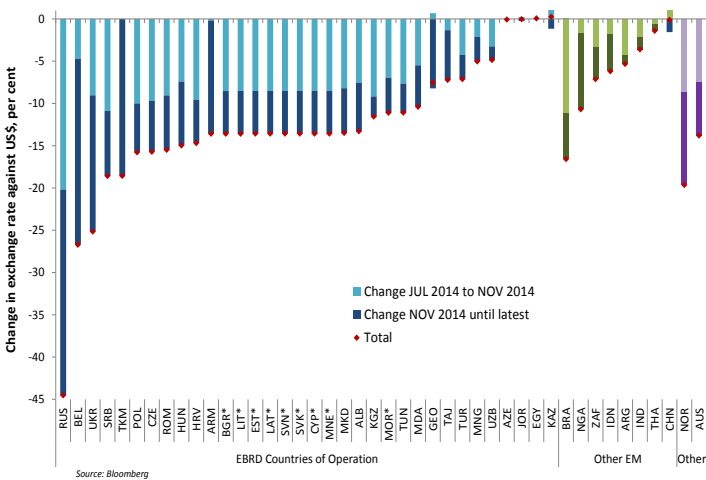
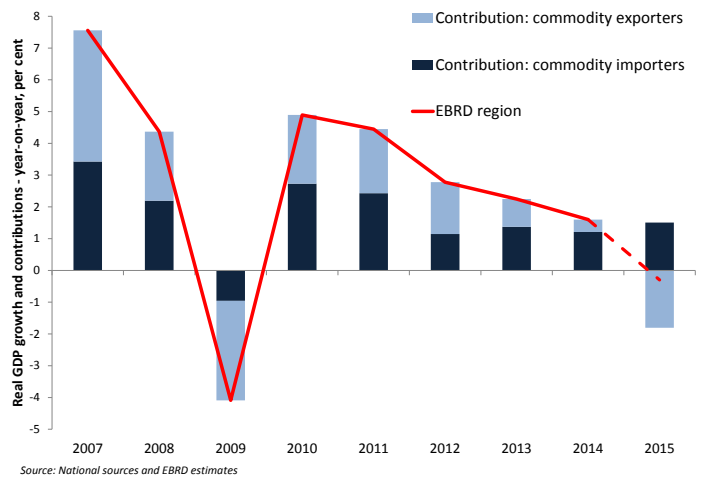


Chart 6. Average GDP growth, per cent



Regional updates

Central Europe and the Baltic States (CEB)

Growth rates in the CEB region have, on the whole, held up better than was expected at the onset of the Russia-Ukraine crisis, and given the deteriorating growth picture in the Eurozone. Relative to the projection issued in September 2014 the weighted average of growth in the eight countries has been only marginally changed to 2.8 per cent in 2014 and 2.6 per cent in 2015. The year 2014 has been significant in that domestic demand became the key support to growth in all countries. By contrast, net exports have suffered from weakening demand in the Eurozone and in other emerging markets (which often provide the final demand in integrated value chains), and from developments in Russia. Domestic consumption has benefited from strong labour market dynamics and low, and in some instances negative, inflation, which has supported household real disposable incomes. Monetary policy in Poland and Hungary has eased further, and currencies in both countries depreciated substantially vis-à-vis the euro in the second half of the year. All eight economies in the region are net oil importers, and we estimate that the substantial fall in the oil price since June last year has reduced annual import bills by around 2 per cent of GDP on average.

- **Poland's** growth has remained relatively buoyant since mid-2013, and continues to rely primarily on domestic demand. Expectations for the growth path in 2014 and 2015 growth have been scaled back somewhat given the adverse effects on exports and industrial sector confidence that emerged from last summer's tensions around Ukraine and the deterioration in Eurozone demand. Still, growth last year likely remained somewhat above 3 per cent. Household consumption is the major component of demand supporting growth. Spending is supported by positive developments in the labour market, as the unemployment rate has fallen to 8.2 per cent at year-end (according to Eurostat), and nominal earnings growth exceeded 3 per cent while consumer inflation has dropped close to zero. This year should see a slight deceleration in growth, notwithstanding the gain in competitiveness vis-à-vis the euro.
- **Hungary's** growth accelerated significantly in 2014, to an estimated 3.2 per cent. Strong growth in the first half of the year was boosted by a number of exceptional factors, such as the accelerated disbursement of EU funds and the one-off boost to household disposable income from cuts in utility tariffs. Since the middle of the year a clear deceleration set in, including due to weakening growth in Germany and elsewhere in the Eurozone which became evident in much diminished growth in Hungarian industrial production. In 2015 earlier temporary factors are no longer relevant and the external environment has deteriorated. Growth is forecast to be closer to the still slow pace of underlying trend growth. Risks linger as Hungary remains exposed to any monetary tightening in the US, though equally could benefit from monetary easing by the ECB.
- After a significant slowdown in 2013, growth in the **Slovak Republic** last year again recovered to an estimated 2.4 per cent. A similar pace of growth is expected for this year. Significantly, growth is now much more reliant on domestic demand with both consumption and investment contributing to growth in equal measure. Consumption in particular has benefited from more

dynamic earnings growth, with real incomes boosted as price levels have remained essentially unchanged. Exports, however, fell in an annual comparison with the second quarter of last year. Given the Slovak Republic's continued high export reliance, the stagnation in the Eurozone's industrial production and capacity constraints in its all-important car industry are concerns for the coming years. There has been a minor drop in the unemployment rate, though this remains well above the EU average, with an exceptionally large component of structural and long-term unemployment.

- Estimates of last year's growth in Latvia and Lithuania have been revised down marginally compared to the last projection in September 2014. Among the three **Baltic states**, Lithuania is expected to grow most rapidly, at 2.9 per cent in 2014 and 3.2 per cent in 2015, followed by Latvia with GDP growth of 2.5 per cent and 3 per cent, respectively. We project more moderate growth rates of 1.7 per cent and 2.2 per cent, respectively, for Estonia. Domestic consumption has been the major engine of growth throughout the last two years in all three economies, underpinned by improving labour market conditions and increasing real wages. The economies of the three Baltic states are more directly exposed to developments in Russia, a major trading partner. The slide in Baltic exports to Russia due to the loss in competitiveness that resulted from the rouble depreciation is likely to exceed the negative effect of the Russian food ban that was imposed in early August. For the period up to November 2014, exports of Lithuanian-origin goods to Russia declined by 15 per cent compared with the same period of the previous year, though exporting companies have been successful in re-orienting trade to other markets.
- After consecutive slowdowns in 2012 and 2013, **Slovenia's** GDP grew at an estimated 2.7 per cent in 2014. Growth surprised on the upside due to both domestic demand and net exports. Several factors, including the lower than expected country risk premium and increased business confidence, higher utilisation of EU funds (albeit partly used for one-off investments such as sound barriers along motorways), and somewhat slower corporate restructuring process kept domestic demand positive, while increased competitiveness through lower wages helped the country increase its exports despite a weakening growth in Eurozone. We expect growth in 2015 to continue but moderate to 1.6 per cent as necessary corporate restructuring, albeit positive for growth prospects in the medium term, weighs on consumption in the short term, and necessary fiscal consolidation limits government spending.
- Our estimate for growth in **Croatia** in 2014 remains unchanged at -0.5 per cent, implying six years in a row of recession. For 2015, we have also left our forecast of modest growth (0.5 per cent) unchanged. Like other countries in the region, Croatia may benefit from reduced global oil prices, but the economy will continue to be weighed down by weak confidence and investment, as well as likely policy paralysis in the run-up to general elections towards the end of the year.

South-Eastern Europe (SEE)

The year 2014 proved to be a difficult one for the countries of south-eastern Europe (SEE). Pending the release of the fourth quarter data, weighted average growth is estimated at 1.7 per cent (excluding Cyprus), a full percentage point below the 2013 figure. Although the average is only marginally worse than our September 2014 forecast, the release of the third quarter data since then, along with other high-frequency data, warranted a significant downgrade in growth estimates in several cases, but also improved estimates in a couple of others. The main downward revisions were in **Serbia** and **Montenegro**. In Serbia, the damage to vital sectors of the economy from major floods in May 2014 was worse than expected. As a result, GDP is likely to have dropped by about 2 per cent for the year as a whole. Economic performance in Montenegro has been disappointing, possibly compounded by difficulties in Serbia and Russia (both countries being important sources of tourism revenue), as well as a delayed investment agenda, and growth last year is likely to have been around 1.3 per cent, rather than the 3 per cent originally expected. We have also lowered our growth estimate for **Kosovo** by a full percentage point (from 3.5 to 2.5 per cent), based on weak first quarter data (not available at the previous round) and the general sluggishness of other (albeit limited) economic indicators. On the positive side, the economy of **FYR Macedonia** has been powering ahead on the back of strong export performance and rising personal consumption, and growth is likely to have been close to 4 per cent, compared to our September forecast of 3 per cent. In **Bosnia and Herzegovina**, the impact of the floods in May was less severe than originally feared, and exports and retail sales have helped to maintain growth in positive territory. We have therefore revised our growth estimate from 0.2 to 0.9 per cent. Our estimates for **Bulgaria** and **Romania** remain unchanged, while we have lowered the growth estimate for **Albania** marginally, from 1.7 to 1.5 per cent, reflecting weak second quarter data released after our September forecast was published.

Looking ahead to the current year (2015), most countries can expect a modest gain from the dramatic reduction in the oil price. Nevertheless, the overall outlook remains subdued, reflecting country-specific constraints. Average growth this year is expected to pick up to 2.2 per cent, though down from our September forecast of 2.6 per cent. The main downward revisions are in **Bulgaria** and **Serbia**. In Bulgaria, the resolution of the banking sector difficulties that occurred last year has been delayed, which is likely to limit fiscal space and credit growth in the current year. Domestic demand will be further constrained by somewhat lower investments resulting from the cancellation of the South Stream pipeline project. Our growth forecast is thus lowered from 2 to 0.8 per cent. Serbia's economic woes are likely to continue this year and we now expect just 0.5 per cent growth, rather than the 2 per cent predicted last September. The introduction of a new IMF programme in Serbia, expected in the spring, will help restore fiscal discipline and investor confidence but will also be accompanied by front-loaded austerity measures that will keep domestic demand at depressed levels in the short term. Elsewhere, we expect a rebound in **Montenegro** on the back of strong FDI inflows and progress on a major highway project, raising our forecast from 2.5 to 3 per cent, and **FYR Macedonia** is now likely to grow at 3.5 per cent (versus 3 per cent forecast in September) with continued strong export performance. We have kept our forecasts unchanged for the region's largest economy, **Romania**, at 2.8 per cent, as rising confidence and investment and lower oil prices

may be balanced by increased geopolitical tensions and Eurozone uncertainties. Positive terms of gains are also being offset by country-specific factors and/or weak external demand outlook in **Albania, Bosnia and Herzegovina** and **Kosovo**, where we thus have maintained our forecasts.

In **Cyprus**, economic indicators have continued to surprise on the upside. The year-on-year GDP reductions in the second and third quarters of 2014 were both below 2 per cent, and the quarter-on-quarter changes have been consistently improving since mid-2013. Sectors such as trade, tourism (hotels and restaurants) and legal and accounting services have started to record positive growth rates again. As a result, we have substantially upgraded our growth estimate for 2014 from -3.5 to -2.1 per cent. For 2015, we expect Cyprus to continue on the path to recovery, aided by lower oil prices as the country has a major trade deficit in oil products. While we had expected zero growth in 2015, we have now upgraded this to 0.7 per cent. At the same time, the economy is still subject to major downside risks, and lending to the economy is still held back by the legacy of the crisis and the high level of NPLs (around 50 per cent).

Turkey

Amidst Eurozone weaknesses, continued geopolitical risks in Middle East and Ukraine and inflation pressure which required a tighter monetary stance, **Turkey's** economic growth decelerated to 1.7 per cent year-on-year in the third quarter of 2014, down from 4.8 per cent in the first quarter and 2.2 per cent in the second quarter of the year. While net exports remained the most important driver of growth in the third quarter, the weakness in major exports markets, including the Eurozone, Iraq, and Russia, led to its declining contribution. At the same time, the tight monetary stance, which was necessary to tame rising inflation, constrained the expansion of domestic demand, leading to an estimated 2.9 per cent growth in 2014. In 2015, the fall in oil prices will benefit the economy and reduce the still large current account deficit which was mainly fuelled by the energy import bill of around US\$ 50 billion in January-November 2014. The positive effect of a fall in oil prices on GDP is likely to be offset by continued weakness in external demand and lower tourism receipts from Russian tourists, which make up 7 per cent of all tourists. The economy is thus expected to continue to grow around 3 per cent in 2015.

Alongside a fall in food prices, the energy price reduction has already led to a decline in inflation to 8.2 per cent in December, and will continue to push inflation down in the first half of 2015. This will provide space for further interest rate cuts in 2015, although the pace and the extent of the cuts will likely depend on the extent to which geopolitical risks and a prospective monetary tightening in the US put pressure on the lira and therefore inflation. The main risks to the economy in 2015 stem from changing global liquidity conditions, as well as geopolitical risks and their impact on external demand and the country risk premium. The domestic uncertainty around 2015 Parliamentary elections is not expected to have a large impact on the economy, provided it does not lead to a major change in current commitments to implement necessary structural reforms and preserve institutional independence.

Eastern Europe and the Caucasus (EEC)
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Most countries in the EEC region ended 2014 with slower growth and higher vulnerabilities. Ukraine's economy contracted sharply due to the ongoing economic and security crisis. We now estimate the 2014 contraction in Ukraine to be slightly less pronounced than originally expected, mainly because of a good harvest and lower natural gas imports. We expect 2015 to be a difficult year for the region. EEC countries will be affected by a cumulative impact of projected negative economic growth in Russia, regional geopolitical tensions, structural bottlenecks and recent currency volatility, which will adversely affect trade dynamics and the highly dollarized banking sectors, fuel inflation and distort external competitiveness.

Azerbaijan will be affected by the steep decline in oil prices, given its high dependency on hydrocarbons. While Azerbaijan's ample foreign currency reserves at the central bank and the country's oil fund will provide cushions against potential external shocks, growth in the non-oil sector alone is unlikely to result in robust overall growth rates. We expect GDP growth to moderate to 1.5 per cent in 2015.

In **Armenia** and **Moldova**, we see economic growth grinding to a halt in 2015. The risk of these countries falling into recession is high on account of the regional slowdown and the expected negative 2015 growth in Russia, which is a major trade and financial partner and source of remittances. The oil price decline is expected to partially offset negative external developments as both countries are net importers of hydrocarbons, although the positive effects will be limited. Both countries experienced depreciation of their currencies in late 2014. Further currency movements could trigger adverse balance sheet effects in real and financial sectors, bearing in mind the high dollarization rates in the banking sector.

In **Georgia**, GDP growth reached 5 per cent in 2014, compared with around 3 per cent in 2013, spurred on by reduced domestic political uncertainty and helped by the signing of the Association Agreement with the EU. Although growth has been broad-based, some sectors have exhibited particular strong expansion, with construction, for example, showing double-digit growth. FDI levels in 2014 were also sharply higher than in the previous year. The Russia/Ukraine crisis has to date had limited impact on growth, with reduction in remittances from Russia offset by increased remittances from other countries, and no notable impact on trade with Russia. The resilience of trade can be explained by low base effect as the level of trade with Russia has not yet recovered to the levels prior to the 2008 conflict. The collapsing Rouble has not had a significant effect. Sound policies of the National Bank have helped in containing the depreciation of the Lari to just 8 per cent against the US dollar in 2014. In 2015, growth is expected to decline, reflecting the fallout from the Russia/Ukraine crisis which will affect remittances and trade (with Russia, and other trade partners that are being affected by Russia/Ukraine crisis) as well as the tourism sector. The negative impact on growth will be mitigated by plunging oil prices and improving investor sentiment as a result of the signing of the Association Agreement and lower political uncertainty.

Belarus's economy is expected to contract by 1.5 per cent in 2015, reversing the short-lived mild recovery in 2014. Belarus's high dependency on Russia represents a source of vulnerability, which is exacerbated by Belarus's own very significant

external imbalances, liquidity risks, low levels of reserves and structural limitations to economic growth. The devaluation of the Belarussian rubel, while necessary for external adjustment, is expected to affect domestic demand, increase credit risks and trigger negative balance sheet effects in the banking sector. Contingent liabilities of the government represent another source of vulnerability, given the heavy participation of the state in the economy.

In **Ukraine**, real GDP is expected to fall by 5 per cent in 2015 after a 7.5 per cent fall in 2014. Ukraine enters 2015 with incomplete external and fiscal adjustment, very low level of foreign exchange reserves, material external liquidity needs, uncertainty about international financial assistance and ongoing fighting in Donbas. Any stabilization and rebound of growth will depend on both external and domestic factors: the ability of the government to implement reforms in key areas (fiscal, energy, banking, deregulation and anti-corruption); the reduction of the regional geopolitical risks; and adequately timed and scaled international assistance. The process of unravelling of Ukraine's fiscal and current account deficits is complicated by regional security issues and domestic structural challenges.

Ukraine's external position remains extremely vulnerable. The official exchange rate of the Ukrainian hryvnia lost approximately 50 per cent of its value against US\$ in 2014, and black market exchange rates have resurfaced. Despite this depreciation and heavy currency controls, the external balance of payments remains in deficit as the current account did not adjust sufficiently, partly because of the destruction of productive capacity in Donbas. The financial account of the balance of payments registered significant net outflows. As a result, Ukraine's official reserve assets fell to US\$ 7.5 billion at the end of December 2014 (around one month of imports), down from US\$ 20.4 billion at the end of 2013. On the fiscal side, the adjustment is yet to start, with the overall budget deficit expected at close to 10 per cent of GDP in 2015 (before any adjustments under the IMF programme). Fiscal space is extremely limited and fiscal and quasi-fiscal pressures remain significant. Public debt jumped to approximately 70 per cent of GDP in 2014 from 40 per cent of GDP in 2013 and is projected to increase further in 2015. In the banking sector, the authorities are dealing with multiple banking sector restructuring issues. More than 30 banks were declared insolvent in 2014 and deposit outflows were material. The banking sector remains vulnerable to further hryvnia depreciation and to the continuation of the economic turbulence, and represents a major source of contingent liabilities for the government. Ukraine needs a credible macro-stabilisation programme with additional international financing to cover the external financing gap. Longer-term stabilisation requires both international financial assistance and a major structural reform effort.

Russia

Russia's growth performance and prospects worsened significantly throughout 2014 as negative cyclical factors reinforced the earlier structural deceleration. The Russian economy slid into recession in November 2014 and the decline is expected to continue throughout 2015 due to low oil prices and the increasing impact of economic sanctions. After showing 0.8 per cent growth in the in the first three quarters of 2014 year-on-year, GDP declined in November by -0.5 per cent. GDP growth in 2014 is estimated to be around 0.4 per cent.

Low oil prices have a particularly strong negative effect on Russian GDP growth as oil and gas (with prices of the latter mostly indexed to oil) make up about two-thirds of exports (or US\$ 350 billion) and around one quarter of overall budgetary revenues. Indirect effects are even more important as most other industries and services also depend on revenues from the oil and gas industry.

The geopolitical crisis and resulting sanctions also work through both direct and indirect channels. While sanctions directly restrict access of certain companies to financial markets or cutting edge technologies, indirectly they also affect other corporates and the general investment environment. Eurobond issuance and syndicated borrowing by Russian companies (not only of those affected by the sanctions) declined by more than 60 per cent in 2014 while investments have also been hit due to tighter funding and worsening business prospects, falling by around 3 per cent in 2014. Weakening investment poses a significant risk to future recovery and potential growth as existing productive capacities will be depleted. Missing investments will take time to replace, which may cause problems in keeping up oil and gas production in the future.

Consumption, a major remaining growth driver, has also decelerated (2 per cent growth in 2014 vs. 3.9 per cent in 2013) on the back of slower retail lending (16 per cent in 2014 vs. 29 per cent in 2013), weaker consumer confidence and decelerating real wage growth (2 per cent in 2014 vs. 5 per cent in 2013). Net exports remained the main driver of growth in 2014 but mostly due to the adjustment in imports as domestic demand softened.

The strongly depreciating rouble (by around 50 per cent against the US dollar in 2014) led to a surge in already high inflation, reaching levels above 11 per cent in December 2014 with further pass-through from the weak currency expected in the coming months. A currency crisis in mid-December, with the US dollar almost hitting the 80 roubles mark, prompted the central bank of Russia (CBR) to hike the policy rate by 650 basis points to 17 per cent (resulting in an overall increase of 1150 basis points in 2014). The free float of the rouble allowed the CBR to reduce interventions to US\$ 1 billion in November after spending US\$ 71 billion by end-October. However the CBR spent a further US\$ 11.3 billion during the currency panic in mid-December to support the rouble.

Money market rates reached up to 35 per cent during the peak of the turbulences in December 2014. Although interest rates have since subsided to somewhat lower levels, they may prove prohibitively high for investment and will also stifle household borrowing. Despite measures by the central bank allowing forbearance, the worsening economic environment together with high interest rates have led to a sharp increase of non-performing loans to levels close to those experienced in 2009. The higher rouble value of foreign currency bank assets due to the depreciated currency will also require more capital. An amount of one trillion roubles has been set aside from the National Welfare Fund to support systemic (mostly state-owned) banks.

Private capital outflows totalled US\$ 85 billion in the first nine months of 2014 and are estimated to have reached US\$ 151 billion for the year as a whole, contributing to the weakening of the rouble. Cautious measures affecting foreign currency holdings of state-owned companies may have helped to contain outflows in the short-term but

political uncertainty and potential fears of stricter capital controls may prompt further outflows.

The sharp depreciation of the rouble will broadly offset the effect of falling oil prices on the budget for now. However, declining profits, feeble economic activity, and decreasing (formal) employment will take their toll on non-oil tax revenues. The announced plans to cut budget expenditures are likely to have an adverse impact on economic activity if they are implemented across the growth-supporting items, such as wages of low-income public employees as well as investment programmes. Furthermore, regional budget balances will be hit as oil taxes are directed to the Federal budget. This will further weigh on the debt sustainability of selected regions.

Our growth forecast for 2015 is -4.8 per cent, based on a yearly average oil price assumption of US\$ 58 per barrel and sanctions being in place. As the structural and cyclical negative factors reinforce each other, weak investment activity jeopardises long-term growth prospects. A fast turnaround in the geopolitical crisis and strong improvement in the business climate would be needed to counteract the negative processes.

Central Asia

The Central Asian region has been experiencing a slowdown, driven pre-dominantly by external factors. The Russia/Ukraine crisis, which has contributed to a slowdown in Russia and a sharp depreciation of the rouble, and plunging oil prices are contributing to lower GDP growth across this sub-region. The countries are suffering from reduced trade, lower growth of remittances from Russia, and the deterioration of investor sentiment towards the former Commonwealth of Independent States (CIS) region. The lower oil (and, to lesser extent, natural gas) prices are having a negative effect on the growth of net exporters (with particularly significant impact on Kazakhstan) and a positive effect on growth of net importers (particularly the Kyrgyz Republic and Tajikistan). These external factors add to the significant internal vulnerabilities, including weak banking sectors and disruptions to large extractive projects. As a result, average GDP growth in these countries is estimated to have decelerated from around 7 per cent in 2013 to around 5.5 per cent in 2014.

The depreciation of the rouble and other external factors are also contributing to weakening of currencies in the Central Asian countries. However, the significant drop of the Rouble exchange rate has only partially been mirrored to date, with 19 per cent devaluation in Kazakhstan (in February 2014) and Turkmenistan (in January 2015), and 16, 10, and 9 per cent depreciation of currencies in the Kyrgyz Republic, Tajikistan and Uzbekistan, respectively, in 2014. Notwithstanding the impact of external factors, growth in the Central Asia region has remained well above the levels observed in the other EBRD sub-regions, and the weakening of exchange rates has not been disruptive. The year 2015, however, can be expected to be a very challenging one for the region, with the build-up of external pressures crystalizing into a further slowdown of growth and depreciations of currencies. These countries are putting in place various fiscal, monetary and administrative measures to minimise the impact (for example, the infrastructure investment-based fiscal stimulus programme Nurly Zhol in Kazakhstan), which will to some extent mitigate the negative impact of external factors. Nevertheless, in 2015 a further slowdown, particularly in the largest oil

exporter in the region, Kazakhstan, and gradual weakening of currencies can be expected.

- In **Kazakhstan**, GDP growth declined from 6 per cent in 2013 to 4.3 per cent in 2014. The decline was predominantly driven by the impact of Russia/Ukraine crisis – slowdown of growth in Russia, impact of sanctions imposed on Russia and the Russian counter-sanctions and impact of collapsing Rouble – and the plunging oil price. The impact of external factors is compounded by internal factors, with an overhang of NPLs in the banking sector (around 30 per cent of total loans) continuing to be a drag on growth. Inflation rose from 5.9 per cent in 2013 to 6.7 per cent in 2014, reflecting the 19 per cent devaluation of the tenge in February 2014 and impact of the Russian counter-sanctions restricting the import of food products imports from the US, EU and number of other countries. The economic environment can be expected to deteriorate further in 2015, reflecting the collapsing oil price. Pro-active fiscal, monetary and regulatory policies will include implementation of (largely infrastructure investment based) fiscal stimulus program Nurly Zhol, announced by the President in November 2014, a new shorter-term joint economic and monetary policy announced by the Ministry of Economy and National Bank of Kazakhstan (NBK) in December 2014, and measures by the NBK to reduce the NPLs in banking sector. These measures will help mitigate the fallout from the difficult external environment. Reflecting the difficult external environment, GDP growth is expected to decline to 1.5 per cent in 2015. Inflation is projected at around 6.5 per cent. The tenge can be expected to depreciate, combined with the change in exchange rate regime from the current fixed rate regime to a (managed) floating, along with inflation targeting.
- In the **Kyrgyz Republic**, growth dropped from 10.5 per cent in 2013 to 3.6 per cent in 2014, reflecting the impact of slowdown in Russia on remittances and on exports, weaker industrial production and agriculture sector as well as softer growth of gold mining after a significant increase in 2013 (the latter was largely due to a “base effect”). Fragilities of the banking sector also continue to be a drag on growth. Inflation averaged around 7.5 per cent in 2014, compared to 6.6 per cent in 2013, pushed up by a 16 per cent depreciation of Som. GDP growth in 2015 is expected to decline further to close to 3 per cent, reflecting the continue impact of the Russia/Ukraine crisis (through lower remittances and a more difficult environment for exports), and slowdown in Kazakhstan, the largest trading partner of the Kyrgyz Republic. This impact will be somewhat offset by the positive effect on growth of collapsing oil prices (the Kyrgyz Republic is a significant net importer of oil/petroleum products). The lack of a stable permanent solution to the Kumtor gold mine operations remains a significant downside risk to growth. The country’s membership of the Eurasian Customs Union may also have an effect on trade and other activities. One of the key short run effects may come from increased investment in customs infrastructure, sanitary testing and certification facilities that will be carried out using financing provided by the other Union’s members. Inflation is projected to average 6.5 per cent in 2015. A further gradual depreciation of currency can be expected in 2015 in light of the depreciation of the rouble.

- In **Tajikistan**, GDP growth remained strong at an estimated 6.7 per cent in 2014, with only limited impact of the Russia/Ukraine crisis, notwithstanding the very high proportion of remittances that the country receives from Russia. The impact of the collapsing Rouble on the Tajik somoni has been limited to date, with the currency depreciating by only 10 per cent in 2014, partly helped by monetary and administrative measures employed by the Central Bank. Notwithstanding the strong growth rate in 2014, a build-up of external factors can be expected to crystalize in 2015. Combined with weaknesses in the banking sector, including increasing levels of NPLs, it is projected to lead to a decline in GDP growth in 2015.
- In **Turkmenistan**, GDP growth remained strong at 10.2 per cent in 2014 (estimated), driven by large investment projects and strong gas exports to China, with only limited impact of the difficult external environment on growth. On 1st January 2015, the manat was devalued by 19 per cent, the first devaluation in seven years, as a result of the sharp depreciation of the rouble, weakening of currencies of other neighbours and plunging oil price. Depreciation will also facilitate implementation of the government's strategic policy to improve the competitive position of companies in non-extractive sectors. GDP growth in 2015 is expected to remain strong at 9.7 per cent, with only limited impact from the collapsing oil prices and slowdown in Russia.
- **Uzbekistan's** GDP growth remained strong at around 8 per cent in 2014, and inflation has remained high at around 11 per cent. The growth in 2015 can be expected to decline slightly to 7.8 per cent, reflecting continued drag from the Russia/Ukraine crisis resulting in lower remittances and more subdued trade. Inflation is projected to remain at its current level.
- Growth in **Mongolia** has been decelerating. From the peak of 17.3 per cent in 2011, growth slowed down to 7 per cent in the first nine months of 2014 and an estimated 6 per cent in the year as a whole, as inflows of foreign direct investment declined significantly. Inflation has remained high (around 11 per cent), reflecting pressures from higher import prices as well as expansionary fiscal and monetary stance. Growth is expected to decelerate further due to continued delays in the second phase of Oyu Tolgoi, a large copper mining project, and lower prices of key export commodities.

Southern and Eastern Mediterranean (SEMED)

The 2014 growth estimate for SEMED countries has been revised down to 2.3 per cent compared with the forecast of 2.6 per cent in September 2014, due to weaker than expected economic performance in all countries except Egypt. However, growth momentum in the region is expected to pick up in 2015 to 3.9 per cent, supported by lower oil prices, the recovery in the US and economic reform measures across the region. As all SEMED countries are net oil importers, lower oil prices are expected to improve fiscal and external balances, ease the continued implementation of energy subsidy reforms, and potentially expand the fiscal space to fund capital expenditures and social safety nets.

- In **Egypt**, economic conditions have stabilized thanks to financial support from the GCC countries, policy reforms and a more stable political situation. Although growth averaged only 2.2 per cent in FY2013/14, there were encouraging signs of pick-up in momentum in the second half of the year which continued in the first quarter of FY2014/15. Private consumption has remained the main driver of growth, but the rebounding investment activity has become the second most important contributor, after contracting for a continuous 18-month period since mid-2012. Net exports – especially of petroleum – are now the main drag on growth. The upwards revision to our FY2014/15 forecast to 3.8 per cent (from 3.2 per cent in September) reflects the strong start to the year, better-than-expected investment performance and the expected boost to domestic demand from lower oil prices. In addition, falling oil prices will provide a favourable environment to continued subsidy reform implementation and smooth the adjustment for energy-intensive sectors. A 20 per cent fall in oil prices is estimated to lower Egypt's fiscal deficit by around 1 per cent of GDP, so that significant oil price declines can potentially create fiscal space for higher spending on investment and social safety nets.
- In **Jordan**, a difficult regional environment and ongoing fiscal retrenchment constrained growth to an estimated 3.1 per cent on the year in 2014 – below the average growth rate of 6 per cent over the last decade. Turmoil in Syria and Iraq, which share borders with Jordan and account for over 20 per cent of the country's exports, has continued to disrupt trade routes. The influx of Syrian refugees into Jordan – officially numbering over 600,000 but unofficially likely to be considerably higher – has also strained public services, government finances and informal labour markets. Looking ahead to 2015, oil price falls will significantly benefit Jordan, which imports 96 per cent of its energy needs, and ease fiscal and external pressures. Jordan's terms of trade are estimated to improve by 12 per cent in 2015, assuming an average oil price of US\$ 58 per barrel, the largest effect out of any country in the EBRD region. Nevertheless, the domestic and external challenges facing Jordan are expected to weigh down on growth, which is projected to pick up modestly to 3.7 per cent in 2015.
- **Morocco's** growth was weaker than expected in 2014 at an estimated 2.4 per cent, constrained by a contraction in agricultural output and a slow recovery in non-agricultural activities. A pick-up in activity is projected for 2015 as agricultural output normalises and non-agricultural growth accelerates, helped by a recovery in the Eurozone and falling oil prices. The latter would significantly lower Morocco's import bill – over 20 per cent of which is spending on energy imports.
- Growth in 2014 was sluggish in **Tunisia**. Labour strikes and protests contributed to large contractions in oil and gas extraction industries, but growth in other sectors also disappointed, restraining growth to an estimated 2.3 per cent. A modest pick-up to 3 per cent is expected in 2015 as a recovery in the Eurozone and the recent exchange rate depreciation help support Tunisian exports, and improved political stability supports investment and consumption. As a net oil importer, Tunisia stands to benefit from the

reduction in global energy prices – though to a lesser extent than Jordan and Morocco – with a fall in oil prices to an average of US\$ 58 per barrel expected to improve Tunisia’s terms of trade by 2 per cent. However, several factors will limit the pickup in growth in 2015, including turmoil in neighbouring Libya and delays to financial sector reforms, which would weigh on investor sentiment.