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The Impact of China on Europe and Central Asia

Europe and Central Asia Economic Update
Office of the Regional Chief Economist
April 2016

WORLD BANK **ECA ECONOMIC UPDATE** APRIL 2016

The Impact of China on Europe and Central Asia

Office of the Chief Economist

WORLD BANK GROUP

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Abbreviations

AMC	Asset management companies
BaU	Business as usual
BH	Bosnia and Herzegovina
BIS	Bank for International Settlements
BRICS	Brazil, Russia, India, China and South Africa
CDS	Credit default swaps
CGE	Computable general equilibrium
CIS	Commonwealth of Independent States
CIT	Corporate Income Tax
CPI	Consumer price index
ECA	Europe and Central Asia
ECB	European Central Bank
ECE	Early Care and Education
EDP	Excessive Deficit Procedure
EEU	Eurasian Economic Union
EFTA	European Free Trade Association
EMU	Economic and Monetary Union
FDI	Foreign direct investment
FYR	Former Yugoslav Republic
GEM	Global Economic Monitor
GDP	Gross domestic product
GTAP	Global Trade Analysis Project
HPP	Hydro power projects
IMF	International Monetary Fund
ISIC	International Standard Industrial Classification
LIBOR	London Interbank Offered Rate
LTE	Long-Term Evolution
MTO	Medium-Term Objective
NPL	Non-performing loans
OPEC	Organization of the Petroleum Exporting Countries
PPML	Poisson Pseudo-Maximum Likelihood
PPP	Purchasing power parity
S&P	Standard & Poors
SAA	Stabilization and Association Agreement
SOE	State-owned enterprises
US	United States
WEO	World Economic Outlook
WDI	World Development Institute

Country groups

TABLE 0.1 Regional classification

<table>
<tr><td rowspan="4">Europe and Central Asia</td><td rowspan="2">European Union and Western Balkans</td><td>Western Europe</td><td>Southern Europe</td><td>Central Europe</td><td>Northern Europe</td><td>Western Balkans</td></tr>
<tr><td>Austria
Belgium
France
Germany
Ireland
Luxemburg
The Netherlands
United Kingdom</td><td>Greece
Italy
Portugal
Spain
Cyprus
Malta</td><td>Bulgaria
Croatia
Czech Republic
Hungary
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Estonia
Latvia
Lithuania</td><td>Albania
Bosnia and Herzegovina
Kosovo
FYR Macedonia
Montenegro
Serbia</td></tr>
<tr><td rowspan="2">Eastern Europe and Central Asia</td><td>South Caucasus</td><td>Central Asia</td><td>Russian Federation</td><td>Turkey</td><td>Other Eastern Europe</td></tr>
<tr><td>Armenia
Azerbaijan
Georgia</td><td>Kazakhstan
Kyrgyz Republic
Tajikistan
Turkmenistan
Uzbekistan</td><td></td><td></td><td>Belarus
Moldova
Ukraine</td></tr>
</table>

Introduction

The economies of Europe and Central Asia (ECA) are facing complex headwinds. The policy reaction to those headwinds may change these economies for years to come. Against the backdrop of adverse global developments, the prospects for many ECA economies are for weak growth, at best. However, several of the headwinds also carry seeds for future growth. The collapse in oil revenues and remittances, and the associated sharp real depreciations, improve competitiveness in the production of internationally tradable products (this was also analyzed in detail in the September 2015 edition of the ECA economic update[1]). The weakening of the Euro, caused by monetary policies of the Federal Reserve and The European Central Bank moving in opposite directions, makes European countries more competitive, as is already demonstrated in recent export data. The current slowdown and transformation of China's economy can make producers in ECA more competitive, even if the changes in China might also have negative welfare impacts for some parts of the region.

In the eastern part of ECA, the task of governments is to orchestrate a coordinated crisis response. The collapse of oil revenues and the associated decline in remittances has triggered a chain reaction of shocks. Adjustment to these shocks requires a new monetary policy regime, resolution of serious fragilities in banking sectors, fiscal reforms that put government finances on a sustainable path, while guaranteeing fair burden sharing, and facilitation of job creation in sectors that compete internationally. It is crucial that, while a deepening of the crisis is being avoided, policies resolutely enable the necessary shift away from the production of non-tradables to the production of tradables. Improvement of institutions and governance is needed to eliminate binding constraints that deter the development of new activities.

In the western part of ECA, policy coordination within the European Union is being tested by the refugee crisis and a possible Brexit. At the same time, the modest recovery continues in this part of the region. To put this recovery on a sustainable path it is crucial that the European Union can address changes in the economic environment, like the individualization of labor markets in the sharing economy, in an effective and coordinated way.

Meanwhile, the Chinese economy has slowed down and is in the process of a fundamental transformation. The economy is shifting from investments to consumption, from inward FDI to outward FDI, and from low-skill intensive to skill-intensive production. These developments are having major impacts on the ECA region. The changes in China's economy can have adverse impacts on exporters of investment goods and natural resources. It can mean a competitive challenge for countries with a comparative advantage in skill-intensive production. However, it creates opportunities for those who compete at the lower end of manufacturing and for those who receive China's outward FDI. This report analyses all of these challenges and points outs the opportunities to become more competitive in global markets. These opportunities are strongly supported by the real depreciation that many countries in the region have undergone.

Note

1. http://www.worldbank.org/en/region/eca/publication/europe-and-central-asia-economic-update-october-2015

PART

Economic Outlook

Policy Coordination Is Being Tested

Summary

- The European Union continues its modest recovery, benefitting from accelerating exports, driven by real deprecation of the euro. Despite daunting political challenges in the European Union, there are silver linings on the economic horizon, illustrated by a one percentage point reduction in the unemployment rate in 2015.
- Growth in the European Union and the Western Balkans is expected to stabilize at 1.8 percent. Growth is especially robust in Central Europe and the Western Balkans. In both sub-regions GDP growth is expected to exceed 3 percent next year.
- The economies of Europe and Central Asia (ECA) are facing complex challenges. The task of governments is to orchestrate a coordinated crisis response to the collapse in oil revenues and the subsequent shocks: declines in remittances, depreciations, fall in real-estate prices, increased NPLs, and solvency problems in the banking sectors.
- Following double-digit terms-of-trade losses, in addition to a GDP contraction of 1.1 percent in 2015, GDP in Eastern Europe and Central Asia is expected to show practically no growth in 2016, implying a downward adjustment of one percentage point since late last year. Especially large are the downward adjustments for the South Caucasus (3.3 percentage points), Central Asia (1.6 percentage points) and Russia (1.3 percentage points).

1.1 Hard times

The global economic environment has become more challenging for economies in Europe and Central Asia. Global trade is growing at a historically slow pace, partly because of disappointing growth in emerging economies. International capital flows are subdued, as investors are looking for safe havens. Low and volatile oil prices, together with geopolitical tensions, remain a huge challenge for economies in the eastern part of the region. The refugee crisis is threatening a turn towards inward-looking policies in European countries, jeopardizing free cross-border movements in the Schengen area. The Brexit referendum further tests European cooperation and integration. Terrorist attacks in France, Turkey, and Belgium have heightened anxiety throughout the region.

Despite many common threats, prospects differ substantially across the region. Oil-exporting countries and countries that depend on remittances from those oil-exporting countries are in recession or close to recession (see table 1.1). After a contraction of 1.1 percent in 2015 in Eastern Europe and Central Asia, GDP in this sub-region is now expected to show practically no growth in 2016, implying a downward adjustment of a full percentage point since the last regional forecast in October 2015. Especially large are the downward adjustments for the South Caucuses (3.3 percentage points), Central Asia (1.6 percentage points), and Russia (1.3 percentage points). In the European Union and the Western Balkans, on the other hand, GDP growth is expected to average 1.8 percent this year, unchanged from the expectations half a year ago. In Southern Europe the recovery is finally taking hold, although growth is still not strong enough to undo the damage caused by the Great Recession. GDP in Southern Europe is still 4 percent below its 2007 level, while GDP in other parts of the European Union has well surpassed pre-crisis levels. Growth is forecast to remain robust in Central Europe.

TABLE 1.1 Weak growth in Europe and Central Asia

	GDP growth, % annual				Change in forecast since October 2015	
	2014	2015e	2016f	2017f	2015e	2016f
Europe and Central Asia	1.2	1.4	1.6	1.9	0.0	−0.3
European Union and Western Balkans	1.3	1.9	1.8	1.8	0.0	−0.1
Western EU	1.5	1.7	1.7	1.7	−0.1	−0.2
Northern EU	1.5	2.2	2.3	2.2	0.2	0.0
Central EU	2.8	3.5	3.2	3.1	0.2	0.0
Southern EU	0.3	1.6	1.6	1.6	0.2	0.1
Western Balkans	0.5	2.2	2.7	3.2	0.5	0.4
Eastern Europe and Central Asia	0.2	−1.1	0.1	2.0	0.4	−1.0
South Caucasus	3.2	1.6	−0.6	1.7	−0.4	−3.3
Central Asia	5.0	2.7	1.9	3.2	0.0	−1.6
Russian Federation	−1.4	−3.7	−1.9	1.1	0.1	−1.3
Turkey	2.9	4.2	3.5	3.5	1.0	0.1
Other Eastern Europe	−4.0	−7.8	−0.2	1.2	1.3	−0.7

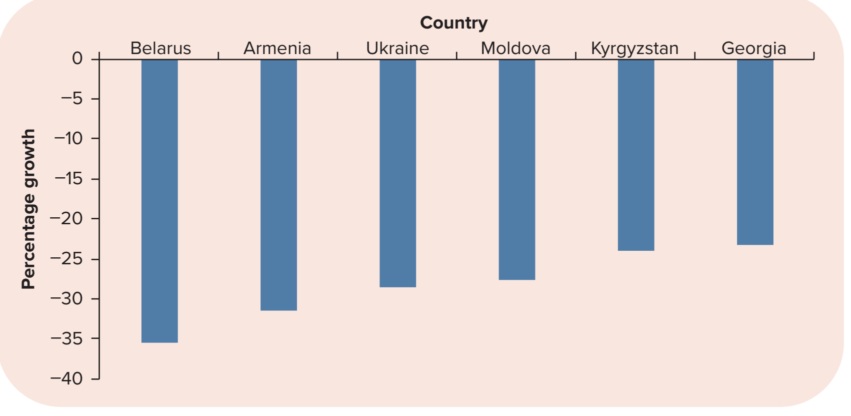
Source: World Bank data

The eastern part of the region is hit by a pervasive crisis, as the collapse of oil prices caused a chain reaction with far-reaching consequences. Steep declines in oil revenues and sharply reduced purchasing power of remittances have led to double digit declines in real income, much larger than declines in GDP or other measures of production volumes. Figure 1.1 illustrates the decline in remittances, deflated by the import price, in some remittance-dependent countries in Eastern Europe and Central Asia in 2015. These declines range from 25 to 35 percent. The drop in income in oil-exporting and surrounding economies make major reductions in imports unavoidable, and will require increases in exports to keep the external balance of payments sustainable and to create employment in tradable sectors as jobs in the non-tradable sectors are being lost. Currency depreciations are needed to trigger these adjustments. However, these depreciations expose fragilities in banking sectors across this part of the region because of large financial dollarization. Banks are further tested as NPLs are on the rise, the profitability of domestic sales is waning and real estate prices start falling.

The magnitude of the impact of lower oil prices on oil-exporting countries was already apparent in 2015. Figure 1.1 illustrates the decline in remittances, deflated by the import price, in 2015. These declines range from 25 to 35 percent. The impact of lower oil revenues on domestic consumption and imports is especially clear. For example, in Russia GDP contracted 3.7 percent in 2015, while private consumption declined 10 percent and import volumes fell by almost 30 percent. These numbers reflect the large terms-of-trade losses and the sharp depreciation that were caused by the collapse of oil prices. For the whole of Eastern Europe and Central Asia growth in private consumption is expected to resume only in 2017, and there are significant downside risks to that forecast (see figure 1.2).

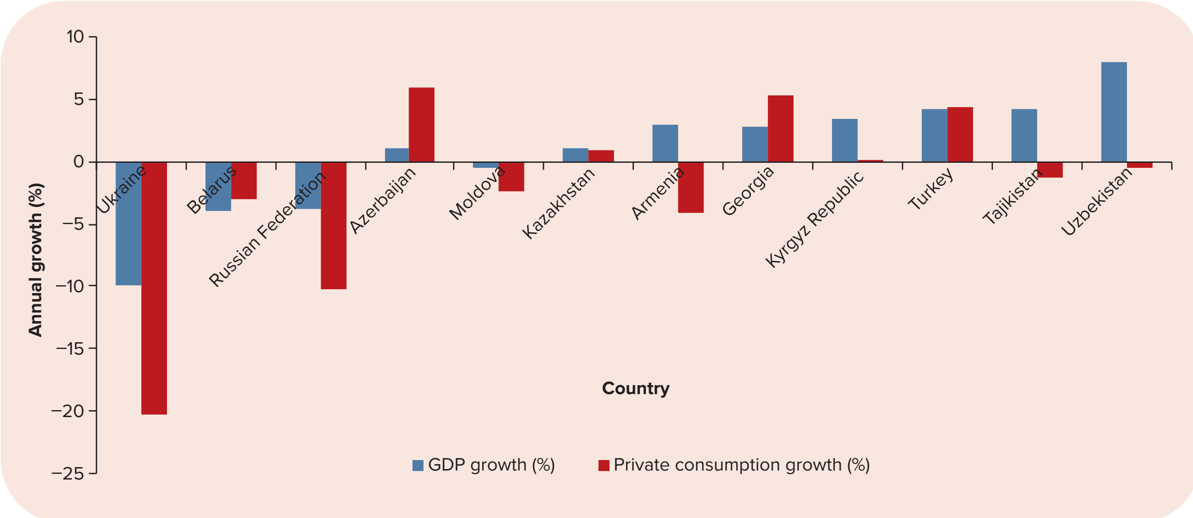
Countries in the European Union face multiple risks. The refugee crisis puts to the test Europe's ability to effectively coordinate policies. The possibility of the United Kingdom exiting the European Union (BREXIT) is yet another example of the political complications in the European integration process. This elevated uncertainty has suppressed stock markets and sustained fragility in banking sectors. Employment has still not fully recovered from the Great Recession, while structural shift towards more flexible work arrangements requires a rethinking of the social contract.

FIGURE 1.1 Sharp declines in remittances in 2015 (percentage growth in 2015 of remittances, deflated by import price)



Source: National Central Banks

FIGURE 1.2 **Consumption has sharply declined in Eastern Europe and Central Asia (annual growth rates 2015)**



Source: World Bank data, staff calculations

Still, the economic prospects in the European Union also contain silver linings. The weaker euro, caused by monetary policy adjustments in the Federal Reserve and the ECB, and low oil prices help sustain the cautious recovery. This is particularly apparent in export volumes that outpace global trade. The European Union will likely experience in 2017 its fifth year in a row of positive GDP growth. The longer the recovery continues, the more outcomes can surprise on the upside. But for the moment the strength of the recovery remains disappointing.

While the European Union is focused on sustaining and strengthening the recovery, many countries in Eastern Europe and Central Asia are trying to prevent a worsening of the economy. The key problem in the European Union is that policy options are limited. Monetary easing is approaching its limits as interest rates have entered negative territory. And, although slowly more fiscal space is being created, government debt remains at high levels. The key problem in Eastern Europe is that the dramatically changed economic environment requires fundamental changes in both monetary and fiscal policy, while there is little to no time for trial and error.

The remainder of this chapter consists of four sections. The first one describes recent trends in trade and labor markets. The next one analyzes international capital flows and financial markets. That section is followed by an intermezzo that describes recent developments in the refugee crisis. The chapter concludes with a discussion of monetary and fiscal policy options.

1.2 A few silver linings in export and labor markets

The volume of global trade expanded in 2015 at a rate of 2 percent. That is 3 percentage points lower than the average growth rate over the last 25 years. This partly mirrors a weakening of the global economy, but mostly reflects a structural

change. The volume of global trade used to grow roughly twice as fast as the volume of global industrial production, but now both are growing more or less at the same rate. Global industrial production grew 1.9 percent in 2015, merely 0.8 percentage points below its long-term average (figure 1.3).

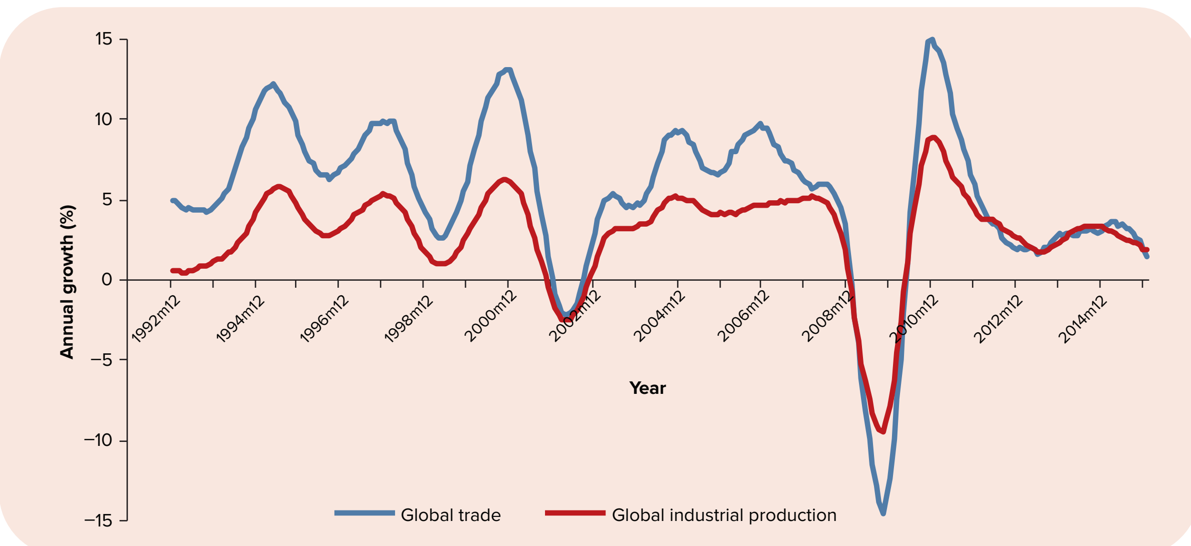
Many factors may explain the structural slowdown in global trade. Chief drivers of the lower production elasticity of trade are a slower pace of expansion of global supply chains and lower investment rates, as investment is more import-intensive than other components of global GDP[1]. Other possible explanations for the structural decline of global trade growth are the slower pace of trade liberalization and slower declines in transportation costs.

However, even with lower overall trade growth there are still opportunities to gain market share. This was recently illustrated by Europe's export performance. For a long period export growth of the Euro Area had fallen behind global export growth. During the last ten years export growth from the Euro Area averaged 1.2 percent per year, less than half the 2.9 percent global annual growth during that same period. In 2015, however, the Euro Area's export growth exceeded the global average (figure 1.4). This follows the divergence of monetary policy between the Federal Reserve and the ECB, which resulted in a real depreciation of the euro.

The impact of real effective exchange rates on trade is clearly illustrated in figure 1.5. It plots the deceleration of export volume growth in 2015 against the real effective depreciation. China and the United States experienced double digit real effective appreciations and, as a result, their export growth decelerated by between 4 and 5 percentage points. All European countries, on the other hand, experienced a real effective depreciation and almost all saw faster growth of exports than in 2014.

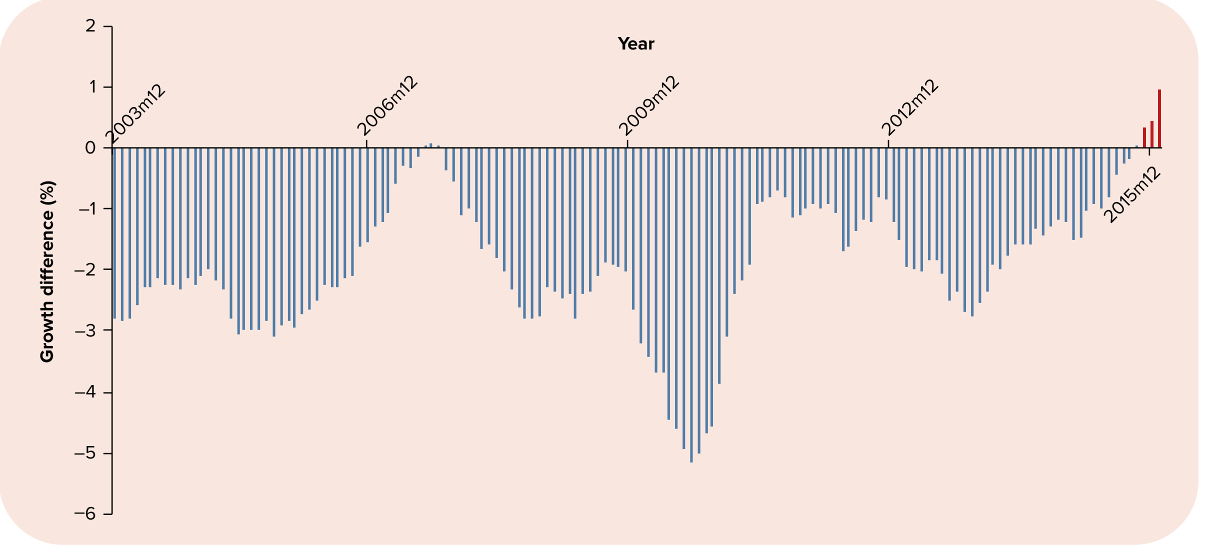
The more dramatic depreciations in Eastern Europe and Central Asia provide an even greater potential for more rapid export growth than in the Euro

FIGURE 1.3 **Global trade has settled on a slow growth path (annual growth, 12m/12m percentage)**



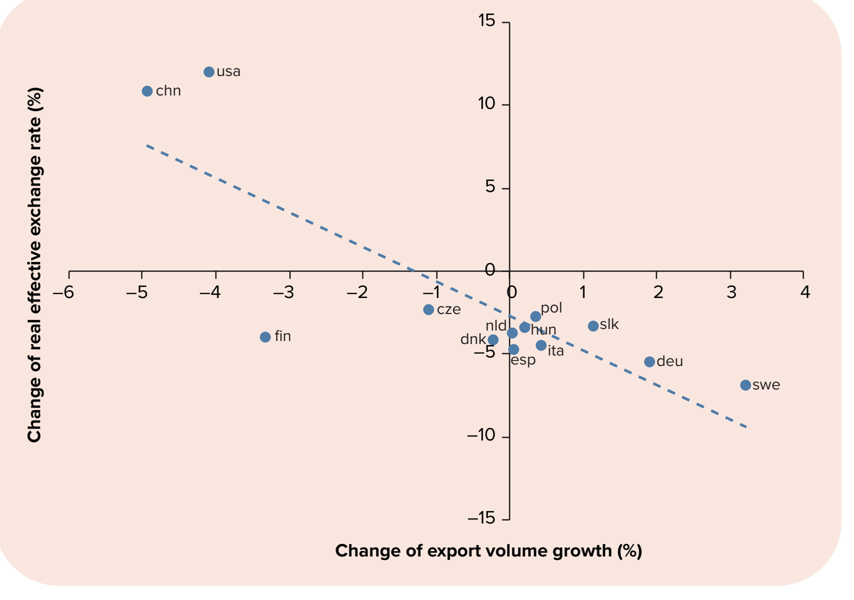
Source: Netherlands Bureau of Economic Analysis (http://cpb.nl/cijfer/cpb-wereldhandelsmonitor-januari-2016)

FIGURE 1.4 **Euro area export growth now outpaces global average (percentage points difference between euro area export growth and global export growth, 12m/12m)**



Source: Netherlands Bureau of Economic Analysis (http://cpb.nl/cijfer/cpb-wereldhandelsmonitor-januari-2016)

FIGURE 1.5 **European export growth accelerates as U.S. and Chinese exports slow down (2014–2015)**

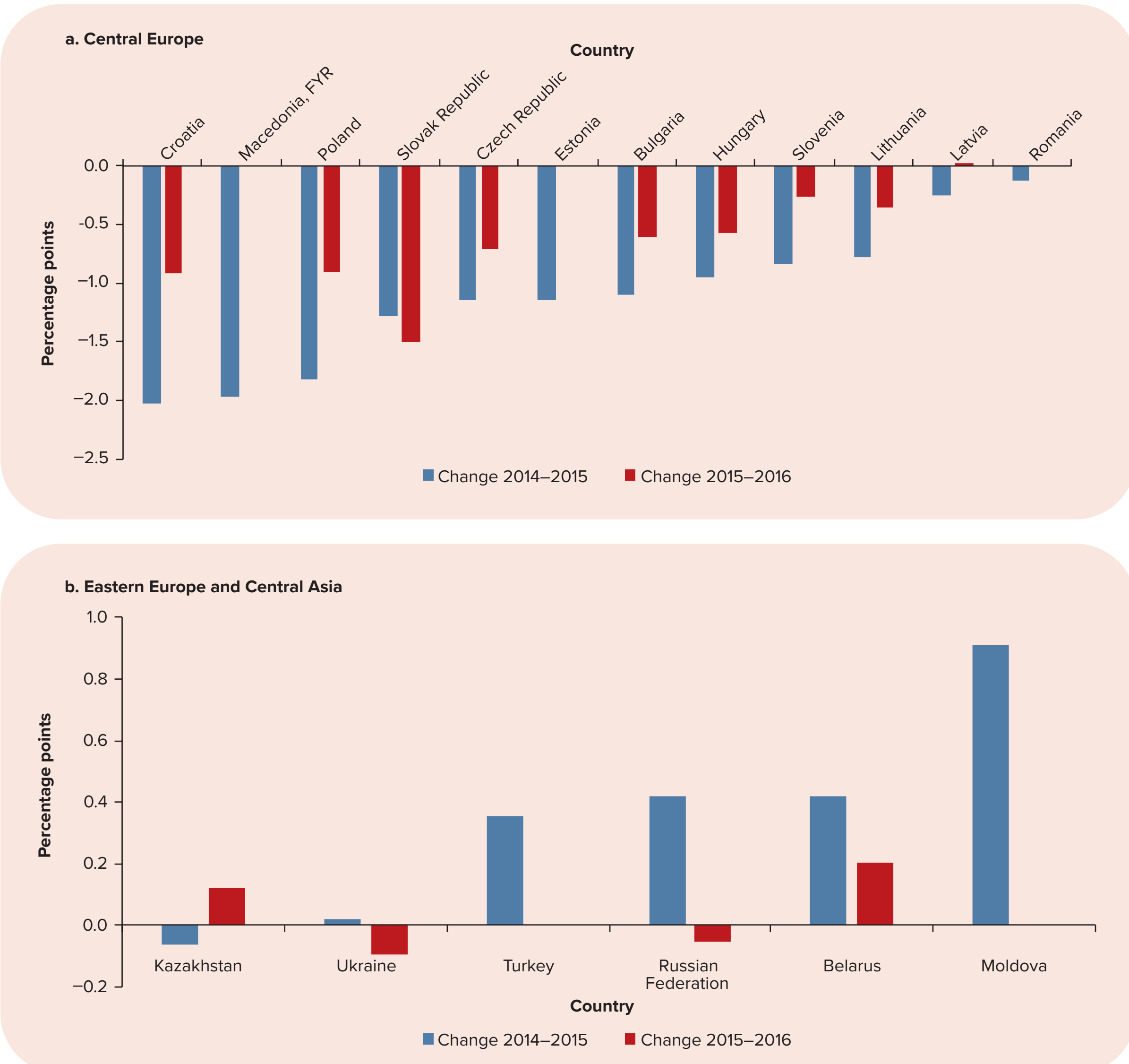


Source: World Bank GEM data

Area. Chapter 2 of this publication presents model simulations of the potential impact of those depreciations. The extent to which this potential is realized depends on how easily jobs in the tradable sectors can be created to replace the jobs that are currently being lost in the non-tradable sectors. The long period of high and rising oil prices has wiped out many firms that were no longer internationally competitive and has rewarded rent seeking rather than efficiency in non-tradable sectors like construction. This, combined with the considerable challenges in banking sectors, complicates the necessary transition.

Recent developments in labor markets confirm the brighter prospects in the western part of the region and the serious challenges in the eastern part. The unemployment rate in the European Union fell to 9 percent in December 2015, down almost 1 percentage point from a year before. This is equivalent to about 2 million individuals exiting unemployment. Labor market conditions especially improved in Central Europe, with unemployment rates falling in 2015 by close to 2 percentage points in Croatia, Macedonia, and Poland (figure 1.6A). The falling unemployment rate in the European Union coincides with moderately decreasing real unit labor costs, which echo the improved international competitiveness discussed above. The employment rate is back to its pre-crisis level, just above 70

FIGURE 1.6 Unemployment falling in the west and rising in the east



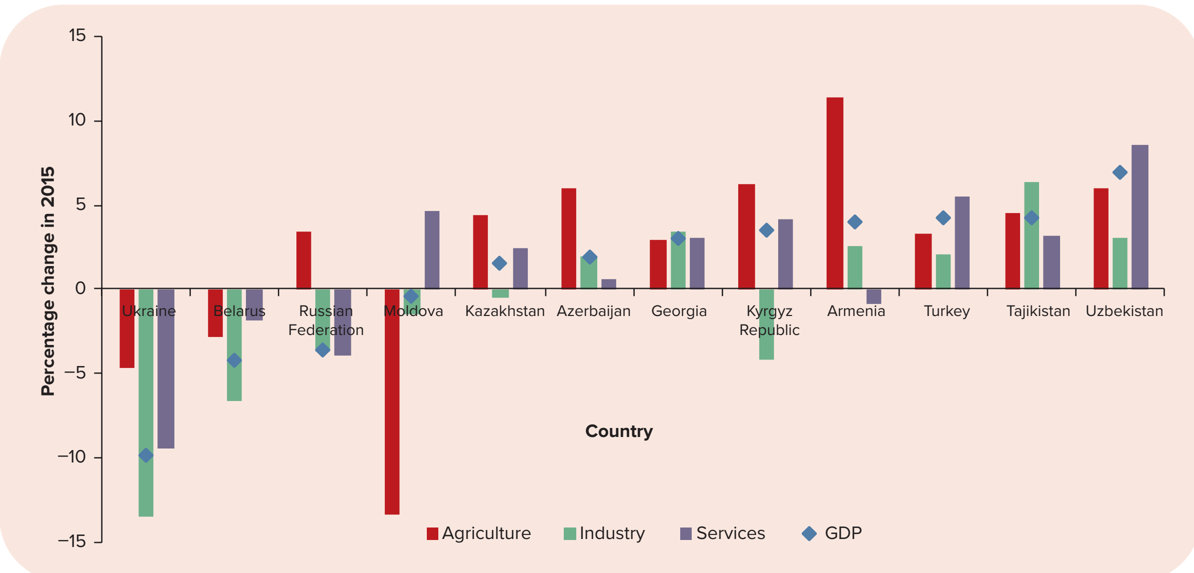
Source: World Bank data, staff calculations

percent. However, the unemployment rate is still much above its pre-crisis level of 6.8 percent. The higher unemployment rate and equal employment rate (compared to pre-crisis levels) reflects long-term trends of increasing participation rates of women and older workers.

Labor markets are deteriorating in the east as jobs in the non-tradable sectors are being lost. In many countries of Eastern Europe and Central Asia unemployment increased in 2015 (figure 1.6B). Jobs are being lost in sectors that produce for the domestic markets, like construction and retail services. Job creation in sectors that compete internationally has not yet been enough to compensate for these losses. In several of these countries unemployment rates may rise further due to the return of migrants from Russia – a migrant destination for many workers in the region. Given that labor income (from domestic or foreign sources) has been a major driver of poverty reduction and shared prosperity in the past, the job losses and declines in purchasing power of remittances are likely to reverse those positive trends.

The only viable and sustainable response to lower oil revenues and lower remittances is a shift of employment opportunities towards tradable sectors. Such a shift takes time, but there are already first signs of changes in this direction. In most countries in the East, with the exception of Moldova which experienced a drought, agriculture made a greater contribution to output growth in 2015 than in past years. Real depreciation has made it easier for farmers to compete with foreign competitors. The growth of the agricultural sector also helped compensate for the slower growth, or contraction, of the industrial sector in Azerbaijan, the Kyrgyz Republic and Russia (figure 1.7). Going forward, economies can sufficiently stem the tide of job losses only by seizing opportunities in manufacturing and services sectors that compete with foreign producers.

FIGURE 1.7 Strong growth of agriculture in the east



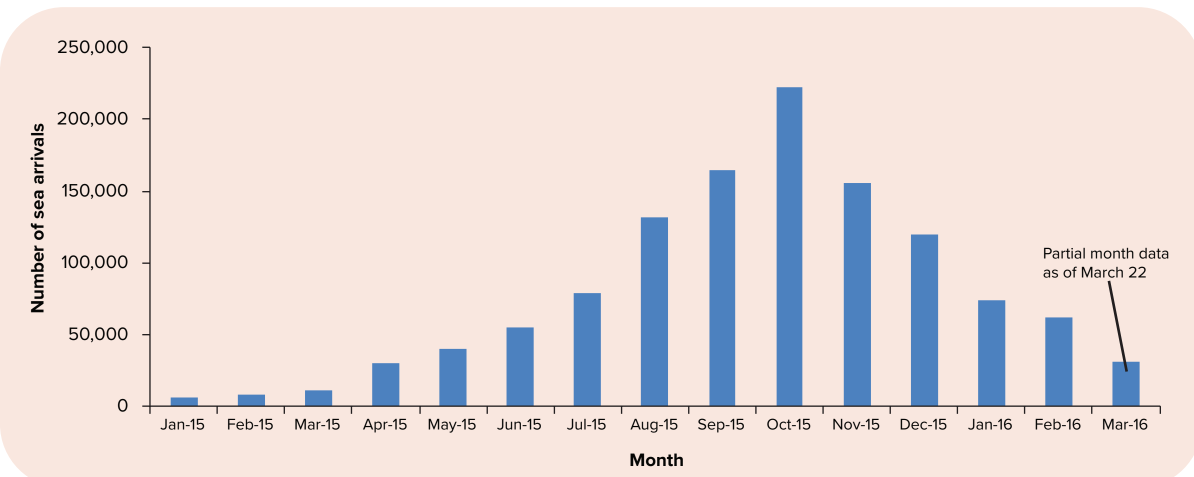
Source: World Bank data, staff calculations

The sheer magnitude of the oil price collapse and the pervasiveness of its consequences imply that substantial downside risks surround the macroeconomic and poverty forecasts for the Eastern Europe and Central Asia. Only coordinated and swift policy response can prevent a deepening and broadening of the adverse impacts. The required policy responses range from adjusting monetary policy to stabilizing banking sectors, and putting fiscal accounts back on a sustainable path. But none of the policy responses will be successful in the long run if institutional or other impediments prevent further diversification in product and job markets.

1.3 The Refugee Crisis

Due to the conflicts in Syria, Iraq, and continuing violence and instability in Afghanistan, as well as other conflicts in the Middle East and Africa, a burgeoning refugee and humanitarian crisis has exploded onto the global stage. As of March 2016 approximately 4.8 million Syrian refugees were registered in Turkey, and the Middle East and North Africa region. Of these refugees, 2.7 million were registered in Turkey, 1 million in Lebanon, 635,000 in Jordan, 245,000 in Iraq and 145,000 in Egypt and other North African countries. Of the nearly 5 million refugees, 220,000 were registered in the first 3 months of 2016.[2] About a quarter of these people, some 1.2 million, have made the risky and arduous journey from the Middle East and North Africa by sea to Europe, landing mostly in Italy and Greece (figure 1.8). Three nationalities accounted for 85 percent of the total arrivals from January 2015 to March 2016: Syria—46 percent, Afghanistan—24 percent, and Iraq—15 percent. The remainder came mainly from Iran, Pakistan, and various conflict afflicted countries in Africa. First-time asylum applications in Europe by people from Syria, Afghanistan and Iraq jumped some 130 percent in the 12 months between Q4 2014 and Q4 2015.[3] Many European countries are concerned about the economic and social impact of these flows.

FIGURE 1.8 Surge in monthly sea arrivals into Europe



Source: http://data.unhcr.org/mediterranean/regional.php

Unlike a gradual flow of economic migrants, refugees typically arrive over a relatively short period of time and are often concentrated in a small number of local communities. The sudden and concentrated arrival creates more complications for the host countries than the sheer size of the refugee flows. For the EU as a whole, the 1.2 million sea arrivals from all refugee countries represents only about 0.2 percent of the total population in 2015 (about half that for just Syrian refugees). By comparison, prior to the current refugee crisis (on January 1, 2014), 33.5 million people (6.4 percent of the total population) living in the EU28 had been born outside the EU28. However, for some host communities the change has been dramatic. In addition, the relatively modest increase in the number of people (as a share of the total population) who are coming in as refugees comes on top of a relatively large within-EU28 migration experienced since 2000 due to greater regional integration (on average the total foreign-born population within EU28 countries, including from other EU28 countries, is nearly 10 percent).

The crisis primarily is driven by the rapid increase in the number of refugees and lack of capacity to manage these inflows of people and allocate them among EU countries. In September, 2015 an agreement was reached among EU member states to reallocate some 120,000 refugees from Italy, Greece and Hungary.[4] As of March 2016, some 5,500 have been relocated or resettled.[5] Subsequently, an agreement was reached between Turkey and the EU to manage the flow of Syrian migrants into Europe.[6] The EU and Turkey agreed to:

- return to Turkey all irregular migrants crossing from Turkey to the Greek islands from 20 March 2016, in full accordance with EU and international law
- for every Syrian returned to Turkey (up to 72,000 Syrian refugees in 2016), another Syrian will be resettled from Turkey to the EU, on the basis of existing commitments
- Turkey will take any necessary measures to prevent new sea or land routes for illegal migration
- once irregular crossings end, a voluntary humanitarian admission scheme will be activated and the EU will further speed up the disbursement of the initially allocated €3bn support to Turkey and will mobilize an additional €3bn once these resources are used and provided commitments have been met
- the EU and Turkey will work to improve humanitarian conditions inside Syria
- EU leaders and Turkey also agreed to accelerate the fulfilment of the visa liberalization roadmap, with a view to lifting visa requirements for Turkish citizens by end of June 2016 at the latest, if all benchmarks have been met. They reconfirmed their commitment to re-energize the accession process as set out in the joint statement of 29 November 2015. They agreed, as a next step, to open chapter 33 on financial and budgetary provisions in Turkey's accession negotiations.

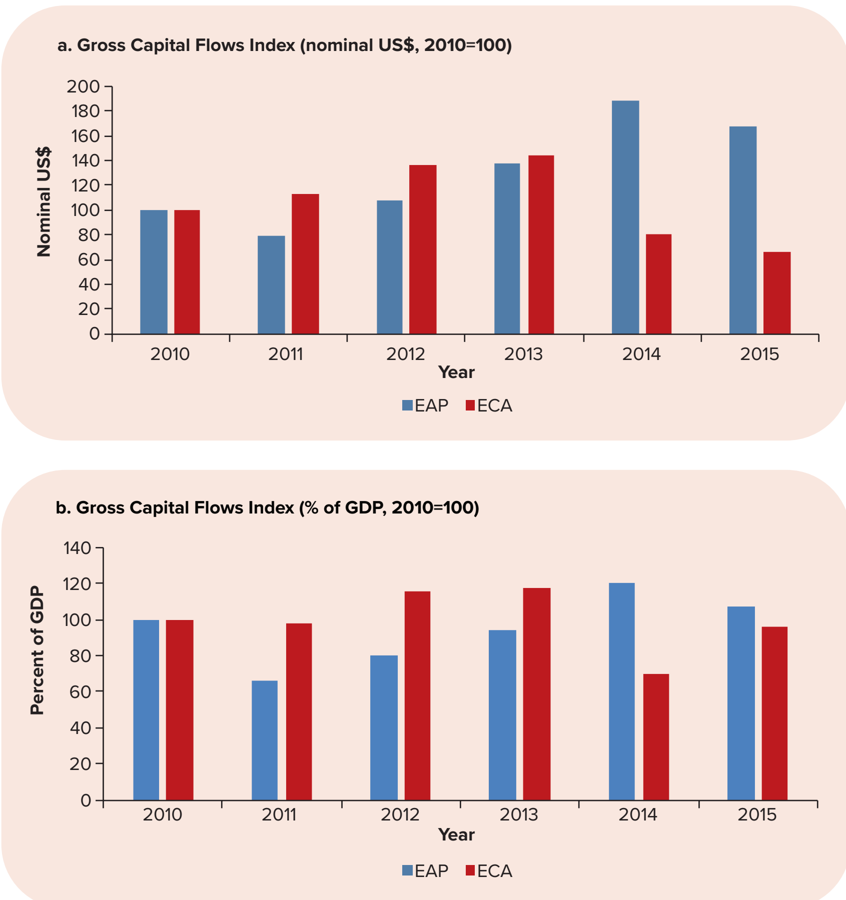
The success of any program will depend on the ability of migrants and refugees to successfully integrate into the economic and social fabric of the host countries. It is unlikely that many Syrian refugees will return to the worst affected areas in the near future, as a return to stability and economic reconstruction will likely take years. Institutions will need to be enhanced to improve host countries' ability to absorb migrants, as will education, housing, and programs to facilitate integration. Yet, while there are modest adjustment costs, migration offers

far greater dynamic growth benefits through increasing the working age population and adding to the labor and human capital endowment of the receiving country.[7] These critical factors are not directly addressed in recent proposals, but are on the minds and agendas of many host country residents and policy makers.

1.4 Fragility of banking sectors threatens economic recovery

Economic developments in Europe and Central Asia are evolving against the backdrop of heightened anxiety in international financial markets. These financial concerns have led to elevated spreads, especially for exporters of natural resources, and have slowed international capital flows to emerging markets as investors are looking for safe havens. First indications are that the dollar value of portfolio flows and bank lending to emerging markets in 2016 will fall significantly below 2015 levels, and that capital flows to emerging markets in Europe and Central Asia will be especially small (figure 1.9A).

FIGURE 1.9 Drop in capital flows not as large as it seems



Source: World Bank data, staff calculations

The drop in capital flows is less severe if expressed as percent of GDP in receiving countries. The decline in the dollar value of capital flows has been reinforced by the appreciation of the dollar. By definition the dollar value of GDP declined in countries that underwent large real depreciations vis-à-vis the dollar. Many of those countries are in Eastern Europe and Central Asia. As a result, the relative size of the capital inflows did not decline as much as the nominal dollar values suggest. Figure 1.9B provides a striking example. In recent years capital flows into emerging Europe and Central Asia have substantially fallen behind capital flows into emerging East Asia. This largely reflects the difference in real depreciation; as a percent of nominal GDP the difference in capital flows was much smaller. However, it remains that globally capital flows are likely to fall sharply in 2016.

The reduction in capital flows is not uniform across the region (figure 1.10). The gradual decline in lending to Russia from international banks and bond markets coincided with a sharp rise of these capital flows to Turkey. Capital flows into Russia have been limited by international sanctions, but the decline in flows to Russia very much resembles that of other oil exporting countries. This implies that the problems banking sectors in oil-exporting countries face as a result of reduced oil revenues and associated depreciations have been exacerbated by international capital reversals.

The decline in oil prices and subsequent currency devaluations have had major effects on the financial sectors in oil producing countries.

- In *Russia*, the significant devaluation of the ruble has increased the cost of foreign debt service for the banking sector and increased the risk of default on foreign currency denominated loans issued by banks, leading to capital shortfalls. The authorities pledged approximately one trillion rubles (US$16.5 billion) in December 2014 to recapitalize systemic banks. The majority of these funds have now been utilized, and it is possible that further state support will be necessary as NPLs continue to rise.
- In *Azerbaijan*, expected devaluations caused a doubling of the share of dollar deposits during 2015, significantly widening the currency mismatch of banks, leading them to recognize massive conversion losses which eroded their capital. In addition, the sharp reduction of export proceeds from oil and lower domestic demand has boosted NPLs, bringing additional losses and capital erosion to the banking sector.
- In *Kazakhstan*, tight monetary policy to prevent further devaluation of the tenge has led to a squeeze in local currency liquidity and a rise in interest rates. Lending and profitability are likely to be weak in 2016–17, and asset quality is likely to deteriorate. Credit demand is also likely to be low, as the weak economic outlook will encourage households and businesses to deleverage.

Financial sectors of countries closely integrated with Russia have also been hit. The depreciation of the ruble sharply reduced the purchasing power of remittances, which in turn triggered depreciations in remittances-receiving countries with adverse impacts on their financial sectors. Moreover, companies in surrounding countries saw their competitiveness vis-à-vis Russian producers erode, which impaired profitability in banking sectors. Finally, a decline in banking sec-

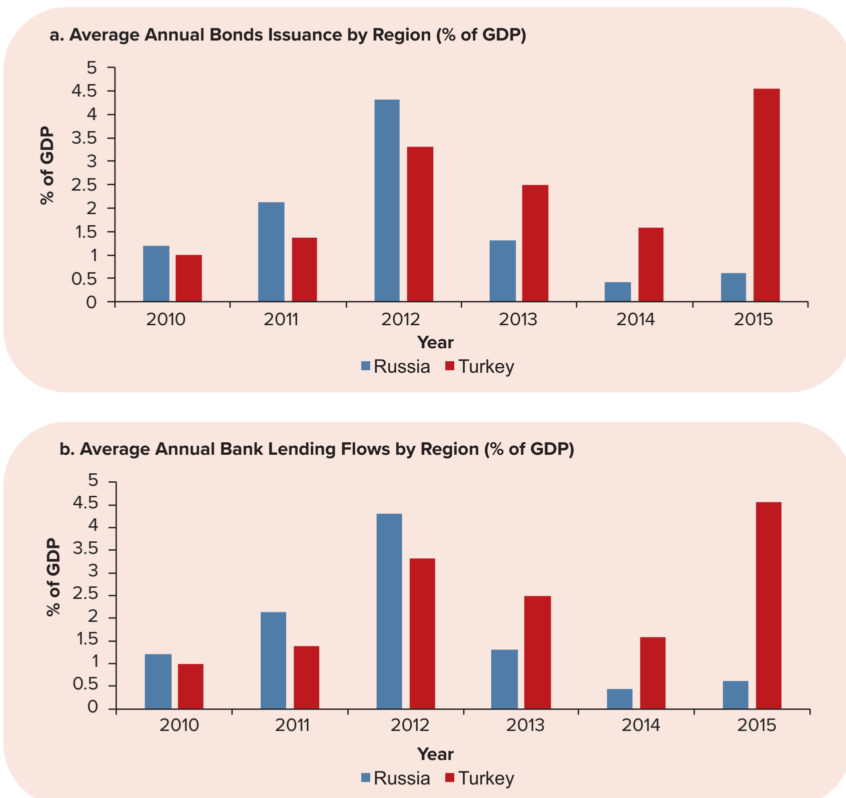
tor flows from Russia is also likely to affect banking sectors in neighboring countries, given the non-negligible presence of Russian banks in some of them.

The oil shock with all its repercussions has afflicted financial sectors that already had poor governance. Insufficient powers and low capacity of supervisors, inadequate financial safety nets, limited depth and underdeveloped financial infrastructure have made the banking sectors in Eastern Europe and Central Asia very vulnerable to adverse shocks. State ownership of banking assets remains high in several countries in the region, leading in some cases to political intervention, regulatory forbearance, and interconnected institutions, resulting in large sectoral and related-party lending, diminishing the efficiency and sustainability of the business model, and making it more difficult to adjust to external shocks.

Under these circumstances, the first priority is prevention of an escalating banking crisis. Given that several countries are facing banking sector distress or are already in a full-fledged banking crisis, a clear and comprehensive crisis response framework needs to be put in place, including emergency liquidity support to prevent contagion, least-cost resolution of failed banks, state intervention and support of systemic banks, and adequate funding of deposit insurance schemes. An assessment of the major threat that banking sectors face (see, for example, table 1.2) is indispensable for an effective crisis response.

Apart from an urgent crisis response, banking sectors in Eastern ECA are in urgent need of reform. While during the oil boom banking sectors could survive

FIGURE 1.10 **Capital flows declined for Russia, and increased for Turkey**



Source: World Bank data, staff calculations

TABLE 1.2 Banking problems in Eastern Europe and Central Asia

Country	Remittances from Russia (% of GDP), 2014 or latest available	Currency depreciation from Jan. 1 2015–Feb. 29 2016 (%)	Asset share of Russian-owned banks (%), 2014	NPLs to total loans (%), 2015 or latest available	Open foreign exchange position (%), 2015 or latest available	Capital adequacy ratio (%), 2015 or latest available	Return on assets (%), 2015 or latest available	Liquid assets to total assets (%), 2015 or latest available
Armenia	12.3	2.7	28.0	8.8	4.2	17.1	−0.8	28.7
Azerbaijan	0.2	99.8	—	13.8	43.1	12.4	−1.4	17.9
Belarus	0.8	40.8	23.7	6.5	12.4	19.2	1.7	31.2
Georgia	7.1	26.6	4.8	2.7	6.5	17.5	2.7	23.4
Kazakhstan	0.1	89.7	9.6	9.2	23.6	16.2	1.5	20.6
Kyrgyz Republic	23.5	24.2	—	7.9	18.4	22.6	−1.3	n.a.
Russia	—	25.2	—	7.4	4.6	12.7	0.2	26.5
Tajikistan	32.2	47.9	—	19.1	−2.7	16.1	2.6	22.4

Sources: IMF, World Bank, Bloomberg, Bankscope, Central banks' websites, staff calculations
Notes:
-For remittances: "red": > 10% of GDP; "yellow": 3–10% of GDP; "green": <3% of GDP.
-For currency depreciation: "red": > 40%; "yellow": 20–40%; "green": <20%.
-For asset share of Russian-owned banks: "red": > 20% of total assets; "yellow": 4–20% of total assets; "green": <4% of total assets.
-For NPLs: "red": > 12% of total loans; "yellow": 7–12% of total loans; "green": <7% of total loans.
-For open FX position: "red": > 10%; "yellow": 0–10%; "green": <0%.
-For capital adequacy ratio: "red": < 14%; "yellow": 14–18%; "green": >18%.
-For return on assets: "red": < 0%; "yellow": 0–1.5%; "green": >1.5%.
-For liquid assets: "red": < 22% of total assets; "yellow" of total assets: 22–26%; "green": >26% of total assets.

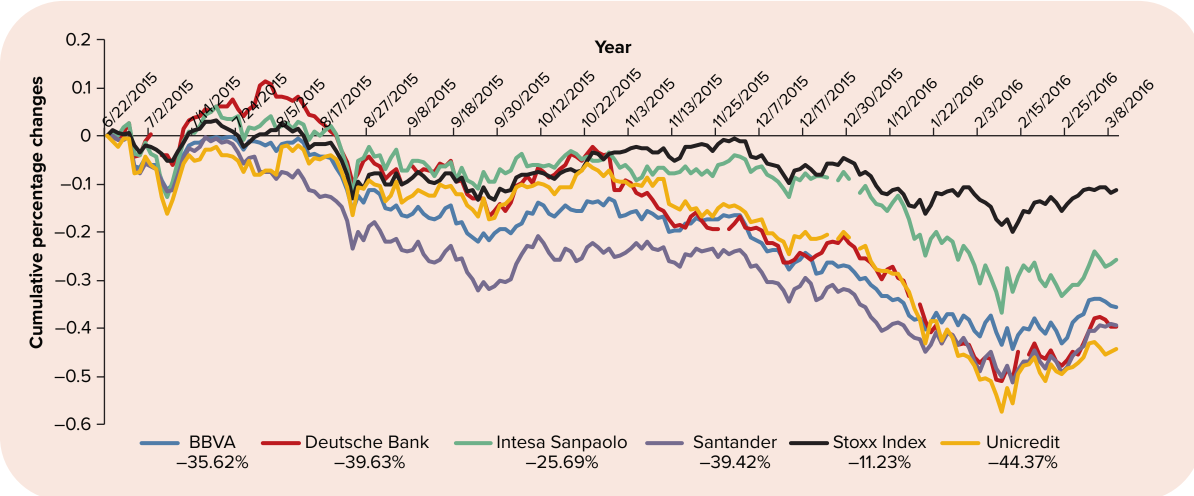
despite poor governance, it has now become a key binding constraint on financial stability and economic growth in new sectors. Eastern ECA suffers from low financial penetration, shallow non-banking sectors and deficient financial infrastructure, including credit reporting systems, payment systems, secured transaction regimes and insolvency frameworks. Measures to ensure an adequate level of competition and efficiency in the banking sector, with a focus on transparency, corporate governance, increased financial intermediation are needed to diversify these economies and seize new opportunities.

Although much less affected by recent adverse shocks, banks in the European Union remain fragile. European bank stocks have experienced a significant drop since mid-2015, driven by a handful of banks (figure 1.11). The Eurostoxx 600 Bank Index has fallen by 11 percent since June 2015, and at one point touched its lowest level since December 2011. The decline was mostly driven by five banks: Unicredit (-44 percent) Deutsche Bank (-40 percent), Santander (-39 percent), BBVA (-36 percent) and Intesa (-26 percent).

Unresolved NPLs continue to be a problem, and banks' business models are not adjusting fast enough to the new environment. Consolidation of the sector has been moderate, and banks in many European countries have become significantly risk-averse, curtailing lending to riskier segments of the market, and parking their excess liquidity in low-yielding securities, waiting for regulatory and economic uncertainties to wane.

The application of bail-in rules in the resolution of banks has added to the current cautionary approach. Bail-in rules during bank resolution result in the allocation of losses to shareholders and unsecured creditors, to minimize the cost of resolution for taxpayers. These rules began to be applied in 2016, with some

FIGURE 1.11 **European banks remain fragile**



Source: Bloomberg

negative effects in the few cases of bank resolution that have occurred. In Portugal, a case of discrimination among senior bondholders within the same class took place; in addition, it was ruled that credit default swaps (CDSs) insuring bonds of the resolved bank would not be triggered as a result of the application of bail-in. In Italy, resolution of small cooperative banks imposed losses on retail clients who only then realized they owned subordinated debt instead of deposits. These developments have led investors to become more risk-averse to bank-related securities, including stocks.

In addition to these general problems, a number of idiosyncratic reasons are responsible for the drop in European bank stocks.

- Deutsche Bank's stock price was heavily affected by sanctions related to the LIBOR scandal (for which it agreed to pay $2.5 billion in fines), and to business with countries sanctioned by the United States (for which is was fined for $258 million), plus a deep restructuring of its investment banking arm, resulting in a loss of €1.2 billion in the last quarter of 2015.
- The poor performance of Spanish banks was in part due to losses from currency depreciation in emerging markets where they have presence (for example, Mexico), overvalued real estate collateral, and a recent decision by the Constitutional Court to remove interest rate floors on mortgages, resulting in banks having to compensate mortgage clients.
- The delayed and seemingly insufficient efforts to resolve the relatively high level of NPLs have affected Italian banks' share prices. The NPL ratio of the Italian banking sector remains at 17 percent of total loans, or around €350 billion. An agreement with the EC only partially reversed the marked downward trend in the share prices of banks, but it remains to be seen if these efforts will be sufficient to clean their balance sheets.

A comprehensive approach needs to be taken to resolve the NPL burden in Europe. Such an approach could include efforts in three areas: 1) regulatory and

supervisory efforts to incentivize banks to restructure their NPL portfolios, through provisioning requirements and time-bound restructuring plans; 2) an overhaul of insolvency regimes to reduce obstacles and facilitate out-of-court restructuring; and 3) the development of a private market for distressed debt, with the support of public asset management companies (AMCs) if needed. Recent cases in Europe of the establishment of AMCs include Ireland and Slovenia, while the UK introduced an asset protection scheme, under which banks paid a fee to the government to get insurance for distressed assets that they continued to manage.

1.5 Policy makers are walking a tightrope

The current policy challenges in the region are daunting. In the European Union policy coordination is being tested and even European integration itself is being challenged. In Eastern Europe and Central Asia several governments are engaged in crisis prevention or even crisis response. This final section focuses on monetary policy and fiscal policy, where the problems are perhaps not the most daunting, but are quite intricate in the current economic environment.

The most complicated task is to adjust monetary policy in oil-exporting and surrounding countries. During the oil price boom most of those countries had a fixed exchange rate regime, targeting the U.S. dollar. With large and increasing inflows of oil revenues and remittances this was a stable policy regime. Any real appreciation that was required to maintain market equilibrium was created by inflation, in excess of U.S. inflation. Any surplus of foreign inflows was absorbed by rising reserves. With the collapse of the oil price and subsequently of remittances these fixed exchange rate regimes are no longer sustainable. Central banks have no choice but to shift towards flexible exchange rates. This allows the real exchange rate to adjust downward without forcing a deep deflationary recession.

The shift towards flexible exchange rates is not without danger. In partly dollarized financial markets sharp depreciations can lead to defaults and fragility in the banking sectors, and in general depreciation can have large distributional impacts. Because of these dangers, it is tempting to adopt the shift in exchange rate regime gradually or halfheartedly. Such an approach, however, can seriously backfire. Partial adjustment of the exchange rate is likely to generate expectations of further exchange rate depreciation, which in turn will intensify the dollarization of the financial sector and might trigger capital flight. Insufficient depreciation also increases fiscal problems and hampers the required transformation of the economy towards more tradable production. Thus, it is essential to fully embrace a new exchange rate regime and to deal promptly with the adverse consequences by addressing vulnerabilities in the banking sector.

Once central banks let go of a fixed exchange rate regime, they have to adopt a credible new policy anchor. Inflation targeting is a natural choice. However, it is not obvious which inflation rate should be targeted. Many central banks in advanced economies target the consumer price index (CPI). However, that might not be the right choice for oil exporting economies at the moment. The recent rapid increase in the CPI may reflect a one-time shift in relative prices due to ris-

ing import prices, rather than a sign of emerging inflation. Targeting the CPI, therefore, could result in overly tight monetary policy, particularly if central banks seek to quickly establish stable inflation expectations.

For central banks in oil-exporting countries it seems much more appropriate to target the GDP deflator than the CPI. The GDP deflator measures the price change of value-added, and does not include the rise of import prices. There are two reasons why the value-added deflator is more appropriate. First, it is a better reflection of under- or overutilization of domestic production capacity. Maintaining a low and stable GDP deflator is equivalent to maintaining equilibrium in the domestic economy. Secondly, central banks should only be worried about a fast rise in import prices if it is the start of self-sustaining high inflation rates. This is not an academic discussion as the differences between increases in the CPI and the GDP deflator are currently large. For example, in the Russian Federation the CPI rose by 15.5 percent in 2015, while the GDP deflator rose by 6 percent (table 1.3). Targeting the CPI would lead to unnecessarily tight monetary policy.

For countries that are highly dependent on oil exports an alternative to inflation targeting is to target the oil price in local currency. That means that exchange rate movements would compensate for any change in oil prices in U.S. dollars. This approach is very much the equilibrium solution under stable domestic prices, and has several advantages. First, oil prices can be immediately observed on a daily basis, so there is a lot of information about the variable that is being targeted. Second, it will reduce exchange rate speculation as the oil price is difficult to predict. Third, it might make for an easier transition for central banks that are accustomed to target exchange rates. The interventions used to achieve the target would be the same as in the previous regime, the only difference being that the level of the exchange rate that is targeted is no longer constant.

The level of intervention needed to maintain a stable oil price in domestic currency is not necessarily large. Foreign exchange markets already have a tendency to react to dollar oil price changes by exchange rate adjustments. A clear example is what happened with the ruble in the recent past. Both monthly changes and daily changes of the ruble-dollar exchange rate were highly correlated with changes in the dollar price of oil (figure 1.12). Consequently, the oil price has been much more stable in rubles than in dollars.

The monetary policy challenges facing the European Union are rather different. No radical adjustment of the monetary policy regime is needed. Unlike in many countries in Eastern Europe and Central Asia, import prices are declining. As a result CPI inflation in the European Union is negligible or even negative. The ECB and other central banks have experimented with negative interest rates. The central bank of Sweden has been particularly innovative in pushing the lower bound of nominal interest rates downwards. It is not clear what the direct impact of these negative interest rates has been on investment and the recovery. However, the indirect impact through the weakening of the euro did stimulate exports, and as such contributed to the recovery.

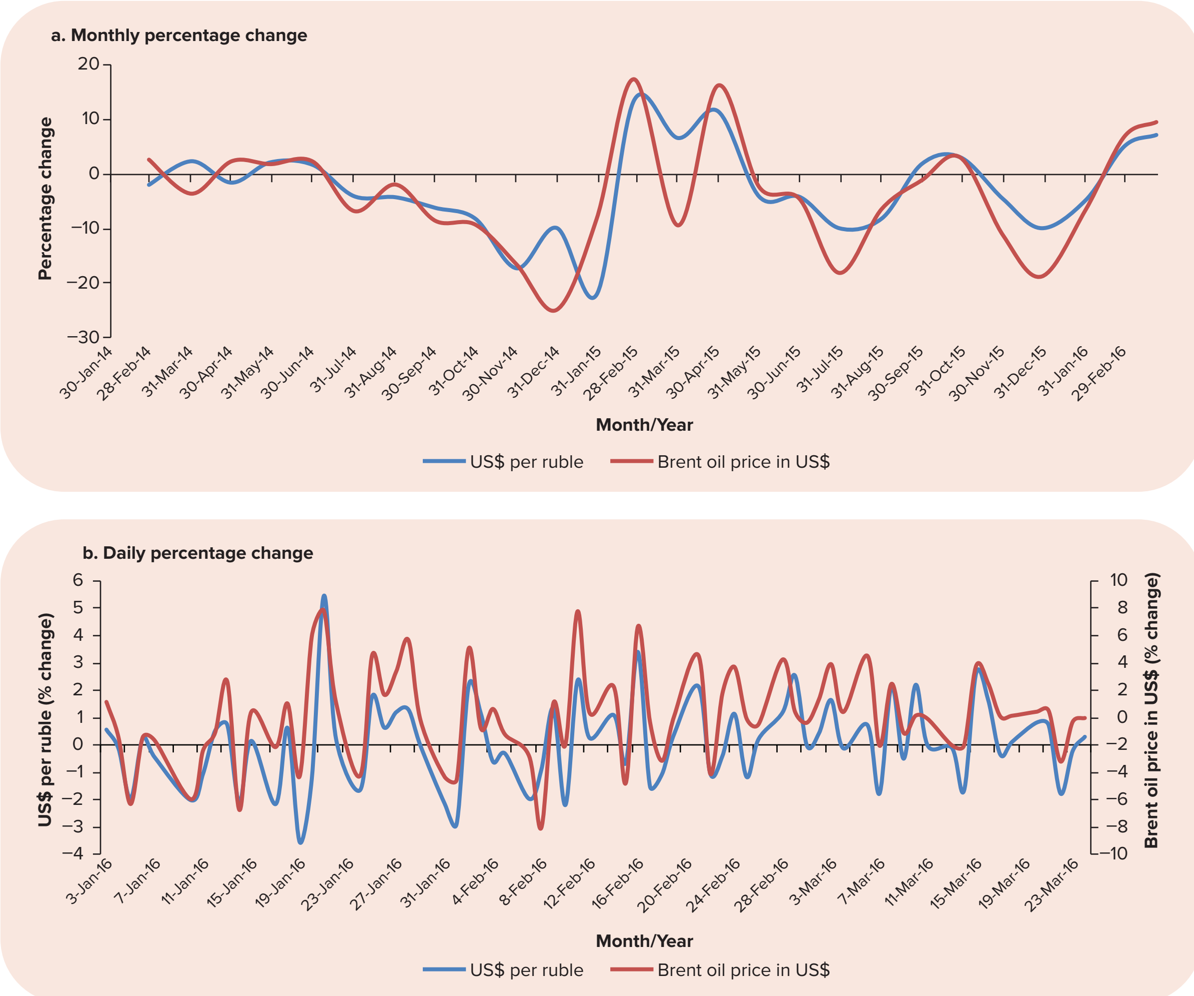
The negative policy interest rates in Europe also may have had adverse effects. It may have made the banking sector even less attractive to investors in comparison to other markets. Several central banks in Europe—including the ECB—have set the policy interest rate on their deposit facilities at negative levels

TABLE 1.3 Large differences in 2015 between GDP and CPI deflators

Change in 2015 over 2014	GDP deflator (percent)	CPI (percent)	Difference (percentage point)
Russian Federation	6.0	15.5	−9.5
Norway	−2.0	2.2	−4.2
Turkey	5.7	7.7	−1.9
Canada	−0.5	1.1	−1.6
Netherlands	0.3	0.6	−0.3
Switzerland	−1.3	−1.1	−0.1
Slovak Republic	−0.2	−0.3	0.1
Belgium	0.9	0.6	0.3
Czech Republic	0.7	0.3	0.4
Austria	1.4	0.9	0.5
Denmark	1.0	0.5	0.5
Finland	0.4	−0.2	0.6
Latvia	0.9	0.2	0.7
Slovenia	0.2	−0.5	0.7
Italy	0.8	0.0	0.7
United States	1.0	0.1	0.9
France	1.2	0.1	1.1
Spain	0.6	−0.5	1.1
Japan	2.0	0.8	1.2
Greece	−0.6	−1.7	1.2
Lithuania	0.5	−0.9	1.4
Poland	0.5	−0.9	1.4
Portugal	1.9	0.5	1.4
Germany	2.0	0.2	1.8
Hungary	1.7	−0.1	1.8
Estonia	1.4	−0.5	1.9
Sweden	2.0	0.0	2.0
Luxembourg	2.6	0.5	2.2
Ireland	3.6	−0.3	3.9
Iceland	5.9	1.6	4.3

Source: OECD quarterly national accounts; World Bank GEM database

FIGURE 1.12 **Ruble exchange rate closely follows oil price**



Source: World Bank data, staff calculations

in order to encourage lending by making it costly for banks to hold excess reserves at their central banks. While this may work in the short term, a persistent negative rate environment represents a challenge to banks' business model, as it narrows the spread between short- and long-term interest rates, making it more difficult for banks to obtain returns from maturity transformation (borrowing funds short-term and lending long-term), thus reducing net interest margins, and undermining their profitability. By contrast, the United States has begun a period of rising interest rates, which makes the European market less attractive for investors in search of higher yields.

Like central banks in oil-exporting countries, central banks in the European Union might want to focus more on the GDP deflator than on the CPI. There is currently a striking difference between the two measures of inflation. For example, the German GDP deflator rose by 2 percent in 2015, significantly higher than the 0.2 percent rise in the CPI. Similarly, in Sweden GDP inflation was 2 percent,

while CPI inflation was 0 percent (table 1.3). This is the mirror image of what happened in oil-exporting countries. In the European Union import prices fell as a result of the collapse in oil prices, but this might have been a one-time relative price adjustment. The implication is that less monetary easing is needed once the target shifts towards the value-added deflator.

The rise in housing prices relative to the CPI in 2015 in European countries is another sign that the CPI doesn't tell the whole story. For example, in Germany housing prices rose 5 percentage points faster than the CPI in 2015. A similar pattern is seen in many other European countries (figure 1.13). Monetary policy has more impact on the prices of domestically produced goods, and especially more impact on prices of durable goods, including housing. Since in current economic circumstances relative prices are changing more than usual, central banks might want to broaden their target beyond the CPI.

Like in the case of monetary policy, the fiscal challenges differ considerably between the eastern part and the western part of the region. For many countries in the eastern part debt levels are low, but their fiscal position is rapidly deteriorating, as revenues dropped because of falling oil-revenues and tax incomes (table 1.4). And the situation might become significantly more precarious because of contingent liabilities that are linked to fragile banking sectors. For many countries in the western part the opposite is true. The fiscal position is improving, but debt levels are very high. The difference within the region are striking, with the Southern and Western Europe sub regions having the highest average rates of 133 and 88 percent respectively, and Central Asia and Russia having the lowest average rates at 28 and 20 respectively. However, the latter rates could rise rapidly because of contingent liabilities. Banking crises entail significant fiscal costs to

FIGURE 1.13 Home prices recovering in most countries, but falling in oil-exporting countries (percentage change in home prices deflated by CPI 2015/2014)

Source: Bank for International Settlements (BIS), World Bank GEM, staff calculations

TABLE 1.4 Increased debt ratios restrict fiscal space for most countries in the region

		Changes 2008–2015 (percent points)			2015 Levels (percentage)		
		Government debt/GDP	All revenue/ GDP	All expenses/ GDP	Debt/GDP	General government revenue/ GDP	General government expenses/ GDP
Western Europe	Austria	18.2	1.7	2.2	86.7	50.0	52.0
	Belgium	14.6	2.3	4.0	106.7	50.6	53.4
	France	29.2	3.4	4.0	97.1	53.2	57.0
	Germany	5.5	1.0	0.5	70.7	44.4	43.9
	Ireland	58.2	−1.2	−6.3	100.6	33.7	35.6
	The Netherlands	9.2	−1.4	0.9	67.6	42.4	44.5
	United Kingdom	37.1	−1.0	−1.8	88.9	36.0	40.3
Southern Europe	Greece	88.2	5.2	−0.5	196.9	45.9	50.1
	Italy	30.8	2.9	2.9	133.1	48.0	50.7
	Portugal	56.1	3.2	2.6	127.8	44.8	47.9
	Spain	59.2	0.9	0.9	98.6	37.6	42.0
	Cyprus	61.7	−0.3	2.0	106.4	39.6	40.9
Central Europe	Bulgaria	13.6	−1.2	3.6	28.6	35.8	37.8
	Croatia	53.3	1.8	4.2	89.3	43.4	48.5
	Czech Republic	12.0	2.1	1.9	40.6	40.2	42.0
	Hungary	3.4	1.2	0.2	75.3	46.4	49.1
	Poland	4.1	−1.7	−2.5	51.1	39.1	41.8
	Romania	27.5	0.4	−2.5	40.9	32.0	33.8
	Slovak Republic	25.1	5.0	5.1	53.3	39.3	41.8
	Slovenia	60.2	0.4	3.8	81.8	40.8	44.5
Northern Europe	Denmark	13.6	−2.0	3.9	47.0	51.7	54.4
	Finland	29.3	3.1	10.5	61.9	55.6	58.7
	Sweden	7.2	−2.3	1.1	43.9	48.7	50.1
	Estonia	6.3	2.3	0.1	10.8	38.4	39.1
	Latvia	21.6	1.7	0.0	37.8	35.1	36.5
	Lithuania	23.4	−0.9	−2.9	38.8	32.9	34.1
	Albania	18.2	0.2	0.4	73.3	27.0	32.1
Western Balkans	Bosnia and Herzegovina	14.6	0.9	−0.6	45.5	46.5	48.1
	Kosovo	45.5	45.5	45.5	45.5	45.5	45.5
	FYR Macedonia	16.5	−3.7	−0.7	37.1	29.1	33.1
	Montenegro	40.9	−6.2	0.5	69.9	42.2	52.2
	Serbia	44.3	−1.4	0.6	76.7	40.1	44.0

(Continued next page)

TABLE 1.4 (continued)

		Changes 2008–2015 (percent points)			2015 Levels (percentage)		
		Government debt/GDP	All revenue/ GDP	All expenses/ GDP	Debt/GDP	General government revenue/ GDP	General government expenses/ GDP
South Caucuses	Armenia	31.4	0.9	3.2	46.1	21.4	25.4
	Azerbaijan	13.3	−24.3	3.6	20.6	26.8	34.7
	Georgia	21.8	−2.6	−3.2	45.4	28.1	29.5
Central Asia	Kazakhstan	11.5	−7.9	−3.5	18.3	20.4	23.6
	Kyrgyz Republic	11.5	5.5	8.9	60.0	35.8	38.2
	Tajikistan	2.9	4.1	1.0	32.9	26.3	28.2
	Turkmenistan	15.9	−7.0	3.9	18.7	13.8	14.8
	Uzbekistan	−1.1	−5.4	2.2	11.6	35.3	35.2
Russia		12.4	−5.3	5.3	20.4	33.9	39.6
Turkey		−7.8	3.8	2.0	32.1	35.6	36.5
Other Eastern Europe	Belarus	18.8	−9.3	−5.0	40.4	41.4	43.8
	Moldova	25.6	−4.6	−1.6	44.8	36.0	39.9
	Ukraine	74.7	−1.5	−0.4	94.4	40.8	45.0

Source: IMF World Economic Outlook (WEO) database

stabilize the banking sector, particularly in the absence of an adequate framework for bank resolution, including burden sharing mechanisms for shareholders. This all means that in most countries in Europe and Central Asia fiscal space is limited, albeit for different reasons.

Current circumstances ask for the right type of fiscal spending, rather than for large amounts of general fiscal stimulus. Priorities of fiscal policy in the eastern part of the region are the protection of the most vulnerable households and the facilitation of the transition from non-tradable to tradable production. Countries such as Belarus, the Kyrgyz Republic and Russia actually strengthened their social protection to counter poverty increase. Under the pressure of fiscal consolidation, Armenia, Belarus, and Ukraine are planning to raise utility tariffs to cost recovery, but the complementing mitigation measures will help soften the negative impact on households. Government investments in trade facilitation are currently much more effective than stimulus of the domestic construction sector, even if the latter is tempting as many jobs are being lost in the construction sector. Priority of fiscal policy in the western part of the region is stimulus of private investment that is still at subdued levels.

Notes

1. See, for example, Constantinescu, Mattoo, and Ruta (2015), "The Global Trade Slowdown", World Bank Policy Research Working Paper, 7158.
2. Source: http://data.unhcr.org/syrianrefugees/regional.php, Data updated March 22, 2016
3. Source: http://ec.europa.eu/eurostat/statistics-explained/index.php/Asylum_quarterly_report.
4. Source: http://europa.eu/rapid/press-release_IP-15-5596_en.htm
5. Source: http://ec.europa.eu/dgs/home-affairs/what-we-do/policies/european-agenda-migration/background-information/docs/20160316/relocation_and_resettlement_-_state_of_play_en.pdf
6. Source: http://europa.eu/rapid/press-release_MEMO-16-963_en.htm
7. For a short brief on economic impact of migration see (OECD, 2014) and (IMF, 2015): https://www.oecd.org/migration/OECD%20Migration%20Policy%20Debates%20Numero%202.pdf and http://www.imf.org/external/np/g20/pdf/2015/111515background.pdf/

2

China's Impact on Europe and Central Asia

Summary

- The slowing pace of GDP growth in China has important implications for countries in Europe and Central Asia, but they are not all negative. This is because the slowdown reflects lower growth potential that reduces China's exports as much as China's imports. Lower potential growth in China creates some opportunities in the western part of ECA as producers in these countries will face less competition at home and in third markets, but it will probably hurt eastern countries as demand for their natural resource will decrease.
- The reduction of labor intensive Chinese exports will affect factor prices differently: wages, especially those for lower skilled workers, may benefit relative to capital income.
- When the structural slowdown is accompanied by a rebalancing of the Chinese economy (more consumption, less investment, increasing skill levels of workers, more outward FDI), the eastern part of the region will likely benefit more than the western one.
- Recent real depreciations in ECA represent a strong force for changing trade relations with China. Countries in the region become more competitive and increased domestic production of tradables will substitute imports and increase market shares abroad.
- Shifting resources out of non-tradables into tradables and seizing these opportunities requires policy reforms. Facilitating mobility in labor markets and flexibility in domestic banking are particularly important. This as adjustment is complicated by rigidities and vested interests that have emerged during the long period of high oil prices.

2.1 Introduction

After decades of exceptionally strong economic growth, China became in 2007 the largest exporter in the world. China is currently the second largest importer. Its import market is roughly the size of the imports of the other BRICS (Brazil, the Russian Federation, India, and South Africa), Japan, and Turkey combined.

The Chinese economy has become a leader in other dimensions too. Investment in China was in 2015 four times the level in Japan, and exceeds investment in the United States and the European Union by 35 and 25 percent, respectively. Exceptionally strong investment demand in China has created large export opportunities for Germany and other western European countries that are specialized in the production of investment goods. In many metal markets China represents more than 50 percent of global demand. This has created big export opportunities for resource-rich countries in Central Asia.

In 2009, immediately after the global financial crisis and in the midst of the Great Recession, China engaged in massive domestic stimulus. The volume of China's imports increased by 4.9 percent, while import volumes outside China declined by 12.4 percent. Since 2009 China's import volumes have increased a further 80 percent, compared with a global increase of 36 percent.

Because of this dominant role of the Chinese economy, it is not surprising that China's current economic slowdown, combined with signs of vulnerability in China's financial sector, has triggered serious concerns throughout the global economy. And it is not surprising that countries in Europe and Central Asia (ECA) are anxious, as their links with China through trade and FDI have intensified over time.

This chapter explores these links between China and the ECA region, against the backdrop of recent developments. The relevant developments go well beyond China's slowdown. They also include the ongoing changes in the structure of the Chinese economy: the shift from investment towards consumption (rebalancing); the shift from inward FDI towards outward FDI; and the increasingly higher skill levels of the workforce in China. Moreover, recent developments in the ECA region itself will also affect the relation with China. In particular, the sharp depreciations in oil-exporting and neighboring countries have made these countries significantly more competitive vis-à-vis Chinese producers.

Simulations presented in this chapter suggest the following conclusions:

- **The character of the slowdown in China matters.** The impact of a cyclical slowdown (caused by a sudden drop in Chinese domestic demand) on the ECA region differs from the impact of a structural slowdown (caused by slower productivity growth). The main difference is in the impact on trade balance. A structural slowdown implies a reduction of production and thus of both imports and exports, with ambiguous but probably small effect on the trade balance. A cyclical slowdown is triggered by a reduction of demand and thus is associated to a reduction of imports but not of exports with an increase in the trade surplus. This has clearly different implications on trade balance – i.e.

on overall Chinese demand of global production – than a structural slowdown. So far, the current slowdown has more structural than cyclical characteristics. A structural slowdown is less negative for the ECA region, but also poses challenges, because it leads to shifts in the sectoral composition of trade. Accommodating such shifts requires mobility in labor markets and flexibility in domestic banking sectors and capital markets.

- **The impact of a slowdown in China due to lower productivity growth would differ across countries, sectors, and factors of production.** Slower productivity growth in China would benefit the western part of the ECA region by improving the competitive position of their manufactures exports, but hurt the eastern part of ECA by reducing demand for their natural resources exports. China's slowdown also would reduce the return to investment relative to wages, and improve the wages of unskilled workers relative to skilled workers. The reason is that China's rapid export growth has been low-skilled, labor-intensive. That has put downward pressure on wages in other countries. As China's export growth loses pace then that downward pressure eases.
- **A rebalancing of the Chinese economy could benefit eastern ECA, while hurting western ECA.** China's efforts to become a high-income economy will require increasing consumption relative to investment and shifting towards the production and export of high-skilled manufactures. Such a rebalancing would hurt western ECA by reducing demand for their capital goods exports and increasing competition for high-skilled manufactures exports in general. At the same time, rebalancing could increase opportunities for eastern ECA's low-skilled manufactures and improve their access to outward FDI flows from China.
- **The new opportunities created by sharp real depreciations in ECA countries can easily be underestimated.** The links between China and ECA are not only important because of changes in China, but also because of changes in ECA. That is especially clear for the recent depreciations. These real depreciations, caused by reduced oil revenues and reduced remittances, create opportunities for import substitution and increased penetration of Chinese markets. But especially in oil exporting countries, these opportunities can be impeded by inflexibilities and vested interests that have emerged during a long period of high oil prices.
- The remainder of this chapter consists of six sections. The first one describes China's evolving role in the global economy and characterizes recent developments in China's economy. The following section considers the changing trade links between the ECA region and China. The following three sections present simulations using a global econometric gravity model and a global general equilibrium model. These simulations illustrate the possible impact on ECA of real depreciations following a collapse in oil prices, of the slowdown in China, and of the transformation in the Chinese economy. A final section concludes.

2.2 China: a dominant economic power in transition

After 25 years of rapid economic growth, China became in 2007 the world's largest exporter and is currently the world's second largest importer after the United States. Currently, China exports almost 60 percent more than the United States, the second largest exporter, and 75 percent more than Germany, the world's third largest exporter. A quarter of the world's fixed investment takes place in China, 30 percent more than in the European Union and 40 percent more than in the United States. In many metal markets China represents more than half of global demand.

Because of China's dominant position in the global economy, disruptions in China's economy can have worldwide consequences. Two concerns currently stand out:

- China's GDP growth, which averaged 10.5 percent per year between 1990 and 2010, has fallen below 7 percent. Even during the late 1990s, at the height of Asian financial crisis, China's GDP growth remained above 7.5 percent. During the global financial crisis in 2009, when global GDP contracted for the first time in at least 50 years, China's GDP expanded more than 9 percent, fueled by exceptionally strong domestic stimulus. The recent slowdown is unsettling markets and raising policy makers' concerns over the impact on other economies.
- The high investment rate in China since 2009 has been associated with falling returns to capital and emerging NPLs, which will test the solidity of the banking sector, and which might expose vulnerabilities associated with the shadow banking sector. A rebalancing of China's economy, marked by a reduction of investment in favor of consumption, is essential to achieve the sustainable growth required to become a high-income economy. Other important elements of this rebalancing addressed below include the shift from inward FDI to outward FDI, and the shift from low-skill intensive production to high-skill intensive production. All of these changes could have far-reaching consequences for the rest of the world.

Reduced competitiveness as the driver of China's slowdown

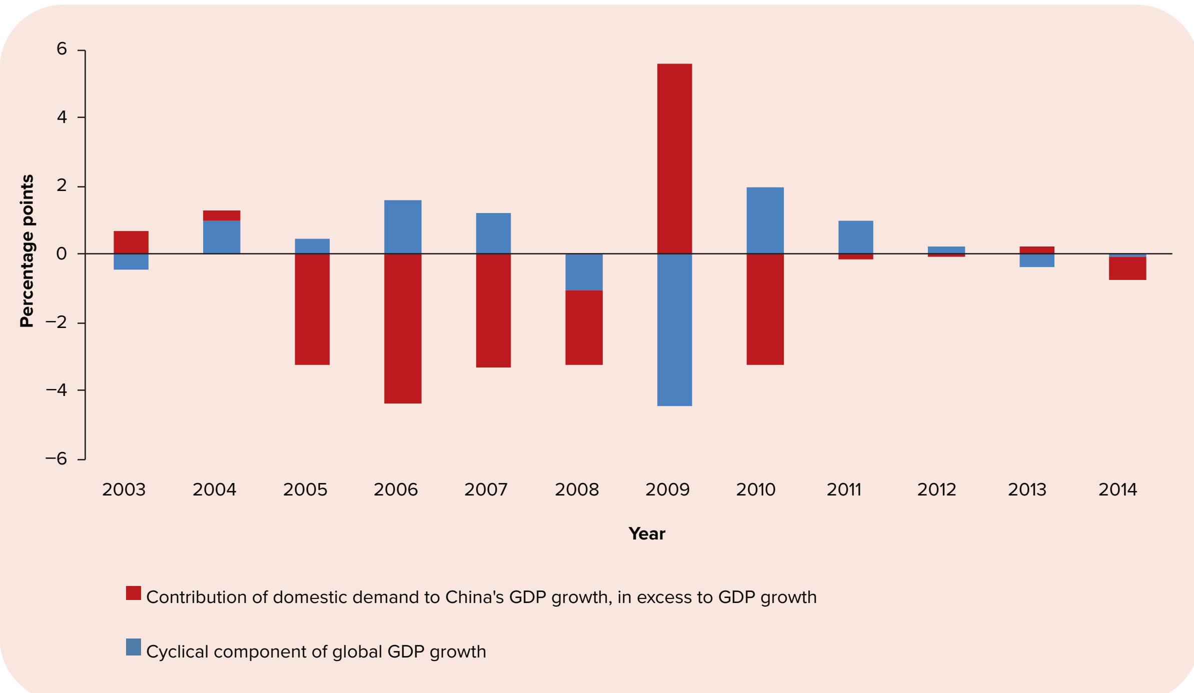
Understanding the character of the slowdown in China is essential for analyzing its impact on the global economy. In short-term macroeconomic analysis, slower GDP growth is typically viewed as reducing imports and thus reducing demand for other countries' exports. From this perspective, slower growth in China is exacerbating the difficulties facing the global economy, which is still struggling to recover fully from the global financial crisis. However, for two related reasons a slowdown in China's GDP is not necessarily a slowdown in demand for the rest of the world. The first reason is that China's domestic demand can outpace its GDP growth, implying strong net imports from the rest of the world. The second reason is that slower GDP growth can be caused by supply-side phenomena, resulting in slower growth of China's production capacity. This

implies that not only imports but also exports are being reduced. Because of these reasons slowing GDP growth can actually coincide with accelerated demand for goods produced in the rest of the world. To reflect changes in China's production capacity as cause of its GDP slowdown, this report doesn't use short-term, demand-oriented models, but gravity models and general equilibrium models in which the supply side is explicitly taken into account.

China's recent slowdown did not reflect a reduction in demand for the rest of the world. Indeed, China has made a net contribution to global demand since the onset of the financial crisis. Examining the relationship between the growth of GDP and domestic demand provides some insight into China's impact on the global economic cycle. At the height of the global boom (the three years from 2005 to 2007), China's GDP expanded by 12.7 percent per year but domestic demand by only 9.5 percent, reflecting a strong positive contribution of net exports to China's GDP growth. Thus, China's exports absorbed a significant part of strong global demand that was only partially compensated by China's import demand. However, the opposite happened at the depth of the global financial crisis in 2009: China's GDP expanded by 9.2 percent but domestic demand increased by 16.4 percent, reflecting exceptionally strong domestic stimulus. Although China's GDP growth had slowed compared with the period before the crisis, China contribution to demand for the rest of the world had actually increased substantially.

China's contribution to global demand has been countercyclical before and after the financial crisis. In figure 2.1, the blue bars show the cyclical component of global GDP growth, calculated as actual growth minus a seven-year moving

FIGURE 2.1 **China's domestic demand has been countercyclical to the global cycle**



Source: World Development Indicators, World Bank, and calculations by the authors

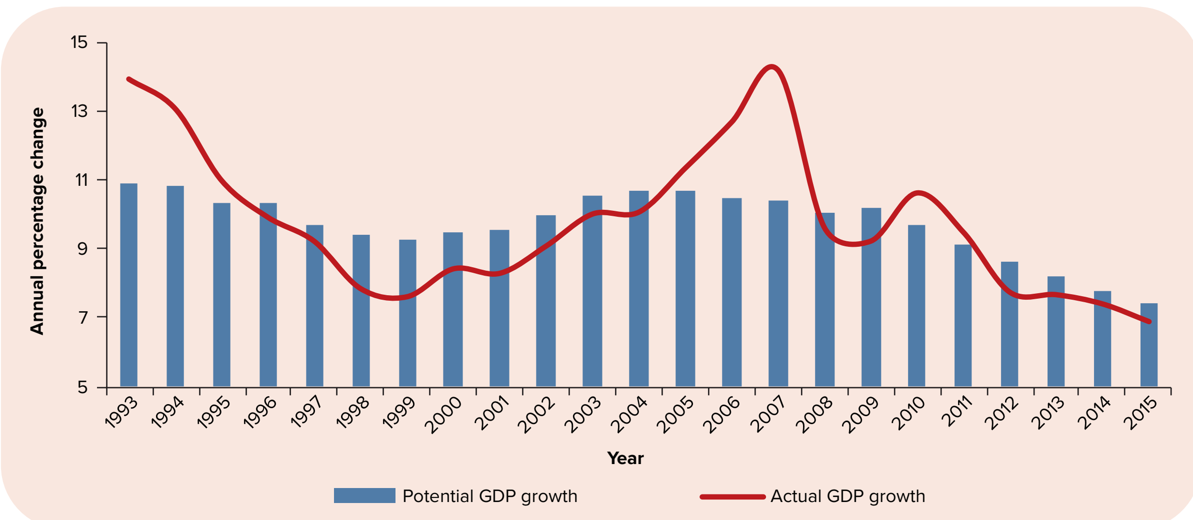
average of global growth. The red bars show the contribution of domestic demand to China's GDP growth, in excess of GDP growth. So, for example, in 2009 GDP growth in China would have been 5.5 percentage points higher if all domestic demand growth would have been translated into GDP growth. In reality, however, net exports subtracted 5.5 percentage points from GDP growth. The implication of that negative contribution of net exports was that China, on a net basis, stimulated demand in the rest of the world.

China's slowdown likely reflects slower growth of productive capacity, which has important implications for the impact on the global economy. Rapid growth in China had been driven by technological catch up in the manufacturing sector and an abundant supply of unskilled labor, as workers in the countryside were attracted to higher-paying jobs in manufacturing centers. Maintaining the pace of expansion is becoming difficult, however, as the gap with the technological frontier narrows and labor becomes scarcer. The growth rate of productive capacity, as estimated by a production function with filtered trends in total factor productivity[1], appears to be falling (figure 2.2).

The slowdown in potential growth is confirmed by recent data on exports. The volume of exports from China did not increase during the last 12 months, while growth during the preceding 10 years, including the period of the great recession, had averaged 8 percent per year. Instead of gaining market share in global trade, as it did for several decades, China is now losing market share. Apparently, it is difficult for Chinese companies to continue to increase their competitiveness vis-à-vis foreign suppliers.

A productivity-led slowdown in China has mixed implications for the rest of the world. Slower export growth increases opportunities for producers of manufactures in other countries, who find it easier to compete with China at home and in third countries. On the other hand, China's imports also are decelerating, which reduces effective demand in the rest of the world, especially for

FIGURE 2.2 **Slowdown in China coincides with decelerating potential growth**



Source: World Development Indicators, World Bank, and calculations by the authors

the exporters of natural resources in the ECA region. Slower export growth by China also hurts consumers worldwide, who had benefited from cheaper goods due to fast productivity growth in China.

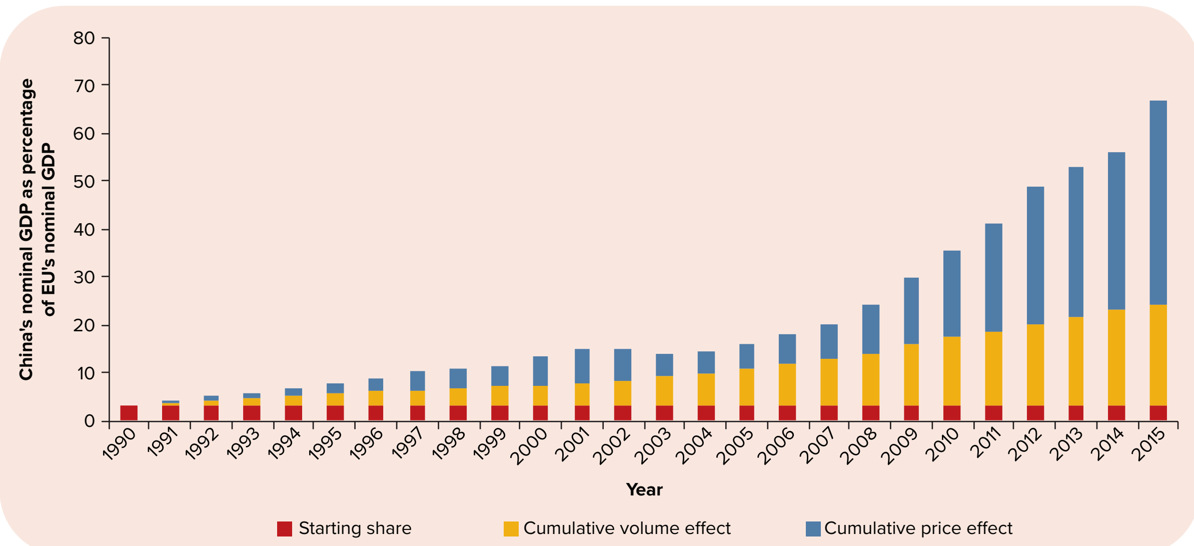
The massive domestic stimulus and increasing scarcity of low-skilled labor has driven a real appreciation of China's currency, which has become the main reason for rising incomes in China. China's GDP increased in nominal terms from only 3 percent of the GDP in the European Union in 1990 to 65 percent in 2015 (figure 2.3). In the 17 years before the global financial crisis, almost 60 percent of the relative increase of China's GDP was caused by faster volume growth. The remainder was the result of real appreciation.[2] Between 2008 and 2015, however, more than 70 percent of the relative rise in China's GDP was caused by real appreciation in China vis-à-vis the European Union. This real appreciation is consistent with the description of the sharp slowing of China's export growth since the global crisis as a supply shock.

Rebalancing in China

Ongoing structural changes in China's economy may have an even greater impact on the global economy than the slowdown in China's productivity growth. These structural changes are needed to either correct built-up imbalances, or to prepare for future growth in more advanced and higher value-added segments of the global economy. Three changes will have a particularly significant impact on the ECA region: the shift from investment to consumption, the shift from inward to outward FDI, and the shift from low-skill intensive to high-skill intensive production.

The coming decline in China's investment rate has important implications for ECA. Prior to the financial crisis, the level of China's investment was roughly appropriate given its rapid growth. During the 1990s, investment averaged close

FIGURE 2.3 China is catching up to the European Union



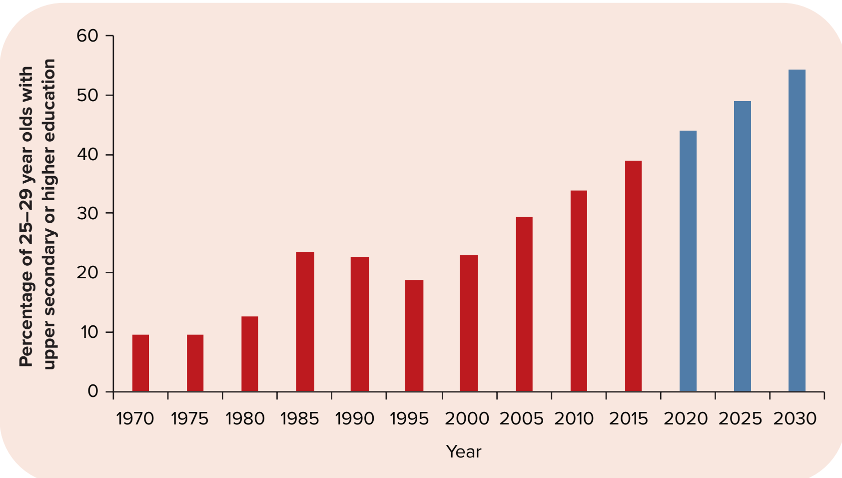
Source: World Development Indicators, World Bank, and calculations by the authors

to 35 percent of GDP, typical for an economy growing at rate of 10 percent per year. In 2003, at the start of the global boom, China's investment rate increased to around 40 percent, which supported an acceleration of GDP to 12 percent per year during the boom. However, after the global financial crisis China's investment rate increased to 45 percent, while GDP growth declined. Given that lower growth path, the current investment rate may be 15 percentage points above its equilibrium level. This implies a rapid increase in the capital output ratio, inevitably leading lower return to that capital. Even if the adjustment is smooth and China is able to increase consumption at the same pace as it decreases investment, the consequences for the Europe and Central Asia of this rebalancing can be significant. The challenges are especially large for the German economy, which is specialized in the production of investment goods, and which has a large share of China's market.

Likely increases in outward FDI from China represent an important opportunity for many countries in ECA. Only a few years ago outward FDI from China was negligible, while inward FDI was around 3 percent of China's GDP. This has changed dramatically. In 2015 outward FDI amounted to US$ 167 billion, roughly 70 percent of inward FDI. Soon outward FDI is expected to exceed inward FDI. The rapid rise of direct investment abroad reflects an internationalization of Chinese companies that will allow them to capture a larger part of the higher end of the value chain. While in the past Chinese firms gained access to foreign technology and to international markets through inward FDI, they are increasingly gaining this access through outward FDI, as many other economies that moved towards high-income status have done before. Of particular importance to the eastern part of the ECA region is China's objective to develop a new Silk Road connecting Asia and Europe.

China's comparative advantage is shifting from low-skilled to high-skill manufactures. Education levels have risen sharply in China over the past 15 years, increasing the supply of high-skilled workers (figure 2.4). In addition, the aging of China's population and slower internal migration from rural to urban

FIGURE 2.4 Since 2000 education levels in China are sharply increasing



Source: World Development Indicators, World Bank, and calculations by the authors

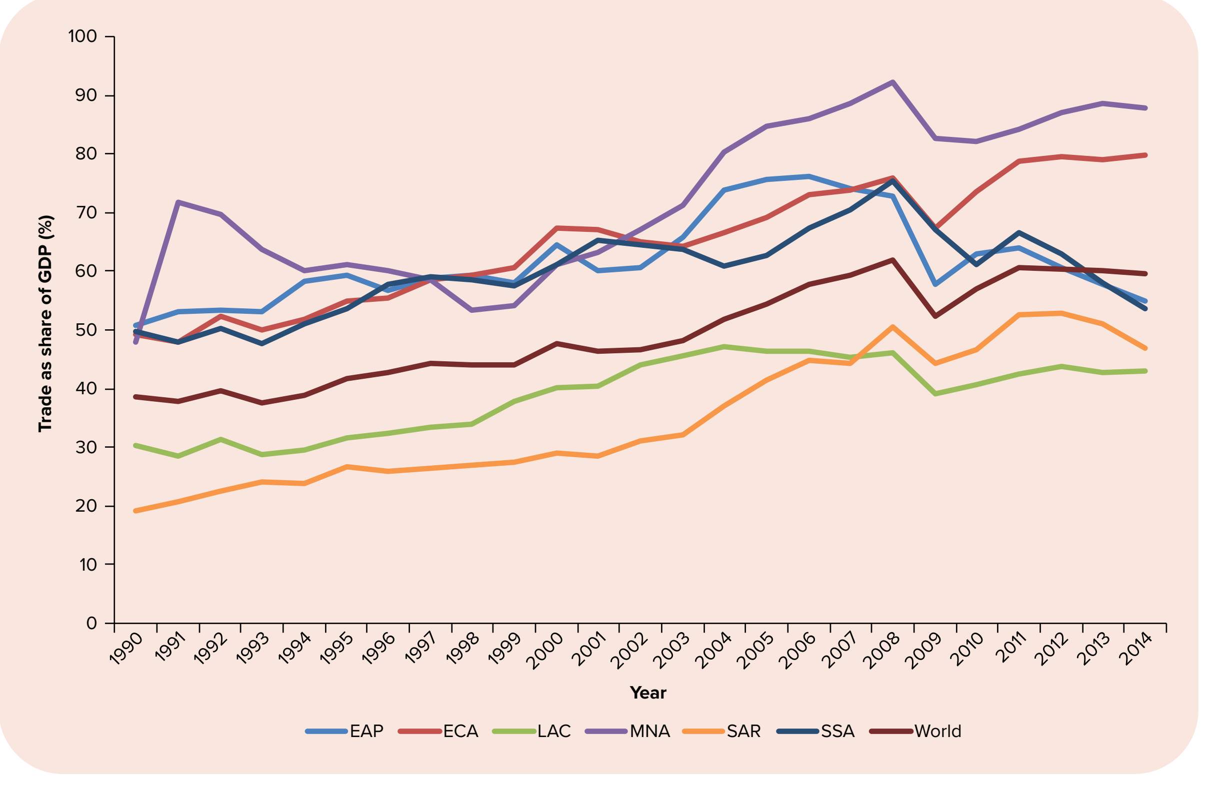
areas is making labor less plentiful. These changes in China will have a significant impact on the international division of labor. Central Asia will find it easier to compete with China in sectors where China historically has been strong. On the other hand, China increasingly will become competitive in sectors where Europe used to have a comparative advantage.

2.3 ECA's links with China

ECA has become more open to trade and is more open than other regions. Both exports and imports from ECA increased by almost two and a half times from 1995 to 2014, at constant prices. By 2014, total trade equaled 80 percent of GDP, making ECA (after the Middle East and North Africa) the region most open to trade (figure 2.5). However, ECA countries trade more with each other than with the rest of the world: two-thirds of ECA's imports come from other ECA countries, reflecting proximity, integration of countries within the European Union, and the historical ties among the countries that were members of the Soviet Union.[3]

China's trade with ECA has grown rapidly over the past 20 years, and China is ECA's largest import partner outside of the region. China's share of ECA's

FIGURE 2.5 ECA has become more open to trade and is more open than other regions



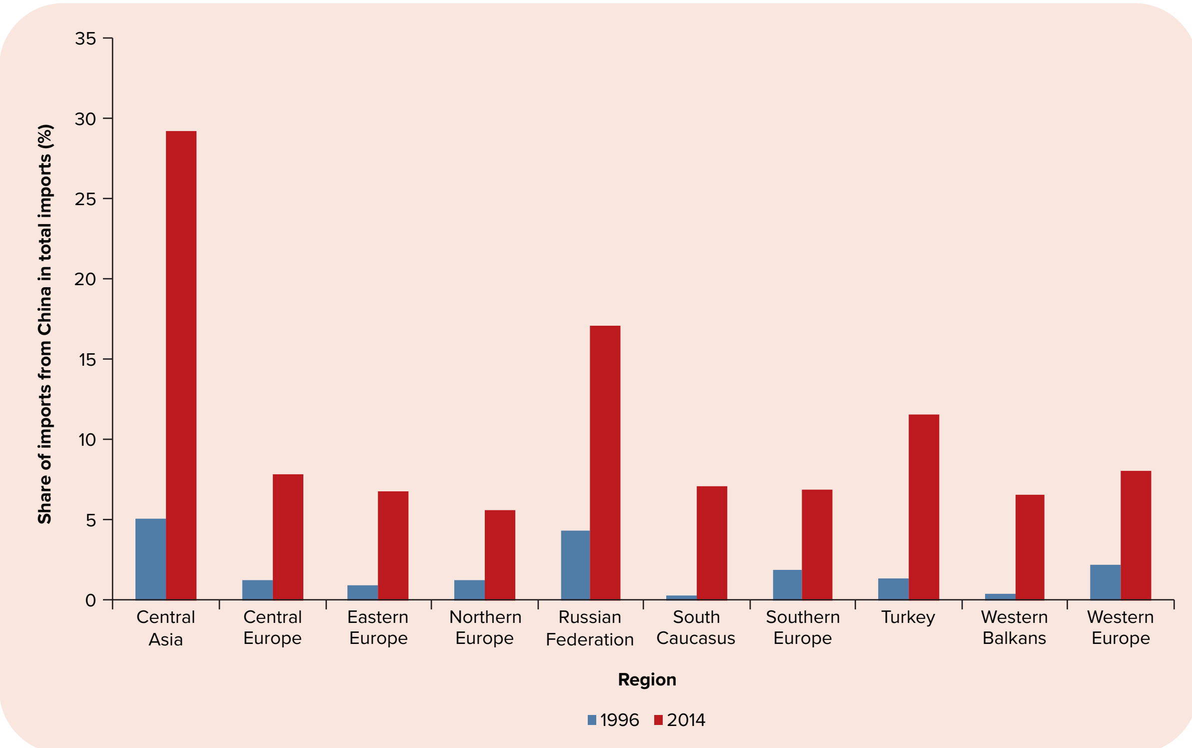
Source: World Development Indicators, World Bank, and calculations by the authors
Note: EAP=East Asia and the Pacific, ECA=Europe and Central Asia, LAC=Latin America and the Caribbean, MNA=Middle East and North Africa, SAR=South Asia, SSA=Sub-Saharan Africa.

imports increased from 2 percent in 1996 to 8 percent in 2014. Within ECA, the countries in Central Asia have experienced the largest increase in the share of imports coming from China, from 5 percent in 1996 to 29 percent in 2014. [4] But China's share of imports also increased sharply in Russia (from 4 percent to 17 percent) and Turkey (1 percent to 12 percent), and more than tripled in every ECA sub-region (figure 2.6). Fully 98 percent of ECA's imports from China are manufactures, mostly imported by Western Europe.

China's share of ECA exports has also increased but by less than for ECA's imports. In 2014, ECA's exports to China were 4.5 percent of the total, or only about three-fifths of ECA's exports to North America and about the same level as exports to the Middle East and North Africa. Again, Central Asia and Russia have the strongest trade ties with China: China's share of Central Asia's exports was 19 percent, and its share of Russian exports 8 percent (figure 2.7).

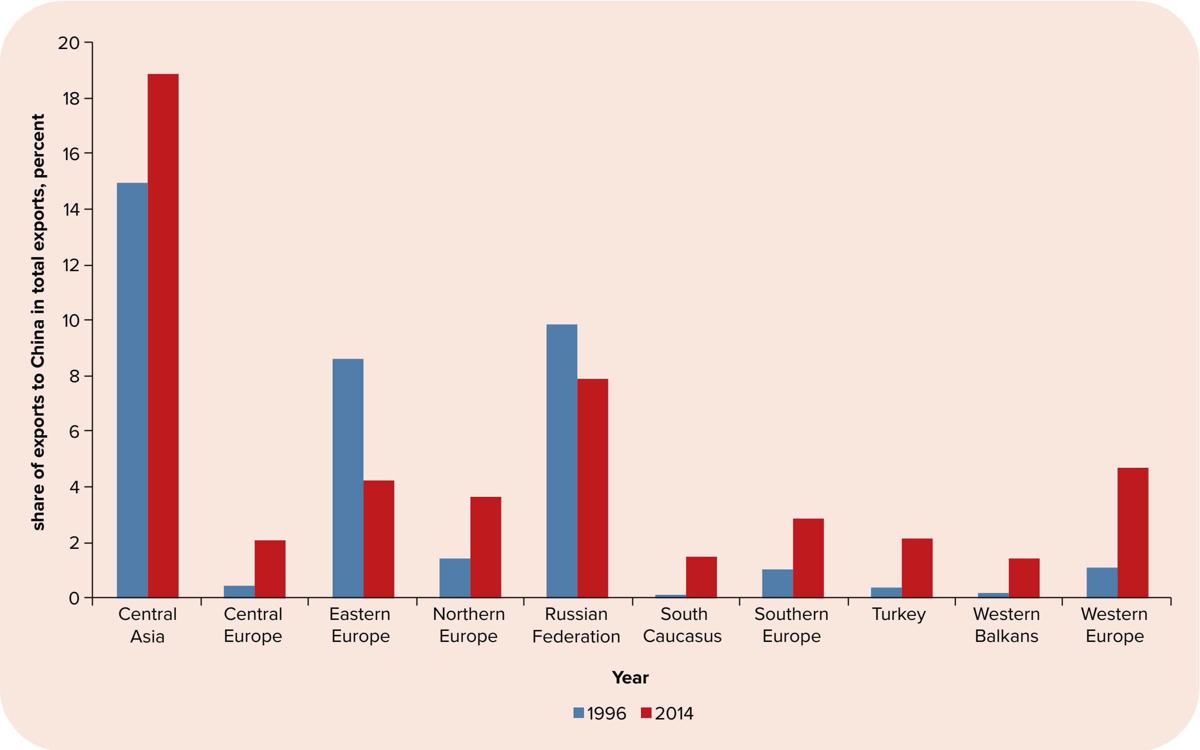
The composition of ECA's exports to China has shifted towards natural resources. The share of natural resources exports (coal and coal products, oil and petroleum, natural gas and minerals) in ECA's exports to China increased from 1 percent in 1996 to 12 percent in 2014 (figure 2.8). This largely reflects the boom in production of natural resources during this period in Central Asia and Russia, and leads to an increase of natural resources in exports not only to China but also

FIGURE 2.6 China's share of imports by ECA has expanded rapidly, 1996–2014 (share of imports from China in total imports, percent)



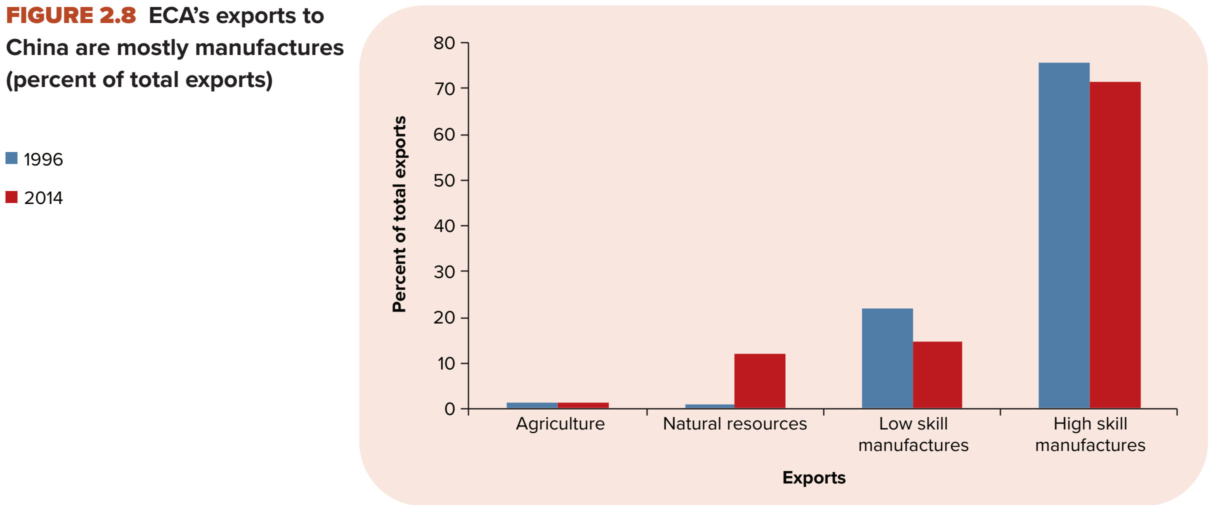
Source: UN COMTRADE, United Nations, and calculations by the authors
Note: See Annex A for regional classification

FIGURE 2.7 **China's share of ECA's exports is less than its share of imports, 1996–2014 (share of exports to China in total exports, percent)**



Source: UN COMTRADE, United Nations, and calculations by the authors
Note: See Annex A for regional classification

FIGURE 2.8 **ECA's exports to China are mostly manufactures (percent of total exports)**

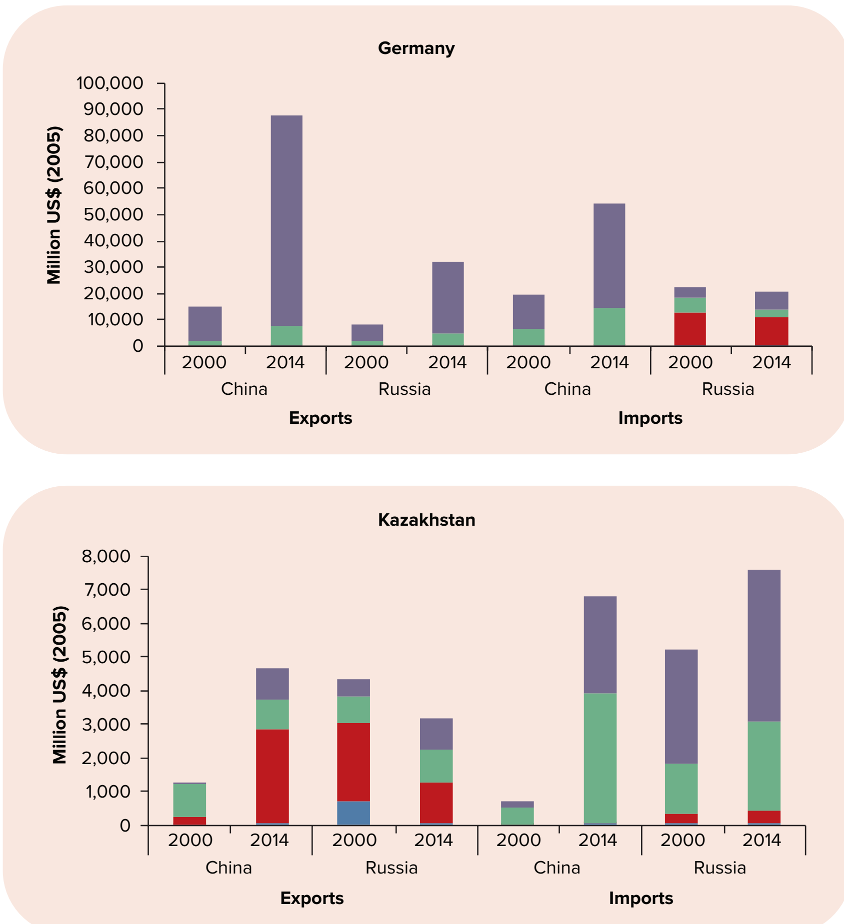


Source: UN COMTRADE, United Nations, and calculations by the authors
Note: See Annex A for sectoral classification

to the rest of the world. If developments in China affect the world prices of natural resources, this may have implications on ECA's exports of natural resources not only to China, but also to the rest of the world. Nevertheless, while China is more likely to affect prices of non-oil resources, for example, metals, its weight in the oil and gas market is less dominant, and the latter account for a much larger share of exports, both in growth and levels. Furthermore, ECA's exports to China remain mostly high-skilled manufactures, largely from the European Union. High-skilled manufactures accounted for 72 percent of ECA's exports to China in 2014, down only slightly from 76 percent in 1996.

The experience of Germany and Kazakhstan illustrate the intensification of ECA's trade with China. Together with Russia, China has been among the top export destinations and import origins for most ECA countries. Nevertheless, its importance as a trade partner has increased significantly compared with other top trade partners within and outside the region. Germany's exports to China increased by almost six times from 2000 to 2014 at constant prices, compared to almost four times to Russia (figure 2.9). Most of Germany's exports to both countries were high-skilled manufactures. Kazakhstan's exports to China more than

FIGURE 2.9 Germany's and Kazakhstan's trade with China increased sharply, 2000–14 (constant prices)

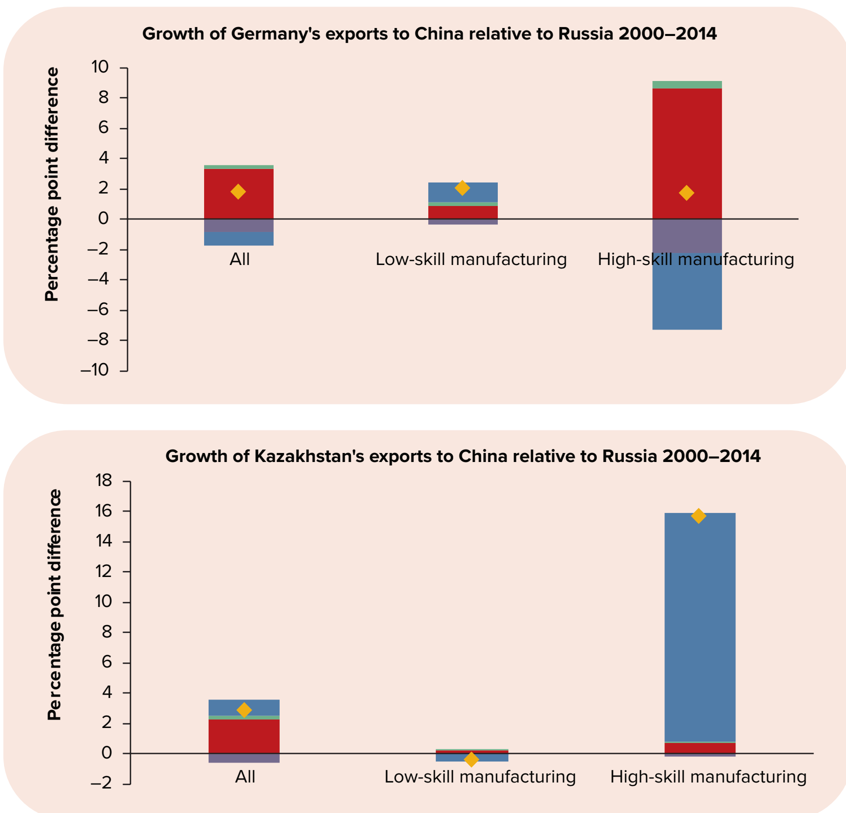


Source: UN COMTRADE, United Nations, and calculations by the authors
Note: See Annex A for sectoral classification

tripled, largely reflecting increased exports of natural resources, while Kazakhstan's exports to Russia declined by around a quarter, as natural resource exports almost halved. This may reflect growing self-sufficiency in Russia due to oil, gas, and minerals discoveries. Similarly, imports from China by both Germany and Kazakhstan increased much more rapidly than imports from Russia over 2000 to 2014 (Germany's imports from Russia actually declined slightly).[5]

For both Germany and Kazakhstan, the more rapid increase in exports to China than to Russia from 2000 to 2014 was due to more rapid growth in GDP per capita in China. The result of the gravity model described in Box 2.1 indicates that a major factor that drives the intensification of trade between ECA and China is the higher GDP growth in China, compared with that of other trade partners such as Russia. This growth is partially offset by the smaller real depreciation of the currencies of Germany and Kazakhstan against the renminbi than the ruble, which favored trade with Russia (figure 2.10). There are, of course, other factors that cannot be explained in the model which drive the growth of exports to China. For high-skilled manufactures, for example, these factors reduce the percentage point difference in the rate of growth between Germany's exports to China and to Russia. In Kazakhstan, by contrast, the more rapid growth in high-skill manufactures exports to China than to Russia is almost entirely due to unexplained factors.

FIGURE 2.10 More rapid growth of exports to China than to Russia reflected China's booming per capita income

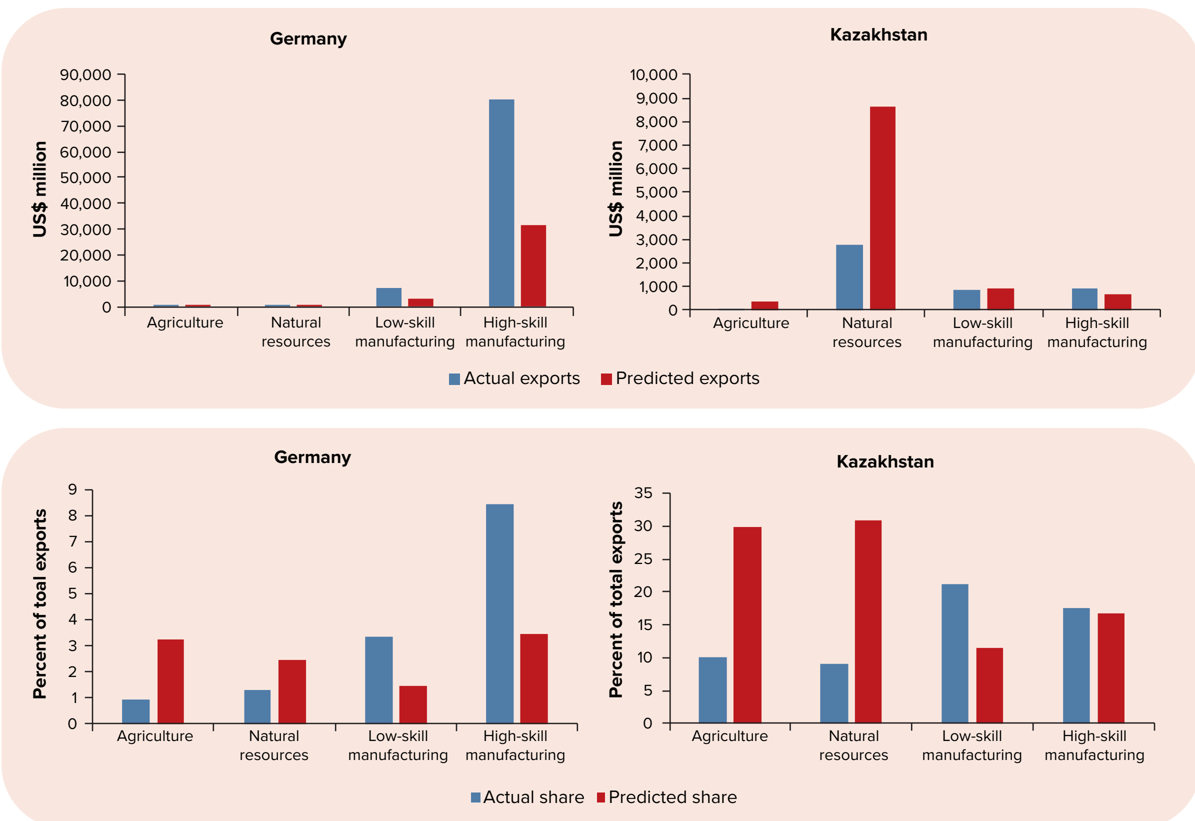


GDP per capita
Population
Relative exchange rate
Other
Total change

Source: Results from the gravity model with data from UN COMTRADE, United Nations
Note: See Annex A for sectoral classification

Kazakhstan appears to have considerable potential to increase exports to China, while Germany may not. By 2014, the level of Germany's manufactures exports to China were more than twice the level predicted by the fundamental determinants of trade represented in the gravity model, including the economic and population sizes of the both Germany and China (the supply and demand factors) as well as other historical and economic links between them such as colonial link, common language, belonging to the same regional trade agreement, and the distance between the two countries. Thus, the potential for further increases of German exports to China may be limited. On the other hand, the actual exports of Kazakhstan to China, particularly in agriculture and natural resources, are lower than the values predicted by the gravity model, and the differences can be a significant share of total Kazakhstan exports (19.8 and 21.8 percent of total agriculture and natural resources exports, respectively) (figure 2.11). The difference between the predicted and actual exports can be due to many country-specific factors, such as relative productivity or institutional framework, many of which can be influenced by policies. In other words, Kazakhstan may have a significant opportunity to boost exports to China going forward.

FIGURE 2.11 Kazakhstan has greater potential than Germany to increase exports to China (exports to China at constant prices)



Source: UN COMTRADE, United Nations, and calculations by the authors
Note: Predicted level of trade based on gravity model with data from UN COMTRADE, United Nations. See Annex A for sectoral classification.

BOX 2.1 Using a gravity model to explain trade

The gravity model is an econometric approach to explaining trade relationships between two countries on the basis of their size, distance, and other variables. The model is inspired by Newton's Gravitational Law which states that the gravitational force between two objects is proportional to their masses and inversely proportional to the square of the distance. Key appealing features of the gravity approach, as applied to international trade, are that (i) it takes into account the supply side—i.e. that trade flows are determined, amongst other variables, by the GDP of the exporting countries—and (ii) that countries with similar economic size trade more with one another (similar tastes between countries with close levels of development). In the version of the model used here, bilateral trade flows are estimated as a function of GDP per capita and population of origin and destination countries, the real exchange rate and distance between the two countries, and whether they are contiguous, have a colonial link, have a common official language, are both in the European Union, or participate together in another regional trade agreement. The model also includes dummy variables for the year and country, to control for influences on trade that are specific to a particular year (e.g. the global financial crisis) and country. Separate estimations are done for agricultural products, natural resources, low-skilled manufactures, high-skilled manufactures, and total trade.

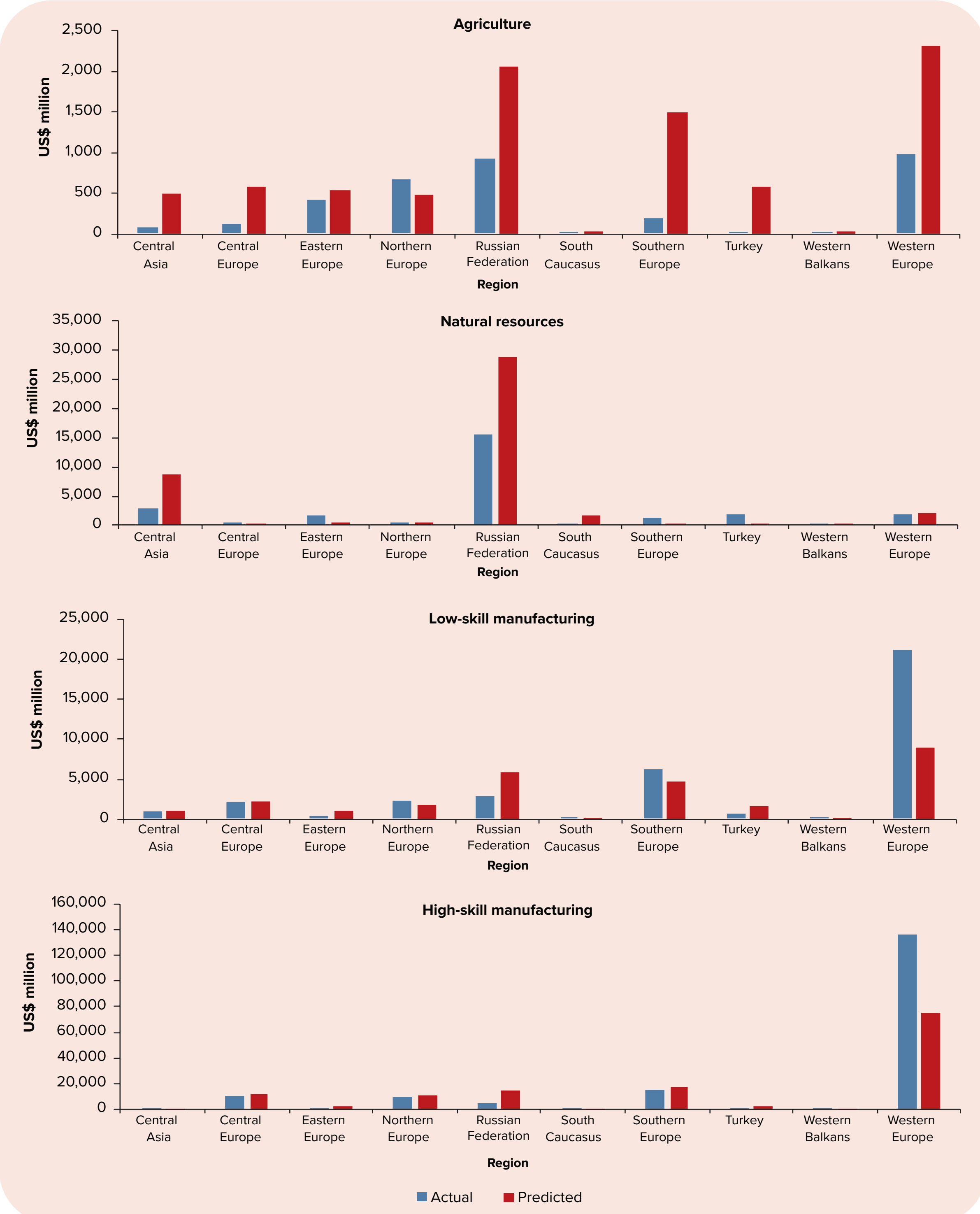
The relationship between trade in each of the commodity groupings listed above and the independent variables is estimated using a bilateral trade matrix encompassing most countries of the world for the period 1996–2014 (see Annex A for more details). In the main text, we use the gravity model to explain both the evolution of trade over time and the level of 2014. The estimated coefficients can also be used to conduct 'simulations'. In other words, it is possible to answer questions like: "what would be the impact on trade flows if the real exchange rate were to change while all other variables remain fixed?"

The gravity model has achieved considerable success in explaining trade relationships since its introduction by Jan Tijnbergen in 1962.[6] One limitation of the model used here is that the results cannot take into account some of the endogenous relationships. While most of the independent variables are truly exogenous (e.g. distance), the real exchange rate is not. Thus, the change in trade flows generated by a change in the real exchange rate will not reflect the impact of the real exchange rate change on GDP. Another drawback is that each bilateral flow is modeled as independent of other. For example if an income shock to China causes its exports to Germany to decline, the gravity model does not allow the other trade partners of Germany to fill in this potential gap.

Exports remain well below potential in several ECA countries. Applying a similar analysis to the ECA region as a whole, several countries appear to have substantial opportunities for intensifying their trade with China. In 2014, exports to China from Russia, the South Caucasus, and Central Asia were at or below predicted across all four sectors (agriculture, natural resources, low-skilled manufactures, and high-skilled manufactures), and exports to China from Turkey, Eastern Europe, and Western Balkans were at or below predicted in three out of the four (figure 2.12). By contrast, Western Europe's exports of manufactured goods (which make up the bulk of their exports) considerably exceeded prediction.

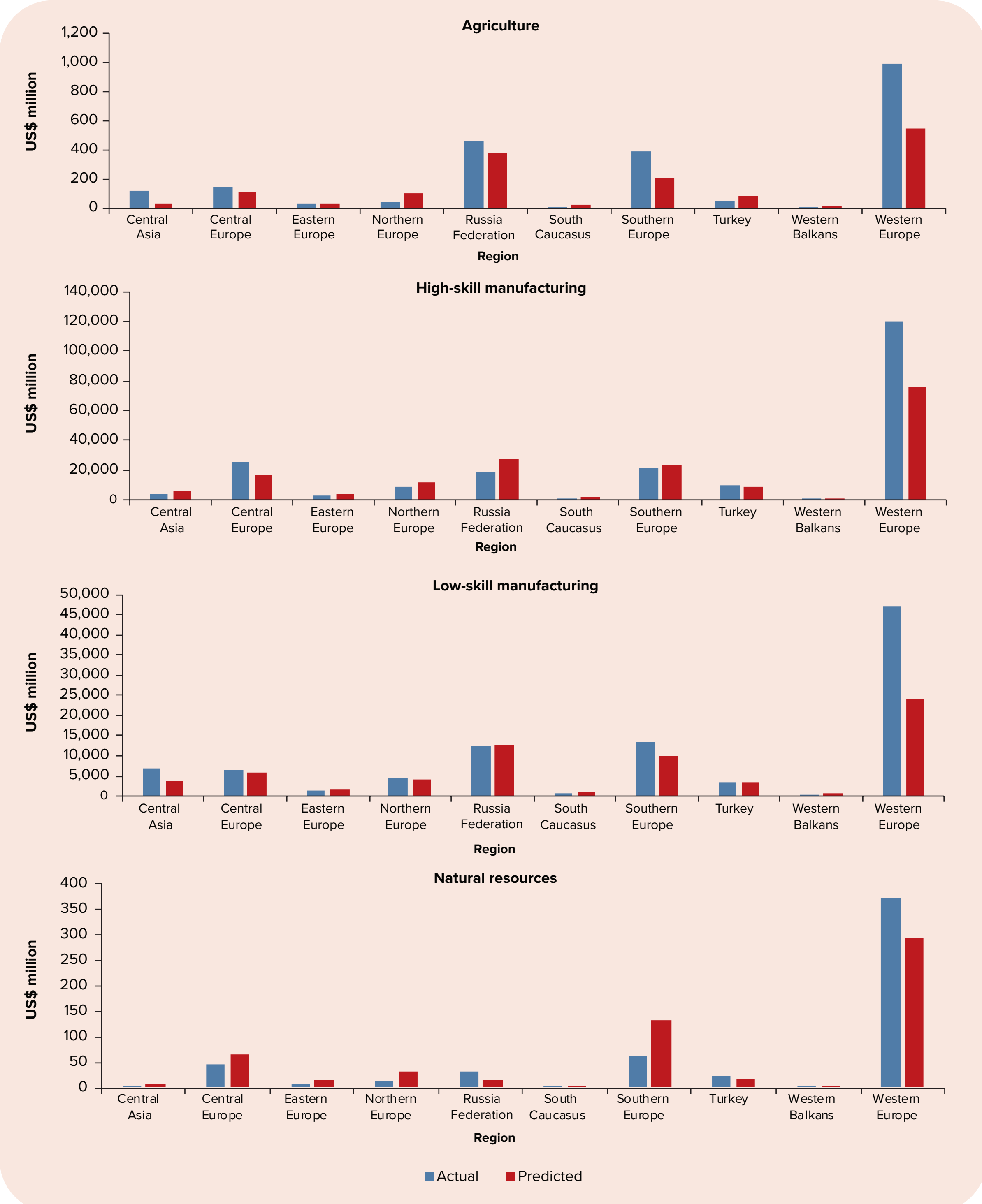
ECA's imports from China in 2014 were much closer to prediction than were ECA's exports to China. For example, the actual level of ECA's imports of low-skilled manufactures from China was either close to or significantly above prediction in all sub-regions (figure 2.13). The actual level of ECA's imports of high-

FIGURE 2.12 **Eastern ECA may have greater potential than western ECA to increase exports to China (exports to China by sector from ECA sub-regions)**



Source: UN COMTRADE, United Nations, and calculations by the authors
Note: Predicted exports based on gravity model with data from UN COMTRADE, United Nations. See Annex A for sectoral and regional classification.

FIGURE 2.13 China's potential to increase import penetration in ECA is limited (imports from China by sector from ECA sub-regions)



Source: UN COMTRADE, United Nations, and calculations by the authors
Note: predicted level of imports from China based on gravity model with data from UN COMTRADE, United Nations. See Annex A for regional and sectoral classification.

skilled manufactures from China was slightly lower than predicted in a few of the sub-regions, although the differences were small. This may indicate that China's ability to further penetrate ECA's domestic markets is limited, and more so in high-skilled than in low-skilled manufactures.

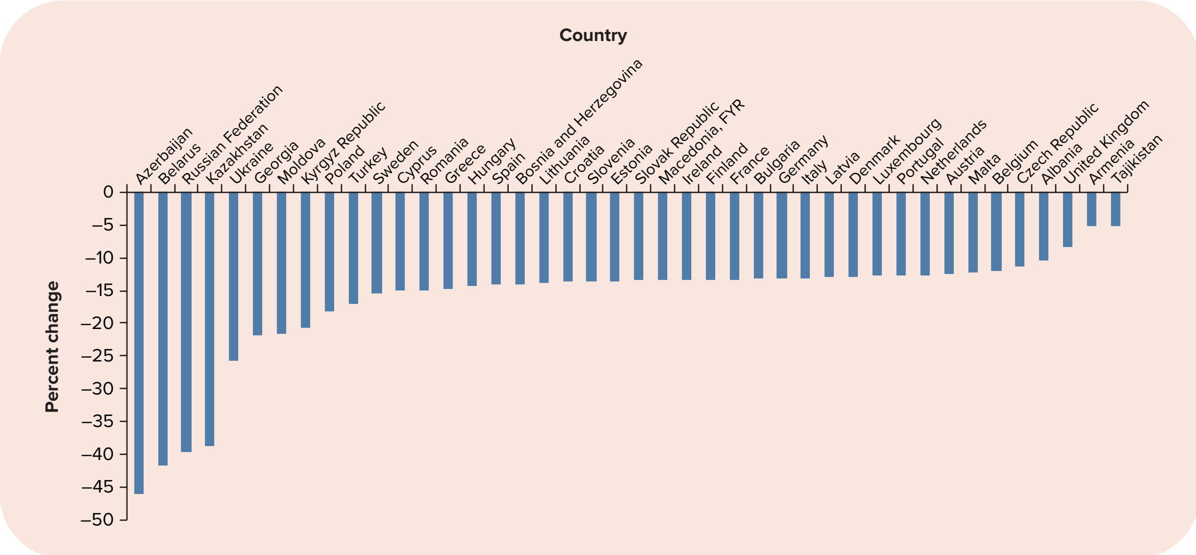
In summary, many ECA countries appear to have considerable potential to export more to China, while China's import penetration of ECA's markets is likely to slow. Countries in eastern ECA have particularly low levels of exports relative to what is estimated by the gravity model. Exports to China from the more developed countries of Western Europe, however, appear to be close to or higher than potential, indicating more limited opportunities for future export growth.

2.4 Gaining competitiveness vis-à-vis China

Exchange rate depreciation through early this year significantly increased the competitiveness of ECA's tradable production. The recent decline in the oil price has sharply reduced economic activity in oil-exporting countries in ECA, which in turn has reduced exports from, and remittances inflows to, other countries in the region. While lower oil prices represent a significant welfare loss for these countries, adjustment to lower oil prices also creates opportunities. Falling export revenues and remittances receipts drove currency depreciations in these countries that were much greater than differences in inflation rates with major trading partners. In addition, other ECA countries also experienced currency depreciation in 2015, for example due to slow recovery in the European Union and the crisis in the Ukraine. Thus, the competitiveness of domestic production of tradables, both vis-à-vis imports and in export markets, improved in all ECA countries. Given the continued real appreciation of the renminbi against most major currencies, the real depreciation of ECA's currencies vis-à-vis China's has been large, ranging from about 5 percent for Tajikistan to 46 percent for Azerbaijan (figure 2.14).

Exchange rate depreciation, however, does not automatically result in an increase in the domestic production of tradables. Entrepreneurs have to be able to shift investment to tradables, and workers have to move into jobs in tradables sectors with rising wages. Thus, limits on firm start up (e.g. due to a cumbersome or corrupt administrative machinery handling necessary approvals), a low level of financial sector development, and rules that discourage hiring (e.g. requirements of excessive termination payments) can slow the output response to exchange rate depreciation. Such impediments may be particularly important in oil-exporting countries, where the dominant role of government during a prolonged period of high oil prices may have encouraged rent seeking and discouraged entrepreneurial activity. On the other hand, it is important to avoid underestimating the potential for increases in domestic production of tradables in response to a large real depreciation. The competitive position of most ECA countries has changed radically over the past year, and a major goal of policy should be to facilitate the changes in economic structure that are necessary to capitalize on this opportunity.

FIGURE 2.14 **ECA currencies depreciated sharply over past year (percent change in real exchange rate with China, Jan–Feb 2015 to Jan–Feb 2016)**



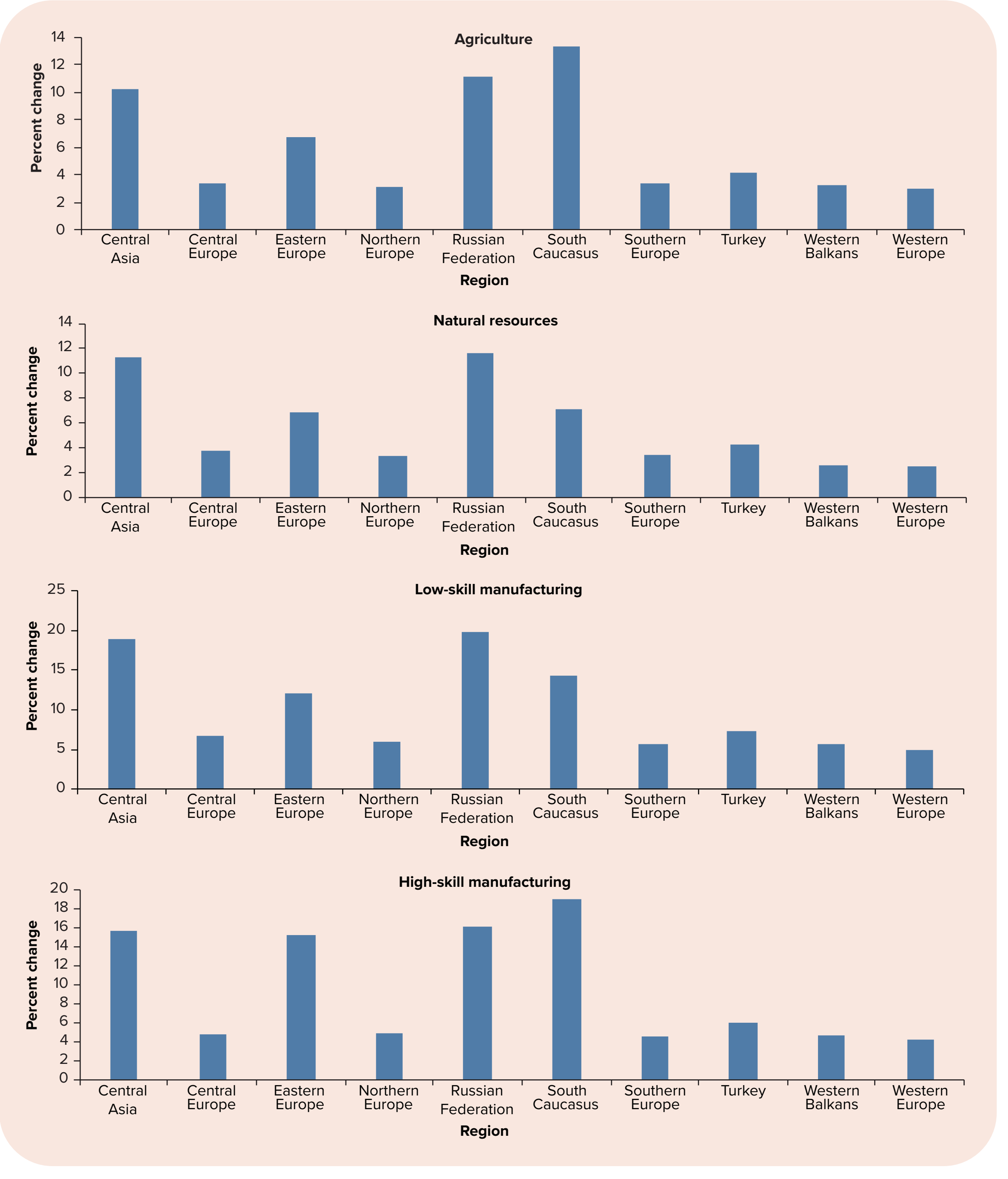
Source: Global Economic Monitor, World Bank, and calculations by the authors
Note: The 2016 exchange rate data are not available for all countries, in which case the latest data (in 2015) are used.

The increase in the potential level of oil-rich ECA's total exports as a result of the real depreciation of currencies in early 2016 is expected to be significant. For example Central Asia and Russia are expected to increase their total manufacturing exports by more than 10 percent.[7] The increase in potential exports to China is even greater, because ECA exchange rates depreciated by more in real terms against the renminbi than against the average of other currencies.

The magnitude of the increase in potential exports differs substantially across ECA countries. The currencies of Russia and most countries in Central Asia, South Caucasus and Eastern Europe experienced the largest real depreciation against the renminbi, and thus the estimate of the rise in their potential exports to China is relatively large (figure 2.15). By contrast, the increase in potential exports from countries that experienced a more limited real depreciation with China, for example Western Europe, is relatively small.

The change in export potential due to depreciation varies by sector. Producers of manufactures often can respond relatively quickly to increased demand due to exchange rate depreciation, as importers switch to their (now cheaper) products. However, producers of oil and minerals may respond more slowly, given the time required to develop new deposits or to upgrade transport infrastructure. While the speed of the response to changes in demand will vary (producers with excess capacity may respond quickly), nevertheless the estimated relationships between price changes and the supply response will tend to be smaller in natural resources than in manufactures.[8] For example, the real depreciation of the ruble against the renminbi increases Russia's potential exports of natural resources to China by 11.6 percent, but Russia's potential exports of low-skilled manufactures to China by over 19 percent.

FIGURE 2.15 Exchange rate depreciation could boost ECA's exports to China (percent change in volume of total exports)



Source: based on gravity model with data from UN COMTRADE, United Nations, and Global Economic Monitor, World Bank.
Note: The figure shows the percentage change in potential exports from each region in each sector estimated by the gravity model, as a result of the real depreciation experienced from early 2015 to early 2016. See Annex A for more details on the simulation, and regional and sectoral classification.

The depreciation of ECA currencies also opens opportunities for increasing domestic sales of tradable goods. As the price of domestic products declines relative to Chinese products, consumers and firms in ECA will switch from imports to domestic production. Russia and countries in Central Asia, South Caucasus and Eastern Europe experience the largest percentage reductions in potential imports, although the percentage declines in imports of agricultural goods are substantially less than the declines in manufactures. Interestingly, all sub-regions except Russia and Central Asia experience a rise in imports of natural resources due to the depreciation. This results from the increased supply of natural resources from Russia and Central Asia (which are major suppliers to other ECA sub-regions), where the real exchange rate depreciation was quite large (figure 2.16).

2.5 How does China's growth slowdown affect ECA?

As discussed in section 2.2, China is experiencing a structural transformation marked by lower productivity growth and a rebalancing of its economy. These transformations in China present the ECA region with both challenges and opportunities, which differ across countries, sectors, and factors (low-skilled workers, high-skilled workers, and capital). This and the next section use a computable general equilibrium model (see box 2.2) to calculate the impact on ECA

BOX 2.2 Computable general equilibrium model

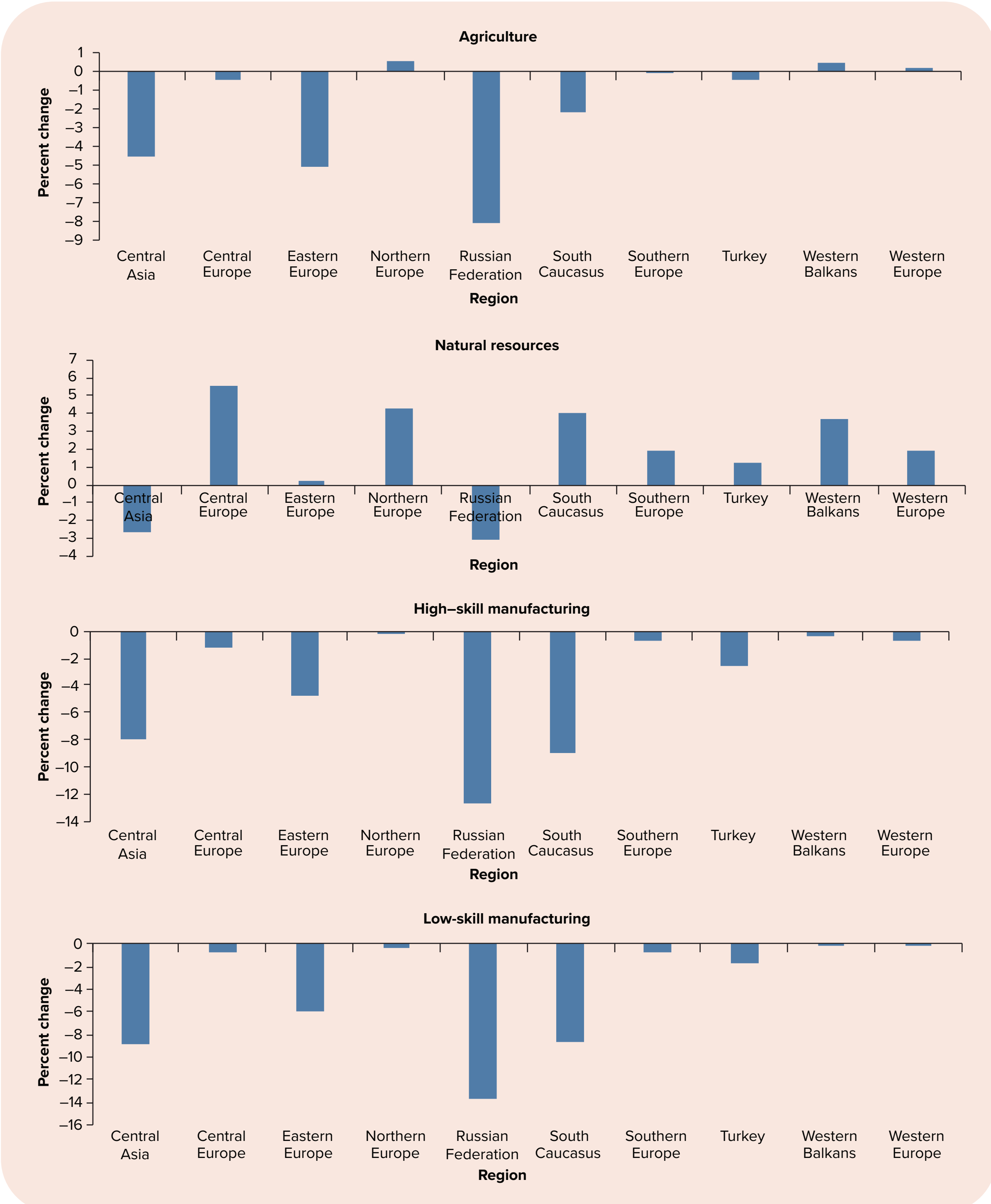
The impact on ECA of changes in China, in this section and the next, is simulated with a computable general equilibrium model (CGE). The CGE is based on a base year data matrix that traces the flows between sectors within each ECA sub-region and between ECA sub-regions and abroad. Firms purchase factors (for example labor and capital) and intermediate inputs to produce goods and services. Payments to factors of production are allocated to households (after taxes), and households use this income to purchase the goods and services produced by firms. The government sector receives all net tax payments and purchases goods and services.

In each scenario, changes in exogenous variables, for example productivity growth, are imposed and the model is solved as a sequence of comparative static equilibria, where the factors of production are exogenous in each time period and linked to the next time period through identities. For example, the capital stock in period two equals the capital stock in period one plus investment and minus depreciation in period one. Similarly, the labor force in period two equals the labor force in period one, plus new entrants and minus those retiring.

The CGE assumes that markets clear, so that the equality of supply and demand determine equilibrium prices for factors, goods and services. For example, all workers are employed, so that a change in demand for labor is reflected in changes in the wage rate and not in changes in unemployment. Thus, the results presented in the main text do not take into account frictions that could increase unemployment or idle machines as labor and capital shift to new production. The CGE model provides an order of magnitude estimate of the impact of a slowdown in China once all economic actors have completed their adjustment to the new equilibrium. The model should not be viewed as providing information on changes in economic activity during the adjustment process.

Note: For a description of the CGE model used in this chapter, see ENV-Linkages Model, Version X.04, by Dominique van der Mensbrugghe with Jean Chateau, Rob Dellink and Francois Chantret.

FIGURE 2.16 **Exchange rate depreciation has created opportunities to compete with imports (percent change in potential imports as a result of real exchange rate depreciation in ECA)**

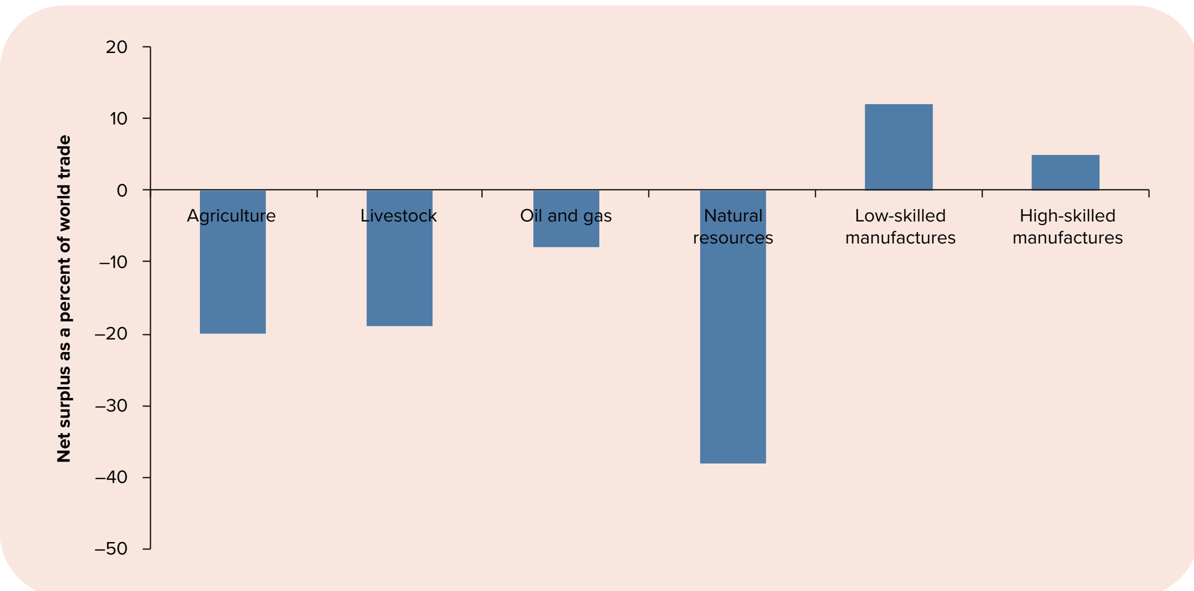


Source: Based on gravity model with data from UN COMTRADE, United Nations, and Global Economic Monitor, World Bank.
Note: The figure shows the percentage change in potential imports to each region in each sector estimated by the gravity model, as a result of the real depreciation experienced from early 2015 to early 2016. See Annex A for more details on the simulation, and regional and sectoral classification.

countries of slower economic growth in China and of its rebalancing. These changes of the Chinese economy are intended as experiments. They address 'what if' questions and should not be considered forecasts of the most likely future path of the Chinese economy.[9] For example, this section compares a business as usual (BaU) scenario with an alternative where GDP growth is 3 percentage points a year lower over a period of 10 years. While, as shown in figure 2.2, potential GDP growth in China has probably already decreased by close to 3 percentage points between 2000–2010 and 2011–2015, the 3 percentage points difference between the BaU and the alternative scenario should not be interpreted as a forecast of a further drop, but simply as a what if question.

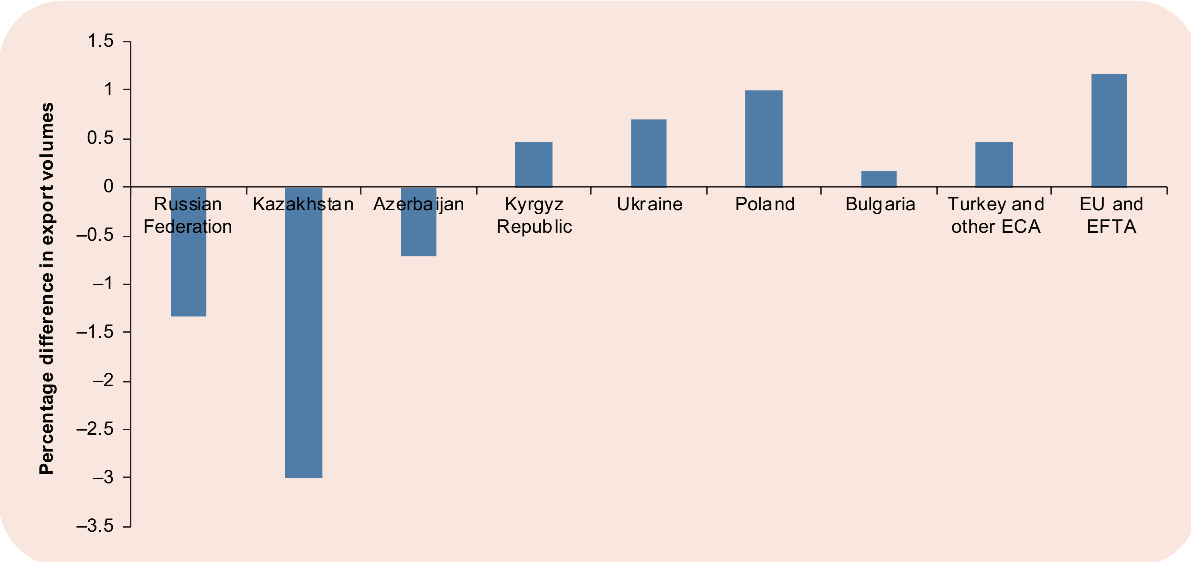
A reduction of economic growth in China—coming from a deceleration of productivity growth that is uniform across sectors—is transmitted to the world economy as both a decline in import demand from China and a reduction of export supply from China. China's specialization determines which sectors and countries will be most affected by China's slower growth in demand and exports. In 2016, China is projected[10] to run a large deficit in primary commodities, particularly natural resources where the deficit reaches 38 percent of world trade (figure 2.17). At the same time, China's net surplus is projected at 12 percent and 5 percent of world trade for low-skilled and high-skilled manufactures, respectively. Thus, slower growth in China will tend to reduce demand for the products of countries that specialize in primary commodities, but also reduce the competition faced by countries that specialize in manufactures. In sum, a Chinese economy growing at a slower pace represents a challenge for some sectors or countries, and an opportunity for others.

FIGURE 2.17 China imports primary goods and exports manufactures (net surplus as a percent of world trade, 2016 Business as Usual)



Source: Author's calculation based on CGE simulations
Note: See Annex B for sectoral classification.

FIGURE 2.18 **China's slowdown has a mixed impact on ECA's exports (percentage difference in export values in slowdown compared to business as usual scenario)**



Source: Author's calculation based on CGE simulations.
Note: Percent differences between the two scenarios are calculated in 2025 (i.e. after 10 years of slower growth). See Annex B for regional classification.

A slowdown in China would have a significant impact on trade in ECA (figure 2.18). China is an important destination of exports from the eastern part of the region—10 and 24 percent of total exports of Russia and Kazakhstan, respectively, go to China—while the western part of the region is less dependent on demand from China. Thus the fall in exports to China would affect the eastern part of ECA more than the west.

The fall in China's demand would particularly hit exporters of primary commodities, mostly from the east. The eastern part of the region is more specialized in the production and exporting of natural resources and agricultural products, and China's demand for these products would fall sharply relative to the business as usual scenario. The slowdown reduces China's total import demand for oil and gas by about 12 percent, while China's supply of these products is basically unchanged. A similar demand shock is registered when agricultural products are considered: Chinese demand shrinks by 9 percent, while China's supply of agricultural products falls by 7 percent. Exporters of agricultural products and natural resources can find new markets, or expand market share in existing ones, to substitute for lower demand from China. However, this would require reducing their prices, so the scope for such substitution is limited.

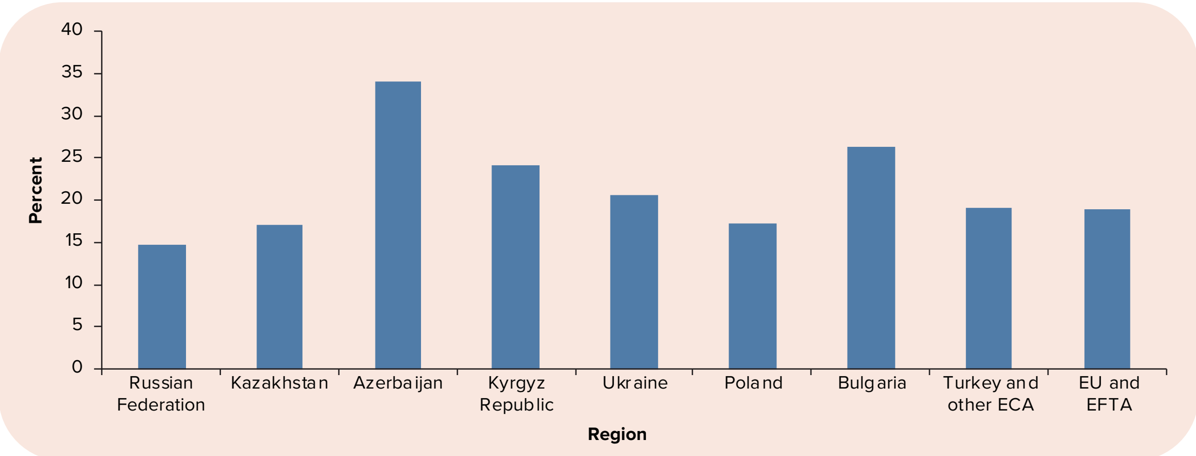
Countries in the western part of ECA can benefit from the slowdown in China. Countries such as Poland, Bulgaria, and members of the European Union tend to specialize in high-skilled manufactures. The slowdown reduces China's imports of these goods by 7 percent, but also reduces China's exports of these goods by almost 11 percent. The demand for ECA's exports of high-skilled manufactures rises in third markets (in the simulation compared to the business as usual scenario), as China's exports of high-skilled manufactures become rela-

tively more expensive. Overall, exports from countries in the western part of ECA would rise due to the slowdown in China's GDP. This calculation of the impact on both primary commodity and manufactures exports represents a structural shift in demand, and does not reflect short-term disruptions that could occur (see box 2.2).

Countries where export production accounts for a larger share of output and employment will experience a larger impact on their domestic economy, for good or ill, from the slowdown in China. About 13 percent of global production (including intermediate goods) is traded. However, some sectors are more 'open' than others. Trade in natural resources (metals, mineral, oil and gas) tends to be quite large relative to sectoral output, as production is concentrated in a limited number of countries; on average a third of global production of natural resources is traded. High-skilled manufacturing (i.e. heavy manufacturing and investment goods) also is quite open, with again almost a third of its production being traded. By comparison, only about 20 percent of total production is traded in low-skill manufacturing sectors (food products, textile and other light manufacturing). Agricultural sectors tend to be even less open, because many countries pursue policies of self-sufficiency in food production and agricultural trade is more distorted than trade in other goods.

This pattern also can be seen in ECA countries. Countries that specialize in oil and gas may export more than half of that sector's output. The differences across ECA regions in total export to production ratios are not great, in part because in most countries the share of services that is exported is low compared to other sectors, while services tend to account for a large share of production. Nevertheless, countries in the less developed, eastern part of ECA have somewhat higher ratios of exports to production (although Russia is an important exception) than countries in the more developed, western part of ECA (figure 2.19). Thus, the (negative) impact on GDP of China's slowdown will be slightly greater in the east than the (positive) impact on GDP in the west.

FIGURE 2.19 **Share of exports in GDP is larger in the east (forecast of 2016 export to GDP ratio at current prices, percent)**



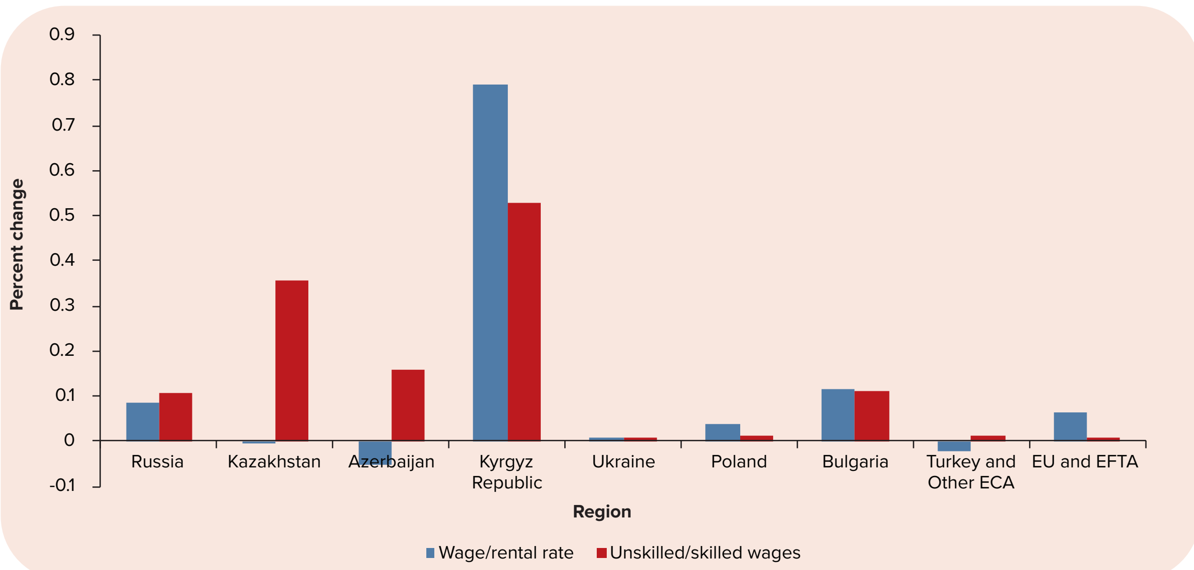
Source: Author's calculation based on CGE simulations
Note: Exports are taken from the national income accounts, and hence include both goods and services. See Annex B for sectoral classification.

A slowdown in China also would affect the terms of trade of ECA countries. As China's demand for imports slows, its terms of trade will rise by 2.4 percent (an improvement equal to 0.6 percent of GDP) compared to the business as usual scenario. Terms of trade changes for countries in the western part of ECA would be minimal. Lower demand from China will reduce the prices of oil, gas, and minerals that these countries import, which would balance some decline in the prices of their manufactured exports as they switch from China to other markets (and the increase of prices of Chinese goods still imported by the western countries of ECA)[11]. Countries in eastern ECA, however, will experience a decline in the price of their oil, gas and minerals exports as China's demand slows. Lower prices on their exports will result in a real depreciation of the exchange rate in most countries of eastern ECA, while real exchange rate changes will be small in the western part of ECA.

China's deceleration would benefit lower skilled workers versus high-skilled ones, and labor vis-à-vis capital. China specializes in the production of low-skilled manufactured goods, so a slowdown in China's export growth will increase demand for the goods produced by low-skilled workers in other countries, thus improving their wages relative to high-skilled workers (figure 2.20). At the same time, reduced demand from China for relatively capital-intensive goods such as oil, gas, and minerals, would reduce the return on capital compared to wages, thus benefiting workers in general. As the impact of the slowdown in China on the terms of trade and real exchange rate is larger in the eastern part of ECA than in the west, the impact on factor prices is also greater in the east.

In summary, slower growth in China would reduce the growth of demand for ECA's oil, gas, and mineral exports, which will particularly affect countries in the eastern part of ECA. While China's demand for the manufactured exports

FIGURE 2.20 China's slowdown improves returns to workers, particularly unskilled workers (percent change in China slowdown versus business as usual scenarios)



Source: Author's calculation based on CGE simulations

also will slow, exporters of manufactures will face reduced competition from China in third markets, leading to an overall rise in their exports compared to the business as usual scenario. Slower demand for capital-intensive goods lowers the return on capital compared to wages, while a reduced supply of China's exports of manufactures increases low-skilled wages relative to high-skilled wages.

While the magnitudes are much smaller, this scenario is in a sense a mirror image of the role that China has played over the past thirty years. Rapid growth in China generated substantial benefits for the world economy, increasing the supply of low-cost goods, providing profitable opportunities for investment by foreign firms, and increasing the efficiency of global supply chains. At the same time, China's entry into global markets had important distributional affects: the rise in the supply of low-skilled manufactures and rapid increase in the demand for capital-intensive products reduced low-skilled wages relative to high-skilled wages, and increased the return on capital relative to wages. Thus, China's rise made some contribution to increasing inequality in the rest of the world. A productivity slowdown in China accompanied by rising wages of low-skilled workers might dampen consumption growth but would also imply a partial reversal of this distributional impact.

2.6 Rebalancing: shifting opportunities

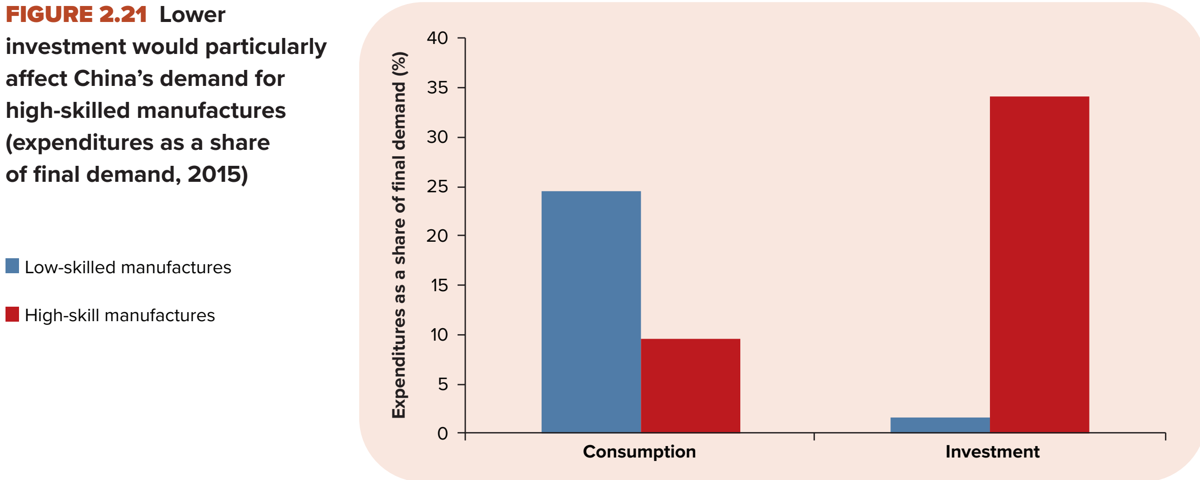
The impact on the global economy of slowing productivity growth in China will depend on the extent of structural change. The scenario in section 2.5 assumed a decline in productivity that was uniform across sectors. In this section, we examine the impact of structural changes in China that would boost growth in the face of the erosion of China's competitive position in low-skilled manufactures. While to some extent such changes will arise spontaneously as productivity slows and low-skilled manufacturing production becomes less profitable, policy reform can facilitate this process.

As discussed in section 2.2, structural changes required for a rebalancing of China's economy that will have a significant impact on ECA include a shift from investment to consumption, rising comparative advantage in high-skill manufactures, and increased outward FDI. The following assumptions are implemented in the CGE model to reflect the rebalancing scenario:

(i) In 2015, investment equaled 42 percent of GDP, compared to 35 percent for consumption (13 percent was government expenditures and the remainder net exports). We assume that the share of investment in GDP will fall by more than 15 percentage points over a period of 10 years, with a corresponding rise in the share of consumption. Slower growth in investment compared to consumption will imply slower growth in demand from China for capital goods, as high-skill manufactures (which are largely capital goods) account for 34.1 percent of investment demand but only 9.5 percent of consumer demand (figure 2.21). Thus, China's demand for capital goods imports is likely to decelerate.

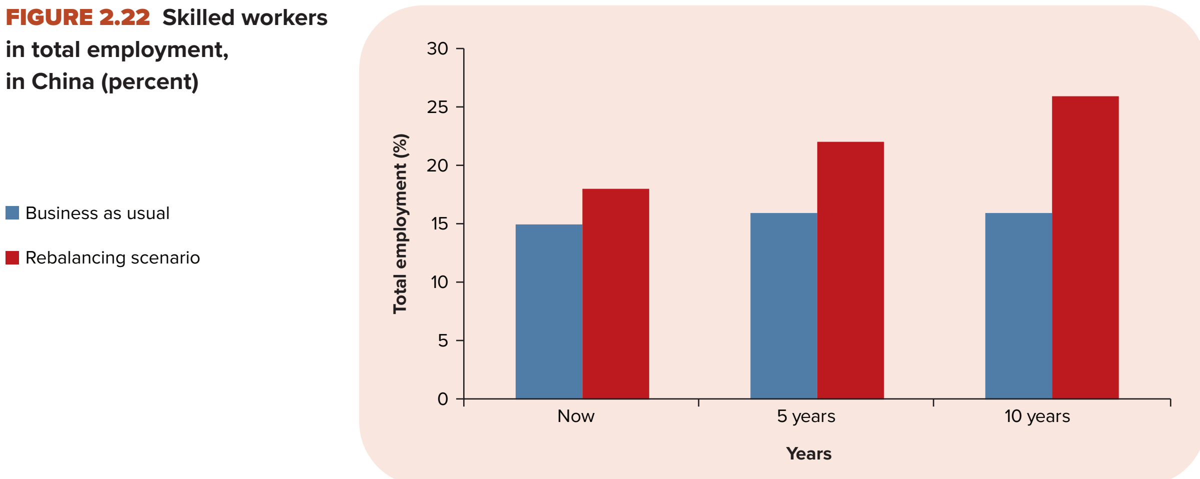
(ii) Greater investment in education will increase the inflow of skilled workers into the labor force. We assume that the share of skilled workers in China will almost double over the next 10 years, implying an increase of 100 million skilled

FIGURE 2.21 Lower investment would particularly affect China's demand for high-skilled manufactures (expenditures as a share of final demand, 2015)



Source: Author's calculation based on CGE simulations

FIGURE 2.22 Skilled workers in total employment, in China (percent)



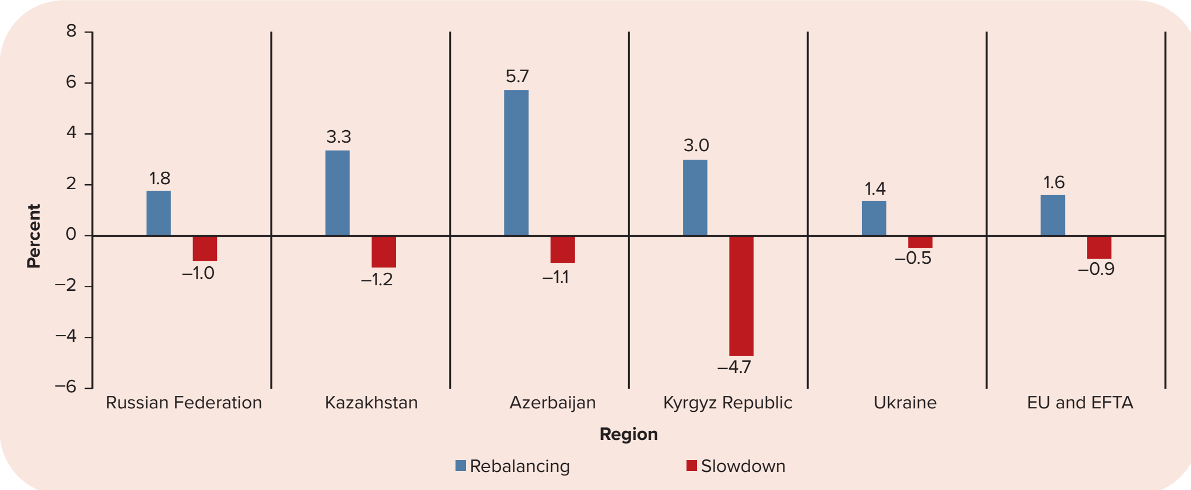
Source: Author's calculation based on CGE simulations

workers (figure 2.22). The increasing share of skilled workers will improve China's comparative advantage in high-skilled manufactures, with important implications for its trade with ECA.

(iii) Finally, the simulation includes a rise of China's FDI outflows equal to 5 percentage points of GDP over the next 10 years. This increase in investment is allocated in proportion to the GDP of countries now receiving FDI from China, with the exception of Central Asia that is receiving larger flows. Higher FDI inflows will increase the capital stock and therefore growth, finance a greater volume of imports, and lead to an appreciation of the exchange rate, which will in turn change both the trade balance and the composition of trade.

The rebalancing scenario has very different effects on ECA countries than the slowdown discussed in section 2.5. Rebalancing would increase household consumption (at constant prices) across the region, while the slowdown scenario would reduce household consumption. The eastern part of the region benefits

FIGURE 2.23 **Change in private consumption relative to business as usual scenario (percent)**



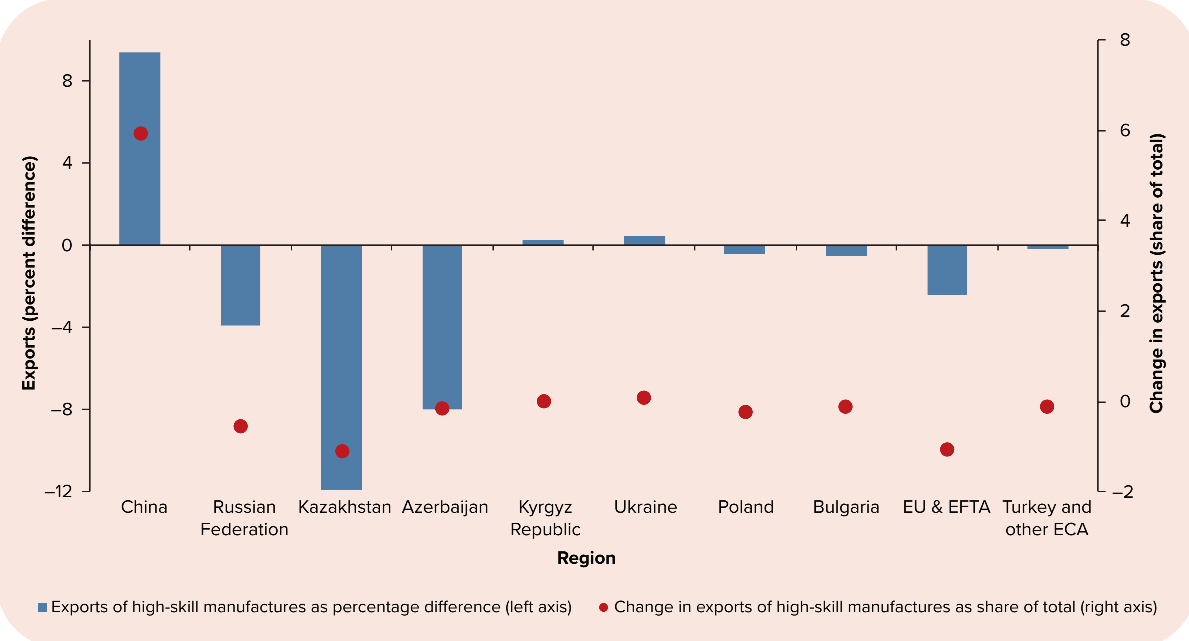
Source: Author's calculation based on CGE simulations

more than the west due to shifts in China's comparative advantage in manufactures (see below). Higher FDI outflows from China are also likely to boost production of natural resources in eastern ECA, while reducing opportunities for profit by multinational firms in the more developed west. The impact on private consumption is quite large for some countries in Central Asia. For example, by 2025 household consumption rises in Azerbaijan by almost 6 percent in the rebalancing simulation (figure 2.23). By contrast, the increases in household consumption in Western Europe are relatively small.

The rebalancing scenario has a particularly large impact on trade of high-skill manufactures. Compared to the business as usual scenario, by 2025 China reduces its imports of high-skill manufactures by 21 percent and increases its exports by 9 percent. The increase in exports is due in part to the increased supply of high-skilled workers, and also because China's increased foreign direct investment outflows raise foreign demand for high-skilled manufacturing, especially by China's close trading partners.[12]

The impact on different countries in ECA of changes in China's demand and supply of high-skilled manufactures depends on both geographic and product specialization. By 2025, for instance, Kazakhstan's exports to China of high-skilled manufactures are 12 percent lower in the rebalancing scenario compared to the business as usual scenario (figure 2.24). While Kazakhstan's exports of high-skill manufacturing represent only 9 percent of total exports, more than half of them are directed to China. Kazakhstan's total exports fall by only 1.1 percent. Western Europe's exports of high-skilled manufactures are only 2.5 percent lower in the rebalancing scenario than in the business as usual scenario. While for Western Europe these exports account for 43 percent of the total value, only 7 percent of them are sold to China. Thus Western Europe's total exports also fall by 1.1 percent. In other words, Western Europe is much more specialized in the production of high-skill manufactures than Kazakhstan (and other Central Asian countries) and so potentially more affected by a drop in demand for these

FIGURE 2.24 **Rebalancing boosts China's exports of high-skilled manufactures and reduces ECA's (percentage difference between rebalancing and business as usual scenarios)**

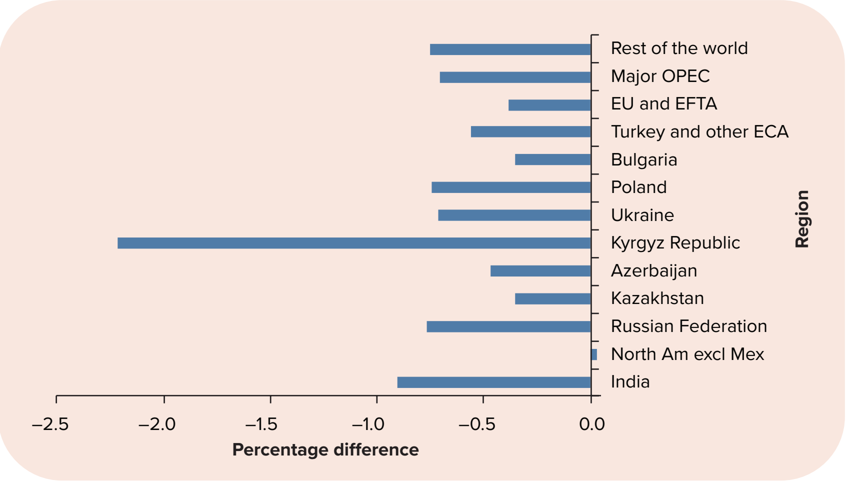


Source: Author's calculation based on CGE simulations
Note: Percent differences between the two scenarios are calculated in 2025 (i.e. after 10 years of rebalancing). See Annex B for regional classification.

goods. But, at the same time, Western Europe is much more diversified in terms of geographic destinations, and thus a Chinese reduction in demand is not as significant.

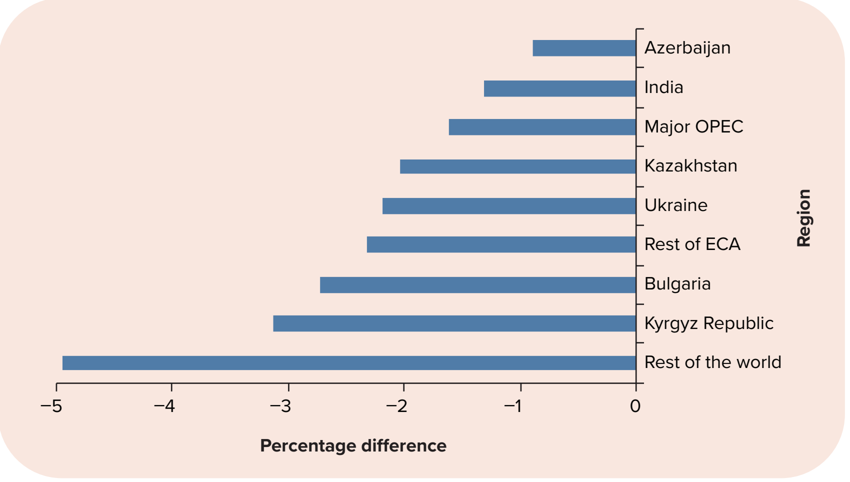
The rebalancing scenario, and specifically the increased share of skilled workers in China, would reduce inequality in the global economy. The entry of about 100 million new skilled workers in China economy affects the premia that educated workers command over unskilled ones. China begins importing a lower amount of skilled intensive products and actually increases its exports of these products to all trading partners. This reduces the wages of skilled (and generally higher income) workers relative to unskilled (and generally lower income) workers. The skill premium falls in all country groupings, with the exception of North America (figure 2.25). For some, such as the Kyrgyz Republic, the premia decreases by more than two percentage points.[13] This is the result of the expansion of sectors that use more intensively unskilled workers, mainly agriculture and manufacturing.[14] For similar reasons, the urban premium (the gap between wages of unskilled workers employed in manufacturing and services versus wages of those employed in agriculture) falls in the rebalancing scenario compared to the business as usual scenario. In other words, the specialization of production towards exportables and specifically towards agriculture increase demand for unskilled workers whose wages are then bid up (figure 2.26). The shift from investment to consumption in China also reduces demand for capital goods (most of which are high-skill manufactures), and thus reduces the return on capital vis-à-vis labor.

FIGURE 2.25 **China rebalancing reduces the skill premium globally (percentage difference in skill premium between rebalancing and business as usual scenarios)**



Source: Author's calculation based on CGE simulations
Note: Percent differences between the two scenarios are calculated in 2025 (in this figure only the change in the share of skilled workers is accounted for, i.e. the increase of consumption and large capital outflows are excluded). See Annex B for regional classification.

FIGURE 2.26 **China skilling reduces the return on urban occupations for unskilled workers (percentage difference between wages of unskilled in urban versus rural occupations in rebalancing versus business as usual scenarios)**



Source: Author's calculation based on CGE simulations
Note: Percent differences between the two scenarios are calculated in 2025 (in this figure only the change in the share of skilled workers is accounted for, i.e. the increase of consumption and large capital outflows are excluded). See Annex B for regional classification.

2.7 Conclusions

China is important for ECA. ECA's imports from China have grown rapidly over the past two decades, and China is now ECA countries' largest import partner outside the region. ECA's exports to China also have increased, albeit at a lower rate than imports from China. China is also a significant competitor for ECA's export products in third markets, and has a large influence on the global prices of ECA's natural resources. Exports from many countries in eastern ECA remain well below the level predicted by the gravity model, indicating considerable potential to expand their exports going forward. By contrast, in most countries in

western ECA, exports are close to or above the level predicted by the gravity model, indicating less potential for expansion.

Going forward, changes in China's large, dynamic economy will offer important opportunities and challenges for ECA economies. The impact of China on individual ECA countries will vary greatly, depending on the structure of each economy. Three scenarios are explored to measure this impact: a real depreciation in ECA currencies, based on the 2015 experience; a productivity slowdown in China; and a rebalancing of the Chinese economy. The principal lessons for ECA from these scenarios include:

- All ECA currencies depreciated significantly in real terms against the renminbi in 2015, increasing the competitive position of ECA products in China, in third markets, and in ECA's domestic economies.
- A continuing slowdown in productivity in China would erode the competitive position of countries in eastern ECA. Slowing demand for their natural resource exports would reduce their export volumes and lower their terms of trade. By contrast, lower productivity growth in China would improve the competitive position of exporters of manufactures, thus benefiting the more developed countries of western ECA. Lower productivity growth in China also would imply shifts in the distribution of income towards wages versus capital and towards low-skilled workers versus high-skilled workers, particularly in eastern ECA.
- A rebalancing of the Chinese economy towards more rapid growth in consumption and efforts to increase production of high-skilled manufactures would tend to benefit eastern ECA more than western ECA. Exports of high-skilled manufactures from more developed countries in western ECA would face greater competition from China, while the demand for low-skilled manufactures from less developed ECA countries could increase.

Reviewing the opportunities and challenges offered by ECA's economic relationship with China provides important information for policy. Extracting the maximum benefit from, and limiting the adverse effects of, changes in export opportunities due to shifts in China's comparative advantage requires flexible labor and capital markets. This underlines the importance of policy reforms to improve flexibility. Even with current policies, however, ECA economies have considerable potential to capitalize on these opportunities. Recognizing this potential, and understanding the magnitude and direction of changes generated by ECA's trade relationships with China, can provide important support for the reforms necessary to improve welfare.

Annex A: Gravity Model

Gravity model

The gravity model covers 208 countries and territories and spans the period of 1996–2014. Trade data come from the UN Comtrade. The real exchange rates come from the Global Economic Monitoring database. GDP per capita and population are taken from the World Development Indicators database. Following Anderson (2011), the model employs a Poisson Pseudo-Maximum Likelihood (PPML) technique to take into account the many zeros in the data. The estimation equation and results are summarized below.

$$
\begin{aligned}
Ln(trade_{ijt}) = \alpha + \beta_1 \ln(real\ exchange\ rate) + \beta_2 \ln(real\ GDPpc_{it}) \\
+ \beta_3 \ln(real\ GDPpc_{jt}) + \beta_4 \ln(pop_{it}) + \beta_5 \ln(pop_{jt}) \\
+ \beta_6 \ln(distance_{ij}) + \beta_7 contiguous_{ij} + \beta_8 colonial\ link_{ij} \\
+ \beta_9 common\ language_{ij} + \beta_{10} EU_{ijt} + \beta_{11} other\ RTA_{ijt} \\
+ \beta_{12} WTO_{it} + \beta_{13} WTO_{jt} + Z_i + Z_j + Z_t + u_{ijt}
\end{aligned}
$$

Where $Ln(trade_{ijt})$ is the trade between origin country i and destination country j at time t. Z_i, Z_j, and Z_t are country and year fixed effects.

TABLE A1 Gravity Model Results

	Agriculture	Natural resources	Low-skill manufacturing	High-skill manufacturing	All sectors
Ln(real exchange rate)	−0.22***	−0.23***	−0.39***	−0.32***	−0.32***
Ln(GDP per capita 2005 USD_origin)	−0.27***	0.35***	−0.02***	0.62***	0.40***
Ln(GDP per capita 2005 USD_destination)	1.29***	1.04***	0.88***	0.96***	0.97***
Ln(Population origin)	−1.09***	0.61***	0.34***	−0.17***	0.32***
Ln(Population destination)	1.39***	0.98***	1.42***	0.34***	0.56***
Ln(distance)	−0.69***	−1.02***	−0.56***	−0.54***	−0.54***
Contiguous	0.63***	0.50***	0.66***	0.47***	0.55***
Colonial link	0.44***	0.77***	0.43***	0.13***	0.22***
Common language	0.08***	0.30***	0.25***	0.20***	0.20***
Other Regional Trade Agreement	0.52***	0.58***	0.54***	0.57***	0.58***
European Union	1.37***	0.71***	1.15***	0.93***	0.95***
1 if origin is GATT/WTO member	−0.12***	0.03***	0.25***	0.23***	0.20***
1 if destination is GATT/WTO member	0.26***	0.60***	0.01***	0.21***	0.18***
Constant	5.61***	−15.66***	−15.60***	2.67***	−4.61***
Observations	411,728	301,408	472,639	479,037	486,723

Simulation of potential export changes based on exchange rate depreciations

We calculate the real exchange rate depreciation for each country pair in the sample for the period between January 2015 and February 2016. The expected percentage change in exports is the product of the real exchange rate elasticity for each sector, estimated from the gravity equation, and the actual real exchange rate change. This expected percentage change in exports is applied to the 2014 bilateral trade flow for each pair of trading partners (the latest trade data available). The results are then aggregated for each country and region. Thus the combined effect on exports depends not only on the size of the real exchange rate change but also on the pattern of trade of each country or region, that is, the effect is larger if a country appreciated / depreciated against an important trading partner. For example, despite similar levels of real depreciation in Russia and Central Asia against the world as a whole, the expected percentage increase of total exports in Russia is larger than in Central Asia. This is partly explained by the fact that Russia is a major trading partner for the Central Asian economies which did not depreciate vis-à-vis Russia. On the other hand, the Central Asian economies account for a relatively small share of total Russian exports.

The expected impact of the real depreciation in ECA on the region's exports is calculated assuming that all other determinants of trade in the gravity equation remain the same as in 2014. This assumption is unlikely to hold in reality. The large oil price decline, which was one of the drivers of the real depreciations in the Eastern part of the region in the last two years, will likely have important effects on the real economy which could in turn impact trade flows (likely in the opposite direction of the real exchange rate impacts). This simulation therefore reflects only the partial impact of the real exchange rate change on bilateral trade flows.

Regional and sectoral classification

The gravity model results, when aggregated to the regional groups, use the regional classification as shown in table 0.1 on the page xi.

TABLE A2 Sectoral classification

Sector aggregate	Sector
Agriculture	Paddy rice, Wheat, Cereal grains nec, Vegetables, fruit, nuts, Oil seeds, Sugar cane, sugar beet, Plant-based fibers, Crops nec, Bovine cattle, sheep and goats, horses, Animal products nec, Raw milk, Wool, silk-worm cocoons, Forestry, Fishing
Natural resources	Coal, Oil, Gas, Minerals nec, Petroleum, coal products
Low-skill manufacturing	Bovine meat products, Meat products nec, Vegetable oils and fats, Dairy products, Processed rice, Sugar, Food products nec, Beverages and tobacco products , Textiles, Wearing apparel, Leather products, Wood products, Mineral products nec, Ferrous metals, Metals nec, Metal products, Manufactures nec
High-skill manufacturing	Paper products, publishing, Chemical, rubber, plastic products, Motor vehicles and parts, Transport equipment nec, Electronic equipment, Machinery and equipment nec

Source: Sectors are classified according to ISIC Rev. 3. The sector aggregates are classified according to Lakatos et al. (2015).
Note: nec=not elsewhere classified

References

Anderson, James E. 2011. "The Gravity Model," *Annual Review of Economics* 3(1): 133–160.

Lakatos, Csilla, Maryla Maliszewska, and Israel Osorio-Rodarte. 2015. "China's Slowdown and Rebalancing: Potential Growth and Poverty Impacts on Sub-Saharan Africa." Mimeo.

Annex B: Computable General Equilibrium Model

Additional Tables

This annex provides more detailed information on the initial situation of trade flows and the impact of the slowdown in China as simulated using the CGE model.

The following tables illustrate the initial situation in terms of trade flows. The first two tables show the global market share of importers (table B1), of exporters (table B2) by broad category of good and service, i.e. how much each country imports or exports as a share of total world imports and exports.

TABLE B1 Global market share by importer and good (%)

Importer:	Agriculture	Livestock	Oil Gas and Refined oil	Natural resources	Low-skill Manuf	High-skill Manuf	Low-skill Services	High-skill Services	Total Trade
China	22	23	10	39	6	10	6	3	10
India	2	1	6	7	3	2	2	3	3
North Am excl Mex	8	8	16	3	15	17	11	15	15
Russian Federation	2	2	0	1	2	2	2	2	2
Kazakhstan	0	0	0	0	0	0	1	0	0
Azerbaijan	0	0	0	0	0	0	0	0	0
Kyrgyz Republic	0	0	0	0	0	0	0	0	0
Ukraine	0	0	1	1	0	0	0	0	0
Poland	1	2	1	1	1	1	1	1	1
Bulgaria	0	0	0	1	0	0	0	0	0
Turkey and rest of ECA	3	6	4	2	5	5	3	3	4
EU and EFTA	26	30	26	16	34	30	42	45	32
Major OPEC	7	6	3	2	6	5	5	6	5
Rest of the world	29	21	32	29	27	27	26	22	27

Source: 2011 GTAP data, projected using the CGE model to 2016; percentages calculated using current prices.

TABLE B2 Global Market share by exporter and good (%)

Exporter:	Agriculture	Livestock	Oil Gas and Refined oil	Natural resources	Low-skill Manuf	High-skill Manuf	Low-skill Services	High-skill Services	Total Trade
China	2	4	2	1	18	16	5	3	11
India	2	1	3	3	3	1	1	4	2
North Am excl Mex	28	19	8	8	9	13	9	20	12
Russian Federation	2	0	12	5	2	1	2	1	3
Kazakhstan	0	0	2	1	0	0	0	0	0
Azerbaijan	0	0	1	0	0	0	0	0	0
Kyrgyz Republic	0	0	0	0	0	0	0	0	0
Ukraine	1	0	0	1	1	0	1	0	0
Poland	0	1	0	0	1	1	1	1	1
Bulgaria	0	0	0	0	0	0	0	0	0
Turkey and rest of ECA	4	6	2	1	5	4	5	3	4
EU and EFTA	18	34	13	7	30	33	41	48	31
Major Opec	3	2	33	11	3	2	4	3	7
Rest of the world	39	33	24	60	27	29	29	18	28

Source: 2011 GTAP data, projected using the CGE model to 2016; percentages calculated using current prices

The next two tables show the importance of trading partners from the point of view of China, i.e. how much China imports from a specific country as a percentage of its total imports (table B3); and likewise on the export side (table B4).

TABLE B3 Chinese imports by source and good (%)

Exporter:	Agriculture	Livestock	Oil Gas and Refined oil	Natural resources	Low-skill Manuf	High-skill Manuf	Low-skill Services	High-skill Services	Total Trade
India	3	0	0	7	3	1	3	8	2
North Am excl Mex	40	25	1	4	11	11	5	20	11
Russian Federation	3	0	11	3	3	1	1	1	3
Kazakhstan	0	0	4	1	2	0	0	0	1
Azerbaijan	0	0	0	0	0	0	0	0	0
Kyrgyz Republic	0	0	0	0	0	0	0	0	0
Ukraine	0	0	0	1	0	0	0	0	0
Poland	0	0	0	0	0	0	0	0	0
Bulgaria	0	0	0	0	0	0	0	0	0
Turkey and rest of ECA	1	1	4	1	1	1	3	3	2
EU and EFTA	1	17	1	2	15	19	27	30	14
Major Opec	1	0	32	11	4	3	5	8	8
Rest of the world	51	56	46	70	61	63	56	31	59

Source: 2011 GTAP data, projected using the CGE model to 2016; percentages calculated using current prices

TABLE B4 Chinese exports by destination and good (%)

Importer:	Agriculture	Livestock	Oil Gas and Refined oil	Natural resources	Low-skill Manuf	High-skill Manuf	Low-skill Services	High-skill Services	Total Trade
India	3	1	7	5	2	4	2	3	3
North Am excl Mex	6	14	3	9	24	26	11	20	24
Russian Federation	6	1	2	1	3	2	3	2	2
Kazakhstan	1	0	2	0	1	0	1	0	1
Azerbaijan	0	0	0	0	0	0	0	0	0
Kyrgyz Republic	0	0	0	0	1	0	0	0	0
Ukraine	0	0	0	0	0	0	0	0	0
Poland	0	2	0	1	1	1	0	0	1
Bulgaria	0	0	0	0	0	0	0	0	0
Turkey and rest of ECA	1	2	1	2	2	4	2	2	3
EU and EFTA	10	34	7	13	21	18	33	28	20
Major Opec	12	2	8	3	6	6	7	11	6
Rest of the world	60	43	70	65	39	39	40	34	40

Source: 2011 GTAP data, projected using the CGE model to 2016; percentages calculated using current prices

The next two tables show the importance of China as a source of imports (table B5) or as a destination of exports (table B6) from the point of view of the various trading partners.

TABLE B5 Imports from China as a percent share of imports from all countries

Exporter:	Agriculture	Livestock	Oil Gas and Refined oil	Natural resources	Low-skill Manuf	High-skill Manuf	Low-skill Services	High-skill Services	Total Trade
India	2	4	2	1	15	33	6	3	13
North Am excl Mex	1	7	0	4	28	24	5	3	18
Russian Federation	4	1	17	2	25	16	7	3	15
Kazakhstan	10	1	27	2	54	26	6	2	25
Azerbaijan	0	0	1	5	9	8	6	2	7
Kyrgyz Republic	11	12	2	0	78	34	5	2	53
Ukraine	2	1	0	1	19	13	4	2	9
Poland	1	6	1	2	10	9	1	0	7
Bulgaria	1	1	0	0	4	7	5	1	4
Turkey and rest of ECA	1	1	0	1	8	12	2	2	8
EU and EFTA	1	4	1	1	11	9	4	2	7
Major Opec	3	1	6	2	19	19	7	5	15
Rest of the world	3	8	4	3	26	23	8	4	17
World	2	4	2	1	18	16	5	3	11

Source: 2011 GTAP data, projected using the CGE model to 2016; percentages calculated using current prices

TABLE B6 Exports to China as a percent share of exports to all countries

Exporter:	Agriculture	Livestock	Oil Gas and Refined oil	Natural resources	Low-skill Manuf	High-skill Manuf	Low-skill Services	High-skill Services	Total Trade
India	30	8	0	78	5	5	12	7	8
North Am excl Mex	31	31	1	19	8	9	4	3	9
Russian Federation	27	11	9	24	11	12	3	2	10
Kazakhstan	2	26	22	34	26	46	2	2	24
Azerbaijan	1	0	0	70	0	11	1	2	1
Kyrgyz Rep	1	46	25	41	6	2	3	2	5
Ukraine	1	1	0	43	1	2	3	3	5
Poland	0	3	0	2	2	1	0	0	1
Bulgaria	0	0	0	10	3	1	3	3	2
Turkey and rest of ECA	6	2	23	39	1	3	4	4	4
EU and EFTA	1	12	0	8	3	6	4	2	4
Major Opec	5	4	10	39	6	16	8	8	11
Rest of the world	29	39	19	45	14	23	12	6	20
World	22	23	10	39	6	10	6	3	10

Source: 2011 GTAP data, projected using the CGE model to 2016; percentages calculated using current prices

The next table shows the surplus or deficit of major trading partners, by sector.

TABLE B7 Trade surplus (+) or deficit (-) as % of world trade

Trader:	Agriculture	Livestock	Oil Gas and Refined oil	Natural resources	Low-skill Manuf	High-skill Manuf	Low-skill Services	High-skill Services	Total Trade
China	-20	-19	-8	-38	12	5	-1	-1	2
India	0	-1	-3	-4	0	-1	0	1	-1
North Am excl Mex	20	11	-8	5	-6	-4	-2	4	-3
Russian Federation	0	-1	12	4	0	-2	0	-1	1
Kazakhstan	0	0	2	1	0	0	0	0	0
Azerbaijan	0	0	1	0	0	0	0	0	0
Kyrgyz Republic	0	0	0	0	0	0	0	0	0
Ukraine	1	0	-1	1	0	0	0	0	0
Poland	0	0	-1	-1	0	0	0	0	0
Bulgaria	0	0	0	-1	0	0	0	0	0
Turkey and rest of ECA	1	-1	-3	-1	0	0	2	0	0
EU and EFTA	-8	3	-14	-8	-4	3	0	3	-1
Major Opec	-4	-4	30	10	-2	-2	-2	-3	2
Rest of the world	10	12	-8	32	0	1	4	-3	1

Source: 2011 GTAP data, projected using the CGE model to 2016; percentages calculated using current prices

The next two tables show the difference between trade flows between the business as usual scenario and the China slowdown scenario, for total trade and high-skilled manufactures.

TABLE B8 Trade flows in current prices, % difference China slowdown versus BaU, total trade

	Exporter													
	chn	ind	oea	rus	kaz	aze	kgz	ukr	pol	bgr	xec	eur	opc	row	wld
importer															
chn	0	-9	-8	-10	-10	-10	-10	-10	-9	-9	-10	-8	-10	-8	-8.4
ind	-9	0	1	2	2	-1	1	1	1	2	1	1	1	1	-0.4
oea	-9	1	1	1	2	0	1	1	1	1	1	1	1	2	-0.4
rus	-9	1	0	0	1	1	0	1	0	0	0	0	1	1	-0.8
kaz	-8	1	1	3	0	2	1	3	1	0	0	0	1	1	-1.3
aze	-10	0	0	1	1	0	0	0	0	0	0	0	1	0	-0.6
kgz	-3	4	3	4	4	8	0	7	0	3	2	1	4	4	0.1
ukr	-9	1	0	1	2	0	1	0	1	1	0	1	2	1	0.0
pol	-10	1	1	0	2	2	2	1	0	0	1	1	2	2	0.1
bgr	-10	1	0	0	1	0	1	0	0	0	0	0	1	1	0.0
xec	-10	0	0	0	2	0	1	1	0	0	1	1	1	1	0.0
eur	-10	0	0	0	2	0	0	0	0	0	1	1	1	1	-0.1
opc	-10	0	0	1	1	-1	0	0	0	0	0	0	1	1	-0.8
row	-9	0	1	0	1	-1	1	1	0	0	1	1	0	2	-0.7
wld	-9.3	-0.4	0.0	-0.5	-1.0	-0.3	-0.3	0.2	0.3	0.1	0.1	0.3	-0.5	-0.5	-1.2

Source: Global CGE model simulations; Percent differences between the two scenarios are calculated in 2016.

TABLE B9 Trade flows in current prices, % difference China slowdown versus BaU, high-skill manufacturing

	Exporter														
	chn	**ind**	**oea**	**rus**	**kaz**	**aze**	**kgz**	**ukr**	**pol**	**bgr**	**xec**	**eur**	**opc**	**row**	**wld**
importer															
chn	0	-7	-7	-6	-5	-6	-7	-7	-8	-7	-8	-7	-6	-7	-6.8
ind	-10	0	3	5	5	5	3	3	3	3	3	3	5	4	-0.9
oea	-11	2	2	4	4	4	2	2	2	2	2	2	4	3	-0.5
rus	-9	1	1	0	2	2	1	1	0	1	1	1	2	1	-0.8
kaz	-11	2	2	3	0	3	2	2	2	2	2	2	4	3	-1.1
aze	-12	0	0	2	2	0	0	1	0	0	0	0	2	1	-0.4
kgz	-7	5	5	6	6	6	0	5	4	5	4	5	6	5	0.9
ukr	-10	1	1	3	3	2	1	0	1	1	1	1	3	2	0.1
pol	-11	1	1	2	3	2	0	1	0	1	1	1	3	2	0.1
bgr	-11	1	1	2	3	2	0	1	1	0	1	1	3	2	0.1
xec	-11	1	1	3	3	3	1	2	1	1	1	2	3	2	0.1
eur	-11	1	1	2	3	2	1	1	1	1	1	1	3	2	0.0
opc	-11	1	1	3	3	2	1	1	1	1	1	1	3	2	-0.9
row	-11	2	2	3	4	3	2	2	2	2	2	2	4	3	-0.6
wld	-10.6	1.1	0.9	1.9	-0.7	1.7	1.2	1.1	0.7	1.1	0.7	0.9	1.9	0.4	-1.0

Source: Global CGE model simulations; Percent differences between the two scenarios are calculated in 2016.

Computable General Equilibrium Regional and sectoral definitions

The tables below show the country or regions and sector or good that are used in the global CGE model simulations. The data for this country-region and sector-good aggregations comes from the GTAP dataset.

TABLE B10 Regional aggregation

Model Country or Region group code	Model Country or Region group name	Countries members of group
chn	China	
ind	India	
oea	North Am excl Mex, including:	
		Canada
		United States of America
rus	Russian Federation	
kaz	Kazakhstan	
aze	Azerbaijan	
kgz	Kyrgyz Rep	
ukr	Ukraine	
pol	Poland	
bgr	Bulgaria	
xec	Turkey and Rest of ECA, including:	
		Turkey
		Czech Republic
		Hungary
		Slovakia
		Slovenia
		Albania
		Belarus
		Croatia
		Romania
		Rest of Eastern Europe
		Rest of Europe
		Rest of Former Soviet Union
		Armenia
		Georgia
eur	EU and EFTA, including:	
		Austria
		Belgium
		Cyprus
		Denmark
		Estonia
		Finland
		France
		Germany

(Continued next page)

TABLE B10 (continued)

Model Country or Region group code	Model Country or Region group name	Countries members of group
		Greece
		Ireland
		Italy
		Latvia
		Lithuania
		Luxembourg
		Malta
		Netherlands
		Portugal
		Spain
		Sweden
		United Kingdom
		Switzerland
		Norway
		Rest of EFTA
opc	Major Opec, including:	
		Indonesia
		Ecuador
		Venezuela
		Iran Islamic Republic of
		Kuwait
		Qatar
		Saudi Arabia
		United Arab Emirates
		Nigeria
row	Rest of the world	All remaining countries

TABLE B11 Sectoral aggregation

Model aggregated sectors/goods	GTAP individual sectors/goods
Agriculture	Paddy rice
	Wheat
	Cereal grains, n.e.s.
	Vegetables and fruits
	Oil seeds
	Sugar cane and sugar beet
	Plant-based fibers
	Crops, n.e.s.
	Bovine cattle, sheep and goats, horses
	Animal products n.e.s.
	Raw milk
	Wool, silk-worm cocoons
	Forestry

(Continued next page)

TABLE B11 (continued)

Model aggregated sectors/goods	GTAP individual sectors/goods
	Fishing
Natural Resources	Coal
	Minerals n.e.s.
Oil and Gas	Oil
	Gas
	Petroleum, coal products
Low-skill manufacturing	Bovine cattle, sheep and goat, horse meat products
	Meat products n.e.s.
	Vegetable oils and fats
	Dairy products
	Processed rice
	Sugar
	Food products n.e.s.
	Beverages and tobacco products
	Textiles
	Wearing apparel
	Leather products
	Wood products
	Paper products, publishing
High-skill manufacturing	Chemical, rubber, plastic products
	Mineral products n.e.s.
	Ferrous metals
	Metals n.e.s.
	Metal products
	Motor vehicles and parts
	Transport equipment n.e.s.
	Electronic equipment
	Machinery and equipment n.e.s.
	Manufactures n.e.s.
Low-skill Services	Electricity
	Gas manufacture, distribution
	Water
	Construction
	Trade
	Transport n.e.s.
	Sea transport
	Air transport
High-skill Services	Communication
	Financial services n.e.s.
	Insurance
	Business services n.e.s.
	Recreation and other services
	Public administration and defence, education, health services
	Dwellings

Notes

1. Potential GDP is estimated using a standard production function approach. Labor inputs are obtained from employment data; physical capital stock is estimated using a permanent inventory method. Total factor productivity is a residual; i.e. it is the difference between observed GDP and GDP levels predicted by the production function. The cyclical component of this residual total factor productivity is filtered out, and 'trend' total factor productivity is obtained. This trend total factor productivity is added to the primary factors and potential GDP is thus estimated.
2. It is typical that in fast growing developing countries prices are growing faster than prices in slower growing, more advanced countries (all expressed in the same currency). This Balassa-Samuelson effect is caused by a large differential across countries in productivity growth in the tradable sectors, while that differential is smaller for non-tradable sectors.
3. On the relationship between Central Asia and Russia, see Laruelle, Marlene. 2009. "Russia in Central Asia: Old History, New Challenges" EU-Central Asia Monitoring. http://www.isn.ethz.ch/Digital-Library/Articles/Detail/?id=172418
4. See Annex B for a regional disaggregation of the model.
5. The trade data are reported in terms of total sales rather than value added, and China is an important center for the re-export of manufactured goods. Thus, the large volume of Germany's manufactured imports from China does not necessarily reflect the structure of China's domestic production.
6. Tinbergen, Jan. 1962. Shaping the World Economy: Suggestions for an International Economic Policy. New York: Twentieth Century Fund.
7. The export response is calculated by multiplying the real exchange rate elasticity for each sector, estimated from the gravity model, to the actual real exchange rate change between 1/2015 and 2/2016. The effect on exports does not take into account the impact of the real exchange rate change on other model variables such as GDP.
8. The gravity model does not account for the fact that natural resources are often traded in international currency (US dollars), and thus may overestimate the impact of real exchange rate change on the exports natural resources.
9. In fact, some analysts think that a scenario where both slower growth and rebalancing happen at the same time is more likely than a scenario with just one of these two changes. However, the analysis presents the results of slower growth separately from that of rebalancing to facilitate the identification of the channel of transmission and the measurement of their magnitudes.
10. The most recent base year for the database of the Global Trade Analysis Project (www.gtap.agecon.purdue.edu) which is used in the CGE model is 2011. Therefore the model is used to predict the values of imports and exports for 2016 reported in the text. The quantitative results and comments will not be different if one had used the observed data for 2015.
11. It would be possible to break down the analysis of the impact of a slowdown in China further and consider the cost and benefits for consumers and producers separately. For example, the term of trade increase associated to a slowdown in China, as discussed in the text, means that price of Chines goods exported will increase. This has negative impact on consumers in countries importing these goods, even if it allows producers in these same countries to become more competitive and increase their sales.
12. The shift in China from investment towards consumption would, by itself, reduce exports of capital goods from China.
13. Note that in China, not shown in the table, the skill premium is reduced by about 50%.
14. In North America agriculture tends to be skill intensive and its expansion (due to an increase in demand by China) increases the skill premium. Note that in all countries high-skilled services is one of the largest employer and, by far, the one with the highest skill intensity in production.

PART II

Country Pages

ALBANIA

Table 1	2015
Population, million	2.9
GDP, current US$ billion	11.7
GDP per capita, current US$	4030
Poverty rate ($2.5/day 2005PPP terms)[a]	6.7
Poverty rate ($5/day 2005PPP terms)[a]	47.5
Gini Coefficient[a]	29.0
Life Expectancy at birth, years[b]	77.4

Sources: World Bank WDI and Macro Poverty Outlook.
Notes:
(a) Most recent value (2012)
(b) Most recent WDI value (2013)

The Albanian economy accelerated in 2015, and is expected to continue recovering over the next three years. Private investment in large infrastructure projects and improvements in business climate are expected to support this expansion. Reignited job creation will support a gradual recovery in private consumption. Fiscal consolidation, which has fallen largely on expenditures, will limit the overall contribution of the public sector to growth. Stronger economic activity and job creation are expected to lift living standards and support gradual poverty reduction.

Recent developments

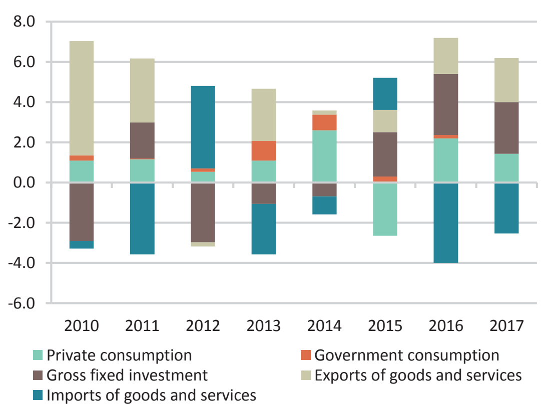
Albania's economy continued to recover in 2015, supported by robust private investment. Growth is estimated to have reached 2.6 percent, with gross fixed capital formation contributing 2.2 percentage points to the economic expansion. The large contribution reflected investment in the Trans Adriatic Pipeline and a hydropower plant in Southern Albania. Consumption contributed negatively to GDP growth in 2015, but there were signs of a recovery towards the end of the year. Fiscal consolidation continued to take place in 2015, limiting the Government contribution to GDP growth. The budget deficit is estimated to have reached 4.8 percent of GDP in 2015, down from 5.9 percent in 2014. This deficit included arrears clearance of 1.3 percent of GDP. While revenues collection underperformed, a spike in non-tax revenues, interest savings, and an across-the-board under-execution of expenditure kept the overall budget in line with expectations. Finally, net exports contributed positively to growth. Unfavorable international oil and mineral prices contribute to a weak performance of real exports, which was more than compensate by a larger drop in real imports.

The current account deficit is estimated to have narrowed in 2015, despite the high volatility in remittance flows. A one-off reduction in net imports of electricity, and a stronger than expected performance in tourism helped narrow the trade deficit. Remittances climbed in the first and second quarter of 2015, but decreased in the second half of the year following the crisis in Greece and tighter capital controls in the banking system. Albania large errors and omissions accounts fluctuated symmetrically to remittance flows, suggesting that transfers made their way to Albania through alternative means. As such, impacts on household income are expected to be small. Net FDI inflows financed about 70 percent of the current account deficit. The Eurobond issuance of 450 million EUR in early November complemented the external financing and let to an increase in international reserves, which exceeded five months of imports at yearend.

Labor markets have improved steadily, with a slightly higher employment rate in the third quarter of 2015 compared to the same period in 2014. This is led by employment expansion in construction, manufacturing, mining, and non-market services. Agricultural employment declined somewhat in the third quarter of 2015, after increasing earlier in the year. Growth in employment rate (1.9 pps) was partially offset by an increase in the labor force participation, leading to modest decline of 0.4 pps in unemployment (to 17.1 in 2015). The employment rate has slightly improved for men while remaining stagnant for women. Women are increasingly participating in the labor market, but facing increasing rates of unemployment. Youth unemployment (15-29 years) declined with respect to the previous year, but remained high at 32.3 percent.

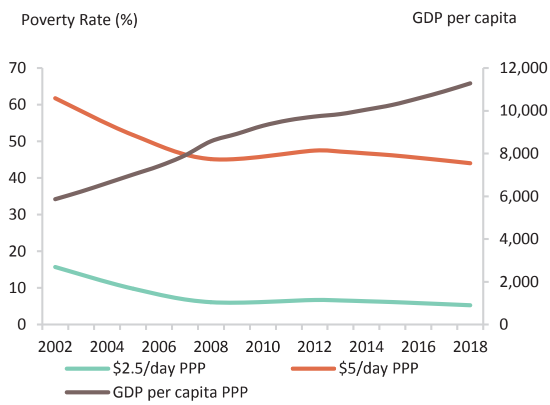
Poverty is expected to continue on a slow decline, as economic growth translates

FIGURE 1 Albania / GDP growth decomposition



Sources: INSTAT and World Bank forecasts.

FIGURE 2 Albania / Actual and projected poverty rates and GDP per capita



Sources: World Bank (see notes to Table 2).

into job creation. The expected decline comes on the heels of an increase in poverty from 2008 to 2012, when poverty increased to 47.5 percent in 2012 from 45.2 percent in 2008 ($5/day PPP). Poverty is estimated to have moderately declined to 46.7 percent in 2014 with progress hindered by weakening of labor markets in the past years with increases in the unemployment rate. Nevertheless, labor markets are slowly picking up, particularly in sectors in which poorer individuals are often employed, including agriculture and construction. The unemployment rate for the working age population declined slightly in 2015, despite an increase in the labor force participation rate. Given the gradual labor market improvements this year, moderate poverty ($5/day, 2005 PPP) is expected to stand at 46.2 percent in 2015.

Outlook

The Albanian economy is expected to accelerate gradually in the medium term. Stronger growth is projected on the basis of a pickup in investment in large FDI-financed infrastructure projects, a recovery of consumption, and buoyant exports. These, in turn, will be supported by improvements in the business climate and a pickup in lending as a result of reforms to address high NPLs. Continued fiscal consolidation will limit the direct contribution from the government. All in all, growth is likely to strengthen to 3.2 percent in 2016 and 3.5 percent in 2017.

Poverty is expected to continue its slow downward trend. The gradual acceleration of the economic and modest improvements in the labor market will likely drive the changes in poverty, given persistently low remittances inflows and no significant changes in social protection benefits. The downward trend is expected to gradually continue with poverty at 45.5 percent in 2016 and 44.8 percent in 2017.

Growth prospects for Albania rely on the continued implementation of structural reforms, with an upside potential if these are accelerated. Reforms in progress – in energy, investment management, and pensions - are expected to both promote growth and have positive distributional effects. New pensions indexation rules and the introduction of a social pension, as well as the focus on compensating changes to energy tariffs through the existing social assistance program, are aimed at protecting the real incomes of the poor and less well-off.

Risks and challenges

Even if employment has increased, labor markets remain weak limiting the potential of the Albanian economy. A high rate of informality in employment in Albania hampers productivity, tax revenue collections, and regulatory compliance. Increasing activity rates and lowering unemployment, as well as improving the quality of employment, are enduring challenges to lifting living standards.

Moving forward, Albania faces the challenge of finding sustainable sources of growth while ensuring that the poor and vulnerable are adequately protected. In this context, it is critical to maintain the structural reform momentum and fiscal consolidation efforts. Priority areas include, addressing high NPLs and weak business climate, strengthening tax administration and closing loopholes, additional reforms in the energy sector, strengthening public investment management, and mitigating fiscal risks. As fiscal consolidation efforts progress, it is critical to maintain a distributional impact lens to reforms.

TABLE 2 Albania / Macro poverty outlook indicators (annual percent change unless indicated otherwise)

	2013	2014	2015 e	2016 f	2017 f	2018 f
Real GDP growth, at constant market prices	1.1	2.0	2.6	3.2	3.5	3.8
Private Consumption	1.5	3.6	-3.6	3.2	2.1	2.3
Government Consumption	2.9	2.3	0.9	0.5	-0.1	0.7
Gross Fixed Capital Investment	-4.6	-3.1	10.7	13.6	10.5	7.5
Exports, Goods and Services	8.1	0.6	3.2	5.3	6.3	6.3
Imports, Goods and Services	2.5	1.6	-1.6	4.0	2.5	2.2
Real GDP growth, at constant factor prices	1.4	2.2	2.5	3.2	3.5	3.8
Agriculture	0.7	2.2	0.8	3.0	3.2	3.0
Industry	4.9	-2.7	6.3	1.1	4.2	5.0
Services	0.3	4.3	1.6	4.1	3.4	3.6
Inflation (Consumer Price Index)	1.9	1.6	1.8	2.3	2.7	3.0
Current Account Balance (% of GDP)	-10.7	-12.8	-6.7	-4.1	-7.1	-8.5
Financial and Capital Account (% of GDP)	7.6	10.1	4.1	1.6	4.7	6.2
Net Foreign Direct Investment (% of GDP)	9.6	8.2	7.0	7.9	7.7	7.1
Fiscal Balance (% of GDP)	-5.0	-5.9	-4.8	-2.5	-1.6	-0.7
Debt (% of GDP)	70.1	71.8	71.9	70.7	68.1	64.4
Primary Balance (% of GDP)	-1.7	-3.1	-2.2	0.3	1.3	2.2
Poverty rate ($2.5/day PPP terms)[a,b,c]	6.6	6.4	6.1	5.9	5.6	5.3
Poverty rate ($5/day PPP terms)[a,b,c]	47.2	46.7	46.2	45.5	44.8	44.0

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: e = estimate, f = forecast.
(a) Calculations based on ECAPOV harmonization, using 2002-LSMS and 2012-LSMS.
(b) Projection using annualized elasticity (2002-2012) with pass-through = 1 based on GDP per capita constant PPP.
(c) Projections are from 2013 to 2018.

ARMENIA

Table 1	2015
Population, million	3.0
GDP, current US$ billion	10.6
GDP per capita, current US$	3501
Poverty rate ($2.5/day 2005PPP terms)[a]	26.3
Poverty rate ($5/day 2005PPP terms)[a]	75.9
Gini Coefficient[a]	31.5
Life Expectancy at birth, years[b]	74.4

Sources: World Bank WDI and Macro Poverty Outlook.
Notes:
(a) Most recent value (2014)
(b) Most recent WDI value (2013)

As external conditions deteriorated, Armenia's economic activity slowed in 2015, but performed better than initially expected. The fiscal deficit widened sharply, driven by the weak revenue collection, compounded by the introduction of a fiscal stimulus . The economy is expected to recover modestly over the medium term as global economic conditions improve gradually. However, growth prospects are shadowed by the slow progress on structural reform agenda, hindering job creation and poverty reduction.

Recent developments

Growth slowed slightly to 3 percent in 2015 from 3.5 percent in 2014, despite the spillover from Russia and the fall in the prices of base metals, Armenia's main export commodities. Output expansion was driven by a good agriculture harvest, the opening of a new copper mine, and a fiscal stimulus. Growth of services and manufacturing suffered due to the softening demand driven by the sharp fall in remittances.

The fiscal position deteriorated significantly, reflecting slowing economic activity in tax-generating sectors and the fiscal stimulus, comprising tax relief and increased spending on infrastructure investment, social protection, public sector wages, and subsidized lending. Following the decision to raise electricity tariffs in June, the government, under intense public pressures, agreed to temporarily compensate households and SMEs for the tariff increase (0.1 percent of GDP). The resulting fiscal deficit, estimated at 4.9 percent of GDP (compared with 2 percent in 2014), was financed mainly by external borrowing, including Eurobonds and budget support from the World Bank, leading to a build-up of government debt to about 50 percent of GDP at end-2015.

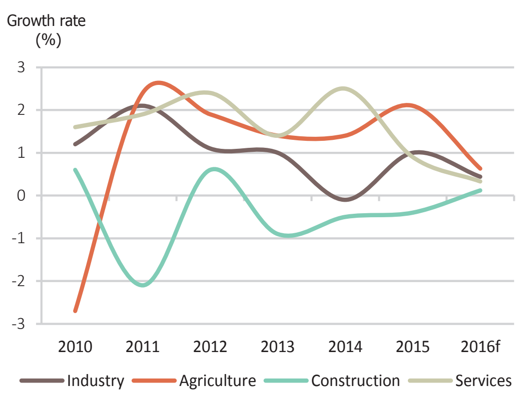
Inflation has been declining since mid-2015, with the dissipation of the pass-through effect of the dram's depreciation in late 2014. As domestic demand weakened further, inflation declined to -0.2 percent (y/y) in December 2015, allowing the Central Bank to cut policy rates in steps. However, monetary conditions remained tight with negative credit growth.

The current account deficit narrowed to an estimated 3.2 percent of GDP in 2015 from 7.3 percent in 2014, due to the significant reduction in the trade deficit, which more than compensated for the 36 percent fall in remittances (in US dollar terms). The improved trade balance was the result of the exchange rate adjustment and a sharp import contraction, reflecting soft domestic demand and low international energy and food prices. Exports performed better than expected, as declining exports to Russia were largely offset by rising exports to China and the Middle East. On the back of improved external accounts, pressures on the dram eased; the Central Bank reduced forex intervention sharply in the second half of the year, leading to an increase in official reserves to US$1.8 billion at end-2015 from US$1.4 billion in January 2015.

Vulnerabilities in the banking sector intensified, and the share of nonperforming loans increased from 3.7 percent in early 2015 to more than 9 percent in late 2015. In the context of high dollarization, currency mismatches on banks' balance sheets pose risks to the sector's stability and profitability, prompting the Central Bank to raise the minimum capital requirement during the year.

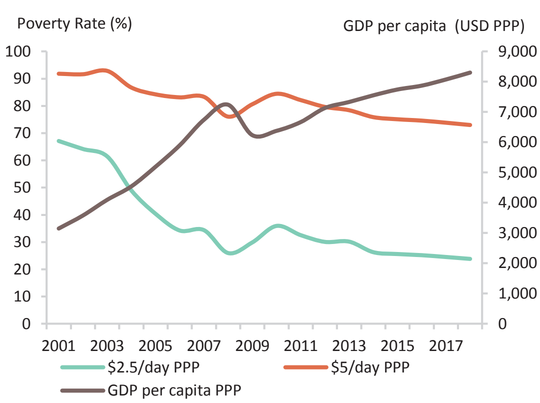
Falling remittances and weak domestic labor market conditions slowed progress on poverty reduction. The poverty rate (measured at US$2.5/day) fell from 26.3 percent in 2014 to an estimated 25.6 percent in 2015. Lower remittance inflows have translated into welfare losses for all

FIGURE 1 Armenia / GDP growth by sector, 2010-2016



Sources: Armenia Statistical Service.

FIGURE 2 Armenia / Actual and estimated poverty rates and GDP per capita (PPP)



Sources: World Bank (see notes to Table 2).

households. Despite strong agricultural growth, the domestic labor market deteriorated due to limited job creation in other sectors compounded by the large-scale return of migrant workers from Russia. The unemployment rate rose from 17.5 percent in Q3 2014 to 18.2 percent in Q3 2015.

Outlook

Growth is projected to slow to 1.9 percent in 2016, on the back of continued weaknesses in the external conditions and fiscal tightening. With the recovery of the global economy, including metal prices, Armenia's growth is expected to pick up over the medium term, but only moderately to about 3 percent a year, hampered by structural weaknesses.

The budget deficit is projected to remain wide in 2016, at 3.9 percent of GDP, despite fiscal tightening through a combination of revenue raising measures and moderate expenditure cuts. The fiscal position is expected to improve over time, as the stimulus measures are phased out and an economic recovery boosts revenue collection.

Poverty reduction and income growth across all levels of the welfare distribution are likely to stagnate during 2017-18. Even under an optimistic scenario—the agricultural sector continues to perform well and remittance inflows recover—without substantial improvements in the business environment and the domestic labor market the poverty rate is projected to fall only gradually to 23.8 percent in 2018. The elimination of temporary electricity subsidies, scheduled in August 2016, would negatively affect poor households, whose expenditure of electricity amounts to more than 5 percent of total consumption.

Risks and challenges

Armenia's economic outlook is subject to considerable downside risks. Sustaining growth in a difficult external environment with limited fiscal space is a serious policy challenge. Further deterioration of the external environment, including a worsening recession in Russia the slow recovery of base metal prices, represent significant risks to Armenia's prospects for economic growth and job creation. Furthermore, recent reshuffling in the government personnel and political developments slated for 2017-18 (Parliamentary and Presidential elections) could delay the implementation of structural reforms necessary to improve the business environment, thereby hindering productivity growth over the medium term.

As public debt continues to rise, the government has to consolidate fiscal position, while protecting critical expenditures in areas such as social assistance and public investment. Persistently low capital outlays, which bore the brunt of expenditure compression in recent years, and low execution rates of public investment could limit Armenia's medium-term growth. Armenia's fiscal sustainability could be also threatened by the deteriorating financial performance of the energy sector.

TABLE 2 Armenia / Macro poverty outlook indicators (annual percent change unless indicated otherwise)

	2013	2014	2015 e	2016 f	2017 f	2018 f
Real GDP growth, at constant market prices	3.3	3.5	3.0	1.9	2.8	2.9
Private Consumption	0.9	0.5	-4.1	1.3	2.2	2.6
Government Consumption	7.0	6.7	-4.8	-6.3	4.6	4.3
Gross Fixed Capital Investment	-7.0	-2.4	0.5	0.8	1.6	1.4
Exports, Goods and Services	8.6	6.4	-1.0	3.2	4.3	5.2
Imports, Goods and Services	-2.1	-1.0	-17.3	1.2	2.3	3.6
Real GDP growth, at constant factor prices	3.2	3.7	4.0	1.8	2.8	3.0
Agriculture	7.6	7.8	11.4	3.2	3.6	3.8
Industry	0.5	-2.2	2.6	1.9	3.3	4.1
Services	2.4	5.9	-0.9	0.3	1.4	1.1
Inflation (Consumer Price Index)	5.8	3.0	3.7	3.5	4.0	4.0
Current Account Balance (% of GDP)	-7.6	-7.3	-3.2	-3.3	-3.5	-4.0
Financial and Capital Account (% of GDP)	10.3	7.9	3.8	4.0	4.1	4.7
Net Foreign Direct Investment (% of GDP)	3.2	3.3	3.2	3.8	4.2	4.7
Fiscal Balance (% of GDP)	-1.6	-2.0	-4.9	-3.9	-2.4	-1.3
Debt (% of GDP)	40.9	43.7	49.3	52.2	51.5	50.4
Primary Balance (% of GDP)	-0.6	-0.7	-3.2	-2.0	-0.5	0.2
Poverty rate ($2.5/day PPP terms)[a,b,c]	30.2	26.3	25.6	25.2	24.5	23.8
Poverty rate ($5/day PPP terms)[a,b,c]	78.4	75.9	75.1	74.6	73.8	73.0

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: e = estimate, f = forecast.
(a) Calculations based on ECAPOV harmonization, using 2011-ILCS and 2014-ILCS.
(b) Projection using point-to-point elasticity (2011-2014) with pass-through = 0.7 based on GDP per capita constant PPP.
(c) Actual data: 2013, 2014. Projections are from 2015 to 2018.

AZERBAIJAN

Table 1	2015
Population, million	9.6
GDP, current US$ billion	53.1
GDP per capita, current US$	5512
School enrollment, primary (% gross)[a]	98.0
Life Expectancy at birth, years[a]	70.6

Sources: World Bank WDI and Macro Poverty Outlook.
Notes:
(a) Most recent WDI value (2013).

Azerbaijan's growth slowed in the latter half of 2015, affected by the continued plunge in oil prices and reduced public investment, which depressed construction activity. Inflation soared as a result of large manat devaluations, raising concerns about new social vulnerabilities. With still-low oil prices in the forecast, Azerbaijan's growth and its fiscal and external positions are likely to weaken further in 2016. Posing significant downside risks are intensifying financial sector vulnerabilities, the slow pace of reforms, and an underdeveloped macroeconomic policy framework.

Recent developments

The overall economy grew by 1.1 percent in 2015, compared with 2.8 percent in 2014. The sharp fall in oil prices continued to weigh on Azerbaijan's oil-reliant economy. The non-oil sector performed strongly in the first half of 2015, fueled by large government investment. However, it decelerated markedly in the latter half of the year as the government cut back capital outlays, leading to a decline of over 13 percent in the construction sector, the country's main non-oil growth driver.

Faced with falling oil exports and currency depreciation of key trading-partner countries, the authorities devalued the manat in February 2015 and continued to intervene in the market before shifting to a managed float exchange rate regime in December. During 2015, international reserves fell from US$14 billion to US$5 billion, while the manat depreciated by 100 percent against the US dollar from AZN0.78/US$ to AZN1.56/US$.

The current account position finished 2015 with a surplus of 0.8 percent of GDP, compared with a surplus of 13.8 percent in 2014. Despite the large manat depreciation, the trade balance worsened due to imports for large-scale public investment in early 2015. Non-oil exports fell by 6.6 percent, reflecting Russia' recession.

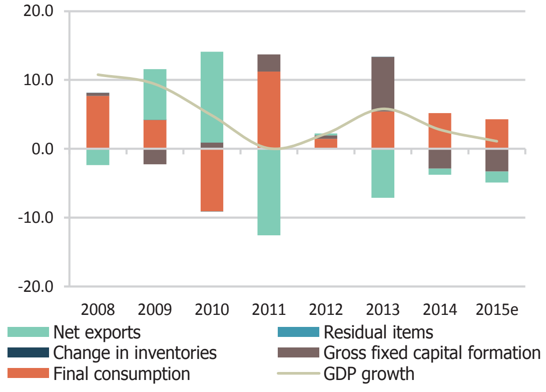
Banking-sector vulnerability has been intensifying. Dollarization increased after February's devaluation and continued throughout the year. The quality of banks' asset portfolios deteriorated, and non-performing loans (NPLs) rose sharply as growth fell and servicing foreign currency-denominated loans became more costly. The authorities withdrew the licenses of eight banks and injected large amounts of liquidity to recapitalize the International Bank of Azerbaijan, which had 37 percent of the country's banking assets in 2014. The economy's supply of credit contracted 7 percent in 2015.

Due to the devaluation's pass-through effect, inflation accelerated to 7.7 percent (year-on-year) in December 2015, up from 1.5 percent a year earlier. Despite the credit contraction, policy rates were raised in steps to curb pressures on the manat.

The consolidated fiscal deficit—the central government, the Nakhchivan autonomous region, the State Oil Fund, and the Social Protection Fund—widened from 0.4 percent of GDP in 2014 to 5.2 percent in 2015. Large spending cuts by the central government were more than offset by a 40 percent decline in the Oil Fund's revenue. At the end of 2015, Oil Fund assets stood at US$33.5 billion, compared with US$37 billion a year earlier.

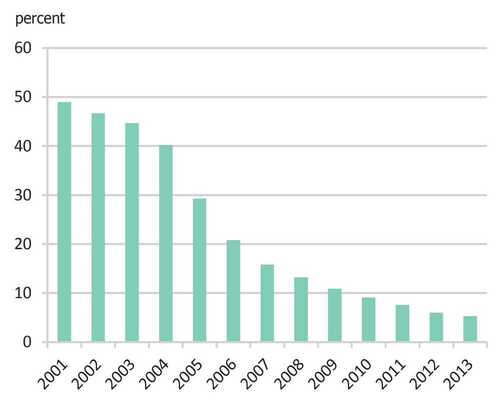
Over the past decade, Azerbaijan has experienced significant and steady poverty reduction, led by high consumption growth among the less well off. Despite slowing growth, the official poverty rate fell from 6 percent in 2012 to 5 percent in 2014. Data are not available, but it appears unlikely that poverty reduction continued into 2015, when sharp rising inflation likely affected households' income and consumption.

FIGURE 1 Azerbaijan / GDP growth decomposition, 2008-2014 (percentage points/percent)



Sources: State Statistical Committee.

FIGURE 2 Azerbaijan / National poverty headcount rate, 2001-2013



Sources: State Statistical Committee calculations.

Income from labor, self-employment, and pensions—key sources of poverty reduction in Azerbaijan—are to a large extent rooted in budgetary support, and therefore are reliant on oil revenues. Construction, which benefits from public investment, has experienced a large contraction, with serious implications for employment and income. Agricultural growth of 4.4 percent helped protect incomes among the 38 percent of the population employed in this sector.

Outlook

The economy is projected to contract by 1.9 percent in 2016, weakened by low oil prices, tight monetary conditions, and erosion of real income due to inflation. With a gradual recovery of oil prices, growth is likely to pick up in 2017 and reach 1.3 percent in 2018.

The consolidated fiscal deficit is projected to widen significantly to 14 percent of GDP in 2016, driven by higher social spending (about 4 percent of GDP) and larger public investment, including construction of the Southern Gas Corridor pipeline (4.25 percent of GDP). The bulk of public investment will take place outside the country, so its impact on the domestic economy is likely to be limited. The fiscal deficit is expected to narrow over 2017-18 as oil prices gradually recover and large investment ends.

The current account deficit is projected to widen to 4.7 percent of GDP in 2016, with the fall in oil exports more than offsetting the impact of contracting demand. As oil prices recover, the current account is projected to return to surplus over 2017-18.

While data limitations do not allow for poverty projections, poverty can be expected to rise over 2016-18 in a context of slow growth, high inflation, and limited fiscal space to provide social protection for vulnerable households.

Risks and challenges

Azerbaijan's key challenge remains reliance on oil in the face of volatile prices and declining oil output. The financial sector wrestles with increased fragility. A very sharp increase in dollarization and rising NPLs could lead to more bank failures, reduced credit, and costly debt servicing that inhibits real sector recovery. Limited exchange rate flexibility, the lack of effective monetary policy framework, and low levels of market development inhibit the economy's flexibility to respond to shocks. Limited reforms in the past have delayed modernization and productivity growth in the non-oil tradable sectors.

TABLE 2 **Azerbaijan** / Macro poverty outlook indicators (annual percent change unless indicated otherwise)

	2013	2014	2015 e	2016 f	2017 f	2018 f
Real GDP growth, at constant market prices	5.8	2.8	1.1	-1.9	0.7	1.3
Private Consumption	8.1	8.5	6.0	-2.6	2.0	2.4
Government Consumption	9.0	4.0	-4.1	-5.7	1.2	2.1
Gross Fixed Capital Investment	19.4	4.4	-11.5	-17.0	-3.0	0.8
Exports, Goods and Services	1.5	-1.1	-1.0	-2.0	-0.7	-0.7
Imports, Goods and Services	10.0	4.1	-5.0	-10.0	-0.8	0.2
Real GDP growth, at constant factor prices	5.6	2.7	1.1	-1.9	0.7	1.3
Agriculture	4.9	-2.6	6.0	4.2	4.0	4.0
Industry	1.8	-1.7	2.0	-3.0	1.4	1.4
Services	16.9	15.1	-2.0	-1.0	-1.8	0.3
Inflation (Consumer Price Index)	2.5	1.5	7.7	14.0	2.4	2.1
Current Account Balance (% of GDP)	16.5	13.8	0.8	-4.7	3.1	4.7
Financial and Capital Account (% of GDP)	-13.9	-10.1	-9.8	-10.1	-15.0	-14.3
Net Foreign Direct Investment (% of GDP)	1.5	3.2	3.4	5.0	4.8	4.8
Fiscal Balance (% of GDP)	1.4	-0.4	-5.2	-14.4	-7.0	-3.2
Debt (% of GDP)	13.6	15.5	16.1	30.2	35.6	54.7
Primary Balance (% of GDP)	1.7	-0.2	-5.0	-14.2	-6.6	-2.5

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Note: f = forecast.

BELARUS

Table 1	2015
Population, million	9.5
GDP, current US$ billion	53.5
GDP per capita, current US$	5633
Poverty rate ($5/day 2005 PPP terms)	0.31
Gini Coefficient [a]	28.0
School enrollment, primary (% gross)[b]	99.1
Life Expectancy at birth, years [b]	73.2

Sources: World Bank, WDI, and Macro Poverty Outlook.
Notes:
(a) Most recent value (2014)
(b) Life Expectancy data show most recent WDI value (2014)

Recession in Russia and low commodity prices have had a major impact on Belarus's economy, which shrank 3.9 percent in 2015, the first recession in two decades. Economic outlook remains bleak, with real GDP projected to decline by 3 percent in 2016 and by 1 percent in 2017, subject to uncertainty related to oil prices and developments in main trading partners. Although the poverty impact has remained muted so far, households' disposable incomes are expected to deteriorate.

Recent developments

In 2015, the Belarusian economy entered a recession as real GDP contracted 3.9 percent, compared to a modest increase of 1.6 percent in 2014. The external environment has deteriorated considerably, leading to a sharp reduction in total exports of goods and services by 24.1 percent, while imports shrank by 25.4 percent. In particular, the slowdown in Russia hit Belarusian industrial output, which fell by 6.6 percent y/y, while exports of goods to the Russian market dropped by 26 percent y/y. Given faltering exports and sizeable debt repayments in foreign currency coming due, macro policies have been tightened to narrow external and fiscal balances. Gross fixed capital investments fell by 15.2 percent y/y due to budget cuts in capital expenditures and containment of directed lending.

Although the nominal broad money growth exceeded the 30 percent target announced by the National Bank of Belarus, the recession helped to contain inflationary pressures. Annual inflation stood at 13.5 percent in 2015, well below the 18±2 percent target and also lower than the 18.1 percent inflation observed in 2014.

The exchange rate policy has mainly responded to deteriorating conditions in Russia, where the Ruble (RUR) has moved in tandem with oil prices. During 2015, the Belarusian Ruble (BYR) depreciated against the US$ by 36 percent, and vis-à-vis the RUR by 19 percent. Foreign reserves, excluding gold, stood at US$2.7 billion at end-2015, covering one month of imports of goods and services.

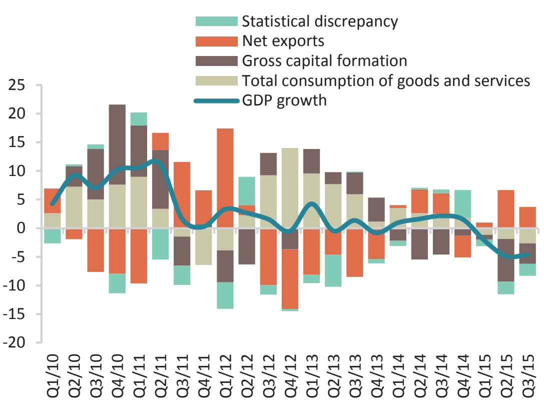
Economic weakness led to falling revenues from corporate income tax, VAT, and excise taxes. These losses, however, were more than offset by foreign trade tax gains stemming from an agreement with Russia whereby Belarus retains export duties on oil products, as well as from the reintroduction of export duties on potash fertilizer exports. The Government paid back US$2 billion of foreign debt in 2015, of which two-thirds was refinanced by taking on new loans from the Russian Government and commercial banks. The general government surplus reached 1.5 percent of GDP. However, if certain quasi-fiscal activities were properly accounted for, the budget balance would have exhibited a small deficit.

The labor market is under stress. SOEs did not shed labor, but rather shortened the working week. Reduction of real wages and incomes, by 3.1 and 5.9 percent, respectively, led to a contraction in private consumption by 3.3 percent y/y. Yet, the Government has prevented a rise in poverty by spending more on targeted social assistance as the number of applicants increased. Measured at the international standard of PPP US$ 5/day, poverty in Belarus remains low at below 1 percent of the population.

Outlook

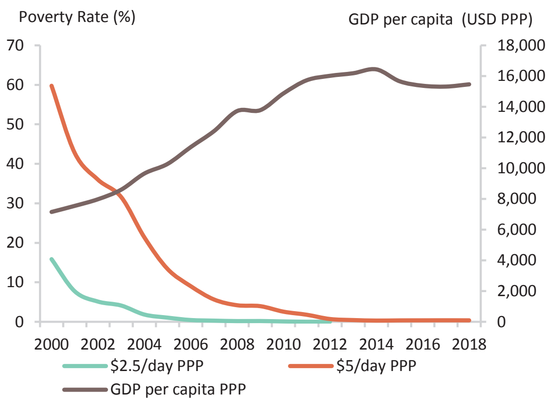
This outlook is subject to uncertainty related to oil prices and market volatility in

FIGURE 1 Belarus / Contributions to quarterly GDP Growth



Sources: WB Staff calculations based on Belstat data.

FIGURE 2 Belarus / Actual and estimated poverty rates and GDP per capita (PPP)



Source: World Bank (see notes to Table 2).

Russia, the CIS, and Ukraine. Real GDP is projected to contract by 3 percent in 2016 and by 1 percent in 2017. Progress on structural reforms would bolster medium-term prospects, but growth is unlikely to pick up immediately because of lags in diversifying products and markets, particularly for SOEs. Risks remain considerable. A steeper slowdown in neighboring markets would lead to a sharper recession, particularly since mineral products and fertilizers account for more than a third of total exports.

Further monetary and fiscal tightening would be necessary to adjust to external shocks, adding to contractionary pressures. Limited access to external financing and increasing losses in the SOE sector constrain the space for countercyclical policies. Continued distress in the SOE sector will be deleterious to employment creation and job transition, in a context where existing unemployment benefits are extremely low, while the Government plans on expanding them are not yet clarified.

The current account deficit is projected to average 3 percent of GDP in 2016-2017 compared to 8.7 percent in 2013-2014. External financing needs, however, are substantial because of maturing foreign liabilities. As the level of international reserves is low, the repayments of foreign currency -denominated public debt – estimated to be US$3.3 billion in 2016, of which one-third is due to domestic residents – could only be met by partial refinancing. The Government is seeking official financing assistance from the IMF (up to US$3 billion) and the Eurasian Fund for Stabilization and Development of the EurAsEc (up to US$2 billion) to support international reserves and debt service obligations.

Risks and challenges

Growth can be spurred by appropriately sequenced reforms, supported by international partners and investors. Restructuring the SOE sector is essential to reduce distortive state interventions and improve firms' performance. Companies in the public sector should move away from imposed quantitative and employment targets toward productivity and profitability, with their managerial autonomy strengthened by appropriate corporate governance arrangements. More room for the development of the private sector can help unleash productivity and employment growth.

The negative impact of large-scale reforms needs to be mitigated. A reduction in government directed lending, compounded by the growing debt overhang in the real sector, could lead to wage and tax arrears, further spreading the shock among households and public finances. To address social concerns related to enterprise restructuring and layoffs, revamping the current unemployment benefits system would help. Additional social assistance would be required for households to cope with increases in utility tariffs, but appropriate modalities of support have yet to be designed and implemented.

TABLE 2 Belarus / Macro poverty outlook indicators (annual percent change unless indicated otherwise)

	2013	2014	2015	2016 f	2017 f	2018 f
Real GDP growth, at constant market prices	1.1	1.6	-3.9	-3.0	-1.0	0.3
Private Consumption	10.8	4.4	-3.0	-1.5	-0.5	0.2
Government Consumption	-2.0	-1.8	-1.8	0.0	0.3	0.1
Gross Fixed Capital Investment	3.8	-8.8	-8.6	-9.2	-2.0	0.8
Change in Inventories, % contrib.	1.9	1.9	0	0	0	0
Exports, Goods and Services	-14.6	5.3	-4.2	-1.5	0.5	1.2
Imports, Goods and Services	-4.2	2.4	-7.0	-3.0	0.2	1.0
Real GDP growth, at constant factor prices	1.6	2.0	-4.2	-2.5	-0.9	0.4
Agriculture	-4.2	3.9	-2.8	-2.0	0.5	1.6
Manufacturing	-1.9	0.5	-6.6	-5.5	-2.2	0.3
Services	8.2	3.4	-1.8	-0.4	0.2	0.2
Inflation (Household Consumption Deflator)	17.3	18.0	18.0	17.0	16.0	16.0
Inflation (Consumer Price Index)	18.3	18.1	13.5	14.0	13.0	11.5
Current Account Balance (% of GDP)	-10.0	-6.9	-3.8	-2.8	-3.0	-3.3
Fiscal Balance (% of GDP)[a]	0.2	1.2	1.3	0.2	0.4	0.7
Poverty rate ($5/day PPP terms)[b]	0.44	0.31	0.36	0.37	0.38	0.37

Sources: World Bank.
Notes: f = forecast.
(a)Fiscal Balance does not include extra-budgetary and quasi-fiscal expenditures.
(b)Calculations based on ECAPOV harmonization, using 2014-HHS.
Projection using neutral distribution (2014) with pass-through = 0.87 based on GDP per capita constant PPP.
Actual: 2013, 2014. Projections are from 2015 to 2018.

BOSNIA AND HERZEGOVINA

	2015
Population, million	3.8
GDP, current US$ billion	15.5
GDP per capita, current US$	4078
Gini Coefficient [a]	0.33
Life Expectancy at birth, years [b]	76.1

Sources: World Bank, WDI, and Macro Poverty Outlook.
Notes:
(a) Gini data based on ECATSD (2011)
(b) Life Expectancy data show most recent WDI value (2013)

We project growth in Bosnia and Herzegovina (BH) in 2015 to reach 2.8 percent. Growth was higher than expected with a supportive external environment boosting net exports and domestic activity rebounding from the impact of the 2014 floods. However, labor market support for poverty reduction was limited, with little improvement in employment and wages largely stagnant. Reforms are being advanced in a number of areas, such as labor regulations and public finances, with the potential to improve future job creation.

Recent developments

Economic growth performed better-than-expected in 2015. Net exports were the main driver of growth, with consumption also supportive and investment a drag on growth. Real GDP expanded by 4.3 percent year-on-year (y/y) in Q2 –the highest rate in the last five years – and by 3.1 percent in Q3. On the production side, manufacturing and retail trade contributed around half the growth of real value added in the first three quarters of 2015. High frequency data suggest softening GDP dynamics in late 2015, and we project growth to be 2.8 percent for 2015 as a whole.

The growth pick-up has not been reflected in labor market performance. Unemployment remains high, at 27.7 percent, with the number of persons in paid employment rising by only 1.9 percent y/y in November 2015. Net earnings were stagnant throughout 2015 across most sectors (up only 0.5 percent y/y in nominal terms). In a positive development both Republika Srpska (RS) and the Federation of Bosnia and Herzegovina (FBH) adopted new labor laws to address some long-standing rigidities, aiming to support future job creation. However, the FBH constitutional court recently ruled that the FBH law needed to return to Parliament due to violation of procedure.

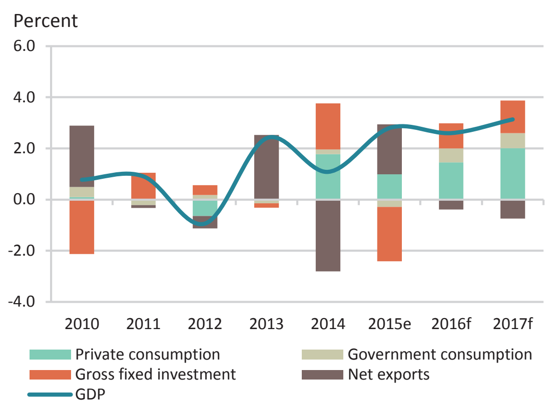
Consumer price deflation persists, driven by lower imported goods prices, including those linked to international oil prices. The consumer price index declined by 1.3 percent y/y in December (the 13th consecutive month of y/y declines). Declining consumer prices provided some boost to real incomes given the limited growth in nominal earnings. However, they also increase the real burden of debt, potentially adding to the asset quality concerns faced in the banking system (with the non-performing to total loan ratio at 13.7 percent). Credit growth remains weak, giving limited support to economic activity.

Falling oil prices contributed to declining imports and improved external demand supported exports. Imports fell by 2.1 percent y/y in 2015 while exports, mainly to regional neighbors and the EU, increased by 3.5 percent. The trade deficit over the period, valued in euro, fell by 8.7 percent to €3.5 billion (but remains at just under 30 percent of GDP). This contributed to a narrowing in the current account deficit to a projected 6.3 percent of GDP.

While the fiscal deficit in 2015 is projected to remain broadly unchanged, at 2 percent of GDP, there are some positive signs of improvements in budgetary processes and steps towards much-needed improvements in the quality and structure of spending. For example, a moratorium on employment in the public sector was introduced for 2016 and pension reforms are ongoing in FBH. Given previous delays in budget adoption, the adoption of all three 2016 budgets by the end December 2015 was also a positive sign, at least relative to the delays of recent years.

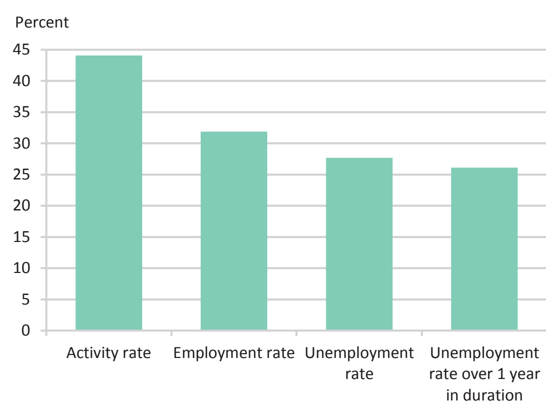
The potential adoption of a new IMF program, which is under discussion, will provide an anchor for the medium-term macro-fiscal framework and, along with support from the EC and World Bank, help to

FIGURE 1 Bosnia and Herzegovina / Contributions to annual GDP growth



Sources: BHAS, World Bank staff estimate.

FIGURE 2 Bosnia and Herzegovina / Labor market indicators, 2015



Sources: LFS 2015 report, World Bank staff calculations.

address underlying fiscal challenges, which are a major focus of the Reform Agenda adopted by the authorities in mid -2015. In another important development, BH formally submitted its application for EU membership in mid-February 2016.

Outlook

Supported primarily by domestic demand growth, we project economic growth to strengthen to above 3 percent in the medium term. Investment is projected to pick-up as a result of improvements in the business environment from implementation of the Reform Agenda, as well as from a number of specific investments in the energy and tourism sectors. External conditions will support a stable inflow of remittances which, combined with sustained lower oil prices, will underpin a gradual pick up in consumption, which will remain a key driver of growth. The recovery in EU import demand will also lead to a moderate rise in exports. However, net external demand will continue to be a drag on growth, given the relative strength of domestic demand for imports. As a result of these dynamics, we project real GDP growth to strengthen gradually from 2.8 percent in 2015 to 3.5 percent in 2018.

Adverse shocks to external trade and financial conditions, along with limited progress in implementing the reform agenda are the main risks to this outlook, impacting in particular net exports and investment. The fiscal deficit is projected to remain around 2 percent of GDP through 2018 with gradual implementation of reforms to reduce current spending, for example, on wages, and to improve revenue performance, for example, by addressing VAT fraud and tax arrears.

Unemployment, particularly among youth, is expected to remain high but to move onto a declining path. However, given the substantial remaining slack in the labor market, real wages are expected to remain largely flat. As a result, the poverty headcount is forecast to improve only marginally. While ongoing reforms may support future labor market performance a high tax wedge, especially among low-wage workers, makes job creation particularly problematic for low-skilled workers among the poor and the B40.

Risks and challenges

The key economic challenge faced by the country is rebalancing the economy towards investment and private-sector led growth and away from consumption. Reform of a large, highly decentralized and fragmented public sector is a fundamental component of this rebalancing. Although fiscal deficits remain relatively moderate, the fiscal sector remains characterized by a high tax burden and inefficient patterns of spending. Fiscal consolidation efforts will not be effective if structural rigidities on the expenditure side remain unaddressed, e.g. a large public wage bill and sizeable and poorly targeted social assistance. The adoption of a proposed IMF program, and support from other partners including the World Bank, can help the authorities to deliver on this challenging agenda.

Sustained reform progress across the broader areas of focus of the Reform Agenda is also a challenge, given the sensitive nature of reforms of labor markets and social policy, as well as the local elections later in 2016. Reforms may also have near-term distributional implications which may require mitigating measures. However, despite these challenges, sustained implementation of the reform agenda is a prerequisite for improved shared prosperity and poverty reduction over the medium term, and for progress towards EU membership.

TABLE 2 Bosnia and Herzegovina / Macro poverty outlook indicators (annual percent change unless indicated otherwise)

	2013	2014	2015 e	2016 f	2017 f	2018 f
Real GDP growth, at constant market prices	2.4	1.1	2.8	2.6	3.1	3.5
Private Consumption	0.0	2.2	1.2	1.8	2.5	2.5
Government Consumption	-0.6	0.9	-1.3	2.6	2.8	3.0
Gross Fixed Capital Investment	-0.9	10.1	-11.0	5.8	7.4	9.6
Exports, Goods and Services	7.9	4.2	3.0	2.0	2.5	3.0
Imports, Goods and Services	-0.1	8.1	-1.7	2.0	3.0	3.5
Real GDP growth, at constant factor prices	2.5	1.2	2.8	2.6	3.1	3.5
Agriculture	16.1	-9.4	0.5	1.0	2.0	2.0
Industry	3.7	0.0	2.0	2.5	3.0	3.0
Services	0.4	3.2	3.5	2.8	3.3	3.9
Prices: Inflation	0.8	-0.5	-0.7	-0.6	0.9	0.9
Current Account Balance (% of GDP)	-5.7	-7.8	-6.3	-6.4	-7.1	-8.0
Financial and Capital Account (% of GDP)	4.8	6.7	6.3	6.4	7.1	8.0
Net Foreign Direct Investment (% of GDP)	1.6	2.6	1.4	1.7	1.9	2.3
Fiscal Balance (% of GDP)	-1.9	-2.0	-1.7	-2.1	-2.1	-1.9
Debt (% of GDP)	40.8	43.0	43.8	45.2	45.6	48.4
Primary Balance (% of GDP)	-1.2	-1.3	-0.7	-1.1	-1.2	-0.8

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Note: f = forecast.

BULGARIA

Table 1	2015
Population, million	7.2
GDP, current US$ billion	49.1
GDP per capita, current US$	6838
Poverty rate ($2.5/day 2005PPP terms)[a]	5.6
Poverty rate ($5/day 2005PPP terms)[a]	16.4
Gini Coefficient[a]	36.0
School enrollment, primary (% gross)[b]	99.5
Life Expectancy at birth, years[b]	74.3

Sources: World Bank WDI and Macro Poverty Outlook.
Notes:
(a) Most recent value (2012)
(b) Most recent WDI value (2013)

Bulgaria's economic recovery strengthened in 2015 and supported improved fiscal performance but the medium-term outlook remains challenging. Stronger growth and improvements in labor markets have contributed to poverty reduction. Further gains in growth, poverty reduction and shared prosperity would hinge on strengthening institutions, boosting the skills and employability of the labor force, and improving the effectiveness and efficiency of public spending.

Recent developments

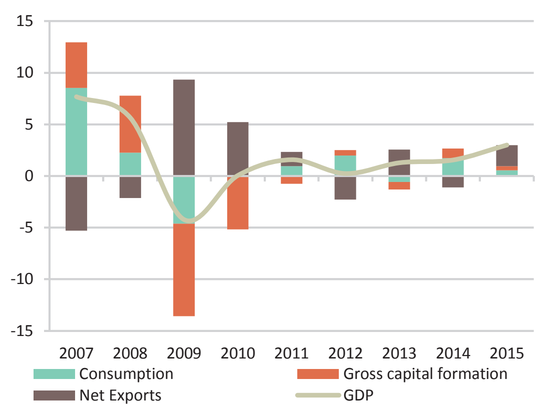
Economic recovery strengthened in 2015 following five years of slow economic growth. GDP grew by 3 percent in 2015, a significant improvement compared to 2009-14. Exports expanded at robust rate and were the key driver of growth despite the crisis in neighboring Greece and heightened geopolitical tensions. Domestic demand benefited from a spur in investment from intensified implementation of EU-funded projects, continuing labor market improvements, and low inflation. Consumption recovered in the second half of the year as declining unemployment, rising wages and a low inflation boosted real household incomes. Unemployment declined to a six-year low (7.9 percent of the labor force in Q4-2015) while new jobs were created in sectors -- such as construction and industry -- that were the hardest hit during the 2009 crisis and that employ a relatively large share of low-skilled labor, boding well for poverty reduction.

Estimated poverty declined modestly from 15.3 percent in 2014 to 14.5 percent in 2015 (5.5 percent to 5.0 percent, respectively, at the $2.50 poverty line). This reflects a mix of employment and wage gains among low-skilled workers, especially in the construction sector, and relatively static pensions and social benefits for the large share of poorer households that are out of the labor market. Nevertheless, unemployment is still high, especially long-term and youth, and with high regional variation. Inactivity among certain groups of population is also high as a result of education system with deteriorating quality and rising inequality, and a large number of people excluded from economic opportunities, such as elderly, people living in rural areas, and the Roma. Excluding a large number of people is damaging for growth in the case of Bulgaria which is undergoing the steepest decline in population in the world.

Accelerated economic activity and improved tax compliance strengthened Bulgaria's fiscal position. The fiscal deficit, estimated at 2.5 percent of GDP in 2015, was better than expected. Buoyant tax revenues and accelerated absorption of EU funds supported the achievement of the fiscal outcome despite difficulties in implementing the planned cuts in the wage bill in some sectors. Government debt is projected to have increased to 28.1 percent of GDP in 2015. Debt remains the third lowest in the EU.

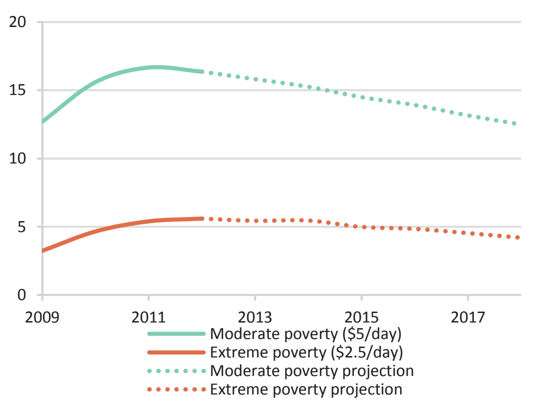
The external current account was again in surplus supported by further narrowing of the trade balance. Bulgaria exported more investment goods and raw materials, especially to the EU, while import growth was modest in line with low oil prices and was concentrated in investment and consumer goods. On the basis of the improved external position, reduced exposures of Greek-owned banks in Bulgaria, and one-off factors affecting intercompany lending, external private debt shrank by almost 14 percentage points of GDP in a year, to 63.1 percent of GDP in 2015.

FIGURE 1 Bulgaria / Contributions to annual growth, percentage points



Sources: NSI and World Bank staff estimates.

FIGURE 2 Bulgaria / Poverty Rates



Sources: World Bank.

Outlook

GDP growth is projected to slow to 2.2 percent in 2016 as the impact of higher absorption of EU funds on public investment and consumption diminishes sharply with the start of the new financing period. Private investment is likely to continue to be weak in line with still constrained lending. Going forward, the economic recovery is projected to be modest, with growth picking up to 2.7 percent in 2017 and 3 percent in 2018. Recovery of external demand is likely to be slow as a result of weakening of growth in emerging markets and lingering geopolitical tensions in the region.
Poverty at the $5 poverty line is expected to continue declining slowly to 13.9 percent in 2016, 13.2 percent in 2017 and 12.5 percent in 2018 (4.8, 4.5 and 4.2 percent, respectively, at the $2.50 poverty line). Increased child benefits (for a second child or twin) and children with permanent disabilities are expected to contribute to poverty reduction, as is financial support to cover heating costs for children and the elderly. Labor market developments such as minimum wage increases and the Youth Guarantee program for activating young people not in education, employment or training are expected to help reduce poverty as well.
The external current account is expected to continue to be in surplus as economic activity firms before shifting to a small deficit in 2018. Export growth is likely to slow in response to a weakening outlook in emerging markets. Import growth is likely to be affected by weakening domestic demand for investment goods.
Fiscal consolidation is likely to continue in 2016 and beyond. The fiscal deficit is expected to be reduced to 2.2 percent of GDP in 2016 and to 1.3 percent by 2018. Limited improvements in spending efficiency of select sectors could undermine fiscal consolidation plans going forward and limit the potential of public spending to enhance growth. High contingent liabilities in the energy and banking sector present risk to fiscal accounts.

Risks and challenges

The key challenge for Bulgaria is to accelerate convergence with the rest of the EU and deal with the negative consequences of its demographic change. Accelerating convergence would require improvements in productivity and in labor force participation. According to a recent World Bank report, Bulgaria will need to raise its productivity growth to at least 4 percent per year to reach the average EU income levels within a generation. Yet, recent productivity growth has been disappointing while improvements in labor force participation have been constrained by weak demand and skill shortages while a large portion of the population is at risk of poverty or social inclusion.
Addressing the challenge of convergence would require stepping up reforms to strengthen the legal and institutional framework, boosting the skills of the labor force, and increasing effectiveness of public spending.
Reforms to strengthen the effectiveness of the judiciary, reduce the potential for corruption, and improve the regulation of energy and financial sector could strengthen confidence and reduce fiscal pressures. Improving the education outcomes can have a significant impact on poverty reduction and shared prosperity. Enhancing the effectiveness of public spending on pensions, health and long-term care will be important for boosting Bulgaria's growth and ensure more inclusive and sustainable growth.

TABLE 2 Bulgaria / Macro poverty outlook indicators (annual percent change unless indicated otherwise)

	2013	2014	2015 e	2016 f	2017 f	2018 f
Real GDP growth, at constant market prices	1.3	1.6	3.0	2.2	2.7	3.0
Private Consumption	-1.4	2.7	0.8	2.1	2.6	3.3
Government Consumption	2.2	0.1	0.3	1.2	1.4	1.7
Gross Fixed Capital Investment	0.3	3.4	2.5	1.4	2.3	2.6
Exports, Goods and Services	9.2	-0.1	7.6	4.2	4.4	4.8
Imports, Goods and Services	4.9	1.5	4.4	3.7	4.0	4.9
Real GDP growth, at constant factor prices	1.1	1.8	1.5	2.2	2.7	3.0
Agriculture	3.2	5.2	-1.4	1.0	1.2	1.5
Industry	0.2	0.9	2.8	2.2	3.0	3.3
Services	1.3	1.9	1.2	2.4	2.7	3.0
Inflation (Consumer Price Index)	0.9	-1.4	-1.1	-0.2	1.1	1.4
Current Account Balance (% of GDP)	1.3	0.9	1.4	1.1	1.0	-0.1
Financial and Capital Account (% of GDP)	-1.0	2.8	-3.1	-0.1	-0.4	-0.1
Foreign Direct Investment in Bulgaria (% of GDP)	3.3	3.1	3.6	3.5	3.7	3.8
Fiscal Balance (% of GDP)	-0.8	-5.8	-2.5	-2.2	-1.9	-1.3
Debt (% of GDP)	18.0	27.0	28.1	29.5	30.2	30.5
Primary Balance (% of GDP)	-0.1	-4.9	-1.5	-1.2	-1.0	-0.4
Poverty rate ($2.5/day 2005 PPP terms)[a,b,c]	5.5	5.5	5.0	4.8	4.5	4.2
Poverty rate ($5/day 2005 PPP terms)[a,b,c]	15.8	15.3	14.5	13.9	13.2	12.5

Sources: NSI; BNB; Eurostat; World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: f = forecast.
(a) Calculations based on ECAPOV harmonization, using 2012-EU-SILC.
(b) Projection using neutral distribution (2012) with pass-through = 0.87 based on GDP per capita constant PPP.
(c) Actual data: 2012. Projections are from 2013 to 2018.

CROATIA

Table 1	2015
Population, million	4.2
GDP, current US$ billion	49.0
GDP per capita, current US$	11580
Poverty rate ($2.5/day 2005PPP terms)[a]	2.1
Poverty rate ($5/day 2005PPP terms)[a]	9.4
Gini Coefficient[a]	32.5
School enrollment, primary (% gross)[b]	96.8
Life Expectancy at birth, years[b]	76.9

Sources: World Bank WDI and Macro Poverty Outlook.
Notes:
(a) Most recent value (2012)
(b) Most recent WDI value (2013)

After six years of recession, Croatia started a gradual recovery in 2015 led by external demand and private consumption. Given the labor market recovery, as well as the reduced income taxation and the expansion of employment subsidies in 2015, the poverty rate has likely continued trending downwards. The fiscal deficit is set to continue declining towards 3 percent of GDP, with the public debt stabilizing. Economic growth of 1.9 percent in 2016, will come from tourism and investments driven by EU funds absorption.

Recent developments

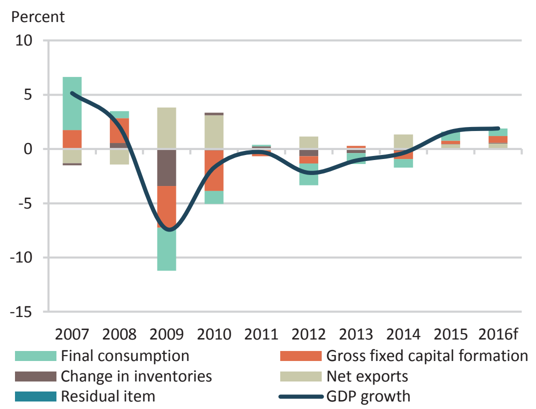
After a prolonged recession, Croatia started a gradual recovery in 2015 reaching an annual growth of 1.6 percent. Growth was led by exports of goods and services, underpinned by EU recovery, as well as higher private consumption, boosted by oil and food price declines, income tax changes and labor market recovery.

Administrative unemployment data continued its downward trend, reflecting growth both in public and private service employment. In 2015, Croatia doubled the amount of employment subsidies supported by the EU Youth Guarantee Scheme and strengthened other active labor market programs for vulnerable groups, which led to employment growth. Still, the unemployment rate at 17 percent remained high compared to EU peers. The increase in real net wages (4.1 percent) due to legislative changes in the income tax and deflationary pressures, increased disposable household incomes in 2015. In addition, the government adopted a debt relief scheme, a reduction of the penalty interest rate, a measure financing the cost of electricity for socially-vulnerable households that are already receiving minimal social assistance or disability benefits, and conversion of all CHF-loans to EUR-loans, all aimed at easing households' debt burden and helping improve their living standards. As a result, the absolute poverty rate measured at $5/day PPP is expected to have decreased from 9.8 percent in 2014 to 9.0 percent in 2015. The decline is likely to have happened despite a decrease in real pensions by 0.5 percent in 2015 as the number of new early retirees increased. Compared to the pre-crisis level, real per capita income in 2015 was about 8 percent lower.

Fiscal vulnerabilities declined in 2015, led by improved tax collection and a lower wage bill. The general government deficit declined to a still high 4.7 percent of GDP on an accrual basis from 5.6 percent in 2014, and public debt rose further to almost 88 percent of GDP. During 2015, limited progress was registered in the area of fiscal governance, including the reform of the public administration and the adoption of a public debt management strategy. Some of the saving measures identified in the spending review are being implemented, but at a slow pace. The reform of wage-setting in the public sector and state-owned enterprises and the reform of the social protection system were put on hold in the run-up to the elections.

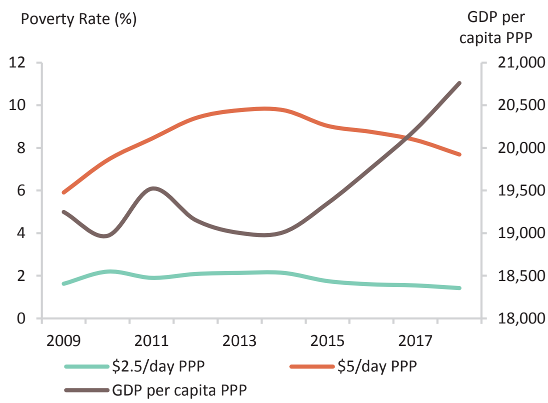
While deposits increased, deleveraging continued in 2015 as companies turned to direct foreign borrowing. Households reduced their liabilities to the banking sector by 1.5 percent in December 2015 when the conversion and partial write-off of CHF loans started. So far, households converted the equivalent of 0.6 percent of GDP in EUR-denominated loans, while 0.3 percent of GDP was written off. Non-performing loans, after their peak in June 2015, slightly declined to 16.6 percent in December 2015.

FIGURE 1 Croatia / Contributions to annual GDP growth



Sources: World Bank.

FIGURE 2 Croatia / Actual and estimated poverty rates and GDP per capita (PPP)



Sources: World Bank (see notes to table 2).

Outlook

Economic activity is expected to continue recovering in 2016-18 with growth averaging 2.1 percent a year, led by strengthened private consumption, exports and investment, benefitting from the improved absorption of EU funds. Private consumption is expected to grow reflecting labor market recovery, increased consumer confidence and slowdown in deleveraging. Stronger utilization of EU funds will boost investment, while government consumption is projected to remain subdued due to the need for fiscal consolidation under the Excessive Deficit Procedure (EDP) with the EU. The speed of adjustment is likely to be slower than prescribed by the EDP, however.

As the growth gradually accelerates, the absolute poverty rate measured at US$5/day at PPP is projected to decline to 8.4 percent in 2017 and further to 7.7 percent in 2018, led by labor market improvement, in particular in the service sector (tourism, construction and professional services). Labor force participation at 52.7 percent in 2015 is among the lowest in EU and presents a strong determinant of low household income and of vulnerability to poverty.

Addressing structural issues to boost growth and job creation is expected to be a priority of the new government formed after the parliamentary elections of early November. The 2016 budget aiming to reduce deficit to close to 3 percent of GDP and stabilize public debt does not plan to reduce pension and wages, but reductions in subsidies and operational costs are likely to occur. The fiscal consolidation path the new government will pursue is likely to affect investors' and credit agencies' decisions. In January 2016, following Fitch, the S&P affirmed BB/'B credit rating on Croatia with the outlook remaining negative, while in March, Moody's downgraded Croatia's rating to Ba2 from Ba1 and maintained the negative outlook due to the government's large and increasing debt burden and continuing weak medium-term economic growth prospects.

On the monetary policy side, the current account surplus, coupled with the strengthening of banks' external positions and announced fiscal consolidation opened the room for central bank to introduce structural repo operations aimed at ensuring long-term liquidity, decreasing the financing costs for domestic sectors and with strengthened domestic demand, boosting lending in local currency to corporates and households.

Risks and challenges

Risks are still skewed to the downside. External factors, such as a slowdown in Croatia's main trading partners, the Fed's tightening monetary policy and increased emerging market risk premium, could undermine Croatia's fragile recovery, affecting exports and raising financing costs. On the domestic side, high government and private debt, jointly representing more than 200 percent of GDP in 2014, will continue to constrain public and private investment and household consumption. Debt sustainability analysis indicates high risks in the medium term, while the scope of fiscal consolidation measures for 2016 and 2017 is still uncertain. A wage increase of 6 percent planned for 2016 as per the 2009 wage agreement and the delayed cancelation of the loyalty bonuses would add additional 0.65 percent of GDP to spending in 2016 that could hamper the fiscal consolidation plans. The continued arrears creation in the health sector will also require additional savings measures. Lifting potential growth from the current 1 percent requires sustained investment and deep structural reforms in labor and especially product markets to support full utilization of the labor force, while ensuring robust productivity growth.

TABLE 2 Croatia / Macro poverty outlook indicators (annual percent change unless indicated otherwise)

	2013	2014	2015 e	2016 f	2017 f	2018 f
Real GDP growth, at constant market prices	-1.1	-0.4	1.6	1.9	2.0	2.4
Private Consumption	-1.8	-0.7	1.2	1.2	1.3	1.6
Government Consumption	0.3	-1.9	0.6	0.0	0.5	0.8
Gross Fixed Capital Investment	1.4	-3.6	1.6	3.1	3.7	3.9
Exports, Goods and Services	3.1	7.3	9.2	3.6	3.0	2.9
Imports, Goods and Services	3.1	4.3	8.6	2.6	2.5	2.2
Real GDP growth, at constant factor prices	-1.1	-0.1	1.4	1.9	2.0	2.4
Agriculture	-0.6	0.0	-0.4	1.5	2.0	2.2
Industry	-2.8	0.5	1.9	2.6	2.8	2.8
Services	-0.6	-0.3	1.3	1.7	1.7	2.3
Inflation (Consumer Price Index)	2.2	-0.2	-0.5	0.9	1.5	1.9
Current Account Balance (% of GDP)	1.0	0.8	4.5	2.0	1.9	1.7
Financial and Capital Account (% of GDP)	1.0	0.6	-3.6	-0.7	-0.6	-0.5
Net Foreign Direct Investment (% of GDP)	1.9	3.0	1.6	2.7	3.1	3.5
Fiscal Balance (% of GDP)	-5.4	-5.6	-4.7	-3.3	-2.8	-2.4
Debt (% of GDP)	80.8	85.1	87.8	88.8	89.0	88.3
Primary Balance (% of GDP)	-1.9	-2.1	-1.1	0.2	0.7	1.1
Poverty rate ($2.5/day PPP terms)[a,b,c]	2.1	2.1	1.7	1.6	1.5	1.4
Poverty rate ($5/day PPP terms)[a,b,c]	9.8	9.8	9.0	8.7	8.4	7.7

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: e = estimate, f = forecast.
(a) Calculations based on ECAPOV harmonization, using 2012-EU-SILC.
(b) Projection using neutral distribution (2012) with pass-through = 1 based on GDP per capita constant PPP.
(c) Projections are from 2013 to 2018.

GEORGIA

Table 1	2015
Population, million	3.7
GDP, current US$ billion	14.0
GDP per capita, current US$	3754
Poverty rate ($2.5/day 2005PPP terms)[a]	32.3
Poverty rate ($5/day 2005PPP terms)[a]	69.4
Gini Coefficient[a]	40.1
School enrollment, primary (% gross)[b]	106.1
Life Expectancy at birth, years[b]	73.9

Sources: World Bank WDI and Macro Poverty Outlook.
Notes:
(a) Most recent value (2014)
(b) Most recent WDI value (2013)

GDP growth slowed to 2.8 percent in 2015 largely because of a weaker external environment. With pre-election uncertainty and continued weakness in the external markets, growth in 2016 is projected at 3 percent. Public capital spending supported growth in 2015 but overruns in other expenditures raised the fiscal deficit to 3.7 percent of GDP. Lower corporate income taxes are likely to raise the fiscal deficit over the medium-term. Modest growth and rising inflation are expected to slow the pace of poverty reduction in 2016.

Recent developments

The recession in Russia and slower growth among other trading partners impacted Georgia through lower exports and reduced remittances, particularly from Russia and Greece.

The tradable sector suffered the most, with industrial production contracting by one percent in 2015. As a result, growth moderated from 4.6 percent in 2014 to 2.8 percent in 2015. The slower growth was supported by non-tradables like construction (+15.2 percent) and services (+3 percent) and foreign direct investment (FDI). These sectors helped increase employment by 10 percent in 2015, raising real wages by 3.7 percent. The construction, real estate and health sectors experienced the largest wage increases. However, unemployment remains high, particularly in urban areas and among younger workers.

Driven by a decline in exports and remittances, the current-account deficit widened to 11 percent of GDP, and the lari has lost 30 percent of its value against the US dollar since December 2014. The depreciation raised inflationary expectations, leading the National Bank of Georgia (NBG) to increase the policy rate from 4 percent in February 2015 to 8 percent in December. The tightening of monetary policy together with lower oil prices helped contain inflation during 2015 to 4.9 percent. Prudent financial sector supervision ensured stability of the banking sector and low level of NPLs at 2.3 percent in 2015.

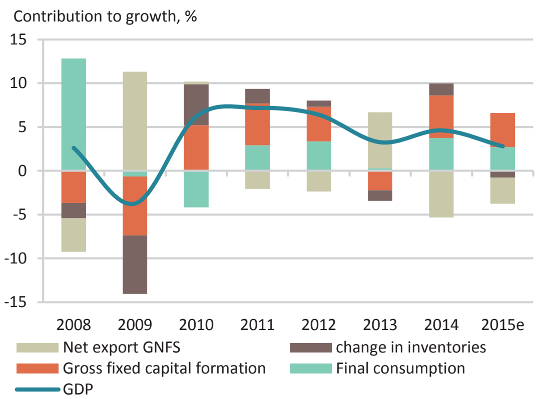
In an environment of weak external demand and high policy rates the government supported growth through a 17 percent increase in capital expenditures. This was coupled with a 9 percent increase in current spending, raising the fiscal deficit to 3.7 percent of GDP in 2015 compared with a budgeted deficit of 3 percent. The deviation was mainly driven by an overrun in current spending and on-lending to municipalities.

The poverty rate fell during 2010-14 and is estimated to have declined further in 2015, although at a slower pace. The extreme poverty rate (US$2.5/day) was estimated at 32.3 percent in 2014. Increases in salaries and social transfers drove poverty reduction during 2010-14, with the former playing a greater role in urban areas. Since 2013, agricultural income and employment opportunities in construction and tourism have also contributed to the decline in poverty levels. However, the rural poverty rate remains roughly twice the urban rate.

Outlook

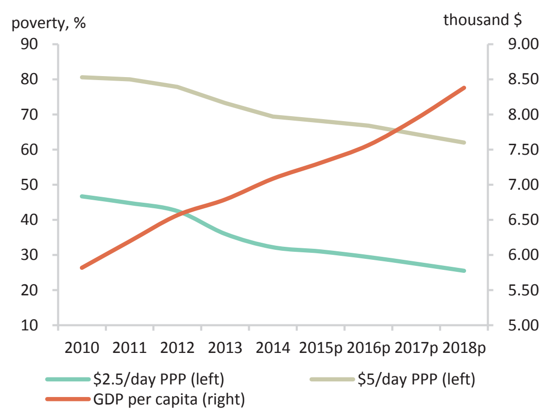
With Parliamentary elections scheduled for October 2016 and the weakness in external markets likely to persist, growth is projected at 3 percent in 2016. The spillover effects from the Russia-Ukraine crisis and the slowdown among Georgia's main trading partners are likely to push the current-account deficit to 10 percent of GDP in 2016. Greater policy certainty following the election, a modest recovery in

FIGURE 1 Georgia / GDP growth decomposition (% contribution)



Source: Geostat.

FIGURE 2 Georgia / Poverty rates, 2010-2018 (2005 US$ PPP)



Source: World Bank Poverty Global Practice.

external markets and strong FDI inflows—particularly related to the BP-pipeline expansion, the upcoming Anaklia deep-sea port, and hydro power projects (HPPs)—are projected to boost growth to 4.5 percent in 2017 and 5 percent in 2018. The current account deficit is also expected to go down gradually in the outer years.

Georgia's anticipated adoption of the Estonian tax model, which would replace the corporate profit tax with dividend tax, is expected to increase the fiscal deficit in the short-to-medium term. While this measure could boost medium-term growth, tax revenues will decline immediately. Besides, pensions will rise by 12.5 percent in July 2016 and teachers' salaries will increase further in April. Thus total expenditures are expected to exceed 30 percent of GDP in 2016 and the fiscal deficit is projected to increase to 4-5 percent of GDP, assuming that the Estonian tax model is adopted in 2016. The decline in tax revenues is likely to persist over the medium-term which will keep the deficit level elevated compared with the past. The stock of public debt is also likely to increase with increased deficit levels.

Poverty levels are anticipated to decrease further during 2016-18, although food-price inflation and modest economic growth will slow the pace of poverty reduction in 2016. Increased construction activity supported by large anticipated investments and the growth of tourism-related services are expected to drive job creation and poverty reduction. The rise in real salaries observed since 2010 is also likely to continue, which should further reduce poverty rates, while the expected increase in pensions will have a positive distributional impact. However, fiscal constraints are expected to limit the role of social assistance in the future. Moreover, higher food prices in 2016 will disproportionately affect the purchasing power of households at the bottom of the income distribution, as food represents a larger share of their consumption basket

Risks and challenges

Political and policy uncertainty stemming from the October parliamentary elections along with the existing geopolitical risks could weaken consumer and business confidence and slow the pace of reforms. However, overall policy continuity is likely to be maintained, as both the ruling and opposition parties are equally committed to Georgia's European integration aspirations and business friendly policies.

Slow growth, a large current-account deficit, high levels of external debt, a widening fiscal deficit, elevated rural poverty and high rates of unemployment are among the main challenges to economic growth and poverty reduction in Georgia. Given its limited domestic savings, Georgia relies on foreign savings to finance the bulk of its investments. This has led to persistently high current-account deficits, with external debt exceeding 100 percent of GDP. Falling exports and remittance inflows, a high level of dollarization at 65 percent and low reserves (3 months of imports) have heightened foreign-exchange risks. Mitigating factors include the floating exchange rate, market access and the support of international financial institutions. Falling corporate tax revenues, increases in recurrent spending and contingent liabilities arising from power-purchase agreements are all sources of fiscal risk. The government will need to better manage aggregate demand through lower deficits and establish an adequate mechanism to monitor and reduce contingent liabilities. The contribution of social benefits to poverty reduction will also need to be balanced against labor force participation objectives.

TABLE 2 Georgia / Key Economic Indicators (% change unless otherwise indicated)

	2013	2014	2015 e	2016 f	2017 f	2018 f
Real GDP growth, at constant market prices	3.4	4.6	2.8	3.0	4.5	5.0
Private Consumption	-0.1	3.2	5.4	-2.6	2.6	5.5
Government Consumption	4.3	11.2	3.5	5.5	5.7	3.8
Gross Fixed Capital Investment	-10.1	24.4	4.2	-3.9	3.9	7.0
Exports, Goods and Services	20.3	0.4	-10.9	3.8	4.0	6.9
Imports, Goods and Services	2.9	11.1	-6.6	-5.2	2.0	7.3
Real GDP growth, at constant factor prices	3.8	4.4	3.0	2.4	4.4	4.8
Agriculture	11.3	1.6	2.9	3.0	4.0	2.0
Industry	3.6	4.5	3.4	6.0	6.0	5.0
Services	3.1	4.7	3.0	1.2	3.9	5.1
Inflation (Private Consumption Deflator)	0.6	4.5	7.7	3.9	3.7	4.7
Current Account Balance (% of GDP)	-5.8	-10.6	-11.0	-10.0	-8.8	-8.3
Financial and Capital Account (% of GDP)	5.8	10.6	11.0	10.0	8.8	8.3
Net Foreign Direct Investment (% of GDP)	5.1	8.1	9.1	9.8	9.5	8.9
Poverty rate ($2.5/day PPP terms)[a,b,c]	36.0	32.3	31.0	29.4	27.5	25.5
Poverty rate ($5/day PPP terms)[a,b,c]	73.3	69.4	68.2	66.8	64.4	62.0

Sources: World Bank. Macroeconomics and Fiscal Management Global Practice. and Poverty Global Practice.Due to pending tax reforms and expenditure adjustments, fiscal i
Notes: e = estimate, f = forecast.
(a) Calculations based on ECAPOV harmonization, using 2014-HIS.
(b) Projection using neutral distribution (2014) with pass-through = 0.87 based on GDP per capita constant PPP.
(c) Actual data: 2013, 2014. Projections are from 2015 to 2018.

KAZAKHSTAN

Table 1	2015
Population, million	17.5
GDP, current US$ billion	189.6
GDP per capita, current US$	10840
Poverty rate ($2.5/day 2005PPP terms)[a]	0.4
Poverty rate ($5/day 2005PPP terms)[a]	15.2
Gini Coefficient[a]	26.3
School enrollment, primary (% gross)[b]	104.9
Life Expectancy at birth, years[b]	69.6

Sources: World Bank WDI and Macro Poverty Outlook.
Notes:
(a) Most recent value (2013)
(b) Most recent WDI value (2013)

Kazakhstan's growth is slowing from 1.2 percent of GDP in 2015 to an estimated 0.1 percent in 2016 due to low global oil prices and weakened domestic and external demand. Growth is expected to pick up over 2017-18 as oil prices recover and oil production increases, but will remain below its long-run potential. Weak job creation will limit progress on poverty reduction in the near term, but a decline in the poverty rate is anticipated in 2017-18 as growth accelerates.

Recent developments

Falling oil prices and weakened domestic and export demand in China and Russia caused Kazakhstan's GDP growth rate to slow from 4.1 percent in 2014 to 1.2 percent in 2015. The move to a floating exchange-rate regime in August 2015 led to a sharp depreciation of the tenge (KZT), which negatively affected private domestic demand and intensified inflationary pressures. Industrial output contracted by 1.6 percent in 2015, while the service-sector growth rate fell from 5.7 percent in 2014 to an estimated 2.3 percent in 2015. Agricultural production grew by an estimated 4.4 percent, but the sector's contribution to GDP growth is relatively minor. Some labor market indicators are beginning to weaken. Real wages declined by 2.4 percent between 2014 and 2015, and the official unemployment rate remained at 5 percent in 2015 before rising to 5.1 percent in January 2016.

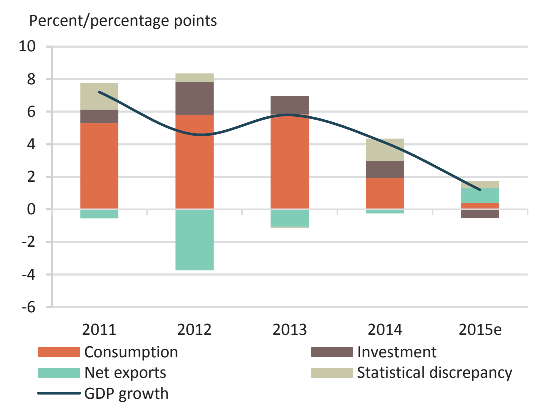
The government continued to implement the anti-crisis program launched in late 2014. Falling oil prices and a large-scale off-budget investment initiative led to a deterioration of the consolidated fiscal stance from a balanced position in 2014 to a deficit of 7.8 percent of GDP in 2015, despite cuts in budgetary outlays.

The continued decline of oil prices in 2015 increased external imbalances and fueled speculative pressure on the tenge. The central bank intervened aggressively to defend the exchange rate until mid-2015, providing injections of foreign exchange and tightening tenge liquidity. In August, however, the central bank announced the shift to a floating exchange-rate regime and inflation targeting. The tenge lost almost half its value against the US dollar between mid-August (KZT 188/US$) and end-December 2015 (KZT 340/US$). The depreciation helped reduce imports in Q4 2015, but the steep drop in export revenue turned the current-account balance from a surplus of 2.6 percent of GDP in 2014 to a deficit of 2.9 percent in 2015. While foreign-exchange-denominated loans represented just 23.2 percent of total loans in August 2015, the banking sector will be subject to increasing pressure, as the share of nonperforming loans is expected to rise.

Weak domestic demand put downward pressure on the inflation rate, which fell to a historic low of 3.8 percent, year-on-year (y/y), in August 2015 before the pass-through effect of the depreciation caused it to spike, reaching to 13.6 percent, y/y, in December 2015. Worsening terms of trade, coupled with wealth and price effects related to the depreciation, are expected to erode household purchasing power.

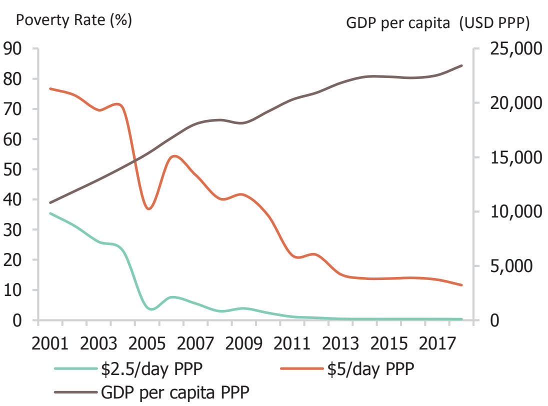
Progress on poverty reduction largely stalled in 2014 and 2015 due to slow growth and a weak labor market. The government is attempting to soften the impact of the slowing economy by protecting social spending and increasing pensions. However, pro-poor transfer programs are still relatively undeveloped, leaving low-income households vulnerable to rising food prices, falling real wages and diminished employment opportunities.

FIGURE 1 Kazakhstan / Contribution to GDP growth



Source: World Bank estimates based on data from Statistical Office of Kazakhstan.

FIGURE 2 Kazakhstan / Actual and estimated poverty rates and GDP per capita (PPP)



Sources: World Bank (see notes to table 2).

Outlook

The GDP growth rate is projected to fall to just 0.1 percent in 2016, while inflation is expected to remain elevated. These projections are based on the current 2016 oil price forecast of US$37 per barrel, and no major improvement in external conditions is anticipated over the near term. The current-account deficit is expected to worsen as the economy continues to adjust to low oil prices. Consumer price inflation is projected to peak in 2016 before falling back to single digits by the end of the year as the effect of the tenge's depreciation on domestic prices fades. Nevertheless, consumer prices are expected to rise by an average of about 13.7 percent over the year. GDP growth is projected to pick up to about 1.9 percent in 2017 and 3.7 percent in 2018, assuming that average oil prices will recover to US$48 per barrel in 2017 and US$51.4 in 2018 and that the Kashagan offshore oilfield will commence production on schedule. Rising oil output and an improving external environment are expected to contribute to a broad-based economic recovery, starting with the oil sector and related services. However, sustaining higher growth rates will depend on implementation of structural reforms designed to support private-sector development and economic diversification.

The poverty rate is projected to show a small uptick in 2016 before declining at a moderate pace over 2017-2018 as the economy recovers. However, since the initial rebound in growth will result primarily from the oil sector, rather than being broad based, wages will remain subject to downward pressure in 2017 and employment growth will improve only marginally. As inflation continues to affect consumer purchasing power, and demand declines as real wages fall, strengthening targeted social assistance programs may temporarily help protect the poor.

Going forward, the government plans to consolidate its fiscal stance and reduce the nonoil deficit to a more sustainable level over the medium term. The government recently announced an ambitious reform agenda, supported by ongoing efforts to privatize state-owned enterprises and improve the business climate.

Risks and challenges

Kazakhstan's economic outlook is vulnerable to three main sources of downside risk. First, oil prices may fall below the baseline projection of US$37 per barrel. Second, progress on the structural reform agenda to support diversification may stall, , especially the privatization of state-owned enterprises and key revisions to the regulatory framework. And third, insufficient coordination between macroeconomic policies and structural reforms may adversely affect the quality of growth and its contribution to job creation, which could have negative welfare implications, particularly for poor households. Moreover, the quality of the fiscal adjustment will hinge on improvements in the quality and efficiency of expenditures, while the implementation of inflation targeting and the floating exchange-rate regime will depend on the monetary authorities ensuring adequate capacity building for and systematic communication about the reform agenda. If a broad-based recovery fails to materialize, a continued decline in real incomes could further undermine the welfare of poor households. An increase in targeted social transfers may be necessary to mitigate the impact of inflation and falling real incomes, but the key challenge will be to prioritize spending on poor and vulnerable groups in order to maximize the impact of a limited fiscal envelope.

TABLE 2 Kazakhstan / Macro poverty outlook indicators (annual percent change unless indicated otherwise)

	2013	2014	2015 e	2016 f	2017 f	2018 f
Real GDP growth, at constant market prices	5.8	4.1	1.2	0.1	1.9	3.7
Private Consumption	12.6	1.8	1.0	-2.0	1.5	4.5
Government Consumption	1.7	9.8	-1.3	4.2	0.9	3.0
Gross Fixed Capital Investment	4.9	4.4	-2.1	-5.6	7.9	4.8
Exports, Goods and Services	2.1	-3.2	-2.2	-2.1	2.1	2.5
Imports, Goods and Services	7.4	-4.0	-6.0	-5.0	1.9	5.4
Real GDP growth, at constant factor prices	5.4	3.9	1.0	0.2	1.8	3.7
Agriculture	11.2	1.3	4.4	3.5	3.5	3.5
Industry	3.1	1.5	-1.6	-1.2	1.6	2.6
Services	6.4	5.7	2.3	0.7	1.8	4.3
Inflation (Consumer Price Index)	5.8	6.7	6.6	13.7	4.5	4.4
Current Account Balance (% of GDP)	0.4	2.6	-2.9	-4.7	-1.5	-1.8
Financial and Capital Account (% of GDP)	2.6	2.5	8.1	12.4	8.7	7.8
Net Foreign Direct Investment (% of GDP)	3.3	2.1	2.3	4.3	4.2	4.0
Fiscal Balance (% of GDP)	3.6	0.0	-7.8	-4.8	-1.8	-1.6
Debt (% of GDP)	11.9	13.8	21.3	19.1	17.0	16.9
Primary Balance (% of GDP)	4.1	0.5	-7.2	-3.5	-1.4	-1.2
Poverty rate ($2.5/day PPP terms)[a,b,c]	0.4	0.4	0.4	0.4	0.4	0.3
Poverty rate ($5/day PPP terms)[a,b,c]	15.2	13.8	13.8	14.0	13.4	11.6

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: e = estimate, f = forecast.
(a) Calculations based on ECAPOV harmonization, using 2013-HBS.
(b) Projection using neutral distribution (2013) with pass-through = 0.87 based on GDP per capita constant PPP.
(c) Projections are from 2014 to 2018.

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KOSOVO

Table 1	2015
Population, million	1.8
GDP, current US$ billion	6.4
GDP per capita, current US$	3551
School enrollment, primary (% gross)[a]	98.3
Life Expectancy at birth, years[a]	70.5

Sources: World Bank WDI and Macro Poverty Outlook.
Notes:
(a) Most recent WDI value (2013)

Economic growth recovered in 2015 to 3.6percent, driven primarily by private investment. Growth is projected to strengthen to 4 percent a year in 2017 and 2018, subject to political downside risks. Incomes of low income households should see a boost from a pick-up in growth in agriculture, agro-processing, and construction, and from a steady inflow of remittances. However, growth so far has resulted in only limited employment creation, which will continue constraining poverty reduction at home and support pressure to seek employment abroad.

Recent developments

In 2015 growth recovered to 3.6 percent, driven by domestic demand. This was primarily on account of a 147 percent increase in FDI that supported a pickup in private investment across sectors, and a 9 percent growth in remittances. An election-driven 25 percent increase in public sector wages since April 2014 impacted Q1 2015 growth. Stagnating exports, coupled with a positive growth in imports, resulted in a negative net exports contribution to overall growth.

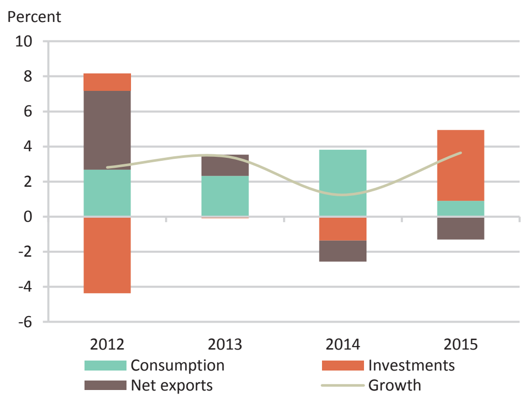
External imbalances widened in 2015 with the current account deficit increasing to 9.4 percent of GDP from 7.9 percent in 2014. The larger CAD is due to larger profits recorded by foreign-invested companies; most of the profit was retained rather than repatriated abroad and is therefore included in the financial account under FDI. Deflation of 0.5 percent in 2015, reflecting largely falling fuel and food prices, helped support real household incomes.

Across sectors, growth picked up strongly in 2015 in construction, and, to a lesser extent, in agriculture, both of which should boost incomes of low skilled households. However, there is no real evidence yet of notable labor market improvements. According to the latest (2014) data, youth unemployment is especially high at 61 percent. Almost three-fourths of the unemployed are long-term. About 10.7 percent of the working age population were discouraged workers. While the poverty incidence among public sector workers is low, public wage increases introduce distortions into the job market, constraining the ability of the private sector to create jobs and address the issue of high unemployment.

The poverty headcount stood at 29.7 percent in 2011 based on national estimates. Throughout the 2008-09 global economic crisis, income growth of the bottom 40 percent (B40) outpaced growth of the top 60 percent (T60), driven primarily by increases in earnings. Still, households, and particularly those in the B40, remain constrained by very high dependency ratios – the total economic dependency ratio (ratio of the inactive population aged 15 and older and employment for ages 20-74) in Kosovo was 266 percent in 2014, compared to 120 percent for EU28.

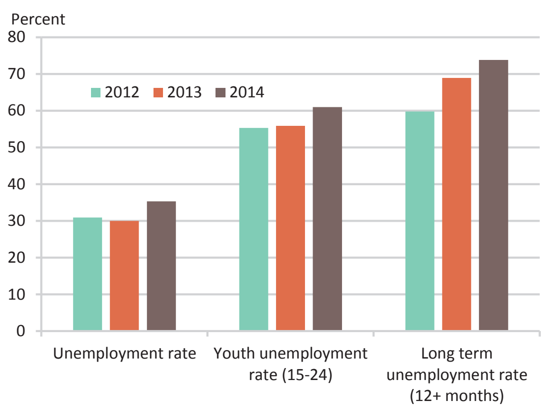
Thanks to improved tax collection and some expenditure cuts, fiscal stability returned and the fiscal deficit fell to 1.9 percent, of GDP in accordance with the fiscal rule that limits the deficit to 2 percent. Revenues grew by 9.4 percent, while expenditures increased by 8.5 percent, which included a 16 percent increase in transfers and an 8.2 percent increase in the wage bill due to Q1 impact of wage increases. Government debt increased by 1.5 percent of GDP but remained low at 11.9 percent of GDP, with manageable servicing arrangements. The financial sector was profitable and stable, with growing credit and deposit (7.3 percent and 6.4 percent), and, due to improved enforcement, a falling stock of NPLs (from 8.8 percent in February 2014 to 6.2 percent in January 2016).

FIGURE 1 Kosovo / Growth by components



Sources: Statistics Agency of Kosovo and WB staff.

FIGURE 2 Kosovo / Unemployment statistics (2012-2014)



Sources: Statistics Agency of Kosovo and WB staff.

Outlook

Subject to political stability and planned implementation of large investment projects, the economy is projected to grow at 3.6 percent in 2016, driven by domestic demand. Due to increased pensions of former contributors and inclusively to war veterans, and higher remittances, the contribution of consumption is expected to increase to 2.4 pp in 2016 and 2.7 pp in 2017. Investment will continue to contribute positively through public spending on the highway to FYR Macedonia and private investment, including the Brezovica ski resort financed by foreign investors. The Stabilization and Association Agreement (SAA) with the EU, signed in 2015, should provide a further boost to FDI. The current account deficit is expected to remain little changed at 9.6 percent of GDP. The recent approval of the investment amendment to the fiscal rule will open up additional fiscal room for productive investment in strategic sectors and boost public investments and economic growth in coming years.

Poverty dynamics will be influenced by a number of factors. Growth in agriculture picked up in 2015 and should maintain momentum during 2016-2017, boosted by recent reforms, as well as government subsidies and donor grants such as the EU Instrument for Pre-Accession Assistance (IPA II). With job creation, training, income source diversification, and support for agri-processing among key focus areas in the sector, the rural poor and B40 may benefit from additional employment opportunities and improvements in labor productivity. In the past, poverty and income dynamics have been strongly determined by labor earnings. The remaining structural barriers like the inadequacy of the education system, low ECE rates among low income households, make rapid improvements in the labor market challenging, thus constraining future poverty reduction.

Risks and challenges

The outlook is subject to downside risks such as weaker than planned execution of public investment and potential political and social unrest leading to lower FDI. Fiscal pressures resulting from revenue, expenditure and regulatory side are also a risk.

Lack of energy security remains a key obstacle to attracting FDI, as well as constraining private sector participation, competitiveness, and having negative social and health implications. Ensuring energy affordability for low income households will also be a challenge, as achieving cost recovery may require very large increases in consumer prices; which would require, in turn, substantial improvements to the social welfare infrastructure, primarily increasing coverage of the poor.

Addressing Kosovo's vulnerabilities, high unemployment and poverty requires significant and far reaching structural reforms to boost economic growth and make it more inclusive. The National Development Strategy 2016-2021 provides some direction on how to address key structural impediments and accelerate reforms.

TABLE 2 Kosovo / Macro poverty outlook indicators (annual percent change unless indicated otherwise)

	2013	2014	2015 e	2016 f	2017 f	2018 f
Real GDP growth, at constant market prices	3.4	1.2	3.6	3.6	4.0	4.1
Private Consumption	2	4.2	1.4	2.6	2.8	2.6
Government Consumption	3.3	19.1	-0.5	-0.2	-0.1	0
Gross Fixed Capital Investment	-0.2	-11.1	4.1	1.4	1.4	1.8
Exports, Goods and Services	2.3	13.9	0.1	0.5	0.6	0.6
Imports, Goods and Services	-1.5	5.0	-1.4	-0.7	-0.7	-0.7
Real GDP growth, at constant factor prices	3.4	1.2	3.6	3.6	4.0	4.1
Agriculture	0.2	0.1	0.7	0.6	0.8	0.7
Industry	1.5	0	0.4	0.9	0.9	0.4
Services	2.1	1.4	1.3	1.0	2.9	2.0
Inflation (Private Consumption Deflator)	2.4	0.3	-0.5	0.5	0.8	1.2
Current Account Balance (% of GDP)	-6.5	-7.9	-9.4	-9.6	-9.8	-9.9
Fiscal Balance (% of GDP)	-3.1	-2.6	-1.9	-1.8	-1.7	-2.0
Debt (% of GDP)	9.0	10.4	11.9	15.2	16.7	17.7
Primary Balance (% of GDP)	-2.9	-2.4	-1.7	-1.5	-1.4	-1.7

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Note: f = forecast.

KYRGYZ REPUBLIC

Table 1	2015
Population, million	5.9
GDP, current US$ billion	6.6
GDP per capita, current US$	1109
Poverty rate ($2.5/day 2005PPP terms)[a]	29.2
Poverty rate ($5/day 2005PPP terms)[a]	83.9
Gini Coefficient[a]	26.8
School enrollment, primary (% gross)[b]	105.9
Life Expectancy at birth, years[b]	70.0

Sources: World Bank WDI and Macro Poverty Outlook.
Notes:
(a) Most recent value (2014)
(b) Most recent WDI value (2013)

In 2015 the Kyrgyz economy weathered the impact of a worsening external environment relatively well, supported by strong agricultural output and increased public spending. Growth is expected to remain sluggish in 2016 and 2017, with increased public investment only partially offsetting depressed private demand. The pace of poverty reduction is likely to slow in the short run. However, the economy is anticipated to recover in 2018 as the external environment improves.

Recent developments

A deteriorating external environment negatively affected the Kyrgyz economy in 2015. Exports and remittance inflows fell sharply, and gold output diminished. However, due to the strong performance of the agricultural sector and robust construction activity supported by large-scale public investment, the GDP growth rate slowed modestly from 4 percent in 2014 to 3.5 percent in 2015.

Large central bank dividends and one-off proceeds from a mining license sale boosted nontax revenues to 8.1 percent of GDP. Rising nontax revenues narrowed the fiscal deficit from 3.9 percent of GDP in 2014 to 3 percent in 2015 even as capital investment grew and tax revenues declined.

Currency depreciation among the country's main trading partners, coupled with a decline in gold output, caused the som to depreciate by 20 percent against the US dollar during 2015. Imports declined markedly, narrowing the current-account deficit from 16.7 percent of GDP in 2014 to 14.7 percent in 2015. Despite the depreciation, average annual inflation moderated to 6.5 percent in 2015, reflecting lower international food and fuel prices.

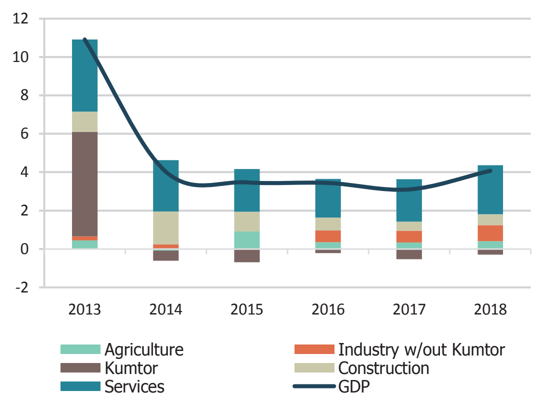
The poverty rate (measured at US$2.5 per day, 2005 PPP terms) is estimated to have fallen slightly in 2015, with improvements in rural incomes and increases in social transfers mitigating the decline in real remittances and the impact of slowing job growth in the service and construction sectors. A 10 percent increase in pensions in 2015 provided an important additional source of income for poor households. Strengthened social protection measures—including a 15 percent increase in the Guaranteed Minimum Income, which determines eligibility for the Benefit for Low-Income Families Program, and the establishment of a flat rate for pro-poor transfers—boosted consumption among households in the bottom quintile of the welfare distribution. However, low rates of public spending on the benefit for low income families (0.5 percent of GDP in 2014) limited the coverage of pro-poor transfers to less than one-third of the poorest quintile.

Outlook

GDP growth is projected to decelerate marginally to 3.4 percent in 2016 as weak private demand negatively affects the agriculture, residential construction and service sectors. Meanwhile, gold output will decline slowly and industry will accelerate due to the depreciation of the som and the anticipated completion of several large industrial projects. On the demand side, private consumption growth is expected to remain subdued, while implementation of the public investment program will boost demand for construction and related services. Rising public investment and full-year public sector wage increases are expected to cause the fiscal deficit to deteriorate to 7.4 percent of GDP in 2016.

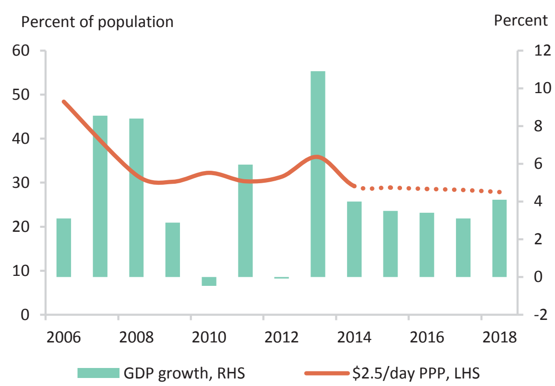
Given the high import content of large

FIGURE 1 Kyrgyz Republic / Contribution to growth (in percentage points / percent)



Source: Kyrgyz authorities.

FIGURE 2 Kyrgyz Republic / GDP growth and actual and projected poverty rate



Sources: Kyrgyz authorities and WB staff calculations.

infrastructure projects, the current-account deficit is expected to widen to 17.2 percent of GDP. With gold output projected to decline further while pressure on regional currencies persists, the som is expected to continue depreciating, albeit at a more moderate pace. In this context, the central bank is expected to maintain a conservative stance in order to contain inflation.

Looking forward, private sector and external demand are expected to recover but the fiscal stimulus to phase out and gold output to decline further. As a result, overall growth is projected to slow to 3.1 percent in 2017 before rebounding to 4.1 percent in 2018 with internal and external balances improving as public spending is curtailed. Likewise, the –hitherto protracted- process of adapting national regulations and systems to new Eurasian Economic Union (EEU) requirements should allow Kyrgyz producers to gain greater access to the common market as the economies of Russia and Kazakhstan begin to recover.

Limited fiscal space will preclude any significant increase in social spending, though targeting improvements may enhance expenditure efficiency. Moderate growth in the agricultural sector will slow rural poverty reduction, though a gradual recovery in remittances, which primarily benefit poor rural households, could help offset this effect. The overall poverty rate is also expected to continue declining albeit at a slower pace, and is projected to reach 28.6 percent in 2016 and 28.3 percent in 2017.

Risks and challenges

Exogenous regional developments are the primary source of medium-term risk. The pace of the recovery in Russia and Kazakhstan will affect the performance of Kyrgyz exports, demand for Kyrgyz labor and, to a lesser extent, foreign direct investment inflows. Adverse exchange-rate developments could negatively impact domestic output growth through the financial sector, and a further depreciation of the ruble could slow the pace of poverty reduction by eroding the real value of ruble-denominated remittances.

Although the Kyrgyz financial sector is well capitalized, and the share of nonperforming loans remains manageable at less than 6 percent, stress tests suggest that a significant depreciation of the som or a crash in the real estate market could threaten systemically important banks due to currency mismatches and the possible deterioration of portfolio quality. This would present the monetary authorities with a difficult tradeoff between containing inflationary expectations and allowing banks to rebuild their balance sheets.

Domestic challenges relate to the speed at which the Kyrgyz Republic will be able to leverage EEU accession to boost exports and foster deeper regional trade integration. Thus far, accession to the common market has not benefited Kyrgyz exporters to the extent anticipated due to higher external tariffs on key textile inputs for the garment industry and strict application of EEU technical and phytosanitary regulations at the Kazakh border.

Given the limited fiscal space to increase pro-poor transfers, further poverty reduction will hinge on employment and wage dynamics, especially in the formal private sector. Expanding job opportunities will require addressing barriers to formal sector employment and supporting the transition of workers away from informal activities.

TABLE 2 Kyrgyz Republic / Macro poverty outlook indicators (annual percent change unless indicated otherwise)

	2013	2014	2015 e	2016 f	2017 f	2018 f
Real GDP growth, at constant market prices	10.9	4.0	3.5	3.4	3.1	4.1
Private Consumption	8.0	3.0	0.2	1.9	2.7	3.4
Government Consumption	-0.4	-0.5	6.4	2.6	-4.5	-1.6
Gross Fixed Capital Investment	1.3	17.4	2.3	7.6	5.5	5.5
Exports, Goods and Services	12.3	-6.2	-5.3	2.0	5.6	7.8
Imports, Goods and Services	4.1	1.6	-9.0	1.8	3.0	4.1
Real GDP growth, at constant factor prices	10.9	4.1	3.5	3.4	3.0	4.0
Agriculture	2.6	-0.6	6.2	2.5	2.5	3.0
Industry	30.5	5.1	-4.2	2.6	6.4	9.1
Services	11.5	6.6	4.2	4.1	2.5	3.2
Inflation (Consumer Price Index)	6.6	7.5	6.5	6.5	6.5	6.0
Current Account Balance (% of GDP)	-15.0	-16.7	-14.7	-17.2	-12.9	-11.4
Financial and Capital Account (% of GDP)	14.4	8.8	14.5	14.0	17.1	15.3
Net Foreign Direct Investment (% of GDP)	8.5	2.3	8.9	8.7	7.1	6.8
Fiscal Balance (% of GDP)	-3.7	-3.9	-3.0	-7.4	-4.6	-2.0
Debt (% of GDP)	46.1	52.6	68.8	71.7	73.3	72.0
Primary Balance (% of GDP)	-2.9	-3.0	-2.0	-6.6	-3.6	-0.8
Poverty rate ($2.5/day PPP terms)[a,b,c]	35.8	29.2	28.9	28.6	28.3	27.9

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: e = estimate, f = forecast.
(a) Calculations based on ECAPOV harmonization, using 2010-KIHS and 2014-KIHS.
(b) Projection using annualized elasticity (2010-2014) with pass-through = 0.87 based on GDP per capita constant PPP.
(c) Actual: 2013, 2014. Projections are from 2015 to 2018.

MACEDONIA FYR

Table 1	2015
Population, million	2.1
GDP, current US$ billion	10.1
GDP per capita, current US$	4845
Poverty rate ($2.5/day 2005PPP terms)[a]	12.7
Poverty rate ($5/day 2005PPP terms)[a]	34.3
Gini Coefficient[a]	36.0
School enrollment, primary (% gross)[b]	89.3
Life Expectancy at birth, years[b]	75.0

Sources: World Bank WDI and Macro Poverty Outlook.
Notes:
(a) Most recent value (2013)
(b) Most recent WDI value (2013)

FYR Macedonia's economic growth remained robust at 3.7 percent in 2015, despite the political turmoil. Growth was driven by private consumption, supported by higher employment, wages, and pensions, and by government spending, which increased 23 percent in the second half of 2015. Investment also expanded, driven by FDI and public works. Positive economic and labor market developments supported a gradual reduction in poverty. Growth is expected to accelerate during the forecasting period, with positive spillovers to poverty reduction.

Recent developments

FYR Macedonia's economy is estimated to have expanded 3.7 percent in 2015. Growth was mainly driven by construction, wholesale and retail trade and services, particularly real estate and financial services. Manufacturing activities contracted in the first half of 2015, but partially recovered in the second half of the 2015. On the demand side, growth was largely driven by private consumption pushed up by growing employment, higher real wages, pensions and social transfers, likely related to the expectations of upcoming elections. Government consumption of goods and services also increased sharply by 23 percent in the second half of the year. Gross investments rebounded in the second of 2015, after a sharp decline in the second quarter of the year. The recovery supported by publicly financed construction of new highways and FDI.

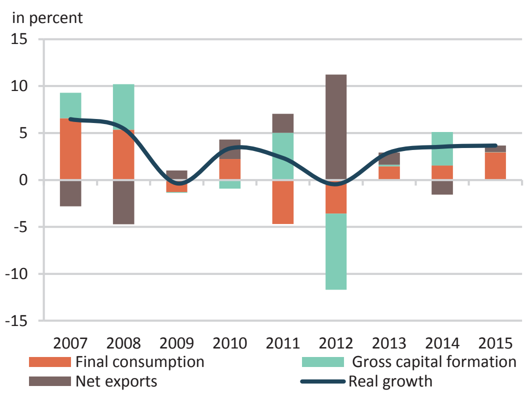
Deflationary pleasures persisted. Falling global oil prices led to deflation of 0.3 percent in 2015, the same as in 2014, benefiting people at the bottom of the income distribution who spend a larger share of their income on food. Twelve-month core inflation remained positive at 0.5 percent.

Exports grew faster than imports in 2015, further narrowing the trade deficit. Export growth was largely driven by FDI-related exports (40 percent of overall exports). Exports of "traditional" products such as iron and steel, ores and slag, and tobacco declined. Export destinations became more concentrated with 44 percent of exports going to Germany (mainly automobile parts). Imports expanded driven by FDI, suggesting a solid export growth in the coming period. The current account deficit widened to 1.4 percent of GDP from 0.8 percent in 2014 despite the narrower trade deficit, driven by a lower surplus in the income accounts. Private transfers were slightly lower than in 2014, but covered the trade deficit, alleviating external financing pressures. Higher outflows of FDI were registered in 2015, likely related to the political uncertainties, resulting in slightly lower net FDI inflows compared to 2014.

The financial sector remained sound. Credit growth reached 9.5 percent (y-o-y) in 2015 largely driven by household lending. Non-performing loans fell to 10.6 percent in December. The banking sector remains profitable, highly liquid and well-provisioned. While household debt is still moderate (22.2 percent of GDP), the central bank acted cautiously and introduced prudential measures to slow the expansion of consumption-related credit and encourage corporate lending.

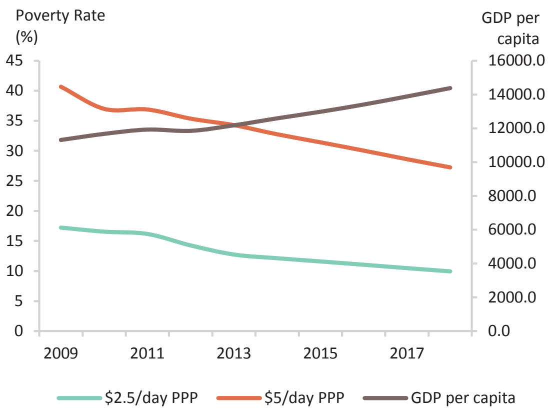
The fiscal deficit narrowed in 2015, helped by the deferment of pension transfers to January 2016. Total revenues increased to 28.8 percent of GDP driven by the re-introduction of a profit tax on earnings that were not reinvested (not collected since 2009), and by higher social contributions linked to improvements in the labor markets. Expenditures also increased, but less than revenues and stood at 32.3 percent of GDP largely reflecting higher public wages, pensions, social transfers, and spending on goods and services

FIGURE 1 Macedonia FYR / GDP growth decomposition



Sources: FYR Macedonia State Statistics Office and World Bank staff calculations.

FIGURE 2 Macedonia FYR / Actual and projected poverty rates and GDP per capita



Source: World Bank (see notes to Table 2).

(especially in the second half of 2015). The central government deficit reached 3.5 percent of GDP in 2015, lower than 2014 (4.2 percent) and the revised budget for 2015 (3.7 percent), but higher than the level proposed in the Medium Term Fiscal Strategy 2015-2017 (3.4 percent of GDP). The difference between actual and revised budget deficits reflect contributions by the state funded pension fund to the private funds (around 0.1 percent of GDP) related to 2015, but differed to January 2016.

Public debt continued to increase in 2015, but remains below the regional average at 46.4 percent of GDP. In addition to the fiscal deficit, state guarantees associated with large investment projects also contributed to the increase. While the public debt is still moderate, it has increased fast in the last five year (by 20 p.p. of GDP). Continuing this trend could pose risks to the economy.

Unemployment declined supported by widespread job creation. Employment grew in manufacturing, public administration, services, and construction. Labor force participation remained stable, leading to a decline in unemployment from 28.1 percent in 2014 to 26.1 percent in 2015. Youth unemployment, at 47.3 percent, dropped significantly in 2015 helped by public youth employment programs. Long-term unemployment remains elevated, at 61 percent of total unemployment.

Poverty is expected to have continued to decrease in 2015, on account of the better labor market outcomes and higher government transfers. Using the US$5/day and $2.5/day lines (2005 PPP), poverty rates were estimated at 34.3 and 12.7 in 2013, following a decreasing trend present at least since 2009, the earliest for when comparable data is available. In 2014-2015, higher real wages and employment opportunities created in construction, manufacturing and services are expected to have contributed to further reductions in poverty. Slightly lower private transfers in 2015 should have had only a negligible effect on poverty, compared to that coming from falling prices and higher social transfers.

Outlook

Growth is expected to stay at 3.7 percent in 2016 and accelerate to 4 percent in 2017 and 2018, led by public investment in two major highways as well as by strong FDI. Private consumption is expected to remain robust supported by further increases in employment, public wages, pensions and social transfers. Large FDI-related exports are likely to be accompanied by higher imports associated with investment projects, leading to a relatively small contribution from net external demand. Poverty is expected to continue its downward trend on account of increases in employment in construction, pensions and social transfers.

Risks and challenges

The political situation remains the primary downside risk to the economy in the near term. Prolonged political uncertainties could affect investment decisions and slow down economic activity. The escalation of the current refugee crisis also poses a downside risk, especially if the EU decides to close its borders or significantly limit the inflow.

Medium term challenges include the need for fiscal consolidation and prioritization of public spending and further improving labor market outcomes to improve growth elasticity of poverty reduction.

Limited access to microdata and an outdated census limit the ability to track and benchmark improvements in living conditions in a timely manner.

TABLE 2 **Macedonia FYR** / Macro poverty outlook indicators (annual percent change unless indicated otherwise)

	2013	2014	2015 e	2016 f	2017 f	2018 f
Real GDP growth, at constant market prices	2.9	3.5	3.7	3.7	4.0	4.0
Private Consumption	1.9	2.1	3.2	3.4	3.6	3.6
Government Consumption	0.5	1.0	4.6	4.6	4.0	2.3
Gross Fixed Capital Investment	1.9	6.9	0.3	5.1	7.1	8.3
Exports, Goods and Services	6.1	18.2	4.6	7.7	8.2	7.8
Imports, Goods and Services	2.2	16.0	2.4	6.8	7.5	7.3
Real GDP growth, at constant factor prices	4.4	6.5	4.5	3.9	3.8	4.1
Agriculture	8.6	2.2	-0.7	0.0	1.0	1.0
Industry	7.6	11.8	7.8	6.0	4.8	4.9
Services	2.6	5.0	3.9	3.4	3.7	4.1
Inflation (Consumer Price Index)	2.8	-0.1	0.0	0.9	1.6	2.0
Current Account Balance (% of GDP)	-1.6	-0.9	-1.4	-1.7	-2.1	-2.6
Financial and Capital Account (% of GDP)	1.5	0.5	1.1	2.0	3.1	4.1
Net Foreign Direct Investment (% of GDP)	2.8	2.3	1.9	2.1	2.5	2.7
Fiscal Balance (% of GDP)	-4.0	-4.2	-3.5	-3.4	-3.0	-2.7
Debt (% of GDP)	34.0	38.2	37.9	39.9	41.1	41.7
Primary Balance (% of GDP)	-3.1	-3.2	-2.3	-2.1	-1.8	-1.6
Poverty rate ($2.5/day PPP terms)[a,b,c]	12.7	12.1	11.6	11.1	10.5	9.9
Poverty rate ($5/day PPP terms)[a,b,c]	34.3	32.8	31.4	30.0	28.6	27.2

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: e = estimate, f = forecast.
(a) Calculations based on grouped-data from SILC harmonization, using 2014-SILC (survey year)
(b) Projection using neutral distribution (2013) with pass-through = 1 based on GPD per capita constant PPP.
(c) Projections are from 2014 to 2018.

MOLDOVA

Table 1	2015
Population, million	3.5
GDP, current US$ billion	6.5
GDP per capita, current US$	1828
Poverty rate ($2.5/day 2005PPP terms)[a]	2.9
Poverty rate ($5/day 2005PPP terms)[a]	40.7
Gini Coefficient[a]	26.8
School enrollment, primary (% gross)[b]	93.8
Life Expectancy at birth, years[b]	68.7

Sources: World Bank WDI and Macro Poverty Outlook.
Notes:
(a) Most recent value (2014)
(b) Most recent WDI value (2013)

The Moldovan economy moved into recession in the second half of 2015 driven by weaker external flows, large scale bank fraud, tighter monetary policy and a drought. Poverty is estimated to have slightly increased with weak labor markets failing to contribute to raising living standards. Economic growth and poverty reduction will remain stagnant in 2016, with an expected recovery in 2017 as investment confidence increases. Fiscal consolidation is needed while ensuring that poverty gains are not further eroded.

Recent developments

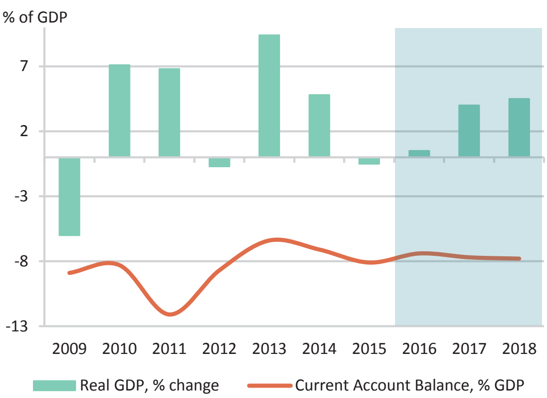
The economy flipped into recession in the second half of 2015 due to a drought, weak external flows, repercussions of a large scale bank fraud, and tight monetary policy. Amid political instability since 2014 and bank fraud, the economy grew 3.6 percent in the first half of 2015. However, severe drought and weaker domestic activity, reflecting tighter monetary policy and fiscal squeeze, offset the positive contribution from net exports. As a result, real GDP declined 0.5 percent in 2015. After the government guaranteed deposits in 3 insolvent banks with a total cost of 12 percent of GDP, monetary policy responded aggressively to higher inflation. The National Bank raised the base interest rate to a record high of 19.5 percent, virtually stopping credit growth. Twelve-month inflation almost doubled to 9.7 percent on average in 2015, nonetheless. Remittances dropped sharply in 2015, leading to an expansion of the current account deficit to 8.5 percent of GDP from 7.1 percent in 2014. Foreign reserves stabilized after a drop in the first quarter of 2015, settling to the equivalent of 3 months of imports.

Confronted with lower revenues and financing in 2015, the government adjusted expenditures while prioritizing social payments. Reflecting a weaker economy, high interest rates and lower external grants, revenues dropped 6.2 percent in real terms. Expenditure increased 4.5 percent, but were 6.9 percent below planned levels. Since June 2015, the Government has had to freeze procurement of goods and services, and to ration capital expenditures. As a result, the government maintained the real value of social spending, while capital expenditures faced a double-digit decline. The cash deficit increased to 2.2 percent of GDP, from 1.7 percent a year ago.

The already poor performing labor market remained weak in 2015. Unemployment increased in three out of four quarters, ending at 4.2 percent by the end of 2015. Employment did not catch up with the increase in the labor force, around 3 percent, likely due to the return of people working abroad. Average earnings in 2015 increased slightly in real values (0.7 percent), probably stemming from an increase in self-employment earnings in the non-agricultural sector, counterbalancing the decline in households' income from employment and agriculture.

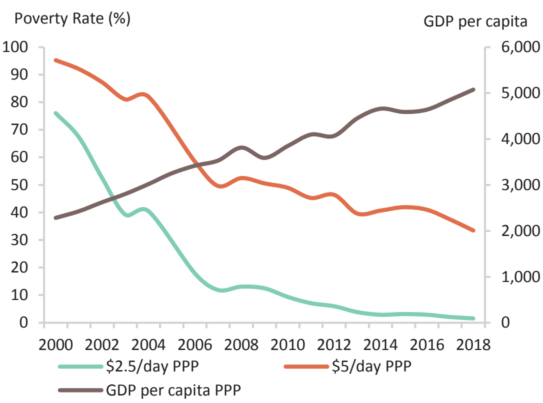
A severe summer drought, lower remittances and higher inflation are estimated to have affected living standards in Moldova in 2015, pushing poverty into an upward trend. Poverty had been on the decline for recent years, going from 46.4 percent of the population in 2012 (US$5 per day, 2005 PPP) to an estimated 40.7 percent in 2014. However, developments throughout the year 2015 are estimated to have halted this downward trend, with poverty estimated to stand at 41.9 percent in 2015. In addition to the impact of a severe summer drought on the agricultural sector, in which many poor are concentrated, the decline in remittances may have pushed some into poverty and increased the depth of poverty for the already poor. Although only 27 percent

FIGURE 1 Moldova / Real GDP and current account projections



Sources: National authorities and WB's projections.

FIGURE 2 Moldova / Actual and estimated poverty rates and GDP per capita (PPP)



Sources: World Bank (see notes to Table 2).

of the non-poor received remittances, those who do are highly dependent on them, with remittances accounting for 55 percent of their income. Furthermore, 15 percent of the poor derive more than half of their income from remittances.

Outlook

The economy is projected to remain subdued in 2016, with growth close to nil. Net exports are expected to be the main growth driver given the exchange rate adjustment and tighter domestic demand policies. Prolonged low remittances and higher costs of domestic financing coupled with lack of investor confidence after the fraud in the banking system will constrain domestic absorption. The budget deficit is expected to increase to 3.2 percent of GDP in 2016.

Accordingly, poverty is expected to decline only modestly in 2016, by less than one percentage point. Remittances are likely to remain at lower levels, inflationary pressures remain and a recovery in labor markets is not expected in the short term. Although fiscal policies have protected social payments, the overall limited fiscal capacity could affect households through other fronts. Poverty is expected to stand at 41 percent in 2016.

As the economy stabilizes and investor confidence improves, Moldova is expected slowly to regain its growth momentum reaching its full potential by 2017-2018; slight reductions in poverty may follow. As inflationary pressures dissipate, consumer prices are projected to decrease to the central bank's inflation target range of 5±1.5 percent starting in 2017. Along with the economic recovery, fiscal deficits are likely to decline to 2.5 percent of GDP by 2018. Weaker domestic activity will keep the current account deficit on a gradually declining path. The acceleration in growth is expected to be accompanied by a reduction in poverty to 37.5 percent in 2017 and could reach 33.4 percent in 2018.

Risks and challenges

Moldova has limited macroeconomic buffers and needs to deal with major governance issues. A flexible exchange rate will help mitigate some of the shocks, but efficient public spending and institutions are the most important elements of macroeconomic stabilization. Major efforts in regaining the efficiency and credibility of the banking sector, fighting corruption and dealing with governance issues are needed to regain investor and consumer confidence.

Moldova faces a need for fiscal consolidation to maintain fiscal sustainability, while protecting the less well-off. A weaker economy, high interest rates, the fiscal cost of the failed banks and lower external financing exacerbate the immediate fiscal pressures stemming from indexation of social payments. With higher projected public debt and lower external grants and financing, Moldova should concentrate on efficiency gains in public recurrent expenditure and improve governance. This process needs to take account of the distributional impacts that fiscal measures – either on the revenue or the expenditure side - may have, particularly on the less well-off.

Moving forward, strengthening labor markets is critical for growth and poverty reduction. Promoting a sound business environment and improving governance are necessary steps to boost job creation and open up opportunities in the labor market.

TABLE 2 Moldova / Macro poverty outlook indicators (annual percent change unless indicated otherwise)

	2013	2014	2015 e	2016 f	2017 f	2018 f
Real GDP growth, at constant market prices	9.4	4.8	-0.5	0.5	4.0	4.5
Private Consumption	6.4	3.2	-2.3	-0.7	3.2	3.4
Government Consumption	-0.1	0.1	0.0	-0.7	2.0	1.7
Gross Fixed Capital Investment	3.8	10.0	-1.2	-1.5	4.3	5.1
Exports, Goods and Services	9.6	1.0	2.3	1.2	3.2	5.8
Imports, Goods and Services	4.4	0.4	-4.3	0.1	3.8	4.9
Real GDP growth, at constant factor prices	10.6	5.4	-0.4	0.7	3.8	4.5
Agriculture	46.6	8.5	-13.4	7.8	5.3	5.4
Industry	7.6	7.5	-1.4	0.2	4.9	5.6
Services	2.5	3.8	4.6	-1.4	3.0	3.9
Inflation (Consumer Price Index)	4.6	5.1	9.7	8.9	5.4	4.8
Current Account Balance (% of GDP)	-6.4	-7.1	-8.1	-7.7	-7.4	-7.1
Financial and Capital Account (% of GDP)	5.3	8.2	9.4	8.7	8.3	7.9
Net Foreign Direct Investment (% of GDP)	3.1	3.9	4.5	4.4	4.8	5.0
Fiscal Balance (% of GDP)	-2.0	-1.9	-2.3	-3.2	-2.5	-2.1
Debt (% of GDP)	31.7	32.5	44.7	45.8	45.1	44.7
Primary Balance (% of GDP)	-1.3	-1.2	-1.3	-2.0	-1.3	-1.0
Poverty rate ($2.5/day PPP terms)[a,b,c]	3.8	2.9	3.1	2.9	2.1	1.5
Poverty rate ($5/day PPP terms)[a,b,c]	39.6	40.7	41.9	41.0	37.5	33.4

Sources: World Bank. Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: e = estimate, f = forecast.
(a) Calculations based on ECAPOV harmonization, using 2014-HBS.
(b) Projection using neutral distribution (2014) with pass-through = 1 based on GDP per capita constant PPP.
(c) Actual: 2013, 2014. Projections are from 2015 to 2018.

MONTENEGRO

Table 1	2015
Population, million	0.6
GDP, current US$ billion	4.0
GDP per capita, current US$	6427
Poverty rate ($2.5/day 2005PPP terms)[a]	1.0
Poverty rate ($5/day 2005PPP terms)[a]	13.3
Gini Coefficient[a]	31.9
School enrollment, primary (% gross)[b]	100.9
Life Expectancy at birth, years[b]	74.6

Sources: World Bank WDI and Macro Poverty Outlook.
Notes:
(a) Most recent value (2014)
(b) Most recent WDI value (2013)

Economic growth is expected to remain robust in 2016 driven by the Bar-Boljare highway construction as well as tourism projects. With labor market improvements, especially in low-skilled sectors, poverty is estimated to have declined steadily since its peak in 2012. Unemployment remained high and labor force participation low, however. Capital investment along with the revenue underperformance pushed the fiscal deficit to 7 percent of GDP and public debt to 68 percent of GDP. External debt remained elevated despite strong FDI inflows.

Recent developments

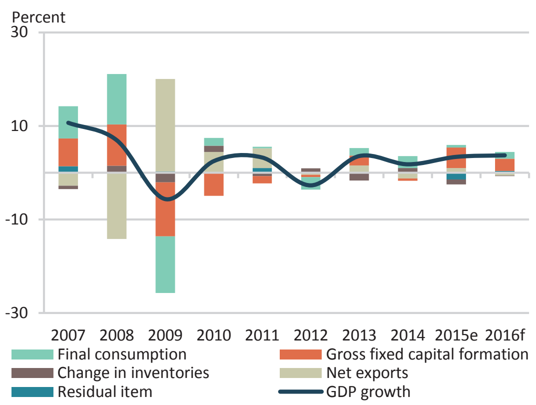
Real GDP is estimated to have expanded by 3.4 percent in 2015, up from 1.8 percent in 2014, fueled by exports of services and investments in tourism and the Bar-Boljare highway section. Positive economic growth since 2013 has increased employment, including in low-skilled sectors such as construction and administrative and support services. Gross wage increases in agriculture, construction and tourism in 2015 were among the highest across sectors. This composition of growth and employment expansion, at least in the short run, has been in general beneficial for improving welfare of the poor.

The labor market has been mostly improving, though structural issues remain. The four-quarter average unemployment rate fell to 17.6 percent in September 2015 from its peak of close to 20 percent in 2012. Activity and employment rates rose from 50 percent and 40.1 percent, respectively, in 2012 to 55 per-cent and 45.9 percent, respectively in Q3 2015, surpassing 2008 levels. However, they remained very low compared to EU peers due to structural factors such as the incomplete economic transition, labor mismatches and high reservation wages. While the unemployment rate for most workers went down over the last two years (until September 2015), older workers aged 50-64 experienced a slight increase. The new 2015 law on foreign workers--which further limits quotas of work permits for foreign workers and introduces the strict requirement of employing available local labor from the unemployment bureau—aims to protect domestic workers but may have impacts on firms' efficient use of labor and competitiveness. Further, the amendments to the Law on Social and Child Care introduced lifetime benefit for women giving birth to three or more children in the amount of 70 percent of the average net salary, under the condition of 25 years of service or 15 years for mothers of three or four and more children, respectively. Women with this right are also entitled to health insurance. This is likely to trigger worsening of an already low female labor participation rate. Additionally, the fiscal impact of this policy is assessed at 1 percent of GDP. Overall poverty trend closely mirrors labor market performance, especially employment in low-skill sectors. With continued economic recovery including in these sectors, poverty (measured at the regional poverty line of US$5 in 2005 PPP) has declined from its peak at 19.2 percent in 2012 to an estimated 11.9 percent in 2015.

External imbalances narrowed in 2015 on the back of strong tourism performance (receipts up by 19 percent y-oy), while goods export continued to struggle given the narrow export base of Montenegro. The current account deficit (CAD) declined to 13.4 percent of GDP from 15.2 percent in 2014. The still high CAD was financed by robust net inflows of FDI (mostly in banking and real estate) which surged to 17.2 percent of GDP in 2015.

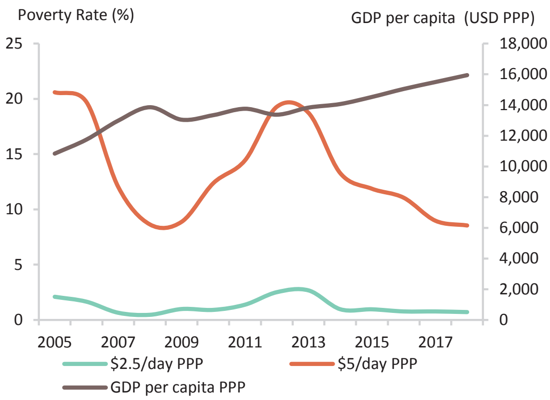
Lending gradually recovered in 2015 with strong growth of the deposit base driven mostly by corporate sector. The share of

FIGURE 1 Montenegro / Contributions to annual GDP growth



Sources: World Bank.

FIGURE 2 Montenegro / Actual and estimated poverty rates and GDP per capita (PPP)



Sources: World Bank (see notes to Table 2).

non-performing loans declined from 15.9 percent at the end of 2014 to 12.5 percent in 2015, partially due to a sale of non-performing assets to factoring companies. However, despite a surge in the number of banks to 15 in 2015 from 12 in 2014 and record low rates in the eurozone, the interest rates margins remained high and the bank profitability low on average.

After consolidation measures reduced the fiscal deficit to 3.1 percent of GDP in 2014, a rise in capital (highway-related) expenditures along with the revenue underperformance increased the fiscal deficit to 7 percent of GDP in 2015. As expected, public debt continued its upward trend to close to 68 percent of GDP in 2015. This macro-fiscal framework led the Standard & Poor's to affirm Montenegro's long-term and short-term B+/B ratings with stable outlook. In early March, the government issued EUR300 million 5-year Eurobond at a coupon of 5.75 percent, almost two percentage points above the last issue.

Outlook

The economy is estimated to grow by 3.3 percent a year on average over the medium term driven by investment in public infrastructure (highway and energy) and tourism. Improvement in the labor market, led by new employment in services, but also the government's plan to increase public sector wages, pensions, and some social benefits in 2016, will boost private consumption and contribute to further poverty reduction. Welfare gains through employment in highly cyclical sectors are, however, volatile for the bottom income quintiles. Poverty measured at US$5 in 2005 PPP is expected to decline further to 9.0 percent by 2017, though with high vulnerability to macro risks.

Fiscal policy will remain expansionary in 2016-18 with the 2016 deficit projected at 6.2 percent of GDP. The government plans to allocate as much as 9 percent of GDP for capital investments, with public debt expected to rise to 72.3 percent of GDP in 2016. The borrowing requirement in 2016 is around 18 percent of GDP to repay the Eurobond coming for redemption and finance the budget deficit. Deficits for 2017 -2018 have also been raised upward from the earlier estimates presented in the September 2015 Fiscal Guidelines; the government now is not planning to eliminate primary deficit by 2018.

Rising highway-related imports is likely to deepen already large external vulnerabilities with the current account deficit in 2016 expected to widen to 15 percent of GDP and external debt exceeding 140 percent of GDP in the projection period.

Risks and challenges

Risks to the outlook remain tilted to the downside. Slower or stagnating growth in the Euro area, as well as financial market volatility present the main external risks for budget financing and growth prospects. The large share of debt denominated in US dollars (in 2014 the equivalent to EUR688 million of the highway loan) and the large borrowing needs over the medium term presents substantial risks to public finances. The geopolitical tensions are not expected to have direct impacts on the Montenegrin economy. Risks on the domestic side include delays in the implementation of needed structural reforms to stabilize public finances and increase competitiveness ahead of the general elections set for the autumn of 2016. This could reduce foreign investors' confidence and their investments in Montenegro. Household welfare gains continue to be highly vulnerable to macro risks and the associated volatility in the labor market.

TABLE 2 Montenegro / Macro poverty outlook indicators (annual percent change unless indicated otherwise)

	2013	2014	2015 e	2016 f	2017 f	2018 f
Real GDP growth, at constant market prices	3.5	1.8	3.4	3.7	3.1	3.0
Private Consumption	1.6	2.9	1.4	1.1	2.3	2.5
Government Consumption	1.3	1.4	-3.0	3.2	0.0	1.7
Gross Fixed Capital Investment	10.7	-2.5	23.2	11.6	2.8	-1.8
Exports, Goods and Services	-1.3	-0.7	6.5	1.7	2.0	2.2
Imports, Goods and Services	-3.1	1.6	2.0	2.3	-0.4	-1.5
Real GDP growth, at constant factor prices	4.1	1.9	3.4	3.7	3.1	3.0
Agriculture	13.6	1.8	3.2	3.3	2.1	2.1
Industry	4.3	4.5	5.8	4.7	3.5	3.5
Services	2.4	0.8	2.4	3.3	3.1	2.9
Inflation (Private Consumption Deflator)	1.9	-1.0	1.6	1.7	1.9	1.5
Current Account Balance (% of GDP)	-14.5	-15.2	-13.4	-14.2	-14.9	-15.2
Financial and Capital Account (% of GDP)	7.0	3.6	3.3	10.3	11.1	11.6
Net Foreign Direct Investment (% of GDP)	9.6	10.2	17.2	11.0	11.2	10.8
Fiscal Balance (% of GDP)	-4.6	-3.1	-7.0	-6.2	-6.4	-5.6
Debt (% of GDP)	57.5	59.9	68.0	72.3	76.4	78.6
Primary Balance (% of GDP)	-2.4	-0.8	-4.7	-4.1	-3.8	-3.1
Poverty rate ($2.5/day PPP terms)[a,b,c]	2.7	1.0	1.0	0.8	0.8	0.7
Poverty rate ($5/day PPP terms)[a,b,c]	18.7	13.3	11.9	11.1	9.0	8.5

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: e = estimate, f = forecast.
(a) Calculations based on ECAPOV harmonization, using 2014-HBS.
(b) Projection using neutral distribution (2014) with pass-through = 0.87 based on GDP per capita constant PPP.
(c) Actual data: 2013, 2014. Projections are from 2015 to 2018.

POLAND

Table 1	2015
Population, million	38.0
GDP, current US$ billion	475.8
GDP per capita, current US$	12518
Poverty rate ($2.5/day 2005PPP terms)[a]	0.9
Poverty rate ($5/day 2005PPP terms)[a]	5.1
Gini Coefficient[a]	33.1
School enrollment, primary (% gross)[b]	101.2
Life Expectancy at birth, years[b]	76.8

Sources: World Bank WDI and Macro Poverty Outlook.
Notes:
(a) Most recent value (2012)
(b) Most recent WDI value (2013)

Growth picked up in 2015 driven mainly by domestic demand. Private consumption was bolstered by improving labor market conditions and negative consumer price inflation due to lower energy prices. We project Poland's growth to strengthen from 3.6 percent in 2015 to 3.7 percent in 2016 but moderate slightly in the years beyond in line with the weaker outlook for the Eurozone. The new government targets a more dynamic and more inclusive – spatially as well -- economic growth and recently announced a comprehensive reform plan to boost investment.

Recent developments

Economic growth picked up to 3.6 percent in 2015 from 3.4 percent in 2014 on the back of robust private and public consumption, investment, and a slightly positive contribution from net exports. The latter has been sustained by the weaker Zloty, cheap oil, and a gradual rebound in import demand from Western Europe. Private consumption continued to benefit from higher real disposable incomes as a result of improved labor market conditions in 2015 characterized by a solid 4.2 percent growth of average nominal wages and its even higher increase in real terms due to negative inflation of 0.9 percent and relatively strong household credit growth.

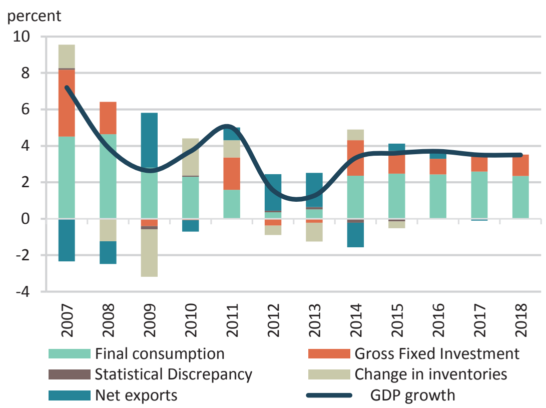
Employment continued to grow by around 1 percent in 2015 and the LFS unemployment rate fell to 6.9 percent, a level not seen since 2008. Employment growth was dominated by workers with tertiary education, with modest gains among employees with secondary education and job cuts among low skilled workers. After two years when virtually all new employment has been in the form of temporary contracts (both Labor Code and Civil Contracts), new permanent jobs dominated in 2015. This positive change reflected an improved bargaining position of employees during the economic upturn and the anticipated forthcoming regulatory changes making 'junk contacts' less appealing for employers.

Moderate poverty is expected to have declined from 5.1 percent in 2012 to 4.4 percent in 2015 using the $5.00/day 2005 PPP poverty line, in line with increases in private consumption and higher employment.

The general government deficit is estimated to have declined to 3.0 percent of GDP in 2015 from 3.3 percent in 2014 owing to a rebound in direct taxes, in line with strong labor market performance. Public debt to GDP ratio increased in 2015 to 51.1 percent, up from 50.4 percent of GDP in 2014. Prudent fiscal management of local governments which reportedly recorded a surplus of 0.3 percent of GDP contributed to these results.

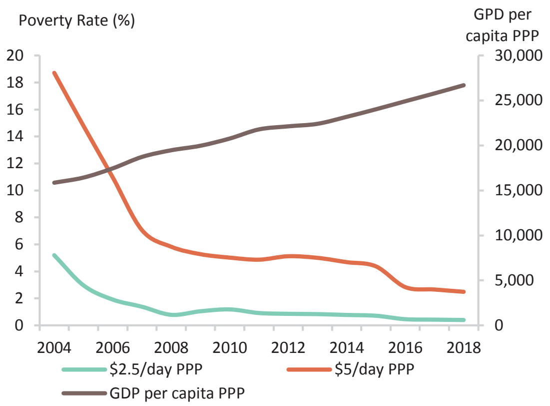
Favorable financing conditions have supported credit growth, but the banking sector faces new challenges. The strengthening of the Swiss Franc has affected about 575,000 families holding mortgages denominated in the SFR, leading the new President to propose measures to convert them into zlotys at a loss for the banks. This, compounded by the introduction of a new tax on bank assets, has led to concerns over bank profitability. Poland's external position has strengthened in 2015 and trade of goods recorded a surplus of 0.8 percent of GDP, after decades of persistent deficit. At the same time, the current account deficit narrowed from 2 percent in 2014 to 0.5 percent of GDP only in 2015. Gross external debt (72.3 percent of GDP in the 3rd quarter of 2015) stabilized at its end 2014 level (72.4 percent of GDP).

FIGURE 1 Poland / Contributions to annual GDP growth



Sources: World Bank team estimates based on Central Statistical Office.

FIGURE 2 Poland / Actual and estimated poverty rates and GDP per capita (PPP)



Sources: World Bank (see notes to table 2).

Outlook

The outlook remains favorable as real GDP is projected to increase by 3.7 percent in 2016 and 3.5 percent in 2017-18 even as economic prospects for the euro area moderate. In 2016, private consumption is set to become an even more dominant growth driver, supported by further improvements in the labor market and an increase in government transfers, notably a new generous child benefit, the Family 500+. Investment is expected to grow moderately as a result of high capacity utilization and low interest rates.

Further declines in poverty incidence are expected in 2016 as growth in employment and real wages. More importantly the introduction of the new family benefit program is expected to lead to increases in disposable incomes and a significant reduction in poverty. Financial support for the elderly and more generous pensions' indexation should continue this trend into 2017. The $5.00/day 2005 PPP poverty rate is projected to decline to 2.8 percent in 2016 and then further to 2.6 percent in 2017.

The Government is targeting a fiscal deficit of around 3.0 percent of GDP in 2016, the Maastricht criterion and the Excessive Deficit Procedure threshold. Despite robust economic performance, we expect a deterioration of the structural fiscal deficit. This is mainly due to the introduction of the Family 500+, which is expected to increase spending by about 1 percent of GDP in 2016. This will be funded through the new taxes on financial institutions and retail sales (yielding about 0.3 percent of GDP) and receipts of 0.5 percent of GDP from the sale of LTE frequency, and some improvements in VAT tax compliance. In recent months, the Government undertook decisive efforts to reduce huge tax gaps in VAT and CIT.

The fiscal outlook beyond 2016 is uncertain, our baseline path shows an increase in the deficit to 3.3 percent of GDP in 2017. However, the outcome will depend on the recent government proposals which could further increase the deficit, including a higher tax-free threshold for the personal income tax, lowering the retirement age, or a return to the standard VAT rate of 22% from the current 23% rate.

In mid-February, the authorities announced the 'Program for Responsible Development,' which presents a medium-term reform agenda. The program has five pillars: re-industrialization, development of innovative firms, capital for development, foreign expansion, and social and regional development.

Risks and challenges

Despite the relatively benign economic forecast, the balance of risks remains skewed to the downside. External challenges result from geopolitical tensions and economic slowdown in large emerging markets. There are three main internal risks.

First, the fiscal deficit in 2017 and years beyond may exceed the 3 percent of GDP if larger public spending is accompanied with gradual improvements in tax compliance. Second, the proposed return to a lower retirement age weaken fiscal sustainability in the long term. Third, the solution to the legacy of Swiss Franc denominated mortgages proposed by the President office could significantly affect bank profitability if not the soundness of the financial system.

Poland's challenge is to accelerate inducive growth with an aging society. There is a need to improve enabling regulatory environment. This can be supported by policies removing barriers for investment and by investment in people to raise skills. There is a scope to upgrade aging infrastructure, in particular in the energy sector, and promote digitalization agenda. Also, Poland needs to improve the efficiency of public administration and improve the quality of public services.

TABLE 2 Poland / Macro poverty outlook indicators (annual percent change unless indicated otherwise)

	2013	2014	2015 e	2016 f	2017 f	2018 f
Real GDP growth, at constant market prices	1.3	3.3	3.6	3.7	3.5	3.5
Private Consumption	0.2	2.5	3.1	3.3	3.3	3.2
Government Consumption	2.2	4.9	3.6	2.8	3.7	2.7
Gross Fixed Capital Investment	-1.1	9.8	5.9	4.0	4.7	5.3
Exports, Goods and Services	6.1	6.4	6.6	5.6	4.6	4.1
Imports, Goods and Services	1.7	10.0	5.9	4.9	5.0	4.2
Real GDP growth, at constant factor prices	1.3	3.3	3.5	3.8	3.7	3.6
Agriculture	9.1	1.1	-4.5	1.8	0.4	0.4
Industry	1.3	4.9	5.4	4.2	5.1	4.7
Services	1.1	2.8	3.1	3.7	3.2	3.3
Inflation (Consumer Price Index)	1.2	0.2	-0.9	0.5	1.0	1.5
Current Account Balance (% of GDP)	-1.3	-2.0	-0.5	-0.9	-1.4	-1.9
Financial and Capital Account (% of GDP)	3.6	3.3	3.1	3.6	4.1	4.6
Net Foreign Direct Investment (% of GDP)	0.8	2.0	1.9	1.8	2.0	1.9
Fiscal Balance (% of GDP)	-4.0	-3.3	-3.0	-3.0	-3.3	-3.2
Debt (% of GDP)	55.9	50.4	51.1	51.6	51.7	51.7
Primary Balance (% of GDP)	-1.5	-1.4	-1.0	-1.0	-1.2	-1.2
Poverty rate ($2.5/day PPP terms)[a,b,c]	0.8	0.8	0.7	0.5	0.4	0.4
Poverty rate ($5/day PPP terms)[a,b,c]	5.0	4.7	4.4	2.8	2.7	2.5

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: e = estimate, f = forecast.
(a) Calculations based on ECAPOV harmonization, using 2004-EU-SILC and 2012-EU-SILC.
(b) Projection using point-to-point elasticity (2004-2012) with pass-through = 1 based on GDP per capita constant PPP.
(c) 2016 projection reflects expected impact of the Family 500+ program. Projections are from 2013 to 2018.

MPO Apr 16

ROMANIA

Table 1	2015
Population, million	19.8
GDP, current US$ billion	186.2
GDP per capita, current US$	9383
Poverty rate ($2.5/day 2005PPP terms)[a]	11.1
Poverty rate ($5/day 2005PPP terms)[a]	32.6
Gini Coefficient[a]	34.9
School enrollment, primary (% gross)[b]	94.2
Life Expectancy at birth, years[b]	74.5

Sources: World Bank WDI and Macro Poverty Outlook.
Notes:
(a) Most recent value (2012)
(b) Most recent WDI value (2013)

Economic growth accelerated in 2015, driven by private consumption and investment. Fiscal consolidation continued, but a tax reduction package adopted recently will reverse this trend, putting pressure on the budget deficit in 2016 and 2017. Economic growth, fiscal relaxation and increased support for vulnerable groups have continued to reduce poverty. Reforms of SOEs and public spending should boost Romania's growth potential. Managing fiscal risks in 2016 and 2017 requires careful attention by the authorities.

Recent developments

Economic growth accelerated to 3.7 percent in 2015 from 2.8 percent in 2014, driven by the domestic demand. On the expenditure side, growth was led by private consumption (up 6.2 percent yoy) and by investment (up 7.5 percent yoy). Private consumption was aided by the VAT rate cut for food in June 2015, which boosted disposable incomes and real wages. Investment displayed a rebound led by advances in the absorption of EU funds in the second half of 2015, and by improvements in the housing market. On the production side, the drivers were retail trade (up 6.4 percent yoy) and construction (up 8.8 percent yoy). The ITC sector recorded a significant expansion (up 11.8 percent yoy) and has become one of the most dynamic in the EU.

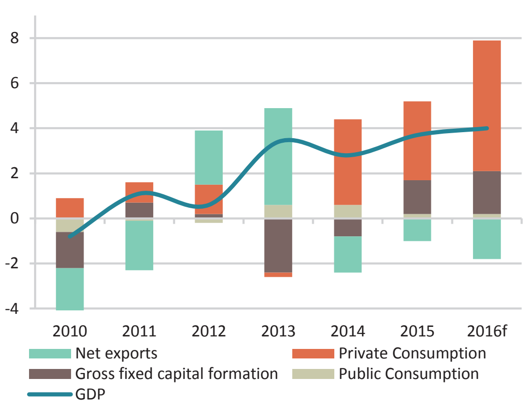
The reduction in the standard VAT rate to 20 percent from 24 percent, implemented in January 2016, brought inflation deeper into negative territory, at -2.7 percent yoy at end-February. Price declines have helped the NBR maintain accommodative monetary policy. The policy rate was kept at 1.75 percent in January, in the context of the large fiscal easing, closing of the output gap and rising unit labor costs. Despite the favorable liquidity conditions, credit growth continued to be subdued, especially to corporations. Credit to corporations fell 3.1 percent yoy in October 2015, while credit to households registered an expansion of 1.7 percent yoy.

The general government deficit declined to 1.5 percent of GDP in 2015, from 1.9 percent in 2014, helping Romania to reach the medium term objective for the structural deficit for a second year in a row. The reduction in the deficit reflects good revenue performance and expenditure containment. Spurred by economic growth, revenue collection increased from profit taxes (13 percent up nominally), income taxes (12.4 percent), and VAT (12.3 percent). Investments from the European funds advanced from 1.6 percent of GDP in 2014 to 2.4 percent in 2015. The wage bill was flat relative to 2014, at 7.4 percent of GDP, while interest payments declined driven by the favorable financing conditions.

Aided by the reduction in social contributions by 5 ppts in October 2014, real wages increased by 11.5 percent yoy in October 2015. Economic growth positively impacted employment, but improvements in labor force participation and job creation have been modest, signaling continued rigidities in the labor market. The employment rate increased to 63.2 percent in Q3 of 2015, up from 62.6 percent in Q3 of 2014. The unemployment rate was 6.8 percent in October 2015, similar to October 2014.

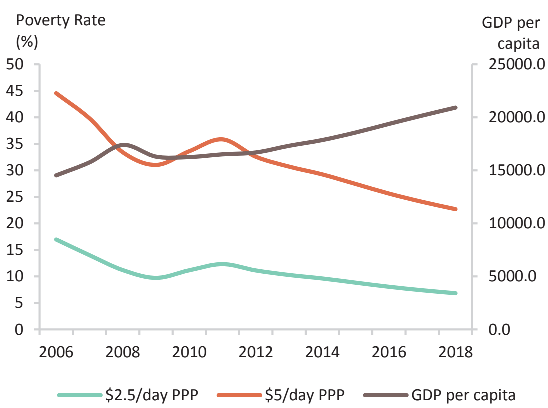
Moderate poverty is projected to have declined from a peak of 35.8 percent in 2011 to 27.4 percent in 2015 using the $5.00/day 2005 PPP poverty line, reflecting increases in private consumption, higher employment, improved real wages, and increased support to vulnerable categories. Cuts to the VAT rate for food have increased household purchasing power and improved welfare outcomes, as food makes up a larger portion of the budgets of the poorest members of society. However, employment

FIGURE 1 Romania / Contributions to annual GDP growth



Sources: World Bank and Romanian National Statistical Institute.

FIGURE 2 Romania / Actual and estimated poverty rates and GDP per capita



Sources: World Bank.

growth has been concentrated in high-skilled areas, while integration of young people and other excluded groups remains a challenge.

Outlook

Growth is expected to remain above potential in 2016 and 2017, supported by the expansionary fiscal policy and improvements in the labor market. The fiscal relaxation measures implemented in 2016, coupled with the wage increases in the public sector, will further boost private consumption. Low inflation and accommodative monetary conditions will help improve credit and may positively impact private investment. Additional fiscal relaxation measures have been adopted by the government to be implemented in 2017, including a further VAT cut to 19 percent, the elimination of the special construction tax and a reduction of the excise rate for fuels. We project a further acceleration of growth to 4 percent in 2016. Acceleration of consumption is also expected to widen external imbalances, but the current account deficit will remain manageable. Inflation will stay in negative territory until June 2016, when the effect of the VAT cut for food fades out, and it is likely it will gradually increase towards 1.4 percent at end-2016, in line with NBR projections.

Following the tax cuts and public sector wage increases, the budget deficit will widen significantly in 2016 and 2017. In line with the 2016 budget and the Medium-Term Fiscal Framework, the consolidated budget deficit is projected to widen towards 3 percent of GDP in both 2016 and 2017. In the absence of tax policy changes, which seem unlikely in an election year, the government will need to rely on the containment of current spending, cuts in capital spending and improvements in tax efficiency to avoid reentering the Excessive Deficit Procedure (EDP) and stay within the deficit 3 percent boundary of the EU Growth and Stability Pact.

Continued strong private consumption aided by a lower VAT and growth in employment and real wages, should boost real incomes and lead to further declines in poverty incidence. The planned introduction of a minimum social inclusion income program is expected to improve targeting and increase the level of benefits for the most vulnerable. The $5.00/day 2005 PPP poverty rate is projected to decline to 25.6 percent in 2016 and to 24 percent in 2017.

Risks and challenges

Risks to this outlook are important. The short term fiscal risks, in particular, need to be carefully managed in the context of the uncertain external environment and of the approaching general elections, scheduled for the autumn of 2016. The revision of the unitary public wage legislation, currently underway, may increase spending pressures and amplify the risk of reentering into the EDP. Over the medium term, the focus of fiscal policy should be rebalanced from boosting consumption to supporting long term sustainable growth. A return to the stop-and-go approach to the unfinished structural reforms agenda, characteristic of the past, entails risks for the sustainability of the economic recovery. Structural reforms should focus on energy, SOEs, and on enhancing the quality of public spending. Renewed efforts are needed to improve labor participation and generate broad-based employment, as unemployment remains high among the youth and low-skilled.

TABLE 2 Romania / Macro poverty outlook indicators (annual percent change unless indicated otherwise)

	2013	2014	2015 e	2016 f	2017 f	2018 f
Real GDP growth, at constant market prices	3.4	2.8	3.7	4.0	3.7	3.4
Private Consumption	-0.2	4.1	6.2	6.0	5.3	5.0
Government Consumption	14.0	13.6	1.5	3.5	3.6	3.5
Gross Fixed Capital Investment	-9.2	-3.3	7.5	8.5	8.0	7.0
Exports, Goods and Services	14.4	8.2	4.7	5.9	5.4	5.6
Imports, Goods and Services	4.0	7.7	8.4	7.7	7.4	7.3
Real GDP growth, at constant factor prices	3.4	2.8	3.7	4.0	3.7	3.4
Agriculture	26.6	1.5	-9.4	5.3	3.3	3.3
Industry	8.0	3.6	2.0	2.9	3.3	3.3
Services	-3.1	2.4	7.4	4.6	4.1	3.4
Inflation (Consumer Price Index)	4.0	1.1	-0.9	-0.3	2.4	2.7
Current Account Balance (% of GDP)	-0.8	-0.5	-1.1	-2.3	-3.5	-4.1
Financial and Capital Account (% of GDP)	1.3	0.8	0.0	0.3	0.5	0.9
Net Foreign Direct Investment (% of GDP)	2.2	1.6	1.6	1.6	1.6	1.7
Fiscal Balance (% of GDP)	-2.5	-1.9	-1.5	-2.8	-2.8	-2.7
Debt (% of GDP)	38.8	40.6	40.1	40.0	40.2	40.7
Primary Balance (% of GDP)	-0.8	-0.3	0.0	-1.2	-1.2	-1.0
Poverty rate ($2.5/day PPP terms)[a,b,c]	10.3	9.6	8.8	8.1	7.4	6.8
Poverty rate ($5/day PPP terms)[a,b,c]	30.7	29.2	27.4	25.6	24.1	22.7

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: e = estimate, f = forecast.
(a) Calculations based on ECAPOV harmonization, using 2006-EU-SILC and 2012-EU-SILC.
(b) Projection using annualized elasticity (2006-2012) with pass-through = 0.7 based on GDP per capita constant PPP.
(c) Projections are from 2013 to 2018.

RUSSIAN FEDERATION

Table 1	2015
Population, million	143.3
GDP, current US$ billion	1324.8
GDP per capita, current US$	9242
Poverty rate ($2.5/day 2005PPP terms)[a]	0.8
Poverty rate ($5/day 2005PPP terms)[a]	7.3
Gini Coefficient[a]	41.6
School enrollment, primary (% gross)[b]	100.6
Life Expectancy at birth, years[b]	70.4

Sources: World Bank WDI and Macro Poverty Outlook.
Notes:
(a) Most recent value (2012)
(b) Most recent WDI value (2013)

In 2015, Russia's economy saw the consequences of the previous year's oil price shock and sanctions causing real GDP to contract 3.7 percent. A second oil price shock in August delayed an anticipated recovery. The economy adjusted through a sharp drop in gross domestic income, which sapped consumer demand and discouraged investment. External balances adjusted smoothly, helped by the central bank's adherence to the free float. However, a tight fiscal stance, accompanied by double-digit inflation, negatively impacted poverty trends.

Recent developments

Facing a difficult economic adjustment, Russia's economy went through a deep recession in 2015, hitting its low point in the second quarter of 2015. Expectations that Russia's economy would rebound in the third quarter of 2015 did not materialize. By the end of the year, Russia's economy had contracted for six consecutive quarters, with year-over-year negative growth only moderating slightly to -4.1 percent in the third quarter and -3.7 percent in quarter four.

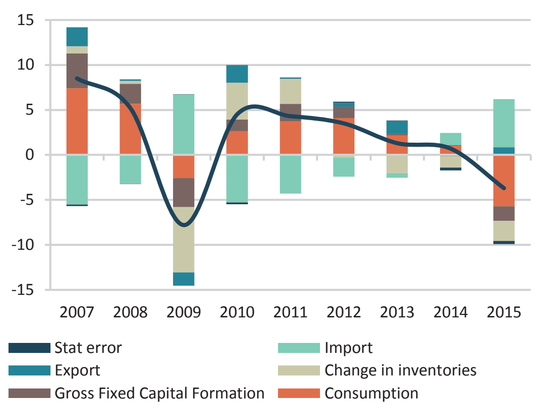
An unanticipated second oil price shock in August renewed pressure on the ruble and kept inflation in double digits at 15.6 percent. Rising inflation eroded real wages, pensions, and other transfers, contributing to an estimated 7.9 percent decline in consumption, the first contraction since the global financial crisis of 2008. The authorities' efforts to contain inflationary pressures presented an obstacle to monetary easing, and the central bank has kept its key policy rates at 11 percent since August 2015. Meanwhile, international sanctions have been extended, limiting access to global financial markets, restricting capital inflows, and damaging investor confidence. High capital costs and plummeting consumer demand provided firms with little incentive to invest in expanded production; as a result, gross capital formation dropped by 18.3 percent in 2015, contracting for a third consecutive year.

The central bank's adherence to a flexible exchange rate regime fostered currency realignment and supported the economic transition. In 2015, the ruble's average exchange rate depreciated 37.4 percent against the US dollar, while oil prices dropped 47 percent. Meanwhile, a 16.5 percent depreciation of the real effective exchange rate drove import volumes down 25.6 percent, nearly doubling the current-account surplus to 5 percent of GDP. Relative prices now favor Russian firms, and export performance improved in some non-energy commodity sectors, such as coal, metals, and chemicals. Helped by the free float, the fiscal impact of the adjustment was less severe than for other oil-exporter countries, yet Russia's government needed to launch a fiscal-consolidation plan.

Federal expenditure decreased in real terms but not enough to compensate for declining oil revenues, resulting in a deficit of 2.4 percent. This was financed by the Reserve Fund, which halved by the end of 2015 to US$46.0 billion. A RUB2.4 billion anti-crisis plan helped to cushion some of the consolidation's impacts—e.g., through the full indexation of pensions—and supported financial-sector stability through bank recapitalization.

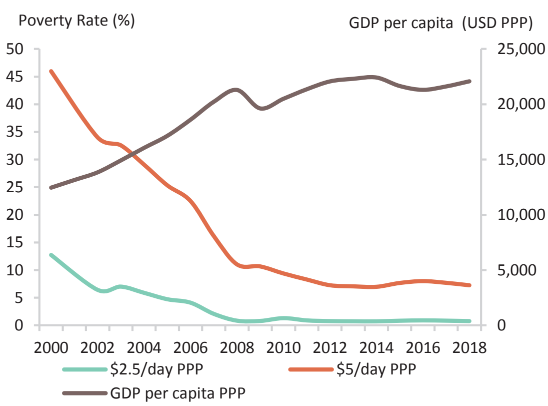
The moderate poverty rate (US$5 in 2005 PPP) rose from 7.0 percent in 2014 to 7.7 percent in 2015. Adverse trends in inflation and income both played roles in the higher poverty rate. Food price inflation averaged 19.1 percent in 2015 and disproportionately reduced the purchasing power of poorer households, where food makes up over 40 percent of total consumption. Nominal wage growth could not compensate for the high inflation, and

FIGURE 1 Russian Federation /GDP growth structure (percentage points/percent)



Sources: Russian Statistical Authorities and World Bank staff calculations.

FIGURE 2 Russian Federation / Actual and estimated poverty rates and GDP per capita (PPP)



Source: World Bank (see notes to table 2).

real wages fell 9.5 percent in 2015. The bright spot is that unemployment increased only slightly to 5.6 percent, up from a record low of 5.3 percent in 2014. However, the limited indexation of public wages, pensions, and transfers impacted poor households that rely on the public sector for a significant part of their incomes (close to 60 percent of the income of the poorest 20 percent of the population comes from public-sector wages, pensions, and other transfers). Real income growth among the bottom 40 percent of the population did not continue to converge with average income growth—so progress on shared prosperity slowed.

Outlook

The conditions that pushed Russia's economy into recession are likely to linger, and the World Bank's current baseline scenario anticipates another tough year, with a decline in real GDP of 1.9 percent in 2016. Oil prices are projected to average US$37 per barrel in 2016, then rebound in 2017 to their 2015 average of around US$50 per barrel. Commodity prices will continue to dominate Russia's medium-term outlook. GDP growth is projected to return to a positive 1.1 percent in 2017 due to improving investment dynamics, led by rising oil prices and declining credit cost. Russia's poverty rate is expected to rise further in 2016 as the economy continues to contract and unemployment rises. Meanwhile, fiscal consolidation will limit the government's latitude for countercyclical policies and antipoverty spending. Poverty, as measured by the international moderate poverty line, is expected to rise from 7.7 percent in 2015 to 8.0 percent in 2016. The economic recovery envisaged in 2017 and stronger targeting of social benefits are expected to support a decline in the poverty rate to 7.7 percent in 2017.

Risks and challenges

The focus of Russia's economic adjustment is now shifting to challenges in fiscal policy and financial-sector restructuring. At the same time, the policy space for Russia's second phase of adjustment is shrinking in light of depleting fiscal buffers. Maintaining fiscal discipline will require bold choices during the 2017 budget-planning process, with authorities striving to determine the structure and policy priorities of the medium-term fiscal framework. A massive bank recapitalization temporarily stabilized the financial sector, but managing systemic vulnerabilities will require constant vigilance and a readiness to implement further measures. Russia's longer-term growth will depend on the strength of its structural reforms.

Poor households have come to rely increasingly on fiscal transfers, pensions, and public-sector wages. There is scope to extend support to the most vulnerable through improved targeting of social-protection programs—i.e., allocating public funds with fewer leakages to the non-poor and a higher poverty-reduction impact. Over the medium-term, the challenge will be restoring the labor market as the driver of poverty reduction and the income growth among the bottom 40 percent of the population.

TABLE 2 Russian Federation / Macro poverty outlook indicators (annual percent change unless indicated otherwise)

	2013	2014	2015 e	2016 f	2017 f	2018 f
Real GDP growth, at constant market prices	1.3	0.7	-3.7	-1.9	1.1	1.8
Private Consumption	3.7	1.7	-10.1	-3.0	0.4	2.0
Government Consumption	1.4	0.4	-1.8	-1.0	-0.6	0.0
Gross Fixed Capital Investment	0.9	-0.6	-7.6	-7.5	3.7	6.6
Exports, Goods and Services	4.8	0.3	3.1	2.5	2.0	2.0
Imports, Goods and Services	2.3	-5.9	-25.6	-3.5	3.5	10.0
Real GDP growth, at constant factor prices	1.3	0.8	-3.6	-1.8	1.1	1.8
Agriculture	4.7	2.2	3.5	4.0	2.0	2.0
Industry	0.6	0.7	-3.7	-0.5	1.5	2.5
Services	1.2	0.8	-3.9	-2.2	1.0	1.7
Inflation (Consumer Price Index)	6.8	7.8	15.6	7.6	4.8	4.0
Current Account Balance (% of GDP)	1.6	2.9	5.2	3.5	2.4	1.0
Financial and Capital Account (% of GDP)	-1.1	-3.2	-4.9	-3.5	-2.4	-1.0
Net Foreign Direct Investment (% of GDP)	-0.8	-1.7	-2.0	-1.0	-0.6	-0.5
Fiscal Balance (% of GDP)	-1.2	-1.1	-3.5	-4.6	-2.3	-2.2
Debt (% of GDP)	12.8	14.3	14.6	15.4	18.6	19.6
Primary Balance (% of GDP)	-0.6	-0.4	-2.7	-3.8	-1.0	-0.9
Poverty rate ($2.5/day PPP terms)[a,b,c]	0.7	0.7	0.8	0.9	0.9	0.8
Poverty rate ($5/day PPP terms)[a,b,c]	7.1	7.0	7.7	8.0	7.7	7.3

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: e = estimate, f = forecast.
(a) Calculations based on ECAPOV harmonization, using 2012-HBS.
(b) Projection using neutral distribution (2012) with pass-through = 1 based on GDP per capita constant PPP.
(c) Projections are from 2013 to 2018.

SERBIA

Table 1	2015
Population, million	7.1
GDP, current US$ billion	36.1
GDP per capita, current US$	5091
Poverty rate ($2.5/day 2005PPP terms)[a]	1.4
Poverty rate ($5/day 2005PPP terms)[a]	14.5
Gini Coefficient[a]	29.1
School enrollment, primary (% gross)[b]	93.0
Life Expectancy at birth, years[b]	74.8

Sources: World Bank WDI and Macro Poverty Outlook.
Notes:
(a) Most recent value (2013)
(b) Most recent WDI value (2013)

Serbia's economic performance in 2015 was marked by a return to growth and a decline in unemployment despite the ongoing implementation of the Government's fiscal consolidation program. Progress on key fiscal and structural reforms was maintained, but many challenging reforms remain. Poverty, which reached an estimated 14.5 percent (living under $5/day PPP) in 2014, is expected to decline to 13.9 percent in 2016. High degrees of vulnerability remain due to still weak labor markets and, if not mitigated, the impacts of fiscal consolidation measures

Recent developments

Growth in 2015 turned out to be stronger than previously projected. After a strong rebound in Q3 to 2.3 percent y/y, initial estimates of real GDP growth in Q4 were 1.2 percent y/y. Growth for 2015 as a whole is estimated at 0.8 percent, well above a contraction of 0.5 percent originally projected in early 2015. Private investment was particularly supportive. Growth could have been even stronger if not for a drought. Agricultural output (accounting for 8 percent of GDP) declined by 7.6 percent y/y in real terms in 2015.

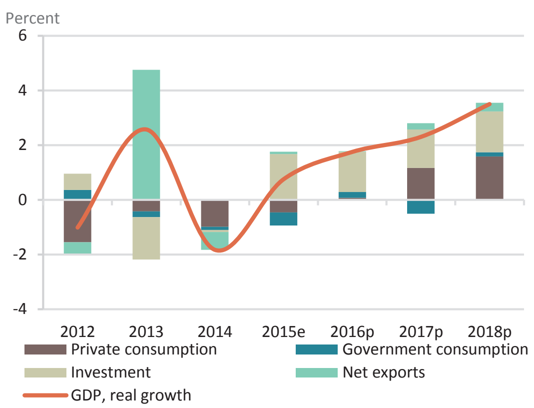
As growth returned, unemployment fell steadily from 19.4 percent in 2014 to 17.9 percent in 2015. Both the activity rate and employment rate, ending in Q4 2015 at 51.6 percent and 42.4 percent respectively, are returning to pre-crisis levels. Private, formal sector jobs increased in 2015 while the government continued to impose a hiring freeze and SOEs reduced employment by around 15,000 people (0.6 percent of total employment). Overall, the average number of employed persons increased slightly in 2015. With public sector wages reduced, aggregate real wages continued to decline in 2015, down 2 percent y/y.

Poverty reduction has slowly resumed since poverty peaked in 2010. As a result of some improvements in economic and employment conditions, the poverty rate – using the regional poverty line of $5/day in 2005 PPP – dropped from 15.1 percent in 2010 to 14.5 percent in 2013. Poverty is estimated to remain at 14.4 percent in 2015. While rising private sector employment has improved welfare, the decline in agriculture output in 2015 is likely to have had adverse impacts on rural poverty.

The Government's ongoing fiscal consolidation program, as supported by a precautionary IMF program, aims to put public debt-to-GDP on a downward path from a peak of 79 percent in 2016. Measures, including freezes and cuts in public wages and pensions, and increases in electricity tariffs, along with a substantial increase in one-off non-tax revenues, resulted in a major decrease of the fiscal deficit – from 6.7 percent of GDP in 2014 to 3.7 percent in 2015. These measures may have limited immediate poverty impact since public sector employees are less likely than others to be in the bottom income quintiles. However, further retrenchments may have negative poverty impacts. The 2014 nominal cuts in pensions were progressive, but the freezing of pension indexation was across the board.

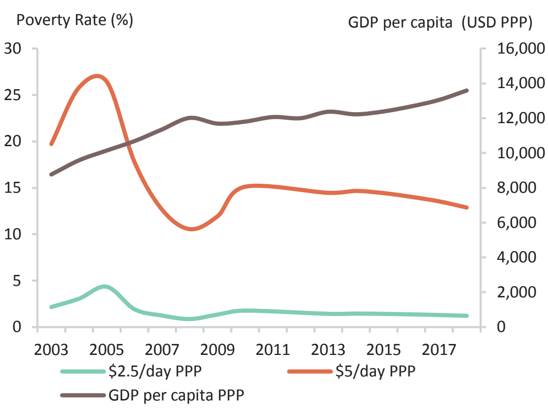
Inflation continues to undershoot its target band, due to lower oil prices and weak domestic demand. Inflation remained in the range of 2 percent throughout 2015, although picked up in January 2016 to 2.4 percent y/y, in part due to a significant rise in food prices. Low inflation in 2015 helped protect purchasing power, but the food price rise in early 2016 is likely to disproportionately affect the poor. The impact of the increase in electricity tariffs on the poor was to some extent mitigated by regulated discounts for energy vulnerable customers. After substantial easing in 2015, the monetary policy rate was cut a further 0.25 percentage points in January

FIGURE 1 Serbia / Contributions to annual GDP growth



Sources: World Bank Staff Calculations based on Statistical Office Data.

FIGURE 2 Serbia / Actual and estimated poverty rates and GDP per capita (PPP)



Sources: World Bank (see notes to Table 2).

2016, in the face of weak domestic and global inflation pressures.
External sector performance has improved, supported by the pick-up in growth in Europe in 2015. Merchandise exports grew by 6.6 percent in 2015 (in euro terms) while imports increased by 4.1 percent, as investment recovered. With service exports and remittances up by 12.2 percent and 11.5 percent respectively, the current account deficit reached a record low level of 4.7 percent of GDP (down 20 percent in euro terms on 2014). Foreign direct investments in 2015 increased significantly (by 46 percent). The dinar has fallen slightly against the euro since the end of 2015. The banking sector remains stable and loans to private sector increased by 3 percent by year end, while loans to households increased 4.7 percent.

Outlook

We project growth in Serbia to rise from 0.8 percent in 2015 to 1.8 percent in 2016 and to 3.5 percent by 2018, underpinned by rising investment, a gradual recovery of consumption, and improving external demand. Ongoing fiscal consolidation measures - targeting an additional structural reduction in the deficit of 2.3 percent over 2016-2018, following a 2.5 percent reduction in 2015 - will limit near-term domestic demand, but will be beneficial in the medium-term through supporting investment. The main domestic risk to growth is delays in structural reforms, for example, due to the impact of the early elections which may also deter foreign investors. With domestic demand only recovering gradually and low import prices, inflation is set to return to the target band only in mid-2016.
With economic growth and improvements in the labor market though with remaining structural challenges, poverty is expected to decline gradually. Poverty measured at the $5/day poverty line is estimated to decline slowly to 14 percent in 2016 and 13.5 percent in 2017. Possible future rises in energy prices as part of financial consolidation plans are expected to increase energy stress, particularly on poor households, who spend disproportionately more on energy as part of total budget.

Risks and challenges

While recognizing the positive fiscal consolidation progress, there remains the need for sustained implementation of the structural reforms. This is crucial in order to maintain macro stability and to create an environment conducive for higher (private sector led) growth and poverty reduction over the medium term.
The potential distributional impacts of comprehensive structural reforms, while supportive of future overall employment and income growth, are likely to pose challenges to poverty reduction in the short term, requiring mitigating measures. Moreover, despite recent improvements, labor force participation and employment ratios are still low while unemployment is high, especially for youth. Social protection and job opportunities to mitigate adverse impacts and facilitate access to employment need to be an important part of the policy agenda.

TABLE 2 Serbia / Macro poverty outlook indicators (annual percent change unless indicated otherwise)

	2013	2014	2015 e	2016 f	2017 f	2018 f
Real GDP growth, at constant market prices	2.6	-1.7	0.8	1.8	2.3	3.5
Private Consumption	-0.6	-1.3	-0.6	0.1	1.6	2.2
Government Consumption	-1.1	0.2	-2.6	1.6	0.6	3.4
Gross Fixed Capital Investment	-12.0	-3.8	8.3	6.7	6.4	6.0
Exports, Goods and Services	21.3	5.7	8.2	7.7	7.6	7.7
Imports, Goods and Services	5.0	5.6	6.1	6.0	5.7	5.7
Real GDP growth, at constant factor prices	3.3	-1.8	0.5	1.9	2.2	3.5
Agriculture	20.9	1.4	-8.1	8.1	2.7	3.6
Industry	4.2	-6.9	4.6	4.3	5.2	5.6
Services	0.4	0.2	0.0	-0.2	0.5	2.4
Inflation (Consumer Price Index)	7.8	2.1	1.9	1.7	3.1	3.5
Current Account Balance (% of GDP)	-6.1	-6.0	-4.7	-4.6	-4.4	-4.3
Financial and Capital Account (% of GDP)	5.7	5.1	3.5	5.7	5.9	5.7
Net Foreign Direct Investment (% of GDP)	3.8	3.7	5.5	4.8	4.7	4.5
Fiscal Balance (% of GDP)	-5.6	-6.6	-3.7	-3.6	-2.7	-1.8
Debt (% of GDP)	61.0	71.7	76.8	78.7	77.7	74.7
Primary Balance (% of GDP)	-3.1	-3.6	-0.3	-0.1	1.0	2.1
Poverty rate ($2.5/day PPP terms)[a,b,c]	1.4	1.5	1.4	1.4	1.3	1.2
Poverty rate ($5/day PPP terms)[a,b,c]	14.5	14.7	14.4	14.0	13.5	12.9

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: e = estimate, f = forecast.
(a) Calculations based on ECAPOV harmonization, using 2006-HBS and 2013-HBS.
(b) Projection using point-to-point elasticity (2006-2013) with pass-through = 1 based on GDP per capita constant PPP.
(c) Actual data: 2013. Projections are from 2014 to 2018.

SLOVENIA

Table 1	2015
Population, million	2.1
GDP, current US$ billion	42.8
GDP per capita, current US$	20763
Poverty rate ($5/day 2005PPP terms)[a]	0.2
Gini Coefficient[a]	25.6
School enrollment, primary (% gross)[b]	98.9
Life Expectancy at birth, years[b]	80.1

Sources: World Bank WDI and Macro Poverty Outlook.
Notes:
(a) Most recent value (2012)
(b) Most recent WDI value (2013)

Economic activity continued to be strong in 2015 boosted by investments and private consumption recovery. Improved labor market conditions pushed the unemployment rate down to 9 percent and is likely to decrease further as job creation is expected to pick up in the projection period. The fiscal consolidation efforts have likely brought deficit down below 4 percent of GDP in 2015, while public debt remained elevated at above 83 percent of GDP in 2015. Ongoing deleveraging contributed to reducing external vulnerabilities and improving net international investment position.

Recent developments

After reaching 3 percent in 2014, economic activity continued to expand by unexpectedly high 2.9 percent in 2015. Growth remained robust driven by decelerating contribution of exports of goods and investments, but strengthened personal consumption. After declining for five consecutive years, government consumption increased in 2015 as fiscal consolidation efforts eased.

A recovery of consumption reflects rising consumer confidence, continued low energy prices and improved labor market conditions with growing employment (up by 0.9 percent), particularly in manufacturing and administrative and support services. Survey-based unemployment rate declined to 9 percent, some 0.7 percentage points below the 2014 level. Major breakthrough, however, was achieved with a decline of youth unemployment rate which at 17.1 percent is now approaching the pre-crisis levels. Apprenticeship programs as well as Youth Guarantee Scheme financing helped with the school-to-work transition of youth. Increase in net wages underpinned by deflationary pressures which marked the whole of 2015 resulted in higher household disposable income which likely led to further decline of poverty.

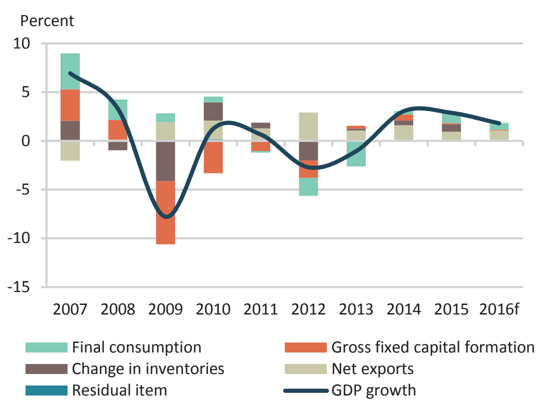
The current account surplus continued to increase for a fifth year in a row reaching historically high levels, 7.3 percent of GDP in 2015, primarily owing to faster growth of export of goods and services. Deleveraging trend in the corporate sector contributed to external debt reduction to 116 percent of GDP in 2015 (from 124.2 percent of GDP in 2014), while government at the same time increased its borrowings.

The banking sector consolidation continued with two banks being liquidated in February 2016 and folded into the Bank Assets Management Company, the bad bank, although without negative fiscal impact since banks have positive capital and will be able to settle their outstanding liabilities to the state.

Fiscal consolidation continued in 2015 with fiscal deficit likely brought down below 4 percent of GDP on the back of reduced expenditures but also rising revenues. Improved economic and labor market situation, increase in some taxes (extension of the fourth personal income tax bracket) and charges, as well as broadening of the social contribution basis helped boosting revenues. Austerity measures extended on the wage freeze, subsidies, investments and capital transfers reduced overall expenditures. Nevertheless, public debt grew above 84 percent of GDP by September 2015 from 80.8 percent in 2014 .

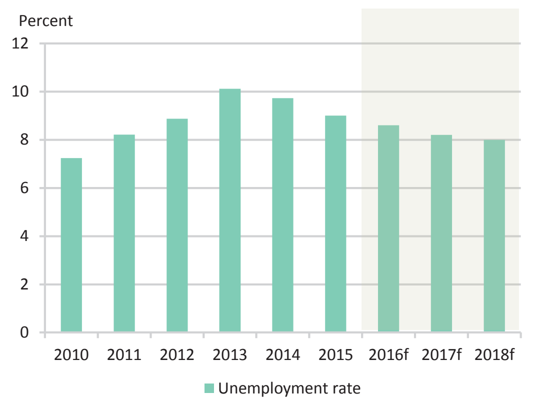
The Fiscal Rules Act was passed, but an independent Fiscal Council, a new independent body tasked with monitoring fiscal policy, has yet to be appointed. The government has nominated three experts to the fiscal council, which will need the support of two thirds of MPs to be appointed for a five-year term on the council. The council will assess the compliance of fiscal policy with the fiscal rule and EU regulations, monitor the implementation

FIGURE 1 Slovenia / Contributions to annual GDP growth



Sources: SORS, World Bank.

FIGURE 2 Slovenia / Unemployment rate (%)



Sources: SORS, World Bank.

of the state budget as well local, pension and health budgets. It will also assess whether circumstances have arisen that warrant a deviation from the objective of having the budget balanced over the medium term.

Outlook

Slovenia's economy is expected to moderate to 1.8 percent in 2016 mainly due to lower public investment as previous programming period of the EU funding came to the end. However, the growth is expected to accelerate again from 2017. The main drivers of economic recovery will be private consumption reflecting further growth in disposable income amid improving consumer confidence and labor market conditions, and private investment which is expected to accelerate gradually due to lower indebtedness but also improved access to finance. The contribution of net exports is to decrease progressively, as domestic demand fuels imports; by mid-2017 economic growth is expected to be almost fully driven by domestic demand.

The current account surplus is projected to remain high, as long as deleveraging in the corporate sector continues. Net international investment position improvement is expected to continue and reduce risks to its external position.

Fiscal consolidation is likely to continue in the projection period with fiscal deficit declining to 1.9 percent of GDP by 2018 supported by economic recovery but also government measures which are expected to remain in effect in the next few years. The Commission could in 2016 stop the excessive deficit procedure, which it launched in December 2009, as Slovenia is on track to bringing the deficit below the 3 percent of GDP ceiling. However, the focus on fiscal policy will then be on reaching the medium-term budgetary objective, which in Slovenia's case means a balanced budget or a structural effort of 0.6 percent of GDP in 2016 for an appropriate adjustment path towards the MTO. Public debt is also expected to start declining after years of steep growth.

To finance 2016 budget needs, the government in February issued a 16-year bond worth EUR1.5bn at 147 basis points spread over mid-swaps, implying yield of 2.338 percent. Unstable conditions on the capital markets at the start of 2016 caused the actual spread to nearly double compared to 20-year Eurobond of 1 billion issued in March last year, but also the final pricing is about 0.35-0.40 percentage points above EMU peripherals like Italy and Spain. Although at more unfavorable conditions, this issue together with the sovereign's cash reserve ensured the sovereign is prefunded by mid-2017.

Risks and challenges

Risks to the outlook are set on the downside. Slovenia's economic growth could be hampered by a slowdown in its main trading partners and worsening of the already volatile financial markets. On the domestic side, the slow resolution of the banking sector NPLs, the resolution of the assets held in the Bank Asset Management Company, delayed fiscal consolidation process and structural reforms could undermine projected growth.

Despite recent improvements, labor market continues to struggle with structural challenges. Long-term unemployment decreased but still accounts for over half of the total unemployed, while employment rates of low-skilled and older workers remained low. Although decreased to 11.5 percent of total loans, the level of NPLs remained high which together with low credit demand, deleveraging pressures and credit risk, continue to exert pressure on the profitability of the banking sector.

TABLE 2 Slovenia / Macro poverty outlook indicators (annual percent change unless indicated otherwise)

	2013	2014	2015 e	2016 f	2017 f	2018 f
Real GDP growth, at constant market prices	-1.1	3.0	2.9	1.8	2.2	2.4
Private Consumption	-4.1	0.7	1.7	1.2	1.5	1.8
Government Consumption	-1.5	-0.1	0.7	0.2	0.6	0.9
Gross Fixed Capital Investment	1.7	3.2	0.5	0.4	3.0	3.4
Exports, Goods and Services	3.1	5.8	5.2	4.9	4.4	4.3
Imports, Goods and Services	1.7	4.0	4.4	4.0	4.0	3.9
Real GDP growth, at constant factor prices	-0.7	3.8	2.9	1.8	2.2	2.4
Agriculture	-4.3	10.0	2.4	2.5	1.5	1.6
Industry	-1.7	5.5	3.1	2.5	2.4	2.4
Services	-0.2	2.9	2.8	1.5	2.1	2.4
Inflation (Consumer Price Index)	1.8	0.2	-0.5	0.8	1.5	1.8
Current Account Balance (% of GDP)	5.6	7.0	7.3	7.8	7.5	7.2
Financial and Capital Account (% of GDP)	-3.4	-6.7	-5.0	-5.5	-5.5	-5.1
Net Foreign Direct Investment (% of GDP)	0.1	1.6	2.3	2.5	2.6	2.8
Fiscal Balance (% of GDP)	-15.0	-5.0	-2.9	-2.7	-2.1	-1.9
Debt (% of GDP)	70.8	80.8	83.6	80.3	79.5	78.0
Primary Balance (% of GDP)	-12.4	-1.8	0.2	0.4	0.9	1.0

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Note: f = forecast.

TAJIKISTAN

Table 1	2015
Population, million	8.5
GDP, current US$ billion	7.9
GDP per capita, current US$	930
Poverty rate (LCU 165.628/month)[a]	31.3
Gini Coefficient[a]	28.0
School enrollment, primary (% gross)[b]	99.6
Life Expectancy at birth, years[b]	67.3

Sources: World Bank WDI and Macro Poverty Outlook.
Notes:
(a) Most recent value (2015)
(b) Most recent WDI value (2013)

Tajikistan's economy grew by 4.2 percent in 2015, driven by a large increase in government investment, which partially offset the adverse impact of negative external conditions. The fiscal and external accounts deteriorated, affected by the sharp fall in remittances and foreign-financed public investment. The economy is expected to recover slowly over the medium term as the external environment improves. Falling remittances and sluggish employment growth will slow the pace of poverty reduction, but continued progress is expected through 2018.

Recent developments

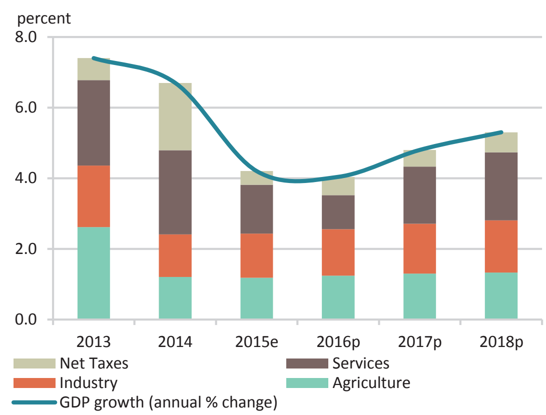
Tajikistan's GDP growth rate slowed from 6.7 percent in 2014 to an estimated 4.2 percent in 2015 as external conditions deteriorated. Remittances from Russia declined, demand for Tajikistan's exports remained weak, and prices for the country's key export commodities—aluminum and cotton—continued to fall. Externally financed public investment doubled, stimulating the growth of construction and construction-related industry, which offset the poor performance of services.

The sharp increase in foreign-financed investment widened the fiscal deficit to 2.2 percent of GDP in 2015 from a near balance in 2014. Domestic tax and nontax revenues rose as the authorities increased pressure on businesses to meet revenue targets, which partially compensated for a decline in revenues from foreign economic activities. Although the primary fiscal balance was close to zero in 2015, rising debt-service obligations and contingent liabilities generated by state-owned enterprises (SOEs) are narrowing the fiscal space. As of end-2015, the total debt stock of the 24 largest SOEs was estimated at 44 percent of GDP, and about 75 percent of bank loans to SOEs are classified as nonperforming loans (NPLs). The overall share of NPLs in the banking system increased to 30 percent by the end of the year.

The somoni depreciated by over 24 percent against the US dollar during 2015, mitigating pressures on the economy and the external accounts. A sharp contraction in imports improved the trade balance, but plummeting remittances widened the current-account deficit from 3.6 percent of GDP in 2014 to an estimated 6 percent in 2015.

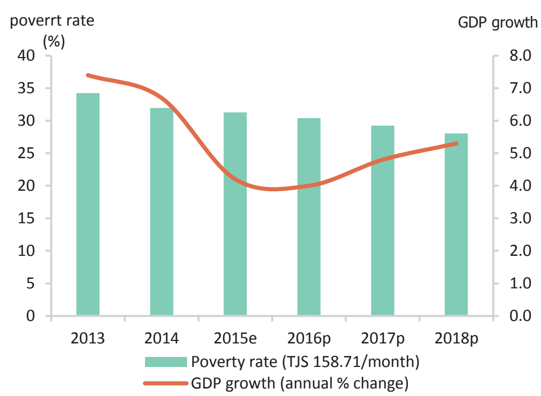
Russia's ongoing recession, the depreciation of the ruble and the tightening of immigration regulations caused remittances to decline by 33 percent in US dollar terms in 2015. Although the decline was less dramatic in somoni terms (16 percent), lower real remittances and limited job creation in the domestic formal sector slowed the pace of poverty reduction. The national poverty rate fell from 37.4 percent in 2012 to 31.3 percent in Q3 2015, but it remained essentially unchanged between the first and third quarters of 2015. Between May and November, seasonally unadjusted average real per capita income climbed among households in the top 60 percent of the distribution and remained largely unchanged among those in the bottom 40 percent. During the summer and fall, the decline in the real value of remittances was partially offset by seasonal increases in remittance volumes, agricultural income and self-employment earnings. However, this trend reversed in the winter months, when declines in remittances, wages, self-employment earnings and agricultural income per capita were observed across all regions and income levels as the agricultural season ended and migrant workers returned.

FIGURE 1 Tajikistan / GDP growth decomposition



Sources: TajStat, World Bank staff estimates.

FIGURE 2 Tajikistan / Actual and projected national poverty rates and GDP growth



Sources: World Bank (see Notes to Table 2).

Outlook

The GDP growth rate is projected to remain at about 4 percent in 2016 as the continued expansion of public investment counters the effects of an adverse external environment. A further decline in remittances, albeit at a slower pace, is expected to put downward pressure on private consumption growth. Large construction projects, some related to the 25th anniversary of Tajikistan's independence, will continue to drive the rapid growth of the industry and construction sectors, while the depreciation of the somoni will encourage import substitution. High rates of public investment and planned increases in public sector wages and benefits will further widen the fiscal deficit. Growth is expected to accelerate over the medium term as the external environment improves, large-scale investment continues and remittances recover, but growth rates will remain below recent historical averages.

Poverty reduction is expected to continue. The national poverty rate is projected to drop to 30.4 percent in 2016 and 28.1 percent in 2018. Food prices climbed significantly in the first quarter of 2016, disproportionately impacting poorer and rural households for whom food represents an especially large share of total consumption. The planned expansion of the Targeted Social Assistance Program to 40 districts in 2016 and then to the entire country is expected to mitigate the impact of the worsening external environment on extreme poor, while a proposed increase in pensions and benefits is expected to have a positive effect on poverty.

Risks and challenges

Risks to the outlook are tilted to the downside. A weaker-than-expected recovery in Russia and Kazakhstan could depress remittances, while a more severe slowdown in Turkey and China could reduce exports and foreign direct investment. Risks arising from SOEs and the financial sector could threaten both overall economic growth and fiscal revenues. Despite the numerous reforms initiated by the new central bank management, high NPL ratios, weak capital positions and liquidity constraints continue to weaken the financial sector.

In a context of limited private sector growth, declining remittance inflows and weak external demand, the government's main policy challenges will be to promote job creation, maintain fiscal sustainability and protect pro-poor spending. Key priorities include addressing financial sector vulnerabilities and improving the governance of SOEs to minimize fiscal risks and enhance service delivery. Further progress on the structural reform agenda would improve the business climate, helping Tajikistan sustain economic growth, positive employment dynamics and steady poverty reduction despite an adverse external environment.

TABLE 2 Tajikistan / Macro poverty outlook indicators (annual percent change unless indicated otherwise)

	2013	2014	2015 e	2016 f	2017 f	2018 f
Real GDP growth, at constant market prices	7.4	6.7	4.2	4.0	4.8	5.3
Private Consumption	4.1	4.1	-1.2	0.0	3.0	3.7
Government Consumption	-20.7	0.9	3.1	2.5	2.3	2.3
Gross Fixed Capital Investment	35.4	2.6	12.9	9.0	8.1	9.3
Exports, Goods and Services	5.5	5.5	3.5	5.8	6.5	7.3
Imports, Goods and Services	5.9	5.9	1.5	4.5	5.0	6.5
Real GDP growth, at constant factor prices	7.4	5.2	4.2	3.9	4.8	5.2
Agriculture	10.0	4.5	4.5	4.7	4.9	5.0
Industry	8.8	6.0	6.3	6.5	6.8	7.0
Services	5.3	5.3	3.1	2.1	3.8	4.5
Inflation (Consumer Price Index)	5.0	6.1	5.8	10.5	8.5	8.0
Current Account Balance (% of GDP)	-2.4	-3.6	-6.0	-5.9	-5.0	-3.4
Financial and Capital Account (% of GDP)	0.1	3.2	5.5	5.6	5.0	2.1
Net Foreign Direct Investment (% of GDP)	1.0	2.9	2.9	4.1	3.6	4.0
Fiscal Balance (% of GDP)	-1.1	-0.1	-2.2	-3.3	-3.0	-2.4
Debt (% of GDP)	38.0	36.5	39.9	47.3	48.5	52.4
Primary Balance (% of GDP)	0.1	0.4	-0.1	-1.2	-0.4	-0.7
Poverty rate (LCU 165.628/month Somoni)[a,b,c]	34.3	32.0	31.3	30.4	29.3	28.1

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: e = estimate, f = forecast.
(a) Calculations based on 2015 HBS.
(b) Projection using neutral distribution (2015) with pass-through = (0.7) based on GDP per capita constant PPP. Actual data: 2013, 2014, 2015. Projections are from 2016 to 2018.
(c) Actual data: 2013, 2014, 2015. Projections are from 2016 to 2018.

TURKEY

Table 1	2015
Population, million	76.7
GDP, current US$ billion	716.9
GDP per capita, current US$	9345
Poverty rate ($2.5/day 2005PPP terms)[a]	3.4
Poverty rate ($5/day 2005PPP terms)[a]	18.7
Gini Coefficient[a]	40.2
School enrollment, primary (% gross)[b]	100.0
Life Expectancy at birth, years[b]	74.9

Sources: World Bank WDI and Macro Poverty Outlook.
Notes:
(a) Most recent value (2013)
(b) Most recent WDI value (2013)

Growth is estimated to have increased to 4.2 percent in 2015, much higher than expected. Despite depressed consumer confidence and election uncertainty, private consumption became the main driver of growth, thanks to strong real wage growth, a large decline in oil prices, and the wealth effect from currency depreciation. Turkey`s economy continues to face headwinds on several fronts, which justifies a cautious medium-term, macro-poverty outlook.

Recent developments

The Justice and Development Party (AK Party) regained the majority in the November 1 parliamentary elections, ending political uncertainty. However, attempts to bolster the AK Party's support in parliament and push for constitutional changes could prove a major distraction in the near future.

Despite election uncertainty, growth is estimated to have increased to 4.2 percent from 2.9 percent in 2014, thanks to strong domestic demand. Government spending continued to support growth, while private investment remained depressed amid a weakening business climate. Exports slowed sharply due to slower demand from the EU, the economic crisis in Russia, and geopolitical developments. However, real exchange rate depreciation led to a decline in imports and a positive contribution of net exports to growth in 2015.

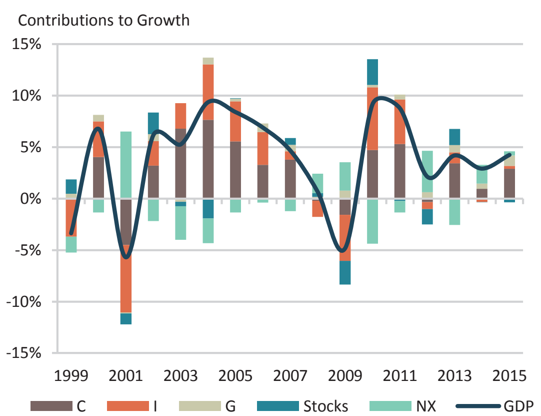
Nominal wage growth was comfortably above the inflation rate, which buoyed disposable incomes and encouraged consumer spending. Lower global oil prices reduced outlays for fuel and this income effect fueled consumption. Moreover, many households hold foreign currency deposits, and thus the large depreciation of the lira created a wealth effect, which also supported consumption. However, pass-through of currency depreciation stoked inflation, to 9.6 percent by January 2016, significantly above the Central Bank`s target band of 3-7 percent. Despite the higher overall growth, employment creation in non-agricultural sectors slowed and the non-agricultural unemployment rate stabilized around 12.5 percent in Q4 of 2015.

The gold-adjusted current account deficit narrowed by 0.3 percentage points to 5.0 percent of GDP in 2015, thanks to the large fall in energy prices. However, the current account improvement was much smaller than expected, indicating that the core current account deficit actually widened. This deterioration in fundamentals highlights that external adjustment is driven by cyclical factors instead of structural reforms. On the financing side, inflows to Turkey slowed sharply due to domestic political uncertainty and a deterioration in global risk appetite. Amid large portfolio outflows Central Bank reserve assets dropped by $11.8 billion in 2015. The population at the lower end of the income distribution has benefitted from both improved access to jobs as well as access to better jobs with higher income and less informality. This has resulted in a continued decreasing trend in poverty. For 2013, the latest year of available data, extreme poverty (based on US$2.5 per day) affected 3.4 percent of the population, while moderate poverty (based on US$5 per day) decreased to 18.7 percent.

Outlook

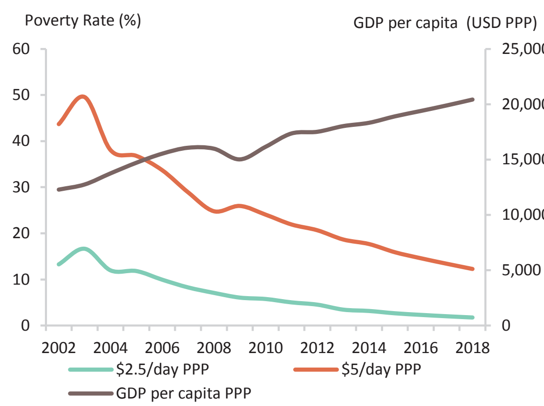
We expect private consumption to continue to drive growth in 2016, thanks to the 30 percent rise in the minimum wage introduced in January and a small but

FIGURE 1 Turkey / Contributions to annual GDP growth



Sources: Turk Stat.

FIGURE 2 Turkey / Actual and estimated poverty rates and GDP per capita (PPP)



Sources: World Bank (See notes to Table 2).

positive contribution from public spending. Continued demand pressures are likely to make disinflation a slow process. Lira depreciation has strained balance sheets and raised the debt service burdens of the corporate sector, which has large foreign exchange exposures. These weigh heavily on private investment, along with a widespread perception of deteriorating institutional quality and business climate. Firming activity in the EU is helping exports, but Russian sanctions and security concerns will limit export growth and tourism revenue in 2016. Economic growth is likely to slow to 3.5 percent in 2016. Increasing security concerns and any deterioration of the political situation are the main downside risks to our growth forecast.

Low oil prices are helping to stabilize the current account deficit at around 4.6 percent of GDP. At the same time, the continuing need for large capital inflows is a concern, amid difficult global financing conditions, and weakening Central Bank net reserves. The general government deficit is likely to widen to 2.7 percent of GDP because of election promises and weaker revenue growth. However, the implications on real government consumption will be limited given the nominal nature of election promises, such as increases in pensions and wage hikes.

Poverty is expected to continue its downward trend, but the rate of poverty reduction may be lower in the coming years. It is anticipated that employment and wage income will continue to be the main drivers of poverty reduction in the context of the strong increase in the minimum wage. Extreme poverty is projected to decline to 2.6 percent in 2015 from 3.4 percent in 2013, while moderate poverty is slated to decrease to 15.9 percent in 2015 from 18.6 percent in 2013.

The poverty outlook is conditioned on the role of the rising minimum wage. On one hand, the population at the lower end of the income distribution will benefit from a rising real minimum wage, even if not formally employed, through its effect on the overall wage structure. On the other hand, the move may lead to slower job creation in sectors that are unskilled labor intensive. As a result, the employment rate for younger or low-skilled workers may worsen disproportionately, and the unemployment gap between skilled and unskilled workers could increase.

Risks and challenges

Medium-term growth prospects depend on the implementation of structural reforms. The new government is well positioned to proceed with the implementation of its structural reform program to bring back investment and productivity growth. The program rightly focuses on macro stability with new tax legislation and financial sector development, as well as flexibility in the labor market by allowing more flexible contracts and reducing severance pay obligations. More is needed to enhance the quality of regulatory institutions and strengthen the rule of law, in order to create a better environment for domestic and foreign investors and restore investment growth in Turkey.

Inequality has recently stagnated. This is important, as growth appears not to translate fully into higher incomes for the poor in countries that are less equal. Continuing to elevate the skill level of those at the lower end of the income distribution will be important to boost the prospects of making economic growth inclusive. Finally, the labor market reform could have a progressive distributive incidence at the margin since the potentially detrimental impact of higher minimum wages on job creation is more binding for workers from lower income households.

TABLE 2 Turkey / Macro poverty outlook indicators (annual percent change unless indicated otherwise)

	2013	2014	2015 e	2016 f	2017 f	2018 f
Real GDP growth, at constant market prices	4.2	2.9	4.2	3.5	3.5	3.6
Private Consumption	5.1	1.4	4.4	5.1	4.0	3.8
Government Consumption	6.5	4.7	9.3	4.1	2.4	2.6
Gross Fixed Capital Investment	4.4	-1.3	1.1	2.1	3.5	4.9
Exports, Goods and Services	-0.2	6.8	0.8	1.5	4.3	4.6
Imports, Goods and Services	9.0	-0.2	-0.7	4.5	5.1	5.8
Real GDP growth, at constant factor prices	4.9	3.3	4.2	3.5	3.4	3.5
Agriculture	3.5	-1.9	3.3	1.9	1.9	1.9
Industry	4.1	3.5	2.1	1.5	1.5	1.5
Services	5.5	4.0	5.5	4.8	4.6	4.7
Inflation (Consumer Price Index)	7.4	8.2	8.8	8.5	8.0	7.5
Current Account Balance (% of GDP)	-7.9	-5.8	-4.5	-4.6	-4.9	-5.0
Financial and Capital Account (% of GDP)	7.5	5.4	3.1	4.3	4.6	4.7
Net Foreign Direct Investment (% of GDP)	1.1	0.7	1.6	1.3	1.4	1.5
Fiscal Balance (% of GDP)	-0.7	-0.6	0.0	-2.7	-2.6	-1.8
Debt (% of GDP)	38.7	36.2	34.9	35.3	35.0	34.3
Primary Balance (% of GDP)	2.5	2.4	2.8	0.2	0.4	1.3
Poverty rate ($2.5/day PPP terms)[a,b,c]	3.4	3.2	2.7	2.3	2.0	1.7
Poverty rate ($5/day PPP terms)[a,b,c]	18.7	17.7	15.9	14.6	13.4	12.3

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: e = estimate, f = forecast.
(a) Calculations based on ECAPOV harmonization, using 2007-HICE, 2012-HICE, and 2013-HICE.
(b) Projection using point-to-point elasticity (2007-2012) with pass-through = 1 based on GDP per capita constant PPP.
(c) Point-to-point elasticity was the method of choice, taking into consideration the local context. Years 2008-2009 were crisis years and would provide a biased view if taken as baseline.

TURKMENISTAN

Table 1	2015
Population, million [a]	5.4
GDP, current US$ billion [a]	43.6
GDP per capita, current US$ [a]	8118
Life Expectancy at birth, years [b]	65

Sources: World Bank, WDI, and Macro Poverty Outlook.
Notes:
(a) World Bank staff estimates (2015).
(b) Life Expectancy data show most recent WDI value (2013)

Turkmenistan's growth slowed in 2015 due to declining world oil and natural gas prices and weaker external demand. In early 2015, the authorities made a one-time adjustment to the exchange rate in an effort to mitigate pressures on external accounts. In view of declining revenues from the hydrocarbon sector, the authorities froze some public investment programs, while maintaining social spending. They are committed to structural reforms aimed at diversifying the economy and promoting more sustainable growth.

Recent developments

The global decline in oil and gas prices and weaker external demand from its major trade partners, including China, slowed Turkmenistan's economic growth to 6.5 percent in 2015, down from more than 10 percent a year in 2013-14. On the domestic demand side, growth was supported by consumption and, to a lesser extent, by investments, although the government cut back some of its public investment in 2015 to avoid increasing the fiscal deficit. On the supply side, growth was driven by retail trade and transport and communication.

Oil and gas export earnings fell by nearly a half in 2015, leading to a deterioration of the external accounts. The authorities swiftly responded to the shock by devaluating the Turkmen manat by 18.6 percent against the U.S. dollar in January 2015. However, the current account closed the year with a significantly higher deficit, estimated at 11.8 percent of GDP, compared with 6.7 percent in 2014.

On the fiscal policy front, the government made a commendable effort to improve spending efficiency, while freezing new large public investment programs in light of declining revenue inflows. At the same time, the government maintained commitments to social spending and provided support to small-scale agriculture producers and export-oriented and import-substituting firms. Given the limited monetary policy tools available under the fixed exchange rate arrangement, the fiscal adjustment helped to keep inflation low despite the devaluation's pass-through effect.

Turkmenistan does not produce an official poverty measure, and there are no targeted social assistance programs in place to protect the vulnerable from external shocks. However, the government is considering gradually transferring from a universal public subsidy system to a more targeted, needs-based allocation system for social assistance.

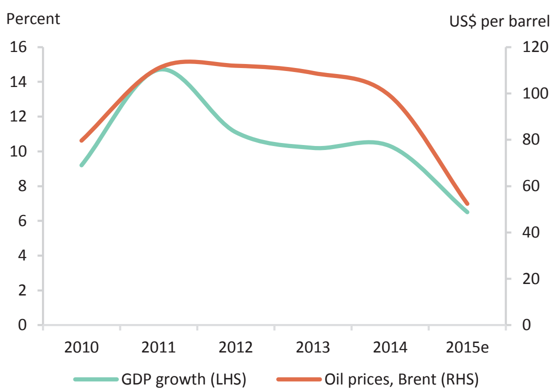
Outlook

Turkmenistan is expected to face another difficult year in 2016. Growth is projected to slow further to 5 percent in 2016 under a baseline scenario that assumes an average oil price of US$37 per barrel and continued fiscal consolidation. If hydrocarbon prices stay low, they will adversely affect Turkmenistan's GDP growth rate and its external and fiscal balances.

Risks and challenges

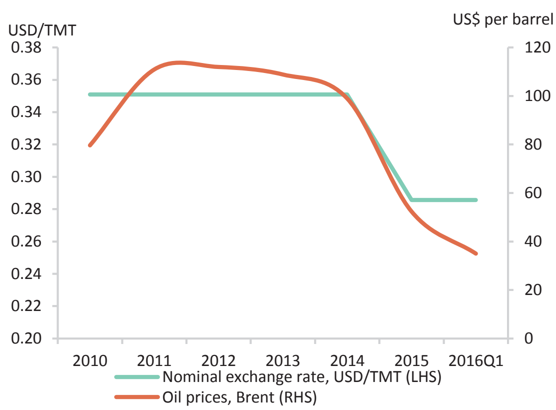
Turkmenistan's fiscal revenues and its balance of payments are highly dependent on external demand for its hydrocarbon resources and on their prices on global markets. Downside risks to our

FIGURE 1 Turkmenistan / Real GDP growth and oil prices (Percent; US$/per barrel)



Source: State Statistics Committee of Turkmenistan.

FIGURE 2 Turkmenistan / Nominal exchange rate and oil prices (US$/TMT /US$ per barrel)



Source: Central Bank of Turkmenistan.

baseline scenario include a protracted oil glut, exacerbated by an increase of oil exports from Iran and/or the inability of Russia and the OPEC members to agree on potential production cuts. The Chinese economy's slowdown and uneven recoveries in the U.S. and Europe may also contribute to the continuation of the oil glut. Besides weaknesses in international hydrocarbon prices, the potential spillover effects from Russia's continued recession and the Chinese economy's ongoing slowdown pose risks and challenges for Turkmenistan.

Core domestic policy concerns center on increasing the Turkmen economy's resilience to external shocks and ensuring sustainable growth and job creation. However, low implementation capacity may hinder the acceleration of structural reforms to diversify the economy, such as strengthening institutions and creating appropriate skills and a level playing field for the private sector. The institutional reform agenda includes improving the quality of fiscal decisions, strengthening efficiency of public spending and overall public financial management, streamlining the role of the state, and modernizing the public sector administration with better institutional capacities. Turkmenistan's top development priority is putting a sound and transparent system of public resource management in place to ensure that its considerable natural resource wealth will be efficiently used to improve basic living standards and reverse the recent deterioration in the provision of social services.

TABLE 2 Turkmenistan / Macro poverty outlook indicators (annual percent change unless indicated otherwise)

	2013	2014	2015 e	2016 f
Real GDP growth, at constant market prices	10.2	10.3	6.5	5.0
Prices: Inflation	6.8	6.0	5.5	5.0
Current Account Balance (% of GDP)	-7.2	-6.7	-11.8	-13.0
of which: Exports of oil and gas (% of GDP)	43.5	38.2	26.0	18.2
Financial and Capital Account (% of GDP)	14.5	8.6	8.2	7.4
of which: Net Foreign Direct Investment (% of GDP)	9.1	8.6	9.8	9.0
Fiscal Balance (% of GDP)	10.4	4.9	-1.0	-2.5
Debt (% of GDP)	21.1	16.8	21.0	22.0

Sources: World Bank, International Monetary Fund.
Notes: f = forecast.

UKRAINE

Table 1	2015
Population, million	45.1
GDP, current US$ billion	88.0
GDP per capita, current US$	1954
Poverty rate ($5/day 2005PPP terms)[a]	3.3
Gini Coefficient[a]	24.1
School enrollment, primary (% gross)[b]	106.0
Life Expectancy at birth, years[b]	70.9

Sources: World Bank WDI and Macro Poverty Outlook.
Notes:
(a) Most recent value (2014)
(b) Most recent WDI value (2013)

The economy contracted by 10 percent in 2015 due to unprecedented shocks from the conflict in the East and lower global commodity prices, although initial signs of stabilization emerged in the fourth quarter. A gradual economic recovery is expected, contingent on reform progress and no further escalation of the conflict. The general government deficit, including Naftogaz, was reduced to 2 percent of GDP in 2015, although the fiscal outlook remains challenging. Poverty is estimated to have almost doubled in 2015 and is projected to remain elevated through 2018 in light of the gradual recovery, tight fiscal conditions, and further utility tariff increases.

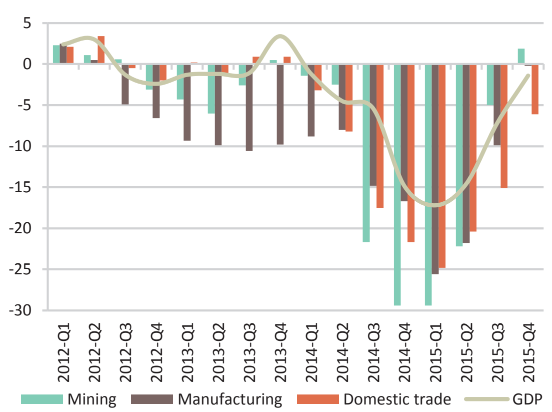
Recent developments

After a sharp contraction in economic activity through the first three quarters of 2015, initial signs of stabilization emerged in the fourth quarter. Real GDP contracted by 10 percent in 2015 overall. The conflict has led to widespread disruption in supply and distribution chains and undermined confidence, while the drop in global commodity prices has led to a serious deterioration of Ukraine's terms of trade. While the external economic environment remains difficult, the conflict in the east has de-escalated since September 2015 and macroeconomic and structural reforms have begun to stabilize confidence. As a result, real GDP contracted more modestly by 1.4 percent y/y in the fourth quarter of 2015, compared to 7.2 percent y/y in the third quarter and 16 percent y/y in the first half of 2015. Industrial production declined by a more modest 5 percent in the fourth quarter and rebounded 7.6 percent in February 2016. Inflation remained high at 43.3 percent y/y in December 2015 due to currency depreciation and utility tariff hikes, but abated from a peak of 61 percent in April.

Poverty is estimated to have increased sharply in 2015. Disposable incomes have contracted significantly from the deep recession. As a result, the poverty rate (under $5/day in 2005 PPP) is estimated to have increased from 3.3 percent in 2014 to 5.8 percent in 2015, while moderate poverty (WB national methodology for Ukraine) is estimated to have increased from 15.2 percent in 2014 to 22.2 percent in 2015. Labor market conditions deteriorated, with real wages down by 13 percent y/y in December 2015 and unemployment remaining elevated at 9.5 percent at end 2015. Poor households were affected by the dramatic increase in energy prices in 2015, with the new means-tested housing utility subsidy program partly mitigating the impact.

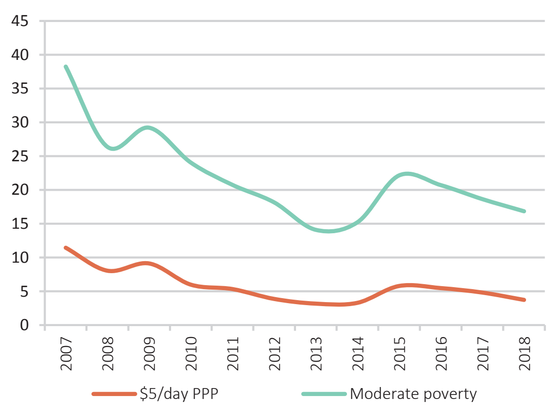
The authorities adopted decisive policies to reduce fiscal and external imbalances. Despite revenue losses from Donetsk and Luhansk, the headline fiscal deficit was reduced to 1.1 percent of GDP in 2015 from 4.5 percent in 2014, due to tight controls on spending and higher inflation. In addition, the Naftogaz deficit was reduced to 0.9 percent of GDP in 2015 from 5.6 percent in 2014 on the back of tariff increases and lower prices of imported gas. In November 2015, Ukraine successfully restructured about $15 billion of its public external debt. As a result of these developments, public and guaranteed debt stabilized at 82 percent of GDP in 2015, up from 70 percent in 2014. In parallel, currency depreciation, recession, and administrative controls compressed imports and narrowed the current account deficit to 0.2 percent of GDP in 2015 from 3.5 percent in 2014. Official disbursements amounted to $8.5 billion in 2015 and helped support private debt repayments and an increase in international reserves to $13.3 billion at end-2015, equivalent to 3.5 months of imports.

FIGURE 1 Ukraine / GDP growth, y/y, 2012-2015



Sources: Ukrainian Statistical Office and World Bank staff calculations.

FIGURE 2 Ukraine / Poverty Rates, actual and projected, 2007-2018



Sources: World Bank (see notes to Table 2).

Outlook

Prospects for economic recovery remain uncertain and depend on how the conflict in the East unfolds and whether reforms on multiple fronts can be advanced in an uncertain environment. If the conflict does not escalate further and progress is made on reforms, a gradual economic recovery is expected, with growth of 1 percent in 2016 and 2 percent in 2017. The real depreciation coupled with efforts to tap the EU market should support exports and tradables, while improved expenditure efficiency should unlock public investment. Continued banking sector reforms should also permit a gradual resumption of lending. In the medium term, growth could pick up to 3-4 percent. The outlook is subject to serious risks, including an escalation of the conflict, further deterioration in the external environment, and difficulty to advance reforms in the face of political instability.

The fiscal outlook remains challenging and has been shaped further by a far-reaching tax reform adopted together with the 2016 budget. The fiscal framework actually projects an increase in the fiscal deficit to 3 percent of GDP in 2016 (because of lower NBU profit transfers). Meeting this deficit target will prove challenging, particularly in light of the payroll tax rate cut from 40 to 22 percent in 2016. Estimates suggest that short term revenue losses could amount to 3 percent of GDP, which would require challenging compensatory measures to broaden the tax base, strengthen tax administration, and rationalize current expenditures. If these challenging measures are successful, the fiscal deficit is projected to narrow to 2 percent of GDP by 2018.

In line with the projected gradual economic recovery, poverty is expected to decline gradually in 2016-2018, although remaining above the level in 2014. Fiscal consolidation will require restraint on growth of public-sector wages, pensions, and other social programs, as well as further energy tariff increases, which will affect household purchasing power across the income distribution.

Despite the narrowing of the current account deficit and restructuring of debt, external vulnerabilities are expected to persist. Ukraine will require significant external financing to meet repayments on its external debt. Further cooperation with the IMF and other official creditors will be important to meet external financing needs and rebuild international reserves.

Risks and challenges

Ukraine will need to advance reforms on multiple fronts to achieve sustainable recovery and shared prosperity going forward. First, in light of the difficult external environment and persisting vulnerabilities, safeguarding macroeconomic stability will be critical. This will require reforms to continue fiscal consolidation and strengthen the financial sector, while maintaining a flexible exchange rate. Second, Ukraine will need to improve productivity and create jobs by investing in infrastructure, improving the business climate, and taking advantage of trade opportunities. Third, Ukraine will need to provide smarter and more effective services to the population to ensure that the benefits of recovery are broadly shared. Intensifying anti-corruption and governance reforms to reduce the influence of vested interests will prove important across the board.

TABLE 2 Ukraine / Macro poverty outlook indicators (annual percent change unless indicated otherwise)

	2013	2014	2015	2016 f	2017 f	2018 f
Real GDP growth, at constant market prices	0.0	-6.6	-9.9	1.0	2.0	3.0
Private Consumption	6.9	-8.3	-20.2	-1.5	0.5	3.0
Government Consumption	-0.9	1.1	1.0	1.0	1.5	1.5
Gross Fixed Capital Investment	-8.4	-21.8	8.5	9.5	10.5	5.6
Exports, Goods and Services	-8.1	-14.5	-16.9	2.2	5.0	4.0
Imports, Goods and Services	-3.5	-22.1	-22.0	0.6	2.3	4.6
Real GDP growth, at constant factor prices	0.0	-6.6	-9.9	1.0	2.0	3.0
Agriculture	13.8	2.9	-4.7	0.7	1.5	2.0
Industry	-3.8	-14.6	-13.5	1.4	2.8	3.0
Services	-1.3	-4.2	-9.5	0.9	1.8	3.4
Inflation (Consumer Price Index)	-0.3	12.1	43.3	12.2	8.0	6.0
Current Account Balance (% of GDP)	-8.6	-3.5	-0.2	-1.3	-0.7	-1.0
Financial and Capital Account (% of GDP)	10.5	-6.7	1.1	-1.2	0.9	2.1
Net Foreign Direct Investment (% of GDP)	2.1	0.2	3.3	2.3	3.1	3.8
Fiscal Balance (% of GDP)	-4.8	-4.5	-1.1	-3.0	-2.0	1.5
Debt (% of GDP)	40.7	71.1	81.6	80.4	79.8	78.2
Primary Balance (% of GDP)	-2.3	-1.2	3.1	1.2	2.2	2.7
Poverty rate ($2.5/day PPP terms)[a,b,c]	0.1	0.0	0.1	0.1	0.1	0.0
Poverty rate ($5/day PPP terms)[a,b,c]	3.2	3.3	5.8	5.5	4.8	3.7

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: f = forecast.
(a) Calculations based on ECAPOV harmonization, using 2014-HLCS.
(b) Projection using neutral distribution (2014) with pass-through = 1 based on GDP per capita constant PPP.
(c) Actual data: 2013, 2014. Projections are from 2015 to 2018.

UZBEKISTAN

Table 1	2015
Population, million	31.1
GDP, current US$ billion	66.9
GDP per capita, current US$	2151
Life Expectancy at birth, years [a]	68.1

Sources: World Bank, WDI, and Macro Poverty Outlook.
Notes:
(a) Most recent WDI value (2013).

Despite the worsening external environment, Uzbekistan's economy continued to grow at a robust pace in 2015, supported by a large fiscal stimulus package. While counter-cyclical fiscal policies are expected to continue in 2016, growth is projected to decelerate slightly, and returning migrants will increase pressure on the labor market. The pace of poverty reduction is expected to slow over the medium term.

Recent developments

GDP grew at a rate of 8 percent in 2015 as the government implemented a major counter-cyclical fiscal policy in response to the deepening recession in Russia—one of Uzbekistan's largest trading partners and its primary source of remittances. A substantial increase in public investment drove growth on the demand side, while business taxes were cut. These measures largely offset the impact of a worsening external environment. However, personal consumption hardly increased in 2015 due to the erosion of real wages.

The countercyclical stimulus package caused the augmented fiscal surplus, which includes the Fund for Reconstruction and Development, to narrow from 2 percent of GDP in 2014 to an estimated 0.4 percent in 2015.

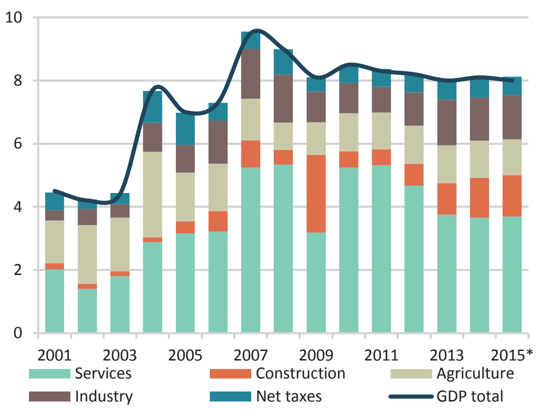
A worsening regional economic environment weakened the external accounts. The current account surplus declined from 1.7 percent of GDP in 2014 to 0.9 percent in 2015. Total exports declined by 5.3 percent during 2015 due to falling global commodity prices, slowing growth among Uzbekistan's major trading partners, and the real appreciation of the Uzbek som against key regional currencies. The sharp depreciation of the ruble and declining real incomes in Russia caused inbound remittances to fall by 40 percent in 2015 in US dollar terms to 4.9 percent of GDP from 8.6 percent of GDP in 2014. The weakening Russian labor market also prompted many migrant workers to return. Imports dropped due to lower private consumption of durable goods and nonfood consumer items, as well as further import substitution by domestic fuel and chemical production. The government tightened foreign-exchange access to protect the external balance from deteriorating too rapidly and to continue building international reserves.

The national poverty rate declined from 14.1 percent in 2013 to 13.7 percent in 2014 and reached an estimated 13.6 percent in 2015. Robust economic growth, small-business development and targeted social assistance programs are driving poverty reduction. The distribution of income has become more equitable over time, and the official Gini coefficient fell from 0.39 in 2001 to 0.29 in 2013. However, the unemployment rate rose from 4.9 percent in 2014 to 5.2 percent in 2015.

Outlook

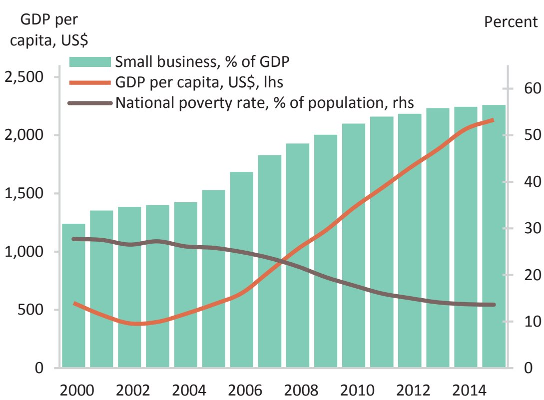
The average GDP growth rate is projected to slow by almost one percentage point to 7.2 percent during 2016-17. Low global commodity prices, an ongoing deceleration in China, and weak demand from Russia and Kazakhstan are expected to drive this trend. Although prices for Uzbekistan's key commodities (except gold) are expected to slowly rise from 2017 onwards, Uzbekistan's main trading partners are projected to recover only marginally. However, as tight foreign-exchange controls are expected to keep imports subdued, the external accounts should

FIGURE 1 Uzbekistan / Sectoral contributions to GDP growth, 2001-2015



Sources: Uzbekistan official statistics, World Bank staff calculations.

FIGURE 2 Uzbekistan / Poverty, GDP per capita, and small business development, 2000–2015



Source: Official statistics from the Government of Uzbekistan.

improve gradually over time.

The government will continue to implement expansionary policies to support the economy. Increased public investment under the newly adopted industrial, agricultural and infrastructure development programs for 2015-19 is expected to sustain high rates of investment growth, while income tax cuts and public sector wage increases help to shore up private consumption. However, Uzbekistan's restrictive trade and foreign-exchange regimes, the monopolization of certain sectors by state-owned enterprises, and frequent power outages caused by deteriorating infrastructure are projected to progressively diminish the return on investment under the baseline scenario. The government is expected to maintain its commitment to prudent fiscal policies, which will enable it to continue saving a substantial share of commodity revenue and strengthen the economy's resilience to adverse shocks.

Improvements in the business climate for micro- and small firms, including efforts to expand their access to credit, will help the labor market absorb returning migrants. However, slowing income growth and a large influx of returning migrants will limit progress in reducing unemployment, poverty and inequality over the near term, with all three expected to remain broadly unchanged through 2018.

Risks and challenges

Uzbekistan's economic outlook is subject to significant downside risks. A further decline in prices for its key export commodities—gas, copper, gold and cotton—or a more severe downturn among its main trading partners could adversely affect export receipts, domestic consumption, the current account and the fiscal balances.

The government has recently launched a number of programs focusing on industrial modernization, infrastructure development and agricultural productivity. These initiatives could significantly boost Uzbekistan's long-term growth potential if complemented by more ambitious structural reforms aimed at supporting a robust and competitive private sector, enhancing economic efficiency and promoting more inclusive grow.

TABLE 2 Uzbekistan / Selected economic indicators (annual percent change unless indicated otherwise)

	2013	2014	2015 e	2016 f	2017 f	2018 f
Real GDP growth, at constant market prices	8.0	8.1	8.0	7.3	7.2	7.2
Private Consumption	4.8	5.8	-0.5	-0.3	3.5	5.0
Government Consumption	5.9	9.9	8.4	3.1	2.0	2.9
Gross Fixed Capital Investment	10.7	9.6	9.5	9.3	9.4	10.0
Exports, Goods and Services	8.3	-5.1	-5.3	-2.8	0.2	2.6
Imports, Goods and Services	5.9	-4.1	-13.4	-6.9	-5.3	1.1
Real GDP growth, at constant factor prices	9.4	8.0	9.0	7.5	7.2	7.2
Agriculture	6.8	6.9	6.8	6.6	6.5	6.5
Industry	6.0	5.7	5.8	4.5	4.0	4.2
Services	12.0	9.3	11.1	8.9	8.4	8.4
Inflation (Private Consumption Deflator)	10.2	10.0	10.0	9.0	8.0	8.0
Current Account Balance (% of GDP)	2.9	1.7	0.9	0.8	0.9	1.0
Fiscal Balance (% of GDP)	2.5	2.0	0.4	0.3	0.6	0.7
Debt (% of GDP)	8.5	8.3	10.5	15.6	14.1	12.2
Primary Balance (% of GDP)	2.6	2.1	0.5	0.4	0.8	0.7

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Note: f = forecast.

The Impact of China on Europe and Central Asia

Europe and Central Asia Economic Update
Office of the Regional Chief Economist
April 2016

The economies of Europe and Central Asia (ECA) are facing complex challenges. In the eastern part of the region the task of governments is to orchestrate a coordinated crisis response. The collapse of oil revenues and the associated decline in remittances triggered a chain reaction of shocks. Adjustment to these shocks requires a new monetary policy regime, resolution of serious fragilities in banking sectors, fiscal reforms that put government finances on a sustainable path, while guaranteeing fair burden sharing, and facilitation of job creation in sectors that compete internationally. In the western part of the region policy coordination within the European Union is being tested by the refugee crisis and a possible Brexit. Meanwhile the Chinese economy has slowed down and is in the process of fundamental transformation. Also these developments have major impacts on the ECA region. The report analyses all these challenges and points at the opportunities to become more competitive in global markets.

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