WORLD BANK GROUP

Trade in Transition

Europe and Central Asia Economic Update
Office of the Chief Economist
May 2017

WORLD BANK **ECA ECONOMIC UPDATE** MAY 2017

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1 2 3 4   20 19 18 17

ISBN (electronic): 978-1-4648-1113-5
DOI: 10.1596/978-1-4648-1113-5

Cover design: World Bank

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Acknowledgments

The Europe and Central Asia (ECA) Economic Update is a joint product of ECA's Office of the Chief Economist, the Macro and Fiscal Management Global Practice, and the Poverty Global Practice, with inputs from the Developments Prospects Group.

Part I was prepared by a team in the Chief Economist's Office led by Hans Timmer and including Mathilde Lebrand, Georgi Panterov, William Shaw, Ekaterina Ushakova, Emmanuel Vazquez, and Hernan Winkler. Chapter 1 benefitted from forecasts (presented in Part II) prepared by economists in the Macro and Fiscal Management Global Practice. Maurizio Bussolo, David Gould, Carl Hanlon, Cyril Muller, Fadia M. Saadah, and Mariam J. Sherman provided valuable comments on Part I.

Part II was prepared by teams from the Macro and Fiscal Management Global Practice (led by Andrew Burns, Maria De los Angeles Cuqui Gonzalez Miranda, Lalita M. Moorty, and Gallina Andronova Vincelette) and the Poverty Global Practice (led by Luis-Felipe Lopez-Calva). These teams included the following staff: Sarah Nankya Babirye, Marina Bakanova, Cesar Cancho, Marie-Anne Chambonnier, Alexandru Cojocaru, Marcel Chistruga, Pablo Facundo Cuevas, Barbara Cunha, Maria Eugenia Davalos, Nancy Sabina Davies-Cole, Agim Demukaj, Mariam Dolidze, Donato De Rosa, Bakyt Dubashov, Olga Emelyanova, Mismake D. Galatis, Anastasia Golovach, Gohar Gyulumyan, Kiryl Haiduk, Marco Antonio Hernandez Ore, Sandra Hlivnjak, Stella Ilieva, Maria Gabriela Inchauste Comboni, Saida Ismailakhunova, Charl Jooste, Jonathan George Karver, Faruk Khan, Edith Kikoni, Yeon Soo Kim, Naoko Kojo, Christos Kostopoulos, Aurelien Kruse, Leszek Pawel Kasek, Caterina Ruggeri Laderchi, Sanja Madzarevic-Sujster, Mikhail Matytsin, Kristina Cathrine Mercado, Moritz Meyer, Jose Montes, Metin Nebiler, Minh Cong Nguyen, Trang Van Nguyen, Olasupo Olusi, Catalin Pauna, Ruslan Piontkivsky, Mona Prasad, Dinar Dhamma Prihardini, Alisher Rajabov, Nadir Ramazanov, Paul Andres Corral Rodas, Apurva Sanghi, Ilyas Sarsenov, Sarosh Sattar, William Hutchins Seitz, Lazar Sestovic, Hilda Shijaku, Bojan Shimbov, Maryna Sidarenka, Nistha Sinha, Emily Sinnott, Emilia Skrok, Karlis Smits, David Andrew Stephan, Congyan Tan, Thi Thanh Thanh Bui, Eskender Trushin, Ekaterina Vostroknutova, Rogier Van den Brink, Pinar Yasar, Ayberk Yilmaz, and Bakhrom Ziyaev.

Ekaterina Ushakova oversaw the layout and production of the report. Barbara Karni edited and Michael Alwan typeset it. Artem Kolesnikov, John Mackedon, and Inga Paichadze provided communications and outreach support, including the dedicated webpage (http://www.worldbank.org/en/region/eca/publication/europe-and-central-asia-economic-update).

Abbreviations

BHAS	BiH Agency for Statistics
BiH	Bosnia and Herzegovina
BoA	Bank of Albania
CAD	Current account deficit
CBU	Central Bank of Uzbekistan
CPI	Consumer price index
CROSTAT	Croatian Bureau of Statistics
ECA	Europe and Central Asia
ECAPOV	ECAPOV (ECA Poverty) database of standardized household surveys
EDP	Excessive Deficit Procedure
EEU	Euroasian Economic Union
ESA	European System of Accounts
EU-SILC	European Union Statistics on Income and Living Conditions
FDI	Foreign direct investment
FX	Foreign exchange
FYR	Fiscal year
GDP	Gross domestic product
HRK	Croatian Kuna
ICOR	Incremental capital-output ratio
ICT	Information and communication technology
ILO	International Labour Organization
IFI	International financial institution
IMF	International Monetary Fund
IT	Information technology
LTE	Long-Term Evolution
NAFTA	North Atlantic Free Trade Agreement
NBP	National Bank of Poland
NBR	National Bank of Romania
NBS	National Bank of Serbia
NPL	Non- performing loans
NSI	National Statistical Institute
PPG	Public and publically guaranteed
PPP	Purchasing power parity
SME	Small and medium enterprise
SOE	State-owned enterprises

SOFAZ	Azerbaijan State Oil Fund
SSC	Social security contribution
TFP	Total factor productivity
TSA	Targeted Social Assistance
UFRD	Uzbekistan Fund for Reconstruction and Development
US	United States
WB	World Bank
WDI	World Development Institute
WTO	World Trade Organization

Country Groups

TABLE E.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 (AUT)
Belgium (BEL)
France (FRA)
Germany (DEU)
Ireland (IRL)
Luxemburg (LUX)
The Netherlands (LUX)
United Kingdom (GBR)</td><td>Greece (GRC)
Italy (ITA)
Portugal (PRT)
Spain (ESP)
Cyprus (CYP)
Malta (MLT)</td><td>Bulgaria (BGR)
Croatia (HRV)
Czech Republic (CZE)
Hungary (HUN)
Poland (POL)
Romania (ROU)
Slovak Republic (SVK)
Slovenia (SVN)</td><td>Denmark (DNK)
Finland (FIN)
Sweden (SWE)
Estonia (EST)
Latvia (LVA)
Lithuania (LTU)</td><td>Albania (ALB)
Bosnia and Herzegovina (BIH)
Kosovo (KSV)
FYR Macedonia (MKD)
Montenegro (MNE)
Serbia (SRB)</td></tr>
<tr><td rowspan="2">Eastern Europe and Central Asia</td><td>South Caucasus</td><td>Central Asia</td><td>Russian Federation (RUS)</td><td>Turkey (TUR)</td><td>Other Eastern Europe</td></tr>
<tr><td>Armenia (ARM)
Azerbaijan (AZE)
Georgia (GEO)</td><td>Kazakhstan (KAZ)
Kyrgyz Republic (KGZ)
Tajikistan (TJK)
Turkmenistan (TKM)
Uzbekistan (UZB)</td><td></td><td></td><td>Belarus (BLR)
Moldova (MDA)
Ukraine (UKR)</td></tr>
</table>

Executive Summary

After strong economic headwinds in recent years, economies in Europe and Central Asia (ECA) are returning to a more stable growth path. In the European Union a sustained, albeit modest, recovery has started to reduce unemployment, pushing inflation into positive territory. In Eastern Europe the stabilization of oil prices at about $50 a barrel has provided some breathing room for governments, which have begun adjusting their policies to the lower prices.

Even if the cyclical economic headwinds abate, major challenges remain. Brexit has thrown the European Union into unchartered territory. In the eastern part of the region, the decline in oil prices has left the financial system in many countries in dire straits. In most countries in the region, the adjustment to the "new normal," in which the conditions of the boom period cannot be replicated, is still incomplete. Pivotal upcoming elections and sustained geopolitical tensions further complicate the outlook for the region.

Major changes in international specialization patterns also have implications for the region Global competition and technological changes are shifting employment opportunities across occupations and sectors and changing the nature of labor contracts. In this environment, the call for trade protection has become louder.

Trade has contributed to development in ECA. It was critical to transition economies' success in raising living standards during, and especially after, the 1990s. Integration into global markets for energy, agriculture, and manufactured products enabled a more efficient use of resources. Integration into the value chains of "factory Europe" led to technological catching up and the upgrading of industrial structures. The slowdown of China's exports, which has driven the recent slowdown in global trade, has opened up new opportunities for ECA.

As trade remains a key part of their future success, many countries in ECA will have to navigate three important new transitions. The first is the continued shift of resources from production that is not internationally traded to production that competes in international markets. During the boom period, large oil revenues, large capital inflows, and substantial inflows of labor remittances allowed countries to import substantially more (nonenergy) products than they exported. In the new normal, doing so is no longer possible; countries need to engage in a sustained shift from imports to exports.

The second transition is a reorientation toward Asia. ECA currently relies strongly on intraregional trade and is underperforming in Asian markets. Robust future growth requires a rebalancing of these trade links.

The third transition is the shift from goods to services, where most future growth opportunities lie. The share of services in global consumption is rising, and services are increasingly becoming tradable across borders. These trends are reflected in the rising share of services in exports from Western Europe, but other parts of ECA are falling behind.

All three transitions will have consequences for specialization patterns, investment patterns, and labor markets. As countries navigate these transitions, they will have to rethink not merely trade relations but the way factor markets are organized.

PART

Economic Outlook

1

Time to Adjust to the New Normal

1.1 Overview

Countries in ECA have gone through turbulent times since the global financial crisis of 2008. In the western part of the region, the European Union and neighboring countries were mired in the fallout from the financial crisis, with weakened banking sectors, lack of growth, high unemployment, and greatly narrowed fiscal space. The Brexit vote—and voters' dissatisfaction more generally—have threatened European cohesion, and the refugee crisis has tested Europe's capacity to implement a unified policy responsive.

In the Russian Federation and Central Asia, the fall in oil prices resulted in greater income losses than experienced after the global financial crisis, creating challenges well beyond income losses and fiscal pressures. Monetary policy regimes became sustainable, prices of real estate and other assets tumbled, several banks became insolvent, and demand for workers in construction and domestic services softened.

Calmer waters are probably on the horizon. In the western part of the region, a continued recovery has begun to reduce unemployment, and inflation has moved decisively into positive territory. In the eastern part of the region, governments have begun adjusting policies to the lower level of oil prices, which have stabilized at about $50 a barrel. Exchange rate depreciations have reduced fiscal pressures and made tradable sectors more competitive. Governments have started resolving insolvencies in the banking sectors, although major challenges remain. Fiscal policies are being modified to align with new economic realities.

As the economic cycle moves into a more neutral phase, there is more space to address profound structural changes. New specialization patterns are emerging after the adjustment of commodity prices and the rebalancing in China. New technologies are changing production methods and upending traditional labor market relations. Most economies in ECA will have to facilitate the shift from nontradable production to internationally competitive production of tradable goods and services.

As after any extraordinary boom and subsequent crisis, a new growth model is needed. During the boom, secular trends that challenged the existing growth models could be ignored, because incomes were rising. During the crisis and its direct aftermath, policy makers and economic decision makers were occupied with countercyclical responses. Now that the economic headwinds are easing, structural challenges are clearer and need to be addressed.

1.2 Despite political tensions, solid growth is likely

Political rifts, social tensions, and geopolitical conflicts have dominated recent news about ECA. But the economic news has been positive (table 1.1). In the European Union, recovery is being sustained, with 2017 and 2018 likely the fourth and fifth consecutive years in which growth will average almost 2 percent. As a result, unemployment rates are falling and inflation returning to more normal levels. In Eastern Europe and Central Asia, activity is rebounding after the fall in oil prices at the end of 2014. Stabilization of oil prices at around $50 per barrel—well above the in January 2016 low of $30 per barrel—has supported the rebound.

The sustained recovery is most evident in Central Europe, where GDP growth continues to exceed 3 percent a year and the structure of the economy has improved. Exports of goods and services are growing more than twice as fast as GDP. The current account deficit, which peaked at close to 8 percent of GDP in 2007, turned into a slight surplus in 2015. Government debt, which rose sharply after the global financial crisis, is stabilizing at about 50 percent of GDP.

In 2009 Northern Europe experienced the steepest contraction of all ECA subregions. The contraction was especially steep in the Baltic States, which suffered a sudden reversal in capital inflows. The change forced an abrupt and sharp decline in these countries' current accounts, which had deficits of more than 15 percent of GDP in 2007. By 2009 Latvia, Estonia, and Lithuania had surpluses. The contraction was followed by a lackluster recovery, but this subregion is now back on a stable growth path of more than 2 percent a year. Throughout this recovery, fiscal deficits have remained limited, with factors other than government spending driving the resumption of growth. As in Central Europe, exports are growing twice as rapidly as GDP, at more than 4 percent a year.

In the Western Balkans, GDP growth is projected to accelerate to 3.5 percent a year in 2018. Although the rate is significantly below the average annual growth of 5.5 percent during the 2000–08 boom period, it represents the strongest growth since the global financial crisis. Export growth has been an important driver of the recovery in the Western Balkans, where the volume of goods and services exports increased by 8 percent a year in 2013–16. Although current deficits remain substantial, averaging 6.5 percent of GDP in 2016, they are much smaller than the more than 19 percent registered in 2008. Exceptionally high unemployment rates remain one of the biggest economic problems facing the Western Balkans. Although lower than the 32 percent rate in 2009 and the even higher rates during the boom before the global financial crisis, unemployment still remains very high, averaging 24 percent of the labor force in 2016.

Turkey has entered a new phase, after a long period of remarkably strong growth. The rebound following the 2001 crisis exceeded expectations, with growth averaging more than 7 percent a year in 2002–07. Turkey was one of the few countries in the world in which growth was equally strong before and after the crisis, with annual growth averaging 7.4 percent in 2010–15. Growth slowed to 2.9 percent in 2016, as exports declined, the currency weakened, inflation rose, and investment slowed and business confidence declined in the wake of the failed coup. Even with the slight acceleration forecast for 2017 and 2018, growth is projected to remain well below the pace of the last 15 years. Structural weaknesses will prevent a return to the high growth rates of the past.

In the South Caucasus, near-term growth prospects are much weaker than in the western part of the ECA region. After a 2.2 percent contraction in 2016, no growth is expected this year, and growth of just 1.6 percent is projected for 2018. During the boom years of 2000–08, the average annual growth rate was 13.5 percent. Even in the period right after the global financial crisis (2009–13), annual

TABLE 1.1 Growth in Europe and Central Asia is stabilizing

Region/subregion	Annual GDP growth (percent)					Change in forecast since October 2016		
	2014	2015	2016 (estimate)	2017 (forecast)	2018 (forecast)	2015	2016 (estimate)	2017 (forecast)
Europe and Central Asia	1.7	1.9	1.8	1.9	1.8	0.5	0.2	0.3
European Union and Western Balkans	1.6	2.2	1.9	1.8	1.6	0.3	0.1	0.4
Western European Union	1.8	2.2	1.8	1.7	1.4	0.5	0.1	0.5
Northern European Union	1.7	2.4	2.3	2.1	2.1	0.1	0.0	0.0
Central European Union	2.9	3.8	3.1	3.2	3.1	0.2	–0.2	0.1
Southern European Union	0.6	1.6	1.8	1.5	1.4	0.0	0.3	0.2
Western Balkans	0.2	2.2	2.8	3.2	3.5	0.0	0.1	0.0
Eastern Europe and Central Asia	2.1	0.1	1.0	2.2	2.5	1.3	0.3	0.0
South Caucasus	2.7	1.7	–2.2	0.0	1.6	0.0	–1.1	–2.2
Central Asia	5.1	2.9	2.8	3.8	4.0	0.0	0.8	0.5
Russian Federation	0.7	–2.8	–0.2	1.3	1.4	0.9	0.4	–0.2
Turkey	5.2	6.1	2.9	3.5	3.9	2.1	–0.3	0.0
Other Eastern Europe	–3.8	–7.7	0.8	1.3	2.7	0.0	0.9	0.1

Source: World Bank data.

growth averaged 3.7 percent. The main cause of the current lack of growth is the fall in oil prices at the end of 2014, which has directly affected Azerbaijan and indirectly affected Armenia and Georgia (through diminished remittances and reduced export opportunities). Regaining competitiveness in international markets is perhaps more essential for further recovery in the South Caucasus than in other subregion of ECA.

Average annual growth in Central Asia grew was more than 9 percent during 2000–07. It fell to 3.5 percent during the global financial crisis but recovered to 6.5 percent in 2010–14. After the fall in oil prices in 2014, average annual growth dropped below 3 percent in 2015 and 2016, with the sharpest slowdown in Kazakhstan, where output actually contracted. Kazakhstan also suffered a double-digit income decline as a result of the terms of trade losses after the fall in oil prices. Despite the many vulnerabilities the oil price shock created in Central Asia, a modest cyclical growth rebound is expected in the next few years.

Of all oil exporters in the region, Russia managed the most agile response to the price decline. It was the first country to float its currency to allow the unavoidable depreciation, and it implemented fiscal adjustments without much delay. These inevitable macroeconomic adjustments led to a 20 percent real depreciation, a one-time jump in import prices and consumer prices, a cumulative 35 percent decline in import volumes, a 15 percent decline in consumption, and a 3 percent decline in GDP. The current account surplus persisted, and the fiscal deficit remained limited. The sharp declines in imports and consumption are consistent with the large terms-of-trade loss and the required change in the structure of the economy. Growth in Russia is projected to turn resume in 2017 and 2018, with consumption growth surpassing GDP growth.

For the ECA region as a whole, this short-term outlook is more positive than the one presented half a year ago, as illustrated in table 1.1. For most subregions, growth is expected to be more robust in 2017 (the South Caucasus, where the impact of the fall in oil prices on Azerbaijan is more damaging than earlier projected, is a notable exception).

Despite the improved outlook, several challenges—many of these which can be grouped under the label "adjustment to the new normal"—require urgent attention. For many countries in the western part of the region, the drivers of sustainable growth are now different from the drivers during the boom period that ended 10 years ago. For countries in the eastern part of the region, the new normal is characterized by sustained lower oil prices, lower imports, higher exports of nonoil products, fewer workers producing goods and services that are not internationally tradable, and new employment in internationally competitive sectors.

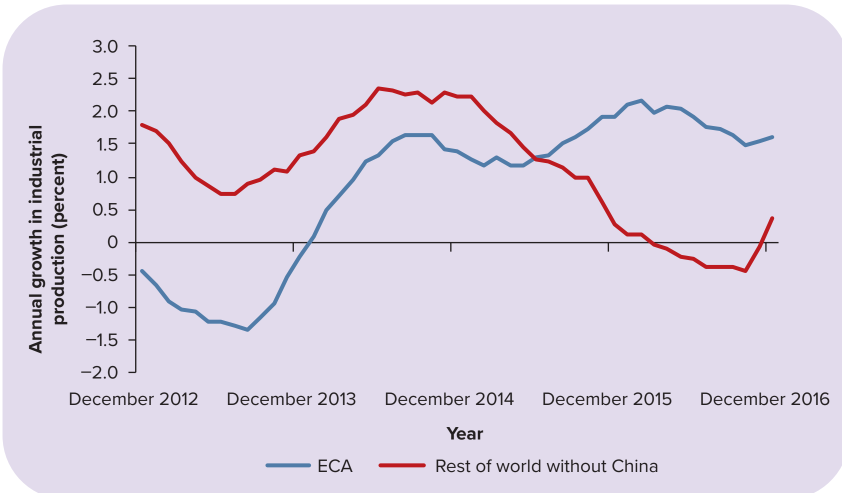
Other major challenges are linked to long-term trends in technological change and shifts in the international division of labor, which have potentially far-reaching consequences for the way product and labor markets are organized. These changes could be largely ignored during the boom period, when growth was robust even without adjustments, or during the direct aftermath of the crisis, when all hands were on deck to mitigate the deep recession. These underlying trends can no longer be ignored. If the problems originating from these structural shifts are not addressed, political instability, economic anxiety, and social tensions will likely remain.

1.3 The region has entered a more neutral cyclical phase

After years of economic setbacks, most economies in ECA have now moved into a more neutral cyclical phase. Monthly data on region-wide aggregate industrial production show that the region has been on a steady growth path since 2014 (figure 1.1). Growth remained strong in 2016 despite the weakening of activity in the rest of the world, excluding China.

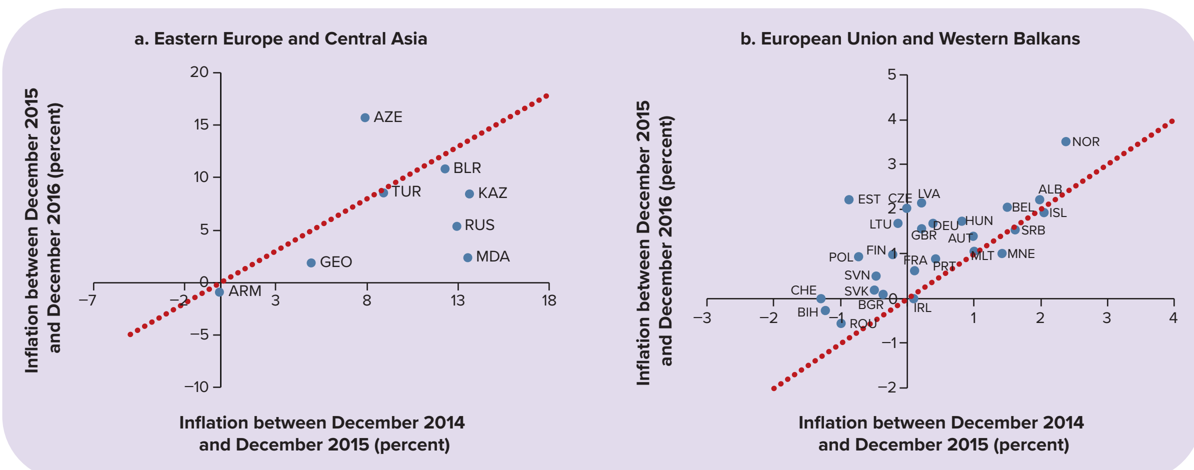
Inflation figures provide another indication that the region is entering a more neutral cyclical phase. In 2016 the median increase in consumer prices in the European Union was 1 percent, up from just 0.2 percent in 2015. Virtually all countries experienced rising inflation (figure 1.2). In many European countries, the GDP deflator was already rising at almost 2 percent a year in 2015, signaling

FIGURE 1.1 Growth in Europe and Central Asia is stabilizing



Source: World Bank.
Note: Figures show changes in growth with respect to same month the previous year.

FIGURE 1.2 Inflation in the region is normalizing



Source: World Bank.

a roughly normal utilization rate of production capacity. The consumer price deflator had remained low because of terms-of-trade gains, in particular the downward effect on consumer prices of cheaper energy imports. Now that oil prices have stabilized, consumer price inflation is converging to the rise in the cost of domestic production, as reflected in the GDP deflator.

This return to positive inflation rates across the board implies that the authorities will soon begin discussing a tapering of monetary stimulus. The central bank in Sweden has been creative in finding ways to push interest rates into negative territory to avoid deflation. But the GDP deflator in Sweden rose to 2 percent in 2015, and in 2016 consumption prices also started rising, convincing the monetary authorities that the economy has reached a more neutral cyclical phase.

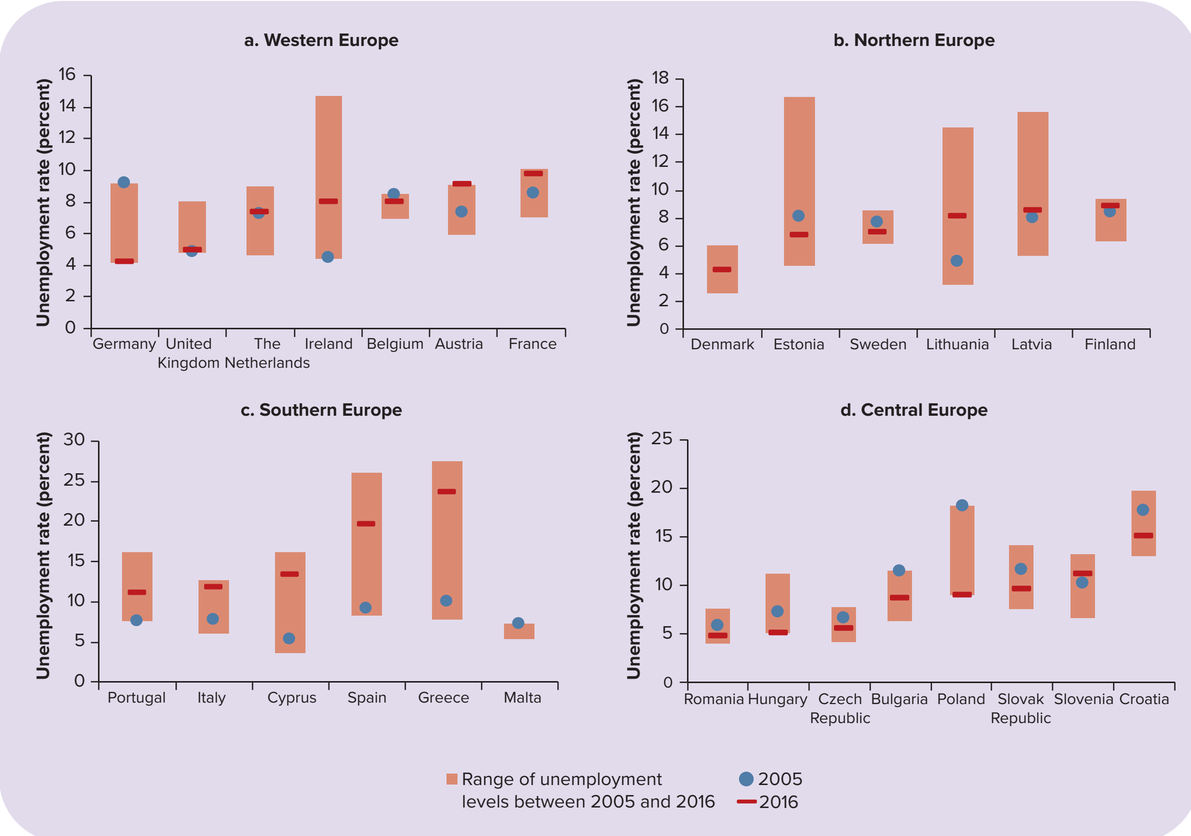
Inflation in the eastern part of the ECA region was the mirror image of inflation in the western part. All countries except Azerbaijan experienced a drop in inflation in 2016. The drop was steep in energy-exporting countries—7.5 percentage points in Russia and more than 5 percentage points in Kazakhstan—indicating that the jump in prices in 2015 was a one-time relative price adjustment rather than the start of an inflationary spiral. Depreciations led to sharp increases in import prices but not prices of domestically produced goods. This unavoidable adjustment after the fall in oil prices provides the incentive for adjustments in production and consumption patterns.

These one-time adjustments in relative prices illustrate the dilemma facing monetary authorities in oil-exporting countries. The fall in oil prices forced them to abandon a system of stable exchange rates to allow the unavoidable real depreciation. The change in exchange rate regime required a new monetary anchor and a rebuilding of trust in the currency. However, changes had to be made in an environment in which low trust in the local currency had already triggered a partial dollarization of financial sectors. It is therefore understandable that central banks in oil-exporting countries aimed to shift to inflation targeting and an attempt to stop double-digit inflation in its tracks. If, however, the target is consumer price inflation, the data can easily be misinterpreted. The sharp rise in consumer prices largely reflected relative price changes between domestically and foreign produced goods and services rather than inflationary tensions in the domestic economy. In short, in both the eastern and western part of the ECA region, cyclical tensions may have been weaker than consumer price inflation or deflation suggest.

Reduced underutilization of capacity has also become visible in unemployment data. In most EU countries, unemployment rates are now back at or even below 2005 levels, when the global economic boom was in full swing (figure 1.3). Unemployment rates in Central Europe and Germany have dropped to remarkably low levels. In Germany only 4.1 percent of the labor force is considered unemployed, down from 9.1 percent in 2005. In Poland unemployment declined by even more, falling from 18.2 percent to 8.9 percent. Unemployment rates in Bulgaria, Croatia, the Czech Republic, Hungary, Romania, and the Slovak Republic are substantially below their 2005 levels, on average by 2 percentage points.

The situation is different in Southern Europe, where the financial crisis hit hard and more profound structural reforms were needed to find new sources of stable growth. Unemployment rates in 2016 were 13.5 percent higher than in 2005

FIGURE 1.3 Unemployment rates in the European Union have fallen



Source: World Bank.

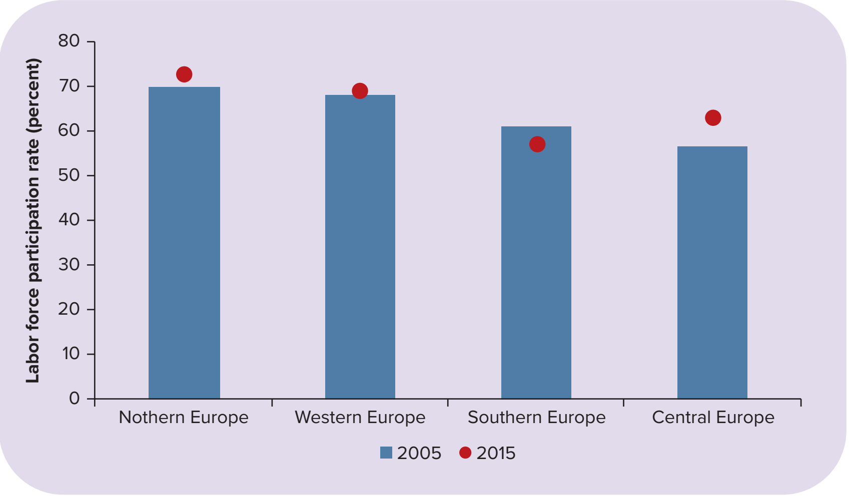
in Greece, 10.5 percent higher in Spain, 4.0 percent higher in Italy, and 3.5 percent higher in Portugal. But even in these countries unemployment rates are now on average 4 percentage points lower than their recent peaks, signaling that slow recovery is taking hold in Southern Europe.

The rise in participation rates in the European Union is even more remarkable than the decline in unemployment rates. In Northern, Western, and Central Europe, participation rates are now higher than they were in 2005 (figure 1.4). Only in Southern Europe is the share of the population participating in the labor market smaller than in 2005.

The broad-based rise of participation rates in Europe is surprising given population aging and the fact that participation rates are lower among older people than young people. If participation rates per age cohort remain constant over time, the participation rate should decline as a country's population ages. But the data show sharp increases in the overall participation rates of two of region's most rapidly aging countries, Bulgaria and Germany, over the past 15 years (figure 1.5).

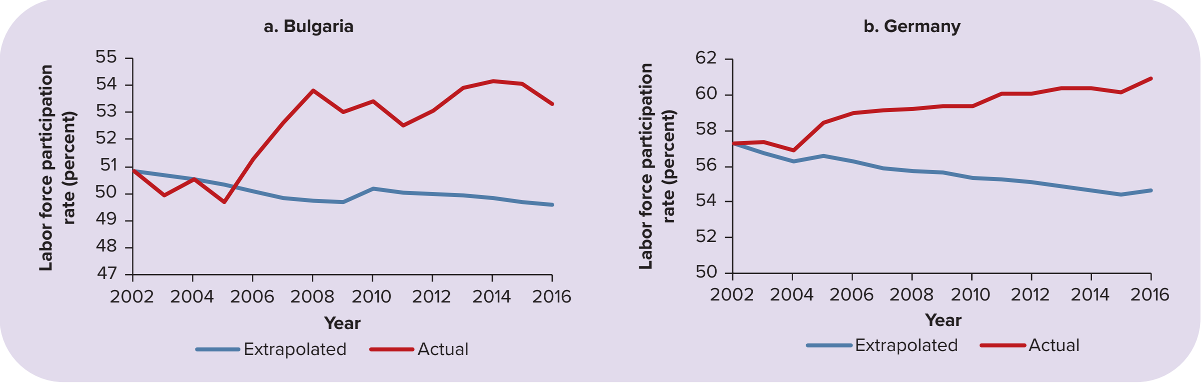
The divergence between the actual and extrapolated participation rates suggests that behavior within cohorts is changing. More people in older age cohorts are now willing to remain active in the labor market—because they expect to live longer and feel healthier, because there are more opportunities for them in labor

FIGURE 1.4 Labor force participation in most of the region has risen



Source: World Bank.

FIGURE 1.5 Contrary to expectations, labor participation rates in two aging societies—Bulgaria and Germany—have increased



Source: World Bank.
Note: Spreads in Ireland, Italy, Portugal, and Spain are measured on the left-hand axis; Greek spreads are measured on the right-hand axis.

markets with fewer younger competitors, or because less generous pension or other policies make it more difficult to retire. These developments also make clear that technical extrapolations of behavior can be misleading and are not good at forecasting the need for fiscal adaptation to aging. Behavioral adjustments make demographic trends much less threatening than is often assumed. Policies should thus focus on facilitating behavioral adjustments rather than on achieving fiscal sustainability based on technical extrapolations.

Growing employment, lower unemployment rates, and higher participation rates are signs of cyclical improvements; they are not indications that structural problems can be ignored. Most of the additional employment since the global financial crisis came was part-time or temporary employment. The "gig economy" and platform economics, which provide a digital environment for individuals to trade with one another, are rapidly gaining market share, reducing job security and making social protection systems increasingly obsolete.

1.4 The new normal requires new policies

Deep global economic crises change the world economy and economic policies for many decades. The role of the government was never the same after the Great Depression: Governments now spend one third or more of national income—a multiple of the single-digit percentages of the period before the Depression. The larger role of the government reduced the volatility of market economies through built-in automatic stabilizers. Large government sectors became the new normal for many decades—arguably until today.

Economic policies drastically changed after the oil crises of the 1970s. Although the share of government in total spending remained substantial, the role of market mechanisms became much more prominent. Europe liberalized capital flows and privatized utility and other companies. Developing countries integrated into global markets for goods and services, and the centrally planned economies of Europe ultimately transitioned to market economies.

This wave of liberalization and globalization followed a period of inward-looking development after World War II. Western Europe was rebuilt with little international reserves available to engage in intensive cross-border economic relationships. Central Europe was absorbed into the system of centrally planned economies. Governments in several Asian countries strengthened their control over production and distribution. In Latin America import-substitution was the leading paradigm for quickly developing national industries.

These inward-looking policies were running into their own limitations at the time of the oil crises. The new wave of globalization that started in earnest during the 1990s addressed those problems and resulted in a sharp acceleration of growth in developing countries. One can argue that relying more on the market has been the new normal since the late 1980s or early 1990s.

It is likely that the global financial crisis of 2008 will also change the direction of policies to address emerging problems and the limitations of existing growth models. It is too early to define these new policies in detail, but they will probably address inequality of opportunity, which has been rising since the beginning of this century. The drivers of rising inequality of opportunity include new technologies that change the way production, work, and merchandizing are organized; the globalization of production, labor, and capital; and the accumulation of wealth, which when transferred to new generations gives some young people advantages over others.

Technological progress and integration of economies across is welcome, because they yield huge overall benefits and create new opportunities. However, new measures are needed to ensure that everyone has a fair chance to seize the new opportunities and share in these benefits.

The current volatile political landscape, including increasing populism in the western part of the ECA region and rising social tensions in the eastern part, could well be harbingers of dramatic policy changes. A positive outcome of such changes would be a more level playing field and reduction of the concentration of economic power.

Rising inequality of opportunity is an example of underlying trends that are often ignored during a boom period, because all incomes are rising. Such trends are often also largely ignored during the ensuing recessions, when policy makers focus on firefighting. Now that the cyclical situation is normalizing, there is a strong case for addressing the structural problems that have emerged. Leveling the playing field might well move to center stage. Rethinking economic and social rules so that more people can participate in the economies of the ECA region could become a key element of the new normal.

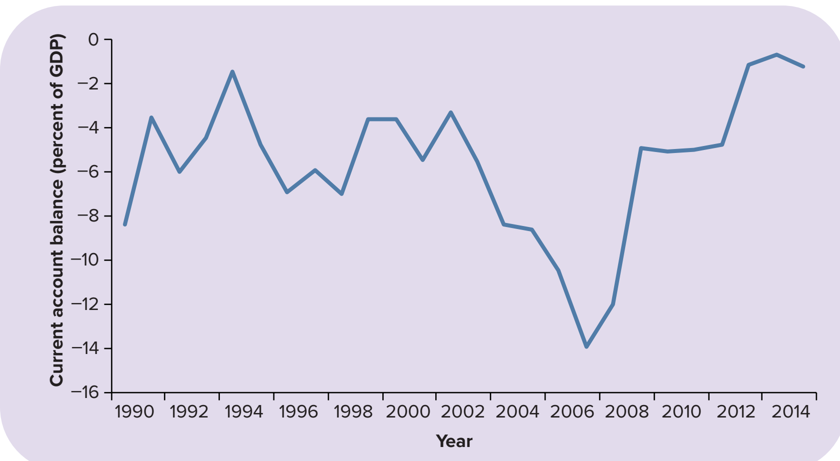
Other elements of the new normal are changes in the structure of economies. During the boom period, many countries enjoyed large capital inflows, substantial inflows of remittance, rising oil revenues, or a combination of the three. As a result, imports grew faster than (nonoil) exports, and these economies started growing rapidly through investments in the nontradable sectors, especially real estate. In the new normal, capital inflows are more moderate, oil prices have stabilized at lower levels, and the purchasing power of remittances has declined. As a result, large current account deficits, which had become prevalent in Central Europe, the Baltics, and the Western Balkans, were no longer sustainable.

Romania is one of many countries that experienced a sudden tightening of its current account balance after the global financial crisis (figure 1.6). After the fall in oil prices, in 2014, the large (nonoil) current account deficits in the eastern part of the region were no longer sustainable.

As current account deficits tighten or even reverse, growth can no longer come from increased production of nontradables. It must come from production of goods and services that are tradable in internationally competitive markets. This structural change in the new normal has far-reaching consequences. It means that financial sectors, education systems, and competition policies that supported old firms in existing sectors will have to adjust so that they can ensure that new firms are able to compete internationally.

In the new normal, countries can also no longer rely on high investment rates. During the boom period, investment rates rose to grow the capital stock fast enough to keep up with rapidly expanding GDP. Once GDP growth fell, as the boom reached its limits, capital accumulation was too rapid. The result was rising capital-output ratios, lower returns to capital, and the underutilization of capital.

FIGURE 1.6 Romania's boom was characterized by current account deficits, which financed the growth of nontradables



Source: World Bank.

Where a boom is exceptionally strong and the growth slowdown sharp, it takes many years of low investment to adjust the capital stock to GDP.

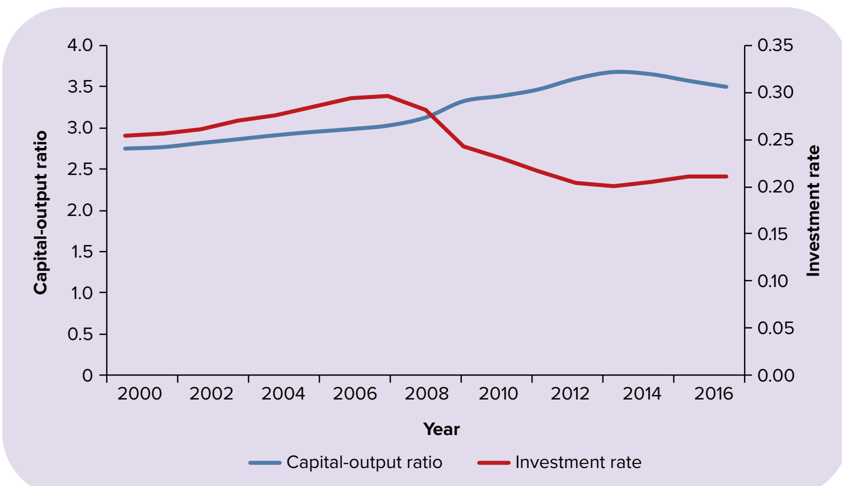
Spain is a clear example of this phenomenon (figure 1.7). Despite the lower investment rate after the crisis, the capital-output ratio continued to increase. Only in recent years did the ratio decline; it still remains well above levels during the boom period. Even once the capital-output ratio falls back to its original level, the equilibrium investment rate will still be lower than during the boom, because high, unsustainable GDP growth rates are unlikely to return. The equilibrium growth of the capital stock—and the equilibrium investment rate—will be lower than during the boom.

The high level of the current capital stock in several countries is the most plausible explanation of why low interest rates—and loose monetary policy more generally—have not significantly boosted investment rates. Investment rates will not recover fully if GDP growth does not return to the precrisis level. Rather than trying to boost overall investment, policy makers should focus on adjusting production patterns to the conditions of the new normal.

Technological changes in the rest of the world, demographic changes, growth differentials, the maturation of global value chains, and changes in commodity prices have led to changes in specialization patterns and patterns of trade. These changes could be ignored during the boom period, when old specialization patterns generated sufficient income growth, and during the recession, when companies focused on short-term survival and governments focused on countercyclical measures (which actually reinforced existing production patterns, by supporting existing spending patterns). As many economies in ECA enter a more neutral phase, adjustment to changed global specialization patterns can no longer be postponed.

Adjustment to the new normal requires structural reforms rather than countercyclical responses. These adjustments will not emerge automatically. Monetary policy that worked well in the case of large capital inflows, large oil revenues, or substantial remittances will have to adjust when these inflows remain

FIGURE 1.7 Spain's investment rate has fallen to reduce overinvestment



Source: World Bank.

permanently at lower levels. Financial institutions that served mature companies in existing sectors well will have to adjust to serve start-ups in new sectors. Social protection systems that were designed when long-term, steady employment was the norm will need rethinking as the gig economy and platform economics gain momentum. Even infrastructure and trade policies that supported old trade relations need modification, as the international division of labor is changing. Adjustment to the new normal thus comprises a broad agenda—one that should no longer be delayed.

2

Shifting Trade Patterns

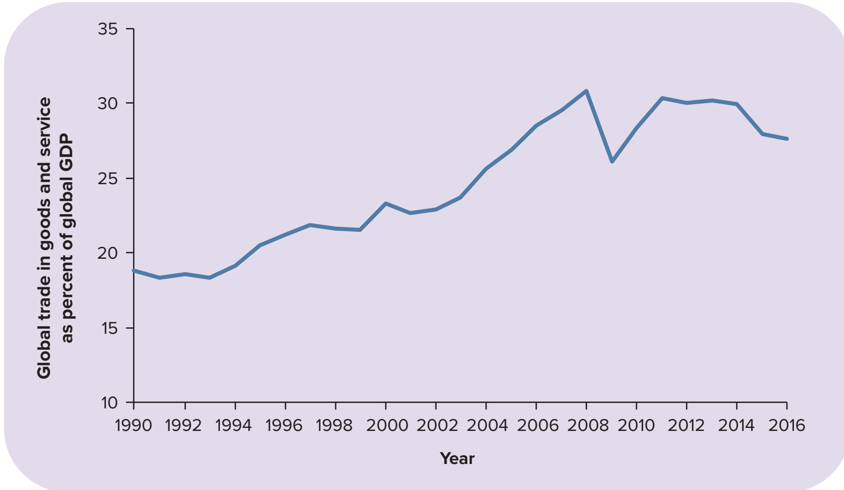
2.1 Overview

During the first half of the 1990s the value of global trade in goods and services averaged a little less than 19 percent of global GDP. By 2008, at the end of the global economic boom, that percentage had risen to almost 31 percent (figure 2.1). In slightly more than a decade the global economy had radically transformed itself. Centrally planned economies had transitioned into market economies, with several of them integrating into the European common market; 29 transition economies and developing countries had joined the World Trade Organization (WTO); high import tariffs and import substitution had largely become phenomena of the past; China had developed into the world's manufacturing powerhouse, quadrupling its share in global industrial production; and global value chains had revolutionized the way companies cooperate across borders (Taglioni and Winkler 2016).

The rapid integration of developing and transition economies in global markets came with a sharp acceleration of their per capita GDP growth, closing part of the income gap with high-income countries (figure 2.2). The wave of globalization culminated in the global boom between 2003 and 2007. Globalization had become an unrelenting force, driving innovation and spreading technologies across borders.

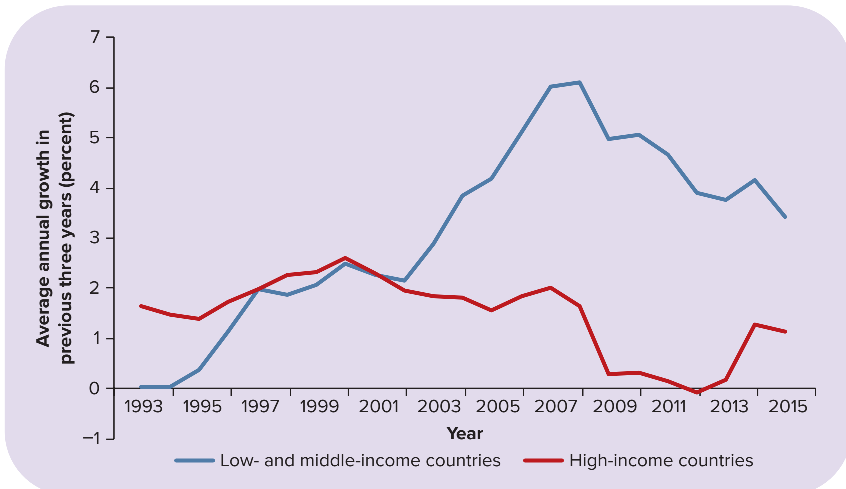
Integration into global markets for goods and services played an instrumental role in the transition of many countries in ECA to market economies. The opening up to international trade resulted in a convergence of domestic relative prices

FIGURE 2.1 Global trade intensified rapidly between 1990 and 2008



Source: World Bank.

FIGURE 2.2 Developing countries have grown more rapidly than high-income countries since 2002, narrowing the income gap between them



Source: World Bank.

to levels consistent with global demand and supply, which triggered a more efficient use of resources. Integration into European value chains induced crucial technological catch-up. Specialization patterns in transition economies started to reflect their comparative advantages, and comparative advantages started shifting, as a result of technology transfers. As a result, industries in Central Europe moved up the value chain, as their production became more skill intensive.

The surge in global trade and production also created imbalances. Domestic credit booms and rapidly expanding cross-border capital flows, both fueled by financial innovation, led to spiraling asset prices and unsustainable private sector debts in numerous countries, ultimately leading to the global financial crisis. Several countries in the region ended up with outsized current account deficits, overinvestment in real estate, a production structure tilted toward nontradables, and excessive dependence on foreign currency loans.

Global trade volumes slowed down dramatically after the financial crisis and are no longer growing twice as fast as global production. In fact, it is no longer clear that globalization remains the dominant and persistent force driving growth. Increasingly, negative side-effects of trade are emphasized—especially on the job security of the middle class. Although there is little evidence of a rise in protectionism, support for shielding domestic markets from international competition is growing.

Trade still has many more upsides than downsides in ECA. Unlike the trade slowdown at the global level, ECA's trade volumes are still growing twice as fast as GDP. And trade remains a crucial element of strategies to find new sources of growth. As emphasized in chapter 1 of this report, reduced capital inflows, smaller oil revenues, and diminished remittances are forcing countries to increase production in internationally competitive sectors. Once again, former transition economies are restructuring their production patterns through international trade.

This shift toward increased competitiveness in international markets is not the only transition countries in ECA are navigating. A second transition is the shift from intraregional to global trade, in order to benefit more from dynamics in Asia and the advantages global brands offer. A third ongoing transition is the shift from international trade in goods to international trade in services. Services are increasing as a share of global consumption, and services are progressively becoming more internationally tradable. Supporting opportunities for digital development is essential to benefit from this third transition.

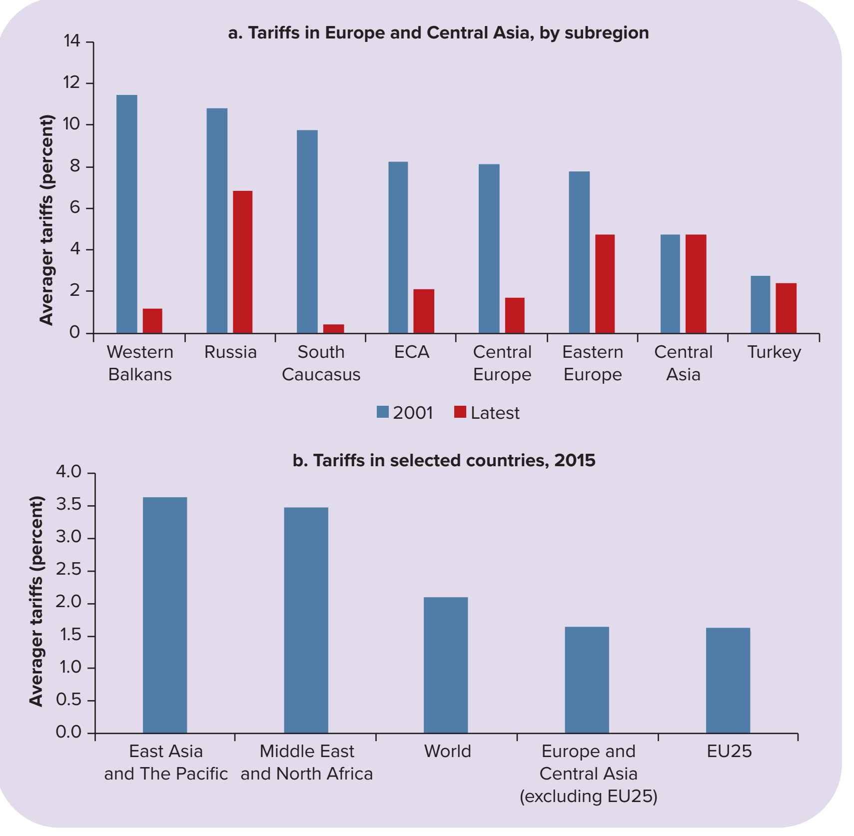
2.2 Integration in global markets enabled the transition to market economies

Until the fall of the Berlin Wall, in November 1989, trade between Central European countries and the Soviet Union and among the republics of the Soviet Union was largely centrally managed. It did not necessarily reflect comparative advantages or encourage an optimal use of resources. Trade with market economies was limited, and relative prices within the centrally planned economies often deviated significantly from global prices.

When the transition economies opened up to world markets, these old trade relations and the associated specialization patterns broke down (Broadman 2005). The immediate impact was a collapse of overall trade and production. From the mid-1990s, however, new trade relations and production patterns emerged. Meanwhile, in 1993 the European Union completed the establishment of a common market, with free movement of goods, services, people, and money.

These two developments—the opening up of the transition economies and the integration of the European Union—transformed international trade in the ECA region, with trade volumes of the transition economies tripling in a decade, while trade volumes of the European Union doubled. The deepening of trade continued during the 2000s, as many transition economies joined the WTO and several joined the European Union. Tariffs were reduced to the lowest levels in the world (figure 2.3).

FIGURE 2.3 **Tariff reductions continued into the 2000s**



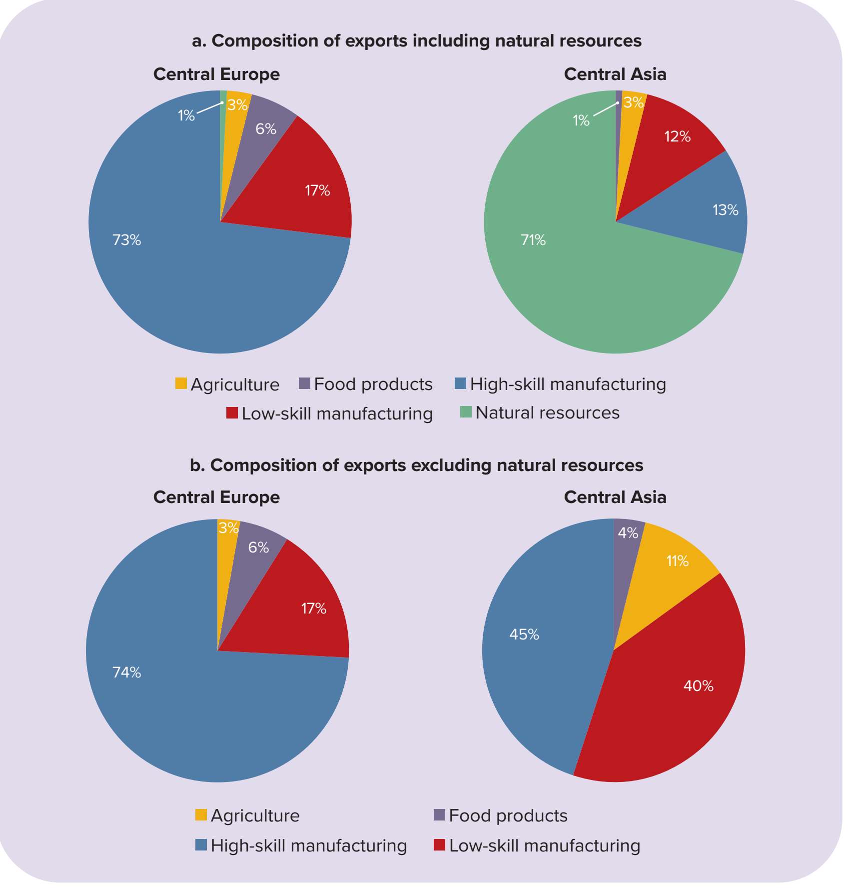
Source: World Bank.

The first consequence of the reintegration of transition economies into global markets was that relative prices became consistent with global demand and supply. The change ensured a more efficient use of resources, in which specialization patterns and trade patterns clearly reflected comparative advantages. Central Europe specialized in high-skilled manufacturing, while Central Asia specialized in natural resources (figure 2.4). Central Asia's manufactured exports are more low-skill intensive, consistent with education differentials between Central Europe and Central Asia.

With these two distinct specialization patterns, ECA countries were drawn toward two nodes of economic activity. Countries in the Baltics, Central Europe, and the Western Balkans intensified their participation in Western Europe, as they received FDI and became part of cross-border value chains or their workers migrated west. Countries in Central Asia, and to some extent the South Caucasus, benefited from rising Russian oil revenues, which provided export opportunities as well as employment opportunities in Russia.

Perhaps even more important than the new trade patterns were the domestic efficiency gains that came with the transition. The oil-producing countries are an example of this more efficient use of resources. Domestic energy prices increased as they converged toward the higher prices in global markets, causing domestic energy to be used more efficiently. In Russia, for example, per capita

FIGURE 2.4 Exports from Europe and Central Asia reflect subregions' comparative advantages



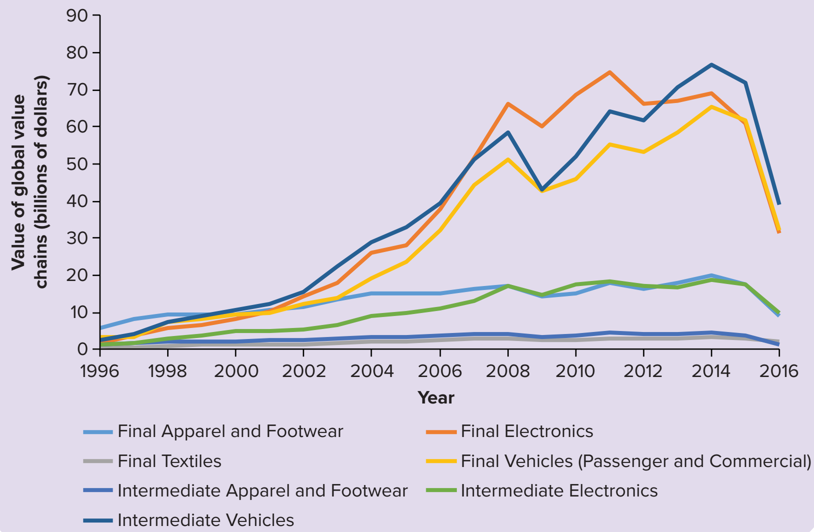
Source: World Bank.
Note: Figures are for most recent years available.

energy consumption was 30 percent lower at the end of the 1990s than at the beginning of that decade. The reduction in domestic demand enabled more oil to be exported, a change that had a profound impact on global energy markets. Despite robust global economic growth, reduced energy demand in the oil-exporting transition economies created a glut in global oil markets. Oil prices declined until they hit the nadir of just $10 a barrel at the end of the 1990s.

Once the glut was absorbed, oil prices started rising, benefitting the oil-exporting countries in the region. With a long delay, global oil supply adjusted to high oil prices, which finally pushed oil prices down again, forcing production patterns in Russia, Kazakhstan, Azerbaijan, and surrounding countries to adjust.

This experience illustrates the strong interaction between international markets and domestic production patterns. Indeed, open trade relations are not merely opportunities to earn export revenues or consume imported goods and services. They are also a conduit for aligning domestic production and consumption patterns with global markets forces. The key role played by trade in the transition to market economies was not an accident. Open trade relations directly affected the functioning of domestic product and factor markets.

FIGURE 2.5 **Central Europe integrated into automotive value chains**



Source: World Bank.

Integration into global markets had a particularly important impact in Central Europe, where it enabled domestic manufacturing to become part of "Factory Europe," especially the region-wide value chains clustered around the German automotive industry. The surge in exports of intermediate and final vehicles was a broad-based phenomenon in Central Europe (figure 2.5). As Central European companies became part of the cross-border value chains, Factory Europe become a powerful economic force in the global economy, benefitting not only new accession countries, but also older members of the European Union.

The impact on domestic markets did not come simply from opportunities to export existing production. Associated FDI inflows provided access to more advanced technologies, which in a relatively short period enabled domestic industries to move up the value chain (box 2.1).

BOX 2.1 Automotive value chains: The case of Romania's Dacia

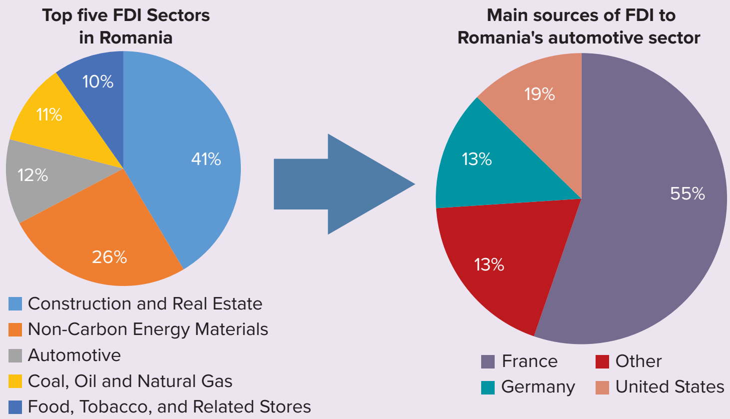
Automotive exports in Romania surged in anticipation of and following its accession to the European Union. The surge was directly related to FDI flows, as accession significantly improved the country's attractiveness to foreign capital. An important share of these FDI flows went to the automotive sector. European, and to some extent even American, car manufacturers relocated entire stages of their production process to Romania.

The automotive sector was the third-largest recipient of FDI flows into Romania between 2003 and 2011, with combined flows of almost $11 billion. Only construction and real estate and noncarbon energy materials received more FDI (figure B2.1.1).

(Continued next page)

BOX 2.1 (continued)

FIGURE B2.1.1 The automotive sector was the third-largest recipient of foreign direct investment in Romania between 2003 and 2011



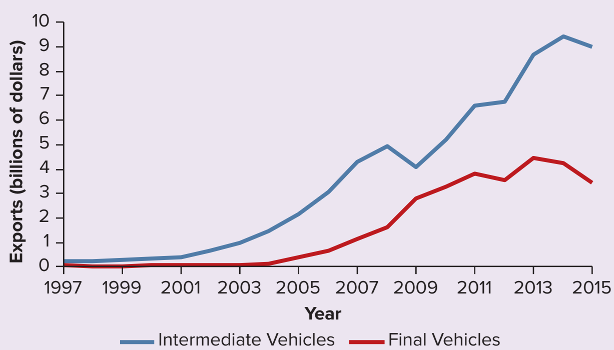
Source: fDi Markets (n.d.)

French manufacturing firms were the largest source of FDI in Romania's automotive sector. In 1999 Renault acquired Romania's domestic car manufacturer Dacia, leveraging existing technological links between the two companies that went back decades.

Initially, the bulk of automotive FDI was concentrated in the production of parts and components, such as Daimler's gearbox production and Ford's engine factory in Craiova. However, FDI inflows generated multiple knowledge spillovers, which supported the transition to more upstream stages of manufacturing. These spillovers included the retraining of the workforce as well as transfers of managerial and corporate governance expertise. Following the initial growth of Romanian exports of intermediate vehicles and parts, exports of final vehicles began to rise rapidly, helping Romania capture a larger share of the value added (figure B2.1.2).

Dacia became Europe's fastest-growing brand at a time when major European brands experienced declines in revenues. Its export growth was so impressive that in the first half of 2014, the 4.7 percent rise in total sales of Renault were due entirely to Dacia models. Dacia accounted for about 24 percent of Renault's Western European sales in 2013, according to the *Financial Times*.

FIGURE B2.1.2 Romania has moved from exporting parts to exporting vehicles



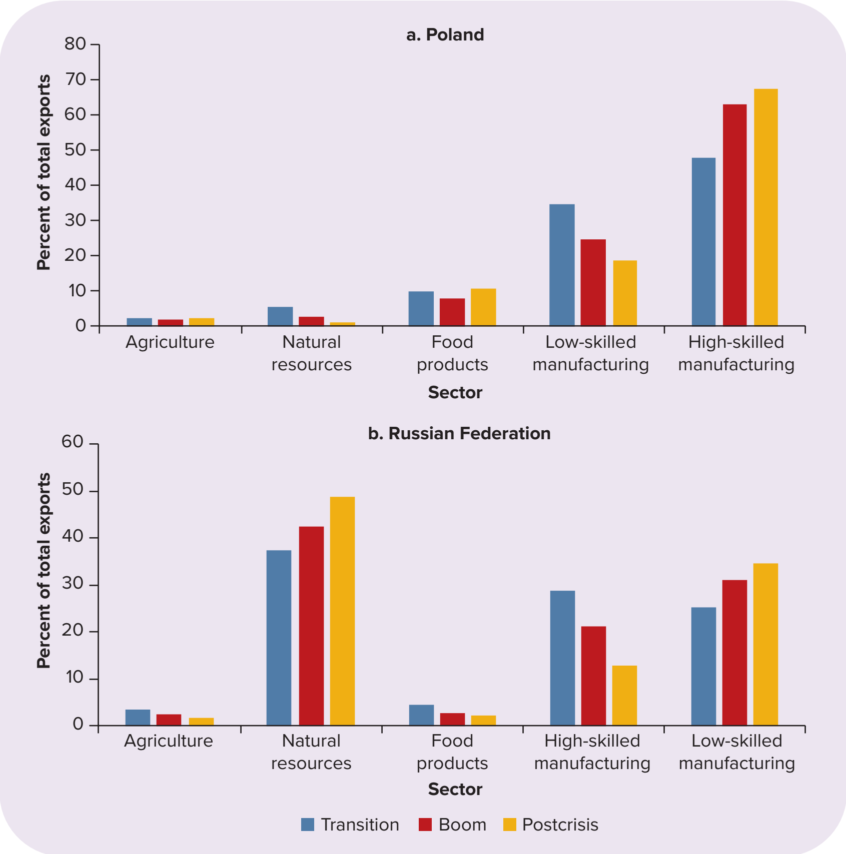
Source: UNCTAD (n.d.)

Many transition economies—including not only Central European economies like Poland but also oil exporters like Russia—have shifted from low-skill- to high-skill-intensive manufactured products (figure 2.6). Trade openness has led to specialization patterns that are consistent with comparative advantages. These patterns are not static: as companies engage in global competition and participate in global value chains, workers gain access to new technologies, bringing high-skill intensive production within reach. In the mid-1990s almost all transition economies underperformed in high-skill-intensive manufacturing exports; two decades later, they have an export pattern that is consistent with their fundamentals according to global empirical models (figure 2.7).

Since the early 1990s, trade in Europe has surged and brought domestic prices in line with prices in global markets. It has encouraged a more efficient use of resources, facilitated the upgrading of production structures, and provided access to a broader consumption package. The opening up to trade has transformed economies.

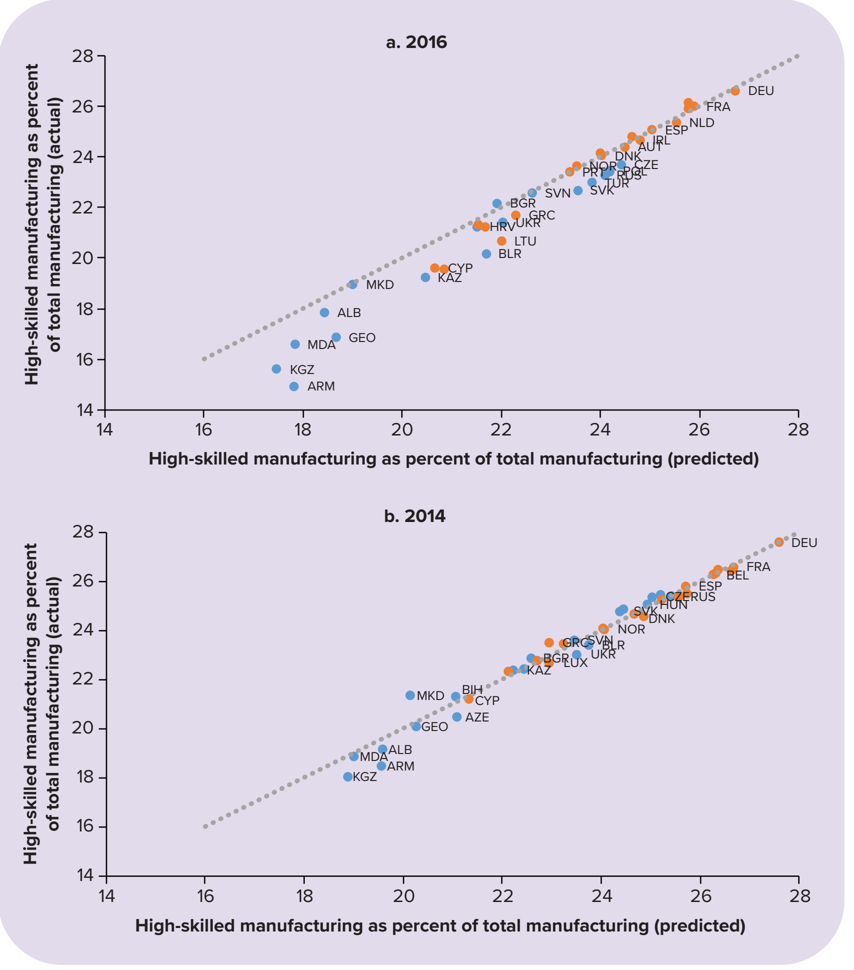
It is difficult to calculate the exact contribution of trade openness to income growth. Part of the difficulty is that production and trade influence each other in complicated and simultaneous ways, making it difficult to determine the direction of causality. In addition, third factors may affect both income and trade. FDI flows, investments in transportation infrastructure, improved competition poli-

FIGURE 2.6 Transition economies have gradually shifted toward high-skilled-intensive exports



Source: World Bank.

FIGURE 2.7 High-skilled manufacturing in Europe and Central Asia has matured



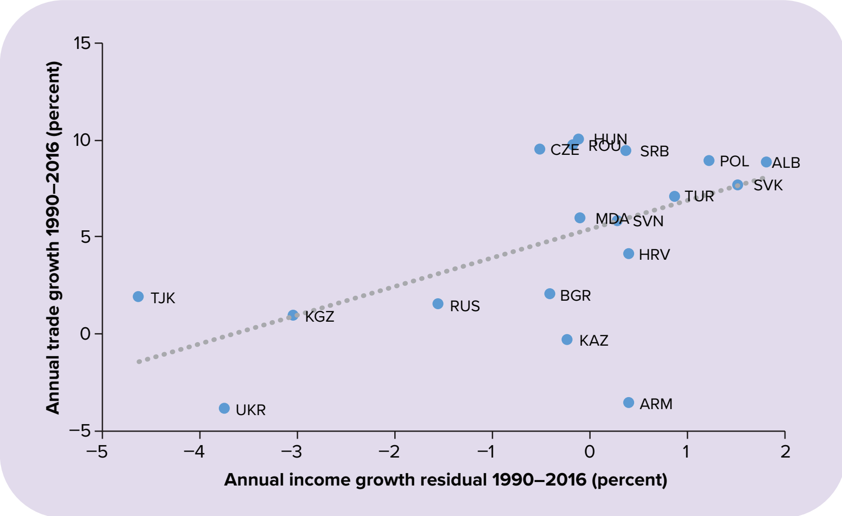
Source: World Bank.

cies, the introduction of new technologies, prudent macroeconomic policies, the elimination of dual exchange rates, and the deepening of financial sectors can all raise both trade and income. Whatever the direction of causation, rapid growth in income tends to coincide with rapid growth of trade.

One way to illustrate this phenomenon is by correlating the growth of trade volumes with the unexplained residuals from standard equations explaining income growth (figure 2.8). This correlation suggests that transition economies in Central Europe may have benefitted more from a trade-productivity spiral than did countries in Eastern Europe and Central Asia.

The transition to market economies and the deepening of the common market in the European Union since the early 1990s occurred against the backdrop of a worldwide wave of globalization. The global trends of tariff reductions, FDI flows, technology transfers, and behind-the-border measures were more pronounced in ECA. In the early 1990s, the brisk changes in several transition economies created hardship in the form of deep recessions; changed rendered large parts of production capacity and employment obsolete. The subsequent consequences of the transition more than compensated for these losses, however.

FIGURE 2.8 Growth in international trade coincided with faster income growth



Source: World Bank.

In the wake of the global financial crisis of almost a decade ago, sectoral adjustments have taken center stage once again in the western part of ECA. In the eastern part of the region, adjustments are occurring in the wake of the fall in oil prices in 2014. The financial crisis and the fall in oil prices have led to the dissolving of financial institutions and the downsizing of construction sectors. Significant changes in relative prices require the creation of new jobs in new sectors. New technologies are changing the way people work, products are produced, and merchandise is sold.

Governments and companies have to navigate these adjustments. Doing this are particularly challenging because global comparative advantages have changed and global trade slowed sharply in recent years. In this period of adjustment and uncertainty, it is worth exploring whether trade is still part of the solution or has become part of the problem.

2.3 Is there too little or too much trade?

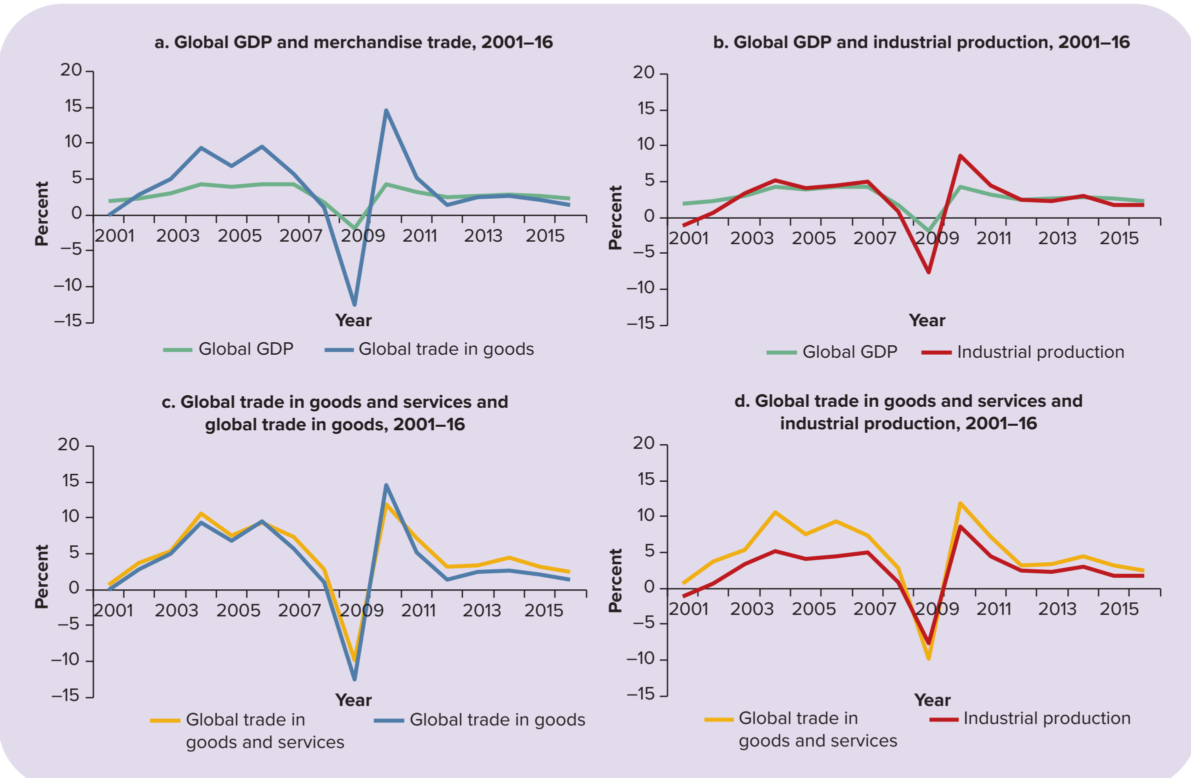
For two decades, from the mid-1980s until the mid-2000s, globalization of production through rapid expansion of international trade was incontestably the dominant economic trend across developing and high-income economies. The reintegration of China in global markets, the deepening of the common market in the European Union, the signing of the North Atlantic Free Trade Agreement (NAFTA), the fall of the Berlin Wall, the liberalization of capital account, the booming of FDI, and the expansion of the use of global value chains made international trade grow much faster than global production and income. Innovation and transfers of technologies became global phenomena, and competitive pressures in global markets forced discipline in macroeconomic policies and microeconomic regulations in domestic economies. Trade volumes grew twice as rapidly as production volumes. Globalization coincided with fast global growth and the catching up of emerging economies to the higher productivity levels in the high-income countries. Opening up to trade had become a leading developing strategy.

The slowdown in trade growth. Since the global financial crisis, global trade growth has slowed considerably. In recent years, global trade volumes have not grown faster than global production volumes, raising the question of whether trade remains a viable development strategy. Simultaneously, concerns are growing that there has been too much trade, that in many countries trade has replaced middle-class jobs and has weakened job security. Has globalization come to a standstill? If so, what are the implications for the ECA region?

The volume of global merchandise trade grew 1.3 percent in 2016, a full percentage point less than the 2.3 percent growth in the volume of global GDP (figure 2.9, panel a). This slow growth of global trade seems to have become the new norm. Between 2010 and 2016, global merchandise trade grew at an average rate of 1.9 percent a year while global GDP expanded by 2.6 percent annually. This pattern is the inverse of what had been the norm for a long time. At least since the mid-1980s, on average global trade outpaced global GDP growth, culminating in the 2003–07 boom, when trade volumes grew by about 8 percent a year, twice as fast as GDP.

Cyclical swings in trade have also been much more pronounced than cyclical fluctuations in GDP. In 2009, for example, global trade contracted 15 percent before largely recovering in 2010. The main reason for the strong cyclical behavior of trade is that cyclical components of GDP, especially investment and durable

FIGURE 2.9 Global trade has slowed relative to GDP



Source: Netherlands Bureau for Economic Policy Analysis 2017.

consumption, have relatively large import content. The least cyclical components of GDP tend to be less tradable in international markets. Industrial production (panel b of figure 2.9) normally follows GDP closely, but like trade, it is also closely linked to the more cyclical components. One therefore expects a closer link between merchandise trade and industrial production than between trade and GDP.

One reason for the changing relationship between GDP and merchandise trade is that services are becoming a larger share of GDP. The increase reflects both the rise in income and the increasing tradability of services like health and education. One could therefore expect trade in in goods and services to expand more rapidly than trade in good, as it has in recent years (figure 2.9, panel c).

Panel d of figure 2.9 compares growth in global industrial production and growth in global goods and services trade. The two variables are much more closely correlated than GDP and trade in goods (panel a of figure 2.9). Even with this closer correlation, however, a structural break is evident. The conclusion is that global trade—not only merchandise trade relative to GDP but also trade and services relative to industrial production, which better captures the cyclical character of tradable production—is slowing down.

Explanations of the structural slowdown in trade focus on three drivers that boosted the earlier globalization of production (Boz, Bussière, and Marsilli 2014; Freund 2016; Word Bank 2015a). First, the sharp decline in tariffs during the 1990s and early 2000s—as transition economies opened up, developing countries joined the WTO, and high-income countries engaged in deeper integration—is thought to have temporarily boosted trade growth. Once the larger trade shares, consistent with lower tariffs, were reached, trade remained at elevated levels but did not continue to grow at the same pace. There is debate about whether protectionism has increased in recent years. Evenett and Fritz (2015) find some evidence of rising protectionism, which Hoekman (2015) and Kee et al (2013) downplay. Whatever the trend in protectionism has been, trade liberalization is no longer the dominant trend, if only because tariffs have already reached very low levels.

Second, the global value chains that were created in the 1990s, have matured (Ferrantino, Michael and Taglioni 2014). Their growth came with a sharp increase in cross-border trade. Trade flows remain at higher levels but are no longer increasing at the same pace.

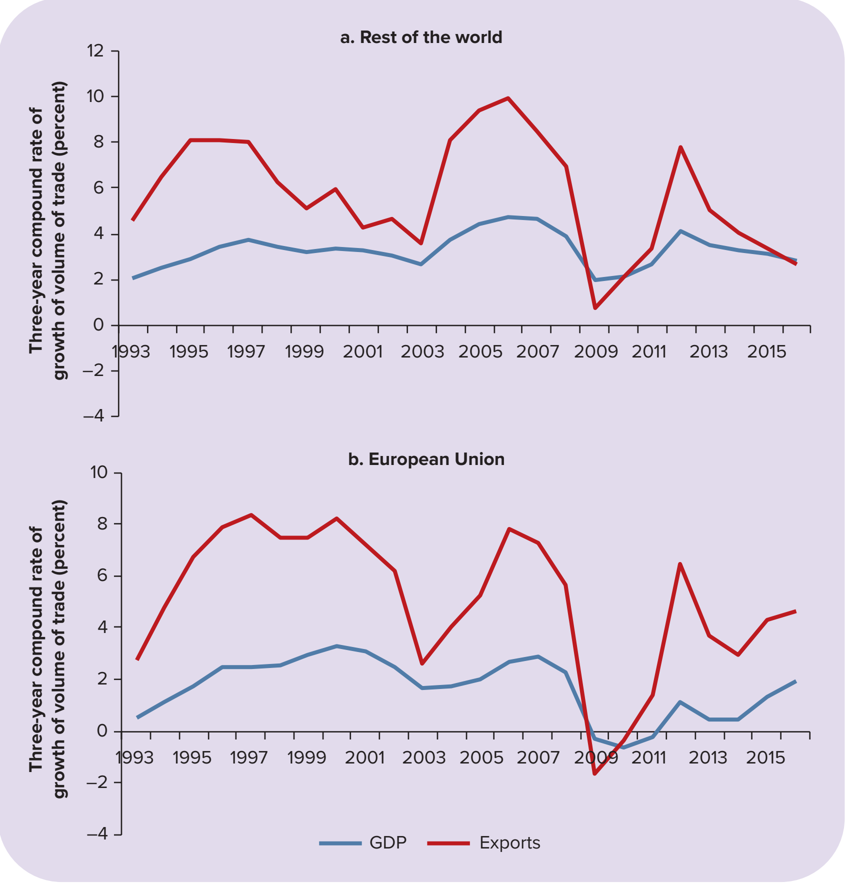
Last, and empirically not least, is the rise of China (Hong, Lee, Liao, and Seneviratne 2015). China's share in world merchandise exports (at current prices) was 2 percent in 1990, 4 percent in 2000, 12 percent in 2010, and 15 percent in 2015. Its rapid gain in market share during the 1990s and 2000s was a major factor in the acceleration of global trade. Booming Chinese exports did not merely replace exports from other countries, they also created new cross-border trade. As the country opened up and its companies became more productive, China became the manufacturing powerhouse of the world. Its share of global industrial production rose from only a few percent during the 1990s to 25 percent in 2016. This concentration of industrial production replaced production in other countries that had been local, resulting in large increases in global trade.

It is now much more difficult for China to increase its market share. On the supply side, labor is becoming scarcer and thus more expensive. On the demand side, saturation set in, and it is arithmetically impossible to continue to increase market shares at the same pace. The maturation of China's market shares in global consumption is an important driver of the slowdown in global trade.

Should trade still be a central element of an economic growth strategy? At least from the perspective of ECA, the answer is an unqualified yes. European trade is still growing relatively rapidly. In contrast to the rest of the world, where trade dropped sharply relative to GDP growth in recent years, export growth in ECA is much brisker than growth of GDP for several reasons (figure 2.10). First, exports of services from Northern and Western Europe increased. Second, Factory Europe can still compete with Factory Asia. The massive increase in China's share in global industrial production came mostly at the cost of regions other than ECA, whose market share declined only slightly (figure 2.11).

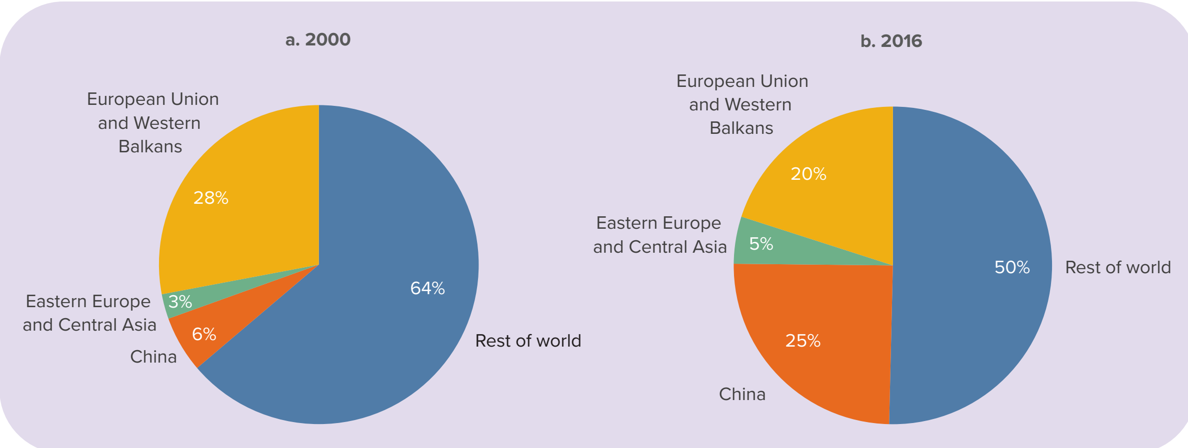
Exports from the European Union continue to grow faster than GDP. They lag GDP in Eastern Europe and Central Asia, but they have done so since 2000, largely because of Dutch disease, cause by high and rising oil prices. This worsened export competitiveness. Between 2000 and 2014, export volumes in the eastern part of the ECA region grew at the same rate as GDP, while import volumes grew more than twice as fast as GDP. This pattern reflected the rapidly rising

FIGURE 2.10 Export growth in Europe and Central Asia remains brisk



Source: World Bank.

FIGURE 2.11 **The rise of China as an industrial producer hurt Europe and Central Asia less than other regions**



Source: World Bank.

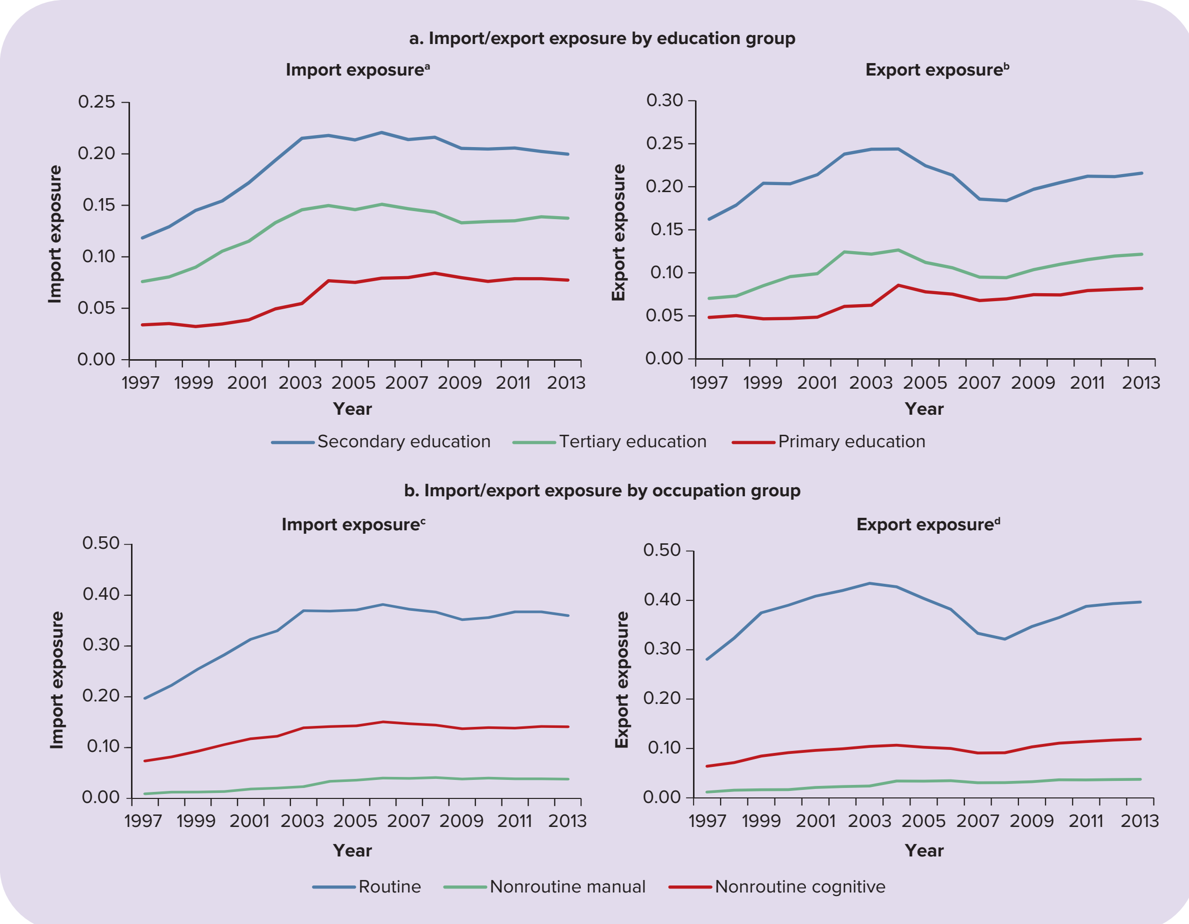
purchasing power from the huge terms-of-trade gains in that period and a loss in international competitiveness. After the fall in oil prices at the end of 2014, imports started declining and exports started rising faster than GDP, although GDP growth has been very low the past two years. More adjustments are needed to reverse the limited export growth and rapid import growth since 2000. The challenge is not the global slowdown (indeed, China's reduced export growth, an important driver of the slowdown in global trade, could well provide new export opportunities for Central Asia (World Bank 2015b). Rather it is the need to regain international competitiveness. The real depreciations in the wake of the fall in oil prices are important steps toward doing so.

The costs of globalization. Is there too much trade from ECA's perspective? How relevant for ECA is the global debate on the negative side effects of trade on job security, uncertainty, and inequality (Becchettam and Jansen 2011)?

Trade affects different sectors of the economy and different parts of the labor market in different ways. Middle-class workers tend to be more exposed to trade in manufacturing products than other workers. In Romania, for example, workers with secondary education, who are likely to belong to the middle class, are more likely than other workers to be employed in sectors that export manufacturing products or sectors that compete with manufacturing imports. Workers with tertiary education and workers with only primary education tend to be employed in sectors that do not compete in international markets (figure 2.12, panel a).

Shifts in trade patterns and price changes in international markets affect some workers more directly affected than others. But trade does not necessarily hurt workers in the middle class, for several reasons. First, middle-class workers may suffer more from import competition, they also benefit more than other workers from export opportunities. Trade exposure by itself seems less important than whether a country runs a current account deficit or surplus. During the boom before 2008, for example, export exposure in Romania declined because its current account deficit was ballooning (Baumgarten, Geishecker, and Gorg, 2010), Ebenstein and others 2014). The pressure on the jobs of workers with secondary

FIGURE 2.12 **In Romania—as elsewhere—workers with secondary education and workers performing routine jobs are more exposed to trade than other workers**



Source: Own calculations based on data from COMTRADE (imports and exports of goods by industry), UNIDO (output by industry in 2002) and SES (employment by industry and occupation in 2002).
Note:
a,c. Import exposure of each occupation was computed as the weighted sum of the import penetration in all the manufacturing industries (ISIC rev.3 15-36), where import penetration in each industry was computed as the ratio of actual imports to domestic absorption in 2002 (Y-X+M), and the weights are the employment participation of each industry in the total employment of the corresponding occupation in 2002.
b,d. Export exposure of each occupation was computed as the weighted sum of the export penetration in all the manufacturing industries (ISIC rev.3 15-36), where export penetration in each industry was computed as the ratio of actual exports to output in 2002, and the weights are the employment participation of each industry in the total employment of the corresponding occupation in 2002.

education had little to do with trade policies and everything to do with capital inflows and the macroeconomic policies that created the deficit.

Second, it is very difficult to determine whether international competition or technological progress and automation are responsible for changes in labor market conditions (Autor, Dorn, and Hanson 2015). Workers that are more exposed to trade often perform routine jobs, which are more prone to disappear because of automation (figure 2.12, panel b).

Third, the indirect effects of trade on labor markets may be as important as the direct effects. An obvious example is the impact of oil prices on labor markets in oil-exporting economies. When oil prices rose, all domestic prices increased (through the Dutch disease effect), and it became profitable to invest in domestic nontradable sectors (World Bank 2016b). Jobs were created in construction and domestic services like retail. When oil prices fell, many of these jobs, which are not directly exposed to trade, were eliminated. These indirect effects spread well beyond the borders of oil-exporting countries, because high oil prices created jobs in oil-exporting countries for migrant workers. In a similar way, cheaper imports can create better jobs in domestic retail sectors. Labor markets are too integrated to derive firm conclusions from the direct effects of trade exposure.

The continued importance of trade. The most important reason why ECA should still embrace new trade opportunities is that many countries in the region have to shift from non-tradable production following sharp adjustments in the current accounts. Because of changes in the external environment (lower oil prices, reduced capital inflows, and lower purchasing power of remittances), many countries need a new growth strategy. The creation of new jobs in sectors that compete internationally must be a central part of that strategy.

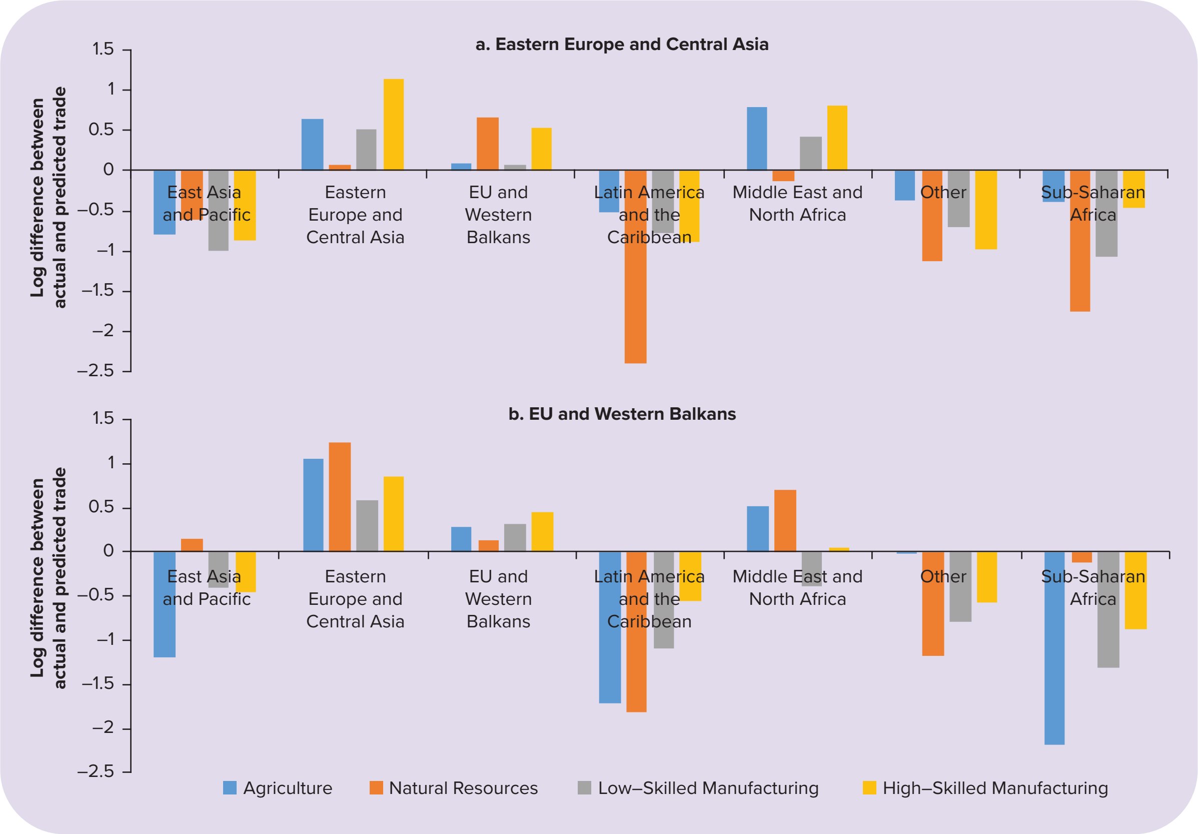
At least for ECA, there is no reason to declare that there is too little or too much trade. The status quo is not stable, however. In addition to moving away from nontradables, ECA countries have to navigate at least two other transitions in trade. One is the shift from intraregional trade to global trade. Integration into Factory Europe, especially the value chains around German industry, has been very successful for Central European countries. These value chains serve primarily the regional market. It is one of the reasons why intraregional trade in ECA is more than predicted by a global gravity model (figure 2.13). This figure shows first for the eastern part of the region and then for the western part of the region the export performance in different destinations, in deviation from the expected export performance in those destinations. For example, for both parts of the region exports of high-skilled manufacturing to other ECA countries is stronger than expected. But those high-value added exports to East Asia and most other regions are weaker than expected.

In order to fully catch up with high-income countries, however, countries in the region need to develop more global brands that can be sold worldwide. Major opportunities remained unexploited to intensify trade links with Asia, which is increasingly becoming the center of global commerce. Initiatives to revive the old silk road are an important part of this transition to global trade.

Another ongoing transition is the shift from international trade in goods to international trade in services (Papageorgiou, Wang, Loungani, and Mishra 2017). The share of services in total exports has risen steadily in Western Europe since 2011 (figure 2.14). This trend has not yet reached other parts of the ECA region. Supporting opportunities for digital development is essential to benefit from this third transition.

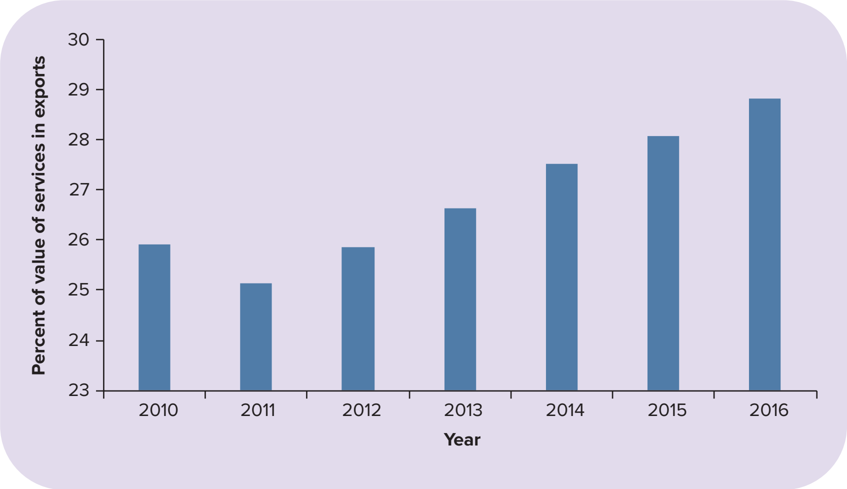
During the transition of the 1990s, trade played an essential role in transforming the domestic economies of the formerly centrally planned economies. Even against the backdrop of a worldwide wave of globalization, the opening up to international trade was more critical in ECA than for most other regions. During the coming years, trade will once again play a decisive role in adjusting domestic production structures in ECA. And once again, it is likely that trade will be particularly important.

FIGURE 2.13 Europe and Central Asia could trade more with other regions



Source: World Bank.

FIGURE 2.14 The share of services in EU exports is rising



Source: World Bank.

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PART II

Selected Country Pages

ALBANIA

Table 1	2016
Population, million	2.9
GDP, current US$ billion	11.4
GDP per capita, current US$	3923
Poverty rate ($2.5/day 2005PPP terms)[a]	6.7
Poverty rate ($5/day 2005PPP terms)[a]	47.5
Gini Coefficient[a]	29.0
School enrollment, primary (% gross)[b]	107.8
Life Expectancy at birth, years[b]	77.6

Source:World Bank WDI and Macro Poverty Outlook
Notes:
(a) Most recent value (2012)
(b) Most recent WDI value (2014)

Growth strengthened to 3.2 percent in 2016 and is projected to average 3.6 percent during 2017-19. Private investments in FDI-financed energy projects and consumption recovery drove recent economic expansion. Growth improved labor market outcomes, gradually leading to more inclusive access to jobs and poverty reduction. The fiscal position improved in 2016 due to increased revenue collection and restrained spending. Progress on the reform agenda, stronger growth, and job creation are expected to sustain the gains in poverty reduction.

Recent developments

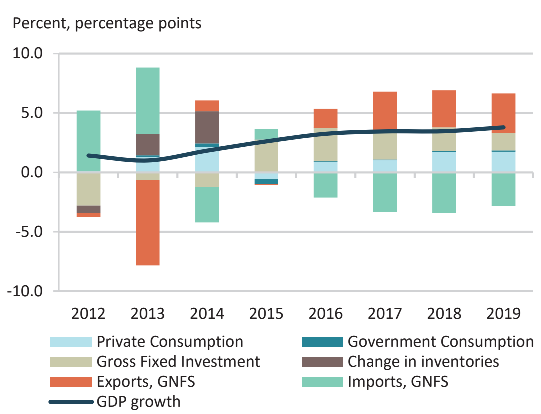
Albania's economy expanded by 3.2 percent in 2016, supported by robust domestic demand. Private investment in two large energy projects financed by foreign capital—the Trans-Adriatic Pipeline and a hydropower plant—and a recovery in private consumption drove this growth. The increase in private consumption was driven by improvements in employment and the easing of credit conditions. Net exports contributed positively to growth, on the back of tourism services exports expanding by 25.4 percent, while goods trade contributed negatively. With industry affected by the unfavorable commodity prices, the services sector was the main driver of growth, followed by the labor-intensive construction and agriculture sectors.

Prudent fiscal and monetary policies sustained macroeconomic stability. The fiscal deficit for 2016 is estimated at 2.2 percent of GDP (compared to 4.6 percent in 2015), in line with the country's fiscal consolidation efforts supported by the fiscal rule. Revenues increased by 6.8 percent in 2016 (y-o-y) while public expenditures (excluding arrears repayments) increased by only 2.4 percentage points in 2016 (y-o-y). The budget primary surplus of 0.2 percent of GDP in 2016 is expected to start bringing down the debt to GDP ratio for the first time to 72.7 percent of GDP. Average annual inflation fell from 1.9 percent in 2015 to 1.3 percent in 2016, below the Bank of Albania's (BoA) target of 3±1 percent prompting an accommodative policy by the central bank.

Investment-related imports widened the current account deficit (CAD) to an estimated 12.1 percent in 2016, up from 10.8 percent in 2015. The expansion was due to a rising trade deficit from 17.3 percent in 2015 to 18.2 percent in 2016, as investment related imports picked up and exports of commodities slowed down. Since the third quarter of 2016 there has however been an improvement thanks to the favorable tourism season. Remittances have also been broadly stable despite weak growth in the main source countries (Greece and Italy). The CAD was financed at 60 percent by FDIs, and 10 percent by inflows in the form of budget support. At end-2016, the stock of foreign exchange reserves is 2.9 billion euros, sufficient to cover about 5.7 months of imports of goods and services.

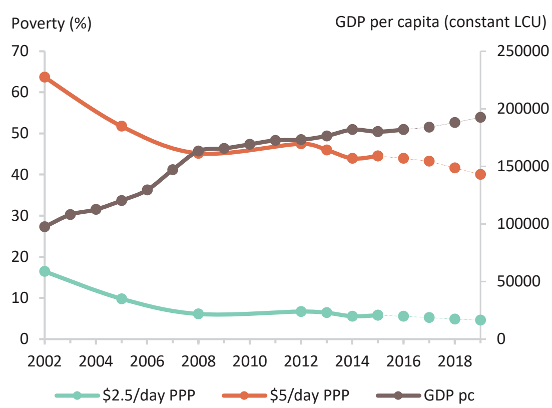
Stronger growth stimulated job creation in 2016. In the third quarter of 2016 employment grew by 8.5 percent (y-o-y), driven by job creation in industry (13.6 percent) and services (8.2 percent). Labor force participation increased to 67.3 percent, 2.6 percentage points higher than in the same quarter in 2015. The official unemployment rate declined by 2.5 percentage points to 14.7 percent, with more than half of the unemployed still being long-term unemployed. As a result, the employment rate among those 15-64 years climbed to 57.1 percent in the third quarter of 2016, the highest rate since early 2012. Nominal wages continued their decline since the end of 2013, but will be helped in 2017 by the end of the public wages freeze.

FIGURE 1 Albania / GDP growth, contributions to growth



Sources: Instat, Ministry of finance, World Bank staff projections.

FIGURE 2 Albania / Actual and projected poverty rates and private consumption per capita



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

Poverty is estimated to have declined as economic growth and labor markets have picked up. The poverty rate (measured as US$ 5/day, 2005 PPP) is estimated to have decreased in 2016 to 43.9 percent, compared to 44.5 percent in 2015, with job creation in sectors, such as construction, that benefit poor and low-skilled individuals. For some households, the decline in nominal wages likely muted some of the progress taking place on employment, while the halt of a previous downward trend in remittances provides positive prospects for remittance-receiving households. Moreover, labor market patterns suggest a more inclusive growth pattern. The improvements in employment are, for example, primarily driven by a reduction in youth unemployment (especially among women), as well as higher female labor force participation rates.

Outlook

Albania's economic outlook is expected to improve over the medium-term. Growth is projected at 3.5 percent during 2017-18 and expected to increase further to 3.8 percent in 2019. Private investments in two large energy projects will continue to support growth, aided by private consumption while labor market improves, and net exports supported by demand from the EU. The CAD will remain elevated as imports continue to grow, following the pace of investment, and be financed by FDI. Continued fiscal consolidation and other reform efforts are expected to gradually reduce the fiscal deficit to 0.7 percent of GDP by 2019. As a result, the debt-to-GDP ratio is projected to fall below 60 percent of GDP by 2021.

As the economy continues to accelerate and labor markets improve, further gains in poverty reduction are expected. Poverty, measured at the moderate poverty line (US$ 5/day, 2005 PPP), is expected to decline to 43.23 percent in 2017, to 41.6 percent in 2018 and even further to 40.0 percent in 2019.

Risks and challenges

Economic prospects are vulnerable to downside risks. Uncertain global market conditions, in particular slower growth in the Euro area, could reduce Albania's exports and FDI inflows, further translating into lower tax revenues, less public investment and thus slower output growth. The faster pace of normalization of global interest rates also poses a risk. In this context, harnessing growth will require macroeconomic stability and implementation of structural reforms to improve the business climate including continuing judiciary reforms, energy reform, enhancing public investment management, addressing the high ratio of NPLs, and improving skills of the labor force. Importantly, the reform agenda –in, for example, energy and skills– should be informed by equity considerations to sustain and enhance the poverty and inclusion gains thus far.

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

	2014	2015	2016 e	2017 f	2018 f	2019 f
Real GDP growth, at constant market prices	1.8	2.6	3.2	3.5	3.5	3.8
Private Consumption	3.0	-0.8	1.3	1.5	2.5	2.6
Government Consumption	6.4	-9.4	0.8	1.8	2.4	2.5
Gross Fixed Capital Investment	-4.0	9.3	9.0	7.5	5.8	4.3
Exports, Goods and Services	1.8	-0.1	3.3	6.5	6.2	6.4
Imports, Goods and Services	4.6	-1.3	3.3	5.2	5.3	4.2
Real GDP growth, at constant factor prices	2.1	2.8	3.2	3.5	3.5	3.8
Agriculture	2.0	0.5	2.2	3.2	3.0	3.0
Industry	-3.6	5.4	5.9	3.9	4.6	4.6
Services	5.5	2.9	2.2	3.4	3.1	3.8
Inflation (Consumer Price Index)	1.6	1.9	0.9	1.5	2.9	2.9
Current Account Balance (% of GDP)	-12.9	-10.8	-12.1	-13.7	-13.0	-11.8
Financial and Capital Account (% of GDP)	10.2	8.2	9.5	11.1	10.4	9.2
Net Foreign Direct Investment (% of GDP)	8.1	7.7	7.1	8.0	6.9	5.3
Fiscal Balance (% of GDP)	-6.0	-4.6	-2.2	-1.1	-1.0	-0.8
Debt (% of GDP)	72.1	73.7	72.7	70.0	67.0	63.4
Primary Balance (% of GDP)	-3.1	-1.9	0.2	1.2	1.1	1.3
Poverty rate ($2.5/day PPP terms)[a,b,c]	5.6	5.8	5.6	5.2	4.8	4.6
Poverty rate ($5/day PPP terms)[a,b,c]	43.9	44.5	43.9	43.2	41.6	40.0

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 2012-LSMS.
(b) Projection using neutral distribution (2012) with pass-through = 1 based on private consumption per capita in constant LCU.
(c) Nowcast: 2014 - 2016. Forecast are from 2017 to 2019.

ARMENIA

Table 1	2016
Population, million	3.0
GDP, current US$ billion	10.5
GDP per capita, current US$	3486
Poverty rate ($2.5/day 2005PPP terms)[a]	22.6
Poverty rate ($5/day 2005PPP terms)[a]	71.7
Gini Coefficient[a]	32.4
Life Expectancy at birth, years[b]	74.6

Source:World Bank WDI and Macro Poverty Outlook
Notes:
(a) Most recent value (2015)
(b) Most recent WDI value (2014)

A combination of low commodity prices, declining remittances, weak domestic demand and increased political uncertainty undermined Armenia's growth and fiscal position, and reversed the trend in poverty reduction in 2016. While the economy is expected to recover modestly over the medium term, the parliamentary and presidential elections slated for 2017-18 may delay progress on the structural reform agenda and undermine prospects for further poverty reduction.

Recent developments

Growth slowed considerably – to 0.2 percent in 2016 from 3 percent in 2015 – due to the protracted slump in global metal prices (Armenia's main commodity exports), falling remittances, and an unexpected Cabinet reshuffle, all of which affected market sentiment. A 20 percent expansion in the non-resource tradeable sectors, driven by the restored trade ties with Russia and penetration into China and Middle East, failed to offset a double-digit contraction in construction and a substantial decline in agricultural output. In contrast, the continued decline in remittances, dwindling foreign direct investment inflows, and lower public investment weakened domestic demand substantially. However, by January 2017, the economy was already showing some signs of renewed dynamism, as the economic activity index grew by 6.5 percent (y/y). The incipient recovery of global commodity prices buoyed the extractive industries and rising private consumption drove renewed growth in the services and retail trade sectors.

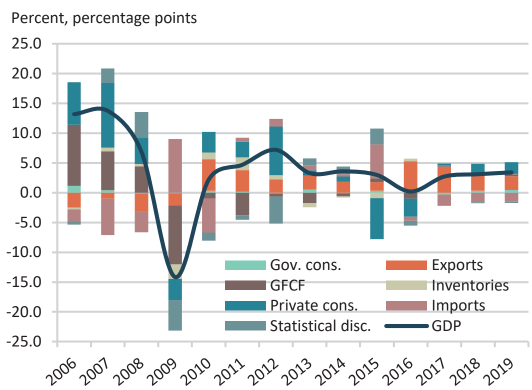
The fiscal deficit widened to 5.4 percent of GDP in 2016 from 4.8 percent a year earlier, driven by expenditure overruns and the weak revenue collection resulting from the sluggish demand, deflation and lower-than-expected customs revenue. The higher deficit led to a further build-up of public debt to 55.3 percent of GDP at end-2016, and triggered the fiscal rule, requiring the government to implement a fiscal consolidation beginning in 2017. The fiscal balance was in small surplus in January 2017, supported by improved tax collection and the government's adherence to its approved spending limits. The new government's tax policy and administration reforms have strengthened revenue performance. In particular, changes to the excise-tax regime in January 2017 have more than doubled excise revenues (y/y), while the Tax Code (approved in 2016) will fully take effect in 2018.

In view of the weak economic activity, the central bank eased monetary policy by cutting the policy rate gradually from over 10 percent in January 2016 to 6 percent in February 2017. However, the high levels of dollarization (63 percent of total loans, and 66 percent of deposits) limit the effectiveness of monetary stimulus. Weak domestic demand, a reduction in utility tariffs, a continued decline in import prices, and the appreciation of the Dram in real effective terms, caused a cumulative deflation of 1.4 percent between December 2015 and December 2016.

The financial sector remained stable throughout 2016. The authorities enhanced the bank capitalization standards (in line with Basel III). The new standard has been met by 17 banks, representing 93 percent of total banking sector assets. Meanwhile, total credit to the private sector grew by 15 percent by December 2016 (y/y), while lending in domestic currency rose by 24 percent. However, the ratio of nonperforming loans rose to 10 percent as of end-year, suggesting the presence of risks.

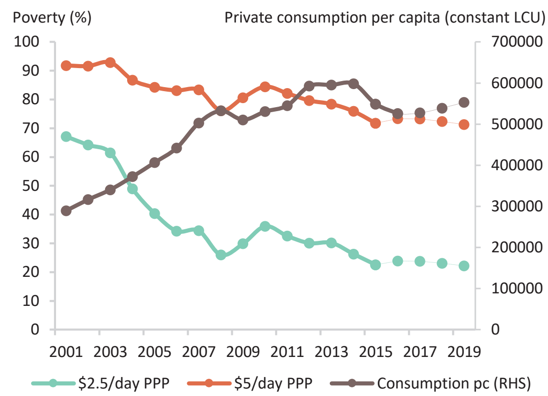
The current account deficit remained narrow at an estimated 2.4 percent of GDP in

FIGURE 1 Armenia / GDP growth, contributions to growth



Sources: World Bank.

FIGURE 2 Armenia / Actual and projected poverty rates and private consumption per capita



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

2016, supported by a 20 percent increase in exports, coupled with anemic import demand. The Russian recession continued to negatively impact remittances, which fell by 35 percent in 2015 and a further 10 percent in 2016.

Declining wage and remittance income increased the poverty rate from 22.6 percent in 2015 to an estimated 23.9 percent in 2016 at PPP-adjusted 2.5 dollar/day poverty line. The increase of the international poverty rate masks different developments across locations in the country; in urban areas outside Yerevan, the large number of returning temporary and permanent migrants is placing additional pressure on labor markets, and it is expected that the increase of poverty will be higher than in rural areas. In the latter, subsistence farming acts as a coping mechanism for weak domestic and international labor markets.

Outlook

Growth is projected to accelerate to 2.7 percent in 2017, reflecting the sustained expansion of the tradable sectors and a modest recovery in domestic consumption. Medium term growth is projected to average 3-3.5 percent a year, given structural weaknesses in the domestic policy framework, and remaining uncertainties in external environment.

The government's planned expenditure restraint and full implementation of the Tax Code are expected to keep the fiscal deficit below 3 percent of GDP over the medium term. Policy changes envisaged in the Tax Code would boost revenues by 2 percentage points of GDP by 2021.

Future poverty reduction will hinge on the recovery of the domestic economy, labor-market dynamics, and remittance inflows. Low growth rates, unfavorable external conditions, and limited fiscal space could slow the pace of poverty reduction; as a result, the poverty rate is projected to fall from 23.8 percent in 2017 to 22.2 percent in 2019.

Risks and challenges

Armenia's medium-term outlook remains sensitive to internal and external factors, which entail both upside and downside risks. Growth prospects depend on the government's ability to scale up high-quality investment, and speed up structural reform. Challenges to this include the upcoming parliamentary and presidential elections in April 2017 and May 2018, respectively. Cabinet changes in the wake of each election could adversely affect investor confidence and slow the pace of reform. Domestic political pressures could compound with the negative impact external shocks—including a slower-than expected recovery in Russia. Upside risks include plans for a new Framework Agreement with the EU and an anticipated increase in trade with Iran following the easing of international sanctions and revisiting bilateral arrangements for trade facilitation. The recent mandatory increase in capital-adequacy ratios is strengthening the financial sector, but the rise of nonperforming loans poses new challenges.

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

	2014	2015	2016 e	2017 f	2018 f	2019 f
Real GDP growth, at constant market prices	3.6	3.0	0.2	2.7	3.1	3.4
Private Consumption	1.0	-7.9	-3.9	0.5	2.3	2.7
Government Consumption	-1.2	4.5	2.5	-3.9	4.6	6.2
Gross Fixed Capital Investment	-2.2	3.0	-4.6	0.6	1.6	1.9
Exports, Goods and Services	6.4	4.9	17.0	12.4	6.5	5.8
Imports, Goods and Services	-1.0	-15.1	2.2	5.5	4.8	4.5
Real GDP growth, at constant factor prices	3.9	4.0	0.8	2.3	2.8	3.1
Agriculture	6.1	13.2	-5.8	3.5	2.7	2.2
Industry	-2.3	3.7	-0.9	4.5	3.8	3.5
Services	8.3	-3.6	8.9	-0.8	1.9	3.4
Inflation (Consumer Price Index)	3.0	3.7	-1.4	1.5	3.2	3.0
Current Account Balance (% of GDP)	-7.6	-2.6	-2.4	-2.7	-3.2	-3.6
Financial and Capital Account (% of GDP)	7.9	4.2	4.6	3.3	3.8	4.1
Net Foreign Direct Investment (% of GDP)	3.3	1.5	2.3	4.5	6.5	7.4
Fiscal Balance (% of GDP)	-1.9	-4.8	-5.4	-2.7	-2.5	-2.6
Debt (% of GDP)	43.7	48.8	55.3	56.7	58.0	58.2
Primary Balance (% of GDP)	-0.4	-3.0	-3.5	-0.6	-0.4	-0.5
Poverty rate ($2.5/day PPP terms)[a,b,c]	26.3	22.6	23.9	23.8	23.0	22.2
Poverty rate ($5/day PPP terms)[a,b,c]	75.9	71.7	73.4	73.3	72.4	71.3

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 2011-ILCS, 2014-ILCS, and 2015-ILCS.
(b) Projection using point-to-point elasticity (2011-2014) with pass-through = 0.7 based on private consumption per capita in constant LCU.
(c) Actual data: 2014, 2015. Nowcast: 2016. Forecast are from 2017 to 2019.

AZERBAIJAN

Table 1	2016
Population, million	9.8
GDP, current US$ billion	37.3
GDP per capita, current US$	3823
School enrollment, primary (% gross)[a]	100.5
Life Expectancy at birth, years[a]	70.7

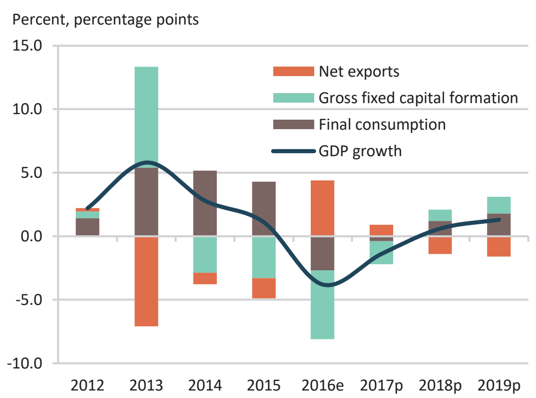
Source:World Bank WDI and Macro Poverty Outlook
Notes:
(a) Most recent WDI value (2014)

2016 marked a year of deep economic recession for Azerbaijan — the first in two decades. Investment and consumption fell sharply due to a cut in public investment, a credit crunch caused by banking sector distress, and a drop in real income. Going forward, with high policy uncertainty and financial sector vulnerability lingering, and the government planning on further fiscal consolidation, recovery may prove elusive. Under some downside scenarios, the good progress achieved in poverty reduction faces the risk of reversal.

Recent developments

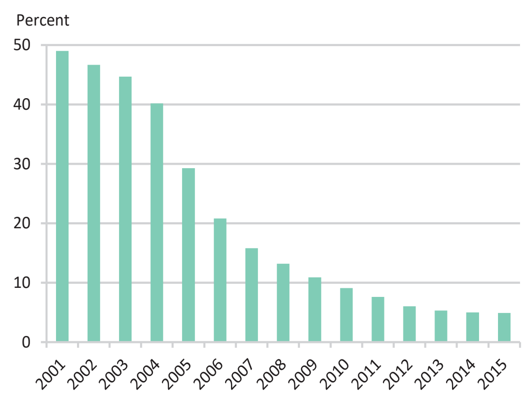
The Azerbaijani economy continued to suffer from the oil price shock, contracting by 3.8 percent in 2016. The recession was driven by a fall by 5.4 percent in non-oil sector output. This decline reflected the credit crunch linked to the ongoing banking sector distress, the tight monetary policy, and a sizeable cut in public investment. Oil GDP showed no growth in 2016.
Driven by a 40 percent fall in oil exports, Azerbaijan's external accounts deteriorated from a near balanced position in 2015 to a deficit of 4.8 percent of GDP by September 2016. The resulting acute shortages of foreign exchange led to a depreciation of the manat (13.5 percent against the US dollar during 2016) and, in turn, reduced imports by 12 percent (y/y) in the first three quarters of 2016. International reserves stood at US$ 3.9 billion at end -2016, compared to US$ 5 billion a year earlier. The central bank has restrained from intervening in the foreign exchange market since mid-2016, while the State Oil Fund (SOFAZ) sold foreign exchange for local currency to cover its budget transfers.
Annual inflation rose to 15.6 percent in 2016, driven mainly by the pass-through from the manat depreciation and a rise in domestic food prices reflecting an increased demand for Azerbaijani food from Russia. To curb the price pressures, the central bank tightened monetary policy significantly, raising the policy rate by 12 percentage points from February to September 2016, and expanded deposit auction operations to absorb manat liquidity. However, inflationary pressures remain strong, reflecting a large increase in the prices of electricity and natural gas in January.
The consolidated fiscal balance (including balances of the SOFAZ, the social protection fund and the Nakhchivan autonomous region) recorded a surplus at 0.3 percent of GDP in 2016, compared with a deficit of 6.2 percent in 2015, as lower oil revenues and increases in wages, pension and targeted social assistance was offset by cuts in public investment and significantly lower-than-planned spending by the Oil Fund. This fiscal outturn was supported by increased customs revenue (as a result of Customs reform) and the manat depreciation, which raised prices of imports in the manat.
Public confidence in the financial system remains weak. Total bank deposits fell by 23 percent in 2016, while credit to the private sector contracted by 24 percent. An overall banking sector resolution framework remains absent. However, the authorities introduced ad hoc measures to reduce uncertainty. These included the enactment of guarantees for all household deposits, the enforcement of responsible lending standards, restrictions on FX lending, more capital injections to the major state bank (IBA), and the issuance of a promissory note to support the Deposit Insurance Fund's payout to depositors of failed banks. There were signs of stabilization towards the end 2016.
The government also accelerated structural reforms, including the simplification of customs clearance and licensing to support private sector growth. In December

FIGURE 1 Azerbaijan / GDP growth, contributions to growth



Sources: State Statistical Committee and World Bank staff estimation.

FIGURE 2 Azerbaijan / Official poverty rate, 2001-15



Sources: State Statistical Committee.
Notes: The official national poverty rates for 2013-2015 have not been reviewed by the World Bank.

2016, the government launched a "Strategic Roadmap for the National Economy and Main Economic Sectors" which outlined the medium- and long-term goals for the development of the economy and eleven key sectors.

Social conditions became a major source of concern. In 2015, the official poverty rate was 4.9 percent. Although higher social spending could be beneficial, reduction in public investment is expected to have adversely affected households, especially those relying on construction sector jobs. High inflation will affect the poor, due to increases in price of items with high import content, especially food. Simulations suggest that the inflation spike of June 2015-February 2016 may have pushed an estimated 300,000 Azerbaijanis to live on less than AZN 72.5 per month—a consumption level about half the official poverty line of AZN 135.6 in 2015.

Outlook

Azerbaijan's economy is likely to experience another year of negative growth in 2017 despite the anticipated recovery of oil prices, as oil production is not expected to increase and the non-oil sector continues to be affected by the government's spending cuts and the banking sector distress. However, output is projected to expand from 2018 onwards, supported by the acceleration of oil GDP as Shah Deniz gas field begins production. Non-oil sector growth will remain weak, as the government is set to keep tight stance on both fiscal and monetary policies to safeguard macroeconomic stability, and the banking sector slowly regains strength to support the private sector. Inflation will abate due to limited liquidity on the market and will hover about 5 percent a year. Meanwhile there will be a notable improvement in the consolidated fiscal position over 2017-2019, as a result of envisioned spending consolidation. While the government will follow up the roadmap document with action plans, the implementation of the investment program could be delayed, since fiscal consolidation will remain a policy priority for the government through the medium-term.

Current conditions do not appear conducive to significant poverty reduction. While recent efforts to step up social spending should help alleviate poverty, constrained private sector growth could have a negative impact on the poor.

Risks and challenges

Risks to growth and poverty reduction remain high. The immediate challenge for the government is to minimize the impact of the planned fiscal consolidation on growth and safeguard spending to protect the poor. Another challenge going forward is to restore the confidence of the public and the investors, which relies on bold reforms that accelerate banking sector resolution and improve business environment, as well as the government's transparency and effectiveness in communicating these policies.

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

	2014	2015	2016 e	2017 f	2018 f	2019 f
Real GDP growth, at constant market prices	2.0	1.1	-3.8	-1.4	0.6	1.3
Private Consumption	8.5	6.0	-2.8	-0.1	2.2	2.4
Government Consumption	4.0	-7.1	-8.1	-2.9	-1.0	1.4
Gross Fixed Capital Investment	1.4	-9.9	-23.4	-10.0	5.5	6.8
Exports, Goods and Services	-1.1	-1.0	-2.0	-1.1	-0.5	-0.5
Imports, Goods and Services	4.1	-5.0	-10.0	-3.0	2.2	2.2
Real GDP growth, at constant factor prices	1.8	0.9	-3.7	-1.7	0.4	1.2
Agriculture	-2.6	6.6	2.6	3.4	4.2	4.5
Industry	-1.7	-2.4	-5.5	-2.9	-0.8	0.3
Services	11.9	6.9	-1.7	-0.8	1.8	2.0
Inflation (Consumer Price Index)	1.5	7.7	15.6	7.8	4.2	3.8
Current Account Balance (% of GDP)	13.6	-0.4	-1.8	0.8	3.9	4.3
Financial and Capital Account (% of GDP)	-9.8	4.2	5.6	4.0	0.7	0.3
Net Foreign Direct Investment (% of GDP)	3.2	3.2	3.3	4.2	4.0	4.0
Fiscal Balance (% of GDP)	-0.4	-6.2	0.3	6.0	8.3	7.7
Primary Balance (% of GDP)	-0.2	-5.5	1.0	7.2	9.7	8.7

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

BELARUS

Table 1	2016
Population, million	9.5
GDP, current US$ billion	45.3
GDP per capita, current US$	4769
Poverty rate ($2.5/day 2005PPP terms) [a]	0.0
Poverty rate ($5/day 2005PPP terms) [a]	0.6
Gini Coefficient [a]	26.6
School enrollment, primary (% gross) [b]	97.8
Life Expectancy at birth, years [b]	72.5

Source: World Bank WDI and Macro Poverty Outlook
Notes:
(a) Most recent value (2015)
(b) Most recent WDI value (2014)

The economy continued to decline due to weakness in exports and final consumption. The contraction has put pressures on external and fiscal accounts as large public debt repayments come due in 2017. Economic recovery is expected to remain modest and gradual as negative feedback loops would continue to subdue domestic demand, while weak labor market could further deteriorate household incomes. Necessary adjustment measures and accelerated reforms are necessary to improve market expectations and mobilize investment for sustainable recovery.

Recent developments

In 2016, the economy continued to contract, albeit at a slower pace, as tight fiscal and monetary policies have helped to support macroeconomic stabilization. In 2016, real GDP decreased by 2.6 percent vis-à-vis 3.9 percent in 2015. Goods and services exports continued to decline—by 9.3 percent y/y in nominal US$ terms in contrast to 24.3 percent in 2015—due to persistent weak external demand and a 21 percent cut in crude oil supplies from Russia resulting from unresolved gas dispute. Domestic demand remained suppressed and final consumption fell dramatically, while further cuts in directed lending and public capital expenditures continued to dampen gross fixed investments. Over the three quarters of 2016, households lowered their consumption by 6.1 percent, while gross capital formation fell sharply by almost 20 percent y/y. At the same time, agriculture and several manufacturing sectors have registered growth in recent quarters, mostly owing to the base effect, and a very tepid recovery in Russia.

Ongoing recession has put additional pressures on external and fiscal accounts. The current account deficit amounted to 3.6 percent of GDP in 2016 driven by growing trade and primary income deficits (with interest and dividend payments at 4.5 percent of GDP). The financing of the deficit—by additional short-term borrowing of commercial banks and general government—remains unsustainable.

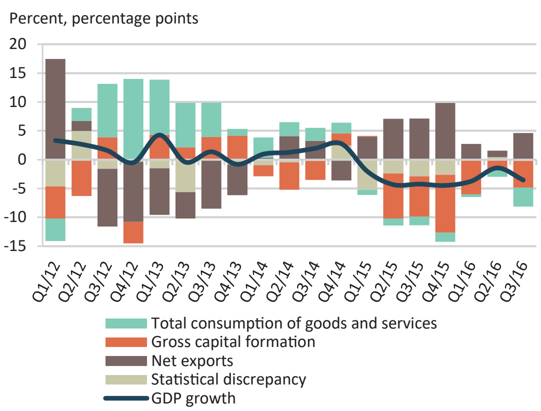
Declining general government revenues (by 5.6 percent in real terms y/y) has prompted the government to tighten spending (by 5.7 percent y/y) and to right-size the wage bill in the public sector, further weakening aggregate demand. Public and publicly guaranteed debt has reached almost 48 percent of GDP, an increase of 17 percentage points in just four years.

Household wealth continues to deteriorate amid weak labor market. A 30 percent increase in utility prices has eroded the purchasing power of the B20 and B40 households. In 2016, net job creation was negative and the number of employed persons shrank by 2.2 percent. Real wages fell by 4 percent vis-à-vis 2015 and by more than 6 percent in some regions (Gomel and Grodno). Real disposable incomes were down by about 7 percent y/y everywhere, except Minsk and its oblast, where the fall was about 4 percent y/y. So far, the rise in official poverty has been small—by 0.6 percentage points between Q1 and Q4 of 2016—contained by a 10 percent annual increase in spending on targeted social assistance.

Outlook

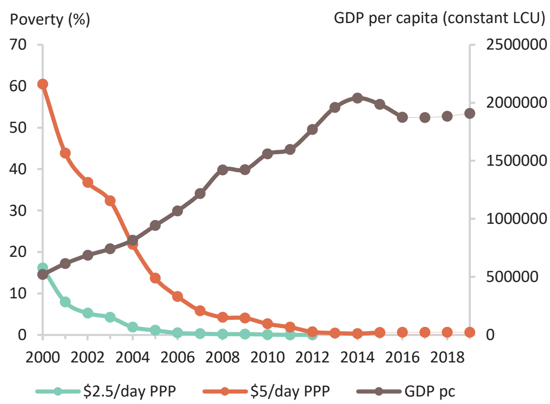
Economic recovery is expected to remain weak and gradual as negative feedback loops will continue to subdue domestic demand. Economic stabilization measures of 2015–2016, including greater exchange rate flexibility, directed lending restrictions, as well as monetary and fiscal tightening,

FIGURE 1 Belarus / GDP growth, contributions to growth



Sources: World Bank Staff calculations based on Belstat data.

FIGURE 2 Belarus / Actual and projected poverty rates and GDP per capita (constant LCU)



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

set important preconditions for growth. However, some necessary adjustment measures—including further planned cuts in directed lending—will continue to have a negative drag on growth. Policy efforts to stimulate the short-term demand will be limited by financial and fiscal pressure, including a possible need to recapitalize state-owned banks and costs associated with SOE restructuring.

The poverty rate—measured at US$5/day at PPP—is projected to increase slightly during 2016–2017 due to a combination of weak labor market conditions and higher unemployment associated with transformations in SOE sector and related structural adjustments in the labor market. Increases in utility tariffs to a full cost recovery by the end of 2018 would require more robust mitigation measures by improving the targeting of existing household utility subsidy program.

The recovery is likely to be long and gradual, but needs to be anchored on key structural reform measures. One of them is establishment of a robust and sustainable unemployment benefit system and enhanced support for job mobility that could provide a cushion against demand-dampening inequality and poverty. SOE restructuring remains essential in creating a new foundation for a sustainable growth trajectory.

Risks and challenges

Large external debt repayments maturing in 2017 and 2018 create a risk of disorderly adjustment in external imbalances. In 2017, the Government will need to allocate US$3.4 billion—or 7.5 percent of projected GDP—on public debt repayment and payment of interest. Meeting these obligations would require issuance of bonds denominated in foreign currency, both domestic and external. Current account balances are likely to worsen if commodity prices to remain low, further adversely affecting the terms of trade. Ultimately, this adjustment in external imbalances could have a negative impact on real incomes and poverty.

On the positive side, a faster pace of structural transformation – supported by a prudent policy mix – would strengthen financial sector, improve enterprise performance, and increase household in-comes. Export diversification could help the economy, especially when the global and regional recovery becomes stronger. However, this would require Belarusian enterprises to develop new competences in market entry and new product development. A strong commitment to reforms will be an important element to boost the market confidence and to mobilize private investment at home and from abroad in order to put Belarus on a sustainable growth trajectory.

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

	2014	2015	2016 e	2017 f	2018 f	2019 f
Real GDP growth, at constant market prices	1.7	-3.9	-2.6	-0.4	0.7	1.2
Private Consumption	4.3	-2.4	-5.8	-0.1	0.2	1.1
Government Consumption	-2.0	-0.4	-4.7	1.2	-3.1	-1.3
Gross Fixed Capital Investment	-5.3	-15.9	-18.4	-12.2	3.9	5.8
Exports, Goods and Services	5.3	-2.0	-0.8	-0.1	2.8	3.8
Imports, Goods and Services	2.4	-8.5	-3.1	-1.1	2.4	3.2
Real GDP growth, at constant factor prices	2.2	-4.2	-2.6	-0.4	0.9	1.4
Agriculture	2.8	-2.8	3.4	3.8	3.8	4.3
Industry	1.5	-6.8	-0.4	2.1	2.5	3.4
Services	3.0	-1.5	-6.7	-4.6	-2.0	-2.2
Inflation (Consumer Price Index)	18.1	13.5	11.8	10.0	9.5	8.5
Current Account Balance (% of GDP)	-6.9	-3.7	-3.6	-3.8	-3.8	-3.7
Financial and Capital Account (% of GDP)	7.5	4.3	4.2	4.4	4.4	4.3
Net Foreign Direct Investment (% of GDP)	2.4	2.4	2.1	2.1	2.5	2.8
Fiscal Balance (% of GDP)	1.1	1.2	1.6	0.7	0.9	1.3
Debt (% of GDP)	38.8	47.7	47.7	50.9	54.2	55.9
Primary Balance (% of GDP)	2.3	2.8	4.4	3.5	3.8	3.9
Poverty rate ($5/day PPP terms)[a,b,c]	0.3	0.6	0.6	0.6	0.6	0.6

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 2012-HHS and 2015-HHS.
(b) Projection using point-to-point elasticity (2012-2015) with pass-through = 1 based on private consumption per capita in constant LCU.
(c) Actual data: 2014, 2015. Nowcast: 2016. Forecast are from 2017 to 2019.

BOSNIA AND HERZEGOVINA

Table 1	2016
Population, million	3.5
GDP, current US$ billion	16.7
GDP per capita, current US$	4771
Gini Coefficient[a]	33.8
School enrollment, primary (% gross)[b]	101.2
Life Expectancy at birth, years[b]	76.3

Source:World Bank WDI and Macro Poverty Outlook
Notes:
(a) Most recent value (2011)
(b) Most recent WDI value (2014)

Economic growth in Bosnia and Herzegovina (BiH) is estimated to have reached 2.8 percent in 2016. Growth was driven primarily by consumption, with investments also supportive. Labor income contribution for poverty reduction was limited, in the absence of improvements in employment and with wages largely stagnant. As the reform agenda advances, economic growth is projected to accelerate to 4 percent in the medium term.

Recent developments

Growth is estimated to have reached 2.8 percent in 2016, down from 3 percent in 2015. Although consistent with this publication's earlier projection, growth is 0.4 percentage points (pp) lower than envisaged by the official estimates. Consumption remains the dominant driver of growth (1.8 pp contribution), with net exports and investments also supportive (0.7 pp and 0.3 pp contributions, respectively). On production side, agriculture and manufacturing contributed about 70 percent, together offsetting a contraction in services.

Unemployment remains high, with modest improvements in the labor market. The unemployment rate fell from 27.7 percent in 2015 to 25.4 percent in 2016, masking a reduction in employment in absolute terms, in spite of the positive economic growth. Still, the employment rate was not affected and even increased slightly, on account of a reduction of the working age population. The industrial sector created new employment in 2016, while agriculture and services shed employment in absolute terms. Public administration employment was also in decline. Unemployment among the youth (those between 15 and 24 years of age) has decreased but remains high, at 54.3 percent (59 percent for women and 52 percent for men). Given the strong connection of income of the bottom 40 percent of income distribution to labor income, poverty is expected to have remained unaltered. However, the lack of recent data for poverty monitoring limits the ability of producing an accurate diagnosis of living conditions in the country or to report progress in this arena .

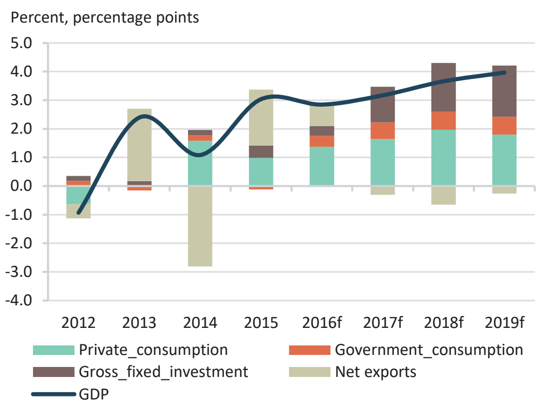
Consumer price deflation provided a small boost to real incomes. The consumer price index (CPI) dropped by 0.3 percent y-o-y in November, the 23th consecutive month of decline. The biggest driver of the fall were imported goods, reflecting low prices, such as food (down 0.6 percent y-o-y), clothing and footwear (down 8.4 percent), and out-patient services (down 4.7 percent). In contrast, notable price rises were seen for alcohol and tobacco, with smaller price rises for education, housing and utilities. Given the limited growth in nominal salaries, declining consumer prices provided a small boost to real incomes: the net monthly salary in November 2016 averaged €433, up by 2.5 percent y-o-y in nominal terms.

While strong fiscal consolidation was seen in 2015, fiscal accounts are likely to have deteriorated in 2016. The fiscal balance of BiH was in a positive surplus of 0.7 percent of GDP in 2015. With the 2016 revenues-to-GDP ratio projected to have remained stable, an increase in social spending and a recovery in capital spending, are estimated to have moved the fiscal balance to a deficit of 0.6 percent of GDP in 2016.

Outlook

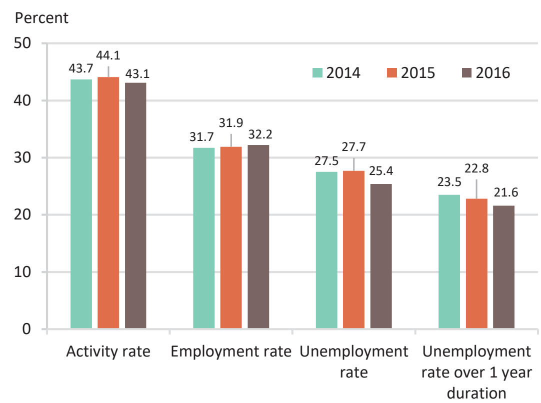
Supported primarily by domestic demand, economic growth is projected to strengthen from 2.8 percent in 2016 to 4

FIGURE 1 Bosnia and Herzegovina / GDP growth, contributions to growth



Sources: BiH Agency for Statistics (BHAS), World Bank staff estimates.

FIGURE 2 Bosnia and Herzegovina / Labor market indicators, 2014—2016



Sources: LFS 2014-2016 report, World Bank staff calculations.

percent by 2019. The strengthened growth performance will be underpinned by (i) a pick-up in investment resulting from expected improvements in the business environment, new energy, transport and tourism projects; and (ii) higher consumption due to steady flow of remittances, persistent deflation and low oil prices.

As poverty is strongly associated with unemployment and inactivity in BiH, for economic growth to translate into poverty reduction, improvements in labor market participation and employment will remain key. The implementation of new labor laws in both BiH Federation and Republika Srpska, and the introduction of support schemes for first-time job seekers, may support improved employment outcomes in 2017. However, as unemployment remains high, and since real wages are expected to remain largely flat due to the substantial remaining slack in the labor market, poverty is projected to remain stagnant or to decline only modestly over the next couple of years.

The current account deficit is forecast to improve in the short run due to favorable external conditions (low oil prices and improved external demand for exports). In the medium run, with slow progress on ongoing structural reforms, CAD is expected to deteriorate from 5 percent of GDP in 2016 to 6.7 percent of GDP by 2019. As the government proceeds with its ambitious fiscal adjustment, the consolidated overall fiscal balance is projected to move to a surplus of 1.6 percent of GDP in 2019. A balanced budget is projected in 2019, on the assumption of progress on the ongoing structural reform agenda.

Risks and challenges

Although fiscal deficit remains small, the fiscal situation still suffers from a combination of high tax burden and inefficient patterns of spending. Fiscal consolidation would not be effective if structural rigidities on the expenditure side are not addressed, especially the large public wage bill and sizeable and poorly targeted social assistance. Moreover, a full accounting of arrears does not exist in BiH and its reporting and monitoring is very weak. The presence of large undocumented public arrears poses a key risk to the prudent execution of fiscal policy. The size and complexity of public debt have increased in recent years. The ratio of BiH debt-to-GDP has risen from 30.2 percent in 2010 to 41.9 percent in 2015, consisting largely of concessional debt to IFIs. Sustained fiscal consolidation will be needed to bring down public debt to below 40 percent of GDP—an appropriate level for an emerging economy with a currency board and limited access to international markets.

Political uncertainties that could hold back the reform agenda are seen as the highest risk for the medium term outlook. Still continued progress on the reform agenda is evident as the country received in December 2016 a detailed Questionnaire from the European Commission on which its readiness to be granted EU candidate status will be evaluated -- the first step in the accession process. The three year Extended Fund Facility IMF program agreed in September 2016, and support from other partners like the World Bank, will also help the authorities to deliver on their ambitious reform agenda.

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

	2014	2015	2016 e	2017 f	2018 f	2019 f
Real GDP growth, at constant market prices	1.1	3.0	2.8	3.2	3.7	4.0
Private Consumption	1.9	1.2	1.7	2.1	2.5	2.3
Government Consumption	0.9	-0.5	1.8	2.8	3.0	3.0
Gross Fixed Capital Investment	1.1	2.5	2.0	7.4	9.6	9.6
Exports, Goods and Services	4.2	3.0	4.1	2.5	3.0	3.5
Imports, Goods and Services	8.1	-1.7	1.2	2.2	3.2	2.8
Real GDP growth, at constant factor prices	1.1	3.0	2.9	3.2	3.6	4.0
Agriculture	-12.7	8.5	5.0	2.8	3.0	3.0
Industry	1.8	3.0	3.0	2.7	3.0	3.0
Services	2.5	2.5	2.6	3.5	3.9	4.4
Inflation (Private Consumption Deflator)	-0.5	-0.5	-0.8	0.9	1.4	1.4
Current Account Balance (% of GDP)	-6.8	-5.4	-5.1	-6.0	-6.5	-6.7
Financial and Capital Account (% of GDP)	6.6	5.2	4.9	5.7	6.3	6.5
Net Foreign Direct Investment (% of GDP)	2.6	1.2	1.2	1.2	2.3	2.8
Fiscal Balance (% of GDP)	-2.0	0.7	-0.6	-0.6	-0.7	0.0
Debt (% of GDP)	41.8	41.9	42.5	40.6	39.1	37.4
Primary Balance (% of GDP)	-1.2	1.6	0.5	0.5	1.0	1.4

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

BULGARIA

Table 1	2016
Population, million	7.1
GDP, current US$ billion	51.6
GDP per capita, current US$	7239
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]	99.4
Life Expectancy at birth, years[b]	74.9

Sources: World Bank WDI and Macro Poverty Outlook.
Notes:
(a) Most recent value (2012)
(b) Most recent WDI value (2014)

Bulgaria's economic recovery continued in 2016 and supported improved fiscal performance but the medium-term outlook remains challenging. Stronger growth and improvements in the labor market 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

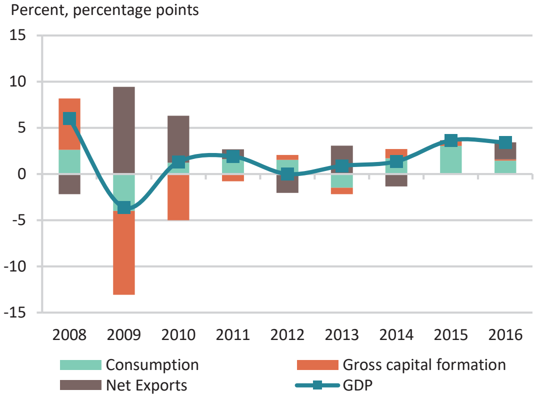
Similar to 2015, GDP grew by 3.4 percent in 2016, a significant improvement compared to the 2009-14 period. Exports, supported by strong demand from EU, expanded at a robust rate and were the key driver of growth. Private consumption continued to improve on the basis of low inflation and favorable labor market conditions. Unemployment declined to a seven-year low (7.6 percent of the labor force in 2016), new jobs were created in a number of sectors employing both high and low-skilled labor, and wages in the private sector grew by close to 10 percent in real terms compared to 2015. Although the slow start of EU financed capital projects negatively affected fixed investment, surge in inventories kept overall investment growth positive. Weaker investment compared to 2015 meant slower output and employment growth of industry and declining output and loss of jobs in construction. The recovery of agriculture output and productivity offset to some extent the lower contribution of industry and construction to GDP growth.

On account of robust economic growth and an equally strong labor market performance, poverty continued to decline in 2016. Moderate poverty ($5/day) and extreme poverty ($2.5/day) are estimated to have declined from 14.7 percent and 5.0 percent in 2015 to 13.7 percent and 4.8 percent, respectively, by the end of 2016. However, income inequality is one of the highest in the EU and has been increasing, with the income of the richest 20 percent of the population being more than seven times that of the poorest 20 percent in 2015. While declining, unemployment is still high, especially long-term and youth, and with high regional variation. Inactivity among certain groups of the population remains high as a result of an education system with deteriorating quality and rising inequality, and a large number of people excluded from economic opportunities, such as the elderly, people living in rural areas, and the Roma. Excluding a large number of people is especially damaging for growth in the case of Bulgaria which is undergoing the steepest decline in population in the world.

Strong economic activity and slow implementation of public investment projects strengthened Bulgaria's cash fiscal position. Fiscal accounts recorded a cash surplus of 1.6 percent of GDP in 2016, compared to a planned deficit of 2 percent. This was the first surplus since 2008 and was supported by sustained improvements in tax collection which more than offset lower revenues from EU grants. The slower than expected start of the new cycle of EU-financed capital projects, kept public spending well below the planned level and at close to 60 percent of its 2015 level.

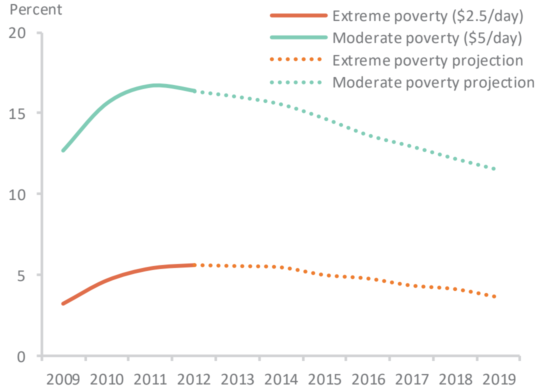
The external current account surplus continued to grow supported by further narrowing of the trade balance and declining FDI income payments. The trade deficit narrowed on an annual basis supported by favorable terms of trade and fast growing exports.

FIGURE 1 Bulgaria / GDP growth, contributions to growth



Sources: NSI and World Bank staff estimates

FIGURE 2 Bulgaria / Poverty rates, percent (at $2.5 and $5 per day, PPP terms)



Sources: World Bank staff estimates.

Outlook

GDP growth is projected to slow to 3.0 percent in 2017, as the positive contribution of external trade diminishes with oil prices surging and uncertainty in the EU increasing. Household consumption is likely to be the key driver of growth as labor market and credit conditions improve further. Going forward, the economic recovery is projected to be modest, with growth picking up to 3.2 percent in 2018 and 3.3 percent in 2019. Recovery of external demand is likely to be constrained by lingering geopolitical tensions in the region, and uncertainty related to the Brexit. Investor sentiment is likely to be affected by the ability of the new government to reinstate political stability and implement growth enhancing reforms.

Poverty reduction is expected to continue at a modest pace in the near term. Continued improvements in employment and wages, as well as scheduled increases in pensions and minimum wages, should support real incomes and therefore further reductions in poverty of the elderly and working poor. Moderate poverty is projected to fall to 13.0 percent in 2017 and 12.2 percent in 2018, whereas extreme poverty is projected to fall to 4.3 percent in 2017 and 4.1 percent in 2018.

The external current account is expected to continue to be in surplus, although declining by 2019. Export growth is projected to be robust, in line with Bulgaria's improved competitiveness on EU markets. Import growth is likely to be affected by higher oil prices and strengthening domestic demand for investment goods.

The fiscal position is likely to weaken slightly in 2017 but improve in the medium term. In 2017, fiscal accounts are set to be in a deficit of 0.6 percent of GDP (based on ESA 2010 methodology) as implementation of EU funded capital projects accelerates compared to 2016. Strong revenue collection driven by further improvements in compliance and an increased social contribution rate is likely to support fiscal consolidation in the medium term. 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.

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, annual average productivity growth over the last 5 years was 2.2 percent while improvements in labor force participation were constrained by skill shortages and a large portion of the population is at risk of poverty or social exclusion.

Enhancing productivity growth would require strengthening institutions, enhancing the skills and employability of all Bulgarians, and making public spending on health, pensions and long-term care more effective and efficient to ensure inclusiveness and sustainability of growth in the face of demographic changes.

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

	2014	2015	2016 e	2017 f	2018 f	2019 f
Real GDP growth, at constant market prices	1.3	3.6	3.4	3.0	3.2	3.3
Private Consumption	2.5	3.9	2.1	3.0	3.2	3.4
Government Consumption	-0.8	2.9	0.6	1.8	2.4	1.0
Gross Fixed Capital Investment	3.4	2.7	-4.0	1.0	3.5	3.7
Exports, Goods and Services	3.1	5.7	5.7	5.2	4.8	4.9
Imports, Goods and Services	5.2	5.4	2.8	3.1	4.4	4.8
Real GDP growth, at constant factor prices	1.5	3.1	2.7	3.0	3.2	3.3
Agriculture	4.8	-6.8	4.3	1.2	1.5	1.5
Industry	0.3	4.2	2.0	2.1	3.3	3.3
Services	1.7	3.3	3.0	3.5	3.3	3.5
Inflation (Consumer Price Index)	-1.4	-0.1	-0.8	1.1	1.3	1.3
Current Account Balance (% of GDP)	0.1	0.4	3.9	2.7	1.5	0.3
Financial and Capital Account (% of GDP)	2.9	-3.8	-4.3	-0.6	0.5	1.7
Net Foreign Direct Investment (% of GDP)	2.7	3.7	1.6	1.9	2.2	3.1
Fiscal Balance (% of GDP)	-5.5	-1.7	1.0	-0.6	-0.4	0.0
Debt (% of GDP)	27.0	26.0	27.4	26.6	25.7	24.5
Primary Balance (% of GDP)	-4.7	-0.8	1.9	0.3	0.5	0.9
Poverty rate ($2.5/day PPP terms)[a,b,c]	5.5	5.0	4.8	4.3	4.1	3.6
Poverty rate ($5/day PPP terms)[a,b,c]	15.6	14.7	13.7	13.0	12.2	11.5

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 2012-EU-SILC.
(b) Projection using neutral distribution (2012) with pass-through = 0.87 based on GDP per capita in constant LCU.
(c) Nowcast: 2014 - 2016. Forecast are from 2017 to 2019.

CROATIA

Table 1	2016
Population, million	4.2
GDP, current US$ billion	50.2
GDP per capita, current US$	12018
Poverty rate ($2.5/day 2005PPP terms)[a]	2.1
Poverty rate ($5/day 2005PPP terms)[a]	9.4
Gini Coefficient[a]	32.5
Life Expectancy at birth, years[b]	77.1

Source:World Bank WDI and Macro Poverty Outlook
Notes:
(a) Most recent value (2012)
(b) Most recent WDI value (2014)

Growth strengthened in 2016 led by exports, domestic demand and investment recovery. Given the labor market recovery and real wage and disposable income increase, the poverty rate has continued trending downwards to 8.4 percent (at $5/day PPP). Due to the improved fiscal outcomes, Croatia would likely exit the Excessive Deficit Procedure in 2017. Yet, fiscal imbalances would require further narrowing in the medium term, while stronger personal consumption and EU funds absorption would continue to support solid growth in 2017-19.

Recent developments

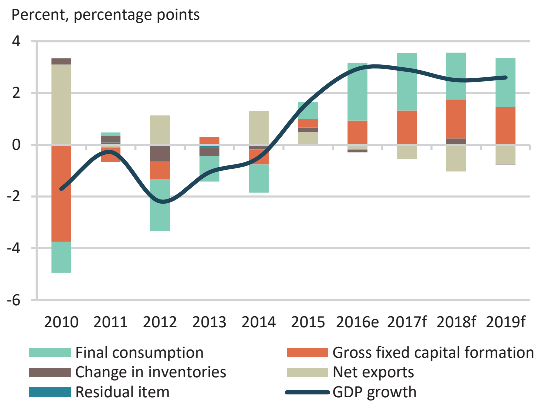
Growth doubled in 2016 to 2.9 percent on the back of the record-high tourist season, accelerated private consumption, and a rebound of investment after six years of decline. The recovery was broad based, with a surge in industrial production, construction and tourism contributing the most to the accelerated growth.

Labor market performance improved with a sharp decline of unemployment to 14 percent in 2016 (down by 2.5 percentage points from 2015) as job creation and net migration outflows intensified. A high level of emigration (around 54,000 people left the country) and continued outflows from inactivity into early retirement, led to declines in labor force participation. Thus, the employment rate remained at low 44.5 percent, far below the EU average.

Real net wages increased by 3 percent due to the deflationary and labor market pressures in sectors that face skill shortages. Compared to the pre-crisis level, real per capita income in 2016 stood at about 4 percent lower level, while the absolute poverty rate measured at $5/day PPP increased from 5.9 in 2009 to 8.4 percent in 2016. This increase of absolute poverty between 2009 and 2016 was largely driven by a downturn of labor markets – both a decrease of total employment and real wages – and limited public transfers to poor and especially elderly households that show poverty rates far above the national average.

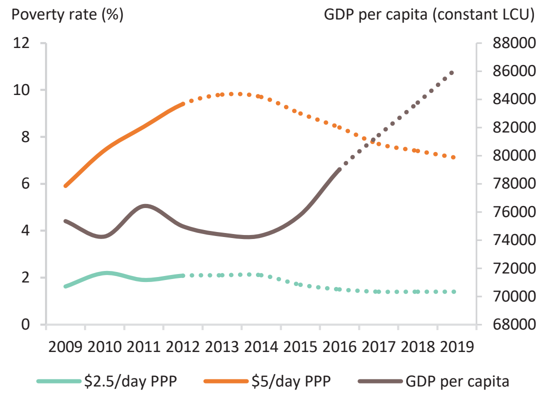
External imbalances narrowed as current account remained in surplus of 2.7 percent of GDP in 2016. Net exports of services due to a record-high tourist season and improved absorption of EU funds have contributed most to this result. Domestic demand recovery underpinned import growth that led to deterioration of trade balance, which increased to 16.2 percent of GDP. External debt declined to 91.4 percent of GDP in 2016, over 12 percentage points lower level than a year ago driven by continued deleveraging of both financial sector and government, which switched its refinancing to domestic market. Fiscal consolidation continued in 2016 with general government deficit (ESA methodology) narrowing to below 2 percent of GDP from 3.3 percent in 2015. Revenues increased substantially led by rising tax revenues (especially corporate tax, VAT and excises), while spending was restraint due to temporary financing in effect throughout the first quarter after the general elections and no government until the snap elections in September 2016. Yet, given the automatic rise, public wage bill and social spending grew. Given the robust primary surplus, public debt decreased to 84.2 percent of GDP from 86.6 percent at end-2015. Croatia is likely to meet the requirements for exiting the Excessive Deficit Procedure (EDP) from June 2017. Yet, the 2017 budget target a rise in headline as well as the structural deficit, which may put the country back under the EDP unless corrective measures are not undertaken. Government adopted the 2017 budget with a deficit of 2.1 percent of GDP relax-

FIGURE 1 Croatia / GDP growth, contributions to growth



Sources: CROSTAT, World Bank.

FIGURE 2 Croatia / Actual and projected poverty rates and real GDP per capita, 2009-2019



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

ing both revenue as well as spending amid optimistic growth projection of over 3 percent. Aside from personal tax cuts, tax reform includes profit tax reduction to 18 percent (from 20 percent) while SMEs with income lower than 3 million HRK now pay a 12-percent profit tax. In addition, lower VAT rate of 13 percent is applied to the delivery of electricity, waste collection, funeral services and farming raw materials. The estimated loss of revenues is 0.6 percent of GDP. Budget also raised civil servants' wages by over 6 percent, veterans' benefits as well as maternity benefits in a quest to prevent further demographic decline. The spending rise accounts for 1 percent of GDP.

Outlook

The economy is expected to grow by 2.9 percent in 2017, and around 2.6 percent in 2018-19. Growth will be led by strengthened personal consumption, tourism and investments, benefitting from the EU funds absorption. Personal consumption is expected to intensify reflecting personal tax reform, labor market recovery, and a pick-up in lending activity. Current account surplus will decline to 1.6 percent given a high import-reliance of the growth model.

Croatia might exit the Excessive Deficit Procedure in 2017 based on the past performance. Public finances would continue to improve with headline fiscal deficit amounting to 1.7 percent of GDP in 2017-19, although structural deficit would grow to 3 percent of GDP. Positive labor market developments and an increase of real pensions by 1.6 percent year-on-year mainly due to the deflationary pressures in 2016, are expected to support growth of disposable income for all segments of the welfare distribution. A tax reform package which includes personal tax cuts with income brackets changed from 12, 25 and 40 percent to 24 and 36 percent along with an increase of non-taxable income by 46 percent would also support the income growth. It is expected that by 2019 the absolute poverty rate measured at $5/day PPP will decline further to 7.1 percent.

Risks and challenges

Risks are still skewed to the downside. Although fiscal outcomes are better than expected, new fiscal expansion and domestic policy uncertainty adds to the risks of slowing down the pace of structural reforms and achieving sustainability of public debt. Still high levels of private and public sector indebtedness amid the Fed's monetary tightening and the increased volatility on the financial market are set against the country's borrowing requirements of 11 percent of GDP in 2017-19. Sustained fiscal consolidation and competitiveness reforms are needed to reduce macroeconomic imbalances and protect nascent recovery. Yet, the growth recovery has reduced the reform drive. Improvements in labor markets will be key to achieve a sustainable reduction in absolute poverty. However, this will only materialize if the domestic economy is able to create additional jobs such that the unemployment rate can decline further, and activity rates and employment rates increase substantially. The increase in fixed-term employment – particularly high among new hires – became possible through a liberalization of the labor market in 2013 and 2014, and opens a pathway into the labor market, but looking forward it also creates risks in terms of a dual labor market which potentially undermines the role of labor markets to support private consumption growth and welfare improvements.

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

	2014	2015	2016 e	2017 f	2018 f	2019 f
Real GDP growth, at constant market prices	-0.4	1.6	2.9	2.9	2.5	2.6
Private Consumption	-0.7	1.2	3.3	3.5	2.7	2.6
Government Consumption	-1.9	0.6	1.7	1.0	1.2	2.0
Gross Fixed Capital Investment	-3.6	1.6	4.6	6.0	7.0	6.5
Exports, Goods and Services	7.3	9.2	6.7	5.6	4.2	4.4
Imports, Goods and Services	4.3	8.6	7.3	7.0	6.4	5.9
Real GDP growth, at constant factor prices	-0.1	1.4	2.8	2.9	2.5	2.6
Agriculture	0.0	-0.4	0.1	2.0	2.1	2.2
Industry	0.5	1.9	4.3	2.8	2.7	2.7
Services	-0.3	1.3	2.4	3.0	2.4	2.6
Inflation (Consumer Price Index)	-0.2	-0.5	-1.0	1.0	1.5	2.0
Current Account Balance (% of GDP)	2.0	5.3	2.7	1.9	1.5	1.2
Financial and Capital Account (% of GDP)	-0.8	-3.8	0.5	-2.7	-2.4	-2.1
Net Foreign Direct Investment (% of GDP)	1.6	0.6	4.3	3.1	3.1	3.1
Fiscal Balance (% of GDP)	-5.4	-3.3	-1.9	-2.1	-1.8	-1.2
Debt (% of GDP)	86.6	86.7	84.2	83.8	82.1	80.4
Primary Balance (% of GDP)	-1.9	0.3	1.5	1.3	1.6	2.1
Poverty rate ($2.5/day PPP terms)[a,b,c]	2.1	1.7	1.5	1.4	1.4	1.4
Poverty rate ($5/day PPP terms)[a,b,c]	9.7	9.0	8.4	7.7	7.4	7.1

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 = 0.87 based on GDP per capita in constant LCU.
(c) Nowcast: 2014 - 2016. Forecast are from 2017 to 2019.

GEORGIA

Table 1	2016
Population, million	3.7
GDP, current US$ billion	14.2
GDP per capita, current US$	3833
Poverty rate ($2.5/day 2005PPP terms)[a]	31.2
Poverty rate ($5/day 2005PPP terms)[a]	69.3
Gini Coefficient[a]	38.5
School enrollment, primary (% gross)[b]	116.9
Life Expectancy at birth, years[b]	74.5

Source:World Bank WDI and Macro Poverty Outlook
Notes:
(a) Most recent value (2015)
(b) Most recent WDI value (2014)

Georgia's economy grew by 2.7 percent in 2016, driven by construction and other non-tradables. In 2017 growth is projected to recover moderately at 3.5 percent, led by external demand and public investment. As a result, the fiscal deficit will remain elevated at 4.1 percent of GDP, unchanged from 2016. Poverty is expected to decline modestly in 2017 as economic growth recovers and translates into higher labor income.

Recent developments

Amidst a worsened external environment, exports declined by 4 percent in 2016. Remittances recovered in the second half of the year (after a weak start) increasing by 7 percent for 2016 as a whole. In contrast, construction and other non-tradables grew by 20 percent, raising GDP growth in 2016 to 2.7 percent. Net employment creation has, however, been low until recently, explaining the limited role it has played in poverty reduction. In rural areas, the sale of agricultural products contributed to poverty reduction, although it still lags labor income and social assistance. Despite the continuous downtrend in poverty in recent years, large urban-rural disparities persist.

In an effort to support growth, the government boosted capital spending by 6 percent in 2016. This was accompanied by a 13 percent increase in current spending, widening the fiscal deficit to 4.1 percent of GDP.

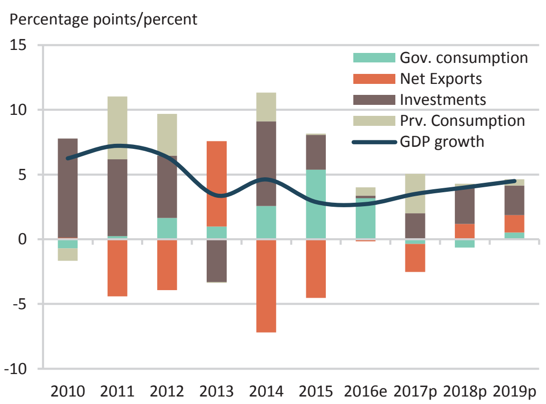
With economic growth below potential, real effective exchange rate appreciation (due to stronger nominal depreciation in partner countries than in Georgia) and high unemployment, inflation remained low at 1.8 percent (y/y) in December 2016; as a result, the National Bank of Georgia maintained its policy rate at 6.5 percent. However, the policy rate was raised in January 2017 (by 25 basis points) to reflect rising inflation expectations from higher excise taxes. Prudent banking supervision reinforced the stability of the banking sector, yielding a return on assets of 2.8 percent and return on equity of 19.2 percent. Nonperforming loans (>90 days past due) represented only 3.7 percent of gross loans in December 2016, down from 2015 level of 4.4 percent. The decline in exports and remittances, along with the slow adjustment of imports, widened the current account deficit from 12 percent of GDP in 2015 to 13.3 percent in 2016. Foreign direct investment financed nearly 90 percent of the deficit. External debt increased from 107 percent of GDP in 2015 to 108 percent in 2016 driven by the higher external deficit and a 10 percent nominal depreciation of the Lari.

Poverty at 2005 PPP US$2.5 per day fell to 31.2 percent in 2015, continuing a decline that began in 2010 (when poverty peaked at 46.7 percent). Estimates suggest poverty declined further in 2016, although at a slower pace because of modest economic growth. During 2013-15, poverty reduction was largely driven by a combination of strong growth in the construction and non-tradable sectors, both of which employ a large number of unskilled workers, and an increase in agricultural income.

Outlook

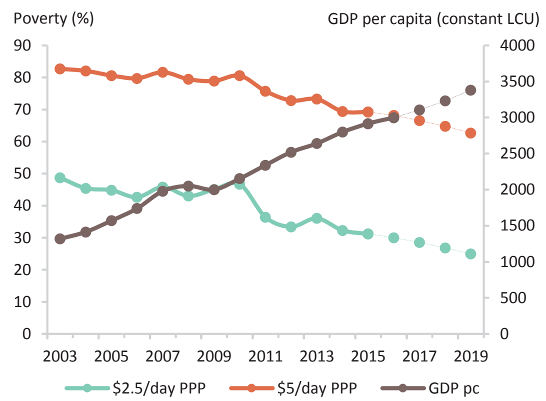
Economic growth is projected to average 4 percent a year over the medium-term, but downside risks to growth remain. The pick-up in growth in 2017 will largely be driven by high investment and some recovery in the export markets. With the Russian economy recovering in 2017 and

FIGURE 1 Georgia / GDP growth decomposition



Source: WB estimates based on Geostat statistics.

FIGURE 2 Georgia / Poverty rate and GDP per capita



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

an uptick in oil prices, growth in Georgia's trading partners is likely to increase, raising Georgia's export. FDI inflows, which largely originated from Azerbaijan and Turkey in 2016, remain resilient. In the outer years, growth prospects factor in improved economic ties with the EU. The downside risks arise primarily from a protracted period of slowdown among Georgia's trading partners.

Fiscal sustainability is expected to be strengthened through the revenue enhancing measures announced in the 2017 budget to counter the impact of the adoption of the Estonian tax model. The latter, which replaced the corporate income tax with a dividend tax, came into effect in January 2017, reducing tax revenues by 1.5 percent of GDP. To offset this loss, the government increased excise for tobacco and fuel, and introduced an excise tax on cars. Under the 2017 budget, the government committed to restraining current spending. The fiscal deficit is expected to narrow in 2017-20 as a result of these measures. However, capital expenditures and net lending are budgeted to increase from 6.5 percent of GDP in 2016 to 8 percent. Georgia's public debt rose to 45 percent of GDP in 2016 and is likely to be maintained at this level over the medium-term.

The poverty rate is projected to continue declining through 2018, reaching 26.8 percent (measured at US$2.5/day). Economic recovery in general (and of construction activity, in particular, supported by anticipated investments) is expected to drive poverty reduction through increased job opportunities. However, employment generation in tradeable sectors will be critical for sustaining the declining poverty trend going forward. It is unlikely that large social transfers would drive poverty reduction in the near future against the background of limited fiscal space.

Risks and challenges

Key macroeconomic vulnerabilities faced by Georgia include risks to external and fiscal sustainability. Continued disturbance in some of Georgia's main export markets and longer-term stagnation in the EU could further impact external performance. On the fiscal front, lower corporate tax revenues, high social spending commitments and plans to significantly ramp up capital spending pose risks to the plans for fiscal consolidation. In addition, contingent liabilities arising from state owned enterprises and the existing power purchase agreements with hydropower companies also pose potential risks to fiscal sustainability.

The pace of poverty reduction may continue slowing down, and eventually stall if the pace of private sector employment growth in recent years were not to endure. Rural poverty risks remain high if agricultural productivity does not increase and non-agricultural employment opportunities do not continue to expand.

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

	2014	2015	2016 e	2017 f	2018 f	2019 f
Real GDP growth, at constant market prices	4.6	2.9	2.7	3.5	4.0	4.5
Private Consumption	3.2	0.1	1.0	4.7	0.3	0.8
Government Consumption	11.2	22.1	11.0	-1.2	-2.1	1.9
Gross Fixed Capital Investment	24.4	11.7	6.9	6.8	9.6	7.1
Exports, Goods and Services	0.4	6.0	-0.8	4.0	3.2	4.7
Imports, Goods and Services	11.1	10.4	-0.3	5.5	0.4	1.2
Real GDP growth, at constant factor prices	4.4	3.2	2.6	2.2	4.2	4.2
Agriculture	1.6	1.5	3.0	4.0	2.0	1.0
Industry	4.6	4.1	6.0	6.0	5.0	4.0
Services	4.7	3.1	1.5	0.7	4.1	4.7
Inflation (Consumer Price Index)	3.1	4.0	2.1	5.7	2.4	3.0
Current Account Balance (% of GDP)	-10.6	-11.9	-13.3	-12.6	-12.2	-11.4
Financial and Capital Account (% of GDP)	10.6	11.9	13.3	12.6	12.2	11.4
Net Foreign Direct Investment (% of GDP)	8.1	9.0	11.0	10.3	10.0	9.9
Primary Balance (% of GDP)	-2.1	-2.8	-2.9	-2.7	-2.4	-2.1
Poverty rate ($2.5/day PPP terms)[a,b,c]	32.3	31.2	30.0	28.5	26.8	25.0
Poverty rate ($5/day PPP terms)[a,b,c]	69.4	69.3	68.2	66.6	64.8	62.7

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 2015-HIS.
(b) Projection using neutral distribution (2015) with pass-through = 0.87 based on GDP per capita in constant LCU.
(c) Actual data: 2014, 2015. Nowcast: 2016. Forecast are from 2017 to 2019.

KAZAKHSTAN

Table 1	2016
Population, million	17.8
GDP, current US$ billion	133.7
GDP per capita, current US$	7511
Poverty rate ($2.5/day 2005PPP terms)[a]	0.6
Poverty rate ($5/day 2005PPP terms)[a]	19.5
Gini Coefficient[a]	26.5
School enrollment, primary (% gross)[b]	110.7
Life Expectancy at birth, years[b]	70.5

Source:World Bank WDI and Macro Poverty Outlook
Notes:
(a) Most recent value (2015)
(b) Most recent WDI value (2014)

In 2016, Kazakhstan's real GDP growth continued to slow and real wages declined further, adversely affecting poverty rates. The authorities reacted by extending additional spending measures and loosening monetary policy during the year. Medium-term growth is projected to pick up slowly as oil prices recover and oil production gradually expands. To improve Kazakhstan's growth prospects, and to enhance the sustainability and inclusiveness of growth, the authorities will need to deepen structural reforms designed to facilitate economic transformation.

Recent developments

Kazakhstan's economy continued to suffer from a protracted slowdown in global oil prices and weak domestic demand. Real GDP growth declined from 1.2 percent in 2015 to an estimated 1 percent in 2016.

On the supply side, a declining oil production and slowing growth in the services sector hindered overall economic growth, but rising output in the agriculture and metallurgy sectors partially offset this dynamic. Construction also expanded, due to large projects in the oil sector.

On the demand side, private consumption weakened considerably due to the pass-through effect of currency devaluation that fueled inflation to 14.6 percent (annual average) and undermined the purchasing power of households. Inflationary pressures subsided in Q4 2016, allowing the central bank to loosen its contractionary monetary policy stance.

Banking sector activity remained depressed, and lending to the economy continued contracting in real terms. The authorities announced plans to support the sector by recapitalizing large banks and addressing nonperforming loan (NPL) issues. For this purpose, the government will inject an additional US$6.5 billion into the Problem Loans Fund in 2017.

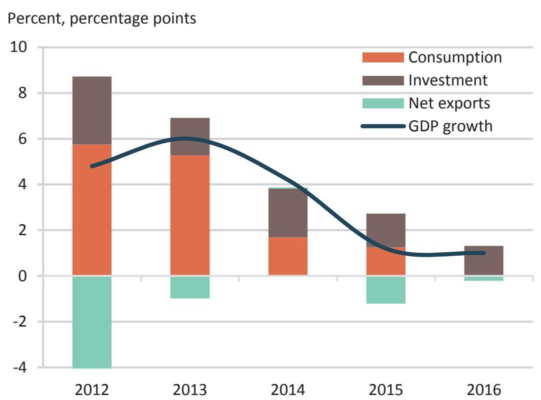
Lower oil prices and oil output also widened the current account deficit significantly—from 3 percent of GDP in 2015 to 6.1 percent in 2016. However, investments in oil production pushed up net foreign direct investment inflows to 10.7 percent of GDP, more than offsetting the current account deficit. This enabled the central bank to partially replenish its international reserves, which it had drawn down to finance foreign exchange interventions in previous years.

During 2016, the government maintained an accommodative fiscal policy to support economic growth, and the authorities postponed a planned fiscal consolidation. The extended economic support program focuses on increasing pensions, stipends, and other social transfers, including disability benefits and survivor allowances. The package also maintains subsidies to state-owned enterprises (SOEs) and small and medium enterprises, while providing support for bank recapitalization. While the overall fiscal deficit narrowed from 7.8 percent of GDP in 2015 to 5.3 percent in 2016, the nonoil deficit remained elevated at 10.2 percent of GDP in 2016, 2 percentage points higher than its pre-crisis level.

The economic slowdown negatively affected the labor market and affected household income adversely in 2016, with the decline in average real wages (0.9 percent) and employment (0.5 percent). Women and youth are the first to experience the effects of the slowdown. During 2014-15, the female labor market participation rate slid from 66.4 percent to 65.7 percent and youth unemployment rose from 6.8 percent to 8.3 percent. Consequently, the poverty rate (PPP US$5 per day) rose from 16.1 to 19.5 percent in 2014-15 and stabilized at an estimated 19.8 percent in 2016.

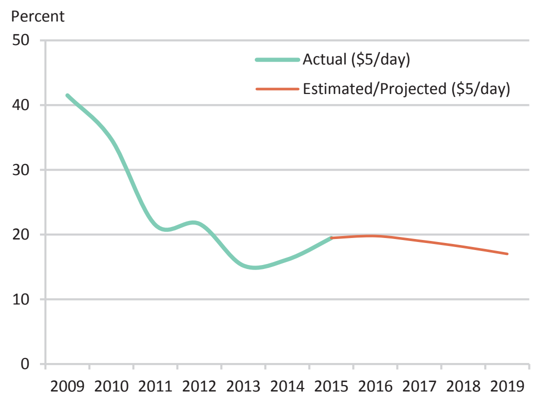
The authorities attempted to mitigate the impact of falling real incomes by adjusting

FIGURE 1 Kazakhstan / Contribution to GDP growth



Sources: Statistical Office of Kazakhstan.

FIGURE 2 Kazakhstan / Actual and projected poverty rates



Sources: World Bank staff estimates.

pensions and other social transfers and expanding employment support programs. An increase in social transfers from 3.8 percent of GDP in 2015 to 4.0 percent in 2016 primarily benefitted households receiving pensions, and their income levels remained steady. To support employment and labor productivity, the government allocated additional funding to the Employment Road Map-2020, and adopted a Productive Employment and Mass Entrepreneurship Program for 2017-2021. However, these measures were unable to mitigate the full impact of the slowdown on household income, especially for low income families.

Outlook

Economic activity is projected to pick up gradually over the medium term, but growth will remain well below its 2014 level, when the oil price shock hit the economy. Output is projected to expand by 2.4-2.9 percent per year during 2017-19, reducing the poverty rate to a level of about 17 percent by 2019. A projected increase in oil prices from US$55 per barrel in 2017 to about US$60-62 in 2018-19 will drive growth, supported by increased oil production, as rising output at the Kashagan offshore oil field is expected to more than offset declining output among older oilfields.

The outlook for the current account is generally positive, while the fiscal position is expected to deteriorate, due in part to the large banking sector support package approved in early 2017. Efforts to resolve NPL problems in the banking sector, however, are expected to support growth by facilitating the long-awaited recovery of lending to the economy. Over the longer term, the ongoing implementation of the "100 Concrete Steps" institutional reform program may have positive spillovers for private sector development and economic diversification.

Gradually improving economic performance will allow the government to resume the fiscal consolidation process while protecting the existing social spending commitments and efforts to strengthen safety nets for households in extreme poverty. The government is also expected to make further progress on the restructuring and privatization of SOEs in 2017 and 2018, which will be critical for lowering fiscal risks.

An improving economy will allow the central bank to maintain its focus on inflation targeting. Going forward, the flexible exchange rate regime will help the economy better absorb external shocks.

As the inflationary pass-through effect of the recent currency depreciation fades, real wages and consumer purchasing power are expected to improve. This may help accelerate poverty reduction, though at a much slower pace than before.

Risks and challenges

Downside risks to Kazakhstan's economic outlook include the potential weakening of the external environment, capacity constraints, and the loss of reform momentum. The economy's vulnerability to external shocks remains the major source of risk to medium-term growth and poverty reduction. The anticipated political transition, including an ongoing constitutional reform process, may slow the shift to a new development model aimed at promoting more sustainable and inclusive growth. The successful implementation of the institutional and structural reforms included in the "100 Concrete Steps" program will be vital to strengthen public institutions and improve the quality of human capital. If successfully implemented, these reforms will likely contribute to improved living standards, poverty reduction, and shared prosperity.

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

	2014	2015	2016 e	2017 f	2018 f	2019 f
Real GDP growth, at constant market prices	4.2	1.2	1.0	2.4	2.6	2.9
Private Consumption	1.4	1.8	-0.5	1.0	1.5	2.0
Government Consumption	9.8	2.4	2.4	1.7	-2.3	1.7
Gross Fixed Capital Investment	4.4	4.2	5.3	7.4	7.1	5.8
Exports, Goods and Services	-2.5	-4.1	-3.0	3.5	1.8	2.1
Imports, Goods and Services	-4.0	-0.1	-2.7	4.1	2.0	2.2
Real GDP growth, at constant factor prices	3.9	1.9	1.0	2.5	2.6	2.9
Agriculture	1.3	3.5	5.5	3.0	3.0	3.0
Industry	1.5	-0.4	0.6	3.3	2.3	2.6
Services	5.7	3.2	0.9	2.0	2.8	3.1
Inflation (Consumer Price Index)	6.7	6.6	14.6	6.2	4.7	4.9
Current Account Balance (% of GDP)	2.7	-3.0	-6.1	-2.4	-1.4	-1.2
Financial and Capital Account (% of GDP)	3.3	5.5	7.2	3.3	2.2	2.0
Net Foreign Direct Investment (% of GDP)	2.2	1.8	10.7	2.6	2.4	2.2
Fiscal Balance (% of GDP)	0.0	-7.8	-5.3	-8.0	-3.3	-3.4
Debt (% of GDP)	14.5	21.9	20.1	18.3	20.0	22.3
Primary Balance (% of GDP)	0.6	-7.1	-4.2	-7.1	-2.7	-2.7
Poverty rate ($2.5/day PPP terms)[a,b,c]	0.4	0.6	0.6	0.5	0.5	0.5
Poverty rate ($5/day PPP terms)[a,b,c]	16.1	19.5	19.8	19.0	18.1	17.0

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 2015-HBS.
(b) Projection using neutral distribution (2015) with pass-through = 1 based on GDP per capita in constant LCU.
(c) Actual data: 2014-2015. Nowcast: 2016. Forecast are from 2017 to 2019.

KOSOVO

Table 1	2016
Population, million	1.8
GDP, current US$ billion	6.6
GDP per capita, current US$	3654
School enrollment, primary (% gross)[a]	n.a.
Life Expectancy at birth, years[a]	70.8

Source:World Bank WDI and Macro Poverty Outlook
Notes:
(a) Most recent WDI value (2014)

The economy grew by 3.6 percent in 2016, driven primarily by private consumption and investment. Higher growth rates are projected for 2017-18, boosted by public investment pickup. Growth resulted in employment creation in 2016, supporting poverty reduction at home; but sustained poverty reduction remains challenging as labor markets remain weak and pressures to seek employment abroad remain high.

Recent developments

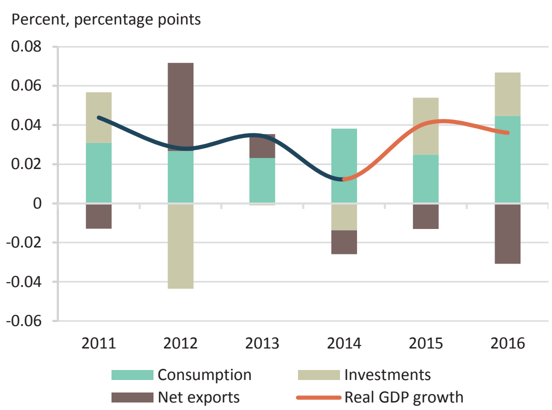
Kosovo's economy is estimated to have grown at 3.6 percent in 2016. Growth in 2016 was due to consumption (contributing 4.5 percentage points, pp) and an investment-driven recovery in domestic demand (2.2 pp). Net exports subtracted 3.1 pp from growth, as growth of exports of travel services could not match that of imports for domestic consumption and investment. A healthy expansion of activities in trade, transportation, financial sector and accommodation made the services sector a chief contributor to growth, followed by agriculture, and industry.

Improved revenue collection and a low execution of the capital budget helped contain the fiscal deficit to about 1.3 percent of GDP in 2016. A combination of both collection efforts and policy change (increase in the VAT rate from 16 to 18 percent at the end of 2015) contributed to a 2.3 percent of GDP increase in tax revenues in 2016. Revenues grew by 5.6 percent y/y, and expenditures 6.5 percent y/y, including 9.8 percent y/y growth in capital investments, 10.7 percent y/y in transfers and 4.1 percent y/y in wages. The fast increase in transfers was due to the increase in the number of beneficiaries qualifying for the war veteran social assistance, adding to fiscal pressures, and reducing the fiscal room for targeted support to the poor. The public and publicly guaranteed debt is still low by regional comparison, but continued its upward trend reaching 14.6 percent of GDP in 2016 from 12.9 percent of GDP in 2015.

The current account deficit (CAD) widened from 10.4 percent of GDP in 2015 to 11.5 percent of GDP in 2016, primarily due to a deteriorating trade deficit (3.2 percent increase y/y). Imports grew by 6.7 percent y/y on account of strong domestic demand. Meanwhile, lower prices for base metals led to a 4.6 percent y/y decline in exports (Ferronikeli, the main exporter, temporarily halted production due to low prices). Declining FDI inflows weighed down the financial account balance in 2016. Net FDI fell by 34.4 percent y/y as at the end November 2016 because of a 29.2 percent decline in FDI inflows (likely signaling the start of saturation in the diaspora's demand for real estate and financial intermediation services), and a 25.7 percent increase in equity investment and fund shares outflows. Consumer prices increased on average 0.3 percent in 2016 driven by higher fuel and food prices by the end of 2016, but still low to help maintain purchasing power of household incomes.

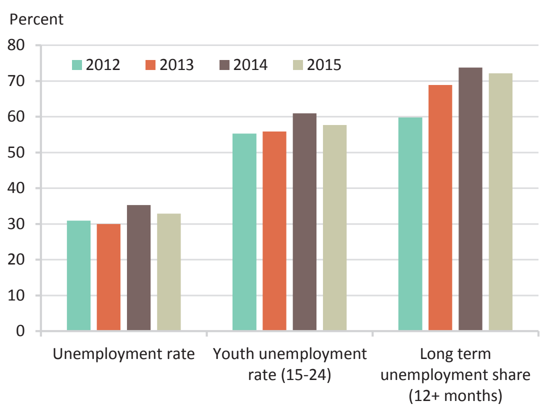
The labor market is showing some signs of improvement and contributing to poverty reduction. Unemployment among women fell by 5 percentage points in 2015 to 36.3 percent (male unemployment fell from 33.3 to 31.8 percent). The share of employed in vulnerable employment also declined in 2015. Based on preliminary data, there have been further declines in unemployment rate including that of the youth in 2016, although these dynamics remain to be ascertained once data for the full year are available. Poverty declined in 2015 on account of the economic recovery, particular-

FIGURE 1 Kosovo / GDP growth, contributions to growth



Sources: Statistics Agency of Kosovo and WB staff.

FIGURE 2 Kosovo / Key unemployment indicators



Sources: Statistics Agency of Kosovo and WB staff.

ly in agriculture, higher remittances, wages and pensions, and is projected to have continued on a downward trend in 2016 driven by labor market improvements, and benefiting from stable prices.

Outlook

Economic growth in Kosovo is projected to reach 3.9 percent in 2017, as higher public and private investments are expected to contribute 2.7 pp to overall growth, and higher disposable incomes will contribute to higher consumption (a further 2.3 pp of overall GDP growth). The contribution of net exports will remain negative on account of fast import growth and weak exports constrained by a small export base.

The fiscal rule is expected to keep the fiscal deficit low, while the recently adopted investment amendment is opening up some fiscal space for IFI-financed capital projects in strategic sectors, which will boost public investment and economic growth. Doubts remain, however, as to the government's capacity to absorb these funds.

Investment growth will cause a slight widening of the current account deficit (CAD) in 2017-2018. FDI is expected to increase in 2018-19, especially with new investments in power generation capacities. This should boost growth and provide additional employment opportunities.

The financial sector is expected to remain liquid and strong with both loans and deposits growing, while NPLs declining due to good market conditions.

Poverty is projected to continue declining slowly in 2017-2018, on account of some improvements in the labor market, a recovery in agriculture, as well as higher remittances and stable prices. Yet, poverty reduction during the forecasting period will remain constrained by high inactivity and unemployment rates, particularly among youth, and by firms' limited capacity to create net new jobs.

Risks and challenges

The outlook is subject to downside risks. They include the sensitive political situation in the north and demarcation with Montenegro, and perceived high corruption, that have disrupted economic agenda. Addressing high unemployment and poverty requires significant structural reforms to boost economic growth and make it more inclusive.

The overall positive economic forecasts depend on growing FDI inflows, which cannot materialize in the presence of key political/domestic risks. Reform priorities include shifting the sources of growth towards tradable sectors, increasing domestic productivity, engaging and providing employment opportunities to youth, addressing corruption, improving environmental sustainability and addressing constraints in the energy sector.

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

	2014	2015	2016 f	2017 f	2018 f	2019 f
Real GDP growth, at constant market prices	1.2	4.1	3.6	3.9	4.2	4.4
Private Consumption	4.8	4.0	5.8	2.0	3.3	2.2
Government Consumption	-2.5	-6.5	-4.1	3.7	1.8	1.6
Gross Fixed Capital Investment	-3.3	12.5	8.6	10.6	8.0	7.0
Exports, Goods and Services	16.8	2.5	4.8	2.8	5.0	8.4
Imports, Goods and Services	8.6	3.6	8.1	4.4	4.2	2.9
Real GDP growth, at constant factor prices	5.1	2.9	5.7	4.4	4.9	5.2
Agriculture	0.8	-4.1	13.2	6.8	8.4	9.0
Industry	0.1	5.9	6.8	4.8	5.9	6.2
Services	9.3	2.9	3.4	3.6	3.4	3.6
Inflation (Consumer Price Index)	0.4	-0.5	0.3	0.7	1.2	1.7
Current Account Balance (% of GDP)	-9.1	-10.4	-11.5	-12.5	-13.3	-12.9
Fiscal Balance (% of GDP)	-2.6	-1.9	-1.3	-2.6	-2.9	-2.9
Debt (% of GDP)	10.6	12.9	14.6	17.6	20.4	22.0
Primary Balance (% of GDP)	-2.4	-1.7	-0.9	-2.1	-2.4	-2.4

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.

Note: f = forecast.

KYRGYZ REPUBLIC

Table 1	2016
Population, million	6.0
GDP, current US$ billion	6.6
GDP per capita, current US$	1083
Poverty rate ($2.5/day 2005PPP terms)[a]	32.9
Poverty rate ($5/day 2005PPP terms)[a]	85.0
Gini Coefficient[a]	29.0
School enrollment, primary (% gross)[b]	106.1
Life Expectancy at birth, years[b]	70.2

Source:World Bank WDI and Macro Poverty Outlook
Notes:
(a) Most recent value (2015)
(b) Most recent WDI value (2014)

The Kyrgyz economy performed better than expected in 2016, but the headline figures mask underlying weaknesses in the quality of growth. Growth was driven by recovering gold production and remittances, and high public spending. Modestly positive poverty trends resulted from transfers and price developments, rather than improvements in earned incomes. Going forward, the economy is expected to recover, but remains vulnerable to the external environment.

Recent developments

Economic growth is estimated at 3.8 percent in 2016, declining only slightly from 3.9 percent in the previous year. The output expansion was driven mainly by the recovery of gold production (particularly in the second half of the year), which increased by 5 percent after a -8.3 percent decline in 2015. Non-gold growth slowed to 3.7 percent from 4.9 percent in 2015, driven by the deceleration in agriculture and construction. On the demand side, growth was led mostly by private consumption, fueled by an 18 percent increase in remittances (in US dollar terms) and higher government spending.

The current account deficit narrowed from 11 percent of GDP in 2015 to 9.4 percent in 2016, due to the recovery of remittances and some improvement of the trade balance to 31.8 percent of GDP from 33.6 percent a year ago. Exports in US dollars fell by 1.5 percent in 2016 despite higher gold exports, and imports in US dollars contracted by 4.7 percent. The current account deficit was mainly financed by FDI inflows and government borrowing.

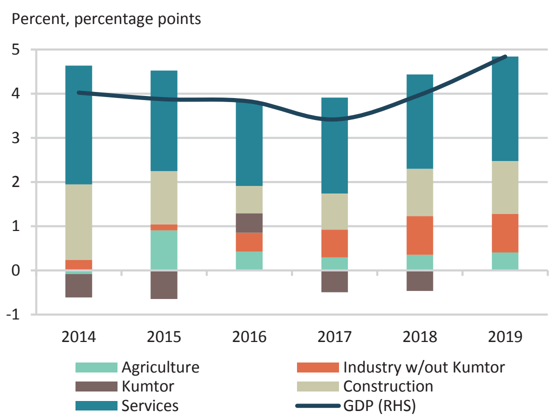
Over the course of 2016, the som appreciated by almost 9 percent relative to the US dollar (owing to the improvement in regional developments and recovering remittances). The Central Bank intervened in the foreign exchange market in the first quarter of 2016 to counter the appreciation trends, and thereafter alternated purchases and sales to keep the exchange rate stable. Together with low food and energy prices, this helped lower inflation, which barely reached 0.4 percent (annual average).

Fiscal policy was significantly expansionary, led by public investment and current spending over-runs. The stronger som allowed the government to adopt an expansionary stance, by relieving pressure on debt indicators and counterbalancing the depreciation bias of public spending.

The budget deficit grew to 6.6 percent of GDP from 3 percent in 2015. While tax revenues increased as a share of GDP (to 25.2 percent thanks to increased customs rates and improved tax administration), this was more than offset by lower non-tax proceeds, driving a reduction in total revenues to 33.3 percent of GDP from 34.9 percent a year ago. At the same time, expenditures ballooned to 39.8 percent of GDP (up from 38 percent in 2015) driven by both higher recurrent and capital outlays. Thanks to the appreciation of the som vis-à-vis the dollar, the public debt-to-GDP ratio declined to 61.7 percent of GDP as of end December 2016 from 67.2 percent a year ago.

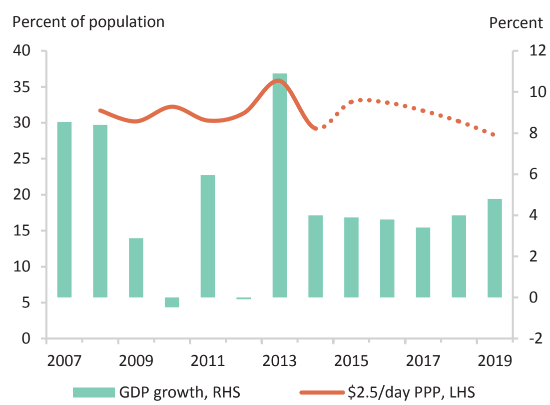
The poverty rate (measured at US$2.5 per day, 2005 PPP terms) is estimated to have stagnated in 2016 at 32.8 percent. Low prices (external and domestic) and higher remittance inflows supported households' consumption, but this was not accompanied by job creation or earned income growth. Subdued activity in construction and agriculture, where about 50 percent of the bottom 40 are employed, constrained real labor income growth for the poor. Job creation did not keep pace with the growth in the labor force, with new job creation occurring mostly in low productivity services.

FIGURE 1 Kyrgyz Republic / GDP growth, contributions to growth



Sources: World Bank.

FIGURE 2 Kyrgyz Republic / Actual and projected poverty and GDP growth rates



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

Outlook

The overall macroeconomic situation is expected to remain broadly unchanged in 2017, assuming exchange rate stability and no sudden deterioration in the external environment, especially the economic fortunes of Russia and Kazakhstan.

Growth is projected to decelerate slightly to 3.4 percent in 2017 reflecting a planned decline in gold production, while non-gold growth is projected to remain flat. In 2018 growth is expected to recover to 4 percent owing to remittance supported-consumption; in contrast, thethe contribution from investment would be neutral, and negative from net exports .

In light of the high debt burden (projected to remain above 60 percent of GDP in coming years), the government has committed to a significant fiscal consolidation over 2017-18, according to which the government deficit (excluding on-lending) would be reduced by about 2.5 percentage points to 2.1 percent of GDP by 2018 (a reduction to 4.2 percent including on-lending). The adjustment would be expenditure-led, with capital spending (-2.5 pp of GDP) and the wage bill (-1.5pp of GDP) being the main drivers; total revenue is projected to fall by 1.5 percentage points (due to expected lower grant support).

Stable growth projections for agriculture and construction, and further increases in remittances, are likely to support rural poverty reduction during 2017-18. Private sector real wages would rise slowly, resulting in a slight reduction in urban poverty, where wage employment is more prevalent. Social transfers will continue to play an important role in driving poverty reduction in both urban and rural areas. A scheduled increase in pensions should have a positive distributional effect given that pensions represent close to 15 percent of income among the poor. Finally, lower food prices in 2017 should also positively impact the purchasing power of households at the bottom of the income distribution. As a result, the national poverty rate is projected to decline to 31.7 percent in 2017 and 30.2 percent in 2018.

Risks and challenges

Although overall risks related to exogenous regional developments appear to have moderated, with greater oil prices and exchange rate stability, the country's economy and the welfare of Kyrgyz citizens remain highly exposed to remittance inflows. Exchange rate developments could also affect trade patterns, with local producers already facing competition from Kazakh and other producers from the Euroasian Economic Union (EEU) given the appreciation of the som relative to their currencies. A major challenge is to accelerate the process of convergence of local production to EEU standards, as well as to boost the competitiveness of the economy and its attractiveness to investors. More than headline growth, it is the quality of the growth process and jobs linkages that are key for sustainable poverty reduction.

Lastly, while countercyclical fiscal policy has helped the Kyrgyz economy to weather the impact of the regional crisis, fiscal consolidation will necessarily entail painful adjustments and risks (particularly in an electoral year). Ensuring that it is not derailed and not carried out at the expense of key social programs will be a major challenge.

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

	2014	2015	2016 e	2017 f	2018 f	2019 f
Real GDP growth, at constant market prices	4.0	3.9	3.8	3.4	4.0	4.8
Private Consumption	3.0	-6.0	2.2	2.5	3.2	3.5
Government Consumption	8.0	1.9	11.0	-6.2	-5.6	-1.2
Gross Fixed Capital Investment	13.0	4.3	3.2	7.2	8.5	8.6
Exports, Goods and Services	-6.2	-4.0	-11.3	12.7	11.5	12.8
Imports, Goods and Services	1.6	-17.0	-7.4	5.5	6.9	8.0
Real GDP growth, at constant factor prices	4.0	3.9	3.6	3.2	3.7	4.6
Agriculture	-0.5	6.2	3.0	2.2	2.7	3.1
Industry	5.7	2.9	5.9	3.7	5.7	8.1
Services	6.9	2.6	3.2	3.7	3.7	4.5
Inflation (Consumer Price Index)	7.5	6.5	0.4	3.6	4.0	4.0
Current Account Balance (% of GDP)	-15.9	-11.1	-9.4	-11.7	-10.9	-9.1
Financial and Capital Account (% of GDP)	8.3	12.4	9.4	11.7	10.9	9.1
Net Foreign Direct Investment (% of GDP)	3.1	15.1	8.1	6.8	6.6	6.5
Fiscal Balance (% of GDP)	-4.1	-3.0	-6.6	-4.7	-4.2	-3.1
Debt (% of GDP)	53.6	67.2	61.7	62.8	63.9	63.2
Primary Balance (% of GDP)	-3.2	-2.0	-5.6	-3.9	-2.6	-2.1
Poverty rate ($2.5/day PPP terms)[a,b,c]	29.2	32.9	32.8	31.7	30.2	28.3

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 2009-KIHS and 2015-KIHS.
(b) Projection using average elasticity (2009-2015) with pass-through = 0.7 based on GDP per capita in constant LCU.
(c) Actual data: 2014, 2015. Nowcast: 2016. Forecast are from 2017 to 2019.

MACEDONIA, FYR

Table 1	2016
Population, million	2.1
GDP, current US$ billion	10.9
GDP per capita, current US$	5234
Poverty rate ($2.5/day 2005PPP terms)[a]	12.7
Poverty rate ($5/day 2005PPP terms)[a]	34.3
Gini Coefficient[a]	36.0
Life Expectancy at birth, years[b]	75.2

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

Economic growth slowed to 2.4 percent in 2016 as political uncertainty caused a drop in private investment. Unemployment eased due to fiscal stimulus and declining labor force participation. Under-execution of capital spending led to a smaller fiscal deficit in 2016, but current spending increased. Public and publicly guaranteed debt reached 48 percent of GDP. Growth is projected to average 3.3 percent during 2017-2019, driven by private consumption and a recovery in private investment, as political uncertainties dissipate and confidence is restored.

Recent developments

Political uncertainty took a toll on growth in 2016, slowing it from 3.8 percent in 2015 to 2.4 percent. Growth was largely driven by household consumption, contributing 3 percentage points (pp) and supported by rising employment, wages, pensions, and household lending. Relatively flat government consumption contributed just 0.2 pp to growth. Concern about the political situation affected investment, which fell by 4.3 percent from 2015 and subtracted 1.4 pp from growth in 2016, despite significant investment in roads. Net-exports added 0.7 pp to growth, as goods and services trade balances were in small surplus, supported by solid FDI related exports and IT and transport services growth. Affected by political uncertainties, industrial output declined by 2.2 percent in 2016.

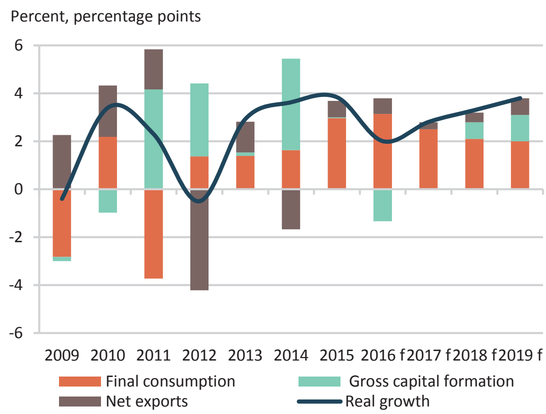
Deflation persisted in 2016, for a third year in a row. Low international food and oil prices, combined with lower domestic utility prices led to a price deflation of 0.2 percent in 2016.

Unemployment continued to fall in 2016 because of fiscal interventions to create jobs and as labor force participation contracted. Employment grew 2.1 percent y-o-y in 2016, with a large share of net created positions linked to government stimulus programs. Yet, labor force participation fell to 56.8 percent in 2016, the lowest rate since 2012. As a result, the average unemployment rate was 23.7 percent at end-2016. Despite a government stimulus for youth employment in particular, mainly in the form of exemptions from social contributions, youth unemployment increased from 47.4 percent in 2015 to 48.3 percent. Youth is the only age group whose participation in the labor force has been declining since 2012. Long-term unemployment remains high at 81 percent of all unemployed.

The current account deficit (CAD) widened but remains manageable at 3.1 percent of GDP in 2016, up from 2.1 percent in 2015. The solid increase of goods and services exports was not enough to compensate for the significant rise in capital outflows in the form of dividend payment and profit repatriation. In addition, private transfers also helped to push up the CAD. Nevertheless, the CAD was more than fully financed by net FDIs, which reached 3.6 percent of GDP in 2016. As of yearend 2016, foreign exchange reserves were still solid at 4.9 months of imports.

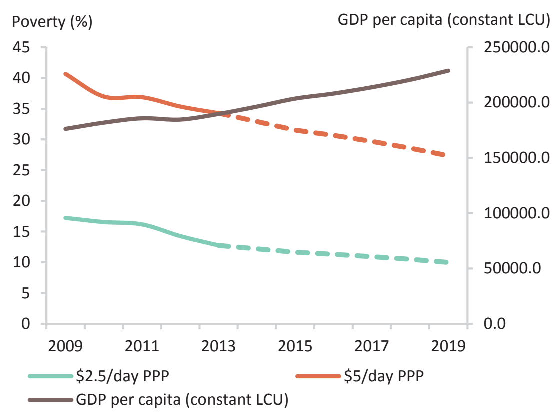
Although credit continued to expand in 2016, it masked a significant slowdown in corporate lending because of the uncertain political climate. Overall credit growth was strong at 6.5 percent in 2016 (y-o-y), but corporate lending growth plunged from 7.1 percent in 2015 to 3.2 percent. The banking sector is profitable and well-capitalized, with a capital adequacy ratio of 15.7 percent as of Q3 2016, well above the regulatory minimum of 8 percent. The loan-to-deposit ratio stood at 88 percent, which suggests that banks have significant room to increase lending, especially to the corporate sector, once the political uncertainties are resolved. Non-performing-loans declined from 10.6 percent at end-

FIGURE 1 Macedonia FYR / GDP growth, contributions to growth



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

FIGURE 2 Macedonia / Annual and projected poverty rates and GDP per capita



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

2015 to 6.5 percent at end-2016, as a result of write-off of fully-provisioned loans for more than two years.

The fiscal deficit declined in 2016, largely due to under-execution of capital spending. The deficit declined to 2.6 percent of GDP, significantly lower than the 4 percent announced in the second budget revision. The decline relates mainly to a low execution of capital spending in the context of a prolonged election cycle. Total revenues were 27.9 percent of GDP, declining from 2015 by 1 pp, due to lower personal income tax and contributions related to the tax-exempt job-creation. The revenue decline was more than matched by an expenditure decline of 1.8 pp. However, the change in composition makes budget less sustainable: significant underperformance in capital spending is now combined with current spending that surpassed 90 percent of the overall public expenditure.

Public and publically guaranteed (PPG) debt continued to rise in 2016, driven were the 450 million Eurobond issuance and the accelerated pace of construction of two highways, which added to the guaranteed debt. PPG debt reached 47.7 percent of GDP in 2016, compared to 46.4 percent in 2015.

Poverty is estimated to have declined in 2016 on account of the better labor market outcomes and increased productivity and real wages, but progress is expected to slowdown in 2017. Using the US$5/day and $2.5/day lines (2005 PPP), poverty rates were projected to have fallen to 30.7 and 11.3 in 2016, down from 34.3 and 12.7 in 2013 and continuing a decreasing trend present at least since 2009. In 2016, reductions in unemployment and rising real wages, but also employment growth in unskilled labor intensive sectors (i.e. construction) are expected to have contributed to poverty reduction, since rising labor income constituted the most important driver of income growth at the bottom of the distribution.

Outlook

Growth is expected to accelerate to 2.8 percent in 2017 and continue on up to 3.3 percent in 2018, assuming that political uncertainties are resolved in early 2017, which would improve the confidence of both consumers and private investors. The fiscal deficit is expected to remain at a sizable 3.2 percent of GDP in 2017 but then to decline gradually to 2.3 percent in 2019. As a result, PPG debt is expected to increase to 55 percent by 2019 (of which 13 pp are guarantees). The CAD is expected to average 2.6 percent of GDP in 2017-2019, driven by consumption and investment demand.

Poverty is expected to continue its downward trend in the next few years. Higher productivity and real wage growth and continuous improvement in labor market indicators will play a critical role for poverty reduction. However, to the extent that employment opportunities among the less-skilled contract, or that fiscal consolidation efforts lead to a contraction of the construction sector, poverty reduction may stall.

Risks

The political situation remains the primary downside risk to the economy , which may further erode consumer and private investor confidence, but also postpone the necessary structural reforms. In addition, growing fiscal risks with a rapidly rising public debt, could threaten stability and undermine growth prospects in the medium term.

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

	2014	2015	2016 e	2017 f	2018 f	2019 f
Real GDP growth, at constant market prices	3.6	3.8	2.4	2.8	3.3	3.8
Private Consumption	2.2	3.7	4.2	3.2	2.5	2.4
Government Consumption	3.0	2.1	1.1	1.6	2.2	2.4
Gross Fixed Capital Investment	5.7	2.1	-3.9	0.0	3.1	5.0
Exports, Goods and Services	16.5	6.7	11.5	7.7	6.8	6.4
Imports, Goods and Services	14.1	5.2	7.6	5.6	4.8	4.3
Real GDP growth, at constant factor prices	6.5	4.5	3.2	1.7	3.0	4.3
Agriculture	2.2	-0.7	2.8	1.5	1.2	1.0
Industry	11.8	7.8	7.6	8.0	5.5	5.0
Services	5.0	3.9	1.3	-1.3	1.9	4.4
Inflation (Consumer Price Index)	-0.3	-0.3	-0.2	0.6	1.4	1.8
Current Account Balance (% of GDP)	-0.6	-2.0	-3.1	-3.0	-2.7	-2.1
Financial and Capital Account (% of GDP)	-0.6	1.6	2.8	2.6	2.3	1.8
Net Foreign Direct Investment (% of GDP)	2.3	2.3	3.6	2.5	2.7	2.9
Fiscal Balance (% of GDP)	-4.2	-3.6	-2.6	-3.2	-2.7	-2.3
Debt (% of GDP)	38.1	38.1	37.7	39.3	40.0	40.6
Primary Balance (% of GDP)	-3.2	-2.4	-1.4	-2.0	-1.3	-0.8
Poverty rate ($2.5/day PPP terms)[a,b]	12.2	11.6	11.3	10.9	10.5	10.0
Poverty rate ($5/day PPP terms)[a,b]	32.9	31.5	30.7	29.7	28.6	27.3

Sources: World Bank. Macroeconomics and Fiscal Management Global Practice. and Poverty Global Practice.
Notes: e = estimate, f = forecast.
(a) Calculations based on SILC harmonization, using 2014-SILC grouped data (survey year).
(b) Projection using neutral distribution (2013) with pass-through = 0.87 based on GPD per capita constant LCU.

MOLDOVA

Table 1	2016
Population, million	3.6
GDP, current US$ billion	6.8
GDP per capita, current US$	1902
Poverty rate ($2.5/day 2005PPP terms)[a]	2.9
Poverty rate ($5/day 2005PPP terms)[a]	38.2
Gini Coefficient[a]	27.0
School enrollment, primary (% gross)[b]	93.8
Life Expectancy at birth, years[b]	71.2

Source:World Bank WDI and Macro Poverty Outlook
Notes:
(a) Most recent value (2015)
(b) Most recent WDI value (2014)

In 2016 Moldova registered robust growth, recovery was supported by favorable conditions in agriculture and robust private consumption. Higher wages, lower inflation and higher employment resulted in a decline in poverty rate. Supported by consumption and accommodative fiscal policy, growth is projected to maintain its momentum in the medium-term. While Moldova is slowly rebuilding its macroeconomic buffers, major policy challenges related to governance—particularly in the financial sector—and efficiency of public spending remain.

Recent developments

Moldova's economy has recovered from the 2015 recension and grew by 4.1 percent in 2016 supported by a strong recovery in agriculture and robust private consumption. A strong increase in wages and a good harvest supported growth in private consumption and a buildup of inventory stocks—cumulatively these two categories contributed to 5.4 percentage points to overall growth. At the same time the contribution of net exports (-1.3 percentage points) and fixed investments remained negative (-1.1 percentage points) as access to financing remains constrained. On the production side, agriculture (increasing by 18.2 percent) and trade sectors were the main sources of growth (both contributing 3.1 percentage points), while value added of the financial sector remained negative (-0.9 percentage points) due to weak intermediation activity.

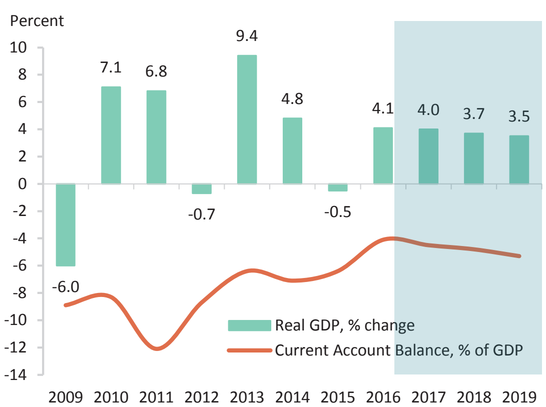
Consumer inflation reached a nadir of 2.4 percent in December 2016 before returning to the target range. From September 2016—mostly due to the base effect—CPI temporarily breached the lower limit of the (5+/-1.5) target range, and decelerating further to 2.4 percent by December 2016, before bouncing back to 5.1 percent in March 2017. Following the loss in confidence after the banking crisis, credit activity declined and non-performing loans increased by almost 6 percentage points to 16.3 percent during 2016, resulting in increased excess liquidity. In response, the central bank stopped the accommodative policy stancekeeping the policy rate at 9 percent since October 2016 and increasing the required reserves ratio in April 2017 to absorb the excess liquidity.

Largely due to lower levels of imports and growth of exports the current account deficit narrowed by 2.3 percentage points to 4.1 percent of GDP in 2016. A double digit increase in exports of cereals drove a 4 percent growth in merchandize exports. A flexible exchange rate regime and disbursements of external assistance facilitated the accumulation of foreign reserves, covering more than 5 months of imports by end-2016.

The agreement with IMF and external financial assistance from WB, EU, and Romania in the second half of the year eased the government's financing constraint. Still, budget execution (deficit of 1.8 percent of GDP) was significantly below the plan (deficit of 3.2 percent) as some expenditures were not financed in full due to late December disbursements of external budget support. Public expenditures fell by almost 2 percent in real terms, largely through lower capital expenditures, as social expenditures and the wage bill were maintained at budgeted levels. By end-2016, the public debt and guarantees is estimated to have decreased by 2.2 percentage points to 44.8 percent of GDP.

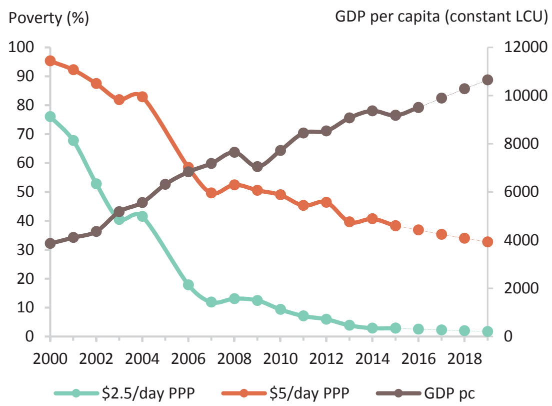
Latest data reveal that poverty—measured at PPP US$5/day—declined by 2 percentage points in 2015 to 38.2 percent, on account of higher employment levels and wage growth. While data for 2016 is not yet available, a number of positive factors, including a good harvest and growth in sectors like agriculture that are

FIGURE 1 Moldova / Actual and projected GDP growth and current accounts



Sources: National authorities and World Bank estimates.

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



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

important to low income households, falling unemployment (down 0.4 percentage points to 3.8 percent in Q42016, y/y), particularly in rural areas, real wage increases (+3.7 percent growth in real terms, y/y), declining prices, and the fact lower public expenditures did not translate into lower social expenditures, indicate that the falling poverty trend is likely to have been preserved in 2016.

Outlook

Supported by consumption and fiscal stimulus, growth momentum will be maintained in 2017. A supportive agricultural year will boost growth to 4 percent in 2017. This is expected to help stimulate exports and create new jobs. Following the under-execution in 2016, and underpinned by strong public transfers in real terms and capital investments, in 2017 the fiscal deficit will widen by 0.7 percentage points to -2.5 percent of GDP.

In the medium-term growth will slow to 3.7 percent in 2018 and 3.5 percent in 2019. Accommodative fiscal policy—in particular public investments—and remittances are expected to further sustain economic growth in 2018. The revitalization of foreign inflows, improvements in the financial sector and business environment will encourage the growth of investments. While the fiscal deficit is expected to widen to around 3 percent of GDP, the public debt and guarantees are set to reflect the external assistance increase in 2017 and 2018, and slowly decline by end-2019. As growth strengthens and savings decline, the current account deficit will increase gradually, although below the historical averages.

Inflationary pressures will keep inflation close to the targeted value of 5 percent. The main pressures stem from increased liquidity in the banking system, the adjustments of utility tariffs and the recovery in economic activity. In the election year of 2018, supply side inflationary pressures will moderate and by of 2019, the inflation rate is projected to converge to the target value of 5 percent.

Poverty is projected to decline further against the background of positive GDP and wage growth and wider fiscal space. However, the pace of poverty reduction is projected to slow down on account of increasing utility tariffs, inflationary pressures, and continued structural labor market weaknesses. Over the forecast period until 2019, the PPP US$5/day poverty headcount is projected to decline by some additional 5 percentage points.

Risks and challenges

There are a number of downside risks to the baseline growth scenario. First, the lead-up to 2018 parliamentary elections could slow down the pace of implementation of reforms. Second, weaker than expected growth in key economies, including the EU and Russia, could have a negative impact on growth in Moldova.

Limited external demand, slow TFP growth and capital accumulation, combined with low labor force participation, point to a need to rebalance drivers of growth. Major policy challenges stem from (i) general governance issues and state capture, in particular important for the restructuring of the financial system and the energy sector, (ii) efficiency of fiscal spending, particularly in education and health, and (iii) the need to strengthen labor markets to put future poverty reduction on a more stable footing than the earlier heavy reliance on remittances and pension growth that were the main contributors to B40 income growth in the recent past. It will be important to advance key economic reforms to create a more transparent and rules-based environment for private sector employment creation.

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

	2014	2015	2016 e	2017 f	2018 f	2019 f
Real GDP growth, at constant market prices	4.8	-0.5	4.1	4.0	3.7	3.5
Private Consumption	3.2	-2.3	3.6	3.8	3.6	3.4
Government Consumption	0.1	0.4	0.1	1.0	0.5	0.1
Gross Fixed Capital Investment	10.0	-1.2	-3.0	2.9	3.8	4.5
Exports, Goods and Services	1.0	2.3	8.8	9.4	3.8	4.0
Imports, Goods and Services	0.4	-4.3	5.9	6.8	3.9	4.2
Real GDP growth, at constant factor prices	5.4	-0.4	4.8	3.3	3.8	4.3
Agriculture	8.5	-13.4	18.2	2.5	3.8	4.1
Industry	7.5	3.5	2.1	3.7	4.1	5.5
Services	3.8	3.4	1.4	3.4	3.7	4.1
Inflation (Consumer Price Index)	5.1	9.7	6.9	5.3	4.8	5.0
Current Account Balance (% of GDP)	-7.1	-6.4	-4.1	-4.5	-4.8	-5.3
Financial and Capital Account (% of GDP)	8.2	7.2	3.3	4.0	4.3	4.8
Net Foreign Direct Investment (% of GDP)	3.9	3.5	1.9	2.9	3.4	4.0
Fiscal Balance (% of GDP)	-1.7	-2.2	-1.8	-2.5	-3.0	-2.7
Debt (% of GDP)	38.2	46.6	44.2	44.6	43.9	43.0
Primary Balance (% of GDP)	-1.0	-1.4	-0.5	-1.0	-1.8	-1.6
Poverty rate ($2.5/day PPP terms)[a,b,c]	2.9	2.9	2.5	2.2	1.9	1.7
Poverty rate ($5/day PPP terms)[a,b,c]	40.7	38.2	36.8	35.3	33.9	32.7

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 2010-HBS and 2015-HBS.
(b) Projection using point-to-point elasticity (2010-2015) with pass-through = 0.87 based on private consumption per capita in constant LCU.
(c) Actual data: 2014, 2015. Nowcast: 2016. Forecast are from 2017 to 2019.

MONTENEGRO

Table 1	2016
Population, million	0.6
GDP, current US$ billion	4.1
GDP per capita, current US$	6703
Poverty rate ($2.5/day 2005PPP terms)[a]	1.0
Poverty rate ($5/day 2005PPP terms)[a]	13.2
Gini Coefficient[b]	26.2
Life Expectancy at birth, years[a]	76.5

Sources: World Bank WDI and Macro Poverty Outlook.
Notes:
a) Most recent value (2015)
b) Gini data show most recent value (2013)
c) Most recent value (2014)

Growth slowed down in 2016 due to the highway construction delay, struggling industry and levelling off tourism. Although labor market deteriorated mainly due to early exit of women from the labor force to access mothers' benefit, poverty is estimated to have declined in 2016 as social transfers surged. Yet, unemployment rate increased, while labor force participation remained low. Despite positive economic outlook, growth model dependent on large public investment and consumption puts public finances on unsustainable path and requires ambitious fiscal consolidation efforts.

Recent developments

Growth slowed down in 2016 to 2.5 percent after a growth of 3.2 percent in 2015. Investment, largely driven by tourism, energy, and highway construction, remained the main driver of growth, contributing 6.6 percentage points to growth in 2016. Household consumption also remained robust, contributing an additional 2.2 percentage points, while government consumption contributed additional 0.2 percentage points, led by public sector wage rise. In contrast, net exports subtracted over 6 percentage points from growth as rapid rise in imports of equipment and materials for the highway and windmills projects combined with the continued weak service export performance. Industrial production in 2016 fell by 4.7 percent (yoy) as growth in the energy sector could not offset sharp declines in manufacturing and mining. While tourist arrivals grew by about 6 percent, the tourist night-stays rose by only 1.8 percent, compared to a double-digit growth in the previous year.

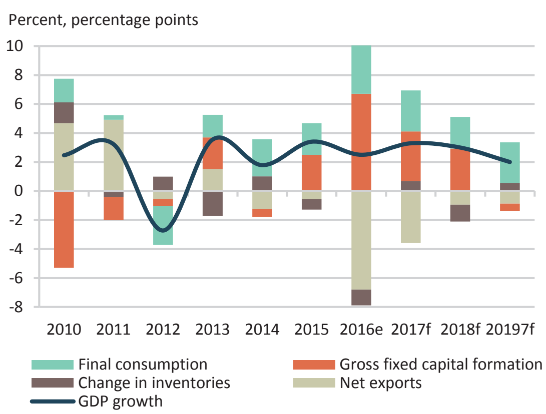
The labor market stagnated in 2016, despite growth. Starting in 2016, amendments to the Law on Social Care and Child Protection provided a lifetime benefit to mothers with three or more children, who can qualify based on 15 years of registered unemployment or 15 or 25 years of employment. Since then, the number of registered unemployed has increased by more than 10,000, and around 4,000 women have left formal jobs to receive the benefit. The large infrastructure projects did not create a visible employment impact as they largely rely on imported labor. As a result, four-quarter average unemployment rate increased slightly, reaching 17.7 percent in 2016 (up from 17.6 percent a year before), while employment rate grew to 44.9 percent. Despite large employment programs for youth, their unemployment rate remained high at 36.1 percent, with the long-term unemployment of 75 percent.

At the same time, led by public sector wage growth, real wages grew by 3.4 percent in 2016, well above productivity growth, indicating a rise in unit labor cost by over 7 percent in 2016. Some poor households have seen increased income due to the mother benefit, even though as designed it is not poverty-targeted, discourages work, and represents a fiscal burden (close to 2 percent of GDP). With these developments and economic recovery starting in 2012, poverty (measured at US$5 in 2005 PPP) declined from its peak at 19.6 percent in 2012 to an estimated 12.8 percent in 2016.

Deflation persisted through most of the year, amid low international oil and food prices. Average inflation in 2016 was negative at 0.2 percent. However, prices grew in the last quarter of 2016 by 0.5 percent given the spillovers of international oil and food price increase, which may have disproportionate impacts on the poor's purchasing power.

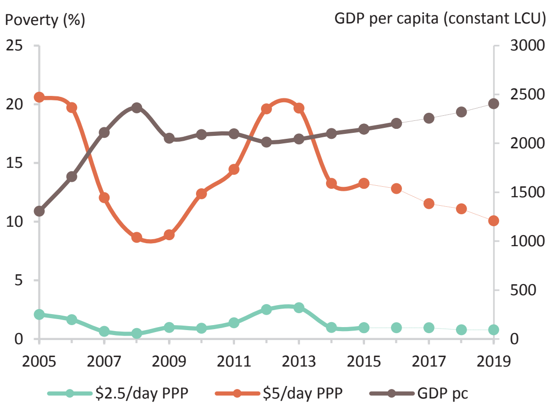
General government deficit declined to below 4 percent of GDP in 2016 from 7.3 percent of GDP in 2015, mostly on the back of capital spending cuts. Revenue boost came from improved collections but did not compensate for the 10-percent rise

FIGURE 1 Montenegro / GDP growth, contributions to growth



Sources: MONSTAT, World Bank.

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



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

in public sector wages, introduction of the mothers' lifetime benefit, a 3-percent rise in pensions and 20-percent rise in minimum pension. Public debt stagnated at around 66 percent of GDP.

Together with the 2017 budget, the new government adopted a set of fiscal consolidation measures amounting to 3.2 percent of GDP. The measures included a rise in excise taxes and a reduction in VAT exemptions, a collection of tax arrears, a 25-percent reduction of the amount of the mothers' benefit, an 8-percent reduction of wages of officials, and the freeze of seniority bonus payment until 2019, as well as selective cuts in capital expenditures. The mother benefit reduction, while necessary for the sustainability of public finances, is expected to partially offset some of its earlier impact on poverty.

Lending activity recovered slightly, while non-performing loans (NPLs) declined to 10.3 percent in 2016. Credits to households grew substantially by close to 11 percent, given the low base effect, while after reaching the yearly low in September, corporate lending recovered as well, growing by 1.9 percent in December 2016. Deposits grew by above 9 percent. Current account deficit further widened to 18.9 percent on a four-quarter basis in 2016, on the back of the rising construction-related imports and the large dividend payout. Net FDIs also declined to 9.8 percent of GDP covering around half of the CAD financing.

Outlook

The economy is expected to grow by an average of 2.8 percent annually in 2017-19 on large public investments and personal consumption. Yet, once the large public investment impetus to growth slows down, the overall growth rate will decline too, further exposing existing weaknesses in fiscal and external balances. External imbalances are set to widen again close to 21 percent of GDP, which together with further rise in fiscal deficit and debt would add to already high vulnerability to external shocks. Inflation is projected at 2 percent in the period 2017-19.

Fiscal deficit is projected to expand to above 6 percent in 2017-18 and then come down to around 4 percent of GDP by 2019. Poverty (measured at US$5 in 2005 PPP) is estimated to decline slowly to 11.5 percent in 2017, subject to employment rebound, including in construction and tourism.

Risks and challenges

Montenegro's economic outlook is positive with downside risks on the rise. Large fiscal deficits and growing public debt call for fiscal consolidation to create the space for an orderly servicing of the large (above 16 percent of GDP) refinancing needs in the 2019-2021 period. Reducing the deficit will not be easy, but is of utmost urgency given the need to reassure markets and allow for a successful rollover of existing obligations under the credit rating of B+ with a negative outlook. Large external imbalances are still widening adding to already high external vulnerability. Domestic policy uncertainty and slow pace of structural reforms combine with a complicated political environment. While recent fiscal consolidation efforts are a step forward, additional measures on both the spending and revenue sides would be needed to achieve a sustainable trajectory of public finances. Such measures would have distributional impacts that would need to be taken into account in designing policy reforms.

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

	2014	2015	2016 f	2017 f	2018 f	2019 f
Real GDP growth, at constant market prices	1.8	3.4	2.5	3.3	3.0	2.0
Private Consumption	2.9	2.2	2.6	3.5	2.9	3.7
Government Consumption	1.4	1.9	8.1	0.0	-0.9	-1.1
Gross Fixed Capital Investment	-2.5	11.9	29.6	12.0	9.4	-1.5
Exports, Goods and Services	-0.7	-0.7	-1.1	0.7	-1.2	0.6
Imports, Goods and Services	1.6	0.0	0.0	0.0	0.0	0.0
Real GDP growth, at constant factor prices	1.9	5.7	5.1	2.8	2.9	2.4
Agriculture	1.8	4.4	14.1	6.8	2.9	2.5
Industry	4.5	3.9	2.5	3.3	3.0	2.0
Services	0.7	3.2	3.3	2.1	2.1	2.1
Inflation (Consumer Price Index)	-0.7	1.5	-0.2	1.8	1.9	1.9
Inflation (GDP Deflator)	1.0	1.4	1.5	1.1	1.7	1.8
Current Account Balance (% of GDP)	-15.2	-13.3	-18.9	-19.6	-20.2	-20.6
Financial and Capital Account (% of GDP)	3.7	4.4	13.0	15.8	16.7	17.1
Net Foreign Direct Investment (% of GDP)	10.2	17.1	9.8	10.0	9.7	9.6
Fiscal Balance (% of GDP)	-3.1	-7.3	-3.6	-6.0	-5.6	-3.8
Debt (% of GDP)	59.9	66.7	65.9	71.4	75.8	78.7
Primary Balance (% of GDP)	-0.9	-4.9	-1.4	-3.5	-3.3	-1.4

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

POLAND

Table 1	2016
Population, million	38.0
GDP, current US$ billion	469.8
GDP per capita, current US$	12374
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]	101.3
Life Expectancy at birth, years[b]	77.0

Source:World Bank WDI and Macro Poverty Outlook
Notes:
(a) Most recent value (2012)
(b) Most recent WDI value (2014)

Growth in Poland slowed from 3.9 percent in 2015 to 2.8 percent in 2016. Private and public consumption remained strong, bolstered by strong labor market performance. As a result, poverty is expected to continue declining. Weaker public investment contributed negatively to growth but it helped offset increased current spending, keeping the fiscal deficit stable. Growth is projected to pick up to 3.3 percent in 2017 on the back of stronger investment, and remain broadly stable over the medium term.

Recent developments

Economic growth slowed to 2.8 percent in 2016 down from 3.9 percent a year earlier, dragged by lower investment. Total investment declined by 5.5 percent in 2016, the largest decline since 2002, despite record low interest rates and high production capacity utilization. Lower transfers from the EU budget weighed on public investment, while policy uncertainty affected domestic and foreign private investment.

Private consumption was the main driver of growth as it expanded by 3.6 percent, the strongest pace since 2008, boosted by robust real income growth due to a record low unemployment rate (below 6 percent), solid growth of real wages (4.2 percent compared to 3.5 percent in 2015) and the new Family 500+ benefit program, introduced in April 2016.

Growth picked up significantly in the fourth quarter compared to the previous quarters, while high-frequency indicators (IP, PMI) have been robust, indicating that the slowdown of the Polish economy could be temporary.

Boosted by higher food and energy prices in international markets and a relatively weak Zloty, both producer and consumer prices have rebounded, with the CPI moving from a small deflation of 0.2 percent year on year in October 2016 to 2.2 percent inflation in February 2017. Rising inflation creates risk of erosion of real incomes, but a tight labor market ensured that wages grew faster than inflation in recent quarters. However, higher inflation expectations have pushed yields of long term T-bonds close to 4 percent, signaling an end to record low public debt servicing costs.

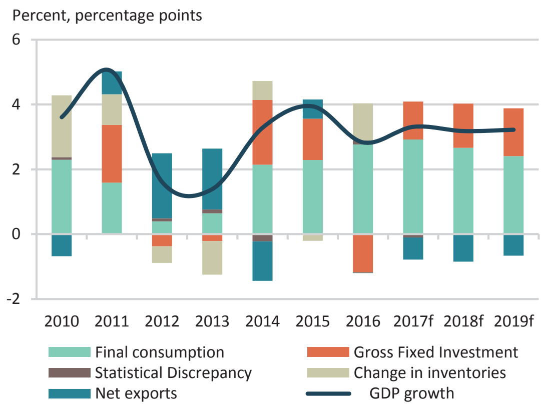
Labor market conditions continued to improve in 2016, as employment increased and unemployment reached record lows (5.5 percent in the fourth quarter of 2016). Employment rates reached record highs, but continue to be below the EU average due to low labor force participation of young (age 20-30) and older workers (ages 50-60).

Poverty and shared prosperity indicators are estimated to have continued to improve in 2016, driven by strong private consumption supported by a strong labor market and the introduction of the Family 500+ program. Moderate poverty is expected to have declined from 4.5 percent in 2015 to 3.2 percent in 2016 using the $5.00/day 2005 PPP poverty line.

The fiscal deficit is expected to have narrowed slightly from 2.6 percent of GDP in 2015 to 2.5 percent of GDP in 2016 due to under-performance of public investment, in particular at the local government level, which recorded a 0.4 percent of GDP surplus associated with lower than expected absorption of EU funds. Additional revenues off-set increases in spending. Revenues from VAT and labor taxes were quite robust due to strong private consumption and employment. Fiscal results were also backed by a new 'bank tax' and one-off receipts, such as LTE digital dividend or higher-than-budgeted payment from the NBP profit.

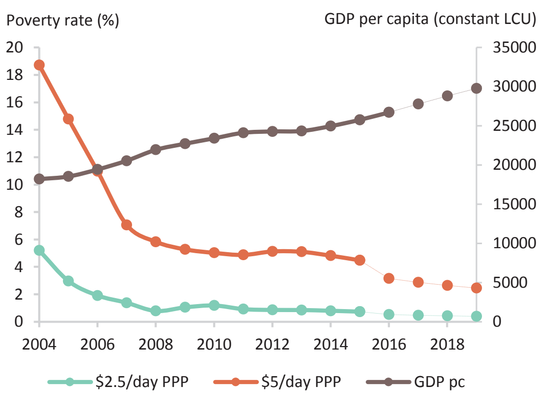
Poland's external position remained almost balanced with a current account deficit of 0.5 percent of GDP in 2016. This was

FIGURE 1 Poland / GDP growth, contributions to growth



Sources: MFMod, World Bank.

FIGURE 2 Poland / Actual and projected poverty rates and real GDP per capita, 2000-2019



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

mainly driven by a services trade surplus, particularly in ICT and business services. Strong merchandise exports and a fall in energy commodity prices translated into a surplus in the foreign trade balance.

Outlook

GDP growth is expected to pick up in 2017 to 3.3 percent and broadly stabilize around 3.2 percent over the medium term, driven by domestic demand. The decision on rollback of statutory retirement ages from October 2017 is expected to weaken Poland's growth potential. Investment is expected to grow with a recovery in the EU budget transfers this year while consumption growth is expected to remain solid due to strong labor market performance and Family 500+ benefits to be paid for the whole year (they were effective only for ¾ of the year in 2016).

Robust private consumption and a strong labor market should continue to boost real incomes and lead to further declines in poverty incidence in the short term. Although a planned 8 percent increase in the minimum wage in 2017 will likely increase the incomes of the bottom of the distribution, this will be tempered by rising prices. The $5.00/day 2005 PPP poverty rate is projected to decline to 2.9 percent in 2017.

The general government deficit is set to widen again in 2017 to 2.6 percent of GDP, only slightly below the 3 percent EU threshold that would trigger entering into the Excessive Deficit Procedure. Spending is expected to increase as the full-year cost of the Family 500+ program is reflected in the budget and as the government's decision to roll back the planned increases of the retirement age start to affect the budget beginning in October 2017. The change in retirement age will result in lower social contributions from the cohort eligible for earlier retirement, as well as higher spending on a larger number of pensioners, including retirees who receive minimum pensions or are under preferential pension regimes. Public revenues are expected to grow moderately, in line with improving economic performance and various legislative, organizational, and IT measures aimed at reducing the sizeable VAT gap. They include the introduction of integrated tax, tax control, and customs services in the National Fiscal Administration which became operational from March 1, 2017.

Risks and challenges

Despite a relatively benign economic forecast, risks remain skewed to the downside due to uncertainty in the global economy, including in advanced economies.

In our baseline scenario, assuming moderate improvements in VAT compliance, the headline fiscal deficit is set to reach 2.6 percent of GDP in 2017 and reach the 3 percent of GDP threshold in 2018 and 2019. This scenario is subject to substantial uncertainty associated with macroeconomic trends (both growth and inflation), efficiency of the new fiscal administration, and effects of government's endeavors to increase effectiveness of public spending through the budget system reform.

To guard against these risks, a swift implementation of market-friendly structural measures from the Strategy for Responsible Development are required to promote investment and innovation and counterbalance emerging labor shortages. The latter are likely to be exacerbated by deactivation incentives to work stemming from more generous social benefits for younger workers and lower retirement ages for older cohorts.

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

	2014	2015	2016 e	2017 f	2018 f	2019 f
Real GDP growth, at constant market prices	3.3	3.9	2.8	3.3	3.2	3.2
Private Consumption	2.4	3.2	3.6	3.9	3.6	3.2
Government Consumption	4.1	2.3	3.8	3.4	3.0	2.8
Gross Fixed Capital Investment	10.0	6.1	-5.5	5.9	6.7	7.0
Exports, Goods and Services	6.7	7.7	8.4	5.4	5.2	5.1
Imports, Goods and Services	10.0	6.6	8.7	7.1	7.0	6.4
Real GDP growth, at constant factor prices	3.3	3.8	2.7	3.3	3.1	3.2
Agriculture	0.7	-6.2	2.2	2.5	2.2	2.2
Industry	4.5	6.5	3.6	5.4	4.9	4.9
Services	2.9	3.2	2.4	2.6	2.4	2.6
Inflation (Consumer Price Index)	0.1	-1.0	-0.6	1.9	2.3	2.5
Current Account Balance (% of GDP)	-2.0	-0.2	-0.5	-0.7	-1.7	-2.5
Financial and Capital Account (% of GDP)	3.3	1.2	5.9	2.5	2.7	3.2
Net Foreign Direct Investment (% of GDP)	2.0	0.9	1.1	1.2	1.2	1.2
Fiscal Balance (% of GDP)	-3.3	-2.6	-2.5	-2.6	-3.0	-3.1
Debt (% of GDP)	50.5	51.0	52.9	51.5	51.3	50.7
Primary Balance (% of GDP)	-1.4	-0.8	-0.9	-0.8	-1.2	-1.2
Poverty rate ($2.5/day PPP terms)[a,b,c,d]	0.8	0.7	0.5	0.5	0.4	0.4
Poverty rate ($5/day PPP terms)[a,b,c,d]	4.8	4.5	3.2	2.9	2.6	2.4

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 2004-EU-SILC and 2012-EU-SILC.
(b) Projection using point-to-point elasticity (2004-2012) with pass-through = 1 based on private consumption per capita in constant LCU.
(c) Nowcast: 2014 - 2016. Forecast are from 2017 to 2019.
(d) The 2016 estimate includes simulations of the impact of the introduction of the Family 500+ program.

ROMANIA

Table 1	2016
Population, million	19.6
GDP, current US$ billion	187.0
GDP per capita, current US$	9528
Poverty rate ($2.5/day 2005PPP terms)[a]	11.1
Poverty rate ($5/day 2005PPP terms)[a]	32.6
Gini Coefficient[a]	34.9
Life Expectancy at birth, years[b]	75.1

Source:World Bank WDI and Macro Poverty Outlook
Notes:
(a) Most recent value (2012)
(b) Most recent WDI value (2014)

Romania's economy grew by 4.8 percent in 2016, a new post-crisis high and one of the fastest in the EU. The performance was fueled by an expansionary fiscal policy and labor market improvements which, combined with an increased support to vulnerable groups, contributed to poverty reduction. Growth and poverty reduction are expected to remain solid in 2017 and 2018, but risks to the outlook have increased. Fiscal policy has turned pro-cyclical and there is a risk for the budget deficit to exceed 3 percent of GDP in 2017.

Recent developments

The economy grew by 4.8 percent in 2016, driven by an expansionary fiscal policy and improvements in the labor market. Growth was led by private consumption (up 6.8 percent yoy), which was boosted by a reduction in the standard VAT rate from 24 to 20 percent in January 2016, and by increases in the minimum and public sector wages and pensions. Investment underperformed, reflecting the poor performance of public investment mainly due to the drop in EU investment funding. Imports stimulated by the robust domestic demand widened the current account deficit to 2.4 percent of GDP in 2016. On the production side, ICT (up 14.2 percent yoy) was the main driver, while industry (up 1.7 percent yoy) and construction (up 1.9 percent yoy) posted timid growth.

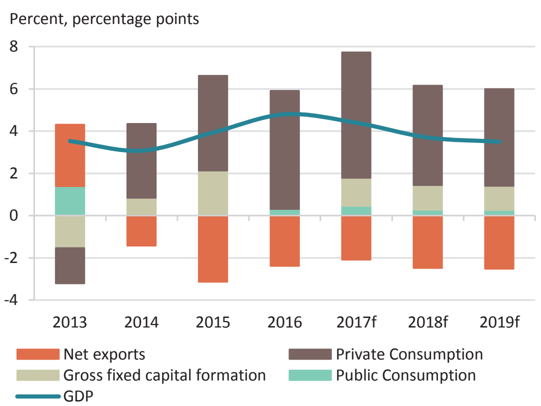
Inflation fell to a record low in 2016 and remains subdued, supporting an accommodative monetary policy. Annual headline inflation barely moved into positive territory in February 2017 (0.2 percent), as the base effect of the VAT cut dissipated. The NBR maintained the policy rate at 1.75 percent in February, amid negative corporate credit growth (down 3.5 percent yoy as of January 2017) and increasing concerns over the further relaxation of the fiscal stance.

Fiscal policy turned pro-cyclical in 2016. The budget deficit was 2.4 percent of GDP at end-2016, lower than the initial target of 2.8 percent, but on an upward trend due to the fiscal stimuli. Low public investment spending (down 31.6 percent yoy at end-December), especially from EU funds, contributed to the lower-than-expected deficit.

The labor market strengthened further on the back of strong economic growth, as real wages increased by 12 percent yoy and unemployment fell to 5.5 percent, an eight-year low as of end-December 2016. Nonetheless, the low employment rate of 63.1 in Q3 reflects persistent structural rigidities in the labor market. High skilled labor was affected by the population decline of around 6 percent since 2007 and by the emigration of young people.

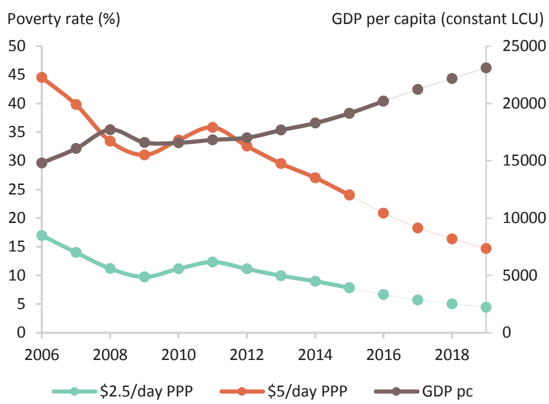
In line with sustained growth, low inflation and a strong labor market, both extreme and moderate poverty are estimated to have declined further in 2016; however, they remain among the highest in the EU. Extreme poverty (using the $2.50/day 2005 PPP poverty line) is estimated to have decreased from 11.1 percent in 2012 to 6.6 percent in 2016. Meanwhile, moderate poverty (using the $5.00/day 2005 PPP poverty line) is estimated to have decreased from 32.6 percent in 2012 to 20.8 percent in 2016. High poverty incidence is associated with high inactivity levels, particularly in rural and marginalized areas. Thus, income inequality has been increasing. By 2015 the income of the richest 20 percent of the population was more than eight times higher than the income of the poorest 20 percent, a ratio significantly higher than the EU average, reflecting large differences across regions and a deep rural-urban divide.

FIGURE 1 Romania / GDP growth, contributions to growth



Sources: World Bank, Romanian National Statistical Institute.

FIGURE 2 Romania / Actual and projected poverty rates



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

Outlook

Growth is expected to remain solid in 2017 and 2018. GDP will likely expand by around 4.4 percent in 2017, as additional fiscal stimulus is being implemented. In January 2017, the VAT rate was further cut to 19 percent, the minimum wage was hiked by 16 percent, and further tax reductions were introduced for pensions below a certain threshold. The continued pick-up in consumption is expected to contribute to the widening of the current account deficit to 3.1 percent in 2017, from 2.4 percent at end-December 2016. Coupled with a positive output gap and increased import prices, aggregate demand will drive inflation upwards. The NBR projects a gradual increase in inflation towards 1.7 percent at the end of 2017.
The adoption of the fiscal relaxation measures has put pressure on the consolidated budget deficit. The fiscal deficit is projected to go above 3 percent of GDP in 2017, which would place Romania on a trajectory towards re-entering the Excessive Deficit Procedure of the EU. The widening of the fiscal deficit will push public debt to 42.8 percent of GDP at end-2019, from 39.9 percent in 2015. Nevertheless, public debt remains one of the lowest in the EU.
Continued strong private consumption growth aided by a lower VAT rate, growth in employment and real wages, and the new minimum inclusion income should boost real incomes and lead to further declines in poverty incidence. The $2.50/day 2005 PPP poverty rate is projected to further decline to below 5 percent in 2019 and the $5.00/day 2005 PPP poverty rate is projected to decline to 14.7 percent in 2019. Adopted in 2016, the minimum inclusion income law, due to enter into force in 2018, consolidates three means-tested programs, doubling the current budget and increasing the adequacy and coverage of benefits.

Risks and challenges

Accumulating fiscal pressures and the pro-cyclicality of fiscal policy reduce the space to maneuver for policy-makers in a case of adverse exogenous shocks. The authorities should also consider corrective measures to prevent the risk that the budget deficit exceeds 3 percent of GDP in 2017. Externally, increased uncertainty about the global economic conditions and policy ambiguities in some developed countries have increased the probability of a repositioning in investor sentiment towards the emerging market economies. This would trigger pressures on the currency and an increase in the external debt.
Accelerating the process of convergence with the EU requires renewed attention to the unfinished structural reforms agenda. Structural reforms should continue to focus on strengthening the public administration and combatting corruption, enhancing the quality of spending by introducing results-informed budgeting, and advancing the SOE corporate governance agenda. Renewed efforts are needed to improve the quality of education, the access to healthcare, and to ensure that public sector and minimum wage increases do not jeopardize external competitiveness and encourage labor force participation. Gradually, the focus of fiscal policy should be rebalanced away from boosting consumption towards supporting a sustainable EU convergence path based on productivity improvements.

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

	2014	2015	2016 e	2017 f	2018 f	2019 f
Real GDP growth, at constant market prices	3.1	3.9	4.8	4.4	3.7	3.5
Private Consumption	4.4	5.6	6.8	7.1	5.5	5.3
Government Consumption	0.5	-0.7	4.7	6.9	4.2	4.0
Gross Fixed Capital Investment	3.2	8.3	0.0	5.2	4.5	4.4
Exports, Goods and Services	8.0	5.4	7.6	6.4	4.6	4.5
Imports, Goods and Services	8.7	9.2	9.3	7.8	6.9	6.7
Real GDP growth, at constant factor prices	3.2	3.6	4.9	4.4	3.7	3.5
Agriculture	4.3	-11.8	0.1	3.3	3.3	3.3
Industry	3.6	5.4	1.7	2.9	2.5	2.5
Services	3.0	4.8	6.7	5.1	4.2	3.9
Inflation (Consumer Price Index)	1.1	-0.6	-1.5	1.0	2.5	2.8
Current Account Balance (% of GDP)	-0.5	-1.1	-2.4	-3.1	-3.5	-4.1
Financial and Capital Account (% of GDP)	0.6	1.2	2.5	3.2	3.6	4.2
Net Foreign Direct Investment (% of GDP)	1.6	1.9	2.4	2.5	2.8	2.8
Fiscal Balance (% of GDP)	-1.9	-1.5	-2.4	-3.6	-3.8	-3.3
Debt (% of GDP)	40.5	39.9	39.8	40.7	41.9	42.8
Primary Balance (% of GDP)	-0.3	-0.1	-0.9	-2.1	-1.9	-1.9
Poverty rate ($2.5/day PPP terms)[a,b,c]	9.0	7.8	6.6	5.7	5.0	4.4
Poverty rate ($5/day PPP terms)[a,b,c]	27.0	24.0	20.8	18.3	16.3	14.7

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 2007-EU-SILC and 2012-EU-SILC.
(b) Projection using annualized elasticity (2007-2012) with pass-through = 0.7 based on GDP per capita in constant LCU.
(c) Nowcast: 2014 - 2016. Forecast are from 2017 to 2019.

RUSSIAN FEDERATION

Table 1	2016
GDP, current US$ billion	1283.7
GDP per capita, current US$	8752
Poverty rate ($2.5/day 2005PPP terms)[a]	0.4
Poverty rate ($5/day 2005PPP terms)[a]	6.7
Gini Coefficient[a]	37.7
School enrollment, primary (% gross)[b]	100.2
Life Expectancy at birth, years[b]	70.4

Sources: WDI, MPO, Rosstat, and Bank of Russia.
Notes:
(a) Most recent value (2015)
(b) Most recent WDI value (2014)

The Russian economy is coping with the shocks of low oil prices and restricted access to international financial markets. The poverty rate is estimated to have risen over the last year as real incomes declined. Russia is heading toward a moderate growth rate over the 2017 to 2019 period, supported by rising oil prices and macroeconomic stability. Nevertheless, structural reforms will be necessary to boost productivity and raise the country's long-term growth trajectory.

Recent developments

Russia's output contraction eased from 2.8 percent in 2015 to 0.2 percent in 2016 as the economy adjusted to low oil prices and restricted access to international financial markets. The tradable sectors benefited from the relative price adjustment and drove growth in 2016. Meanwhile, the non-tradable sectors continued to contract in 2016, albeit at a slower pace. A protracted decline in real incomes has reduced private consumption, but this trend has slowed as consumer confidence has improved. While improving sentiment also appears to have prompted a robust inventory restocking in the second half of 2016, fixed capital investment remained subdued, reflecting a still-low growth outlook, policy uncertainty, restricted access to international financial markets, continued adjustments to the earlier terms-of-trade shock, and relatively tight monetary policy.

Monetary policy remains prudent and consistent with inflation targeting. The authorities successfully reduced the inflation rate from 15.5 percent in 2015 to 7.1 percent in 2016. Recognizing that several one-off factors supported the reduction in headline inflation, the Bank of Russia maintained a moderately tight monetary stance as inflation expectations remained elevated.

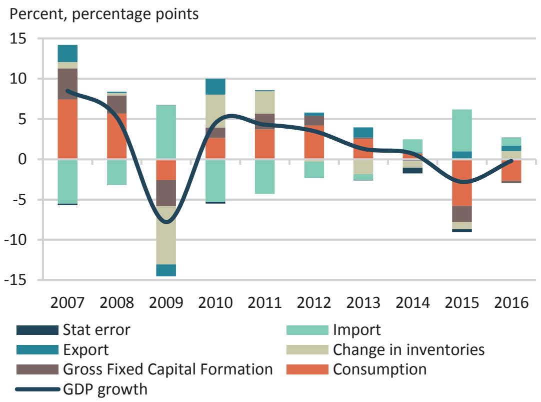
The banking system has largely stabilized, but has not yet fully recovered, and credit growth remains stalled. Asset quality continues to be weak, and demand for loans is low, especially in the corporate sector. However, the worsening trend in non-performing loans decelerated, and by December 1, 2016, the banking sector's capitalization levels had stabilized at an aggregate capital-adequacy ratio of 12.7 percent, above the regulatory minimum of 8 percent.

The balance of payments remained stable despite adverse terms-of-trade conditions and restricted access to international capital markets. The current-account surplus shrank from US$69 billion in 2015 to US$22.2 billion in 2016 as the trade surplus weakened. Lower commodity prices reduced goods exports in the first half of 2016. Meanwhile, imports remained broadly stable and began to rise in the second half of 2016, supported by a stronger ruble, the incipient recovery in real wages, and inventory restocking. A decrease in net capital outflows mirrored the decline of the current-account surplus.

The fiscal stance deteriorated, but the deficit remained contained. The general government's primary budget deficit widened from 2.6 percent of GDP in 2015 to 2.8 percent in 2016, driven by a slight increase in expenditures, although higher nonoil revenues compensated for falling oil revenues. General government primary spending increased by 0.2 percent of GDP between 2015 and 2016, but decreased slightly in real terms. National defense, environmental protection, and public health were the only categories for which expenditures increased in real terms.

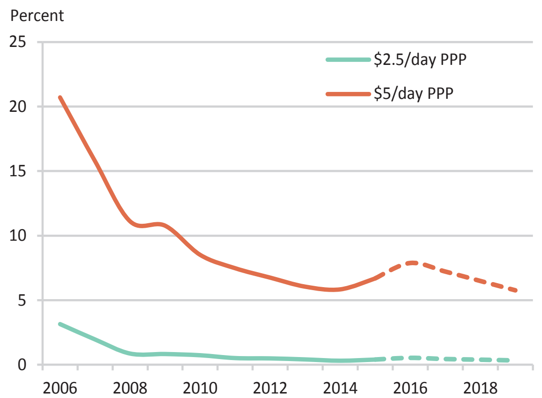
Poverty increased in 2015 and 2016. Moderate poverty rose from 5.8 percent in 2014 to 6.7 percent in 2015 as inflation eroded

FIGURE 1 Russian Federation / GDP growth, contributions to growth



Sources: Russian Statistical Authorities and World Bank staff calculations.

FIGURE 2 Russian Federation /Actual and projected poverty rates



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

the real value of wages and social benefits, and the middle class contracted for the first time since 2009.[1] In 2016, inflation slowed and real wage growth resumed, but income from other sources, including pensions, contracted again. Consequently, disposable income fell in real terms, household consumption declined by 5 percent, and current estimates suggest that the poverty rate rose further to 7.9 percent. However, the prevalence of extreme poverty remains marginal.

Outlook

Given the relatively weak external environment, we project that the Russian economy will grow at a rate of 1.3 percent in 2017 and 1.4 percent in 2018-19. The terms of trade are expected to moderately improve, with average oil prices rising to US$55 per barrel in 2017, US$60.0 per barrel in 2018, and US$61.5 per barrel in 2019, driving a recovery in domestic demand. Supported by the anticipated resumption of real wage and income growth, consumption is projected to reassert its role as an important contributor to growth in 2017-19. A gradual monetary easing and improved investor confidence are expected to support an increase in fixed capital investment in 2017.

The government is planning further fiscal-consolidation measures. A new fiscal rule, slated to take effect in 2020, will mandate that oil revenues be saved or spent based on a threshold price of US$40 per barrel. The Ministry of Finance has already started executing daily foreign-currency transactions based on this threshold. The approved medium-term fiscal framework, which envisions an expenditure-focused consolidation effort, is also supporting the transition to the new rule.

The moderate poverty rate is expected to fall in 2017, but will remain elevated. During 2010-14, increases in pensions and public-sector wages drove income growth among households in the bottom 40 percent of the income distribution. However, in a context of fiscal consolidation, labor income is expected to become the main contributor to shared prosperity. As the economy rebounds, wage growth in the private sector and a modest real increase in pension payments in 2017 will support income growth and reduce poverty. However, many households remain very close to the poverty line and without formal jobs.

Risks and challenges

Important downside risks persist. Continuing to implement the fiscal adjustment while managing lingering inflationary pressures will remain a key challenge over the medium term. The government can mitigate downside risks by establishing the new fiscal rule and adhering to the medium-term budget framework.

The Russian economy's medium-term prospects are constrained by its low potential for total factor productivity growth. Easing this constraint will require deepening and accelerating structural reforms. Priority policy objectives include reducing the role of the state in the economy, protecting property rights, improving the institutional and regulatory framework, and promoting fair competition.

1/ Moderate and extreme poverty are defined as per capita consumption equivalent to less than US$5 and less than US$2.50 per day in 2005 ppp terms, respectively. "Middle Class" is defined as a per capita consumption level between US$5 and US$10. These trends are consistent with the poverty rate under national line that increased in 2015 to 13.3 percent from 11.2 percent in 2014.

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

	2014	2015	2016 e	2017 f	2018 f	2019 f
Real GDP growth, at constant market prices[a]	0.7	-2.8	-0.2	1.3	1.4	1.4
Private Consumption	2.0	-9.7	-5.0	1.8	2.5	2.5
Government Consumption	-2.1	-3.1	-0.3	-1.1	-1.1	-1.1
Gross Fixed Capital Investment	-1.0	-9.4	-1.4	2.0	2.5	3.5
Exports, Goods and Services	0.5	3.7	2.3	1.7	1.5	1.5
Imports, Goods and Services	-7.6	-25.5	-5.0	5.0	4.0	4.0
Real GDP growth, at constant factor prices	0.9	-2.5	-0.3	1.3	1.3	1.4
Agriculture	2.0	2.9	3.3	1.2	1.7	1.7
Industry	-0.2	-2.8	-0.1	1.6	1.6	1.7
Services	1.4	-2.7	-0.6	1.2	1.2	1.2
Inflation (Consumer Price Index)	7.8	15.5	7.1	4.5	4.0	4.0
Current Account Balance (% of GDP)	2.8	5.0	1.7	1.6	1.2	0.9
Financial and Capital Account (% of GDP)	-3.1	-5.3	-1.7	-1.6	-1.2	-0.9
Net Foreign Direct Investment (% of GDP)	-1.7	-1.1	0.2	-0.4	-0.3	-0.2
Fiscal Balance (% of GDP)[b]	-1.1	-3.4	-3.7	-2.2	-0.9	-0.2
Debt (% of GDP)	15.6	15.9	15.7	17.0	17.0	17.0
Primary Balance (% of GDP)[b]	-0.5	-2.6	-2.8	-1.3	0.0	0.9
Poverty rate ($2.5/day PPP terms)[c,d,e]	0.3	0.4	0.5	0.5	0.4	0.4
Poverty rate ($5/day PPP terms)[c,d,e]	5.8	6.7	7.9	7.5	6.9	6.4

Sources: Rosstat, Bank of Russia, Ministry of Finance, World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
(a) Growth projections are based on national accounts data released in February 2017.
(b) Fiscal and Primary Balance refer to general government balances.
(c) Calculations based on ECAPOV harmonization, using 2015-HBS.
(d) Projection using neutral distribution (2015) with pass-through = 1 based on private consumption per capita in constant LCU.
(e) Actual data: 2014, 2015. Nowcast: 2016. Forecast are from 2017 to 2019.

SERBIA

Table 1	2016
Population, million	7.1
GDP, current US$ billion	37.7
GDP per capita, current US$	5340
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]	100.9
Life Expectancy at birth, years[b]	75.2

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

The recovery of the Serbian economy continued in 2016. Preliminary estimates suggest an annual growth of 2.8 percent. Growth translated in the creation of new jobs, though to a large extent in the informal sector. Progress with fiscal adjustment continued on the back of structural reforms, primarily regarding SOEs. Poverty, which reached an estimated 14.5 percent (living under $5/day PPP) in 2013, is expected to decline to 13.6 percent in 2016. High degrees of vulnerability remain due to still weak labor markets.

Recent developments

The Serbian economy benefited from recovery of consumption (up 1.1 percent) and exports (up 11.9 percent, y/y) in 2016. As a result, real GDP growth is estimated at 2.8 percent (y/y). Unlike in previous periods, both in 2015 and 2016, private investment provided particular support to growth. Growth could have been even stronger if not for a recent increase in imports (6.8 percent in real terms).

Looking across sectors of the economy, growth in 2016 was broad based. Agricultural output increased by 8.3 percent y/y in real terms in 2016; value added in industry increased by 3.6 percent and in services by 2.2 percent compared to 2015.

Improved economic performance reflected on the labor market with employment rates finally exceeding those from before the international financial crisis. Both the activity rate and employment rate, at 52.3 percent and 45.5 percent respectively in the last quarter of 2016, have increased steadily over the last two years. Unemployment rate fell to 13 percent in Q4, its lowest level since 2008. In 2016, real wages increased by 2.6 percent (y/y) after declining for three consecutive years. However, almost a third of the increase in employment came from the informal sector. Youth unemployment dropped as well, but remains high, at 31.2 percent.

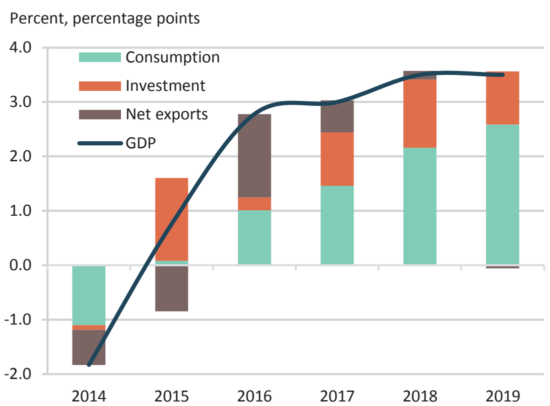
Since employment and labor income are critical for the welfare of the poor and vulnerable, poverty (measured using the regional line of $5/day 2005 PPP) is estimated to have declined from 14.9 percent in 2014 to 13.6 percent in 2016. The recovery in agriculture output in 2016 is likely to have had positive impacts on rural poverty. Yet it is estimated that poverty has not returned to its lowest level seen in 2008.

Fiscal consolidation continues successfully, and in 2016 the general government budget deficit reached 1.4 percent of GDP compared to 6.6 percent of GDP in 2014. Public debt declined to around 74 percent of GDP by year-end. Different measures included as part of the fiscal consolidation efforts are estimated to have small negative impacts on poverty, and there were some mitigating measures in place. Few poor individuals working in the public sector were affected by recent freezes and cuts in wages, but in 2016 there was an increase in wages in some sectors. The poverty impact of the 2014 nominal reductions in pensions was eased by the progressivity of the reductions. The energy bill discount program for vulnerable populations was expanded to mitigate the impact of increases in electricity tariff in 2015 and 2016.

Inflation averaged 1.2 percent in 2016, well below the central bank target band, due to a still relatively weak domestic demand. Low inflation in 2016, and in particular a decrease of food prices (thanks to the good agriculture season) helped protect purchasing power.

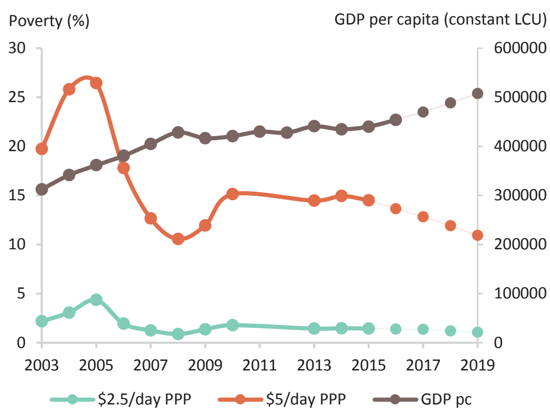
The current account deficit (CAD) shrank by 13 percent in euro terms in 2016 compared to 2015. This came as a result from an improved trade balance (down 12.9 percent) and occurred despite lower re-

FIGURE 1 Serbia / GDP growth, contributions to growth



Sources: WB staff calculations based on Statistical Office data.

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



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

mittances (a drop of 9.4 percent y/y). FDI reached a 5.5 percent of GDP. The dinar has fallen slightly (1.5 percent) against the euro in 2016 despite significant and frequent interventions by the NBS. Foreign currency reserves declined by about EUR 170 million in 2016. The banking sector remains stable and loans to private sector increased by 2.5 percent by year-end (y/y).

Outlook

Growth is projected to accelerate from 2.8 percent in 2016 to about 4 percent over the medium term. An increase in consumption (both private and government) is expected to be the main driver of growth in outer years of the projections period, with investment gaining in importance as well. The ongoing fiscal consolidation program targets the fiscal deficit to decline to around 1 percent of GDP over the medium term. This should bring public debt as a share of GDP to below 70 percent of GDP by 2019. With domestic demand recovering gradually, inflation is set to return to the target band in 2017. External balances are projected to improve as well, with the CAD below 4 percent of GDP over the medium term.

With economic growth and improvements in the labor market, though with remaining structural challenges, poverty is expected to continue its gradual decline. Poverty measured at the $5/day poverty line is estimated to decline to 12.8 percent in 2017 and 11.9 percent in 2018. Future rises in electricity tariffs as envisioned under the financial consolidation plan of the public utility are expected to further increase energy stress, particularly on poor households. While the energy bill discount program for vulnerable customers has been expanded, implementation challenges remain.

Risks and challenges

While recognizing the positive fiscal consolidation progress in 2015 and 2016, there remains the need for sustained implementation of structural reforms. A broad spectrum of reforms is envisaged (mainly in the field of social sectors and SOEs) which is crucial in order to ensure faster growth of the economy and the creation of new jobs.

The potential distributional impacts of these important structural reforms may present continued challenges to faster poverty reduction in the short run. Moreover, despite recent improvements, labor force participation and employment ratios are still low while unemployment is high, especially for the young. Therefore, policy design needs to consider appropriate social assistance and facilitate access to employment to mitigate adverse impacts.

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

	2014	2015	2016 e	2017 f	2018 f	2019 f
Real GDP growth, at constant market prices	-1.8	0.8	2.8	3.0	3.5	3.5
Private Consumption	-1.3	0.5	0.8	1.4	2.2	2.9
Government Consumption	-0.6	-1.5	2.3	-1.1	1.9	1.9
Gross Fixed Capital Investment	-3.6	5.6	7.7	4.7	6.4	6.1
Exports, Goods and Services	5.7	10.2	11.9	7.4	7.4	7.5
Imports, Goods and Services	5.6	9.3	6.8	5.1	5.9	6.4
Real GDP growth, at constant factor prices	-2.0	0.7	3.3	2.4	3.5	3.5
Agriculture	2.0	-7.7	8.1	-2.0	2.6	3.0
Industry	-6.4	3.0	1.7	5.2	5.4	5.4
Services	-0.5	1.1	2.4	1.8	2.7	2.7
Inflation (Consumer Price Index)	2.1	1.4	1.7	3.1	3.5	3.5
Current Account Balance (% of GDP)	-6.0	-4.8	-4.0	-3.9	-3.9	-3.9
Financial and Capital Account (% of GDP)	5.1	3.9	3.2	3.1	3.0	3.1
Net Foreign Direct Investment (% of GDP)	3.7	3.7	3.8	3.8	3.9	3.9
Fiscal Balance (% of GDP)	-6.6	-3.7	-1.4	-1.4	-1.2	-1.0
Debt (% of GDP)	72.4	75.6	74.6	73.0	70.2	66.8
Primary Balance (% of GDP)	-3.6	-0.4	2.1	2.1	3.0	2.5
Poverty rate ($2.5/day PPP terms)[a,b,c]	1.5	1.4	1.4	1.3	1.2	1.0
Poverty rate ($5/day PPP terms)[a,b,c]	14.9	14.5	13.6	12.8	11.9	10.9

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 2013-HBS.
(b) Projection using neutral distribution (2013) with pass-through = 0.7 based on GDP per capita in constant LCU.
(c) Nowcast: 2014 - 2016. Forecast are from 2017 to 2019.

TAJIKISTAN

Table 1	2016
Population, million	8.6
GDP, current US$ billion	6.9
GDP per capita, current US$	804
Poverty rate (national poverty line)[a]	31.3
Gini Coefficient[a]	28.0
School enrollment, primary (% gross)[b]	99.0
Life Expectancy at birth, years[b]	69.4

Source: World Bank WDI and Macro Poverty Outlook
Notes:
(a) Most recent value (2015)
(b) Most recent WDI value (2014)

Tajikistan's economy grew strongly by 6.9 percent in 2016, driven by foreign-financed public and private investments. Growth is expected to slow slightly in 2017 before gradually rebounding over the medium term as the external environment improves. The outlook for growth remains positive, and poverty reduction may accelerate in 2017 as remittances recover. However, the government also needs to enhance its macroeconomic and fiscal policy frameworks to address financial sector vulnerabilities and inefficient state-owned enterprises.

Recent developments

GDP growth rose from 6.0 percent in 2015 to 6.9 percent in 2016, per official estimates. Foreign-financed investment spurred growth in the industrial and construction sectors, which expanded by 16 percent and 20.3 percent, respectively. The mining and food-processing subsectors drove the increase in industrial output, while expanded activity on Rogun Hydropower Plant and public investment dedicated to the 25th anniversary of independence spurred the construction sector. Agricultural output grew by 5.2 percent (y/y), supported by efficiency gains and favorable weather. Low external trade activity slowed growth of services, while currency depreciation coupled with a further drop in real remittances caused private consumption to contract. However, the robust growth of fixed investment and an improved net export position more than compensated for a decline in private consumption.

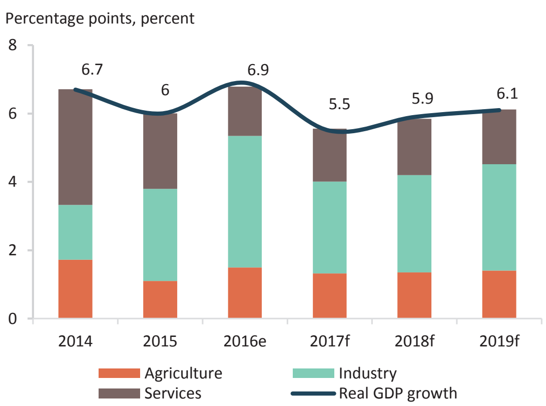
Declines in consumption and remittances had especially negative implications for the financial sector, which already suffered from weak corporate governance, risk management, and regulatory oversight. At end-2016, the government bailed out two systemically important banks at a cost of 6 percent of GDP, and in early 2017 the licenses of two smaller banks were revoked. However, needed amendments to the banking resolution and supervisory framework which are key to restoring stability to the system, are still pending.

Official inflation remained broadly stable at 5.9 percent (annual average). The currency depreciation in early 2016 and rise in utility tariffs in the last quarter of 2016 put pressure on prices, but low imported oil and food prices offset this effect.

The fiscal position deteriorated due to less-than-expected revenues from external trade, and higher foreign-financed public investment. To contain the deficit, the government revised the budget downward by 0.8 percent of GDP in mid-2016, cutting low-priority current and capital spending, while fully protecting core social outlays and strategic capital investments. The government also increased public sector wages and pensions, and expanded Targeted Social Assistance (TSA) program. In 2016, the fiscal deficit (excluding financial sector bailout) widened to 4.0 percent of GDP from 1.9 percent in 2015. Public and publicly-guaranteed debt surged from 34 percent of GDP in 2015 to 41 percent in 2016. The new debt was largely driven by domestic bond issuances for the bank bailout. External debt continues to dominate the debt structure at 32.4 percent of GDP. The creditor profile remains biased towards China accounting for over half of total external debt.

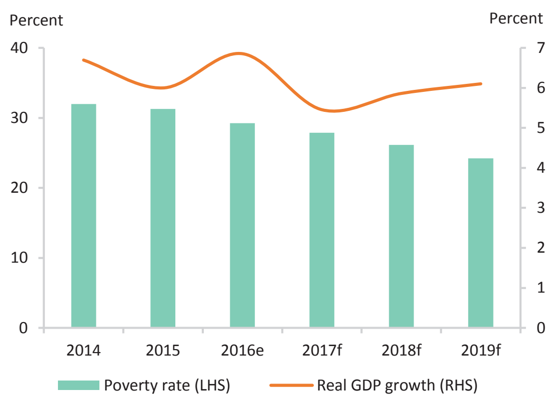
The currency depreciation led to a decline in imports and modest export growth, improving the external position despite reduced remittances. The current-account deficit narrowed from 6.4 percent of GDP in 2015 to an estimated 3.8 percent in 2016. The introduction of foreign exchange surrender requirement and domestic gold purchases boosted the growth of the money supply. However, due to banking sec-

FIGURE 1 Tajikistan / GDP growth decomposition, actual and projected, 2014-19



Sources: TajStat, World Bank staff estimates.

FIGURE 2 Tajikistan / The national poverty rate and GDP growth, actual and projected, 2014-19



Source: World Bank staff estimates.

tor vulnerabilities and reduced business activity, credit to the private sector remained broadly unchanged in 2016. Over the past year, the central bank steadily tightened monetary policy by raising the policy rate from 8 percent to 12.5 percent while sharply increasing sterilization to stem inflationary pressures. Stable foreign exchange markets and gold purchases facilitated the accumulation of international reserves, which rose by 30 percent during 2016 to reach 2.7 months of imports according to official estimates.

The national poverty rate fell from 37.4 percent in 2012 to 30.3 percent in the third quarter of 2016. Extreme poverty declined from 18.2 percent in 2013 to 14 percent in 2016. Wage income continues to drive poverty trends, but lower remittances in 2014-16 slowed the pace of poverty reduction.

Outlook

Growth is projected to slow to 5.5 percent in 2017 due to structural vulnerabilities among state-owned enterprises, lingering financial sector distress, and a planned fiscal consolidation. Diminishing fiscal space is expected to slow the pace of public investment.

The gradual economic recovery of Russia and other trading partners is expected to bolster remittances, accelerating poverty reduction and spurring growth in consumption and services. However, overall improvements in macroeconomic management and progress in priority reform areas such as financial regulation, the business climate, public financial management, and SOE oversight will be vital to medium-term growth. The fiscal deficit is likely to stay high affected by additional need for bank recapitalization in 2017 and 2018, hence resulting in growing public debt trajectory. The overall external position is projected to be positive with FDI and debt inflows more than offsetting the current account deficit. Prudent monetary policy should keep the inflation rate in the mid-single digits.

The poverty rate is expected to continue to fall at a steady pace, but this hinges on a continued increase in remittances. Strong domestic economic growth and an incipient recovery in Russia, supported by more accommodative migration regulations, will boost income growth among vulnerable households. The new Law on Social Assistance and the nationwide expansion of the TSA program are expected to further reduce extreme poverty. The national poverty rate is projected to fall from 29.3 percent in 2016 to 26.1 percent by 2018.

Risks and challenges

Despite the anticipated recovery of the external environment, risks to growth are tilted to the downside. Large contingent liabilities related to state-owned enterprises and weaknesses in the business climate will continue to hamper economic activity, and could add to debt-related risks. Ongoing asset-quality reviews at commercial banks may reveal new capitalization needs and further increase fiscal costs.

A weaker-than-expected recovery among regional economies or delays in the expansion of the TSA program could hinder progress on poverty reduction. Finally, a combination of credit constraints and slow employment growth in pro-poor sectors such as construction and agriculture will continue to present a serious challenge to the government's poverty-reduction efforts.

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

	2014	2015	2016 e	2017 f	2018 f	2019 f
Real GDP growth, at constant market prices	6.7	6.0	6.9	5.5	5.9	6.1
Private Consumption	1.8	-12.3	-4.1	1.5	3.0	3.5
Government Consumption	4.1	3.3	2.4	3.5	3.8	4.3
Gross Fixed Capital Investment	20.0	24.4	21.2	11.8	11.8	11.8
Exports, Goods and Services	0.0	0.0	7.7	4.2	5.0	5.2
Imports, Goods and Services	1.1	0.0	-15.0	0.0	2.0	2.5
Real GDP growth, at constant factor prices	5.0	5.4	6.6	6.0	6.4	6.4
Agriculture	4.5	3.2	5.2	5.3	5.6	5.6
Industry	5.1	11.2	16.0	10.7	11.0	11.2
Services	5.3	3.8	2.5	3.6	4.0	3.8
Inflation (Consumer Price Index)	6.1	5.8	5.9	7.0	7.0	7.0
Current Account Balance (% of GDP)	-2.8	-6.4	-3.8	-4.7	-4.5	-4.4
Financial and Capital Account (% of GDP)	5.5	7.9	8.1	7.7	7.0	6.4
Net Foreign Direct Investment (% of GDP)	3.4	5.4	5.0	3.2	3.2	3.2
Fiscal Balance (% of GDP)[a]	0.0	-1.9	-10.1	-6.5	-5.4	-1.5
Debt (% of GDP)[a]	27.9	34.0	41.4	48.9	54.2	55.6
Primary Balance (% of GDP)[a]	0.4	-1.3	-9.6	-5.7	-4.9	-1.1
Poverty rate (national poverty line)[b,c,d]	32.0	31.3	29.3	27.9	26.1	24.2

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: e = estimate, f = forecast.
(a) a) Calculations include financial sector bailout in 2016 (6 percent of GDP) and projected additional recapitalization in 2017 (4 percent of GDP) and 2018 (3.5 percent of GDP). Materialization of fiscal risks due to contingent liabilities of SOEs may additionally result in 8 percent of GDP over the medium term which is excluded from current calculations.
(b) Calculations based on 2015 HBS. National poverty line: LCU 167.7583/month.
(c) Projection using neutral distribution (2015) with pass-through = (0.7) based on GDP per capita constant PPP.
(d) Actual data: 2014, 2015. Nowcast: 2016. Forecast are from 2017 to 2019.

TURKEY

Table 1	2016
Population, million	77.8
GDP, current US$ billion	857.7
GDP per capita, current US$	11032
Poverty rate ($2.5/day 2005PPP terms)[a]	3.1
Poverty rate ($5/day 2005PPP terms)[a]	18.3
Gini Coefficient[a]	41.2
School enrollment, primary (% gross)[b]	106.9
Life Expectancy at birth, years[b]	74.9

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

Turkey's growth slowed from 6.1 percent in 2015 to 2.9 percent in 2016, as the failed coup attempt depressed consumer and business confidence. The rebound in global oil prices led to a widening current account deficit, while the rapid depreciation of the Lira and a poor harvest drove inflation higher. Meanwhile, the pace of poverty reduction lost momentum. In the medium-term, with larger macro imbalances, Turkey faces substantially slower growth and poverty reduction, as structural weaknesses become binding.

Recent developments

Turkey's growth rate slowed from 6.1 percent in 2015 to 2.9 percent in 2016. After recording the largest contraction since the global financial crisis in Q3, GDP growth was stronger than expected in Q4, driven by a rebound in private consumption and net exports. Recovery in private consumption was strong, as consumers front-loaded their spending, particularly auto and white goods purchases, with the anticipation that prices will rise due to currency depreciation. Following a notable drop in Q3, investment spending slightly recovered in Q4 despite deteriorating balance sheets and declining profitability due to currency depreciation. High frequency indicators point to a continuation of recovery in early Q1 of 2017.

In the second half of 2016, the current account deficit widened by $3.3 billion to $32.6 billion, mostly due to a sharp drop in tourist arrivals, while financial inflows weakened on the back of increased domestic uncertainty, deteriorating macroeconomic balances, and a less favorable global environment. Amid portfolio outflows, the Lira depreciated by 33.4 percent between July and late January, to recover by 5.6 percent by early March following the Central Bank's tightening steps.

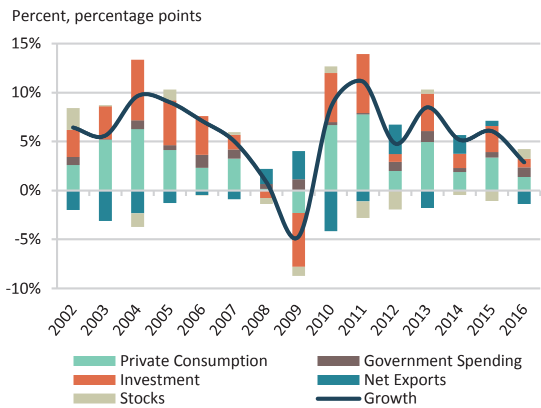
After easing to 7 percent in November, headline inflation climbed to 10.1 percent in February, due to the sharp increase in transport and food prices. Pump prices for gasoline and diesel increased by over 30 percent y-o-y in February, due to the rebound in global oil prices and the depreciation of the Lira. In addition, poor harvest due to unfavorable weather conditions increased food prices, substantially adding to headline inflation.

The rapid Lira depreciation led the Central Bank to increase interest rates and return to unorthodox monetary policy. Since November, the Central Bank increased the late liquidity lending rate, the overnight lending rate and the 1-week repo rate by 125 bps, 100 bps, and 50 bps, respectively, leading to a 262 bps increase in the average cost of funding. At the same time, fiscal policy has been providing considerable stimulus. Central government expenditures grew substantially, while stronger than expected performance in non-tax revenues, such as interest and share income and capital revenues, kept the budget deficit at 1.2 percent of GDP in 2016.

Poverty and extreme poverty continue to decrease, albeit at a slower pace. The population with per capita expenditure below the poverty line (5 US$ a day in 2005 PPP) reached a low of 18.3 percent, from 24.1 a decade earlier. Extreme poverty, the population with per capita expenditure below 2.5 US$ a day in 2005 PPP, decreased to 3.1 percent, compared to 5.3 in the early 2000s. The improvement has been mainly driven by higher wages and better access to jobs, with social assistance fulfilling a complementary and relatively minor supporting role.

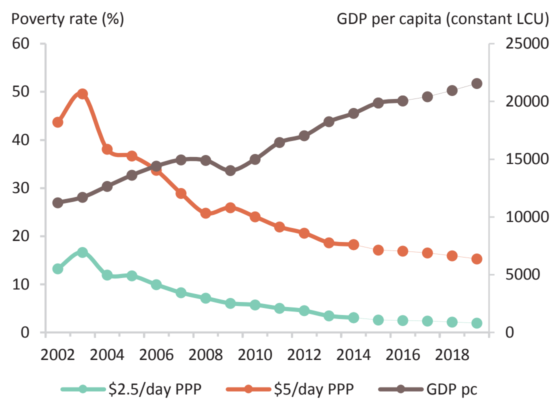
Such positive trend, however, is losing momentum. Unemployment has been on the rise, reaching 12.1 percent of the labor force in November 2016; a level similar to November 2009 when the financial crisis strongly affected the Turkish economy.

FIGURE 1 Turkey / GDP growth, contributions to growth



Sources: Turkstat and World Bank staff calculation.

FIGURE 2 Turkey / Actual and projected poverty rates and GDP per capita (constant LCU)



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

This is 3.7 percentage points higher than November 2011 when the lowest unemployment rate of the decade was observed. Moreover, the jobless rate among the youth (ages 15 to 24) followed roughly the same trend by increasing to 21.6 percent in November 2016, very similar to the levels recorded during the economic crisis (21.8 percent in November 2009).

Outlook

Growth is expected to strengthen gradually in the course of 2017 and is projected at 3.5 percent for the year as whole. Following a contraction in 2016, exports are likely to grow in 2017 thanks to stronger growth in the EU, while imports are expected to increase at a moderate pace as domestic demand recovers. Security concerns are likely to limit the recovery of tourist arrivals from both Europe and Russia. The depreciation of the Lira may further feed into consumer prices, eroding the purchasing power of households. Moreover, the balance sheet of corporates might deteriorate given the large open FX position, thus weakening private investment prospects. The recent monetary policy tightening is likely to constrain the recovery of domestic demand in the near future, while falling banking sector rollover rates may limit credit growth. In 2017, with a rising energy deficit due to the rebound in global oil prices, the current account deficit is expected to increase to 5 percent of GDP, while inflation is likely to remain well above target.

Poverty is forecasted to decrease at a slow rhythm, in the midst of a sluggish labor market and rising inequality. With private consumption forecast to grow in the coming years, poverty and extreme poverty are estimated to decline to 16.8 and 2.82 percent, respectively, in 2017; and to 16.2 and 2.73 percent in 2018. This forecast depends crucially on no further deteriorations in the labor market, and assumes the current social assistance scheme does not change. While in recent years lower income households have had increasing access to quality jobs in the formal sector, the high labor costs and minimum wage in a context of slower economic activity will be putting some of the gains at risk.

Risks and challenges

In the medium-term Turkey faces a substantially slower growth path with larger macro imbalances, as structural weaknesses remain intact. The quality of growth has weakened in the past few years, as productivity growth stagnated and investment spending concentrated in construction. Turkey`s current account deficit is likely to increase to 6 percent by 2019, while the normalization of global monetary policies will make the competition for foreign funds fiercer among developing countries, with higher costs. There is an urgent need for a return to implementing the structural reform agenda to restore investor confidence, address vulnerabilities and lift growth.

The government's recently announced "employment mobilization" campaign is aiming to create 2 million new jobs to contain the rise in joblessness. The campaign includes a subsidy to employers on salaries of new formal hires for 12 months. From an equity perspective, since most formal jobs are accessed by the non-poor, the effects of the campaign will disproportionately benefit higher income households. The main challenge will be how to promote a more inclusive mix of beneficiaries and improve the distributive impacts of the campaign.

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

	2014	2015	2016 e	2017 f	2018 f	2019 f
Real GDP growth, at constant market prices	5.2	6.1	2.9	3.5	3.9	4.1
Private Consumption	1.9	3.4	1.4	1.6	2.4	2.6
Government Consumption	0.4	0.5	1.0	1.1	0.9	0.9
Gross Fixed Capital Investment	1.5	2.7	0.9	1.0	1.5	1.6
Exports, Goods and Services	1.8	0.9	-0.5	0.8	1.1	1.2
Imports, Goods and Services	-0.1	0.4	0.9	1.0	2.0	2.2
Real GDP growth, at constant factor prices	5.6	5.7	2.8	3.6	4.0	4.2
Agriculture	0.6	9.1	-4.1	1.9	1.9	1.9
Industry	5.5	5.0	5.2	1.5	1.5	1.5
Services	6.3	5.6	2.5	4.9	5.5	5.8
Inflation (Consumer Price Index)	8.9	7.7	8.5	9.0	8.5	8.0
Current Account Balance (% of GDP)	-4.7	-3.7	-3.8	-5.0	-5.5	-6.0
Financial and Capital Account (% of GDP)	4.4	2.6	2.5	4.4	4.8	5.2
Net Foreign Direct Investment (% of GDP)	0.6	1.4	1.1	1.3	1.3	1.2
Fiscal Balance (% of GDP)	-0.5	-0.1	-1.7	-1.5	-1.3	-1.0
Debt (% of GDP)	31.0	30.0	30.5	30.4	29.9	29.2
Primary Balance (% of GDP)	2.0	2.2	0.5	0.7	0.9	1.2
Poverty rate ($2.5/day PPP terms)[a,b,c]	3.1	2.6	2.5	2.4	2.2	2.0
Poverty rate ($5/day PPP terms)[a,b,c]	18.3	17.1	16.9	16.5	15.9	15.3

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 2008-HICES, 2013-HICES, and 2014-HICES.
(b) Projection using annualized elasticity (2008-2013) with pass-through = 1 based on GDP per capita in constant LCU.
(c) Actual data: 2014. Nowcast: 2015 - 2016. Forecast are from 2017 to 2019.

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TURKMENISTAN

Table 1	2016
Population, million [a]	5.4
GDP, current US$ billion [a]	37.7
GDP per capita, current US$ [a]	6930
Life Expectancy at birth, years [b]	66

Sources: World Bank, WDI, and Macro Poverty Outlook.
Notes:
(a) World Bank staff estimates (2016)
(b) Most recent WDI value (2014)

Lower hydrocarbon prices and sluggish external demand have continued to undermine Turkmenistan's economic performance. In 2016, real GDP growth slowed, imbalances in the external position widened, and domestic demand weakened. While data on social indicators are limited, the slowdown has likely had an adverse impact on welfare. Medium-term growth is projected to improve as hydrocarbon prices and export revenues gradually recover. Deeper structural reforms will be necessary to improve the sustainability and inclusiveness of growth.

Recent developments

On February 12, 2017, President Gurbanguly Berdimuhamedov was reelected to a third term with 97.7 percent of the vote. As Turkmenistan is one of the most hydrocarbon-dependent economies in the world—with the hydrocarbon sector accounting for half of GDP, more than 90 percent of exports, and more than 80 percent of fiscal revenues—the administration will continue targeting a gradual transition toward a more diversified, market-driven economy. The government's plan calls for continued public support to entrepreneurship and greater public investment in education and health. To improve social indicators, the country will attempt to leverage its natural resource wealth to increase real incomes and raise living standards.

GDP growth slowed marginally from 6.5 percent in 2015 to 6.2 percent in 2016, according to official data, as the continued decline of global hydrocarbon prices affected export revenue and domestic demand. The Russian government's decision to end gas imports from Turkmenistan, a contract dispute with Iran, and the ongoing slowdown of the Chinese economy appear to have also affected hydrocarbon output and exports. Meanwhile, a 36.8 percent reduction in public investment and a 27.6 percent drop in foreign direct investment (FDI) in large oil and gas projects slowed growth in the construction sector. Driven in part by increased government subsidies, consumption growth remained robust, and retail trade expanded.

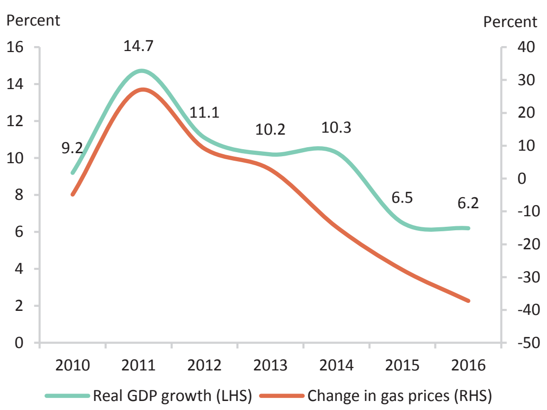
Turkmenistan's external position continued to deteriorate in 2016, as falling exports widened the current account deficit. To maintain the exchange rate peg at 3.5 Turkmen manat per US dollar, the authorities tightened restrictions on access to foreign exchange, while imports were slow to adjust. Combined with lower FDI inflows, the higher current account deficit may have created a balance-of-payments gap that required the central bank to tap its foreign exchange reserves.

The central bank focused on maintaining the currency peg by tightening liquidity and restricting the foreign exchange operations. Official statistics indicate that the annual inflation rate averaged 6 percent in 2016, supported by administrative price controls.

The government maintained a tight fiscal policy stance (excluding off-budget fiscal operations). While falling hydrocarbon receipts reduced state budget revenues by 2.5 percent of GDP in 2016, lower capital outlays and the partial rationalization of social subsidies slashed public spending by 3.8 percent of GDP, yielding a modest budget surplus of 0.6 percent of GDP. The authorities do not publish information on the country's six off-budget funds, including the stabilization fund, and the government's consolidated fiscal position remains unclear.

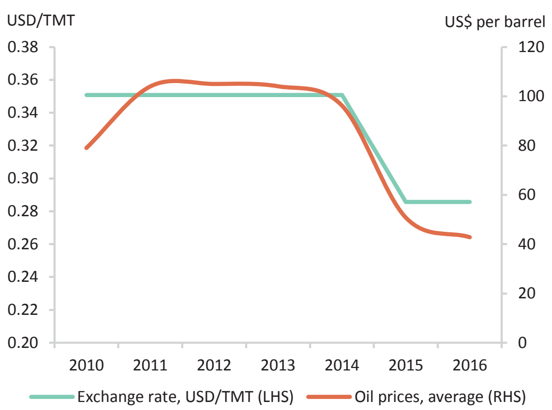
Turkmenistan does not release official statistics on living standards, and little is known about the labor market. Data constraints prevent a thorough analysis of the social impact of slowing economic growth.

FIGURE 1 Turkmenistan / Real GDP growth and percent change in gas prices



Sources: State Statistics Committee of Turkmenistan.

FIGURE 2 Turkmenistan / Exchange rate and oil prices



Sources: Central Bank of Turkmenistan.

Outlook

Turkmenistan's GDP growth rate is projected to increase marginally in 2017, with a moderate recovery in hydrocarbon prices and lessened exchange rate pressures. While rising hydrocarbon prices are expected to narrow the current account deficit in 2017, it will remain elevated due to the slow import adjustment process. A further slowdown in net capital inflows may compel the authorities either to use additional official foreign exchange reserves to close the external financing gap, or to adjust the exchange rate peg.

The authorities are expected to maintain a tight monetary policy stance to support the fixed exchange rate and ensure macroeconomic stability, though this will likely have a negative impact on the economy. Fiscal consolidation is expected to continue, which should strengthen fiscal and debt sustainability. However, a persistent balance-of-payments deficit could raise net public debt if the authorities choose to close the gap by borrowing or by spending its hydrocarbon-revenue reserves.

Risks and challenges

Turkmenistan's outlook is subject to both external and domestic downside risks. External risks include a protracted slump in global hydrocarbon prices or reduced demand for Turkmenistan's natural gas exports, either of which could be caused by a sharper-than-expected slowdown in the Chinese economy. Deteriorating external conditions could diminish export revenue, further eroding the external and fiscal positions, increasing pressure on the exchange rate, and depressing domestic demand. Domestic risks are primarily policy-focused and include a slowing momentum on the structural reform agenda or a reversal of recent efforts to promote economic diversification and private sector development.

Tight administrative controls and the public sector's large overall role in economic activity remain the key obstacles to private sector development in Turkmenistan. The public sector and state-owned monopolies continue to dominate the economy and the formal labor market. FDI remains limited outside the hydrocarbon sector. Deeper structural reforms and improvements in the investment climate could help to attract investors in the non-resource sectors and leverage the broader potential of Turkmenistan's economy.

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

	2014	2015	2016 e	2017 f
Real GDP growth, at constant market prices	10.3	6.5	6.2	6.3
Prices: Inflation	6.0	7.4	6.0	6.0
Current Account Balance (% of GDP)	-7.1	-12.3	-17.8	-15.9
of which: Exports of oil and gas (% of GDP)	42.1	29.9	18.1	18.4
Financial and Capital Account (% of GDP)	9.5	10.0	9.6	8.8
of which: Net Foreign Direct Investment (% of GDP)	9.5	12.5	8.6	8.4
State Budget Balance (% of GDP)	0.9	-0.7	0.6	0.0
Public Debt (% of GDP)	17.9	21.0	21.1	19.5

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

UKRAINE

Table 1	2016
Population, million	42.5
GDP, current US$ billion	92.6
GDP per capita, current US$	2174
Poverty rate ($2.5/day 2005PPP terms)[a]	0.3
Poverty rate ($5/day 2005PPP terms)[a]	6.5
Gini Coefficient[a]	25.5
School enrollment, primary (% gross)[b]	100.0
Life Expectancy at birth, years[b]	71.2

Source: World Bank WDI and Macro Poverty Outlook
Notes:
(a) Most recent value (2015)
(b) Most recent WDI value (2014)

Ukraine's economy grew by 2.3 percent in 2016 after around 16 percent cumulative real GDP contraction in the previous two years. The recovery was supported by a bumper harvest and a pickup from low levels in manufacturing, construction, and key services. The poverty rate remained elevated in 2016, but declined slightly relative to 2015 levels due to lower inflation and higher wages. The economic outlook is modest given significant headwinds related to the conflict and trade blockade in the east of Ukraine. Sustainable recovery is contingent on renewed structural reform momentum.

Recent developments

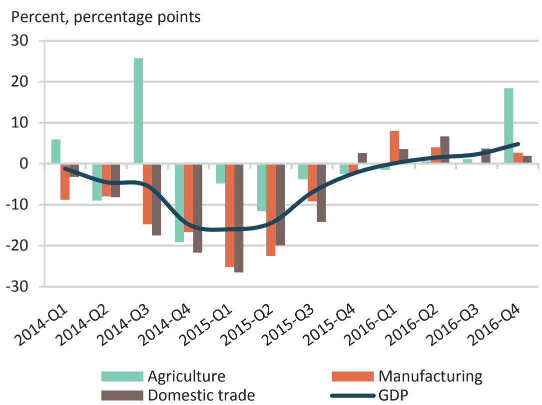
The economy has stabilized, but the recovery remains modest, with growth of 2.3 percent in 2016. Decisive reforms in 2014 and 2015 helped to restore confidence and address key macroeconomic vulnerabilities after two years of sharp contraction. The recovery was supported by a bumper harvest, with agriculture growing by 6 percent in 2016. In addition, other sectors also rebounded, with manufacturing, construction, domestic trade, and transport growing by 3.6, 16.3, 4.0, and 3.0 percent, respectively. In addition, fixed investment grew by 20 percent in 2016, pointing toward strengthening investor confidence. However, the overall pace of recovery remains modest as significant weaknesses remain in some parts of the services sector, including education, health, and financial services.

The poverty rate remained elevated in 2016, but declined slightly relative to 2015. Real income growth benefited from stabilization in consumer prices. Inflation slowed to 12.4 percent in 2016 from 43.3 percent at end-2015 on the back of exchange rate stabilization, subdued domestic demand and prudent monetary policy. This gave some respite to lower income households who over the last two years have been hit by the recession, the freeze in pensions and benefits at times of high inflation, and increases in prices of energy (partly offset by the scale up of social assistance but with uneven coverage of the bottom deciles). However, labor market conditions remained weak, unemployment rate grew to 9.3 percent in 2016.

Fiscal performance was better than expected in 2016, supported by stronger than expected tax revenues and expenditure restraint. The fiscal deficit (excluding Naftogaz) was 2.2 percent of GDP in 2016, up from 1.2 percent in 2015, but lower than previously projected. Total government revenues declined by 11 percent in real terms in 2016, in large part due to the cut in the social security contribution (SSC) rate. SSC revenues declined from 9.6 percent of GDP in 2015 to 5.5 percent in 2016—smaller than total pension spending of 10.8 percent of GDP. The resulting pension fund deficit of 5 percent of GDP has become a major fiscal vulnerability. On the other hand, other key tax revenues performed better than planned due to the pickup in economic activity in 2016. At the same time, the authorities implemented additional expenditure restraint measures in 2016, resulting in a decline in expenditures by over 9 percent in real terms. Public debt increased to 81 percent of GDP due to the costs for recapitalization and nationalization of PrivatBank in December of 2016.

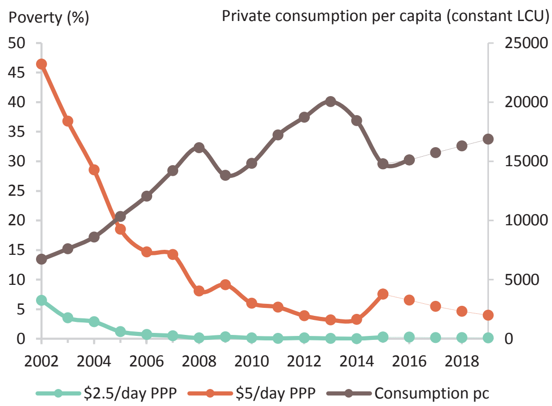
The current account deficit widened to 3.8 percent GDP in 2016 due to an increase in intermediate and investment goods. Despite a significant reduction of imports of gas , the merchandize trade deficit doubled in 2016 due to an increase in imports of investment goods. Higher FDI inflows—mainly related to bank recapitalization—were sufficient to cover the current account deficit in 2016. International reserves grew to US$15.5bn—an equivalent of 3.4 months of imports.

FIGURE 1 Ukraine / GDP growth (yoy), contributions to growth, by sector



Sources: Ukraine Statistics Service.

FIGURE 2 Ukraine / Actual and projected poverty rates and private consumption per capita (constant LCU)



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

Outlook

While the economy is expected to grow modestly, sustainable recovery is contingent on renewed structural reform momentum. Economic recovery is expected to benefit from more favorable terms of trade, strengthening domestic demand, and a gradual resumption of bank lending. The recent trade blockade would have a negative impact mainly in two sectors—steel production and electricity generation. Growth is projected at 2.0 in 2017 and 3.5 percent in 2018. Sustained recovery and growth of 4 percent or more will require accelerating implementation of politically difficult reforms to address longstanding structural challenges, including reducing corruption and improving governance, implementing land reform, strengthening competition and easing regulation.

External imbalances are expected to remain elevated due to current account pressures and debt repayment needs. In addition to remaining structural rigidities, the trade blockade undermines exports recovery—the current account deficit is expected to widen to 4.1 percent of GDP in 2017. Ukraine will require external financing to meet repayments of corporate external debt amounting to about $7 billion per year during 2017-2018. Maintaining cooperation with the IMF and other official creditors will be important to meet external financing needs and restore the investor confidence.

Going forward as growth prospects improve, the poverty rate is expected to continue declining gradually. However, the magnitude of this reduction will depend on the pattern of growth in the sectors were most of the poor/vulnerable are employed and the dynamics of key prices including energy. The reduction of poverty would be mainly driven by the growth of wages and other private incomes.

Risks and challenges

Risks to the economic outlook is high due to uncertainties regarding developments of the conflict in the east and progress with reforms on multiple fronts. The conflict in east of Ukraine has escalated considerably since end-January 2017 adding to the headwinds faced by the economy. The ongoing trade disruption is already accounted in the base-line projections, however, if the conflict escalates further, it may have broader negative impact on confidence, pace of economic recovery and external financing needs. .

The fiscal outlook remains challenging—addressing fiscal vulnerabilities would require a comprehensive fiscal consolidation that is underpinned by structural reforms. Despite a significant reduction in fiscal imbalances over the last two years, medium term fiscal pressures remain significant. In 2017, the consolidated fiscal deficit is projected to widen to 3.1 percent of GDP due to an increase in minimum wages and the deficit of the Pension fund. The fiscal framework targets a reduction of the deficit to 2 percent of GDP by 2020. Achieving this target will require a systematic fiscal consolidation anchored by comprehensive pension and tax reforms.

In addition, there is a risk that, ad-hoc fiscal consolidation measures could have a disproportionally high impact on poor and vulnerable segments of society. Without strengthening the targeting of the existing HUS program, some of the planned cuts in coverage could add to existing pressures on poorer households, as could fiscal measures introduced to cover the budget deficit. Moreover, the recent rise in the minimum wage could increase the incidence of informality among low-wage earners.

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

	2014	2015	2016 e	2017 f	2018 f	2019 f
Real GDP growth, at constant market prices	-6.6	-9.8	2.3	2.0	3.5	4.0
Total Consumption	-6.2	-15.9	1.4	3.1	2.8	3.3
Gross Fixed Capital Investment	-24.0	-9.2	20.1	15.4	7.9	7.7
Exports, Goods and Services	-22.1	-17.9	8.4	1.7	1.6	6.7
Imports, Goods and Services	-6.2	-15.9	1.4	3.1	2.8	3.3
Real GDP growth, at constant factor prices	-6.6	-9.8	2.3	2.0	3.5	4.0
Agriculture	2.3	-4.7	6.0	2.0	3.0	3.0
Industry	-11.6	-13.4	3.0	1.5	3.5	4.0
Services	-6.1	-9.6	-2.9	2.2	3.6	4.1
Inflation (Consumer Price Index)	24.9	43.3	12.4	10.2	7.0	6.0
Current Account Balance (% of GDP)	-3.5	-0.2	-3.7	-4.1	-3.0	-3.3
Financial and Capital Account (% of GDP)	3.0	-5.4	4.0	1.6	7.0	3.0
Net Foreign Direct Investment (% of GDP)	0.2	3.6	3.5	1.8	2.5	3.2
Fiscal Balance (% of GDP)	-4.5	-2.2	-2.3	-3.1	-2.6	-2.4
Debt (% of GDP)	70.3	79.4	81.2	88.8	83.5	75.9
Primary Balance (% of GDP)	-0.2	3.0	2.0	1.2	1.8	1.8
Poverty rate ($2.5/day PPP terms)[a,b,c]	0.0	0.3	0.3	0.2	0.2	0.1
Poverty rate ($5/day PPP terms)[a,b,c]	3.3	7.5	6.5	5.5	4.6	4.0

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 2015-HLCS.
(b) Projection using neutral distribution (2015) with pass-through = 1 (High) based on private consumption per capita in constant LCU.
(c) Actual data: 2014, 2015. Nowcast: 2016. Forecast are from 2017 to 2019

UZBEKISTAN

Table 1	2016
Population, million	31.5
GDP, current US$ billion	67.1
GDP per capita, current US$	2126
Life Expectancy at birth, years[a]	68.2

Source:World Bank WDI and Macro Poverty Outlook
Notes:

(a) Most recent WDI value (2014)

Uzbekistan's political transition is completed with both new president and government in place in January 2017. During 2016, the economy performed well, and GDP growth of 7.8 percent is attributed to investment supported by state budget. The outlook for 2017 is favorable, given a continuation of economic policies and a slightly improving external environment. Downside risks pertain mainly to TFP growth slowdown due to potential delays in structural reforms.

Recent developments

Uzbekistan's GDP growth slowed marginally to 7.8 percent in 2016 from 8 percent in 2015, according to official statistics. Growth was supported by the expansion in services (12.5 percent), agriculture (6.6 percent), and industry (5 percent), led by the newly adopted development programs for 2016-20 on infrastructure, industry, agriculture, and services sectors, including tourism.

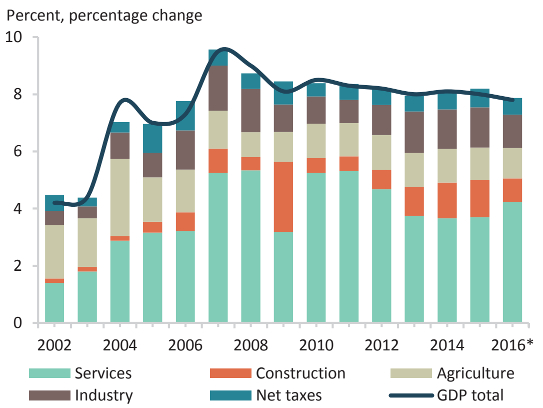
On the demand side, the main driver of economic growth was investment, which grew at 9.5 percent per annum – led by the large public investment program for 2015-19 supporting the development programs and investment by the private sector and state-owned enterprises (SOEs). This was further bolstered by an increase in bank credit and co-financing by the Uzbekistan Fund for Reconstruction and Development (UFRD). Private consumption recovered in 2016, following a considerable slowdown in 2015, owing to increases in public sector wages, pensions and social allowances. Remittances were below their 2015 level throughout 2016, but they started recovering in Q4 of 2016 by around 8 percent (y/y).

Uzbekistan's exports grew in 2016 despite the weak external environment, reversing the negative trend in the previous three years. A small improvement in total exports (0.5 percent) was driven by improvements in exports of chemicals, machinery, gold and services that offset declines in gas, metals and cotton. Uzbekistan's imports declined (mainly energy, food, and consumer durables) due to further import-substitution of fuels and food, as well as import compression measures, such as foreign currency rationing; all these factors mitigated the pressures on the external accounts.

The impact of the deteriorated external environment of recent years (Russian crisis, slower growth in China, and lower commodities prices) was seen in the return of up to 1 million labor migrants to Uzbekistan in 2014-16 and in the slight deterioration of the external and fiscal accounts. Given Uzbekistan's broader development policy—that has reduced reliance on foreign trade and increased the role of domestic absorption based on Uzbekistan's 32 million population and the support of the UFRD and FDI—the adverse impact of the external environment appears to have been somewhat mitigated. Still, Uzbekistan's GDP growth and investment figures suggest a weakening of the economy, as evidenced by lower TFP growth and a worsening incremental capital-output ratio (ICOR).

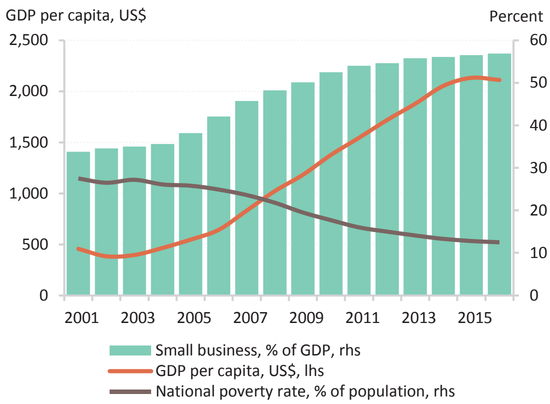
During 2016 as in several previous years, fiscal policy sought to offset the weakened consumer demand attributed to the reduced remittances and a weakening economy. The government increased investment, salaries and transfers, while cutting back on administrative and related expenses. To support the economy, the authorities also cut direct taxes on business and citizens. Uzbekistan's overall fiscal surplus is estimated to have improved modestly in 2016 due to both increased revenues and reduced current expenditures.

FIGURE 1 Uzbekistan / GDP growth, contributions to growth, by sector



Source: Uzbekistan official statistics, World Bank staff calculations.

FIGURE 2 Uzbekistan / Poverty, GDP per capita, and small business development, 2001–2016



Sources: Uzbekistan official statistics.
Note: The national poverty line is minimum food consumption equivalent to 2,100 calories per person per day and it does not include non-food items. Due to the lack of access to microdata the Bank cannot validate the official figures after 2003.

In 2016, the government also launched a privatization program and, by end-year, it had sold stakes in 609 state-owned enterprises to Uzbek residents, while the minority shares in 59 Uzbek joint stock companies were sold to foreign investors.

Uzbekistan's monetary and exchange rate policies were largely unchanged in 2016. The Central Bank of Uzbekistan's (CBU) policy remained broadly accommodative. As a result, inflation remained stable from 2015 (at about 8 ½ percent). The CBU's refinancing rate was maintained at 9 percent in 2016 (i.e. slightly positive in real terms), helping total banking deposits to grow by 27.5 percent (y/y) in the first 9 months of 2016, and total banking loans to grow by 25.7 percent (y/y). Non-performing loans (NPLs) appear to have remained relatively stable at 0.4 percent according to CBU estimates. Moody's assesses NPLs at 4-5 percent in August 2016.

Although validation is not possible due to lack of access to micro data, the official poverty rate declined from 14.1 percent in 2013 to 12.8 percent in 2015 and an estimated 12.5 percent in 2016. Robust economic growth, small business development, and targeted government safety net programs may have driven poverty reduction, whereas return migration and lack of robust employment growth could have been a draft on the opportunities of the poor. 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 was at 5.2 percent in both 2016 and 2015, i.e. increased from 4.9 percent in 2014.

Outlook

Uzbekistan's growth outlook is predicated on continued robust domestic investment supported by the allocation of fiscal resources (including from the UFRD), and a gradual recovery of commodity prices, remittances, and private consumption growth. Annual GDP growth is projected to slow slightly—from 7.8 percent in 2016 to an average 7.7 percent—over the medium term. The fiscal balance will recover modestly, but will not reach pre-2015 rates. While currency weakening will support growth, monetary policy is expected to be broadly accommodative, but somewhat more restrained than in previous years, aiming at a gradual reduction in the inflation rate. As the external environment gradually recovers, Uzbekistan's external accounts could improve modestly over time, including under the current policy of tight foreign exchange controls to contain import growth.

While data limitations do not allow for poverty projections, an increased income growth and revival of remittances could help sustain the progress in reducing unemployment and poverty over the near term.

Risks and challenges

Uzbekistan's economy faces upside and downside risks. On the upside, are the prospects for commodity prices. In addition, the presidential transition following elections in late 2016 preserved the political stability, while announcing 2017 to be the "Year of Dialogue with People"—an effort that could yield ownership for modernization efforts in the country. On the downside, the recovery in the Russian economy and in commodity prices could be delayed, as could domestic structural reforms. Importantly, the economy's vulnerabilities may be understated given data limitations.

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

	2014	2015	2016 e	2017 f	2018 f	2019 f
Real GDP growth, at constant market prices	8.1	8.0	7.8	7.6	7.7	7.8
Private Consumption	5.8	0.8	3.2	5.6	6.8	6.0
Government Consumption	9.9	4.0	-2.0	1.2	1.2	2.8
Gross Fixed Capital Investment	9.6	9.6	9.5	9.8	10.2	9.8
Exports, Goods and Services	-5.1	-5.3	0.5	1.4	3.2	5.4
Imports, Goods and Services	-4.1	-13.4	-2.4	-1.5	2.6	3.0
Real GDP growth, at constant factor prices	7.9	7.9	7.9	7.6	7.7	7.8
Agriculture	6.9	6.8	6.6	6.5	6.5	6.5
Industry	8.5	8.5	6.9	7.1	7.2	7.2
Services	8.2	8.2	9.0	8.3	8.5	8.6
Inflation (Private Consumption Deflator)	9.1	8.5	8.4	8.2	8.0	8.0
Current Account Balance (% of GDP)	1.7	0.9	1.3	1.7	1.8	2.3
Fiscal Balance (% of GDP)	2.0	0.8	1.0	1.1	1.4	1.5
Debt (% of GDP)	8.3	8.4	9.6	10.6	11.2	11.6
Primary Balance (% of GDP)	2.1	0.9	1.1	1.2	1.5	1.6

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

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Trade in Transition

Trade played a pivotal role during the transition of many countries in Europe and Central Asia to market economies. It foced a more efficient use of resourced and supported adoption of new technologies. Going forward, trade will again be crucial as countries adjust to new specialization patterns in the world. The adjustment requires not merely tweaking of trade policies, but rather a rethinking of how labor markets and capital markets are organized.

ISBN (electronic): 978-1-4648-1113-5

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