WORLD BANK GROUP

# Low Commodity Prices and Weak Currencies

**Europe and Central Asia Economic Update**
Office of the Regional Chief Economist
October 2015

WORLD BANK **ECA ECONOMIC UPDATE** OCTOBER 2015

# Low Commodity Prices and Weak Currencies

Office of the Chief Economist

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# Abbreviations

| | |
|---|---|
| AKP | Justice and Development Party, Turkey |
| BH | Bosnia and Herzegovina |
| BHAS | BH Agency for Statistics |
| BOP | Balance of payments |
| BYR | Belarusian ruble |
| CAD | Current account deficit |
| CBR | Central Bank of Russia |
| CDS | Credit default swap |
| CGE | Computable general equilibrium |
| CHF | Swiss franc |
| CIS | Commonwealth of Independent States |
| CPI | Consumer price index |
| CROSTAT | Croatian Bureau of Statistics |
| EBRD | European Bank for Reconstruction and Development |
| ECA | Europe and Central Asia |
| ECAPOV | Eastern Europe and Central Asia household survey data archive |
| ECATSD | ECA Team for Statistical Development |
| ECB | European Central Bank |
| ECE | Early childhood education |
| EDP | Excessive Deficit Procedure |
| EEU | Eurasian Economic Union |
| EFSD | Eurasian Fund for Stabilization and Development |
| ELSTAT | Hellenic Statistical Authority |
| EUR | Euro |
| FBH | Federation of Bosnia and Herzegovina |
| FDI | Foreign direct investment |
| FYR | Former Yugoslav Republic (of Macedonia) |
| GDP | Gross domestic product |
| GOU | Government of Uzbekistan |
| GIC | Growth incidence curve |
| HBS | Household budget survey |
| HRK | Croatian kuna |
| IMF | International Monetary Fund |
| KIHS | Kyrgyz Integrated Household Survey |
| LFS | Labour Force Survey |
| MENA | Middle East and North Africa |

| | |
|---|---|
| MSE | Micro and small businesses |
| NBH | National Bank of Hungary |
| NBKR | National Bank of Kyrgyz Republic |
| NBR | National Bank of Romania |
| NBRB | National Bank of Belarus |
| NBS | National Bank of Serbia |
| NPL | Non-performing loans |
| NSI | National Statistics Institute |
| PIT | Personal income tax |
| PPP | Purchasing power parity |
| RUR | Russian ruble |
| S&P | Standard & Poor's |
| SILC | Survey of Living Conditions |
| SOE | State-owned enterprises |
| SORS | Statistical Office of the Republic of Slovenia |
| TANAP | Trans-Anatolia Natural Gas Pipeline |
| WB | World Bank |
| WDI | World Development Indicators |
| WTI | West Texas Intermediate |

# Introduction

Against the backdrop of a weakening global economy and volatility in international financial markets, countries of the Europe and Central Asia region (ECA) are transitioning to a new normal.

Oil-exporting countries in eastern part of ECA face the difficult adjustment to low commodity prices. That adjustment unavoidably comes with sharp real depreciations, job losses in construction and domestic services, falling asset prices (especially real estate and equity prices), increased fragility in partly dollarized financial sectors, and declining household incomes. Very similar adjustments are taking place in surrounding countries with strong links to oil exporters through remittances and trade flows. Because of terms-of-trade losses and sharp declines in real remittances, most of the affected countries have seen their purchasing power drop more than 10 percent this year, much more than suggested by GDP numbers.

The adjustment in eastern part of ECA also comes with new opportunities in tradable sectors. Diversification strategies can now be much more successful than during the oil-price boom. That implies job creation in sectors that produce tradable, non-oil products, and exports to new destinations. To seize these opportunities policy makers have to embrace the new normal by using flexible exchange rates, absorbing negative side effects, and facilitating investments in new sectors with competitive job opportunities.

In western part of ECA, the fragile recovery continues, despite significant headwinds in the global economy. In the European Union and the Western Balkans the new normal poses the question how to achieve a recovery of investments without the tailwinds of a global credit boom. Especially for Southern European countries, access to finance will not be as easy as before 2008.

Risks in western part of ECA are more balanced than in the east. While risks in the east are predominantly on the downside, west ECA countries are less affected by ongoing volatility in global financial markets. There are idiosyncratic risks in the west associated with large migrations of refugees escaping the Syrian war and the implementation of Greece's reform program, as well as other lingering geopolitical issues. On the other hand, there are promising opportunities, created by a weaker euro and lower oil prices, that could stimulate investment more than anticipated in the baseline forecast that is presented in this report. The challenge for policy makers and financial markets is how to create an environment that is conducive to a stronger rebound in private investments. Faster and more effective insolvency procedures, strengthened financial sectors, and higher absorption of E.U. structural funds could contribute to such a rebound.

This Economic Update consists of two parts: (i) Economic Outlook, comprising two chapters, and (ii) Country Pages. In Part I, the first chapter describes the outlook for GDP growth, and then goes beyond GDP in a couple of important areas. It shows that terms-of-trade losses for oil exporters this year are much larger than changes in GDP. Furthermore, the discussion suggests a way to calculate real values of remittances. For remittances-receiving countries the changes in real remittances also outweigh changes in GDP. Finally, the chapter shows that at the height of the Greek crisis, households in Greece suffered larger losses in income than suggested by GDP numbers.

The second chapter is more analytical. It establishes the link between oil prices and real exchange rates, both theoretically and empirically. It also presents model simulations that describe the consequences of oil prices on sectoral patterns and income distribution. Understanding these pervasive impacts is crucial for the design of policy responses.

Part II of this Economic Update contains 26 two-page Macro Poverty Outlook reports for ECA countries.

PART

# Economic Outlook

1

# Fragile Recovery in the West, Difficult Adjustments in the East

## Summary


- Against the backdrop of an uncertain global environment and a slowing global economy, the European Union continues its fragile recovery, with expected 1.9 percent GDP growth this year. The recovery is broad-based. In Northern, Western, and Eastern Europe growth this year is expected to exceed growth in 2014 by half a percentage point. The acceleration in Southern Europe is on track to be a full percentage point.
- This recovery is supported by the European Central Bank's accodative monetary stance, and the subsequent 12 percent depreciation of the euro versus the U.S. dollar. This improved Europe's near-term competitiveness compared to U.S. and Asian producers. A sustained recovery will require a pickup in investments, which are still 10 percent below their peak level in 2007.
- In the Eastern Europe and Central Asia region, or eastern ECA, the 1.5 percent GDP growth in 2014 is likely to turn into a 1 percent contraction this year. Moreover, income losses are far larger than 1 percent this year. Oil exporters have experienced declines in income this year, including terms-of-trade losses, of more than 10 percent associated with flagging oil prices. In surrounding countries income losses are also much larger than suggested by the GDP numbers, because of the declining real values of remittances.
- The sharp decline in income has pervasive impacts. It requires vast real depreciations, fiscal adjustments, shifts in production from nontradables to trad-


ables, and shifts in the direction of exports away from oil exporters towards Asian economies. At the same time, social safety nets and the resilience of banks are being tested.

- Separately, the deep recession in Ukraine continues and in Greece GDP is once again shrinking as the country struggles to undergo needed economic reforms and capital controls continue to constrain economic activity. Also in those two countries GDP numbers tell only part of the story, as fiscal adjustments have put an additional burden on vulnerable households.

## Introduction

Global headlines are dominated by the recent volatility in financial markets and disappointing growth in large, emerging economies. This negative news casts a shadow over the prospects in Europe and Central Asia (ECA). Reduced capital flows and weak global import demand add to ongoing challenges. Still, global weakness, while contributing to uncertainty, is not the main determinant of growth performance in the region. The main drivers are the continued domestic recovery, however fragile, in western ECA, and the difficult adjustment in eastern ECA to the "new normal" of lower oil prices.

The European Union and the Western Balkans are on track to achieve higher growth this year than last year, supported by accomodative monetary policy. Under current expectations higher growth will be sustained in 2016. The volatile global environment constitutes a downside risk, but there are also promising opportunities. Current investment levels are still far below their peak in 2007, reflecting the long reverberation of the banking crisis. Once the recovery progresses and the credit conditions normalize, the rebound in investment and overall growth may be stronger than is currently assumed in the baseline forecast. Policy measures to facilitate investments by start-up companies that can compete in global markets would be especially opportune at this juncture.

At the same time, eastern ECA has been hard hit by declining commodity prices, with particularly large drops in oil prices. Income losses in oil-exporting countries are more than 10 percent this year because of the decline in oil revenues. Several surrounding countries are suffering equally large income losses because of the sharply reduced purchasing power of remittances. These income losses are not a mere macro phenomenon, but translate into sharply declining household incomes, with elevated poverty rates as a result. Under these circumstances it is very difficult to prevent a drop in activity and an increase in unemployment. And indeed, many countries in ECA have fallen into recession. For policy makers, firms, and households it is crucial to recognize the dramatic realignment of relative prices, and to realize that this "new normal" not only brings challenges, but also creates opportunities to diversify. It is crucial that economies seize these opportunities as early as possible.

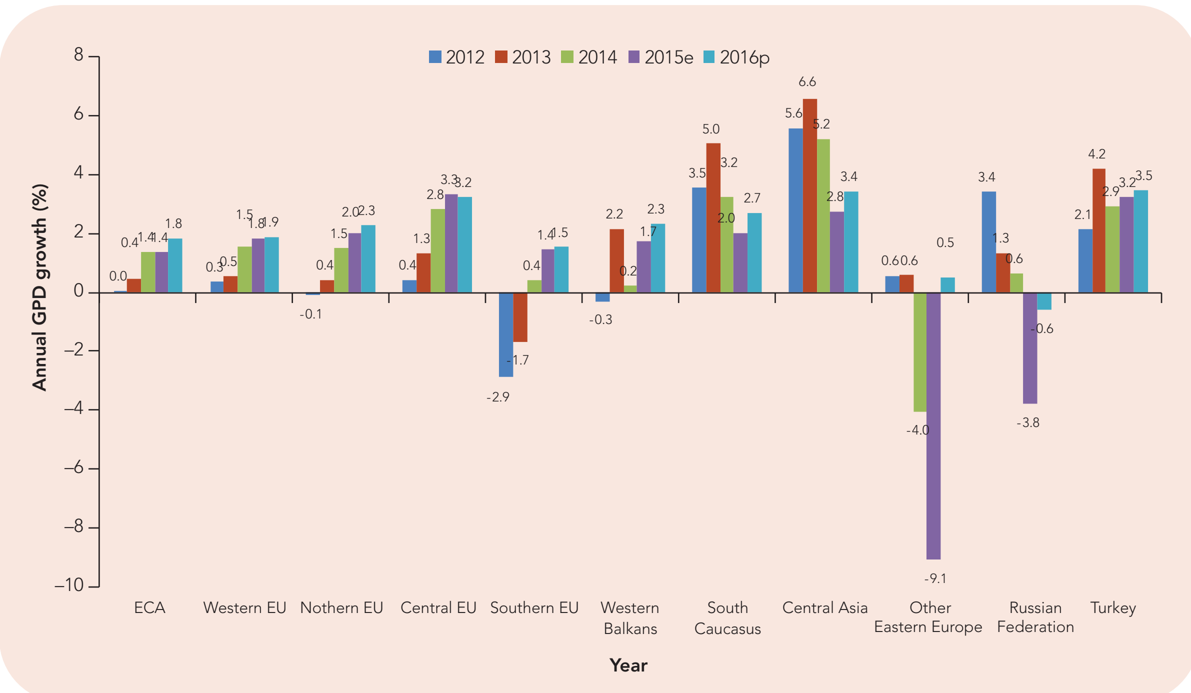
The World Bank's newly broadened coverage of the ECA region now includes the advanced countries in Western, Southern, and Northern Europe as well as its traditional coverage of Eastern Europe and Central Asia. Average GDP growth for our expanded regional coverage is expected to be 1.5 percent this year, which is close to last year's 1.4 percent growth rate. For 2016, growth is forecast to accelerate to 1.9 percent growth as the recovery in the European Union is expected to be sustained and the recession in ECA is likely to bottom out.

## Acceleration in the West

For the western part of ECA—including Western, Northern, Central, and Southern Europe as well as the Western Balkans—growth is expected to accelerate from 1.4 percent in 2014 to 1.9 percent in 2015. This is a continuous, albeit feeble, rebound from a contraction of 0.4 percent in 2012 and the barely positive 0.1 percent growth in 2013. The pace of growth next year is expected to be 2 percent in western ECA, matching this year's growth (figure 1.1).

Northern Europe is projected to experience a perceptible increase in growth in 2016 (from 1.9 to 2.3 percent), while Central Europe is likely to maintain its robust growth of around 3.3 percent. Southern Europe will likely see a modest acceleration from 1.3 percent growth in 2015 to 1.5 percent growth in 2016, but this is by far not enough to shed the legacy of the crisis. The Western Balkans will likely see growth accelerate to 2.3 percent in 2016, from 1.7 percent in 2015. However, unemployment will remain excessive, with nearly half of the youth labor force unemployed in recent years, compared to 20 percent in the rest of the European Union.

**FIGURE 1.1 Annual GDP Growth in ECA and European Union, 2012–16 (percent)**




*Source:* World Bank data.

Despite this ongoing recovery in the European Union, growth falls short of what is needed to undo the damage of the crisis years and to put the region on a path of self-sustaining and balanced growth. Both external and domestic factors are responsible for this subpar performance. Externally, the slowdown in emerging economies and in global trade and the weak capital flows constitute serious headwinds. Domestically, the investment climate is not favorable as governments, financial sectors, firms, and households are still recovering from the aftermath of the financial crisis, particularly in Central and Southern Europe. The consequence is continued fiscal consolidation, a deleveraged and risk-averse banking sector with high non-performing loans, and private spending that is constraint by debt overhang. Under these circumstances, it might not be surprising that private investments are the missing link in the recovery. The volume of investments is still 10 percent below its 2007 level (figure 1.2). Higher growth will require policies that facilitate access to financing of new innovative companies and internationally competitive firms.

The banking union should help improve the stability of the financial sector. However, the relatively small size of capital markets as an alternative source of financing to bank lending remains a limiting factor in the speed of recovery. Moves toward a capital markets union, although still at a very early stage, would help deepen private sources of capital. A unified capital market would consolidate the investment climate across the region, support investors in assessing country risks, and deepen alternative sources of private investment.

## Contraction in the East

The eastern part of ECA has experienced outright contraction over the last 12 months. Output is expected to decline 0.9 percent in 2015 and then recover to a modest 1.5 percent growth in 2016, as countries continue to adjust to lower oil prices. The sharpest declines have been in the Russian Federation, which is projected to contract 3.8 percent in 2015 and 0.6 percent in 2016, due to ongoing

**FIGURE 1.2**
**Investment Volume in the European Union Still Not Back to Pre-Crisis Levels, 2000–14 (percent)**

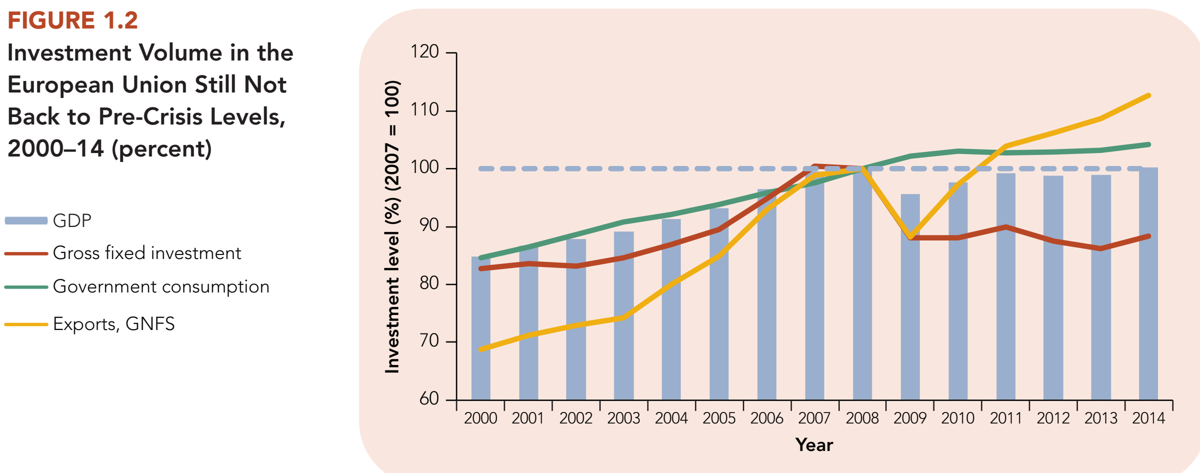


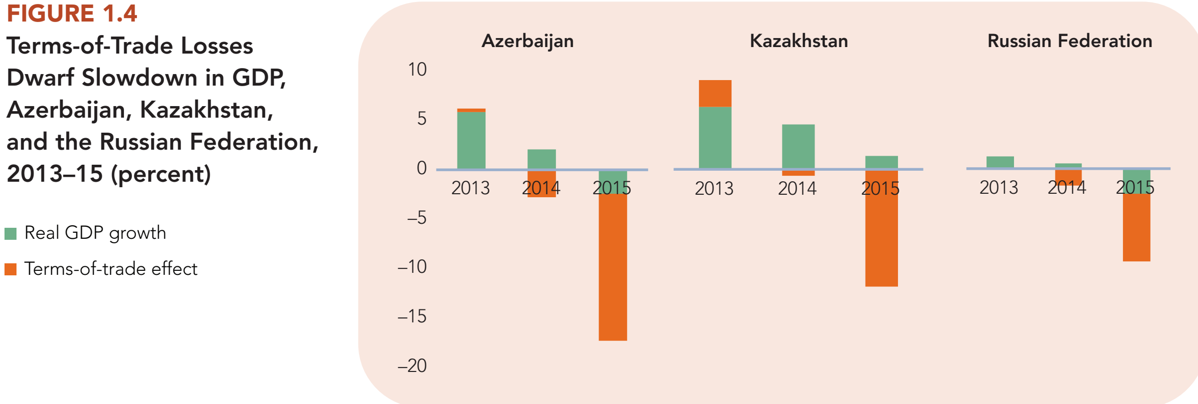
**FIGURE 1.3 Ongoing Contraction in the Eastern Part of ECA (percent)**


weakness in oil markets. Unlike the western part of ECA, which has seen ongoing acceleration of industrial production, most of the eastern ECA is seeing further contractions (figure 1.3).

The South Caucasus, other Eastern European countries (Belarus, Moldova, and Ukraine), and Central Asia have been, directly and indirectly, hard hit by the fall in oil prices. The sharp real depreciations in oil-exporting countries had a large negative impact in surrounding countries through lower trade and remittances flows. Growth rates in 2015 are expected to be about half those seen in 2014 in the South Caucasus and Central Asia, while other Eastern European countries are estimated to have fallen further into recession. In Turkey, growth is projected to increase modestly from 2.9 percent in 2014 to 3.2 percent in 2015. As the region's markets adjust to lower prices, and advanced-country economies, particularly in the European Union and the United States, continue to expand, Eastern Europe, Central Asia, and Turkey are all expected to see higher, albeit modest, growth in 2016, while Russia is projected to continue to contract, but at a more modest pace.

For countries directly and indirectly adversely affected by lower oil prices, GDP tells only a small part of the story when it comes to the sharp decline in spending power available to their citizens. The real domestic income of a country also includes terms-of-trade gains or losses, which result from changes in export

**FIGURE 1.4**
**Terms-of-Trade Losses Dwarf Slowdown in GDP, Azerbaijan, Kazakhstan, and the Russian Federation, 2013–15 (percent)**




## BOX 1.1 How to Measure Income Generated by Remittances: The Case of the Kyrgyz Republic

Workers' remittances are a sizable source of income for several countries in Europe and Central Asia (ECA). In Albania, Armenia, Georgia, the Kyrgyz Republic, Tajikistan, and Uzbekistan, remittances exceeded 10 percent of GDP in at least one of the last five years. It total, remittance inflows into ECA were an estimated US$165 billion last year. Obviously, households in the receiving countries benefit directly from the money sent from abroad by family and friends, but the large aggregate transfers also have significant macroeconomic impacts.

So, remittances are substantial. But how exactly should we measure their size in a way that is relevant for the receiving countries? Let's first look at two measures that are often used, but have significant problems.

- The nominal dollar amount is clearly not an optimal measure. For example, an appreciation of the U.S. dollar compared to all other currencies would automatically reduce the dollar amount of remittances from the Russian Federation to the Kyrgyz Republic, while the amount in Russian rubles or Kyrgyzstani som remains unchanged. Such a decline in the dollar amount would also not affect the purchasing power of those who receive the

*(Continued)*

and import prices. The fall in the oil prices and the subsequent devaluation of the ruble caused large changes in import and export prices, and consequently large terms-of-trade losses. This has had a much stronger adverse impact on buying power than what is reflected simply by GDP (figure 1.4).

The real value of remittances received from abroad is also an important part of the purchasing power in a country that is not a consequence of real GDP[1]. The real value of remittances has sharply declined in the region because of real depreciations in countries where the remittances originate (box 1.1).

1. The real value of remittances refers here to the purchasing power of remittances in terms of imported goods and services, that is, nominal remittances deflated by the import price.

**BOX 1.1** *(continued)*

remittances, unless the remittances are used to buy U.S. products.

- The size of remittances relative to nominal GDP in the receiving country seems a better measure. This ratio is independent of currencies and makes remittances comparable to self-generated income. However, this measure also has a disadvantage. When remittances surge, the nominal value of GDP tends to increase as well, as the increased transfers from abroad push up domestic prices. This is similar to the Dutch disease effect of high oil prices for an oil exporter (see Chapter 2 of this report). As a result, ex post remittances might be little changed relative to GDP, while the purchasing power created by the surge in remittances actually does increase.

A better measure is remittances deflated by the import price. This expresses remittances in terms of purchasing power of imports. This measure of "real remittances" is also independent of currencies and can be added to real GDP. If one adds also terms-of-trade gains, which takes into account the import capacity generated by export revenues, then we can define the growth of total real income[a] as the weighted sum of the growth of real remittances and the growth of real income derived from GDP. The latter is the sum of real GDP growth and terms-of trade gains. This definition of the growth of total real income is expressed in equation B1.1:

(B1.1)
$$\breve{y} = \frac{R(-1)}{GDP(-1)+R(-1)}\left(\widetilde{R/p_m}\right) + \frac{GDP(-1)}{GDP(-1)+R(-1)}\left[\left(\widetilde{GDP/p_g}\right)+TOT\right]$$
$$TOT = \frac{X(-1)}{GDP(-1)}\left(\widetilde{p_x/p_m}\right),$$

where is percentage growth of variable *x; y* is real income; *R, GDP,* and *X* are nominal values of respectively remittances, GDP, and exports; *TOT* is terms-of-trade gains as percent of GDP; and $p_m$, $p_g$, and $p_x$ are deflators of respectively imports, GDP, and exports.

Combining equation B1.1 with equation B1.2 shows that growth of real income consists of three components: growths of real remittances, real GDP growth, and terms-of-trade gains.

(B1.2)
$$\breve{y} = \frac{R(-1)}{GDP(-1)+R(-1)}\left(\widetilde{R/p_m}\right) + \frac{GDP(-1)}{GDP(-1)+R(-1)}\left(\widetilde{GDP/p_g}\right) + \frac{X(-1)}{GDP(-1)+R(-1)}\left(\widetilde{p_x/p_m}\right).$$

This definition of overall income growth puts both remittancesand GDP in perspective. When remittances are relatively large, the impact of changes in GDP on overall income or overall purchasing power becomes relatively small.

Instead of looking at GDP growth itself, it seems more relevant to look at the contribution of GDP to overall income growth.

In the Kyrgyz Republic, all three sources of income growth are substantial. In relative terms only Tajikistan receives more remittances than the Kyrgyz Republic. Terms-of-trade gains and losses are also sizeable as the Kyrgyz Republic exports gold, which is subject to large price swings (see figure B1.1).

From 2006 until 2012, total income grew on average 10 percent per year. GDP growth contributed only one third of that overall growth, remittances contributed slightly more than one third, and terms-of-trade gains were responsible for slightly less than one third of overall income growth. Because of terms-of-trade gains, driven by rising gold prices, income kept expanding in 2009, despite a decline in remittances. At the height of the global crisis gold prices kept rising as gold

a. This income concept differs from gross domestic income and gross national income, which also include terms-of-trade gains, but don't include all the remittance transfers.

*(Continued)*

**BOX 1.1** *(continued)*

was one of the few safe havens for global investors. In those six years of high growth the capacity to import surged spectacularly. Import volumes increased 77 percent, while export volumes increased 22 percent.

After 2012 income growth declined dramatically. In 2013 gold prices started to decline and terms-of-trade gains turned into terms-of-trade losses. In real terms, remittances began to decline in 2014 and are estimated to have dropped dramatically in 2015. As a result, overall income growth was barely positive in 2014 and will be strongly negative in 2015, even with continued expansion of GDP.

**FIGURE B1.1.1 Like Oil Prices, Gold Prices Have Declined Since 2013, 1960–14 (percent)**

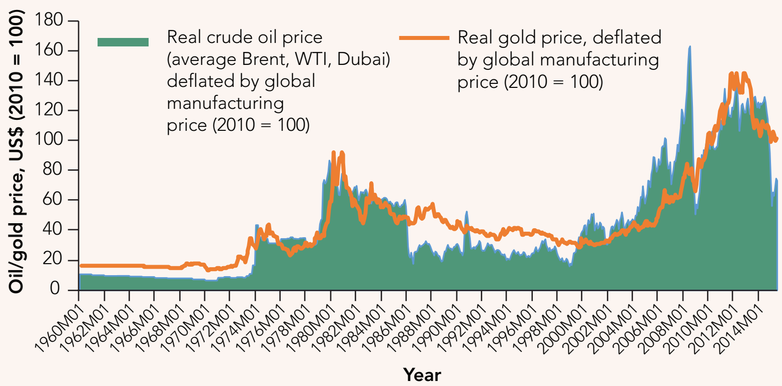
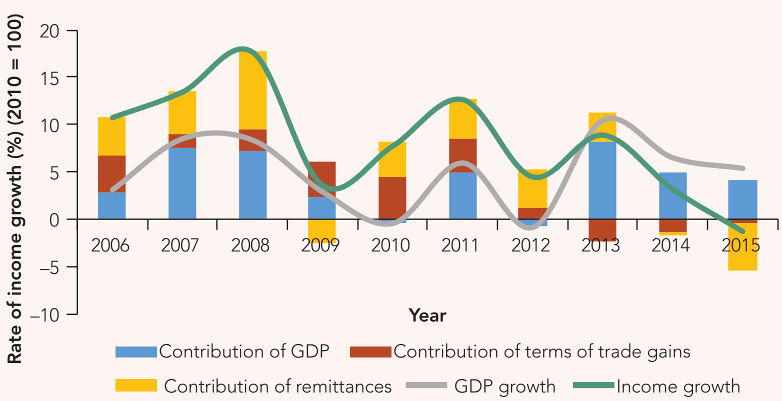



**FIGURE B1.1.2 Kyrgyz Republic Income Growth Vastly Exceeded GDP Growth, but Is Now Being Reversed, 2006–15 (percent)**



Given the weaker buying power of many households in eastern part of ECA, poverty rates are expected to rise in several countries. This is a reversal of the downward trend toward lower poverty rates across the region. Poor households in oil-exporting countries and remittances-receiving countries are hit by higher import prices due to devaluations, the disappearance of jobs in construction and other nontradable sectors, and because of fiscal pressures. This highlights the need for a quick adjustment to the new economic reality. Only if countries seize new opportunities in tradable sectors can the deterioration of poverty rates be stopped.

Exchange rate adjustments, along with prudent monetary policy to keep domestic inflation under control, will help countries regain competitiveness in global markets in the eastern part of ECA. However, while structural reforms continue, the pace of longer-term reforms has slowed and large gaps remain for the eastern part of ECA, such as in competition policy, small-scale privatization, trade and foreign exchange regimes, and price liberalization. Reinvigorating reforms is key to building economic resistance and setting the region back on the path to robust growth.

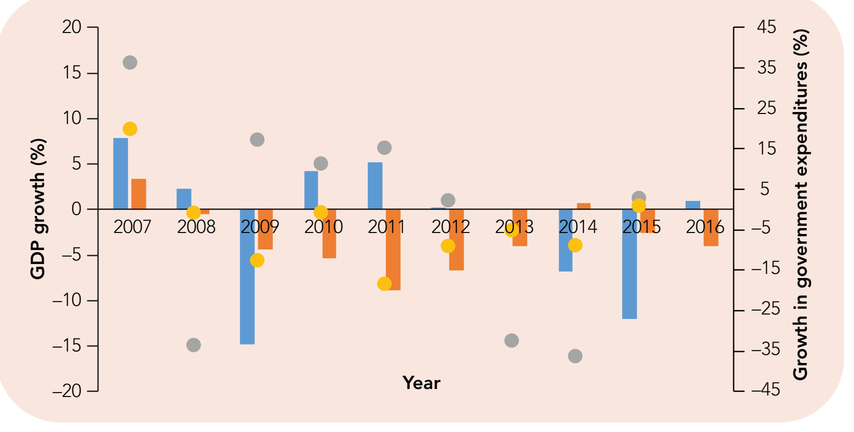
## ECA Countries in Crisis

Within the last year, Ukraine and Greece both went through (and are still undergoing) dramatic economic crises. While broader financial and economic contagion to rest of the ECA region has been restrained, the domestic consequences have been unprecedentedly harsh. The genesis of these crises are very different, but there have been several commonalities: unsustainable debt, drying-up of liquidity, and required large structural reforms and cutbacks in public expenditure.

For Greece, the 2008 crisis exposed large fiscal imbalances, with subsequent attempts at debt restructuring and fiscal reforms being only partially successful. The unwinding of unsustainable conditions from the boom period caused a GDP contraction of more than 25 percent. The impact on households was much harsher, as the reduction of fiscal deficits came with higher taxes and lower transfers (box 1.2). Moreover, there is no quick resolution in sight becuase capital controls now constrain economic activity. Growth is forecasted to contract 2.5 percent in 2015 and a further 4 percent in 2016 (figure 1.5). The country is facing the

**FIGURE 1.5**
**Greece and Ukraine in Crisis as GDP and Government Expenditures Decline, 2007–16 (percent)**

Ukraine, GDP growth, %
Ukraine, Growth in Government Expenditures, %
Greece, GDP growth, %
Greece, Growth in Government Expenditures, %



daunting task of enacting reforms that unleash new drivers of growth and build efficient social safety systems.

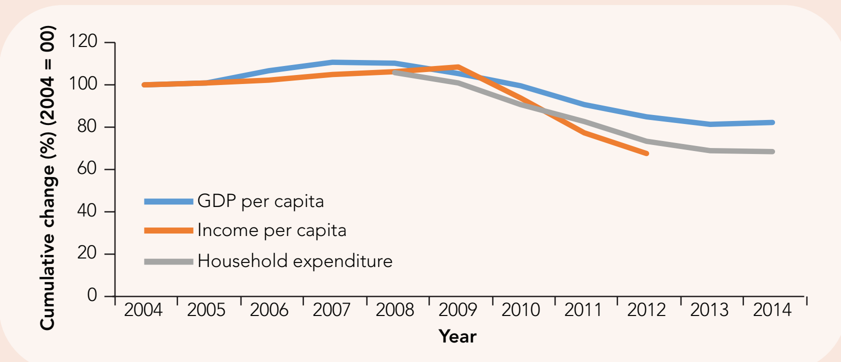
In Ukraine, the conflict in the industrialized eastern regions brought adverse consequences for the country's economy and Ukrainian people. Even prior to the conflict, fiscal accounts and balances were precarious and the daunting challenge is to achieve under current difficult circumstances debt restructuring and significant structural reforms, including the improvement of the business climate, decentralization and reduction of the size of the state, SOE reform, and the creation of a national anti-corruption agency. The economy in Ukraine contracted 6.8 percent in 2014 and is forecasted to shrink 12 percent in 2015, with a modest recovery of 1 percent in 2016.

## BOX 1.2 Hardship in Greece

Like many other countries, Greece has suffered from a big economic contraction since the financial crisis. But, unlike others whose GDP reduction has been either brief (2–3 years in the case of Iceland and Ireland) or of smaller scale (less than 2 percent annually in Croatia and Spain), the contraction in Greece lasted much longer—six years of negative growth from 2008 to 2013—and was bigger—an annual decline of 4 percent in GDP per capita. This has accumulated to a reduction of output of nearly 26 percent, equivalent to shifting the Greek economy a full decade back into the past: the level of output in 2012 was equivalent to that of 2000. There was a brief period of growth in 2014, but the long uncertainty of the bailout deal and the subsequent capital controls have made the country slide back into recession.

The economic contraction has led to even larger deterioration of household incomes. During the period of 2010–12, GDP per capita declined by an average of 7 percent every year, accumulating to a total loss of about 20 percent. During the same period, household disposable income per capita fell 14 percent yearly, almost double the GDP contraction, and the total three-year loss was 38 percent (figure B1.2.1). As a result, absolute poverty (at

**FIGURE B1.2.1 Household Income and Expenditure in Greece Has Decreased More than GDP, 2004–14 (percent)**




*Source:* World Bank's World Develoment Indicators (WDI) for GDP; EU Statistics on Income and Living Conditions User Database (EU-SILC UDB) surveys 2005–13 for income; and the Greek statistics authority ELSTAT (Press Release dated September 7, 2015) for expenditure.

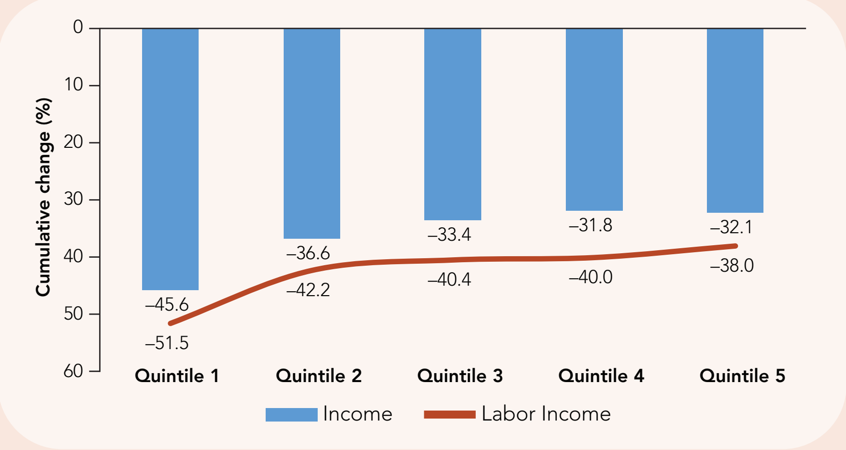
*(Continued)*

**BOX 1.2** *(continued)*

US$5 per day) increased by 6 percentage points, from 2 percent in 2009 to 8 percent in 2012. Dissaving allowed expenditure to fall less than income (–27 percent).

The income losses of the bottom quintile of the welfare distribution were more than 45 percent, significantly larger than the average decline of 38 percent (figure B1.2.2). The income of the bottom 40 percent of households declined 41 percent. Two sources of income explain this difference in income losses across the distribution. First, labor income of the bottom 40, which accounted for 70 percent of total income, fell by around 47 percent, compared with a 39 percent reduction among the top 60 percent of households. The rise in unemployment has affected the bottom 40 to a much larger extent than the top 60 as the former group includes more young people and the less skilled.

**FIGURE B1.2.2 Higher Household Income Reduction for the Bottom of the Income Distribution in Greece, 2009–12 (percent)**




*Source:* WDI for GDP, EU-SILC UDB surveys 2009–13.

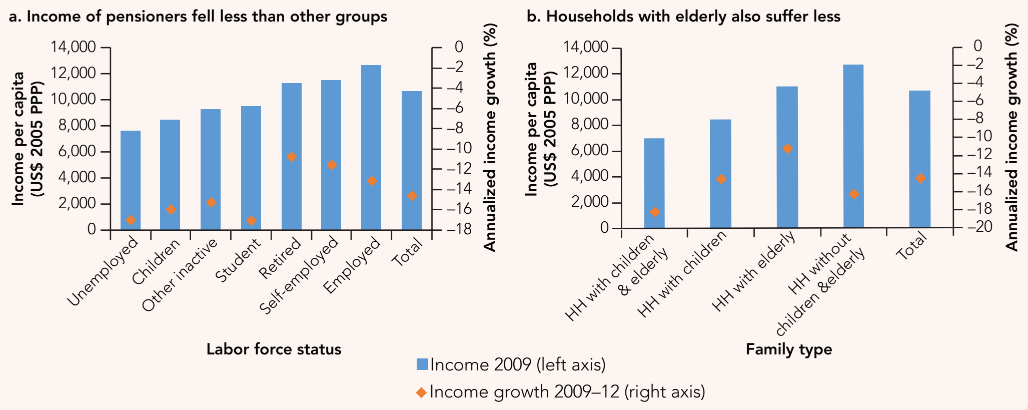
Second, middle-income households depend more on pension income, and this has declined less during the crisis, hence playing an important role in protecting many families from falling into poverty. Government expenditure on contributory pensions actually increased since 2009, while spending on social pensions and other benefits have gone down, including a big reduction in family/children benefits. As a result, pensioners' incomes dropped less than the rest of the population (figure B1.2.3, panel a). Household members also benefited from this resilience of pension income (figure B1.2.3, panel b). The poverty rate among households with elderly members was low to begin with (less than 0.3 percent) and hardly increased in the crisis, whereas an addition of 5.7 percent of households without elderly members fell into poverty between 2009 and 2012. Social transfers are small, accounting for less than 5 percent of income of the bottom 40; they covered few low-income households and played a limited role in protecting them from falling into poverty.[a]

a. A means-tested family benefit was introduced in late 2013 (which is not captured in data available for this Update), but it is difficult to estimate how much it will help mitigate the rise in poverty in households with children.

*(Continued)*

**BOX 1.2** *(continued)*

**FIGURE B1.2.3 Household Income Reduction for the Bottom of the Distribution in Greece, 2009–12 (US$)**




*Source:* WDI for GDP, EU-SILC UDB surveys 2009–13.

*Sources:* This box draws on the brief "Poverty Impacts of the Greece Crisis and Potential Policy Responses," by Gabriela Inchauste, Ramya Sundaram, Moritz Meyer, Natalia Millan, and Tu Chi Nguyen; and Hernan Winkler's note on recent labor market developments in Greece.

## The External Environment has Raised Uncertainty

The economic developments in ECA are unfolding against the backdrop of a deteriorating global environment. Slowing world trade and reduced capital flows have become strong headwinds, while low commodity prices pose serious challenges for the eastern part of ECA (figures 1.6 and 1.7 ).

These headwinds are likely not short-lived, but rather herald a "new normal." The causes of the weak environment are more of a structural than a cyclical nature. Trade is on a slower trend as potential growth in emerging economies has become more tempered and rapid expansion after past trade liberalization has faded. Commodity prices are suppressed as mining and exploitation capacity has cumulated over the last decade. Capital flows are less abundant as monetary policy in the United States normalizes.

Gross capital flows to emerging markets (equity, bonds, and bank lending) began to soften in May 2015 as expectations of higher returns in developing countries weakened relative to stronger prospects in the United States. For ECA, the capital flows had already declined in 2014, mostly attributable to lower bank lending to Russia, as capital inflows weakened for all commodity exporters.[2] In

2. In the short run, however, some of these commodity-exporting countries may experience an uptick in flows as demand increases. For example, capital flows into Kazakhstan have increased, as the country has sold several large bond issues to compensate for deteriorating oil revenues.

**FIGURE 1.6** Commodity Prices Decline and Global Trade Slows

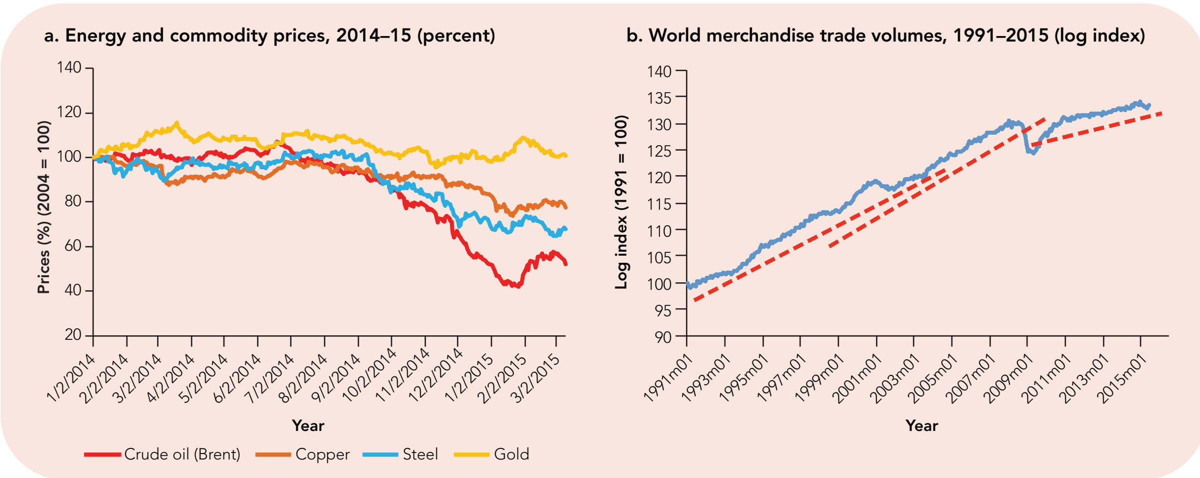
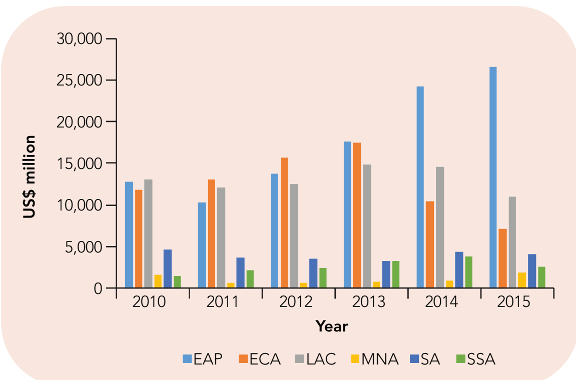
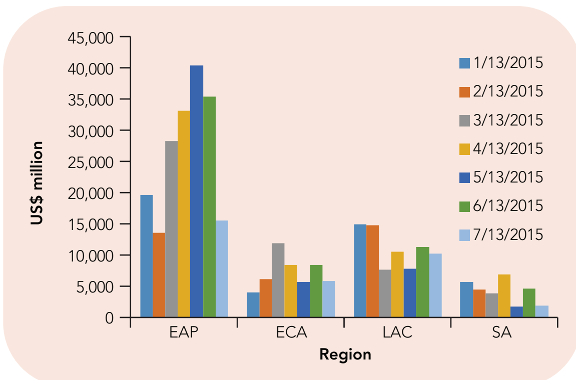



**FIGURE 1.7** Gross Capital Flows to Emerging ECA Countries Have Fallen

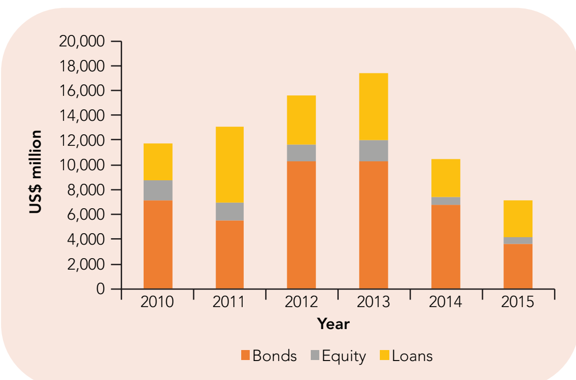
**a. Average monthly gross capital flows by region**



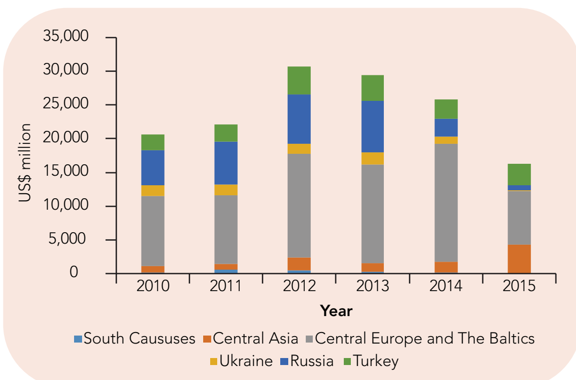

**b. Monthly gross capital flows by region, Jan-July 2015**




**c. ECA average monthly capital flows**



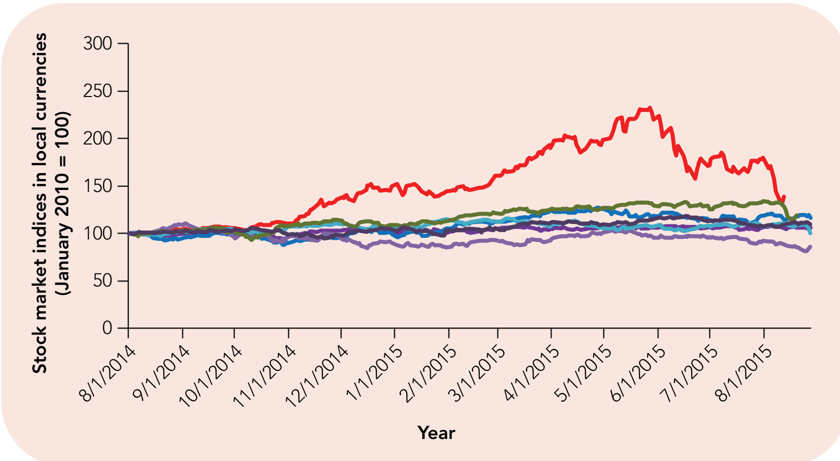

**d. ECA gross capital flows by subregion**



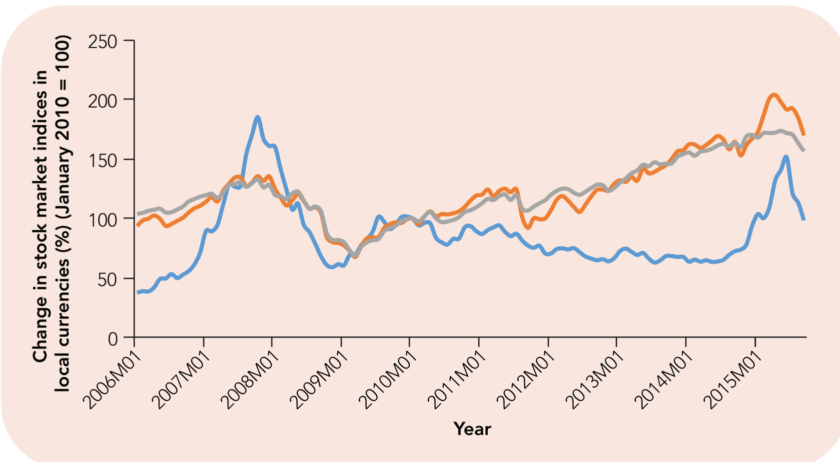

*Note:* 2015 represents monthly average through July 2015.

**FIGURE 1.8**
**Stock Markets in ECA Are More Affected by Commodity Dependency than China's Volatility**

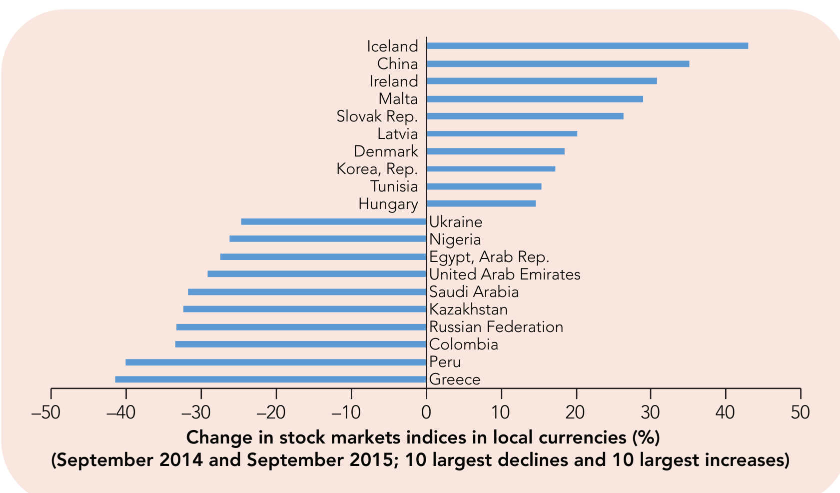
**a. Recent volatility in stock markets occured mainly in China**




**b. China's stock market behaves differently**




**c. Stock markets in oil exporting countries have been under pressure**



2015 capital flows into ECA further declined, as the uncertainty in bond markets affected Central Europe and the Baltics.

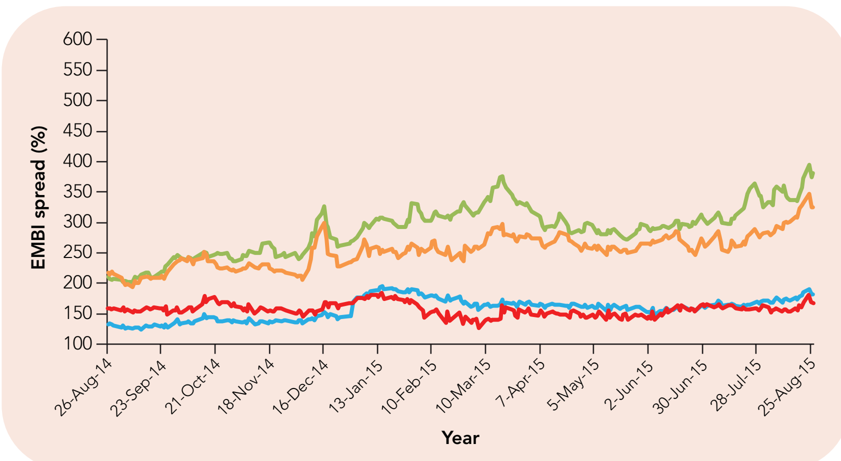
This deterioration of the global environment came with large losses in several stock markets, but these losses were not uniform. Apart from the dramatic burst of China's short-lived stock market bubble, the losses were concentrated in commodity-exporting countries, as exemplified by the relatively strong fall in equity prices in Brazil and South-Africa (figure 1.8). In Europe and Central Asia, most markets have continued to remain stable or post modest gains compared to year earlier levels, while Russia and neighboring countries have posted losses. Dependency on commodity markets and large borrowing requirements seems to have been much more important in recent months than general contagion of China's stock market adjustment.

These headwinds are incorporated in the baseline outlook, but risks surrounding that outlook have also intensified. In the transition to the "new normal" uncertainty and risks have increased, as for example reflected in rising spreads in global bond markets (figure 1.9). A big source of uncertainty is how smooth the

**FIGURE 1.9**
**Greater Global Uncertainty Has Been Concentrated in Commodity-Dependent Exporters**

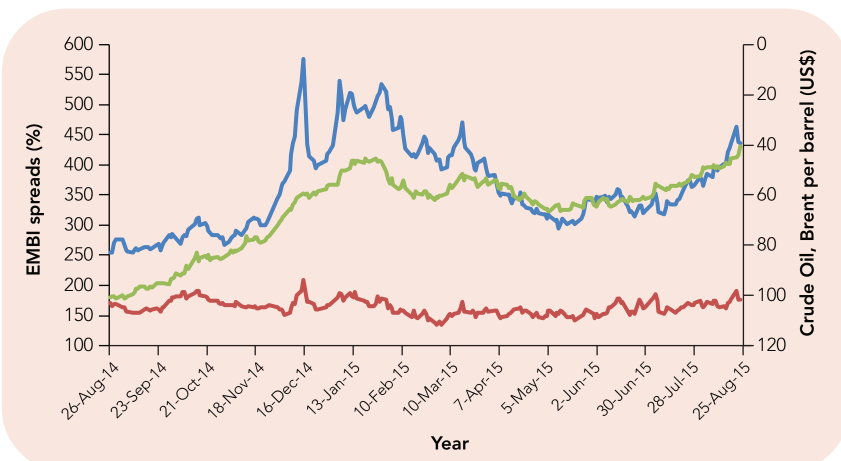
Brazil
China
India
South Africa

**a. Emerging Market Bond Index (EMBI) strip spreads for large emerging market economies**




**b. Bond spreads moved with oil prices for oil exporters, and were stable for oil importers (spreads in basis points; oil price in US$ per barrel)**

EMBI spread, oil exporters (Azerbaijan, Kazakhstan, Russian Federation)
EMBI spread, Central Europe
Crude Oil, Brent (right-hand axis, reverse scale)



adjustment can be in the Chinese economy to lower growth and lower investment, after decades of rapid expansion and the current excessively high investment rates because of effective stimulus in recent years. Another source of uncertainty is the timing of monetary tightening by the U.S. Federal Reserve. The Fed chose not to raise rates in its September 16th meeting, partly in response to deteriorating global conditions. But the unwinding of the Fed's easy monetary policy is unlikely to be postponed for long.

Like the deterioration of the global environment, increased uncertainty has mainly affected commodity exporters, which experienced much sharper rises in spreads than average. Average credit spreads in the large, commodity-exporting, emerging-market economies (particularly Brazil and South Africa) have increased substantially since May 2015 by almost 100 basis points. Spreads for India and China have also increased, but much less.

As a result, the downside risks are especially large in countries with large external financing needs (Turkey) and that, directly or indirectly, depend on commodity exports (Russia, Central Asia, and the South Caucasus). In this environment policy makers have to be proactive in enacting measures that can mitigate negative consequences and help seize new opportunities. To build economic resistance and set the stage for robust growth in the eastern ECA, adjusting to the "new normal" of low oil prices with exchange rate flexibility and an agile business climate is critical.

For the other parts of ECA (Northern, Western, Southern, and Central Europe, and the Western Balkans) risks are more balanced. These countries are less affected by ongoing volatility in global financial markets. On the under hand, there are also promising opportunities. If the fragile recovery continues, benefitting from a weaker euro and lower oil prices, then the rebound in investment may well become stronger than anticipated in the baseline. The challenge for policy makers and financial markets is how to stimulate and facilitate such a stronger rebound in private investments.

## Conclusions

Overall growth is expected to increase in the ECA region during 2015 and accelerate in 2016. However, the region has still not fully recovered from the aftereffects of the global financial crisis. ECA is in the midst of strong crosswinds, with the western part seeing steady growth and the eastern part seeing further contraction. Much of the eastern ECA is hard hit by declining commodity prices, particularly oil. Geopolitical risks and increased financial market volatility in emerging markets are dampening potential growth across all countries. To build economic resilience and set the stage for robust growth in eastern ECA, adjusting to the "new normal" of low oil prices with exchange rate flexibility and an agile business climate is critical.

For western ECA, the recovery remains fragile. A sustained recovery is only possible with a rebound in investments, which are still below pre-crisis levels. Europe's heavy reliance on the banking sector and the cumbersome resolution of the debt overhang have delayed this rebound. The global uptick in financial market volatility as well as lingering geopolitical risks have made the necessary recovery of investments more uncertain. The relatively small size of capital markets as an alternative source of financing to bank lending also has limited the speed of recovery. Moves toward deepening capital markets and improving the climate for private investment will further solidify the economic expansion.

2

# Oil Prices and Real Exchange Rates


## Summary

Exchange rate depreciations of 30 percent or more in Eastern Europe and Central Asia over the last year are part of a transition toward a new equilibrium. Many structural changes occurred during the oil boom, including real appreciations, shifts toward the production of nontradable goods and services, and sharp rises in real estate prices. These have to be reversed now that the oil prices are at a structurally lower level.

The required changes are not limited to oil-exporting countries. Neighboring countries that received large amounts of remittances from workers in the oil-exporting countries experienced similar structural changes during the oil boom. Changes in these countries will also have to be reversed.

For oil-dependent countries, adjusting to lower oil prices is much more difficult than adjusting to higher oil prices. The drop almost always happens much faster than the rise. Moreover, while during an oil boom the associated real appreciation can be accommodated by either nominal appreciations or higher inflation (or a combination of the two), the real depreciation after the oil price drop is typically only be achieved by nominal depreciation of local currencies, as large domestic deflation is difficult to achieve in practical terms. However, depreciation of currencies tests the stability of financial markets that are partly dollarized.

Governments, firms, and households should recognize the unavoidable pervasive changes. Postponement of adjustments will increase the costs and prevent the creation of new jobs in tradable sectors. Rapid adjustment will create new


opportunities as real depreciation implies increased competitiveness in international markets. Diversification strategies will have now much more success than during the oil boom. This allows a shift toward non-oil exports, and within exports a redirection toward Asia and Western Europe, away from trade with oil-dependent countries.

Declines in oil revenues and remittances affect poor households through several transmission channels: (i) prices of imported goods (including food for many countries) rise, which reduces real income and real consumption; (ii) fiscal pressures may leave less room for transfers; (iii) the number of jobs in nontradable sectors (especially construction) will shrink; and (iv) the purchasing power of remittances sharply declines. Under these circumstances, efficient and targeted social safety nets are essential. It is equally important that obstacles to growth of companies that can seize new opportunities in tradable sectors are reduced. For example, banks should be ready to provide credit to small exporting firms, rather than merely to oil-related and construction-related firms, which have dominated these economies during the oil boom.

## Introduction

Societies in Eastern Europe and Central Asia face huge challenges as their economies need to adjust to a new normal. For households and firms, the challenges are how to adjust to lower incomes and dramatically different relative prices, and how to seize new opportunities that are created by the improved competitiveness. For governments, the challenges are how to facilitate the reversal of structural changes that occurred during the oil boom, how to prevent financial instability, and how to protect the most vulnerable.

For firms, households, and governments alike, it is important to recognize that pervasive structural adjustments are unavoidable. This chapter aims to contribute to the understanding and recognition of these structural changes.

The chapter contains three parts. In the first part (following this introduction) the theoretical relationship between oil prices (and remittances) and real exchange rate is discussed with the help of a simple economic model. The second part presents an econometric analysis of the empirical relation between oil prices and real exchange rates. The third part analyzes the impact in the Russian Federation of the oil price drop on production patterns and on incomes of individual households. The third part reports the outcomes of model simulations with a general equilibrium model and a microeconomic simulation model.

## Dutch Disease in a Nutshell

Real exchange rates of oil-exporting countries are strongly correlated with oil prices for a simple reason. If oil prices rise, income in an oil-exporting country increases. The government, firms, and households want to spend the additional income on domestically produced goods and imports. Supply of imports is elastic, implying that the increased demand for imports can easily be met by increased volumes of imports, without significant upward pressure on import prices. Supply of domestically produced goods and services, however, is inelastic. Therefore, increased demand creates upward pressure on prices—including, for example, prices for real estate and restaurant services. As a result, not only the energy price, but also all domestic prices and wages, rise relative to prices and wages abroad. In other words, the country experiences a real appreciation.

Because of the real appreciation, companies producing internationally tradable non-oil products find it increasingly difficult to compete in international markets. This loss in competitiveness because of rising oil revenues was coined "Dutch disease" by *The Economist*, describing the consequence of rising gas revenues in the Netherlands during the 1970s.

The real appreciations were very visible in the region when oil prices rose. For example, during the oil price boom that started in 2000 domestic prices in Russia doubled relative to prices in the United States.[1] The cost of living became very high in Moscow for foreigners, but not for Russian citizens, whose income went up with the domestic prices. The main impact for Russian citizens of the higher oil prices was that imports became cheaper. The mirror image of the relatively cheap imports is that Russian exports became relatively expensive. With rising oil prices, oil-exporting countries become less competitive in non-oil exports. This loss in competitiveness is often referred to as Dutch disease or the transfer problem.

This mechanism is not limited to oil exporters, but is basically the same for countries that receive large transfers from abroad like remittances or aid flows. The recipients of higher oil prices (government and firms) are different from the recipients of remittances (households). However, the macroeconomic impact is very similar. Once the additional income is spent (either by governments, firms, or households) in the domestic economy, all prices and wages will go up and everybody will experience an increase in purchasing power as imports become relatively cheap.

The expected correlation between the real exchange rate and oil prices can more formally be illustrated with a small model. A country produces a fixed amount of oil ($e$) that is exported. Furthermore, the country produces non-oil goods and services ($q$), which can be exported ($x$) or sold domestically ($d$). Its consumers demand the domestic goods and services ($d$) as well as imports ($m$). Assume relative spending on imported and domestic products can be described as follows in equation 2.1:[2]

$$\frac{m}{p_d d} = \frac{\mu}{1-\mu} \tag{2.1}$$

where is the price of domestically produced goods and services, relative to the import price (this domestic price relative to an international price can be seen as

1. This happened despite the fiscal rule to automatically save some of the oil revenues in a sovereign wealth fund if oil prices exceeded a threshold level. The sovereign wealth fund and the associated surpluses on the trade balance mitigated but did not prevent the real appreciation.

2. This indicates that preferences can be described by a Cobb-Douglas utility function and implies that the price elasticity of imports equals one, which is close to or just above what is frequently found in empirical literature.

the real exchange rate); and μ is the preference for imports and equals the share of imports in the total value of consumption.

Total exports comprise energy exports (*e*), which are exogenous, and non-energy exports (*x*). Demand for the latter is a function of the real exchange rate. If domestic prices increase relative to international prices, then the exports become expensive for foreign buyers and demand for these exports declines, as shown in equation 2.2:

$$x = \theta(p_d)^{-\gamma} \tag{2.2}$$

where θ is a scale parameter and γ is the price elasticity of exports, often estimated to be around 2.

The model can be closed by assuming that the trade balance is in equilibrium, as shown in equation 2.3:

$$m = p_d x + p_e e \tag{2.3}$$

where is the price of energy relative the import price, and *e* is the exogenous volume of energy exports.

Equation 2.4 further contains the assumption that domestic production capacity (*q*) is fully used to produce domestically consumed products (*d*) and non-energy exports (*x*):

$$q = d + x. \tag{2.4}$$

Combining these four equations establishes the implicit relationship between the real exchange rate and energy prices shown in equation 2.5:

$$p_d = \frac{1-\mu}{\mu} \frac{\beta p_d^{1-\gamma} + p_e e}{q - \beta p_d^{-\gamma}}. \tag{2.5}$$

This relationship implies energy price elasticity of the real exchange rate, as shown in equation 2.6:

$$\beta \equiv \frac{\Delta p_d}{\Delta p_e} \frac{p_e}{p_d} = \frac{\theta}{\theta + \gamma(1 - \theta + \sigma)} \tag{2.6}$$

where β is the energy price elasticity of the real exchange rate; the share of energy in overall export revenues is

$$\theta = \frac{p_e e}{p_d x + p_e e};$$

and the ratio between non-energy exports and domestically consumed non-energy production is

$$\sigma = \frac{x}{d}.$$

If there are no energy exports (θ=0), then the elasticity is zero: the energy price has no impact on the real exchange rate. If all exports are energy exports (θ=1 and σ=0), then the elasticity is 1: a percentage change in the energy price requires an equal percentage change of the real exchange rate. Most energy exporters will be in between these two extremes. The larger the share of energy in total exports, the larger the elasticity. The larger the share of non-energy in domestic production, the smaller the elasticity. So, a more diversified, more open economy is expected to experience smaller changes in the real exchange rate when oil prices change. That is indeed confirmed by the empirical analysis presented in the next section, where the elasticity $\beta$ from equation 2.5 is estimated in a log-linearized form in equation 2.7:

$$\ln(p_d) = \alpha + \beta \ln(p_e). \tag{2.7}$$

The correlation between domestic prices and oil prices has interesting side effect. From the perspective of households and firms in oil-exporting countries, relative oil prices are much less volatile than from the perspective of households and firms in oil-importing countries. Figure 2.1 provides a rather striking illustration of that observation. In contrast to what happens in an oil-importing country, relative oil prices hardly changed in oil-exporting countries. The implication is that when oil prices are high there are fewer incentives to save energy in oil-exporting countries (even absent subsidies) than there are in oil-importing countries. Another implication is that when oil prices fall in world markets, households in oil-exporting countries hardly experience that the cost of energy has come down. Because of the real depreciation oil prices hardly change relative to domestic prices and wages.

The change in real exchange rates has many other consequences. One is that in case of higher oil prices the production of non-oil tradables in an oil-exporting country is decimated. Non-oil exports decline and imports increase sharply. Domestic production is increasingly concentrated on nontradables.

Another consequence is that purchasing power of wages will increase. This is because import prices will fall relative to domestic producer prices, while nominal wages are linked to the producer prices. Because of the real appreciation, everybody becomes richer as imports become more affordable. In the first half of the previous decade this phenomenon accounted for an annual 10 percent increase of real income in Russia, on top of what was generated by productivity increases.

**FIGURE 2.1**
**Real Oil Price Stability in Oil-Exporting and Oil-Importing Countries, Relative to CPI, 1995–2013 (percent)**

Once oil prices fall, and are expected to remain low for a considerable time, appreciation has to be reversed. As real incomes decline, imports become more expensive and will have to be reduced. Production capacity and jobs in the tradable sectors will have to be built up again, and new export channels will have to be opened. Real depreciation is the main trigger behind these changes, as it restores competitiveness in the nontradable sector.

The world is more complicated than described in the simple model that is discussed in this section. Domestic production is not completely inelastic. Production capacity can be boosted by attracting foreign capital and foreign workers. Linked to those cross-border flows, the value of imports does not necessarily equal the value of exports. Moreover the price elasticity of imports can deviate from one. Nevertheless, the basic thrust of the simple model is empirically relevant. The next section shows that in out-of-sample forecasts, estimated elasticities explain rather accurately some recent big changes in exchange rates. Such accurate forecasting means that these recent exchange-rate movements do not signal general volatility in financial markets. Rather, they reflect adjustments toward new equilibrium-relative prices, as explained by the simple model in this section.

## Empirical Evidence of (Reversed) Dutch Disease

The previous section explained how the real exchange rates of oil-exporting countries are linked to oil prices. The analysis suggests a stronger positive correlation for countries with less-diversified exports and for countries in which oil is a larger part of overall production.

This section provides empirical evidence of these results. In this empirical analysis we estimate the impact of oil prices on domestic prices, both relative to an international price.

The consumer price index (CPI) is used as the domestic price, and the CPI in the United States is used as the international price. The use of CPIs has two advantages. First, monthly data are available for these price indices. Second, the domestic CPI relative to a foreign CPI, both expressed in the same currency, is a common measure of the real exchange rate.[3] The oil price is the unweighted average of Brent, West Texas Intermediate (WTI), and Dubai oil prices.

Equation 2.7 of the previous section is used to estimate the elasticity β:

$$\ln(p_d) = \alpha + \beta \ln{(p_e)}..$$

Table 2.1 shows the estimation results. The elasticity for the oil exporters in Europe and Central Asia is twice the size of the elasticity of Canada and Norway. That is consistent with the more-diversified character of the economy in the latter two countries.

3. The change in the real exchange rate equals the change in the nominal exchange rate, corrected for inflation differentials in local currencies.

**TABLE 2.1 Oil Price Elasticities of the Real Exchange Rate**
(t-values in parentheses)

| | Norway | Russian Federation | Kazakhstan | Azerbaijan | Armenia | Georgia | Kyrgyz Republic | Canada |
|---|---|---|---|---|---|---|---|---|
| Elasticity (β) | 0.25 | 0.64 | 0.47 | 0.56 | 0.52 | 0.51 | 0.45 | 0.29 |
| | (21.95) | (34.23) | (29.82) | (21.02) | (26.39 ) | (34.83) | ( 25.46) | (39.13) |
| $R^2$ | 0.72 | 0.87 | 0.83 | 0.71 | 0.79 | 0.87 | 0.78 | 0.89 |
| Number of observations | 183 | 183 | 183 | 183 | 183 | 183 | 183 | 183 |

Particularly interesting is the very high elasticity for Armenia, Georgia, and the Kyrgyz Republic, which are not themselves oil-exporting countries. But because of their close relations with oil-exporting countries, their economies react in a similar way to oil price changes. The main transmission channel is substantial worker remittances, which are 21 percent of GDP in Armenia, 12 percent in Georgia, and 31 percent in the Kyrgyz Republic. When oil prices raise real exchange rates in oil-exporting countries, the value of remittances in terms of an international currency rises too, in turn pushing up wages and prices in the remittance-receiving countries. Another, but less important, transmission channel is exports from the surrounding countries to the oil exporters. Rising oil prices in oil-exporting countries lead to increased import demand from neighboring countries, again raising prices and wages in those bordering countries. The result is a sharp real appreciation compared to the rest of the world when rising oil prices spread across the borders of the oil-exporting countries. In 2015 the value of remittances in oil-exporting countries is deflated with the fall in oil prices. Thus, neighboring economies also require sharp real depreciations compared to the rest of the world.

Figure 2.2 shows how the estimated equations track the real exchange rates of three oil exporters: the Russia Federation, Kazakhstan, and Azerbaijan. The dotted lines indicate the model results, including out-of-sample forecasts after March 2015. The solid lines indicate the actual real exchange rates.

The graphs show that the Russian real exchange rate closely follows the value expected on the basis of changes in the oil price. This is especially true for 2015, after the decision to float the nominal exchange rate of the ruble. The rebound in the spring of 2015, following the temporary rise in oil prices, might have overshot a bit. The amplitude of the both the actual and expected swings in the real exchange rate are spectacular. The real exchange rate tripled during the long oil boom and halved during short periods of collapsing oil prices. These swings illustrate how powerful this mechanism is.

The actual real exchange rate in Kazakhstan has been less flexible than the Russian rate. Still, the outcomes broadly follow the expected pattern on the basis of oil prices. Interestingly, after the recent float of the tenge, the real exchange rate immediately adjusted to what the estimated equations consider an equilibrium level. The depreciation of the tenge corrected an imbalance that was building up in the Kazakh economy.

In Azerbaijan the real exchange rate is much more stable than in the other two oil-exporting countries. However, Azerbaijan also experienced a sharp real ap-

**FIGURE 2.2**
**Different Exchange Rate Policies in the Russia Federation, Kazakhstan, and Azerbaijan, 2000–15 (percent)**

Real exchange rate compared to US$
Equilibrium real exchange rate

**a. Ruble adjustment closely follows oil prices**


**b. Tenge adjustment moves toward equilibrium**


**c Azerbaijan adjustment is discrete and incomplete**

preciation during the oil price boom. This happened for a small part through appreciation of the nominal exchange rate, but for a much larger part through higher inflation than abroad. The devaluation of the manat in February 2015 moved the real exchange rate toward its expected value. This is in contrast to two other oil exporters, Russia and Kazakhstan, which are tracking the equilibrium value more closely.

Figure 2.3 shows that swings in real exchange rates are not limited to the oil exporters. For example, Georgia and Armenia have experienced similar developments. In the most recent period, Georgia adjusted substantially more than Armenia. The final illustration of the estimation is for Norway and Canada, two oil exporters that are more diversified than the oil producers in Europe and Central Asia. That is reflected in the much smaller amplitude of the swings in real exchange rates in these two countries (figure 2.4). Nevertheless, those countries also have experienced noticeable real depreciations over the last year.

**FIGURE 2.3**
**Real Exchange Rate Adjustment in Georgia and Armenia, 2000–15 (percent)**

Real exchange rate compared to US$
Equilibrium real exchange rate

**a. Georgia has adjusted more**


**b. Armenia has adjusted less**

**FIGURE 2.4**
**Real Exchange Rate Diversification in Norway and Canada, 2000–15 (percent)**

Real exchange rate compared to US$

Equilibrium real exchange rate

**a. Norway**


**b. Canada**


All these graphs of real exchange rates show that a real appreciation is much more gradual than a real depreciation. This reflects the fact that it took much longer for oil prices to rise than to fall. The slow rise phenomenon is also common in the case of asset bubbles. It takes much longer for capital to flow into an asset boom than to flow away once the bubble bursts.

The rapid pace of developments is one of the many challenges for policy makers in the current situation. Moreover, the adjustments associated with the current rapid real depreciation have to be implemented in an environment of large income losses. As was shown in chapter 1, income losses in oil-exporting countries will exceed 10 percent this year.

Another difference between the real appreciation during the oil boom and the current real depreciation is that the former could be achieved by either nominal appreciation or by additional inflation, whereas deflation is not really an option and nominal depreciation is the only viable way to achieve equilibrium. Deflation can probably only be achieved by a deep recession, which can be prevented or at least mitigated with nominal depreciations. A complication for policy makers is, however, that many of the affected countries have partly dollarized financial sectors. That means that authorities have to put measures in place to stabilize financial sectors at the same time as they allow the currency to depreciate.

Depreciation of the nominal currency has also important advantages. It mitigates fiscal pressure, because governments in oil-exporting countries receive oil revenues in dollars, while many of their expenditures are in local currency. In general, a nominal depreciation immediately spreads the burden of the oil revenue loss across the economy, just as real appreciation during booms spreads the benefits across the economy. Moreover, the nominal depreciation immediately creates the required improved competitiveness in non-oil tradable sectors. Preventing the needed depreciation is very costly. First of all, foreign exchange reserves are lost to counteract downward pressure on the currency. Second, it puts more pressure on the fiscal situation than needed. Third, and most important, it prevents the shift toward the production of non-oil tradables.

Figure 2.5 illustrates the different drivers behind real appreciations and depreciations for the Russian Federation. The red line shows the real exchange rate, or in other words the cumulative real appreciation. The yellow and green bars add up to this cumulative appreciation. The yellow bars indicate how much of the cumulative change in the real exchange rate was caused by inflation differentials and how much was caused by changes in the nominal exchange rate. Clearly, the role of the nominal exchange rate was minimal during the oil price boom. However, during periods of sharp drops in oil prices (early 2009, late 2014) all of the adjustment came from depreciations of the nominal exchange rate.

The recent sharp real depreciations in the region imply improved opportunities for producers of non-oil tradable goods and services. The mirror image of a real depreciation is improved competitiveness compared to producers in countries that did not experience the real depreciation. This leads to a shift toward non-oil exports and within the exports a shift away from Russia toward China and Turkey. Figure 2.6 shows the five largest export destinations for six countries that experience real depreciations. The numbers inside the pie charts indicate

**FIGURE 2.5**
**The Russian Federation: Inflation during Boom, Depreciation during Bust, 2000–15 (percent)**

Relative inflation
Exchange rate appreciation
Real appreciation

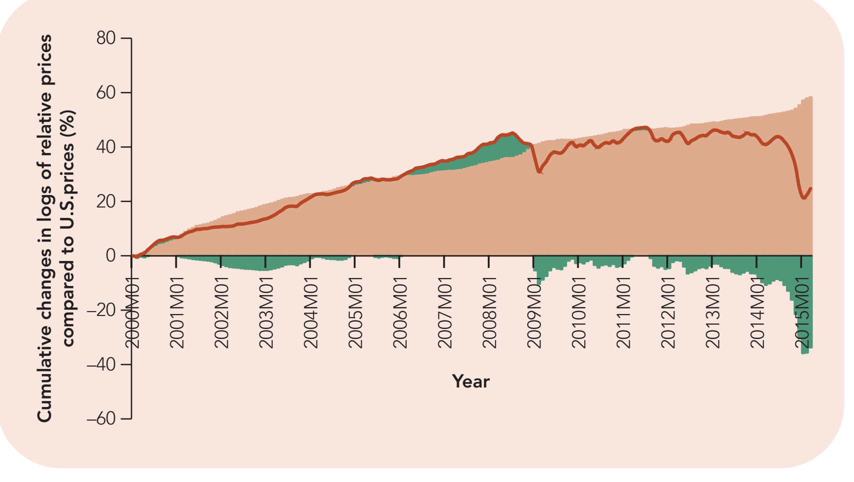
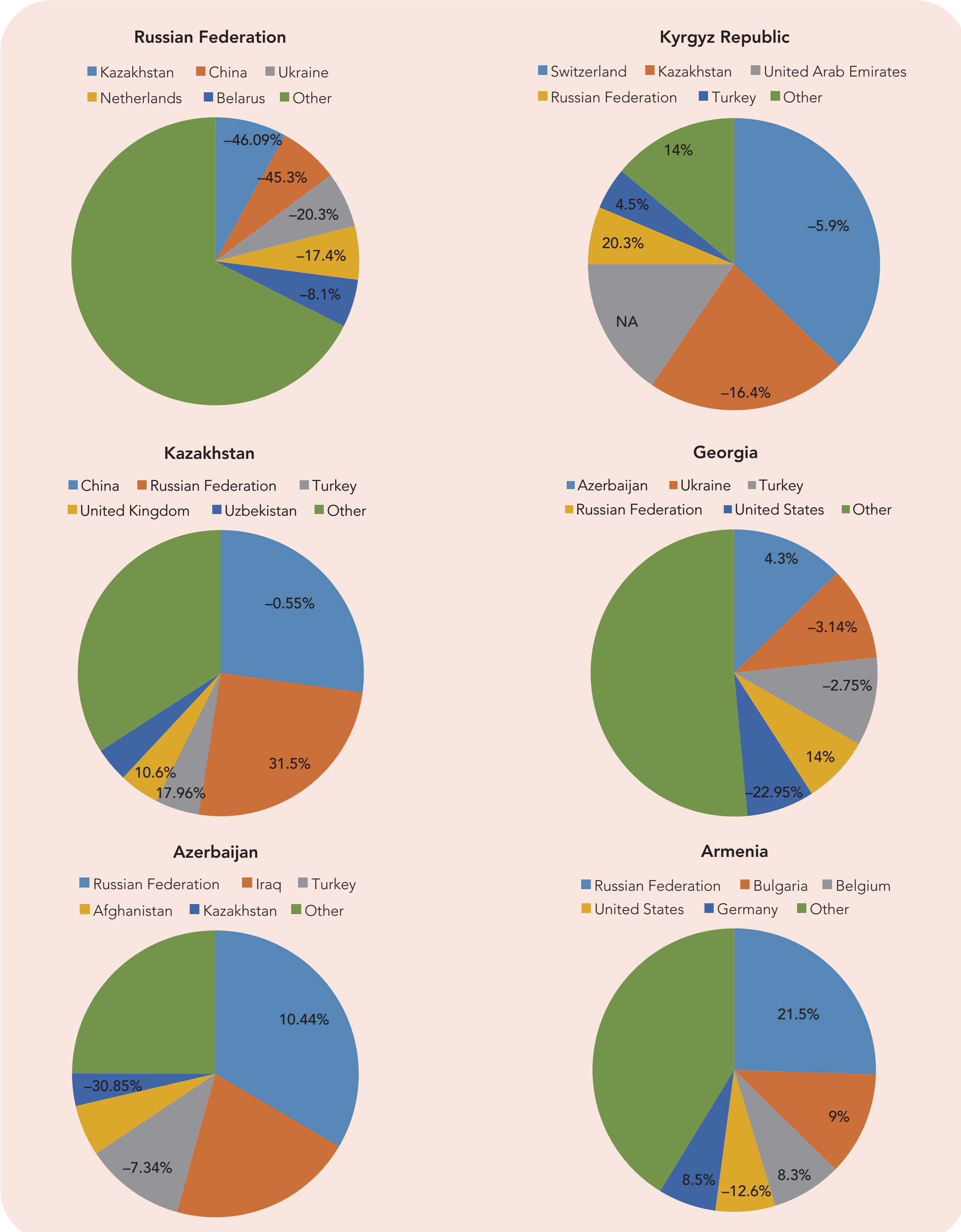


**FIGURE 2.6** **Changes in Relative Prices Redirect Exports across Destinations, Selected Countries, 2014–15 (percent)**



changes in competitiveness compared to the respective export destination, as measured by the change in the bilateral real exchange rate between July 2014 and July 2015. A negative number indicates a real bilateral depreciation or an improvement in competitiveness.

Russia has experienced huge improvements in competitiveness in the non-oil sector, even if the relative costs are not yet back to levels before the oil price boom. As the mirror image, neighboring countries all lost competitiveness against Russia, but they gained advantages in other export destinations, particularly Turkey and China.

The real depreciations will also cause structural shifts within the domestic economies and again these shifts are reversals of what the countries experienced during the oil price boom. Demand for construction and nontradable services will decline and with that some of the jobs in these sectors will disappear. Often the less-experienced, less-skilled workers will lose their jobs first. Many of those had moved from rural areas into cities during the oil boom. Households experience rising costs of imports, while social security programs are under pressure.

The next section will illustrate some of these shifts in domestic economies with model simulations of the shock in Russia, combining a computable general equilibrium (CGE) model with a microsimulation model.

## Simulating the Impact of Oil Prices on Inequality

For oil-exporting countries, oil revenues are concentrated in a few companies and the government and, typically, only a small percentage of the total work force is employed in oil sector. In the case of Russia, the largest oil exporter of the region, less than 2 percent of the jobs are in the oil and gas sector. Nevertheless, the sharp decline in oil revenues deeply affects the structure of the whole economy and the income of all households through several channels.

- For all households and all firms, real income declines as imports become more expensive. These terms-of-trade losses tend to be much larger than the losses due to reduction in production (GDP) and employment.
- As a result of the income loss, demand for nontradable goods and services decreases, forcing a shift of jobs and activity out of construction, commerce, transport, and other nontradable services. This may create unemployment and underutilization of capacity. But even if new employment is created in tradable sectors, the shift may well affect relative wages and skill premia. It also may change wage differentials between rural and urban areas.
- Asset prices, including real estate prices, will likely drop sharply. Moreover, those who have borrowed in foreign currency suddenly experience a rise in real debt.
- Transfers from the government, which is facing shrinking oil royalties, may be under pressure.

These channels are also relevant for neighboring remittance-receiving countries. Besides a drop in oil revenues, these countries experience a commensurable, or even larger, drop in remittance flows. This is because most migrant workers reside in oil-exporting countries. A reduction of jobs available to migrant workers or a reduction in the value of the remittances due to depreciated currencies causes the drop. Therefore the same spending, resource movements, and fiscal channels are at work. In addition, there may be a further drag on economic activity if these countries export mainly to oil-producing countries. Conversely, there may be some boost coming from savings on energy costs.

Although the change in energy prices will affect everybody, the impact will likely affect some groups more than others.

- Shrinking rents for oil companies and declines in asset prices will reduce personal income disparities, as capital incomes are concentrated among rich households.
- Workers losing jobs in shrinking sectors may not find another job or may have to move to informal or to lower-paid occupations. It is often the less-experienced and the less-skilled workers who are first to lose their job. This increases income inequality.
- In general, sectoral shifts will change relative wages, depending on the factor intensity of the affected sectors—that is, whether they use more or fewer skilled services and whether they are located in urban or in rural areas. The nontradable sectors are more skill-intensive than the tradable ones. Therefore, a decline in oil prices will likely reduce the skill premium in labor markets.
- The reduction of energy prices and the increased cost of imported consumption goods will have complex distributional consequences because of the opposing forces at play. On balance, consumer prices increase less for richer households than for poorer households, mainly because richer households spend a relatively large part of their budget on real estate and nontradable services.

To analyze at least some of these transmission channels, this section simulates the impact of the oil price shock for the Russian economy and Russian households and the related reduction of remittance flows for the Kyrgyz Republic. The analysis makes use of sectoral general equilibrium models, which are linked to microeconomic simulation models.

Consider first the case of Russia. One outcome of the simulation of a 50 percent reduction in the oil price is that per capita consumption is reduced by 6.9 percent, very similar to the actual terms-of-trade loss that Russia is suffering this year. The simulation suggests that the bottom 40 percent of households would reduce consumption by 6.2 percent and the top 60 percent by 7.0 percent (see table 2.2). Poverty rates rise for all the usual poverty lines. For example, when measured at the low line of US$2.5 a day, the oil shock increases poverty by dragging about 400,000 people below that line. At higher poverty lines, such as US$5 and US$10 per day, 2 million and 5.4 million additional people fall behind and poverty rates increase to 10 and 40 percent, respectively. Due to a slight progres-

**TABLE 2.2 Poverty Increases in the Russian Federation after Oil Prices Fall, 2011**

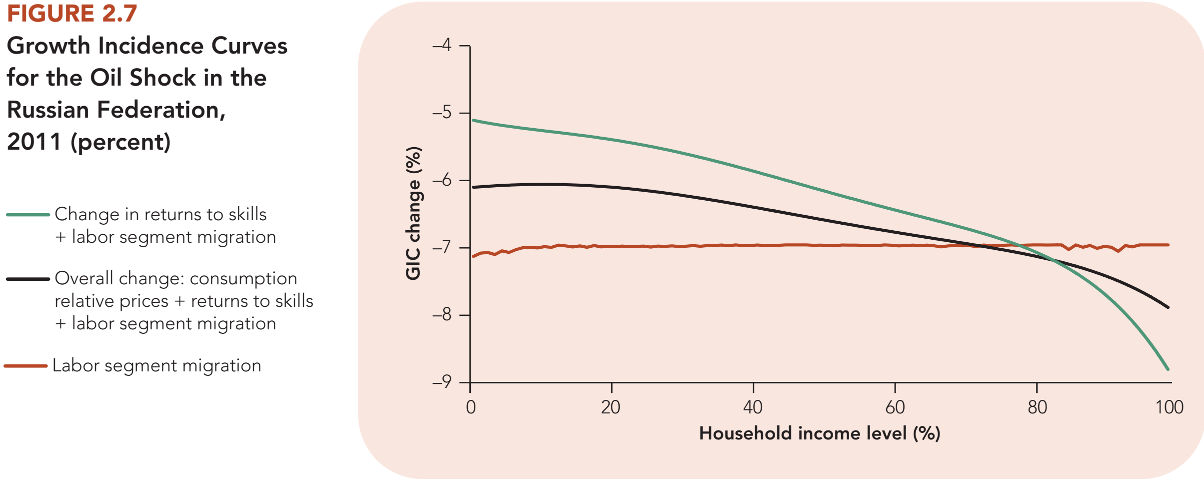
| | Without oil shock | With oil shock | Change (%) |
|---|---|---|---|
| Per capita consumption (US$) | 6,364 | 5,927 | −6.9 |
| Bottom 40% | 2,567 | 2,408 | −6.2 |
| Top 60% | 8,896 | 8,272 | −7.0 |
| Poverty headcount (%) | | | |
| US$2.5 per day line | 0.9 | 1.2 | 0.3 |
| US$5 per day line | 8.3 | 9.8 | 1.5 |

*Sources:* Household budget survey (HBS) data (2011) and microsimulation results.
*Note:* Per capita consumption is expressed in 2005 U.S. dollar PPP; poverty headcounts are expressed in percentages. The column "Change" measures differences for per capita consumption as percentage change with respect to the baseline without shock, and percentage points differences for the poverty headcounts.

sive impact (because richer people are affected slightly more than poorer ones), the Gini coefficient, a standard indicator of inequality, decreases marginally, from 41.1 to 40.9. Unskilled workers misplaced from jobs in nontradable services are among those who lose the most.

The negative impact of the oil shock is slightly stronger for the richer than for the poorer households, as illustrated by the growth incidence curve (GIC); see the GIC labeled "Overall change" in figure 2.7. The figure shows that all households suffer, and there is a slight reduction in inequality. Apart from the average decline in income of 6.9 percent, the relative changes in income depend on various factors. These include movement of workers from urban to rural labor market segments, change in the returns to skills, and shifts in relative consumption prices. Some workers (mainly unskilled) will return from the urban employment to rural employment, which comes with a significant loss of income. However, the overall regressive impact on income distribution is small, as shown by the GIC labeled "Labor segment migration," because it involves relatively few workers. The other factors have a much larger impact on the income distribution.

**FIGURE 2.7**
**Growth Incidence Curves for the Oil Shock in the Russian Federation, 2011 (percent)**




*Sources:* HBS data (2011) and microsimulation results.
*Note:* The microsimulation is done in stages: first, workers move across segments; second, changes in relative factor prices are applied; third, changes in relative goods prices are applied.

Because of the reduced demand for nontradable products, which are skill-intensive, skill premia decline. This affects more the upper part of the distribution, where skilled workers are found (see figure 2.9), and it is reflected by the negatively sloped "Change in returns to skills" GIC.

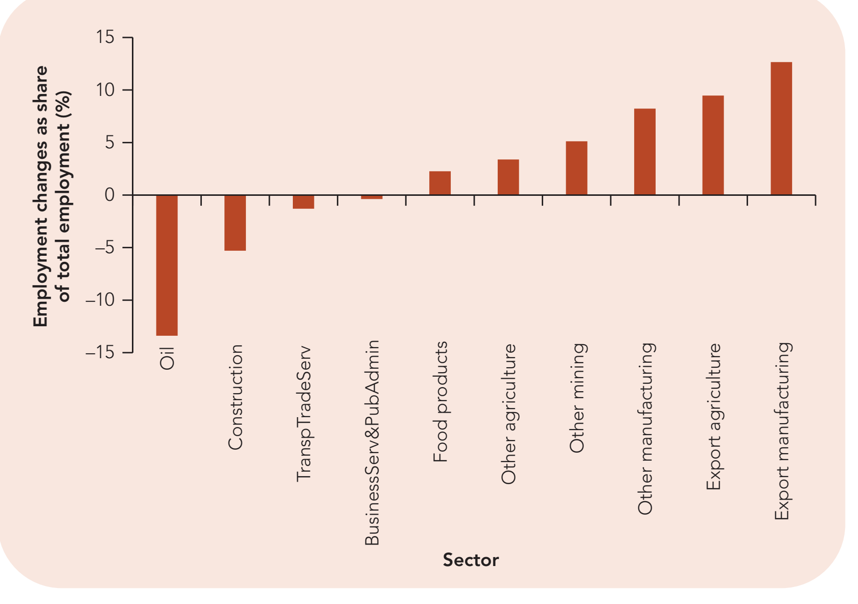
Finally, changes in relative consumption prices favor the rich and hurt the poor. As shown by the "Overall change" GIC, the change in consumption prices is less steep than loss of skill premia shown in the "Change in returns to skills" GIC. The changing consumer prices have several opposing effects.

- Tradable manufactured products become relatively expensive as their import content is high. Richer households consume more manufactured products than poorer households.
- Real estate and nontradable services become cheaper relative to other products. These nontradables are an important part of the consumption basket of richer households.
- Poorer households spend a relatively large part of their budget on agricultural products. These become more expensive relative to nontradable products because agricultural products can easily substitute the more expensive imports. Agricultural product prices rise relative to other prices despite falling fertilizer costs, which are linked to lower energy prices.

On balance, the relative rise of manufactured and agricultural products and the relative decline of real estate prices and prices of nontradable services benefit the rich and hurt the poor.

Figure 2.8 shows that, in terms of output contraction, besides the oil sector, the hardest hit sectors in terms of employment are construction, transport and com-

**FIGURE 2.8**
**Sectoral Shifts Triggered by Oil Price Decline in the Russian Federation, 2011 (percent)**




*Sources:* HBS data (2011) and microsimulation results.

munication, other business services, and public services. Heavy job losses are recorded in the simulations for the construction and transport-communication service sectors, about 0.9 and 1.1 percent of total employment, respectively. These percentages, translated into actual levels of employment, represent close to 500,000 jobs lost in the construction sector and 700,000 jobs lose in the transport-communication sector.

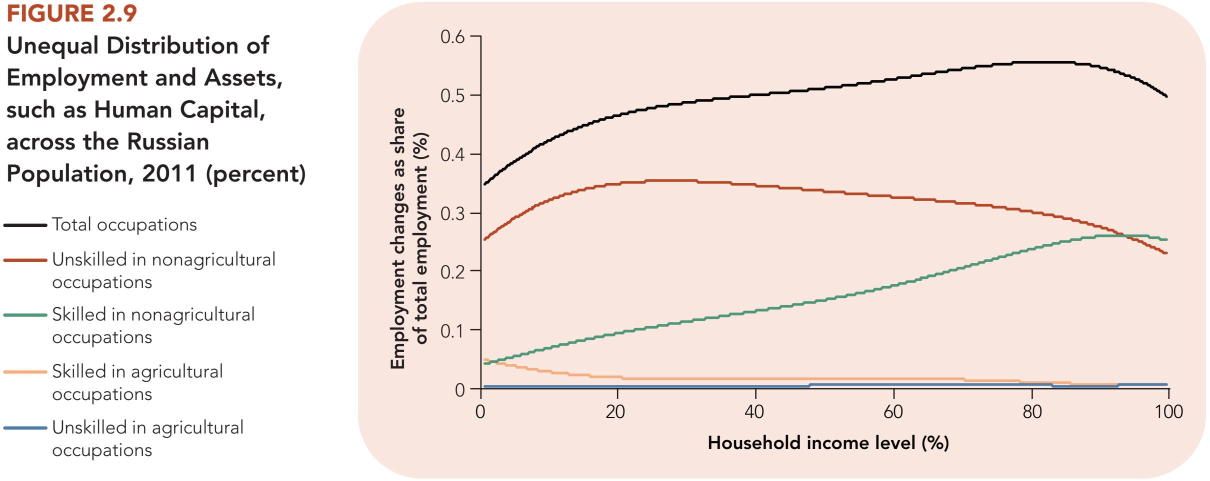
Import-competing industries and export-oriented sectors would benefit from the real depreciation and experience output expansions. A potential large gain is highlighted in the manufacturing sector, which may create close to 800,000 jobs.

As discussed above, labor market shifts are the main reason why the income decline is not the same across the income distribution. Most of the expanding tradable sectors are less skill-intensive than the contracting nontradable ones. Therefore, the skill premium decreases. These skills are concentrated in richer households, as depicted in figure 2.9. This figure shows that even the intensity of the use of labor, the main source of income for most households, is not uniformly distributed. The bottom 40 percent of households record an average employment rate of 45 percent against an average of 53 percent for the top 60 percent of households.

These differences are relevant because the simulation does not take into account that public transfers may contract following the oil price shock. A reduction in social government programs may hit poorer households harder, given their more intense dependency on transfers and lower employability.

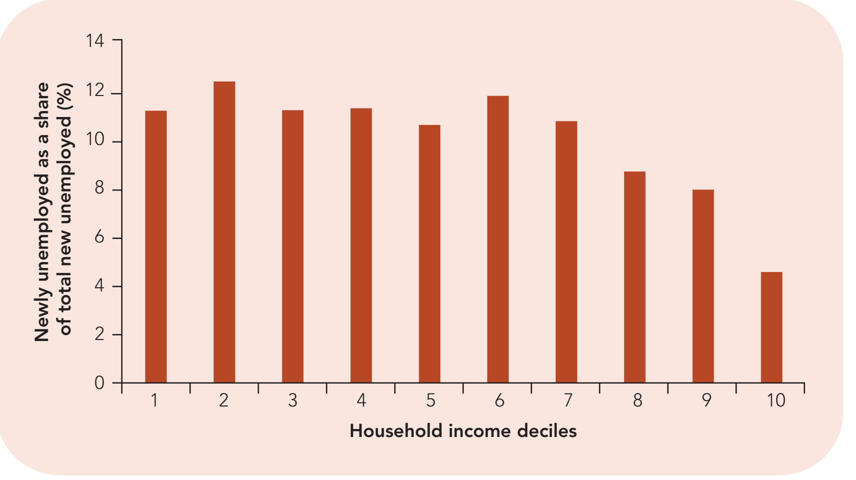
Furthermore, the additional jobs created in the expanding sectors are opportunities that are realized in the general equilibrium model, but they may not necessarily be realized immediately in the real economy. As a thought experiment, an additional microsimulation was carried: all those who would lose their jobs in the contracting sectors—up to 3.1 percent of total employment—were unable to find a new job and would become unemployed. Abstracting from multiplier effects, what would be the distributional impact of this increase in unemployment?

**FIGURE 2.9**
**Unequal Distribution of Employment and Assets, such as Human Capital, across the Russian Population, 2011 (percent)**




*Sources:* HBS data (2011) and microsimulation results.

**FIGURE 2.10**
**Equal Distribution of Job Losses in the Contracting Nontradable Sectors in the Russian Federation, Excepting the Top Decile, 2011 (percent)**




*Sources:* HBS data (2011) and microsimulation results.

An econometric estimation that takes into account the characteristics of the workers (and their households) was carried out to identify those who are most likely to lose their job.[4] As expected, less-qualified, younger, and female workers are more likely to become unemployed. However, these individuals are found across the income distribution (see figure 2.10). Thus, vulnerability to becoming unemployed is not concentrated in a particular income group. The ultimate impact of unemployment vulnerability on income distribution would depend very much on the access new unemployed people have to insurance and transfer systems.

More mechanisms are at work than can be captured by these model simulations. However, these simulations already show a pervasive impact for the Russian economy and for Russian households. For the government, firms, and households alike it is important to recognize these sea changes.

As mentioned above, the impact of oil prices is not limited to oil-exporting countries, but spreads to neighboring countries, especially through workers' remittances. Consider in particular the case of the Kyrgyz Republic. This is the second most remittance-dependent country in the world, only after Tajikistan. A total of 77 percent of remittances to the Kyrgyz Republic come from Russia and their value equaled 30.3 percent of Kyrgyz GDP in 2014. For the first seven months of 2015, the inflow of remittances reported by the National Bank of Kyrgyz Republic (NBKR) dropped by 22 percent in nominal U.S. dollar value compared with the same period of 2014. If this trend continues, the loss in remittances would be equivalent to 7.4 percent of the Kyrgyz GDP, more than double the drop in 2009. This is a major shock, similar in magnitude to the 6.9 percent drop in consumption recorded for the oil price shock in Russia.

4. Specifically, workers more likely to be unemployed are selected through a multinomial probit estimation that computes the probability of either being employed in tradable sectors, employed in nontradable sectors, or being unemployed according to individual and households characteristics. These characteristics include gender, education level, age, marital status, household size, living in urban or rural areas, and headship.

**TABLE 2.3 Poverty Increases in the Kyrgyz Republic after the Fall in Remittances, 2011**

| | No remittance shock | With remittance shock | Change |
|---|---|---|---|
| Per capita consumption (US$) | 1,339 | 1,256 | −6.2 |
| Bottom 40% | 777 | 726 | −6.5 |
| Top 60% | 1,714 | 1,609 | −6.1 |
| Poverty headcount (%) | | | |
| US$2.5 per day line | 30.3 | 36.3 | 6.0 |
| US$5 per day line | 83.4 | 86.2 | 2.8 |

*Sources:* Kyrgyz Integrated Household Survey (KIHS) data (2011) and microsimulation results.
*Note:* Per capita consumption is expressed in 2005 U.S. dollar PPP; poverty headcounts are expressed in percentages. The column "Change" measures differences for per capita consumption as percentage change with respect to the no shock case, and percentage points differences for the poverty headcounts.

To account for the distributive impact of this remittance shock, a methodology combining a CGE model and a microsimulation model has been applied, as in the case of the Russian simulations. The main results are summarized in table 2.3.

The remittance shock is large and it implies significant increases in the poverty headcount ratios. Welfare, measured by per capita consumption, decreases for all households but slightly more for the bottom 40 percent. The Gini coefficient marginally increases from 27.8 to 27.9. Also in the Kyrgyz case, the real depreciation triggers resource reallocation toward tradables; and once again the skill and urban premia are reduced, which implies that the richer part of the population is affected through this channel more severely. However, on balance the bottom 40 suffers larger losses than the top 60 and inequality increases. The overall impact is regressive because the change in remittances, unlike the change in oil revenues in the Russian case, directly affects a specific set of households. Households receiving remittances are highly dependent on them and a large shock is likely to push many of them into poverty or toward the bottom 40 percent group, even if initially these households were in the middle of the distribution.

When compared with those that did not receive remittances, households reporting remittance receipts are, on average, more likely to have heads who are female, older, and less skilled. Remittance recipient households are also more likely to live in rural areas (79 percent), have a slightly higher dependency ratio, and have fewer remaining adults who are employed than nonremittance households (see table 2.4). Despite all this, they were before the shock still relatively rich, thanks to the support from abroad. Indeed, remittances account for between 40 and 90 percent of the income of remittance households.

Remittances are received by households across the entire welfare distribution, although they are slightly more concentrated in the middle groups. Deciles 4 to 7 all have between 14 and 15 percent of their households receiving remittances, while the richest and especially the poorest deciles register a much smaller share. As shown by the panel b of figure 2.11, at more than 50 percent, remittances represent a very large share of income for recipient households.

Given this high degree of dependence, the large decline in remittances pushes a large number of households who were, before the shock, in the middle of the distribution toward the poorer tail of the distribution. This explains why the

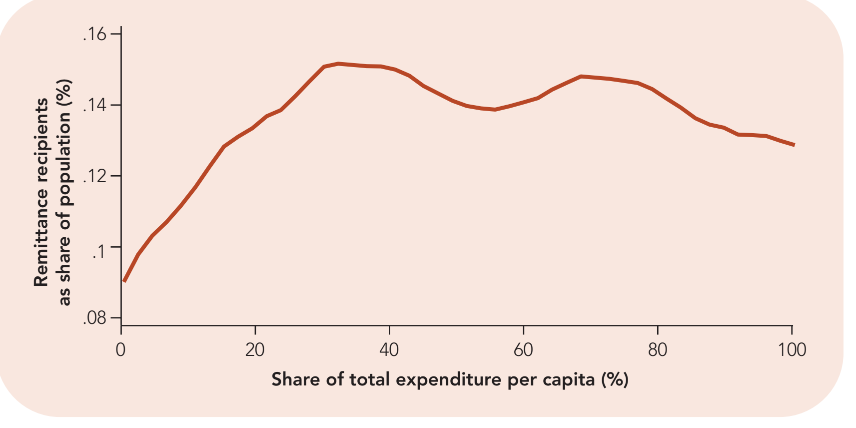
**TABLE 2.4 Characteristics of Remittance and Nonremittance Households in the Kyrgyz Republic, 2011**

| | Remittance households | Nonremittance households | Differences |
|---|---|---|---|
| Household head female | 0.35 | 0.30 | 0.05 |
| Household head age | 52.84 | 51.03 | 1.81 |
| Household head skilled | 0.24 | 0.31 | −0.07 |
| Urban | 0.21 | 0.40 | −0.19 |
| Household size | 4.91 | 4.77 | 0.15 |
| Dependency ratio | 0.80 | 0.71 | 0.10 |
| Share of employed adults | 0.42 | 0.56 | −0.13 |
| Consumption per capita (2005 US$ PPP) | 1,371 | 1,334 | 36.78 |
| Households | 1.983 | 17,836 | |

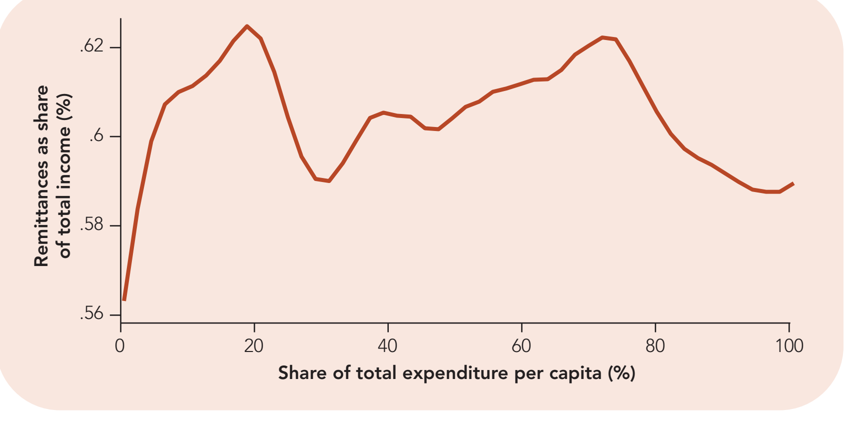
*Source*: KIHS 2011 and microsimulation results.

**FIGURE 2.11 The Importance of Remittances as a Source of Income across the Income Distribution in the Kyrgyz Republic, 2011 (percent)**

**a. Remittance recipients as share of population (%)**

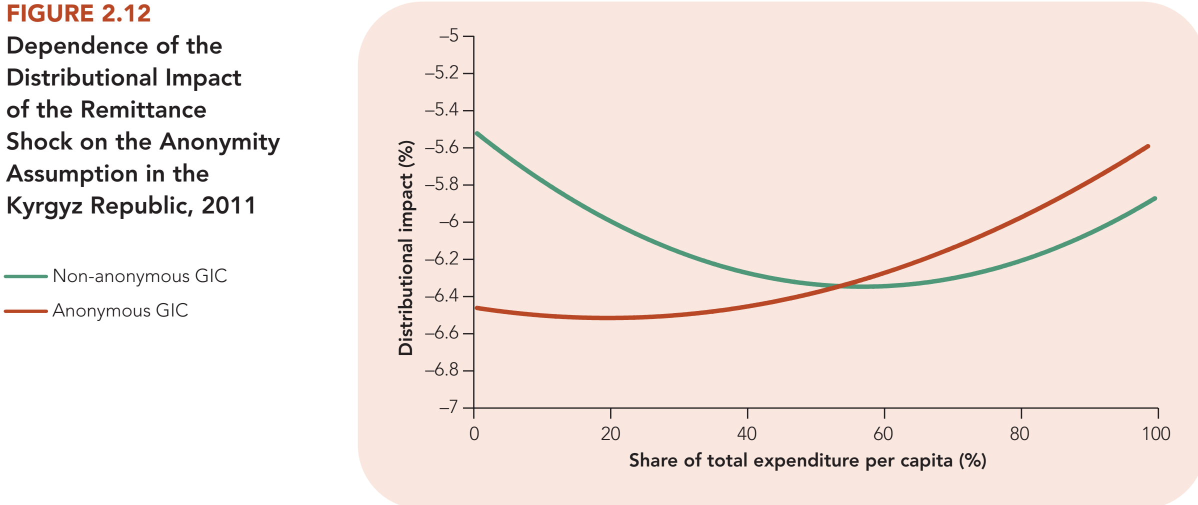



**b. Remittances as share of income for recipients (%)**




*Source:* KIHS 2011 (questionnaire #6) and microsimulation results.
*Note:* A kernel-weighted local polynomial regression was used to smooth the distribution. Expenditure includes durables, health, and imputed rents.

**FIGURE 2.12**
**Dependence of the Distributional Impact of the Remittance Shock on the Anonymity Assumption in the Kyrgyz Republic, 2011**




*Sources:* HBS data (2011) and microsimulation results.

anonymous bottom 40 indicator of table 2.3 shows a deterioration worse than that for the top 60, or why the anonymous GIC in figure 2.12 has a negative slope.

This regressive impact disappears once the anonymity of the bottom 40 indicator is abandoned. If one controls for the composition of the people in the various deciles or, in other words, if one 'follows' individuals after the shock, then the incidence of the remittance shock appears to be more concentrated around the middle of the distribution, as shown in figure 2.12.

## Conclusions

This chapter discussed the relationship in oil-exporting countries between oil prices and real exchange rates, using a simple theoretical model, econometric estimation, and large simulation models. The conclusions are that the relationship is strong in the oil-exporting countries, that the consequences of this strong relationship are pervasive, and that similar impacts are being felt in many neighboring countries.

Reality is more complicated than can be captured in simple models. There are still many issues to be explored in more detail. Just a few of these include the impact of sovereign wealth funds, the impact on capital flows, the labor market consequences for the migrant workers, the vulnerabilities caused by dollarization of financial sectors, and the adequacy of social safety nets.

But it is already clear that the adjustment to the new normal poses many policy challenges, from monetary and fiscal policy, to labor market and business climate policies. None of these challenges should lead to postponement of the adjustments. Such postponement would be very costly and would ultimately backfire.

PART II

# Country Pages

# ALBANIA

| | 2014 |
|---|---|
| Population, million | 2.9 |
| GDP, current US$ billion | 13.0 |
| GDP per capita, current US$ | 4507 |
| Poverty rate ($2.5/day 2005 PPP terms) [a] | 6.7 |
| Poverty rate ($5/day 2005 PPP terms) [a] | 47.5 |
| Gini Coefficient [b] | 29.0 |
| Life Expectancy at birth, years [c] | 77.4 |

Sources: World Bank, WDI, and Macro Poverty Outlook.
Notes:
(a) Most recent value (2012)
(b) Gini data show most recent WDI value (2012)
(c) Life Expectancy data show most recent WDI value (2013)

*Growth accelerated in 2015 and is expected to continue an upward trajectory over the next three years, albeit remaining below potential. Improved business climate and exports will drive this expansion and gradually reignite job creation, while consumption, consumer confidence and labor markets stabilize. Fiscal consolidation has so far fallen largely on expenditures as revenues underperformed, despite new tax measures. As employment improves, gains in living standards are expected with poverty continuing to decline.*

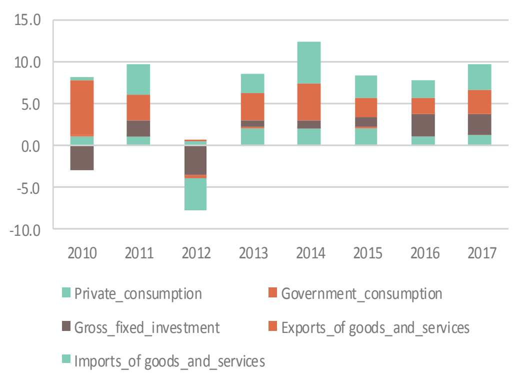
## Recent developments

Growth is accelerating in Albania, although it remains below the long-term trend. Growth picked up to 2.8 percent y/y in the first quarter of 2015, driven by the rise in private investment and improvement in the balance of trade; private consumption contracted and public sector expenditure remained unchanged. Confidence in industry, services and among consumers has been on the rise, indicating continued momentum in the first half of the year. While oil exports fell in response to oil price developments, traditional Albanian exports such as textile and shoes continued to increase. On the other hand increases in machineries and equipment drove the increase in imports, thus supporting a more benign investment prospect. Inflation remains below target reflecting stagnant import prices, a persistent output gap. Growth estimates for 2015 were revised downward to 2.7 percent (from 3 percent in the beginning of the year), due to the impacts of February's floods on the agricultural sector and the reduction of oil production in response to external price developments, but are still higher than 2014 (2.1 percent). Modest fiscal consolidation has taken place in the first half of 2015 with lower than expected revenues, conditioning a lower realization of expenditures, and capital expenditure in particular. As a response, the government has recently started a broad action against informality and tax evasion with which it hopes to close the revenue gap.

Poverty is expected to continue on a slow decline, as economic growth translates into job creation. Poverty ($5/day PPP) increased to 47.5 percent in 2012 from 45.2 percent in 2008, and is estimated to have moderately declined to 46.7 percent in 2014 with progress hindered by weakening of labor markets in the past years with increases in the unemployment rate. Nevertheless, labor markets are slowly picking up, particularly in sectors in which poorer individuals are often employed, including agriculture and construction. The unemployment rate for the working age population slightly dropped from 17.7 percent in the second quarter of 2014 to 17.3 percent in the second quarter of 2015, despite an increase in the labor force participation rate. Among younger workers, however, unemployment rose from 33.5 percent to 34.2 percent in the same period, partly driven by an increase participation rate in this age group. Given the gradual labor market improvements this year, moderate poverty ($5/day, 2005 PPP) is expected to stand at 46.1 percent in 2015.

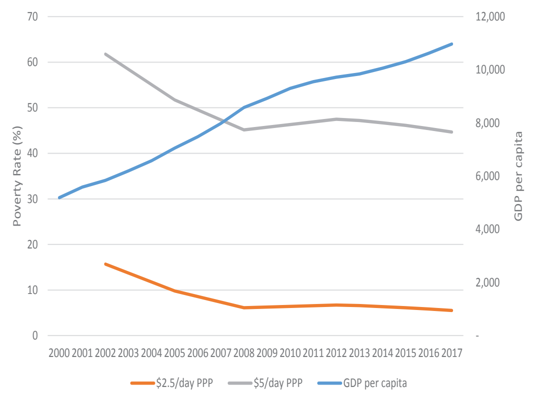
Lower remittance inflows given recent events in Greece and slightly higher food inflation than overall inflation may be affecting living standards, but likely not dramatically this year. Remittance inflows declined from 11.7 percent of GDP in 2008 to 8.4 percent in 2014 due to economic conditions in the Eurozone. Though remittances represent a smaller source of income for poor households, a reduction in inflows may contribute to slowing Albania's overall economic activity and thus economic opportunities for households.

**FIGURE 1 Albania** / GDP contribution by sector




Sources: Instat.

**FIGURE 2 Albania** / Actual and projected poverty rates and real GDP per capita, 2000-2017




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

## Outlook

The Albanian economy is expected to expand by 3.4 percent in 2016 and by 3.5 percent in 2017 albeit remaining below potential. Developments in Greece, sluggish credit and labor markets and the slowing down of the reform momentum, including fiscal consolidation, prevent growth returning to a sustainable path. As in 2015, for the next two years growth is expected to be broad-based, driven by both domestic and external demand. Net exports are expected to pick up following a gradual recovery in the EU. Improvement of the business climate is expected to boost private investment, and consumption on a medium-term horizon, despite the impact of the debt crisis in Greece on remittances, exports and the credit market.

As the economy gradually accelerates, further albeit slow declines in poverty are expected. Following the expected broad-based economic growth patterns, continued improvements in employment rates across sectors will likely drive the modest changes in poverty, given persistently low remittances inflows and no significant changes in social protection benefits. The downward trend is expected to gradually continue with poverty at 45.4 percent in 2016 and 44.7 percent in 2017.

Growth prospects for Albania hinge on the implementation of the structural reform agenda on energy, financial management of public investment, and pensions. Reforms in progress are expected to both promote growth and have positive distributional effects. New pensions indexation rules and the introduction of a social pension, as well as the focus on compensating changes to energy tariffs through the existing social assistance program, are aimed at protecting the real incomes of the poor and less well-off. Albania would need to commit to a strong fiscal consolidation in the medium term for its debt to return to a sustainable path.

## Challenges

Persistently weak labor markets limit the potential of the Albanian economy. A high rate of informality in employment in Albania hampers productivity growth, tax revenue collections, and keeps regulatory compliance low. Increasing activity rates and lowering unemployment, particularly among youth and women, as well as improving the quality of employment across population groups, are enduring challenges to lifting living standards.

Developments in Greece may have a larger than expected impact on Albania's growth and poverty reduction prospects, through reduced remittances, exports, investment. A prolonged crisis in Greece beyond the baseline scenario, could further shock the business and consumer confidence, the labor markets and living standards of the population could be affected. In particular, given the high number of Albanian migrants and/or seasonal workers to Greece, remittances inflows could decrease from an already depressed level since the wake of the 2008 crisis.

Moving forward, Albania faces the challenge of resiliently sustaining economic growth and creating jobs, while ensuring that the poor and vulnerable are adequately protected.

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

| | 2012 | 2013 | 2014 | 2015 f | 2016 f | 2017 f |
|---|---|---|---|---|---|---|
| **Real GDP growth, at constant market prices** | 1.6 | 1.1 | 2.1 | 2.7 | 3.4 | 3.5 |
| Private Consumption | 0.1 | 1.4 | 3.4 | -0.7 | 2.0 | 1.9 |
| Government Consumption | 0.1 | 2.9 | 8.7 | 1.1 | 3.3 | 0.8 |
| Gross Fixed Capital Investment | -7.9 | -2.1 | -2.2 | 8.2 | 8.0 | 8.4 |
| Exports, Goods and Services | -0.6 | 7.9 | -13.1 | -1.5 | 7.6 | 6.1 |
| Imports, Goods and Services | -6.6 | 5.0 | -7.7 | -3.6 | 6.2 | 4.8 |
| **Real GDP growth, at constant factor prices** | -0.2 | 1.5 | 1.7 | 3.0 | 4.4 | 5.2 |
| Agriculture | 5.4 | 0.7 | 2.0 | 1.8 | 3.1 | 3.8 |
| Industry | -12.1 | 5.3 | -4.9 | 1.6 | 10.8 | 12.1 |
| Services | 3.2 | 0.3 | 4.3 | 4.1 | 2.5 | 3.0 |
| **Prices** | | | | | | |
| Inflation (GDP price deflator) | 1.4 | -1.0 | 0.4 | 2.4 | 2.9 | 3.0 |
| Inflation (Consumer Price Index) | 2.0 | 1.9 | 1.6 | 2.9 | 2.5 | 2.9 |
| **Current Account Balance (% of GDP)** | -10.2 | -10.7 | -13.0 | -13.1 | -13.4 | -12.6 |
| **Fiscal Balance (% of GDP)** | -3.4 | -5.2 | -5.8 | -5.1 | -2.3 | -0.2 |
| **Poverty Rate** [a, b, c] | | | | | | |
| Poverty rate ($2.5/day 2005 PPP terms) | 6.7 | 6.6 | 6.3 | 6.1 | 5.8 | 5.5 |
| Poverty rate ($5/day 2005 PPP terms) | 47.5 | 47.2 | 46.7 | 46.1 | 45.4 | 44.7 |

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: f = forecast.
(a) Calculations based on ECAPOV harmonization, using 2002-LSMS and 2012-LSMS.
(b) Projection using annualized elasticity (2002-2012) with pass-through = 1 based on GDP per capita constant PPP.
(c) Actual data: 2012. Estimates for 2013 through 2014, projections are from 2015 to 2017.

# ARMENIA

| | 2014 |
|---|---|
| Population, million | 3.0 |
| GDP, current US$ billion | 11.6 |
| GDP per capita, current US$ | 3898 |
| Poverty rate($2.5/day 2005PPP terms) [a] | 30.2 |
| Poverty rate($5/day 2005PPP terms) [a] | 78.4 |
| Gini Coefficient [b] | 30.3 |
| Life Expectancy at birth, years [c] | 74.4 |

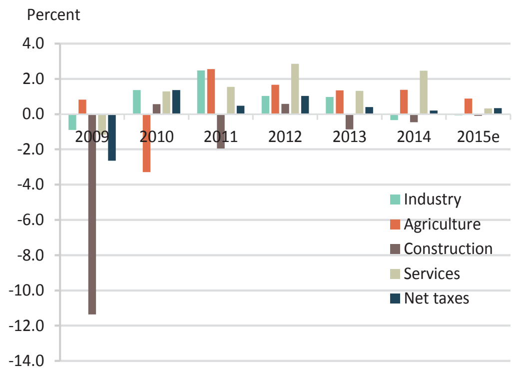
Sources: World Bank, WDI, and Macro Poverty Outlook.
Notes:
(a) Most recent value (2013)
(b) Gini data show most recent WDI value (2012)
(c) Life Expectancy data show most recent WDI value (2013)

*Despite its strong performance during the first half of 2015 , Armenia's economy is expected to slow significantly in the second half of the year. GDP growth is projected to fall from 3.4 percent in 2014 to 2.1 percent in 2015 due to the spillover effects from the Russian recession and low prices for Armenia's key export commodities. Moderate progress in reducing poverty and promoting shared prosperity during 2010-14 could be reversed by a combination of low growth, rising electricity tariffs and deteriorating prospects for migration and remittances.*

## Recent developments

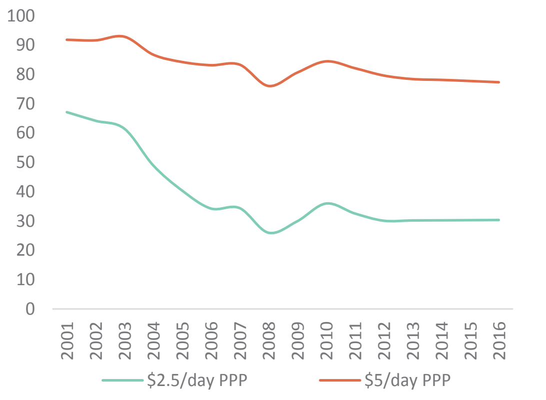
Real GDP grew by 3.7 percent, year-on-year (y/y) in the first half of 2015. Good agricultural conditions and the opening of the new copper mine more than offset the poor performance of other sectors, particularly manufacturing, retail and real estate.
The government's fiscal position has deteriorated, as strong growth in the first half of the year did not translate into higher revenues due to the largely tax-exempt nature of the agricultural sector. Increased budgetary lending and defense outlays are putting upward pressure on public expenditures, as is the introduction unbudgeted subsidies to compensate households and small businesses for increased electricity tariffs. As a result, the fiscal deficit widened from 1.9 percent of GDP in 2014 to 3 percent in the first half of 2015.
The Armenian dram has depreciated by 17 percent against the US dollar since November 2014, prompting the central bank to intervene in the foreign-exchange market. However, the real effective exchange rate has appreciated due to the sharp decline in relative currency values among Armenia's main trading partners, particularly Russia, as the ruble has depreciated by 80 percent against the US dollar since November 2014. At end-July 2015 the dram's real effective exchange rate was up 7.5 percent from a year earlier.
After reaching 5.8 percent in March, 12-month inflation declined to 3.6 percent in August, allowing the central bank to loosen its monetary policy stance. The key policy rate has been cut by a cumulative 25 basis points since February 2015 from a historic high of 10.5 percent.
A steep decline in exports and remittances has weakened the external account, though import compression partially offset this effect. The current account deficit expanded from 7.3 percent of GDP in 2014 to 17 percent in the first quarter of 2015.
After declining steadily for the past several years the poverty rate (at US$2.50 per day) plateaued at 30.2 percent in 2014, still above its pre-crisis level. Gains in poverty reduction have been driven by robust agricultural output and by higher employment and earnings in the nonagricultural sectors. Remittances and pension payments supported consumption growth among households in the lower end of the income distribution.
In 2015, however, slowing domestic economic activity and the weakening of the Russian labor market has hindered poverty reduction. Falling remittances are expected to negatively impact the welfare of households at all income levels. Roughly 40 percent of households in the bottom quintile receive remittances, which equal about 5 percent of their aggregate household consumption.
Russia's declining demand for migrant workers is not only curbing remittances but also prompting Armenian workers to return to the domestic labor market, which is putting upward pressure on the unemployment rate. Unemployment in Armenia rose from 17.6 percent in 2014 to 19.1 percent in March 2015. Falling remittances and weakening labor markets combined with rising inflation and limited

**FIGURE 1** **Armenia** / GDP Growth by Sector, 2009-2015




Source: Armenia Statistical Service.

**FIGURE 2** **Armenia** / Actual and projected poverty rates, 2001-2017




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

fiscal space for countercyclical spending are preventing further progress in poverty reduction.

## Outlook

GDP growth is expected to reach just 2.1 percent in 2015 as a worsening external environment takes toll in the second half of the year. With the Russian economy projected to contract and base metal prices expected to remain low, GDP growth in Armenia is expected to average 2-3 percent per year over the medium term.

The fiscal deficit is projected to widen to 4 percent of GDP in 2015 and will be financed fully by external borrowing. The government's fiscal position should improve as the economy gradually strengthens. However, the public debt stock will continue to rise, and fiscal consolidation efforts, especially on the revenue side, will be necessary to ensure fiscal sustainability. The poverty rate is expected to remain broadly unchanged at about 30 percent through 2017. Low growth, increasing unemployment, weaker remittance flows and rising electricity tariffs will continue to negatively impact household welfare over the medium term.

## Challenges

Sustaining growth in the face of a worsening external environment with limited space for fiscal stimulus will pose a serious challenge to Armenian policymakers. The relative appreciation of the Armenian dram against the Russian ruble could further constrain growth by reducing the competitiveness of Armenian exports. However, a potential normalization with Iran over its nuclear program could facilitate increased trade and enable Iran to serve as a transit route for shipping Armenian goods to the Middle East and Asia.

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

| | 2012 | 2013 | 2014 | 2015 f | 2016 f | 2017 f |
|---|---|---|---|---|---|---|
| **Real GDP growth, at constant market prices** | 7.2 | 3.3 | 3.5 | 2.1 | 2.7 | 3.0 |
| Private Consumption | 7.7 | 2.8 | 0.2 | -1.5 | 2.4 | 1.7 |
| Government Consumption | -1.4 | 16.3 | -0.9 | -14.3 | -12.1 | 0.6 |
| Gross Fixed Capital Investment | -1.9 | -7.9 | -8.0 | 1.6 | 2.4 | 5.8 |
| Exports, Goods and Services | 8.4 | 16.3 | 22.6 | 6.0 | 2.7 | 1.6 |
| Imports, Goods and Services | -2.8 | 0.7 | 7.7 | -6.4 | 0.4 | 2.6 |
| **Real GDP growth, at constant factor prices** | 7.1 | 3.6 | 4.1 | 2.4 | 2.8 | 3.1 |
| Agriculture | 9.5 | 7.6 | 7.8 | 6.3 | 4.0 | 4.0 |
| Industry | 5.2 | 0.8 | -0.8 | 0.7 | 2.5 | 4.1 |
| Services | 7.2 | 3.2 | 5.5 | 0.6 | 2.0 | 1.5 |
| **Prices** | | | | | | |
| Inflation (GDP price deflator) | 5.3 | 3.4 | 2.7 | 3.1 | 3.3 | 3.7 |
| Inflation (Consumer Price Index) | 2.6 | 5.8 | 3.0 | 5.6 | 3.1 | 4.0 |
| **Current Account Balance (% of GDP)** | -10.0 | -7.6 | -7.3 | -7.3 | -6.5 | -5.7 |
| **Fiscal Balance (% of GDP)** | -1.4 | -1.6 | -1.9 | -4.0 | -3.3 | -2.7 |
| **Poverty Rate** [a, b, c] | | | | | | |
| Poverty rate ($2.5/day 2005PPP terms) | 30.1 | 30.2 | 30.2 | 30.2 | 30.3 | 30.3 |
| Poverty rate ($5/day 2005PPP terms) | 79.6 | 78.4 | 78.2 | 78.0 | 77.8 | 77.6 |

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: f = forecast.
(a) Calculations based on ECAPOV harmonization, using 2009-ILCS and 2013-ILCS.
(b) Projection using Point-to-point elasticity (2009-2013) with pass-through = 0.7 based on GDP per capita constant PPP.
(c) Actual data: 2012. Data for 2013-4 are estimates, data from 2015 through 2017 are projections.

# AZERBAIJAN

| | 2014 |
|---|---|
| Population, million | 9.5 |
| GDP, current US$ billion | 75.2 |
| GDP per capita, current US$ | 7921 |
| Gini Coefficient [a] | 33.0 |
| Life Expectancy at birth, years [b] | 70.6 |

Sources: World Bank, WDI, and Macro Poverty Outlook.
Notes:
(a) Gini data show most recent WDI value (2008)
(b) Life Expectancy data show most recent WDI value (2013)

*Growth accelerated to 5.7 percent, year-on-year (y/y), in the first half of 2015, driven by public investment and the robust performance of the agricultural and non-oil manufacturing sectors. However, the decline in value of oil exports caused the current-account surplus to narrow sharply and pushed the budget balance into deficit. The Azerbaijani manat stabilized following a 34 percent devaluation in February. Slowing growth and rising inflation in the wake of the manat's devaluation are likely to increase poverty rates.*

## Recent developments

Despite a turbulent external environment Azerbaijan's GDP growth accelerated to 5.7 percent in the first half of 2015 as agriculture and non-oil manufacturing rapidly expanded. Although oil production fell in 2015, an increase in refining capacity boosted total oil-sector output by 0.6 percent, y/y. Meanwhile, non-oil GDP grew by 9.2 percent in the first half of the year, fueled by public investment related to the European Games, the Trans-Anatolia Natural Gas Pipeline (TANAP) and ongoing projects in the Shah Deniz gas field. Agriculture and non-oil manufacturing, including food-processing, chemical production and construction materials, also experienced robust growth.

In the first quarter of 2015 the current account surplus plunged to 0.4 percent of GDP due to a steep decline in oil prices and increased imports in preparation for the European Games. Oil revenues fell by 38 percent in the first half of the year, significantly weakening the fiscal balance. Consolidated expenditures (including the State, Nakhchivan autonomous region, the State Oil Fund and the Social Protection Fund) remained stable compared with the past year, but consolidated revenues dropped substantially. However, growth in the non-oil sector led to a 10 percent growth in non-oil revenues.

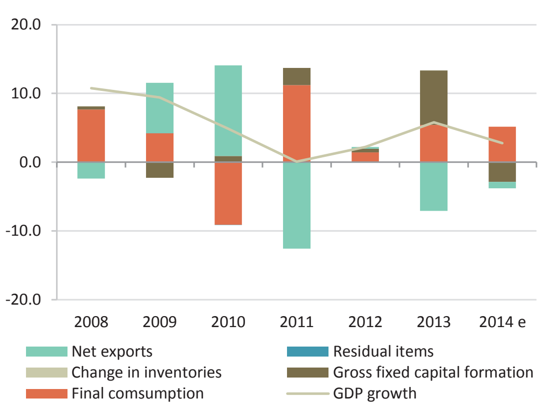
After a 34 percent devaluation against the US dollar in late February the manat has remained relatively stable. However, depreciation pressures intensified in late August, prompting the central bank to draw down its foreign-exchange reserves by US$1.2 billion. Exchange rate uncertainty encouraged dollarization, and the share of foreign-exchange deposits nearly doubled to 71 percent. Prices increased in March 2015, following the devaluation, but government intervention, including increased oversight of wholesale and retail trade companies, along with a contraction of the money supply, has kept inflation relatively low in subsequent months. As a result, consumer prices increased by a moderate 4.4 percent in the first half of the year.

Poverty rates in Azerbaijan have steadily declined over the past decade (Figure 2), as consumption among households in the lower end of the income distribution has steadily increased. According to official statistics the national poverty headcount rate continued to fall from 6 percent in 2012 to 5 percent in 2014 despite slowing economic growth. The extreme poverty rate, measured according to the international poverty line of US$1.25 per person per day, is below the World Bank's global target of 3 percent by 2030. However, the official poverty statistics for 2013-2014 have not been verified by the World Bank.

## Outlook

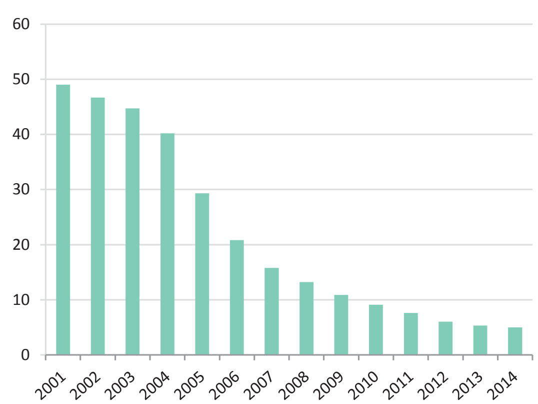
Economic growth is projected to average 2.4 percent per year over 2015-17, as oil production continues to decline and lower oil revenues constrain public spending. Falling oil exports are projected to reduce the current account surplus to 5.2 percent

**FIGURE 1 Azerbaijan** / GDP Growth Decomposition, 2008-2014




Sources: Government of Azerbaijan and Bank staff calculations.

**FIGURE 2 Azerbaijan** / National poverty rate, 2001-2014




Source: State Statistical Committee calculations.
Notes: Poverty lines set by government yearly (AZN125 for 2013).

of GDP over the medium term. Moreover, the weakening of the Russian economy presents an important downside risk, as Russia accounts for one-third of Azerbaijan's non-oil exports.

Public investment is projected to fall to an average of 10.3 percent of GDP between 2015 and 2017, reducing non-oil GDP growth to less than 4 percent per year. However, investment in the hydrocarbons sector will significantly increase in 2016-17 due to the construction of major gas pipelines.

The consolidated fiscal deficit is projected to average 1.4 percent of GDP over the medium term. A deficit of 3.4 percent of GDP is anticipated in 2015, reflecting the impact of low oil prices and a one-off increase in public investment. This deficit is expected to narrow over 2016-17 as oil prices gradually recover and the government consolidates its expenditures.

After a modest rise in 2015, inflation is projected to fall below 5 percent per year over the medium term.

While data limitations do not allow for poverty projections, sustaining the pace of poverty reduction over 2015-16 will be challenging in a context of slow growth, falling oil revenues and lower rates of public investment.

## *Challenges*

Low oil prices and declining oil output remain the most salient risks to Azerbaijan's growth prospects, as the country's economy has been largely driven by public spending and investment financed by oil revenues.

Weaknesses in the financial sector pose a significant challenge, as increased dollarization is constraining the supply of credit. In addition, a further deterioration in regional economic conditions could increase pressure on the exchange rate.

Despite slowing growth, the government intends to protect vulnerable households and safeguard its achievements in poverty reduction. However, given a shrinking resource envelope, re-orienting spending towards greater efficiency is needed to generate the necessary fiscal space.

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

| | 2012 | 2013 | 2014 | 2015 f | 2016 f | 2017 f |
|---|---|---|---|---|---|---|
| **Real GDP growth, at constant market prices** | 2.2 | 5.8 | 2.8 | 2.0 | 2.6 | 2.7 |
| Private Consumption | 2.2 | 8.1 | 8.5 | 5.5 | 3.2 | 3.0 |
| Government Consumption | 2.2 | 9.0 | 4.0 | -4.6 | -5.4 | -5.0 |
| Gross Fixed Capital Investment | 2.2 | 19.4 | -2.1 | -3.6 | 2.2 | 3.9 |
| Exports, Goods and Services | 2.2 | 1.5 | -2.5 | -1.0 | -0.6 | -0.7 |
| Imports, Goods and Services | 2.2 | 10.0 | 1.1 | -3.6 | -2.5 | -2.0 |
| **Real GDP growth, at constant factor prices** | 0.8 | 5.2 | 2.6 | 2.8 | 2.2 | 2.1 |
| Agriculture | 6.6 | 4.9 | -2.4 | 6.0 | 4.2 | 4.0 |
| Industry | 18.6 | 1.8 | 0.5 | 2.0 | 1.5 | 1.4 |
| Services | -30.6 | 15.1 | 9.6 | 3.8 | 3.5 | 3.2 |
| **Prices** | | | | | | |
| Inflation (GDP price deflator) | 2.8 | 0.5 | -1.4 | -6.1 | 5.9 | 4.9 |
| Inflation (Consumer Price Index) | 1.1 | 2.5 | 1.5 | 7.5 | 4.1 | 4.1 |
| **Current Account Balance (% of GDP)** | 21.5 | 16.5 | 13.8 | 2.9 | 5.5 | 7.4 |
| **Fiscal Balance (% of GDP)** | 3.7 | 1.7 | 2.7 | -3.4 | -1.1 | 0.7 |

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

# BELARUS

| | 2014 |
|---|---|
| Population, million | 9.4 |
| GDP, current US$ billion | 76.1 |
| GDP per capita, current US$ | 8074 |
| Gini Coefficient [b] | 27.5 |
| Life Expectancy at birth, years [c] | 73.2 |

Sources: World Bank, WDI, and Macro Poverty Outlook.
Notes:
(a) Most recent value (2012)
(b) Gini data show most recent WDI value (2011)
(c) Life Expectancy data show most recent WDI value (2013)

*The Belarus economy is in recession due to an adverse external environment with falling exports and a sharp depreciation of the Russian ruble. To preserve already low foreign exchange reserves, the authorities tightened monetary and fiscal policies and allowed for greater exchange rate flexibility, while seeking to refinance the growing foreign public debt. Over the medium term, economic growth is likely to remain low—given expectations for modest recovery in Europe and weakness in Russia—unless structural reforms are undertaken.*

## Recent developments

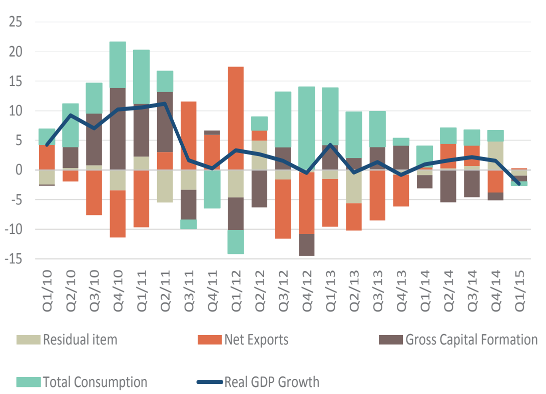
The Belarussian economy is in recession with real output contracting for the first time since 1995. In January-July 2015, real GDP dropped 4 percent y/y, compared to a modest increase of 1.6 percent y/y in the same period in 2014. Industrial output fell by 7.2 percent y/y, with all subsectors but chemicals shrinking and some by a large magnitude. A late start of the harvesting season at end-July instead of earlier in the month led to a decline in agricultural output by 11.5 percent y/y. Lower growth and persistent inflation reduced real wages and incomes, thus leading to a fall in private consumption by 0.5 percent y/y in the first quarter. Gross fixed capital investments continued contracting—with a reduction of 14.6 percent y/y (on top of the 9.1 percent y/y drop observed a year ago), led by downscaling of public capital expenditures and some compression of directed lending

Labor market outcomes worsened with the recession. In July 2015, employment decreased by 1.5 percent y/y, while the number of officially registered unemployment more than doubled. In January-June 2015, 7.7 percent of the active labor force worked reduced hours (compared to only 3.1 percent a year ago), and 5.1 percent of workers were affected by temporary production stoppages in the firms employing them.

At the beginning of 2015, the National Bank of Belarus (NBRB) adopted a base-money targeting regime, setting a nominal broad money supply growth target at 30 percent for the year in order to reach an inflation rate of 18±2 percent. Even though monetary growth was higher than targeted since February, in January-July 2015 the inflation rate was below the lower bound of the band at 14.9 percent (compared to 17.5 percent a year ago). Since mid-2014, the exchange rate policy has mainly responded to deteriorating conditions in Russia. The Belarusian rubel (BYR) depreciated against the USD by 23 percent in January 2015, and another 19 percent from late May to late August. Competitiveness relative to regional partners, however, remains an issue: inflation in Belarus is larger than in Russia and, in addition, the BYR appreciated against the Russian ruble (RUR) by about 8 percent in nominal terms since mid-2014.

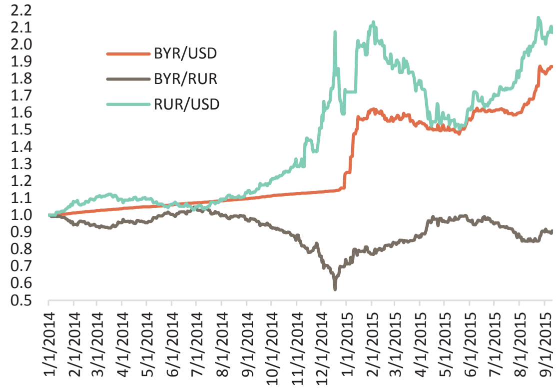
Foreign trade and current-account imbalances are narrowing because of lower demand for imports and the exchange rate depreciation, but Belarus still faces large external financing requirements. During the first half of 2015, imports of goods and services decreased by 27.6 percent y/y in dollar value, more than exports that declined by 24.3 percent y/y. Shrinking markets and the RUR depreciation hit sales of goods to Russia, which fell by 33.3 percent y/y in dollar value. Current account deficit stood at 5.2 percent of GDP in January-May 2015—almost half of what it was a year ago. In the first seven months of 2015, the Government paid USD 1.6 billion of foreign debt, and nearly half of this sum was refinanced using new loans disbursed by Russia. Foreign reserves, excluding gold, declined by 16 percent since the beginning of 2015, and by August stand at

**FIGURE 1 Belarus** / Contributions to quarterly GDP Growth




Source: World Bank Staff Estimates based on the National Statistical Committee Data.

**FIGURE 2 Belarus** / Daily currency dynamics, index values (1/1/2014=1)




Source: National Bank of Belarus, Central Bank of Russia.

USD 2.85 billion, barely covering one month of imports of goods and services.

## Outlook

Belarus' economic outlook for 2015 remains bleak, with real GDP projected to decline by 3.5 percent. Domestic demand is likely to remain weak, with declining investment and consumption, and the current account deficit is expected to narrow to 4.2 percent of GDP. Additional official financing assistance has been requested from the Eurasian Fund for Stabilization and Development (EFSD) of the EurAsEC and Russia to support international reserves at the NBRB and to meet public foreign debt obligations falling due in the next few months—nearly USD2.2 billion to be repaid from August to December 2015.

For 2016 and 2017, the outlook is predicated upon the persistence of limited access to foreign financing and thus the necessity to further adjust output and the real exchange rate to close the BOP gap. Exchange rate fluctuations, along with planned increases in utility tariffs, will keep inflation in double-digit territory. The current account deficit is expected to narrow modestly to 3-4 percent of GDP, reflecting the difficulties to attract external financing.

If the authorities undertake macroeconomic adjustment and structural reforms, supported by international financing, growth may initially be lower in 2016, but prospects of a recovery in 2017 are stronger. Admittedly, the outlook for 2016 and 2017 is subject to uncertainty related to oil prices, the developments in Russia and Ukraine. Progress on a comprehensive structural reform agenda would also affect outcomes

## Challenges

The major challenge is to avoid falling into a low-growth equilibrium because of long -standing structural problems, including excessive state intervention in the economy, poor SOEs performance, weak international competitiveness, and macroeconomic imbalances. A return to growth will be possible if Belarus implements critical structural reforms. There is consensus that boosting productivity is a key to restoring growth; nevertheless, the policy focus so far has been on state-led technological upgrading of selected manufacturing sectors, with much less attention to other aspects of enterprise performance. In the complex environment, shaped by external pressures and an electoral cycle at home, growth can be spurred by appropriately sequenced reforms supported by international partners and investors. In any case, the backbone of change is to break the barriers to doing business more efficiently as resources are locked-in less productive uses by SOEs, supported by subsidized loans and granted with debt rescheduling. This short-sighted policy needs to be changed if Belarus is to return to a sustainable growth path in the future.

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

| | 2012 | 2013 | 2014 | 2015 f | 2016 f | 2017 f |
|---|---|---|---|---|---|---|
| **Real GDP growth, at constant market prices** | 1.7 | 1.1 | 1.6 | -3.5 | -0.5 | 1.0 |
| Private Consumption | 10.7 | 10.8 | 4.4 | -3.0 | -1.4 | 1.5 |
| Government Consumption | -1.0 | -2.1 | -1.9 | -2.0 | -0.5 | 0.0 |
| Gross Fixed Capital Investment | -11.3 | 9.6 | -8.9 | -12.3 | -0.7 | 1.7 |
| Exports, Goods and Services | 11.2 | -16.0 | -3.6 | -14.0 | -1.0 | 2.0 |
| Imports, Goods and Services | 10.9 | -4.2 | -7.4 | -15.0 | -2.0 | 2.5 |
| **Real GDP growth, at constant factor prices** | 1.3 | 0.5 | 1.7 | -3.8 | -0.5 | 1.1 |
| Agriculture | 6.4 | -3.8 | 3.9 | 1.0 | 2.0 | 2.0 |
| Industry | 2.0 | -2.0 | 0.5 | -7.0 | -1.1 | 1.0 |
| Services | -1.1 | 5.2 | 2.5 | -1.3 | -0.5 | 1.0 |
| **Prices** | | | | | | |
| Inflation (GDP price deflator) | 75.4 | 21.1 | 18.1 | 17.4 | 17.8 | 14.9 |
| Inflation (Consumer Price Index) | 59.1 | 18.3 | 18.3 | 16.5 | 15.5 | 14.5 |
| **Current Account Balance (% of GDP)** | -2.9 | -10.4 | -6.8 | -4.2 | -3.2 | -3.9 |
| **Fiscal Balance (% of GDP)** | 1.7 | 0.1 | 1.1 | 1.8 | 0.1 | 0.2 |

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

# BOSNIA AND HERZEGOVINA

| | 2014 |
|---|---|
| Population, million | 3.8 |
| GDP, current US$ billion | 16.8 |
| GDP per capita, current US$ | 4769 |
| Gini Coefficient [a] | 33.4 |
| Life Expectancy at birth, years [b] | 76.3 |

Sources: World Bank, WDI, Macro Poverty Outlook, and BHAS.
Notes:
(a) Gini data show most recent WDI value (2007)
(b) Life Expectancy data show most recent WDI value (2013)

*High frequency indicators suggest some recent pick-up in activity. Growth in 2015 overall is likely to recover to 2 percent, supported by reconstruction after the 2014 floods and improving external demand. With still-weak labor dynamics, the poverty headcount is likely to improve only marginally. A joint agreement between the national and sub-national authorities on the country's priority reform agenda was signed in July 2015. Implementation of this agenda, including long-awaited labor reforms, is key to an improved medium-term outlook.*

## Recent developments

High frequency data for the first half of 2015 point to an acceleration in economic activity. First official estimates show GDP growth of 2.1 percent year-on-year in the first quarter, mainly driven by construction and services. Stronger indirect revenue collection also points to recovering domestic demand. Industrial production, in decline during 2014 following the floods of May that year, has also recovered, moving to positive growth by March 2015, and reaching 4.3 percent year-on-year in June. The 2014 floods hit agriculture and energy output the most, contributing to the fall in growth to 0.8 percent in 2014.

Slow progress in advancing reforms contributed to an unchanged, and high, unemployment rate (27 percent in 2015) and constant gross earnings over 2014 to 2015. Youth unemployment was an extremely high 62 percent in 2014. Much of the increase in employment seen in early 2015 (a 1.7 percent rise in the first quarter from a year earlier) originated in public administration.

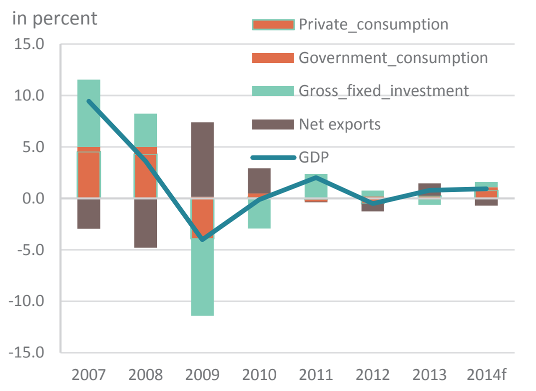
The stalling in recent years of the pre-crisis poverty reduction trend reflects the strong relationship of poverty (and shared prosperity) to labor market performance, especially in sectors that employ lower skilled workers. The poor (and the bottom 40) are disproportionally low skilled and unemployed, or employed in low-skilled occupations and sectors. The recent increases in employment in public administration, for example, will thus have little effect on poverty reduction or on boosting shared prosperity, as very few poor or Bottom 40 households are employed there.

Deflation moderated in the first half of 2015 with consumer prices falling by 0.5 percent year-on-year in the first half of 2015 (versus a fall of 1.5 percent a year earlier). The biggest drivers to the fall came from the prices of imported goods, including oil, food, clothing and footwear. This trend will benefit low income households primarily in urban areas but for agricultural producers it will may be offset by the negative effect of lower food prices; a large share of the poor reside in rural areas, and poverty incidence among those in the agricultural sectors is high.

In the second quarter of 2015 the convertible mark - pegged to the Euro under the currency board arrangement weakened moderately against the dollar but as of July was still down 12 percent relative to December 2014 following the marked depreciation earlier in 2015. As a result, combined with falling domestic prices, the real effective exchange rate weakened by 4 percent from December 2014 to July 2015. Risks of adverse balance sheet effects from the dollar strengthening is limited by the modest share of dollar-denominated external debt (about 16 percent).

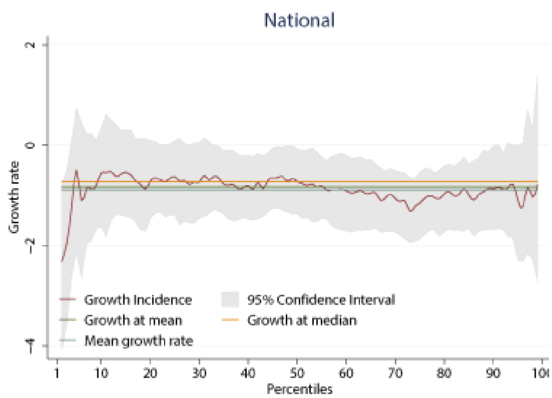
After the delayed adoption of the 2015 budget by the BH institutions, following the protracted time for government formation in FBH and BH Institutions, the Fiscal Council came to an agreement on the fiscal framework for 2016-2018 at the end of June 2015. After the delayed adoption of the 2015 budget by the BH institutions, following the protracted time for

**FIGURE 1 Bosnia and Herzegovina** / Contributions to annual GDP growth




Source: BH Agency for Statistics (BHAS), World Bank staff estimates.

**FIGURE 2 Bosnia and Herzegovina** /Growth incidence curve, 2007-2011




Source: World Bank, BHAS, FBO and RSIS (2015). Poverty and inequality in BH 2007-2011. World Bank Report No. 97643.

government formation in FBH and BH Institutions, the Fiscal Council came to an agreement on the fiscal framework for 2016-2018 at the end of June 2015.

## Outlook

Growth is projected to strengthen to 2 percent in 2015 and to further rise in the medium-term. Near-term support will come from the recovery in external demand and the stepping up of reconstruction after the 2014 floods. Unless addressed, the slow implementation of long-standing reforms will continue to be dampen medium-term growth. Other risks to the outlook include possible delays in Europe's recovery which would have an impact on exports, remittances and capital flows. The 2015 fiscal deficit is projected to remain around 2 percent of GDP, as in the two previous years, with fiscal consolidation to be gradually introduced in order to absorb the shock caused by the floods.

Unemployment, particularly among youth, is expected to remain high, with some improvement in employment as activity picks up. However, the private sector remains constrained by the high tax burden, which constrains hiring. Real wages are expected to remain largely flat. The drought this year is also likely to have a negative effect on rural households employed in agriculture, especially among smaller (and poorer) farmers, who are less able to insure against negative shocks.

Overall, the poverty headcount is likely to improve only marginally. In the medium term, the impact of the projected rise in growth on poverty reduction and improved shared prosperity will depend critically on the creation of new jobs.

## Challenges

The challenge for fiscal policy will be to secure medium-term sustainability while supporting the needed recovery in growth. Fiscal consolidation will need to be gradually introduced in order to absorb the shock caused by the floods. The sustainability of public debt needs to be closely monitored as its scope, size and complexity has increased. In addition, particular focus will be needed on documentation of the arrears, full accounting of which does not exist.

Reducing unemployment, while maintaining macroeconomic stability will require an ambitious policy agenda. A persistent challenge is the high cost of employment, given the high tax wedge on labor, especially among low-wage workers. This makes it difficult for employers to create formal jobs for lower skilled workers, resulting in persistent unemployment, underemployment and a high degree of informality, especially among the poor and in the Bottom 40 group. One of the possibilities is to support formalization of employment via the new labor code legislation currently being adopted in FBH and which is going through consultations with social partners in the Republika Srpska. The social protection system remains poorly targeted, with virtually no effect on the poverty headcount, and improving coverage and targeting will be required alongside labor market reforms to ensure an effective safety net.

Having recently signed the Reform Agenda, the authorities now face the challenge of delivering on the reforms at the core of the agenda. Besides helping strengthen potential growth and supporting improved living standards, reform implementation will be essential for sustaining EU integration. In turn, the adoption and implementation of reforms in key areas, from the labor market to management of fiscal spending, will depend crucially on political dynamics.

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

| | 2012 | 2013 | 2014 | 2015 f | 2016 f | 2017 f |
|---|---|---|---|---|---|---|
| **Real GDP growth, at constant market prices** | | | 0.9 | 2.0 | 2.1 | 3.2 |
| Private Consumption | | | 1.0 | 1.4 | 2.8 | 3.0 |
| Government Consumption | | | 1.4 | 1.7 | 2.5 | 2.8 |
| Gross Fixed Capital Investment | | | 2.9 | 3.7 | 3.0 | 2.5 |
| Exports, Goods and Services | | | -1.8 | 2.4 | 4.0 | 4.0 |
| Imports, Goods and Services | | | 0.3 | 1.8 | 3.5 | 3.0 |
| **Real GDP growth, at constant factor prices** | -1.2 | 2.5 | 0.8 | 1.9 | 2.3 | 3.1 |
| Agriculture | -11.4 | 15.8 | -9.6 | -2.0 | 2.5 | 3.0 |
| Industry | -2.5 | 3.5 | -1.6 | 2.9 | 3.0 | 3.3 |
| Services | 0.7 | 0.5 | 3.2 | 2.0 | 2.0 | 3.0 |
| **Prices** | | | | | | |
| Inflation (GDP price deflator) | 2.6 | 0.8 | 2.4 | -0.7 | -0.6 | 0.9 |
| Inflation (Consumer Price Index) | 2.0 | -0.1 | -0.9 | -0.4 | .. | .. |
| **Current Account Balance (% of GDP)** | -8.9 | -5.7 | -7.6 | -7.9 | -6.0 | -6.5 |
| **Fiscal Balance (% of GDP)** | -2.0 | -2.2 | -2.1 | -1.9 | -1.8 | -1.7 |

Source: World Bank.
Note: f = forecast.

# BULGARIA

| | 2014 |
|---|---|
| Population, million | 7.3 |
| GDP, current US$ billion | 55.7 |
| GDP per capita, current US$ | 7630 |
| Poverty rate ($2.5/day 2005 PPP terms) [a] | 5.6 |
| Poverty rate ($5/day 2005 PPP terms) [a] | 16.4 |
| Gini Coefficient [b] | 34.3 |
| Life Expectancy at birth, years [c] | 74.3 |

Sources: World Bank, WDI, and Macro Poverty Outlook.
Notes:
(a) Most recent value (2012)
(b) Gini data show most recent WDI value (2011)
(c) Life Expectancy data show most recent WDI value (2013)

*Recent positive developments are likely to help accelerate Bulgaria's convergence to EU average living standards and reduce poverty. Economic growth in 2015 is likely to be higher than initially expected, supported by strong exports, especially in the first half of 2015, and recovery of investment. Declining unemployment, growing employment in industry and construction, and rising incomes have contributed to reducing poverty. Political stability and the reinvigoration of reforms are likely to continue strengthening the fiscal position in the medium term.*

## Recent developments

Supported by exports and investment, GDP grew by 2.4 percent year-on-year in Q2-2015. Exports were boosted by economic recovery in the Eurozone while investment, mainly public, expanded in line with intensified implementation of EU-funded projects. Consumption contributed to growth but its contribution slowed compared to Q1-2015 despite continuing deflation, rising incomes and a decline in unemployment.

Unemployment fell by 2.1 percentage points in a year and reached 9.4 percent in July 2015, supported by growing employment and active labor market policies. Employment picked up mostly in the fastest growing sector, ICT, and started to recover in industry and construction, the sectors that were hit hardest by the global financial crisis. These sectors, together with real estate, contributed the most to GDP growth. Employment growth, however, slowed in Q2 compared to Q1-2015 as a result of weakening of activity in agriculture and tourism.

With employment picking up, poverty fell slightly to 15.2 percent in 2014 at the $5 a day poverty line, but remains substantially higher than the pre-crisis level of 13.0 percent, as employment remains well below pre-crisis levels—particularly in low-skilled jobs.

Deflationary pressures, driven by falling international oil prices, continued to affect the harmonized index of consumer prices, which declined by 1.1 percent in July 2015 on an annual basis. These pressures were somewhat dampened compared to 2014 due to increases in administrative prices, depreciation of the Lev against the US dollar, and rising unit labor costs.

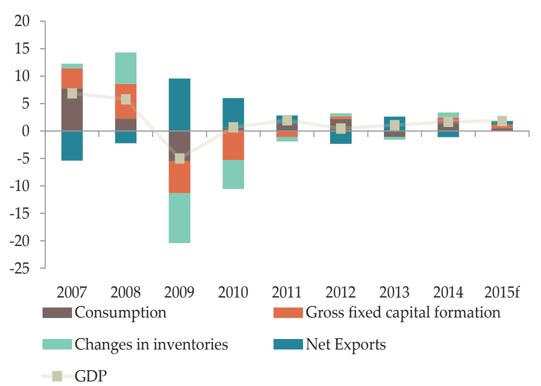
The external current account turned into in a small surplus in the first half of 2015 from a small deficit a year earlier. The trade deficit narrowed significantly, supported by robust export growth. Exports expanded by 12.6 percent year-on-year and were affected by stronger external demand for electrical machines, copper, and grain, higher prices of metals and the depreciating Lev. Import growth was more subdued (5.4 percent), based on higher demand for raw materials and investment. Net capital inflows increased as a result of the government debt issue and higher capital inflows from the EU while FDI inflows increased slightly to 1.9 percent of annual GDP.

Banks reduced their exposure to foreign capital, including to Greece, in the first half of 2015. As a result, gross external debt declined to 89.3 percent of GDP in June 2015 from 94.7 percent in the end of 2014.

Though the Bulgarian banking sector had high exposure to Greece, it has weathered the Greek crisis well. The measures that the Bulgarian National Bank took prior to the crisis in Greece helped ensure financial and operational independence of Bulgarian banks and thus mitigated the negative effects from the introduction of the bank holiday in Greece in July.

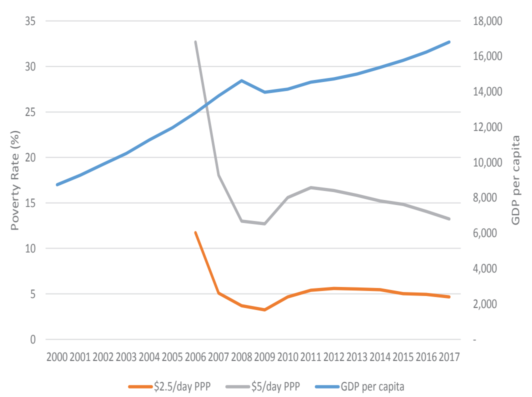
After a widening of the fiscal deficit in

**FIGURE 1 Bulgaria /** Contributions to annual growth, percentage points




Source: NSI and World Bank staff estimates.

**FIGURE 2 Bulgaria** / Actual and projected poverty rates and real GDP per capita, 2000-2017




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

2014, fiscal policy tightened in 2015. Fiscal accounts were in surplus until July 2015 as revenue increased by 13 percent year-on-year in response to improvements in tax compliance and increased inflows of EU funds. Buoyant revenue supported the substantial fiscal consolidation planned in 2015 and is expected to mitigate the slow progress in tightening of expenditure in some sectors. In March 2015 the Government issued Eurobonds amounting to €3.1 billion to finance sizable debt repayments due in 2015. Government debt increased to 28.7 percent of GDP in June 2015 compared to 26.9 percent in the end of 2014. Nevertheless, Bulgaria still has one of the lowest government debt-to-GDP ratios in the EU.

## Outlook

GDP is projected to grow by 1.9 percent in 2015, picking up speed compared to 2014 because of stronger exports and investment. The economic recovery is projected to be modest, with growth improving to only 2.2 percent in 2016 and 2.7 percent in 2017. The rebound of domestic demand is expected to support growth in the medium term while the contribution of net exports is likely to turn negative.

Poverty is expected to decline only marginally to 14.8 percent in 2015 and 14.1 percent in 2016. Increased child benefits and heating subsidies for children and elderly are expected to contribute to poverty reduction. Labor market developments such as minimum wage increases and the Youth Guarantee program for activating young people not in education, employment or training are expected to help reduce poverty as well.

The external current account is expected to continue to be in surplus in 2015, supported by strong external demand and positive terms of trade effects. Exports growth is likely to decelerate in the second half of 2015 due to the negative impact from the temporary capital controls in Greece during the summer and moderation of demand in China. In 2016 and 2017 the current account is expected to turn into deficit as import growth accelerates.

The government is on track with carrying its plan for significant fiscal consolidation in 2015 and in the medium-term. The cash fiscal deficit is expected to be reduced to 2.9 percent of GDP in 2015 and to narrow by about 0.5 percentage points of GDP per year in 2016 and 2017.

## Challenges

The outlook is subject to downside risks related to the strength of recovery in the EU and pace of structural reforms domestically. Bulgaria's adverse demographics will continue be a challenge . Improving growth, employment, and poverty outcomes will depend on expanding access to training and employment, especially for young people, Roma, and the low-skilled.

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

| | 2012 | 2013 | 2014 | 2015 f | 2016 f | 2017 f |
|---|---|---|---|---|---|---|
| **Real GDP growth, at constant market prices** | 0.5 | 1.1 | 1.7 | 1.9 | 2.2 | 2.7 |
| Private Consumption | 3.9 | -2.3 | 2.0 | 0.7 | 2.6 | 3.4 |
| Government Consumption | -1.0 | 2.8 | 3.8 | -0.5 | 1.2 | 1.4 |
| Gross Fixed Capital Investment | 1.9 | -0.1 | 2.8 | 3.2 | 2.2 | 3.2 |
| Exports, Goods and Services | 0.7 | 9.2 | 2.3 | 6.0 | 3.8 | 4.5 |
| Imports, Goods and Services | 4.5 | 4.9 | 3.8 | 4.9 | 3.9 | 4.9 |
| **Real GDP growth, at constant factor prices** | -0.5 | 1.2 | 1.6 | 1.8 | 2.2 | 2.7 |
| Agriculture | -7.3 | 3.3 | 5.2 | -0.1 | 1.5 | 1.5 |
| Industry | 1.6 | -0.1 | 2.0 | 2.4 | 2.9 | 3.3 |
| Services | -0.8 | 1.6 | 1.2 | 1.7 | 1.9 | 2.5 |
| **Prices** | | | | | | |
| Inflation (GDP price deflator) | 1.6 | -0.8 | 0.6 | 1.2 | 1.3 | 1.6 |
| Inflation (Consumer Price Index) | 2.4 | 0.4 | -1.6 | -0.8 | 0.2 | 1.4 |
| **Current Account Balance (% of GDP)** | -0.3 | 1.9 | 0.9 | 0.7 | -0.9 | -1.4 |
| **Fiscal Balance (% of GDP)** | -0.5 | -1.8 | -3.7 | -2.9 | -2.5 | -1.9 |
| **Poverty Rate** [a, b, c] | | | | | | |
| Poverty rate ($2.5/day 2005 PPP terms) | 5.6 | 5.5 | 5.5 | 5.0 | 4.9 | 4.7 |
| Poverty rate ($5/day 2005 PPP terms) | 16.4 | 15.8 | 15.2 | 14.8 | 14.1 | 13.2 |

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: f = forecast.
(a) Calculations based on ECAPOV harmonization, using 2012-EU-SILC.
(b) Projection using neutral distribution (2012) with pass-through = 0.87 based on GDP per capita constant PPP.
(c) Actual data: 2012. Projections are from 2013 to 2017.

# CROATIA

| | 2014 |
|---|---|
| Population, million | 4.2 |
| GDP, current US$ billion | 57.1 |
| GDP per capita, current US$ | 13465 |
| Poverty rate ($2.5/day 2005 PPP terms) [a] | 2.1 |
| Poverty rate ($5/day 2005 PPP terms) [a] | 9.8 |
| Gini Coefficient [b] | 30.9 |
| Life Expectancy at birth, years [c] | 77.1 |

Sources: World Bank, WDI, and Macro Poverty Outlook.
Notes:
(a) Most recent value (2012)
(b) Gini data show most recent value (2013)
(c) Life Expectancy data show most recent value (2013)

*After twelve quarters of economic contraction, Croatia returned to growth in early 2015, supported by external demand and personal consumption. There are early signs of labor market recovery, from a low level, leaving the unemployment rate high at about 17 percent. The fiscal deficit remained high at 5.7 percent of GDP in 2014, and fiscal consolidation is likely to soften even in 2015 as the country enters a pre-election period. To stem further growth in public debt–which reached 85 percent of GDP–fiscal adjustment needs to be supplemented with faster growth.*

## Recent developments

Growth turned positive in late 2014 and grew further in the first half of 2015 (0.85 percent y-o-y), supported by external demand and personal consumption. While in 2014 GDP declined by 0.4 percent (to 13 percent below the pre-crisis GDP after six years of recession), in 2015, the economy is expected to grow by 0.9 percent. Construction--showing signs of bottoming out supported by a doubling of EU funds, together with personal consumption and exports should lead the recovery. Business optimism and consumer confidence improved slightly in early 2015, the latter due to a reduction of personal income tax rates, freeze of the CHF/HRK exchange rate and the debt relief scheme implemented for social welfare beneficiaries.

A 12-month decline in prices by 0.3 percent in January-July 2015 – after a similar drop in 2014-- also helped improve living standards. Unemployment remained high at about 17 percent in H1 2015 despite strong active labor market policies and reduced labor shedding with slower corporate restructuring. Labor force participation rose to 52.4 percent and the employment rate (ages 15+) to 43.3 percent, while real wages grew by 3.5 percent year-on-year. Real pensions declined by 0.8 percent year-on-year in April 2015 as inflow to early retirement increased in 2014, with adverse poverty impacts among households dependent on pension income.

Specifically, real per capita income remained flat in 2014 and over 8 percent below its pre-crisis level. It is estimated that the poverty rate, measured at $5/day PPP 2005, remained essentially unchanged in 2014 at 9.8 percent.

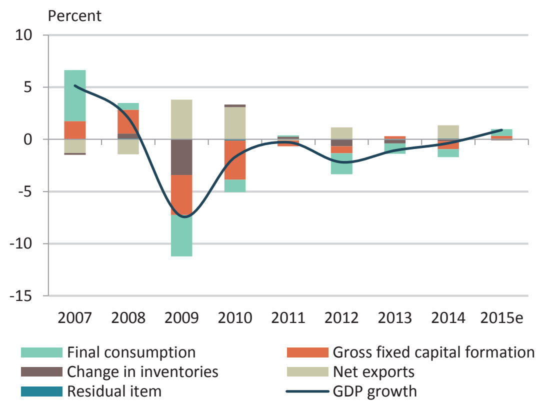
The fiscal deficit reached 5.7 percent of GDP in 2014 (ESA2010 methodology), averaging 6 percent over the last six years. The fiscal deficit reached 5 percent of 2015 GDP by March 2015 on the back of capital investment and interest payments' rise and despite strong revenue performance. Public debt more than doubled from 2008 to 85 percent of GDP by May 2015. In March 2015, ahead of the April redemption of a €1 billion bond, the government issued a 10-year €1.5 billion Eurobond with a yield of 3.3 percent or 260 basis points above the mid-swap rate. In July, both S&P and Fitch reduced the country's outlook to negative but kept the BB long-term rating.

The current account remained in rough balance in 2014. The trade deficit narrowed to 14.8 percent of GDP reflecting growing exports to the EU and lower oil prices. Deleveraging by parent banks continued, however. Inflows of FDI tripled compared to a year earlier. The central bank sold €500 million in early 2015 to protect the kuna from further weakening.

## Outlook

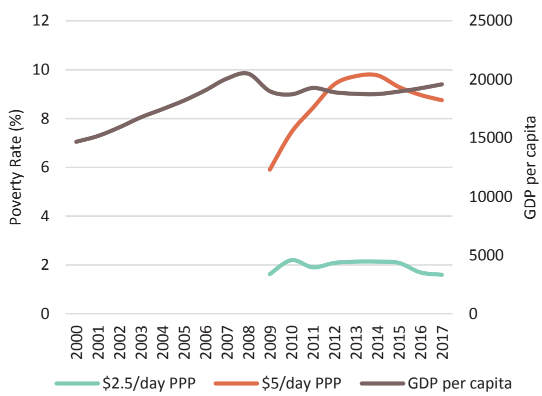
Economic activity is expected to recover gradually, with real GDP growth strengthening from 0.9 percent in 2015 to 1.5 percent in 2017. Tourism and business services are expected to contribute to

**FIGURE 1 Croatia** / Contributions to annual GDP growth




Sources: CROSTAT, World Bank.

**FIGURE 2 Croatia** / Actual and projected poverty rates and real GDP per capita, 2000-2017




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

growth, with exports of pharmaceuticals, apparel, and car parts to Germany and Italy that are part of supply chains supporting manufacturing growth. Vacancies in construction and manufacturing industries are suggesting this recovery is already underway. In addition, low inflation (projected at 0.2 percent), particularly in the energy and transport sectors, will boost real incomes, including among the poor, who spend over 10 percent of their income on these items.

Private consumption is projected to grow by 1.5 percent in 2015, supported by a debt relief scheme for the poorest, a government decision to fix the CHF-loan repayment exchange rate to ease the debt burden, and the personal income tax cuts ahead of elections. Government consumption is projected to remain subdued due to the required fiscal consolidation under the Excessive Deficit Procedure (EDP) with the EU. Nonetheless, the fiscal target under the EDP will likely be missed in 2015. The initial budget remained insufficiently ambitious, targeting a deficit of 5 percent of GDP.

The fiscal deficit by March already reached 5 percent of GDP despite strong revenue growth thanks to the recovery of private consumption and pre-season tourism. By July, the Government accepted only one set of recommendations from the Spending Review, aiming to rationalize costs of 187 state agencies (saving about HRK1 billion, or 0.3 percent of GDP a year). In its 2015 Convergence Programme, the government planned to correct the excessive deficit by 2017, which is not in line with the 2016 deadline recommended by the European Council, which would lead to public debt rising well above 90 percent of GDP by 2017. Although the European Council in June 2015 decided not to activate the corrective action against Croatia, it pointed out that the "level of ambition remains below expectations in a number of areas", and has given six new recommendations that the Croatian Government should meet in 2015 and 2016. In this context and in the absence of stronger private employment and wage growth, poverty is projected to decline only marginally, to 9.3 percent in 2015 and 9.0 percent in 2016.

The new stress test of the financial sector suggests that a currency shock in the economy will not cause a system-wide disruption, but revealed weaknesses in eight small- and medium-sized banks.

NPLs slightly increased to 17.3 percent in June 2015, threefold the pre-crisis low. Corporate sector NPLs rose to 30.9 percent, despite the pre-bankruptcy settlement schemes, while household NPLs increased to 12.1 percent.

## *Challenges*

The outlook is subject to downside risks. Due to its reliance on volatile capital flows and because of high public and private indebtedness, Croatia remains vulnerable to increased financial market volatility. A missed EDP target, still weak consumption, slow corporate sector restructuring and EU funds absorption could further undermine investors' perceptions and lead to further downward revision of Croatia's non-investment grade credit rating. The government approved the draft legislation to convert all CHF-loans to EUR-loans leading to HRK8 billion in bank losses. While this can help with reducing the debt relief for households, potential negative effects on international reserves, the kuna exchange rate, and financial stability are yet to be assessed. Progress in addressing inactivity and unemployment as the main causes of the recent rise in poverty remains slow. Addressing fiscal vulnerability and existing social challenges requires faster implementation of structural reforms; however, this remains unlikely in an election year.

**TABLE Croatia** / Selected Economic and Social Indicators, Projections 2015- (annual percent change unless indicated otherwise)

| | 2012 | 2013 | 2014 | 2015 f | 2016 f | 2017 f |
|---|---|---|---|---|---|---|
| **Real GDP growth, at constant market prices** | -2.2 | -1.1 | -0.4 | 0.9 | 1.2 | 1.5 |
| Private Consumption | -3.0 | -1.8 | -0.7 | 1.5 | 1.0 | 1.2 |
| Government Consumption | -1.0 | 0.3 | -1.9 | -1.1 | -0.1 | 1.0 |
| Gross Fixed Capital Investment | -3.3 | 1.4 | -3.6 | 1.3 | 3.8 | 4.0 |
| Exports, Goods and Services | -0.1 | 3.1 | 7.3 | 2.0 | 2.2 | 1.4 |
| Imports, Goods and Services | -3.0 | 3.1 | 4.3 | 2.1 | 2.6 | 2.0 |
| **Real GDP growth, at constant factor prices** | -3.2 | -1.1 | -0.1 | 0.9 | 1.2 | 1.5 |
| Agriculture | -14.7 | -0.6 | 0.0 | 0.4 | 1.5 | 2.0 |
| Industry | -6.6 | -2.8 | 0.5 | 2.3 | 2.5 | 2.7 |
| Services | -1.2 | -0.6 | -0.3 | 0.5 | 0.7 | 1.1 |
| **Prices** | | | | | | |
| Inflation (GDP price deflator) | 1.6 | 0.8 | 0.0 | 1.1 | 2.3 | 2.7 |
| Inflation (Consumer Price Index) | 3.4 | 2.2 | -0.2 | 0.2 | 1.5 | 2.0 |
| Inflation (Private Consumption Deflator) | 3.2 | 1.9 | -0.4 | 0.4 | 2.6 | 3.5 |
| Inflation (Consumer Price Index) | 3.4 | 2.2 | -0.2 | 0.2 | 1.5 | 2.0 |
| **Current Account Balance (% of GDP)** | -0.4 | 0.8 | 0.6 | 0.8 | 0.6 | 0.2 |
| **Fiscal Balance (% of GDP)** | -5.3 | -5.4 | -5.7 | -5.0 | -4.1 | -3.4 |
| **Poverty Rate** [a,b,c] | | | | | | |
| Poverty rate ($2.5/day PPP terms) | 2.1 | 2.1 | 2.1 | 2.1 | 1.7 | 1.6 |
| Poverty rate ($5/day PPP terms) | 9.4 | 9.7 | 9.8 | 9.3 | 9.0 | 8.7 |

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: f = forecast. In annual percent change unless indicated otherwise.
Calculations based on 2009-EU-SILC Survey, 2012-EU-SILC survey, .
Projection using Neutral Distribution (2012) with pass-through = 0.87 based on GDP per capita constant PPP.
a) Calculations based on 2012-EU-SILC survey.
b) Projection using neutral distribution (2012) with pass-through = 0.87 based on GDP per capita constant PPP.
c) b) Actual data: 2012. Data for 2012-14 are World Bank estimates, projections are from 2013 to 2017.

# CZECH REPUBLIC

| | 2014 |
|---|---|
| Population, million | 10.6 |
| GDP, current US$ billion | 205.3 |
| GDP per capita, current US$ | 19400 |
| Gini Coefficient [a] | 26.4 |
| Life Expectancy at birth, years [b] | 78.1 |

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

*The Czech economy gathered speed in 2015 with GDP growing at 4.4 percent in Q2-2015, the highest rate over the last seven years. Growth was supported by strong domestic demand as labor market conditions eased and EU -funded investment increased. Domestic demand should continue to fuel growth in the medium term although growth is expected to decelerate in 2016 compared to 2015 as the one-off factors boosting investment will not be in place.*

## Recent developments

Growth accelerated to 4.4 percent year-on-year in Q2-2015, the highest growth rate since 2007, supported by strong domestic demand. Investment was the key growth driver and expanded by 8.4 percent on the account of faster absorption of EU funds. The importance of consumption increased significantly compared to 2014 as it was boosted by improvements in labor market outcomes, low inflation, easing credit conditions, and expansionary fiscal policy. Exports grew at robust rate but was outpaced by imports as demand for investment goods increased.

Growth was associated with continuing improvements in the labor market. Gains in employment were concentrated in manufacturing, trade, transport, and tourism, and information and communication, sectors that contributed most to GDP growth in Q2-2015. Unemployment is one of the lowest in the EU and declined to 5.1 percent in July 2015 from 5.9 percent a year earlier. The Czech Republic also has the lowest share of people living at risk of poverty and social exclusion in the EU—14.6 percent in 2013 compared to 24.5 percent in the EU and 30 percent in the EU New Member States.

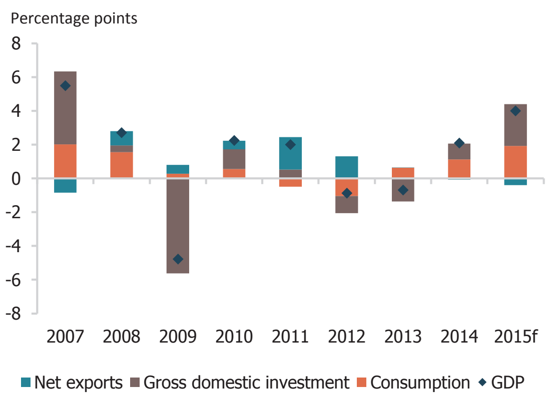
Consumer price inflation in the first seven months of 2015 of 0.4 percent on an annual basis was broadly unchanged compared to a year ago. The increase in excise duty of tobacco and higher gas prices exerted upward pressures on inflation while introduction of a second reduced VAT rate and cuts in prices of health services and fuel kept inflation low.

The external current account was in surplus in the first seven months of the year (1.7 percent of annual GDP), exceeding by 0.5 percentage points of GDP the surplus achieved in the same period a year earlier due to gains in exports of services and transfers from the EU. Performance of goods exports also improved on the basis of stronger external demand for machinery and equipment and weaker koruna. Machinery and equipment and gas supported higher imports while low oil prices reduced the value of imported petroleum and petroleum products.

The fiscal deficit in 2015, of 1.9 percent of GDP, is expected to remain broadly unchanged compared to 2014. Better than expected economic growth and increased excise on tobacco products are likely to offset the negative effects from the introduction of a reduced VAT rate on books, medicines, and child nutritional products. Spending pressures relate to higher indexation of pensions and rising wage bill as well as exceptionally high capital spending due to one-off transaction related to purchase of an aircraft and faster implementation of EU-funded projects as the deadline for disbursements ends in December this year.

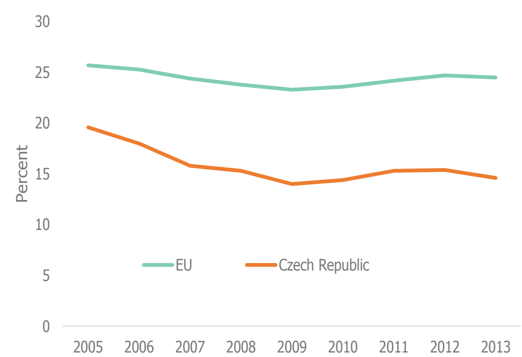
The banking sector remains liquid, well capitalized and non-performing loans are declining. Lending to non-financial corporations and households gathered speed in the first half of 2015 in line with better economic prospects and easing of lending conditions. Non-financial corporations increased significantly their deposits with

**FIGURE 1 Czech Republic** / Contributions to annual growth, percentage points




Sources: Eurostat and World Bank staff estimates.

**FIGURE 2 Czech Republic** / Percent of people at risk of poverty or social exclusion, percent




Source: Eurostat.

banks while growth in household deposits was more moderate compared to 2014.

## Outlook

The outlook for the Czech economy continues to improve. GDP growth is projected to accelerate to 4 percent in 2015 but slow down to 2.8 percent in 2016 and 2017 as effects from one-of factors at paly in 2015 wane. Economic recovery in 2015 is projected to be led by robust domestic demand boosted by government investment and policies to boost consumption. With the expected slow start of implementation of investment projects under the new financing period for EU funds, government investment is likely to slow down in 2016 and 2017 with improvements in investment expected to be driven mainly by private sector. Planned further increases in wage bill and low inflation should underpin robust household consumption in 2016 and 2017. Exports are likely to be boosted by continuing economic recovery in the EU but the contribution of net exports on growth is likely to be neutral.

Consumer price inflation (CPI) is likely to be contained by low fuel prices with CPI growing in 2015 by 0.4 percent, unchanged from 2014. Price developments in the medium term are likely to be driven by demand pressures, further increase in excises on tobacco and rising fuel prices.

External current account surplus is likely to increase in 2015 to 1.3 percent of GDP and then gradually decline to 0.6 percent by 2017. This decline will be driven mainly because of widening deficit of primary incomes and moderation of net services. The trade surplus is expected to continue to improve as recovery strengthens in main trade partners.

Government deficit is expected to decline gradually to 0.8 percent of GDP by 2017. The fiscal consolidation plans rely on better revenue collection as a result of continuous increase in excise rate on tobacco products and measures to boost tax compliance as well as on some savings in spending. Investment spending is expected to decline sharply as the effects from one-off factors dissipate.

## Challenges

The outlook is subject to downside risks coming from the external environment. Risks are related mainly to the strength and sustainability of recovery in the EU.

Renewed momentum to structural reforms associated with improvements in business environment, investments in human capital and research and development could mitigate to some extent negative impacts from external environment.

**TABLE Czech Republic** / Macro poverty outlook indicators (annual percent change unless indicated otherwise)

| | 2012 | 2013 | 2014 | 2015f | 2016f | 2017f |
|---|---|---|---|---|---|---|
| **Real GDP, at constant market prices** | -0.9 | -0.5 | 2.0 | 4.0 | 2.5 | 2.9 |
| Private Consumption | -1.4 | 0.7 | 1.5 | 3.1 | 2.9 | 3.0 |
| Government Consumption | -1.8 | 2.4 | 1.8 | 2.1 | 2.0 | 1.8 |
| Gross Fixed Capital Investment | -3.2 | -2.7 | 2.0 | 7.5 | 3.0 | 3.5 |
| Change in Inventories, % contrib | -0.2 | -0.4 | 0.4 | 0.0 | 0.0 | 0.0 |
| Exports, Goods and Services | 4.3 | 0.0 | 8.9 | 7.9 | 7.0 | 6.7 |
| Imports, Goods and Services | 2.7 | 0.1 | 9.8 | 8.6 | 7.5 | 7.0 |
| **Real GDP, at constant factor prices** | -0.9 | -1.3 | 2.6 | 4.0 | 2.5 | 2.9 |
| Agriculture | 9.4 | 3.4 | 2.9 | 1.2 | 1.1 | 1.2 |
| Industry | 0.0 | 0.0 | 1.3 | 3.4 | 1.7 | 2.0 |
| Services | 0.0 | 1.0 | 2.0 | 3.0 | 4.0 | 5.0 |
| **Inflation (Consumer Price Index)** | 3.3 | 1.4 | 0.4 | 0.4 | 1.4 | 1.8 |
| **Current Account Balance,% of GDP** | -1.6 | -0.5 | 0.6 | 1.3 | 0.8 | 0.6 |
| **Fiscal Balance, % of GDP** | -3.9 | -1.2 | -2.0 | -1.9 | -1.2 | -0.8 |

Sources: CSO, CNB, Eurostat, and World Bank

Note:

f = forecast.

# GEORGIA

| | 2014 |
|---|---|
| Population, million | 4.5 |
| GDP, current US$ billion | 16.2 |
| GDP per capita, current US$ | 3551 |
| Poverty rate ($2.5/day 2005 PPP terms) [a] | 32.3 |
| Poverty rate ($5/day 2005 PPP terms) [a] | 69.4 |
| Gini Coefficient [b] | 41.4 |
| Life Expectancy at birth, years [c] | 73.9 |

Sources: World Bank, WDI, and Macro Poverty Outlook.
Notes:
(a) Most recent value (2014)
(b) Gini data show most recent WDI value (2012)
(c) Life Expectancy data show most recent WDI value (2013)

*Georgia's economic growth moderated in the first half of 2015 to 2.6 percent, year-on-year, as the external environment worsened resulting in weak export demand, a slower-than-expected adjustment in imports and declining remittances. For 2015 as a whole, growth is likely at 2 percent, driven primarily by investment and supported by a modest increase in consumption. The fiscal deficit is projected at 3 percent of GDP due to improved revenue collection in the first half of 2015 and a downward revision in the budget. Poverty rates continued to decline in 2014.*

## Recent developments

Georgia's economy slowed during the first half of 2015 as external conditions remained bleak. Low growth during the first quarter reflected the weak performance of manufacturing and wholesale trade, while residential construction, pipeline transportation, financial intermediation and the agricultural sector all made positive contributions.

Exports decreased by 24 percent year-on-year (y/y) during the first half of 2015, while imports, which are 4 times higher than exports, fell by 9 percent. Remittances also fell sharply as labor market conditions in Russia and other European destinations for Georgian migrants continued to worsen. International tourist arrivals, however, have so far remained stable despite regional turbulence. The current-account deficit widened from 9.7 percent of GDP in 2014 to 14 percent in the first quarter of 2015. Foreign direct investment (FDI) financed 25 percent of the external deficit, and private external debt financed 30 percent. The rest was covered by short-term financial flows, primarily, reserve losses of commercial banks. The central bank has maintained gross international reserves at US$2.5 billion as of end-June (equivalent to 3.5 months of imports). With limited central bank intervention, the economy largely adjusted to the external shock through the depreciation of the lari.

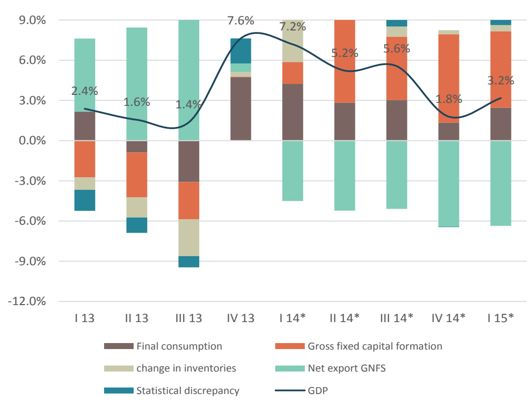
Despite a 22 percent nominal depreciation of the lari to the US dollar during January to August 2015 and high rates of dollarization (over 65 percent), the financial sector still appears relatively stable. The average capital-adequacy ratio remains above 16 percent, the share of nonperforming loans is low at around 3 percent, and the overall liquidity ratio is high at close to 40 percent. A rescheduling of dollar-denominated loans to extend maturities, strict banking supervision, proactive management of dollarization and informal savings practices have helped so far. However, in the medium-term, some deterioration is likely.

The depreciation of the lari pushed the inflation rate to 5.4 percent in August 2015 (y/y), above the target rate of 5 percent. As a result, the central bank gradually raised the policy rate from 4 percent in January 2015 to 6 percent in August.

Improved tax administration coupled with the depreciation of the lari boosted import-related VAT collections, generating an 11.9 percent increase in tax revenues in the first half of 2015 (y/y). Expenditures were in line with the budget resulting in a fiscal deficit of 0.8 percent of GDP. However, due to slowing growth, total revenue collection during 2015 is likely to be much lower than originally budgeted. Following a downward revision of the budget in July 2015 the annual fiscal deficit is projected at 3 percent of GDP.

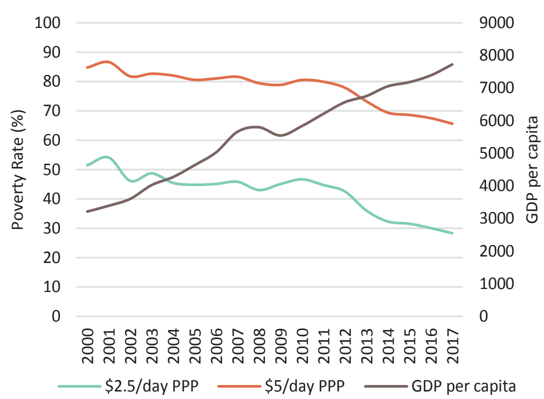
Unemployment fell to 12.4 percent in 2014, though urban and youth unemployment remain persistently high at 22 and 31 percent, respectively. Poverty continued to decline through 2014, as the US$2.5/day and US$5/day poverty rates fell to 32.3 and 69.4 percent, respectively. Nonagricultural labor income and social transfers

**FIGURE 1 Georgia** / GDP Growth Composition (%)




Sources: GeoStat.

**FIGURE 2 Georgia** / Actual and projected poverty rates and real GDP per capita, 2000-2017




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

were the main drivers of poverty reduction during 2010-2013, with the former playing a larger role in urban areas while employment creation has so far played a secondary role. During 2015, food-price inflation and falling remittances are expected to negatively impact poverty. Despite the overall decline in poverty rates, large urban-rural disparities persist, and the rural poverty rate is roughly double the urban rate.

## *Outlook*

A gradual economic recovery is expected to begin in 2016 with some pick-up in growth in Georgia's main trading partners. Growth is expected to recover from 2 percent in 2015 to 3 percent in 2016 and reach 4.5 percent in 2017. However, downside risks to growth remain.

No major fiscal policy shifts are anticipated over the medium term, and the fiscal deficit is projected to remain at around 3 percent of GDP. Slower-than-expected growth could depress revenues, potentially requiring a further consolidation of current expenditures or significant efficiency improvements in public investment management. The fiscal deficit is expected to narrow to 2.6 percent of GDP by 2017.

Lower GDP growth rates are likely to slow the pace of poverty reduction. The poverty rate at US$2.5/day is expected to reach 31.6 percent in 2015 and 28.3 percent in 2017. Limited fiscal space will preclude further increases in social spending, though a potential rise in pension payments and efficiency improvements in the Targeted Social Assistance program could modestly accelerate poverty reduction. However, subdued agricultural growth could present a serious obstacle to poverty reduction in rural areas. Further changes in consumer price inflation and remittances are expected to be small as conditions in the region gradually improve.

## *Challenges*

Georgia faces three main challenges over the medium term: mitigating external vulnerabilities, managing fiscal pressures, and reducing unemployment.

External debt reached 103 percent of GDP at end-March 2015, making debt sustainability a source of concern. Meanwhile, financial dollarization has exacerbated Georgia's vulnerability to exchange-rate shocks. In this context, maintaining macro-financial stability will require a combination of fiscal discipline, monetary vigilance and a sustained commitment to structural reforms.

The government's focus on social spending is helping to reduce poverty and build human capital, but it is also increasing expenditure rigidity. Prudent fiscal management will be essential to manage aggregate demand and maintain fiscal sustainability. Finally, reforms to further enhance the business climate would support economic growth, strengthen the fiscal performance and accelerate job creation.

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

| | 2012 | 2013 | 2014 | 2015 f | 2016 f | 2017 f |
|---|---|---|---|---|---|---|
| **Real GDP growth, at constant market prices** | 6.4 | 3.3 | 4.8 | 2.0 | 3.0 | 4.5 |
| Private Consumption | 3.5 | -2.6 | 2.9 | 2.9 | 2.1 | 1.6 |
| Government Consumption | 3.3 | -2.7 | 4.7 | 5.6 | 5.2 | 4.5 |
| Gross Fixed Capital Investment | 18.2 | 3.5 | 25.6 | 5.1 | 2.4 | 6.7 |
| Exports, Goods and Services | 11.8 | 21.0 | -0.1 | 6.8 | 3.2 | 4.3 |
| Imports, Goods and Services | 12.0 | 3.0 | 9.8 | 5.7 | -0.8 | 2.2 |
| **Real GDP growth, at constant factor prices** | 5.9 | 4.3 | 4.6 | 2.0 | 2.5 | 5.1 |
| Agriculture | -3.7 | 11.3 | 1.5 | 2.9 | 2.8 | 2.0 |
| Industry | 9.5 | 2.3 | 5.0 | 1.5 | 3.8 | 5.0 |
| Services | 6.8 | 3.6 | 5.3 | 2.0 | 1.8 | 6.0 |
| **Prices** | | | | | | |
| Inflation (GDP price deflator) | 1.2 | -0.7 | 1.2 | 7.6 | 6.1 | 6.0 |
| Inflation (Consumer Price Index) | -0.9 | -0.5 | 3.1 | 5.0 | 6.0 | 6.0 |
| **Current Account Balance (% of GDP)** | -11.7 | -5.7 | -9.7 | -11.0 | -9.5 | -8.5 |
| **Fiscal Balance (% of GDP)** | -3.0 | -2.6 | -3.0 | -3.0 | -2.9 | -2.6 |
| **Poverty Rate** [a, b, c] | | | | | | |
| Poverty rate ($2.5/day 2005 PPP terms) | 42.5 | 36.0 | 32.3 | 31.6 | 30.1 | 28.3 |
| Poverty rate ($5/day 2005 PPP terms) | 77.9 | 73.3 | 69.4 | 68.6 | 67.5 | 65.7 |

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: f = forecast.
(a) Calculations based on ECAPOV harmonization, using 2012 and 2014-HIS.
(b) Projection using neutral distribution (2014) with pass-through = 0.87 based on GDP per capita constant PPP.
(c) Actual data: 2012, 2013, 2014. Projections are from 2015 to 2017.

# HUNGARY

| | 2014 |
|---|---|
| Population, million | 9.9 |
| GDP, current US$ billion | 137.1 |
| GDP per capita, current US$ | 13856 |
| Gini Coefficient [a] | 28.9 |
| Life Expectancy at birth, years [b] | 75.1 |

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

*Economic growth has been strong in 2015, supported by exports, manufacturing and domestic demand. Private consumption remains on an upward path, as disposable incomes of households improve. Investment shows mixed signals. Labor market conditions have been improving. Growth is expected to remain solid, as domestic demand strengthens. Uncertainties in the external environment represent a downside risk due to Hungary's high level of public debt. Further reforms in the business environment and the banking sector are needed to stimulate private sector development.*

## Recent developments

Economic growth has been strong so far in 2015, supported by exports and domestic demand. Growth however decelerated from 3.5 percent in the first quarter, mainly due to a poor performance by agriculture. On the production side, industry (up 6.1 percent yoy), and in particular manufacturing (up 7.0 percent), and construction (up 6.5 percent yoy) were the drivers, while agriculture contracted by 16.8 percent yoy due to unfavorable weather conditions. On the expenditure side, growth was led by household consumption (up 3.0 percent yoy) and gross fixed capital formation (up 5.2 percent yoy). Investment growth was driven primarily by the construction sector. Public investment went up by 15.3 percent yoy. External trade remained a main contributor to GDP expansion, but the growth rates of exports (up 7.5 percent yoy) and imports (up 6.5 percent yoy) slowed relative to the previous quarter.

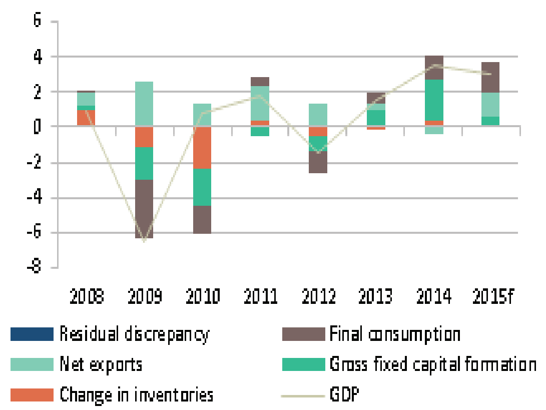
Economic growth helped improve the labor market conditions. The employment rate increased by 3.4 percent yoy during May –July 2015 to 64.1 percent, while unemployment declined to 6.8 percent of the labor force in June 2015 (down from 8 percent in June 2014). Noticeably, youth unemployment has been on a steady declining path, reaching 17.8 percent in the second quarter, (down from 25.7 percent, respectively 20.7 percent, in the same period of 2013 and 2014). Gross monthly earnings expanded by 3.6 percent yoy in June driven by the private sector (up 4.8 percent yoy).

Since 2012 the government has been pursuing fiscal consolidation with the aim of bringing down the level of public debt. For 2015 the government targets a fiscal deficit of 2.4 percent of GDP, down from 2.6 percent in 2014, to be achieved through higher revenues and expenditure containment. The consolidated budget deficit widened slightly in H1 of 2015, in spite of a tax revenue increases (up 5.0 percent yoy), due to the withholding of some payments for EU-funded projects following a dispute over local tendering processes.

CPI growth turned positive in May 2015, but it gradually declined subsequently reaching 0.0 percent yoy in August. The drop in inflation was driven by low fuel and food prices. The low inflation environment allowed the National Bank of Hungary (NBH) to further cut its benchmark interest rate by 15 bps in July, to 1.35 percent.

Sovereign borrowing costs remain low, with the 10-year bond yields reaching 3.46 percent in August and the 5-year CDS spreads at around 167 bps at end-August. The government aims to reduce the high level of public debt (77 percent of GDP at end-2014) through expenditure restrain. A debt-relief and conversion program was enforced in 2015 for households indebted in foreign currency, which is estimated to have cost the banking sector up to $3.5 billion, affecting its profitability and the recovery of credit. Despite the improvements in economic activity and the monetary easing stance of NBH, credit to non-financial corporations contracted by 3.4 percent yoy in the second quarter.

**FIGURE 1** **Hungary** / Contributions to annual GDP growth




Sources: World Bank.

**FIGURE 2** **Hungary** / Budget deficit and public debt, 2009-14


Sources: Eurostat.

## *Outlook*

The economy is expected to grow in 2015 by around 3.0 percent. Growth in 2015 will be affected by the contraction of agricultural production and the slowdown in government spending. On the upside, the external sector will remain a driver of growth, in spite of the slowdown in exports and imports growth. We forecast a growth rate of around 3 percent for 2016, as the EU economy further strengthens and the disposable incomes of households grow, including due to the implementation of the debt relief scheme and the increases in real wages and employment. Private investment growth will depend on the improvement of credit conditions for the corporate sector.

The intention of the authorities to improve the regulatory environment for the banking sector and to reduce the banking tax starting with 2016 should boost business confidence. The ability of the authorities to rapidly mobilize the EU funds available for the period 2014-2020 will positively impact upon the public investment, which was one of the drivers of growth in 2014. Labor market conditions are expected to improve, driven by growth, accommodative monetary conditions and lower household indebtedness. The government plans to narrow the fiscal deficit to 2.4 percent of GDP in 2015 and reduce public debt through spending cuts, higher tax revenues and higher reliance on borrowing from the domestic markets. We expect this policy to continue to be pursued in 2016, although the reduction in the bank tax will affect revenues. On the other hand, the further strengthening of the domestic demand should bring in additional revenues, as observed in the first half of 2015.

Inflation is expected to gradually move higher in the rest of 2015 and in 2016, as the effects of the low energy prices dissipate and as domestic demand gains momentum. An increase in the food prices is expected due to the poor agricultural production and seasonal patterns.

The NBH may keep the loose monetary conditions for an extended period, due to the low inflation environment, the stable growth conditions and the ongoing quantitative easing of the ECB, which limit the scope of a rate hike in the near future.

## *Challenges*

Hungary's economic growth prospects remain good. Risks are associated primarily with the increase in the US policy interest rates and the country's high level of public debt. The authorities aim to mitigate this by increasing the share of the Forint-denominated debt and by maintaining a comfortable level of foreign exchange reserves. On the downside, economic uncertainties in the region, and a protracted recovery in the Eurozone could hamper market confidence and adversely affect Hungary's growth prospects and financing costs. Given the high level of integration of its trade with the Eurozone, Hungary is susceptible to adverse shocks. Cognizant of these risks, the government is committed to continuing to pursue a cautious fiscal policy. The planned reduction in the banking tax in 2016 may however affect the deficit target. For the medium term, Hungary should focus on boosting the economic growth potential by encouraging the development of the private sector.

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

| | 2012 | 2013 | 2014 | 2015 f | 2016 f | 2017 f |
|---|---|---|---|---|---|---|
| **Real GDP growth, at constant market prices** | -1.5 | 1.5 | 3.6 | 3.0 | 3.1 | 3.2 |
| Private Consumption | -1.9 | -0.1 | 1.6 | 2.9 | 3.0 | 3.0 |
| Government Consumption | -1.3 | 3.3 | 2.5 | 0.2 | 0.5 | 0.6 |
| Gross Fixed Capital Investment | -4.2 | 5.2 | 11.7 | 2.1 | 3.8 | 4.6 |
| Exports, Goods and Services | -1.5 | 5.9 | 8.7 | 7.6 | 6.8 | 6.5 |
| Imports, Goods and Services | -3.3 | 5.9 | 10.0 | 7.1 | 6.8 | 6.6 |
| **Real GDP growth, at constant factor prices** | -1.5 | 1.5 | 3.5 | 2.9 | 3.3 | 3.2 |
| Agriculture | -22.6 | 15.1 | 12.5 | -4.0 | 5.1 | 1.0 |
| Industry | -1.8 | -2.2 | 6.5 | 5.1 | 4.8 | 4.6 |
| Services | -0.1 | 2.5 | 1.8 | 2.3 | 2.5 | 2.6 |
| **Prices** | | | | | | |
| Inflation (GDP price deflator) | 3.4 | 3.0 | 3.1 | -0.3 | 2.1 | 2.3 |
| Inflation (Consumer Price Index) | 5.7 | 1.7 | -0.2 | 0.2 | 2.4 | 2.5 |
| **Current Account Balance (% of GDP)** | 1.8 | 4.2 | 3.3 | 4.7 | 2.6 | 2.2 |
| **Fiscal Balance (% of GDP)** | -2.3 | -2.4 | -2.9 | -2.5 | -2.5 | -2.5 |

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

# KAZAKHSTAN

| | 2014 |
|---|---|
| Population, million | 17.2 |
| GDP, current US$ billion | 217.4 |
| GDP per capita, current US$ | 12631 |
| Poverty rate ($2.5/day 2005 PPP terms) [a] | 0.4 |
| Poverty rate ($5/day 2005 PPP terms) [a] | 15.3 |
| Gini Coefficient [b] | 28.6 |
| Life Expectancy at birth, years [c] | 69.6 |

Sources: World Bank, WDI, and Macro Poverty Outlook.
Notes:
(a) Most recent value (2013)
(b) Gini data show most recent WDI value (2010)
(c) Life Expectancy data show most recent WDI value (2013)

*Kazakhstan's GDP growth rate is expected to slow from 4.4 percent in 2014 to an estimated 1.5 percent in 2015 due to low oil prices and weaker domestic and external demand. Both the fiscal and external balances are projected to turn to deficits in 2015. Given current growth projections it is unlikely that Kazakhstan will be able to sustain the pace of poverty reduction. In this context expanding social safety net systems and carefully targeting public investments could help.*

## Recent developments

Real GDP growth slowed further in the first half of 2015. Falling external and domestic demand continued to be affected by the fall in oil prices and weakening demand in China and Russia negatively impacted the export sector. In response to the weak demand, industrial output growth stagnate at about 0.2 percent in the first 7 months of 2015, similar to the same period in 2014. Services sector growth fell from 5.7 percent in 2014 to an estimated 2.1 percent in the same period. Inflation declined to an estimated 3.9 percent y/y in July 2015, but pass-through effects from the depreciation of the tenge are expected to boost inflation in the second half of the year.

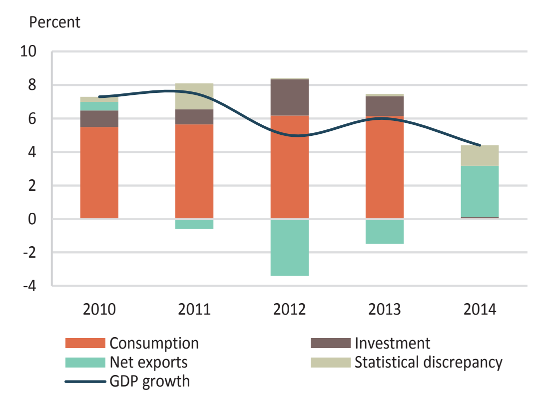
Global oil prices fell by about 50 percent between June 2014 and June 2015, fueling speculative pressure on the tenge. The central bank intervened aggressively to defend the exchange rate, providing injections of foreign exchange and tightening tenge liquidity. As a result the credit supply contracted by 12 between June 2014 and June 2015.

Faced with persistently low oil prices and high external imbalances the central bank announced the adoption of a floating exchange-rate regime on August 20, 2015, triggering a 25 percent depreciation of the tenge against the US dollar.

The government has continued to implement the fiscal consolidation program launched in early 2015 while protecting social expenditures to mitigate the poverty impacts of the depreciation. The steep drop in oil revenue prompted the government to cut spending from 22.2 percent of GDP in 2014 to a projected 21.7 percent in 2015. President Nazarbayev announced a 10 percent increase in the wages of health and education workers and a 25 percent increase in social benefits and scholarships in an effort to partially compensate for the rise in inflation expected in the wake of the depreciation. The government also plans to continue managing price increases for about 33 basic goods.

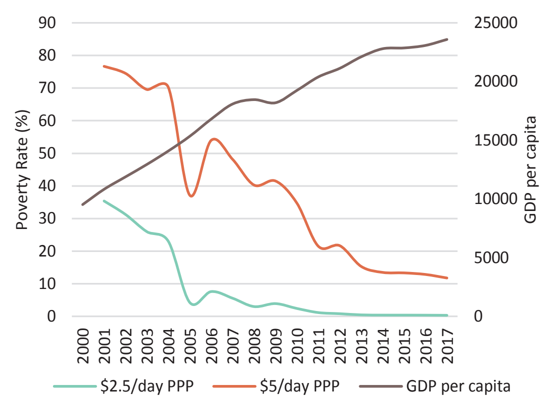
Kazakhstan's poverty rate (at US$5 per day in 2005 PPP) fell from 54 percent in 2006 to 15.3 percent in 2013. This remarkable achievement was driven by strong economic growth, robust job creation and rising real wages. Despite the effects of the recent economic slowdown a combination of wage increases in the public sector, increased social spending and price controls is expected to leave poverty rates at 13.3 percent in 2015, essentially unchanged from 2014. While undertaking fiscal consolidation, the government is moving forward with two economic programs launched in 2014 designed to support selected segments of the economy. The first program is mostly used to address weaknesses in the financial sector by writing off nonperforming loans and subsidizing credit to small and medium enterprises. This program was complemented by an additional injection of KTZ 250 billion into the banking sector and two consumer-credit interventions to support domestic demand. The second program, Nurly Zhol, is a public investment initiative targeting the transportation and logistics, industrial, energy, public utilities,

**FIGURE 1 Kazakhstan** / Real GDP Growth Composition by Expenditure




Sources: Statistical Office of Kazakhstan.

**FIGURE 2 Kazakhstan** / Actual and projected poverty rates and real GDP per capita, 2000-2017




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

housing, and social infrastructure sectors. It will be implemented from 2015-2019.

## Outlook

Assuming that oil prices average about US$50 per barrel in 2015 and then gradually increase to US$58 per barrel by 2017, GDP growth would be projected to gradually recover from 1.5 percent in 2015 to 3.3 percent by 2017. Weak internal and external demand will constrain growth in the industrial and service sectors, and domestic demand will be negatively impacted by the price and wealth effects of the depreciation. CPI inflation is expected to rise from 7.4 percent (y/y) in December 2014 to about 8.1 percent (y/y) in December 2015. Continued fiscal consolidation will improve the overall fiscal balance from a deficit of 2.9 percent of GDP in 2015 to a surplus of 1.8 percent in 2017.

Slowing growth will likely reduce the pace of poverty reduction. Dampened growth in industrial and services sectors will impact on welfare, since wages and employment in the private sector have been the driving force behind recent poverty reduction. Poverty will not necessarily increase since the population in the oil regions and workers in the private sector tend to be better off, but upward mobility will be limited and the pace of poverty reduction will slow. Poverty rates are projected to decline modestly from 13.3 percent in 2015 to 11.8 percent in 2017.

## Challenges

Oil prices will continue to have a major influence over Kazakhstan's growth prospects, as well as its fiscal and external balances and exchange-rate dynamics. Slowing growth and a worsening external environment underscore the need to strengthen the sustainability of the country's macroeconomic framework, facilitate the adjustment to lower oil prices, and continue to implement structural reform to enhance competitiveness. While expenditure consolidation will be important to the sustainability of the fiscal accounts, social expenditures should continue to be protected. The planned expansion of the Orleu conditional cash program nationwide in 2016 will enhance social protection. Kazakhstan continues to exhibit regional disparities in economic outcomes and poverty reduction. The geographic targeting of investments supported by Nurly Zhol can influence the extent to which they support poverty reduction and promote shared prosperity. Agricultural regions are both the most populous and poorest in the country. Moreover, rural households are often the most vulnerable to shocks, and agricultural regions experienced rising poverty rates during the global financial crisis in 2009 and a drought in 2012. Accelerating poverty reduction and promoting shared prosperity will require that special attention be paid to the regional dimensions of development policies

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

| | 2012 | 2013 | 2014 | 2015 f | 2016 f | 2017 f |
|---|---|---|---|---|---|---|
| **Real GDP growth, at constant market prices** | 5.0 | 6.0 | 4.4 | 1.5 | 2.1 | 3.3 |
| Private Consumption | 11.0 | 12.6 | -2.0 | -1.0 | 2.0 | 3.0 |
| Government Consumption | 13.2 | 1.7 | 10.3 | -5.0 | 0.4 | 0.0 |
| Gross Fixed Capital Investment | 9.1 | 4.9 | 0.2 | 0.7 | 3.8 | 4.8 |
| Exports, Goods and Services | 4.7 | -0.2 | -4.6 | -1.6 | 1.0 | 6.2 |
| Imports, Goods and Services | 20.9 | 5.2 | -15.7 | -5.0 | 2.5 | 3.0 |
| **Real GDP growth, at constant factor prices** | 5.4 | 5.6 | 4.0 | 1.7 | 2.1 | 3.3 |
| Agriculture | -17.4 | 11.2 | 1.3 | 2.7 | 2.5 | 3.3 |
| Industry | 1.9 | 3.1 | 1.8 | 0.9 | 1.4 | 3.3 |
| Services | 10.6 | 6.7 | 5.7 | 2.1 | 2.5 | 3.3 |
| **Prices** | | | | | | |
| Inflation (GDP price deflator) | 4.8 | 9.7 | 6.0 | -1.7 | 12.8 | 5.0 |
| Inflation (Consumer Price Index) | 5.2 | 5.8 | 6.7 | 5.3 | 9.5 | 5.3 |
| **Current Account Balance (% of GDP)** | 0.5 | 0.4 | 2.1 | -1.2 | -0.4 | 0.2 |
| **Fiscal Balance (% of GDP)** | 3.9 | 3.4 | 0.9 | -2.9 | 0.5 | 1.8 |
| **Poverty Rate** [a, b, c] | | | | | | |
| Poverty rate ($2.5/day 2005 PPP terms) | 0.8 | 0.4 | 0.4 | 0.4 | 0.3 | 0.3 |
| Poverty rate ($5/day 2005 PPP terms) | 21.7 | 15.3 | 13.5 | 13.3 | 12.8 | 11.8 |

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: f = forecast.
(a) Calculations based on 2009-HBS Survey, 2013-HBS survey, .
(b) Projection using average elasticity (2009-2013) with pass-through = 1 based on GDP per capita constant PPP.
(c) Actual data: 2012, 2013. Projections are from 2014 to 2017.

# KOSOVO

| | 2014 |
|---|---|
| Population, million | 1.8 |
| GDP, current US$ billion | 7.2 |
| GDP per capita, current US$ | 3952 |
| Life Expectancy at birth, years [a] | 70.5 |

Sources: World Bank, WDI, and Macro Poverty Outlook
Note:
(a) Life Expectancy data show most recent value (2013)

*The economy is showing signs of broad-based recovery in 2015, mainly driven by domestic demand. Growth is expected to accelerate to 3 percent in 2015 and 3.6 percent in 2016-2017, but it continues to provide limited opportunities for formal employment. Incomes of low-income households will be boosted by accelerating agricultural growth and reduction in VAT rates for basic foods and utilities, but delayed implementation of some social reforms (e.g. health insurance) due to the fiscal rule will have a dampening effect.*

## Recent developments

The economy is showing signs of broad-based recovery in 2015, mainly due to domestic demand and stronger growth of exports than imports. The economy grew at 0.2 percent in Q1 2015, driven by 2.3 percent growth in private consumption, a 1.5 percent growth in government consumption, a 0.6 percent decline of investments and a zero net exports contribution. A pick-up of private consumption growth and investments led to higher economic growth in Q2 2015. The Greek crisis had no effect on any of the economic sectors in Kosovo due to lack of economic ties.

External imbalances widened the current account deficit in the first half of 2015.

Prices remained stable with average deflation of 0.5 percent during the first half year 2015, which should boost real household incomes.

However, increases in public wages are introducing distortions into the job market by increasing the premium on full-time public sector jobs. Thus, economic growth is not underpinned by formal job creation. LFS 2014 data reveal a 5 percentage point increase in the overall unemployment rate and the youth unemployment rate during 2013-2014. The latter is especially high (over 61 percent). About 10.7 percent of the working age population were discouraged workers in 2014. Many Kosovars are reported to have migrated illegally to Western Europe during November 2014-March 2015, driven by unemployment.

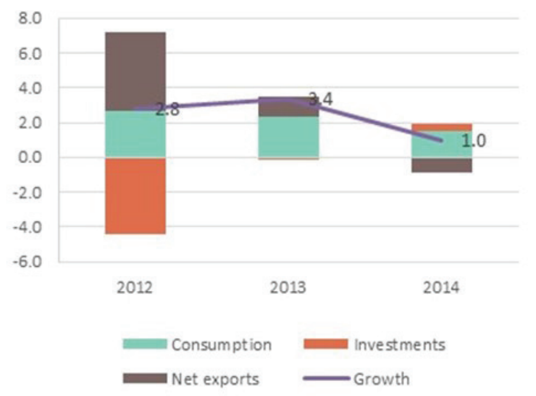
The temporary fiscal deficit by June 2015 was 1.3 percent of GDP. Revenues grew by 7 percent in first half of 2015 compared to same period last year, mainly due to improved tax collection. Expenditures increased by 5.8 percent, due to growth in subsidies and wages (19.5 percent and 10.7 percent), counterbalanced by a 15.3 percent decline in capital investments. Government debt was low at 11.6 percent of GDP by mid-2015, and with low interest rates, debt service is at 3 percent of GDP. The financial sector remains healthy, credit and deposit rates growing (7.1 percent and 0.3 percent) while NPLs falling from 8.8 percent (Q1 2014) to 7.1 percent (July 2015) due to work of private enforcement agents.

Poverty decreased from 34.5 percent to 29.7 percent from 2009-2011 according to national figures, and income growth of the bottom 40 percent outpaced growth of the T60 group during 2006-2011, driven primarily by increases in earnings (comprising 50-60 percent of household incomes across all deciles and accounting for the bulk of income growth during 2009 -2013); pensions and social assistance contributed little to B40 income gains. While aggregate employment was stable, there is evidence of employment shifts to higher productivity sectors during the pre-crisis period, especially among the B40 .

## Outlook

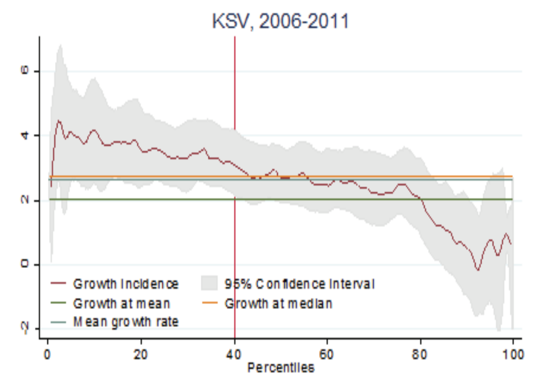
Economic growth is expected to reach 3 percent in 2015, 3.5 percent in 2016 and 3.7 percent in 2017, supported by larger FDI, consumption and exports. In 2015 we assume no interruptions on energy pro-

**FIGURE 1 Kosovo** / Contribution to annual GDP growth




Source: Statistics Agency of Kosovo and WB staff.

**FIGURE 2 Kosovo** / Growth incidence Curve (GIC), 2006-2011




Source: Statistics Agency of Kosovo and WB staff.

duction (unlike explosion in Kosovo A power plant in 2014) and no large price deflation of consumption caused by public wage increase which lead to lower growth in 2014. Consumption is expected to grow at 3 percent in 2015 and 4.4 percent in 2016, fueled by remittances and wages.

Gross fixed capital formation will grow by 5.4 percent in 2015 and 5 percent in 2016. Growth of public investment is expected to recover in the second half of 2015 due to fiscal stability boosted by new fiscal consolidation program (new IMF SBA – in July 2015), by cutting recurrent expenditure and delaying some social reforms, while maintaining larger investments.

Since out of pocket health expenditures are high as a share of household budgets, particularly for low income households (with an estimated poverty impact of about 2 percentage points of poverty headcount), this will postpone the anticipated positive poverty effect of the introduction of mandatory health insurance.

Excess liquidity in the banking sector will continue to provide macro-fiscal stability by financing government domestic debt.

CAD will remain unchanged at 8.2 percent of GDP, because trade balance will grow by only 0.9 percent as export of services (travel expenses) grows faster in second half-year.

Poverty dynamics will be influenced by a combination of factors. First, growth in the agricultural sector is forecast to accelerate to 4.5 percent annually during 2015-2017. Agro food processing and other manufacturing is expected to grow at around 6.5 percent. This will benefit the rural poor and B40; 60 percent of the poor live in rural areas. Incomes of low income households should also be boosted by the stable price level, and by the reduction of the VAT rate to 8 percent for main food commodities, and utilities. Second, poverty and income dynamics has been strongly determined by labor earnings, and since the labor market situation is not forecast to improve in the immediate future due to remaining structural barriers like the inadequacy of the education system, low ECE rates among low income households, this will constrain future poverty reduction.

## *Challenges*

The outlook is subject to downside risks such as weaker than planned execution of public investments and potential dissatisfaction with lack of jobs. Preserving budget investments at significant levels amid fiscal consolidation will be a challenge.

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

Addressing Kosovo's macroeconomic vulnerabilities, high unemployment and poverty requires significant and far reaching structural reforms to boost economic growth and make it more inclusive.

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

| | 2012 | 2013 | 2014 | 2015 f | 2016 f | 2017 f |
|---|---|---|---|---|---|---|
| **Real GDP growth, at constant market prices** | 2.8 | 3.4 | 1.0 | 3.0 | 3.5 | 3.7 |
| Private Consumption | 2.7 | 2.0 | 1.3 | 2.4 | 3.6 | 3.6 |
| Government Consumption | 4.4 | 6.6 | 5.3 | 6.7 | 9.3 | 14.4 |
| Gross Fixed Capital Investment | -13.7 | -0.2 | 1.8 | 6.3 | 5.5 | 1.2 |
| Exports, Goods and Services | 0.7 | 2.3 | 17.4 | 11.2 | 6.3 | 7.2 |
| Imports, Goods and Services | -7.6 | -1.5 | 8.0 | 7.5 | 7.3 | 7.2 |
| **Real GDP growth, at constant factor prices** | 3.0 | 4.7 | 0.1 | 3.4 | 3.8 | 3.6 |
| Agriculture | -8.5 | 1.4 | 0.4 | 5.8 | 3.4 | 4.3 |
| Industry | 6.5 | 7.4 | -3.5 | 10.2 | 5.7 | 5.3 |
| Services | 4.6 | 4.1 | 2.1 | -0.9 | 2.7 | 2.5 |
| **Prices** | | | | | | |
| Inflation (GDP price deflator) | 1.1 | 1.2 | 1.2 | 1.2 | 1.2 | 1.3 |
| Inflation (Consumer Price Index) | 2.5 | 1.8 | 0.4 | -0.1 | .. | .. |
| **Current Account Balance (% of GDP)** | -7.5 | -6.9 | -8.1 | -8.2 | -8.0 | -7.9 |
| **Fiscal Balance (% of GDP)** | -2.6 | -2.9 | -2.3 | -2.6 | -2.5 | -3.0 |

Source: World Bank.
Notes: f = forecast. In annual percent change unless indicated otherwise.

# KYRGYZ REPUBLIC

| | 2014 |
|---|---|
| Population, million | 5.7 |
| GDP, current US$ billion | 7.4 |
| GDP per capita, current US$ | 1301 |
| Poverty rate ($2.5/day 2005 PPP terms) [a] | 31.3 |
| Gini Coefficient [b] | 27.4 |
| Life Expectancy at birth, years [c] | 70.0 |

Sources: World Bank, WDI, and Macro Poverty Outlook.
Notes:
(a) Most recent value (2012)
(b) Gini data show most recent WDI value (2012)
(c) Life Expectancy data show most recent WDI value (2013)

*Real GDP growth is projected to slow to 2 percent in 2015, reflecting an adverse regional economic environment and lower domestic gold production. Growth is expected to recover gradually over the medium term, but significant downside risks remain. A modest growth outlook combined with falling remittances and imported inflationary pressures may slow the pace of poverty reduction.*

## Recent developments

A strong agricultural season and front-loaded gold production drove robust growth during the first half of 2015. Economic output outside the gold sector increased by 4.5 percent, year-on-year (y/y), with growth in agriculture and services offsetting a slowdown in the non-gold industrial and construction sectors. Domestic consumption and net exports made positive contributions to growth. However, total investment contracted as the government slowed the implementation of the public investment program and private construction growth declined.

Conservative fiscal policies, including a deceleration in foreign-financed capital investment coupled with efforts to contain current spending, yielded a fiscal surplus of 2.1 percent of GDP in the first half of 2015, according to preliminary estimates.

Frontloaded gold exports and a steep drop in both import volumes and prices significantly improved the trade balance during the first half of the year. However, falling remittance inflows widened the current-account deficit, which—together with the depreciation of the Russian ruble and the Kazakhstani tenge—put downward pressure on the exchange rate. In the first eight months of the year the Kyrgyzstani som lost 10.5 percent of its value against the US dollar, prompting the central bank to sell US$179 million in an effort to smooth the depreciation.

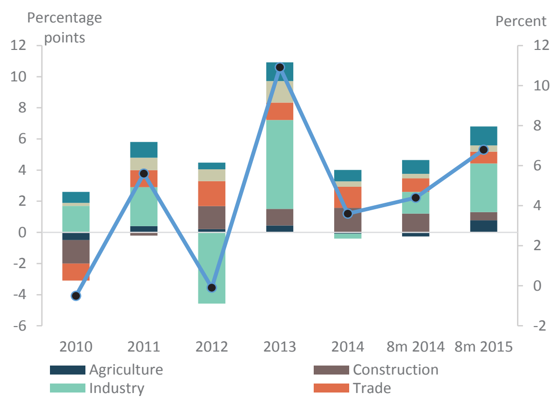
The annual inflation rate fell significantly during the first seven months of the year (5 percent in July versus 10.5 percent in December 2014), reflecting the combined impact of relative fiscal restraint, tight monetary policies and the slow growth of the money supply, as well as favorable terms-of-trade developments and lower remittance inflows. Nevertheless, inflation is still expected to average 9.4 percent in 2015 due to the pass-through effect of the som's depreciation.

Poverty reduction in the Kyrgyz Republic has been uneven in recent years, and changes in poverty rates tend to lag economic growth. However, preliminary estimates suggest that the share of the population living on less than US$2.5 per day fell sharply from 30.2 percent in 2013 to 25.2 percent in 2014. Wage growth and strong agricultural sales are driving poverty reduction. Pensions and social transfers have also supported increased consumption among the poor, though these programs are relatively small and limited in scope. The decline in remittances is expected to increase the vulnerability of households that include migrant workers, which are estimated to comprise about 15 percent of total households.

## Outlook

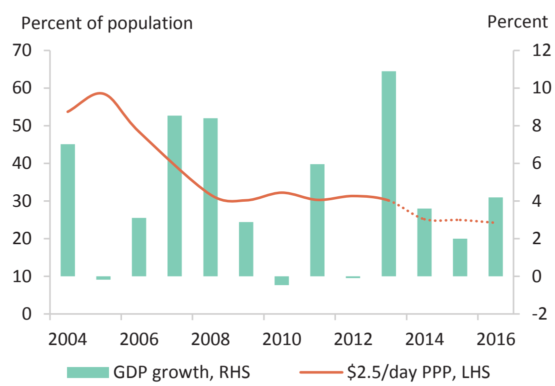
Despite a strong first semester economic growth is expected to slow to an annual average of 2 percent in 2015. This forecast is based on the expectation (i) that gold output and prices will remain low during the second half of the year, and (ii) that weaknesses in the external environment

**FIGURE 1 Kyrgyz Republic** / GDP Growth by Sector




Sources: Kyrgyz authorities and WB staff calculations using the Kyrgyz Republic Household Budget Survey.

**FIGURE 2 Kyrgyz Republic** / Actual and projected poverty rates and real GDP growth, 2004-2017




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

will continue to adversely affect both exports and domestic demand via trade and remittances, respectively. The planned acceleration of public investment in the second half of the year is expected to partially mitigate these trends. However, the planned investment projects will be largely foreign-funded and rely heavily on imported inputs, reducing their impact on the domestic economy.

Fiscal balances are projected to deteriorate in the second half of 2015, due a substantial increase in both capital investment and current spending on wages and procurement. The fiscal deficit is expected to reach 5.8 percent of GDP in 2015, up from 4.1 percent in 2014, generating a significant increase in the public debt stock. Falling remittance inflows will widen the current-account deficit to an estimated 18.5 percent of GDP, putting further pressure on the som.

Modest improvements in the external environment and, more importantly, rising gold production should help the Kyrgyz Republic return to a higher growth trajectory. GDP is expected to increase by 4.2 percent in 2016 and 3.4 percent in 2017 (and 3.7 percent and 4.2 percent for the non-gold economy). After an increase in 2015, inflation is projected to decline in subsequent years.

Modest progress in poverty reduction and shared prosperity is anticipated over the near term, though the weak connectivity between gold output and economy-wide income levels and employment rates will blunt the impact of overall growth. The poverty rate is projected to fall slightly from 25.2 percent in 2014 to 25 percent in 2015 and 24.3 percent in 2016, as modest output growth, declining remittances and fiscal consolidation slow the growth of household income.

## Challenges

The key risks to the Kyrgyz Republic's economic outlook are primarily external. Developments in Russia and Kazakhstan, including movements in the ruble and tenge, will directly affect the value of the som and influence inflation dynamics.

The extent to which the Kyrgyz Republic is able to leverage its accession to the Eurasian Economic Union (EEU) to boost exports and deepen regional integration will depend on its progress in improving trade logistics and transport infrastructure, as well as its efforts to harmonize domestic rules and regulations with EEU norms.

While stronger economic growth should allow the government to continue to expand public investment while rebuilding fiscal buffers, already high debt-to-GDP ratios and new wage increase commitments made in 2015, limit the scope for further countercyclical spending if growth were to falter.

Further depreciation may require additional efforts to reinforce financial sector resilience, particularly given the already high levels of dollarization on bank balance sheets.

The Kyrgyz Republic faces the risk of poverty stagnating at a high level. Without growth in domestic jobs and wages, migration opportunities or an expansion of the safety net, sustained welfare improvements are likely to be limited. In turn a challenge for the government will be to proceed with necessary fiscal consolidation while safeguarding those expenditures that are most directly pro-poor.

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

| | 2012 | 2013 | 2014 | 2015 f | 2016 f | 2017 f |
|---|---|---|---|---|---|---|
| **Real GDP growth, at constant market prices** | -0.1 | 10.9 | 3.6 | 2.0 | 4.2 | 3.4 |
| Private Consumption | 11.2 | 8.0 | 5.3 | 0.5 | 3.0 | 2.4 |
| Government Consumption | 2.1 | -0.4 | -0.5 | 2.1 | 4.2 | 2.4 |
| Gross Fixed Capital Investment | 36.5 | 1.3 | 13.3 | 5.0 | 6.8 | 5.9 |
| Exports, Goods and Services | -19.2 | 12.3 | -7.4 | -5.5 | 8.8 | 8.5 |
| Imports, Goods and Services | 12.4 | 4.1 | -2.6 | -3.7 | 5.4 | 5.2 |
| **Real GDP growth, at constant factor prices** | -0.1 | 10.5 | 3.6 | 2.2 | 3.8 | 3.3 |
| Agriculture | 1.2 | 2.9 | -0.6 | 3.0 | 2.5 | 2.9 |
| Industry | -11.7 | 28.0 | -1.7 | -5.1 | 7.5 | 0.7 |
| Services | 2.4 | 11.3 | 7.8 | 3.7 | 3.7 | 4.2 |
| **Prices** | | | | | | |
| Inflation (GDP price deflator) | 8.7 | 3.2 | 7.9 | 7.7 | 9.6 | 6.9 |
| Inflation (Consumer Price Index) | 2.7 | 6.6 | 7.5 | 9.4 | 8.7 | 6.6 |
| **Current Account Balance (% of GDP)** | -15.6 | -15.0 | -16.8 | -18.5 | -16.9 | -11.4 |
| **Fiscal Balance (% of GDP)** | -5.7 | -3.9 | -4.1 | -5.8 | -5.3 | -3.7 |
| **Poverty Rate** | | | | | | |
| Poverty rate ($2.5/day PPP terms) 1/ | 31.3 | 31.2 | 25.2 | 25.0 | 24.2 | 23.7 |

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: f = forecast. In annual percent change unless indicated otherwise.

1/ Calculations based on ECAPOV harmonization, using 2008-KIHS, 2011-KIHS, and 2012-KIHS.
Projection using Annualized elasticity (2008-2011) with pass-through = 1 based on GDP per capita constant PPP.
Actual data: 2012. Data for 2013-4 are estimates, data from 2015 through 2017 are projections

# MACEDONIA FYR

| | 2014 |
|---|---|
| Population, mn | 2.1 |
| GDP, US$, bn | 11.3 |
| GDP per Capita, US$ | 5370 |
| GDP per Capita, US$ PPP | 12096 |
| Poverty rate, US$5/day PPP[1] | 35.0 |
| Poverty rate, relative line[2] | 24.2 |
| Gini coefficient, income[2] | 37.0 |
| Life expectancy[3] | 75.2 |
| School enrolment rate, primary[4] | 89.2 |

Sources: State Statistical office, Central Bank, WDI and Staff Calculations
Notes:
1/ Data for 2008
2/ Based on SILC data for 2013
3/ Data for 2013
4/ Data for 2012

*FYR Macedonia's economic growth moderated slightly in the first half 2015 following political turmoil. Overall, growth is expect to slow down to 3.2 percent in 2015 from 3.8 percent in 2014, and to gradually pick up in 2016 and 2017. This dynamic is supported by continued public investment, strong FDI-related net exports, and a gradual increase in private consumption. Robust economic activity, employment creation, and public transfers are expected to continue contributing to poverty reduction in the forecasting period.*

## Recent developments

High frequency data suggests a moderate, but widespread slowdown in economic activity in 2015, possibly linked to political turmoil. Industrial production growth slowed down in the first half of 2015, as growth moderated in a broad range of industries including apparel, mining, tobacco, non-metallic mineral and electrical equipment. In contrast, construction , measured by the value added of complete construction work, remained robust in this period.

On the demand side, consumption and investment leading indicators provide mixed signals. VAT revenues and imports and domestic production of consumption goods have declined. However, retail trade increased by 2.1 percent (y-o-y) in real terms and household credit growth averaged 12 percent (y-o-y) in the first half of 2015. Private consumption is expected to be fueled by increases in public wages, pensions and social benefits in the second half of 2015. Slow downs in capital spending and FDIs suggest moderation in gross investment. Yet, investment loans to companies increased by 7.6 percent (y-o-y) in the first half of 2015 (compared to 4.4 percent increase for 2014).

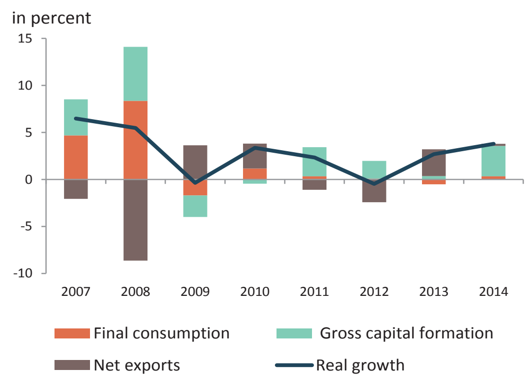
Deflation persisted in the first half of 2015. Prices briefly increased in the first half of 2015, but fell again by 0.4 percent (y-o-y) in July 2015, driven by energy prices. In Jan-Jul 2015 , average prices were 0.3 percent lower than in Jan-Jul 2014.

Unemployment continued to decline, helped by job creation in a range of sectors . In the first quarter of 2015, unemployment averaged 27.3 percent, down from 28.4 percent a year earlier. High frequency data points to further increase in job creation in the second quarter. Youth unemployment has also declined to 48 percent (from 53 percent in 2014), but it is still among the highest in the region. Long-term unemployment remains a problem, reaching 46 percent of unemployed individuals.

Exports growth moderated slightly, while imports growth accelerated in the second quarter of 2015. Still, the trade deficit narrowed by 30 percent in the first half of 2015. While both accounts experienced positive growth in Euros, they declined in US$ terms reflecting a depreciation of the Denar (which is pegged to the EUR) vis-à-vis the US$. Private transfers were slightly lower than in 2014, but fully covered the trade deficit, alleviating external financing pressures. Net FDI inflows decreased by 40 percent (y-o-y), largely driven capital outflows registered in May 2015 (the height of the political turmoil and the Greek crises).

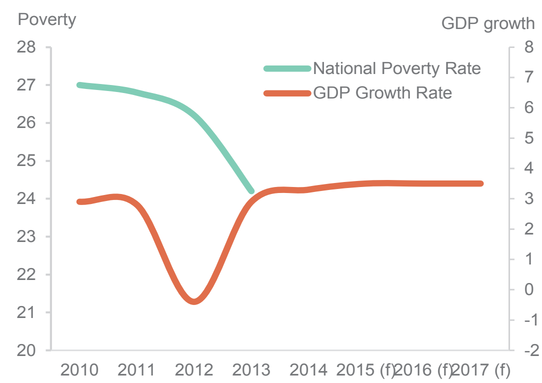
The government revised up the fiscal deficit projections for 2015. The government has recently introduced the 2015 supplementary budget, which increased expenditures and shifts its composition unfavorably. Around 2/3 of public spending consists of public wages, social transfers and subsidies, capital spending is low and constantly under realized. While the government made efforts to decrease the share of wages and unemployment benefits in total spending, increases in pensions, social benefits and subsidies have outweighed these efforts. In contrast, capi-

**FIGURE 1 Macedonia FYR** / Contributions to Annual GDP Growth




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

**FIGURE 2 Macedonia FYR** / Actual and projected poverty rates and real GDP per capita, 2000-2017




Note: National poverty defined at 60% of median equivalised income.
Sources: Poverty from Macedonia SSO. GDP growth from WDI and World Bank projections.

tal expenditures have declined as a share of total spending in the past three years. The government has missed its initial fiscal targets every year since 2012, which reflects weaknesses in public financial management.

Although still lower than the regional average, FYR Macedonia's public debt has increased rapidly in recent years. Public debt has almost doubled since 2008, reaching 43.7 percent of GDP in the first quarter of 2015. The debt is expected to continue increasing in 2015 as the government stepped-up its domestic borrowing to finance the re-payment of EUR 150 million Eurobond and pre-finance part of the deficit level for 2016. The public debt is expect to reach 50 percent of GDP in 2017, following the implementation of an ambitious policy program put forward in 2014.

Poverty has declined in the recent years, following employment growth and increases in government transfers. Although internationally comparable estimates of poverty are not available for FYR of Macedonia, national estimates register a decrease in poverty rates, from 27.0 percent in 2010 to 24.2 in 2013, despite a 6 percent increase in the poverty line, signaling an improvement in living conditions at the bottom of the distribution driven by considerable employment creation and continuous increases in pensions and agricultural subsidies in the recent years.

## Outlook

Growth is expected to pick-up in 2016 and 2017, reaching 3.4 and 3.7, respectively, under the assumption that there is no further escalation of the political turmoil. Public investment, FDI related exports and to a lesser extend manufacturing are expected to drive growth. Private consumption is expected to gradually pick-up as employment expands .

Poverty rates are expected to decline in the medium-term. Strong growth in 2015-2017 is expected to contribute to further poverty reduction, as long as employment creation continues to take place. Increases in social benefits are also expected to contribute to this result in the near term, but with possible implications for fiscal sustainability. As in recent years, the expected average annual growth of 1 percent in agriculture is unlikely to lead to significant employment creation or farm income increases, making a considerable reduction in rural poverty unlikely in the short term.

## Challenges

The country is facing some challenges in the coming period that include further repercussions from the political crisis, sustainable and credible fiscal consolidation; continued reduction in unemployment, especially youth and long-term unemployment.

Limited access to the SILC and HBS microdata limits the to track and benchmark improvements in living conditions.

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

| | 2012 | 2013 | 2014 | 2015 f | 2016 f | 2017 f |
|---|---|---|---|---|---|---|
| **Real GDP growth, at constant market prices** | -0.5 | 2.7 | 3.8 | 3.2 | 3.4 | 3.7 |
| Private Consumption | 1.2 | 2.1 | 2.3 | 1.9 | 2.2 | 2.4 |
| Government Consumption | 2.4 | 2.5 | -1.2 | 0.7 | 1.0 | 1.0 |
| Gross Fixed Capital Investment | 10.2 | -16.6 | 13.5 | 15.5 | 10.0 | 9.0 |
| Exports, Goods and Services | 2.0 | -2.7 | 17.0 | 7.5 | 8.0 | 8.2 |
| Imports, Goods and Services | 8.2 | -10.0 | 14.5 | 6.8 | 7.2 | 7.5 |
| **Real GDP growth, at constant factor prices** | -0.6 | 4.1 | 3.6 | 2.7 | 3.2 | 3.7 |
| Agriculture | -16.0 | 9.0 | 2.0 | 1.0 | 1.0 | 1.0 |
| Industry | -5.0 | 5.9 | 5.0 | 3.5 | 5.0 | 6.0 |
| Services | 3.8 | 2.8 | 3.2 | 2.6 | 2.8 | 3.1 |
| **Prices** | | | | | | |
| Inflation (GDP price deflator) | 1.0 | 4.3 | 1.4 | -5.8 | 1.1 | 1.1 |
| Inflation (Consumer Price Index) | 3.3 | 2.8 | -0.1 | 0.4 | 1.4 | 2.0 |
| **Current Account Balance (% of GDP)** | -3.1 | -1.8 | -1.5 | -2.8 | -3.1 | -3.0 |
| **Fiscal Balance (% of GDP)** | -3.9 | -4.0 | -4.2 | -3.9 | -3.5 | -3.0 |

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

# MOLDOVA

| | 2014 |
|---|---|
| Population, million | 3.5 |
| GDP, current US$ billion | 8.0 |
| GDP per capita, current US$ | 2243 |
| Poverty rate ($2.5/day 2005 PPP terms) [a] | 3.8 |
| Poverty rate ($5/day 2005 PPP terms) [a] | 39.6 |
| Gini Coefficient [b] | 30.6 |
| Life Expectancy at birth, years [c] | 68.7 |

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

*While Moldova's economic performance was strong in early 2015, a recession is projected in the second half of the year due to the bad harvest and negative shocks from demand and remittances. Poverty ($5/day) could increase by 1.2 p.p. to 37.8 percent in 2015. A modest recovery is expected in 2016 which will likely halt further increases in poverty. However, risks from the external environment and costs of the failed banks' resolution could undermine macroeconomic stability and affect living standards.*

## Recent developments

Despite a slowdown of external demand and remittances, the economy grew 3.6 percent y/y in the first half of 2015. Depreciation pressures stimulated net exports contributing 3.9 percentage points (p.p.), while the low level of remittances almost halted consumption growth. Small growth of fixed investments was fully compensated by a decline in stocks.

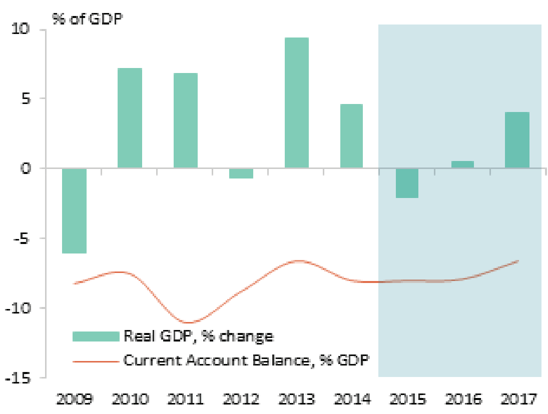
Consumer price inflation has been on the rise and above the central bank target range, so the National Bank of Moldova has significantly tightened the policy stance. Twelve-month inflation exceeded the target range of 5±1.5 percent in March and stood at 12.2 percent in August 2015. Depreciation of the Leu resulted in higher import prices, and emergency loans to three troubled banks increased liquidity in the system. In response, the monetary authority increased the base interest rate by 13 p.p. since the beginning of the year to 19.5 percent and significantly tightened the mandatory reserve requirement in national currency.

Recessions in Ukraine and Russia and domestic political instability worsened Moldova's external position, while trade reorientation towards the EU markets continued. Exports to Russia halved and Romania became the largest export market for Moldova. In July, money transfers (a proxy for remittances) to Moldova dropped 30 percent, y/y. As a result, the Leu lost almost a quarter of its value against the dollar since the beginning of 2015 and foreign reserves decreased 8 percent, although still covering over 3 months of imports.

The government faces increased fiscal pressures due to lower external assistance and underperforming tax collections. In January-July 2015, the general government deficit was 0.8 percent of GDP, but the government had to ration expenditures to align them with available financing. Due to higher borrowing costs, lower collections at customs and lower official external assistance, the government restricted procurement of goods and services.

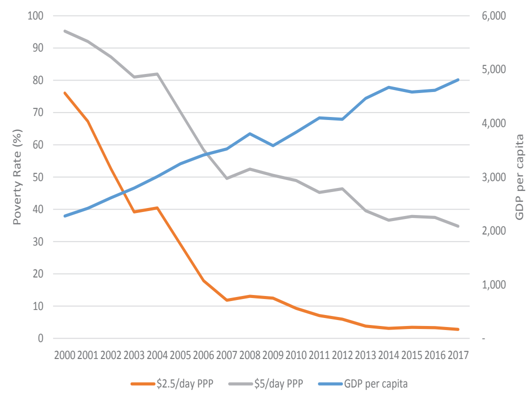
Higher inflation, lower remittances and a severe summer drought are likely already affecting living standards in Moldova, pushing poverty into an upward trend. Poverty has been on the decline in recent years, going from 46.4 percent in 2012 ($5/day, 2005 PPP) to an estimated 36.6 percent in 2014. However, recent developments are likely to have had a negative impact on household income. Farmers, particular small ones, have been hard hit by the combination of Russian restrictions and a severe summer drought and, with most of the Moldovan poor residing in rural areas and employed in agriculture, this is expected to have had a negative impact on the rural poor and vulnerable. Moreover, the combination of declining remittances inflows, which account for 15-20 percent of household income, and a slight increase in the unemployment rate (going from 3.7 percent in Q2 2014 to 4.1 percent in Q2 2015), have likely put additional downward pressure on household income. Finally, higher consumer inflation has started to erode households' purchasing power.

**FIGURE 1 Moldova** / Real GDP growth and current account balance




Source: National authorities and World Bank team.

**FIGURE 2 Moldova** / Actual and projected poverty rates and real GDP per capita, 2000-2017




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

## Outlook

Moldova's economy is projected to shrink and poverty levels are expected to increase in 2015. The economy is likely to sharply contract by 6 percent in the second half of 2015 resulting in a 2 percent decline for the year due to hot weather affecting crop output (with a double digit decline), projected deep recessions of the eastern partners, and tighter monetary policy. The 20 percent decrease in remittances and weak domestic credit expansion will lead to the contraction of domestic demand. Moderate poverty rates ($5/day, 2005 PPP) will increase by 1.2 p.p., to 37.8 percent. The economic contraction in the second half of the year, coupled with the reduction in remittances and higher inflation, will add to the negative effects on households. Increases in public wages in late 2014 and indexation of pensions in April 2015 are expected to partially mitigate incomes shocks for some groups, but less so for those in the bottom 40 percent of the distribution who rely relatively less on wage income.
Moldova's economy will slowly regain its growth momentum in 2016, expected to be accompanied by very modest declines in poverty. The projected slow economic recovery of 0.5 percent will be constrained by still low remittances flows, subdued consumption, high credit costs and higher local energy tariffs. Net exports are projected to be the main growth driver given the exchange rate adjustments and trade reorientation away from CIS countries. The long overdue increase of utilities' tariffs will keep inflation above the target range in 2015-2016. With a weaker economy, fiscal pressures will persist from high recurrent expenditures, recognition of fiscal cost of failed banks and lower external budget support. For households, despite some recovery in 2016, double-digit inflation– partly from increase in utility tariffs - and lower remittances are expected to limit any significant improvements in living standards and poverty rates. Moderate poverty is likely to stand at 37.5 percent in 2016.

## Challenges

The unfavorable regional environment, monetary and fiscal costs of resolution of the troubled banks and poor governance in the banking sector risk undermining the macroeconomic stability achieved in recent years. With higher projected public debt and lower levels of foreign reserves, Moldova has limited macroeconomic buffers to sustain a more severe deterioration of the economic activity. The recognition of the losses in the banking sector could increase the public debt to 47 percent of GDP in 2015, from 32.5 percent a year earlier. It is important for Moldova to maintain the flexible exchange rate arrangement to withstand adverse external shocks.
Lower than expected growth of traditional trading partners and failure to improve domestic business environment could have a bigger negative impact on Moldova with further poverty increases. These poverty increases could materialize through potentially higher unemployment, higher utility tariffs and prices, and persistently low remittances inflows. Moving forward, structural reforms supported by development partners and investors are needed to maintain macro-fiscal stability, increase the competitiveness of the Moldovan economy and boost job creation for more sustainable market income sources for households.

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

| | 2012 | 2013 | 2014 | 2015 f | 2016 f | 2017 f |
|---|---|---|---|---|---|---|
| **Real GDP growth, at constant market prices** | -0.7 | 9.4 | 4.6 | -2.0 | 0.5 | 4.0 |
| Private Consumption | 1.0 | 6.4 | 2.9 | -1.8 | 0.6 | 3.7 |
| Government Consumption | 0.7 | -0.1 | 0.2 | -2.0 | 0.2 | 2.2 |
| Gross Fixed Capital Investment | 1.8 | 3.8 | 10.1 | -7.3 | -0.8 | 1.4 |
| Exports, Goods and Services | 1.7 | 9.6 | 1.1 | -1.1 | 3.7 | 4.5 |
| Imports, Goods and Services | 2.2 | 4.4 | 0.4 | -3.5 | 2.8 | 3.8 |
| **Real GDP growth, at constant factor prices** | -1.1 | 10.6 | 5.4 | -2.0 | 0.4 | 4.0 |
| Agriculture | -20.1 | 46.6 | 8.2 | -12.5 | 7.7 | 5.3 |
| Industry | 8.3 | 1.5 | 6.2 | 2.8 | -1.1 | 4.0 |
| Services | 2.7 | 4.0 | 4.2 | 0.6 | -1.5 | 3.5 |
| **Prices** | | | | | | |
| Inflation (GDP price deflator) | 7.9 | 4.1 | 6.3 | 8.9 | 9.8 | 5.4 |
| Inflation (Consumer Price Index) | 4.6 | 4.6 | 5.1 | 9.5 | 11.9 | 5.0 |
| **Current Account Balance (% of GDP)** | -8.8 | -6.6 | -8.0 | -8.0 | -7.9 | -6.6 |
| **Fiscal Balance (% of GDP)** | -2.1 | -1.8 | -1.8 | -2.7 | -3.0 | -2.5 |
| **Poverty Rate** [a, b, c] | | | | | | |
| Poverty rate ($2.5/day 2005 PPP terms) | 6.0 | 3.8 | 3.1 | 3.4 | 3.4 | 2.8 |
| Poverty rate ($5/day 2005 PPP terms) | 46.4 | 39.6 | 36.6 | 37.8 | 37.5 | 34.8 |

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: f = forecast.
(a) Calculations based on ECAPOV harmonization, using 2013-HBS.
(b) Projection using neutral distribution (2013) with pass-through = 0.87 based on GDP per capita constant PPP.
(c) Actual data: 2012, 2013. Projections are from 2014 to 2017.

# MONTENEGRO

| | 2014 |
|---|---|
| Population, million | 0.6 |
| GDP, current US$ billion | 4.6 |
| GDP per capita, current US$ | 7318 |
| Poverty rate ($2.5/day PPP terms) [a] | 2.8 |
| Poverty rate ($5/day PPP terms) [a] | 18.7 |
| Gini Coefficient [b] | 32.2 |
| Life Expectancy at birth, years [c] | 74.8 |

Sources: World Bank, WDI, Macro Poverty Outlook, and ECA TSD.
Notes:
(a) Most recent value (2013)
(b) Gini data show most recent ECATSD value (2013)
(c) Life Expectancy data show most recent WDI value (2013)

*Economic activity accelerated in early 2015 on the back of stronger growth in private consumption and investment. Poverty is expected to continue declining given economic growth and notable improvements in activity and employment rates, now the highest since 2008. However, high unemployment, in particular of youth and elderly, remains a challenge. External and fiscal imbalances have started to worsen in 2015 because of highway-related imports and capital spending. The fiscal deficit of 6 percent of GDP in 2015 would worsen debt sustainability.*

## Recent developments

The economy grew by 1.5 percent in 2014, led by private consumption and investment that partially offset the negative effects of the floods, delayed large investment projects and weaker than expected external demand. Real activity improved in the beginning of 2015 with growth strengthening to 3.2 percent year-on-year in Q1. Tourism outcomes reinforced retail trade, while construction output went up by 9.7 percent from a year earlier.

Poverty was reduced with positive economic growth since 2012, though with high vulnerability to macro risks. Poverty, (at $5/day 2005 PPP), peaked at 19.2 percent in 2012 and declined to an estimated 18.7 percent in 2014. While social transfers have contributed to reducing poverty, the overall poverty trend closely mirrors labor market performance, particularly employment growth in low-skill sectors. The unemployment rate in the first half of 2015 amounted to 17.6 percent (a four-quarter average), reaching its lowest level since 2008, and labor force participation and employment among the population 15 and above increased to 53.1 and 43.8 percent, respectively. Higher rates of employment growth in sectors such as agriculture and administrative and support service, together with higher average real net wages in agriculture (2.3 percent) and construction (6.5 percent) are likely to have translated into income growth among poor households.

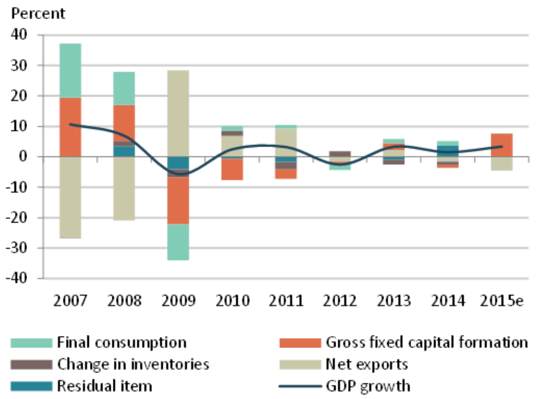
The labor market recovery has been uneven, however. The unemployment rate for workers aged 50-64 as well as those living in the poorer Northern region increased.

Although fiscal consolidation efforts led to a reduction of the deficit to 1.4 percent of GDP in 2014, highway construction costs (about 23 percent of GDP) will burden public finances in 2015-2018, worsen debt sustainability and increase financing risks. While the 2015 deficit is likely to amount to about 6 percent of GDP, the government reform program aims to support the achievement of large non-highway fiscal surplus. The proposal would be enacted through additional revenue measures (retaining the crisis PIT tax and increase in the rate of health insurance contribution by 0.5 percentage points) as well as a pension indexation freeze in 2015, and elimination of retirement under more favorable terms. Refinancing risk in 2015 was reduced by the ECB's monetary easing that led to improved external financing conditions. The March 2015 Eurobond worth €500 million was issued at a rate of 3.87 percent (half the rate from the 2010 issue). However, in H1 2015, public debt increased to 70.8 percent of GDP (or 82.2 percent with guarantees included) which raises the risks of future refinancing.

External imbalances deepened in early 2015. Declining net exports, dividend payments to equity holders abroad and a drop in workers' remittances widened the current account deficit (CAD) to 15.9 percent in H1 2015, reversing a five-year positive trend.

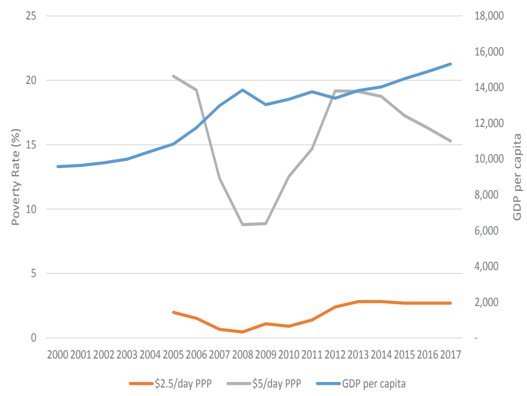
Because remittances are a relatively small share of the incomes of poor households, the decline in remittances is expected to have only a moderate impact on their incomes. This high level of CAD was fi-

**FIGURE 1 Montenegro** / Contributions to annual GDP growth




Sources: MONSTAT, World Bank.

**FIGURE 2 Montenegro** / Actual and projected poverty rates and real GDP per capita, 2000-2017




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

nanced by robust net FDIs amounting to 10 percent of GDP. However, debt-creating inflows remain high leading to a further rise in external debt to GDP ratio estimated at 121 percent.

After months of declining, lending growth turned positive in May on the back of stronger credit to households. Non-performing loans rose to 16.4 percent of total loans by July 2015, from 15.9 percent in 2014. In parallel, the newly enacted Law on Voluntary Financial Restructuring of Debts to Financial Institutions will hopefully lead to resolution of bad assets to unlock access to capital to corporates. In addition, in August 2015, the parliament adopted the law on conversion of CHF loans into EUR costing some EUR30 million (0.8 percent of GDP) to be equally shared among the borrowers, the bank and the state. Domestic deposits growth accelerated to 13.2 percent in July 2015. After persistent deflation throughout 2014, 12-month inflation turned positive (1.5 percent) in the first seven months of 2015 as demand picked up.

## Outlook

Economic growth is expected to expand in 2015 to 3.4 percent and remain at around 3 percent in 2016-2017, driven by public and private sector investments into public infrastructure and tourism. Positive economic growth, through improved labor demand and continued employment expansion, is expected to lead to further poverty reduction. Lower energy and transport costs associated with falling oil prices are expected to benefit poor households, who spend a relatively high share of total expenditures on these items.

The fiscal deficit will be averaging 6 percent of GDP a year due to the planned annual 9.5 percent of GDP in capital spending. Government consumption is projected to decrease to create fiscal space for a sharp rise in public investments in 2015-18. Public debt will rise throughout the medium term to peak in 2018 at 77 percent of GDP. This macro-fiscal framework already led the credit rating agencies to downgrade Montenegro's sovereign rating (to B+ with a stable outlook) which may increase the cost for the bonds redemption in 2016. Furthermore, the external imbalance is likely to rise further from the already high level due to the imports required for highway construction. FDI is projected to remain stable (based on announced investments in infrastructure, tourism, energy and agriculture projects) at around 9 percent of GDP, covering more than half of CAD.

## Challenges

The outlook is subject to downside risks. A regional sovereign debt crisis and geopolitical tensions, while not having a direct impact on Montenegro, may affect the economy via second-round effects (trade and capital flows from EU, as well as increased financial volatility).

There are also risks on the fiscal side that include the maturity in 2016 of the 5-year Eurobond equivalent to 10 percent of GDP and the exchange rate risk related to the dollar-denominated highway loan. While the highway project presents a growth opportunity, it is also the main downside risk for economy. The authorities need to ensure fiscal discipline, strengthen the banking sector and undertake structural reforms to raise potential growth once the highway construction ends. Household welfare remains highly exposed to macro risks and the labor market is vulnerable to volatile regional economic conditions.

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

| | 2012 | 2013 | 2014 | 2015 f | 2016 f | 2017 f |
|---|---|---|---|---|---|---|
| **Real GDP growth, at constant market prices** | -2.5 | 3.3 | 1.5 | 3.4 | 2.9 | 3.0 |
| Private Consumption | -3.2 | 1.1 | 1.3 | 1.2 | 2.5 | 2.2 |
| Government Consumption | 3.1 | 1.4 | 1.5 | -3.1 | -1.5 | 0.3 |
| Gross Fixed Capital Investment | -3.3 | 8.8 | -3.0 | 29.3 | -3.7 | -3.4 |
| Exports, Goods and Services | -1.2 | -1.3 | -0.4 | 0.7 | 1.6 | 0.7 |
| Imports, Goods and Services | 0.9 | -3.1 | 1.5 | 5.0 | -1.8 | -2.1 |
| **Real GDP growth, at constant factor prices** | -2.0 | 3.8 | 1.5 | 3.4 | 2.9 | 3.0 |
| Agriculture | -10.5 | 16.1 | -22.3 | 3.2 | 3.3 | 2.1 |
| Industry | -9.5 | 4.3 | 4.5 | 5.8 | 4.7 | 3.5 |
| Services | 3.1 | 1.6 | 4.7 | 2.4 | 2.0 | 2.8 |
| **Prices** | | | | | | |
| Inflation (GDP price deflator) | -0.1 | 2.2 | 1.4 | 1.0 | 2.7 | 1.6 |
| Inflation (Consumer Price Index) | 4.1 | 2.2 | -0.7 | 0.0 | .. | .. |
| Inflation (Private Consumption Deflator) | 2.0 | 1.9 | -0.9 | 4.2 | 2.0 | 1.3 |
| Inflation (Consumer Price Index) | 4.1 | 2.2 | -0.7 | 1.0 | 1.9 | 2.0 |
| **Current Account Balance (% of GDP)** | -18.7 | -14.6 | -15.4 | -16.0 | -16.4 | -16.8 |
| **Fiscal Balance (% of GDP)** | -5.9 | -4.8 | -1.4 | -5.9 | -5.5 | -4.4 |
| **Poverty Rate** | | | | | | |
| Poverty rate ($2.5/day PPP terms) | 2.4 | 2.8 | 2.8 | 2.7 | 2.7 | 2.7 |
| Poverty rate ($5/day PPP terms) | 19.2 | 19.1 | 18.7 | 17.3 | 16.3 | 15.3 |

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: f = forecast. In annual percent change unless indicated otherwise.
Calculations based on ECAPOV harmonization, using 2013-HBS.
Projection using Neutral Distribution (2013) with pass-through = 0.87 based on GDP per capita constant PPP.
(c) Data for 2012-13 are actual, 2014 is an estimate and 2015-17 are projections.

# POLAND

| | 2014 |
|---|---|
| Population, million | 38.0 |
| GDP, current US$ billion | 549.6 |
| GDP per capita, current US$ | 14457 |
| Poverty rate ($2.5/day 2005 PPP terms) [a] | 0.9 |
| Poverty rate ($5/day 2005 PPP terms) [a] | 5.1 |
| Gini Coefficient [b] | 33.1 |
| Life Expectancy at birth, years [c] | 76.8 |

Sources: World Bank, WDI, and Macro Poverty Outlook.
Notes:
(a) Most recent value (2012).
(b) Gini data show most recent WDI value (2012).
(c) Life Expectancy data show most recent WDI value (2013).

*Growth in Poland stabilized at 3.4 percent in the first half of 2015 and was mainly driven by domestic demand. Growth is projected to pick up in the second half of the year, to reach 3.6 percent for 2015 as a whole. Job creation and real increases in wages and pensions have resulted in faster poverty reduction.*

*We project growth to increase gradually to 3.9 percent over the medium term. We project poverty to continue to decline through 2017.*

## Recent developments

In the first half of 2015, the economy expanded by 3.4 percent year on year, the same rate as in 2014, up from 1.7 percent in 2013. Domestic demand increased by 3 percent in the first half of the year and remained the main growth driver, while the contribution of net exports was slightly positive. Private consumption continued to benefit from higher real disposable incomes as a result of improved labor market conditions, relatively strong credit growth to households, and a boost from consumer price declines as wages rose. Investment was supported by solid corporate profits, growing confidence, record low interest rates and final disbursements from the EU's previous financial perspective (budget). On the production side, economic activity has been led by strong growth in financial services, telecommunications and industry.

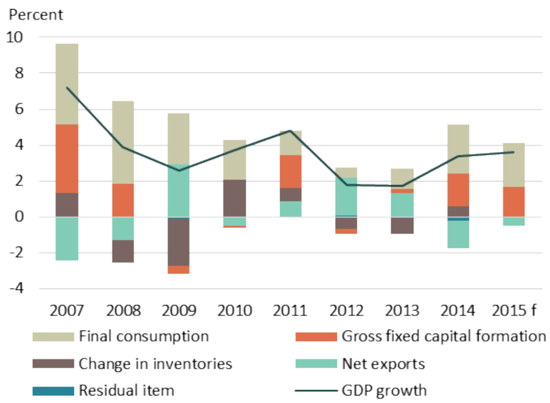
Solid economic growth is creating more jobs. According to the latest LFS survey, the unemployment rate declined by almost 2 percentage points over the year, from 9.1 percent in the 2nd quarter of 2014 to 7.4 percent in the 2nd quarter of 2015. In the same period, the number of employed increased by 1.2 percent (193,000), with 2.4 percent (282,000) more jobs created in the private sector, offsetting the 2.3 percent (89,000) jobs lost in the public sector. Annual growth in nominal wages and salaries slowed to 3.1 percent in the second quarter of the year, from 4.1 percent in the first quarter, but real purchasing power was boosted as consumer prices fell by 0.9 percent (year on year). Between mid-2014 and mid-2015 average wages in the enterprise sector increased by 2.5 percent. In the same period, average pensions increased by 2.3 percent in the general system.

Job creation and real increases in wages and pensions are expected to have resulted in further poverty reduction in 2014. Poverty reduction was swift before the 2009 crisis, with the US $5-a-day 2005 PPP poverty rate declining from 18.7 percent in 2004 to 5.3 percent in 2009. However, the slow recovery halted progress, with poverty remaining at slightly above 5 percent through 2013. Supported by increases in real incomes, poverty is estimated to have declined to 4.8 percent in 2014.

Since February 2013 headline inflation has been below the Central Bank's 1.5-3.5 percent target range and since July 2014 consumer prices have fallen due to energy and food price declines. The main policy interest rate remains at record low of 1.5 percent.

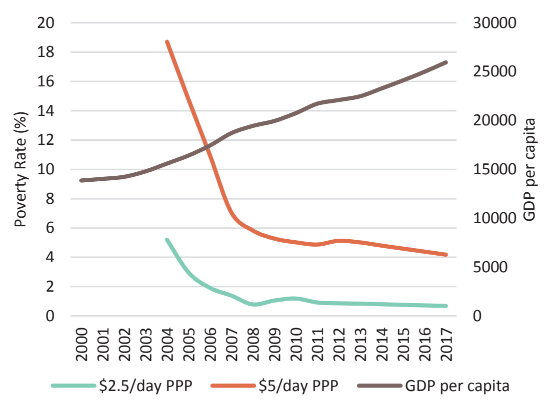
Poland has further strengthened its trade and financial linkages with the euro area where Germany as its main trading partner, accounts for almost 30 percent of exports. In the first half of 2015, the trade balance turned into a US$3.7 billion surplus, from a US$1.1 billion deficit in the first half of 2014. After the current account deficit widened from 1.3 percent of GDP in 2013 to 2.3 percent of GDP in 2014, a significant improvement is expected in 2015. A moderation of foreign capital flows or increased portfolio investment volatility pose limited threats to Poland's external balances. Gross external debt increased from 69.6 percent of GDP in 2013 to 71.9 percent of GDP in 2014.

**FIGURE 1 Poland** / Contributions to annual GDP growth




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

**FIGURE 2 Poland** / Actual and projected poverty rates (2004 -2017) and GDP per capita (2000-2017)




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

Fiscal consolidation enabled Poland to exit the EU Excessive Deficit Procedure this Spring, one year ahead of schedule. The general government deficit declined to 3.2 percent of GDP in 2014, from 4.0 percent in 2013 owing to a rebound in direct and indirect taxes, in line with more dynamic domestic demand, the continued freeze of the central government's wage bill, while interest payments declined due to record low yields of new bonds and changes to the pension system. The latter also contributed to a fall in public debt, from 55.7 percent of GDP in 2013, to 50 percent of GDP in 2014.

## Outlook

Going forward, we project Poland's economy to grow at a rate above 3½ percent, with negligible internal and external imbalances. Domestic demand is likely to remain the main locomotive of growth amid stronger private consumption and solid investment growth. Private consumption growth is forecast to reach 3.4-3.6 percent in 2015-2016 backed by continued increases in disposable incomes following the cyclical upswing in employment. This is expected to strengthen wage demands and gradually push up core and headline inflation toward their reference rate, while the decline in food prices will also be halted by the country-wide drought. Robust investment growth of around 8 percent in 2015-2016 will be backed by solid enterprise profits, record-low costs of credit and sizeable EU funds.

These positive domestic demand trends should also boost tax collection. While the fiscal stance is set to remain fairly conservative, in line with fiscal rules, the pace of consolidation will moderate as the constraints imposed by the EDP procedure are lifted (e.g. wages maybe unfrozen for the first time in six years). The headline deficit is expected to decline modestly, to 2.9-2.8 percent of GDP in 2015-2016. Some structural shifts, however, are expected as social expenditures rise with the introduction of new social benefits and programs supporting families with children, the elderly or more generous pensions' indexation result from commitments made during the election year. Funding new spending items will require increased effectiveness of public spending, and more efficient tax administration.

Underpinned by these developments, we project poverty, measured by the US$5-a-day in 2005 PPP, to decline to 4.6 percent in 2015 and fall to 4.2 percent by 2017.

## Challenges

Despite the relatively benign forecast, the balance of risks for the Polish economy is slightly skewed to the downside. The main challenges are external and largely indirect- starting from geopolitical tensions and protracted conflict in Eastern Ukraine. Unfavorable economic developments both in close (EU) or more distant (China) markets may affect Poland directly and indirectly and undermine growth prospects through trade, financial and confidence channels. But internally, parliamentary elections pose a risk of heightened political instability with the potential for some reversals of the current conservative fiscal policies. Upside risks include a stronger recovery in the Eurozone or further declines in oil prices, which benefit Poland as a large oil importer.

In the medium-term, Poland needs to improve the efficiency of public finances and do more to ensure that economic growth includes better the poor. Doing business reforms could encourage productivity and innovation. Lastly, the country needs to manage the transition towards a low-emissions economy.

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

| | 2012 | 2013 | 2014 | 2015 f | 2016 f | 2017 f |
|---|---|---|---|---|---|---|
| **Real GDP growth, at constant market prices** | 1.8 | 1.7 | 3.4 | 3.6 | 3.7 | 3.9 |
| Private Consumption | 0.9 | 1.2 | 3.0 | 3.4 | 3.5 | 3.7 |
| Government Consumption | 0.2 | 2.1 | 4.7 | 2.3 | 1.4 | 1.4 |
| Gross Fixed Capital Investment | -1.5 | 1.1 | 9.2 | 8.0 | 7.6 | 7.8 |
| Exports, Goods and Services | 4.3 | 4.8 | 5.7 | 5.8 | 6.3 | 6.6 |
| Imports, Goods and Services | -0.6 | 1.8 | 9.1 | 7.1 | 7.0 | 7.3 |
| **Real GDP growth, at constant factor prices** | 1.8 | 1.8 | 3.2 | 3.7 | 4.0 | 4.0 |
| Agriculture | -4.7 | 6.3 | 3.8 | 0.9 | 1.7 | 0.6 |
| Industry | 2.0 | 1.3 | 4.1 | 4.4 | 5.2 | 4.8 |
| Services | 2.0 | 1.9 | 2.9 | 3.5 | 3.7 | 3.9 |
| **Prices** | | | | | | |
| Inflation (GDP price deflator) | 2.2 | 1.1 | 0.8 | -0.5 | 1.1 | 1.5 |
| Inflation (Consumer Price Index) | 3.7 | 1.2 | 0.2 | -0.8 | 1.2 | 1.5 |
| Inflation (Private Consumption Deflator) | 3.2 | 0.7 | 0.1 | -0.8 | 1.2 | 1.5 |
| Inflation (Consumer Price Index) | 3.7 | 1.2 | 0.2 | -0.8 | 1.2 | 1.5 |
| **Current Account Balance (% of GDP)** | -3.6 | -1.3 | -1.9 | -1.5 | -1.7 | -2.3 |
| **Fiscal Balance (% of GDP)** | -3.7 | -4.0 | -3.2 | -2.9 | -2.8 | -2.5 |
| **Poverty Rate** [a, b, c] | | | | | | |
| Poverty rate ($2.5/day 2005 PPP terms) | 0.9 | 0.8 | 0.8 | 0.8 | 0.7 | 0.7 |
| Poverty rate ($5/day 2005 PPP terms) | 5.1 | 5.0 | 4.8 | 4.6 | 4.4 | 4.2 |

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: f = forecast.
(a) Calculations based on 2004-EU-SILC Survey, 2012-EU-SILC survey, .
(b) Projection using point-to-point elasticity (2004-2012) with pass-through = 0.7 based on GDP per capita constant PPP.
(c) Actual data: 2012. Data for 2013-4 are estimates, data from 2015 through 2017 are projections.

# ROMANIA

| | 2014 |
|---|---|
| Population, million | 21.2 |
| GDP, current US$ billion | 203.7 |
| GDP per capita, current US$ | 9586 |
| Poverty rate ($2.5/day 2005 PPP terms) [a] | 11.1 |
| Poverty rate ($5/day 2005 PPP terms) [a] | 32.6 |
| Gini Coefficient [b] | 34.9 |
| Life Expectancy at birth, years [c] | 74.5 |

Sources: World Bank, WDI, Macro Poverty Outlook, and ECA TSD.
Notes:
(a) Most recent value (2012).
(b) Gini data show most recent WDI value (2012).
(c) Life Expectancy data show most recent WDI value (2013).

*Real GDP growth was strong in the first half of 2015, driven by private consumption and investment. Romania's macroeconomic situation remains sound: the consolidated budget is in surplus, the current account deficit low and inflation negative. Real GDP growth is expected to reach 3.6 percent in 2015. Poverty is on a downward trajectory and has reached historical lows. Risks to the outlook remain significant. Faster implementation of structural reforms will be important to accelerate growth.*

## Recent developments

At 3.7 percent (y-o-y), Romania achieved one of the highest growth rates in the EU in the first half of 2015. On the production side, growth was propelled by a recovery in construction and industry, in particular the production of machinery and transport equipment. On the demand side, it was fueled by strong growth of private consumption and investment. Private consumption increased by 5.4 percent (y-o-y) due to increases in wages and a decline in the VAT rate for food from 24 percent to 9 percent in June 2015. Private investment grew strongly. Although improving, public investment remained subdued reflecting a lower-than expected absorption of EU funds. Fueled by domestic consumption, import growth outpaced export growth. Yet, export growth was strong at 6.2 percent (y-o-y) driven by exports of manufacturing goods and services. Overall, the trade surplus declined slightly y-o-y, while the current account deficit remained low at around 0.4 percent in terms of GDP as of end-June 2015.

Growth has led to increases in wages as employment and labor force participation remained constant and job creation low. Labor force participation was 64 percent in March, below the 70 percent national target and lower than the EU28 average. Unemployment has been broadly stable over the last year and remains at 6.8 percent as of end-July, below the EU average of 9.8 percent. Yet, youth unemployment remains high (at 23 percent in March), above the EU average of 20.1 percent. Poverty is projected to have declined from 35.8 percent in 2011 to 28.4 percent in 2014 using the US$5.00/day PPP poverty line

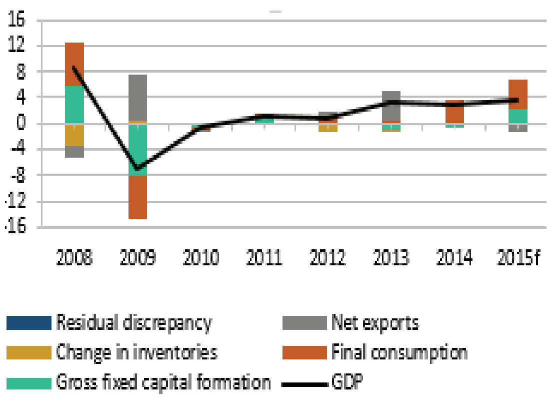
The cut in the VAT rate for food in June 2015 has increased the purchasing power of Romanians, particularly for the poorest members of society for whom food is a larger portion of their budgets. The budget was in surplus in the first 7 months of 2015 due to strong revenue performance and lower than budgeted spending. Revenues grew by 9.9 percent (y-o-y) between January and July 2015, largely driven by increases in revenues from PIT, VAT and excises. Spending was contained due to lower interest payments and public investment. The government is expected to meet the fiscal headline deficit of 1.86 percent of GDP in 2015.

The reduction of the VAT rate for foodstuff from 24 percent to 9 percent starting in June 2015 drove consumer prices into negative territory (-1.9 percent yoy in August). The low inflation environment enabled the central bank to maintain relaxed monetary conditions and ample liquidity in the market. The central bank kept its policy rate at 1.75 percent in its July session. Credit growth remains timid, with credit to households expanding by 3.4 percent in July 2015, while credit to corporations fell by 4.7 percent. Non-performing loans declined substantially, from 21.9 percent at the end of 2013 to 12.8 percent at the end-July 2015.

## Outlook

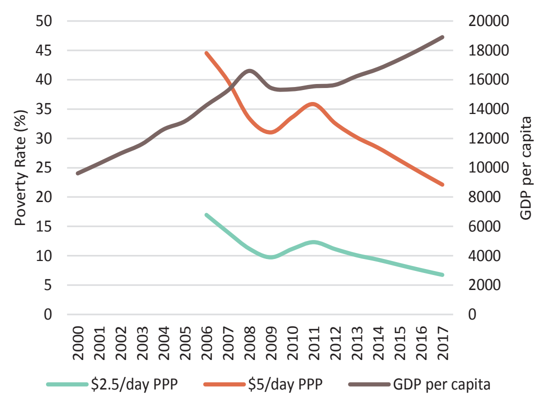
The economic outlook for the rest of 2015 and for 2016 is positive. Real GDP growth

**FIGURE 1 Romania** / Contributions to annual GDP growth




Sources: World Bank.

**FIGURE 2 Romania** / Actual and projected poverty rates (2006-2017) and GDP per capita (2000-2017)




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

in 2015 is projected to slow down slightly in the second half due to a drought-induced decline in agricultural production and to reach a solid 3.6 percent for the entire year. It is expected to accelerate to 3.9 percent in 2016, supported by strong domestic consumption and investment. The current account deficit is expected to modestly widen over the medium term, as imports increase driven by demand. The fiscal deficit is expected to widen in 2016. The Fiscal Code approved by the Parliament in September envisages several tax cuts starting in January 2016, including in VAT from 24 percent to 20 percent. The Fiscal Council estimates that the fiscal impact of the measures presented would be around 1.1 percent of GDP in 2016.

Consumer prices will remain in negative territory in 2015, thanks to the one-off effect of the June VAT rate cut and helped by lower oil prices and weak inflation in the EU. The annual inflation rate will likely remain negative in the first half of 2016 due the VAT rate cut. With deflation in sight for the foreseeable future, the NBR is expected to maintain the current policy rate of 1.75 percent for the rest of 2015 and in early 2016. Continued recovery of domestic demand and growth in employment and real wages, aided by low inflation should boost real incomes and lead to further declines in poverty incidence. The US$5.00/day 2005PPP poverty rate is projected to decline to 26.3 percent in 2015 then further to 24.2 percent in 2016 and 22.1 percent in 2017. Similarly, the US$2.50/day 2005PPP poverty rate is likely to fall from 9.3 percent in 2014 to 8.4 percent in 2015 and to 6.7 percent by 2017.

Accelerating structural reform implementation will be important to sustain growth. Key reform areas include public expenditure management, tax administration, energy, transport, cadaster and property registration, and the public enterprise sector.

## *Challenges*

Risks to this outlook remain significant. Key risks include ad-hoc spending measures in the run-up to the 2016 election, global financial market volatility, the expected increase in the global interest rates and anemic Eurozone growth. They could be mitigated through prudent fiscal policies, an accelerated implementation of structural reforms and a better absorption of the EU funds. Romania's macro-fiscal fundamentals are sound, and export growth has remained solid even in the context of weak external demand, suggesting that Romania is in a good position to weather potential external shocks.

On the upside, improved credit conditions, enhanced investment sentiment and gradual strengthening of economic activity in the EU would boost growth prospects.

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

| | 2012 | 2013 | 2014 | 2015 f | 2016 f | 2017 f |
|---|---|---|---|---|---|---|
| **Real GDP growth, at constant market prices** | 0.4 | 3.5 | 2.8 | 3.6 | 3.9 | 4.1 |
| Private Consumption | 1.3 | 1.3 | 4.5 | 6.1 | 5.7 | 5.1 |
| Government Consumption | 3.3 | -1.2 | 13.7 | 2.9 | 3.4 | 3.5 |
| Gross Fixed Capital Investment | 11.3 | -3.3 | -3.5 | 9.7 | 10.1 | 9.8 |
| Exports, Goods and Services | -1.8 | 13.5 | 8.1 | 6.6 | 5.9 | 5.3 |
| Imports, Goods and Services | 1.4 | 2.4 | 7.7 | 9.8 | 8.6 | 7.3 |
| **Real GDP growth, at constant factor prices** | 0.3 | 3.5 | 2.5 | 3.3 | 3.8 | 3.9 |
| Agriculture | -22.4 | 26.6 | 1.5 | -4.0 | 5.3 | 3.3 |
| Industry | -0.9 | 8.0 | 3.6 | 2.9 | 2.9 | 3.3 |
| Services | 5.7 | -3.0 | 1.8 | 5.1 | 4.2 | 4.5 |
| **Prices** | | | | | | |
| Inflation (GDP price deflator) | 6.0 | 5.0 | 1.4 | 0.8 | 2.8 | 3.6 |
| Inflation (Consumer Price Index) | 3.3 | 4.0 | 1.1 | -0.3 | 1.3 | 2.6 |
| **Current Account Balance (% of GDP)** | -3.9 | -1.1 | -0.4 | -1.2 | -2.0 | -2.3 |
| **Fiscal Balance (% of GDP)** | -2.5 | -2.5 | -1.9 | -1.9 | -2.1 | -2.2 |
| **Poverty Rate** [a, b, c] | | | | | | |
| Poverty rate ($2.5/day 2005 PPP terms) | 11.1 | 10.1 | 9.3 | 8.4 | 7.6 | 6.7 |
| Poverty rate ($5/day 2005 PPP terms) | 32.6 | 30.2 | 28.4 | 26.3 | 24.2 | 22.1 |

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Note: f = forecast.
(a) Calculations based on 2006-EU-SILC Survey, 2012-EU-SILC Survey.
(b) Projection using point-to-point elasticity (2006-2012) with pass-through = 0.7 based on GDP per capita constant PPP.
(c) Actual data: 2012. Data for 2013-4 are estimates, data from 2015 through 2017 are projections.

# RUSSIAN FEDERATION

| | 2014 |
|---|---|
| Population, million | 146.1 |
| GDP, current US$ billion | 1860.6 |
| GDP per capita, current US$ | 12736 |
| Poverty rate ($2.5/day 2005 PPP terms) [a] | 0.8 |
| Poverty rate ($5/day 2005 PPP terms) [a] | 7.3 |
| Gini Coefficient [b] | 41.6 |
| Life Expectancy at birth, years [c] | 70.9 |

Sources: World Bank, WDI, and Macro Poverty Outlook.
Notes:
(a) Most recent value (2012).
(b) Gini data show most recent value (2012).
(c) Life Expectancy data show most recent value (2013).

*The Russian economy continues its difficult adjustment to the 2014 terms-of-trade shock amid a tense geopolitical context marked by ongoing international sanctions. In the first half of 2015 the economy shrank by 3.5 percent (y/y), as the contraction in domestic demand accelerated. Oil and gas prices continued to fall, leading to a depreciation of the ruble. The pass-through effect of this depreciation fueled inflation, eroding real wages and incomes. Poverty rates are increasing, and progress in promoting shared prosperity has stalled.*

## Recent developments

Russia's recession, which began in the fourth quarter of 2014, deepened significantly in the first half of 2015. In the first quarter of 2015 growth dropped from an anemic but positive 0.4 percent (y/y) to negative 2.2 percent, and in the second quarter the economy contracted at a rate of 4.6 percent. Domestic demand continues to decline, and a combination of lingering policy uncertainty, a weak domestic market and high capital costs prompted a sharp contraction in investment. Meanwhile, consumption dropped by 6.4 percent in the first quarter (y/y), its fastest rate since the 1998 crisis.

Consumer demand dropped as double-digit inflation eroded real wages and incomes, which fell by an average of 8.5 percent in the first half of 2015. However, the deterioration of real wages was also the primary mechanism through which the labor market adjusted to lower demand, and unemployment increased only slightly from 5.3 percent in 2014 to 5.6 percent in the first half of 2015.

In the first half of 2015 the ruble depreciated by 38.9 percent against the US dollar (y/y), in line with the decline in oil prices. Meanwhile, the Central Bank of Russia's (CBR) successful transition to a free-floating exchange rate allowed imports to adjust to a real effective exchange rate depreciation of more than 17 percent, doubling the current-account balance to 8 percent of GDP. Depreciation weakened domestic demand and contributed to a 25 percent (y/y) contraction in imports during the first quarter of 2015. Depreciation also boosted export performance in certain sectors such as chemical production and machine-building.

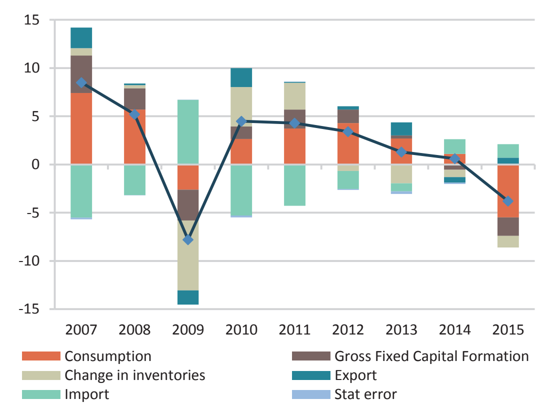
Nevertheless, the pass-through effect of the depreciation pushed inflation to levels not seen since 2002. 12-month consumer price index (CPI) inflation peaked at 16.9 percent in March 2015, largely driven by rising food prices. By February food prices had increased by 23.3 percent (y/y), after rising by 15.4 percent in 2014. Food-price inflation is hitting poor households particularly hard.

To support credit growth the CBR launched a cautious monetary-easing cycle in January, cutting policy rates by a cumulative 600 basis points to 11 percent before pausing the cycle in September as inflation remained elevated. Measures to support the financial sector successfully contained systemic risks.

In January the government also initiated a RUB2.4 trillion anti-crisis program, which appears to have contained systemic risks.

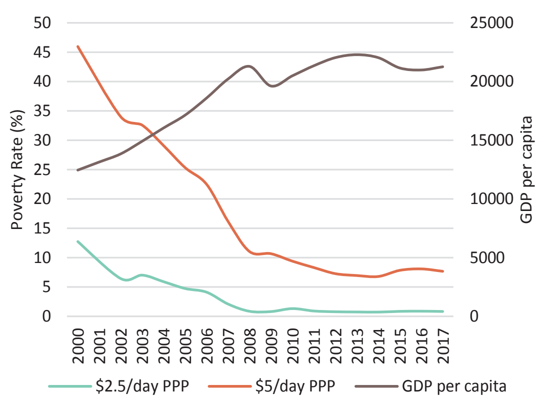
Low oil prices ushered in a difficult period of fiscal consolidation as downward pressure on federal revenue continued. Fiscal balances deteriorated in the first half of 2015 due to a shortfall in oil revenues and the frontloading of expenditures, diminishing Russia's fiscal buffers. By end-2015 real public spending is expected to fall by 5 percent (y/y) despite the temporary increase in the first half of the year. Falling oil revenues constrained the government's ability to counter the decline in real income, and increases in both pensions and social benefits were insufficient to offset inflation.

**FIGURE 1 Russian Federation** / GDP Growth by Sector (percent)




Sources: Russian Statistical Authorities and World Bank staff calculations.

**FIGURE 2 Russian Federation** / Actual and projected poverty rates and real GDP per capita, 2000-2017




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

The erosion of real income increased poverty and exacerbated the vulnerability of households in the lower 40 percent of the income distribution. The moderate poverty rate (US$7.90 in 2011 PPP) was estimated at 6.8 percent in 2014, while extreme poverty (US$3.85 in 2011 PPP) has remained below 1 percent since 2007. Progress in shared prosperity began to stall in 2014, when income growth among households in the lower 40 percent of the distribution fell below the overall average, and the growth of the middle class halted in 2014.

## Outlook

Adverse external conditions pose a serious challenge to Russia's growth prospects. The continued impact of the adjustment to lower oil prices in a context of ongoing international sanctions will cause the Russian economy to contract in 2015. Russia's medium-term growth trajectory will hinge on its ability to adapt to new economic realities. While the process of structural transformation will be difficult, it also presents a valuable opportunity to improve allocative efficiency and bolster long-term competitiveness.

Russia's economy is projected to contract by 3.8 percent in 2015 and 0.6 percent in 2016 before rebounding to a modest growth rate of 1.5 percent in 2017. The recession, and particularly the steep decline in households' purchasing power, is expected to lead to the first significant increase in the poverty rate since 1999, with moderate poverty rising to 7.8 percent in 2015 and 8.1 percent in 2016.

This outlook assumes that government and central bank policies will continue to support Russia's macroeconomic adjustment over the projection period, but policy uncertainty remains high.

## Challenges

Russia faces complex challenges as it strives to complete the structural transformation that began with its recent macroeconomic adjustment.

Despite recent stabilization measures financial-sector risks remain elevated, and further recapitalization of systemically vital banks could increase pressure on fiscal buffers. Fiscal sustainability risks are already rising, and the revenue uncertainty generated by slow growth and volatile oil prices is complicating medium-term budget planning.

Dependence on fiscal transfers will remain a source of vulnerability for households in the lower 40 percent of the income distribution, as inflation is likely to continue undermining the real value of these transfers. Broad-based employment growth will be critical to poverty reduction and the expansion of the middle class.

Despite the serious short-term challenges posed by Russia's economic transformation, the reallocation of productive factors could substantially enhance its medium-term growth potential. However, completing the adjustment process will require a supportive policy environment, and without deep structural reforms Russia could fall into a medium-term low-growth trap.

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

| | 2012 | 2013 | 2014 | 2015 f | 2016 f | 2017 f |
|---|---|---|---|---|---|---|
| **Real GDP growth, at constant market prices** | 3.4 | 1.3 | 0.6 | -3.8 | -0.6 | 1.5 |
| Private Consumption | 7.7 | 4.9 | 1.2 | -9.0 | -1.5 | 1.3 |
| Government Consumption | 2.6 | 1.1 | -0.1 | -2.9 | -2.0 | 0.0 |
| Gross Fixed Capital Investment | 6.7 | 0.9 | -2.0 | -8.8 | -1.0 | 5.3 |
| Exports, Goods and Services | 1.1 | 4.6 | -0.1 | 1.0 | 1.5 | 2.5 |
| Imports, Goods and Services | 8.7 | 3.8 | -7.9 | -22.0 | 1.5 | 6.0 |
| **Real GDP growth, at constant factor prices** | 3.6 | 1.7 | 0.9 | -3.9 | -0.6 | 1.7 |
| Agriculture | -3.4 | 4.2 | 1.3 | 3.0 | 1.0 | 1.0 |
| Industry | 2.3 | 0.4 | 0.6 | -2.0 | 1.5 | 2.0 |
| Services | 4.9 | 2.3 | 1.1 | -5.5 | -2.0 | 1.5 |
| **Prices** | | | | | | |
| Inflation (GDP price deflator) | 7.4 | 5.0 | 7.2 | 13.9 | 6.1 | 3.4 |
| Inflation (Consumer Price Index) | 5.1 | 6.8 | 7.8 | 15.5 | 7.5 | 5.0 |
| **Current Account Balance (% of GDP)** | 3.5 | 1.7 | 3.1 | 7.7 | 6.8 | 5.0 |
| **Fiscal Balance (% of GDP)** | 0.4 | -1.3 | -1.2 | -4.3 | -2.1 | -1.7 |
| **Poverty Rate** [a, b, c] | | | | | | |
| Poverty rate ($2.5/day 2005 PPP terms) | 0.8 | 0.7 | 0.7 | 0.8 | 0.9 | 0.8 |
| Poverty rate ($5/day 2005 PPP terms) | 7.3 | 6.9 | 6.8 | 7.8 | 8.1 | 7.7 |

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: f = forecast.
(a) Calculations based on ECAPOV harmonization, using 2011-HBS and 2012-HBS.
(b) Projection using annualized elasticity (2011-2012) with pass-through = 1 based on GDP per capita constant PPP.
(c) Actual data for 2012; 2013-14 are estimates; 2015-17 are projections.

# SERBIA

| | 2014 |
|---|---|
| Population, million | 7.1 |
| GDP, current US$ billion | 43.8 |
| GDP per capita, current US$ | 6181 |
| Poverty rate ($2.5/day 2005 PPP terms) [a] | 1.7 |
| Poverty rate ($5/day 2005 PPP terms) [a] | 14.5 |
| Gini Coefficient [b] | 29.7 |
| Life Expectancy at birth, years [c] | 74.8 |

Sources: World Bank, WDI, and Macro Poverty Outlook.
Notes:
(a) Most recent value (2010).
(b) Gini data show most recent WDI value (2010).
(c) Life Expectancy data show most recent WDI value (2013).

*Serbia's economy moved out of recession in Q2 2015, as activity recovered from the 2014 floods. Growth of 0.5 percent is projected for 2015, rising to around 2 percent for 2016 and 2017, supported by exports and domestic demand. Poverty, which reached an estimated 14.5 percent (living under $5/day PPP) in 2014, is expected to decline to 13.9 percent in 2016. High degree of vulnerability remains due to still weak labor markets and, if not mitigated, the impacts of fiscal consolidation measures.*

## Recent developments

Serbia's economy moved out of recession in Q2 2015, growing by 1 percent year-on-year (y/y). Activity is recovering following the 1.8 percent contraction in GDP in 2014, which was mainly due to the May 2014 floods. The weakness in consumption in the second quarter was less than expected, as private sector wages started to rise, partially offsetting cuts in public sector wages. Exports were also supportive, along with investment, although government capital spending was weak.

Labor market performance has also recently shown some improvement. The unemployment rate of 17.9 percent in Q2 2015, although up from 16.8 percent in Q4 2014 due to a smaller number of informal sector jobs, was down relative to 20.3 percent a year earlier. The activity rate also increased, moving up to 51.4 percent. With public sector wages frozen, overall real wages fell again over H1 2015, down 1.6 percent y/y following a contraction of 0.7 percent over 2014 as a whole.

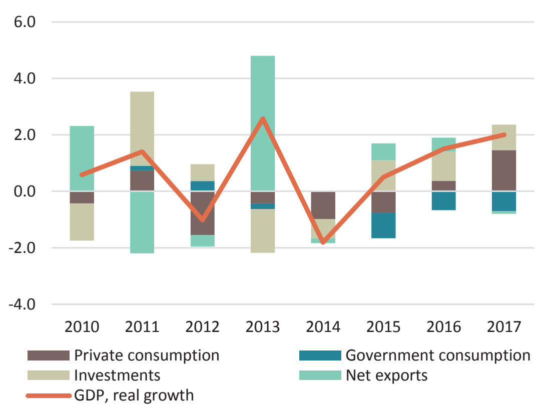
Poverty went up after the crisis and during the recessions of 2012 and 2014, mainly due to losses in employment and labor income. Using the standardized regional moderate poverty line of $5/day in 2005 PPP, the poverty rate peaked at 15.1 percent in 2010. After falling in 2011, poverty rose slightly again in 2012 and 2014 to an estimated 14.8 percent and 14.5 percent, respectively.

Recent spending freezes, cuts in public wage and pensions, and increases in electricity tariffs, as part of the government's needed fiscal consolidation program, may create adverse impacts on some households. While the immediate poverty impact may be limited since less than 10 percent of the working poor (living below 60 percent median income) work in the public sector, further public sector retrenchments may have negative impacts on future poverty. The poverty impact of the 2014 nominal cuts in pensions, which account for close to one quarter of income among households in the bottom two quintiles, is also eased because the cuts were progressive. However, the freezing of pension indexation will be felt across the board, unless partially compensated for, e.g., by continued employment.

General government fiscal performance was better than projected in the first half of 2015. Revenues were significantly higher due to one-off factors including the sale of 4G licenses and transfer of net income from SOEs. Expenditures were broadly under control, with wage and pension spending restrained. As a result, the revised 2015 fiscal deficit projection is 4.3 percent of GDP (versus 5.3 percent originally), with public debt-to-GDP set to reach 76 percent at end-2015 (up from 72.4 percent at end-2014 in part due to valuation effects from the dollar's appreciation over the year).

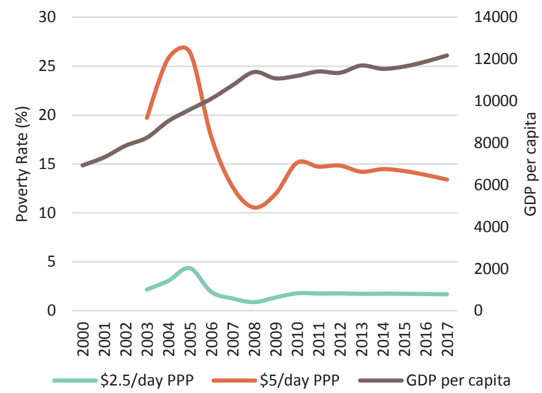
External sector performance has also improved with the strengthening Euro Area recovery. Merchandise exports grew by 8 percent y/y in H1 2015 in euro terms with service exports and remittances up by 15 percent and 13 percent respectively. As a result, the current account deficit (in euro terms) declined by 30 percent in the first

**FIGURE 1 Serbia** / Contribution to Growth 2007-2017




Sources: WB staff calculations based on Statistical Office data.

**FIGURE 2 Serbia** / Actual and projected poverty rates and real GDP per capita, 2000-2017




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

half. The dinar has remained broadly stable against the euro over the year to date, declining against a stronger US dollar. Spillovers from the Greek crisis to Serbia's banking sector have been limited to date with the authorities taking a proactive policy response, for example, in terms of enhanced monitoring of Greek bank subsidiaries and in communications to the public. Twelve-month consumer price inflation remained in the range of 2 percent over H1, below the target band of the National Bank of Serbia (NBS) of 4 ± 1.5 percent, although it slowed down to 1 percent (y/y) in July, primarily as a result of lower food price inflation. Core inflation peaked in March at 2.9 percent, falling thereafter. There is expected to be a more significant rise in inflation following August's electricity price increase, bringing inflation back into the target band by year-end.

## Outlook

Growth is expected to pick up in the second half of 2015, moving full-year growth up to 0.5 percent (compared to a previous projection of nil). Most of the growth will come from the recovery of industrial output, following the impact of the 2014 floods, and improved export performance. Construction and services are also expected to be supportive. However, agriculture value added is expected to fall by about 8 percent in 2015 compared to 2014 as a result of a recent drought. Declines in private and public consumption will be offset by a rise in investments and net exports (which will also support the narrowing in the current account deficit to 4.7 percent of GDP).
The fragile though positive macro-fiscal outlook is expected to slowly bring back poverty reduction, albeit with a continued high level of vulnerability. Poverty measured at the $5/day poverty line is expected to decline slowly to 14.3 percent in 2015 and 13.9 percent in 2016, with some improvements in labor demand and employment expansion. However, the expected decline in agriculture output for 2015 is likely to increase rural poverty. While food price increases have been modest, the recent rise in electricity tariffs approved in August 2015 is expected to increase energy stress, particularly on poor households, who have a relatively higher share of total expenditures on energy.

## Challenges

While recognizing the positive fiscal consolidation progress in 2015-to-date, there remains the need for sustained implementation of the government's fiscal consolidation program and related structural reforms. This is crucial in order to maintain macro stability and to create an environment conducive for higher growth and poverty reduction over the medium term.
The potential distributional impacts of comprehensive structural reforms, while supportive of future overall employment and income growth, are likely to pose challenges to poverty reduction in the short term, requiring mitigating measures. Moreover, despite recent improvements, labor force participation and employment ratios are still low while unemployment is high, especially for youth. Social protection and job opportunities to mitigate adverse impacts and facilitate access to productive employment need to be an important part of the policy agenda.

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

| | 2012 | 2013 | 2014 | 2015 f | 2016 f | 2017 f |
|---|---|---|---|---|---|---|
| **Real GDP growth, at constant market prices** | -1.0 | 2.6 | -1.8 | 0.5 | 1.5 | 2.0 |
| Private Consumption | -2.0 | -0.6 | -1.3 | -0.8 | 0.5 | 1.5 |
| Government Consumption | 2.0 | -1.1 | 0.1 | -3.0 | -1.8 | -3.1 |
| Gross Fixed Capital Investment | 13.2 | -12.0 | -2.7 | 5.6 | 4.8 | 7.4 |
| Exports, Goods and Services | 0.8 | 21.3 | 3.9 | 9.0 | 4.8 | 6.7 |
| Imports, Goods and Services | 1.4 | 5.0 | 3.3 | 5.9 | 3.0 | 5.6 |
| **Real GDP growth, at constant factor prices** | -0.8 | 3.3 | -2.0 | 0.1 | 1.5 | 1.8 |
| Agriculture | -17.3 | 20.9 | 0.8 | -8.0 | 9.0 | 1.8 |
| Industry | 2.4 | 4.2 | -7.1 | 6.7 | 4.0 | 2.5 |
| Services | 0.4 | 0.4 | 0.1 | -1.6 | -0.9 | 1.4 |
| **Prices** | | | | | | |
| Inflation (GDP price deflator) | 6.3 | 5.4 | 1.9 | 2.0 | 3.0 | 3.6 |
| Inflation (Consumer Price Index) | 7.8 | 7.8 | 2.9 | 1.3 | .. | .. |
| Inflation (Private Consumption Deflator) | 7.3 | 6.2 | 2.6 | 1.6 | 3.2 | 4.0 |
| Inflation (Consumer Price Index) | 7.3 | 7.7 | 2.1 | 1.6 | 3.4 | 4.0 |
| **Current Account Balance (% of GDP)** | -11.6 | -6.1 | -6.0 | -4.0 | -3.8 | -3.9 |
| **Fiscal Balance (% of GDP)** | -7.2 | -5.6 | -6.7 | -4.0 | -3.9 | -3.0 |
| **Poverty Rate** | | | | | | |
| Poverty rate ($2.5/day PPP terms) | 1.8 | 1.7 | 1.7 | 1.7 | 1.7 | 1.7 |
| Poverty rate ($5/day PPP terms) | 14.8 | 14.2 | 14.5 | 14.3 | 13.9 | 13.4 |

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: f = forecast. In annual percent change unless indicated otherwise.
Calculations based on 2006-HBS Survey, 2010-HBS survey, .
Projection using Point-to-point elasticity (2006-2010)
a) Calculations based on 2006-HBS Survey, 2010-HBS survey.
b) Projection using point-to-point elasticity (2006-2010) with pass-through = 1 based on GDP per capita constant PPP.
c) Data for 2012 through 2014 are estimates, data for 2015-2017 are projections.

# SLOVAK REPUBLIC

| | 2014 |
|---|---|
| Population, million | 5.5 |
| GDP, current US$ billion | 99.8 |
| GDP per capita, current US$ | 18258 |
| Gini Coefficient [a] | 26.6 |
| Life Expectancy at birth, years [b] | 76.1 |

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

*Economic activity accelerated with GDP growth reaching 3.2 percent in Q2-2015 supported by stronger domestic demand. Improvements in the labor market continued: employment expanded in almost all sectors, unemployment declined faster than in previous years, and wages increased in line with rising productivity and low inflation. The outlook is brightening with GDP expected to gradually pick up from 3.1 percent in 2015 to 3.5 percent by 2017 as the recovery of domestic demand takes hold.*

## Recent developments

GDP growth increased to 3.2 percent in Q2-2015 supported by stronger domestic demand. Investment expanded by 12 percent and was the key driver of growth as implementation of EU-funded projects intensified in the end of the current financing period. Private consumption continued to strengthen, boosted by growing incomes and employment, low inflation and easing of credit conditions. Exports expanded at a robust rate as a result of recovery in external demand but with faster expansion of imports the contribution of net exports to growth was negative. Manufacturing, construction, and trade, transport and tourism which generated most of the growth in Q2-2015.

Resurgence of economic activity supported continuing improvements in the labor market. Job creation intensified in all sectors but construction with manufacturing, professional services, and public administration contributing the most to employment growth. Unemployment fell faster than in previous years and reached 11.7 percent in July 2015, down from 13.1 percent a year earlier but remained high compared to the rest of the EU. Slovakia has relatively large youth and long-term unemployment. At he same time, Slovakia has a relatively low share of people living at risk of poverty or social exclusion—19.8 percent in 2013 compared to 24.5 percent in the EU and 30 percent in the EU New Members States.

Consumer price inflation declined by 0.3 percent in the first eight months of 2015 compared to a year ago driven by declining fuel, electricity, and food prices.

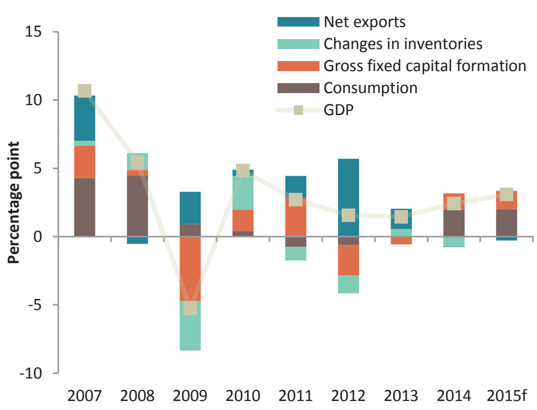
The external current account surplus narrowed to 0.1 percent of annual GDP in the first half of 2015 from 0.8 percent a year earlier as the trade surplus narrowed significantly. Trade dynamics was affected by strong external demand for vehicles and even stronger domestic demand for investment and intermediary goods (vehicles, machinery and electronic equipment, and basic metals).

The fiscal position is expected to improve in 2015, thanks mostly to revenue measures. Revenue has turned out better than expected, especially from valued added tax and corporate income tax. Financial corrections related to drawing of EU funds and spending of local governments represent bring uncertainty to the implementation of the budget.

The banking sector remains liquid, well capitalized and profitable and nearly 70 percent of the banking system is already subject to direct supervision from the ECB under the Single Supervisory Mechanism. The National Bank of Slovakia will continue to play an important role in banking supervision.

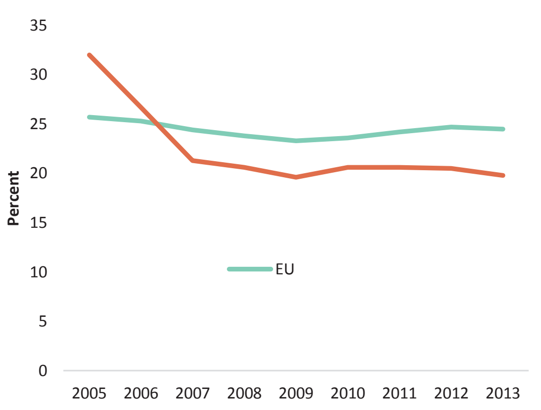
Lending to non-financial corporations remained sluggish despite low interest rates. At the same time, lending to households, especially consumer and housing lending, continued to expand. Growth of household deposits slowed in 2015 in line with increased household consumption.

**FIGURE 1 Slovak Republic** / Contributions to annual growth




Sources: Statistical Office of Slovak Republic, World Bank.

**FIGURE 2 Slovak Republic** / Percent of population at risk of poverty or social inclusion, %




Source: Eurostat.

## Outlook

The outlook for the Slovak economy is improving. GDP is projected to grow by 3.1 percent in 2015 and accelerate gradually to 3.5 percent by 2017. The growth momentum is likely to be supported by robust domestic demand. With employment and wage growth firming, inflation still low, and credit conditions improving, consumption is set to increase its importance for growth in the medium term. At the same time, government consumption growth is likely to be subdued, constrained by the increasing fiscal consolidation in 2016 and 2017. Investment growth is likely to start moderating in 2016, affected by slow disbursement of EU funds in the beginning of the new financing period. Stronger exports are expected to offset the reduced reliance on investment as an impetus for growth in the medium term.

With lower oil import prices and a stronger euro against the dollar, Slovakia is likely to have another year of deflation in 2015. As consumption strengthens further and the pressures from falling oil prices wane, consumer prices are likely to slowly increase from 1.2 percent in 2016 to 1.8 percent in 2017.

The external current account surplus is expected to reach 0.7 percent of GDP in 2015 and 1.3 percent in 2017. Improved exports prospects are based on expectations about continuing recovery in in the Eurozone and enhanced competitiveness of Slovak exporters.

Government deficit is expected to narrow from 2.6 percent of GDP in 2015 to 1 percent by 2017. Consolidation of fiscal accounts relies on better tax compliance but will also require substantial savings in spending. Spending by local governments would continue to create uncertainty while general elections in 2016 are likely to put an upward pressure on overall spending.

## Challenges

The outlook is subject to downside risks coming from the external environment. Risks are related mostly to the strength and sustainability of recovery in the EU as well as the fallout of economic slowdown in China.

Structural reforms associated with improvements in the business environment, upgrade of infrastructure and maintaining labor market flexibility could ensure Slovak economy is set on a higher growth path.

**TABLE Slovak Republic** / Macro poverty outlook indicators (annual percent change unless indicated otherwise)

| | 2012 | 2013 | 2014 | 2015 f | 2016 f | 2017 f |
|---|---|---|---|---|---|---|
| **Real GDP growth, at constant market prices** | 1.6 | 1.4 | 2.4 | 3.1 | 3.3 | 3.5 |
| Private Consumption | -0.4 | -0.7 | 2.2 | 2.3 | 2.8 | 3.0 |
| Government Consumption | -2.0 | 2.4 | 4.4 | 2.5 | 1.6 | 1.0 |
| Gross Fixed Capital Investment | -9.3 | -2.7 | 5.7 | 6.1 | 3.6 | 3.8 |
| Exports, Goods and Services | 9.3 | 5.2 | 4.6 | 4.6 | 5.9 | 6.3 |
| Imports, Goods and Services | 2.6 | 3.8 | 5.0 | 5.3 | 5.5 | 5.8 |
| **Real GDP growth, at constant factor prices** | 2.6 | 1.0 | 2.2 | 3.1 | 3.3 | 3.5 |
| Agriculture | 2.8 | 19.5 | -1.3 | 1.0 | 1.3 | 1.5 |
| Industry | 1.1 | -3.5 | 2.6 | 4.7 | 4.9 | 5.2 |
| Services | 3.4 | 2.6 | 2.2 | 2.4 | 2.6 | 2.7 |
| **Prices** | | | | | | |
| Inflation (GDP price deflator) | 1.3 | 0.5 | -0.2 | 0.5 | 1.9 | 1.9 |
| Inflation (Consumer Price Index) | 3.6 | 1.4 | -0.1 | -0.1 | 1.2 | 1.8 |
| **Current Account Balance (% of GDP)** | 0.9 | 1.5 | 0.1 | 0.7 | 1.3 | 1.4 |
| **Fiscal Balance (% of GDP)** | -4.2 | -2.6 | -2.9 | -2.6 | -1.9 | -1.0 |

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

# SLOVENIA

| | 2014 |
|---|---|
| Population, million | 2.1 |
| GDP, current US$ billion | 49.7 |
| GDP per capita, current US$ | 24205 |
| Gini Coefficient [a] | 24.4 |
| Life Expectancy at birth, years [b] | 80.3 |

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

*Slovenia's economy continued to grow robustly in the first half of 2015 driven by exports and inventory accumulation. The unemployment rate declined to 9.5 percent in the first half of 2015 on the back of employment growth. The fiscal deficit is likely to decline to below 3 percent of GDP in 2015 supported by EU funds and legislated fiscal rule to reach the balanced budget by 2020. The main risks to the outlook come from potential delays in undertaking further fiscal consolidation and growth-enhancing structural reforms amid opposition to public sector reform and privatization.*

## Recent developments

After the economy grew by 3 percent in 2014, robust growth continued in the first half of 2015 on the back of external demand, inventory accumulation and strengthened private consumption. The strongest contribution to growth came from exports (growing annually at 5.8 percent), especially of motor vehicles. Tourism also contributed to growth, while construction decreased by 3.8 percent as the 2007-13 EU funding period comes to an end. Employment continued rising in the first six months of 2015 (about one percent on average in 2014-2015), while unemployment sharply decreased, pushing the survey-based unemployment rate down to 9.5 percent in the first half of 2015, about 0.6 percentage point lower than in the same period last year. Both employment and the activity rates (for ages 15+) grew to 51.8 and 57.3 percent, respectively. Gross wages rose in the first half of 2015, mainly due to the public sector, although public sector employment declined as part of the consolidation program. Youth unemployment declined to 19 percent, while long-term unemployment remains stubbornly high at above 56 percent. In 2013, 14.5 percent of the population was considered to be living at risk of relative poverty with increasing inequality. However, for 2014, poverty was estimated to decline as real per capita income rose and deflationary trends continued throughout 2015 (prices decreased by 0.5 percent by July). Fiscal consolidation continued in 2015. After reducing the general government deficit to 4.9 percent of GDP in 2014 (ESA2010 methodology), the deficit declined further in the first quarter of 2015 to 4.7 percent of GDP, on track to reach the budgeted 2.9 percent by the end of the year. This was achieved mainly through better revenue collection, while keeping control over expenditure growth (at 1.2 percent driven by a double-digit rise in interest payments). Public debt amounted to 81.9 percent of GDP in March 2015 raising refinancing risks.

Standard and Poor's raised the outlook for Slovenia's 'A-' rating from negative to stable, citing improved growth prospects and reduced policy uncertainty. For any future rating upgrades, focus will need to remain on sustained fiscal consolidation, health care, labor and administration reforms, banking system resolution and the ongoing privatization process.

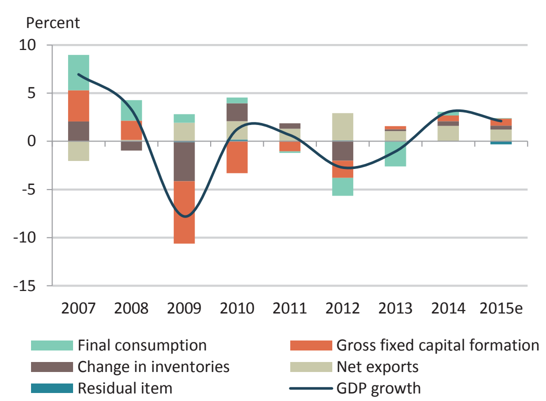
While corporate deleveraging continued in 2015, loans to households increased, supporting the recovery in personal consumption. The quality of banks' assets improved, with non-performing loans amounting to 11.6 percent of the banking system's total exposure in April 2015.

After reaching 7 percent of GDP in 2014, the current account surplus slightly widened in the first half of 2015 due to export growth and reduced investment income outflows. Net FDI stood at around 1 percent of GDP on a rolling basis.

## Outlook

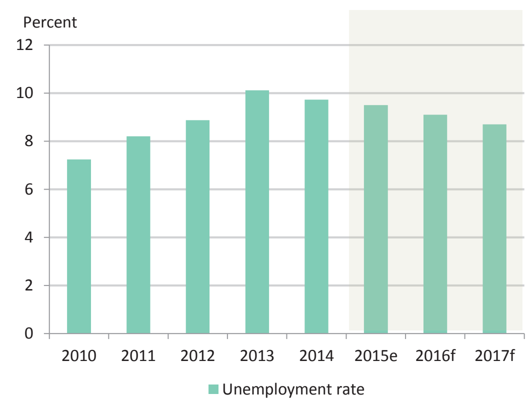
Economic growth is expected to moderate in 2015-17 to 2 percent. Growth will be broad-based with exports, investment and

**FIGURE 1 Slovenia** / Contributions to annual GDP growth, percentage points




Sources: SORS, World Bank.

**FIGURE 2 Slovenia** / Unemployment rate, percent




Sources: SORS, World Bank.

consumption as the main drivers. Recovery in most of Slovenia's main trading partners is expected to support exports, additionally underpinned by gains in competitiveness. Private investment is assessed to rise in that period, supported by reinvigorated privatization, while after the initial slump in 2016, public investment would be benefitting from the new 2014-20 EU financial perspective. Private consumption is also expected to strengthen on the back of labor market improvement and credit recovery, while government consumption will contract as the new fiscal rule kicks in. Slovenia needs to ensure a durable correction of the excessive deficit in 2015, and achieve fiscal adjustment of 0.6 percent of GDP towards the medium-term objective in 2016. By end-2015, the government must present pension, health system and labor market reforms, start cutting the number of state agencies, and revamp the tax system (lower taxation of labor and increase real estate taxes) to ensure that consolidation is sustainable.

Annual inflation is projected to remain negative in 2015 due to the decline in global commodity prices, trending upwards in the following years as domestic demand strengthens. Unemployment is expected to fall below 9 percent in 2017, which along with growth in per capita income, is likely to lead to a further decline in poverty.

Some improvement in measures of shared prosperity are expected despite the fiscal constraints and measures to revamp the pension system, on the back of labor market improvements. The government needs to keep spending under control given that Slovenia is scheduled to start the gradual implementation of the balanced budget rule. Public debt stabilization will to a large extent rest on structural reforms tackling pressures from population aging, ongoing commitment to privatization as well as a credible mechanism to reach the medium-term fiscal objective.

The Parliament in July 2015 endorsed the law on fiscal rule, to be overseen by the Fiscal Council as an independent body, with the 2016 effectiveness. The act envisages gradual achievement of the balanced structural budget by 2020. While implementing the debt brake after that period, the rule allows for exceptions (protecting social transfers, pensions and state institutions) in cases of extraordinary circumstances and recessions. The Parliament also enacted the asset management strategy, a blueprint for privatization that reduced the list of strategic companies and offers for a full privatization 46 companies, while in 21 it aims to retain only the controlling stake.

## *Challenges*

The outlook is subject to downside risks around the sovereign debt crisis in the Eurozone and the still vulnerable and volatile international environment.

While Slovenia enjoys relatively low interest rates, the annual external financing needs over the medium term area stand at close to 12 percent of GDP. At the same time, domestically, inconsistency between the needed fiscal consolidation and public sector awareness creates delays in reform program implementation. There are diverging opinions on the role of key state-owned enterprise, including on their privatization. Public sector unions rejected government proposal on the wage policy, which aims to extend a ban on hiring and promotions until the end of 2016. Further bank and firms restructuring, with overall ambitious NPL reduction targets, are equally important to reduce the likelihood of a renewed financial stress and the medium-term risk of fiscal support.

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

| | 2012 | 2013 | 2014 | 2015 f | 2016 f | 2017 f |
|---|---|---|---|---|---|---|
| **Real GDP growth, at constant market prices** | -2.7 | -1.1 | 3.0 | 2.1 | 1.8 | 1.9 |
| Private Consumption | -2.5 | -4.1 | 0.7 | 0.6 | 1.2 | 1.5 |
| Government Consumption | -2.3 | -1.5 | -0.1 | -1.5 | 0.1 | 0.2 |
| Gross Fixed Capital Investment | -8.8 | 1.7 | 3.2 | 3.7 | 0.3 | 2.1 |
| Exports, Goods and Services | 0.6 | 3.1 | 5.8 | 5.0 | 5.1 | 4.6 |
| Imports, Goods and Services | -3.7 | 1.7 | 4.0 | 3.8 | 4.0 | 4.2 |
| **Real GDP growth, at constant factor prices** | -2.4 | -0.7 | 3.8 | 2.1 | 1.8 | 1.9 |
| Agriculture | -8.2 | -4.3 | 10.0 | 2.4 | 2.6 | 1.6 |
| Industry | -3.6 | -1.7 | 5.5 | 3.1 | 2.5 | 2.2 |
| Services | -1.6 | -0.2 | 2.9 | 1.7 | 1.5 | 1.8 |
| **Prices** | | | | | | |
| Inflation (GDP price deflator) | 0.3 | 0.8 | 0.8 | -0.1 | 1.5 | 1.0 |
| Inflation (Consumer Price Index) | 2.6 | 1.8 | 0.2 | -0.2 | 1.0 | 1.3 |
| **Current Account Balance (% of GDP)** | 2.6 | 5.6 | 7.0 | 6.9 | 6.8 | 6.5 |
| **Fiscal Balance (% of GDP)** | -4.0 | -14.9 | -4.9 | -2.9 | -2.8 | -2.7 |

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: f = forecast. In annual percent change unless indicated otherwise.

# TAJIKISTAN

| | 2014 |
|---|---|
| Population, million | 8.4 |
| GDP, current US$ billion | 9.2 |
| GDP per capita, current US$ | 1100 |
| Poverty rate (Somoni 158.71/month) [a] | 32.0 |
| Gini Coefficient [b] | 29.0 |
| Life Expectancy at birth, years [c] | 67.4 |

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

*Tajikistan's GDP growth rate is expected to decline from 6.7 percent in 2014 to 4.2 percent in 2015 due to negative spillover effects from the Russian recession and low prices for Tajikistan's key export commodities. Strong economic growth helped cut the poverty rate from 37.4 percent in 2012 to 32 percent in 2014, but sustaining these gains and achieving further progress will become increasingly difficult as the external environment worsens.*

## Recent developments

Economic growth slowed during the first half of 2015 as global prices for Tajikistan's key exports—cotton and aluminum—steadily declined. The worsening external environment was exacerbated by the contraction of the Russian economy, which is both Tajikistan's main source of remittance inflows and important export market. During the first half of 2015 the US dollar value of remittances fell by 32 percent, year-on-year, curbing domestic demand and suppressing growth in the service sector. Remittances are Tajikistan's second-largest source of household income across all consumption deciles. High-frequency survey data suggest that from early May through mid-July 2015 the real average value of remittances dropped by 22 percent among households in the bottom 40 percent of the consumption distribution.

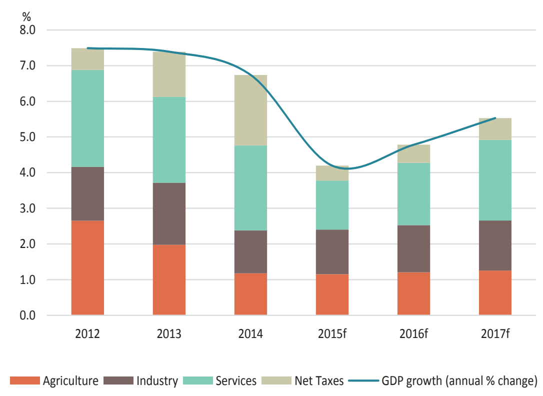
The Tajik somoni has depreciated by 18 percent against the US dollar since January 2015. The pass-through effect of the depreciation pushed the inflation rate from 5.3 percent to 6.3 percent, year-on-year (y/y), during the first half of 2015.

Concerned about rising inflation rates and their potential impact on social stability the central bank has defended the somoni through a combination of interventions and administrative controls, including imposing ceilings on exchange rates set by foreign-exchange offices. This policy has depleted the country's already low foreign reserves, which stood at about one month of imports in early July. Meanwhile, pressures on the somoni have continued to mount. The available information suggests that the trade deficit narrowed in the first half of 2015 as an 8 percent decline in merchandise exports (y/y) was more than offset by a 25 percent drop in merchandise imports (y/y). Nevertheless, a steep decline in remittance inflows likely widened the current-account deficit in the first half of 2015.

Public revenue fell in the first half of 2015 as the contraction in imports reduced customs and VAT revenue. However, a substantial increase in direct tax and non-tax revenue mitigated the effect on the fiscal balance, which showed a surplus of 1 percent of GDP in the first half of 2015. The government cut expenditures while protecting social programs, which continue to account for about half of total spending. The external public debt stock fell below 20 percent of GDP at end-June 2015, yet Tajikistan's fiscal stance and debt profile remain vulnerable to significant risks stemming from the quasi-fiscal activities of state-owned enterprises and weaknesses in the banking sector.

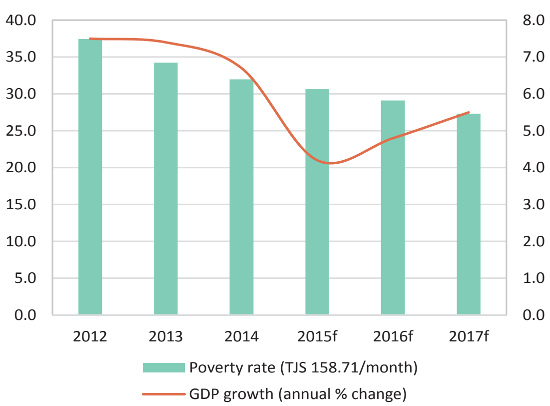
The national poverty rate fell from 37.4 percent in 2012 to 31.6 percent in the first quarter of 2015, but the pace of poverty reduction has slowed. Between May and July 2015 average real income per capita dropped by 23 percent for households in the bottom 40 percent of the consumption distribution. This was primarily due to lower remittance income, and a drop in the value of remittances was only partially offset by a seasonal increase in the number of transfers, as well as a rise in agricultural income during the summer

**FIGURE 1 Tajikistan** / GDP growth and contribution to GDP growth by sector, 2012-2017




Sources: TajStat, World Bank staff calculations.

**FIGURE 2 Tajikistan** / Actual and projected poverty rates and GDP per capita, 2012-2017




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

months. The decline in poverty in recent years has been driven by real wage growth, particularly in the public sector, combined with an increase in pension payments and strong remittance inflows. However, limited employment creation outside the public sector, falling remittances and rising prices are now slowing the rate of poverty reduction. With GDP per capita of less than US$1,100 in 2014 Tajikistan remains the poorest country in the Europe and Central Asia region.

## Outlook

The recession in Russia, combined with slowing growth among Tajikistan's other major trading partners, including Turkey, Kazakhstan and China, will negatively impact its short-term outlook. However, after decelerating to 4.2 percent in 2015, GDP growth is projected to recover gradually in the medium term, though it is expected to remain below recent averages. The current-account deficit is projected to improve moderately, narrowing from about 8 percent of GDP in 2014 to 6.3 percent in 2015 and remaining at around 6 percent thereafter. The depreciation of the somoni will continue to put upward pressure on the inflation rate, though low international food and fuel prices may hold inflation to single digits in 2015. The fiscal accounts (excluding externally financed public investment program) are expected to remain roughly balanced over the near term. However, external-account volatility, dwindling foreign-exchange reserves, contingent liabilities generated by state-owned enterprises and systemic vulnerabilities in the banking sector all pose significant risks to the macroeconomic outlook.

Slowing GDP growth is expected to limit progress in poverty reduction, but the poverty rate is still projected to fall to 30.7 percent in 2015 and reach 27.3 percent by 2017. Meanwhile, lower remittances, a weaker labor market, and diminished real wage growth is expected to slow the growth of household purchasing power. The poor will likely be negatively affected by both the decline in remittances and higher inflation rates, though low international food and fuel prices will help contain consumer price inflation.

A lack of well-targeted social programs leaves households vulnerable to economic shocks. However, the planned expansion of the Targeted Social Assistance Program is expected to mitigate the effects of a worsening external environment on poor households.

## Challenges

As external and domestic pressures continue to mount the authorities are confronted with the need to strengthen macroeconomic management, reinforce resilience against external shocks, and implement reforms to boost productivity and competitiveness. The government has already approved an action plan for 2015-16 designed to address the deteriorating external environment. Policymakers are also formulating new medium- and long-term development strategies that better reflect the country's changing macroeconomic circumstances. High on the agenda are rebuilding foreign-exchange reserves, addressing financial sector vulnerabilities, and improving the governance of state-owned enterprises to minimize fiscal risks and enhance service delivery. Further efforts to facilitate private sector development by improving the business climate and advancing the structural reform agenda would help Tajikistan sustain economic growth, job creation and poverty reduction despite an adverse external environment.

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

| | 2012 | 2013 | 2014 | 2015 f | 2016 f | 2017 f |
|---|---|---|---|---|---|---|
| **Real GDP growth, at constant market prices** | 7.5 | 7.4 | 6.7 | 4.2 | 4.8 | 5.5 |
| Private Consumption | 8.2 | 9.1 | 4.1 | -1.2 | 2.5 | 3.3 |
| Government Consumption | 1.1 | 1.1 | 1.1 | 1.0 | 1.0 | 1.0 |
| Gross Fixed Capital Investment | 5.3 | 5.1 | 6.4 | 7.7 | 12.0 | 6.5 |
| Exports, Goods and Services | 5.9 | 5.5 | 5.5 | 3.5 | 4.5 | 7.3 |
| Imports, Goods and Services | 6.2 | 5.9 | 5.9 | 1.5 | 5.0 | 6.5 |
| **Real GDP growth, at constant factor prices** | 7.5 | 6.7 | 5.2 | 4.2 | 4.8 | 5.5 |
| Agriculture | 10.4 | 7.6 | 4.5 | 4.5 | 4.7 | 4.9 |
| Industry | 7.7 | 8.8 | 6.0 | 6.3 | 6.5 | 6.8 |
| Services | 5.8 | 5.3 | 5.3 | 3.1 | 4.0 | 5.2 |
| **Prices** | | | | | | |
| Inflation (GDP price deflator) | 12.0 | 4.9 | 6.7 | 11.7 | 8.5 | 5.1 |
| Inflation (Consumer Price Index) | 5.7 | 5.0 | 6.2 | 8.5 | 7.5 | 7.0 |
| **Current Account Balance (% of GDP)** | -2.6 | -2.8 | -7.9 | -6.3 | -6.0 | -5.9 |
| **Fiscal Balance (% of GDP)** | 0.6 | -1.0 | -0.5 | -1.4 | -1.9 | -1.8 |
| **Poverty Rate** [a, b, c] | | | | | | |
| Poverty rate (Somoni 158.71/month) | 37.4 | 34.3 | 32.0 | 30.7 | 29.1 | 27.3 |

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: f = forecast.
(a) Calculations based on 2014 HBS.
(b) Projection using neutral distribution method (2014) with pass-through = 0.7 based on GDP per capita constant PPP.
(c) Actual data: 2012, 2013, 2014. Projections are from 2015 to 2017.

# TURKEY

| | 2014 |
|---|---|
| Population, million | 76.2 |
| GDP, current US$ billion | 800.0 |
| GDP per capita, current US$ | 10501 |
| Poverty rate($2.5/day 2005PPP terms) [a] | 4.5 |
| Poverty rate($5/day 2005PPP terms) [a] | 20.7 |
| Gini Coefficient [b] | 40.0 |
| Life Expectancy at birth, years [c] | 74.9 |

Sources: World Bank, WDI, and Macro Poverty Outlook.
Notes:
(a) Most recent value (2012).
(b) Gini data show most recent WDI value (2011).
(c) Life Expectancy data show most recent WDI value (2013).

*Economic growth surprised positively with 3.4 percent year-on-year in the first half of 2015, up from 2.9 percent in 2014, despite political uncertainty in the run-up to the June parliamentary election. The election resulted in a hung parliament. With another election scheduled for November 1, 2015, uncertainties continue, while escalating tensions in Turkey's South East and a weak international environment weigh on growth and poverty. Medium-term prospects depend on the resolution of political uncertainty and the restoration of investor confidence.*

## Recent developments

Surprisingly, Turkish GDP growth reached 3.4 percent year-on-year in the first half of 2015 compared with 2.9 percent in 2014, despite political uncertainty in the run-up to the June election. Private consumption lost momentum, partly compensated by higher public spending. Net exports, which contributed positively to GDP in the first quarter because of gold exports and a slump in imports, became a drag on growth with weak export demand. However, private investment surged by 7.8 percent q-o-q in the second quarter, which indicates that the private sector front-loaded investment spending before the June elections, anticipating elimination of political uncertainties after the election.

The hoped-for external adjustment fueled by a weaker lira and significantly lower oil prices has not materialized because of disappointing global demand. Turkey`s 12-month rolling gold-adjusted current account deficit widened to $45 billion (5.8 percent of GDP) in July 2015.

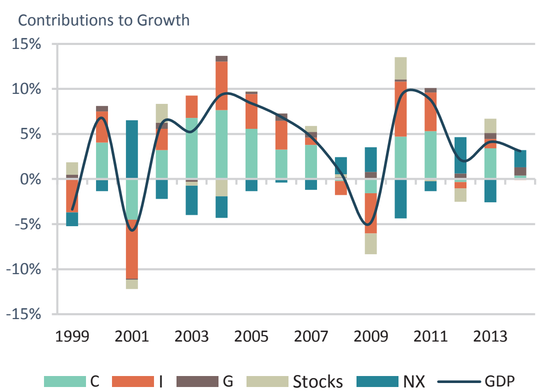
Domestic political concerns and global financial market jitters reduced financial inflows in the first seven months of 2015. A drawdown of foreign exchange reserves by $2.5 billion financed some of the current account deficit, with the unrecorded transactions amounting to a positive $9.1 billion in this period. The Turkish lira depreciated by 31 percent against the US dollar and 23 percent against the euro between January and mid-September 2015.

The rapid rise in food prices elevated inflation in the first four months of 2015. Food prices dropped with the new harvest after April, easing the pressure on inflation. However, recently, food prices started to rise again and the lira continued to depreciate, pushing 12-month inflation up to 7.1 percent by August.

Record-high job creation supported poverty reduction in recent years despite a slow-down in growth. However, job creation slowed in the first half of 2015, and unemployment rate inched up to 10.5 percent in June 2015, which is above the pre-crisis level. Unemployment is also becoming more long-term with about one third of job seekers looking for a job for more than six months. Moreover, labor force participation rate remains low at 51.4 percent as of June 2015. Among the employed, informal employment remains high, and the pace at which it was declining slowed considerably, especially among male workers. These factors constrain poverty reduction and shared prosperity in Turkey. Also, the elevated food inflation has affected low-income groups disproportionately, because food composes a higher fraction of their consumption basket.

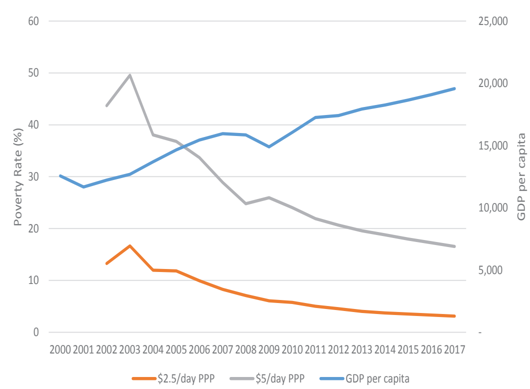
The contribution of sectoral shifts in employment from agriculture to the other sectors, which was a significant factor in poverty reduction in the pre-crisis period, weakened recently. In particular, the share of non-agricultural employment increased by only 0.5 percent y-o-y in the second quarter of this year as a result of recent slowdown in job creation. The regional disparities on the other hand continued to diminish, narrowing down the gap be-

**FIGURE 1 Turkey** / Contributions to annual GDP growth




Source: TurkStat.

**FIGURE 2 Turkey** / Actual and projected poverty rates and real GDP per capita, 2000-2017




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

tween the highest and lowest employment rates among regions to 15 percent in the end of last year which was 29 percent in the pre-crisis period. Reflecting all these factors, 18.8 percent and 3.7 percent of population fell below $5 and $2.5 a day PPP poverty lines in Turkey in 2014, respectively.

## Outlook

The Justice and Development Party (AKP) won 41 percent of the votes and the most seats (258 of 550) in parliament in the election held on June 7, 2015. However it fell short of the absolute majority it had held since 2002. Coalition discussions ended without success at the end of the 45-day deadline given in the constitution, paving the way for a snap election on November 1. Opinion polls show that the new election will probably result in a small gain in votes for AKP, but that it would still fall short of the majority needed to form a single-party government. Deep divisions between the political parties would then still make the formation of a government a difficult task.

Economic activity is expected to slow sharply in the second half of 2015 against the backdrop of continued political uncertainty. The renewed currency depreciation and stubbornly high inflation are likely to decrease the purchasing power of households and worsen their financial situation. Hence, we expect private consumption to slow significantly in the remainder of the year. In addition, continuing political uncertainty and escalating tensions in Turkey's South East make it difficult for the private sector to sustain the investment spending witnessed in the second quarter. Businesses are likely to cut investment spending from the second quarter and postpone investment decisions until a new stable political equilibrium is reached. On the external side, although the nascent recovery in the EU is expected to support exports, the economic difficulties in MENA and Russia are likely to restrain export growth in 2015. External adjustment should continue, as lower oil prices will likely reduce the current account deficit by another $5 billion in the remainder of the year.

We see GDP growth reaching 3.2 percent in 2015, with the current account deficit stabilizing at 5.5 percent of GDP and inflation reaching 7.5 percent. The outlook for 2016 depends on the resolution of the political uncertainty in Turkey after the November 1 parliamentary elections. Weaknesses in the labor market are likely to continue in the medium-term, which imply relatively flat patterns for our poverty projections in the medium-term. The $5 and $2.5 a day PPP poverty rates are expected to decline gradually to 17.3 percent and 3.3 percent by 2016, respectively.

## Challenges

Restoring investor confidence is key to growth over the short to medium term. Private investment has been weak for the last three years. Investor sentiment heavily depends on how the political process resolves. Structural reforms were on the political back-burner throughout the recent electoral cycle, although the authorities had been preparing to re-launch structural reforms after the elections. Escalating tensions in the poorest region of Turkey and uncertainty around migration influx from neighboring countries might pose a challenge going forward in terms of poverty reduction. There is an urgent need for a stable, inclusive government and the return to implementation of the structural reform agenda to restore investor confidence.

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

| | 2012 | 2013 | 2014 | 2015 f | 2016 f | 2017 f |
|---|---|---|---|---|---|---|
| **Real GDP growth, at constant market prices** | 2.1 | 4.2 | 2.9 | 3.2 | 3.5 | 3.5 |
| Private Consumption | -0.5 | 5.1 | 1.4 | 3.9 | 4.2 | 4.4 |
| Government Consumption | 6.1 | 6.5 | 4.7 | 7.9 | 2.4 | 2.3 |
| Gross Fixed Capital Investment | -2.7 | 4.4 | -1.3 | 2.8 | 2.5 | 2.5 |
| Exports, Goods and Services | 16.3 | -0.2 | 6.8 | 0.3 | 2.4 | 2.5 |
| Imports, Goods and Services | -0.4 | 9.0 | -0.2 | 3.4 | 3.0 | 3.3 |
| **Real GDP growth, at constant factor prices** | 2.2 | 4.1 | 2.9 | 3.2 | 3.5 | 3.5 |
| Agriculture | 3.1 | 3.5 | -1.1 | 2.0 | 2.0 | 2.0 |
| Industry | 1.6 | 4.0 | 1.5 | 1.6 | 1.6 | 1.6 |
| Services | 2.4 | 4.3 | 4.5 | 4.4 | 4.9 | 4.8 |
| **Prices** | | | | | | |
| Inflation (GDP price deflator) | 6.9 | 6.2 | 8.5 | 10.6 | 9.2 | 8.7 |
| Inflation (Consumer Price Index) | 8.9 | 7.5 | 8.9 | 7.5 | 6.8 | 6.5 |
| **Current Account Balance (% of GDP)** | -6.2 | -7.9 | -5.8 | -5.5 | -5.7 | -5.8 |
| **Fiscal Balance (% of GDP)** | -1.4 | -1.6 | -2.0 | -2.4 | -1.9 | -1.6 |
| **Poverty Rate** [a, b, c] | | | | | | |
| Poverty rate ($2.5/day 2005 PPP terms) | 4.5 | 4.0 | 3.7 | 3.5 | 3.3 | 3.1 |
| Poverty rate ($5/day 2005 PPP terms) | 20.7 | 19.6 | 18.8 | 18.0 | 17.2 | 16.5 |

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: f = forecast.
(a) Calculations based on ECAPOV harmonization, using 2012-HICE.
(b) Projection using neutral distribution (2012) with pass-through = 1 based on GDP per capita constant PPP.
(c) Actual data: 2012. Data for 2013-4 are estimates, data from 2015 through 2017 are projections.

# UKRAINE

| | 2014 |
|---|---|
| Population, million | 45.2 |
| GDP, current US$ billion | 131.8 |
| GDP per capita, current US$ | 2916 |
| Poverty rate ($2.5/day 2005 PPP terms) [a] | 0.1 |
| Poverty rate ($5/day 2005 PPP terms) [a] | 3.2 |
| Gini Coefficient [b] | 24.6 |
| Life Expectancy at birth, years [c] | 70.9 |

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

*An unfavorable global economic environment and the conflict in the east led to a larger than earlier projected decline in real GDP in the first half of 2015 with increasing poverty and unemployment. Despite a few encouraging signs of stabilization, Ukraine's economic prospects are a subject to high risks. We project GDP to decline by 12 percent in 2015 and to recover only gradually starting from 2016. The large decline in output in 2015 is likely to lead to a poverty increase by 5.2 percentage points, equivalent to 2.3 million people in 2015.*

## Recent developments

Real GDP dropped about 16 percent y/y in the first half of 2015, and the decline is broad based across all sectors. Industrial activity contracted 20.5 percent y/y, led by sharp declines in eastern regions. Currency depreciation and a one-off utility-tariff adjustment accelerated inflation, which peaked at 60.9 percent y/y in April and declined to 52.8 percent y/y in August. Meanwhile, fiscal consolidation stabilized the general government headline deficit outperforming the IMF program target. After a sharp depreciation in early 2015 followed by administrative restrictions on imports, the current account is nearly balanced since April. Net capital outflows persisted, driven mainly by external debt payments in excess of official financing flows. This helped to rebuild international reserves that cover 3 months of imports as of beginning of September.

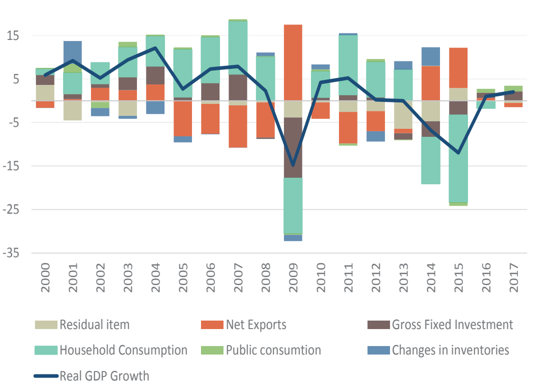
Against the backdrop of negative growth and high inflation, real wages and pensions have declined, thus reversing gains made earlier in income levels, particularly among the less-well off. This decline was only partially offset by social-assistance reforms aimed at better targeting existing benefits, while deteriorating labor-market conditions aggravated these trends. In Q1 the unemployment rate increased to 9.6 percent (from 9.0 percent a year earlier) and real wages declined by 21 percent. This decline is uneven across sectors, with the lowest nominal-wage growth in the public sector, particularly in health, education, public administration, and defense (which employ approximately 28 percent of those employed among the bottom 40 percent in the income distribution). All these factors combined led to an increase in the moderate poverty rate from 3.2 percent in 2013 to 5 percent in 2014.

## Outlook

Despite early signs of stabilization, economic prospects for Ukraine depend on how the conflict in the east unfolds and whether the authorities are able to sustain reforms. Real GDP is projected to contract by 12 percent in 2015, with sharp declines in metals and mining due to the conflict and weakening external demand. Currency depreciation would support net exports and a gas tariff increase coupled with improved spending efficiency should create fiscal space to unlock government investment going forward. In addition, continued resolution of problems in the banking system could permit gradual resumption of lending. These factors, along with a low statistical base, are expected to set the stage for a modest economic recovery, with real GDP growing 1 percent in 2016 and 2 percent in 2017.

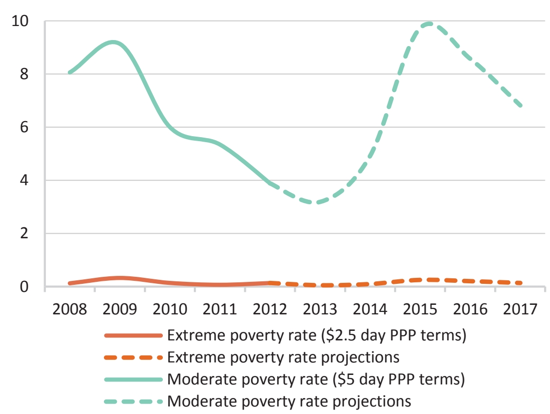
The general government deficit is projected to decline from 4.2 percent of GDP in 2015 to 3.1 percent of GDP in 2017. The gas tariff increase is expected to help reduce the below-the-line financing requirements stemming from the Naftogaz deficit by 2016. Macroeconomic adjustment should help to keep current-account defi-

**FIGURE 1** **Ukraine** / Contributions to GDP growth, percent




Sources: Ukraine State Statistic Service, World Bank.

**FIGURE 2** **Ukraine** / Actual and projected poverty rates, 2008-2017




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

cit relatively low. Financial pressures associated with net capital outflows would also ease, in view of the restructuring of sovereign and quasi-sovereign debt, the ongoing restructuring of foreign liabilities by private-sector companies, and an increase in FDI related to bank recapitalization. If expectations concerning modest economic recovery, gradual currency stabilization, and sustained fiscal discipline are fulfilled, the public and publicly-guaranteed debt would decline to 82 percent of GDP by 2017.

The moderate poverty rate is expected to double to 10.2 percent in 2015. And even if the modest recovery materializes in 2016 and 2017, it would remain above its 2014 levels. Poverty trends are likely to be most influenced by the ongoing fiscal adjustment and the conflict in the east. The fiscal adjustment would continue affecting negatively wage and employment dynamics, especially in the public sector, and contributes directly to social vulnerability, as the subsistence minimum to which the minimum wage, transfers, and pensions are anchored has been frozen for two years. Pension cuts and further tariff increases, together with high inflation, are likely to erode the purchasing power of households throughout the whole distribution, but particularly among the poor and the bottom 40 percent. Besides, the conflict will continue affecting employment. Despite some modest signs of industrial production restarted in June 2015, the situation remains volatile. In addition, internally displaced people remain the most vulnerable groups and those most dependent on public transfers, while their host communities struggle to absorb them, create jobs, and provide services.

## *Challenges*

The outlook is subject to serious downside risks: i) escalation of the conflict that may further jeopardize investor and consumer confidence and destroy industrial potential, ii) global commodity prices decline that negatively impacts Ukraine's terms of trade, iii) slowdown in reforms that may increase structural imbalances again and delay the official financial assistance. The government's capacity to mitigate the severe impacts of the ongoing recession on the poor is likely to be limited in a fiscally constrained environment with multiple demands, even though such measures are crucial for the sustainability of the reforms. In sum, a fragile political environment, geopolitical challenges, possible social resistance to reforms in the absence of strong safety nets, opposition by vested interests who stand to lose from reforms, declining terms of trade, and sharper contraction in global demand – all these factors could undermine reforms and exacerbate fiscal and balance of payment problems. To mitigate a vast array of risks confronting Ukraine, it is important for the authorities to remain committed to continuing macroeconomic and structural reforms.

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

| | 2012 | 2013 | 2014 | 2015 f | 2016 f | 2017 f |
|---|---|---|---|---|---|---|
| **Real GDP growth, at constant market prices** | 0.2 | 0.0 | -6.8 | -12.0 | 1.0 | 2.0 |
| Private Consumption | 8.4 | 6.9 | -9.6 | -18.6 | -1.5 | 0.0 |
| Government Consumption | 4.5 | -0.9 | 0.6 | -5.0 | 5.0 | 7.0 |
| Gross Fixed Capital Investment | 5.0 | -8.4 | -23.0 | -24.8 | 10.7 | 17.3 |
| Exports, Goods and Services | -5.6 | -8.1 | -14.5 | -19.8 | 6.0 | 5.0 |
| Imports, Goods and Services | 3.8 | -3.5 | -22.1 | -31.7 | 3.1 | 6.5 |
| **Real GDP growth, at constant factor prices** | 0.2 | -0.2 | -5.7 | -12.0 | 1.0 | 2.1 |
| Agriculture | -4.3 | 13.8 | 3.0 | -10.0 | 0.0 | 1.5 |
| Industry | -1.8 | -8.0 | -20.0 | -17.0 | 1.4 | 2.8 |
| Services | 2.9 | 1.0 | -0.1 | -10.3 | 1.1 | 2.0 |
| **Prices** | | | | | | |
| Inflation (GDP price deflator) | 7.8 | 4.3 | 14.7 | 41.5 | 20.0 | 10.0 |
| Inflation (Consumer Price Index) | 0.6 | -0.3 | 12.1 | 36.4 | 4.0 | 4.0 |
| **Current Account Balance (% of GDP)** | -8.2 | -9.0 | -5.3 | -1.0 | -1.3 | -1.6 |
| **Fiscal Balance (% of GDP)** | -3.3 | -3.7 | -4.7 | -3.9 | -3.3 | -1.1 |
| **Poverty Rate** [a, b, c] | | | | | | |
| Poverty rate ($2.5/day 2005PPP terms) | 0.1 | 0.1 | 0.1 | 0.3 | 0.2 | 0.1 |
| Poverty rate ($5/day 2005PPP terms) | 3.9 | 3.2 | 4.9 | 9.7 | 8.6 | 6.8 |

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: f = forecast.
(a) Calculations based on ECAPOV harmonization, using 2009-HLCS and 2013-HLCS.
(b) Projection using Annualized elasticity (2009-2013) with pass-through = 1 based on GDP per capita constant PPP.
(c) Actual rates for 2012-2013; 2014 is an estimate and 2015-2017 are projections.

# UZBEKISTAN

| | 2014 |
|---|---|
| Population, (mid-year) mln | 30.8 |
| GDP, US$, bn | 62.7 |
| GDP per Capita, US$ | 2,038 |
| Poverty rate, official[1] | 13.7 |
| Gini coefficient, (2013)[2] | 0.29 |
| Life expectancy at birth[3] | 68.2 |
| School enrolment rate, in general | 99.8 |

Notes and Sources:
1/ Official poverty line is minimum food consumption equivalent to 2,100 kilocalories per person per day;
2/ Uzbekistan: Millennium Development Goals Report - Tashkent, UN, 2015, p.19;
3/ Life expectancy: UN statistics, and 73 by national stat.

*GDP growth in 2015 is projected to slow to 7 percent due to a weaker external environment, including further declining world prices of key commodities. While counter cyclical fiscal policy is expected to continue, and to help bolster economic growth, returning migrants will create pressures for additional good jobs. The sustainable response to these pressures is accelerated structural reforms that lead to increases in productivity. The rapid decline in the official poverty rate of recent years is expected to slow in 2015-17.*

## Recent developments

Uzbekistan's GDP grew at 8.1 percent in 2014, overcoming headwinds from the external environment and aided by counter cyclical fiscal policies and measures to expand credit to the private sector. In the first half of 2015, the economic difficulties in Russia (one of Uzbekistan's largest trading partners) persisted, as did government's response continuing and strengthening the policies initiated in 2014. As a result, GDP grew at 8.1 percent in the first half of 2015.

On the demand side, growth was driven by a strong increase in investment and a more moderate increase in consumption, bolstered by tax rate cuts on businesses and personal incomes and a 17 percent nominal increase in wages of civil servants and SOE employees. On the supply side, the first half of 2015 saw a very significant jump in construction services (18 percent yoy), but also significant growth in services (13.1 percent yoy), agriculture 6.5 percent (yoy) and industry (by 5.8 percent).

The weakened external environment led Uzbekistan's external account to weaken as the exports to Russia and other trading partners (excl. China) declined in the face of lower growth, declining commodity prices, and an appreciating som. Importantly, Uzbekistan's remittances, which came to about 9 percent of GDP in 2014 declined by 48 percent in the first half of 2015.

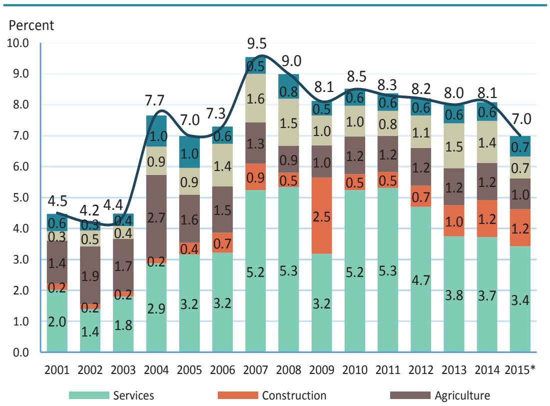
The som appreciated as a result of the (a) depreciations of the Russian ruble, the Kazakh tenge, and the Chinese yuan, and (b) government's efforts to contain domestic inflation and to support priority industrial sectors. For that purpose government kept official exchange rate depreciation at a much lower rate than the currency depreciations of the main trading partners.

Poverty declined from reportedly 14.1 percent in 2013 and to an estimated 13.7 percent in 2014-15, according to the official statistics and the official poverty line. The drop in poverty reflects rapid per capita economic growth, sustained annual increases in salaries, incomes from micro and small businesses (MSEs), and the government's targeted support programs. Over the years, stable net remittances from labor migrants at around 6 percent of GDP on average have helped many families in Uzbekistan to keep poverty at bay. The distribution of income has become more equitable over time, as indicated by the Gini coefficient (income) that fell from 0.39 in 2001 to 0.29 in 2013.

## Outlook

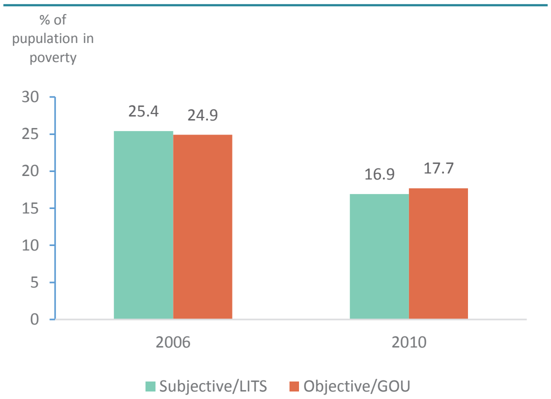
Economic growth is projected to slow to 7 percent in 2015. Two external factors are expected to influence the performance of the Uzbek economy in 2015 and 2016-17. First is the weak economic performance in the country's main trading partners (Russia, China, Kazakhstan, Turkey and Korea,) and, second, lower prices of Uzbekistan's key export commodities -- gas, copper, cotton, and gold. These factors are expected to lead to exports dropping by

**FIGURE 1 Uzbekistan** / Sector Contributions to GDP Growth, 2001–15 (%)




Sources: Uzbek authorities, World Bank.

**FIGURE 2 Uzbekistan** / Official and Subjective Poverty Rates




Sources: EBRD Life in Transition Survey (LITS) 2006 and 2010 on subjective Poverty (defined as falling into the bottom 1/3 of the income distribution) and results of Government of Uzbekistan (GOU) household budget surveys.

6.7 percent, and remittances dropping by 55 percent in 2015. Imports are also expected to decline due to slower growth in industry and tighter control over access to foreign exchange. In turn, the external current account surplus is expected to drop to 0.2 percent of GDP in 2015, from 1.3 percent in 2014.

To counter the adverse external environment, the government is expected to support consumption and investment through increased public investment for the newly adopted industrial and infrastructure development program for 2015–19; increased government spending raising minimum wages, pensions, and social payments to maintain incomes in 2015; additional production and exports of foodstuffs and gold to ensure total export growth in 2015; allocation of additional credit to small firms and making further marginal improvements to the business environment to create jobs, including for returning labor migrants.

With the continuation of fiscal policies to reduce the tax burden, the consolidated state budget surplus is expected to reach 0.8 percent of GDP in 2015, down from 1.6 percent of GDP in 2014. The present scenario does not include any significant changes in monetary or exchange rate polices.

## Challenges

Given weaker income growth and larger inflow of returning migrants in 2015, no progress is expected in the near term to reduce unemployment, poverty or inequality. National poverty (an equivalent of extreme poverty) is expected to remain at 13.7 percent in 2015 and decline only slowly in 2016-17. Inequality (as measured by the Gini coefficient) is projected to remain unchanged by 2017, reflecting relatively weaker income growth of returning migrants and the widening gap between those with jobs and those without.

To strengthen competiveness and to create more good jobs that absorb returning migrants and those entering the labor force, structural reforms to encourage private investment are needed. The authorities continue to advocate a slow transition to a more market-oriented economy; yet a more ambitious structural reform agenda to create space for more private sector investment is now becoming more important given the deterioration in the external demand environment. These reforms can comprise, improving the business environment and governance to reduce cost of trade and finance, further reducing taxes on firms and individuals, and increasing incentives for private investors and SOEs to adopt technologies and for employees to increase productivity.

**TABLE Uzbekistan** / Macroeconomic outlook indicators (annual percent change unless indicated otherwise)

| | 2012 | 2013 | 2014 | 2015 f | 2016 f | 2017 f |
|---|---|---|---|---|---|---|
| **Real GDP growth, at constant market prices** | 8.2 | 8.0 | 8.1 | 7.0 | 7.5 | 7.7 |
| Private Consumption | 5.7 | 6.0 | 5.1 | 4.7 | 5.2 | 5.5 |
| Government Consumption | 8.0 | 9.2 | 13.1 | 9.2 | 6.5 | 6.2 |
| Gross Fixed Capital Investment | -0.3 | 7.9 | 17.7 | 9.0 | 6.5 | 7.6 |
| Exports, Goods and Services | -4.0 | 10.9 | -4.1 | -6.7 | 3.1 | 8.9 |
| Imports, Goods and Services | 9.0 | 4.4 | 5.7 | -3.6 | -1.2 | 4.2 |
| **Real GDP growth, at constant factor prices** | 8.3 | 9.9 | 8.8 | 6.9 | 7.4 | 8.0 |
| Agriculture | 7.0 | 6.8 | 6.9 | 6.0 | 6.7 | 6.8 |
| Industry | 4.4 | 6.0 | 5.7 | 3.0 | 4.0 | 4.5 |
| Services | 10.5 | 13.0 | 10.8 | 8.6 | 8.8 | 9.5 |
| **Prices** | | | | | | |
| Inflation (GDP price deflator) | 17.9 | 13.1 | 12.1 | 11.0 | 10.2 | 10.2 |
| Inflation (Private Consumption Deflator) | 22.9 | 13.0 | 12.0 | 10.0 | 10.0 | 10.0 |
| **Current Account Balance (% of GDP)** | 1.2 | 0.8 | 1.2 | 0.2 | 0.3 | 0.4 |
| **Fiscal Balance (% of GDP)** | 5.3 | 3.5 | 1.6 | 0.8 | 1.2 | 1.7 |

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

# Low Commodity Prices and Weak Currencies

**Europe and Central Asia Economic Update**
Office of the Regional Chief Economist
October 2015

Against the backdrop of a weakening global economy and volatility in international financial markets, countries of the Europe and Central Asia region (ECA) are transitioning to a new normal. Oil-exporting countries in eastern part of ECA face the difficult adjustment to low commodity prices. Faster and more effective insolvency procedures, strengthened financial sectors, and higher absorption of European Union (E.U.) structural funds can contribute to rebound. This economic update consists of two parts: (i) economic outlook, comprising two chapters, and (ii) country pages. In part one, the first chapter describes the outlook for gross domestic product (GDP) growth, and then goes beyond GDP in a couple of important areas. It shows that terms-of-trade losses for oil exporters this year are much larger than changes in GDP. The second chapter establishes the link between oil prices and real exchange rates, both theoretically and empirically. Part two contains 26 two-page macro poverty outlook reports for ECA countries.

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