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Economic situation in the Economic Commission for Europe region (Europe, North America and the Commonwealth of Independent States), 2015-2016

Note by the Secretary-General

The Secretary-General has the honour to transmit herewith an overview report on the economic situation in the Economic Commission for Europe region (Europe, North America and the Commonwealth of Independent States) for the period 2015-2016.

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Economic situation in the Economic Commission for Europe region (Europe, North America and the Commonwealth of Independent States), 2015-2016

Summary

The present report considers the economic performance of the countries of the Economic Commission for Europe region in 2015 and early 2016 and future prospects. While moderate expansion was observed in the European Union and particularly in the United States, the decline in oil prices compounded other debilitating influences in the Commonwealth of Independent States and resulted in a decline in economic activity. Differences in the strength of the recovery led to divergent monetary policy stances in the United States and the euro area. Falling oil prices in the Commonwealth of Independent States led to significant exchange rate volatility. Economic prospects in the Economic Commission for Europe region remain mixed amid significant downside risk factors.

I. Introduction

1. The Economic Commission for Europe (ECE) region includes 56 member States, with very different development levels and economic situations. It contains most of the world's advanced countries, but also a number of lower-middle income economies. For analytical purposes, the present report will divide this large and diverse number of countries into different subregions and group them into two major categories: advanced economies and emerging economies. Advanced economies include: (a) North America, composed of Canada and the United States of America; (b) the countries that are part of the euro area; and (c) other advanced European economies. European emerging economies include: (a) new European Union member States that have not yet joined the euro area; (b) non-European Union countries in South-Eastern Europe, including Turkey; and (c) countries belonging to the Commonwealth of Independent States and Georgia.

II. Overview

2. Growth in ECE member States slowed to 1.6 per cent in 2015, down from 1.9 per cent in 2014. Economic performance was very diverse. While in the United States and the European Union a moderate recovery continued, the adverse trends observed in the Commonwealth of Independent States in late 2014 became stronger and sluggish growth was followed by an outright contraction of output. The decline in oil prices, which almost halved, affected energy-exporting and importing countries differently. This was a major factor explaining the diversity of economic performance in the ECE region. Lower oil prices also negatively affected investment in the energy sector in advanced countries. Output in the Commonwealth of Independent States is expected to shrink for a second consecutive year in 2016, amid further deterioration of the terms of trade, albeit at a more moderate pace. No major changes are envisaged in the United States and the European Union in 2016, with economic expansion projected at similar levels.

3. In the United States, job creation has been fast but wage growth has only recently picked up. By contrast, in the euro area, unemployment levels remain high in many countries, despite some improvement. In the Commonwealth of Independent States, the labour market has been relatively resilient, given the scale of the decline in economic activity, but unemployment has increased and remittances, which are sizeable in the poorest economies, have shrunk sharply.

4. The improvement in labour markets and easier financing conditions have boosted housing prices and residential investment in some advanced countries. However, overall investment has remained relatively weak amid lingering concerns over the strength of global demand, bouts of financial turbulence and, in some countries, still high levels of indebtedness.

5. A more sustained and robust recovery in the United States than in the euro area has been reflected in the divergence of monetary policies. While the United States Federal Reserve increased rates in December 2015 after seven years of no change, the European Central Bank announced further easing measures in March 2016. Past expectations concerning the direction of monetary policy drove movements in exchanges rates, with a sharp appreciation of the United States dollar in 2014 that dampened recent export performance. In the Commonwealth of

Independent States, large exchange rate depreciations have taken place, as the shocks in energy-exporting countries have been transmitted to other economies in this subregion. In early 2016, some recovery in commodity prices was accompanied by currency strengthening.

6. The different role of fiscal policy in supporting the recovery after the 2008-2009 financial crisis in the United States and the euro area contributes to explaining the differences in economic performance in recent years. In the euro area, past tighter fiscal policy has now been replaced by a more relaxed stance. In a number of European Union countries, the refugee crisis has been a source of additional fiscal outlays. In the Commonwealth of Independent States, energy exporters were forced to undertake significant fiscal adjustments, as oil prices were expected to stay low for a long time.

7. There are a number of risks that cloud the horizon. Geopolitical tensions, which have disrupted trade and undermined confidence in the Commonwealth of Independent States, have not yet disappeared. The refugee crisis, while providing a short-term boost to economic activity, is creating strains in a number of European countries. A decision by the United Kingdom to leave the European Union following the referendum scheduled in June 2016 would represent a significant shock and would add to the existing uncertainty.

8. Overall, medium-term growth prospects are being undermined by a number of factors that require policy attention. Ageing will reduce labour supply and therefore growth potential. Large and persistent unemployment levels in some countries not only erode social cohesion but can become entrenched through skill deterioration. Productivity growth has been weak in the aftermath of the financial crisis and current investment levels do not bode well for a significant acceleration. The current predicament of energy-exporting countries shows the need for economic diversification, but this would require, among other things, an investment effort which is at odds with the depressed trends being observed. The multiple challenges faced would need to be addressed by a comprehensive mix of policies that offsets demand weakness, in particular in some countries, but also tackles structural factors undermining growth.

III. North America

9. Despite a disappointing beginning of the year, economic growth remained relatively strong in the United States in 2015, with GDP posting a 2.4 per cent increase, unchanged from 2014. Consumption was well supported by dynamic housing and labour markets and low energy prices. Household debt as a percentage of disposable income, and the cost of servicing this debt, have continued to fall. Given these favourable conditions, private consumption, which accounts for more than two thirds of GDP in the United States, rose by 2.6 per cent in 2015, the fastest rate in a decade. Consumption is expected to provide continued impetus to economic expansion, as these supportive factors are likely to persist.

10. Investment benefited from low oil prices and stronger domestic demand, with the notable exception of the energy sector. By contrast, construction performed particularly well, soaking up pent-up demand and being supported by an acceleration in the rate of household formation. Residential investment grew by 8.7 per cent, the fastest rate of all demand components. Business fixed investment

increased by only 3.1 per cent. Overall, investment has remained weak in the post-crisis period, being well below historical trends, and slowed down in 2015.

11. Net external demand made a negative contribution to growth amid a deteriorating external environment. The trade-weighted United States dollar rose by 10 per cent in 2015 and this appreciation, which is rather large by historical standards, was accompanied by a weakening of demand in some key markets. This resulted in very slow growth in exports. While the current account deficit has been declining, it is still large, reflecting the relative strength of United States demand as compared with the rest of the world.

12. The labour market showed increasing signs of dynamism in 2015, ending the year in a strong note. The worst performer in an overall bright picture was the mining sector, as cuts in oil-related employment led to sizeable job losses. By the end of 2015, non-farm employment was 3.5 per cent higher than at the start of the recession. Unemployment ended the year at 5 per cent, down from 5.6 per cent one year earlier. Long-term unemployment also declined but remained above the pre-crisis average. Broader measures of unemployment, which also consider involuntary part-time occupation, also showed some improvement. These positive trends have continued in early 2016, despite some concerns about economic slowdown.

13. The labour participation rate has been declining since 2000, but this trend accelerated in the post-crisis period. This largely reflects demographic factors but also lower participation rates in some population groups, in particular less educated men, who are retiring from the labour force. However, the participation rate has been picking up since late 2015 as the recovery pulls in new workers. In March 2016, the rate was around 4 percentage points below the peak observed in late 2000.

14. The current economic recovery has been relatively job-rich but wage-poor. Despite sustained economic expansion and unemployment approaching levels close to what could be considered full employment, wage increases have been modest. Nominal average wages were growing at an annual rate of 2.5 per cent by the end of 2015, which was well above inflation and an improvement over the previous year. The continued output recovery should support the acceleration of wage growth. Falling unemployment has boosted consumption, but this effect can be expected to fade away as the economy approaches full employment if not followed by increased wage gains.

15. As a result of low oil prices and a strong dollar, inflationary pressures remain absent, with the consumer price index growing by only 0.7 per cent by the end of 2015. Implicit inflation forecasts from the bond market suggest the absence of price pressures. However, the personal consumption expenditure price index, excluding volatile components, which is the preferred inflation measure used by the Federal Reserve, has been climbing steadily since late 2015. Even if labour costs pick up, as slack disappears, inflation is unlikely to make a strong comeback, given the behaviour of import prices.

16. Fiscal policy is becoming increasingly supportive of growth. In 2015, the federal budget deficit fell 0.3 percentage points, coming down to 2.5 per cent of GDP, but this was the result of growing revenues, as economic activity increased. Overall, public finances made a positive but modest contribution to growth. Tax breaks will reduce projected 2016 revenues and the budget deficit is expected to increase as a percentage of GDP for the first time since the financial crisis, reaching 2.9 per cent, according to Congressional Budget Office.

17. The outlook for monetary policy in the United States remains quite different from that in other advanced economies. Expectations of divergent policy stances, with the United States widely believed to reduce monetary policy accommodation, have underpinned the strengthening of the dollar since 2014. The Federal Reserve increased the target range for the federal fund rate by 0.25 percentage points in December 2015, which was the first change in seven years. This movement had been largely anticipated, though it was initially expected to occur earlier in the year. The prospects of monetary policy tightening in the United States have contributed to harsher financial conditions in emerging markets, amid declining capital flows and exchange rate turbulence. However, rapid tightening seems increasingly implausible in view of renewed concerns over growth and the dampening effect of a strong dollar on inflation. While the labour market remains dynamic, the external environment has become more challenging and monetary authorities in other advanced countries have signalled an easing bias.

18. The continued strength of the United States economy contrasts with concerns on a global slowdown driven by China and other emerging markets. The United States is a relatively closed economy, where exports of goods represented around one eighth of GDP in 2015. But the indirect impact of a worsening external environment can be larger than this ratio would suggest, as financial turbulence and increased risk aversion have damaging implications for investment. The tumultuous start of the year in financial and commodity markets in 2016 has been followed by some stabilization, but renewed turbulence in the world economy could also take its toll on the United States.

19. The United States economy, like other advanced economies, is facing lower labour productivity growth in the post-crisis period. Job gains have been faster than increases in output. Persistent low investment holds back productivity increases. While investment is expected to pick up, as the recovery takes hold, drivers of total productivity growth deserve increased policy attention in order to support sustained income gains.

20. In Canada, economic expansion decelerated abruptly in 2015, with the rate of GDP growth more than halving to 1.2 per cent. This was the slowest rate since the 2009 recession, reflecting the impact of falling oil energy prices. Fixed investment fell sharply, reducing the growth rate by one percentage point. Consumer demand fared better, but job losses in the energy sector, the weakening of the Canadian dollar and record levels of household debt led to moderate growth. A depreciating exchange rate resulted in a stronger net external demand that offset domestic weakness. The good performance of exports continued in early 2016, being driven also by increasing demand from the United States, a major commercial partner. Growth will be supported by fiscal stimulus measures in 2016 but will remain very dependent on external factors. Moderate productivity increases and an ageing workforce undermine future expansion.

IV. Advanced European countries

A. Euro area

21. The euro area recovery gained momentum in 2015, although growth remained modest despite a rather favourable external environment during most of the year. Growth was the fastest since 2011, with GDP posting a 1.6 per cent increase, up from 0.9 per cent in 2014. The pre-crisis output level was finally reached in the first

quarter of 2016. Overall, performance in the euro area has been driven by the combination of four positive factors: the impact of past exchange rate weakness, easier financial conditions, looser fiscal policy and lower energy prices.

22. Domestic demand has played an increased role in the recovery in the euro area, amid a more supportive policy environment. Consumption, in particular, has driven the acceleration of growth. This reflects gains in real disposable income, boosted by improved labour market conditions and falling energy prices. Although consumption is expected to remain strong in 2016, more adverse external conditions and still insufficient progress in reducing unemployment in a number of countries cast some doubts on the future dynamics of consumption.

23. The rebound of investment has remained elusive, reflecting continued uncertainty on the outlook for demand and lingering effects from the crisis, including high levels of debt and unemployment. Sluggish investment means current lower demand and therefore weaker growth impetus, but it has also supply implications for future expansion, as it reduces the potential stock of capital and has negative implications for productivity.

24. Investment rose by 2.3 per cent in 2015, up from 1.3 per cent in 2014. Investment did not appear very sensitive to financing conditions and lending did not increase faster in countries where rates fell more rapidly. Easier financing conditions have facilitated deleveraging and debt refinancing, while lower oil prices have been positive for corporate profitability. Funding to corporates has improved but remains weak in comparison to other business cycles, in line with still subdued investment demand. The Investment Plan for Europe, an initiative of the European Commission, will support infrastructure and innovation spending, with around 80 billion euros in expected investment reached in early 2016. However, this is still little in comparison to a target of 315 billion euros in 2015-2017.

25. Lower funding costs and energy prices should support further acceleration of investment, following increases in capacity utilization and the improvement of corporate margins. Housing starts below the rate of household formation also suggest a pickup in residential investment as house prices recover. However, economic uncertainty may offset these positive factors, thus undermining the sustainability of the recovery.

26. The competitiveness of the euro area has improved and exports have increased faster than overall world trade since 2014, although with significant disparities among countries. For example, Spain increased its share of exports both within and outside the euro area, in contrast with the declines observed in Italy and, in particular, France. After a strong start and despite the depreciation of the euro, export performance deteriorated in the second half of 2015 as the external environment worsened. Countries with stronger relations with the Russian Federation have suffered the impact of sanctions and counter-sanctions and the contraction of economic activity in that country.

27. Overall, net external demand had no impact on growth in 2015. In Germany, the largest economy in the European Union, net external demand contributed only 0.2 percentage points of the 1.7 per cent increase in GDP observed in 2015. Net external demand is likely to have a small but negative contribution to economic expansion in 2016. The strengthening of domestic demand, which will suck in imports, is taking place in a more adverse global environment.

28. Labour market conditions have improved, driven by the continued recovery in a context of moderate wage increases. Job creation has been relatively fast considering the still modest output growth. The unemployment rate declined to 11 per cent in 2015, thus remaining 2.5 percentage points above pre-crisis levels. This aggregate figure masks significant differences, with unemployment remaining very high in some countries. Labour market reforms have brought increased flexibility but employment growth has often been dominated by low quality jobs. Despite the persistence of unemployment, activity rates have been resilient and the trend of growing labour market participation has continued. The existence of high youth and long-term unemployment points to entrenched social problems and negative impacts on potential output. In particular, the share of youth unemployment in total unemployment has increased since mid-2015.

29. The environment of extremely low inflation persisted in 2015. Prices declined in a number of countries and aggregate inflation ended the year at a mere 0.2 per cent. While falling energy prices had a significant effect on overall dynamics, core inflation remained subdued, with a 0.9 per cent increase. These trends continued in early 2016, with no annual price change in March. Inflation may stay low for longer than anticipated owing to the influence of soft energy prices, the persistence of stronger but still weak demand and, despite some recovery in labour markets, low wage growth. Continued undershooting of inflation projections suggests the presence of significant slack in the economy. Declining inflation expectations contribute to increased real interest rates and make more difficult debt servicing, thus resulting in tighter financial conditions.

30. The current account surplus rose from 2.4 per cent of GDP in 2014 to 3 per cent in 2015 as a result of the combination of falling oil prices, a weak exchange rate and a moderate increase of domestic demand. The rebalancing of intra-euro current account balances has been driven by peripheral countries, as a result of weak domestic demand and somewhat improved external performance. However, little adjustment has been seen in countries with large current account surpluses. Germany’s surplus with the euro area has disappeared and its large current account surplus is almost fully explained by the positive balance with the rest of the world.

31. Unlike in the United States, fiscal policy has not been supportive of the post-crisis recovery. However, there was a general relaxation of the fiscal policy stance in the euro area in 2015. In some countries, this has been linked to the arrival of large inflows of refugees and its impact on expenditures. Germany has been the main destination, absorbing some 1 million people, but Austria and, outside the euro area, Hungary and Sweden, have also received a large number of asylum applications. Associated moderate fiscal expansions in recipient countries have given a modest impulse to growth. European Union fiscal rules under the Stability and Growth Pact provide for flexibility to accommodate this increased expenditure. In relative terms, as a percentage of GDP, refugee-related fiscal costs have been particularly large in Denmark and Sweden, both outside the euro area.

32. Over the medium-term, the potential increases in the labour supply could have more sustained effects on economic activity, but this depends on the success in integrating the newcomers in the labour market. Although a number of countries have taken measures to restrict or discourage further inflows, the geopolitical situation suggests continued pressure.

33. Despite this fiscal relaxation, the general government deficit fell to an estimated 2.2 per cent of GDP in 2015, as the pickup in growth boosted revenues and the cost of servicing the debt fell. The persistence of low interest rates for long periods is increasing fiscal space in indebted countries. For highly-rated countries, the movement has been more dramatic: the average yield across German government bonds declined to zero in early April 2016 for the first time in history. The narrowing of the deficit in 2015 was driven by the cyclical factors, while the structural balance remained roughly unchanged, thus resulting in a neutral policy stance. The fiscal stance is expected to become slightly expansionary in 2016, providing further impetus to the recovery. However, six countries in the euro area remain subject to excessive deficit procedures, as progress towards meeting the thresholds of the Stability and Growth Pact is considered unsatisfactory.

34. The situation in Greece was a source of uncertainty early in the year, amid concerns regarding its exit from the euro area. As the country failed to implement the reforms required to access funding, currency controls and bank restrictions were introduced. An agreement was reached in late summer on a new programme of support which re-established access to funding and slowed down the rate of contraction, but was not sufficient to avoid further economic decline in 2015.

35. Given the central role of the banking system in channelling finance in the euro area, in particular for small and medium-sized enterprises, increasing credit flows plays a critical role in the recovery. This is different from the United States, where capital markets are more relevant for corporate financing. Monetary conditions have been accommodative and bank lending rates in the euro area, in particular in countries in the periphery, continued to trend down. Lending surveys have shown easing of lending conditions up to the first quarter of 2016. Financial fragmentation has been reduced, as differences across the economies of the area narrowed. However, high levels of private sector leverage and non-performing loans continue to constrain credit expansion in some economies. Banking fragilities persist, and there is still a need in some countries for a long-term response to tackle this issue.

36. As a response to existing deflationary trends, the European Central Bank continued to provide further monetary stimulus to secure a return of inflation to rates just below 2 per cent, in accordance with its stated target. The balance sheet of the European Central Bank contracted in 2012-2014, as banks repaid loans granted during the crisis, but this course was reversed in January 2015 as the central bank initiated large-scale asset purchases. Unconventional monetary policy measures have increased in importance. In March 2016, the asset purchase programme was extended further, and euro-denominated corporate bonds have been included among the securities to be purchased. New longer-term refinancing operations were introduced to encourage bank lending. In addition, the deposit rate moved further into negative territory, with a 10 basis point cut that left it at minus 0.4 per cent.

37. While further cuts in the deposit rate are seen as a possibility, there are also concerns regarding the potential adverse implications of negative rates for the stability of the financial system. Negative deposit rates are intended to prod banks to lend while encouraging further economic activity through the weakening of the exchange rate. However, negative rates also have a negative impact on banks' profitability, as lenders have been reluctant to pass the costs of negative rates to deposit holders. Increases in lending rates may follow as a way to preserve margins. This unintended effect goes against the aim of this policy.

38. Continued monetary policy stimulus and low oil prices will support the recovery further. However, there are limits to what monetary policy can achieve in a situation characterized by absence of price pressures, low investment demand and weak productivity growth. Monetary policy alone cannot address the problems of countries that need more support, as real interest rates are higher in those countries with higher unemployment rates. This is the result of comparatively lower levels of inflation. Structural policies, including active labour market policies, increased competition and removal of barriers to the internal market, are also necessary to promote productivity growth and encourage economic dynamism. However, in a context of low demand, their impact would be limited, so coordinated initiatives to increase demand may also be necessary.

39. The economic recovery in the euro area is facing a number of internal and external risks. The refugee crisis may lead to the imposition of border controls that would create barriers for the free flow of goods and fragment the Schengen space, thus imposing significant costs. Uncertainty continues to hold back investment. Slower global growth and increased volatility in financial markets, revisiting the substantial declines in asset prices seen at the beginning of 2016, would create a less auspicious environment for the ongoing recovery. Like other advanced economies, the euro area needs to address challenges that are undermining its long-term social cohesion and economic prosperity: rising inequality, low productivity growth and ageing.

B. Other advanced countries

40. Economic growth slowed in the United Kingdom from 2.9 per cent to 2.2 per cent in 2015, still much faster than the euro area but narrowing the previous distance. Domestic demand was the main driver of this expansion, with robust consumption and investment. The household sector saving ratio reached a 50-year low, at 4.4 per cent, amid declining unemployment, growing incomes and increased net financial wealth, which altogether support consumption. While rising debt levels do not point to increased vulnerability in the household sector as a whole, there are some groups that may be stretched. Despite strong domestic demand, inflation remained flat in 2015 as a result of lower oil prices, currency appreciation, moderate wage growth and a competitive retail sector. The weakening of the pound since late 2015 will create some inflationary pressure. Monetary authorities have left rates on hold and continued to point out that the necessary conditions for an increase were not yet present.

41. In contrast to the strength of domestic demand, net exports were a drag on growth. The current account deficit has been large by historical standards in recent years and it remained roughly unchanged in 2015 at around 5 per cent of GDP. The associated large external financial needs have become a focus of attention in the context of the referendum on European Union membership, which will take place on 23 June 2016.

42. If the result of the vote supports the exit from the European Union, this would open a period marked by significant uncertainties regarding trading and regulatory arrangements applicable to the relation between the United Kingdom and the European Union. Negotiations would take place on the terms under which the United Kingdom would trade with the European Union but also with the rest of the

world, as currently European Union rules apply in trade relations with third countries. United Kingdom authorities would also have to decide on the applicability of existing European Union rules under national legislation. Leaving aside the long-run economic consequences of the decision to leave, it is clear that this uncertainty would have immediate negative consequences that would spread beyond the United Kingdom. In the run-up to the referendum, increased market volatility and some slowdown in investment are likely to occur.

43. Sweden was one of the fastest growing economies in the European Union in 2015, with GDP increasing by 4.1 per cent. In the last three years, the expansion has been close to 8 per cent. Consumption, supported by rising incomes and increased employment, has been the main driver of this remarkable expansion. Refugee inflows, which have been large on a relative basis, have boosted government spending. Amid rapid growth, public finances continued to improve nevertheless. A housing boom has boosted residential investment and contributed further to economic dynamism. Despite the strength of demand and the impact of indirect tax increases, inflation has remained subdued owing to low oil prices and an appreciating currency. Monetary authorities continued to cut rates further into negative territory and expanded the bond buying programme in early 2016.

44. In Denmark, growth moderated in 2015, as the weakness of investment offset the relative buoyancy of consumption. Household debt as a percentage of disposable income is the largest among advanced countries and therefore consumption is particularly sensitive to the improvement of financial conditions. Monetary policy is attuned to the need to preserve the peg to the euro, with the deposit rate remaining firmly in negative territory, despite an increase in January 2016.

45. Outside the European Union, the Swiss economy showed significant resilience in the face of the appreciation of the Swiss franc, which followed the removal of the exchange rate floor in January 2015. Core inflation was strongly negative in 2015. These disinflationary dynamics are going to persist in 2016, given the large impact of the exchange rate in a small and very open economy. Negative interest rates have contributed to rapid growth in house prices, which has been tempered by the introduction of macroprudential measures to cool the housing market.

46. Norway's economy suffered from low oil prices and is drawing down resources from its sovereign wealth fund to offset the impact. A worsening outlook for the oil sector affected investment and consumer confidence but the depreciating exchange rate and a looser monetary policy facilitated adjustment and provided impetus to the non-oil export sector. With unemployment at its highest level in a decade, monetary authorities cut rates to 0.25 per cent in March 2016, without ruling out further reductions. As in a number of other advanced countries, low interest rates have fuelled rapid increases in housing prices.

V. Emerging economies

A. New European Union member States

47. Economic performance in this group of countries improved in 2015, with aggregate GDP growing by 3.5 per cent, as compared with 2.8 per cent in 2014. This was much faster than the expansion observed in the rest of the European Union

or the euro area, so convergence with income levels in older European Union members continued. However, the pattern of convergence after the 2008-2009 crisis is much slower than observed in the first years after European Union accession, reflecting the substantial deceleration of growth in relation to the pre-crisis period. While expansion rates of 5 to 6 per cent were typical in these countries before the crisis, the “new normal” is in the 2 to 3 per cent range. Large inflows of foreign direct investment have played an important role in boosting production capacity and integrating these countries into global supply chains. In countries where this process has been less intense, income convergence has also been slower.

48. Before the crisis, the new European Union member countries were running very large current account deficits, which were financed by bank lending and foreign direct investment. This was accompanied by rapid credit growth, rising house prices and exchange rate appreciating pressures. The post-crisis environment is markedly different. There has been a significant turnaround in external balances, with most countries now running surpluses.

49. The expansion of economic activity in 2015 was propelled by domestic demand, which was boosted by low interest rates and strong labour markets. Financing conditions have improved, with credit available more easily and on less restrictive terms. However, the stock of private-sector bank loans declined in some countries, in particular Hungary and Romania. While non-performing loans accounted for a smaller share of all loans, they remained a problem. European Union-funded investment added further impetus to the expansion. Low energy prices contributed to subdued inflation and strengthened external balances.

50. Unemployment has been on a declining trend but some negative trends are also visible in the labour market. In the presence of significant outward migration and adverse demographic trends, some countries are facing labour shortages in particular regions and sectors. This problem is compounded by insufficient internal mobility and the limitations of educational systems.

51. Growth is expected to slow down somewhat in 2016. Policies will remain supportive, with persistent low interest rates and a neutral or, in the case of Poland, expansionary fiscal stance. However, the consumer boom will cool off and investment will weaken, given lower access to European Union funds owing to the disbursement cycle. These transfers were equivalent to 2 to 3 per cent of GDP in most countries, exceeding 3 per cent in Hungary. Bulgaria, the Czech Republic and Hungary will be the countries most affected by lower access to European Union funds. Overall, the growth differential with the rest of the European Union is likely to narrow.

52. The external outlook — regarding the European Union and beyond — remains the main threat for future economic performance. The new member countries’ economies have a high degree of openness, so any slowdown in partner countries, in the European Union in particular, would affect their economic prospects. While the exposure to China is relatively limited, the importance of mutual linkages increases once the impact of participation in global supply chains is taken into account.

53. In Poland, the largest economy among this group of countries, strong domestic demand and low interest rates resulted in a small acceleration of growth to 3.6 per cent. The rapid increase of exports led to a sharp compression of the current account deficit, which almost disappeared. A similar performance is expected in 2016,

against a background of significant fiscal easing. Financial conditions for private sector investment have improved but public investment will lose momentum, given the pattern of access to European Union funds. The sustained expansion is not translating into inflationary pressures, with prices declining by 0.5 per cent in 2015. Deflation will continue through most of 2016, as the pace of reflation is going to be limited by the renewed decline in fuel prices in a context in which strong retail competition has contributed to keeping prices low. The policy rate was cut to 1.5 per cent in the first quarter of 2015 and has remained unchanged since then. A weakening currency and projected fiscal expansion are likely to limit further easing.

54. In the Czech Republic, growth accelerated sharply in 2015, more than doubling to reach 4.3 per cent on the back of robust consumption and, in particular, investment, which was boosted by the desire to tap into European Union funds before the end of the current financial cycle. While investment will come down, consumption is expected to remain strong, driven by a dynamic labour market and improved credit conditions. Despite the acceleration of growth, there have been few price pressures, with inflation ending the year at 0.1 per cent. The Czech National Bank has signalled its intention to continue an expansionary policy stance by delaying the abandonment of the exchange rate floor. This is a response to loosening by the European Central Bank and continued low inflation. Negative deposit rates may be considered to discourage capital inflows that could lead to excessive appreciation. By contrast, fiscal plans point towards further consolidation, with public debt on a declining path since 2013.

55. Hungary is enjoying a recovery of demand from previously depressed levels, posting a strong performance in 2015, with GDP increasing by 2.9 per cent. However, this is below the rate observed in 2014 and the expansion registered in neighbouring countries. After years of austerity, fiscal policy is becoming expansionary. Inflation ended the year at 0.9 per cent and further declines in oil prices imply that price increases will remain well below the 3 per cent target in 2016, which suggests further easing of monetary conditions. However, growth is likely to decline, as the strong contribution of European Union funds to investment fades away after record inflows in 2015 of around 6 per cent of GDP. The typical cyclicality in the disbursements of these funds has been particularly marked in Hungary. Consumer demand, however, will remain strong amid an improving labour market, the favourable impact of the redenomination of households' foreign exchange loans and low inflation.

56. Economic activity picked up in Romania in 2015, with GDP increasing by 3.8 per cent. Domestic demand has been the main driver of expansion, with household consumption in particular being boosted by wage increases and fast credit growth. Investment also picked up, but a relatively low rate of absorption of European Union funds prevented faster increases. The impact of the recovery on employment has been muted, however, in a context of rapid wage gains. Further acceleration of economic growth is expected in 2016, supported by a looser fiscal policy envisaging tax cuts and minimum wage increases.

57. In Bulgaria, economic expansion accelerated sharply, with GDP growing by 3 per cent, double the rate observed in 2014. This was mainly driven by net exports and strong public investment. The national currency is pegged to the euro, so exports have also benefited from the lagged effects of depreciation. These are particularly relevant for Bulgaria, as around 40 of its exports have destination

countries outside the euro area. By contrast, consumption was relatively subdued in a context of low wage growth. Public finances improved markedly, as the 2014 outturn was negatively influenced by the support provided to the financial sector. The expansion is expected to moderate in 2016, as public investment will suffer from lower implementation of projects financed by the European Union.

58. Croatia, the last country to join the European Union in 2013, returned to growth in 2015 after six years of recession. The recovery was due to both domestic and external demand, as tax cuts encouraged consumption and European Union funding boosted investment. Exports performed strongly, resulting in a current account surplus of more than 4 per cent of GDP. They are expected to continue to make a strong contribution to growth in 2016 as well, driven by Croatia's increasingly closer relations with other European Union members. Robust growth facilitated the reduction of the deficit, but the fiscal gap remains large and public debt continued to climb.

B. South-Eastern Europe

59. Economic activity picked up in the Western Balkans region in 2015, following the damaging impact of the floods in Serbia and Bosnia and Herzegovina. Improved performance in the European Union and lower energy prices provided a favourable external environment. The expansion was modest in Serbia, the largest economy, with GDP increasing by 0.8 per cent. It is expected to accelerate in 2016, supported by stronger investment and continued good export performance. Growth in other countries in this region has been much faster. Investment has been a major driver of the expansion, supported by accelerating credit and, in a number of countries, large public investment projects. By contrast, consumption remained relatively subdued amid low inflation. The economic recovery supported job creation, but it was insufficient to address the large structural unemployment that is characteristic of the region. High unemployment is accompanied by low activity rates, which limits growth potential.

60. While the levels of public debt are high, there has been significant progress in reducing fiscal imbalances. In Serbia, the large budget deficit, which represented a major policy concern, shrank considerably thanks to better revenue collection and a number of one-off measures. Despite the acceleration of exports and remittances, driven by the recovery in the European Union, large current account deficits remained throughout the region. Albania, a net energy exporter, was the only country not to benefit from low oil prices. While strong foreign direct investment has contributed to financing these imbalances, foreign debt has also increased in the region in recent years.

61. The reliance on external financing makes these countries vulnerable to a tightening of global financing conditions. Non-performing loans are a source of financial fragility that constrains future credit growth. Economic developments in the European Union, the main commercial partner and source of investments and remittances, will exert a major influence on economic prospects.

62. Economic growth picked up in Turkey in 2015, reaching 4 per cent, up from 3 per cent. The acceleration was driven by increased consumption and the recovery of investment. The pace of expansion is likely to slow down in 2016, partly driven by the impact of geopolitical tensions and Russian sanctions on tourism revenues.

However, strong government spending and increases in the minimum wage in early 2016 will have an expansionary effect. Inflation remained high, as the depreciation of the exchange rate limited the positive impact of falling oil prices. The marked slowdown in credit growth since 2012 has continued, as domestic financial conditions have tightened in a more adverse environment for external financing. However, the credit-to-GDP ratio has doubled in the last five years, in what has been a remarkable and sustained credit boom. The current account deficit has halved in the last three years, falling to 4.4 per cent of GDP, as the country benefited from lower oil prices and reduced gold imports. This adjustment has taken place in the context of low investment and saving rates in comparison with peer countries, which limits potential growth.

C. Commonwealth of Independent States

63. Economic performance in the Commonwealth of Independent States deteriorated sharply in 2015 under the impact of falling commodity prices and geopolitical tensions. Aggregate GDP shrank by 3 per cent after having increased by a mere 0.9 per cent in 2014. While some small economies are net energy importers and therefore could benefit from low oil prices, the positive effect of a lower import bill in these countries has been offset by the transmission of shocks from the Russian Federation. Large depreciations, including those that followed the abandonment of currency pegs in some countries, have boosted inflation. In the presence of significant financial dollarization in many countries in this region, devaluations are a source of banking fragility owing to currency mismatches and the negative impact on debtors' creditworthiness.

64. In 2016, aggregate output is expected to continue to shrink, albeit at a more reduced pace. Low oil prices will force adjustments in energy exporting countries, which will have a depressing effect throughout the region. The persistence of low oil prices and its negative implications are a powerful reminder of the need for economic diversification in order to increase resilience. While energy producers have put fiscal frameworks in place to manage hydrocarbon revenues, much progress is required to facilitate changes in the productive structure that reduces the existing dependence on commodities. Investment is the key channel through which diversification could take place, but it has been shrinking sharply in many countries in the region.

65. The Russian Federation experienced multiple shocks in 2015, including the collapse of the oil price, the depreciation of the rouble and trade disruptions resulting from sanctions and counter-sanctions. Output fell by 3.6 per cent amid plummeting consumption and investment. The continued weakness of the oil price, despite some pickup early in 2016, and the associated fiscal and monetary policy responses will postpone the recovery. As a result, the economy is likely to contract for a second consecutive year. The weakness of consumption will continue, given labour market dynamics and wage freezes in the public sector.

66. The depreciation of the rouble has facilitated the adjustment to lower oil prices, leading to a sharp contraction of imports. Bans on certain imports from Western countries, Ukraine and, as of December 2015, Turkey, also contributed to the decline in imports. The contraction of imports played an important role in limiting the fall of GDP in the context of a large decline of domestic demand.

Import substitution has benefited some sectors, in particular agriculture, food processing and defence goods. However, shrinking investment has prevented the potential for localization from being more fully exploited.

67. The current account surplus increased from 3.1 per cent of GDP in 2014 to 5.3 per cent in 2015, largely as a result of the compression of imports. By contrast, fiscal adjustment was less successful than external rebalancing. Hydrocarbon revenues dropped by around a fifth, or 2.5 per cent of GDP, while expenditures remained flat as a percentage of GDP. Monetary authorities cut rates rapidly in early 2015, reversing the sharp hikes of late 2014, as inflation declined and the exchange rate stabilized. However, renewed rouble weakness associated with further oil price declines resulted in a more cautious attitude, with rates being on hold since the summer. Inflation declined through the year, ending at 12.9 per cent and falling further to 7.3 per cent in March 2016. While inflation expectations remain elevated, base effects and depressed domestic demand suggest further declines.

68. Fiscal adjustment will be a key challenge for the Russian Federation in 2016, as oil prices are likely to be lower than initially envisaged. The use of the Reserve Fund, where part of past hydrocarbon revenues has been accumulated, provides some flexibility but cannot avoid the need for spending cuts to prevent the depletion of resources. The increased current account surplus fully accommodated net private capital outflows in 2015, which were only around one third of the record levels observed in 2014. Banks and corporates deleveraged significantly and, as a result, debt redemption payments in 2016 will be significantly lower. The sanctions have made access to international capital markets more difficult, but the increased reliance on domestic resources means that the Russian Federation is relatively better placed than other emerging economies to cope with a more difficult environment for raising finance. While external debt declined in nominal terms, the depreciation of the rouble drove an increase in its value as a percentage of GDP of around 10 percentage points over the previous year.

69. In Ukraine, output contracted by almost 10 per cent in 2015, with a cumulative decline of around 20 per cent from 2013 to 2015. Fiscal austerity contributed to plummeting domestic demand, with consumption in particular falling by around one fifth in 2015. Modest growth is likely to emerge in 2016, as there were already signs of some stabilization late in 2015. However, a tight budget and the uncertainty linked to the geopolitical situation will dampen demand. Consumption will remain subdued as high inflation erodes real incomes, while export growth will be limited at best, given trade disruptions. There has, however been marked progress in reducing inflation, which came down to 20.9 per cent in March 2016 from a peak 60.9 per cent in April 2015. This has allowed some monetary easing, which is likely to continue.

70. The turnaround in Ukraine’s external balance has been remarkable. The current account deficit shrank from 9 per cent of GDP in 2013 to less than 0.5 per cent in 2015. Imports fell as a result of weak domestic demand and currency depreciation, but also owing to the imposition of special import duties, which are being lifted in 2016. However, the export potential of the country has been severely affected by trade restrictions with the Russian Federation and the conflict in the eastern part of the country.

71. Ukraine entered the Deep and Comprehensive Free Trade Area (DCFTA) with the European Union in January 2016. Most Ukrainian exports already had free

access to the European Union market since April 2014, with the notable exception of agricultural products. However, exports to the European Union fell sharply in 2015, partly reflecting lower commodity prices. The Free Trade Area envisages the gradual adoption by Ukraine of European Union standards and regulations in many areas. The absence of accord on how to address the potential impact of this agreement on the Russian Federation led to a number of retaliatory measures, including the suspension of the free trade agreement between the two countries, an embargo on food imports and transit restrictions.

72. Belarus's economy shrank by almost 4 per cent in 2015 as a result of powerful contractionary domestic and external forces. These included the recessions in the Russian Federation and Ukraine, falling real wages amid declining but still high inflation and restrictive policies. Fiscal constraints became tighter owing to the ongoing output decline but also to the loss of oil duty revenue resulting from lower prices for oil products. The current account deficit shrank but external financing needs are still large. The contraction of economic activity is likely to continue in 2016, as severe external constraints will prevent the adoption of more expansionary policies.

73. Like other energy-exporting countries in the region, Kazakhstan suffered from a deterioration in its terms of trade owing to the fall in oil prices. The contractionary effect was compounded by the recession in the Russian Federation and the slowdown in China, which is becoming an increasingly important commercial partner. Growth decelerated sharply in 2015, with GDP increasing by 1.2 per cent, down from 4.1 per cent in 2014. Persistently low oil prices and tighter policies create strong headwinds for economic activity in 2016.

74. Falling oil prices eroded public finances, as hydrocarbon revenues represented around half of the total. Kazakhstan dipped into its National Oil Fund to avoid a harsher adjustment, but fiscal consolidation and efficiency gains in spending are being sought to prevent a rapid decline of the accumulated resources. The sharp deterioration in the terms of trade resulted in a swing of more than five percentage points of GDP in the current account in 2015, which moved into a deficit close to 3 per cent of GDP. Following the abandonment of the currency peg in August 2015, the tenge lost around half its value in relation to the dollar in the course of six months. This depreciation boosted inflation and prompted the National Bank of Kazakhstan to tighten monetary policy.

75. Economic performance in other countries of the Commonwealth of Independent States, including energy producers, was varied. Azerbaijan suffered from the declining low oil prices and had to adjust to the new adverse environment by slashing public spending on infrastructure and letting the currency depreciate abruptly. A sharp slowdown in growth in 2015 is likely to be followed by an outright contraction in 2016. In non-oil-exporting countries, the benefits of lower oil prices have been offset by the impact of the recession in the Russian Federation in terms of lower exports, investment and, in particular, remittances. Migrant transfers are very large for Kyrgyzstan and Tajikistan and the existing social protection systems are ill-prepared to cope with the large drops observed. China has become an increasingly important partner of Central Asian countries, and its worsened economic outlook is also a risk factor for those countries.

76. Kyrgyzstan joined the Eurasian Economic Union in August 2015, becoming the fifth member of the group, which includes also Armenia, Belarus, Kazakhstan and the Russian Federation. Despite the potential of this association to promote mutual trade and contribute to economic dynamism in the region, trade among its members declined in the first year of its existence in the context of a general drop in economic activity, although the decline was lower than that observed in trade with the rest of the world. With the accession of Kazakhstan to the World Trade Organization in July 2015, Belarus is now the only member of the Eurasian Economic Union that remains outside this global organization.