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Economic situation in the Economic Commission for Europe region (Europe, North America and the Commonwealth of Independent States), 2016-2017

Note by the Secretary-General

The Secretary-General has the honour to transmit herewith a report on the economic situation in the Economic Commission for Europe region (Europe, North America and the Commonwealth of Independent States) for the period 2016-2017.

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Economic situation in the Economic Commission for Europe region (Europe, North America and the Commonwealth of Independent States), 2016-2017

Summary

This report presents the economic performance in the countries of the Economic Commission for Europe region in 2016 and early 2017 and future prospects. Moderate economic expansion continued, and the pace of activity has become more synchronized across the region. Growth in the European Union was faster than in the United States of America, temporarily reversing the trend that has characterized the post-crisis period. After a deep contraction, aggregate output in the Commonwealth of Independent States increased moderately again in 2016, while higher oil prices have improved the outlook. Inflation accelerated in the United States and the euro area, but monetary policy divergence remains, given the different positions in the economic cycle. By contrast, inflation has been falling in the Commonwealth of Independent States, as the impact of past exchange rate depreciation faded away. Despite significant uncertainty and country disparities, economic prospects in the Economic Commission for Europe region have brightened.

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 North America, composed of Canada and the United States of America; the countries that are part of the eurozone; and other advanced European economies. European emerging economies include new European Union member States that have not yet joined the euro area; non-European Union countries in South-Eastern Europe, including Turkey; and countries belonging to the Commonwealth of Independent States and Georgia.

II. Overview

2. Economic prospects have improved in the countries of the ECE region. Aggregate output increased by 1.6 per cent in 2016, down from 1.9 per cent in 2015. This recorded slowdown partly reflected some special circumstances, but the overall dynamics confirm a recovery that is becoming more synchronized across the region. Developments in early 2017 also suggest that the expansion is gaining momentum. There are, however, significant country differences, sources of uncertainty and unaddressed challenges that temper a generally positive economic outlook.

3. In the United States, a mature recovery, supported by steady consumption growth, continued to create jobs at a rapid pace. The euro area showed signs of increased dynamism, although concerns related to the banking sector persisted in some countries. The heavy political calendar and the decision by the United Kingdom of Great Britain and Northern Ireland to leave the European Union did not have a significant impact on confidence. In the new European Union member countries, the economic slowdown observed is temporary and related to the pattern of disbursement of European Union funds. After a poor performance in 2015, growth started to return in the Commonwealth of Independent States, as oil prices bottomed out and the macroeconomic framework became less volatile.

4. Rising but still moderate price pressures, prompted by stronger demand and higher energy prices, have led to further interest rate increases in the United States. In the euro area, a very loose monetary policy continued, but deflation is no longer a concern. A recent spike in inflation reflects largely higher energy prices, and it will abate. In some advanced countries, the extended period of low financing costs has led to rapid growth of asset prices, in particular housing. In the Commonwealth of Independent States, monetary authorities cut interest rates, as the inflation pressures prompted by past devaluations abated.

5. Despite this moderately positive performance, some challenges remain. Comparatively low levels of investment have contributed to the observed sluggish productivity growth across the region. Faster productivity growth increases are required to meet the challenges of ageing populations. In the Commonwealth of Independent States, the necessary economic diversification would require stronger investment activity.

6. While labour market dynamics have generally improved, unemployment rates are still high in some European countries, in particular for the young. Persistent unemployment erodes skills and can become structural. Increased structural unemployment, together with low productivity growth due to sluggish investment,

reduces potential economic growth. Low levels of economic activity can therefore have permanent effects.

7. The 2030 Agenda for Sustainable Development enshrines a commitment to promote environmentally sustainable and socially inclusive economies. Estimates by the International Energy Agency suggest that carbon emissions in the region fell in 2016, in particular in the United States, despite sustained economic expansion. Some negative impacts of the 2008 global financial crisis on social indicators are starting to be slowly reversed. While improved economic performance can facilitate achieving the Sustainable Development Goals, more robust policy action would be required, given the still moderate growth prospects and the scale of the environmental and social challenges ahead.

III. North America

8. The economy of the United Stated presents an overall picture of steady expansion, continuous growth in consumer spending, and increasing but still moderate inflation. Recent economic prospects have improved and suggest an acceleration of economic activity underpinned by solid consumer demand, rapid employment creation and a more favourable external environment.

9. In 2016, economic performance was dampened by the decline in the oil sector due to low oil prices and the negative impact of dollar appreciation on exports. Growth slowed to 1.6 per cent, down from 2.6 per cent in 2015. This was the lowest rate of expansion in five years.

10. Household consumption remains the main and most stable source of expansion. Consumer spending growth has been driven by rising real disposable income, as wages increased and oil prices remained low during most of the year. Financial conditions — low interest rates and improved access to credit — have also supported dynamic consumption. Household debt and debt service relative to income continued to fall, amid historically low interest rates.

11. The overall contribution of fixed investment to GDP growth declined sharply for the year as a whole, but quarterly figures reveal an improving trend, suggesting a growing momentum. Net investment has not increased in line with the number of hours worked in the post-crisis period. The amount of capital per worker has declined, which has contributed to the slow growth of productivity.

12. Relatively weak global demand and a strong dollar have dampened the growth of exports. While services have expanded rapidly, manufacturing, where exports play a more important role, has been trailing behind. The real trade-weighted dollar index rose by 3.9 per cent in 2016, following a 10.6 per cent appreciation in 2015. The real exchange rate is lower than in the period immediately after the financial crisis and softened somewhat in early 2017, but it remains high by historical comparison. Overall, the negative contribution of net external demand to GDP growth declined in 2016 but rose sharply in the last quarter of the year. The overall reliance of the United States economy on external savings remained unchanged, with the current account deficit reaching 2.6 per cent of GDP.

13. Labour market dynamics have been increasingly positive as the recovery matures. The unemployment rate returned to its pre-recession average by mid-2015 and has continued to decline, falling to 4.7 per cent by the end of 2016, down from 4.5 per cent one year earlier. The rapid pace of job creation continued in early 2017. However, there are other indicators, such as long-term unemployment and the share of labour force working part-time for economic reasons, that are still above their pre-crisis levels. This would suggest that the amount of slack in the economy

remains significant and that additional workers could be drawn into the labour force if economic expansion continues. The result of rapid job creation in the presence of only moderate output increases has been slow productivity growth.

14. Wages have been recovering more slowly than has employment in the post-crisis period, but the improvement of the labour market has finally translated into accelerating wage increases. Earnings for all employees rose by 2.8 per cent in February 2017, up from 2.4 per cent one year earlier. Real median household income stagnated for almost a decade in the years previous to the financial crisis and declined afterwards. In 2013, it staged a recovery, which was followed by rapid growth in 2016, reaching 5.2 per cent. However, after that increase, it remains 2.4 per cent below the peak observed in 1999.

15. Inflation remained low but started to pick up more rapidly in the second half of the year, ending 2016 at 2.1 per cent, up from 0.7 per cent one year earlier, largely reflecting the impact of higher energy prices. By contrast, core inflation (excluding food and energy prices), rose in a sustained way through 2015 but remained practically unchanged in 2016 and early 2017. It declined sharply in March 2017 to a level not seen since November 2015. Personal consumption expenditure inflation, the reference indicator used by the United States Federal Reserve, climbed through the year and reached 2.1 per cent in February 2017, just above its 2 per cent target. Inflation expectations have been increasing steadily but stabilized in early 2017. The 10-year break-even inflation rate, as derived from bond prices, had climbed from a low of 1.34 per cent at the end of June 2016 to just below 2 per cent by the end of March 2017.

16. Fiscal policy was broadly neutral in 2016, but there are expectations of some loosening, delivered through a combination of increased infrastructure spending and lower taxes, although full details of the future policy direction remain unknown. Following rapid declines in the period 2012-2014, the federal budget deficit rose by 0.7 percentage points to 3.2 per cent in fiscal year 2016.

17. The Federal Reserve remains the only central bank among advanced countries that has embarked on a tightening cycle. It started with a quarter-point increase in the target range for the federal funds rate in December 2015, to 0.75 per cent, which was followed by two additional, similar hikes in December 2016 and March 2017. As inflation is rising, further rate increases are expected, but the Federal Reserve has signalled that there was no rush for additional tightening, which has been borne out by the March inflation data. Further clarity regarding future fiscal plans will influence decisions on rate hikes.

18. Long-term interest rates have increased amid expectations of a recovering economy. The downward trend observed during the first half of 2016 came to a halt, with rapid increases observed in the last months of the year. In early 2017, after some softening, interest rates have recovered to reach the previous peak.

19. Although policy uncertainty remains significant, the most likely scenario for the immediate future appears to be a fiscal stimulus accompanied by a further tightening of monetary policy. This will result in higher long-term interest rates, which may have negative spillover effects for emerging markets depending on dollar financing. Monetary policy divergence between the United States and other advanced countries will support the value of the dollar.

20. Despite a sustained economic expansion, the United States economy faces some challenges. The slowdown in productivity remains an important concern, as productivity is the most important determinant of living standards over time. Over the past decade, average labour productivity growth was less than half the rate observed in the preceding decade, according to data from the Conference Board.

This is a problem that is shared with other advanced economies, where productivity growth has been even smaller. The decline in productivity growth is related to relative low investment levels in the post-crisis period as well as the declining rate of increase of total factor productivity, that is, productivity gains unexplained by increases in labour or capital and that are associated with innovation, technological changes and improved management. Increasing productivity would require policy attention to the factors influencing both the generation and, critically, the dissemination of innovation. Research carried out at the Organization for Economic Cooperation and Development shows how the productivity gap between frontier firms, where productivity growth is faster, and other firms has increased in advanced economies. This suggests that the factors influencing the dissemination of innovation should be a particular policy concern.

21. The United States economy made some progress in reducing its environmental footprint in 2016, as carbon emissions dropped by about 3 per cent, according to estimations by the International Energy Agency, despite continued output growth. This sharp decline in the carbon intensity of the economy resulted from an increase in shale gas supplies and the replacement of coal by renewable energy. Carbon emissions fell to the lowest level since 1992, in contrast with the expansion of the economy by 80 per cent since that year.

22. In Canada, the economic situation improved following the sharp deceleration observed in 2015, as a consequence of falling oil prices. GDP rose by 1.4 per cent, up from 0.9 per cent. The drag on economic growth from the oil and gas sector declined throughout the year, while other areas of activity picked up. In particular, exports have performed well, supported by the strength of the United States economy and gains in competitiveness due to the depreciation of the exchange rate. Overall, net external demand explained about half of the observed economic expansion. Non-energy investment performed well but was insufficient to prevent the continued contraction of overall investment. The unemployment rate declined slightly (6.6 per cent in February 2017, compared with 7.2 per cent one year earlier), reflecting the diverging fortunes of the energy and non-energy sectors. The policy mix, both fiscal and monetary, was supportive of growth. In order to offset contractionary trends emerging from the energy sector, infrastructure and social housing initiatives were developed to boost demand. Loose monetary policy propped up house prices, which increased rapidly in some key areas.

IV. Advanced European countries

A. Euro area

23. Economic expansion has been supported by the lagging effects of the euro depreciation, relatively low oil prices and a policy mix that has become more conducive to growth. Despite a number of shocks with a negative impact on confidence, including the outcome of the United Kingdom's referendum on European Union membership and lingering geopolitical tensions, the recovery remained resilient and growth has become more broadly based.

24. Recent performance suggests an improved economic picture, with the pace of economic activity expected to accelerate in 2017. Business and consumer confidence indicators reached fresh highs in early 2017, and consensus forecasts were revised upwards, despite existing uncertainties. The flash purchasing manager index for February showed that output was growing at its fastest pace in 70 months.

25. Overall growth figures in 2016 were distorted by the extraordinary performance of the Irish economy in 2015, which had a significant impact on

aggregate expansion, despite its relatively small share in total output in the euro area. Following the inclusion of some activities of multinational firms, as they switched their tax domicile to Ireland, recorded GDP growth in Ireland was 26.3 per cent in 2015. The slight deceleration in growth in the euro area to 1.8 per cent in 2016, down from 2.0 per cent in 2015 reflects the impact of the rapid reported expansion in Ireland in the base year for comparison. Excluding Ireland, there was a slight acceleration from 1.7 per cent to 1.8 per cent, according to European Commission calculations.

26. The expansion has been driven by domestic demand, as consumption was boosted by growing incomes and employment. Private consumption lost some momentum in the second and third quarters but accelerated in the fourth quarter.

27. By contrast, investment, which remains below pre-crisis levels, remained sluggish, despite the improvement in financing conditions. Investment is almost 2 percentage points below the prevailing level in the early 2000s, before the acceleration of investment in the years preceding the 2008 crisis. That poor performance is explained by the collapse of residential investment, which has only recently started to recover. In 2016, growing incomes and low mortgage rates supported a more dynamic housing sector, with increases in construction output and house prices, but high levels of uncertainty and relatively weak demand dampened overall investment. Funding did not appear to be the main problem, given accommodative monetary policies. Higher levels of capacity utilization and low financing costs should eventually lead to increased investment, although elevated debt levels in some cases and, more importantly, persistent uncertainty are creating powerful headwinds.

28. Growth of employment has been rather strong, given the moderate rates of expansion. Job creation has been supported by limited wage increases and, in some countries, labour market reforms. Unemployment, which was on a declining trend throughout 2016, reached 9.5 per cent in February 2017, the lowest level since May 2009. Unemployment is still around 2 percentages higher than before the global financial crisis and is much higher in some countries. Although the dispersion of unemployment rates was reduced, there are significant differences regarding both absolute levels and dynamics across the area. In Italy, the unemployment rate continued to grow in 2016, reaching 12 per cent by the end of the year. In contrast, Germany’s labour market further improved, with the seasonally adjusted unemployment rate falling below 4 per cent for the first time since the reunification of the country.

29. Overall, favourable developments in the labour market have not yet made up for the losses incurred during the crisis. While the recovery has been job-rich, the growth in the number of hours worked has trailed behind. There has been an increase in the share of part-time employment, including involuntary. In addition, there are some groups, including the young and low-skilled, that have particularly large unemployment rates. Nevertheless, better labour market dynamics are having a positive effect on reducing poverty, as the share of people at risk of poverty and social exclusion, which rose in the post-crisis years, started to decline in 2015.

30. Inflation started to pick up in the second half of 2016, as oil price recovered from very low levels. However, core inflation was roughly unchanged, given the persistence of slack in the economy and the absence of wage pressures, including in countries with low unemployment levels. Annual inflation hit 2.0 per cent in February 2017, for the first time in four years, just exceeding the European Central Bank target, which was close to, but below, 2 per cent. However, core inflation remained steady at 0.9 per cent, and has been 1 per cent since August 2013. Differences in inflation rates across countries have narrowed. On the other hand,

because of the absence of stronger inflationary pressures in countries with less labour market slack, the adjustment burden of internal re-balancing has fallen upon the less competitive countries in the euro area.

31. The depreciation of the euro and rising commodity prices will push inflation higher in 2017, as suggested by market measures of inflation expectations. This may be a temporary occurrence: as base effects from higher oil prices fade away, inflation will also decline. The March projections of the European Central Bank foresee that annual inflation will reach 1.7 per cent in 2017, falling to 1.6 per cent in 2018.

32. Fiscal policy is no longer restrictive and has become broadly neutral. Public finances continued to improve on the aggregate, buoyed by better economic performance and very low interest rates. The European Commission estimated that the general government deficit fell by 0.4 percentage points to 1.7 per cent of GDP in 2016. However, the performance of individual member States differed widely. In France and Spain, the budget gap remained above 3 per cent. Six countries, including two outside the euro area, are under ongoing excessive deficit procedures. In some countries, measures to reduce the tax burden on labour have contributed to the decline of the revenue to GDP ratio. In others, there has been some fiscal loosening linked to the arrival of refugees. A constructive fiscal policy remains important to support the recovery and reduce imbalances within the euro area.

33. In six member States, the public debt to GDP ratio exceeds or is close to 100 per cent. High levels of government debt and modest growth imply that interest rate changes can have a large impact on debt sustainability. In this context, purchases of government assets by the European Central Bank have widened fiscal space by limiting increases in sovereign debt yields.

34. Renewed tensions and concerns over the sustainability of Greek debt emerged again, as economic expansion remains too slow to improve debt ratios. After posting some modest growth earlier in the year, the Greek economy contracted again in the last quarter of 2016. Most of the debt is now in public hands, after the 2012 restructuring, and the country has not enjoyed access to capital markets since 2014. Greece has already achieved a primary fiscal surplus, so the disbursement of additional financial support is necessary to honour its obligations vis-à-vis those official creditors.

35. The euro area continues to show a large aggregate current account surplus, reaching an estimated 3.6 per cent of GDP in 2016, as savings exceed investments. The crisis was followed by sharp adjustment in countries with large deficits, as external financing dried out. However, a similar correction did not take place in countries with surpluses, which have tended to grow further, thus resulting in an increasing current account surplus for the region as a whole. In Germany, the current account surplus started to grow rapidly in 2003, with the ratio to GDP increasing from 1.4 per cent to 8.7 per cent in 2016. Large external surpluses imply the continued accumulation of external assets.

36. Lending to households and non-financial corporations has continued to increase, amid declining interest rates and reduction of financial fragmentation across the euro area. However, differences across countries in both interest rates and the dynamics of credit remain. The banking sector has increased its capacity to support the recovery. The recent steepening of the yield curve has also reduced pressures on bank profitability, mitigating ongoing concerns on the negative impacts of loose monetary policy. However, profitability is low and banking fragility persists in some countries, which are still grappling with the legacy of non-performing loans. In a number of countries, including Ireland, Greece, Italy and Portugal, non-performing loans are still at double-digit levels, although for the region as a whole they are on a declining trend.

37. Financing remains cheap, with historically low interest rates and the continuation of quantitative easing by the European Central Bank. In March 2016, the European Central Bank increased the pace of asset purchases from 60 billion euros to 80 billion euros, to provide further momentum to the European recovery. In addition, it initiated a corporate sector asset purchase programme in June 2016, which contributed to easing financing conditions for non-financial corporations. In December 2016, it announced that purchases under the asset purchase programme would be extended until at least December 2017, while starting the reduction of monthly purchases to 60 billion euros in April 2017.

38. The European Central Bank asset purchasing programme has supported the narrowing of interest spreads between core and periphery countries. However, recently spreads in relation to German bunds have widened for some European countries. Demand for bunds have benefited from different risk perceptions but also from changes in European Central Bank rules that now allow purchases of bonds with yields below the deposit rate. Altogether, around 4 trillion euros of euro area sovereign bonds trade at negative yields.

39. Monetary accommodation will continue to ensure that inflation converges towards its target rate of close to, but below, 2 per cent. Recent increases in inflation appear temporary and driven by low energy prices, as European Central Bank forecasts show that inflation will still fall below this target in 2019. While the latest actions of the European Central Bank signal the continuation of a very loose monetary policy, fears of deflation belong to the past, as cyclical indicators are gaining momentum. The recent strength of the European economy has raised questions regarding the timing for winding down quantitative expansion. There are also lingering concerns regarding the side effects of sustained monetary expansion, including, in particular, negative interest rates. While monetary stimulus has led to credit growth in some countries, record low interest rates have also negatively impacted the profitability of banks and created misgivings with respect to potential resource misallocation. In addition, the European Central Bank is running out of assets to buy according to existing rules that forbid purchasing more than one third of a country’s debt or a specific bond.

40. There is therefore a growing awareness of the limits of monetary policy to support the recovery and generate appropriate levels of demand and investment. A more balanced policy mix, including actions to support demand in the short term and increase medium-term growth potential are required. However, as countries with the largest need for fiscal stimulus are also those with larger debt levels, initiatives to support rebalancing within the euro area and structural reforms to increase productivity appear to be the most relevant.

41. Overall, the recovery is becoming well entrenched, but economic prospects remain clouded by significant uncertainty and persistent weakness in some countries. Further, the impact of some positive factors, such as low oil prices, is fading. Low productivity growth remains a major challenge, in particular in the face of rapidly ageing societies. This subdued growth can be partly explained by sluggish investment, but the poor performance of total factor productivity, i.e., that associated with innovation and improved management practices, suggests the need for continued attention to structural reforms that lift growth potential. In some countries, job creation has been associated with precarious employment, which is not conducive to productivity increases. While recent performance suggests an improvement in social indicators, the negative implications of the crisis on inequality in some countries has yet to be fully addressed.

B. Other advanced countries

42. In the United Kingdom, the referendum vote in June 2016 to leave the European Union dramatically changed the economic environment and introduced significant policy uncertainty regarding future arrangements. However, the performance of the British economy after this shock was better than initially envisaged, supported by an accommodating policy reaction. GDP growth slowed from 2.2 per cent in 2015 to 1.8 per cent in 2016.

43. The relative strength of the British economy, which largely outperformed the euro area economy in the second half of 2016, reflects the rapid growth of real earnings and its translation into robust consumption. On an annual basis, private consumption expenditure growth was 3.0 per cent, the fastest rate since 2014. Mounting inflationary expectations, linked to the depreciation of the pound, led to forward purchases. By contrast, investment, which is more sensitive to anticipated future economic performance, was sluggish. Employment growth has softened since the referendum, and the acceleration of inflation will erode real incomes.

44. The weakness of the pound has not boosted exports, which may partly reflect the weight of services and intermediate manufactured goods in British exports, as they are less sensitive to exchange rate variations. Net external demand made a significant negative contribution to growth in 2016. The current account deficit remains at around 5 per cent of GDP, which implies significant external financing needs.

45. Inflation accelerated, ending 2016 at 1.6 per cent, up from 0.2 per cent one year earlier. This was driven by higher oil prices and the depreciation of the pound, which fell by around 17 per cent against the United States dollar in 2016. In the aftermath of the referendum, monetary authorities adopted a number of measures to ease the cost of adjustment to the new situation, including cutting the policy rate to a record low 0.25 per cent and the extension of its quantitative easing programme.

46. Despite the relative resilience of the British economy, there are lingering concerns regarding the impact on trade, investment and future economic performance of the decision to leave the European Union. A protracted period of negotiations remains ahead and the most likely scenario appears to be that the United Kingdom will leave the single market and the customs union. The British economy represents around 15 per cent of the European Union economy, close to the combined weight of all the other European Union countries that remain outside the euro area, and therefore the United Kingdom decision to leave will have a sizeable impact on European Union aggregates.

47. The Swedish economy decelerated in 2016, as robust domestic demand was offset by the negative contribution to growth of net exports. With a 3.3 per cent increase, the pace of expansion remained strong. Inflation has started to increase, despite the appreciation of the krona, but is still low. The Riksbank extended its quantitative expansion programme by another six months in December 2016, with the repo rate at -0.50 per cent since February 2017. A very expansionary monetary policy has supported asset prices. The rapid growth of house prices has led to further increases in household debt. Migration inflows, albeit past its peak, have contributed to fiscal loosening and provided further impetus to the economy.

48. In Denmark, economic performance weakened, with GDP growth being down to 1.3 per cent from 1.6 per cent in 2015. The pace of expansion of households consumption, driven by robust employment and income growth, remained unchanged. Financial conditions are very easy, and this has fed into rapidly rising house prices, particularly in the capital. This has been accompanied by strong housing investment, which rose by 11.0 per cent. Inflation has been recently picking

up, due to higher energy prices and wages but it remained flat in 2016. The country has one of the largest current account surpluses in the European Union, although it fell somewhat in 2016.

49. Outside the European Union, the Norwegian economy slowed down, reflecting the impact of low oil prices, with GDP posting a 1 per cent increase, against 1.6 per cent one year earlier. The country has been using its ample fiscal reserves to offset the contractionary influences stemming from the energy sector, through a combination of tax cuts and increased expenditures. This fiscal stimulus is projected to continue in 2017. As the outlook for returns has worsened, the Government is advancing a proposal to reduce the amount of revenues that can be taken out of the oil fund from the current 4 per cent to 3 per cent. Inflation rose, pushed by a depreciating currency, but has now returned to a declining path. House prices have continued its rapid increase, fuelled by sustained low interest rates, with the Central Bank cutting the policy rate further to 0.5 per cent in March 2016. While financing costs are low, household debt is relatively high.

50. Economic growth accelerated somewhat in Switzerland, following the slowdown in 2015. Despite a strong franc, exports have held well, albeit with differences across sectors, while domestic demand is firming moderately. Inflation turned positive in January 2017, for the first time since August 2014, posting a 0.3 per cent annual increase. However, appreciating pressures over the franc as a safe haven have continued, and the Swiss National Bank has regularly intervened to contain them, resulting in large increases in foreign currency reserves and a very accommodative monetary policy. The strength of the franc has also been supported by the persistently large current account surplus of around 9 per cent of GDP.

V. Emerging economies

A. New European Union member States

51. Economic growth in new States members of the European Union moderated in 2016, but remained strong, dropping to 3.0 per cent, down from 3.7 per cent in 2015, as robust consumption offset weaker investment activity. Sluggish investment was linked to the beginning of a new programming period for European Union co-financed investments and followed years of very strong activity. Starting in 2017, the pace of drawdown of European Union funds will increase as new projects are submitted, and, over the coming years, transfers may reach 2-4 per cent of GDP annually. Increased investment will again become a major driver of growth. The economies of the new member States are very open and their performance is strongly influenced by demand conditions among external partners, namely other European Union countries. The improved prospects of the European economy will have a positive impact on this group of countries.

52. Favourable labour dynamics have been driven by continued economic expansion, and the external cushion provided by migration possibilities within the European Union. At the same time, labour shortages have emerged in particular areas. Falling unemployment has boosted consumption, amid rapid real wage gains. Increases in labour costs and, more recently, oil prices, have resulted in the acceleration of inflation from very low levels. Financing conditions have eased, with improved access to funding by households and corporates in the context of the declining share of non-performing loans, which has nevertheless remained quite high in many countries.

53. While the economic outlook is positive, there are also some sources of uncertainty that cloud the horizon. Any potential problems in the European Union

would quickly spill over into this group of countries, given the existing strong economic linkages. Migration flows and remittances will be negatively impacted by the planned exit of the United Kingdom from the European Union, which would eventually also have implications for fiscal arrangements within the European Union. This is significant for the new European Union member States, as they benefit from significant transfers.

54. In Czechia, after a very strong performance in 2015, with GDP posting a 4.5 per cent increase, economic expansion decelerated to 2.3 per cent. Strong employment growth fuelled household consumption. Net external demand also made a strong contribution to economic activity, while declining infrastructure projects resulted in the contraction of gross fixed capital formation. The strength of the recovery and rising inflation allowed the Czech National Bank to end its commitment to defending the euro/koruna floor in early April 2017. This arrangement was introduced in November 2013 to prevent the appreciation of the currency from adding to existing disinflationary pressures. The country is enjoying a comfortable fiscal position, with revenues boosted by sustained growth and public investment moderating after rapid expansion in recent years.

55. Economic activity slowed down in Hungary to 2.0 per cent, compared to 3.1 per cent in 2015, driven by the fall in investment. Domestic demand, however, remained strong, as wage and employment growth picked up in an increasingly tight labour market. Hungary’s economic performance has been underpinned by rapid export growth, and net external demand continued to make a positive contribution to the economic expansion. Tax cuts and increases in the minimum wage in late 2016 will support further growth, adding to the expected pick-up in investment as the drawdown of European Union funds increases. Inflation accelerated throughout the year, and although it remains comfortably below the 3 per cent target of the National Bank of Hungary, it is expected to pick up. The decline in investment has been accompanied by an increase in the current account surplus, which is estimated to have reached around 5 per cent of GDP in 2016. The emergence of Hungary as a net external lender contrasts with the situation in the pre-crisis period.

56. In Poland, GDP growth slowed to 2.8 per cent, compared with 3.7 per cent in 2016. Private consumption was the main driver of economic expansion, reflecting falling unemployment, rising wages and the impact of additional social spending. This buoyancy contrasts with the weakness of investment prompted mainly by the beginning of a new programming period for European Union funds. The long period of deflation has come to an end, prompted by higher consumer spending and rising energy prices. In November 2016, inflation turned positive for the first time since June 2014, and it is expected to increase further. Public finances have improved, partly reflecting the drop in public investment. The introduction of a universal child benefit and the reduction of the statutory retirement age will increase spending.

57. In Bulgaria, economic expansion continued at similar rates, with GDP increasing by 3.4 per cent in 2016, boosted by strong consumption and, in particular, good exports performance. By contrast, gross fixed capital formation declined. Geopolitical tensions elsewhere have boosted the important tourist sector, which has, in turn, contributed to the widening current account surplus. Prices have been declining since 2013 but started to increase on an annual basis in January 2017. Labour market dynamics were positive, with lower unemployment being accompanied by large increases in real wages. Public finances also improved, owing to good economic performance and lower public investment spending, but also to some tax changes.

58. The pace of economic expansion accelerated in Romania, reaching a post-crisis high of 4.8 per cent. As in other new European Union member countries,

public investment was dampened by the impact of the European Union financing cycle, but that was more than compensated for by strong private investment. Consumption was boosted by growing wages, including in the public sector, amid an improving labour market. Average annual inflation was negative for the second year in a row, but base effects and the strength of domestic demand turned it positive in early 2017. Despite the low-inflation environment, the National Bank of Romania kept its policy rate unchanged throughout 2016 and early 2017. Robust domestic demand, supported by an expansive fiscal policy, led to a widening external deficit. However, growing foreign direct investment is contributing to increased export capacity.

59. Croatia, the newest European Union member, emerged from a long period of contraction in 2015, posting a 1.6 per cent expansion that gathered momentum in 2016 with a 2.9 per cent increase. The recovery was driven by domestic demand but was broad-based. Although there was some deceleration in the growth of exports of goods, the tourism sector performed well and the current account posted a sizeable surplus. Fiscal consolidation translated into a reduction of the ratio of public debt to GDP for the first time in six years. The unemployment rate, reaching 13.5 per cent in the last quarter of 2016, was considerably higher than in other new European Union countries, but has fallen sharply. Outward migration has also played a role in reducing unemployment.

B. South-Eastern Europe

60. In the Western Balkans, economic activity accelerated further in 2016, driven by the strong pick-up in Serbia, the largest economy in the subregion. However, there was some loss of momentum in several countries, in particular the former Yugoslav Republic of Macedonia. These economies are very closely linked to the European Union, which remains a major influence on economic prospects. Despite the acceleration of growth, inflation remained at very low levels. In early 2017, higher oil prices boosted inflation, but the impact was limited. Domestic demand, in particular investment, drove the expansion. Public investment in infrastructure continued to play an important role in Albania and Bosnia and Herzegovina. After years of moderation, improved dynamics in labour markets have boosted consumption. However, despite recent progress, unemployment remains high, exceeding the levels previous to the 2008 crisis, with the exception of the former Yugoslav Republic of Macedonia and Montenegro. Levels of long-term and youth unemployment are particularly high. In some countries, in particular Albania and Serbia, credit expansion supported the strength of domestic demand. By contrast, net external demand made a negative contribution to growth in most countries, with the exception of Serbia and, notably, Montenegro, owing to tourism revenues.

61. The subregion has accumulated large stocks of public debt, and fiscal consolidation efforts continued, although with mixed results. While positive progress was observed in Albania, Bosnia and Herzegovina and Serbia, further worsening took place in other countries. Financing of infrastructure remains a significant source of outlays in the former Yugoslav Republic of Macedonia and Montenegro.

62. The current account deficit grew in almost all of the countries of the subregion, with the notable exception of Serbia. In Albania and Montenegro, imbalances reached double-digit figures. In Albania, an oil exporter, low prices continued to dampen external performance. Growing investment in the subregion translates into large income payments, while remittances have declined. Foreign direct investment remains the main source for covering these deficits, but, as economies in these countries are increasingly dependent on external financing, they are vulnerable to a deterioration of global financing conditions.

63. In Turkey, economic growth nosedived in 2016, dropping from 6.1 per cent in 2015 to 2.9 per cent. Performance deteriorated in the second half of the year, with a 1.3 per cent decline in the third quarter of 2016, reflecting the negative impact on confidence of the failed July coup d'état, but bounced back strongly in the fourth quarter. Falling tourism revenues, which continued to decline in early 2017, had a contractionary impact. The depreciation of the lira, which gathered speed in the last quarter of 2016, pushed up inflation from already high levels, exceeding 10 per cent in February 2017. Geopolitical concerns and dwindling reserves, which barely cover short-term external debt, placed additional pressure on the currency. The Central Bank of Turkey deployed multiple tools to curb inflation, including liquidity measures to prop up the currency, but it has refrained from more aggressive interest rate hikes in view of the weakness of the economy. As in other emerging markets, the country suffered from capital outflows in anticipation of rising interest rates in advanced economies.

C. Commonwealth of Independent States

64. Economic performance improved in the Commonwealth of Independent States in 2016. After contracting by 2.3 per cent in 2015, aggregate GDP remained practically flat, with a 0.3 per cent increase. This mainly reflected a slower pace of contraction in the Russian Federation, down by 0.2 per cent, after shrinking by 2.8 per cent in 2015, according to revised data, and the return to sluggish growth in Ukraine after a severe recession. Recent dynamics and an improved outlook for commodity prices suggest that the expansion will gather momentum but, amid continuing fragilities, will remain modest in 2017.

65. Domestic demand, both consumption and investment, was very weak amid stagnating or declining real wages, poor access to credit and high uncertainty. In the Russian Federation, household consumption, which had been the main driver of the pre-crisis expansion, continued to shrink, with a 3.8 per cent fall that was less than half the precipitous decline observed in 2015. After dropping by 9 per cent in 2015, real wages remained practically flat in 2016 and started to show more dynamism in early 2017. Retail sales were strong in early 2017, partly owing to the impact of a one-off payment to pensioners to compensate for higher inflation. In Ukraine, the increase of the minimum wage supported the acceleration of real wage growth, with a positive impact on consumption. However, although consumer demand is gathering strength in the subregion, it is likely to remain a major dampener on growth.

66. Investment fared badly in most countries, with very large decreases in Belarus, Republic of Moldova and, in particular, Azerbaijan, where construction shrank by one quarter. By contrast, it staged a recovery in Ukraine. Net external demand partly offset these adverse developments. The ongoing fiscal adjustment in energy-exporting countries added to contractionary forces. In the Russian Federation, import substitution supported the performance of some sectors, namely agriculture and the chemical industry. Declining remittances from the Russian Federation depressed incomes in the small energy-importing countries in the region, but an improving trend emerged already in late 2016 and continued in 2017.

67. Despite weak output trends, labour market dynamics were relatively resilient. Sharp adjustment of real wages and underemployment have prevented unemployment figures from climbing higher. In the Russian Federation, unemployment showed little change, despite the ongoing recession, while in Ukraine, the muted recovery failed to make a dent in unemployment figures. In Kazakhstan, the unemployment rate edged lower, from already low levels, while the economically active population continued to shrink. In the smaller countries of Central Asia, returning migrant workers put pressure on local labour markets.

68. Inflation declined throughout the region as the impact of past currency depreciations wore off, exchange rates recovered and demand remained weak. In the Russian Federation, the rouble bottomed out in February 2016, and the ongoing exchange rate appreciation since then has supported the decline of inflation. In Ukraine, inflation declined sharply as the base effects from increases in the previous year's utilities prices dropped from the index, but it started to pick up in the last quarter of 2016 as the economy recovered. In Belarus, despite a large increase in regulated tariffs in early 2016, inflation stabilized but remained high in relation to other trade partners, despite price controls. Prices remained subdued in a number of smaller countries, including Armenia, Kyrgyzstan and the Republic of Moldova.

69. Declining inflation created room for continued loosening of monetary policy. However, monetary policy remained relatively tight in the larger countries of the region. Given persistent concerns about exchange rate stability and inflation, the scope for countercyclical monetary policy was perceived as limited in 2016. However, there were country differences regarding the pace of loosening.

70. In the Russian Federation, falling inflation, which reached 4.6 per cent in February 2017, and rouble appreciation, eventually prompted the Central Bank of Russia to start the easing cycle, with a cut of 0.25 basis points in March 2017 that left the key interest rate, unchanged since September 2016, at 9.75 per cent. Following the past appreciation of the rouble, with the trade-weighted exchange rate up by 38 per cent in the year leading up to February 2017, meeting the Central Bank's medium-term target of 4 per cent inflation appears less challenging. In Kazakhstan, interest rates remained high in early 2016 to support the exchange rate amid inflation levels that remained elevated. The rates came down gradually and, as inflation fell within the National Bank's target band of 6-8 per cent in January 2017, the base rate was cut to 11 per cent in February 2017, 6 percentage points below the level observed one year earlier. In Ukraine, interest rates decreased rapidly in the first half of 2016, but have remain unchanged at 14 per cent since October of that year. By contrast, the Republic of Moldova cut rates rapidly as inflation declined sharply throughout the year. In Armenia, despite ongoing deflationary trends and continued cuts, rates were kept at high levels.

71. Fiscal consolidation was widespread throughout the subregion. Energy producers, including those that entered the downturn with significant buffers, have undertaken measures to put public finances on a sustainable path and slow down the depletion of reserves and assets of the sovereign wealth funds. In the Russian Federation, public wages remained frozen for the second year in a row and benefits were only partially indexed. Despite an improved oil price, the authorities have announced their intention to refrain from spending the additional hydrocarbon revenues and to continue reducing the deficit. In Kazakhstan, the adjustment, including the reduction of lending activities by the oil fund, was accompanied by fiscal reforms to boost non-oil income.

72. In Ukraine, tax reforms, including cuts in the payroll tax rate, had a negative impact on revenues that needed to be compensated for. In addition, the rapid fall of inflation dampened revenues. In Belarus, despite a positive general government balance, the public debt has increased sharply owing to the impact of depreciation and quasi-fiscal operations. Large public debt is also limiting fiscal options in Kyrgyzstan.

73. External balances deteriorated in most countries in the subregion, including the two largest economies. As a result, the aggregate current account surplus shrank markedly, largely reflecting the decline of the Russian Federation's surplus by almost 70 per cent. Terms of trade for the subregion continued to deteriorate, albeit at a much reduced pace. They are expected to improve somewhat in 2017, as commodity prices increase.

74. In the Russian Federation, the onset of the recovery increased the demand for imports, while exports remained subdued. Lower net private capital outflows compensated for a shrinking current account surplus. Despite the persistence of sanctions, corporates have enjoyed improved access to external financing while Russian assets have attracted increased foreign interest. In Kazakhstan, the narrowing of the gap in the non-energy current account balance was insufficient to prevent a continued deficit, which almost doubled in 2016.

75. A major external adjustment has taken place in recent years in Ukraine, which has been supported by the depreciation of the hryvnia. As the economy recovered in 2016, the deficit widened, amid faltering exports. However, private capital returned to the country, a reversal of the trend observed in 2014-2015, when official sector inflows financed large outflows of private capital. The improved financing position more than offset the widening of the current account deficit, thus leading to increased reserves. However, the blockade of rail and cargo links and disputes over the control of key productive assets in the east of Ukraine in early 2017 may have a negative impact on economic performance and export capacity. In Belarus, the external financing position benefited from a $2 billion loan from the Eurasian Fund for Stabilization and Development, of which $800 million were disbursed in 2016. The agreement with the Russian Federation on gas import prices and oil deliveries concluded in April 2017 will contribute further to easing financing constraints. In the smaller Central Asian countries, in particular in Kyrgyzstan, current account deficits remain very large. After plummeting in 2015, remittances continued to fall, albeit at a reduced pace, before staging a recovery in late 2016.

76. Five countries of the Commonwealth — Armenia, Belarus, Kazakhstan, Kyrgyzstan and the Russian Federation — are members of the Eurasian Economic Union, which envisages free movement of goods, services, labour and capital and policy coordination in this economic space. In a context of overall declining trade and subdued economic performance, commercial exchanges among this group of countries shrank, despite progress in the development of an institutional framework for integration. However, the 7 per cent decline in exports within the block was far below the 19 per cent contraction observed in relation to third countries.

77. A fragile banking sector is becoming a source of budgetary outlays in some economies. Past exchange-rate depreciation, coupled with poor economic performance, has damaged asset quality. Supervisors in some countries are continuing efforts to clean up the banking system, including by reducing the number of licences. In Kazakhstan, the Problem Loans Fund is receiving additional resources, which will be partly financed by the National Oil Fund, to facilitate the recognition of bad loans in the banking system. In Azerbaijan, large transfers from the State Oil Fund have been earmarked to attend to the needs of the sector.

78. The economic outlook in the subregion has improved, but growth is likely to remain modest amid continuing downside risks. Past gains in improving living standards and reducing poverty have been eroded and faster, inclusive growth is required to reverse this situation. The recovery of commodity prices is expected to be limited. Energy-exporting countries are facing the reality of protracted low energy prices and the need to search for new engines of growth. Geopolitical risks are still present, undermining confidence. Lower exchange rates have provided opportunities for economic diversification. Progress in this area will need to be supported by appropriate policies that provide sustainable foundations for increased competitiveness in non-resource sectors, including by creating the conditions for substantially raising investment and addressing multiple infrastructure needs.