United Nations E/2018/16

# Economic and Social Council

Distr.: General
20 April 2018

Original: English

**2018 session**
27 July 2017–26 July 2018
Agenda item 15
**Regional cooperation**

# Economic situation in the Economic Commission for Europe region (Europe, North America and the Commonwealth of Independent States), 2017–2018

## 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 2017–2018.

18-06389 (E) 030518

# Economic situation in the Economic Commission for Europe region (Europe, North America and the Commonwealth of Independent States), 2017–2018

*Summary*

The present report presents the economic performance in the countries of the Economic Commission for Europe region in 2017 and early 2018 and future prospects. The pace of economic expansion accelerated in 2017 amid supportive global and policy conditions. All countries registered positive growth for the first time since the global financial crisis, though there were significant differences in subregional and country performance. The normalization of monetary policy is advancing at different speeds in the United States of America and in the euro area, owing to the disparity in their respective cyclical positions. In contrast, further loosening of monetary policy was generally observed in the Commonwealth for Independent States, amid still-falling inflation. The recovery has become more synchronized and the outlook remains positive; however, significant risks remain.

# 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 euro area; 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. The pace of economic activity accelerated in the member States of the Economic Commission for Europe in 2017. For the first time since the 2008 global financial crisis, positive growth was observed in all countries of the region, though there were marked differences in subregional and country performance. The growth of aggregate output increased from 1.7 per cent in 2016 to 2.6 per cent in 2017. That expansion has taken place in the context of a stronger global economy in which past concerns on stagnation are being put aside.

3. Throughout the region, increased signs of economic dynamism have emerged, including rising investment and growth in productivity. Deflation is no longer a threat in advanced countries and the focus is now on how quickly inflationary pressures might develop and how fast the normalization of monetary policy will proceed. So far those pressures have remained muted, which has resulted in countries favouring a gradual tightening of monetary policies. Divergence in monetary policy between the United States, where the recovery has been more sustained, and the euro area has increased. Public finances in the euro area have improved and fiscal policy is no longer restrictive, but fiscal plans for expansion in the United States will result in increased differences in that area as well, and may have potential implications for future monetary policy paths. In contrast, the economic outlook in most countries of the Commonwealth of Independent States, where inflation continued to fall in 2017 and growth prospects were moderate, prompted further loosening of monetary policy. In addition, energy-exporting countries have been adapting their fiscal frameworks to persistently low oil prices.

4. While the economic outlook in the region is generally positive, there are significant risks and sources of uncertainty. After a long period of lax financial conditions, the normalization of monetary policy may reveal hidden frailties. In some countries in the region, low interest rates have fuelled very rapid price increases in housing. In others, large external financing needs are a source of vulnerability that might be exacerbated by increases in interest rates. Geopolitical tensions persist and the prospect of trade conflicts has emerged, which may damage confidence and investment and lead to potentially large negative spillover effects.

5. Nevertheless, the improved economic situation creates a more auspicious context in which to tackle structural challenges while advancing the 2030 Agenda for Sustainable Development and ensuring that this increased economic dynamism is accompanied by progress towards more inclusive and environmentally sustainable economies.

# III. North America

6. The uninterrupted expansion of the economy in the United States for almost a decade has made its recovery one of the longest on record. Gross domestic product (GDP) growth accelerated in 2017, rising by 2.3 per cent, up from 1.5 per cent in 2016. Overall, output is 15 per cent above pre-crisis levels.

7. Falling unemployment and rising asset prices boosted consumption. The personal savings rate declined further, reaching levels not seen since before the global financial crisis. By December 2017, it had dropped to 2.4 per cent, the lowest since September 2005. However, the most significant contribution to the acceleration of GDP was provided by increased investment amid improved confidence. Residential investment, however, trailed behind overall investment. Increased exports, which benefited from a weaker United States dollar and the recovery of the global economy, added to the momentum, but the contribution of net external demand to growth remained slightly negative. Tax policy changes are expected to lend further impetus to economic activity in 2018. Fiscal policy is projected to become more expansionary, with investment reacting positively to cuts in corporate income tax.

8. Unemployment, which was at 4.1 per cent as of February 2018, has fallen to levels below those observed prior to the global financial crisis. Broad measures of unemployment, which include marginally attached and part-time workers, have also continued to improve. The dynamics of the labour market in early 2018 indicated continued strong momentum for job creation. The continued expansion has had a favourable impact on activity rates but the overall growth of the labour force is slowing due to demographic pressures.

9. A tightening labour market, as the economy appears to operate at levels close to full employment, raises risks of overheating. Despite falling unemployment, however, wage growth remained relatively weak in 2017. That was partly a reflection of compositional changes in the labour force, as demographic trends resulted in the exit of highly skilled workers. Moreover, there were significant geographic disparities in economic performance. However, data in early 2018 suggest some acceleration in wage growth, which will be supported further by the planned fiscal loosening.

10. Despite continued economic expansion, inflationary pressures have remained muted so far. The Federal Open Market Committee's preferred inflation measure — the growth deflator for personal consumption expenditures, excluding food and energy — remains persistently below target. Although the preferred inflation measure has been climbing in the second half of 2017, the year ended with annual growth at 1.5 per cent, with the overall headline inflation at 2.1 per cent and advancing to 2.3 per cent by February 2018. However, the decline of bond prices, leading to rising yields, points to rising inflation expectations, which accelerated markedly in early 2018. The break-even inflation rate derived from 10-year bonds grew rapidly, although it stabilized in early 2018.

11. Expectations of higher inflation as the economy powers ahead have driven the Federal Open Market Committee to gradually tighten monetary policy, raising interest rates three times in 2017 by a cumulative 75 basis points and, since October 2017, reducing its balance sheet. The Committee is expected to continue to remove policy accommodations as the labour market tightens further and the pace of wage growth accelerates. In December 2017, it announced that three additional interest rate increases would be justified in 2018. In March 2018, it delivered another interest rate increase of 25 basis points, while upgrading growth projections at the same time. Given the anticipated strength of the economy, it is possible that the pace of tightening might be faster than initially envisaged.

12. The impact of monetary tightening on financial conditions has been mitigated by booming equity markets. The sustained economic recovery has been accompanied by rising equity valuations, as the stock market rose by some 25 per cent in 2017. On the other hand, rising asset prices have created some concerns about potential risks to financial stability. Housing prices continued to climb and, on some measures, are currently above previous peaks. Overall household-debt-servicing payments as a percentage of personal disposable income remained relatively stable in 2017 and, at around 10 per cent, very low by historical standards. Moreover, the weakening of the United States dollar has also contributed to easing financial conditions. The nominal trade-weighted dollar exchange rate slid by 6.7 per cent in 2017 and has continued to fall in 2018.

13. The announced tax reforms will add to the existing growth momentum. However, the expansionary impact of fiscal loosening in an economy that is already very close to full employment may be partly offset by a pace of normalization of monetary policy that turns out to be faster than anticipated.

14. The acceleration of growth has been associated with the further decarbonization of the economy. According to the International Energy Agency though global carbon dioxide emissions increased in 2017, they fell by 0.5 per cent in the United States. That was the third year of falling emissions, resulting from a switch from coal to gas and, in 2017, from an increase of renewables in energy generation.[1]

15. While the economic outlook is positive, there are also some risks and sources of uncertainty. Financial vulnerabilities may have built up following a period of very lax financial conditions, and those vulnerabilities may become apparent as interest rates increase. Increased leverage in the corporate sector makes it more exposed to changes in financing conditions. Given the slow rate of growth in the labour force, a substantial acceleration in productivity is required to deliver sustained expansion rates. Improved trends with regard to investment will contribute to more favourable productivity dynamics. However, the ageing of the population and a rising dependency ratio is likely to have a negative impact on productivity. Emerging trade tensions may contribute to uncertainty and raise undesirable spillover effects.

16. In Canada, the pace of economic expansion doubled in 2017 as GDP increased by 3.0 per cent. Domestic demand, including the acceleration of private consumption and the recovery of investment after two years of contraction, drove growth as energy prices firmed up. The unemployment rate is at a level below what it was before the global financial crisis, fuelling the growth of earnings. A moderately expansionary fiscal policy also contributed to economic dynamism, although infrastructure spending remained below planned levels.

17. Housing prices in Canada have risen rapidly, supported by favourable lending conditions and net migration. The accumulation of housing-related risks in the banking sector has created some concern among monetary authorities. The ratio of household debt to GDP now exceeds 100 per cent. A withdrawal of monetary stimulus has started as growth has accelerated. The central bank, after raising interest rates twice in 2017, delivered a new increase in early 2018 while warning that uncertainty over the future of the North American Free Trade Agreement was clouding the economic outlook.

[1] International Energy Agency, "Global energy & $CO_2$ status report 2017" (March 2018). Available from www.iea.org/publications/freepublications/publication/GECO2017.pdf.

# IV. Advanced European countries

## A. Euro area

18. Economic prospects have brightened in the euro area and a broad-based recovery has been gaining momentum. Economic activity turned out stronger than initially expected in 2017, as GDP growth accelerated to 2.3 per cent from 1.8 per cent in 2016. It was the first time since 2007 that all countries reported positive growth. A significant divergence in the pace of recovery among countries persists, as the rapid expansion in Germany and Spain contrasts sharply with the sluggish performance in Italy. The expansion is expected to continue at a similar pace in 2018, amid a supportive external environment, a still-accommodative monetary policy and a broadly neutral fiscal policy. However, some deceleration is anticipated, with a moderation of sequential growth, as the factors that initially propelled the recovery, including low oil prices and a weak euro, have reversed.

19. Domestic demand has been a major driver of the expansion. The growth of consumption, in particular, has been fuelled by higher employment and increasing labour participation. Overall, the recovery following the global financial crisis in 2008 and the euro area turmoil in 2012 has been characterized by relatively weak investment. However, as the expansion has become more sustained and synchronized, a growing cyclical momentum has emerged, supported by the increase in global activity and trade. The reduction of uncertainty, high-capacity utilization rates and persistent growth in demand has boosted investment, in particular with regard to equipment, while residential investment is trailing behind. Investment surveys point to further acceleration in 2018, amid still-easy financing conditions.

20. Despite the appreciation of the euro, a favourable external environment has supported the expansion of European exports. Unlike in 2016, net external demand made a positive contribution to GDP growth. However, an excessive strengthening of the euro could damage growth prospects. The dynamics of the exchange rate remain a source of uncertainty that influences future inflation and growth.

21. Unemployment continued to fall across the euro area. There are, however, significant differences across the subregion. Labour shortages in particular sectors in some countries are in sharp contrast to double-digit unemployment rates in others. A large gap exists between age groups. While the unemployment rate fell to 7.8 per cent for those between the ages of 25 and 74 by the end of 2017, it was at 17.9 per cent for those under the age of 25. Overall, the number of employed people reached record levels, but the number of hours worked is still below what was observed before the global financial crisis, which suggests the presence of continued slack in the labour market.

22. Despite falling unemployment, wage pressures have remained largely absent. In particular, German wage growth has remained muted. Negotiated monthly earnings rose by 2.5 per cent in 2017, up from 2.0 per cent in 2015–2016, and are still below increases observed in 2012–2014, despite a booming economy. The country accounts for almost one third of the harmonized index of consumer prices for the euro area and therefore has a significant influence in overall inflation dynamics. There are different factors that may have contributed to those limited wage increases. In particular, deep trade integration and the expansion of production networks into neighbouring low-cost Central and Eastern European countries are likely to have had dampening effects.

The increased importance of global value chains[2] contributes to explaining the influence of global conditions in domestic inflation. Large migratory inflows and rising labour participation rates have also had a positive impact on labour supply, thus moderating wage pressures. Research by Deutsche Bundesbank suggests that migration from other member States of the European Union has had an influence in reducing wage pressures in recent years. However, there are indications that wage growth could increase in 2018, as suggested by ongoing negotiations between trade unions and employers, although that could be limited to some unionized sectors.[3]

23. Fixed exchange rates in a monetary union such as the euro area imply that external adjustment to imbalances across euro area members need to take place through differential inflation rates, which will be the drivers of changes in real exchange rates. In practice, and leaving aside the impact of the evolution of productivity, that means that the dynamics of inflation in Germany, where external rebalancing requires real appreciation, would constrain overall inflation in the euro area over the medium to long term.

24. Headline inflation rose slightly, boosted by higher demand, reaching 1.4 per cent by the end of 2017, up from 1.1 per cent one year earlier. However, core inflation, excluding energy and food, remained unchanged, and has been around 1 per cent over the past four years. That has resulted in persistently low inflation expectations. Yields on sovereign bonds have increased, in particular in early 2018, but remain moderate. For the highest-rated borrowers, they are still negative in real terms. Inflation is expected to increase in 2018 as a result of higher oil prices and increased demand pressures emanating from a synchronized recovery, but those influences will be mitigated by an appreciating exchange rate. Deflation is no longer a concern, given the strength of the recovery, high-capacity utilization and declining unemployment rates. However, the emergence of significant inflationary pressures remains an unlikely development.

25. The recovery has gained further momentum, but it is still supported by a very accommodative monetary policy. However, the European Central Bank has indicated that, after years of large bond purchases, the massive monetary stimulus will be gradually withdrawn, as the inflation outlook for the euro area has changed. The Bank reduced monthly net asset purchases from €60 billion to €30 billion as of January 2018. Purchases at that pace will continue until at least September 2018. However, the reinvestment of maturing bonds in the Bank’s portfolio is partly offsetting the reduction, and the impact of that will continue well beyond the end of net asset purchases. Overall, the European Central Bank will retain a substantial presence in bond markets. However, in March 2018, the Bank withdrew a previous pledge to extend the asset purchase programme if needed, showing its confidence in the strength of the recovery. The Bank intends to maintain current low interest rates until after the end of quantitative easing, with no changes anticipated until the middle of 2019.

26. Lending conditions improved further. Loans to both households and corporations continued to increase, rising by around 2.8 per cent in 2017. The health of banking systems in euro area countries has also strengthened, in line with the economic situation. However, large stocks of non-performing loans continue to weigh on the profitability and the lending capacity of that sector in some economies. By the

---

[2] Raphael Auer, Claudio Borio and Andrew Filardo, “The globalisation of inflation: the growing importance of global value chains”, BIS Working Papers, No. 602 (2017). Available from www.bis.org/publ/work602.htm.

[3] Deutsche Bundesbank, “Monthly report, November 2017”, vol. 69, No. 11 (November 2017). Available from www.bundesbank.de/Redaktion/EN/Downloads/Publications/Monthly_Report/2017/2017_11_monthly_report.pdf?__blob=publicationFile.

end of the third quarter of 2017, the ratio of non-performing loans to total loans was in double digits in six countries in the euro area.

27. After bottoming out in 2014, the growth in housing prices accelerated slightly in 2017. The wealth effect of higher housing prices is having a positive influence on consumption. While nominal prices were 7 per cent above the pre-crisis peak level in the third quarter of 2017, in real terms they remained at levels observed in mid-2011. Much faster growth was observed in the European Union as a whole, where housing prices have already reached the record levels registered before the global financial crisis in real terms. There are also significant country differences, as prices in Spain and Italy are still only around three quarters of past record levels.

28. After a sustained period of accommodative monetary policy, the transition to a more normal policy stance raises some policy concerns. Financial imbalances, the misallocation of capital and the mispricing of risks that may have built up under lax financial conditions could become apparent as the pace of economic activity increases and prompts some monetary policy tightening. That may lead to large asset price corrections with undesirable consequences. In particular, risk premiums in sovereign debt markets have fallen partly due to continued bond purchases by the European Central Bank. Reduced intervention by the European Central Bank may increase the vulnerability of peripheral bonds to market sentiment. Debt levels in the non-financial corporate sector are high and are therefore a source of risk if financial conditions tighten.

29. The fiscal position of the euro area has improved due to the cyclical recovery and persistent low financing costs. In 2017, no new Excessive Deficit Procedures were opened, and the Procedures for Greece, Portugal and the United Kingdom of Great Britain and Northern Ireland were abrogated. Spain was the only country to post a deficit above 3 per cent in 2017, but the deviation from that threshold was marginal and within target, due to the strong growth in revenues. However, although fiscal balances are converging, debt burdens are very different, which has important implications for fiscal space There are a number of high-debt countries that may suffer from rising borrowing costs as financial conditions become tighter. In contrast, other countries have the opportunity to boost overall public investment and spending on infrastructure, thereby contributing to the rebalancing in the euro area. Public debt as a share of GDP has been falling in Germany since 2010, but it is still above 100 per cent in Belgium, Cyprus, Greece and Italy. Greece successfully went back to capital markets in the summer of 2017, which showed the progress made in returning to financial normality; however, it also reflected the continued search for yield by investors in a low-interest environment.

30. Discussions on the reform of the institutional architecture of the euro area have been ongoing, including with regard to different initiatives for financial risk-sharing. In December 2017, the European Commission released a road map for deepening Europe's economic and monetary union, which contained a number of proposals, including the establishment of a European monetary fund to assist members in financial distress, on the basis of the existing European Stability Mechanism, and new budgetary instruments to support stability.

31. The euro area continued to show a large current account surplus, equivalent to 3.5 per cent of GDP. Differences in competitiveness led to the building of imbalances in the pre-crisis period. As financing became scarce, countries in the periphery that had large current account deficits were forced to adjust, largely through import contraction resulting from demand compression. There have also been successes in improving external competitiveness. In Spain, exports as a share of GDP are now around 10 percentage points above 2007 levels. With the exception of Greece, all those peripheral countries are running current account surpluses, which means that

 

they are net providers of finance to the rest of the world. Unlike the situation before the global financial crisis, they are not dependent on large capital inflows. However, no symmetric adjustment has been seen in surplus countries. In Germany, which accounts for around two thirds of the current accounts surplus in the euro area, the surplus only declined marginally in 2017 and remained close to 8 per cent of GDP.

32. The improved economic outlook provides a more auspicious environment to undertake necessary structural reforms that raise productivity rates, reduce environmental pressures and foster inclusiveness. Slow productivity growth remains a major concern, although there are some promising trends. One of the factors that explained sluggish productivity trends was low investment levels, but the sustained recovery is now being accompanied by more robust spending on equipment. Higher productivity would relieve inflationary pressures and the dampening impact on growth of an ageing population.

33. Gross fixed capital formation as a percentage of GDP remains, however, below the levels observed before the global financial crisis. Sustained underinvestment, in particular in critical areas such as transport or energy infrastructure, has reduced the growth potential of the economy. It has also prevented the ability to address looming environmental problems more quickly. According to the European Investment Bank, investment in climate change mitigation in the European Union as a whole declined from 1.6 per cent of GDP in 2012 to just 1.2 per cent in 2016.[4]

34. Convergence in real income across countries stagnated in the early years of the euro area and reversed during the global financial crisis. Low growth in productivity in some countries combined with initially lower productivity levels contributed to that adverse development for the cohesion of the monetary union. During the financial boom, cross-border capital flows financed investments in sectors such as housing and real estate, where productivity increases are limited, and so did not make a contribution to sustainable income convergence. Infrastructure investment has been negatively affected by past efforts regarding fiscal consolidation, as capital expenditures were a major target for cuts. Declines in infrastructure spending have been largest in countries with the poorest infrastructure quality, thus impairing real convergence.

35. The recovery has been accompanied by a reversal of some of the negative effects on poverty and income inequality associated with the crisis. Fiscal redistribution is an important policy instrument to mitigate inequality. According to the European Commission, redistribution through the tax systems in the European Union managed to lower income inequality by around one third from 2004 to 2014, and is the main reason for the fact that household inequality in the European Union is much lower than in the United States.[5]

36. While overall household income inequality has remained almost unchanged over the last decade, there are significant disparities across age groups when considering poverty dynamics. The share of people at risk of poverty and social exclusion rose from 21.7 to 23.1 per cent from 2008 to 2016. However, a sharper increase took place for those between the ages of 18 and 24, from 26.4 to 30.3 per cent, while the share of people at risk of poverty and social exclusion declined for those aged 65 years or older. The different dynamics are the result of labour market developments but also, in many countries, of the design of social protection systems,

---

[4] European Investment Bank, Investment report 2017/2018: from recovery to sustainable growth (November 2017). Available from www.eib.org/attachments/efs/economic_investment_report_2017_en.pdf.

[5] European Commission, *Report on Public Finances in EMU, 2017*, Institutional Paper 069 (Luxembourg: Publications Office of the European Union, 2018). Available from https://ec.europa.eu/info/sites/info/files/economy-finance/ip069_en.pdf.

which are geared more towards the protection of pensioners. Addressing the multiple implications of ageing while ensuring intergenerational equity remains a challenge.

## B. Other advanced countries

37. Growth was better than expected in the United Kingdom following the outcome of the referendum on membership in the European Union in June 2016. The immediate negative implications for investment were less than anticipated, but consumption suffered as the depreciation of the pound sterling fuelled inflation and reduced real incomes. Externally oriented sectors performed comparatively better, benefiting from a stronger competitive position. Overall, GDP growth decelerated to 1.7 per cent in 2017 from 1.9 per cent in 2016. That slowdown contrasted with a more robust performance by the country's main trading partners and the strength of the global economy. Sluggish growth and falling unemployment have resulted in weakened productivity trends. The expansion of the labour force was an important driver of economic activity in the United Kingdom over the past decade, but was accompanied by poor productivity performance. The reduction of net inward migration after the referendum on membership in the European Union has also weighed negatively on growth.

38. Inflation overshot the target of 2.0 per cent to reach 3.0 per cent at the end of 2017. The depreciation of the pound sterling and the reduction of the slack in the economy have prompted a change in the inflation outlook. The Bank of England raised interest rates by 25 basis points for the first time in a decade in November 2017, starting the normalization of monetary policy. However, financial conditions remain highly accommodative and continue to provide support to economic activity.

39. Economic prospects in the United Kingdom remain linked to the outcomes of the negotiations on leaving the European Union. In March 2018, an agreement was reached on a transition period of 21 months after March 2019, which is conditional on the conclusion of a withdrawal treaty. During that period, the United Kingdom will continue to abide by the rules of the European Union and will participate in its customs union and single market. That will give governments and businesses further time to plan, but the final details of the withdrawal from the European Union remain undefined. The associated uncertainty will continue to weigh on economic prospects.

40. Economic performance was generally positive in Scandinavian countries. In Norway, the reversal of declines in oil prices boosted economic activity and GDP growth accelerated from 1.1 per cent to 1.8 per cent in 2017, supported by an increase in household consumption and a sharp turnaround in investment. In Sweden, growth was robust. Investment, in particular in housing, made a large contribution to the estimated 2.7 per cent increase in GDP in 2017. However, some data indicating softer economic sentiment emerged in early 2018. In Denmark, growth accelerated slightly to 2.1 per cent in 2017. The turnaround in net external demand, which accounted for almost one quarter of the observed expansion, offset the deceleration of consumption and investment. However, that performance was boosted by a large payment for the use of a patent, which was booked as a services export, which raised the growth rate by 0.4 percentage points, according to Statistics Denmark. That example illustrates the limitations of using GDP to assess domestic activity in a small, open economy such as Denmark or Ireland.

41. Housing prices have been increasing rapidly in recent years in Scandinavian countries, particularly in the capitals. In Denmark, a sharp adjustment in housing prices followed the global financial crisis, but prices recovered afterwards. Household debt is large in Scandinavian countries and monetary authorities have expressed concerns over emerging financial risks. In Denmark, besides the strengthening of

macroprudential policies, property valuation and taxation have been reformed to rein in increases in housing prices. Housing prices started to decline in the middle and/or later months of 2017, depending on the country, which has reduced the likelihood of a larger adjustment.

42. Monetary policy has been very accommodative, which has supported increases in housing prices. Policy rates remain at record lows in Sweden (-0.50 per cent) and Norway (+0.50 per cent). Although inflation has increased, particularly in Denmark, and is expected to increase further, it remains low. In Sweden, inflation peaked in July 2017 and has been falling since then.

43. Growth remained moderate in Switzerland in 2017, as the strong Swiss franc dampened economic activity. Despite some weakening, the exchange rate remained around 20 per cent above the level before the global financial crisis in real trade-weighted terms. Inflation returned to positive territory, after five years of deflation boosted by higher oil prices and the depreciation of the Swiss franc. Overall, wage and price pressures remain very weak. The pace of expansion of economic activity is expected to accelerate significantly in 2018, boosted by the further depreciation of the Swiss franc and favourable international conditions.

# V. Emerging economies

## A. New European Union member States

44. Economic performance was robust in 2017, and output expanded at the fastest rate of growth in a decade, rising from 3.2 per cent in 2016 to 4.8 per cent. The upswing in the rest of the European Union has created a favourable environment for economic activity, while policies are supportive of growth. The expansion will moderate in 2018 but remain robust, as the positive external circumstances are expected to continue. The rapid pace of expansion observed implies further progress in reducing the income gap with member States that joined the European Union earlier. The growth differential is above 2 percentage points, as observed in the years before the global financial crisis, thus contributing to economic convergence.

45. Private consumption, supported by rising real wages and household incomes, has been the main driver of the recovery. Public interventions have also boosted consumption in some countries. In Poland, transfers to families with children provided an additional source of income. In Hungary, the minimum wage increased by 15 per cent in 2017, to be followed by a further 8 per cent in 2018. In Romania, a procyclical fiscal policy fuelled the strong growth of household consumption, which drove the fastest economic expansion observed in the European Union, as GDP increased by 7 per cent.

46. Investment also gathered strength, supported by increases in fiscal transfers from the European Union, improved economic prospects and high-capacity utilization rates. The acceleration of investment was particularly strong in Hungary, as a result of a high rate of absorption of European Union funds. In Poland, public investment recovered as the pace of European Union transfers accelerated. Investment by the private sector remained subdued but is expected to increase, as new opportunities emerge from increased investment in infrastructure co-financed by the European Union. In contrast, overall investment growth in Romania was moderate, while public investment declined, due to the low absorption of European Union funds and the priority attached to current spending. In Croatia, the negative impact of the problems related to the large conglomerate Agrokor contributed to weakening investment.

47. Unemployment rates continued to decline throughout the subregion. In Croatia, despite growing employment and continued emigration, unemployment remained

high, at just below 12 per cent by the end of 2017. In contrast, in Czechia, a low unemployment rate declined further. Czechia has the lowest unemployment rate in the European Union, at 2.4 per cent as of January 2018, followed by Germany with 3.6 per cent.

48. Tightening labour markets have been accompanied by rising wages. Labour shortages have emerged in particular areas in some countries, which have been partly filled by migrant workers. Migration from Ukraine accounts for the bulk of inflows in Czechia and, in particular, Poland, where it has contributed to moderate wage pressures. The availability of skills is emerging as an investment constraint in some countries in the subregion. While migratory outflows have abated, concerns regarding skill drain remain. Over the long term, adverse demographic trends will result in declines in working-age populations, which are projected to be particularly large in Bulgaria, Poland and Romania. In Poland, the reduction of the retirement age introduced last October will further constrain labour supply.

49. Inflation, which was very low or negative in 2016, accelerated in the course of 2017. In Poland, core inflation has been oscillating at around 2 per cent over the past year, although inflation expectations are rising. In Bulgaria, after three years of deflation, prices have started to grow moderately. In Czechia, the appreciation of the exchange rate, following the floating of the koruna in April 2017, has contributed to moderate inflationary pressures. In Romania, inflation has accelerated strongly, boosted by strong demand and higher energy prices, and, at 3.8 per cent as of February 2018, is now the highest rate in the European Union.

50. Strong economic growth has boosted revenues and improved the fiscal positions of countries in the subregion. In Bulgaria, the fiscal windfall was used in late 2017 to significantly increase spending while still keeping the budget in a surplus. In Czechia, very low debt-servicing costs contributed to strengthening the country's fiscal position. Despite rapid growth in expenditures, the deficit remained at around 3 per cent of GDP in Poland. In Croatia, higher-than-expected revenues resulted in a surplus of the primary balance for the first time since the country's independence and led to a reduction of the overall deficit. The ratio of public debt to GDP, which is comparatively high, is on a downward path.

51. Monetary policy trends are diverging in the subregion. While monetary authorities in Hungary and Poland appear less alarmed by inflation so far, authorities seem more ready to tighten policies in Czechia and Romania. In Poland, interest rates have remained unchanged since March 2015. While inflation has come to an end, monetary authorities have not signalled an intention to raise rates yet. The Czech National Bank introduced a very small raise in the policy rate in August 2017, and in early 2018 started to express some concerns on the inflationary impact of wage growth. The National Bank of Romania raised the policy rates, which had been unchanged since May 2015, twice in the first two months of 2018.

52. Credit growth accelerated in the most of the new European Union member States, in particular with regard to households, but continued to contract in Croatia. Overall, credit expansion was relatively contained, as Czechia was the only country posting increases well above nominal GDP growth. Foreign bank funding generally improved, but the robust growth of domestic deposits was by far the main source of financing for the increase in lending. Unlike the situation before the global financial crisis, when foreign capital inflows were substantial, further credit expansion is likely to be constrained by the growth of domestic deposits. Banking sectors in the subregion are in better shape, although the share of non-performing loans remains high and is only declining slowly in Bulgaria and Croatia. Housing prices have also increased rapidly in recent years, although debt-to-income ratios remain well below those observed in member countries that joined the European Union earlier.

53. Current account deficits declined sharply or turned into surpluses in most countries in the subregion after the euro area sovereign debt crisis in 2012, owing to associated tensions in financial markets and their negative impact on cross-border financial flows. That implies an excess of domestic savings over investment, despite the opportunities created for faster economic growth in those economies. In Bulgaria, domestic demand replaced export-led growth in 2017 as the main source of expansion, but the current account surplus remained one of the largest in the region, at around 4 per cent of GDP. As in Croatia, the growth of tourism revenues in Bulgaria supported external balances. In Hungary, the deterioration of the trade balance led to a sharp decline in the current account surplus, which nevertheless remained close to 4 per cent of GDP. In contrast, the current account deficit in the fast-growing Romanian economy increased further, reaching around 3.5 per cent of GDP.

54. The economic prospects of the subregion are closely associated with those of the rest of the European Union, owing to their strong trade and investment links. European Union fiscal transfers under its cohesion policy have a significant impact on domestic demand, and the disbursement cycles influence the dynamics of output. While the recent performance and the immediate outlook are positive, some concerns emerge when considering the medium term. The eventual exit of the United Kingdom from the European Union is likely to result in a reduction of the financing available for transfers to countries that benefit from the cohesion policy, thus weakening the influence of an important growth driver in the new European Union member States.

## B. South-Eastern Europe

55. Economic performance in the Western Balkans was mixed in 2017. Growth accelerated in Albania and, in particular, Montenegro, as both economies expanded at a rate estimated to be close to 4 per cent, while in Bosnia and Herzegovina growth remained steady at around 3 per cent. Improved economic prospects in the European Union and stronger domestic demand fuelled economic dynamism. Investment related to infrastructure continued to boost economic activity, in particular in Montenegro. Private consumption is playing an increasing role in driving the expansion of output, supported by improvements in the labour markets and, in some countries, growing remittances. Increased tourism revenues are also contributing to higher economic dynamism in Bosnia and Herzegovina and Montenegro.

56. In contrast, in Serbia, the largest economy in the subregion, growth slowed to 1.9 per cent in 2017 from 2.8 per cent in 2016. While private consumption is gathering strength, bad weather affected agriculture and the slow pace of implementation of public projects dampened investment. In the former Yugoslav Republic of Macedonia, political tensions resulted in a sharp decline in investment, and overall output remained practically flat.

57. Economic growth has created new jobs, but nevertheless unemployment remains high, particularly in Bosnia and Herzegovina and, despite the introduction of public sector programmes, in the former Yugoslav Republic of Macedonia. Youth unemployment, in particular, is a major problem throughout the subregion that continues to fuel migration.

58. Inflation in the subregion remained low, although it started to increase slightly amid strengthening domestic demand. High unemployment rates indicate a significant amount of slack in labour markets. The absence of price pressures and further progress on fiscal consolidation led the monetary authorities of Serbia to lower interest rates twice in 2017 and to deliver another cut in early 2018. In the former Yugoslav Republic of Macedonia, prices started to grow after three years of deflation.

In Albania, monetary policy remains accommodative, as inflation is still well below the target rate.

59. Stronger domestic demand led to large external deficits, in particular in Montenegro, where investment-related imports fuelled a significant gap. Large deficits create significant financing needs and make the subregion vulnerable to a deterioration in external financing conditions. Foreign direct investment, however, remains the main source of financing and increased export capacity will tend to reduce external imbalances in the future.

60. Economic prospects depend on growth dynamics in the European Union, which absorbs almost three quarters of the goods exports of the countries in the subregion. Accession to the European Union, while still a distant possibility, is providing an anchor for economic policies. It is also a source of financing, with around €1.1 billion expected to be received in 2018 in pre-accession funds. A European Commission strategy on European Union engagement with the Western Balkans[6] was published in February 2018 that presented the indicative steps required for Montenegro and Serbia, the two countries who are already in negotiations, to complete the accession process by 2025. While the income convergence process progressed rapidly from 2000 to 2007, it has stagnated since, and GDP per capita in the subregion is only around one third of the European Union average.

61. The economic growth rate of Turkey more than doubled in 2017, as GDP expanded by 7.4 per cent amid supportive policy conditions and increasing external demand, including rising tourism revenues. The labour market has performed strongly, while absorbing a large increase in the labour force. The rapid pace of job creation and government stimulus has boosted consumption. In contrast, investment has been trailing behind. Inflation accelerated in 2017, fuelled by stronger domestic demand, the weak Turkish lira and rising energy prices. Although it has started to decline, and was at 10.3 per cent in February 2018, inflation remained well above the 5 per cent target. Monetary authorities increased some key interest rates in 2017, but monetary policy remains loose. A very large current account deficit makes the country dependent on external financing and vulnerable to a reversal in foreign capital inflows and the deterioration of financing conditions. Around half of the deficit was financed with portfolio flows in 2017, mainly public bonds, while the share of foreign direct investment declined. While demographic dynamics support long-term growth, investment and productivity trends appear less supportive of future performance.

## C. Commonwealth of Independent States and Georgia

62. The pace of economic activity accelerated in 2017, marked by the return to growth in the Russian Federation after a two-year contraction. Improved terms of trade, a more supportive external environment and less-volatile macroeconomic conditions drove the recovery. Overall, GDP growth was modest and well below the rates seen in the pre-crisis period. Aggregate output of the Commonwealth of Independent States remained practically flat in 2016 and rose by around 2.1 per cent in 2017. The continuation of a supportive external environment, including improved terms of trade, is providing further support to the recovery in 2018.

63. The reaction to the oil price decline initiated in 2014 was quicker in the Russian Federation than in other energy exporters in the Commonwealth of Independent States, which allowed the exchange rate to adjust accordingly. In comparison with past contractions, the recession was much shallower. After shrinking by a cumulative

[6] Available from https://ec.europa.eu/commission/sites/beta-political/files/communication-credible-enlargement-perspective-western-balkans_en.pdf.

2.7 per cent in 2015 and 2016, GDP in the Russian Federation rose by 1.5 per cent in 2017. In contrast, the initial reluctance of other energy-exporting countries to let the currency depreciate resulted in a slower pace of adjustment. In Azerbaijan, output suffered a severe contraction in 2016 and was practically flat in 2017.

64. In Ukraine, the recovery continued for a second year, despite the company seizures and trade blockade in the east of the country. However, the negative impact of those events and the decline of agricultural production dampened economic performance. Overall, the Ukrainian economy has shrunk by around 20 per cent since 2008. Belarus came out of its recession in 2017, with strong industrial growth and a good harvest. The settlement of its dispute with the Russian Federation on oil deliveries and gas debts boosted economic prospects. In Kazakhstan, higher oil prices and increased production at the Kashagan oil field were key factors in the observed increase in growth.

65. The recovery of remittances from the Russian Federation contributed to the acceleration of economic activity in energy importers in Central Asia. In Kyrgyzstan, large increases in gold production boosted output. In Armenia, where remittances are also important, the economy has had a strong recovery, amid rapid industrial growth and higher copper prices.

66. Domestic demand was the main driver of the recovery. The Russian consumer, unlike in previous crises, suffered the brunt of the adjustment during the recent recession, but the dynamics of retail trade and mortgage lending improved amid strong real wage growth. However, consumption remained weak and trailed behind investment. In Ukraine, the minimum wage was doubled and private consumption gained momentum, but gross fixed capital formation continued to show much greater dynamism. In Kazakhstan, increasing exports also contributed to the acceleration of growth.

67. Inflation declined throughout the subregion, supported by the strengthening of exchange rates, but in some countries increases in the price of utilities contributed to an increase in inflation. In the Russian Federation, lower food prices, driven by a good harvest and the resumption of imports from Turkey, contributed to the decline of inflation, which was at 2.2 per cent by February 2018. The recovery of domestic demand and the reversal of the positive impact of exchange rate appreciation may create some inflationary pressures. In Ukraine, inflation remained at elevated levels, at 13.7 per cent at the end of 2017, well above the 8 per cent target. In contrast, inflation in Belarus fell to single digits, supported by a tight monetary policy and the reduction of directed lending. In Uzbekistan, the liberalization of currency regulations and the ongoing shift to convertibility opened new vistas for investment, but the ensuing sharp depreciation of the exchange rate pushed inflationary pressures. In Armenia, deflation came to an end in 2017 and inflation continued to increase in 2018.

68. The weakening of price pressures allowed a cautious loosening of monetary policies, although countries in the subregion are in different positions in the easing cycle. In contrast, disappointing inflation performance in Ukraine, despite the relative stability of the exchange rate, led the National Bank of Ukraine to raise rates aggressively, increasing them by 350 basis points between December 2017 and March 2018 and thereby reversing the cuts from earlier in 2017. In the Russian Federation, real rates are relatively high in comparison to other emerging markets but monetary policy is being loosened. The Central Bank of the Russian Federation cut rates by 50 basis points in December 2017 and by a further 25 basis points to 7.50 per cent in March 2018. Further cuts are expected, but recent weakening in the exchange rate may lead to a pause.

69. Employment was steady during the recent crisis, owing to wage flexibility and the use of part-time work. The current recovery is resulting in growing wage gains,

the reduction of involuntary adjustment mechanisms and declines in unemployment rates. In the Russian Federation, falling unemployment is being accompanied by a shrinking labour force, driven by demographic trends, and the emergence of labour shortages for skilled labour in some areas. In Belarus, the increase in economic growth did not lead to increased employment, owing to the impact of the ongoing restructuring of State-owned enterprises.

70. Oil prices increased in 2017, which boosted public finances in oil producing countries and also in Belarus, which benefits from oil deliveries from the Russian Federation for refining and re-exporting. Despite the recovery, prices are expected to remain much lower than before the sharp decline initiated in 2014. Energy-exporting countries continued to adapt to an environment of persistently low prices and embarked on a path of fiscal consolidation. New fiscal frameworks for the use of hydrocarbon resources were put in place. Medium-term fiscal plans imply further fiscal tightening. At the same time, an increased policy emphasis on the efficiency of public spending and its contribution to growth has emerged in the subregion.

71. Ukraine managed to contain the deficit despite increased public sector wage costs, as tax collection benefited from one-off factors and rising inflation boosted tax receipts. Privatization revenues were well below targets, however. The pension system has one of the largest deficits in the subregion, adding to the public finances gap. A pension reform was introduced in 2017 that increased the effective retirement rate.

72. The acceleration of growth and, in some countries, the strengthening of real exchange rates, was accompanied by increased imports. On the other hand, higher oil prices boosted the value of exports in energy-exporting countries, resulting in a widening of the current account surplus in the Russian Federation and a reduction of the deficit in Kazakhstan, which also benefited from increased oil exports. In Ukraine, growing remittances contributed to containing the current account deficit and offset the impact of an increased trade gap. In Belarus, the recovery of the Russian Federation and the resumption of oil deliveries from that country at normal levels greatly boosted exports.

73. In the Russian Federation, the development of some sectors, such as agriculture and food processing, benefited from import restrictions imposed as counter-sanctions. That translated into a declining share of food imports in retail trade. In Ukraine, the geographic reorientation of trade away from the Russian Federation has been accompanied by a shift in product composition to include more agricultural products. In the Russian Federation, the overall share of the European Union in total trade is falling, while the overall share of China, now the Russian Federation's largest single trade partner, increased. Trade turnover among countries of the Eurasian Economic Union grew faster than trade with other countries.

74. The subregion faced a benign environment with regard to access to capital. A number of countries, including Belarus, the Russian Federation, Ukraine and Tajikistan, took advantage of the search for yield among international investors to launch Eurobonds in 2017 and early 2018. In addition, Belarus refinanced its debt with the Russian Federation following their agreement on payments for gas arrears and a new deal on energy deliveries. In Ukraine, the recent bond issue marked the return to capital markets after the 2015 debt restructuring. Debt-servicing payments loom large in the years ahead. Although financing options have improved, low growth prospects would weigh negatively on debt sustainability in Ukraine. Eurobond proceeds in Tajikistan will be used to finance a hydropower plant.

75. The economic sanctions against the Russian Federation have prompted a process of deleveraging, particularly in the banking sector, in recent years. While the sanctions have limited financing options, they have not precluded access to foreign

funding. The share of non-residents in debt to the Russian Federation increased in 2017, while corporations have made repeated forays into international capital markets.

76. Lending, in particular with regard to households, increased in the Russian Federation and Kazakhstan. However, the banking sector remains in generally poor shape in the subregion. State support has been substantial in recent years and more will be required. In Kazakhstan, for example, government support was around 5 per cent of GDP in 2017. In Ukraine, fiscal consolidation in recent years has been remarkable, and includes the reduction of the quasi-fiscal deficits in the gas sector. However, the cost of restructuring the banking sector looms large and will contribute to the deterioration of public debt ratios. In the Russian Federation, despite recent success in stabilizing the financial system, the Central Bank needed to intervene to rescue the largest private bank, as concerns over its health led to massive withdrawals of deposits. In Tajikistan, the past collapse in remittances created serious problems for the sector, which remains in a fragile situation. Overall, problems in the banking sectors constrain progress in economic diversification.

77. While economic prospects have improved, geopolitical concerns remain. The export capacity of Ukraine has been damaged by its loss of control over resources in the eastern part of the country. New sanctions against the Russian Federation have been introduced by the United States that concern, among other issues, Russian export pipelines and could also target sovereign debt. Sanctions have obvious negative effects, including raising the cost of capital, undermining confidence and making access to technology more difficult. In the short term, however, they have prompted the development of some sectors and reduced reliance on foreign financing. Unlike in 2014, recent sanctions are being imposed in a context of rising oil prices.

78. Despite the recovery and anticipated continued expansion, there is a lack of economic dynamism in the subregion. Once more, the recent downturn has exposed the subregion’s vulnerability to falling commodity prices and its need to accelerate progress on economic diversification. Changes in the economic structure require sufficient levels of investment, which are comparatively low in relation to other emerging economies. Moderate growth prospects have increased policy interest in structural reforms.