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Economic situation in the Economic Commission for Europe region (Europe, North America and the Commonwealth of Independent States), 2014-2015

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 2014-2015.

Economic situation in the Economic Commission for Europe region (Europe, North America and the Commonwealth of Independent States), 2014-2015

Summary

Economic performance in the Economic Commission for Europe (ECE) region improved somewhat in 2014, with gross domestic product (GDP) growth accelerating to 1.8 per cent from 1.2 per cent in 2013. However, there were marked differences across different subregions. The decline in oil prices was supporting the global recovery, including in most countries in the ECE region. However, for a number of energy-exporting economies in the Commonwealth of Independent States, notably the Russian Federation, this development represented a significant shock.

The return to growth of the eurozone, which posted a modest 0.8 per cent GDP increase, primarily explained the overall acceleration. After years of austerity, fiscal policy was becoming less of a drag on economic activity. However, growth rates across the eurozone varied widely, and, despite some progress, financial fragmentation remained. In the European Union countries outside the eurozone, the expansion of economic activity was faster, notably in the United Kingdom of Great Britain and Northern Ireland, which was a major contributor to overall expansion in the European Union. The improvement of economic performance in the new European Union member States in Central Europe was the result of the new dynamism in the eurozone, stronger domestic demand and the use of European Union structural funds. While output in the eurozone remained well below pre-crisis levels, the recovery in the United States of America appeared to gain further momentum, with GDP posting a 2.4 per cent increase and with significant job creation. Divergent expectations regarding economic prospects and the future path of interest rates led to the steady appreciation of the US dollar vis-à-vis the euro, which accelerated in early 2015. In the eurozone and a number of advanced European countries, monetary authorities introduced negative interest rates to address deflationary pressures.

Countries with economies in transition suffered a downturn in 2014. In South and Eastern Europe, this development reflected the impact of major natural disasters. In the Commonwealth of Independent States, the conflict in Ukraine and related geopolitical tensions contributed to a decline in GDP growth from 2.0 to 0.7 per cent. Sanctions against the Russian Federation increased financing costs and undermined confidence, but falling oil prices were the main factor affecting economic performance. Diminished economic prospects in the Russian Federation had a negative impact on other countries in the Commonwealth of Independent States through trade, investment and remittances channels. Currencies in the Commonwealth weakened sharply in late 2014 and early 2015, as a result of lower energy prices, capital outflows and the transmission of shocks across the subregion.

Economic prospects for 2015 in the ECE region were mixed. Activity was expected to accelerate further in the advanced countries. By contrast, output was likely to contract in the Commonwealth of Independent States as the impact of low oil prices was felt more fully. Significant challenges remain. Advanced countries need to address the implications of adverse trends on productivity growth and ageing. In the eurozone, the recovery remains fragile and Greece's crisis could become a threat to stability. Geopolitical tensions have not yet disappeared in the Commonwealth of Independent States, which compound the fragilities created by insufficient economic diversification.

I. Introduction

1. The Economic Commission for Europe (ECE) region includes 56 Member States, with very different levels of development and economic situations. It contains most of the world's advanced countries, but also a number of low- and lower-middle income economies among the European and Central Asian countries with economies in transition. 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. Emerging economies include new European Union member States that have not yet joined the eurozone; non-European Union countries in South-Eastern Europe, including Turkey; and countries belonging to the Commonwealth of Independent States and Georgia.

II. North America

2. Economic performance in the United States of America improved slightly in 2014, with the pace of expansion gathering momentum throughout the year following a weak start, owing to a particularly harsh winter and the reversal of previous inventory build-up. GDP increased by 2.4 per cent, up from 2.2 per cent in 2013. Consumption was robust, increasing by 4.2 per cent at a seasonally adjusted annual rate in the last quarter of 2014 and 2.5 per cent for the whole year. Spending was boosted by lower inflation, employment creation and, in the last quarter, lower energy prices. Increases in household net worth, resulting from higher asset prices and lower levels of debt, will provide further impetus to consumer spending. Unlike the eurozone, where household debt remained high, write-offs and restructuring facilitated deleveraging, thus improving the financial situation of households. Investment growth was also robust, with private fixed investment increasing by 5.2 per cent. However, this is still relatively low for an expansionary phase. As economic activity gathers momentum and business sentiment improves, the pace of investment is likely to accelerate.

3. Labour market dynamics were highly positive. The unemployment rate fell to 5.6 per cent by the end of 2014 amid rapid job creation. The 1.2 percentage point drop in the unemployment rate was the fastest since 1984. Monthly average non-farm employment rose to 246,000, up from 194,000 in 2013. Around two thirds of the decline in overall unemployment was the result of falling long-term unemployment. Despite rapid employment growth, there was little pressure on wages, which suggested continued labour market slack in 2014. As the recovery gathers strength, faster wage growth should be expected. The recovery was also drawing more people into the labour force, increasing the participation rate, which reached 62.9 per cent in February 2015. However, the ageing population constitutes a powerful secular trend, exercising a downward pressure on the participation rate.

4. The acceleration of economic activity did not translate into price pressures. Consumer price inflation fell to 0.7 per cent by the end of December 2014, down from 1.5 per cent in 2013. Most of this decline was the result of falling energy prices. In February 2015, headline inflation was negative, with prices falling by 0.1 per cent on an annual basis. Declining inflation raised the value of real wages,

which increased slowly in nominal terms. However, excluding energy and food prices, there was practically no change in headline inflation compared with the previous year, with a decline from 1.7 per cent to 1.6 per cent in the year to December 2014, rising to 1.7 per cent in February 2015.

5. As the expansion in the United States gathered momentum, expectations of monetary tightening, in contrast with weaker growth in other countries, resulted in the appreciation of the dollar. The pace of appreciation, in particular in relation to the euro, accelerated in early 2015. This trend was expected to continue, with a negative impact on the performance of exports. While the growth of exports of goods and services in real terms remained roughly unchanged at 3.1 per cent in 2014, imports increased by 3.9 per cent, up from 1.1 per cent in 2013, as a result of the acceleration of economic activity and the loss of competitiveness due to the appreciation of the dollar. The current account deficit, however, remained unchanged at 2.4 per cent of GDP, partly reflecting the improvement in the terms of trade resulting from lower energy prices.

6. The United Sates has gone through a significant fiscal consolidation effort in recent years, with the federal deficit-to-GDP ratio falling by seven percentage points in the past five fiscal years. The deficit fell to close to 5 per cent of GDP in 2014, as the acceleration of growth boosted revenues and further consolidation measures to improve public finances were adopted. However, fiscal policy became less of a drag on economic activity. The reduction of the deficit had a contractionary influence in recent years, in particular in 2013, as various countercyclical fiscal initiatives adopted after the recession were removed. Government spending is expected to pick up in 2015, which will support the acceleration of economic activity.

7. Monetary policy remained very supportive of economic activity throughout 2014, but there was a shift towards normalization. New purchases of long-term securities by the Federal Reserve were gradually reduced until they came to an end in October 2014. Although new purchases had been discontinued, the accumulated holdings continued to influence long-term interest rates.

8. Long-term interest rates, as measured by yields on 10-year bonds, fell to 2.2 per cent in December 2014, down 3 per cent from 2013, despite the improvement of the labour market and the end of new asset purchases by the Federal Reserve. Yields continued to fall in early 2015, dropping to 1.9 per cent in April. The absence of inflationary pressures indicated that interest rates would remain low for an extended period. Although the Federal Open Market Committee was expected to raise its policy rate in late 2015, it signalled that it could be patient on the normalization of monetary policy and that any changes would depend on future economic data. Leaving behind a period of zero interest rates will pose a challenge for policymakers as they strive to support the recovery while taming emerging price pressures.

9. While the expansion of the United States economy seemed to be gathering momentum and output is likely to accelerate further in 2015, there are a number of risk factors that could undermine economic performance. The appreciation of the dollar results in a loss of competitiveness, which has already had an impact on the growth of exports. A period of ultra-loose monetary policy is coming to an end, and the reaction of financial markets may lead to new turbulence and negative spillovers for the country. Low rates can lead to excessive risk-taking, creating vulnerabilities that become apparent only under new financial conditions.

10. Over the medium term, growth prospects are undermined by low growth in productivity. The deceleration in productivity preceded the financial crisis of 2008-2009. Productivity growth in the non-farm business sector dropped to 1.4 per cent during the period 2007-2014, down from 2.6 per cent during the period 2000-2007. Ageing and the related decline in labour participation and lower productivity increases have reduced the potential growth rate.

11. Canada benefited from the recovery in the United States and a weaker currency, with growth accelerating to 2.5 per cent in 2014, up from 2.0 per cent in 2013. The expansion was driven by strong household consumption, which rose 2.8 per cent, and robust external demand, with exports increasing 5.4 per cent. By contrast, business fixed investment was almost flat, posting a 0.9 per cent increase. Monetary policy has been accommodative in the absence of price pressures. Inflation ended the year at 1.5 per cent and declined further to 1 per cent in February 2015, driven largely by falls in gasoline prices. Fiscal consolidation has had limited impact on growth. Despite recent good performance, significant financial fragilities remain, in particular large household debt and growing imbalances in parts of the housing market. Canada is a net oil exporter, and persistent low oil prices, while benefiting consumers, will have an overall negative impact on economic prospects.

III. Advanced European countries

A. Eurozone

12. Unlike other advanced economies, the eurozone has undergone a two-dip recession. The economic crisis in 2008-2009 was followed by a short recovery in 2010-2011 before the sovereign debt crisis prompted a new downturn. After two years of contraction, the eurozone returned to growth in 2014. However, economic expansion was sluggish, with GDP increasing by only 0.8 per cent. Slow recoveries are typical of deleveraging experiences after financial crises, but the European downturn has been remarkable. Six quarters after the beginning of the recovery in the second quarter of 2013, GDP in the eurozone remained at 2.2 per cent, below the pre-crisis level of the first quarter of 2008. Output in the periphery of the eurozone (Greece, Ireland, Italy, Portugal and Spain) is still around 9 per cent, below the pre-crisis level.

13. Economic performance was very unequal, with large variation in growth rates across countries. The expansion was more rapid in the new European Union member States that have adopted the euro, Germany and some countries on the periphery, such as Spain and Ireland. The latter was the fastest-growing economy in the eurozone, with GDP increasing by 4.8 per cent. The Italian economy continued to shrink for the third consecutive year, and performance in France was poor.

14. Economic activity is expected to pick up in 2015, supported by oil prices, a more accommodating monetary policy, a slower pace of fiscal consolidation and the depreciation of the euro, which accelerated in late 2014. There are marked differences in projections for 2015 across countries, with stronger performance in Germany and Spain and much weaker growth expected in France and Italy. However, diminished prospects in emerging markets are weighing down exports.

High unemployment rates in some countries and continued deleveraging by corporates and households will constrain the recovery.

15. Consumption was the main driver of the expansion of economic activity, posting a 1.4 per cent overall increase in 2014. However, in some economies consumption has responded weakly to the acceleration of income growth. Trends in inequality have also diverged across the eurozone. The ratio of the share of the disposable income of the top 10 per cent to the bottom 10 per cent has increased since 2008 in Austria, Greece, Italy and Spain, but declined in Belgium, Finland, the United Kingdom of Great Britain and Northern Ireland and Portugal.

16. In contrast with the relative buoyancy of consumption, investment remained sluggish, with gross fixed capital formation posting a 0.3 per cent increase. The fixed investment downturn has been very severe since the beginning of the global financial crisis, but it is no longer a drag on economic growth. The weakness of investments is greater than what has been observed following other financial crises, and, unlike the experience of other advanced countries, the post-crisis recovery in investment remains slow. Multiple factors constrain investment, including low demand, low capacity utilization rates, economic uncertainty and the ongoing deleveraging process to undo previous debt excesses. Fiscal consolidation and the end of the housing bubble have depressed further investment. As a result of this continued weakness, the investment-to-GDP ratio is about 2.5 percentage points below the average of the pre-crisis period of 1998-2007.

17. The ongoing improvement of financial conditions creates better prospects for investment. Confidence in the banking sector has strengthened, owing in part to the results of the European Central Bank Comprehensive Assessment, which was released in October 2014. Unlike the United States, where the situation had been addressed earlier in a resolute way, the unresolved situation of the European banking sector weighed negatively on confidence. This assessment, however, revealed that eurozone banks needed only small capital injections to maintain appropriate capital cover under adverse circumstances.

18. Nonetheless, the situation remains mixed and presents considerable risks. Bank lending to the private sector continued to decline in 2014, albeit at a slower pace. The contraction of lending was driven by loans to the non-financial corporate sector, while the growth of loans to households was positive. Lending rates have fallen significantly since the summer of 2014. However, non-performing loans in some countries remain high, which restricts profitability and lending, and creates vulnerability to shocks. Financial fragmentation persists. Lending costs for corporations on the periphery of the eurozone are still high, and, despite some convergence, there remains a significant gap with core countries.

19. The push from exports was also limited, and the effect of net external demand on growth in 2014 was roughly neutral. The depreciation of the euro will boost exports, but the contribution to overall growth will be limited, as the eurozone is a relatively closed economy in which exports account for around only one fifth of total output.

20. The current account surplus of the eurozone remained large in 2014, representing an estimated 2.8 per cent of GDP. It increased further in early 2015 as a result of the impact of falling oil prices. However, country positions are quite different. Germany, with a surplus equivalent to around 8 per cent of its GDP,

accounts for the bulk of the overall surplus. Ireland, Luxembourg and Slovenia had surpluses close to 5 per cent of GDP. By contrast, Finland, France and Greece posted deficits of around -1.0 to -2 per cent. A sharp correction in the current account imbalances in the eurozone was observed in 2007-2008, with the adjustment falling on the debtor countries on the periphery. The narrowing of imbalances in those economies reflects not only the impact of austerity policies on domestic demand, but also, in particular in Ireland and Spain, improvements in competitiveness.

21. Unemployment remained at elevated levels (11.3 per cent in February 2015, down from 11.8 per cent in 2014), with very large differences across countries. However, the pickup in employment was relatively fast, given moderate improvements in economic activity, which may reflect the impact of labour market reforms in some countries. Labour costs growth remained moderate, thus facilitating job creation. In late 2014, the construction sector was a net job creator for the first time since the 2008-2009 crisis.

22. The unemployment rate for young people, which is more sensitive to economic circumstances, rose significantly in many countries during the recent crisis, and the improvements observed in 2014 and early 2015 were limited. Another major policy concern is the increase in long-term unemployment (i.e., people who remain unemployed for more than 12 months). Long-term unemployment is associated with loss of skills and not easily absorbed when activity picks up. Despite the lack of economic dynamism in recent years, the labour force participation rate has risen over the past decade, stabilizing at around 64 per cent in 2014. Of the largest countries in the eurozone, Spain saw it participation rate fell in 2014, which reflected in part the effect of migratory outflows.

23. Inflation in the eurozone has been well below the European Central Bank price stability objective (below, but close to, 2 per cent) for an extended period. It had been declining and became negative in December 2014. Lower energy prices drove the fall, but core inflation, which strips out the impact of energy and unprocessed food, was also very low, highlighting the existence of persistent slack. There is little indication as yet that current deflation is feeding into expectations of persistent falls in prices in the future, leading to the postponement of purchase decisions. However, deflation remains a major policy concern and adverse shocks could lead to entrenched expectations of price declines. Falling prices result in higher real interest rates and larger debt ratios, as they contribute to slower growth in nominal terms. Although nominal rates have fallen, real interest rates are higher in countries where unemployment is higher, owing to the impact of deflation, thus holding back the recovery in countries where there is more need for it. The depreciation of the euro, which has been prompted by expectations of a growing gap with the United States in terms of monetary policy stances, will help to offset deflationary trends. On the other hand, structural reforms in product and labour markets can contribute to deflationary trends in the short run by increasing competition and reducing price pressures.

24. After years of tightening, the fiscal policy stance was roughly neutral in 2014. Although the direction points towards further fiscal consolidation, a number of countries have been given additional time to meet their fiscal targets. Excessive deficit procedures for six countries were closed in 2014, reflecting progress in reducing their deficits. The overall deficit in the eurozone fell to 2.6 per cent of

GDP in 2014, down from 2.9 per cent in 2013, but the debt-to-GDP ratio continued to climb. The deficit reduction has been prompted by contention with regard to expenditure, declining costs in public debt financing and increased economic activity. Long-term government bond yields decreased dramatically in 2014 and early 2015. Spreads between sovereign bonds in Germany and those in other countries were relatively unaffected by political and market uncertainties concerning Greece in late 2014 and early 2015.

25. There have been some initiatives that allow more flexibility in fiscal policy and increases in public expenditure to support long-term growth. The European Union investment plan, which was presented in November 2014, aims to mobilize investments equivalent to 2.5 per cent of European Union GDP in 2015-2017 in infrastructure and small and medium-sized enterprise projects. However, the impact of this plan will not be felt until 2016.

26. Unlike the United States, where a more expansionary fiscal policy has been deployed, the eurozone has relied on a combination of loose monetary policy and structural reforms to promote economic recovery. As the impact of structural reforms is limited in the short run, this places a heavy burden on monetary policy to support demand. In 2014, the European Central Bank expanded the range of extraordinary measures to fight deflation. After two cuts, the main refinancing rate fell to 0.05 per cent and the marginal lending rate to 0.30 per cent. Since June 2014, the Bank has applied a negative rate on its deposit facility (-0.20 per cent).

27. One of the unconventional measures introduced by the European Central Bank concerns the so-called targeted longer-term refinancing operations, under which banks can borrow up to 1 trillion euros at very advantageous conditions if they meet lending benchmarks set by the Bank. However, existing monetary policy measures appeared insufficient to restore the balance sheet to its the size at the beginning of 2012 (around 3 trillion euros). As banks repaid the European Central Bank long-term loans taken out during the crisis, the balance sheet had fallen to just above 2.2 billion euros by the end of 2014. In order to tackle this question, the Bank initiated a programme of quantitative easing in January 2015, which aimed to purchase assets at a rate of 60 billion euros per month.

28. Purchasing private sector securities will not be sufficient to expand the balance sheet, given the dominance of bank lending in Europe. Therefore, this expanded asset purchase programme envisages the acquisition of government and other public securities, in addition to private asset-backed securities and covered bonds. This has stirred controversy regarding the monetary policy character of this initiative and its impact on the continued willingness of European Governments to introduce reforms. Most of the asset purchases will be sovereign debt with investment grade, although some additional eligibility criteria can be used for other countries that fall below that grade, but where an agreed programme of reforms is in place.

29. Quantitative easing can have a stimulative effect through the impact on the exchange rate. It also indirectly increases fiscal space by reducing financing costs for Governments. Quantitative easing also contributes to lifting the prices of financial assets. However, the private sector in the eurozone is more reliant than those in the United States and the United Kingdom on banking finance compared with on capital markets, so the impact on funding costs for corporations would be more limited than that of similar initiatives used in those countries.

30. Although the economic situation has improved, a number of risks for the eurozone cloud the economic outlook. Part of the stimulative effect of lower oil prices was being unwound in early 2015, owing in part to the depreciation of the euro. A less stringent fiscal policy in support of the recovery will need to be reconciled with a gradual reduction of public debt in some countries over the medium term. The uncertainties regarding the future programme of support for Greece have had a limited impact on sentiment and the eurozone is now in a better situation to deal with further turmoil in that country than in 2012. However, the negative implications of a scenario that may lead to the exit of Greece from the eurozone would be very significant.

31. Despite some expected acceleration, growth in 2015 will be insufficient to make a significant impact on unemployment rates. Increases in structural unemployment reduce potential growth and social cohesion. Therefore, they demand particular policy attention, including through a range of supply-side initiatives to address youth and long-term unemployment. Population ageing and declining productivity growth require structural reforms to address medium-term challenges to growth.

32. Despite its recent troubles, the eurozone continued to expand. Lithuania adopted the euro on 1 January 2015, becoming the nineteenth member of the eurozone. Lithuania had been operating a peg to the euro since 2002. This latest enlargement will not have a major impact on eurozone aggregates, as the country represents only around 0.4 per cent of the combined GDP.

B. Other advanced countries

33. The United Kingdom continued to show greater dynamism than the European overall, accounting for around one third of the growth in total output in 2014, far above its weight in European Union activity. GDP increased by 2.8 per cent in 2014, up from 1.7 per cent in 2013. The expansion became more balanced, as the acceleration of business investment added to the existing momentum of consumer demand. Net external demand was a modest drag on economic activity. Unemployment fell to 5.8 per cent in January 2015 from 7.3 per cent in 2014.

34. Despite the pickup in growth, inflation remained low, with no changes in prices in 2014 and up to February 2015. The appreciation of the pound in 2014, as a result of the acceleration of growth and expectations of monetary policy normalization, contributed to a reduction in price pressures. However, housing prices increased throughout the country, and concerns about affordability and related financial stability risks resurfaced. Net public sector borrowing fell by half, to 5.0 per cent, in the 2014-2015 fiscal year, compared with the 2008-2009 post-crisis peak. Monetary policy remained accommodative, with the main policy rate at 0.5 per cent since 2009 and an ongoing programme of quantitative easing worth 375 billion pounds. A benign inflationary outlook implies that interest rate hikes are not imminent.

35. In Switzerland, economic activity expanded at a rate of around 2 per cent in both 2013 and 2014. The Swiss National Bank abandoned the minimum exchange rate of 1.20 Swiss francs per euro in January 2015, which resulted in a sharp appreciation of the national currency. This will exert a downward pressure on prices and depress the economic outlook. Consumer prices had been roughly unchanged over the past two years but growth became negative in November 2014. The rate of

decline accelerated further, with prices falling by 0.9 per cent in March 2015 over the past 12 months. The removal of the floor with respect to the euro was accompanied by a further move into negative territory of the interest rate on sight deposit account balances to -0.75 per cent in order to reduce appreciating pressures and the resulting tightening of monetary conditions.

36. Denmark, which returned to growth after two years of contraction with a 1 per cent GDP increase in 2014, was forced to undertake strong measures to preserve the peg of its currency to the euro. The pressure increased following the decision of the Swiss National Bank to remove the exchange rate floor. Monetary authorities repeatedly cut rates in early 2015, bringing the rate on its certificates of deposit to -0.75 per cent.

37. In Sweden, growth picked up, with GDP increasing by 2.1 per cent in 2014, up from 1.3 per cent in 2013, driven by strong domestic demand. Despite accelerating economic growth, which has been accompanied by rapid house price increases, inflation has been negative for the past two years. Monetary authorities have resorted to unconventional policy measures to tackle deflationary pressures, which have been exacerbated by the appreciation of the exchange rate. After a decision in February 2015, the Swedish Riksbank was the first central bank to set a negative main policy interest rate, which is now -0.25 per cent.

IV. Emerging economies

A. New European Union member States

38. Economic performance in the new States members of the European Union that remain outside the eurozone was significantly better than in the old European Union member States, although with significant differences. Growth accelerated in 2014, driven by consumer demand in most countries, with aggregate GDP increasing by 2.9 per cent from 1.3 per cent in 2013.

39. The return to growth in the eurozone provided further impetus to economic expansion. External funding conditions improved somewhat, supported by current European Central Bank policies. However, there were funding reductions by Bank for International Settlements reporting banks in varying degrees in nearly all countries. Inflation declines were widespread as a result of falling energy prices and low imported inflation from the eurozone. This subregion also faced some particular challenges, as the impact of Russian countersanctions was stronger owing to closer trade relations.

40. Poland, the largest economy in the subregion, grew by 3.3 per cent in 2014, a sharp increase compared with the 1.7 per cent increase posted in 2013. Investment soared by around 9 per cent, while consumption rose by around 3 per cent. European Union structural funds, which are provided on a co-investment basis, played an important role in driving up investment. In sharp contrast with the vigour of domestic demand, net external demand, which had been driving economic expansion in the past three years, became a drag on growth. This poor external performance reflected the acceleration of domestic demand, which increases imports, but also the strength of the national currency and the importance of the Russian and Ukrainian markets for Polish exporters. Inflation, which had been very

weak for some time, became negative in mid-2014. Despite the ongoing deflationary trends, the National Bank of Poland maintained the interest rate at 2.5 per cent for some time before cutting it to 2 per cent in October 2014. A further cut to 1.5 per cent in March 2015 was likely to mark the end of the easing cycle.

41. The economy of the Czech Republic returned to growth in 2014, with GDP posting a 2 per cent increase after two years of decline. However, GDP still remained below the 2008 level. Consumption accelerated, and investment, which had fallen sharply in 2014, bounced back strongly, with gross fixed capital formation increasing by 4.5 per cent. By contrast, there was no contribution of net external demand to growth. Inflation was very low and became negative in early 2015, driven by low energy prices. After a strong fiscal consolidation effort over the past five years, some relaxation helped the recovery. This shift in policy was expected to continue in 2015, supporting further economic expansion and the use of available European Union structural funds. Monetary policy has been loose, with the benchmark policy rate set at 0.05 per cent, since November 2012. However, commercial lending remains subdued and has increased mainly owing to growing housing loans. Both corporations and households have low levels of debt, which creates a good foundation for expansion as the recovery takes hold.

42. Economic growth accelerated sharply in Hungary in 2014, with GDP posting a 3.6 per cent increase, compared with 1.5 per cent in 2013. European Union-related payments, which accounted for around 6 per cent of GDP, were an important factor driving this expansion. Investment rose by around 14 per cent, boosted by this external injection and the completion of a number of large public investment projects. Consumption was also buoyant, driven by rapid employment and growth in real wages, which was supported by low inflation. The extraordinary performance of investment was unlikely to be repeated in 2015, with a deceleration trend observed since mid-2014. Net external demand was an important contributor to growth in the period after the crisis, but had declined in recent years and turned negative in 2014. Foreign exchange mortgage loans of households, which account for around 10 per cent of GDP, will be converted into national currency bonds. That initiative, which was adopted before the sharp appreciation of the Swiss franc against the euro, will help to defuse financial risks.

43. Economic performance was weaker or experienced a setback in the new European Union member States of South-Eastern Europe. In Romania, GDP growth slowed to 2.9 per cent, down from 3.4 per cent in 2013. While consumption continued to boom, as a result of growing real wages, investment declined, albeit at a slower pace than in 2014, driven by fiscal consolidation and continued difficult access to financing. However, the main reason for the observed deceleration was the diminished contribution of net external demand to growth. Inflation declined throughout the year, ending at 1 per cent in December 2014, and falling further in early 2015. Romania did not take full advantage of European Union available funding, with a rate of utilization of structural and cohesion funds of just around half of the total by the end of 2014. While fiscal consolidation continued, monetary policy eased and the National Bank of Romania cut interest rates from 4 per cent in December 2013 to 2.25 per cent in February 2015.

44. Economic expansion accelerated in Bulgaria, but remained unimpressive, with GDP increasing by 1.7 per cent in 2014, up from 1.1 per cent in 2013. Household consumption resumed growth and became the major engine of economic dynamism,

boosted by rapid increases in real wages. The economic problems in Russia and Ukraine helped to explain the modest growth of exports, which was possible only thanks to increased sales to European Union markets. Despite increasing domestic demand, Bulgaria posted one of the largest declines in prices in the European Union, which fell by 2 per cent by the end of 2014. Public finances were negatively affected by the need to partially cover guaranteed deposits of a failed bank.

45. Croatia's economy had been contracting since 2009, with GDP falling by 0.4 per cent in 2014, against a 0.9 per cent decline in 2013. Domestic demand remained depressed, and only net external demand made a positive contribution to growth. Unemployment was among the highest in the European Union: around 17 per cent by the end of 2014. The public deficit was roughly unchanged, with an estimated gap of 5 per cent of GDP. The appreciation of the Swiss franc against the euro had implications for around 40 per cent of housing loans. A decision was made to shelter households and pass the costs on to the banks, which would add to the troubles of a sector with a large and growing share of non-performing loans.

46. The economic fortunes of these countries are closely associated with the performance of the eurozone. Disappointment over the expected acceleration in the eurozone will take a toll on growth prospects; however, in most countries, domestic demand appears solid and supports the acceleration of economic expansion. Investment is likely to pick up, benefiting from special lending schemes in some countries, European Union structural funds and low rates. Although some countries are particularly dependent on foreign funding conditions, access to financing has improved and all of them run current account surpluses or small deficits, which reduces external vulnerability. The new States members of the European Union are particularly exposed to a disruption of supplies of gas imports from Russia, which could result from a worsening of geopolitical tensions.

B. Non-European Union South-Eastern Europe

47. Economic activity in South-Eastern Europe (excluding Turkey) slowed sharply in 2014, with aggregate GDP almost flat, after posting 2.2 per cent growth in 2013. This was the result of major natural disasters in Bosnia and Herzegovina and Serbia. In other countries, stronger external demand drove an improved performance. The recovery of domestic demand, after years of contraction, was modest. The main exception was Serbia, where both consumption and investment declined, while net exports were flat, resulting in a GDP fall of almost 2 per cent.

48. While infrastructure projects supported domestic demand, high levels of unemployment remained a depressing factor. Low employment rates are a characteristic feature of the subregion, with a significant gender gap, reaching around 20 percentage points in Albania. Weak domestic demand and imported deflation resulted in very low inflation. In Bosnia and Herzegovina, prices declined for the second consecutive year. In Albania, the absence of price pressures allowed interest cuts, despite the observed acceleration in economic activity.

49. Fiscal consolidation remained a persistent policy challenge in the subregion, where slow growth and large spending commitments undermined public finances. The public deficit grew further in Serbia, to around 7 per cent, but the International Monetary Fund (IMF) programme adopted in February 2015 envisaged a path of reduction over the next three years that would create further challenges to economic

growth. In Bosnia and Herzegovina, fiscal consolidation was complicated by the impact of the floods. Unlike other countries in the subregion, the former Yugoslav Republic of Macedonia had the policy space to pursue a more expansionary fiscal policy resulting in an active public investment programme.

50. The subregion showed significant external vulnerabilities, with large current account deficits that widened in most countries in 2014. While the decline in oil prices had a positive impact on most countries, this fall helped to further increase the current account deficit in Albania, which was already at double-digit levels. In Montenegro, the bankruptcy of an aluminium smelting factory damaged export capacity and further contributed to the increase in the largest current account deficit in the region. This was somewhat offset by foreign direct investment inflows of around 10 per cent, linked mainly to the development of the tourism industry.

51. High levels of unemployment have a structural character and will continue to constrain domestic demand and growth in the subregion. Future economic prospects largely depend on the performance of the European Union economies, given the lack of domestic dynamism. In particular, a number of countries have significant trade links with Greece. Large external and public deficits restrict policy space. The banking sector is in poor shape, with high levels of non-performing loans. Structural reforms are required to create a business environment that attracts investments to raise productive capacity, absorb unemployment and address infrastructure bottlenecks.

52. In Turkey, growth slowed in 2014, with GDP increasing by 2.9 per cent, compared with 4.2 per cent in 2013. The expansion was driven by external demand, with exports increasing by 6.8 per cent against flat imports. By contrast, gross fixed capital investment declined by 1.3 per cent, while household consumption increased by the same amount. The current account deficit shrank, but remained close to 6 per cent of GDP. That gap is expected to contract further in 2015 as the impact of low energy prices becomes more visible. Large financing needs make Turkey vulnerable to changes in international investor sentiment. Inflation was well in excess of the Central Bank of Turkey’s target, reaching 7.6 per cent in March 2015. The Bank is running a loose monetary policy, with real interest rates close to zero. This has driven the depreciation of the currency, which has been a major source of inflationary pressures, despite the existing slack in the economy.

C. Commonwealth of Independent States

53. Economic growth slowed sharply in the Commonwealth of Independent States in 2014, as the subregion was affected by major shocks, including geopolitical tensions and a large fall in oil prices, which halved in the second part of the year. Aggregate GDP rose by less than 1 per cent, driven by the poor performance of the Russian economy, which rose by only 0.6 per cent, down from 1.3 per cent in 2013, and a sharp output decline in Ukraine.

54. In the Russian Federation, the imposition of sanctions by the United States and the European Union in relation to the conflict in Ukraine made access to external finance more difficult and created uncertainty, thus contributing to falling investment. Monetary tightening, in response to strong depreciating pressures, resulted in sharp increases in financing costs in late 2014. There were no major public investment projects to offset the reluctance of private business to invest in those adverse circumstances. Those negative influences compounded the persistent

weakness of investment observed in recent years. Household consumption, which had been the main driver of Russia's economic expansion, started also to lose steam, with a marked deceleration that reflected declining wage and retail lending growth throughout the year. Real disposable income contracted for the first time since 1999. The Russian Federation avoided a recession in 2014 thanks to the contribution of net external demand, as the devaluation of the rouble, which accelerated in the second half of the year, cut imports. A weaker rouble and the trade restrictions introduced by the Russian Federation as a response to Western sanctions benefited some manufacturing sectors.

55. In Ukraine, GDP declined by 6.8 per cent, which was largely explained by shrinking activity in Donetsk and Luhansk, the industrial regions directly affected by the conflict, where industrial output fell by more than 30 and 40 per cent, respectively. Consumer demand declined, as rapid inflation eroded purchasing power and a weakened banking system reduced household credit. Investments fell by around a quarter. The devaluation of the national currency and shrinking domestic demand drove down imports sharply. Improved net external demand, despite falling exports, avoided a stronger output contraction.

56. Belarus managed to achieve positive growth in 2014, despite the deterioration in performance in the last part of the year, which was driven by the slowdown in the Russian Federation, its main trading partner, and Ukraine's troubles. The Russian Federation imposed restrictions in mutual trade to avoid the re-export of Western goods affected by Russian countersanctions. Although Belarus is not an oil producer, the decline in oil prices resulted in loss of earnings from re-export agreements concluded with the Russian Federation.

57. The decline in the price of hydrocarbons and the loss of competitiveness brought about by the depreciation of the Russian rouble drove the deceleration of economic activity in Kazakhstan in 2014. Further economic slowdown was expected in 2015, as the resumption of oil production in Kashagan was delayed and low oil prices persisted. Performance in other energy exporting countries varied. While a decline in oil extraction contributed to the observed slowdown in Azerbaijan, there was rapid growth in Uzbekistan and Turkmenistan, where the development of the Galknysh gas field provided further momentum to economic activity. In most of the remaining countries in the subregion, the impact of the downturn in Russia, in particular through lower remittances, dominated the positive effect of lower energy prices.

58. Despite the economic slowdown, there was little impact on the labour market in the Russian Federation, with the unemployment rate reaching historic lows in 2014. The tightness of the labour market is partly explained by the gradual decline in the working-age population. The flexibility of real wages, which continued to fall in early 2015, provided an adjustment mechanism. In addition, the repatriation of migrant labour from other countries of the Commonwealth of Independent States partly absorbed shrinking labour demand, but had negative effects on remittances to the poorest countries in the region, where unemployment rose rapidly. In Kazakhstan, job creation was sufficient to absorb the increase in the active population.

59. Inflationary pressures emerged throughout the subregion as a result of the depreciation of the national currencies. In the Russian Federation, where the currency lost almost half of its value in relation to the United States dollar in 2014,

the food import ban introduced as a response to Western sanctions was an additional contributing factor. As a result, inflation reached 11.4 per cent by the end of December, returning to a level not seen since 2008. Inflation accelerated further in early 2015, reaching more than 16 per cent in February, with food inflation above 20 per cent. However, the strengthening of the rouble initiated in February is expected to contribute to moderate price pressures, so inflation may be close to its peak.

60. In Belarus, the weakening of the exchange rate further boosted already high inflation levels, despite the introduction of price controls in late 2014. Public sector wages were increased in response to currency depreciation, fuelling further price pressures. In Ukraine, inflation surged as the national currency plummeted, bringing the rate of annual change to double digits, in sharp contrast with the mild deflation observed in 2013. By contrast, Kazakhstan managed to keep inflation within target levels, supported by a good harvest.

61. Monetary authorities throughout the subregion addressed depreciating pressures through policy tightening. In the Russian Federation, the pressure on the rouble intensified in the last months of the year, as the decline of oil prices accelerated and sanctions reduced access to foreign exchange. Net private capital outflows reached record levels, reaching 7 per cent of GDP, almost half of which took place in the last quarter of 2014. The Central Bank of Russia hiked rates by 100 basis points in early December and, less than a week later, by 650, to 17 per cent. In January 2015, the Bank cut rates by 200 basis points, but foreign exchange interventions were required to support the rouble in view of the market reaction. As there were signs of some softening in inflationary pressures amid rouble strengthening, a 100 basis points cut was introduced in March 2015, which was likely to be followed by further reductions.

62. The National Bank of Ukraine was forced to hike rates sharply and introduced restrictions on foreign currency transactions, including a 75 per cent surrender requirement on export earnings, to halt currency depreciation. The authorities had few instruments to address the situation, with official reserves falling to a critical level of around 1.5 months of imports in early 2015. With more than half of public debt denominated in foreign currency, the depreciation of the exchange rate has had a significant impact on the debt burden.

63. In Belarus, the authorities cut interest rates earlier in 2014 to revive a weakening economy, but were forced to change tack to address the contagion of currency volatility coming from the Russian Federation in December 2014. They introduced a 30 per cent levy on the purchase of foreign exchange, restricted the expansion of credit and more than doubled short-term lending rates. Some of these measures were modified or removed in the first quarter of 2015.

64. The depreciation of the rouble and falling oil prices prompted exchange rate adjustments throughout the subregion. Kazakhstan devaluated its national currency in February 2014, despite growing reserves, to preserve competitiveness. The authorities later introduced some measures to fight dollarization and reduce depreciation pressures, including lower interest rates on dollar deposits and the conversion of foreign exchange earnings. Azerbaijan, which operated a peg to the dollar, introduced the euro in the reference currency basket and then devaluated the manat in early 2015. Turkmenistan also began 2014 with the devaluation of its national currency by almost 19 per cent against the United States dollar. Among the

non-exporting oil countries, Tajikistan raised interest rates in response to mounting inflation in 2014, to 8.0 per cent from a record low of 4.8 per cent at the beginning of the year. By contrast, Armenia cut rates throughout 2014, as the inflationary pressures linked to gas price increases in 2013 abated. The contagion of currency volatility coming from the Russian Federation led to a sharp reversal in late December 2014 and a series of interest rate hikes.

65. In the Russian Federation, fiscal revenues were boosted by the depreciation of the rouble, offsetting the impact of lacklustre economic performance. Real public expenditure increased after having declined in 2013. The overall federal budget deficit remained unchanged at around 0.5 per cent of GDP, following the issuance of bonds equivalent to 1.4 per cent of GDP to recapitalize the banking system in December 2014. Medium-term budget plans envisaged a balanced budget, with a 10 per cent cut in expenditure for most categories planned in 2015.

66. Energy producers had some policy space to address the slowdown in 2014, but the new era of low oil prices is going to require adjustments. In the Russian Federation, the National Welfare Fund is being increasingly used to finance domestic investments and stabilize the financial system. Currency depreciation and high funding costs have put banks with foreign exchange liabilities in a difficult position, which has resulted in lower credit growth and high interest rates. Around one third of the anti-crisis plan adopted in January 2015 will be financed by the Fund. In late 2014, Kazakhstan announced a policy initiative to boost investment in the country, which envisaged the use of resources of the national oil fund equivalent to almost 1.5 per cent of GDP annually in the period 2015-2017 to finance infrastructure and support small and medium-sized enterprises. At the same time, budget expenditures will be cut by 10 per cent, with the exception of social spending.

67. The fiscal situation in Ukraine became increasingly precarious in 2014 amid shrinking output, rising military expenditures and escalating financing costs. The public deficit reached 4.8 per cent of GDP, but was dwarfed by the quasi-deficit of the State company Naftogaz. A new IMF Extended Fund Facility, approved in early 2015, will provide some relief. Future plans envisage further increases in gas tariffs, a tax reform to encourage reporting, import surcharges and austerity measures to contain non-military expenditure.

68. External balances improved throughout the subregion in 2014. While the growth of exports decelerated, imports plummeted owing to shrinking domestic demand and the depreciation of national currencies. In the Russian Federation, restrictions on the import of food products also contributed to the widening of the trade surplus. Despite the fall in the oil price, the current account surplus almost doubled in 2014 to reach 3 per cent of GDP. However, this improvement was insufficient to accommodate increased net private capital outflows. Geopolitical tensions and a falling oil price reduced the attractiveness of Russian assets, while access to external financing became increasingly difficult. In Ukraine, imports fell by more than a quarter, more than offsetting the decline of exports, which resulted in almost halving the current account deficit to around 4 per cent of GDP. Exchange rate depreciation prompted the external adjustment, but also resulted in a significant deterioration of the debt-to-GDP ratio, which climbed to almost 110 per cent. In Kazakhstan, the current account switched to a deficit, as domestic manufacturers lost competitiveness in relation to Russian producers and oil prices declined. In

most oil and gas importers, the current account deficit widened in 2014, amid sluggish export performance and falling remittances.

69. The Eurasian Economic Union came into force on 1 January 2015. The initial group of signatory countries — Belarus, Kazakhstan and the Russian Federation — was joined by Armenia. The Kyrgyz Republic was expected to become a member in May. The Union envisages the creation of a single market and common policies in a number of key sectors that will result in stronger integration among its members, providing further impetus to mutual trade.

70. The economic outlook in the Commonwealth of Independent States remains challenging, despite some signs of stabilization that emerged in early 2015, following the dramatic currency crisis observed in some countries in 2014. Further geopolitical tensions will have a negative impact on access to finance and the overall business sentiment. An environment of low oil prices, if persistent, will force strong adjustments in energy-exporting countries. The Russian economy will feel the effects of lower oil prices more fully in 2015, and this will negatively affect other countries in the Commonwealth through trade, investment and remittances channels. In energy-importing countries in Central Asia and the Caucasus, the impact of the diminished economic prospects in the Russian Federation will exceed the positive influence of lower oil prices. The depreciation of national currencies has increased competitiveness in some countries, but also weakened the position of the banking system, in which significant fragilities persist. Taking full advantage of the import-substitution possibilities created by currency depreciation will require further structural reforms aimed at improving the business climate and the promotion of economic diversification.