MACROECONOMIC OVERVIEW

€60 BILLION
MONTHLY ASSET PURCHASES UNDER THE ECB'S QUANTITATIVE EASING PROGRAMME

IN 2014 THE ANNUAL GROWTH RATE IN THE TRANSITION REGION WAS
1.9%
DOWN FROM 2.3% IN 2013

COMMODITY EXPORTERS ACCOUNT FOR AROUND
40%
COMPARED WITH AN AVERAGE OF AROUND 10% WORLDWIDE

Over the past year the economic outlook in the transition region has been shaped by a significant decline in the price of oil, persistent geopolitical uncertainty, the launch of a quantitative easing programme in the eurozone and the ongoing crisis in Greece. Although economic growth in many commodity-importing countries has picked up, average growth in the region has been weighed down by the negative shocks faced by Russia, other commodity exporters and countries with strong economic ties to Russia. As a result, the annual growth rate of the transition region as a whole is projected to decline for the fourth consecutive year in 2015.

Introduction

The annual growth rate in the transition region fell from 2.3 per cent in 2013 to 1.9 per cent in 2014 and it is predicted to fall further in 2015. This slowdown in growth has been more pronounced in the region than for emerging markets globally.

At the same time several developments over the past 12 months have shaped the economic outlook for the region. First, oil prices have declined significantly from the levels observed between 2010 and mid-2014. Second, the geopolitical uncertainty surrounding the conflict in Ukraine has remained at very high levels while rising extremism and geopolitical tensions in the Middle East have adversely affected the economies of the southern and eastern Mediterranean (SEMED) and Turkey. Third, in January 2015 the European Central Bank (ECB) announced a quantitative easing programme involving monthly purchases of eligible government bonds by eurozone central banks. In contrast, the US Federal Reserve has phased out its third round of quantitative easing and is expected to tighten monetary policy in the future. Meanwhile, the crisis-hit economies of Ukraine and Greece have continued to undergo major macroeconomic adjustment.

Economic growth in the region

On balance, central Europe and the Baltic states (CEB) have benefited from the ECB's quantitative easing programme, the tentative recovery in the eurozone and the decline in commodity prices. Domestic demand has been the main driver of growth, with unemployment declining and wages rising. Exports have also picked up in some countries. In several cases growth has been boosted by sizeable increases in public investment prior to the end-2015 deadline for disbursement under the previous EU structural funds programme.

Growth performance in south-eastern Europe (SEE) has been mixed, despite an improving external environment. On balance, the region has showed considerable resilience in the face of country-specific negative shocks, such as the severe floods seen in Bosnia and Herzegovina and Serbia in mid-2014. Cyprus is continuing to perform well under its bailout programme (which has been in place since April 2013) with contractions in output slowing significantly in 2014.

After six years of deep recession, Greece (a recipient member country of the EBRD since 2015) recorded marginally positive annual growth (of 0.8 per cent) in 2014. In 2015, however, uncertainty about the new government's reform programme and its relations with international creditors dented investor and consumer confidence, leading to a steady outflow of deposits from the banking system. Matters came to a head in late June and early July when the government closed the country's banks and imposed strict limits on cash withdrawals from ATMs, as well as wide-ranging capital controls. Greece also temporarily went into arrears on its payments to the International Monetary Fund (IMF). The situation eased in the second half of July when the

EU agreed to a €7.2 billion bridging loan to Greece through the European Financial Stabilisation Mechanism, allowing Greece to clear its arrears with the IMF and make a scheduled bond payment to the ECB. The banks reopened on 20 July but the limits on withdrawals and capital controls remained in place.

The annual growth rate in Turkey fell to 2.9 per cent in 2014. The economy has continued to fall short of its growth potential in 2015, despite benefiting from the decline in oil prices, as expectations of monetary tightening in the United States, rising geopolitical tensions in the region, the perceived volatility of domestic politics in the wake of the parliamentary elections in June and weak investor sentiment have increased the country's risk premium, while its export performance has been relatively modest. Turkey's persistent current account deficit narrowed somewhat in 2014, helped by declines in commodity prices, but remained large at 5.7 per cent of GDP.

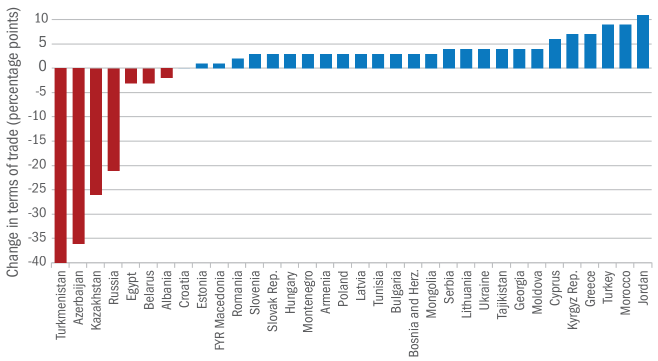
The recovery in the SEMED region has gained momentum. Growth in Egypt, the region's largest economy, has strengthened, driven by increases in private consumption and investment. Economic activity has benefited from policy reforms, a more stable political environment and – thanks to financing from the Gulf Cooperation Council – an accommodative fiscal policy. Elsewhere in the region the pace of recovery has been slower. Meanwhile, the region has continued to suffer from extremist attacks.

While the economic outlook has, on balance, strengthened somewhat in the CEB, SEE and SEMED regions, it has become substantially weaker in Russia, Central Asia and eastern Europe and the Caucasus (EEC). Russia's output contracted in the first half of 2015, with declines in oil prices exacerbating structural problems in the economy and compounding the effect of economic sanctions imposed by the European Union, the United States and several other countries. Indeed, real wages and retail sales fell at a rate of almost 10 per cent in the first few months of 2015.

Declines in remittances and export demand from Russia, coupled with country-specific structural bottlenecks, led to a significant weakening of growth in the EEC region and Central Asia in late 2014 and the first half of 2015. Economic activity in Ukraine suffered further in the first half of 2015, reflecting a lack of investor and consumer confidence, the tightening of fiscal and monetary policies as part of the country's macroeconomic adjustment and reform programme, ongoing discussions on external debt restructuring, increases in energy tariffs, bank failures and far-reaching changes in the banking sector.

The remainder of the macroeconomic overview looks in greater detail at the changes in the external environment and their impact on the economies of the region.

CHART M.1. Terms-of-trade changes due to declines in oil prices



Source: IMF World Economic Outlook and authors' calculations.
Note: These calculations assume that the price of Brent crude oil averages US$ 55 per barrel in 2015, compared with US$ 97 per barrel in 2014. A country's terms of trade are defined as the average price of its exports as a percentage of the average price of its imports.

Declining commodity prices

The price of Brent crude oil has declined sharply from the US$ 100-110 per barrel that was observed in 2010-13 and the first three quarters of 2014. It reached a low of around US$ 45 per barrel in January 2015 before edging up to around US$ 65 per barrel. It then declined again in July 2015, standing at around US$ 50-55 per barrel, when Iran (a major oil producer) concluded an agreement with the international community that paves the way for the removal of economic sanctions restricting the country's exports. The declining price of oil primarily reflects increases in the production of oil (including shale oil) in the United States at a time of weak growth in global demand. Prices of metals have also declined, albeit less dramatically.

Most of the EBRD's countries of operations have benefited directly from the decline in oil prices through reduced bills for energy imports and improvements in their terms of trade (that is to say, the average price of their exports in terms of the average price of their imports; see Chart M.1). The economies that have benefited most from declines in the price of hydrocarbons through reduced import bills include Cyprus, Greece, Jordan, the Kyrgyz Republic, Morocco and Turkey. In the CEB region energy import bills are estimated to have fallen by an average of around 2 per cent of GDP.

Countries in the SEMED region are also benefiting from fiscal savings as a result of reduced spending on explicit or implicit domestic energy subsidies. It is estimated that a 50 per cent decline in oil prices is associated with fiscal savings of between 1 and 3 per cent of GDP across the region. Moreover, lower oil prices provide a favourable environment for further reforms of subsidies – an important element of improving the sustainability of public finances in these countries in the medium term.

At the same time, while gains from reductions in oil prices are generally spread across numerous countries, the losses are concentrated in major exporters of oil and gas (Azerbaijan, Kazakhstan, Russia and Turkmenistan). The decline in oil prices has significantly weakened the economic outlook in these countries. In Russia, for example, declines in oil prices have compounded the effect of weak investor confidence in light of the economic sanctions imposed since March 2014, as well as structural problems in the economy.

While Azerbaijan and Kazakhstan are even more dependent on hydrocarbon exports than Russia (in terms of their contribution to total exports, government revenues and total value added), these economies have been able to accumulate substantial savings in special oil funds, creating the policy space necessary to deploy large-scale fiscal stimulus and thereby cushion the impact of reduced exports and fiscal revenues. In Russia, by contrast, the scope for fiscal loosening is limited by the relatively low level of fiscal reserves in the country's stabilisation funds.

The recession in Russia has resulted in major negative spillover effects for many oil-importing economies in the EEC region and Central Asia which are heavily dependent on Russia for exports, investment and remittances (see the index measuring economic dependence on Russia and the accompanying discussion in the *Transition Report 2014*). In these countries the indirect effects of declining oil prices (through their impact on Russia) may more than offset any direct gains from improvements in their terms of trade.

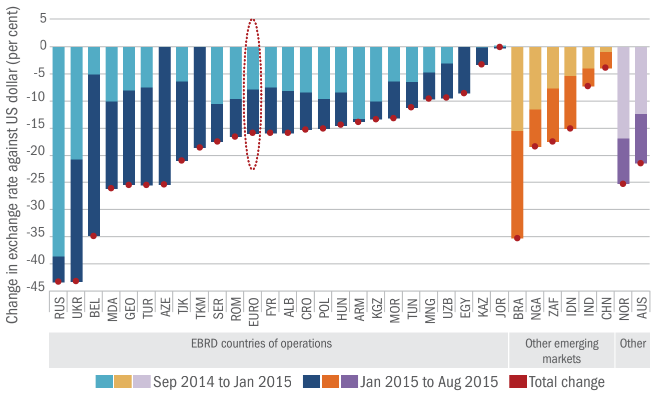
Launch of a quantitative easing programme in the eurozone and the crisis in Greece

Another development that has shaped the economic outlook for the region is the launch of a quantitative easing programme in the eurozone. In late January 2015, faced with falling inflation and a weak outlook for growth in the eurozone, the ECB announced a quantitative easing programme involving monthly asset purchases of €60 billion, directly targeting public debt. The programme will remain in place until at least September 2016. Although that announcement was largely anticipated by the markets, the size and scope of the programme surpassed market expectations.

In response, stock markets in the eurozone rallied and yields on sovereign bonds declined (temporarily turning negative in some cases) before recovering somewhat. The euro then depreciated further against the US dollar in June and July 2015 as the Greek crisis intensified.

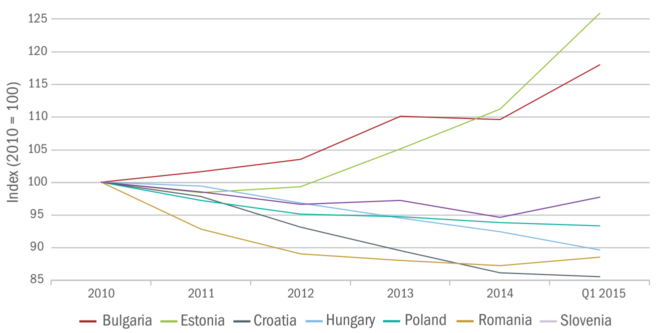
Monetary conditions in eurozone countries and countries with close economic ties to the eurozone have softened following the implementation of quantitative easing. Cyprus, Estonia, Latvia, Lithuania, the Slovak Republic and Slovenia are all directly eligible for asset purchases under the programme (Lithuania being the latest transition country to join the eurozone, having done so on 1 January 2015). Greece may also become eligible as agreement has been reached with the European Commission, the ECB,

CHART M.2. Changes in exchange rates against the US dollar



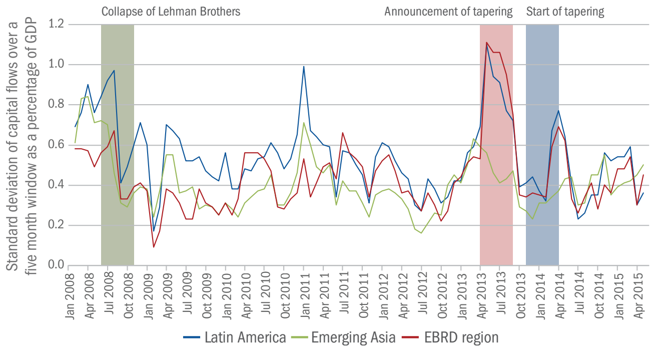
Source: Bloomberg and authors' calculations.
Note: Positive values indicate appreciation against the US dollar.

CHART M.3. Exchange rate-adjusted unit labour costs relative to the EU-15 average



Source: Eurostat and authors' calculations.
Note: Unit labour costs are adjusted for exchange rate differentials and expressed relative to an unweighted average of unit labour costs in the EU-15 economies. Estimates for the first quarter of 2015 are based on incomplete preliminary data.

CHART M.4. Volatility of flows to emerging markets



Source: EPFR Global and authors' calculations.
Note: GDP-weighted averages across countries, based on mutual fund flows. Shaded areas correspond to five-month periods around each event.

the IMF and the European Stability Mechanism regarding a new bailout programme. Interest rates in many other countries in central Europe and the SEE region have declined, mirroring interest rates in the eurozone. Stock markets in these countries have also seen significant gains. For instance, equities in Hungary and Poland outperformed both the S&P benchmark and global emerging market benchmarks in the months that followed the announcement of quantitative easing.

In addition, most currencies in the CEB and SEE regions (as well as that of Turkey) have weakened against the US dollar, mirroring the euro (see Chart M.2). Weaker currencies (on a trade-weighted basis) and more accommodative monetary conditions should boost competitiveness in these economies. While many new EU member states have gained in competitiveness relative to the EU-15 economies since 2010 in terms of exchange rate-adjusted unit labour costs, a number of them (notably Bulgaria and the Baltic states) have been losing competitiveness (see Chart M.3).

At the same time, depreciating currencies can increase the cost of servicing debt denominated in US dollars. Turkey, in particular, may be affected by the rising burden of US dollar-denominated debt, while the depreciation of the euro – the currency of Turkey's key trading partners – is limiting the competitiveness gains derived from the weaker lira.

Expected monetary policy tightening in the United States

By contrast with developments in the eurozone and Japan, monetary policy in the United States has been neutral as the total assets of the Federal Reserve have stopped increasing. As a result, the US dollar has appreciated against most currencies. US monetary policy is expected to gradually tighten as the Federal Reserve raises interest rates.

As discussed in the *Transition Report 2014*, monetary tightening in the United States tends to reduce capital inflows in emerging markets (at least temporarily) and increase the volatility of such inflows. This reflects a perceived deterioration in the balance between the risks and rewards of investing in emerging markets when returns on investment in core advanced markets rise.

Flow data for mutual funds suggest that funds' inflows and outflows are indeed strongly correlated across emerging markets in Asia, Latin America and Europe as they tend to be driven to a very significant extent by the global attitude to risk and monetary conditions in the United States.[1] Furthermore, the volatility of monthly inflows in emerging markets (calculated as the average standard deviation of monthly flows to various countries, expressed as a percentage of GDP, over a five-month period) spiked when the forthcoming tapering of quantitative easing was first announced in June 2013 (see Chart M.4).

The actual tapering (that is to say, the reduction of the monthly purchases of assets by the Federal Reserve) did not start until January 2014 and it was well anticipated and largely priced in by the markets. Nevertheless, the volatility of flows to emerging markets spiked again (albeit less dramatically) when the Federal Reserve actually began tapering.

This episode suggests that capital flows to emerging markets are likely to become significantly more volatile once interest rates begin to rise, with reduced net inflows in emerging markets initially. Countries that rely heavily on capital flows other than foreign direct investment (FDI) for the financing of their current accounts (such as Turkey) will be particularly vulnerable if US interest rates rise more strongly than expected. A sell-off in China's stock markets in August 2015 led to a sharp increase in volatility in the global financial markets. As a result, capital outflows from emerging markets appear to have intensified.

750
BASIS POINTS
CUMULATIVE INTEREST RATE INCREASE BY THE CENTRAL BANK OF RUSSIA IN DECEMBER 2014

[1] See Forbes and Warnock (2012) for evidence that global – rather than domestic – factors play a key role in explaining waves of capital flows. Rey (2013) shows that increases in interest rates in the United States are associated with rises in global measures of risk and uncertainty.

Increased geopolitical uncertainty

The economic outlook for Russia, the EEC region and Central Asia has also been negatively affected by the increased geopolitical uncertainty in the region. The conflict in Ukraine escalated repeatedly in the second half of 2014 and early 2015. The signing of the Minsk II accord in February 2015 has helped to contain the risks on the ground in Ukraine but the situation in eastern Ukraine remains highly volatile.

The sanctions imposed on Russia by the United States and the EU remain in place, as do the Russian counter-sanctions (bans on selected food imports from sanctioning countries). These sanctions, combined with uncertainty about their possible escalation in the future, have limited the ability of banks and firms to access international debt markets, contributed to an increase in net private capital outflows and negatively affected business confidence. If sanctions remain in place for a prolonged period of time, they may negatively affect innovation and technological modernisation in Russia, with a negative impact on productivity in the long term.

Geopolitical tensions are also affecting Turkey and the SEMED region, with the global and regional terrorist threat posed by Islamic State increasing in both Iraq (Turkey's second largest export partner) and Syria. The weaker export environment and deteriorating market sentiment that have resulted from these tensions have all but offset the benefits of declining oil prices for Turkey's economy. Pressure on the value of the country's currency and equities has been compounded by the inconclusive results of the parliamentary elections in June and the military intervention against Kurdish and Islamic State positions in July 2015. Political tensions also remain high in Libya and terrorist attacks have hit the tourist industries of a number of countries in the region.

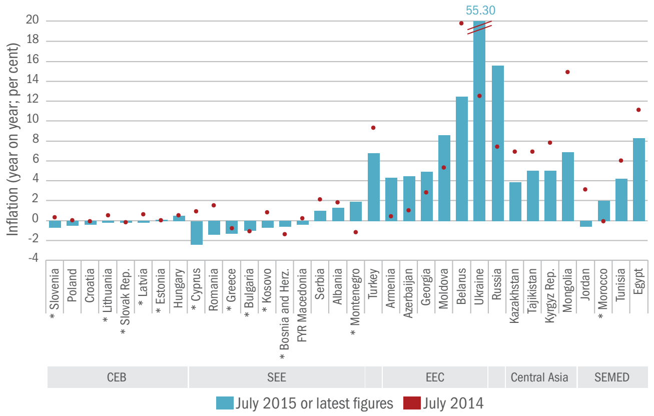
The SEMED countries that have been worst affected by this regional and domestic instability are Jordan and Tunisia. In Jordan, conflict in neighbouring Iraq and Syria has disrupted exports, including those to Turkey and Lebanon. Furthermore, Syrian refugees now account for nearly one-fifth of Jordan's population. This massive influx of refugees has strained public services, government finances and labour markets. In Tunisia, on the other hand, the recent worsening of the domestic security environment is expected to weigh heavily on tourism and investment.

Inflation and interest rates

The sharp decline in oil prices has contributed to further disinflation in most countries in the region. In several CEB and SEE countries consumer prices have declined over the last 12 months (see Chart M.5).[2]

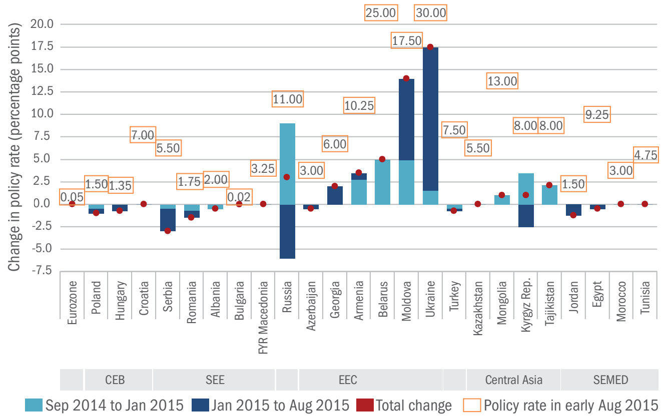
In contrast, inflation in Russia rose to around 15 per cent year-on-year in July 2015. This largely reflected a combination of the pass-through of import prices following the depreciation of the rouble and the impact of the ban on selected food imports that was imposed in 2014 on countries that placed economic sanctions on Russia. Currency depreciations also resulted in significant increases in inflation in the Kyrgyz Republic, Tajikistan

CHART M.5. Inflation rates



Source: National authorities via CEIC Data.
Note: The rates shown are year-on-year figures based on consumer price indices. * denotes a country that uses the euro as legal tender or as an anchor for its exchange rate peg.

CHART M.6. Changes in central bank policy rates



Source: National authorities via CEIC Data.

[2] See Iossifov and Podpiera (2014) for detailed analysis of the factors behind lower inflation in selected CEB and SEE countries.

and Ukraine. Meanwhile, inflation in Turkey is well above the central bank's target for the fourth consecutive year as the depreciation of the lira has pushed up the prices of imported goods, offsetting the disinflationary impact of lower oil prices.

Policy interest rates have been cut in many CEB, SEE and SEMED countries against the background of weak inflationary pressures and quantitative easing in the eurozone (see Chart M.6). At the same time, central banks in a number of countries in the EEC region and Central Asia have had to raise interest rates in response to pressure on their currencies and rising inflation. The Central Bank of Russia, for example, raised its policy rate by 750 basis points, to 17 per cent, in December 2014. By August 2015, however, this rate rise had been almost entirely reversed. At the same time, the central bank provided ample liquidity support to its banking system.

Unemployment

Unemployment has been declining in the CEB and SEE regions, attesting to a strengthening recovery (see Chart M.7). In Poland, the region's largest economy, unemployment has fallen to a level last seen in 2009. This, in turn, has supported a rise in real disposable income and strengthened domestic demand.

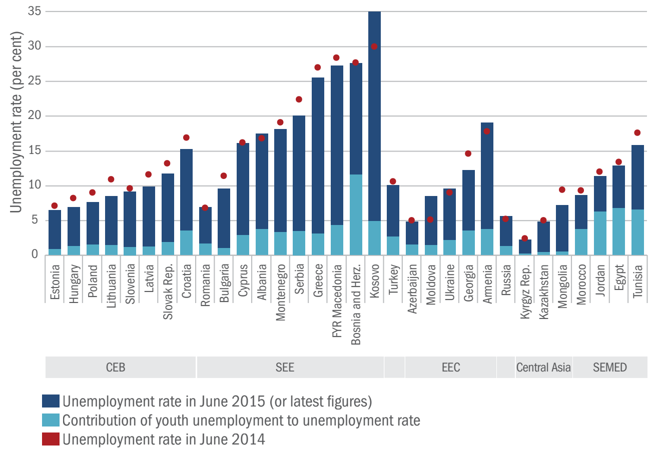
Elsewhere, unemployment rates have remained broadly unchanged, while in crisis-hit Ukraine unemployment has increased. Unemployment in the SEMED region remains high, at levels of between 10 and 15 per cent. In Bosnia and Herzegovina, FYR Macedonia, Kosovo and the SEMED countries, the presence of relatively large numbers of young adults (that is to say, people aged between 15 and 24) and limited job prospects for new entrants have resulted in youth unemployment making a major contribution – between 4 and 12 percentage points – to total unemployment rates (see Chart M.7). In SEMED countries rigid labour markets that favour existing workers and a skills mismatch arising from outdated educational models are further exacerbating the problem of youth unemployment.

Capital flows and remittances

Private capital flows to the transition region have been volatile and remain modest overall. The CEB and SEE regions saw net capital inflows totalling around 1 per cent of GDP in 2014. These inflows declined in the first half of 2015, according to preliminary data. Net private capital outflows from Russia have continued, standing at US$ 154 billion in 2014 and US$ 53 billion in the first half of 2015. To a large extent, these figures reflect the repayment of external debt by Russian banks and firms, since Russia's external debt declined from US$ 732 billion in mid-2014 to US$ 522 billion on 1 October 2015. Turkey continues to rely on non-FDI private capital inflows to finance its large current account deficit (which narrowed somewhat in 2014, standing at 5.7 per cent of GDP).

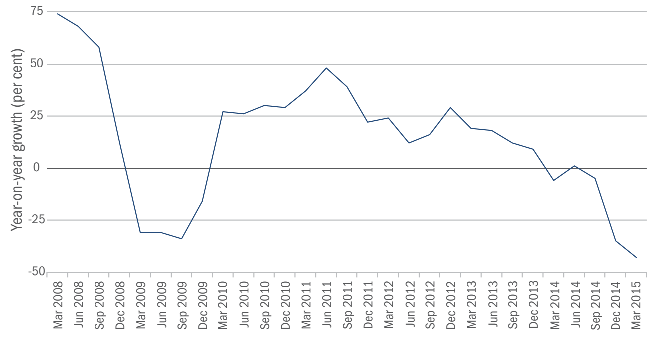
The decline in remittances from Russia to Central Asia and the EEC region has been particularly sharp. By early 2015 remittances were declining at rates similar to those observed in 2009 at the height of the crisis – by around 40 per cent year-on-year

CHART M.7. Unemployment rates



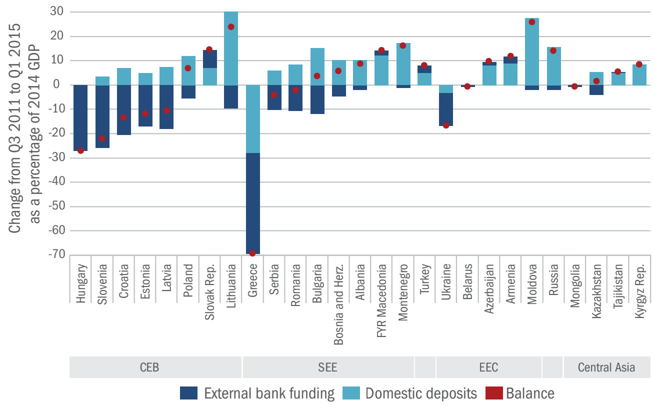
Source: National authorities via CEIC Data.
Note: "Youth unemployment" means unemployment among people aged 15-24.

CHART M.8. Remittances from Russia have declined sharply



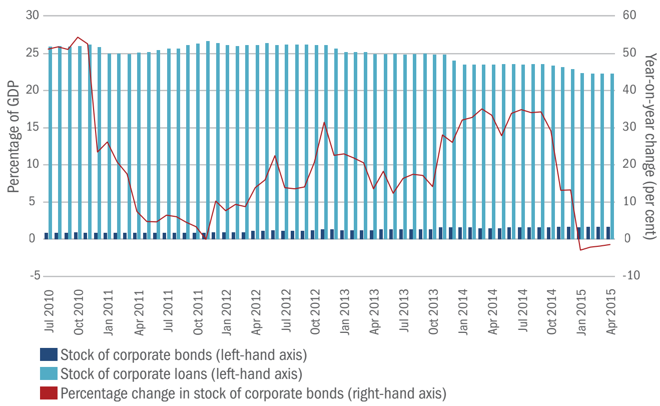
Source: Central Bank of Russia.
Note: Based on data on remittances to Armenia, Azerbaijan, Belarus, Georgia, the Kyrgyz Republic, Moldova, Mongolia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan.

CHART M.9. Changes in external bank funding and domestic deposits



Source: Bank for International Settlements, national authorities via CEIC Data, IMF World Economic Outlook and authors' calculations.

CHART M.10. Stocks of corporate loans and bonds in the CEB and SEE regions as a percentage of GDP



Source: National authorities via CEIC Data, IMF World Economic Outlook, Bloomberg and authors' calculations.
Note: Data represent GDP-weighted averages for the CEB and SEE regions.

AROUND 2%
OF GDP
VALUE OF THE STOCK OF OUTSTANDING CORPORATE BONDS IN CENTRAL AND SOUTH-EASTERN EUROPE

in US dollar terms (see Chart M.8). The impact of declining remittances has been particularly strong in Armenia, Moldova, the Kyrgyz Republic and Tajikistan, where remittances totalled between 20 and 50 per cent of GDP before the crisis (see also Box 2.4).

The decline in remittances reflects a combination of a weaker rouble and the return of a significant number of migrants to their home countries. Although data on actual migration flows are very patchy, hundreds of thousands of migrant workers are reported to have returned to Tajikistan, Uzbekistan and other countries in Central Asia and the EEC region.

Remittances have continued to rise in SEMED countries, where a significant percentage of remittances come from Gulf Cooperation Council countries and the United States.

Currency movements

Weaker inflows of remittances and declines in exports have led to downward pressure on the currencies of countries in the EEC region and Central Asia, including Belarus, Georgia and Moldova (see Chart M.2). A number of countries in this region have intervened extensively in foreign exchange markets and/or raised interest rates to limit the depreciation of their currencies. The currencies of the region's major commodity exporters, Azerbaijan, Kazakhstan and Turkmenistan, have also weakened in response to declines in export revenues. The Ukrainian hryvnia lost almost 45 per cent of its value against the US dollar between August 2014 and July 2015, reflecting the depth of the economic crisis in the country.

The rouble depreciated sharply in late 2014 and early 2015. It then fluctuated broadly in line with the movements of the oil price. In mid-2015 it was around 40 per cent weaker against the policy basket of the US dollar and the euro than it had been a year earlier. Meanwhile, Russia's international reserves declined from around US$ 500 billion in early 2014 to around US$ 350 billion in mid-2015 and have stabilised around that level.

Credit conditions and non-performing loans

Credit growth in the CEB and SEE regions has remained subdued. The rate at which parent banks are reducing their exposure to these regions appears to have increased again in late 2014 and early 2015. In many countries this reduction has not been fully offset by an expansion of the domestic deposit base (see Chart M.9), resulting in tighter credit conditions overall. At the same time, a gradual shift to a larger role for domestic deposits as a source of funding is a welcome development, as it makes the provision of credit more stable in the long term.[3]

Corporate bond issuance in the region has increased strongly since the 2008-09 crisis but from a very low base (see Chart M.10). As a result, overall volumes of outstanding bonds in the CEB and SEE regions, which total around 2 per cent of GDP, represent only a small fraction of the total stock of corporate bank credit. Consequently, the growth of bond financing has been unable to offset the negative or very weak loan growth seen in these economies. Furthermore, corporate bond issuance came

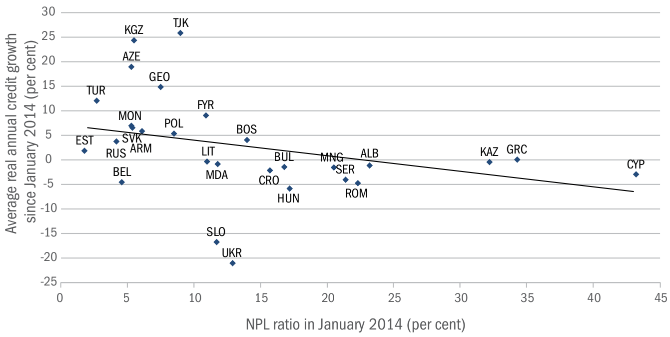
[3] See, for instance, Rai and Kamil (2010) for empirical evidence.

to a halt in early 2015, reflecting weak capital flows to emerging markets more generally.

The recovery of credit remains constrained by high non-performing loan (NPL) ratios. Indeed, Chart M.11 shows that the growth of real bank credit has, on average, been substantially weaker in countries with persistently high NPL ratios. The analysis in Chapter 1 of this report shows that this relationship also holds over longer periods of time and in larger samples of countries. NPLs limit the willingness and ability of banks to lend to corporate and household clients. On the other hand, a lack of credit growth makes it more difficult for companies to refinance their debt or secure bridge financing in the event of temporary liquidity problems, thereby exacerbating NPL problems in an economy.

As a result of decisive action by regulators, NPL ratios have recently declined significantly in both Kazakhstan (following the very high levels observed in 2008-14) and Romania. In contrast, as Ukraine's recession has deepened, its NPL ratio has risen rapidly, approaching 30 per cent. NPL ratios are estimated to be well in excess of 40 per cent in Cyprus and Greece, and close to 20 per cent in several other SEE countries, with even higher ratios in the case of corporate loans. The NPL ratio has also risen in Tunisia, where NPLs account for around 16 per cent of total loans, concentrated in state-owned banks. In addition, significant delays in passing laws to recapitalise and restructure public-sector banks and create an asset management company to absorb toxic assets are restricting the flow of fresh credit to businesses and holding back growth.

CHART M.11. Real credit growth and non-performing loans



Source: National authorities via CEIC Data, and authors' calculations.
Note: Definitions of non-performing loans may vary across countries.

AROUND
40%
DECLINE IN REMITTANCES FROM RUSSIA TO CENTRAL ASIA, THE CAUCASUS AND MOLDOVA IN US DOLLAR TERMS IN THE FIRST HALF OF 2015

Outlook and risks

The annual growth rate in the transition region is expected to fall from 1.9 per cent in 2014 to 0.2 per cent in 2015, before picking up moderately to 1.6 per cent in 2016. To a large extent, this weakening of economic growth reflects the impact that declining oil prices have had on commodity-exporting countries (which account for a large percentage of the region's GDP – around 40 per cent, compared with averages of around 20 per cent in emerging markets globally and around 10 per cent in all economies worldwide) and countries with strong economic ties to Russia. The average numbers, however, mask a significant variation across countries.

Quantitative easing in the eurozone, the weaker euro and declines in oil prices are all benefiting economies in the CEB and SEE regions. Growth in the CEB region is expected to average around 3 per cent in 2015 and 2016, allowing incomes to continue to converge with those of the EU-15 economies. Growth in most of the SEE region is expected to strengthen in 2015 and improve further in 2016. However, the outlook for Greece remains highly uncertain, as it is largely dependent on a commitment to implementing reforms agreed under a new bailout programme and the response of economic activity to those reforms.

Output in Russia is expected to contract in real terms in both 2015 and 2016 as real income, consumption and investment all decline in the face of significantly lower oil prices, which are exacerbating structural problems and the impact of economic sanctions. The general outlook in the EEC region and Central Asia has worsened owing to negative spillovers from the recession in Russia and currency depreciation in the region is amplifying risks associated with currency mismatches in corporate and public-sector balance sheets. Meanwhile, Ukraine's economy is expected to return to growth in 2016 after a deep recession in 2015.

The annual growth rate in Turkey is expected to remain around 3 per cent in both 2015 and 2016, significantly below the country's long-term potential, as the positive impact of declines in oil prices is being offset by weaker external demand, elevated domestic political uncertainty following the inconclusive parliamentary elections in June and the limited scope for interest rate cuts given Turkey's considerable dependence on capital inflows. Meanwhile, declines in oil prices, improved prospects in key export markets and a number of economic reform measures will all continue to support growth in the SEMED region, which is expected to strengthen in 2015.

A high degree of uncertainty surrounds the outlook for growth. Geopolitical risks relating to the situation in Ukraine remain elevated and an escalation of that conflict would have significant negative spillover effects for the region as a whole. The conflict in Syria and the threat posed by Islamic State and other groups are also important sources of risk for the region – particularly the economies of the SEMED region and Turkey – through their impact on trade, investment, tourism and migration flows. In addition, if monetary policy in the United States is tightened more strongly than expected, it could result in sharp increases in external financing costs and large capital outflows from emerging markets, including the transition region. The Institute of International Finance projects net capital flows to emerging markets in 2015 to be at the lowest level in more than two decades.

The persistent uncertainty surrounding the situation in Greece is another major source of risk and a deterioration in the economic outlook for the eurozone could increase the withdrawal of funds by European parent banks operating in the region and exacerbate the contraction of credit, constraining growth in investment and consumption. Furthermore, a potential further decline in oil prices would increase pressure on the Russian economy, with negative spillovers for the economies of Central Asia and the EEC region.

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