

# Polarization and Populism

**Europe and Central Asia Economic Update**

Office of the Regional Chief Economist

November 2016





WORLD BANK **ECA ECONOMIC UPDATE** NOVEMBER 2016

# Polarization and Populism

Office of the Chief Economist

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1818 H Street NW, Washington, DC 20433  
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ISBN (electronic): 978-1-4648-1009-1  
DOI: 10.1596/978-1-4648-1009-1

Cover design: World Bank



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# Acknowledgments

The Europe and Central Asia (ECA) Economic Update (<http://www.worldbank.org/eca/update>) is a joint product of ECA's Office of the Chief Economist, the Macro and Fiscal Management Global Practice, and the Poverty Global Practice, with inputs from the Developments Prospects Group.

Part I was prepared by a team in the Chief Economist Office, led by Hans Timmer, and including Maurizio Bussolo, David Michael Gould, Mathilde Sylvie Maria Lebrand, Georgi Panterov, Nathaniel Wesley Russel, William Shaw, Ekaterina Ushakova, and Hernan Jorge Winkler. Chapter 1 benefitted from forecasts prepared by economists in the Macro and Fiscal Management Global Practice, which are presented in Part II. Earlier work on perceptions, middle class and mobility by the Poverty Global Practice ECA team has been an important source of information and analysis for chapter 2.

Valuable comments were provided by Paul Anthony Clare, Carl Patrick Hanlon, Andras Horvai, Elena Karaban, Apurva Sanghi, and colleagues in Berlin, London and Paris World Bank offices.

Part II with the country pages was prepared by teams in the Macro and Fiscal Management Global Practice (led by Andrew Burns, Ivailo Izvorski, Naoko Kojo and Miria Pigato) and in the Poverty Global Practice (led by Carolina Sanchez). These teams included the following staff: Marina Bakanova, Thi Thanh Thanh Bui, Cesar Cancho, Marie-Anne Chambonnier, Alexandru Cojocaru, Marcel Chistruga, Pablo Facundo Cuevas, Barbara Cunha, Maria Eugenia Davalos, Nancy Sabina Davies-Cole, Agim Demukaj, Doerte Doemeland, Donato De Rosa, Mariam Dolidze, Bakyt Dubashov, Olga Emelyanova, Mismake D. Galatis, Anastasia Golovach, Gohar Gyulumyan, Kiryl Haiduk, Sandra Hlivnjak, Paulina Ewa Holda, Stella Ilieva, Maria Gabriela Inchauste Comboni, Saida Ismailakhunova, Charl Jooste, Faruk Khan, Yeon Soo Kim, Naoko Kojo, Christos Kostopoulos, Aurelien Kruse, Leszek Pawel Kasek, Sanja Madzarevic-Sujster, Mikhail Matytsin, Kristina Cathrine Mercado, Moritz Meyer, Jose Montes, Zakia Nekaiien-Nowrouz, Minh Cong Nguyen, Trang Van Nguyen, Catalin Pauna, Ruslan Piontkivsky, Mona Prasad, Dinar Dhamma Prihardini, Nadir Ramazanov, Caterina Ruggeri Laderchi, Apurva Sanghi, Ilyas Sarsenov, Sarosh Sattar, William Hutchins Seitz, Lazar Sestovic, Hilda Shijaku, Bojan Shimbov, Maryna Sidarenka, Nistha Sinha, Emily Sinnott, Emilia Skrok, David Andrew Stephan, Congyan Tan, Eskender Trushin, Gallina Andronova Vincelette, Ekaterina Vostroknutova, and Ayberk Yilmaz.

Barbara Karni edited and Michael Alwan typeset the report. Ekaterina Ushakova oversaw the layout and production of the report. Artem Kolesnikov worked on the cover design. Paul Anthony Clare, Elena Karaban, and John Mackedon provided communications and outreach support, including the dedicated webpage.





# Abbreviations

BH	Bosnia and Herzegovina
BHAS	BH Agency for Statistics
CAD	Current account deficit
CBBH	Central Bank of Bosnia and Herzegovina
CIS	Commonwealth of Independent States
CIT	Corporate income tax
CPI	Consumer price index
ECA	Europe and Central Asia
ECAPOV	ECA Poverty Monitoring Project database
EDP	Excessive Deficit Procedure
EEU	Eurasian Economic Union
EU-SILC	The European Union Statistics on Income and Living Conditions
FDI	Foreign direct investment
FYR	Former Yugoslav Republic
GDP	Gross domestic product
ICT	Information and communication technology
IMF	International Monetary Fund
LiTS	Life in Transition Survey
LTE	Long-Term Evolution
NEET	Not in education, employment, or training
NPL	Non-performing loans
NRP	National Reform Programme (Croatia)
OECD	Organisation for Economic Co-operation and Development
PPP	Purchasing power parity
PUOM	Prospects of upward mobility
REER	Real effective exchange rate
SAA	Stabilization and Association Agreement
SME	Small and medium enterprises
SOE	State-owned enterprises
SSC	Social security contributions
US	United States
VAT	Value-added tax
WB	World Bank
WDI	World Development Institute
WDI	World Development Indicators



# Country Groups

**TABLE O.1** Regional classification

Europe and Central Asia		Western Europe (WE)	Southern Europe (SE)	Central Europe (CE)	Northern Europe (NE)	Western Balkans (WB)
		Austria (AUT) Belgium (BEL) France (FRA) Germany (DEU) Ireland (IRL) Luxemburg (LUX) The Netherlands (NLD) United Kingdom (GBR)	Greece (GRC) Italy (ITA) Portugal (PRT) Spain (ESP) Cyprus CYP) Malta (MLT)	Bulgaria (BGR) Croatia (HRV) Czech Republic (CZE) Hungary (HUN) Poland (POL) Romania (ROU) Slovak Republic (SVK) Slovenia (SVN)	Denmark (DNK) Finland (FIN) Sweden (SWE) Estonia (EST) Latvia (LVA) Lithuania (LTU)	Albania (ALB) Bosnia and Herzegovina (BIH) Kosovo (KSV) FYR Macedonia (MKD) Montenegro (MNE) Serbia (SRB)
		South Caucasus (SC)	Central Asia (CA)	Russia (RU)	Turkey (TU)	Other Eastern Europe (OE)
		Armenia (ARM) Azerbaijan (AZE) Georgia (GEO)	Kazakhstan (KAZ) Kyrgyz Republic (KGZ) Tajikistan (TJK) Turkmenistan (TKM) Uzbekistan (UZB)			Belarus (BLR) Moldova (MDA) Ukraine (UKR)
	European Union and Western Balkans					
	Eastern Europe and Central Asia					





# Executive Summary

These are tough times for Europe and Central Asia (ECA). The Brexit vote and the refugee crisis are testing the European Union's internal cohesion. Continued vulnerabilities in European banking sectors are curbing the economic recovery. The Russian Federation, Eastern Europe, Central Asia, and South Caucasus are still grappling with the consequences of low oil prices, increasingly compounded by low prices of other commodities. The fall in commodity prices has forced major adjustments in fiscal and monetary policies, made banking sector reforms vital and urgent, and required a shift of economic activity toward exportable products. In Turkey social and political tensions have increased in the aftermath of the coup attempt. Geopolitical frictions in the region are increasing.

These challenges weigh on the economic outlook, causing forecasted GDP growth to be lower than it would have been in a less gloomy environment. Not all of the headwinds translate into a GDP downturn, however. In fact, GDP growth for the region as a whole is expected to modestly accelerate this year, to 1.6 percent, up from 1.4 percent in 2015, thanks partly to ongoing recovery in the European Union and a small rebound from the 2015 contraction in the eastern part of the region.

The absence of a slowdown in GDP growth does not contradict the statement that these are tough times for the region. The region faces difficult structural challenges that, absent strong policy responses, could impair growth and poverty reduction over the long term.

First, lower oil and minerals prices may be here to stay. Oil-exporting countries have suffered large terms-of-trade losses that reduced national income far more than it reduced GDP; in Azerbaijan, for example, national income declined by roughly 25 percent over the last two years. In the absence of a recovery in prices, commodity exporters will have to take steps to ensure that the recent exchange rate depreciations result in shifts in production to manufactures. Space has to be created for new entrepreneurs in export sectors. Large companies that depended on oil revenues and construction orders, and that benefited from lending by related financial institutions, are unlikely to become internationally competitive in new sectors and under new circumstances.

Second, the decline in investment rates in the European Union may well be part of a new normal, reflecting reduced resources as trade deficits shrank after the financial crisis. Lower investment over the long term will mean slower growth, unless policies are adopted to improve productivity. Schooling systems, labor market regulations, and financial intermediaries have to adjust to rapidly changing industrial organization, to take advantage of the emergence of the sharing economy and more atomized production methods.

Third, divergence within the European Union—as a result of diminishing international competitiveness of countries in Southern Europe—could well presage mounting tensions within the currency union.

In this environment, cyclical macroeconomic policy can be only a small part of the solution. In the western part of the region, there is some room for fiscal stimulus after austerity in previous years, while monetary stimulus is reaching its limits. In the eastern part of the region, the opposite is true. Looser monetary policy is a real option, while fiscal policies have to adjust further to lower oil revenues and reduced remittances. However, these cyclical policies will do little to address the pervasive structural challenges. In fact, pure cyclical stimulus can frustrate the necessary adjustments to cope with these structural challenges.

Perhaps the most complicated structural challenge is the growing social and political tension in many countries. Throughout the region there is a tendency toward populism. Voters' preferences are polarizing, as support for the middle of the political spectrum is dwindling. Mistrust in existing institutions and general anxiety are increasing. Surveys show especially concerns about the lack of job security.

The political polarization likely has many causes, and economic challenges or rising distributional tensions may well have played a role. However, this report shows that there is no clear link between the observed anxiety and a simple measure of income inequality. Inequality, measured by the standard Gini coefficient, has actually fallen over the past 10–15 years in some countries in the region. There are, however, indications that the anxiety is correlated with other measures of distributional tensions.

Since 2010 individuals have become more pessimistic about their position in the income distribution, opportunities for upward economic mobility have deteriorated, and incomes have become less secure over time. The latter is caused by rapid increase in temporary and part-time work, and shifts in the demand for skills, driven by new digital technologies, which affect more severely people employed in occupations of the middle the distribution. In addition, there is some evidence that inequality of opportunity, i.e. inequality due to circumstances beyond the control of the individual, has been structurally increasing. If efforts matter less for achieving secure jobs and growing incomes, than people will get discouraged, underinvest in their education or give up their search for employment. Slow overall growth has also likely reduced support for traditional parties. Econometric evidence suggests that political populism in ECA is related to the extended period of slow growth since the financial crisis. The biggest challenge for societies and governments is to provide new perspectives in a new economic era without falling back on fixes that worked in the past under very different circumstances. Coping with the structural challenges and limiting the rise in political polarization will require policies that support adjustment to these new economic realities while limiting the pain that such adjustments can cause. Given the uncertainty surrounding many of these issues, research is essential to guide policy choices.

This report consists of two chapters. Chapter 1 summarizes the short-term outlook before briefly outline the main structural challenges to growth and prosperity facing the region over the longer run. Chapter 2 examines some of the changes that may have increased social and political anxiety.

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PART



# Economic Outlook







# Tough Times for Europe and Central Asia

Europe and Central Asia (ECA) is confronting difficult social and economic challenges that threaten to overturn established political relationships and could have dire implications for long-term growth. Britain's vote in favor of leaving the European Union, geopolitical tensions, the specter of terrorist attacks, the attempted coup in Turkey, the continuing refugee crisis, and the likely long-term shift to lower prices of many countries' commodity exports have greatly increased anxiety over economic prospects. Disappointing global growth has augmented the difficulties for the region.

In the near term, ECA is facing continued slow growth. GDP growth is expected to rise modestly, from a meager 1.4 percent in 2015 to 1.6 percent in 2016, as Russia and neighboring countries start to recover from deep recessions. However, terms-of-trade losses and dwindling remittances have reduced incomes and consumption by much more than GDP in Eastern Europe and Central Asia. Even with a recovery in GDP, 2016 consumption is expected to remain more than 4.5 percent below its 2014 level in the eastern part of ECA. Throughout the region, exchange rate depreciations have contributed to modest acceleration of exports and GDP.

Several structural challenges have become more urgent than the cyclical ones. First, the prospect of an extended period of low commodity export revenues underlines the importance of facilitating shifts in production to tradables. Second, countries that experienced investment booms, accompanied by rising trade deficits, before the financial crisis have to find a new growth model, as the availability of external resources has declined. Third, diverging competitiveness within Europe is creating strains within the European Union.





## The Short-Term Outlook

Britain's decision to leave the European Union, and other shocks that have increased uncertainty, triggered a downward revision from the forecast published in the April *Economic Update* (table 1.1). For the European Union, 2016 GDP growth has been downgraded by 0.2 percentage points, and growth in 2017 is now expected to be 0.5 percentage points lower than forecast half a year ago. Growth in Turkey and the South Caucasus has also been revised downward.

Despite these downward revisions, modest acceleration in GDP is expected in 2016 across the region. A rebound from past downturns is supporting growth despite the new challenges, and currency depreciation is helping the region outperform tepid global trade growth. GDP growth in the European Union and Western Balkans in 2016 is expected to decline only slightly from the previous year, continuing the trend recovery from the financial crisis. GDP growth is expected to rise modestly in France, Germany, and Italy; growth in the United Kingdom is expected to fall by about half a percentage point. The more rapidly growing Central European countries are expected to experience the largest declines in growth (0.4 percentage points) among subregions, with the sharpest fall in the Czech Republic. Unlike the other subregions in the western part of the region, the Western Balkans is forecast to grow, driven by a sharp upswing in Serbia.

Prospects appear less sanguine in the eastern part of the region, although oil-exporting countries should experience a modest rebound from the difficult experience of 2015. Growth in Central Asia is expected to decline to 2 percent in 2016,

**TABLE 1.1 Economic growth in Europe and Central Asia is modest—and likely to remain so**

Region/subregion	Annual GDP growth (percent)					Change in forecast since April 2016		
	2014	2015	2016 (estimate)	2017 (forecast)	2018 (forecast)	2015	2016 (estimate)	2017 (forecast)
Europe and Central Asia	1.5	1.4	1.6	1.5	1.8	0.0	−0.1	−0.4
European Union and Western Balkans	1.5	1.9	1.8	1.4	1.7	0.0	−0.2	−0.5
Western European Union	1.7	1.7	1.6	1.1	1.4	0.0	−0.2	−0.6
Northern European Union	1.4	2.3	2.3	2.0	2.3	0.3	0.0	−0.4
Central European Union	2.9	3.6	3.2	3.1	3.2	0.0	0.0	0.0
Southern European Union	0.4	1.6	1.5	1.3	1.4	−0.1	−0.5	−0.4
Western Balkans	0.3	2.2	2.7	3.2	3.5	−0.1	0.0	0.0
Eastern Europe and Central Asia	1.4	−1.2	0.7	2.3	2.6	−0.1	0.6	0.2
South Caucasus	2.6	1.6	−1.1	2.2	3.0	0.0	−0.5	0.5
Central Asia	5.1	2.9	2.0	3.3	4.4	0.1	0.1	0.1
Russian Federation	0.7	−3.7	−0.6	1.5	1.7	0.0	1.3	0.4
Turkey	3.0	4.0	3.1	3.5	3.6	−0.3	−0.4	0.1
Other Eastern Europe	−4.0	−7.8	−0.1	1.3	2.5	0.0	0.2	0.1

Source: World Bank data.

almost 1 percentage point below the rate in the previous year and well below the 5.1 percent growth recorded in 2014. The South Caucasus are expected to dip into recession in 2016. GDP in the Russian Federation is forecast to fall only slightly, following the 3.6 percent plunge the previous year. Growth in Turkey is expected to fall to 3.1 percent, not 4 percent as forecast in 2015.

The fall in commodity prices is driving significant shifts in consumption, which shows a very different pattern from GDP (table 1.2). In the European Union, consumers are benefiting from lower oil prices. Consumption growth is therefore expected to exceed GDP growth in many countries. Between 2015 and 2018, consumption in the European Union and Western Balkans is expected to grow 0.9 percentage points faster than GDP.

By contrast, in Eastern Europe and Central Asia, consumption declined by 4.8 percent in 2015, compared with a 1.2 percent contraction of GDP. Russia experienced an almost 10 percentage-point fall in consumption and a 3.7 percent-point contraction in GDP. This large decline in consumption reflected a terms-of-trade loss of more than 6 percent of GDP, making the total income loss in Russia 10 percent.

Consumption is expected to decline at a more modest rate in 2016, but the reduction in consumption will be sharper than the GDP contraction. Although data are not yet available, it is likely that the sharp reduction in consumption has reversed the decline in poverty in Russia. Income and consumption are falling behind GDP in many of its neighbors as well, because of the decline in the purchasing power of remittances. Russia is a major source of remittances for many of these countries; the decline in GDP there, coupled with the depreciation of the ruble, has greatly reduced the value of remittance receipts in dollars and in local currencies.

**TABLE 1.2 Consumption is growing more rapidly than GDP in the western part of the region—and declining more rapidly than GDP in the eastern part of the region**

Region/subregion	Annual growth in private consumption (percent)				
	2014	2015	2016 (estimate)	2017 (forecast)	2018 (forecast)
Europe and Central Asia	1.2	0.9	1.7	2.0	2.0
European Union and Western Balkans	1.2	2.0	2.0	1.9	1.8
Western European Union	1.2	2.0	1.9	1.7	1.6
Northern European Union	1.6	2.3	2.0	2.1	2.2
Central European Union	2.3	3.2	4.1	3.6	3.4
Southern European Union	0.9	1.7	1.7	1.6	1.4
Western Balkans	1.0	0.5	1.6	1.9	2.8
Eastern Europe and Central Asia	1.0	−4.8	0.2	2.9	3.5
South Caucasus	5.9	2.6	−1.0	2.6	3.9
Central Asia	2.2	0.0	−0.2	2.4	4.5
Russia	1.5	−9.6	−2.5	3.0	2.5
Turkey	1.4	4.5	4.1	4.1	4.0
Other Eastern Europe	−5.8	−14.8	−1.5	−0.7	0.4

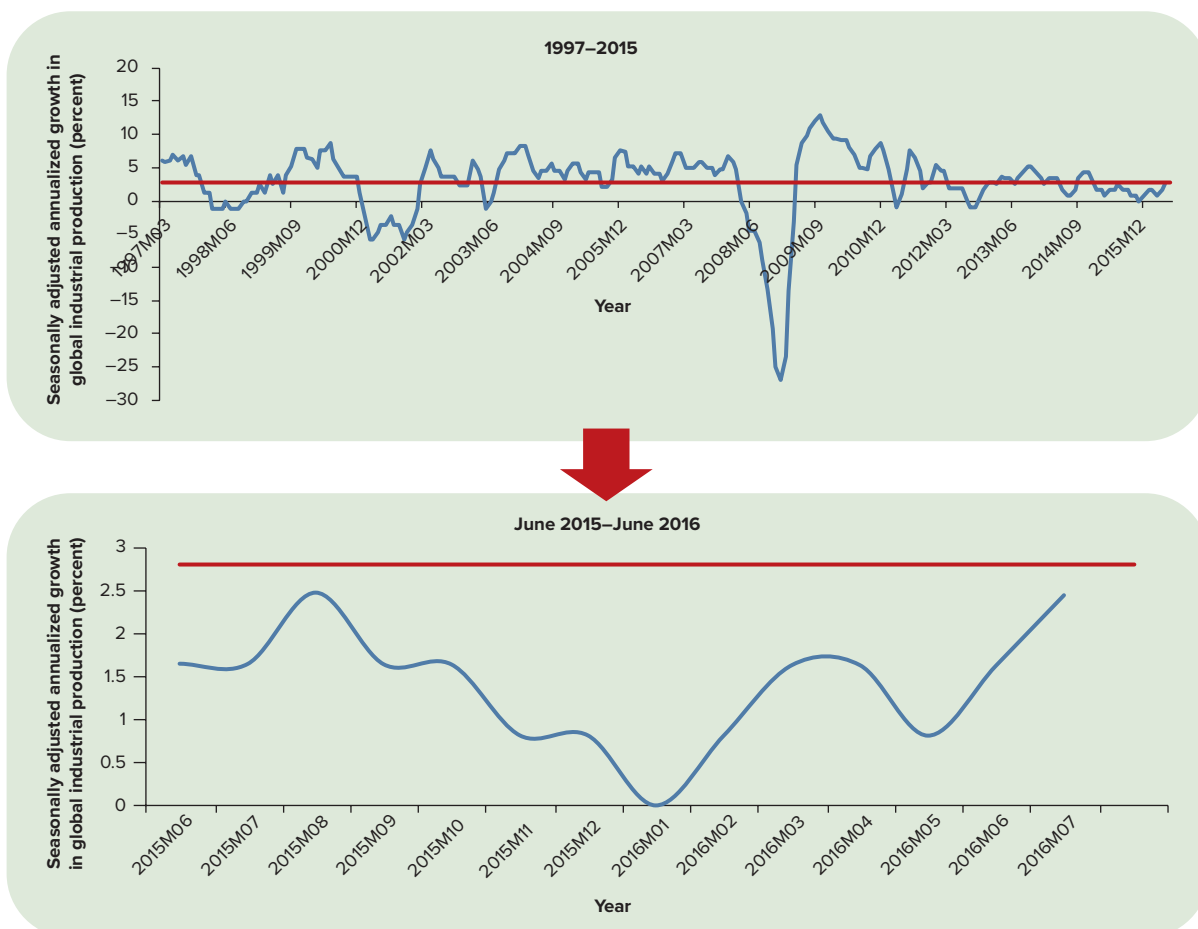
Source: World Bank.

Slow growth in the region is occurring against the backdrop of weak global economic activity. Although changes in global macroeconomic aggregates have been modest compared with previous cyclical events, the growth rates of both global production and global trade are below historical averages. Industrial production grew at an average rate of 1.3 percent between June 2015 and June 2016, lower than the average of 2.8 percent since 1997 (figure 1.1).

In the 12 months following June 2015, global trade growth averaged less than the roughly 4 percent a year it had averaged since 1997, and fluctuations in monthly growth rates, while larger than for industrial production, were smaller than since 1997 (figure 1.2). Export performance by Europe (especially Germany) was stronger than the global average. While exports from China and the United States started contracting in 2015, German exports accelerated (figure 1.3). Better export performance in Europe is helping mitigate the impact of the recent shocks and is an important factor behind the European Union's ability to avoid a severe downturn.

**FIGURE 1.1** Global economic growth was weak in 2015 and 2016

*Global industrial production, 3m/3m, seasonally adjusted annualized rate*



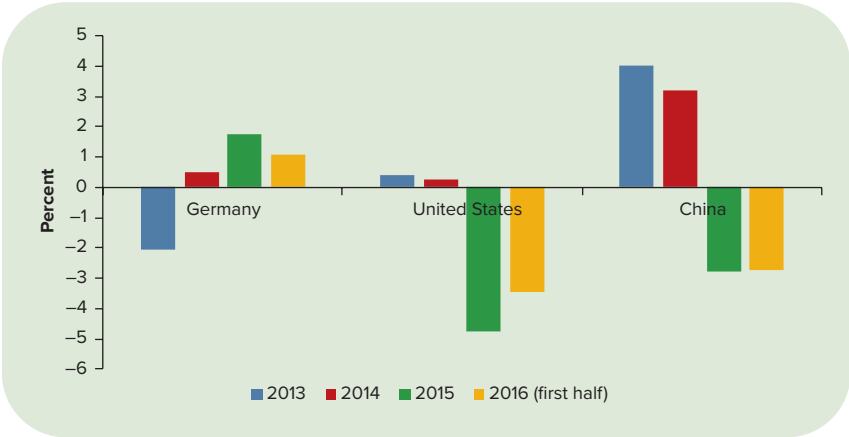
Source: World Bank.

**FIGURE 1.2** Global trade growth rates have settled below historical trend  
*Global trade, constant prices, 3m/3m, seasonally adjusted annualized rate*



Source: World Bank.

**FIGURE 1.3** German exports are outpacing U.S. and Chinese exports  
*Annual growth in export volume growth (percent, year over year)*



Source: World Bank.

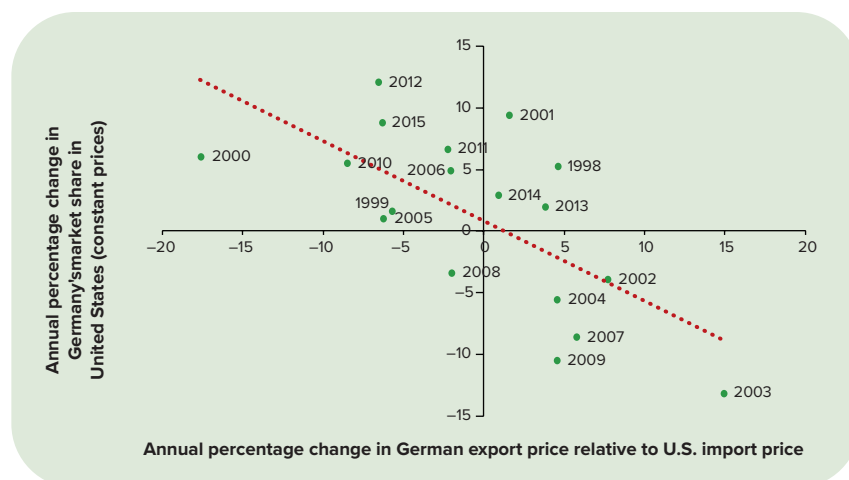
Europe's export performance is strongly linked to the weakening of the euro in the wake of quantitative easing by the European Central Bank. In 2015 the volume of German exports to the United States grew 8.8 times faster than overall imports into the United States. The same year Germany's export prices declined 6.4 percent relative to U.S. overall import prices. Over a longer historical period, the ratio of changes in Germany's export prices to overall U.S. import prices is highly correlated with changes in Germany's market share in the United States (figure 1.4).

The European Union benefited from two major relative price shifts over the past year: Lower commodity prices increased the purchasing power of the commodity importers, and the weakening of the euro made European producers more competitive vis-à-vis other manufacturing exporters. These shifts helped support growth in GDP and consumption, which nevertheless remained slow by historical standards.

Financial sector indicators imply continuing concern over developments in Southern Europe, but markets do not appear to anticipate a major shock. Their stance is roughly consistent with the World Bank's forecast that growth will remain slow in 2016 and slow further in 2017 (table 1.1) but that a major downturn will be avoided.

Secondary market yields on the bonds of weaker EU countries remain significantly higher than yields on German bonds, and the yields on some recently increased (figure 1.5). For example, the secondary market spread on Portuguese bonds over German bunds increased by roughly 1.5 percentage points between January and September 2016, to about 3.5 percentage points, reflecting the weak position of Portugal's banking system. Greek spreads fell a bit over the past year but remain at more than 8 percentage points. Bond spreads remain well below the levels reached earlier in this decade as the euro crisis intensified. Nevertheless, spread levels are more differentiated than before the crisis, indicating continued anxiety over economic developments.

**FIGURE 1.4** Germany's market share in United States fluctuates with relative prices

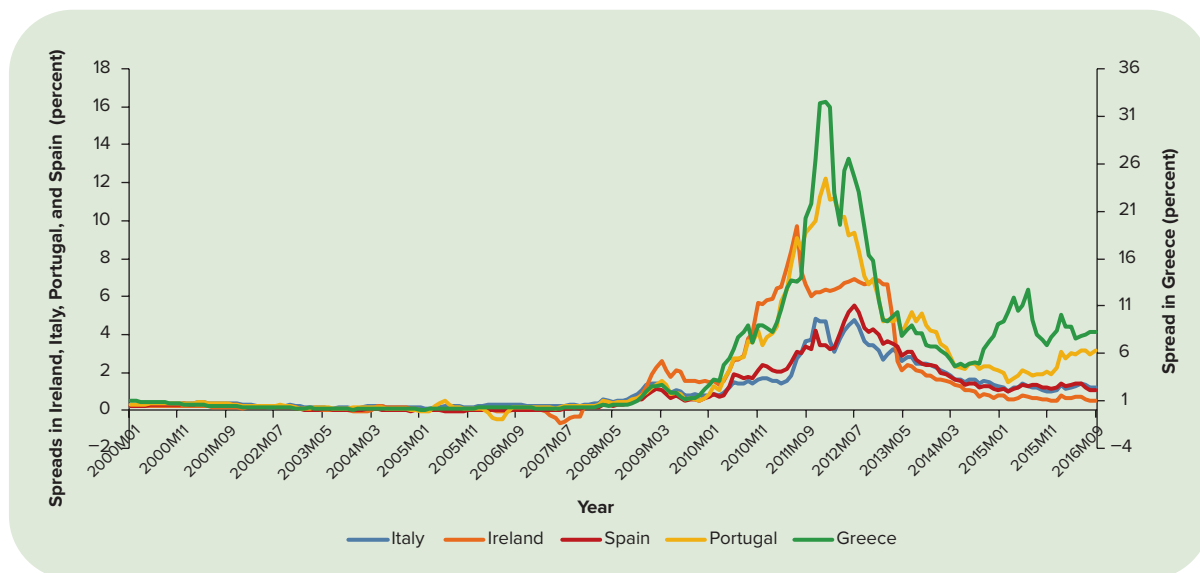


Source: World Bank.



**FIGURE 1.5** Financial anxiety in Southern Europe increased recently, but to levels much below those during the European banking

*Premium over German 10-year bond yield (percentage points)*



Source: World Bank.

Note: Spreads in Ireland, Italy, Portugal, and Spain are measured on the left-hand axis; Greek spreads are measured on the right-hand axis.

## Long-Term Challenges

The forecast of rising growth by 2018 in both the eastern and western parts of the region masks the very difficult long-term challenges facing ECA and the social and political tensions these challenges may generate. This section outlines some structural changes facing ECA, including the necessary adjustment to low commodity prices and lower investment rates. It also highlights economic tensions within the European Union caused by the diverging export performance of sub-regions. These challenges affect countries within the region differently; the appropriate policy responses therefore differ. However, a common thread is that adjustment will require abandoning approaches to economic growth that served a useful purpose in the old economic environment but are now counterproductive.

The recent decline in commodity prices is unlikely to be reversed soon. Since 2013 the prices of minerals and nonprecious metals have fallen sharply relative to the price of manufactures, while the price of crude oil collapsed in the middle of 2014.

Although the prospects for commodity prices are notoriously uncertain, it is unlikely that prices will move back to levels seen in 2004–14, when exceptionally high prices reflected the long-term commodity price cycle. Low prices for oil, metals, and minerals during the 1990s discouraged investment in exploration and production as well as in substitutes. Limited investment eventually constrained supply, which began to drive sharp increases in prices from around the turn of the century.

The opposite is now happening, as investments undertaken over the past decade are boosting supply and driving down prices. In addition, despite recent declines, commodity prices remain somewhat above the average for 1986–2005 (Figure 1.6). With continuing technological innovations in extraction, the substitution of artificial for natural materials, and the development of alternative energy sources, current levels could persist for a long time.

### Lower Oil and Minerals Prices May Be Here to Stay

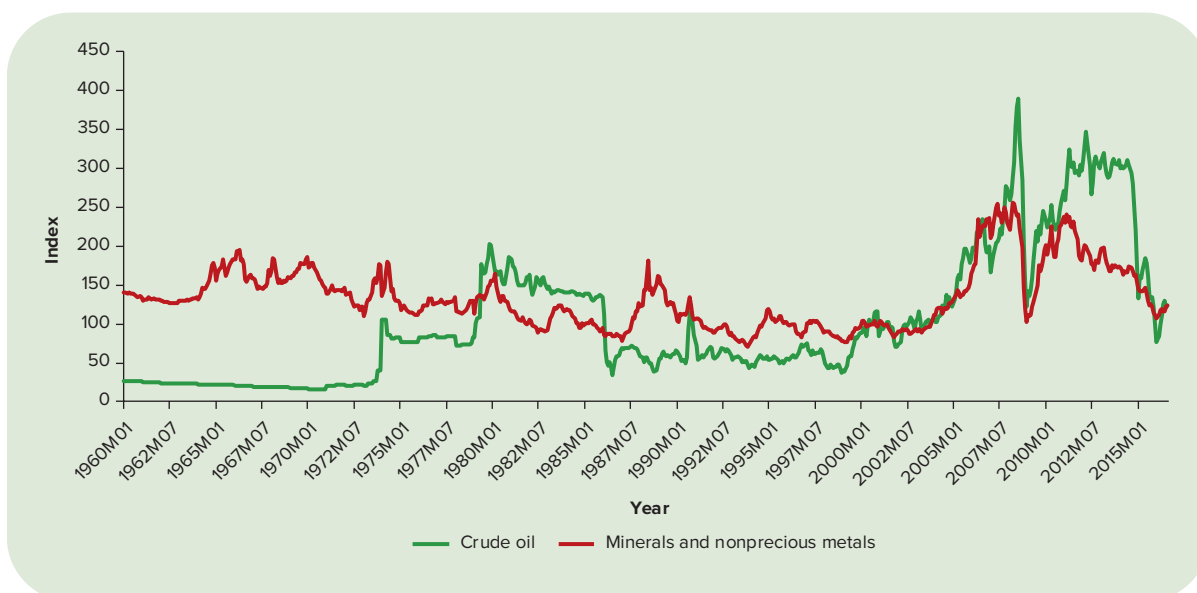
A long-term shift to lower commodity prices will present a considerable challenge to commodity exporters in the eastern part of the region (World Bank 2015). Sustaining growth in the face of massive terms-of-trade losses will require fundamental reforms on a range of fronts.

First, commodity exporters are experiencing a real depreciation of the exchange rate, reversing the appreciation that had been fed by rising export revenues and capital inflows. It is imperative that monetary policy accommodate this change through nominal exchange rate devaluation; if it does not, the necessary real devaluation will have to occur through a decline in the price level, a much more painful and protracted affair. This process has begun, but adjustment has been limited in some countries, particularly countries that relied on a nominal exchange rate anchor. Policy makers may have to adopt a different mindset to permit an adequate devaluation.

Second, the precipitous fall in commodity prices threatens to cause a banking crisis in several countries, especially those with delayed policy responses. Banks have experienced sharp declines in the value of their assets. Low commodity

**FIGURE 1.6** Commodity prices have returned to historical levels

*Index of commodity prices relative to prices of manufactured products (2000=100)*



Source: World Bank.

prices have reduced the value of loans to the oil and minerals sectors, while slow demand growth is impairing the value of loans to the construction sector (essentially a reversal of the Dutch disease that had increased demand for nontradables, such as housing). In addition, many banks were involved in “connected lending” that was not profitable. Such lending could be supported when money was freely available; in the current, more constrained, environment, the low return on these loans threatens banks’ finances. Several banking systems have seen a sharp rise in dollar-denominated liabilities, so that the unavoidable exchange rate depreciation will further impair the solvency of banks and their clients. These issues underline the importance of both urgent steps to prevent a disorderly collapse of banking systems and reforms to improve bank profitability and redirect lending to new sectors that are benefiting from devaluation.

Third, the fall in commodity export receipts has reduced fiscal revenues. Exchange rate depreciation should mitigate this decline, as the local currency value of commodity revenues rises. However, the likely allocation of considerable resources to rescue and restructure insolvent banks will be a further drain on revenues. On balance, a sustainable medium-term fiscal policy in an era of low commodity prices will require both a lower level of expenditures and a reallocation of expenditures to support new economic activities in manufacturing that have been made more profitable as a result of the devaluation.

Fourth, it is essential to protect the most vulnerable members of society from the double-digit declines in household incomes caused by the changes in the terms of trade or lower remittances. Poor households are much less able than other households to sustain sudden, large cuts in their incomes. Efficient social protection is needed to prevent human suffering and the erosion of social cohesion.

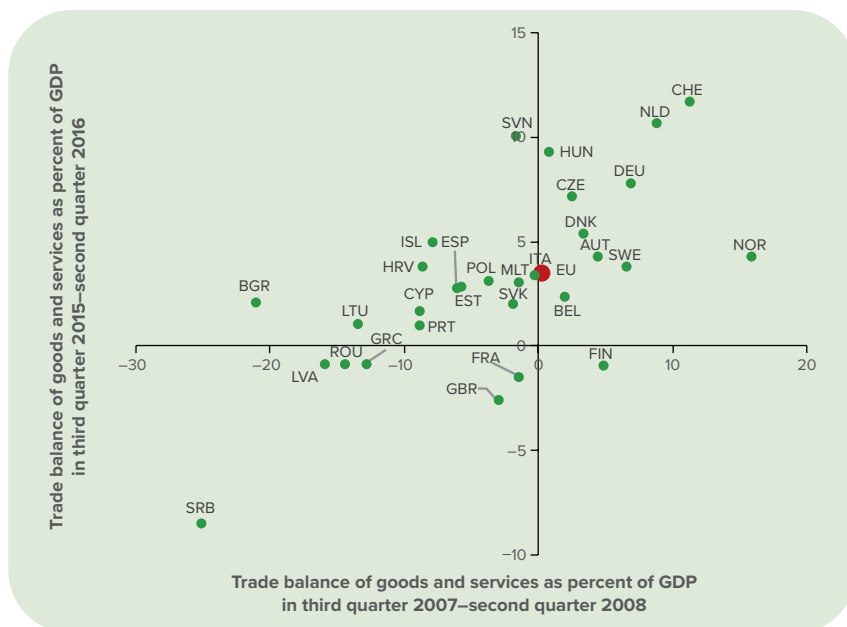
Fifth, and most important, it is essential to support firms in exploiting the new export opportunities offered by a more competitive environment for manufactures. Doing so may challenge powerful interests in both government and the private sector that are used to profiting from the easy availability of funds from commodity exports. The reforms required are far-reaching. They include cutting the cost and time involved in establishing new firms and entering new markets, reducing limits on the movement of labor to new activities while maintaining essential labor protections, and allowing insolvent but well-connected firms to fail.

## **The Decline in Investment Rates in the European Union May Be the New Normal**

In the years before the financial crisis, booming investment in the EU accession countries contributed to rapid growth, which was financed by massive capital inflows and transfers, resulting in large trade deficits. These inflows reflected expectation of improvements in technological progress and in the rule of law, as the accession countries adopted EU rules and standards.

The financial environment is now much more constrained, capital inflows and transfers to the accession countries have fallen sharply, and these countries’ trade deficits have largely disappeared. In most countries, since the third quarter of 2015 the trade deficit as a percentage of GDP has been significantly lower (or the surplus higher) than in the period just before the financial crisis (figure 1.7).

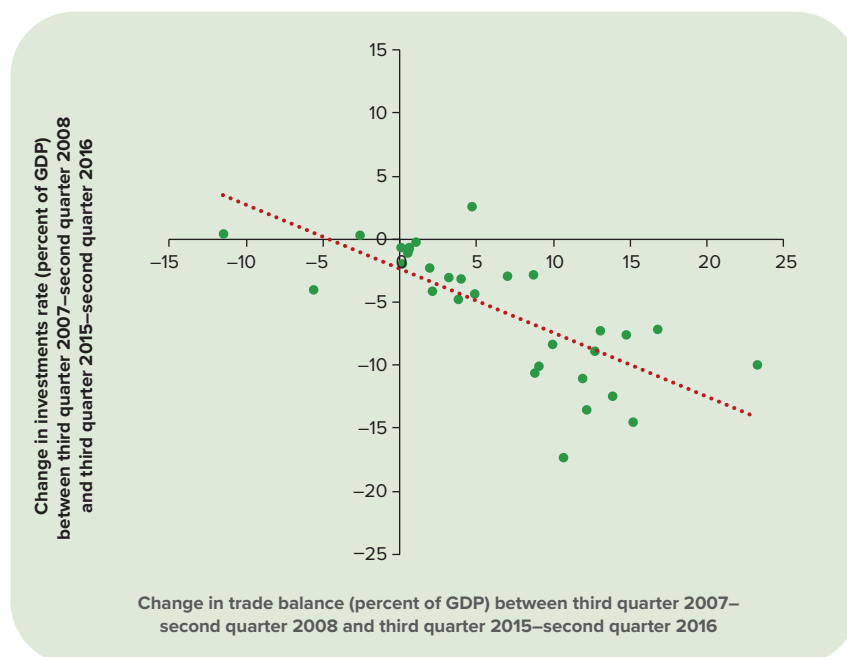
**FIGURE 1.7** Large trade deficits in the European Union disappeared after the crisis



Source: World Bank.

The fall in external resources has likely ushered in a long period of low investment rates. Declines in the trade deficit between the year before the financial crisis and the most recent year are highly correlated with reductions in the ratio of investment to GDP (figure 1.8), indicating that an external resource constraint is driving lower investment. It is unlikely that these countries will be able to re-

**FIGURE 1.8** Adjustments in trade balances led to sharp declines in investment rates



Source: World Bank.

turn to large borrowing in the near term—and it would probably be unwise for them to do so. Many countries in the region will need to adjust to a period of lower investment and slower growth.

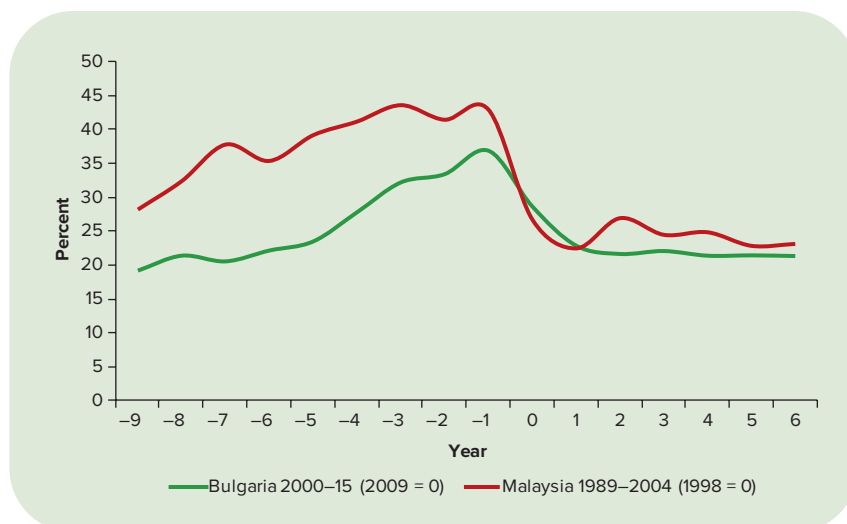
The experience of the accession countries is similar to, albeit less dramatic than, that of Malaysia after the East Asian financial crisis, when the ratio of investment to GDP fell from 43 percent in 1997 to 27 percent in 1998 and remained at or below that level for the next six years. (Figure 1.9 compares Malaysia's decline in the investment rate following the East Asian crisis with Bulgaria's following the global financial crisis.<sup>1</sup>) The decline in external resources will require greater efforts to mobilize domestic savings, a sharper focus on innovation to improve efficiency, and increased integration with the international economy (which may require increased capital outflows) to profit from access to foreign technology and trade ties.

## Lack of Convergence May Threaten European Cohesion

Diverging economic performance within the European Union is challenging policies that were based on a steady increase in convergence. Major progress in achieving a more unified European economy was made over the past few decades, as the accession countries adopted EU rules, the older European economies experienced continued price convergence, and local banks became pan-European banks. These developments involved a continuous, steady increase in integration, with economic institutions evolving to support a more united Europe.

At the same time, competitiveness trends within the European Union, as illustrated by export performance, have been diverging sharply. Since 2000 German exports roughly followed the same trend as global exports, even during the global financial crisis (figure 1.10). By contrast, exports from Southern Europe were well below the global average; at the beginning of 2016, the ratio of Italian exports to global exports was almost half what it was in 2000.<sup>2</sup> Export growth in

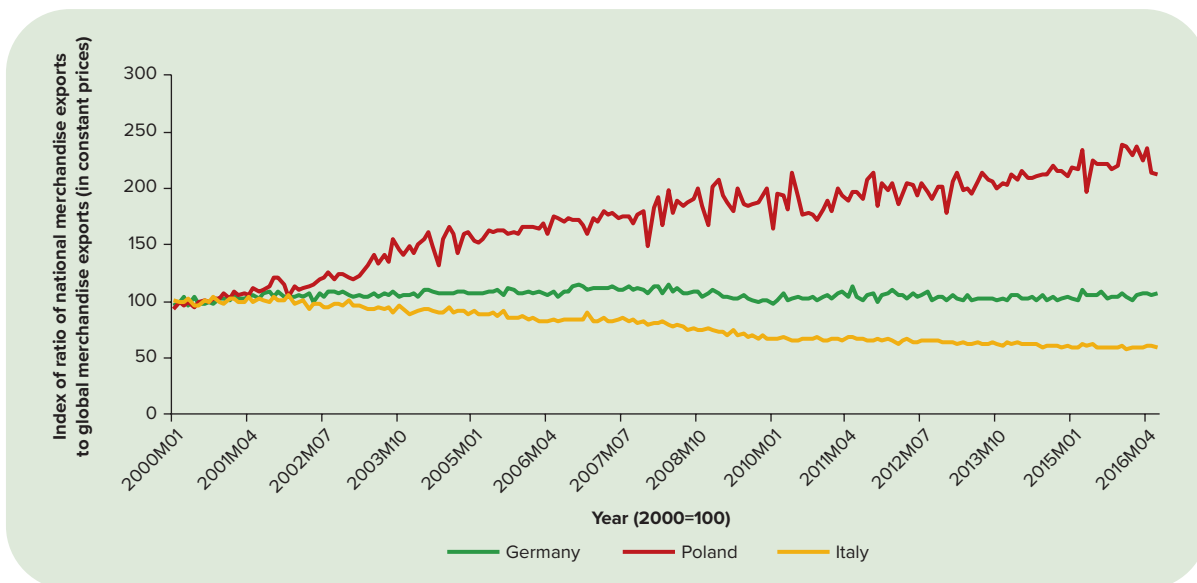
**FIGURE 1.9** The recent decline in investment in EU accession countries is similar to the East Asian experience in the late 1990s



Source: World Bank.

**FIGURE 1.10** Merchandise exports exceeded the global average in Poland, mirrored the global average in Germany, and fell well below the global average in Italy

*Export of merchandise in constant prices, relative to global exports (index 2000=100)*



Source: World Bank.

the new EU accession countries (the Czech Republic, Hungary, and Poland) greatly outperformed global, and German, exports over this period. There is some concern that continued sharp divergence in export performance will place further strains on the common currency, as countries with rapidly growing exports achieve rising growth rates while poorly performing countries are forced to undertake austerity policies to limit the increase in trade deficits.

It is not entirely clear how to accommodate diverging economic performance within the European Union; one could argue that steps either to speed or delay economic integration may be appropriate. One approach is to slow the rise in institutional integration. For example, some accession countries appear less enthusiastic than others about joining the euro. It is important to avoid ambitious steps to promote integration in the face of diverging economic performance.

Another idea is to raise the inflation target, so that the shifts in relative prices required by diverging export performance can be achieved without attempting to force declines in prices on some members. Whether higher inflation can easily be achieved in the current economic environment is an open question.

Still another approach is to adopt policies to speed institutional integration—by, for example, creating a more integrated European labor market so that workers are encouraged to move to more productive economies or by establishing a fiscal union with redistributive policies geared to providing greater support for more slowly growing areas.

These structural challenges to growth cannot easily be addressed by policies aimed at cyclical expansion. Indeed, to some extent policies to support demand in the face of structural weaknesses will prevent the adjustments necessary to cope with these challenges. Attempts to increase investment to earlier levels by

reducing interest rates are likely to be ineffective (if potential investors are credit constrained) or lead to unsustainable borrowing (if credit is freely available). Expansionary policies to compensate for jobs lost as a result of lower export revenues could limit the exchange rate adjustment required to encourage shifts in investment and workers to import-competing or noncommodity exporting sectors.

## Job Security Is Falling

Increasing uncertainty over job security is becoming a major challenge across the region. Although employment in the European Union is now higher than before the 2008 crisis—largely as a result of a higher female employment rate (World Bank 2016a)—all of the additional employment has been in the form of temporary and part-time jobs. Chapter 2 examines this issue, along with other factors that may be contributing to the rise in political extremism in many countries.

## Notes

1. A significant part of the temporary boom in Malaysia's investments reflected construction activities. Real estate prices showed a similar structural break from high to permanently lower prices (Gerlach, Wilson, and Zurbruegg 2006)
2. The divergent pattern between Northern and Southern Europe was also reflected in divergent current accounts, with surpluses in Germany and deficits in Southern Europe (Gross 2012).







# Polarization and Populism

## Introduction and Main Messages

Many countries in Europe and Central Asia (ECA) are witnessing significant political polarization. Increasing numbers of voters appear to be moving away from centrist positions, abandoning long-held political commitments, and losing faith in established parties (and to some extent institutions). Examples include the vote to end Britain's membership in the European Union; the victory of the Freedom Party of Austria (FPÖ) in the first round of the April 2016 presidential elections, leading to the resignation of the Austrian chancellor; the absence of a proper government in Spain for almost 250 days; the success of the Swedish Democrats, who now lead the government in opinion polls; the victory of the Five Star Movement, which advocates holding a referendum on Italy's commitment to the euro, in mayoral races in Rome and Turin; and the rising popularity of Marine Le Pen, the leader of the National Front in France.

Political conflict is perhaps more intense in the eastern part of the region, manifested in violent efforts to change political systems or boundaries. Examples include the smoldering conflict in Armenia and Azerbaijan, the attempted coup in Turkey, the conflict in Ukraine, and uneasiness in Central Asian countries, where political leaders express concerns over the possibility of a local Arab Spring and social unrest.

Many issues—including economic difficulties, ethnic rivalries, the refugee crisis, and geopolitical tensions—may be driving political polarization in ECA. The importance of each varies by country. This chapter focuses on economic problems, where World Bank research can make the most useful contribution.



It first explores whether the anecdotal evidence of increasing political polarization is supported by hard data. There does appear to have been some shift across ECA away from traditional, more centrist political parties, as well as toward more populist political opinions, since the beginning of this century. However, the bulk of votes are still cast for traditional parties, and the trend toward political polarization may have been partially reversed in the most recent years. At the same time, survey evidence indicates that the shares of the populations of Eastern, Southern, and Central Europe that are strongly dissatisfied with their lives are large and rising and a significant share of ECA's population distrusts major institutions.

The chapter then considers three potential economic issues that may be associated with polarization and declining life satisfaction: rising inequality, slow growth since the financial crisis, and structural changes in the labor market. Overall trends in inequality do not appear to be the main driver of political polarization and declining life satisfaction in ECA. Current inequality levels are higher than they used to be at the fall of the Berlin Wall but, at least for the more recent decade, they have not changed much. In fact many countries in the eastern part of the region, with the exception of Russia, have experienced reductions of inequality. This does not mean that distributional tensions are not a factor behind the reduction of subjective wellbeing but simply that changes in an aggregate inequality index do not capture a fully accurate and complete picture of the underlying distributional change.

Several reasons could explain this. First, surveys often fail to measure capital income or to include the richest households, which may understate the level of inequality and distort the trend. Second, the summary indicators of inequality used in empirical work, notably the Gini coefficient, may not capture complex changes in the distribution of income such as, for example, a hollowing of the middle class. Third, people often have different attitudes toward inequality stemming from differences in effort versus unequal opportunities; data on overall inequality may not capture the issues people view as critical. Fourth, reactions to inequality are based on the perceived level of inequality, which may differ significantly from the level registered in surveys and used in analyses.

Dissatisfaction with the extended period of slow growth in ECA has likely contributed to political polarization. Econometric analysis finds that a decrease of 1 percentage point in average GDP growth over the previous four years is associated with an increase of 3.1 percentage points in the share of voters for parties with a more populist stance. Declining life satisfaction, and perhaps political polarization, may also be related to a decline in economic mobility (or perceptions and expectations of mobility).

Europe is undergoing rapid shifts in the labor market, including the rise in temporary and part-time employment, along with a sharp drop in the number of jobs involving middle-skilled, routine tasks in favor of low-skilled and high-skilled, non-routine tasks. These changes, in part driven by technological progress, may have increased uncertainty about job stability and the prospects for achieving a middle-class lifestyle, reducing well-being and undermining support for the parties in power.

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Further research is critical to understanding the link between these three economic issues and the growing dissatisfaction with lives, centrist political parties, and institutions in ECA. The problems are complex, the data to address some of these relationships are not available, and the important economic drivers of dissatisfaction likely differ by country, as well as by economic and social class within countries. The purpose of this chapter is to survey some of the research on these issues, present stylized facts, and highlight potential policy implications.

Understanding the economic drivers of the rise in populism can make an important contribution to policy. The literature shows that political polarization has short- and long-term effects on economic performance. For example, political polarization tends to increase in the aftermath of financial crises; it may actually slow the process of recovery, by reducing the chances of adopting economic reforms (Funke, Schularick, and Trebesch 2016). Political polarization also matters in the long run, because it may impair efficiency, make business cycles more pronounced and frequent, and contribute to economic stagnation (Azzimonti 2011; Azzimonti and Talbert 2014; Binswanger and Oechslin 2015).

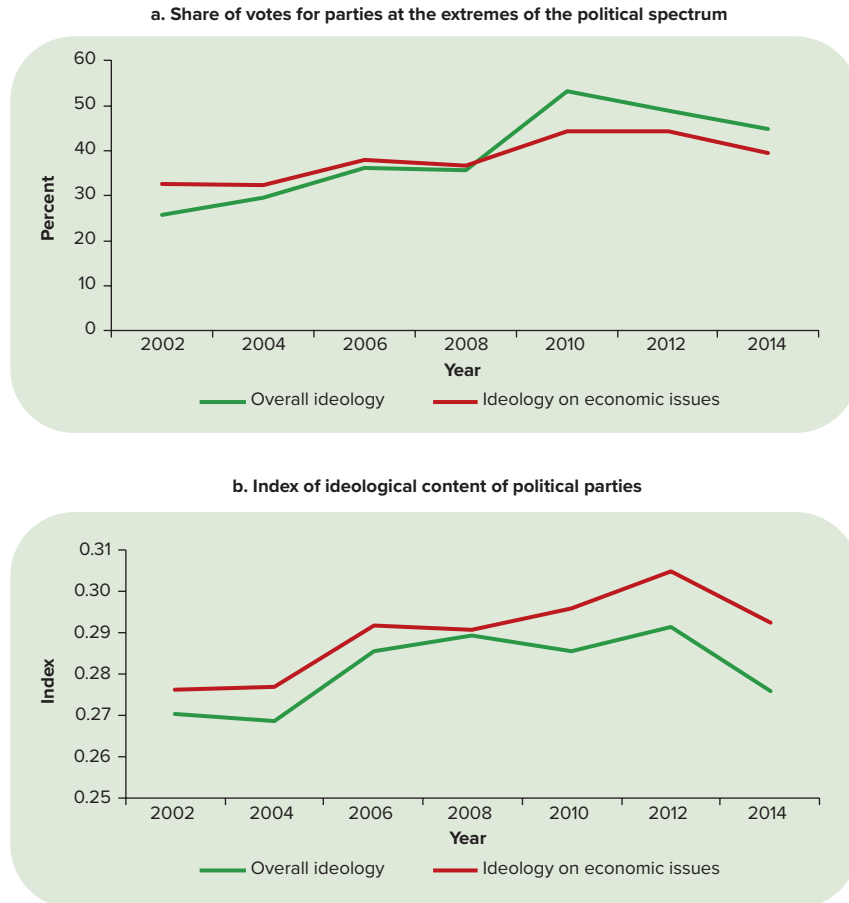
Both theoretical and empirical research are at an early stage. But some tentative observations for policy can be made based on this preliminary work. Inequality, at least in the most recent decade, does not seem to have changed much, however persistently low growth rates have generated less chances of upward mobility and more insecurity. People perceive this growth process as less inclusive. Thus, transfers designed simply to improve income distribution may therefore not address these concerns. Rather, structural policies that increase access to education, health services, and good jobs—that is, policies that improve the distribution of opportunities—may be more successful than transfers in improving both efficiency and equity. Policies should aim to reduce workers' lack of security in a rapidly changing job market—by providing retraining and adequate unemployment insurance and ensuring that working part-time or in a temporary job or becoming unemployed does not mean losing one's benefits, for example.

The structure of this chapter is as follows. The next section summarizes evidence of political polarization and the deterioration of perceived well-being in ECA. The following section considers the impact of changes in inequality, slow growth, and structural changes in the labor market on these phenomena. The last section draws some tentative conclusion and suggests lines for future research.

## **Voting Polarization and Decreasing Subjective Wellbeing: Two Symptoms of Europe and Central Asia's Malaise**

Self-reported voting patterns reveal an increase in political polarization in Europe: the share of people who voted for parties at the extremes of the ideological spectrum increased by more than 20 percentage points between 2002 and 2010 (figure 2.1, panel a). An aggregation of these data using an index of political polarization also shows an increase over this period (figure 2.1, panel b), although all these measures point to a slight decline in polarization between 2012 and 2014.

**FIGURE 2.1** Ideological polarization in Europe increased between 2002 and 2014



Source: Own estimates based on the European Social Survey (2002-2014) and the Chapel Hill Expert Survey (circa 2002- circa 2014). The polarization index in panel b is based on Duclos, Esteban, and Ray 2004.

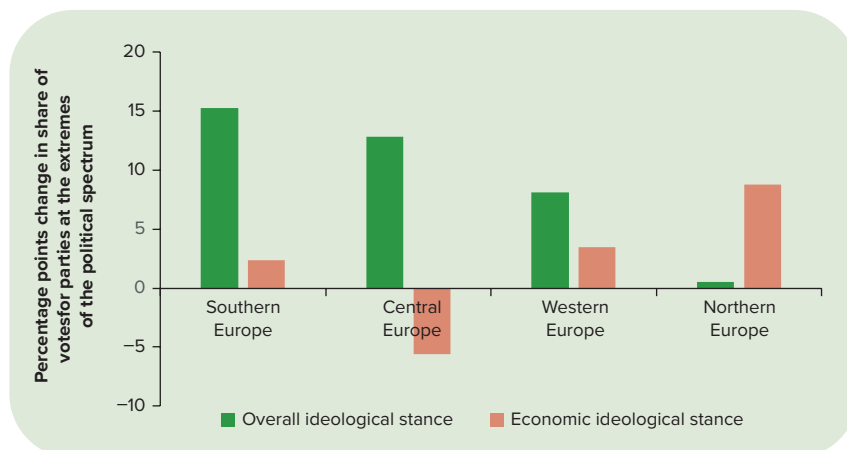
Note: Panel a is based on the European Social Survey, which asks people which party they voted for during the last elections. When this information was missing, responses to the question “Which political party do you feel closest to?” were used. Data from the Chapel Hill Expert Survey (CHES) were used to assign each party a score from 1 (extreme left) to 10 (extreme right), based on rankings by experts of each party’s overall ideological stance and its stance on economic issues. The survey reports the average score assigned by experts, which can take any value between 1 and 10. Panel a shows the percent of voters who voted for parties with ranks of less than 4 or more than 6. The polarization index shown in panel b captures the existence of a few groups of important size whose members share an attribute and feel some degree of identification with members of their own group and some degree of hostility toward other groups. It avoids clustering people around discrete ideological ranking intervals. The index ranges from 0 (no polarization) to 1 (full polarization). The sample of countries includes Austria, Belgium, the Czech Republic, Germany, Denmark, Spain, Finland, France, Hungary, Ireland, Italy, the Netherlands, Poland, Portugal, Slovenia, Sweden, and the United Kingdom.

Even if most voters continue to support traditional parties, growing support for extremist parties is a worrisome trend.

The increase in polarization varied across the region. The share of people who voted for parties at the extremes of the ideological spectrum rose sharply in Southern and Central Europe; the increase was smaller in Western Europe; and the share declined in Northern Europe (figure 2.2).

Along with, and perhaps related to, the rise in political polarization is some evidence of stagnating well-being and a growing dissatisfaction with institutions. The World Values Survey and the Life in Transition Survey measure these changes (box 2.1).

**FIGURE 2.2** Changes in political polarization varied across Europe



Source: Own estimates based on microdata from the European Social Survey (2002–2014) and the Chapel Hill Expert Survey (circa 2002 – circa 2014)  
 Note: Bars shows change in share of people who voted for parties with scores below 4 or above 6 on the 1–10 scale used in the Chapel Hill Expert Survey between circa 2002 and circa 2014.

### BOX 2.1 Surveys of well-being and dissatisfaction with institutions

The World Values Survey is a global survey covering more than 100 countries. It originated in the early 1980s as an extension of the European Values Survey. Its main objective is to investigate “changing values and their impact on social and political life.”<sup>a</sup> The survey asks: “All things considered, how satisfied are you with your life right now?” Respondents reply by choosing a value from 1 (lowest satisfaction) to 10 (highest satisfaction).

The results show that life satisfaction increased globally from 1981 to 2007, rising in 45 out of the 52 countries for which data are available. In contrast, Russian and other transition economies experienced sharp declines in life satisfaction in the 1990s, when inequality was increasing strongly.

Note:

a. Its website ([www.worldvaluessurvey.org](http://www.worldvaluessurvey.org)) notes that “the World Values Survey “has over the years demonstrated that people’s beliefs play a key role in economic development, the emergence and flourishing of democratic institutions, the rise of gender equality, and the extent to which societies have effective government.”

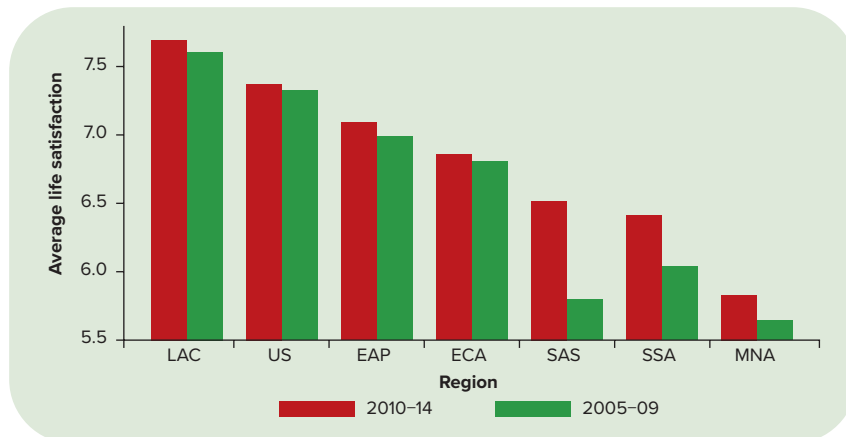
b. LiTS 2006 surveyed almost 29,000 people across 29 countries; LiTS 2010 surveyed almost 39,000 households in 34 countries.

The Life in Transition Survey (LiTS) covers about 30 countries (depending on the wave).<sup>b</sup> Waves are available for 2005, 2010, and 2015. The question used to measure subjective well-being is “Are you overall satisfied with your life?” Respondents choose a value from 1 (strongly agree) to 5 (strongly disagree).

The LiTS examines life satisfaction in more detail than the World Values Survey, because it includes questions about the respondent’s, satisfaction with their job and financial situation, and the country’s economic situation. The answers to these questions are strongly correlated: In 2015, the correlation coefficients for average life satisfaction were 0.68 with average economic satisfaction, 0.88 with average financial situation satisfaction, and 0.92 with average job satisfaction.

The World Values Survey reports that ECA ranks in the middle of the distribution, below Latin America and the Caribbean, the United States, East Asia and Pacific, and South Asia but above the Middle East and North Africa and Sub-Saharan Africa (figure 2.3). Life satisfaction in ECA improved by just 0.7 percent

**FIGURE 2.3** Life satisfaction improved in every world region between 2005–09 and 2010–14



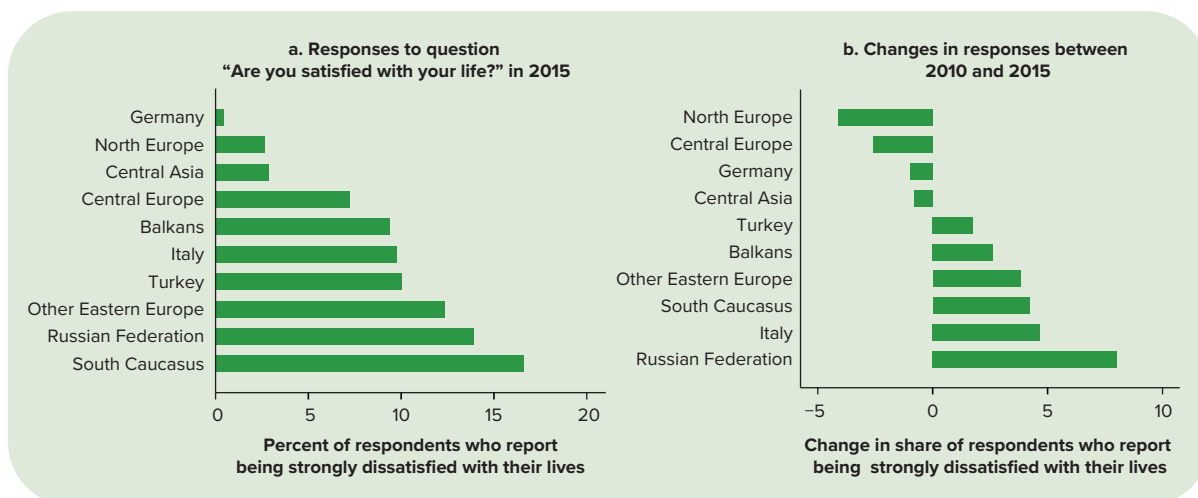
Source: Data from World Values Survey wave 6 (2010–14).

Note: EAP = East Asia and Pacific; ECA = Europe and Central Asia; LAC = Latin America and the Caribbean; MNA = Middle East and North Africa; SAS = South Asia; SSA = Sub-Saharan Africa; US = United States.

between 2005–09 and 2010–14—far less than in South Asia (10 percent), Sub-Saharan Africa (more than 6 percent), and the Middle East and North Africa (3 percent), a region undergoing profound and unsettling changes.<sup>1</sup>

Northern Europe and Germany, which already had a low levels of dissatisfaction, experienced additional reductions. In contrast, several countries in ECA, particularly countries with already high levels of dissatisfaction, experienced rising dissatisfaction between 2010 and 2015 (figure 2.4). More countries or subregions experienced deterioration than improvements in life satisfaction, and the

**FIGURE 2.4** Life satisfaction declined in much of Europe and Central Asia between 2010 and 2015



Source: Life in Transition Survey (LiTS) II and III.

Note: The share of strongly dissatisfied persons is defined by the share of respondents whose answer is “strongly disagree” to the question “Are you satisfied with your life?”. Panel a shows results for 2015, and panel b shows the changes in shares between 2010 (LiTS II) and 2015 (LiTS 2015). Not all European countries are available in the LiTS. “North Europe” stands for Estonia, Latvia, and Lithuania; “Central Europe” for Bulgaria, Croatia, Hungary, Poland, Romania, Slovakia, Slovenia, and Czech Republic; “Central Asia” for Kazakhstan, Kyrgyz Republic, Tajikistan, and Mongolia; “Balkans” for Albania, Bosnia and Herzegovina, Kosovo, FYR Macedonia, Montenegro, and Serbia; “South Caucasus” for Armenia, Azerbaijan, and Georgia; “Other Eastern Europe” for Belarus, Moldova, and Ukraine. Answers for each country are averaged at the regional level. For more information about country groupings and country codes see Table 0.1.

**FIGURE 2.5** Job satisfaction declined in much of Europe and Central Asia between 2010 and 2015



Source: Life in Transition Survey (LiTS) II and III. Note: For country groupings see note of Figure 2.4. Answers for each country are averaged at the regional level.

changes were dramatic given the relatively short period of time. In Italy, for example, the percentage of people who strongly disagreed with the statement of “being overall satisfied” doubled, from about 5 percent to 10 percent.

A strong indication of the degree of dissatisfaction in the region is the significant increase in the share of people expressing strong dissatisfaction with their job in most ECA subregions between 2005 and 2010 (figure 2.5). Like the changes in overall life satisfaction, these changes were small in Central Asia, Northern Europe, Germany, and Central Europe (dissatisfaction actually declined in Central Asia and Northern Europe) and much larger in Eastern Europe, Russia, and the South Caucasus.

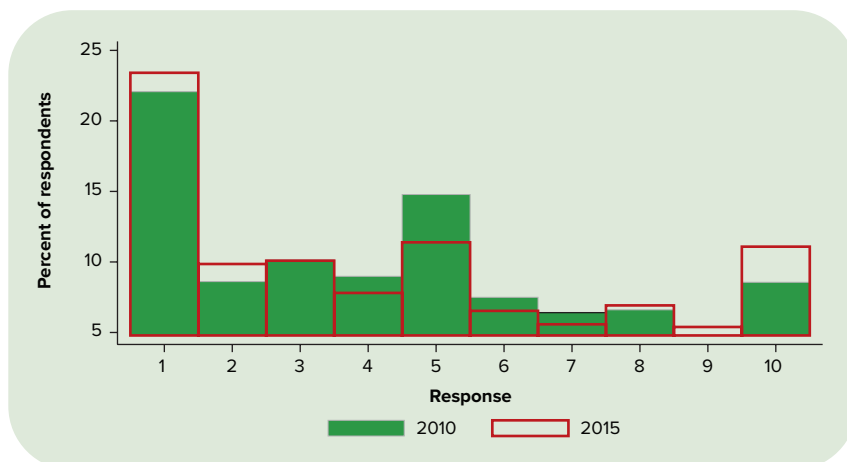
Opinions about policies to improve income distribution also showed polarization. The LiTS survey asks people to indicate, on a scale from 1 to 10, whether they believe that incomes should be made more equal (1) or reflect effort more closely (10). The share of the population with more extreme positions increased between 2010 and 2015, indicating growing dissatisfaction with the status quo (figure 2.6).

The share of the population expressing complete distrust in institutions—except the armed forces and the police (the most trusted institutions) and government—rose between 2010 and 2015 (figure 2.7). Distrust is highest for political parties, which experienced the largest increase in distrust over the period.

## Why Are People in the Region Becoming More Polarized and Less Satisfied?

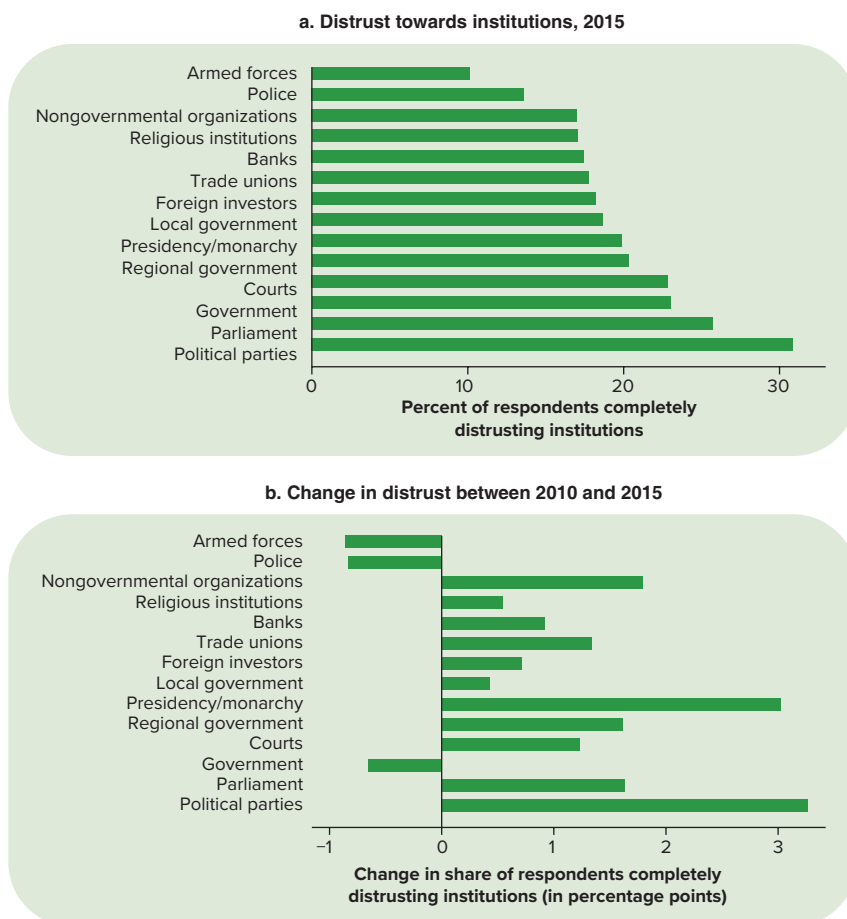
Rising inequality, slow growth, and structural changes in the labor market are three economic issues that may be associated with polarization and declining life satisfaction. This section discusses some of the literature that considers this association, and presents some empirical evidence on it for Europe and Central Asia.

**FIGURE 2.6** Views on income redistribution became more polarized in Europe and Central Asia between 2010 and 2015



Source: Life in Transition Survey (LiTS) II and III. Note: Responses are on a 1–10 scale, where 1 indicates incomes should be more equal and 10 indicates they should be based more on effort. The bars in the graph are simple averages of the percentages across all countries in the LiTS survey.

**FIGURE 2.7** Distrust toward most institutions rose in Europe and Central Asia between 2010 and 2015



Source: Life in Transition Survey (LiTS) II and III.

Note: The question in the survey is: "To what extent do you trust the following institutions?". Each respondent can choose between (answer=1) complete distrust, (answer=2) some distrust, (answer=3) neither trust nor distrust, (answer=4) some trust, and (answer=5) complete trust. The left-hand side panel shows the share of respondents (as a simple average across all countries in LiTS surveys) that choose complete distrust to this question in 2015 (LiTS III). The right-hand panel shows the changes in the share of respondents that indicated complete distrust for each institution between 2010 and 2015.



## Inequality Is Rising

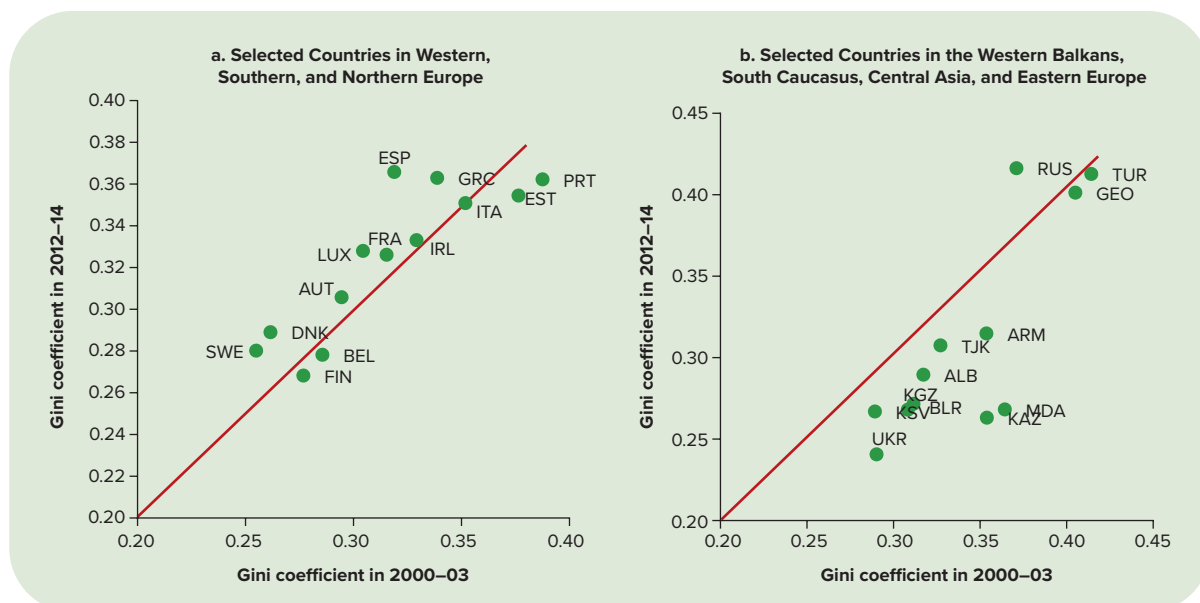
One hypothesis is that rising income inequality is driving political polarization and declines or stagnation in satisfaction with life. Higher inequality may increase demand for redistribution (and higher tax rates) because a larger share of the population feels left behind.<sup>2</sup>

In perhaps the best-known contribution to the theory of voting choice and inequality, Metzler and Richard (1981) argue that the median voter in a country in which income distribution is unequal—or has become less equal—would have an income below the mean. Therefore, he or she would have an incentive to vote in favor of increasing taxation to finance redistribution.

This model is insightful, but other factors affect attitudes toward income distribution. For example, people at the lower end of the income distribution may have expectations of upward mobility that make them prefer less redistribution (Piketty 1995; Benabou and Ok 2001). Societies in which individual effort is believed to be the main source of income formation prefer lower taxes and less redistribution (Alesina and Angeletos 2005). Similarly, more complex mechanisms link inequality and subjective well-being. For example, a specific individual's life satisfaction may be more influenced by how incomes of his or her reference group (friends, peers, neighbors, his or her own income of the past) evolve than by changes in overall inequality (Clark and D'Ambrosio 2015).

ECA experienced significant changes in income distribution over the past decade or so. Most of its countries experienced a reduction in the level of income inequality, with the Gini coefficient declining (figure 2.8). This equalizing trend was much more pronounced in the eastern part of the region (except Russia).

**FIGURE 2.8** Inequality declined in many countries in Europe and Central Asia, particularly in the east



Source: Harmonized data from national household surveys.

Note: For country groupings and country codes see Table 0.1

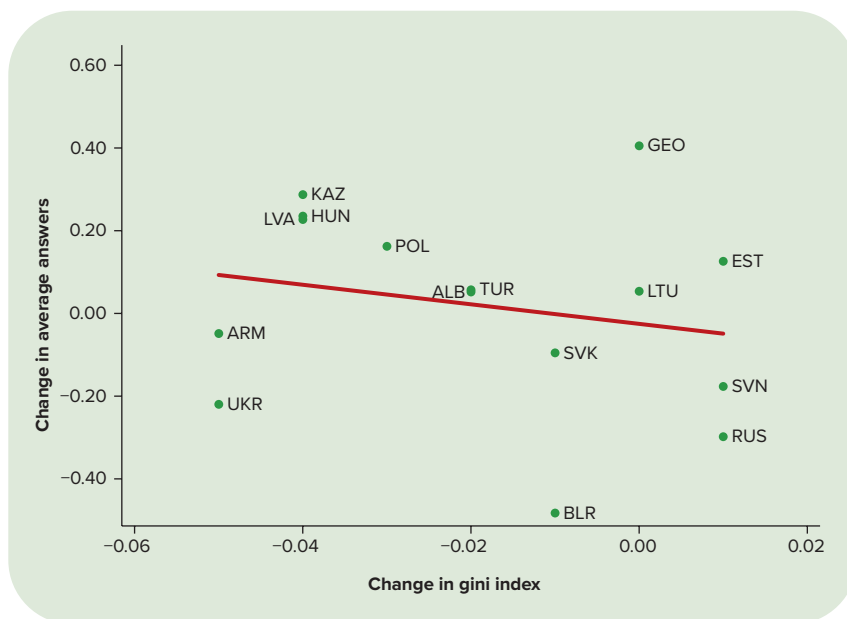
Inequality fell sharply in some countries in ECA. The Gini coefficient fell about 10 points in Kazakhstan and Moldova and about 5 points in Ukraine, the Kyrgyz Republic, Belarus, and Armenia. A 10-point decline in the Gini coefficient in such a short period of time is equivalent to transforming an income distribution similar to that of Spain (with a Gini of about 0.36) into a distribution similar to that of Finland (with a Gini of about 0.26). These large changes may not be confirmed by a more detailed analysis, as data on income distribution in some of these countries may not be very reliable, especially for the earlier time periods.

Note also that these trends of stable or decreasing inequality are quite recent and, when a longer time period is considered, current inequality levels are, for most countries, quite higher than they used to be at the fall of the Berlin Wall. This combined with lower mobility, actual or perceived, may actually have led to lower life satisfaction (more on this below).

The relationship between inequality and well-being during the 2000–2014 period was weak. A simple regression of life satisfaction on inequality shows that the Gini coefficient explains just 5 percent of the cross-country variance of life satisfaction. Furthermore, the correlation between changes in inequality and changes in well-being is low (figure 2.9).

The weak link between inequality and well-being is not surprising. In their reviews of the empirical evidence, Clark, D'Ambrosio (2015) and Ferrer-i-Carbonell and Ramos (2014) report that the relationship has been found to be both positive and negative. This does not mean that distributional change does not matter for people's well-being. Rather, the Gini coefficient may not accurately measure important changes in inequality, or the relationship may be more dependent on perceptions and attitudes than the level of inequality shown by the data.

**FIGURE 2.9** Changes in life satisfaction are only weakly correlated with changes in inequality



Source: LiTS I and III.

Note: The possible responses to the question "Are you satisfied with your life?" are assigned a numerical value from -2 for strongly disagree to +2 for strongly agree. The average is calculated in 2005 and 2015 for each country and the difference is plotted on the vertical axis. For more information about country groupings and country codes see Table 0.1

Two major measurement problems could affect the relationship between the Gini and well-being. First, the distribution of income could become more polarized while the Gini coefficient remains constant or even decreases (for a discussion of polarization versus changes in inequality see, for example, Zhang and Kanbur 2001).

Second, surveys may not accurately measure inequality, because they include labor-related income and transfers but do not accurately measure capital income and normally do not adequately reflect households with very high incomes. As a result, surveys tend to underestimate inequality and possibly distort trends. For example, surveys do not show the huge increase in the number of billionaires, which rose globally from 204 in 1998 to 1,793 in 2015 (statistics obtained from the Forbes list of billionaires<sup>3</sup>). The increase in ECA has been one of the highest in the world, expanding by a factor of more than nine. In some countries, such as Russia, the number rose by a factor of 88.

Life satisfaction may also depend more on perceived inequality than actual inequality, and the two may differ significantly. Perceptions are particularly important in ECA.<sup>4</sup> Sanfey and Teksoz (2007) find that people in transition economies—where inequality was very low before transition but rose markedly during and after transition—tend to overestimate the level of income inequality. Even small increases are noticed and can elicit negative reactions.

Inequality stemming from differences in effort tends to be viewed as more acceptable than inequality of opportunity (that is, inequality related to circumstances beyond an individual's control, such as place of birth, parents' education, or race). Arampatzis et al (2015) and Hassine, N. (2011) argue that an important factor which may explain the Arab Spring was the high level of inequality of opportunity in countries where (standard) inequality was not very high. (Inequality had actually fallen before the revolt in Tunisia, where the Arab Spring began.)

Only a few estimates of inequality of opportunity are available for ECA and only over short intervals of time (Checchi and others 2015). In Norway from 1985 to 2005 (Almås and others 2010), "unfair" inequality rose while inequality as measured by the standard Gini fell. If the two types of inequality move in opposite directions, or are perceived to do so, then the relationship between inequality and well-being could be difficult to detect.

Poland is an example of how attitudes toward changes in income distribution were an important determinant of life satisfaction. Grosfeld and Senik (2010) show that the correlation between life satisfaction and inequality was positive (and significant) during the transition but negative (and still significant) after about 1996. They argue that Poles viewed increasing inequality during the transition period as a positive signal of their potential future higher incomes. Later on, as opportunities were materializing for only a few people, they viewed inequality in a more negative light.

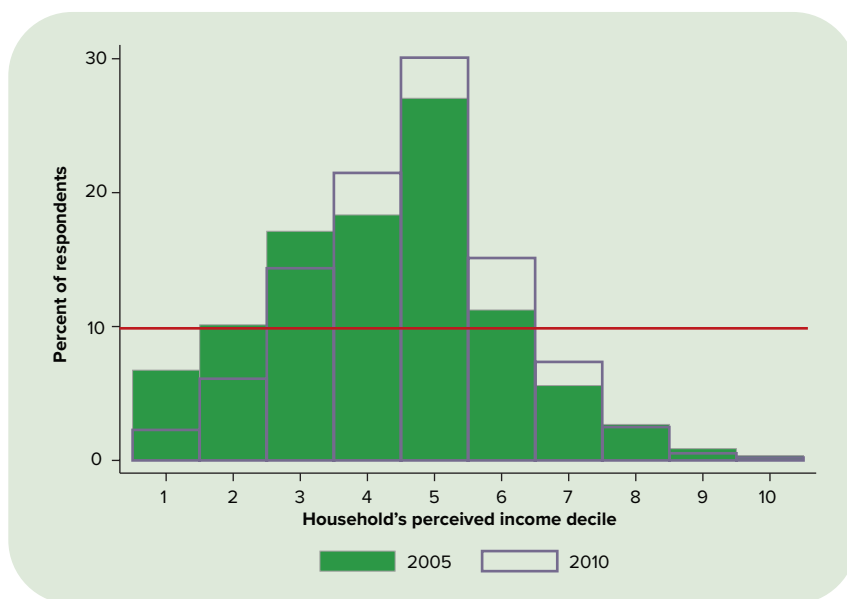
Other attitudes toward inequality affect its relationship with life satisfaction. For the ECA countries in the 2005 LiTS survey, Cojocaru (2014) finds that "disadvantageous inequality" (the distance between one's own income and that of richer people) is associated with lower life satisfaction. However, "advantageous inequality" (the distance between one's income and the incomes of poorer people) has no clear relationship with life satisfaction.

One way to measure aggregate perceptions of inequality is to survey views of the differences between a 'person's income and the incomes of others. Indeed, if people were able to accurately assess all the gaps between their income and the incomes of all others, their subjective perception of aggregate inequality and its measurement using the actual data would coincide.

LiTS I, II and III ask the following question: "Please imagine a 10-step ladder where on the bottom, the first step, stand the poorest 10 percent of people in our country, and on the highest step, the 10th, stand the richest 10 percent. On which step of the 10 is your household today?" Across ECA countries, the average share of the population viewing themselves in the fourth to eighth percentile of the income distribution rose between 2005 and 2010, while the share of people viewing themselves in the bottom three percentiles fell (figure 2.10). If every individual were able to correctly assess his or her position in the distribution, then all ten steps of the income ladder would have the same share of people, i.e. ten percent (in figure 2.10 this would correspond to the uniform distribution indicated by the red line). The results however show that in general there is a bias towards the middle of the ladder indicating that more people perceive belonging to the middle deciles than to their real position. This bias towards the middle fluctuates over time. People in the region became more optimistic during the 2005 to 2010 period, but less optimistic, during the period 2010 to 2015 (figure 2.11).

The experience differs considerably across countries (see the annex). Some countries (such as Romania) show little difference between the distribution of 'people's perceived income relative to others between 2005 and 2015. In others (such as Slovenia), the share of people perceiving their income to be in the bottom half increased. Yet other countries (such as Albania) show marked differences

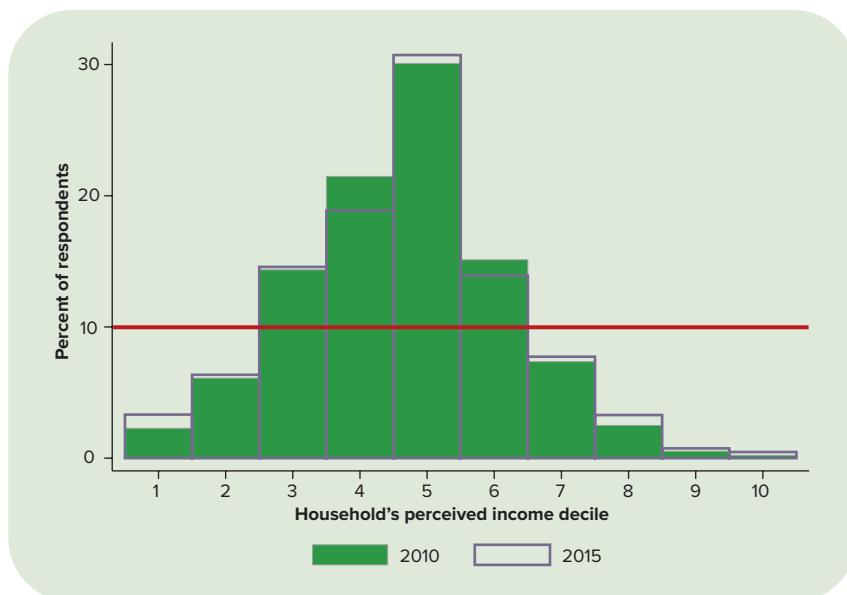
**FIGURE 2.10** The share of people who perceive that they are in the lower income brackets fell between 2005 and 2010



Source: LiTS I and II.

Note: Bars represent simple averages of all countries included in the LiTS. The line at the 10 percent mark represents the uniform distribution, i.e. the level that the bars would have if every individual were to assign his or her income to the correct decile. For more information about country groupings and country codes see Table 0.1

**FIGURE 2.11** The share of people who perceive that they are in the three lowest income brackets rose between 2010 and 2015



Source: LiTS I and II.

Note: Bars represent simple averages of all countries included in the LiTS. The line at the 10 percent mark represents the uniform distribution, i.e. the level that the bars would have if every individual were to assign his or her income to the correct decile. For more information about country groupings and country codes see Table 0.1

over the period in both high- and low-income categories. Perceived inequality could thus well have played a role in changes in well-being in some countries.

It is also likely that people form expectations of how their incomes will evolve in relation to aggregate change in income and its distribution. Thus, expectations of growth likely affect the extent of individual satisfaction and commitment to, as well as trust in, existing institutions and political parties. The next section discusses the extent to which slow growth since the financial crisis may have affected political polarization and life satisfaction.

## Incomes are Stagnant

Poor economic performance—as indicated by high unemployment, declines in production, financial instability, or high inflation—may undermine confidence in the ability of mainstream parties to manage the economy and thus increase support for extremist parties. de Bromhead, A., Eichengreen, B., & O'Rourke, K. H. (2013) examine how the decline in output during the Great Depression led to the rise of right-wing political extremism in the 1920s and 1930s. They show that changes in GDP over a prolonged period rather than the previous year drove the rise in extremism. The intuition is that societies can withstand one-time shocks but that continuing bad economic news reinforces negative expectations and generates a lack of confidence in mainstream parties.

A similar analysis for today's European countries finds that the 2009 crisis led to increased support for populist parties (see Part II).<sup>5</sup> A 1 percentage-point decrease in average GDP growth over the previous four years is associated with a 3.1 percentage-point increase in the share of votes for populist parties (table 2.1).<sup>6</sup>

**TABLE 2.1 Regression results relating GDP growth and votes for extreme political parties**

	(1) ExtremeVote	(2) ExtremeVote	(3) ExtremeVote	(4) ExtremeVote
LagGRgdp	-1.134* (-3.00)	-0.346 (-0.78)		
Postcrisis		10.57* (3.11)		7.442+ (1.88)
AvgGrowth4~s			-3.098* (-4.23)	-1.701+ (-1.64)
_cons	41.12* (27.26)	35.32* (14.97)	46.83* (21.26)	40.24* (9.76)
N	138	138	138	138

Note: LagGRgdp is GDP growth in the previous year. Postcrisis is a dummy variable equal to 1 in the year after the crisis and 0 otherwise. AvgGrowth4~s is average GDP growth in the four previous years. ExtremeVote is the share of votes going to extreme political parties, as defined in Part II. t-statistics are in parentheses. + p<0.11, \* p<0.05.

A 1 percentage-point decrease in GDP growth the previous year is linked to a 1.1 percentage-point increase in the share of votes for populist parties. However, when a dummy variable is included for the period after 2009 to account for changes in extreme voting caused by other aspects of the deteriorating political climate of the postcrisis period, the impact of growth over the past year is no longer significant. In short, it was the long-term deterioration in economic conditions following the crisis that drove the rise in political extremism, not just a one-year fall in output.

Life satisfaction, and perhaps political polarization, may be more related to economic mobility, or perceptions of economic mobility, than to GDP growth. The prospects of becoming richer than average may explain why societies with high (or increasing) inequality do not necessarily experience a rise in political polarization or a decline in life satisfaction.<sup>7</sup> Cojocaru (2014a) tests the prospects of upward mobility (PUOM) hypothesis in ECA using the LiTS II survey. He finds that it is confirmed for EU countries but not for non-EU countries. Lokshin and Ravallion (2000) find support for it for Russia.

Economic mobility deteriorated following the financial crisis. Many households in ECA saw their incomes rise above the \$10 a day threshold—a threshold that represents the lower bound of middle-class income (Ferreira et al. 2013)—during the period of rapid growth (2000–08) (figure 2.12). The number of households crossing this threshold declined significantly following the 2008/09 financial crisis, and in some countries poverty rose. In many countries in the eastern part of the region, upward mobility was strong before the 2008 crisis and dropped dramatically after 2008.<sup>8</sup> In fact, in the more recent period, many people in these countries experienced downward mobility.

Moreover, perceptions of economic mobility have deteriorated in some ECA countries since 2010. In some subregions, the share of the population that felt that their economic circumstances had improved (compared with their parents' generation) declined between 2010 and 2015 (figure 2.13, panel a), and the share of the population that expected their children's economic circumstances to improve (compared with their own) fell (panel b). Views of past and future mobility dif-

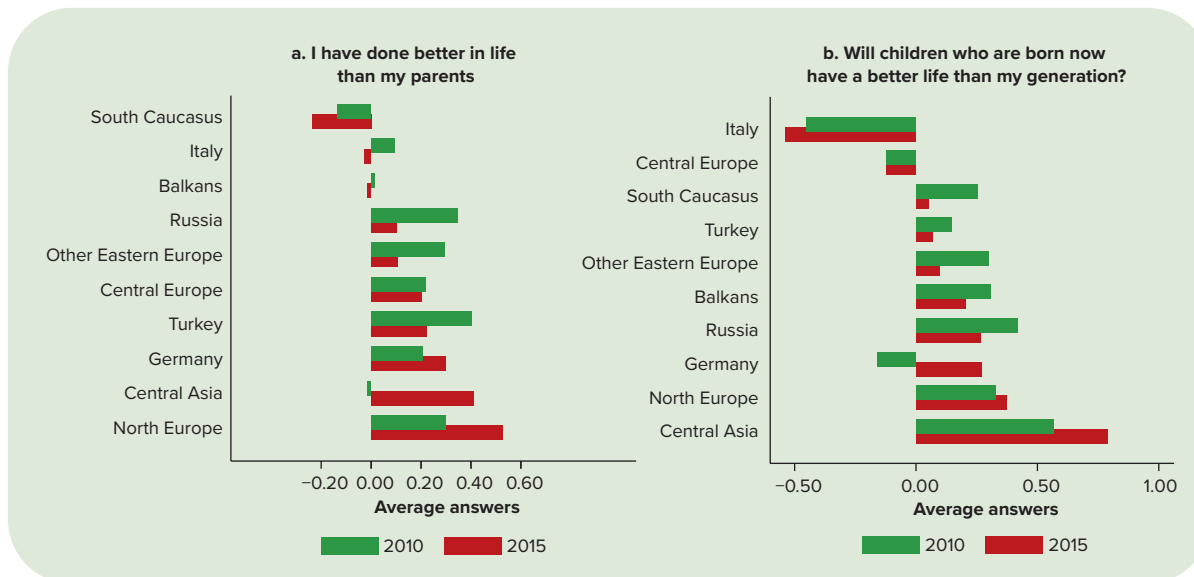
**FIGURE 2.12** The share of people moving out of poverty fell in many countries in Europe and Central Asia after the crisis



Source: Harmonized data from national household surveys.

Note: Economic mobility was estimated using synthetic panel methodology of Dang et al. 2014 for two periods: pre-2008 and post-2008. See also Cancho et al. 2015. For more information about country groupings and country codes see Table 0.1

**FIGURE 2.13** Perceptions and expectations of upward mobility fell in many subregions of Europe and Central Asia between 2010 and 2015



Source: Life in Transition Survey (LiTS) III.

Note: Averages were constructed by assigning the following values to the answers: -2 to "strongly disagree", -1 to "disagree", 0 to "neither agree nor disagree," +1 to "agree," and +2 to "strongly agree." For more information about country groupings and country codes see Table 0.1.

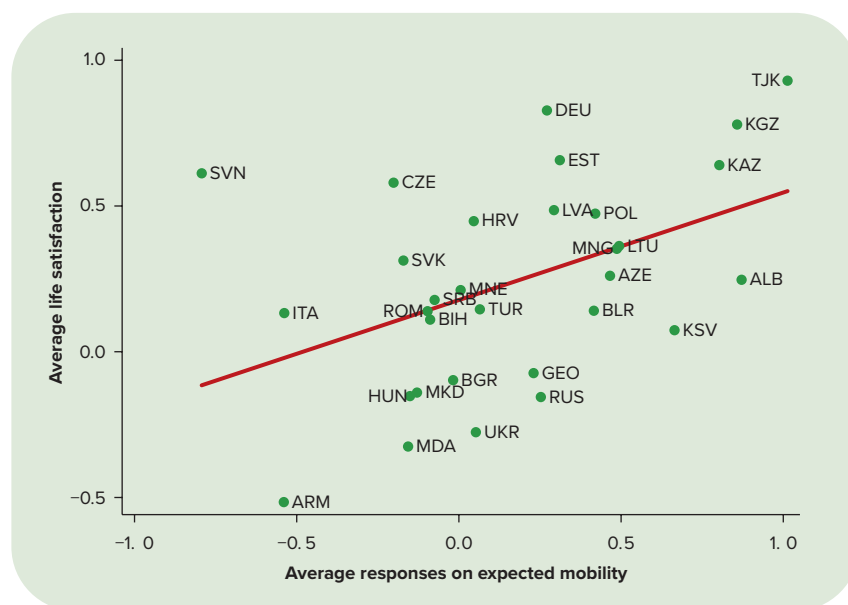
ferred greatly across subregions. On average, the shares of respondents in Germany, Central Asia, and Northern Europe perceiving, or anticipating, improvement in intergenerational economic mobility rose between 2010 and 2015. They deteriorated in Italy, Turkey, other Eastern Europe, Russia, and the South Caucasus over this period.

Perceptions of lower economic mobility may be associated with lower life satisfaction. The perception that one's economic circumstances have deteriorated, or that one's children's economic circumstances will decline, may be associated with lower life satisfaction and greater willingness to support radical changes in policies or political leadership. Rothwell (2016) shows that expectations of very low (or no) upward mobility are a common characteristic among supporters of Donald Trump in the United States. In ECA the country averages for the level of life satisfaction are positively associated with 'people's expectations that their children's incomes will exceed their own. The correlation for 2015 is positive but slightly smaller than for 2010 (figure 2.14). Declines in perceptions and expectations of economic mobility may be thus contributing to a deterioration in life satisfaction—and perhaps to support for populism.

## The Structure of the Labor Market Is Changing

Poor labor market outcomes could be fueling the increasing dissatisfaction and polarization of voters across Europe. In the United States, local labor markets that were more exposed to trade with China experienced both larger declines in manufacturing employment and increasing political polarization (Autor, Dorn, and Hanson 2013; Autor and others 2016). Similar evidence has been found for Europe. Malgouyres (2014) finds that greater exposure to import competition from

**FIGURE 2.14** Expectations that one's children will have higher incomes than one's own are positively associated with life satisfaction



Source: LiTS III.

Note: The possible responses to the question "Are you satisfied with your life?" are assigned a numerical value from -2 for strongly disagree to +2 for strongly agree. For more information about country groupings and country codes see Table 0.1.

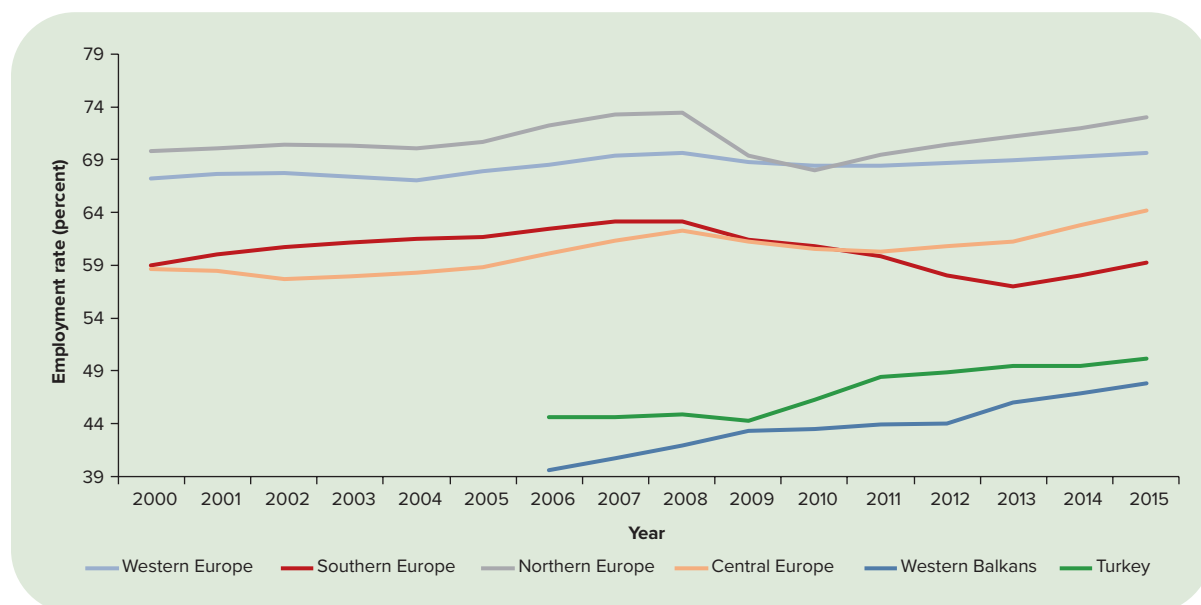


low-wage countries substantially increased the share of votes moving to the far right across French communities and that these effects grew over time. Halla Wagner, and Zweimüller (2012) find that the inflow of immigrants into a community increased support for far-right parties in Austria. In Germany, increasing trade with China and Eastern Europe increased the share of votes for the extreme right, an effect driven mainly by changes in manufacturing employment (Dippel, Gold, and Heblich 2015).

Most European labor markets, however, appear to have fully recovered from the financial crisis, a fact does not appear consistent with the hypothesis that poor labor market performance has driven rising political extremism. The share of working-age people with a job has returned to precrisis levels in Western, Northern, and Central Europe (figure 2.15). In Central Europe, employment rates in 2015 exceeded levels before the crisis hit the region. In Turkey and the Former Yugoslav Republic of Macedonia, employment rates have risen continuously since 2009. The only exception to this pattern is Southern Europe, where labor market recovery began only in 2014; employment rates there remained below precrisis levels in 2015.

These aggregate patterns mask important underlying changes in the structure of ECA's labor markets. Over the past 10–15 years, many workers shifted from permanent, full-time jobs to temporary or part-time employment, and technology drove massive changes in the share of employees in low-, middle-, and high-skilled occupations. Such dramatic changes in work arrangements have no doubt also been accompanied by considerable labor market churning and rising uncertainty over job stability. It is possible that the uncertainty associated with these

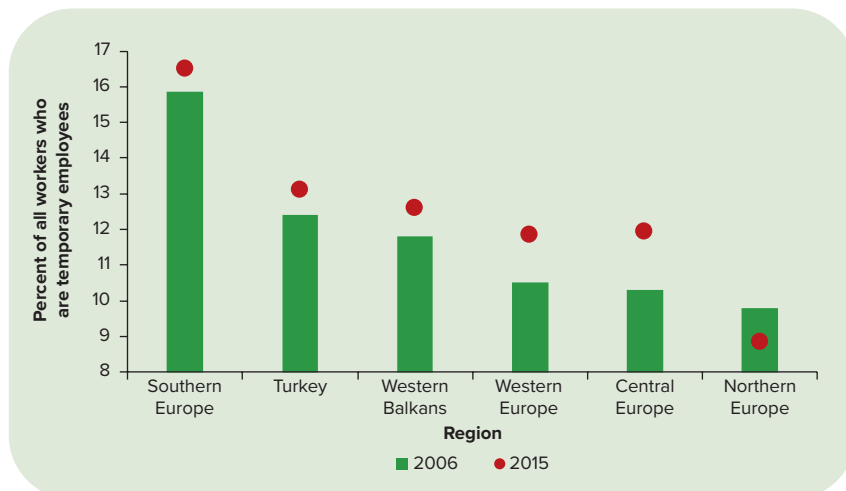
**FIGURE 2.15** By 2015 employment rates in Europe and Central Asia had returned to precrisis levels, except in Southern Europe



Source: Eurostat, LFS

Note: Figures show percentage of population 15–64 employed.

**FIGURE 2.16** Except in Northern Europe, temporary employment rose between 2006 and 2015



Source: Eurostat, LFS.

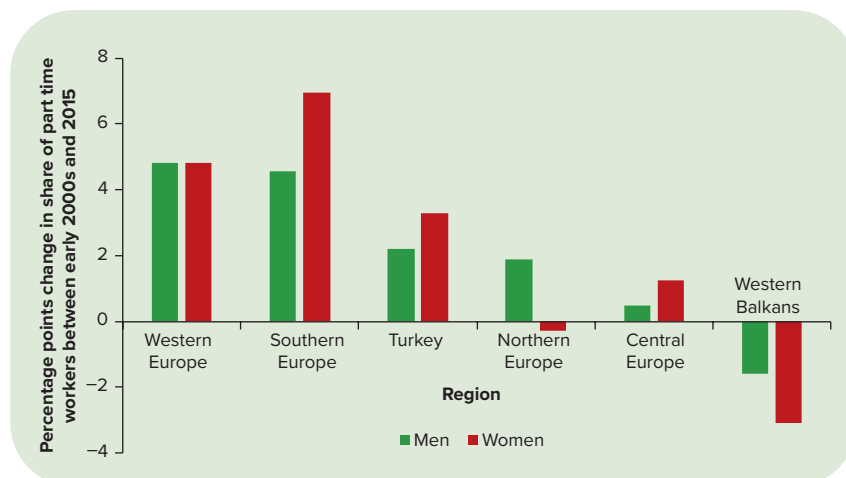
Note: Each data point shows the percentage of employees in temporary contracts.

changes, rather than poor labor market conditions in the aggregate, are driving the rise in political extremism and declining life satisfaction.

Except in Northern Europe, an increasing share of employees hold temporary contracts rather than contracts of unlimited duration. These changes have most pronounced in Western Europe, Southern Europe, and particularly Central Europe (figure 2.17). The share of temporary employees in Poland, for example, increased from 6 percent to 18 percent between 2000 and 2015.

An increasing share of workers hold part-time jobs, especially in Western and Southern Europe. In some Western European countries, including the Netherlands and Switzerland, at least one out of every three workers has a part-time job. Although part-time work is more prevalent among women, both men and women have experienced a substantial rise in part-time work since the early

**FIGURE 2.17** The share of workers in Europe and Central Asia working part-time increased



Source: Eurostat, LFS.

Note: Each data point shows the percentage of employees in temporary contracts.

2000s in most subregions. The rise in part-time work is thus not driven by changes in the gender composition of the labor force or by increasingly flexible work arrangements among women.

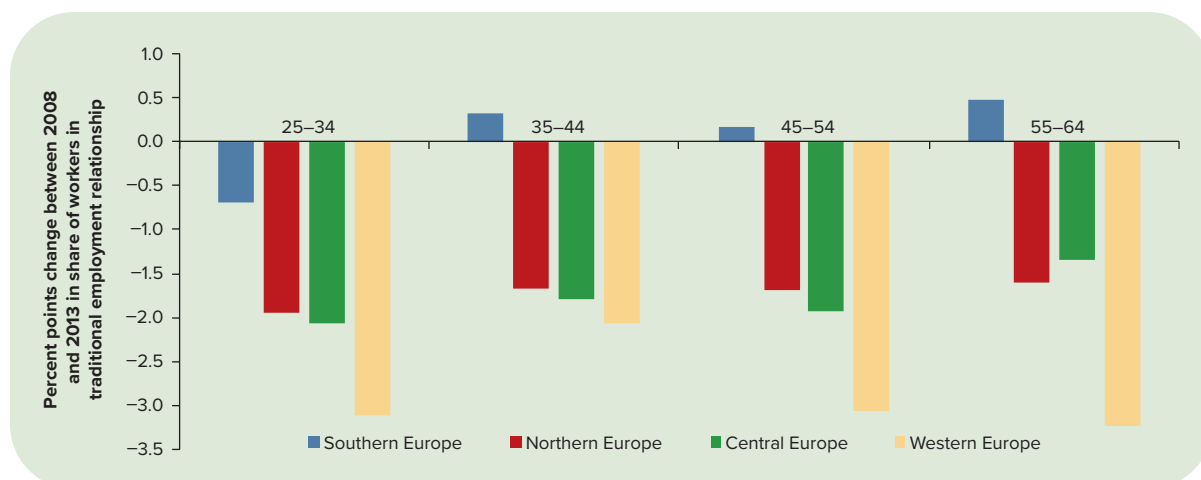
As a result of these changes, the share of workers in traditional employment relationships (defined as salaried workers with a single full-time, permanent job) fell in most countries. The decline was steepest in Western Europe (figure 2.18). The size of the decline in traditional employment was similar for men and women and among workers of different ages (figure 2.19).

**FIGURE 2.18** The share of workers in Europe and Central Asia with traditional work arrangements fell between 2003 and 2013



Source: Own calculations based on microdata from LFS, Eurostat. Workers in traditional employment are those with a salaried job, in a permanent and full-time position and without a second job.

**FIGURE 2.19** The decline in the share of traditional work arrangements in Europe and Central Asia affected all age groups



Source: Own calculations based on microdata from LFS, Eurostat. Workers in traditional employment are those with a salaried job, in a permanent and full-time position and without a second job.

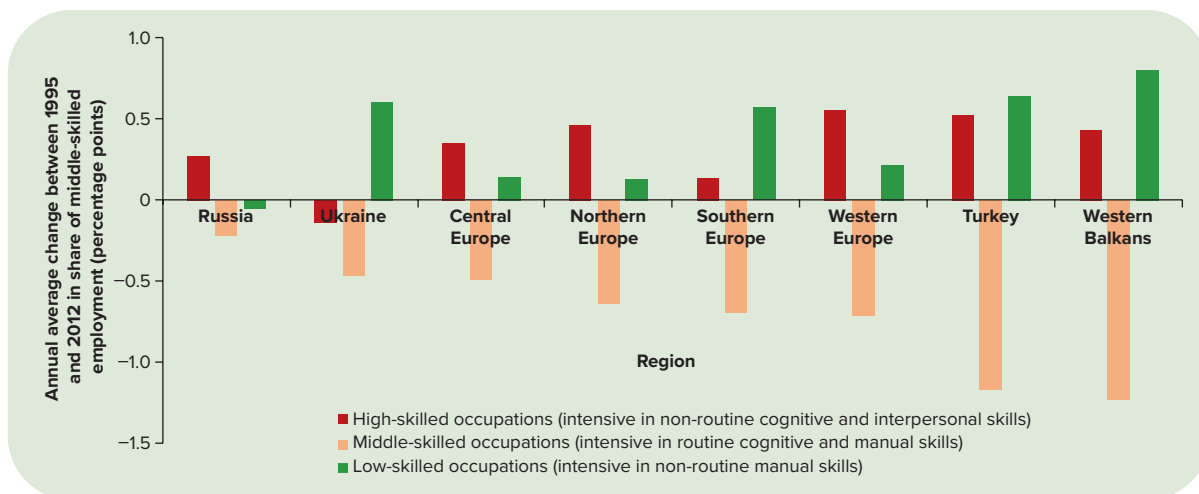
Labor markets in the region (and across the world) also witnessed a dramatic polarization. The share in total employment of middle-skilled occupations that are intensive in routine tasks fell while the share of low- and high-skilled occupations intensive in nonroutine tasks increased (figure 2.20). Scholars argue that some of the technologies associated with the Internet help explain the secular decrease in demand for workers performing routine tasks.<sup>9</sup> ECA experienced a larger decline in routine employment than other parts of the world.

Some anecdotal evidence suggests that the decline in traditional employment has contributed to increasing political polarization. For example, the rise in part-time and temporary work was greater in Poland than in many other countries, and the most recent elections resulted in the rise of a populist government. These labor markets changes occurred at a time when job satisfaction was falling sharply in many ECA countries, as shown in figure 2.5.

The limited empirical evidence does not indicate that increased temporary work is related to polarization toward the right. Negri (2015) shows that people in Organisation for Economic Co-operation and Development (OECD) countries holding temporary contracts are more likely than the average person to vote for left parties. They are also more likely to be involved in the political process than unemployed people. Their support for the left is tied to those parties' support for expansion of the welfare state, not for noncorporatist (that is, more extremist) attitudes.

In contrast, qualitative data from nine countries in ECA show that concerns about jobs and a disappearing middle class are fueling rising discontent—despite good performance in economic growth and shared prosperity (Dávalos and others 2016). Household well-being, as measured by current consumption and ex-

**FIGURE 2.20** The share of middle-skilled employment declined throughout Europe and Central Asia



Source: Data from World Bank 2016.

Note: Figure displays results for countries for which at least seven years of data were available. Classification follows Acemoglu and Autor (2011). High-skilled occupations include legislators, senior officials and managers, professionals, technicians, and associate professionals. Middle-skilled occupations include clerks, craft and related trades workers, and plant and machine operators and assemblers. Low-skilled occupations include service and sales workers and elementary occupations.

pectations of future income, is associated with the unemployment rate and job quality. The decline in traditional employment reduces expectations for income and the ability to enter the middle class.

A large share of the population in ECA views stable and well-paying jobs as out of reach. Dávalos and others (2016) also find that except in Turkey and more traditional communities in FYR Macedonia and Central Asia, most families feel they need at least two full-time employed earners to accumulate enough income to belong to the middle class. Both the number and the quality of jobs matter. The lack of good jobs is driving this discontent and the feeling of being “left behind,” particularly among women and youth, causing discontent to rise in some countries despite solid rates of economic growth. There is also the perception that political and social connections are increasingly critical for accessing jobs and improving ‘well-being. Inequality of opportunity is perceived to be increasing, exacerbating frustration over the decline in traditional employment and middle-skill occupations.

There is, then, some evidence linking structural change in the labor market with political polarization or declines in well-being. Further research is required to address this issue.

## Conclusion

This chapter has framed the analysis of the links between political polarization, growing mistrust in existing institutions, and rising economic challenges across ECA. Simple measures summarizing income distribution do not show rising inequality. However, life satisfaction, perceived inequality, inequality of opportunity, job security, and economic mobility have deteriorated. At the same time, long-term economic growth has fallen to historically low levels, and the composition of demand for skills is changing. Although more detailed analysis at the country level is required on all of these trends to establish firm causality, the evidence presented suggests that economic anxiety may well be part of the driver of political anxiety.

Even the preliminary evidence can provide some broad guidance for policy. If actual income inequality—in particular inequality stemming from differences in effort—is not a driver of declining life satisfaction in many countries, then further redistribution through taxes and transfers is unlikely to greatly improve satisfaction. Rather, measures to ensure equality of opportunity, while boosting overall growth, could break the current vicious circle of economic and political anxiety. This points in the direction of more investments in education, health services, and infrastructure that serve a wide range of people.

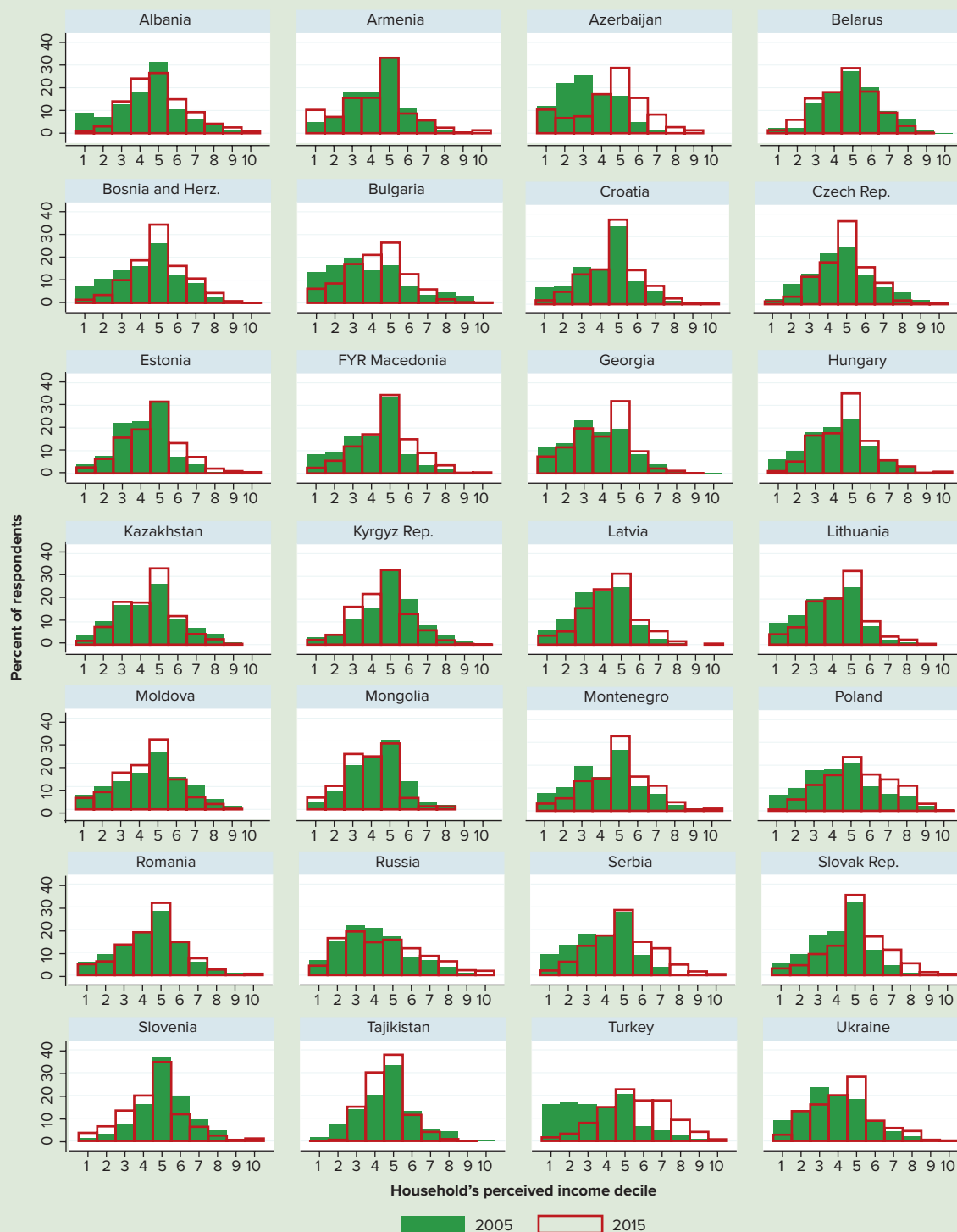
Efforts to retrain workers who lose their jobs, as the international division of labor changes and new technologies are introduced, and to create new jobs will reduce the anxiety people experience as job security declines. Rethinking the architecture of social protection might be required to adjust to new economic realities. This could include an enhanced role of the government in life-long learning; separating eligibility for benefits (including pensions and health insurance) from

employment; and providing services such as child and elder care, which facilitate more flexible employment choices.

To study further the relation between changes in inequality and political polarization or populism, improved data on inequality is needed, including indicators of people's perception of changes in inequality, and measures that differentiate between inequality of opportunity and inequality as the result of differences in efforts. More research is also needed to analyze the links between demand for skills and changes in life satisfaction. This research is urgent because policy changes are imperative to adjust to important economic changes and to reduce social and political anxiety.

## Notes

1. The unremarkable improvement of 1.2 percent for Latin America and the Caribbean should be put in context, as this region's average level (7.7) is very high.
2. These are not necessarily the policy programs of the populist parties that gain ground when there is political polarization.
3. The list is available here: <http://www.forbes.com/billionaires/list/>
4. For a recent analysis see Cancho, Davalos, and Sánchez-Páramo 2015
5. The analysis was based on data from Austria, Belgium, Bulgaria, Cyprus, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Lithuania, the Netherlands, Norway, Poland, Portugal, the Slovak Republic, Slovenia, Spain, Sweden, Switzerland, and the United Kingdom.
6. The regression includes country fixed effects.
7. Mobility refers to relative position—one's position on the income ladder with respect to other people's positions—rather than an absolute income threshold.
8. This analysis replicates a recent case study on mobility in ECA
9. See, for example, Autor, Katz, and Kearney (2008); Acemoglu and Autor (2011); and Autor and Dorn (2013).

**FIGURE 2A.1** Perception and the income ladders in Europe and Central Asia (graphs by country)

Source: LITS I and III.





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PART



# Country Pages





## ALBANIA

**Table 1** 2015

Population, million	2.9
GDP, current US\$ billion	11.1
GDP per capita, current US\$	3840
Poverty rate (\$2.5/day 2005PPP terms) <sup>a</sup>	6.7
Poverty rate (\$5/day 2005PPP terms) <sup>a</sup>	47.5
Gini Coefficient <sup>a</sup>	29.0
School enrollment, primary (% gross) <sup>b</sup>	104.8
Life Expectancy at birth, years <sup>b</sup>	77.4

Sources: World Bank WDI and Macro Poverty Outlook.  
Notes:

(a) Most recent value (2012)

(b) Most recent WDI value (2014)

*Albania's economy is expected to expand in the next three years. The pick-up in growth is driven by private investment and a recovery in consumption. It is reflected in broad-based job creation, driving modest declines in poverty. Fiscal consolidation, backed by both larger revenues and expenditure restraint, limit the overall contribution of the public sector to growth. Progress on the structural reforms, stronger economic activity, and job creation are expected to continue lifting living standards and gradually reducing poverty.*

## Recent developments

Albania's economy continued to expand in 2016, supported by robust private investment and recovering household consumption. Growth accelerated to 3 percent in the first quarter of 2016, and is projected to reach 3.2 percent for the full year. Growth has been led by domestic demand, including private investment supported by large energy projects (which contributed 1.7 pp in the first quarter), and private consumption supported by positive labor market developments since 2015 and the easing of credit standards (which contributed 1.2 pp). Fiscal consolidation continued to take place in 2015, limiting the Government contribution to GDP growth. Overall, net exports are expected to have a small negative contribution to growth, as investment related imports pick up.

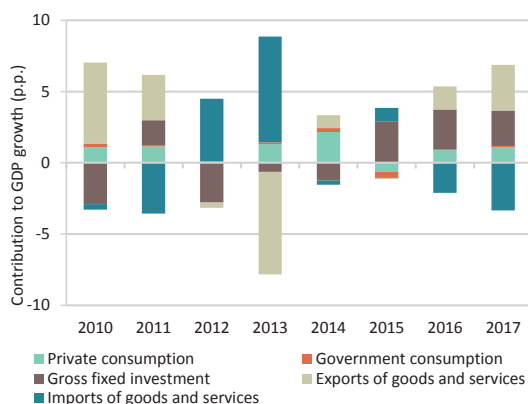
Fiscal results remained on track in 2016, leading to a decline of the public debt to GDP ratio for the first time since the global crisis. The budget deficit is expected to reach 2.5 percent of GDP in 2016, down from 4.8 percent in 2014, helped by strong revenue performance (including increases on excises, VAT, PIT, and CIT revenues), current spending restraint, and lower capital spending. As result, the public debt to GDP ratio is expected to decline to 72.5 percent of GDP in 2016 from 72.7 percent in 2015, in line with the recently approved a new organic budget law that mandates an annual decline in public debt until it reaches 45 percent of GDP.

The current account deficit is expanding in 2016, but continues to be financed primarily

by FDI inflows and external public borrowing. After narrowing to 11.7 percent of GDP in 2015, the deficit is expected to reach 13 percent of the GDP in 2016. The deterioration is led by a worsening balance of trade in goods and services. Exports of goods and services are expected to decline because of lower commodity prices, although services exports are performing well. Total imports continue to increase due to high FDI-related imports. A large decline of remittances (by 10.7 percent), linked to lower growth in the south of the EU, is also contributing to the larger deficit. FDI sank by 44 percent in the first half of the year, especially in the oil-extracting industry, but are expected to partially recover in the second half supported by large investment projects. External volatility also reduced other financing flows. International reserves continue to be at a comfortable level, covering about 7.3 months of imports of goods and services, and proving a buffer in the case of lower than expected financing flows.

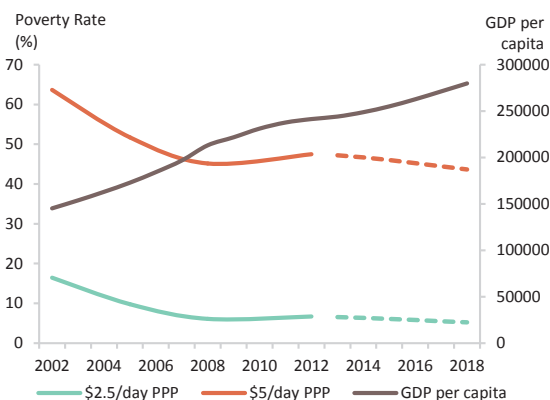
In the context of accelerating economic growth, Albania has benefited from positive job creation. Labor markets have continued to improve steadily, with an employment rate 2.7 percentage points higher in the first quarter of 2016 compared to the same quarter in 2015. The employment rate among those 15-64 years climbed to 54.8 percent in the first quarter of 2016, the highest rate since early 2012. Higher employment rates are driven by job creation in the better-paying sectors of industry and services, which accounted for 50.5 percent and 44.3 percent of overall employment growth, respectively. By contrast, agriculture employment – which still concentrates a large share

**FIGURE 1 Albania / Growth decomposition**



Sources: INSTAT and World Bank forecasts.

**FIGURE 2 Albania / Actual and projected poverty rates and GDP per capita**



Sources: World Bank (see notes to Table 2).



of the workforce and the poor - was stagnant. Better employment outcomes are the result of a reduction in unemployment, as well as higher labor force participation rates. Economic growth combined with positive labor market developments are estimated to have slightly reduced poverty and promoted inclusion. Poverty (measured as US\$ 5/day, 2005 PPP) is estimated to have decreased in 2015 to 46 percent, compared to 46.7 percent in 2014, with job creation in sectors, such as construction, that benefit poor and low-skilled individuals. For some households, the decline in remittances likely muted some of the progress taking place in the labor market. Moreover, labor market patterns suggest progress on inclusion. The slight decline in unemployment (0.4 percentage points between the first quarter of 2015 and the first quarter of 2016 when it stood at 16.9 percent), was mostly driven by changes in youth unemployment (15-29), especially for young women for whom it declined by 5 percentage points. Similarly, labor force participation rates increased by 2.9 percentage points in the same period, primarily due to lower female inactivity. However, not all groups are benefitting from better employment outcomes: among people 30-64 years

old, unemployment and inactivity increased particularly among males, although still remain lower than for other age groups.

## Outlook

The Albanian economy is expected to expand solidly in the near term. Consumption is likely to recover further as the labor market continues to improve, and investment will remain robust supported by large infrastructure projects, especially the Trans Adriatic Pipeline and a hydropower plant in Southern Albania. Once the terms of trade shock on commodities exports eases, net exports are expected to gradually contribute to growth as EU economies recover. Improvement in the business climate and reforms to address high NPLs could further strengthen private investment and consumption over the medium term. Growth is projected to reach 3.2 percent in 2016 and 3.5 percent in 2017 and 2018.

As the economy continues to strengthen and labor markets improve, further gains in poverty reduction are expected. Poverty, measured at the moderate poverty line (US\$ 5/

day, 2005 PPP), is expected to decline to 45.3 percent in 2016, to 44.5 percent in 2017 and even further to 43.7 percent in 2018.

## Risks and challenges

Risk to this outlook are mostly on the downside, but a stronger pace of structure reforms could help mitigate the impacts. External developments associated with financial volatility and slow growth in the EU may adversely impact Albania's growth and poverty prospects through reduced remittances, exports, investment and consequently economic growth. Domestic factors such as fiscal pressures or increased business uncertainty associated with next year's elections could also slow down progress. However, faster than currently expected improvements in the business climate and reforms to address high NPLs could further strengthen private investment and consumption over the medium term. Further gains in poverty reduction hinge on sustained and faster economic growth that translates into more and better jobs, particularly given the downward trend of remittances.

**TABLE 2 Albania / Macro poverty outlook indicators**

(annual percent change unless indicated otherwise)

	2013	2014	2015	2016 f	2017 f	2018 f
<b>Real GDP growth, at constant market prices</b>	1.0	1.8	2.8	3.2	3.5	3.5
Private Consumption	1.8	3.0	-0.9	1.3	1.6	2.5
Government Consumption	2.9	6.4	-8.9	0.9	1.9	2.4
Gross Fixed Capital Investment	-2.0	-4.0	9.9	8.9	7.5	5.8
Exports, Goods and Services	-12.4	1.8	-0.1	3.3	6.5	6.2
Imports, Goods and Services	-7.9	4.6	-1.4	3.3	5.2	5.3
<b>Real GDP growth, at constant factor prices</b>	-0.7	2.1	2.8	3.3	3.5	3.5
Agriculture	1.1	2.0	-0.7	2.3	3.2	3.0
Industry	0.2	-3.6	8.5	5.7	3.8	4.5
Services	-2.4	5.5	2.0	2.5	3.6	3.1
<b>Inflation (Consumer Price Index)</b>	1.9	1.6	1.9	0.9	1.5	2.9
<b>Current Account Balance (% of GDP)</b>	-10.5	-12.5	-11.7	-13.1	-13.0	-12.0
<b>Financial and Capital Account (% of GDP)</b>	8.6	9.8	8.7	10.1	10.6	9.6
Net Foreign Direct Investment (% of GDP)	9.2	8.2	7.4	7.1	7.1	6.5
<b>Fiscal Balance (% of GDP)</b>	-5.2	-6.0	-4.8	-2.5	-2.2	-1.1
<b>Debt (% of GDP)</b>	70.4	72.1	72.7	72.5	70.7	67.8
<b>Primary Balance (% of GDP)</b>	-2.0	-3.1	-2.1	0.3	0.6	1.6
<b>Poverty rate (\$2.5/day PPP terms)<sup>a,b,c</sup></b>	6.6	6.4	6.1	5.8	5.5	5.2
<b>Poverty rate (\$5/day PPP terms)<sup>a,b,c</sup></b>	47.2	46.7	46.0	45.3	44.5	43.7

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.

Notes: e = estimate, f = forecast.

(a) Calculations based on ECAPOV harmonization, using 2002-LSMS and 2012-LSMS with 2005PPP.

(b) Projection using annualized elasticity (2002-2012) with pass-through = 1 based on GDP per capita in constant LCU.

(c) Projections are from 2013 to 2018.



## ARMENIA

**Table 1** 2015

Population, million	3.0
GDP, current US\$ billion	10.5
GDP per capita, current US\$	3489
Poverty rate (\$2.5/day 2005PPP terms) <sup>a</sup>	26.3
Poverty rate (\$5/day 2005PPP terms) <sup>a</sup>	75.9
Gini Coefficient <sup>a</sup>	31.5
Life Expectancy at birth, years <sup>b</sup>	74.5

Sources: World Bank WDI and Macro Poverty Outlook.

Notes:

(a) Most recent value (2014)

(b) Most recent WDI value (2014)

*In 2016 the Armenian economy continued its modest, export-driven recovery. However, fiscal pressures remain elevated due to the negative impact on revenues of a decline in both imports and nominal GDP. Growth remains sensitive to external conditions and internal political shifts, including the government change in September 2016, as well as legislative and presidential elections in 2017-18. Armenia achieved modest poverty reduction gains during 2014-16. This trend may continue given current projections for economic growth, real wages and remittances.*

## Recent developments

During the first seven months of 2016 the Armenian economy grew by 3 percent, year-on-year (y/y), driven by the recovery of agricultural exports to Russia. However, domestic demand remained weak as remittances continued to decline, slowing growth in retail and construction sectors.

Monetary policy conditions remained soft as falling imported and domestic food prices and lower tariffs on natural gas contributed to an ongoing deflationary trend. Although the central bank reduced the policy rate by 5 times in 2016 by a cumulative 1.5 percentage point down to 7.25, the inflation rate still remained -1.5 percent during the first half of 2016.

Deflation, combined with declining imports and weak domestic demand, reduced VAT collection, contributing to the poor performance of public revenue. However, a combination of expenditure rationalization and the 4 percent under-execution of the budget helped contain the fiscal deficit to 1.7 percent of GDP. In July 2016 the government announced an expansion of the existing family benefit program, replacing the untargeted electricity subsidies introduced last year. The public debt stock was equal to 45 percent of GDP at end-2015, consisting mostly of concessional loans.

The current-account deficit remained below 3 percent of GDP during the first 6 months of 2016 due to rising exports and declining imports. Remittance inflows, mostly from Russia, remained weak, while exports to Russia doubled in the first half of 2016 (y/y).

The continued improvement of the external accounts helped ease pressure on the Armenian dram, prompting the central bank to reduce its interventions in the foreign-exchange market and maintain official reserves at 5 months of import coverage.

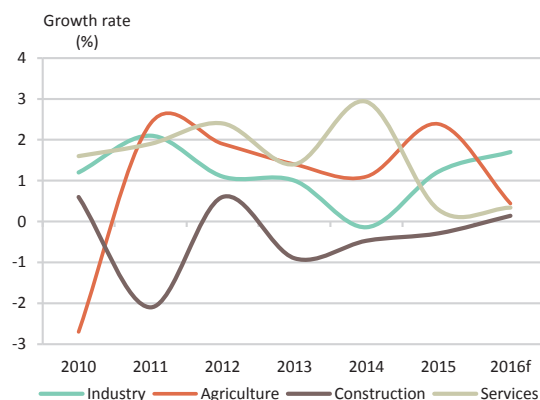
The banking sector is undergoing a major recapitalization. A majority of the country's 21 banks have already met the new capital requirement to be enforced in January 2017. Meanwhile, the dollarization rates for bank deposits and loans have remained broadly unchanged. The nonperforming loan ratio steadily increased from 10.6 percent in December 2014 to 17 percent in March 2016. The banking system recorded losses until February 2016, but profitability has improved since then.

The economic slowdown, combined with the return of migrant workers and a marked decline in remittances, has put downward pressure on employment and income growth. As a result, the poverty rate (measured at the international poverty line of US\$2.50/day) only fell by 1.4 percentage points, from 26.3 percent in 2014 to an estimated 24.9 percent in 2016.

## Outlook

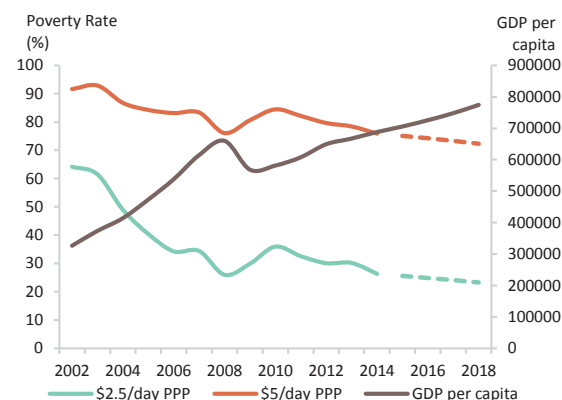
The GDP growth rate is projected to reach 3.1 percent in 2016, supported by rising external demand. As the global economy rebounds and Russia's recession passes its nadir, economic activity in Armenia is expected to moderately accelerate over the medium term. However, structural weaknesses and the slow recovery of domestic demand due to

**FIGURE 1 Armenia / GDP growth by sector, 2010-2016**



Sources: State Statistics Service of Armenia and World Bank staff estimates.

**FIGURE 2 Armenia / Actual and projected poverty rates and GDP per capita**



Sources: World Bank (see notes to Table 2).

stagnant remittances will slow its expansion. A combination of relatively weak revenue collection, moderate economic growth and increased demand for social spending will keep fiscal pressures elevated through the end of 2016. The annual fiscal deficit is projected to reach 4.3 percent of GDP. Public debt stock is expected to exceed 50 percent of GDP in 2016. Over the medium term, however, the fiscal deficit is expected to narrow to a sustainable level of about 2 percent of GDP, as rising growth rates boost revenues. A reformed tax code will facilitate fiscal consolidation over the medium term by improving domestic revenue mobilization by about 3 percent of GDP over 2017-19. The new tax code aims to expand the tax base, rationalize tax rates and close major loopholes in the existing legislation.

Modest but positive growth projections for agriculture and industry, combined with an increase in real wages in both the public and private sectors, are likely to support continued poverty reduction during 2017-18. As a result, the poverty rate is projected to decline from 24.9 percent in 2016 to 23.2 percent in 2018.

The easing of international sanctions against Iran in 2016 has created a unique

opportunity for Armenia to access new export markets and to serve as an overland shipping corridor between Iran and Russia. Moreover, access to Iranian oil may increase competition in the domestic energy market and reduce Armenia's reliance on Russian fuel imports.

## Risks and challenges

Armenia's economic outlook is subject to considerable downside risks. Sustaining growth in a difficult external environment with limited fiscal space poses a serious policy challenge. Any reversal in the external environment and/or a slower-than-expected recovery in prices for Armenia's critical metal exports represent significant risks to economic growth and job creation. Moreover, the municipal, legislative and presidential elections scheduled to take place over 2016-18 could delay the implementation of much needed structural reforms to improve the business environment, investment and productivity growth.

As the public debt burden continues to rise, the government faces the difficult

task of consolidating public finances while protecting critical social expenditures and priority public investments. Persistently low capital outlays, which bore the brunt of expenditure compression in recent years, could limit Armenia's medium-term growth. Further reforms in energy would help to further support the sector's medium-term fiscal sustainability, following the implementation of an improved tariff-setting methodology and the gradual clearance of accumulated arrears.

Significant regional disparities in living standards remain a serious challenge. While households in rural areas and in Yerevan have enjoyed significant income growth in recent years, welfare improvements in urban areas outside the capital have been very limited. Fostering stronger and more inclusive growth in urban areas will require accelerating economic structural transformation reforms in order to facilitate the transfer of productive resources from agriculture and the public sector to manufacturing and services. This process will support a more balanced distribution of economic growth across regions.

**TABLE 2 Armenia / Macro poverty outlook indicators**

(annual percent change unless indicated otherwise)

	2013	2014	2015	2016 f	2017 f	2018 f
<b>Real GDP growth, at constant market prices</b>	3.3	3.6	3.0	3.1	3.3	3.6
Private Consumption	0.9	1.0	-7.9	1.3	2.3	2.6
Government Consumption	7.6	-1.2	4.5	-8.8	0.9	4.3
Gross Fixed Capital Investment	-7.0	-2.2	3.0	1.2	1.5	1.8
Exports, Goods and Services	8.6	6.4	4.9	9.5	6.5	6.3
Imports, Goods and Services	-2.1	-1.0	-15.1	1.2	2.4	3.1
<b>Real GDP growth, at constant factor prices</b>	3.2	3.9	4.0	2.9	3.2	3.6
Agriculture	7.6	6.1	13.2	1.2	1.5	1.8
Industry	0.5	-2.3	3.6	7.4	4.3	3.5
Services	2.5	8.3	-3.2	0.3	3.9	5.5
<b>Inflation (Consumer Price Index)</b>	5.8	3.0	3.7	-0.7	2.7	4.0
<b>Current Account Balance (% of GDP)</b>	-7.3	-7.6	-2.6	-2.8	-3.1	-3.3
<b>Financial and Capital Account (% of GDP)</b>	10.0	7.9	5.9	2.8	3.1	3.3
Net Foreign Direct Investment (% of GDP)	2.9	3.3	1.6	2.5	2.5	2.4
<b>Fiscal Balance (% of GDP)</b>	-1.6	-1.9	-4.8	-4.2	-3.1	-2.3
<b>Debt (% of GDP)</b>	40.7	43.6	48.8	52.5	53.8	53.5
<b>Primary Balance (% of GDP)</b>	-0.6	-0.5	-3.1	-2.4	-1.2	-0.7
<b>Poverty rate (\$2.5/day PPP terms)<sup>a,b,c</sup></b>	30.2	26.3	25.6	24.9	24.1	23.2
<b>Poverty rate (\$5/day PPP terms)<sup>a,b,c</sup></b>	78.4	75.9	75.1	74.2	73.3	72.3

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.

Notes: e = estimate, f = forecast.

(a) Calculations based on ECAPOV harmonization, using 2011-ILCS and 2014-ILCS with 2005PPP.

(b) Projection using point-to-point elasticity (2011-2014) with pass-through = 0.7 based on GDP per capita constant in constant LCU.

(c) Actual data: 2013, 2014. Projections are from 2015 to 2018.

## AZERBAIJAN

**Table 1** 2015

Population, million	9.7
GDP, current US\$ billion	53.4
GDP per capita, current US\$	5529
School enrollment, primary (% gross) <sup>a</sup>	98.0
Life Expectancy at birth, years <sup>a</sup>	70.6

Sources: World Bank WDI and Macro Poverty Outlook.

Notes:

(a) Most recent WDI value (2014)

*Azerbaijan's economy is expected to contract in 2016 for the first time since 1995, due largely to low global oil prices, coupled with sharp cuts in public investment, the key driver of non-oil growth. Policy uncertainty, financial sector vulnerabilities and a generally poor business environment cloud the country's medium-term prospects. Continued progress on poverty reduction will require bold reforms to facilitate private sector growth and strengthen the labor market.*

## Recent developments

Azerbaijan continues to suffer from the protracted slump in global oil prices, and GDP contracted by 3.4 percent (y/y) in the first half of 2016. While oil GDP grew by 2 percent, non-oil output shrank by 6 percent. This was due to cuts in public investment, a crucial component of non-oil growth, and depressed market sentiment related to the large manat devaluations in 2015. The government is accelerating the implementation of its structural reform agenda, including measures to simplify customs-clearance and licensing procedures.

The current account position deteriorated, recording a deficit of 4.6 percent of GDP at end-June 2016, from a near balanced position a year earlier, due to a 40 percent (y/y) decline in oil exports in value.

After a brief period of stability, pressure on the manat has intensified since July, prompting the Central Bank to intervene in the foreign-exchange market. Unable to satisfy the rising demand for foreign currency, many commercial banks have suspended retail foreign-exchange trading, exacerbating uncertainty about the future of the exchange rate. International reserves fell from US\$8.5 billion at end-June 2015 to US\$4.2 billion at end-June 2016.

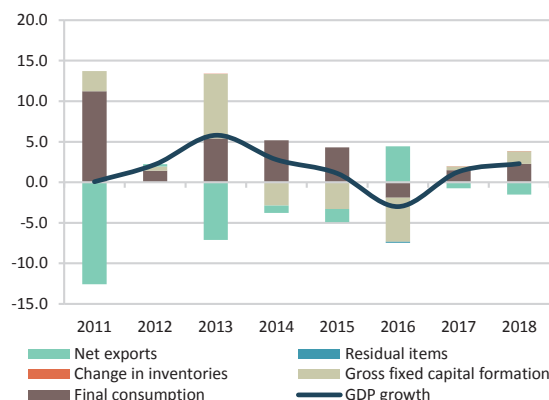
Inflation is on the rise, with official the rate reaching 11.4 percent in July (y/y), due to the devaluation pass-through effect. To curb inflationary pressures, the Central Bank has raised policy rates in steps from 3 to 15 percent since February 2016 while holding deposit auctions to maintain tight liquidity conditions.

Despite significantly lower oil revenues and increases in wages, pensions and targeted social assistance, the consolidated fiscal position (including extra-budgetary spending by the Oil Fund) recorded a surplus of 3.8 percent of GDP in the first half of 2016, supported by cuts in public investment and higher customs revenue resulting from the devaluation. However, the fiscal position is becoming increasingly strained. In August, the government published a list of 71 small enterprises slated for privatization, while developing measures to boost non-oil tax revenues.

A bank restructuring process is under way, but the overall resolution framework remains unclear. Since late 2015, the authorities have revoked the licenses of 12 small banks due to poor capitalization, while the rehabilitation of larger banks is underway. Nevertheless, public confidence in the financial system remains low, and deposit withdrawals have continued in 2016. Bank credits contracted by 24 percent (y/y) in the first half of 2016.

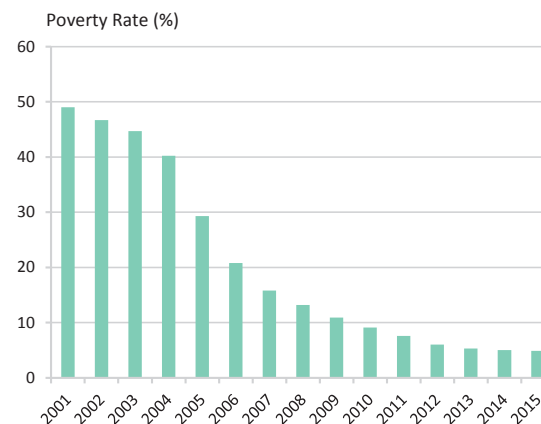
Steady poverty reduction over the last decade, fueled by growing oil revenues, is unlikely to continue in 2016. A simulation of the poverty impact of the inflation spike of June 2015-February 2016 indicates that close to 300,000 Azerbaijanis could be forced to live on less than AZN 72.5 per month, a consumption level about half the official poverty line of AZN 135.6 in 2015. Administrative data in early 2016 show increase in the number of people seeking employment and financial assistance, likely reflecting the collapse of the construction sector, which has been the largest contributor to employment growth in recent years.

**FIGURE 1** Azerbaijan / GDP growth decomposition, 2011-18 (percent)



Sources: State Statistical Committee.

**FIGURE 2** Azerbaijan / Official poverty rate, 2001-2015, (% population)



Sources: State Statistical Committee calculations.

## Outlook

GDP is projected to contract by 3 percent in 2016. Over the medium term, the gradual recovery of oil prices and the anticipated opening of a new gas field in 2018 are likely to support growth and the current account balance.

The consolidated fiscal deficit is projected to widen sharply to 8 percent of GDP in 2016, reflecting extra-budgetary transfers from the Oil Fund for the construction of Southern Caucasus Gas Corridor pipeline (5 percent of GDP), the bulk of which is undertaken outside the country through FDI. The deficit will be financed primarily by withdrawals from the Oil Fund and Treasury cash reserves. The fiscal stance is expected to improve over 2017-18 as oil prices gradually

recover, pipeline construction ends, and efforts to boost non-oil revenue yield results. While data limitations do not allow for projections, rising poverty will be the main concern over 2016-18. Accelerated inflation raises concerns on poverty reduction, especially for fixed income earners such as old-age, survivor and disability pensioners. Labor market income and pensions, the key sources of poverty reduction, are also under threat of shrinking fiscal space as these income sources were to a large extent supported by public spending.

## Risks and challenges

Heavy reliance on oil in an environment of low prices and declining output will

remain Azerbaijan's key challenge for long-term growth and poverty reduction. Despite some progress on the structural reform agenda, the country's challenging business environment, limited macroeconomic policy coordination, and persistent banking sector vulnerabilities continue to constrain private sector growth and inhibit economic diversification of the economy away from oil.

Looking ahead, the past model of oil revenue fueled poverty reduction is no longer sustainable, and further poverty reduction requires the government to undertake bold reforms to facilitate private sector activity and strengthen the labor market. While data limitations do not allow for projections, rising poverty will be the main concern over 2016-18.

**TABLE 2 Azerbaijan / Macro poverty outlook indicators**

(annual percent change unless indicated otherwise)

	2013	2014	2015	2016 f	2017 f	2018 f
<b>Real GDP growth, at constant market prices</b>	5.8	2.0	1.1	-3.0	1.2	2.3
Private Consumption	8.1	8.5	6.0	-2.6	2.5	3.8
Government Consumption	9.0	4.0	-7.1	-2.9	0.0	0.0
Gross Fixed Capital Investment	19.4	1.4	-9.9	-23.4	2.5	8.3
Exports, Goods and Services	1.5	-1.1	-1.0	-2.0	-0.7	-0.5
Imports, Goods and Services	10.0	4.1	-5.0	-10.0	0.5	2.2
<b>Real GDP growth, at constant factor prices</b>	5.6	1.8	1.8	-2.2	2.1	3.2
Agriculture	4.9	-2.6	6.0	4.2	4.0	4.0
Industry	1.8	-1.7	2.0	-3.0	1.4	1.4
Services	16.9	11.9	0.5	-2.2	3.2	7.0
<b>Inflation (Consumer Price Index)</b>	2.5	1.5	7.7	12.0	2.4	2.1
<b>Current Account Balance (% of GDP)</b>	16.5	13.6	-0.4	-0.7	4.8	7.9
<b>Financial and Capital Account (% of GDP)</b>	-13.9	-9.8	4.2	4.3	-1.2	-4.4
Net Foreign Direct Investment (% of GDP)	1.5	3.2	1.5	3.1	3.2	3.0
<b>Fiscal Balance (% of GDP)</b>	1.4	-0.4	-6.2	-8.0	-1.3	2.1
<b>Debt (% of GDP)</b>	13.6	15.7	18.6	18.8	19.8	17.5
<b>Primary Balance (% of GDP)</b>	1.7	-0.2	-5.5	-7.3	-0.6	2.7

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.  
Note: f = forecast.

# BELARUS

**Table 1** **2015**

Population, million	9.4
GDP, current US\$ billion	56.1
GDP per capita, current US\$	5933
Poverty rate (\$2.5/day 2005PPP terms) <sup>a</sup>	0.0
Poverty rate (\$5/day 2005PPP terms) <sup>a</sup>	0.6
Gini Coefficient <sup>a</sup>	26.6
School enrollment, primary (% gross) <sup>b</sup>	99.0
Life Expectancy at birth, years <sup>b</sup>	72.0

Sources: World Bank WDI and Macro Poverty Outlook.

Notes:

(a) Most recent value (2015)

(b) Most recent WDI value (2014)

*Economic activity continues to stagnate, driven by the contraction in Russia, lower export revenues, and domestic structural problems. After contracting this year and next, real GDP is likely to grow 1.3 percent in 2018, driven by improvements in the external environment and the impact of policies to improve competitiveness. However, there is a risk of falling into a trap of persistent low-growth trajectory. Poor macroeconomic and weak labor market conditions will continue constraining improvements to households welfare.*

## Recent developments

In the first seven months of 2016, Belarus's economy shrank by 2.7 percent y/y compared with a 4.1 percent decline a year earlier. The moderation of Russia's GDP decline and tentative recovery in its industry slowed down the contraction of Belarusian industrial output to 2 percent y/y in contrast to 7.2 percent decline a year ago. Slight rebound of machinery exports to Russia helped avoid a deeper fall in merchandize exports, which shrank by 4.4 percent y/y as compared to 32.7 percent drop a year ago. Still, the decrease in the physical volume of exports of oil products and potash fertilizers widened the trade deficit, as total merchandize exports fell by 18.6 percent, while imports dropped by 14.4 percent. The balance of payments pressures eased partially by declining demand for foreign exchange, mainly by individuals.

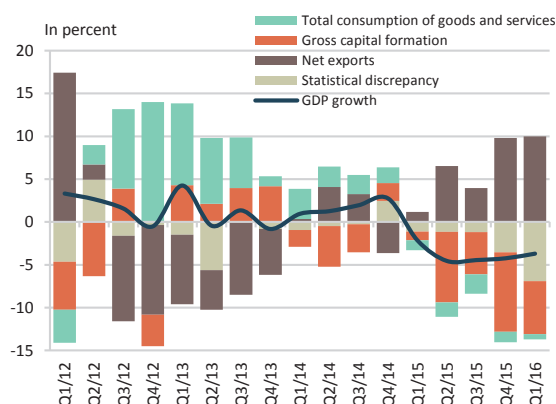
Cuts in public capital expenditures (by 5.1 percent y/y in real terms in the first half of 2016) and real reduction of directed lending dampened gross fixed capital formation by 20.6 percent y/y in January-July 2016. Lower expenses on capital more than offset the decline in revenues by 2.8 percent to help the budget reach a surplus of 1.8 percent of GDP. This fiscal surplus was used to service domestic debt and cover called guarantees. Foreign debt obligations required partial refinancing from the Russian government and commercial banks (US\$239 million) as well as the Eurasian Fund for Stabilization and Development (US\$500 million disbursed under a US\$ 2-billion loan).

Reduction of the nominal broad money supply helped maintain inflation under control. Annualized inflation slowed down to 12.3 percent in July 2016 from 14.9 percent a year ago. Subdued inflation pressures, along with a smaller depreciation of the national currency vis-à-vis the US\$ (by 7 percent during January – early August 2016) allowed the National Bank to cut its benchmark rate from 25 percent to 18 percent.

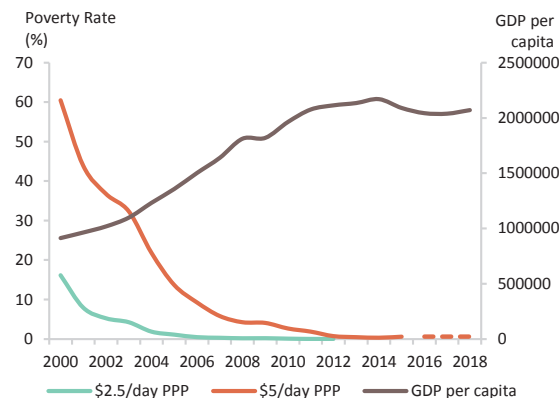
During January-July 2016, real household incomes fell by 7 percent y/y. For 2015, one-third of households reported deterioration of their financial well-being referring to rising prices against the background of shrinking incomes. The PPP US\$5/day poverty headcount, a low 0.32 percent of population in 2014, increased to 0.58 percent in 2015. However, a rise in poverty has been contained by further increases in targeted social assistance spending; by 18.4 percent in real terms in the first half of 2016 y/y, as the number of applicants increased by almost 30 percent, on the top of the 2015 increase by 6.5 percent.

## Outlook

The contraction of GDP in 2016-2017 may not be as deep as previously projected. The momentum of the recession has probably slowed, as evidenced by moderation of output decline in industry and small growth in agriculture and several service sectors. However, with low commodity prices, Belarus is likely to face a deterioration in the terms of trade and a wider current account deficit that will put pressure on foreign reserves

**FIGURE 1 Belarus / Contributions to quarterly GDP Growth**


Sources: World Bank Calculations based on Belstat data.

**FIGURE 2 Belarus / Poverty rates and GDP per capita**


Sources: World Bank Calculations based on Belstat data.

and the exchange rate. The current account deficit is projected to average 4.6 percent of GDP in 2016–2018, up from a previous forecast of 3 percent of GDP.

Given external financing needs and low levels of international reserves (around one month of imports over the last several years), foreign debt refinancing is needed. The Government continues to seek official financing assistance from the IMF and confirms the willingness to issue Eurobonds. In the banking sector, non-performing loans have ticked upward, despite debt rescheduling of large SOEs in mid-2015–2016. Limited access to external financing and increasing losses and indebtedness of the SOE sector constrain the space for any demand stimulus. Financial and fiscal strains could require pro-cyclical policy tightening to preserve fiscal and reserve buffers, including public spending cuts and bank recapitalizations. Disposable household incomes are expected to deteriorate, as the economy remains stagnant and labor markets under stress. This will leave households of the first and second deciles particularly vulnerable. Poverty at US\$5/day is projected to increase further to 0.61 percent in 2016, before returning to 2015

levels by 2018. The share of household budgets dedicated to expenditures on food and utilities is likely to continue during 2016 as a whole. Expenditures on utilities may increase further as part of ongoing district heating reforms, affecting low income households in particular, who already spend more of their budgets on utilities.

## Risks and challenges

The economy is at risk of protracted stagnation due to weak demand from abroad and limited space for stimulus measures. A recovery cannot longer be driven by credit expansion, especially in foreign currency, as enterprises can hardly service additional debt. Instead, capacity utilization has to be increased, as it dropped during the recession.

Sustainable drivers of growth and jobs have to be activated. They are mostly related to improved enterprise performance, especially in the public sector. The business models of SOEs have to be changed towards profit-making and better corpo-

rate governance instead of fulfilling top-down production targets. Given limited room for reinvigoration of domestic investment (also due to high interest rates), better conditions have to be created for participation of foreign investors, including through contract manufacturing projects. Selected SOEs, in which sizeable investments have been recently made, have to be restructured for better capital allocation and efficiency improvements.

Overall, enterprise restructuring has to be accompanied by a set of mitigation measures to minimize any negative impact on poverty and income inequality – not only for social reasons, but also because higher inequality and poverty are likely to dampen demand, thereby reinforcing the stagnation problem. A more comprehensive unemployment benefits and insurance systems would provide additional impetus for SOE reform. Overall, the existing social assistance programs, which are predominantly categorical, have to be strengthened in terms of targeting the most vulnerable and preventing significant leakages to well off. Importantly, revised programs have to meet fiscal constraints.

**TABLE 2 Belarus / Macro poverty outlook indicators**

(annual percent change unless indicated otherwise)

	2013	2014	2015	2016 f	2017 f	2018 f
<b>Real GDP growth, at constant market prices</b>	1.0	1.7	-3.9	-2.5	-0.5	1.3
Private Consumption	10.8	4.4	-2.4	-2.0	-0.4	1.0
Government Consumption	-2.1	-1.8	-1.8	-0.9	0.7	0.1
Gross Fixed Capital Investment	9.5	-8.8	-12.1	-15.0	-3.4	1.9
Exports, Goods and Services	-16.0	-3.6	-4.2	-2.1	0.5	1.2
Imports, Goods and Services	-4.2	-7.4	-7.0	-3.0	0.2	1.0
<b>Real GDP growth, at constant factor prices</b>	1.5	2.1	-4.2	-2.5	-0.5	1.5
Agriculture	-4.2	3.9	-2.8	2.5	2.8	3.0
Industry	-1.9	0.5	-6.6	-3.4	-1.0	1.8
Services	8.0	3.7	-1.6	-2.8	-0.9	0.8
<b>Inflation (Consumer Price Index)</b>	18.3	18.1	13.5	12.2	11.0	9.5
<b>Current Account Balance (% of GDP)</b>	-10.3	-7.0	-3.7	-4.8	-4.6	-4.4
<b>Financial and Capital Account (% of GDP)</b>	11.9	7.7	4.4	5.4	5.2	5.1
Net Foreign Direct Investment (% of GDP)	3.2	2.7	2.6	2.5	2.5	2.5
<b>Fiscal Balance (% of GDP)</b>	0.3	1.4	1.7	0.2	-0.6	-1.0
<b>Debt (% of GDP)</b>	31.5	34.2	48.2	49.1	54.4	51.2
<b>Primary Balance (% of GDP)</b>	1.3	2.4	3.3	3.0	2.3	1.6
<b>Poverty rate (\$5/day PPP terms)<sup>a,b</sup></b>	0.5	0.3	0.6	0.6	0.6	0.6

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.

Notes: e = estimate, f = forecast.

(a) Calculations based on ECAPOV harmonization, using 2015-HHS with 2005PPP.

(b) Projection using neutral distribution (2015) with pass-through = 0.87 based on GDP per capita in constant LCU.



## BOSNIA AND HERZEGOVINA

**Table 1** 2015

Population, million	3.5
GDP, current US\$ billion	16.2
GDP per capita, current US\$	4616
Gini Coefficient <sup>a</sup>	33.8
School enrollment, primary (% gross) <sup>b</sup>	n.a.
Life Expectancy at birth, years <sup>b</sup>	76.1

Sources: World Bank WDI and Macro Poverty Outlook.

Notes:

(a) Most recent value (2011)

(b) Most recent WDI value (2014)

*Growth declined in Q1 of 2016 to 2.1 percent y-o-y after reaching 3.0 percent in 2015. Supported primarily by consumption, medium-term growth is projected to rise above 3 percent. Reforms are advancing in key areas like debt-management, labor markets, and pensions. Growth prospects depend on further progress on the reform agenda and political dynamics in a decentralized institutional structure. Poverty is projected to decline only modestly due to lack of improvements in the labor market.*

### Recent developments

Growth moderated in Q1 of 2016. Real GDP growth in Q1 was 2.1 percent, unchanged from Q4 2015, but down from 3 percent for 2015 overall. Net exports were the main driver, with consumption also supportive. Consumer goods imports increased 4.1 percent year-on-year (y-o-y) in the first half of the year and bank credit to households was up 3.2 percent y-o-y in May. On the production side, manufacturing contributed around half of growth of real value added in Q1, with services about one-third and agriculture and mining the rest, offsetting a contraction in the construction sector.

The pick-up in growth is accompanied by modest labor market improvements. The unemployment rate fell by 2.3 percentage points vis-à-vis 2015 according to LFS 2016 (the number of unemployed fell from 315,000 to 273,000), but remains high at 25.4 percent. The employment rate increased marginally from 31.9 to 32.2 percent during this period, and the activity rate fell from 44.1 percent to 43.1 percent, such that the absolute number of persons in paid employment fell from 822,000 to 801,000. Some key labor market constraints are particularly detrimental to the B40. The high tax wedge for youth and low-skilled constrains their access to formal jobs. Declining numbers of registered unemployed in 2015-2016 were mostly among highly skilled. Public expenditures, while high, are tilted toward public wages, pensions and poorly-targeted cate-

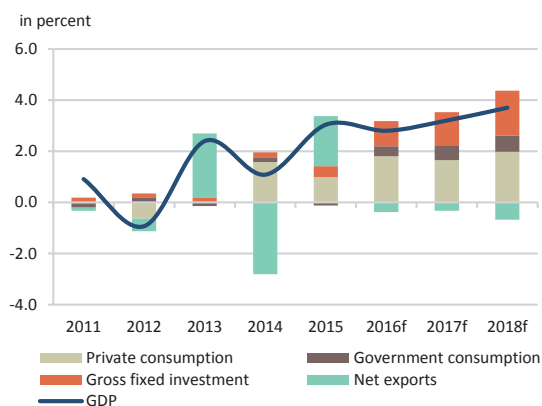
gorical transfers, limiting their poverty impact. While cross-country comparable poverty figures for BH are not available, and latest survey data are from 2011, model estimates suggest a stable poverty rate in recent years.

Consumer price deflation persists. The consumer price index (CPI) dropped by 1.5 percent y-o-y in June, the 19th consecutive month of declines, with the CPI now up only 2.4 percent from its 2010 average. Key drivers are lower prices of imported goods, such as food (down 1.5 percent y-o-y), transport (7.2 percent), clothing and footwear (8.9 percent). In contrast, prices rose for housing, water, health and education, and especially for alcoholic beverages and tobacco (up 8.5 percent). Declining consumer prices continue to boost real incomes of those employed. Net wages increased by 0.6 percent on average during I-VI 2016 compared to I-VI 2015 in nominal terms.

The current account deficit (CAD) widened in Q1 2016, to 5.8 percent of GDP, up from 3.6 percent in Q1 2015. Smaller net income inflows compared to Q1 2015 (down by 3 percentage points of GDP) offset the reduction in the trade deficit. Net FDI inflows increased from 0.4 percent of GDP in Q1 2015 to about 2.3 percent, sufficient to finance about 41 percent of the CAD; the remainder is financed mainly by flows on the capital account and other investments.

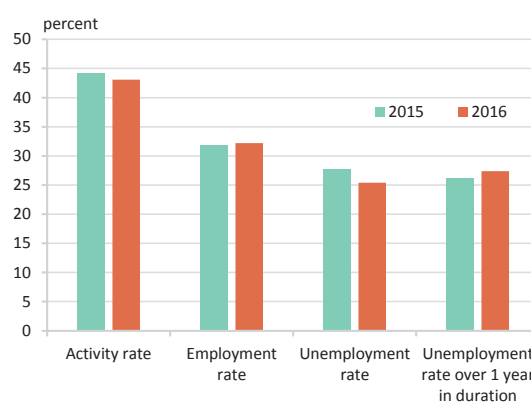
According to Central Bank (CBBH) data, fiscal consolidation in 2015 was strong, but a deficit is expected again in 2016. The consolidated general government fiscal balance in 2015 was in surplus of 0.7 per-

**FIGURE 1** Bosnia and Herzegovina / Contributions to annual GDP growth



Sources: BH Agency for Statistics (BHAS), World Bank staff estimates.

**FIGURE 2** Bosnia and Herzegovina / Labor market indicators, 2015-2016



Sources: LFS 2015 and 2016 (preliminary estimates), BHAS.

cent of GDP – a result of a smaller increase in revenues and a strong decline in expenditures (down 2.8 percentage points of GDP, due to lower capital investment). In 2016, gross revenues from indirect taxes rose by 4.4 percent y-o-y in the first six months (1.7 percent for 2015 as a whole). With the 2016 revenues-to-GDP ratio projected to be stable, the rise in expenditures, particularly the recovery in capital spending, is projected to move the fiscal balance back into deficit equivalent to about 0.6 percent of GDP.

## Outlook

Supported primarily by consumption, economic growth is projected to strengthen to above 3 percent in the medium term. As BH reform agenda advances, a moderate rise in exports is expected, but a strong demand for imports implies that net external demand will continue to be a drag on growth. Remittances will remain stable, and, together with sustained lower oil prices and progress on reforms, will underpin a gradu-

al pick up in consumption, which will remain a key driver of growth. Investments in energy, construction and tourism will support overall investment growth, and job creation in these sectors. Combined with recent employment pick up in agriculture, trade and food services, this should benefit B40 employment outcomes. Based on these dynamics, real GDP growth is projected to strengthen gradually during 2016-2018. Poverty is projected to decline modestly over the next years. The unemployment and long-term unemployment rates remain high, and real wages are expected to remain largely flat due to substantial remaining slack in the labor market. This may dampen the links between growth and poverty, as the latter is strongly associated with unemployment and inactivity in BH. The implementation of new sub-national labor laws in 2015/2016, and the introduction of support schemes for first-time job seekers, may support improved employment outcomes. Yet, key issues, such as improving the ability of public employment institutes in FBH and RS to engage in active employment support, continue to be unresolved.

## Risks and challenges

Achieving prudent, efficient, and effective fiscal policy, and addressing persistent unemployment or underemployment are central to the country's reform agenda and to making further progress on the twin goals. Deficits remain moderate, but the public sector is characterized by a high tax burden and inefficient spending, including poorly-targeted categorical benefits. Fiscal consolidation, or provision of an effective safety net, will not be effective with structural rigidities on the expenditure side unaddressed. Boosting formal job creation, especially among the B40 requires complex measures addressing both labor costs and active labor market policies.

Recent disputes over the publication of census results and the SAA adaptation suggest there is risk for political developments to slow the implementation of the reform agenda, which in turn, raises risks to the country's economic outlook.

**TABLE 2** Bosnia and Herzegovina / Macro poverty outlook indicators

(annual percent change unless indicated otherwise)

	2013	2014	2015	2016 f	2017 f	2018 f
<b>Real GDP growth, at constant market prices</b>	2.4	1.1	3.0	2.8	3.2	3.7
Private Consumption	0.0	1.9	1.2	2.2	2.1	2.5
Government Consumption	-0.6	0.9	-0.5	1.8	2.8	3.0
Gross Fixed Capital Investment	1.0	1.1	2.5	5.8	7.4	9.6
Exports, Goods and Services	7.9	4.2	3.0	2.0	2.5	3.0
Imports, Goods and Services	-0.2	8.1	-1.7	2.0	2.2	3.2
<b>Real GDP growth, at constant factor prices</b>	2.4	1.1	3.0	2.8	3.2	3.7
Agriculture	15.8	-12.7	8.5	5.0	2.8	3.0
Industry	3.8	1.8	3.0	3.0	2.7	3.0
Services	0.4	2.5	2.5	2.5	3.5	4.0
<b>Inflation (Consumer Price Index)</b>	-0.1	-0.9	-1.0	-1.4	0.5	1.0
<b>Current Account Balance (% of GDP)</b>	-5.5	-6.8	-5.4	-4.8	-5.5	-5.9
<b>Financial and Capital Account (% of GDP)</b>	4.8	6.0	4.8	4.8	5.5	5.9
Net Foreign Direct Investment (% of GDP)	1.5	2.4	1.4	1.1	1.1	1.1
<b>Fiscal Balance (% of GDP)</b>	-2.1	-2.0	0.7	-0.6	-0.6	-0.3
<b>Debt (% of GDP)</b>	37.7	41.8	41.9	41.5	39.7	37.4
<b>Primary Balance (% of GDP)</b>	-1.4	-1.2	1.6	0.5	0.5	0.9

Sources: World Bank. Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.  
Note: f = forecast.



# BULGARIA

**Table 1** 2015

Population, million	7.2
GDP, current US\$ billion	49.1
GDP per capita, current US\$	6839
Poverty rate (\$2.5/day 2005PPP terms) <sup>a</sup>	5.6
Poverty rate (\$5/day 2005PPP terms) <sup>a</sup>	16.4
Gini Coefficient <sup>a</sup>	36.0
School enrollment, primary (% gross) <sup>b</sup>	100.1
Life Expectancy at birth, years <sup>b</sup>	74.3

Sources: World Bank WDI and Macro Poverty Outlook.

Notes:

(a) Most recent value (2012)

(b) Most recent WDI value (2014)

*Bulgaria's economic recovery continued in the first half of 2016 and supported improved fiscal performance but the medium-term outlook remains challenging. Stronger growth and improvements in labor markets have contributed to poverty reduction. Further gains in growth, poverty reduction and shared prosperity would hinge on strengthening institutions, boosting the skills and employability of the labor force, and improving the effectiveness and efficiency of public spending.*

## Recent developments

Similarly to 2015, GDP continued to expand at around 3 percent annual rate in the first half of 2016. Economic activity was supported by strong domestic demand which benefited from continuing labor market improvements, low inflation, and increase in inventories. Household consumption remained strong as declining unemployment, rising wages and low inflation boosted real household incomes. Unemployment declined by close to 2 percentage points year-on-year (to 8.2 percent in Q2-2016) while new jobs were created in sectors – such as industry, trade and tourism – that were the hardest hit during the 2009 crisis and that employ a relatively large share of low-skilled labor, boding well for poverty reduction. Export growth slowed down compared to the first half of 2015 on the account of weaker demand in non-EU countries but the contribution of net exports to growth continued to be positive.

With strong economic growth and positive developments in the labor market, the \$5-a-day and \$2.5-a-day poverty rates are estimated to have come down slightly in 2015, from 15.4 percent and 5.5 percent, respectively, in 2014 to 14.5 percent and 5.0 percent, respectively. While declining, unemployment is still high, especially long-term and youth, and with high regional variation. Inactivity among certain groups of the population is also high as a result of an education system with deteriorating quality and rising inequality, and a large number of people excluded from economic opportuni-

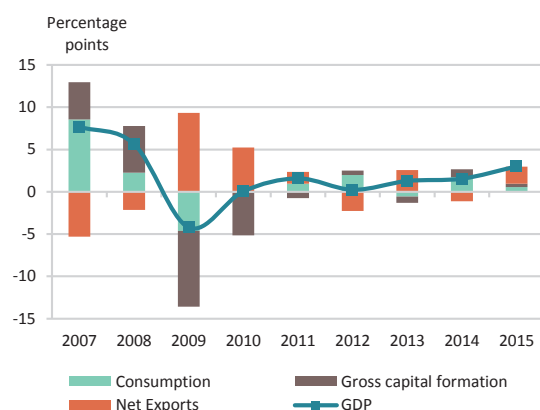
ties, such as the elderly, people living in rural areas, and the Roma. Such exclusion of a large number of people is especially damaging for growth in the case of Bulgaria, a country undergoing the steepest decline in population in the world.

Accelerated economic activity and slow implementation of public investment projects strengthened Bulgaria's cash fiscal position. The fiscal surplus in the first seven months of the year was 3.7 percent of annual GDP. Tax revenues were boosted by strong economic activity and compliance measures while spending declined due to the slow start of EU funded capital projects. Government debt increased to 30.3 percent of GDP in Q1-2016 as the Government issued new debt as part of its medium-term debt strategy. Debt remains the third lowest in the EU. The external current account was again in surplus in Q2-2016 supported by further narrowing of the trade balance. Bulgaria exported more investment and consumer goods, especially to the EU, while import growth was modest in line with low oil and commodity prices. On the basis of the improved external position, external debt shrank by a notch to 76.7 percent of GDP in June 2016 despite increasing Government debt.

## Outlook

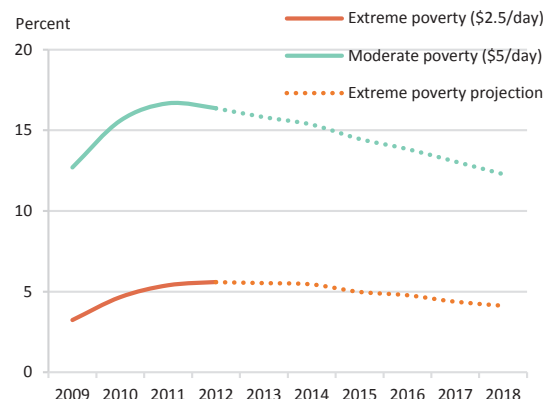
GDP growth is projected to slow to 2.7 percent in 2016 as the impact of higher absorption of EU funds on public investment and consumption diminishes with the start of the new financing period. Household consump-

**FIGURE 1 Bulgaria** / Contributions to annual growth, percentage points



Sources: NSI and World Bank staff estimates.

**FIGURE 2 Bulgaria** / Actual and projected poverty rates



Sources: World Bank staff estimates.

tion is likely to continue expanding while private investment is likely to offset the sharp reduction of EU funded public investment. Going forward, the economic recovery is projected to be modest, with growth picking up to 2.9 percent in 2017 and 3.1 percent in 2018. Recovery of external demand is likely to be slow as a result of weakening outlook in emerging markets, lingering geopolitical tensions in the region, and uncertainty related to the Brexit.

Poverty is projected to continue on its gradual downward path in the near term. Poverty at US\$2.5-a-day is expected to slightly decline to 4.8 percent in 2016, 4.4 percent in 2017 and 4.1 percent in 2018, while the US\$5-a-day poverty rate is likely to decline further to 13.8 percent in 2016, 13.1 percent in 2017, and 12.3 percent in 2018. These projections take into account the expected low inflation that protects the purchasing power of the poor, as well as the planned increases in pensions and the minimum wage.

The external current account is expected to continue to be in surplus, although declining by 2018. Export growth is likely to slow in response to a weakening outlook in emerg-

ing markets. Import growth is likely to be affected by weakening domestic demand for investment goods.

Fiscal consolidation is likely to continue in 2016 and beyond. The fiscal deficit is expected to be lower than initially expected in 2016 and to reach 1.5 percent of GDP (based on ESA2010 methodology) with fiscal accounts broadly balanced by 2018. Limited improvements in spending efficiency of select sectors could undermine fiscal consolidation plans going forward and limit the potential of public spending to enhance growth.

## Risks and challenges

The key challenge for Bulgaria is to accelerate convergence with the rest of the EU and deal with the negative consequences of demographic change. Accelerating convergence would require improvements in productivity and in labor force participation. According to a recent World Bank report, Bulgaria will need to raise its productivity growth to at least 4 percent

per year to reach the average EU income levels within a generation. Yet, recent productivity growth has been disappointing while improvements in labor force participation have been constrained by weak demand and skill shortages while a large portion of the population is at risk of poverty or social inclusion.

Addressing the challenge of convergence would require stepping up reforms to strengthen the legal and institutional framework, boosting the skills of the labor force, and increasing effectiveness of public spending.

Reforms to strengthen the effectiveness of the judiciary, reduce the potential for corruption, and improve the regulation of energy and financial sector could strengthen confidence and reduce fiscal pressures. Improving the education outcomes can have a significant impact on poverty reduction and shared prosperity. Enhancing the effectiveness of public spending on pensions, health and long-term care will be important for boosting Bulgaria's growth and ensure more inclusive and sustainable growth.

**TABLE 2 Bulgaria / Macro poverty outlook indicators**

(annual percent change unless indicated otherwise)

	2013	2014	2015	2016 f	2017 f	2018 f
<b>Real GDP growth, at constant market prices</b>	1.3	1.5	3.0	2.7	2.9	3.1
Private Consumption	-1.4	2.7	0.8	2.3	2.6	3.1
Government Consumption	2.2	0.1	0.3	0.3	1.1	2.2
Gross Fixed Capital Investment	0.3	3.4	2.5	0.0	2.3	3.5
Exports, Goods and Services	9.2	-0.1	7.6	4.7	4.5	4.9
Imports, Goods and Services	4.9	1.5	4.4	3.5	3.6	4.8
<b>Real GDP growth, at constant factor prices</b>	1.0	1.8	1.5	2.7	2.9	3.1
Agriculture	3.2	5.2	-1.4	0.2	1.2	1.5
Industry	0.2	0.9	2.8	2.2	3.0	3.3
Services	1.2	1.9	1.1	3.0	3.0	3.2
<b>Inflation (Consumer Price Index)</b>	0.9	-1.4	-0.1	-0.2	1.1	1.3
<b>Current Account Balance (% of GDP)</b>	1.3	0.9	1.4	1.6	1.8	0.8
<b>Financial and Capital Account (% of GDP)</b>	-0.7	1.8	1.3	1.1	0.9	1.9
Net Foreign Direct Investment (% of GDP)	3.3	3.1	3.6	3.6	3.5	3.5
<b>Fiscal Balance (% of GDP)</b>	-0.4	-5.4	-2.1	-1.5	-0.7	-0.1
<b>Debt (% of GDP)</b>	17.1	27.0	26.7	31.3	30.7	30.4
<b>Primary Balance (% of GDP)</b>	0.3	-4.6	-1.1	-0.6	0.2	0.8
<b>Poverty rate (\$2.5/day PPP terms)<sup>a,b,c</sup></b>	5.5	5.5	5.0	4.8	4.4	4.1
<b>Poverty rate (\$5/day PPP terms)<sup>a,b,c</sup></b>	15.8	15.4	14.5	13.8	13.1	12.3

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.  
Notes: e = estimate, f = forecast.

(a) Calculations based on ECAPOV harmonization, using 2012-EU-SILC with 2005PPP.

(b) Projection using neutral distribution (2012) with pass-through = 0.87 based on GDP per capita in constant LCU.

(c) Projections are from 2013 to 2018.

## CROATIA

**Table 1** 2015

Population, million	4.2
GDP, current US\$ billion	48.7
GDP per capita, current US\$	11629
Poverty rate (\$2.5/day 2005 PPP terms) <sup>a</sup>	2.1
Poverty rate (\$5/day 2005 PPP terms) <sup>a</sup>	9.4
Gini Coefficient <sup>a</sup>	32.5
School enrollment, primary (% gross) <sup>b</sup>	95.8
Life Expectancy at birth, years <sup>b</sup>	76.9

Sources: World Bank WDI and Macro Poverty Outlook.

Notes:

(a) Most recent value (2012)

(b) Most recent WDI value (2014)

Growth has strengthened in 2016 led by domestic demand. Given the labor market recovery and disposable income growth, the poverty rate has likely continued trending downwards to below 9 percent (at \$5/day PPP). The fiscal deficit is set to continue declining towards 2.7 percent of GDP, with public debt declining for the first time since 2008. For 2016 as a whole, economic growth is likely to increase to 2.4 percent, thanks to stronger tourism and investment driven by EU funds absorption. Continued fiscal consolidation efforts may lead to exiting the EU Excessive Deficit Procedure in 2017.

## Recent developments

Growth strengthened further in Q2 to 2.8 percent, the seventh consecutive quarter of growth, on the back of export growth, accelerating private consumption and a rebound of investment. Accelerating household consumption (3.1 percent y-o-y), the highest investment growth in seven years (over 6.3 percent y-o-y) and a rise in general government consumption (2.6 percent y-o-y) more than offset the negative contribution from imports. Deflationary pressures persisted by July 2016 due to administrative prices cuts. The strong annual decline of consumer prices (down 1.5 percent y-o-y by July), was affected by the government cut of the natural gas price by 19 percent late last year that more than offset the recovery of prices of services (in particular health and tourist services, responding to higher demand).

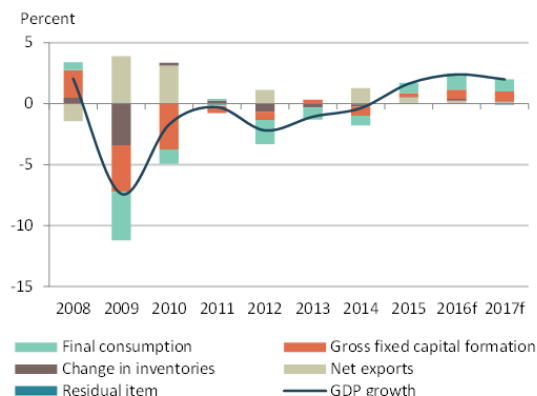
The administrative unemployment rate declined to 13 percent, the lowest level since the summer of 2008, led by increased demand by the tourist sector, manufacturing, trade, and other service activities. Yet, the activity and the employment rates decreased to 51.1 percent and 43.2 percent, respectively, remaining well-below the EU average. More than 95 percent of contracts are for fixed-term employment. Real gross wages grew by 1.7 percent by June, also helped by an accelerated emigration of workers which created pressures on the low-skilled labor market (over 9 percent of unemployed left the country for jobs abroad and some sectors, such as construction and

tourism, already face shortages). Disposable household income grew in 2015 and continued strong in early 2016. Although the effect of the income tax reduction dissipated, deflationary pressures and a decline in unemployment helped increase disposable household incomes in 2016. As a result, the absolute poverty rate measured at US\$5 at PPP decreased from 9.0 percent in 2015 to 8.7 percent in 2016.

The strong current account surplus helped reduce external imbalances. The current account surplus declined to a still high 4.3 percent of GDP on a 4-quarter basis, affected by a strong seasonal trade pattern and a deterioration of primary income balance due to higher profits of foreign owned companies (especially in financial intermediation, food production and tourism). The large surplus, along with doubling of net inflows of FDI to 0.7 percent of GDP on a 4-quarter basis, led to further external debt decline. External debt fell from 103.7 percent of GDP at end-2015 to 97.5 percent of GDP by May 2016, reflecting deleveraging of financial and other sectors, as well as reduction of government foreign liabilities. The net international investment position continued to improve, reaching 75.6 percent of GDP in Q1 2016, declining from its peak of 93 percent in 2010.

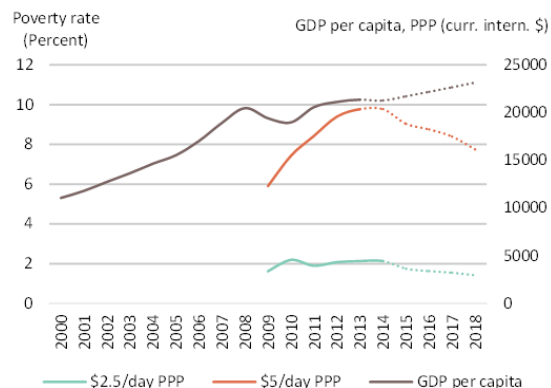
Despite ongoing household and corporate deleveraging, there are some early signs of credit recovery in 2016. Compared to end-2015, loans to corporates stagnated in the first half of 2016; given that two-thirds of loans are denominated in foreign currency, corporate lending adjusted for exchange rate changes picked up. Household loans, still largely influenced by the conversion

**FIGURE 1 Croatia / Contributions to annual GDP growth**



Sources: CROSTAT, World Bank.

**FIGURE 2 Croatia / Actual and projected poverty rates and real GDP per capita, 2000-2018**



Sources: World Bank (see notes to Table 2).

and a partial write-off of CHF loans, decreased by 5 percent by June. Deposits grew by 4.5 percent.

Non-performing loans (NPL) continued to decline in 2016. NPLs further decreased to 15 percent in June from 16.6 percent at-end 2015 due to continued sale of NPLs to factorizing companies and the write-offs.

Fiscal consolidation continued in 2016. The 12-month general government deficit narrowed to 2.1 percent of GDP by March, thanks to higher tax revenues (especially excises) and social contributions and lower expenditures. The latter was supported by temporary financing which was in power in Q1 after the general elections. The fiscal position further improved by May, likely narrowing the general government deficit further below 2 percent of GDP as direct taxes and EU funds absorption improved. Public debt further declined to 83 percent of GDP at the end of May.

Because of the weak coalition, the Government collapsed and the Parliament was dissolved July. The new elections took place on September 11, with neither of the main political parties securing a majority.

## Outlook

Economic expansion is expected to remain solid in 2016-18 with growth averaging 2.3 percent, led by strengthened personal consumption, exports and investment. Personal consumption is expected to intensify reflecting labor market recovery, increased consumer confidence and slowdown in deleveraging. Stronger utilization of EU funds will boost investment, especially public, while government consumption is projected to remain subdued due to the required fiscal consolidation under the Excessive Deficit Procedure (EDP) with the EU and the MIP.

As the economy continues growing, further declines in poverty are expected, with the absolute poverty rate measured at US\$5 at PPP projected to reach 7.7 percent by 2018, which is still elevated for a high-income country such as Croatia. This can be explained by low labor force participation which is among the lowest in the EU and presents a strong determinant of low household income and of vulnerability to poverty in Croatia.

## Risks and challenges

Risks are still skewed to the downside. Along with the risks related to the fiscal consolidation and public debt sustainability, high levels of private sector indebtedness and a potential further rise in emerging markets risk premia emerge as the government plans its 2017 refinancing strategy to cover the redemption of three sovereign bonds. Another protracted government formation after the early elections may lead to delays in EU funds absorption and another year of delays in implementing the structural reform program as announced in the NRP. Furthermore, financial volatility following Brexit and monetary tightening in the USA could negatively reflect on the borrowing costs of companies. While Croatia sees prospects of exiting the Excessive Deficit Procedure in 2017 with the current pace of consolidation, the macroeconomic imbalances will require strong and robust response by the new government.

**TABLE 2 Croatia /** Selected Economic and Social Indicators, Projections 2015-18 (annual percent change unless indicated otherwise)

	2013	2014	2015	2016 f	2017 f	2018 f
<b>Real GDP growth, at constant market prices</b>	-1.1	-0.4	1.6	2.4	2.0	2.4
Private Consumption	-1.8	-0.7	1.2	2.0	1.4	1.6
Government Consumption	0.3	-1.9	0.6	1.0	1.0	0.8
Gross Fixed Capital Investment	1.4	-3.6	1.6	3.7	4.0	4.2
Exports, Goods and Services	3.1	7.3	9.2	3.8	3.0	2.9
Imports, Goods and Services	3.1	4.3	8.6	3.5	2.9	2.6
<b>Real GDP growth, at constant factor prices</b>	-1.1	-0.1	1.4	2.4	2.0	2.4
Agriculture	-0.6	0.0	-0.4	1.5	2.0	2.2
Industry	-2.8	0.5	1.9	2.6	2.8	2.7
Services	-0.5	-0.3	1.3	2.4	1.7	2.3
<b>Inflation (Consumer Price Index)</b>	2.2	-0.2	-0.5	0.8	1.5	1.9
<b>Current Account Balance (% of GDP)</b>	1.0	2.0	5.3	3.2	3.0	2.9
<b>Financial and Capital Account (% of GDP)</b>	1.1	-0.6	-3.9	-4.0	-3.8	-3.8
Net Foreign Direct Investment (% of GDP)	1.9	1.9	0.4	2.7	3.2	3.5
<b>Fiscal Balance (% of GDP)</b>	-5.3	-5.5	-3.2	-2.7	-2.1	-1.5
<b>Debt (% of GDP)</b>	82.2	86.5	86.7	86.0	84.9	82.9
<b>Primary Balance (% of GDP)</b>	-1.8	-2.0	0.4	0.9	1.4	2.0
<b>Poverty rate (\$2.5/day PPP terms)<sup>a,b,c</sup></b>	2.1	2.1	1.7	1.6	1.5	1.4
<b>Poverty rate (\$5/day PPP terms)<sup>a,b,c</sup></b>	9.8	9.7	9.0	8.7	8.4	7.7

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.  
Notes: e = estimate, f = forecast.

(a) Calculations based on ECAPOV harmonization, using 2012-EU-SILC with 2005PPP.

(b) Projection using neutral distribution (2012) with pass-through = 0.87 based on GDP per capita in constant LCU.

(c) Projections are from 2013 to 2018.

## GEORGIA

**Table 1** **2015**

Population, million	3.7
GDP, current US\$ billion	14.0
GDP per capita, current US\$	3765
Poverty rate (\$2.5/day 2005PPP terms) <sup>a</sup>	31.2
Poverty rate (\$5/day 2005PPP terms) <sup>a</sup>	69.3
Gini Coefficient <sup>a</sup>	38.5
School enrollment, primary (% gross) <sup>b</sup>	114.5
Life Expectancy at birth, years <sup>b</sup>	74.4

Sources: World Bank WDI and Macro Poverty Outlook.

Notes:

(a) Most recent value (2015)

(b) Most recent WDI value (2014)

*Georgia's economy grew by 2.9 percent in the first half of 2016, driven by construction and other non-tradables. The annual growth is projected to reach 3.4 percent as external demand slowly recovers, credit picks up, and government spending increases markedly. The fiscal deficit is therefore projected to increase further from 3.8 percent of GDP in 2015 to 4-5 percent in 2016. Poverty is expected to decrease in 2016 as economic growth translates into more dynamic labor markets.*

## Recent developments

Exports and remittances declined in the first half of 2016 amidst a weak external environment marked by low commodity prices. Exports fell by 12.3 percent year on year, while remittances contracted by 2.4 percent. In contrast, construction and other non-tradables grew by 26 percent, raising GDP growth in the first half of 2016 to 2.9 percent. The unemployment rate declined marginally from 12.4 percent in 2014 to 12 percent in 2015, with most jobs created in non-tradable sectors like public administration, education, and social services. By contrast, agricultural employment decreased, slightly shifting the sectoral distribution of employment towards services. With economic growth below potential, persistent unemployment and low inflation at 0.9 percent in August 2016, the National Bank of Georgia reduced the policy rate from 8 percent in March 2016 to 6.5 percent in September. Prudent supervision reinforced the stability of the banking sector yielding a return on assets of 2.4 percent and return on equity of 16.5 percent. Nonperforming loans represented just 2.3 percent of all loans in July 2016.

The decline in exports and remittances, coupled with the slow adjustment of imports widened the current-account deficit from 12 percent of GDP in 2015 to 13 percent in the first quarter of 2016. Foreign direct investment financed nearly 85 percent of this year's current-account deficit, while reserve assets covered the rest. External debt declined from 107 percent of GDP in 2015 to 100 percent in the first quarter of 2016 after

US\$675 million in intercompany loans were converted to equity.

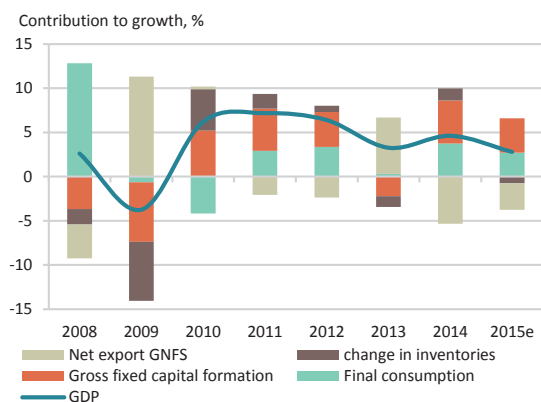
In an effort to support growth, the government boosted capital spending by 6.5 percent in the first half of 2016, year-on-year. This was accompanied by a 13 percent increase in current expenditures, which widened the fiscal deficit to 2.5 percent of GDP in the first half of 2016.

The poverty rate at PPP US\$2.5 per day fell to 31.2 percent in 2015, continuing a decline that began in 2010. Average inflation of 4.9 percent in 2015 increased poverty by about 2 percentage points which was offset by an increase in household incomes. Lower remittances in 2015 had only a marginal impact on account of their limited weight in households' incomes. During 2013-15, poverty reduction was largely driven by a combination of strong growth in the construction and non-tradable sectors, both of which employ large numbers of unskilled workers, and increases in agricultural income related to good agricultural harvests. This contrasts with the experience of 2010-12, when income growth among the poor was mostly driven by increased social transfers. Despite significant gains in agricultural incomes, poverty remains higher in rural areas.

## Outlook

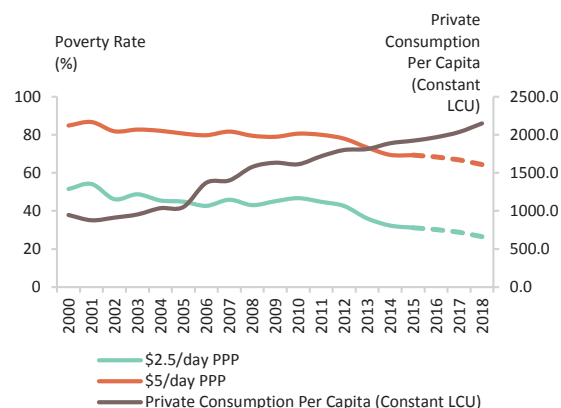
With the significant increase in government spending in the run-up to the October parliamentary elections, growth is likely to pick up to 3.4 percent in 2016. External markets are however likely to remain weak resulting in a large current account deficit of close to

**FIGURE 1 Georgia / GDP growth decomposition**



Sources: Geostat.

**FIGURE 2 Georgia / Actual and projected poverty rates and private consumption per capita**



Sources: World Bank Poverty Global Practice.

Note: See Table 1 footnotes for details on the poverty projection method.



12 percent of GDP during 2016-17. Greater policy certainty following the elections, a modest recovery in external markets and strong foreign direct investment inflows are projected to boost GDP growth rate to 5 percent in 2017-2018. The current-account deficit is expected to narrow gradually in the outer years.

The fiscal deficit is expected to be between 4 to 5 percent of GDP in 2016 because of increased social spending and expenditures that have been announced but not budgeted. The adoption of the Estonian tax model, which replaces the corporate tax with a tax on distributed profits only is expected to widen the deficit further during 2017-19. While the new tax model could boost growth in the medium term, it is expected to cause revenues to decline by 1.5 percent of GDP in 2017. In addition, spending on pensions and teacher salaries will rise in 2017 due to the full-year impact of increases in 2016. In the absence of major consolidation measures the deficit is expected to remain elevated over the medium-term, increasing the public debt stock.

The poverty rate is projected to continue declining through 2018. Construction activity, supported by anticipated investments and the growth of tourism-related services,

is expected to drive poverty reduction through increased job opportunities among the less-skilled. The rise in real wages observed since 2010 is likely to continue, which should further reduce poverty, especially in urban areas where salaried employment is more prevalent. The expected increase in pensions will have a positive distributional effect given that pensions represent close to 20 percent of income among the poor. Lower food prices in 2016 will positively impact the purchasing power of households at the bottom end of the income distribution.

## Risks and challenges

Political and policy uncertainty stemming from the October elections coupled with geopolitical risks could weaken consumer and business confidence and slow the reform process. However, overall policy continuity is likely to be maintained, as both the ruling and opposition parties are equally committed to Georgia's aspirations for European integration.

A large current-account deficit, high external debt, a widening fiscal deficit, elevated rural poverty, regional poverty disparities

and high rates of unemployment pose important challenges to the government's economic development and poverty reduction objectives. Given its limited domestic savings, Georgia relies on foreign capital to finance the bulk of its investments. This has led to persistently high current-account deficits and an external debt burden that is about 100 percent of GDP. Declining exports and remittance inflows, a dollarization rate of 65 percent and low international reserves equivalent to 3 months of imports have heightened foreign-exchange risks. Mitigating factors include the floating exchange rate, broad global market access and the support of international institutions. Falling tax revenues, increases in recurrent spending and contingent liabilities arising from power-purchase agreements all pose fiscal risks. Going forward, the government will need to better manage aggregate demand through lower deficits and establish an adequate mechanism to monitor and minimize contingent liabilities. Changes in the design of social programs like Targeted Social Assistance would help increase labor-force participation at the lower end of the income distribution, where these transfers are mostly targeted.

**TABLE 2 Georgia / Macro poverty outlook indicators**

(annual percent change unless indicated otherwise)

	2013	2014	2015	2016 f	2017 f	2018 f
<b>Real GDP growth, at constant market prices</b>	3.3	4.6	2.8	3.4	5.2	5.3
Private Consumption	-0.6	2.8	1.5	2.2	3.4	5.5
Government Consumption	6.0	6.4	0.5	4.9	0.1	-5.8
Gross Fixed Capital Investment	-37.0	51.0	23.0	-7.5	-3.9	3.9
Exports, Goods and Services	21.0	1.2	-10.8	-10.0	2.6	5.7
Imports, Goods and Services	3.0	10.3	-6.7	-6.8	-2.3	0.4
<b>Real GDP growth, at constant factor prices</b>	2.7	4.6	3.1	3.2	5.2	4.9
Agriculture	11.3	1.5	2.9	3.0	4.0	2.0
Industry	2.3	5.1	3.4	6.0	6.0	5.0
Services	0.9	5.2	3.0	1.9	5.1	5.6
<b>Inflation (Consumer Price Index)</b>	-0.5	3.1	4.0	2.5	3.4	3.5
<b>Current Account Balance (% of GDP)</b>	-5.8	-10.6	-11.7	-11.9	-11.9	-11.0
<b>Financial and Capital Account (% of GDP)</b>	5.6	10.6	11.7	11.9	11.8	10.9
Net Foreign Direct Investment (% of GDP)	5.1	8.1	8.0	7.6	7.3	7.2
<b>Fiscal Balance (% of GDP)</b>	-2.6	-2.9	-3.8	..	..	..
<b>Poverty rate (\$2.5/day PPP terms)<sup>a,b,c</sup></b>	36.0	32.3	31.2	30.2	28.8	26.5
<b>Poverty rate (\$5/day PPP terms)<sup>a,b,c</sup></b>	73.3	69.4	69.3	68.3	66.9	64.3

Sources: World Bank. Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice. Due to pending tax reforms and expenditure adjustments, fiscal is Notes: e = estimate, f = forecast.

(a) Calculations based on ECAPOV harmonization, using 2015-HIS with 2005PPP.

(b) Projection using neutral distribution (2015) with pass-through = 0.87 based on private consumption per capita constant in constant LCU.

(c) Actual data: 2013, 2014, 2015. Projections are from 2016 to 2018.

# KAZAKHSTAN

**Table 1** 2015

Population, million	17.5
GDP, current US\$ billion	184.4
GDP per capita, current US\$	10510
Poverty rate (\$2.5/day 2005PPP terms) <sup>a</sup>	0.4
Poverty rate (\$5/day 2005PPP terms) <sup>a</sup>	15.2
Gini Coefficient <sup>a</sup>	26.3
School enrollment, primary (% gross) <sup>b</sup>	109.2
Life Expectancy at birth, years <sup>b</sup>	69.6

Sources: World Bank WDI and Macro Poverty Outlook.

Notes:

(a) Most recent value (2013)

(b) Most recent WDI value (2014)

*Kazakhstan's economy continued to adjust to the new normal of low oil prices and lower economic performance of its trading partners. GDP growth slowed to nearly zero, year-on-year, in the first half of 2016, while inflation surged due to a depreciation pass-through effect. Poverty is likely to increase in 2016 due to slow growth and high inflation. The economic adjustment is expected to continue, aided by the flexible exchange rate and the ongoing implementation of structural reforms.*

## Recent developments

Like other countries in the region, Kazakhstan has been seriously affected by external shocks, including lower oil prices. GDP growth slowed from 4.2 percent in 2014 to 1.2 percent in 2015 and 0.1 percent during the first half of 2016. Falling oil prices led to a large terms-of-trade shock, while China's growth slowed further and Russia's recession continued, weakening both external and domestic demand.

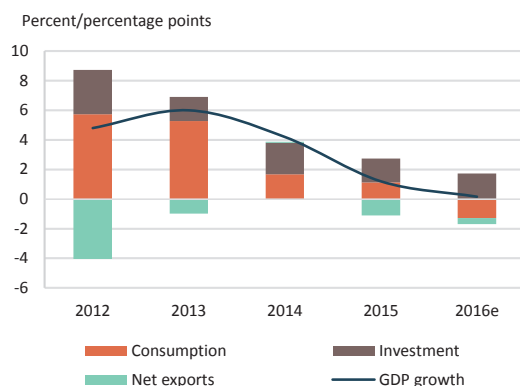
Following the shift to a floating exchange rate in August 2015, the external balance improved from a deficit of over US\$10 billion in 2015 to a surplus of over US\$2 billion in the first half of 2016. Preliminary data suggest that while the current account remained in deficit, it was offset by increased foreign direct investment inflows and a reversal in capital flight. The improved external position allowed the central bank to replenish its official international reserves. Meanwhile, the exchange rate stabilized, averaging below 340 tenge per the U.S. dollar since April 2016, with some temporary spikes observed in mid-summer.

The move to a floating exchange-rate regime and a consecutive removal of administrative price controls initially led to a sharp depreciation of the Kazakhstani tenge and an increase in the inflation rate from 3.8 percent, year-on-year, in August 2015 to 17.7 percent in July 2016, eroding real wages and consumer purchasing power. Low-income households are particularly vulnerable to inflation, declining real wages and reduced employment opportunities. Progress in pov-

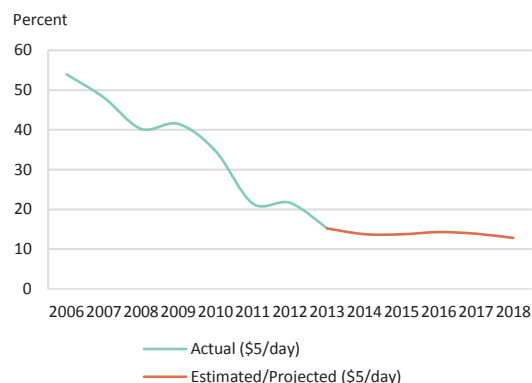
erty reduction has stalled, and the national poverty headcount rate (measured at US\$5 per day in purchasing-power parity terms) remained at an estimated 14 percent during 2014-15. The official unemployment rate rose slightly from 5 percent on average in 2015 to 5.1 percent in summer 2016, indicating that the slowdown started affecting the labor market. Moreover, stagnating employment indicates that no new jobs are being created on a net basis.

Efforts to readjust the economy to lower medium-term oil prices intensified in 2016. The government continued consolidating its fiscal accounts by further cutting lower-priority public investments and transfers to state-owned enterprises. The authorities also launched a privatization program, aimed to cover the fiscal gap and lower the state footprint in the economy. The 2016-18 budget calls for a reduction in the nonoil deficit to 7-8 percent of GDP, improving fiscal sustainability. Meanwhile, social sector spending has been ring-fenced, thus protecting expenditures that benefit the poor. The central bank has taken steps toward the full adoption of inflation targeting. It reintroduced the policy rate in early February 2016 and worked on stabilizing the money market. It targets the year-end inflation of below 8 percent.

The currency depreciation affected the banking sector and its credit activity as it increased banks' relative exposure to foreign exchange lending. To support the banking sector, the authorities postponed introduction of Basel III standards, including measures for an increase in the authorized capital ratio (initially scheduled for January 2016).

**FIGURE 1 Kazakhstan / Contribution to GDP growth**


Sources: Statistical Office of Kazakhstan.

**FIGURE 2 Kazakhstan / Actual and projected poverty rates**


Sources: World Bank staff estimate.

Notes: See notes on Table 2 on data and methods used for projection.

## Outlook

Under the baseline scenario, Kazakhstan's GDP growth rate is projected to remain close to zero in 2016 due to low oil prices and continued sluggishness of external demand. The ongoing fiscal adjustment is expected to keep public sector consumption subdued. Weak domestic demand will slow the recovery of production and retail trade, while low oil prices will continue to inhibit growth of ancillary subsectors such as transportation and wholesale trade. Both the fiscal and current account positions are expected to improve somewhat from their 2015 levels, but will remain in deficit in 2016. Against this backdrop, poverty is estimated to increase slightly in 2016 (using the \$5 poverty line).

Over the medium term, a moderate recovery of oil prices and higher oil production are expected to boost domestic demand. Under the baseline scenario, GDP growth is projected to rise to 1.8 percent in 2017. The current

account deficit is expected to narrow significantly as oil prices increase and the Kashagan oilfield begins production in 2017. Rising oil revenues and continued fiscal consolidation will improve the overall fiscal balance. In 2018, GDP growth is projected to accelerate to 3.4 percent as rising oil output bolsters consumer and investor confidence, and further improvements are expected in the fiscal and current account balances. Barring any new external shocks, inflation is projected to remain modest over the medium term. Concurrent with improvements in the economy, poverty is expected to gradually decline in 2017-18. However, the rapid poverty reduction seen in earlier years appears to have come to a halt.

## Risks and challenges

The baseline outlook is subject to downside risks, both external and domestic. External risks include continued oil glut

that may keep oil prices depressed and lower external demand from key trading partners. Domestic risks include potential production delays at the Kashagan oilfield and a deterioration in the health of the banking sector. The downside risks suggest that the recovery may take a while, affecting job creation and poverty reduction.

To foster economic diversification and increase resilience to external shocks, the authorities need to accelerate the implementation of institutional and structural reforms that would promote private sector development and bolster investor sentiment towards Kazakhstan. To improve inclusiveness of growth, the government will have to introduce a stronger social protection program to help support the poor, thus, mitigating the adverse impact of slower economic growth.

**TABLE 2** Kazakhstan / Macro poverty outlook indicators

(annual percent change unless indicated otherwise)

	2013	2014	2015	2016 f	2017 f	2018 f
<b>Real GDP growth, at constant market prices</b>	6.0	4.2	1.2	0.2	1.8	3.4
Private Consumption	10.6	1.3	1.5	-0.2	2.0	4.5
Government Consumption	1.7	9.8	3.0	-10.8	1.6	1.6
Gross Fixed Capital Investment	5.5	4.4	4.7	6.9	9.1	10.6
Exports, Goods and Services	2.7	-2.5	-4.2	-13.8	1.7	1.8
Imports, Goods and Services	7.8	-4.0	-0.6	-14.4	8.4	10.9
<b>Real GDP growth, at constant factor prices</b>	5.7	4.0	2.0	0.3	1.9	3.5
Agriculture	11.2	1.3	3.5	3.0	3.0	3.0
Industry	3.1	1.8	0.1	0.4	2.1	2.6
Services	6.9	5.7	3.1	0.0	1.7	4.2
<b>Inflation (Consumer Price Index)</b>	5.8	6.7	6.6	14.3	4.9	4.4
<b>Current Account Balance (% of GDP)</b>	0.5	2.9	-3.2	-2.8	-1.8	-1.7
<b>Financial and Capital Account (% of GDP)</b>	8.3	4.2	2.4	-2.5	0.2	3.4
Net Foreign Direct Investment (% of GDP)	3.4	2.2	1.8	3.6	3.0	2.5
<b>Fiscal Balance (% of GDP)</b>	3.7	0.0	-7.8	-4.7	-2.1	-1.5
<b>Debt (% of GDP)</b>	12.6	14.5	21.9	21.0	20.5	20.2
<b>Primary Balance (% of GDP)</b>	4.2	0.6	-7.1	-3.4	-1.1	-0.5
<b>Poverty rate (\$2.5/day PPP terms)<sup>a,b,c</sup></b>	0.4	0.4	0.4	0.4	0.4	0.4
<b>Poverty rate (\$5/day PPP terms)<sup>a,b,c</sup></b>	15.2	13.8	13.9	14.6	14.3	13.2

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.  
Notes: e = estimate, f = forecast.

(a) Calculations based on ECAPOV harmonization, using 2013-HBS with 2005PPP.

(b) Projection using neutral distribution (2013) with pass-through = 0.87 based on GDP per capita in constant LCU.

(c) Actual data: 2013. Projections are from 2014 to 2018.



## KOSOVO

**Table 1** **2015**

Population, million	1.8
GDP, current US\$ billion	6.4
GDP per capita, current US\$	3559
School enrollment, primary (% gross) <sup>a</sup>	n.a.
Life Expectancy at birth, years <sup>a</sup>	70.5

Sources: World Bank WDI and Macro Poverty Outlook.

Notes:

(a) Most recent WDI value (2014)

*The economy recovered in 2015 and is expected to grow at 3.6 percent in 2016, supported by domestic demand. Incomes of low income households should see a boost from a pick-up in growth in agriculture, industry, and construction, and from the new war veteran benefits. These new benefits increased the deficit to 2.5 percent of GDP, partially offsetting the impact of recent tax reforms and the fight against informality. Growth so far has resulted in limited employment creation, which will continue to constrain poverty reduction at home and support pressure to seek employment abroad.*

## Recent developments

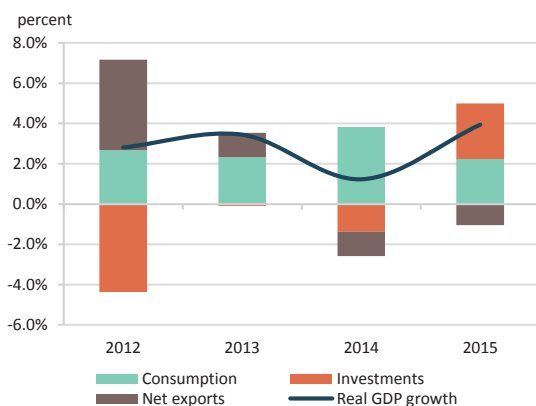
Economic recovery of 2015 extended into the first half of 2016. Growth for 2015 was revised upwards to 3.9 percent, and in Q1 2016 growth remained at 3.8 percent, driven by strong private demand. Remittances growth by 8.5 percent in 2015, as well as increases in public wages and pensions (including payments of war veteran benefits since September) fueled domestic demand. Although remittances declined by 2.7 percent by June 2016, the increase in lending activity by 9.2 percent by July 2016 provided a boost to domestic demand (lending to households was up 15 percent and to corporations 6 percent). External balances deteriorated in the first half of 2016 with the current account deficit growing by 59 percent by June 2016, mainly driven by a rapid increase in imports and declining exports due to lower base metal prices. Primary and secondary income also declined, fueling deficit growth. Consumer prices declined on average 0.5 percent in 2015 driven by lower fuel and food prices, and remained flat in the first half of 2016, helping maintain the purchasing power of household incomes, and further amplifying (albeit marginally) the recent wage and pension increases in real terms. In the labor market, recent developments have been mixed. The unemployment rate fell from 35.3 percent in 2014 to 32.9 percent in 2015, and youth unemployment fell from 61 percent to 57.7 percent, but

this was against a 4 percentage points increase in the inactivity rate, and a 1.7 percentage points decline in the employment rate. In 2015, low skilled workers suffered higher unemployment rates, while more educated population drifted towards employment or inactivity. The large emigration in the first quarter of 2015 also contributed to these shifts in the labor market. While cross-country comparable poverty figures are not available, preliminary estimates suggest a decline in poverty between 2012 and 2015, driven by continued economic growth, higher inflow of remittances, and rapid increase in pensions and public sector wages.

The fiscal deficit remained at 2.1 percent of GDP and within the fiscal rule in 2015. Revenues grew by 9.2 percent, but so did expenditures of all types, including 20 percent growth in capital investments, 8 percent in transfers and 6 percent in wages. The first half of 2016 saw temporary surplus of about 0.6 percent of GDP – this performance was driven by the 15.8 percent growth in tax revenues (in part resulting from VAT rate changing from 16 to 18 percent since September 2015 and in part due to efforts of fighting tax evasion). However, by year end, when most capital expenditures are materialized, a deficit of 2.5 percent is expected. Furthermore, the large increase in the number of war veteran beneficiaries that brought their fiscal costs to about 2 percent of GDP, has increased fiscal pressures.

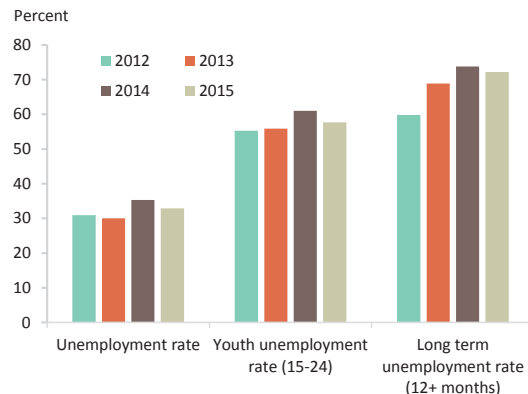
The financial sector remains strong, with both credit and deposits growing at

**FIGURE 1 Kosovo / Growth by components**



Sources: Statistics Agency of Kosovo and WB staff.

**FIGURE 2 Kosovo / Key unemployment indicators**



Sources: Statistics Agency of Kosovo and WB staff.

around 9.1 percent by July 2016, while NPLs have declined to 5.3 percent of total loans and the trend is improving.

## Outlook

Economic growth is expected to increase to 3.9 percent in 2017, supported by growing domestic demand. Consumption is expected to continue to grow. Public investment in the highway towards FYR Macedonia and other strategic infrastructure investments, as well as FDI will also support growth.

The current account deficit is expected to widen to 12.6 percent in 2017 due to a larger trade deficit. The recent launch of SAA with EU is expected to serve as an incentive to boost FDI. The investment amendment to the fiscal rule opened up additional fiscal room to invest in strategic sectors.

The financial sector is expected to remain liquid and strong with both loans and deposits growing, while NPLs declining due to good market conditions.

Poverty has been declining slowly in Kosovo in recent years, and this trend is expected to continue in the near future. The fact that poverty and income dynamics in Kosovo are strongly determined by labor earnings, will continue constraining the degree to which the economic recovery can translate into robust increases in welfare for poor households. The recent decline in the unemployment rate was in part on account of people moving from unemployment into inactivity. Recent dynamics such as the increase in the share of low-skilled workers among the unemployed, the increasing average duration of unemployment, the increasing share of those becoming inactive due to beliefs that no work is available, and the increasing share of youth not in education, employ-

ment or training (NEET) all make sustained poverty reduction during the forecasting period challenging.

## Risks and challenges

The outlook is subject to downside risks, including some ongoing political issues, such as the border demarcation with Montenegro. The sharp increase in the number of beneficiaries of the war veteran scheme poses challenges to keeping the fiscal deficit within its limits in 2016 and maintaining the fiscal transfers at a sustainable level in coming years.

More broadly, addressing macroeconomic vulnerabilities, high unemployment and poverty requires significant and far reaching structural reforms to boost economic growth and make it more inclusive.

**TABLE 2 Kosovo /** Macro poverty outlook indicators

(annual percent change unless indicated otherwise)

	2013	2014	2015	2016 f	2017 f	2018 f
<b>Real GDP growth, at constant market prices</b>	3.4	1.2	3.9	3.6	3.9	3.7
Private Consumption	1.8	4.2	2.9	4.4	2.8	2.7
Government Consumption	0.5	-0.4	-0.6	-0.2	-0.1	-0.1
Gross Fixed Capital Investment	-0.1	-1.4	2.8	1.7	2.3	2.7
Exports, Goods and Services	0.5	2.9	0.6	0.8	0.9	0.6
Imports, Goods and Services	0.8	-4.1	-1.6	-3.2	-2.0	-2.2
<b>Real GDP growth, at constant factor prices</b>	3.4	1.2	3.9	3.6	3.9	3.7
Agriculture	0.2	0.1	0.4	1.5	0.8	0.8
Industry	1.5	0.0	0.7	1.1	0.8	0.6
Services	2.1	1.4	1.2	1.8	2.0	2.5
<b>Inflation (Consumer Price Index)</b>	1.8	0.4	-0.5	0.0	0.3	0.7
<b>Current Account Balance (% of GDP)</b>	-6.4	-7.9	-9.1	-11.4	-12.6	-14.2
<b>Fiscal Balance (% of GDP)</b>	-3.1	-2.6	-2.1	-2.5	-1.7	-1.4
<b>Debt (% of GDP)</b>	9.0	10.5	13.0	14.1	15.7	17.1

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.  
Note: f = forecast.

# KYRGYZ REPUBLIC

**Table 1** 2015

Population, million	5.9
GDP, current US\$ billion	6.6
GDP per capita, current US\$	1108
Poverty rate (\$2.5/day 2005PPP terms) <sup>a</sup>	29.2
Poverty rate (\$5/day 2005PPP terms) <sup>a</sup>	83.9
Gini Coefficient <sup>a</sup>	26.8
School enrollment, primary (% gross) <sup>b</sup>	102.9
Life Expectancy at birth, years <sup>b</sup>	70.0

Sources: World Bank WDI and Macro Poverty Outlook.

Notes:

(a) Most recent value (2014)

(b) Most recent WDI value (2014)

*After showing resilience to headwinds in 2015, the economy contracted in the first half of the year, with overall growth expected to moderate from 3.5 percent in 2015 to 2.2 percent in 2016. High public spending should only partially compensate for depressed private demand, while increasing fiscal imbalances. The incidence of poverty is expected to worsen reflecting the weak dynamism of the economy and depressed real incomes. However, economic activity should recover gradually from 2017 onward, in line with regional trends.*

## Recent developments

After growing by 3.5 percent in 2015, the Kyrgyz economy contracted by 2.3 percent in the first half of 2016, reflecting a sharp decline in gold output (-35.6 percent) and weak performance of the non-gold sector, in particular industry and services. On the demand side, investment contributed positively, thanks to public outlays, partly compensating for lackluster consumption growth and a negative contribution from net exports.

Fiscal policy remained expansionary, with capital spending increasing significantly in line with the planned investment scale-up. Given a parallel decline in revenues, reflecting the overall weakness of the economy as well as a drop in non-tax income, the budget ran a deficit of 8.6 percent of GDP as of July 2016. Nonetheless, the public debt-to-GDP ratio improved to 64.1 percent as of end June (from 68.3 percent at the end of 2015) thanks to the appreciation of the som.

After depreciating by over 20 percent relative to the dollar in 2015, the som appreciated by 11.3 percent during the first half of 2016, reflecting similar trends in the values of the ruble and tenge. In turn, this affected the real value of remittances, which increased by 7 percent in dollar terms. Reflecting the stabilization of the exchange rate, as well as low food and energy prices, y-o-y average inflation barely reached 1.3 percent.

On the external side, the decline in gold production affected the overall perfor-

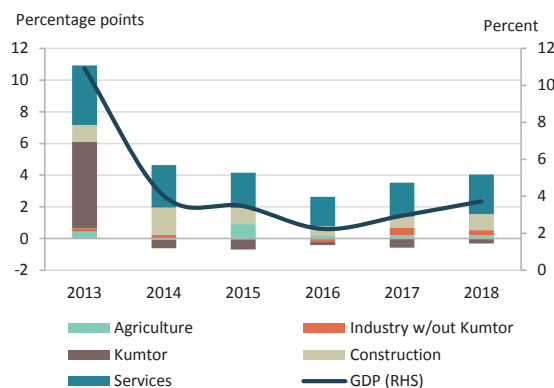
mance of exports, which contracted by 23.6 percent over the first half of the year. Meanwhile imports also contracted (by 7.6 percent) albeit to a lesser extent given the very sharp drop already observed in 2015 and the high import content of public investments. As a result the trade balance is estimated to have deteriorated to 28.3 percent of GDP. The uptick in remittance inflows helped to contain the current account deficit at around 9 percent of GDP.

The poverty rate (measured at US\$2.5 per day, 2005 PPP terms) increased by 1.4 percentage points to 30.6 percent of the population in 2015 due to weak economic growth and lower remittance inflows. The slowdown in services and construction led to fewer employment opportunities and stagnant real wages for low-income unskilled workers. In rural areas households had lower agricultural income due to lower prices of vegetables, meat and fruits. Pensions and cash benefits to poor families helped to mitigate the impact of the decline in real incomes, but the targeted cash transfer program remains underfunded reaching less than one-third of the poorest quintile.

## Outlook

Given the disappointing performance of the economy in the first half of the year, with a significant drop in gold production and exports, as well as the persistence of regional headwinds, GDP growth is expected to moderate to 2.2 percent over 2016. Whereas gold production is project-

**FIGURE 1** Kyrgyz Republic / GDP growth structure



Sources: Kyrgyz authorities and WB staff calculations.

**FIGURE 2** Kyrgyz Republic / Actual and projected poverty and real GDP growth rates



Sources: Kyrgyz authorities and WB staff calculations.

Notes: See notes on Table 2 on data and methods used for projection.

ed to recover relatively over the second half of the year (declining overall by 3.2 percent) agricultural output growth is projected at 1.5 percent (against 6.2 percent in 2015) and non-gold industry to contract by over 2 percent, reflecting supply side constraints and increased competition from Kazakh producers. In line with weak demand and declining prices for food and fuel, inflation should not exceed 3.5 percent.

Fiscal balances are expected to deteriorate relative to 2015, with the overall deficit reaching 7.4 percent of GDP. The widening deficit is projected to come about as a result of both lower non-tax revenues and higher investment outlays. Meanwhile recurrent spending should remain stable as a share of GDP, at just over 30 percent. On the BOP side, both exports and imports are expected decline, albeit to a larger extent for the former given lower gold production and a sharp drop in exports to Kazakhstan. As a result, in spite of recovering remittance inflows (projected to grow by around 5 percent in dollar terms over 2016), current account balances should deteriorate to -13.3 percent of GDP (from -10.4 percent in 2015).

Looking forward to 2017 and 2018, output growth is expected to recover to 3 percent

and 3.7 percent respectively as the external environment continues to improve and Kyrgyz producers adapt to the new requirements under the EEU. As public spending is gradually reduced, internal and external balances should also improve in tandem.

Given modest growth prospects, the poverty rate is projected to remain broadly unchanged at about 31 percent of the population over 2016-2018. Low agricultural growth will impede poverty reduction in rural areas. However, if improvements in safety net targeting materialize, these along with the recovery in remittances could marginally support poverty reduction.

## Risks and challenges

Risks related to exogenous regional developments appear to have moderated, with greater oil prices and exchange rate stability. The improved outlook for growth in Russia and Kazakhstan should positively affect the performance of Kyrgyz exports and demand for Kyrgyz labor (also boosted by preferential agreements under the EEU). The stabilization of exchange rates should positively impact poor households

(via its effect on the value of remittances and real incomes) and decrease the risk of financial sector weaknesses spilling over to the real economy.

However, the persistent weakness of industrial production and exports, point to structural competitiveness challenges, which have been aggravated by the complexity of the transition to EEU standards and norms of production as well as increased competition of CIS and Kazakh producers (including in the traditional re-export segment).

While countercyclical fiscal policy has helped the Kyrgyz economy to weather the impact of the regional crisis, it has come with heightened debt sustainability risks, bringing the country significantly closer to the threshold of high risk of debt distress. To mitigate such risks the authorities have committed not only to phasing out the investment stimulus but also to containing recurrent spending growth, which may be difficult in a low growth / high poverty environment and in the context of upcoming presidential elections.

With limited fiscal space to increase transfers to the poor, further poverty reduction gains will need to come from improvements in job and wage growth—whether domestically or internationally.

**TABLE 2 Kyrgyz Republic / Macro poverty outlook indicators**

(annual percent change unless indicated otherwise)

	2013	2014	2015	2016 f	2017 f	2018 f
<b>Real GDP growth, at constant market prices</b>	10.9	4.0	3.5	2.2	3.0	3.7
Private Consumption	8.0	3.0	-1.0	1.5	2.0	3.2
Government Consumption	-0.4	0.0	0.2	1.3	0.0	1.2
Gross Fixed Capital Investment	1.3	15.7	-4.9	5.0	5.8	4.3
Exports, Goods and Services	12.3	-6.2	-4.0	-8.2	9.7	11.5
Imports, Goods and Services	4.1	1.6	-17.0	-4.2	5.5	6.9
<b>Real GDP growth, at constant factor prices</b>	10.9	4.1	3.4	2.1	2.9	3.6
Agriculture	2.6	-0.5	6.2	1.5	1.5	1.5
Industry	30.5	-1.6	-4.2	-2.6	-0.5	0.2
Services	11.4	8.7	3.9	3.6	4.6	5.6
<b>Inflation (Consumer Price Index)</b>	6.6	7.5	6.5	2.6	5.7	4.8
<b>Current Account Balance (% of GDP)</b>	-15.0	-16.7	-10.4	-13.3	-12.4	-10.4
<b>Financial and Capital Account (% of GDP)</b>	2.1	7.2	1.2	4.2	3.0	0.9
Net Foreign Direct Investment (% of GDP)	8.5	4.7	4.5	4.5	4.6	4.7
<b>Fiscal Balance (% of GDP)</b>	-3.8	-3.9	-3.0	-7.4	-5.1	-3.0
<b>Debt (% of GDP)</b>	47.1	53.6	68.3	73.1	72.5	70.8
<b>Primary Balance (% of GDP)</b>	-2.9	-3.0	-2.0	-6.5	-4.1	-1.9
<b>Poverty rate (\$2.5/day PPP terms)<sup>a,b,c</sup></b>	35.8	29.2	30.6	30.5	30.3	30.1

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.

Notes: e = estimate, f = forecast.

(a) Calculations based on ECAPOV harmonization, using 2010-KIHS and 2014-KIHS with 2005PPP.

(b) Projection using point-to-point elasticity (2010-2014) with pass-through = 0.7 based on GDP per capita in constant LCU.

(c) Actual data: 2013, 2014. Projections are from 2015 to 2018.

# LATVIA

**Table 1** 2015

Population, million	2.0
GDP, current US\$ billion	27.1
GDP per capita, current US\$	13638
Poverty rate (\$2.5/day 2005PPP terms) <sup>a</sup>	2.7
Poverty rate (\$5/day 2005PPP terms) <sup>a</sup>	10.5
Gini Coefficient <sup>a</sup>	35.5
School enrollment, primary (% gross) <sup>b</sup>	104.4
Life Expectancy at birth, years <sup>b</sup>	73.8

Sources: World Bank WDI and Macro Poverty Outlook.

Notes:

(a) Most recent value (2012)

(b) Most recent WDI value (2014)

Growth slowed down to 2.1 percent in the first half of 2016 due to weak investment and exports while strong private consumption continued to provide the main support. The outlook improves in the medium-term with growth likely to increase to 3.6 percent by 2018, thanks to the new stream of EU funded investment projects. Downside risks are significant. Internally, these reflect mainly supply-side constraints from a tightening labor market that may undermine external competitiveness. Externally, weak demand abroad remains the main risk.

## Recent developments

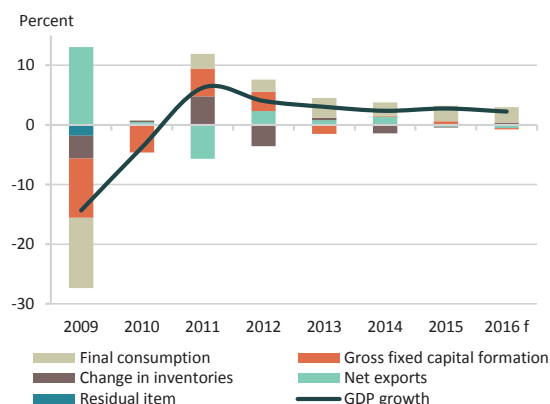
Economic growth slowed down in the first half of 2016 to 2.1 percent from 2.7 percent in 2015 due to an investment slump and weaker export expansion. The main growth driver remained robust private consumption, supported by strong wage growth and zero inflation. A large drop in investment (shrinking by 22 percent from a year earlier in the first half of 2016, although reported with very high inventory levels) reflected delays in the absorption of EU funds from the new financing perspective (with the biggest toll in the construction sector), continued economic and geopolitical uncertainty (most lately also fueled by the results of the Brexit vote) and elusive credit growth (slow turn of the enterprise credit cycle). The external environment also remains challenging with tepid growth in the Euro Area and prolonged recession in Russia translating into exports growing by a mere 1 percent. On a positive note, the main drag is the drop in re-exports while the exports of Latvian produced goods continued to increase and all main exporting industries (including manufacturing, agriculture, transport, tourism and IT) continued to grow. The economy expanded at a pace below its potential and shows no major imbalances with a current account deficit in a small surplus and deflation of 0.6 percent in the first half of 2016. The latter was due to the negative impact of food and imported energy prices. However, supply-side pressures continue to mount in the tightening labor market. The unemployment rate dropped to 9.5 percent

in the second half of 2016 (half its 2008-10 crisis peak), which is close to structural unemployment level, while additional pressure comes from increasingly unfavorable demographic trends and labor emigration. The resulting robust real wage growth (6.7 percent in 2015 and 4.6 percent in the first half of 2016, also supported by considerable minimum wage hikes) continues to outpace productivity growth, which may have implications for external competitiveness.

Public finances are in a good shape with the general government budget deficit at 1.3 percent of GDP in 2015. Revenues were stronger than expected, supported by strong wage growth and improved tax compliance, and with a positive outcome at the local government level. Nevertheless, the deficit was 0.3 percentage point higher than initially planned due to the one-off effect related to a public-private partnership project (the State Revenue Service building).

## Outlook

Economic growth is expected to slow down slightly in 2016 to 2.2 percent, reflecting mainly delays in investment linked to a slow start-up of projects financed from the new 2014-20 EU financing perspective. The outlook improves in the medium-term with economic growth closer to potential, at 3.6-3.7 percent in 2017-18. Going forward growth will likely have a broader base with markedly stronger investment (supported EU-funded projects and a pick-up in credit) and better export performance on the back of improved external conditions, including

**FIGURE 1** Latvia / Contributions to annual GDP growth


Sources: Central Statistical Bureau of Latvia and World Bank.

**FIGURE 2** Latvia / Labor market indicators


Sources: Central Statistical Bureau of Latvia and World Bank.

in the gradually recovering Russian market. At the same time, private consumption will remain robust, thanks to strong income growth, low inflation and good consumer confidence. With the output gap gradually closing, the labor market will continue to tighten. This will create supply constraints as unemployment is almost entirely structural in nature. These pressures will be further fueled by highly unfavorable demographic trends (long-term projections of the labor force falling by 10 percent by 2020, and further 10 percent by 2025) and emigration of some of the young and better qualified resulting in more frequent labor shortages. Against these trends, wage growth is likely to remain strong (despite much weaker minimum wage adjustment in 2016 than in the previous two years), with increases in unit labor costs having substantial implications for external competitiveness.

The 2016 budget deficit is expected to improve to 1 percent of GDP with fiscal tightening consistent with Latvia's own fiscal rules and its EU fiscal commitments. Tax revenue growth is supported by strong private consumption and wage growth as well as revenue-enhancing measures (including postponing PIT cuts, introducing the so-called solidarity tax, and others to broaden the tax base and improve the tax collection). Expenditure

growth is driven by wages and purchases of goods and services, as well as the continued increase in social spending with growing number of pensioners and higher contribution-based benefit rates. Meanwhile, there is a shortfall in public infrastructure projects (due to administrative delays in distribution of EU funds) and capital spending is expected to accelerate only in 2017. In the long-term, however, fiscal sustainability pressures mount as the relatively low level of spending on social protection and health falls short of providing the desired improvements in health and social outcomes.

These spending pressures will be even more pronounced as the Latvian population is aging fast. To respond to these challenges and to limit significant tax avoidance, the government plans to prepare a new tax strategy to enhance the system's equity, revenue mobilization, efficiency and competitiveness.

## Risks and challenges

The overall favorable economic outlook is subject to significant downside risks. Externally, these are mainly related to the fragility of demand from the main trade

partners, in particular prolonged weak growth in the euro area and Russia. Uncertainty is also resulting from protracted geopolitical tensions related to the conflict in Eastern Ukraine and more recently from the Brexit vote. Internally, the main risk relates to supply-side labor constraints and minimum wage increases that are driving up wages. Growing wages can support domestic demand, increasing the upside potential for short-term growth, raise living standards and reduce inequality and emigration risks. But in the medium-term, wage growth exceeding productivity gains can erode companies' profitability and undermine external competitiveness with negative impact for export performance. Therefore strong investment, propelled by resumption of credit growth, will be even more important to support productivity gains and promote future growth. Further actions will be also needed to address the pervasive shadow economy, which is hindering Latvia's economic potential and limiting revenues necessary to improve public services. In the longer term, structural reforms, including in justice, education, health, and infrastructure will be crucial to enhance productivity, maintain competitiveness and support further income convergence.

**TABLE 2** Latvia / Macro poverty outlook indicators

(annual percent change unless indicated otherwise)

	2013	2014	2015	2016 f	2017 f	2018 f
<b>Real GDP growth, at constant market prices</b>	3.0	2.4	2.7	2.2	3.6	3.7
Private Consumption	5.1	2.3	3.3	3.5	3.0	3.4
Government Consumption	1.6	4.9	3.1	2.2	3.1	3.0
Gross Fixed Capital Investment	-6.0	0.5	2.7	-1.0	7.5	6.0
Exports, Goods and Services	1.1	3.1	1.4	2.0	3.8	4.8
Imports, Goods and Services	-0.2	0.8	1.8	2.5	4.5	5.1
<b>Real GDP growth, at constant factor prices</b>	2.5	2.1	2.5	2.2	3.5	3.7
Agriculture	1.2	1.7	5.0	1.0	2.2	4.2
Industry	0.8	1.4	2.2	2.1	2.3	2.8
Services	3.1	2.4	2.5	2.3	4.0	4.0
<b>Inflation (Consumer Price Index)</b>	0.0	0.6	0.2	-0.2	1.6	2.0
<b>Current Account Balance (% of GDP)</b>	-2.4	-2.0	-1.2	-1.4	-1.6	-1.6
<b>Financial and Capital Account (% of GDP)</b>	1.5	-0.2	3.4	3.5	3.5	3.5
Net Foreign Direct Investment (% of GDP)	1.6	1.0	2.3	1.0	2.4	2.4
<b>Fiscal Balance (% of GDP)</b>	-0.9	-1.6	-1.3	-1.0	-1.0	-1.0
<b>Debt (% of GDP)</b>	39.0	40.8	36.4	36.0	35.7	31.5
<b>Primary Balance (% of GDP)</b>	0.6	-0.1	0.1	0.1	0.1	-0.2

Sources: World Bank. Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.  
Note: f = forecast.



## MACEDONIA FYR

Table 1	2015
Population, million	2.1
GDP, current US\$ billion	10.1
GDP per capita, current US\$	4845
Poverty rate (\$2.5/day 2005PPP terms) <sup>a</sup>	12.7
Poverty rate (\$5/day 2005PPP terms) <sup>a</sup>	34.3
Gini Coefficient <sup>a</sup>	36.0
School enrollment, primary (% gross) <sup>b</sup>	85.8
Life expectancy at birth, years <sup>b</sup>	75.0

Sources: World Bank WDI and Macro Poverty Outlook.  
Notes:

(a) Most recent value (2013)

(b) Most recent WDI value (2014)

*FYR Macedonia's growth is expected to slow to 2 percent in 2016, as private investments reacts negatively to the prolonged political uncertainty. As a result, labor market performance also slowed after several years of positive results. Once again, budgetary revisions lead to a larger fiscal deficit and an increase in the public debt above 50 percent of GDP. With the resolution of the political crises likely later this year, growth is expected to pick up to 3.7 percent in 2018, with positive spillovers to poverty reduction.*

## Recent developments

The political turmoil took its toll on growth in the first half of 2016. Economic growth fell from 3.7 percent y-o-y in 2015 to 2.1 percent in the first part of the year. Uncertainties related to the political situation affected investment, which subtracted 0.3 p.p. from growth, reflecting lower private investment and despite large public investment in roads construction. Household consumption was once again the main driver of growth (2 p.p.) supported by increases in employment, public wages, pensions, and household lending. Government consumption and net exports recorded a small, but positive contribution (0.2 p.p. and 0.4 p.p.). Similar patterns are expected for the whole year, with GDP growth at 2 percent.

Deflation persisted in the first half of 2016. Lower global food and oil prices, as well as lower utilities prices led to a general price decline of 0.4 percent for the period January-June 2016. Meanwhile, core inflation remained positive at 1.2 percent.

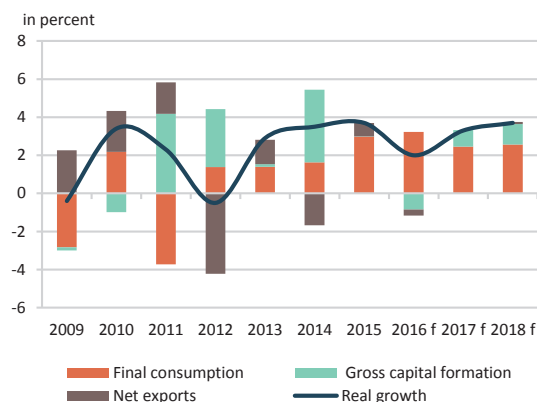
Labor market performance was weak, with the observed decline in unemployment being driven by a drop in labor force participation rather than an increase in employment. After growing for seven quarters, employment declined in the first quarter of the year and increased only mildly in the second one, led by construction, retail trade, and public administration. This dynamics disproportionately affected low skilled workers for which net job creation was negative. Labor force

participation fell sharply to 56.6 percent in the first half of 2016, the lowest since 2012. As a result, unemployment declined slightly to 24.2 percent in the same period. However, youth unemployment rose above 50 percent, despite government youth employment promotion programs.

The current account is expected to widen throughout 2016, but remains fully financed by net inflows of FDI. The current account deficit expanded to approximately 1.8 percent of GDP in the first half of 2016, compared to 1.4 percent in the same period of 2015. This was driven by a deterioration in the trade balance, as imports outpaced exports, and a sharp decline in remittances. As a result of this trend, the full year CAD is expected to widen to 2.1 percent of GDP. The deficit is expected to be fully financed by net FDI (approximately 2.4 percent of GDP). Foreign exchange reserves narrowed to 4.4 months of imports by end-May, as the National Bank intervened to contain depreciation pressures associated with the political crisis, but large Eurobond issuance in July helped restore the stock.

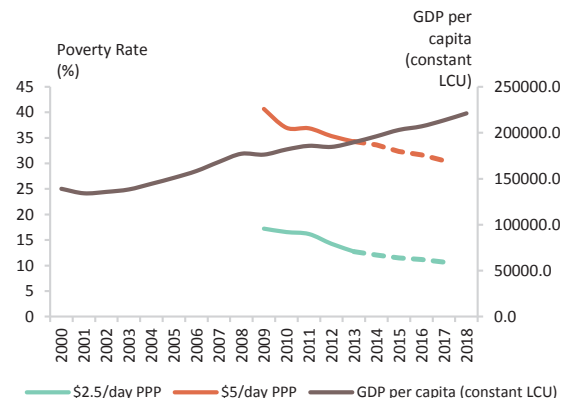
The financial sector also experienced the impact of the economic slowdown. Corporate credit contracted in June 2016 for the first time since 2003. Measures introduced by the National Bank to discourage household lending have not yielded results, and household lending remains robust. Following the political developments in the first half of the year, households and companies drew down their deposits in April and May, for the first time since 2003. However, deposit growth became positive again in June 2016.

**FIGURE 1 Macedonia FYR / Contributions to annual GDP growth**



Sources: FYR Macedonia State Statistics Office and World Bank staff calculations.

**FIGURE 2 Macedonia FYR / Annual and projected poverty rates and GDP per capita**



Sources: Projection using neutral distribution (2014).

The mid-year decision to further prolong the fiscal stimulus led to a deterioration of the fiscal deficit. Supplementary budgets announced in July 2016 and August 2016 will lead to a fiscal expansion instead of the original consolidation plan. The July 2016 supplementary budget abandoned the fiscal consolidation plans and proposed a deficit of 3.6 percent of GDP for 2016 (instead of the 3.2 percent originally planned), linked to higher spending on wages, pensions and social transfers and lower capital spending. Following heavy rains and flood in early August, the government presented a second supplementary budget to accommodate additional expenses associated to the emergency response to the flood, particularly the compensation of affected households. The August budget foresees a fiscal deficit of 4.1 percent of GDP for 2016.

Public debt is expected to increase further in 2016. Combined with higher government guarantees, the fiscal deficit is expected to push public debt above 50 percent of GDP in 2016 from 46.4 in 2015. Debt is expected to expand further in the medium term as the government implements a sizable state-owned enterprise investment portfolio.

Poverty rates continued decreasing in 2015, driven by the positive labor market outcomes before the slowdown in 2016.

Using the \$2.5 a day line (2005 PPP), poverty is expected to have fallen from 12.7 in 2013 to 11.5 in 2015. In 2014-2015, higher real wages and employment opportunities created in manufacturing and services helped further reductions in poverty. The worsening of the labor market outcomes in Q1 2016, though, may have slowdown the pace of poverty reduction in 2016. Lower private transfers in 2015 had a negligible effect on poverty since they represent a small share of income share at the bottom end of the distribution.

## Outlook

Growth is expected to decline to 2 percent in 2016, affected by the political uncertainties, but is should start recovering afterwards. Assuming elections are held by end of 2016, growth will gradually increase to 3.3 percent in 2017 and 3.7 percent in 2018. Private consumption and rising investment, especially public investment related to the construction of the two new highways during this period, are expected to drive growth.

Poverty is likely to continue its downward trend, following the pace of the economic expansion. Higher wages and a recovery in employment will play a critical role for

poverty reduction. However, to the extent that employment opportunities among the less-skilled keep contracting, poverty reduction may stall or even reverse.

## Risks and challenges

The political situation remains the primary downside risk in the near term. Prolonged political uncertainties could further affect investment decisions and slow down economic activity. In addition, the country is facing growing fiscal risks with a rapidly rising public debt. This dynamics could undermine growth prospects in the medium term. Implementing credible fiscal consolidation, with policies for safeguard fiscal sustainability and place public debt firmly on a downward trajectory would help mitigate these risks.

Continued improvement of the labor market outcomes are essential for sustained social gains. Unemployment and especially youth and long-term unemployment are still among the highest in the region.

The government's ability to monitor living standards, distributional impacts of reforms, and more broadly to design and implement evidence-based policies is hindered by limited access to microeconomic data and an outdated census.

**TABLE 2** Macedonia FYR / Macro poverty outlook indicators

(annual percent change unless indicated otherwise)

	2013	2014	2015	2016 f	2017 f	2018 f
<b>Real GDP growth, at constant market prices</b>	2.9	3.5	3.7	2.0	3.3	3.7
Private Consumption	1.9	2.1	3.2	3.2	3.4	3.4
Government Consumption	0.5	1.0	4.5	6.4	-0.1	0.4
Gross Fixed Capital Investment	1.9	6.9	0.3	-3.5	3.9	4.6
Exports, Goods and Services	6.1	18.2	4.6	4.8	5.6	6.7
Imports, Goods and Services	2.2	16.0	2.4	4.1	4.3	5.0
<b>Real GDP growth, at constant factor prices</b>	4.4	6.5	4.5	2.2	3.0	3.7
Agriculture	8.6	2.2	-0.7	0.0	1.0	1.0
Industry	7.6	11.8	7.8	1.5	3.8	4.9
Services	2.6	5.0	3.9	2.8	2.9	3.5
<b>Inflation (Consumer Price Index)</b>	2.8	-0.3	-0.3	-0.1	0.6	1.4
<b>Current Account Balance (% of GDP)</b>	-1.6	-0.9	-1.4	-2.1	-1.7	-1.4
<b>Financial and Capital Account (% of GDP)</b>	1.5	0.5	1.0	1.7	1.3	1.0
Net Foreign Direct Investment (% of GDP)	2.8	2.3	2.3	2.4	2.5	2.7
<b>Fiscal Balance (% of GDP)</b>	-4.0	-4.2	-3.6	-4.1	-3.4	-3.0
<b>Debt (% of GDP)</b>	34.0	38.2	38.0	40.8	42.7	43.9
<b>Primary Balance (% of GDP)</b>	-3.1	-3.2	-2.4	-2.8	-2.2	-1.9
<b>Poverty rate (\$2.5/day PPP terms)<sup>a,b,c</sup></b>	12.7	12.1	11.5	11.2	10.7	10.2
<b>Poverty rate (\$5/day PPP terms)<sup>a,b,c</sup></b>	34.3	33.6	32.3	31.7	30.5	29.3

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.

Notes: e = estimate, f = forecast.

(a) Calculations based on SILC harmonization, using 2014-SILC grouped data (survey year) with 2005PPP.

(b) Projection using neutral distribution (2013) with pass-through = 0.87 based on GDP per capita in constant LCU.

(c) Actual data: 2015. Projections are from 2014 to 2018.



## MOLDOVA

**Table 1** 2015

Population, million	3.5
GDP, current US\$ billion	6.5
GDP per capita, current US\$	1831
Poverty rate (\$2.5/day 2005PPP terms) <sup>a</sup>	2.9
Poverty rate (\$5/day 2005PPP terms) <sup>a</sup>	40.7
Gini Coefficient <sup>a</sup>	27.0
School enrollment, primary (% gross) <sup>b</sup>	93.8
Life Expectancy at birth, years <sup>b</sup>	70.8

Sources: World Bank WDI and Macro Poverty Outlook.

Notes:

(a) Most recent value (2014)

(b) Most recent WDI value (2014)

*Moldova's recovery from the 2015 recession is fragile, as external demand is low and public finances are under strain. Poverty has been almost unchanged.*

*While medium-term growth is projected to be below historical averages, poverty is likely to resume its declining trend. The macro-fiscal consequences of the recent banking fraud and governance of the financial sector dominate the short-term policy agenda. In the long term, the economic expansion needs to be increasingly driven by higher private sector growth and job creation.*

## Recent developments

Moldova is recovering from a recession, but growth is slow and below potential. After a recession in the second half of 2015, the economy grew 1.3 percent year-on-year in the first half of 2016. Private consumption rebounded by 2 percent, supported by government transfers to households, while change in inventories added 4 percentage points (p.p.) to growth. Meanwhile, net exports subtracted 3 p.p. from growth due to weak external demand and the stabilization of the exchange rate. Investment continued to decline, by 1.7 percent, as real interest rates were high and public investment fell.

Consumer inflation is slowing, allowing the National Bank to ease the monetary stance. With the dissipation of the pass-through effect from the depreciation, due to weaker domestic demand, lower import prices and good agricultural yields, 12-month inflation slowed from a peak of 13.6 percent in December 2015 to 3.6 percent in August 2016. In response, the NBM reduced the base interest rate from a peak of 19.5 percent in September 2015 to 10 percent in July 2016.

The external position improved due to lower imports. Lower import commodity prices and weak domestic demand more than offset the reduction in remittances, helping narrow the current account deficit to 7.8 percent of GDP, or 2.7 p.p. lower than last year. Foreign exchange reserves grew to more than 5 months of imports.

Public finances are under pressure due to delays with external funding. The 2016 state budget law was adopted only in July, and it

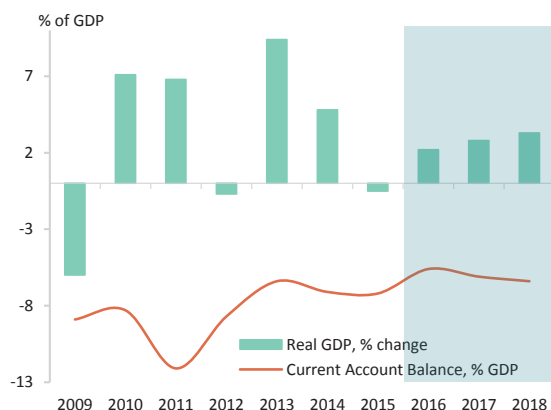
relies heavily on external support (from the EU, the World Bank, and Romania) to finance the planned deficit of 3.2 percent of GDP. In the first half of 2016, with low external financing available, spending decreased 9.6 percent in real terms, as most of the procurement and capital expenditure were stopped. The deficit amounted to 1.1 percent of GDP.

Poverty rates increased less than expected in 2015<sup>1</sup>. Higher consumption growth and stabilization of remittances supported household incomes and kept the moderate poverty rate (5 USD/day, 2005 PPP) little changed at 41 percent in 2015. The extreme poverty rate (2.5 USD/day, 2005 PPP) was stable at 2.9 percent. In the first half of 2016, however, the unemployment rate remained above historical levels, compounding the impact of high inflation and lower remittances on poverty. These effects have been partly offset by a decrease in food prices due to a good year in agriculture and by the indexation of pensions in April 2016.

## Outlook

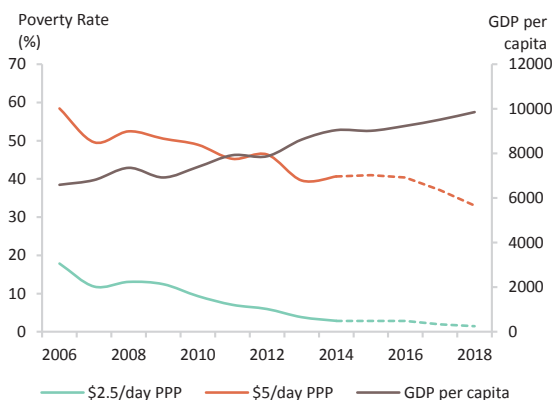
We expect the economy to grow 2.2 percent in 2016, supported by the recovery in agriculture. The agricultural sector is likely to rebound in double-digits from last year's drought-led contraction. Still, high interest rates and political risks around the presidential elections (October 2016) will keep investments subdued. An agreement with the IMF would unlock official external financing, and allow an increase in public expenditure within the deficit ceiling. Despite the project-

**FIGURE 1** Moldova / Actual and projected GDP growth and current account



Source: National authorities and World Bank estimates.

**FIGURE 2** Moldova / Actual and projected poverty rates and GDP per capita



Source: World Bank (see notes to table 2).

ed increase in the price of utilities, consumer inflation is expected to remain within the central bank target range of 5±1.5%. The current account deficit is projected to narrow to below 6 percent of GDP.

Moldova's growth is expected to reach around 3 percent in 2017-2018. The base case assumes modest recovery in major trading partners, including Russia, and improved consumer and investor's confidence, supported by an IMF program and the official financing from development partners. The fiscal deficit is projected to gradually decline to 2.5 percent of GDP to ensure fiscal sustainability, while the current account deficit will likely remain below historical average. The rebound of economy and especially of agriculture will continue supporting households incomes. Despite the tight fiscal situation, the real value of transfers to households is likely to be preserved. This will keep the non-labor income positive in real terms which is especially important for lower income groups, who depend more on public transfers and pensions than the rest of the population (30 percent of total income for the bottom 40 and 16 percent for the top 60). However, inflationary pressures stemming from increases in utility tariffs would add to the burden on lower income groups who spend proportionally more on utilities

(energy accounts for almost one fifth of the bottom 40's budget). As a result, the moderate poverty headcount is projected to decline slightly to the level of 40.4 percent in 2016. As growth accelerates, poverty is expected to go down to 37.1 percent in 2017 and could reach 33 percent in 2018.

## Risks and challenges

Moldova's economic outlook is subject to considerable immediate challenges. On the back of a prolonged recession in Russia and uncertainty in Europe, macroeconomic and fiscal stabilization is an important short-term challenge. Moldova's growth is slow, its public debt has recently increased to deal with the consequences of the banking fraud, so it has limited fiscal space. Restoring confidence is another major challenge. Following the public disclosure of the banking fraud, the authorities began to take the first steps to address the governance problems throughout the financial sector. However, more needs to be done to strengthen the independence, powers, and supervision capacity of the regulators (NBM and NCFM), and to ensure shareholder trans-

parency and good corporate governance in financial institutions.

In the long term, sustainable progress requires a rebalancing of the growth model of Moldova. As the impact of remittances and public transfers moderates, this growth model needs to be increasingly driven by higher private sector growth and job creation, accompanied by urbanization, and better connectivity and inclusion for equitable access to economic opportunities and services. For this, the rule of law and the accountability of institutions should be strengthened, including in the financial sector, and the efficiency and equity of service delivery should be improved. Raising the quality, equity, and relevance of education and training systems is a top priority as well. Supporting priorities include reforming the social protection system, particularly pensions, improving the business regulatory framework, and ensuring sound macroeconomic and fiscal management.

1/We present projections for 2015 even if actual data are available, as the team is investigating inconsistencies between the household survey and other data sources.

**TABLE 2** Moldova / Macro poverty outlook indicators

(annual percent change unless indicated otherwise)

	2013	2014	2015	2016 f	2017 f	2018 f
<b>Real GDP growth, at constant market prices</b>	9.4	4.8	-0.5	2.2	2.8	3.3
Private Consumption	6.4	3.2	-2.3	2.0	2.3	2.9
Government Consumption	-0.1	0.1	0.4	0.2	3.1	2.5
Gross Fixed Capital Investment	3.8	10.0	-1.2	-1.8	3.7	6.3
Exports, Goods and Services	9.6	1.0	2.3	0.9	2.6	3.2
Imports, Goods and Services	4.4	0.4	-4.3	1.5	2.7	3.7
<b>Real GDP growth, at constant factor prices</b>	10.6	5.4	-0.4	2.2	2.8	3.3
Agriculture	46.6	8.5	-13.4	14.8	1.5	3.8
Industry	7.6	7.5	3.5	-0.2	4.9	5.3
Services	2.5	3.8	3.4	-1.1	2.7	2.6
<b>Inflation (Consumer Price Index)</b>	4.6	5.1	9.7	6.9	4.7	4.4
<b>Current Account Balance (% of GDP)</b>	-6.4	-7.1	-7.2	-5.6	-6.1	-6.4
<b>Financial and Capital Account (% of GDP)</b>	5.3	8.2	7.6	5.2	5.7	5.9
Net Foreign Direct Investment (% of GDP)	3.1	3.9	4.1	2.8	3.0	3.5
<b>Fiscal Balance (% of GDP)</b>	-1.8	-1.7	-2.3	-3.2	-2.8	-2.7
<b>Debt (% of GDP)</b>	31.7	32.6	46.5	44.7	45.4	44.6
<b>Primary Balance (% of GDP)</b>	-1.0	-1.0	-1.3	-1.9	-1.7	-1.6
<b>Poverty rate (\$2.5/day PPP terms)<sup>a,b,c</sup></b>	3.8	2.9	2.9	2.8	1.9	1.5
<b>Poverty rate (\$5/day PPP terms)<sup>a,b,c</sup></b>	39.6	40.7	41.0	40.4	37.1	33.0

Sources: World Bank. Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice. Notes: e = estimate, f = forecast.

(a) Calculations based on ECAPOV harmonization, using 2014-HBS with 2005PPP.

(b) Projection using neutral distribution (2014) with pass-through = 1 based on GDP per capita in constant LCU.

(c) Actual data: 2013, 2014, 2015. Projections are from 2016 to 2018.

# MONTENEGRO

**Table 1** 2015

Population, million	0.6
GDP, current US\$ billion	4.0
GDP per capita, current US\$	6417
Poverty rate (\$2.5/day 2005PPP terms) <sup>a</sup>	1.0
Poverty rate (\$5/day 2005PPP terms) <sup>a</sup>	13.3
Gini Coefficient <sup>a</sup>	31.9
School enrollment, primary (% gross) <sup>b</sup>	95.3
Life Expectancy at birth, years <sup>b</sup>	75.7

Sources: World Bank WDI and Macro Poverty Outlook.

Notes:

(a) Most recent value (2014)

(b) Most recent WDI value (2014)

*Economic growth slowed down in early 2016, although strong tourism and the resumed highway construction will likely boost growth in the rest of the year. With labor market improvements, especially in low-skilled sectors, and a rise in social benefits, poverty is projected to decline in 2016. Yet, unemployment remained high and labor force participation low. Despite the projected growth pick-up, the new government will need to adopt a credible fiscal consolidation program aiming to enforce the fiscal rule (debt at 60 percent of GDP) over the medium term.*

## Recent developments

Economic activity slowed down in Q1 2016 to 1.1 percent, compared to 3 percent a year earlier. The dynamics was driven by slower investment due to delayed issuance of construction permits for the new highway. Growth is expected to recover through the rest of the year as high-frequency data suggest. The highway construction has resumed, tourism performed well through the summer, and the industrial production and retail suggested a recovery of consumption. Deflationary pressures that started in late 2015 continued in the first half of 2016, backed by declining oil and food prices, which helped protect household purchasing power, especially of the poor.

Labor markets deteriorated in early 2016, but have rebounded since. With the low tourism season and a hold on highway construction, unemployment was increasing in late 2015 and early 2016, reaching 20 percent by February 2016 (the highest since March 2007). Increases in the unemployment rate were observed among both men and women, and more for youth than for older workers. But as employment in construction and tourism picked up in the second quarter, the unemployment rate dropped to a still high 17.8 percent in July 2016. The generous lifetime mother benefit launched in 2016, while adding to household income, is expected to create work disincentives and undermine the sustainability of social assistance financing (Parliament introduced lifetime benefit for women who have given birth to three or more children in the

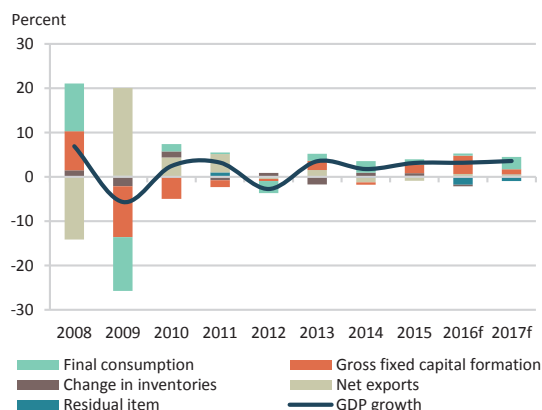
amount of 70 percent of average net salary in Montenegro, conditioned on having 25 or 15 years of service for mothers of three or more children; and benefit equivalent to 40 percent of average wage for women registered as unemployed for at least 15 years). In January 2016 alone, close to 15000 women qualified for the benefit, while some opted to leave jobs in order to become eligible for the benefit. The number of registered unemployed women increased sharply.

Activity and employment rates among people aged 15 and above rose from 50 percent and 40.1 percent in 2012, respectively, to 53.7 percent and 43.5 percent in Q1 2016 (higher rates were observed in Q1 of 2015). Yet, labor market outcomes remain poor due to structural factors such as the incomplete economic transition, labor mismatches and high reservation wages.

The current account deficit (CAD) increased in 2016 despite a solid performance of services. After declining to 13.4 percent of GDP in 2015, the CAD widened again to 17.4 percent of GDP by June 2016. Higher tourism and transport revenues were not enough to offset the significant decline in exports of goods and a surge in imports, largely related to imports of machinery and equipment for the highway construction. In addition, front-loaded dividend payments further added to the widening of the CAD. FDI declined in to 14.1 percent of GDP, largely due to telecom company dividend payout. Still, at over 81 percent coverage, FDI has financed most of the growing CAD.

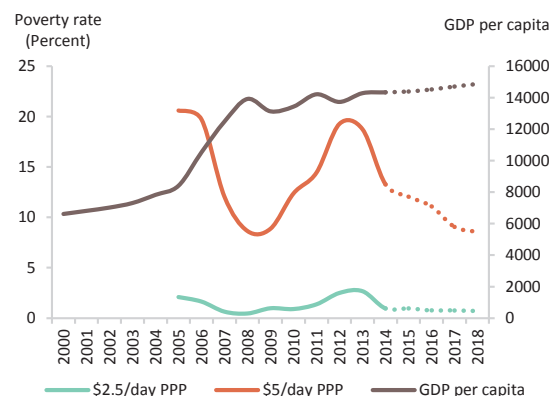
Lending activity slowed down in the first half of 2016. Credit growth declined by 0.2 percent in Q2 2016, affected by a negative growth rates in corporate lending. Deposits

**FIGURE 1 Montenegro / Contributions to annual GDP growth**



Sources: MONSTAT, World Bank.

**FIGURE 2 Montenegro / Actual and projected poverty rates and GDP per capita**



Sources: World Bank (see notes to Table 2).

on the other hand continued to grow in double digits during the first half of 2016.

Central government cash deficit narrowed in the first half of 2016 to 2.3 percent of GDP, from 8 percent in 2015, on the back of delayed execution of highway investment. Yet, a budget revision was announced for the second half in order to accommodate 1.1 percent of GDP budget shortfall associated with the implementation of lifetime mother benefit, pension and public sector wage increases. With budget shortfall and resumed investments, cash deficit level may grow to 8.1 percent of GDP by the year-end. In March 2016, a new 5-year Eurobond was issued in the amount of EUR300 million. In addition, as the construction of the highway resumed in the second half of 2016, disbursements from the China EXIM Bank loan, continued. As a result the public debt is expected to reach 82.6 percent of GDP by end 2016.

Overall poverty trend closely mirrors labor market performance in the past few years, especially employment in low-skill sectors. Positive economic growth since 2013 has increased employment, including in low-skilled sectors agriculture, construction and administrative and support services. This composition of growth and employment expansion, at least in the short run, has been in general beneficial for improving welfare

of the poor, though poverty reduction has likely slowed down with weaker labor market recovery. Poverty (measured at the regional poverty line of US\$5 in 2005 PPP) has declined from its peak at 19.2 percent in 2012 to an estimated 11.9 percent in 2015.

## Outlook

Growth for 2016 is expected to reach 3.2 percent and further pick up in 2017 as the highway construction takes off. Tourism is also expected to continue growing steadily as hotel capacity increases.

After the transition government was voted in and after an agreement between the political parties that the necessary conditions for free and fair elections had been met, parliamentary elections will take place in mid-October. The new government will need to adopt a credible fiscal consolidation program aiming to enforce the fiscal rule of debt at or below 60 percent of GDP over the medium term.

Growth is likely to slowly contribute to poverty reduction in the immediate future, subject to employment rebound including in construction and tourism. The generous lifetime mother benefit adds to beneficiary

household income but is fiscally costly and not necessarily targeted at the poor. International evidence suggests that generous transfers like this is likely to trigger worsening of an already low female labor participation rate. Poverty measured at US\$5 at PPP is expected to decline further to 11.1 percent though with high vulnerability to macro risks.

## Risks and challenges

The country is facing significant fiscal challenges and a rapidly rising debt level that are threatening to undermine growth. In the coming period the country will need to undertake ambitious fiscal consolidation to restore fiscal sustainability and place public debt firmly on a downward trajectory. Montenegro's borrowing needs over the medium term are substantial (about 18 percent of GDP). Risks on the domestic side include delays in implementing needed structural reforms to stabilize finances and increase competitiveness of the economy, as well as high unemployment among the most vulnerable groups. Household welfare gains continue to be highly vulnerable to macro risks and still weak labor markets.

**TABLE 2 Montenegro / Selected Economic and Social Indicators, Projections 2016-18**

	2013	2014	2015	2016 f	2017 f	2018 f
<b>Real GDP growth, at constant market prices</b>	3.5	1.8	3.2	3.2	3.6	3.0
Private Consumption	1.6	2.9	0.7	0.7	3.6	5.1
Government Consumption	1.3	1.4	2.9	-0.3	0.0	1.7
Gross Fixed Capital Investment	10.7	-2.5	10.5	20.7	4.7	0.7
Exports, Goods and Services	-1.3	-0.7	10.2	1.2	3.3	4.8
Imports, Goods and Services	-3.1	1.6	7.9	-0.6	1.0	1.1
<b>Real GDP growth, at constant factor prices</b>	4.1	1.9	3.2	3.2	3.6	3.0
Agriculture	13.6	1.8	3.2	3.3	2.1	2.1
Industry	4.3	4.5	5.8	4.7	3.5	3.5
Services	2.4	0.7	1.9	2.5	3.9	2.9
<b>Inflation (Private Consumption Deflator)</b>	1.9	-1.0	1.2	1.8	0.4	-1.0
<b>Current Account Balance (% of GDP)</b>	-14.5	-15.2	-13.4	-14.1	-14.8	-15.1
<b>Financial and Capital Account (% of GDP)</b>	7.1	3.7	3.3	10.2	11.0	11.5
Net Foreign Direct Investment (% of GDP)	9.6	10.2	17.2	10.9	11.2	10.8
<b>Fiscal Balance (% of GDP)</b>	-4.6	-3.1	-8.0	-8.1	-8.1	-7.2
<b>Debt (% of GDP)</b>	57.5	59.9	68.1	72.0	76.6	78.4
<b>Primary Balance (% of GDP)</b>	-2.5	-0.9	-5.6	-5.9	-5.6	-4.8
<b>Poverty rate (\$2.5/day PPP terms)<sup>a,b,c</sup></b>	2.7	1.0	1.0	1.0	0.8	0.7
<b>Poverty rate (\$5/day PPP terms)<sup>a,b,c</sup></b>	18.7	13.3	12.1	11.1	9.1	8.5

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.

Notes: e = estimate, f = forecast.

(a) Calculations based on ECAPOV harmonization, using 2014-HBS with 2005PPP.

(b) Projection using neutral distribution (2014) with pass-through = 0.87 based on GDP per capita in constant LCU.

(c) Actual data: 2013, 2014. Projections are from 2015 to 2018.

## POLAND

**Table 1** 2015

Population, million	38.0
GDP, current US\$ billion	534.3
GDP per capita, current US\$	14058
Poverty rate (\$2.5/day 2005 PPP terms) <sup>a</sup>	0.9
Poverty rate (\$5/day 2005 PPP terms) <sup>a</sup>	5.1
Gini Coefficient <sup>a</sup>	33.1
School enrollment, primary (% gross) <sup>b</sup>	101.5
Life Expectancy at birth, years <sup>b</sup>	76.7

Sources: World Bank WDI and Macro Poverty Outlook.

Notes:

(a) Most recent value (2012)

(b) Most recent WDI value (2014)

Because of subdued investment activity, growth in Poland slowed down markedly from 3.6 percent in 2015 as a whole to 3.1 percent in the first half of 2016. Growth this year was mainly driven by private and public consumption, bolstered by strong labor market performance and robust real incomes due to persistent negative inflation. Poverty is expected to have continued to decline accordingly. Growth is projected to pick up slightly in the second half of the year on the back of public investment recovery to reach 3.2 percent for 2016 as a whole, and strengthen gradually to 3.5 percent over the medium term.

## Recent developments

Economic growth slowed in the first half of 2016 to 3.1 percent year-on-year, reflecting largely a surprisingly weak first quarter and minor improvement in the second quarter. Although private consumption grew at a robust pace of 3.2 percent accompanied by 4.4 percent growth of public consumption, investment declined by 3.6 percent year-on-year in the first half of 2016. Exports and imports expanded by 8.9 percent and 9.6 percent respectively, leaving the contribution of net exports to growth close to zero.

The stabilization of growth in the second quarter reflects a pickup in private consumption by 3.3 percent on the back of strong labor market performance and real incomes. A decline of investment by 4.9 percent year on year in the second quarter (from a 1.8 percent drop in the 1st quarter) is partly the result of delays in implementation of new EU-funded projects. Increased uncertainty perceived by private investors towards some government initiatives also played a role, as a wait-and-see attitude took hold despite low borrowing rates and high capacity utilization.

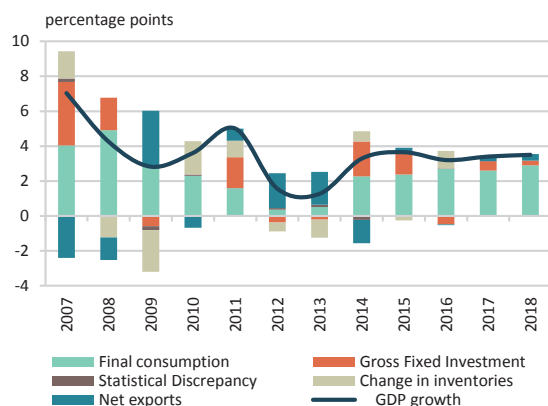
Solid economic growth is creating more jobs. Employment grew by 1.2 percent in the first half of 2016 after increasing 1.4 percent in 2015. Employment in the private sector expanded by 1.9 percent and fell by 1 percent in the public sector. The activity rate increased by 0.4 percentage points to 56.2 percent as both the unemployment rate and the share of inactive workers declined. The LFS unemployment rate of 6.2 percent in the

second quarter was 1.2 percentage points lower than a year before and the lowest since the survey began in 1992.

Moderate poverty is expected to have continued to decline from 5.1 percent in 2012 to 4.5 percent in 2015 using the \$5.00/day 2005 PPP poverty line, in line with increases in private consumption, higher employment, and lower inflation. Poverty is expected to fall further to 3.2 percent in 2016 on account of the introduction on the Family 500+ program.

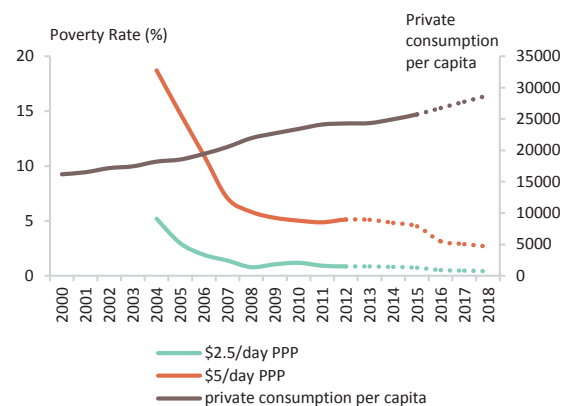
After the fiscal deficit reached 2.6 percent of GDP in 2015, it is to improve further in 2016. In the first half of 2016, the state and subnational budgets have over performed compared to the annual plans. Through end June, the state deficit has reached 34 percent of its annual limit vs 57 percent a year ago, while local government recorded a surplus of about 0.9 percent of GDP. These fiscal results were backed by one-off receipts, such as LTE digital dividend or higher-than-budgeted payment from the NBP profit, and occurred in the context of underperforming public investment. The fiscal balance benefited from a rebound in indirect and direct taxes, a contained public wage bill, and lower interest payments due to low interest rates. The latter helped to limit the increase in public debt in 2015 to 51.1 percent of GDP, up from 50.4 percent of GDP in 2014. Poland's external position strengthened in 2015 as the current account deficit narrowed from 2 percent of GDP in 2014 to 0.2 percent in 2015. Gross external debt declined slightly from 72.4 percent of GDP in 2014 to 71.8 percent in 2015 and stabilized at this level in the first quarter of 2016.

**FIGURE 1 Poland / Contributions to annual GDP**



Source: World Bank.

**FIGURE 2 Poland / Actual and projected poverty rates**



Source: World Bank.

Notes: See notes on Table 2 on data and methods used for projection.



## Outlook

The economic outlook remains favorable, with real GDP projected to increase by 3.2 percent in 2016 and pick up gradually to 3.4 percent in 2017 and 3.5 percent in 2018. The economy is expected to remain well-balanced both internally and externally. Prices are expected to continue to fall in 2016, with low inflation forecast for 2017 and 2018. The external current account deficit is projected to increase only slightly to about 1 percent of GDP by 2018.

Private consumption is set to become an even more dominant growth driver, supported by a tightening labor market and sizeable child benefits from the Family 500+ program. More advanced implementation of new EU-funded projects should support a moderate recovery in public investment, while implementation of market-friendly measures from the Strategy for Responsible Development (also known as the Morawiecki Plan) may also stimulate private investment. A revival of private investment may prove challenging in the context of deteriorated growth prospects for the EU and increased volatility of financial markets which can be associated with decisions of credit rating agencies on Poland.

The new Strategy for Sustainable Development, whose draft was presented for public

consultations in July, is aimed at boosting domestic investment, largely through a mobilization of domestic resources and improved business conditions. The strategy aims to help increase households saving and facilitate the development of the domestic capital market. The strategy is to be fiscally-neutral.

Under our baseline scenario, we project a reduction in the headline fiscal deficit from 2.6 percent of GDP in 2015 to 2.1 percent in 2016, largely due to the slower execution of public investment.

The fiscal policy stance assumed in the draft state budget plans for reduced potential fiscal costs in 2017 but some of them are moved to 2018. These include the decision not to cut the standard VAT rate; enact the law lowering the statutory retirement age no earlier than October 2017; and delay the increase of earnings free from PIT to the start of 2018, when a single labor tax is to be implemented, combining PIT and social security contributions. These measures are expected to lead to a headline deficit of 2.9 percent of GDP in 2017 and 3.4 percent in 2018 under our baseline scenario. These decisions, however, give the authorities more time to synchronize between increased public spending and higher tax revenues resulting from the introduction of new taxes and tax administration reform.

Continued strong private consumption and growth in employment and real wages

should continue to boost real incomes and lead to declines in poverty in the short term. The \$5.00/day 2005 PPP poverty rate is projected to decline to 2.9 percent in 2017 then further to 2.7 percent in 2018.

## Risks and challenges

Despite a relatively benign economic forecast, the balance of risks remain skewed to the downside. On the external side, the already subdued prospects for the global and European economy combine with the forthcoming challenges resulting from 'Brexit.' Internally, the fiscal consolidation depends much on efficiency improvements in tax compliance. Although the latest proposal to solve the legacy of foreign currency denominated mortgages seems manageable, there is still uncertainty over the impact on the financial sector.

Accelerating inclusive growth in the context of an aging society remains a key challenge for the country. There is a need to improve the regulatory environment to increase efficiency and innovation, and to improve the efficiency of public administration and the quality of public services, while protecting the impressive achievements in selected sectors, e.g. education.

**TABLE 2 Poland /** Macro poverty outlook indicators

(annual percent change unless indicated otherwise)

	2013	2014	2015	2016 f	2017 f	2018 f
<b>Real GDP growth, at constant market prices</b>	1.3	3.3	3.6	3.2	3.4	3.5
Private Consumption	0.2	2.4	3.0	3.9	3.6	3.5
Government Consumption	2.2	4.7	3.4	2.2	2.6	4.8
Gross Fixed Capital Investment	-1.1	10.0	5.8	-2.2	2.6	1.4
Exports, Goods and Services	6.1	6.4	6.8	5.2	5.0	4.4
Imports, Goods and Services	1.7	10.0	6.3	5.4	4.6	3.8
<b>Real GDP growth, at constant factor prices</b>	1.3	3.3	3.4	3.2	3.6	3.6
Agriculture	9.1	0.7	-1.5	0.7	1.0	1.2
Industry	1.3	4.6	5.6	3.9	4.7	4.9
Services	1.1	2.9	2.8	3.0	3.2	3.2
<b>Inflation (Consumer Price Index)</b>	1.0	0.1	-1.0	-0.6	1.3	2.3
<b>Current Account Balance (% of GDP)</b>	-1.3	-2.0	-0.2	-0.8	-0.9	-1.1
<b>Financial and Capital Account (% of GDP)</b>	3.6	3.3	1.1	0.8	0.9	1.1
Net Foreign Direct Investment (% of GDP)	0.8	2.0	0.8	2.0	2.0	2.2
<b>Fiscal Balance (% of GDP)</b>	-4.0	-3.3	-2.6	-2.1	-2.9	-3.4
<b>Debt (% of GDP)</b>	56.0	50.5	51.3	52.5	52.3	52.2
<b>Primary Balance (% of GDP)</b>	-1.5	-1.4	-0.8	-0.3	-1.0	-1.5
<b>Poverty rate (\$2.5/day PPP terms)<sup>a,b,c</sup></b>	0.9	0.8	0.7	0.5	0.5	0.4
<b>Poverty rate (\$5/day PPP terms)<sup>a,b,c</sup></b>	5.1	4.8	4.5	3.2	2.9	2.7

Sources: World Bank. Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.

Notes: e = estimate, f = forecast.

(a) Calculations based on ECAPOV harmonization, using 2004-EU-SILC and 2012-EU-SILC with 2005 PPP.

(b) Projection using point-to-point elasticity (2004-2012) with pass-through = 1 based on private consumption per capita in constant LCU.

(c) Projections are from 2013 to 2018.

## ROMANIA

**Table 1** 2015

Population, million <sup>a</sup>	19.8
GDP, current US\$ billion	178.0
GDP per capita, current US\$	9004
Poverty rate (\$2.5/day 2005PPP terms) <sup>b</sup>	11.1
Poverty rate (\$5/day 2005PPP terms) <sup>b</sup>	32.6
Gini Coefficient <sup>a</sup>	34.9
School enrollment, primary (% gross) <sup>c</sup>	95.5
Life Expectancy at birth, years <sup>c</sup>	75.1

Sources: World Bank WDI and Macro Poverty Outlook.  
Notes:

(a) HNP Estimates and Projections, April 2016.

(b) Most recent value (2012)

(c) Most recent WDI value (2014)

Romania's GDP growth rate climbed to 5.2 percent in the first half of 2016 – the highest since 2008 and the fastest in the EU. Growth was fueled by an expansionary fiscal policy and labor market improvements which, combined with an increased support to vulnerable groups, contributed to poverty reduction. Government reforms focus on public administration and SOEs. Growth is expected to remain solid in 2016 and 2017, but risks to the outlook have increased, suggesting that Romania would benefit from re-building fiscal buffers.

## Recent developments

Economic growth accelerated to 5.2 percent in the first half of 2016, led by private consumption (up 9.4 percent), which was boosted by the reduction in the standard VAT rate from 24 percent to 20 percent in January 2016 and labor market improvements. Investment growth remained solid at 7.3 percent due to strong private sector activity, especially in construction and ICT. Exports have continued to expand, but have been outpaced by imports, leading to a widening of the current account deficit to 1.5 percent of GDP by June, from 1.1 percent of GDP in 2015. Still, external debt declined further from 56.1 percent of GDP in December 2015 to 51.8 percent at end-June 2016 as net FDI inflows grew by around 20 percent in H1.

Propped up by strong consumption, rising unit labor costs and the fading out of the base effect of the cut of the VAT rate for food, headline inflation picked up but remained negative, with prices down 0.8 percent in the twelve months through July, helped by the declining import prices. The NBR kept the policy rate at 1.75 percent in August. Credit to companies fell 3.9 percent in July 2016, while credit to households expanded by 6 percent. However, credit growth to households may be impacted by the adoption of the debt discharge law (datio in solutum) approved in April.

The budget deficit widened modestly to 0.5 percent of GDP in the first half of 2016 due to lower revenues. Revenues fell by 2 percent, as improvement in the collection of PIT, CIT and social contributions could not

compensate for the VAT cuts. Expenditures increased 5.5 percent, driven by a larger public wage bill, pension hikes and the doubling of the child allowance.

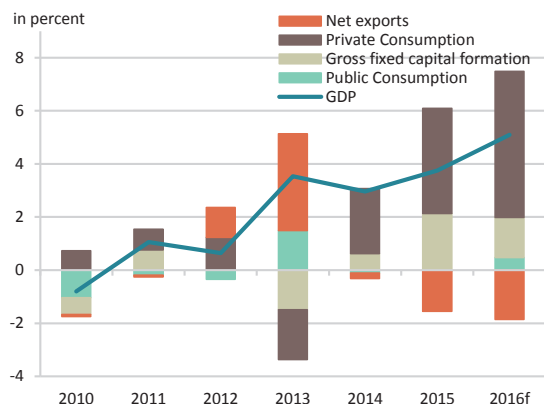
The labor market strengthened further as real wages increased by 13.3 percent in July 2016, and the employment rate reached 59.8 percent in Q1 of 2016, up from 59.1 percent in Q1 of 2015. However, employment growth has been concentrated in high-skilled areas, while integration of young people and other excluded groups remains a challenge. The unemployment rate fell to 6.1 percent by the end-July 2016, below the EU average at 8.6 percent.

Moderate poverty is estimated to have declined from a peak of 35.8 percent in 2011 to 27.0 percent in 2015 using the \$5.00/day 2005 PPP poverty line, reflecting increases in private consumption, higher employment, improved real wages, and increased support to vulnerable categories.

## Outlook

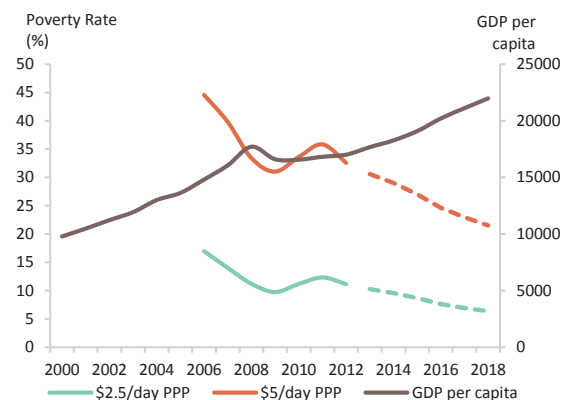
The output gap is expected to close and growth to reach 5.1 percent in 2016. Growth is expected to remain solid in 2017 as additional fiscal relaxation measures will be implemented, including a further VAT cut to 19 percent, the elimination of the special construction tax and a reduction of the excise rate for fuel. Protracted low inflation and accommodative monetary conditions may help improve corporate credit, positively impacting private investment. However, the adoption of the debt discharge law has introduced uncertainty into the legal framework of the

**FIGURE 1 Romania / Contributions to annual GDP growth**



Source: World Bank, Romanian National Statistical Institute.

**FIGURE 2 Romania / Actual and projected poverty rates**



Source: World Bank.

Notes: See notes on Table 2 on data and methods used for projection.

financial sector with potentially negative effects on financial inclusion, bank balance sheets and the construction sector and will likely lead to legal challenges by the banks. Acceleration of consumption is also expected to widen the current account deficit. Inflation is projected to stay in negative territory until end-2016, when the effect of the VAT cut fades out. The NBR projects a gradual increase in inflation towards 2.0 percent by the end of 2017. The current account deficit is expected to widen to 3.6 percent in 2017 due to strong import demand. This is likely to halt the decline in external debt.

In line with the 2016 budget program and the Medium-Term Fiscal Framework of the government, the consolidated budget deficit is projected to widen towards 3 percent of GDP in both 2016 and 2017, pushing public debt to 40.3 percent of GDP in 2017, from 39.8 percent in 2015. The decline in revenues may be partly compensated by lower than expected capital spending, due to a lack of sufficient EU funds projects for the period 2014-2020. The government will need to contain current spending pressures and improve tax efficiency to avoid entering the Excessive Deficit Procedure (EDP).

Continued strong private consumption aided by a lower VAT and growth in employment and real wages should boost real incomes and lead to further declines in poverty. The \$5.00/day 2005 PPP poverty rate is projected to decline by about 1.5 percentage points over 2016-2017. The planned introduction of a minimum social inclusion income program is expected to improve targeting and increase the level of benefits for the most vulnerable.

## Risks and challenges

Risks to this outlook are tilted to the downside. The approaching December 2016 general elections increase the risk of further ad-hoc spending and slow-down in the implementation of structural reforms. Romania strengthened its medium-term fiscal framework, but enforcement remains weak. Externally, increased uncertainty about global economic growth and financial sector volatility have increased the probability of a reversal in investor sentiment in emerging market economies, which in turn could

trigger pressures on the currency and an increase in external debt. However, after years of fiscal consolidation and solid growth, Romania has achieved a sound macroeconomic position with a moderate level of public debt; fewer external and financial sector vulnerabilities, and an improved payment discipline from SOEs, which is likely to mitigate the negative impact of recent policy measures.

Over the medium term, the focus of fiscal policy needs to be rebalanced from boosting consumption to supporting a sustainable growth path that would put Romania on a trajectory to becoming a high-income country. Structural reforms that will help enhance the productive capacity of the economy include measures to combat corruption, enhance the quality of spending, strengthen the public administration and SOEs, and simplify the regulatory environment. Renewed efforts are needed to improve labor participation and generate broad-based employment, as unemployment remains high among the youth and the low-skilled, and to ensure that all Romanians get access to high quality public services.

**TABLE 2 Romania /** Macro poverty outlook indicators

(annual percent change unless indicated otherwise)

	2013	2014	2015	2016 f	2017 f	2018 f
<b>Real GDP growth, at constant market prices</b>	3.5	3.0	3.8	5.1	3.8	3.4
Private Consumption	-2.0	3.7	5.9	8.1	5.7	5.2
Government Consumption	23.7	-1.4	-0.5	6.8	4.8	3.8
Gross Fixed Capital Investment	-5.4	2.5	8.8	6.1	5.6	5.3
Exports, Goods and Services	19.7	8.6	5.5	4.7	4.3	4.2
Imports, Goods and Services	8.8	8.9	9.1	9.1	6.9	6.5
<b>Real GDP growth, at constant factor prices</b>	4.1	2.8	3.5	5.1	3.8	3.4
Agriculture	33.7	2.6	-9.4	6.7	3.3	3.3
Industry	3.8	-2.2	2.0	1.8	3.3	3.3
Services	1.3	4.8	5.7	6.2	4.1	3.5
<b>Inflation (Consumer Price Index)</b>	4.0	1.1	-0.6	-1.5	1.2	2.3
<b>Current Account Balance (% of GDP)</b>	-1.1	-0.5	-1.1	-2.4	-3.6	-4.1
<b>Financial and Capital Account (% of GDP)</b>	1.0	0.6	0.6	0.4	1.2	1.5
Net Foreign Direct Investment (% of GDP)	2.0	1.8	1.8	1.8	1.8	1.8
<b>Fiscal Balance (% of GDP)</b>	-2.5	-1.9	-1.5	-2.8	-2.8	-2.8
<b>Debt (% of GDP)</b>	39.6	40.6	39.8	39.9	40.3	40.7
<b>Primary Balance (% of GDP)</b>	-0.8	-0.3	-0.1	-1.3	-1.3	-1.4
<b>Poverty rate (\$2.5/day PPP terms)<sup>a,b,c</sup></b>	10.2	9.5	8.7	7.6	6.9	6.3
<b>Poverty rate (\$5/day PPP terms)<sup>a,b,c</sup></b>	30.6	29.0	27.0	24.6	22.9	21.5

Sources: World Bank. Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice. Notes: e = estimate, f = forecast.

(a) Calculations based on ECA POV harmonization, using 2006-EU-SILC and 2012-EU-SILC with 2005 PPP.

(b) Projection using annualized elasticity (2006-2012) with pass-through = 0.7 based on GDP per capita constant in constant LCU.

(c) Projections are from 2013 to 2018.



# RUSSIAN FEDERATION

**Table 1** **2015**

Population, million	144.1
GDP, current US\$ billion	1326.0
GDP per capita, current US\$	9057
Poverty rate (\$2.5/day 2005PPP terms) <sup>a</sup>	0.8
Poverty rate (\$5/day 2005PPP terms) <sup>a</sup>	8.2
Gini Coefficient <sup>a</sup>	41.6
School enrollment, primary (% gross) <sup>b</sup>	100.6
Life Expectancy at birth, years <sup>b</sup>	70.4

Sources: World Bank WDI and Macro Poverty Outlook.

Notes:

(a) Most recent value (2012)

(b) Most recent WDI value (2013)

The recession continued in the first half of 2016 as the Russian economy further adjusted to low oil prices and the sanctions environment. Real incomes continued to fall, while the government again indexed public transfers below inflation, pushing the poverty rate from 8.2 to estimated 8.7 percent in 2016. There are signs of stabilization in part supported by the weak ruble, with the economy expected to come out of recession in 2017. Policy uncertainty and structural constraints are expected to limit the pace of recovery in the medium term.

## Recent developments

The recession continued in the first half of 2016 as real GDP contracted by 0.9 percent y/y. Low oil prices and restricted access to international capital markets continue to adversely affect Russia's economy, depressing domestic demand (which continued to contract by 2.1 percent y/y in the first quarter of 2016). However, supported by the return of growth momentum in the services sector, the decline of 0.9 percent is an improvement compared to the 3.7 percent slump in the first half of 2015. The REER depreciated by 5.8 percent in the first eight months of 2016, benefitting the tradable sectors, namely agriculture, chemicals, leather, and rubber production, which reported robust growth in production volume in the first seven months of 2016.

The flexible exchange rate helped stabilize the balance of payments. Worsening terms of trade in the first half of 2016 resulted in the reduction of the current account surplus from 7.1 percent of GDP to 3.0 percent of GDP in the first half of 2016. At the same time, the financial account strengthened as net capital outflows moderated on the back of lower debt repayments in the banking sector. Remaining policy uncertainty constrains Russia from utilizing its improvements in Doing Business ratings, as FDI inflows stayed moderate in the first half of 2016.

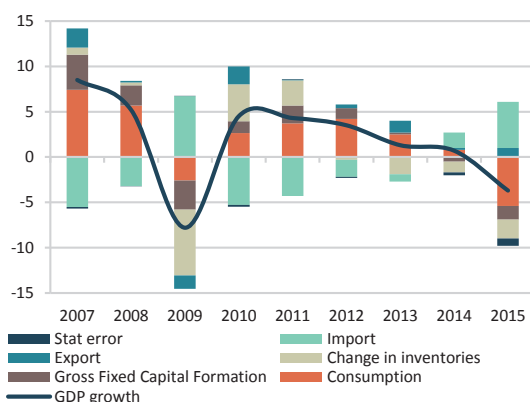
Monetary policy remains prudent and consistent with inflation targeting. Inflation averaged 7.7 percent in the first eight

months of 2016 (compared to 16.0 percent in the same period of 2015). This slowdown was largely due to the sharp deceleration of food inflation from 20.6 percent in January – August 2015 to 6.4 percent in the same period this year, which could have a positive effect on the poor. Tight monetary conditions prevail: key policy rates were cut by only 100 basis points since August 2015 (to 10.5 percent in June 2016 and 10.0 percent in September 2016). The central bank strives to reach 4 percent end year inflation in 2017 and maintaining this rate through 2018.

The banking system remains stable but still vulnerable to macroeconomic risks. The overall capital adequacy ratio resumed its declining trend on the back of low profitability and worsening credit quality: reported NPLs reached 9.7 percent of total loans in the first half of 2016. Despite this challenging environment, the flow of deposits has increased, liquidity in both rubles and foreign exchange has improved, and there are no signs of increased dollarization. The central bank has continued closing banks, most of them small primarily because they are weak or not compliant with regulations (ex, AML/CFT legislation).

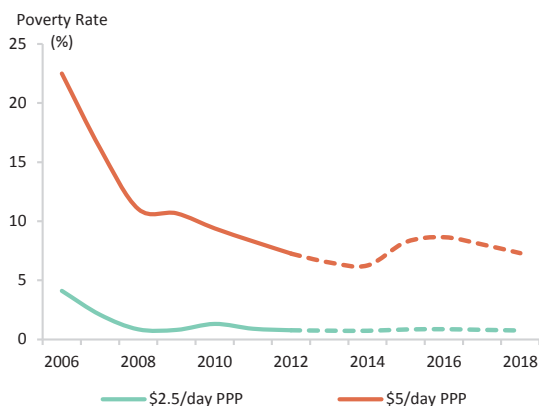
Fiscal consolidation continues. In the first half of 2016, general government primary expenditures shrank by about 1.2 percent of GDP compared to the first six months of 2015, leading to an improvement of the primary non-oil fiscal deficit to 7.3 percent of GDP (from 9.5 percent of GDP in 2015). This was accomplished by freezing public salaries; indexing some public pensions below inflation; and an additional 10 per-

**FIGURE 1 Russian Federation / GDP growth structure**  
(percentage points / percent)



Sources: Russian Statistical Authorities and World Bank staff calculations.

**FIGURE 2 Russian Federation / Actual and projected poverty rates**  
(percent)



Sources: World Bank (see notes to Table 2).

cent across the board cut for all expenditures, except for defense and social. The government targets a federal budget deficit of 3.3 percent of GDP in 2016, compared to a deficit of 2.4 percent of GDP last year. In 2016, the government suspended the fiscal rule and its medium term fiscal framework but plans to reintroduce them in 2017.

The unemployment rate increased marginally in the first seven months of 2016 to 5.7 percent from 5.6 percent in the same period of 2015 as the labor market continued to adjust through real wages. Real wage growth was zero, compared to a contraction of 8.7 percent in 2015. Public transfers and pensions were indexed below inflation and decreased in real terms, continuing adversely affecting the poor. The moderate poverty rate (per capita consumption below US\$5/day in 2005 PPP) grew from 6.3 percent in 2014 to 8.2 percent in 2015. The extreme poverty rate (per capita consumption below US\$2.5/day in 2005 PPP) remained marginal, below 1 percent. However, real consumption of the bottom 40 percent of the income distribution contracted in line with the average distribution, with consumption of the poorest decile contracting the most by 14 percent.

## Outlook

A weak external climate, commodity prices and sanctions will continue to dominate Russia's medium-term outlook. Economic prospects for major advanced and emerging economies have deteriorated amid weak global trade and manufacturing activity. Bleak economic prospects of the EU and slowing down in China (Russia's major trading partners) affect external demand and hence limit recovery. The recent extension of EU sanctions until January 31, 2017 (initially introduced during the 2014 Ukraine crisis) will continue limiting access of Russian financial institutions to international capital markets and hurting Russia's investment climate. Moderately improving terms of trade, with average oil prices projected to be at US\$ 53.2 per barrel in 2017 and US\$59.9 per barrel in 2018, are expected to lead to a recovery in domestic demand. Consequently, Russia's real GDP is projected to contract by 0.6 percent in 2016, before recovering to 1.5 and 1.7 percent growth in 2017 and 2018, respectively.

Low household income growth due to stagnant real wages and a fall in social transfers to households in real terms is

expected to worsen poverty in 2016. Labor income will become the most important driver of increasing incomes for the bottom 40 percent. Below inflation indexation, second year in a row, will be sensitive for people in the bottom of the income distribution as many of them depend on pensions and public transfers. The moderate poverty rate (under US\$5/day) is expected to grow in 2016 to 8.7 percent. Possible improvements in real income dynamics could bring the poverty levels down in 2017 and 2018, but poverty will stay elevated at the levels of 8.0 and 7.3 percent respectively.

## Risks and challenges

This outlook is subject to both downside and upside risks. On the upside, a record harvest could increase agricultural output. Downside risks stem from lower oil prices and intensification of geopolitical tensions. Establishing a new fiscal rule and restoring the medium term budget framework can help address downside risks. Banks face challenges from declining asset quality, low credit growth and weak profitability. Concerted effort is required on part of the central bank to address these challenges.

**TABLE 2 Russian Federation / Macro poverty outlook indicators**

(annual percent change unless indicated otherwise)

	2013	2014	2015	2016 f	2017 f	2018 f
<b>Real GDP growth, at constant market prices</b>	1.3	0.7	-3.7	-0.6	1.5	1.7
Private Consumption	4.4	1.5	-9.6	-2.5	3.0	2.5
Government Consumption	1.4	0.2	-1.8	-0.4	-0.8	-0.8
Gross Fixed Capital Investment	0.9	-2.6	-7.6	-5.0	2.0	4.0
Exports, Goods and Services	4.6	0.6	3.6	0.2	1.0	1.1
Imports, Goods and Services	3.6	-7.6	-25.7	-5.0	8.0	4.0
<b>Real GDP growth, at constant factor prices</b>	1.3	0.9	-3.3	-0.6	1.5	1.7
Agriculture	4.7	2.0	2.9	3.5	2.0	1.5
Industry	0.6	0.1	-3.6	-0.5	1.5	1.5
Services	1.6	1.2	-3.8	-0.7	1.4	1.8
<b>Inflation (Consumer Price Index)</b>	6.8	7.8	15.6	7.1	4.5	4.0
<b>Current Account Balance (% of GDP)</b>	1.5	2.8	5.2	2.2	1.8	1.6
<b>Financial and Capital Account (% of GDP)</b>	-2.1	-8.4	-5.3	-2.2	-1.8	-1.6
Net Foreign Direct Investment (% of GDP)	-0.8	-1.7	-1.2	0.0	0.0	0.1
<b>Fiscal Balance (% of GDP)</b>	-1.2	-1.1	-3.5	-4.2	-2.5	-0.6
<b>Debt (% of GDP)</b>	13.5	16.3	16.7	17.4	17.5	17.2
<b>Primary Balance (% of GDP)</b>	-0.6	-0.4	-2.7	-3.2	-1.5	0.4
<b>Poverty rate (\$2.5/day PPP terms)<sup>a,b,c</sup></b>	0.7	0.7	0.8	0.9	0.8	0.8
<b>Poverty rate (\$5/day PPP terms)<sup>a,b,c</sup></b>	6.5	6.3	8.2	8.7	8.0	7.3

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.  
Notes: e = estimate, f = forecast.

(a) Calculations based on ECA POV harmonization, using 2012-HBS.

(b) Projection using average elasticity (2010-2014) with pass-through = 1 based on private consumption per capita constant in constant LCU.

(c) Projections are from 2013 to 2018.

# SERBIA

**Table 1** 2015

Population, million	7.1
GDP, current US\$ billion	36.1
GDP per capita, current US\$	5080
Poverty rate (\$2.5/day 2005PPP terms) <sup>a</sup>	1.4
Poverty rate (\$5/day 2005PPP terms) <sup>a</sup>	14.5
Gini Coefficient <sup>a</sup>	29.1
School enrollment, primary (% gross) <sup>b</sup>	93.0
Life Expectancy at birth, years <sup>b</sup>	74.8

Sources: World Bank WDI and Macro Poverty Outlook.

Notes:

(a) Most recent value (2013)

(b) Most recent WDI value (2014)

The recovery of the Serbian economy continued in 2016. Growth of 2.9 percent in the first half of the year translated in the creation of new jobs – the employment rate rose to 45.9 percent, a record high level since 2008. Progress with fiscal adjustment continued though implementation of structural reforms slowed down. Poverty, which reached an estimated 14.5 percent in 2013, is expected to decline to 13.9 percent in 2016. Vulnerabilities remain due to still weak labor markets. On-going fiscal and structural reforms will continue to require proper mitigation measures to protect vulnerable groups.

## Recent developments

The Serbian economy benefited from increases in domestic investment and continued strong foreign demand in 2016. As a result, real economic growth is estimated at 2.9 percent in the first half of the year (y/y). Growth for 2016 as a whole now is projected at 2.5 percent. Unlike in previous periods, both in 2015 and 2016 private investment provided particular support to growth. In addition, in 2016, consumption started to recover as well. Growth could have been even stronger if not for a recent increase in imports (8.6 percent in real terms in the first half of 2016) thus leaving the contribution of net exports to growth close to zero.

Looking across sectors of the economy, growth in the first half of 2016 was broad based. Agricultural output (accounting for 8 percent of GDP) increased by 5.7 percent y/y in real terms; value added in industry increased by 4.1 percent and in services by 2.4 percent compared to the same period of 2015.

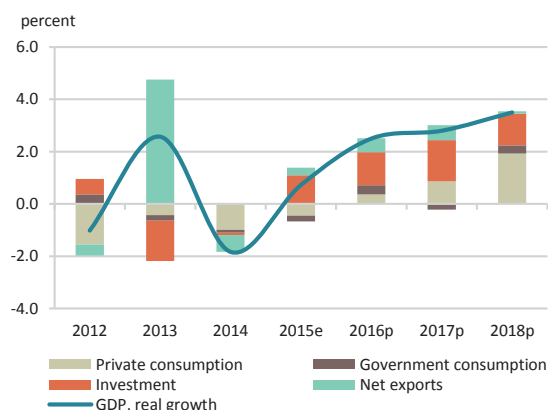
As growth returned, unemployment fell steadily from 17.7 percent on average in 2015 to 15.2 percent in the second quarter of 2016. Both the activity rate and employment rate, at 54.1 percent and 45.9 percent respectively, in the second quarter of 2016, are returning to pre-crisis levels. Still, two thirds of newly created jobs are in the informal sector. Overall wages continued to recover in 2016, rising faster in the private sector (6.2 percent y/y increase through May).

Poverty reduction has slowly resumed since poverty peaked in 2010. As a result of some

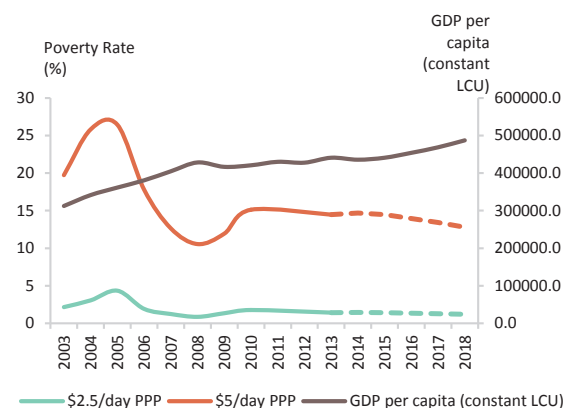
improvements in economic and employment conditions, the poverty rate – using the regional poverty line of \$5/day in 2005 PPP – dropped from 15.1 percent in 2010 to 14.5 percent in 2013. Poverty is estimated to have remained at 14.5 percent in 2015 and has not come back down to its lowest level seen in 2008.

Fiscal consolidation continues, and over the first seven months of 2016 the consolidated general government budget was balanced. The improved budget position came primarily as a result of significantly higher revenues. Public debt declined to 74.9 percent of GDP in July. Different measures included as part of the fiscal consolidation efforts are estimated to have small negative impacts on poverty. This is the case of freezes and cuts in public wages and pensions in 2014 and 2015, and the increases in electricity tariff in 2015 (mitigated by an expansion of the energy bill discount program). Similarly, further public sector retrenchments have only limited impacts on poverty as public workers largely belong to the middle and upper quintiles of the income distribution. The 2014 nominal cuts in pensions were progressive, but the freezing of pension indexation affected pension income across the board.

Inflation averaged 1 percent over the first seven months of 2016, well below the central bank target band, due to lower food prices and weak domestic demand. Low inflation in the first half of 2016 helped protect purchasing power, but other factors may push poverty up later in the year. Namely, food prices might go up in the second half of the year, and there is another increase in electricity tariffs scheduled for October. After substantial easing in 2015, the main policy

**FIGURE 1 Serbia / Contributions to annual real GDP growth**


Source: WB staff calculations based on Statistical Office data.

**FIGURE 2 Serbia / Actual and projected poverty rates and GDP per capita**


Source: Calculations based on ECAPOV, using 2006-HBS and 2013-HBS.

Note: 2014-2018 poverty projected using point-to-point elasticity (2006-2013).

rate was cut more gradually in 2016 to reach 4 percent as of July.

The current account deficit (CAD) shrank by 20 percent in euro terms in the first half of 2016 compared to the same period of 2015. This resulted from an improved trade balance and occurred despite lower remittances (a drop of 8 percent y/y). FDI recovered over the summer months to reach a level higher than this year's CAD (projected at 4.2 percent of GDP). The dinar has fallen slightly (1.3 percent) against the euro over the year to date despite significant and frequent interventions by the NBS. Foreign currency reserves declined by about EUR 800 million in 2016. The banking sector remains stable and loans to private sector increased by 5.6 percent by July (y/y), while loans to households increased by 8.3 percent.

## Outlook

Growth is projected to accelerate from 2.5 percent in 2016 to about 3.5 percent over the medium term. An increase in invest-

ment is expected to be the main driver of growth in 2016 and 2017, while recovery of consumption is expected to lead the growth in outer years of the projections period. The ongoing fiscal consolidation program targets the fiscal deficit to decline to below 2 percent of GDP over the medium term. This should bring public debt as a share of GDP to around 72 percent by 2018. With domestic demand only recovering gradually and low import prices, inflation is set to return to the target band only in early-2017. External balances are projected to improve as the economy becomes more competitive based on recent increase in domestic and foreign investment. CAD is projected to remain below 4 percent of GDP over the medium term.

With economic growth and improvements in the labor market – though with remaining structural challenges – poverty is expected to decline gradually. Poverty measured at the \$5/day poverty line is estimated to decline slowly to 13.9 percent in 2016 and 13.4 percent in 2017. While the energy bill discount program for vulnerable customers has been expanded, implementation challenges

remain. Possible future rises in electricity tariffs and energy prices in general are expected to further increase energy stress, particularly on poor households.

## Risks and challenges

While recognizing the positive fiscal consolidation progress in 2015 and early 2016, there remains the need for sustained implementation of structural reforms. As presented in the prime minister's manifesto of 2016, a broad spectrum of reforms is envisaged which is crucial in order to ensure faster growth of the economy and the creation of new jobs.

The potential distributional impacts of comprehensive structural reforms, while supportive of future overall income growth, are likely to pose challenges to poverty reduction in the short term, requiring mitigating measures. Social protection and job opportunities to mitigate adverse impacts need to remain an important part of the policy agenda.

**TABLE 2** Serbia / Macro poverty outlook indicators

(annual percent change unless indicated otherwise)

	2013	2014	2015	2016 f	2017 f	2018 f
<b>Real GDP growth, at constant market prices</b>	2.6	-1.7	0.8	2.5	2.8	3.5
Private Consumption	-0.6	-1.3	-0.6	0.5	1.2	2.7
Government Consumption	-1.1	0.2	-1.5	2.0	-1.1	1.9
Gross Fixed Capital Investment	-12.0	-3.8	8.3	6.7	8.2	5.5
Exports, Goods and Services	21.3	5.7	7.8	9.9	8.8	7.3
Imports, Goods and Services	5.0	5.6	5.5	6.9	6.2	5.9
<b>Real GDP growth, at constant factor prices</b>	3.3	-1.8	0.5	3.2	2.3	3.6
Agriculture	20.9	1.4	-8.3	8.5	2.7	3.1
Industry	4.2	-6.9	7.6	3.4	4.8	6.7
Services	0.4	0.2	-1.3	2.2	0.9	1.9
<b>Inflation (Consumer Price Index)</b>	7.7	2.1	1.4	1.7	3.1	3.5
<b>Current Account Balance (% of GDP)</b>	-6.1	-6.0	-4.8	-4.2	-3.9	-3.8
<b>Financial and Capital Account (% of GDP)</b>	4.8	5.2	4.1	3.5	3.2	3.1
Net Foreign Direct Investment (% of GDP)	3.6	3.7	5.5	4.7	4.2	4.2
<b>Fiscal Balance (% of GDP)</b>	-5.6	-6.6	-3.7	-2.5	-2.2	-1.7
<b>Debt (% of GDP)</b>	61.0	71.7	77.4	76.8	75.2	72.7
<b>Primary Balance (% of GDP)</b>	-3.1	-3.6	-0.3	1.0	1.4	2.0
<b>Poverty rate (\$2.5/day PPP terms)<sup>a,b,c</sup></b>	1.4	1.5	1.4	1.4	1.3	1.2
<b>Poverty rate (\$5/day PPP terms)<sup>a,b,c</sup></b>	14.5	14.7	14.5	13.9	13.4	12.8

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.  
Notes: e = estimate, f = forecast.

(a) Calculations based on ECAPOV harmonization, using 2006-HBS and 2013-HBS with 2005PPP.

(b) Projection using point-to-point elasticity (2006-2013) with pass-through = 1 based on GDP per capita in constant LCU.

(c) Actual data: 2013. Projections are from 2014 to 2018.

# TAJIKISTAN

**Table 1** 2015

Population, million	8.5
GDP, current US\$ billion	7.8
GDP per capita, current US\$	928
Poverty rate (LCU 167.76/month) <sup>a</sup>	31.3
Gini Coefficient <sup>a</sup>	27.5
School enrollment, primary (% gross) <sup>b</sup>	99.0
Life Expectancy at birth, years <sup>b</sup>	69.2

Sources: World Bank WDI and Macro Poverty Outlook.

Notes:

(a) Most recent value (2015)

(b) Most recent WDI value (2014)

Tajikistan's economy is expected to grow by 6 percent in 2016, driven by high levels of public investment. However, the internal and external balances have deteriorated, and macroeconomic vulnerabilities have become increasingly acute. The GDP growth rate is projected to slow in 2017 before gradually recovering over the medium term, assuming that both macroeconomic stability and fiscal sustainability are maintained. Mirroring the projected trends in economy-wide growth, poverty reduction is expected to continue over the medium term, though at a slower pace than in recent years.

## Recent developments

Despite regional headwinds, Tajikistan's economy grew by a robust 6.6 percent, year-on-year (y/y), during the first half of 2016, supported by a substantial increase in public investment. The sources of growth shifted from services to industry, construction and, more recently, agriculture. Growth in construction and agriculture tends to be especially pro-poor, as these sectors employ a large number of low-skilled workers.

A sharp increase in foreign-financed investment coupled with a slowdown in tax revenues that failed to meet projections, turned a fiscal surplus of 1.5 percent of GDP in the first half of 2015 into a deficit of 5.5 percent of GDP in the first half of 2016. The government responded by tightening expenditure controls, putting continued pressure on businesses to meet revenue targets, and revising the 2016 budget to incorporate realistic macroeconomic assumptions. As the fiscal envelope narrowed, the government took steps to protect core social spending and to honor its commitment to increase the minimum wage by 60 percent, public sector wages by 15-25 percent, pensions by 20 percent and stipends by 30 percent, beginning on July 1st.

An ongoing decline in remittances, which are the major source of foreign exchange, coupled with the legacy of directed lending, poor risk management among banks, and deficiencies in the central bank's supervisory and regulatory framework, have exacerbated financial-sector vulnerabilities. The share of nonperforming loans increased dramati-

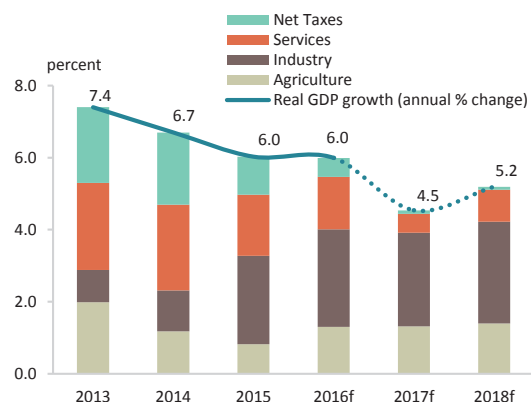
cally from 30 percent of total loans at end-2015 to over 50 percent by June 2016, eroding capital adequacy across the banking system and increasing banks' sensitivity to credit and exchange-rate risks. Many banks also face liquidity pressures due to maturity mismatches and have become increasingly dependent on central bank liquidity support to meet their funding needs. The cost of financing a prospective bank recapitalization and/or the contingent liabilities generated by state-owned enterprises could negatively impact the government's fiscal position.

The external accounts improved only marginally during the first six months of 2016, as a rise in investment-related capital goods imports largely offset a contraction in consumer goods imports. Meanwhile, current transfers continued to fall, though the pace of the decline slowed from 33 percent to 24 percent (y/y). The Tajik somoni depreciated by 11 percent between January and mid-February of 2016, but by end-February the exchange rates had unified, and they remained stable thereafter.

The annualized inflation rate increased to 5.5 percent during the first half of 2016, reflecting the pass-through effect of the depreciation early in the year. To ease inflationary pressures the central bank tightened its monetary policy stance by increasing the refinancing rate and raising the liquidity-support rate above the interbank rate. The central bank also continued its efforts to build up the country's foreign-exchange reserves, mainly in gold, which reached US\$654 million on July 1st, up 32 percent from the beginning of the year.

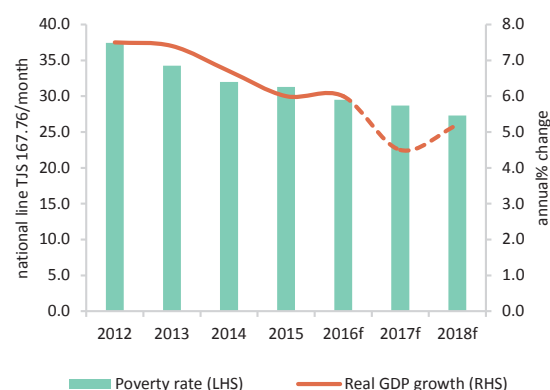
The decline in remittances in 2015 was partially offset by a modest increase in wage

**FIGURE 1 Tajikistan / GDP growth decomposition, actual and projected**



Sources: TajStat, World Bank staff estimates.

**FIGURE 2 Tajikistan / National poverty rate and GDP growth, actual and projected**



Sources: World Bank (see notes for Table 2).



income, especially among poor households. Official survey data indicate that wage income rose by 4.7 percent per capita among poor households in 2015, compared to just 0.4 percent for the population as a whole. Both the national poverty rate and the extreme poverty rate declined during 2015, but the pace of poverty reduction slowed. Data from the “Listening to Tajikistan” (L2T) survey indicate that per capita agricultural and self-employment income grew by nearly 30 percent (y/y) during the first half of 2016, significantly improving the welfare of poor and rural households.

## Outlook

The GDP growth rate is projected to remain broadly stable at 6 percent in 2016, supported by the ongoing expansion of industry, construction and agriculture. On the demand side, consumption is projected to decline moderately while investment growth remains robust. A fiscal adjustment in the second half of 2016 is expected to improve the government’s budgetary position, though the overall budget deficit (including the externally financed public investment program) is expected to reach 4 percent of GDP. Given the significant import content of infrastructure projects, the current-account deficit will likely remain high at about 4.7 percent of GDP. The central bank is expected to maintain a con-

servative stance in an effort to contain inflationary pressures.

Despite projected improvements in the external environment, which include an incipient recovery in Russia that should support a moderate increase in remittances, economic growth is projected to slow in 2017 as domestic vulnerabilities increase. The ongoing fiscal adjustment, though necessary to ensure medium-term fiscal and debt sustainability, will also contribute to lower growth rates. A gradual recovery is expected over the medium term, reflecting enhanced macroeconomic management and the implementation of structural reforms designed to encourage private investment and exports. Slowing growth and persistent weaknesses in the banking sector will have a negative impact on poverty and shared prosperity, though this will be partially offset by the effects of a higher minimum wage. The minimum wage increase is expected to boost incomes among workers at the bottom end of the income distribution, and while it will directly benefit many already-employed workers, its implications for job seekers are less clear. The expansion of the government’s targeted social assistance program to 40 districts beginning in October 2016, followed by its nationwide rollout in October 2017, is also expected to mitigate the impact of lower growth rates on poor and vulnerable households. Poverty reduction is expected to continue, though at a slower pace, and the official poverty rate is expected to fall from 31.3 percent in 2015 to 27.3 percent by 2018.

## Risks and challenges

The risks to Tajikistan’s economic outlook are tilted to the downside, and most relate to domestic factors, i.e. the high contingent liabilities from state-owned enterprises and from the financial sector. In addition, a weaker-than-expected regional economic recovery could depress remittances and trade. Tighter regulations on migrant workers in Russia could further reduce labor migration.

The economy-wide shift toward investment as the primary driver of economic expansion could narrow the distribution of the returns to growth and weaken its impact on poverty reduction and shared prosperity. Lower-than-expected consumption growth could further slow the pace of poverty reduction. Finally, delays in the expansion of the targeted social assistance program could diminish its anticipated effect on the poverty rate.

The government’s most immediate challenges will be to restore financial stability and to complete the fiscal adjustment while protecting pro-poor spending and ensuring the timely and efficient implementation of the targeted social assistance program. Further progress on the structural reform agenda could improve the business climate, helping sustain robust economic growth, steady employment creation and lasting poverty reduction.

**TABLE 2** Tajikistan / Macro poverty outlook indicators

(annual percent change unless indicated otherwise)

	2013	2014	2015	2016 f	2017 f	2018 f
<b>Real GDP growth, at constant market prices</b>	7.4	6.7	6.0	6.0	4.5	5.2
Private Consumption	9.4	1.8	-16.4	-1.5	4.6	5.0
Government Consumption	2.3	7.6	7.5	3.1	6.4	5.4
Gross Fixed Capital Investment	20.3	20.0	13.9	10.5	11.0	9.7
Exports, Goods and Services	-10.0	0.0	9.8	4.3	4.5	5.0
Imports, Goods and Services	1.1	1.1	-12.5	-2.0	5.0	5.0
<b>Real GDP growth, at constant factor prices</b>	5.6	5.0	5.4	6.0	4.9	5.6
Agriculture	7.6	4.5	3.2	5.2	5.3	5.6
Industry	3.9	5.1	11.2	11.8	10.7	11.0
Services	5.3	5.3	3.8	3.4	1.2	2.2
<b>Inflation (Consumer Price Index)</b>	5.0	6.1	5.8	6.0	7.0	7.0
<b>Current Account Balance (% of GDP)</b>	-2.9	-2.8	-6.0	-4.7	-5.0	-5.0
<b>Financial and Capital Account (% of GDP)</b>	0.1	-3.7	-3.8	-3.4	-0.2	-0.1
Net Foreign Direct Investment (% of GDP)	1.2	2.8	5.0	4.1	4.4	5.4
<b>Fiscal Balance (% of GDP)</b>	-0.8	-0.1	-2.1	-4.0	-2.6	-1.7
<b>Debt (% of GDP)</b>	34.7	33.8	38.4	46.6	62.3	62.3
<b>Primary Balance (% of GDP)</b>	-0.3	0.4	-1.5	-3.3	-1.7	-1.1
<b>Poverty rate (LCU 167.7583/month terms)<sup>a,b,c</sup></b>	34.3	32.0	31.3	29.5	28.7	27.3

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.

Notes: e = estimate, f = forecast.

(a) Calculations based on 2015 HBS.

(b) Projection using neutral distribution (2015) with pass-through = (0.7) based on GDP per capita constant PPP. Actual data: 2013, 2014, 2015. Projections are from 2016 to 2018.

(c) Actual data: 2013, 2014. Projections are from 2015 to 2018.

# TURKEY

**Table 1** **2015**

Population, million	76.8
GDP, current US\$ billion	721.1
GDP per capita, current US\$	9387
Poverty rate (\$2.5/day 2005 PPP terms) <sup>a</sup>	3.1
Poverty rate (\$5/day 2005 PPP terms) <sup>a</sup>	18.3
Gini Coefficient <sup>a</sup>	41.2
School enrollment, primary (% gross) <sup>b</sup>	98.6
Life Expectancy at birth, years <sup>b</sup>	74.6

Sources: World Bank WDI and Macro Poverty Outlook.

Notes:

(a) Most recent value (2014)

(b) Most recent WDI value (2014)

*Economic growth has slowed because of weaker expansion in private investment and a smaller contribution from net exports. Poverty reduction is likely to have continued to decline, but at a slower pace. Recent political events, including a failed coup attempt and the subsequent purges in the government and beyond are casting clouds of uncertainty and are expected to affect the pace of economic activity. The full effects on employment creation and informality from large minimum wage hikes remain to be seen. This context of challenges leads to a cautious medium-term macro-poverty outlook.*

## Recent developments

The most salient recent political development in Turkey is the failed coup attempt of July 15. The government was able to regain full control within 24 hours, backed by strong popular support. The coup attempt triggered the declaration of a three-month period of state of emergency and the dismissal of 90,000 public employees.

Working day adjusted GDP growth slowed to 3.7 percent y-o-y in the first half of 2016 from 4 percent in 2015 because of weakening net exports and subdued private investment. Private consumption maintained its momentum, thanks to strengthening real wage growth and recovery in consumer credit. Government spending also rose considerably because of election promises, making a strong contribution to growth. On the other hand, private investment disappointed the hopes for recovery following the November elections, as underlying structural weaknesses remain unaddressed. Imports recovered significantly, thanks to a stable Lira and stronger domestic consumption, while export growth remained weak because of geopolitical problems and Russian sanctions.

External adjustment that has been driven so far by lower oil prices has slowed significantly as tourism revenues fell. Although Turkey's energy bill continued to shrink thanks to lower oil prices, the 12-month current account deficit remains amounted to about \$29.4 billion by June 2016. Headline inflation has been highly volatile due to erratic food prices, but core inflation has been steadily, albeit slowly, coming

down. A stable Lira eased the pressure on prices of imported goods so that 12-month core inflation declined from 9.5 percent in December to 8.4 percent in August 2016.

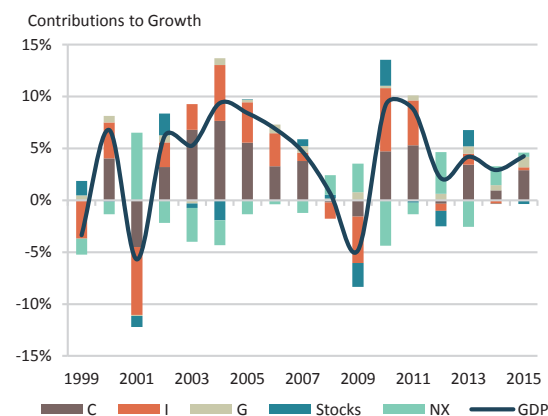
Despite high inflation, the Central Bank lowered the overnight lending rate by 225 basis points between March and August, bringing the average cost of funding down by 100 basis points to around 8 percent. Aiming to support the economy in the aftermath of the failed coup attempt, the Central Bank also lowered the reserve requirement ratios for all maturities by 100 basis points in August and September.

Headline fiscal figures improved in the first half of the year, but there are concerns about the underlying fiscal dynamics. On the expenditure side, a significant decrease in capital and interest expenses mostly offset the substantial rise in current transfers and the wage bill, which increased because of election promises. On the revenue side, tax revenues grew more slowly than in 2015. Nonetheless, larger non-tax revenues led to an overall improvement in budget revenues.

The population with per capita expenditure below the poverty line (5 US\$ a day in 2005 PPP) and extreme poverty line (2.5 US\$ a day in 2005 PPP) decreased to 18.3 and 3.1 percent, respectively, in 2014. At the start of the decade, poverty and extreme poverty affected 24.1 and 5.8 percent of the population, respectively. The improvement has been mainly driven by higher wages and better access to jobs, with social assistance fulfilling a complementary supporting role.

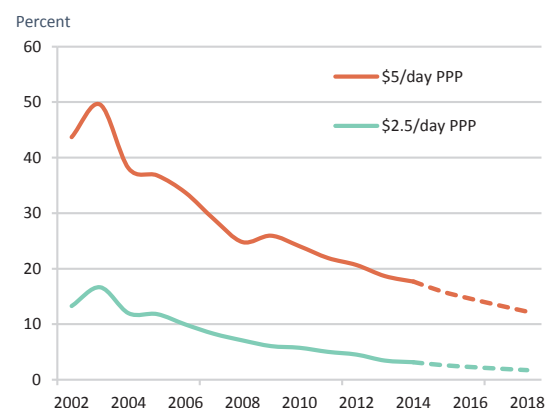
The most significant recent development in the labor market is the 30 percent increase in the minimum wage, approved in January 2016. The recent labor force survey suggests

**FIGURE 1 Turkey / Contributions to annual GDP growth**



Sources: Turk Stat.

**FIGURE 2 Turkey / Actual and projected poverty rates**



Sources: World Bank.

Notes: See notes on Table 2 on data and methods used for projection.

that the increase in labor costs has had no short term impact on employment creation, but may be changing the composition of total employment towards the informal sector, particularly since public employment played a compensating role that may not be sustainable going forward.

## Outlook

We forecast private investment to weaken this year, but the decline may be stronger in the aftermath of the failed coup given that investor confidence became more fragile. Private consumption lost momentum in the second quarter and we expect it to weaken further in Q3 as uncertainty encourages consumers to cut spending and save more. Yet, the available fiscal space provides ample room for the government to partially offset the weakening in private demand and support growth in the remainder of the year. Against this backdrop, we revise our growth forecast for 2016 down to 3.1 percent, from 3.5 percent.

The main downside risk on growth is a possible credit rating downgrade. Moody's

placed Turkey under revision for credit rating downgrade in July, one of two agencies that now rate Turkey as investment grade.

With private consumption forecast to grow in the coming years, poverty (extreme poverty) is estimated to decline to 16 (2.5) percent in 2016, 15 (2.3) percent in 2017, and 14 (2.1) percent in 2018. This projection depends on the labor market effects of the 30 percent minimum wage increase. On the one hand, the raise should boost the incomes of the working poor, not only of formal workers but also of informal workers through a 'lighthouse effect'. On the other, the increase has brought the minimum wage to more than 40 percent of the median wage, which may change hiring decisions. In the medium to long term, employment generation may slow down and its composition may start to tilt further towards informality, undoing some of the positive benefits of the active minimum wage policy.

## Risks and challenges

Since the failed coup attempt, the government has enabled individuals and firms to

restructure tax and social security arrears to the government and has made efforts to reduce bureaucracy, automate opt-in provisions for private pensions, establish a sovereign wealth fund, and facilitate job and residency permits for foreigners. However, there appears to have been no significant advance in implementing a number of long-awaited structural reforms.

While overall poverty and labor market indicators have been evolving favorably, progress has been uneven in certain cases as challenges arise. First, in the poorest regions of the country, poverty has decreased at a slower pace than in the rest. Second, women continue to have relatively low participation in the labor market. The government has announced that comprehensive investment and reconstruction efforts will be undertaken in the Southeast, and that the supply of child care centers will be subsidized with tax exemptions for five years. How these actions help address the regional and female participation challenges in the coming year is likely to have a significant impact on growth.

**TABLE 2 Turkey / Macro poverty outlook indicators**

(annual percent change unless indicated otherwise)

	2013	2014	2015	2016 f	2017 f	2018 f
<b>Real GDP growth, at constant market prices</b>	4.2	3.0	4.0	3.1	3.5	3.6
Private Consumption	5.1	1.4	4.5	4.1	4.1	4.0
Government Consumption	6.5	4.7	6.7	10.4	4.6	3.1
Gross Fixed Capital Investment	4.4	-1.3	3.6	0.8	3.3	4.3
Exports, Goods and Services	-0.2	7.4	-0.8	1.2	3.5	4.3
Imports, Goods and Services	9.0	-0.3	0.3	4.8	5.1	5.8
<b>Real GDP growth, at constant factor prices</b>	4.9	3.4	4.6	3.1	3.5	3.6
Agriculture	3.5	-1.9	3.3	1.9	1.9	1.9
Industry	4.1	3.5	2.1	1.5	1.5	1.5
Services	5.5	4.2	6.2	4.2	4.9	4.8
<b>Inflation (Consumer Price Index)</b>	7.5	8.9	7.7	8.5	8.0	7.5
<b>Current Account Balance (% of GDP)</b>	-7.7	-5.4	-4.5	-4.1	-4.5	-4.7
<b>Financial and Capital Account (% of GDP)</b>	7.6	5.2	3.2	3.9	4.3	4.5
Net Foreign Direct Investment (% of GDP)	1.1	0.7	1.6	0.6	0.5	0.7
<b>Fiscal Balance (% of GDP)</b>	-0.7	-0.6	0.0	-1.8	-1.3	-1.3
<b>Debt (% of GDP)</b>	38.7	36.3	36.0	36.2	36.0	35.8
<b>Primary Balance (% of GDP)</b>	2.5	2.4	2.8	0.9	1.5	1.5
<b>Poverty rate (\$2.5/day PPP terms)<sup>a,b,c</sup></b>	3.4	3.1	2.8	2.5	2.3	2.1
<b>Poverty rate (\$5/day PPP terms)<sup>a,b,c</sup></b>	18.7	18.3	17.0	15.9	14.9	13.9

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.  
Notes: e = estimate, f = forecast.

(a) Calculations based on ECAPOV harmonization, using 2004-HICES and 2014-HICES with 2005PPP.

(b) Projection using point-to-point elasticity (2004-2014) with pass-through = 1 based on private consumption per capita in constant LCU.

(c) Actual data: 2013, 2014. Projections are from 2015 to 2018.



# TURKMENISTAN

**Table 1** **2015**

Population, million <sup>a</sup>	5.4
GDP, current US\$ billion <sup>a</sup>	37.3
GDP per capita, current US\$ <sup>a</sup>	6948
Life Expectancy at birth, years <sup>b</sup>	66.0

Sources: World Bank WDI and Macro Poverty Outlook.

Notes:

(a) World Bank staff revised estimates (2015).

(b) Most recent WDI value (2014).

*Turkmenistan's economy continues to adjust to lower commodity prices and sluggish external demand. GDP growth slowed from 8.7 percent in the first half of 2015 to 6.2 percent in the first half of 2016. While data on living standards are not available, slowing growth has likely had a negative impact on vulnerable households. Growth may accelerate over the medium term if oil and gas prices rise, export volumes recover, and structural reforms improve the business environment and foster private-sector activity.*

## Recent developments

In 2016, like many countries in the region, Turkmenistan continued to adjust to lower commodity prices and sluggish external demand. Prices for natural gas, Turkmenistan's main export, continued to fall through June 2016, adversely affecting the external and fiscal balances and depressing domestic demand. The official data indicate that GDP growth slowed to 6.2 percent, year-on-year (y/y), during the first half of 2016 from 8.7 percent during the same period of 2015. The decline in net exports drove the deceleration: exports revenue dropped by 40.5 percent, y/y, during the first half of 2016, while imports fell by just 5.1 percent. Private consumption growth slowed as evidenced by a decline in retail trade growth from 19.5 percent during the first half of 2015 to 16.1 percent, y/y, during the same period of 2016. Meanwhile, the growth of fixed capital investment fell by nearly half, from 7.9 percent to 4.3 percent, y/y, as the government continued to consolidate its capital budget in an effort to improve investment efficiency.

On the supply side, growth was supported by services and construction. Industrial output grew moderately, as natural gas production stalled due to weaker external demand, driven mainly by the slowdown of the Chinese economy. Agriculture output growth was supported by government subsidies to small-scale, export-oriented and import-substituting agricultural producers.

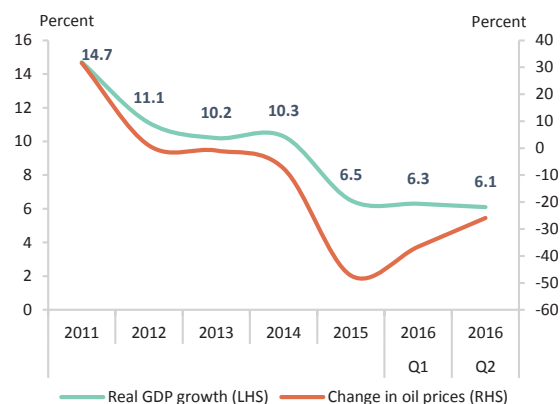
Following the January 2015 devaluation of the Turkmenistan manat, the official exchange rate remained stable at 3.5 manat per US dollar. In 2016, monetary policy has con-

tinued to support the exchange-rate peg, and the central bank's policy tools for controlling inflation remain limited. Inflation is moderating due to weaker domestic demand and tighter monetary conditions. To maintain the peg, the authorities introduced administrative measures—including restrictions on foreign-exchange operations—to curb foreign-exchange outflows.

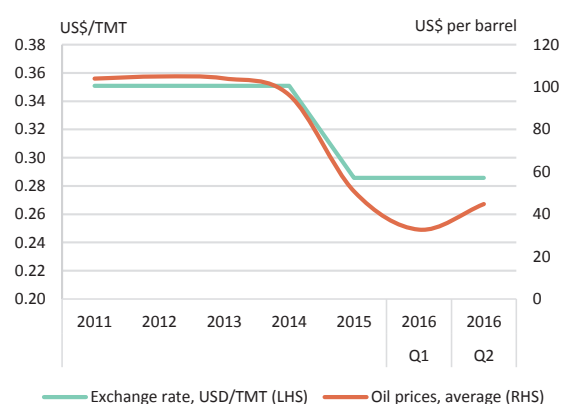
Fiscal consolidation measures implemented during the last 12 months have focused on rationalizing public investment, increasing nonhydrocarbon revenue, developing a privatization program, and improving the efficiency of subsidies and social benefits. In late 2015 and early 2016, the Council of Elders—a consultative body linked to the executive branch—indicated that government dismantle the subsidy system. In April 2016, the authorities announced plans to reduce fiscal expenditures. Public subsidies on electricity, gas and water supply are expected to be scaled back over the medium term. This will likely put further pressure on household consumption, and a targeted social-assistance program is being developed to mitigate the impact of the subsidy reduction on the most vulnerable households. Turkmenistan does not produce official statistics on living standards, and little information is available on the labor market, making it difficult to determine the extent to which slowing growth is affecting poverty and employment dynamics.

## Outlook

The baseline scenario assumes a moderate recovery in hydrocarbon prices during the

**FIGURE 1 Turkmenistan / Real GDP growth and oil prices (percent)**


Sources: State Statistics Committee of Turkmenistan.

**FIGURE 2 Turkmenistan / Exchange rate and oil prices (US\$/TMT; US\$ per barrel)**


Sources: Central Bank of Turkmenistan.

second half of 2016 and projects that annual GDP growth will remain at its current rate of 6.2 percent. The current account deficit is expected to widen from 12.3 percent of GDP in 2015 to more than 13 percent in 2016, financed by ample foreign direct investment inflows in the hydrocarbon sector. Despite the ongoing consolidation, the fiscal deficit is projected to double from 0.7 percent of GDP in 2015 to about 2 percent in 2016. Managing the deficit will require further improvements in expenditure efficiency and budget prioritization.

Turkmenistan's medium-term growth rate is likely to remain below its average during the commodity-price boom. If export volumes recover due to the likely implementation of new gas-export agreements, growth should accelerate from 2017 onward. A recovery in global energy demand would improve Turkmenistan's medium-term growth prospects.

## Risks and challenges

Turkmenistan's baseline outlook is subject to significant downside risks, both external and domestic. External risks include a

protracted global oil supply glut that would keep hydrocarbon prices low and/or a continued slowdown of the Chinese economy that would negatively affect demand for Turkmenistan's natural gas. If these risks materialize, they would reduce export revenue, further weakening the country's external and fiscal positions while depressing domestic demand. Domestic risks include a possible slowdown or even a reversal of the implementation of structural reforms designed to promote economic diversification and support private-sector development.

The economic dominance of the public sector and its tight administrative controls remain the key challenges to private-sector development. The government and its state-owned monopolies play a major role in the economy and continue to account for the majority of employment. Foreign direct investment remains limited outside the hydrocarbon sector. Further reforms in the investment climate will be needed to attract more foreign capital to nonhydrocarbon industries and leverage the country's potential for economic diversification.

The authorities have committed to accelerating privatization efforts. A greater economic role for the private sector and increased diversification remain the government's key strategic priorities, as stated in the National Strategic Development Plan for 2011-2030. The plan also aims to close the income gap between rural and urban areas and ensure inclusive development throughout the country. Advancing the implementation of the institutional and structural reform agenda would help to promote private-sector-driven growth and lead to a more diversified and sustainable development model for Turkmenistan.

**TABLE 2** Turkmenistan / Macro poverty outlook indicators

(annual percent change unless indicated otherwise)

	2013	2014	2015	2016 f
<b>Real GDP growth, at constant market prices</b>	10.2	10.3	6.5	6.2
<b>Prices: Inflation</b>	6.8	6.0	6.0	5.0
<b>Current Account Balance (% of GDP)</b>	-7.2	-6.7	-12.3	-13.3
of which: Exports of oil and gas (% of GDP)	43.0	39.6	29.8	24.2
<b>Financial and Capital Account (% of GDP)</b>	14.5	8.6	8.2	7.4
of which: Net Foreign Direct Investment (% of GDP)	9.0	9.0	12.5	13.0
<b>Fiscal Balance (% of GDP)</b>	1.2	0.4	-0.7	-1.9
<b>Debt (% of GDP)</b>	21.1	16.8	21.0	22.0

Sources: World Bank, International Monetary Fund.  
Note: f = forecast.

## UKRAINE

Table 1	2015
Population, million	42.6
GDP, current US\$ billion	90.4
GDP per capita, current US\$	2,122.0
Poverty rate (\$2.5/day 2005PPP terms) <sup>a</sup>	0.1
Poverty rate (\$5/day 2005PPP terms) <sup>a</sup>	5.8
Gini Coefficient <sup>a</sup>	24.1
School enrollment, primary (% gross) <sup>b</sup>	103.9
Life Expectancy at birth, years <sup>b</sup>	71.0

Sources: World Bank WDI and Macro Poverty Outlook.

Notes:

(a) Most recent value (2014)

(b) Most recent WDI value (2014)

*The economy has stabilized in 2016, but the recovery has not yet taken hold due to the lack of renewed reform momentum and weak external demand. Growth is projected at 1 percent in 2016 and 2 percent in 2017. Deeper structural reforms to bolster investor confidence and productivity are needed to help growth pick up to 3-4 percent in the medium term. Poverty will remain elevated through 2018 due to the slow pace of recovery of economic activity, real wages, and jobs.*

## Recent developments

The economy grew by 0.8 percent in the first half of 2016, compared to a contraction of 4.5 percent in the second half of 2015, but recovery and growth have not yet taken hold except in select sectors. The conflict in the East has de-escalated since September 2015 and the bold reforms of 2014-2015 have begun to stabilize confidence. As a result, initial signs of rebound in select sectors appeared in the first half of 2016, with growth of 5.0 percent y/y in manufacturing, 5.5 percent y/y in domestic trade, and 4.0 percent y/y in transport. However, significant weaknesses remain in other parts of the services sector. Broad-based recovery and growth have been held back by a number of factors, including weak external demand, the continuing conflict in the East of Ukraine, and the lack of renewed reform momentum.

Moderate poverty (US\$5 a day 2005 PPP) is likely to have risen significantly in 2015, before declining gradually in the first half of 2016, thanks to resumed growth in real wages. In 2015, a sharp contraction in economic activity and high inflation are estimated to have almost doubled the moderate poverty rate from 3.3 percent in 2014 to 5.8 percent in 2015.

Inflation slowed to 7.9 percent y/y in July 2016 due to stabilization of the exchange rate and lower commodity prices, after peaking at 43.3 percent y/y at the end of 2015. This slowdown in inflation contributed to rising real wages in most sectors in the first half of 2016. The impacts of labor market dynamics on poverty appear however ambiguous as,

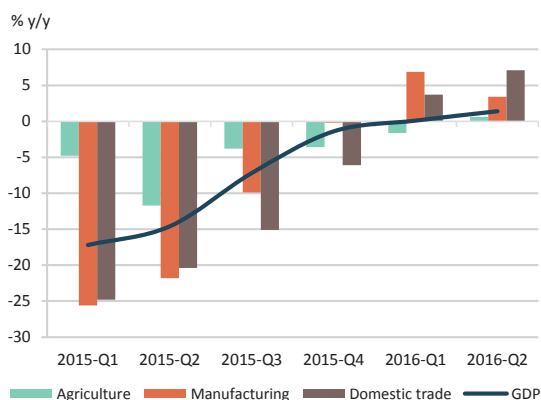
at least in the first quarter of 2016, the unemployment rate continued to increase (9.9 percent compared to 9.1 the previous quarter and 9.6 in Q1 2015) while employment declined, suggesting that some restructuring might be behind the rise in real wages.

After a sharp reduction in large fiscal imbalances in 2015, revenues are down and expenditures are up in 2016. Fiscal pressures have increased in the first half of 2016, revenues declined by 5.4 percent in real terms compared to the first half of 2015, mostly due to lower social security contributions (SSC) resulting from the cut in the SSC rate from 40 percent to 22 percent. On the other hand, expenditures increased by 4.8 percent y/y in real terms in the first half of 2016 due to higher spending on defense, internal order, and social protection. As a result, the general government deficit amounted to 5 percent of GDP in the first half of 2016.

## Outlook

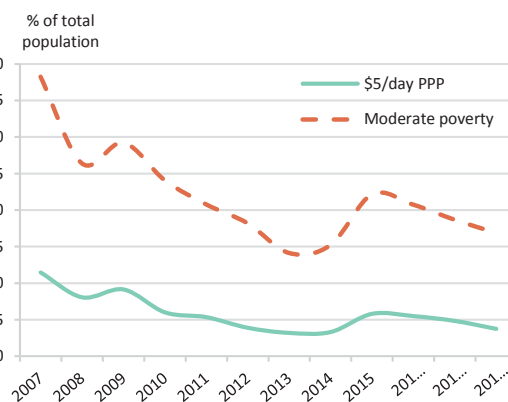
The outlook for economic growth remains weak due to the difficult global economic environment, the ongoing uncertainty related to the conflict in the East, and the challenge of advancing reforms on multiple fronts in a complex political environment. Growth is projected at 1 percent in 2016 and 2 percent in 2017. In the medium term, growth could pick up to 3-4 percent, as deeper structural reforms bolster investor confidence and productivity growth. The real depreciation coupled with reforms to create a level playing field for the private sector, enhance competition, and tap the EU

FIGURE 1 Ukraine / GDP growth, y/y



Sources: Ukraine Statistical Service.

FIGURE 2 Ukraine / Actual and projected poverty rates



Sources: Ukraine Statistical Service, World Bank Estimates.  
Notes: See notes on Table 2 on data and methods used for projection.

market are expected to support exports and tradable sectors of the economy. Reforms to improve expenditure efficiency should create fiscal space to unlock public investment, while continued reforms in the banking sector should permit a gradual resumption of lending.

Despite the return to growth and measures to cushion the impact of reforms on the poor, the decline in employment raises concerns about the pace of poverty reduction going forward. The vulnerability of the displaced population remains a major concern. Poverty rates are projected to decline modestly from 5.8 percent in 2015 to 5.5 in 2016. Despite further growth, moderate poverty is likely to remain above its 2014 levels until 2018; we project poverty reaching 4.9 percent in 2017 and 3.8 percent in 2018.

While household income received a boost from real wage growth (56 percent of poor households have members who are employed), public transfers (including pensions and social assistance, and in particular the house utility subsidy, which keeps in check household energy spending) remain a major

income source for a large share of the poor. The erosion of the real value of the transfers was attenuated by the May 2016 pension increase. Ongoing efforts to target the HUS better should not affect the poor directly, though other groups of the B40 might be affected. Recent changes in the PIT were rather marginal and have little effect on both the poor and the B40. Over 5 percent of Ukraine's population has been displaced by the conflict and remains very vulnerable. Addressing their needs and those of others who might be displaced in the event of a new escalation of the conflict remains a pressing priority.

## Risks and challenges

The fiscal outlook remains challenging and will require a systematic fiscal consolidation effort grounded in structural reforms to support broad based growth and employment creation. In light of lower revenues and higher spending, the fiscal deficit, including Naftogaz, is projected at

4 percent of GDP in 2016, with public and publicly guaranteed debt rising further to 90.2 percent of GDP.

Going forward the fiscal framework targets a reduction of the deficit to 2.6 percent of GDP by 2018. While fiscal consolidation in 2014-15 has drawn on tight spending controls across the board and higher energy tariffs, the consolidation going forward will need to be rooted in deep structural reforms to boost productivity growth and employment. On the fiscal side, needed reforms include measures to manage the largest fiscal risks, create fiscal space for more effective public investment, and improve the efficiency and effectiveness of health, education, and social protection. To meet the general government deficit target of 3.1 percent of GDP in 2017 and 2.6 percent in 2018, the authorities will have to implement additional fiscal measures otherwise debt level may increase again to about 90 percent of GDP in 2017 and is not likely to decline to 71 percent of GDP to 2020 as targeted under the IMF-supported program.

**TABLE 2** Ukraine / Macro poverty outlook indicators

(annual percent change unless indicated otherwise)

	2013	2014	2015	2016 f	2017 f	2018 f
<b>Real GDP growth, at constant market prices</b>	0.0	-6.6	-9.9	1.0	2.0	3.0
Private Consumption	6.9	-8.3	-20.2	0.3	3.0	3.5
Government Consumption	-0.9	1.1	1.0	-1.5	-1.0	-1.0
Gross Fixed Capital Investment	-8.4	-34.5	8.1	8.7	11.3	5.6
Exports, Goods and Services	-8.1	-14.2	-16.9	-2.7	2.7	5.4
Imports, Goods and Services	-3.5	-22.1	-22.0	-1.9	2.6	6.1
<b>Real GDP growth, at constant factor prices</b>	0.0	-6.6	-9.9	1.0	2.0	3.0
Agriculture	13.8	2.9	-4.7	0.8	1.5	2.0
Industry	-3.8	-14.6	-13.5	4.1	2.8	3.0
Services	-1.3	-4.7	-9.5	-2.0	1.8	3.4
<b>Inflation (Consumer Price Index)</b>	-0.3	12.1	48.7	15.0	11.0	8.0
<b>Current Account Balance (% of GDP)</b>	-9.0	-3.5	-0.2	-1.3	-1.6	-1.9
<b>Financial and Capital Account (% of GDP)</b>	9.4	-6.4	6.6	2.5	4.0	8.0
Net Foreign Direct Investment (% of GDP)	2.2	0.2	3.3	3.2	3.8	4.3
<b>Fiscal Balance (% of GDP)</b>	-4.8	-4.5	-1.2	-3.7	-3.1	-2.6
<b>Debt (% of GDP)</b>	40.6	70.3	80.3	90.2	92.8	87.9
<b>Primary Balance (% of GDP)</b>	-2.3	-1.2	3.0	0.9	1.1	1.7
<b>Poverty rate (\$2.5/day PPP terms)<sup>a,b,c</sup></b>	0.1	0.0	0.1	0.1	0.1	0.1
<b>Poverty rate (\$5/day PPP terms)<sup>a,b,c</sup></b>	3.2	3.3	5.8	5.5	4.9	3.8

Sources: World Bank. Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.  
Notes: e = estimate, f = forecast.

(a) Calculations based on ECAPOV harmonization, using 2014-HLCS with 2005PPP.

(b) Projection using neutral distribution (2014) with pass-through = 1 based on GDP per capita constant in constant LCU.

(c) Actual data: 2013, 2014. Projections are from 2015 to 2018.

# UZBEKISTAN

Table 1	2015
Population, million	31.1
GDP, current US\$ billion	69.1
GDP per capita, current US\$	2220
Life Expectancy at birth, years <sup>b</sup>	68.1

Sources: World Bank WDI and Macro Poverty Outlook.  
Notes:

(b) Most recent WDI value (2014)

*Uzbekistan's GDP growth is expected to slow down only marginally in 2016, as the impact of lower commodity prices and weak economic performance of the country's largest trading partners is offset by government's countercyclical fiscal and monetary policies. The current and the fiscal accounts remain positive. The migrants that have returned from Russia and the lower USD remittances are nevertheless expected to put pressure on the labor market and to slow the pace of poverty reduction in the medium term.*

## Recent developments

Continued recession in Russia—Uzbekistan's second largest trading partner and its primary source of remittances,—slowing growth in China (Uzbekistan's largest trading partner), and declining prices of Uzbekistan's export commodities (natural gas, copper, and cotton) all contributed to a slight reduction in Uzbekistan's GDP growth in 2016. Growth slowed to 7.8 percent (y/y) in the first half of 2016, compared with 8.1 percent (y/y) in the same period in 2015. Private consumption remained weak, as income eroded due to persistently high inflation and a 19 percent (y/y) fall in remittances from Russia (as measured in US dollar terms). By contrast, robust investment activity (discussed below), stimulated by some tax relief, supported growth.

In response to the poor external environment in 2016, the authorities introduced additional fiscal measures, including increases in social spending and public investment, and cuts in business and citizen taxes. Back in April 2015, the government had announced a major privatization program to sell, by end-2016, stakes in 1,247 state-owned enterprises; the program would generate public resource in 2015 and 2016, and support the diversification agenda. Of these enterprises, about 305 were privatized in the first half of 2016 to Uzbek residents, while the minority shares in 30 Uzbek joint stock companies were sold to foreign investors.

The central bank's refinancing rate was maintained at 9 percent in January–September of 2016 (i.e. slightly negative in

real terms), helping total banking deposits to grow by 27 percent y/y in the first half of 2016, and total banking loans to grow by 26 percent y/y.

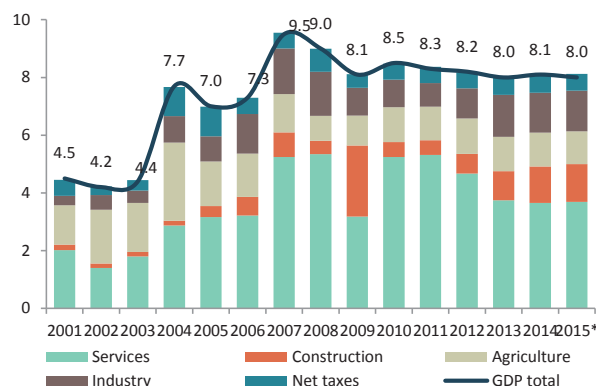
Preliminary official data suggest that total exports increased slightly in the first half of 2016, while remittance inflows and imports continued to decline. Lower imports were due to lower private consumption of durables and non-food consumer items, and further import-substitution of fuels and chemicals, as well as import compression measures, such as foreign currency rationing; all these factors mitigated the pressures on the external accounts.

Although validation is not possible due to lack of access to official micro data, the official poverty rate declined from 14.1 percent in 2013 to 13.7 percent in 2014 and an estimated 13.6 percent in 2015. Robust economic growth, micro- and small business development, and targeted government safety net programs have driven poverty reduction in the past. The distribution of income has become more equitable over time, and the official Gini coefficient fell from 0.39 in 2001 to 0.29 in 2013. However, the unemployment rate increased to 5.2 percent in 2015 from 4.9 percent a year earlier.

## Outlook

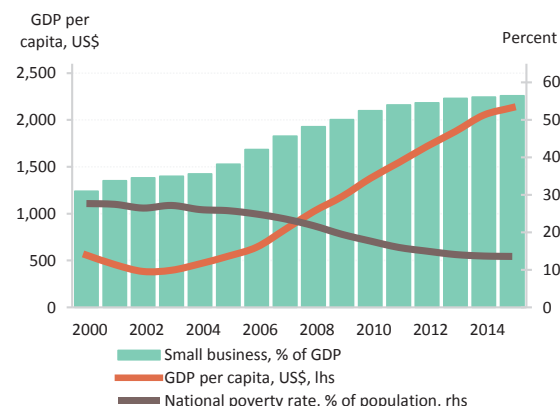
Uzbekistan's positive outlook is predicated on significant investment growth and a gradual recovery of commodities prices which are expected to edge up export revenues. With prospects for recovery in the external environment being sluggish, GDP

**FIGURE 1 Uzbekistan / Sectoral contributions to GDP growth, 2001–2015, percent/percentage points**



Sources: Uzbekistan official statistics, World Bank staff calculations.

**FIGURE 2 Uzbekistan / Poverty, GDP per capita, and small business development, 2000–2015**



Sources: Uzbekistan official data. National poverty line is minimum food intake of 2,100 calories per person per day and it excludes non-food items.  
Note: World Bank cannot validate poverty trend after 2003 as microdata inaccessible.

growth is projected to slow from 8 percent in 2015 to an average 7.4 percent per year over the medium term.

Fiscal policy is expected to play a significant role in maintaining the rate of economic growth, as implementation of Uzbekistan's newly adopted industrial, agriculture, and infrastructure development programs for 2015-19 proceeds, and as tax relief is expected to shore up private consumption. The fiscal balance may recover modestly, but will not reach pre 2015 rates.

Monetary policy is also expected to be accommodative but somewhat more restrained than in previous years, aiming to bring about a gradual reduction in the inflation rate. With the GOU's emphasis on credit growth, the allocation of additional credit to SMEs is expected to facilitate absorption of returning migrants in the labor market.

Uzbekistan's external account will improve modestly over time, as the government con-

tinues its policy of tight foreign exchange controls in order to contain import growth. Demand from Russia and other trading partners is expected to remain weak, as are remittances.

While data limitations do not allow for poverty projections, we expect that slow income growth and a large influx of returning migrants to limit progress in reducing unemployment, poverty and inequality over the near term; these indicators will remain nearly unchanged through 2018.

## Risks and challenges

Uzbekistan's economic outlook is subject to downside risks, stemming from external and domestic sources. On the external side, world prices of key export commodities (gas, copper, gold, and cotton) com-

bined with the lower demand from Uzbekistan's main trading partners (except for gas) could adversely affect Uzbekistan's export performance, consumption, current account and fiscal balances further. An increase in the U.S. interest rates could raise external borrowing costs and slow capital inflows. On the domestic side, the pace and depth of reforms remain uncertain. The recently adopted development programs could help increase the economy's potential, though these need to be complemented by ambitious structural reforms to create jobs, improve economic efficiency, and foster a more inclusive growth.

A new presidential election will be held on December 4th 2016 following the death of the former president on September 2nd 2016. This presidential transition will enhance the political stability of the country.

**TABLE 2** Uzbekistan / Macro poverty outlook indicators

(annual percent change unless indicated otherwise)

	2013	2014	2015	2016 f	2017 f	2018 f
<b>Real GDP growth, at constant market prices</b>	8.0	8.1	8.0	7.3	7.4	7.4
Private Consumption	4.8	5.8	-0.5	-0.3	3.5	5.0
Government Consumption	5.9	9.9	8.4	3.1	2.0	2.9
Gross Fixed Capital Investment	10.7	9.6	9.9	8.0	9.3	10.4
Exports, Goods and Services	8.3	-5.1	-5.3	-1.0	1.4	3.0
Imports, Goods and Services	5.9	-4.1	-13.4	-6.9	-5.3	1.1
<b>Real GDP growth, at constant factor prices</b>	8.0	7.9	7.9	7.3	7.5	7.4
Agriculture	6.8	6.9	6.8	6.6	6.5	6.5
Industry	8.2	8.5	8.5	6.9	7.1	7.2
Services	8.6	8.2	8.2	7.8	8.2	7.9
<b>Inflation (Private Consumption Deflator)</b>	10.2	10.0	10.0	10.0	9.0	8.0
<b>Current Account Balance (% of GDP)</b>	2.9	1.7	0.9	1.1	1.3	1.3
<b>Fiscal Balance (% of GDP)</b>	2.5	2.0	0.4	0.3	0.6	0.7
<b>Debt (% of GDP)</b>	8.5	8.3	10.5	15.5	13.9	12.1
<b>Primary Balance (% of GDP)</b>	2.6	2.1	0.5	0.4	0.8	0.7

Sources: World Bank. Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.  
Note: f = forecast.





WORLD BANK **ECA ECONOMIC UPDATE** NOVEMBER 2016

## Polarization and Populism

These are tough times for Europe and Central Asia. The Brexit vote and the refugee crisis are testing the European Union's internal cohesion. Continued vulnerabilities in European banking sectors are curbing the economic recovery. Russia, Eastern Europe, Central Asia, and the Caucasus are still grappling with the consequences of low oil prices, increasingly compounded by low prices of other commodities. In Turkey, social and political tensions have increased in the aftermath of the coup attempt. Moreover, geopolitical frictions in the region further complicate the challenges.

These turbulent economic times coincide with political polarization and rising populism. This likely reflects anxiety about unequal opportunities and decreasing job security, while low secular growth causes more pessimism about prospects. Coping with the structural challenges outlined above and limiting the rise in populism will require policies that support adjustment to these new economic realities while minimizing the pain that such adjustments can cause.

ISBN (electronic): 978-1-4648-1009-1

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