

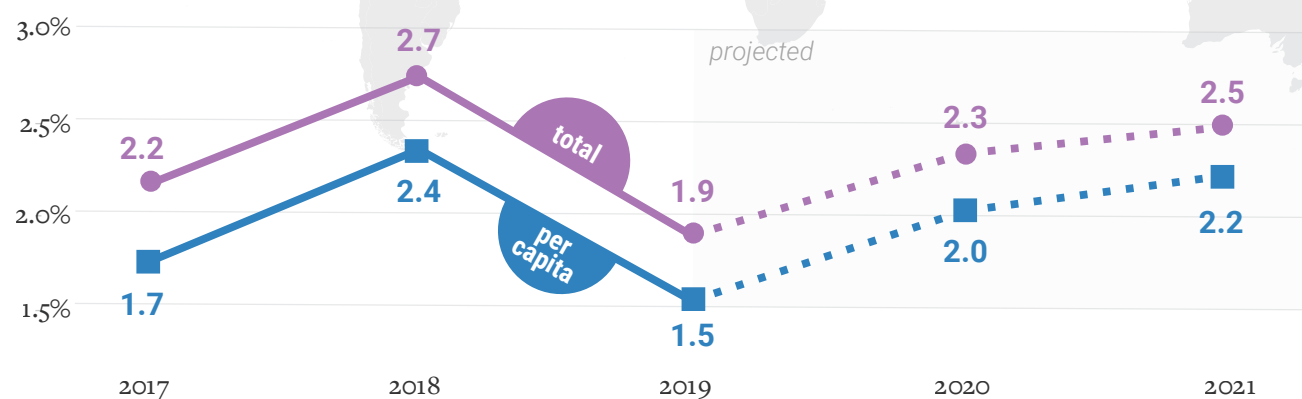
World Economic Situation and Prospects



United Nations
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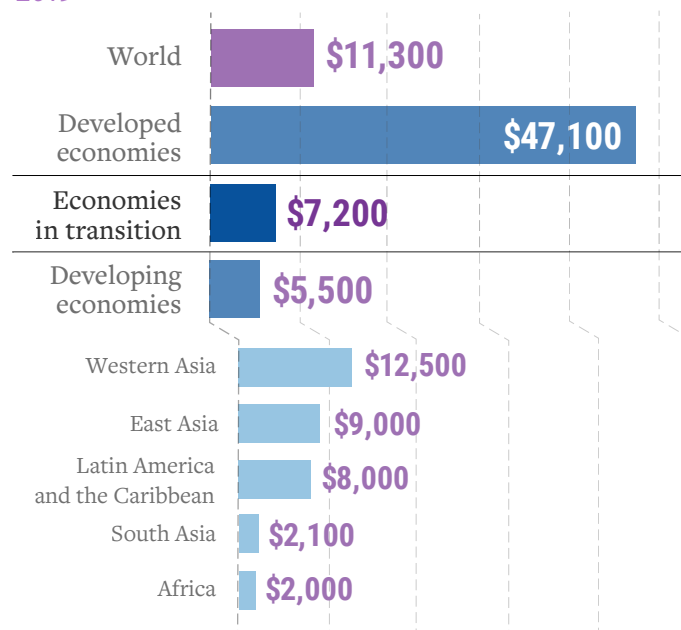
Economies in transition

GDP Growth



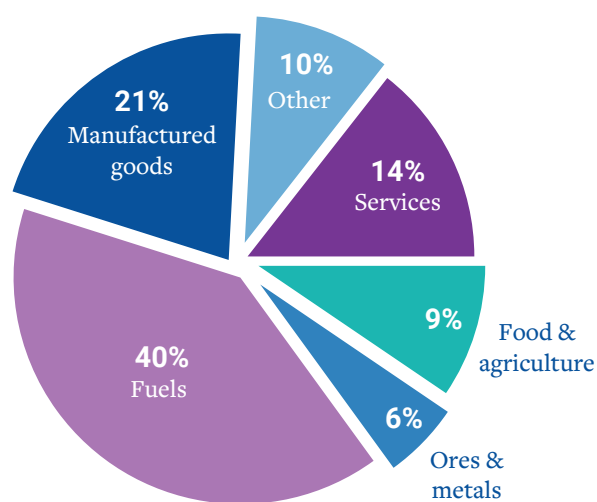
GDP per capita

2019



Export Structure

2018



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Economies in transition

- Aggregate GDP growth in the CIS and Georgia is expected to accelerate in 2020 and 2021.
- The region remains predominantly commodity-dependent and faces the potential for stranded assets down the road.
- In the near term, risks are on the downside.

The Commonwealth of Independent States and Georgia: policy easing in the Russian Federation will support stronger growth

The pace of economic expansion slowed in the Commonwealth of Independent States (CIS) and Georgia in 2019, driven by the marked deceleration in the Russian Federation and the downswing in the terms of trade. Aggregate GDP growth for the region declined to 1.8 per cent in 2019 but is expected to increase modestly to 2.3 per cent in 2020 and 2.4 per cent in 2021.

The economy of the Russian Federation is estimated to have expanded by just 1.1 per cent in 2019. The moderation of economic growth was partly the result of base effects (one-off factors related to energy infrastructure investment bolstered growth in 2018) but also reflected persistently weak consumer demand, partly driven by the VAT rate increase in January 2019. Growth in oil output was curtailed by the production caps agreed with OPEC. Investment growth, boosted by infrastructure spending in the second half of the year, registered a slowdown for 2019 as a whole, and export-oriented sectors outperformed those targeting the domestic market. Among other energy exporters, oilfield repairs dampened oil output in Kazakhstan, but strong domestic demand with rapid growth in construction and services supported estimated GDP growth of 4 per cent, while in Azerbaijan economic activity accelerated thanks to the operationalization of the Southern Gas Corridor and increased natural gas production. In Turkmenistan, the resumption of gas exports to the Russian Federation in April 2019 has improved growth prospects.

Most of the energy-importing CIS countries have enjoyed relatively solid growth. In Ukraine, household consumption was the main driver of growth in 2019, thanks to strengthening consumer confidence and growing real disposable incomes; a strong harvest also contributed to the growth momentum. In Uzbekistan, strong industrial activity, particularly in the construction sector, drove the acceleration of economic growth towards 6 per cent. By contrast, Belarus recorded lacklustre economic performance, with decelerating domestic demand accompanied by a deterioration in the external environment and the suspension of oil flows via the major Druzhba oil pipeline due to contamination; for the year as a whole, GDP growth is estimated at close to 1 per cent. Among the smaller CIS economies, strong domestic demand boosted the services and construction sectors in Armenia, accelerating growth to over 6 per cent, and in Kyrgyzstan, the strengthening of growth to nearly 6 per cent was driven by a jump in gold production.

In spite of the growing challenges characterizing the external environment—including weak energy prices and the further tightening of economic sanctions against the Russian Federation—aggregate growth in the CIS region is expected to accelerate modestly during the period 2020–2021, supported by increased fiscal spending in the Russian Federation in line with the implementation of national development projects and the impact of

Growth in the Russian Federation slowed in 2019...

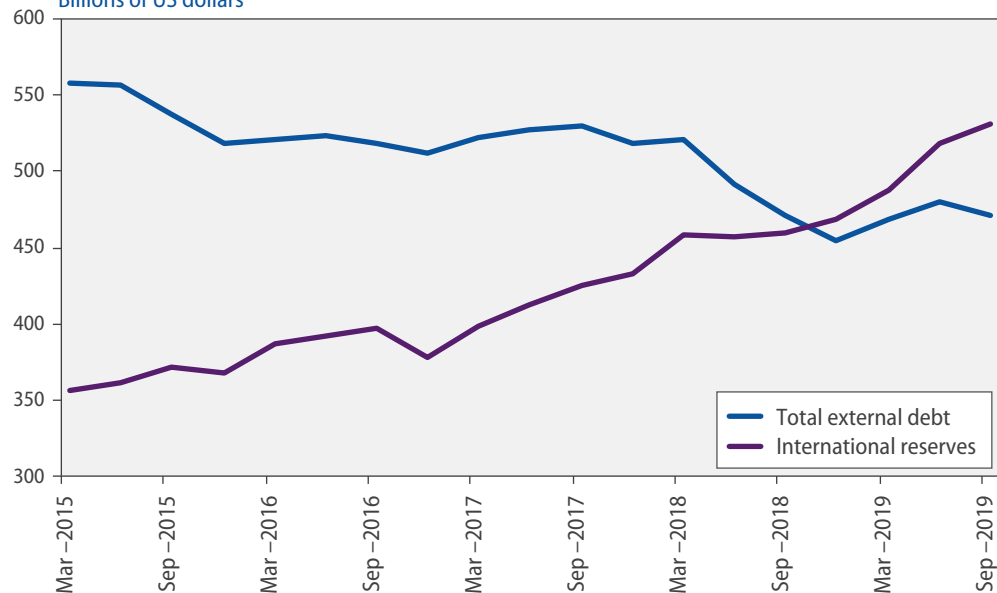
...but increased fiscal spending will support growth in 2020—despite adverse external conditions

monetary easing. In 2019, new sanctions imposed by the United States against the Russian Federation targeted sovereign debt for the first time; however, their scope in this regard remains rather limited. Despite the internal pressures created by the sanctions environment, the improved policy mix of inflation targeting, exchange rate flexibility and the fiscal rule has mitigated the country's vulnerability to oil price fluctuations. Both the current account and the fiscal balance are in surplus, and international reserves exceed total external debt (see figure III.5), as the central bank has continued to buy large quantities of gold and foreign exchange.

Figure III.5

Total external debt and international reserves of the Russian Federation

Billions of US dollars



Source: Central Bank of the Russian Federation.

In Ukraine, despite concluding a new gas transit deal with the Russian Federation that guarantees minimum annual transit volumes for five years, actual gas transit revenue may be volatile. A decline in revenue from transit fees associated with gas flows would negatively affect the balance of payments. The economic outlook in Ukraine is marred by outward labour migration and worker shortages. For Belarus, the near-term outlook depends on whether agreement can be reached on compensatory measures relating to the Russian tax manoeuvre, which replaces oil export duties with a mineral extraction tax. Oil exports from the Russian Federation to Belarus have hitherto been exempted from export duties, and Belarus has also benefited from a lower price for Russian oil in comparison with other importers. Strong growth (above the CIS average) is expected to continue in most countries in Central Asia; the implementation of the Belt and Road Initiative (BRI) should further support the development of energy and transport infrastructure in the region. In some cases, however, the funding of BRI projects is leading to rising debt burdens. Several CIS economies may face financial turbulences as debt repayments become due; in particular, Ukraine has large debt servicing costs over the period 2019–2021 and is expecting further funding from the International Monetary Fund (IMF). To reduce external vulnerability,

countries are seeking to develop local debt markets; in Ukraine, however, the share of government bonds held by foreigners jumped in 2019.

After an initial spike in early 2019 due to the VAT increase, inflation in the Russian Federation followed a declining path, returning to the 4 per cent target of the central bank—largely as a result of sluggish consumer demand, which compelled retailers to absorb price increases. In Ukraine, foreign inflows caused exchange rate appreciation, contributing to disinflation despite rapid growth in real wages and retail sales; however, inflation remains at around 8 per cent. Some other CIS members also recorded high inflation; in Turkmenistan, abolishing the free provision of electricity, gas and other items contributed to price increases, and in Uzbekistan, inflation remained in the double digits because of exchange rate weakness and price liberalization.

Amid falling inflation and low domestic and external demand, the Central Bank of the Russian Federation started cutting interest rates in early 2019. There is still scope for future loosening, given relatively high real rates and the inflation outlook, though fiscal spending plans may constrain further easing. In any case, lower interest rates are unlikely to play a significant role in spurring investment, which has remained weak despite steadily increasing corporate profitability, with many companies hoarding significant cash volumes. The main obstacle to investment is not limited access to finance but rather a lack of business confidence. The National Bank of Ukraine also embarked on monetary easing, even though inflation exceeded its target range. Monetary policy was loosened in Armenia, Azerbaijan, Belarus, Kyrgyzstan and Republic of Moldova as well. In Georgia and Kazakhstan, however, building inflationary pressures led to a tighter monetary stance in the second half of the year. The rapid expansion of consumer lending, especially among the most vulnerable borrowers with higher payment-to-income ratios, has raised concerns among monetary authorities; in Georgia and the Russian Federation, this has prompted a tightening of prudential regulations to constrain the expansion of unsecured household credit.

Unemployment in the Russian Federation hit new lows in 2019, reflecting declines in both the labour force and the number of people in employment; however, informal unemployment remains significant. In Kazakhstan, the slight decline in unemployment has been accompanied by growing employment, and in Uzbekistan, economic expansion has been accompanied by moderate employment growth within the context of a rapidly increasing labour force. In Ukraine and some countries in Central Asia and the Caucasus, outward labour migration provides an alternative to the difficult conditions of local labour markets—which are often compounded by a significant gender gap in labour force participation that limits the potential labour supply.

In the Russian Federation, the fiscal rule adopted earlier to reduce budgetary dependence on hydrocarbon revenues was temporarily relaxed to accommodate increased spending under the national projects programme. However, the fiscal stance in 2019 was broadly neutral; while the fiscal surplus declined as a result of lower oil prices, the surplus still exceeds 2 per cent of GDP. The consolidation of public finances, which significantly reduced federal spending as a share of GDP between 2016 and 2018, is now completed, and the 2020 budget envisages an expansionary shift in fiscal policy, with a particular focus on social spending. Assets in the National Welfare Fund of the Russian Federation are close to exceeding the 7 per cent of GDP threshold, above which the surplus can be spent; this will increase spending capacity by around 1.5 per cent of GDP in 2020, allowing for a countercyclical fiscal expansion. Other energy exporters have been increasing spending as well. In Kazakhstan, the 2019 budget was revised to raise spending on a range of socially oriented initiatives, including wage increases for lower-paid employees and debt relief

Inflation dynamics support monetary policy easing

Labour market situations in the region are diverse

Hydrocarbon exporters are ready to loosen fiscal strings...

for low-income borrowers. Azerbaijan boosted its fiscal position by increasing gas exports, resulting in a higher fiscal surplus; a fiscal rule was introduced in 2019 that will support better management of public finances.

.... while fiscal consolidation continues in most energy-importing countries

Fiscal consolidation continues in Ukraine under the IMF programme, with a further decline in the public debt-to-GDP ratio expected. Armenia is also engaged in ongoing fiscal consolidation efforts in order to meet debt reduction targets. The Russian tax manoeuvre will be implemented gradually over the period 2019–2024, and unless compensation is arranged, Belarus will suffer fiscal losses because of reduced profit margins from refined oil exports, reduced budget transfers obtained from export duties, and lower taxes on oil products.

Risks are largely on the downside

Economic prospects in the region are subject to a number of potential risks. A global slowdown would weaken oil and other commodity prices, affecting remittances to smaller countries, while banking sector vulnerabilities would be exposed by a deterioration in economic conditions. A further intensification of geopolitical tensions would dampen investment and reduce financing options. Meanwhile, the rise of public debt and contingent liabilities in some smaller CIS countries poses risks for exchange rates. Although significant progress has been made in economic diversification, the share of hydrocarbons in the region's exports remains high, with a potential risk of stranded assets over the longer term (see chapter II). All CIS countries face challenges associated with the transition to “green” energy (see box III.1).

South-Eastern Europe: economic growth moderates but remains healthy

Policy-driven income gains should sustain steady growth in Serbia

The pace of economic expansion decelerated in the largest countries in South-Eastern Europe in early 2019, partly due to base effects (a number of one-off factors, including a peak in power generation in Albania and a good harvest in Serbia, contributed to strong performance in 2018). Weak demand from the main trading partners in the European Union also had a dampening influence. Domestic demand is gaining importance in the region; however, internal political uncertainties in Bosnia and Herzegovina curtailed economic activity and access to external financing. In North Macedonia, output accelerated thanks to capital expenditure postponed from 2018. By contrast, Montenegro witnessed a sharp slowdown in investment, and the expected completion of major infrastructure projects may dampen investment further in 2020. Looking forward, in Serbia, employment gains and rises in pensions, public sector salaries and the minimum wage, along with increased government spending, should support growth at between 3 and 4 per cent over the forecast horizon. Similar growth rates are projected elsewhere in the region. Aggregate GDP in South-Eastern Europe is expected to grow by 3.4 per cent in 2020 and 2021.

Inflationary pressures are contained, while labour markets remain a key weakness

Inflationary pressures within the region remain well contained. In Albania, currency appreciation has kept inflation below the lower end of the official target. In Montenegro, the fading of the impact of indirect tax increases in 2018 prompted disinflation. In Serbia, after an uptick early in 2019, inflation has moderated and remains well within the target range. With low inflation, monetary policies have remained accommodative; the National Bank of Serbia reduced its policy rate to a record low of 2.25 per cent in 2019. The region's labour market situation remains difficult, despite the tangible progress achieved in recent years. Relatively high levels of unemployment, especially in Bosnia and Herzegovina, coexist with large gender gaps and a shortage of skilled labour. The informal share of the economy remains large, undermining the ability of Governments to raise fiscal revenues.

Box III.1

Potential benefits of the energy transition in the Commonwealth of Independent States and Georgia

A global energy transition seeking to reduce greenhouse gas emissions and the environmental impact of economic activity is shifting energy demand patterns and influencing technological change. Such a transformation is bound to raise challenges for fossil fuel exporters in the CIS. However, the transition will also bring opportunities to advance sustainable development through improved energy efficiency and the use of cleaner fuels.

Fossil fuels play an outside role, with significant welfare costs

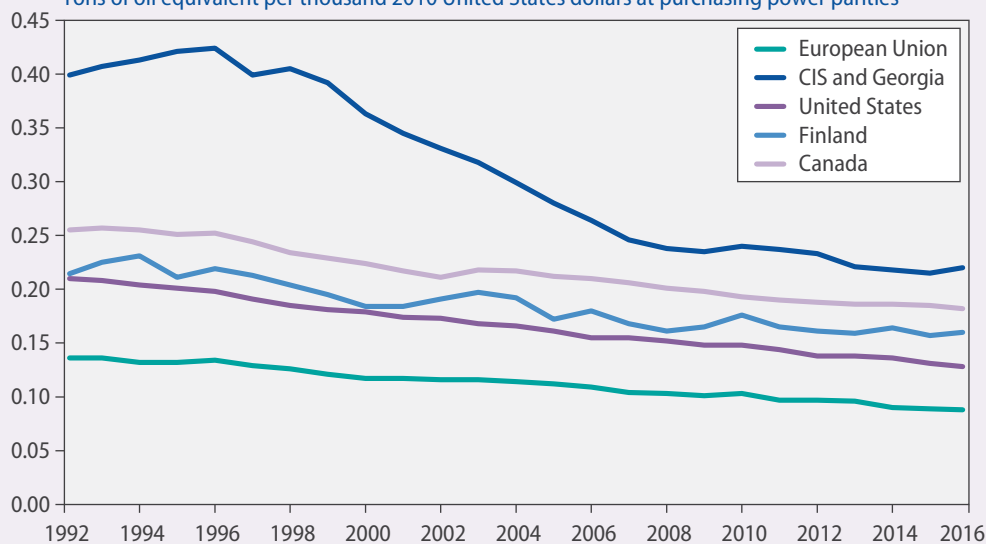
High levels of energy consumption per unit of GDP are characteristic of both energy-exporting and energy-importing countries in the region (see box figure III.1.1). At the outset of the transition, high consumption rates were a reflection of weak incentives for energy saving, given the pricing and availability of energy resources and the structure of the economy. Energy efficiency improved dramatically as relative prices were adjusted towards global market levels. Higher capacity-utilization rates and the shift towards less-energy-intensive sectors drove the rapid decline in energy consumption per unit of GDP observed in the decade prior to the global financial crisis. However, energy intensity remains comparatively high, even when taking into account the cold climate and the length of transport infrastructure as a result of low population density.

Almost 90 per cent of primary energy consumption in the CIS and Georgia comes from fossil fuels, which emit a number of air pollutants when burning that are harmful to public health. Coal, which is particularly polluting, accounts for close to 15 per cent of the total. With this energy mix, poor energy efficiency has negative implications for air quality and health. The welfare cost of premature deaths due to ambient particulate matter is rather high in the region (see box figure III.1.2). In addition to contributing to climate change mitigation, reducing the use of fossil fuels through increased efficiency or shifts towards cleaner fuels brings additional benefits that can be locally captured. These include not only improved health outcomes but also increased competitiveness and export capacity.

Figure III.1.1

Total primary energy supply to GDP ratio

Tons of oil equivalent per thousand 2010 United States dollars at purchasing power parities

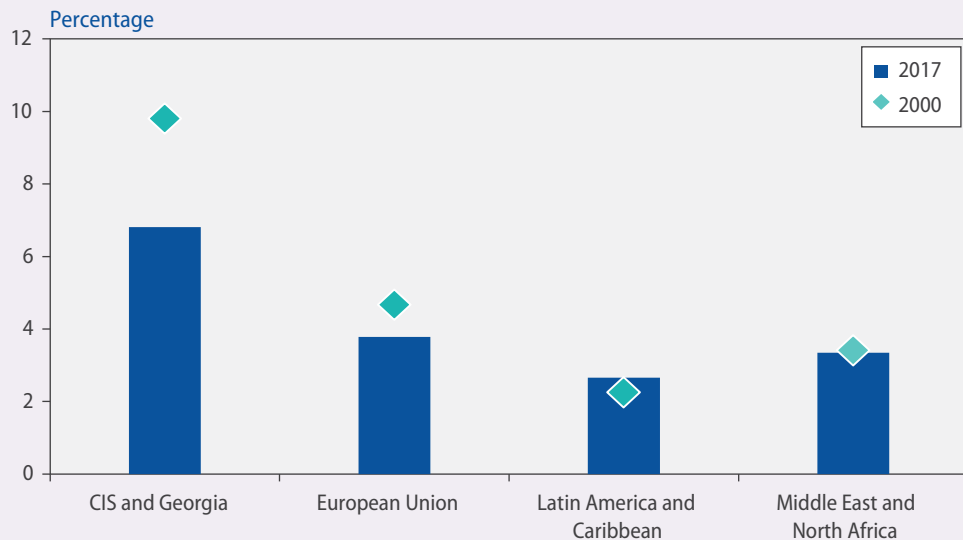


Source: International Energy Agency (IEA), World Energy Balances and Statistics database.

(continued)

Box III.1 (continued)

Figure III.1.2

Welfare cost of premature deaths due to ambient particulate matter as a percentage of GDP

Source: OECD.Stat database.

Bringing about change: adjusting price signals to increase energy efficiency and shift the energy mix

Given the departing situation, the scope for improving energy efficiency and shifting towards cleaner fuels appears substantial. Recent policy efforts have focused on increasing energy efficiency in residential buildings, which account for more than one quarter of final energy consumption. However, price signals have so far not been sufficiently strong to encourage energy efficiency investments, and access to financing for retrofitting remains a constraint in many countries.

Fossil-fuel consumption subsidies, including those related to electricity generation, remain high in the CIS region (see box figure III.1.3), disincentivizing rapid improvements in energy efficiency. Subsidies are present in Ukraine, an energy importer, though significant price adjustments have taken place in recent years. In the Russian Federation, subsidies as a percentage of GDP are low relative to those in other CIS countries and other energy-exporting countries outside the region. In Turkmenistan, the provision of free natural gas, electricity and water to the population was gradually reduced and finally discontinued as of 2019. Overall, policy changes in the region support subsidy reduction. Lowering fossil-fuel energy subsidies encourages efficiency and shifts towards cleaner fuels—though complementary targeted measures to protect the most vulnerable are also required.

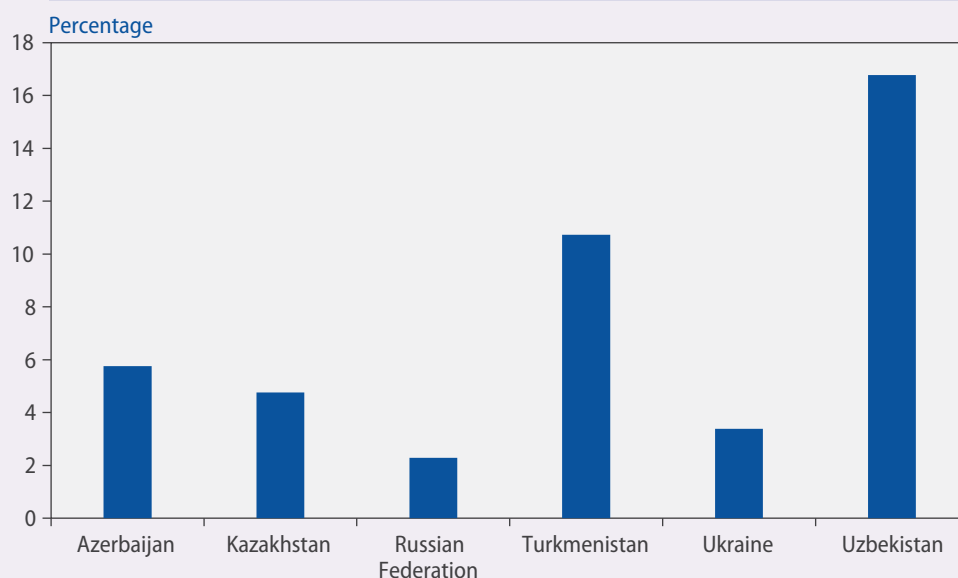
The ongoing reform of oil sector taxation in the Russian Federation—the so-called tax manoeuvre—seeks to eliminate export duties by 2024 and replace them with mineral extraction taxes. Export duties allow domestic prices to remain below global prices, and the tax changes were intended to reduce implicit subsidies in domestic consumption. However, the original aim has been partly undermined by a complex system of subsidies to support domestic refining and dampen the growth of domestic fuel prices. In the absence of compensatory measures, the projected changes in energy taxation in the Russian Federation have negative implications for Belarus in particular; as a member of the Eurasian Economic Union (EAEU), Belarus has benefited from imports of crude oil free of export duty, most of which is refined and re-exported. The formation of the future EAEU common energy market will be an important force shaping energy exchanges and incentives for a greener economy in the region.

Renewable energy: harnessing significant growth potential

Alongside energy efficiency gains, changes in the energy mix offer new development opportunities. Renewable sources presently account for a small share of the energy supply and are largely limited to hydro

(continued)

Figure III.1.3

Fossil-fuel consumption subsidies as a percentage of GDP, 2018

Box III.1 (continued)

Source: IEA (2019a).

energy. Large reserves of fossil fuels, relatively low domestic prices and, until recently, weak policy support have provided little incentive to transform the region's energy industry and infrastructure. However, interest in developing the unrealized potential of renewable energy sources is growing, and new policy frameworks have emerged in some countries. Such development can increase export capacity, contribute to technological advancement, and offer new drivers for regional development, including in remote locations with costly grid connections. In energy-importing countries in Central Asia, the potential for hydropower development is significant. Policies to support this transformation should incorporate suitable incentives through appropriate pricing, address financing constraints, and activate the strategic role of public investments to facilitate the development of renewable energy.

Overall, while the speed of the energy transition remains uncertain, the global decarbonization trend points towards a growing urgency to foster economic diversification and move away from excessive hydrocarbon dependence.

Author: José Palacín
(UNECE).

Public debt remains elevated in most countries in the region, though it has continued to decline as a result of fiscal consolidation efforts, robust growth and improved financing conditions. State-owned enterprises are a source of fiscal risk. In addition, persistent current account deficits remain a structural problem for some countries—most notably Montenegro, in spite of its increased export capacity and growing tourism sector. Overall, the region remains dependent on foreign financing.

Because economic prospects in the region are closely tied to developments in the European Union, its main trading and investment partner, faltering economic performance in the latter remains a major source of risk. Depopulation in the region—especially outflows of youth and skilled workers—is impeding the shift towards higher-skilled industries. Increasing dependency ratios pose serious challenges to growth prospects and the ability to cover future pension needs. Disappointing progress in the process of accession to the European Union may undermine fragile political stability and weaken economic prospects.

Fiscal consolidation remains a challenge in the presence of high debt levels

A downturn in the European Union represents a major source of risk