MACROECONOMIC OVERVIEW

After five consecutive years of economic slow-down, the average annual growth rate in the EBRD region rose to 1.9 per cent in 2016. Nevertheless, that rate remains below the average for a group of comparator economies with similar characteristics. The stronger growth recorded in 2016, which continued in the first few months of 2017, reflects recoveries in the prices of oil and other commodities, which have supported growth in Russia, Central Asia, and eastern Europe and the Caucasus. In contrast, lower revenue from tourism, partly due to security concerns and geopolitical risks, continues to weigh on the economic outlook for the southern and eastern Mediterranean region. Growth in EBRD countries of operations is expected to strengthen further in 2017 and 2018.

1.9%

AVERAGE ANNUAL GROWTH RATE IN THE EBRD REGION IN 2016, UP FROM 1.3% IN 2015

8

NUMBER OF ECONOMIES IN THE EBRD REGION THAT OUTPERFORMED THEIR EMERGING MARKET PEERS BY AT LEAST 1 PERCENTAGE POINT IN TERMS OF GROWTH IN 2016

3%

AVERAGE DEPRECIATION IN THE EBRD REGION'S CURRENCIES AGAINST THE US DOLLAR IN NOVEMBER/ DECEMBER 2016

Growth from a comparative perspective

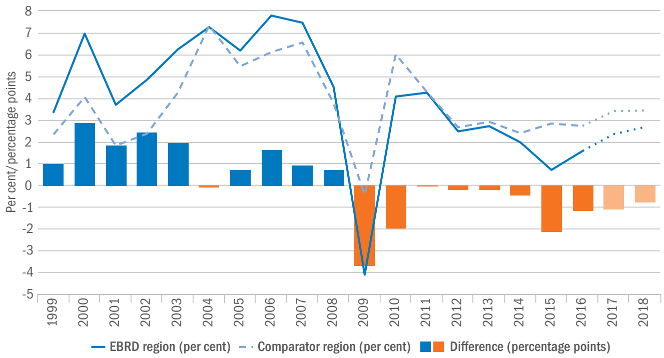
The average annual growth rate in the EBRD region rose to 1.9 per cent in 2016, up from 1.3 per cent – the lowest rate since 2009 – in 2015. This was the first increase in average annual growth since 2010. This upward trend is forecast to continue, as discussed in the latest issue of *Regional Economic Prospects in EBRD Countries of Operations*.[1] However, economic growth is expected to remain modest in 2017 and 2018 – both by historical standards and relative to a group of comparator countries with similar levels of economic development.

Since 2009, average annual growth in the EBRD region has consistently been below the global average as well as the average for a group of countries of similar size with comparable income per capita (see Chart M.1). As in Chapter 1, the calculation here is based on a modified synthetic control method. For each country, a synthetic comparator is calculated as a weighted average of the growth rates of other economies in that year. Those weights are, in turn, based on countries' similarity in terms of their economic characteristics.[2]

Relative to its synthetic comparator, the EBRD region was worse affected by the 2008-09 financial crisis and has subsequently recorded weaker average annual growth every year.[3] In 2016, however, the gap between the EBRD region's average annual growth rate and that of the comparator region narrowed somewhat relative to 2015 – the combined result of stronger economic growth in the EBRD region and moderate growth in a number of other emerging markets, notably in Latin America.

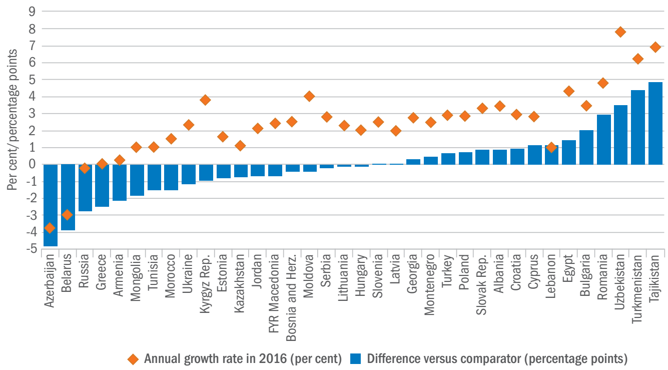
Looking at individual countries where the EBRD invests, eight economies outperformed their reference groups by at least 1 percentage point (see Chart M.2). Indeed, five countries outperformed their comparators by more than 2 percentage points: three Central Asian economies (namely, Tajikistan, Turkmenistan and Uzbekistan), plus Bulgaria and Romania. At the other end of the spectrum, several economies had negative gaps of more than 2 percentage points relative to their comparators: three countries in eastern Europe and the Caucasus (EEC; namely, Armenia, Azerbaijan and Belarus), plus Greece and Russia. On the basis of projections as at 1 October 2017, the gap between the EBRD region and the comparator economies is expected to narrow further in 2017 and 2018, but not to disappear completely.

CHART M.1. Average annual growth rates in the EBRD region and a comparator region



Source: IMF and authors' calculations.
Note: Weighted on the basis of GDP at PPP; figures for 2017 and 2018 are based on IMF and EBRD forecasts as at 1 October 2017.

CHART M.2. Economic growth relative to comparators



Source: IMF and authors' calculations.

[1] This publication presents the latest economic forecasts for all EBRD countries of operations.
[2] See Abadie et al. (2010).
[3] The calculation is conducted as follows. For each economy, the reference group comprises countries that are broadly similar in terms of GDP per capita and population, weighted on the basis of differences in income per capita and population size (see Chapter 1 for a more detailed discussion). For example, the economies with the largest weights in Egypt's reference group include Indonesia, Peru and Sri Lanka. Weights for the EBRD region's economies based on GDP at purchasing power parity (PPP) are then applied to the growth rates of the comparators for each country in order to construct a comparator for the EBRD region as a whole.

Global economic environment

Since mid-2016, the global economic environment has been characterised by increased political uncertainty, combined with robust investor confidence. Economic policy uncertainty has increased as a result of the new administration taking office in the United States of America following the November 2016 presidential election and the United Kingdom officially serving notice of its intention to exit the European Union (with its two-year countdown starting on 29 March 2017).[4]

At the same time, financial markets have remained broadly sanguine. Equities have performed strongly in advanced and emerging market economies alike, with markets pricing in the anticipated benefits of future tax reform in the USA and the positive impact that a stronger US economy is expected to have on the rest of the world. Equities have also performed well in emerging Europe. In advanced economies, financial stocks initially rallied strongly following the US election, but those gains have since been partially reversed, with the prospects for comprehensive financial deregulation being reassessed in light of the impasse over health care reform in the USA. Stock market volatility has been low for a considerable period of time (the longest since 2013, in fact), both in advanced markets and in the EBRD region.

In advanced economies, marked improvements have been seen in indicators of business and consumer confidence and purchasing managers indices. These improvements have been much larger than the changes observed in "hard" data on GDP, sales volumes and industrial production. The strongest contrast between confidence-based and production-based indicators can be seen in the USA, where businesses and consumers appear to be positive about the new administration's expected future policies (including tax cuts, additional infrastructure spending, and deregulation in the financial sector and other industries).

This surge in confidence has not, however, translated into improvements in indicators of output. Indeed, the annual growth rate of global GDP remains modest by historical standards, falling from 3.4 per cent in 2015 to 3.2 per cent in 2016. The annual growth rate in the euro area has also remained broadly stable, fluctuating between 1.8 per cent and 2 per cent between 2015 and the first quarter of 2017. On the other hand, the ongoing weakness of investment spending and international trade has continued to weigh on the outlook for global growth, and credit growth in the USA has weakened markedly.

In advanced markets, the result of the US presidential election on 9 November 2016 also led to a rise in bond yields, which returned to the levels observed prior to the United Kingdom voting to leave the EU in June 2016. Markets swiftly priced in the expected impact of a looser fiscal stance and tighter monetary policy in the USA. In line with market expectations, the US Federal Reserve System raised its policy rate by 0.25 percentage points in December 2016, March 2017 and June 2017, with the target range for that rate now standing at 1-1.25 per cent. Markets expect further gradual tightening – one rate rise in 2018 and another in 2019 – as the US economy benefits from the anticipated fiscal stimulus.

At the same time, spreads between yields on bonds issued by higher-risk emerging market borrowers and yields on US Treasury bonds have declined as investors' search for yield has intensified. Capital flows to emerging markets have strengthened on average, notwithstanding some fluctuation. This suggests that monetary tightening in advanced economies has been implemented more slowly than investors were anticipating. As a result, the currencies of emerging markets have reversed some or all of their post-election losses against the US dollar, with the notable exception of the Turkish lira. Several countries in the EBRD region, including Egypt, have taken advantage of the relatively benign conditions in global financial markets by issuing sovereign bonds at favourable rates.

The European Central Bank (ECB) has maintained its accommodative stance for the time being. Its quantitative easing (QE) programme has been extended by nine months and is now scheduled to run until end-2017, although its monthly asset purchases have been scaled back from €80 billion to €60 billion. Discussions regarding possible future tapering of the ECB's QE programme resulted in the euro strengthening against the US dollar in mid-2017 and reaching its highest level since early 2015.

Oil prices have remained broadly stable, with the price of Brent crude oil fluctuating between US$ 45 and US$ 55 per barrel between mid-2016 and mid-2017. This price level appears to be sufficient to sustain the profitability of some shale oil producers in the USA. The agreement in principle to cut production that was reached by the Organization of the Petroleum Exporting Countries (OPEC) and a number of other oil producers in late 2016 has reduced downward pressure on oil prices. That agreement has since been extended.

The economic outlook for the EBRD region remains materially affected by terrorism, geopolitical tensions and the refugee crisis. Over the past year, Egypt, Jordan, Russia and Turkey have experienced several terrorist attacks, while Syria remains in the grip of a major humanitarian crisis.

Growth performance in the region

The difference between the east and west of the EBRD region in terms of the economic outlook has narrowed since 2016. Increases have been seen in the price of oil following the lows of the first half of 2016 (with Brent crude oil averaging US$ 52 per barrel in the first half of 2017, compared with US$ 40 per barrel in the first half of 2016), benefiting Russia, other commodity exporters, and countries in Central Asia and the EEC region that rely on Russia as a major source of remittances and/or export demand. In contrast, average growth in central Europe and the Baltic states (CEB) and the southern and eastern Mediterranean (SEMED) region declined in 2016, falling by around 0.6 percentage points relative to 2015.

Whereas growth in CEB picked up slightly in the second half of 2016, it averaged only 2.6 per cent for the year as a whole,

[4] See https://fred.stlouisfed.org/ based on the methodology developed by Baker et al. (2015).

down from 3.4 per cent in 2015. That slow-down was due mainly to weak private and public investment, partly reflecting reduced utilisation of EU investment funds during that period. Consumption, on the other hand, has been growing at a steady pace. Growth increased to around 4 per cent year on year in the first half of 2017 on the back of a strong performance by the CEB region's largest economy, Poland, where output growth was boosted by stronger investment activity and an increase in social welfare payments. The Baltic states, Hungary and Slovenia also saw stronger economic growth in the first half of 2017.

More generally, investment activity has remained relatively weak across the EBRD region, with little sign of investment-to-GDP ratios moving back towards the levels that prevailed prior to the 2008-09 financial crisis (see Chart M.3). This reflects the weakness of the economic outlook, the slow utilisation of EU structural and cohesion funds in several countries in the CEB region and south-eastern Europe (SEE), and financing constraints caused by the relatively low levels of domestic savings in many economies. Domestic savings are, in turn, being negatively affected by rapid population ageing in emerging Europe (see Chart M.4), which is putting pressure on government spending. Thus, concerns remain about the potential for a vicious circle whereby a weaker long-term economic outlook depresses investment, and low investment, in turn, further weakens the long-term outlook.

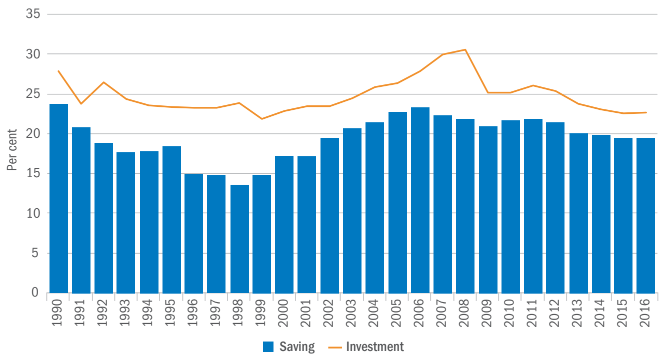
Some of the decline seen in investment-to-GDP ratios may be due to structural shifts in the global economy. Investment goods have become cheaper, so replacing capital stock now requires lower levels of spending. In addition, production has been shifting towards less investment-intensive *services* and away from more investment-intensive *activities* such as manufacturing and mining.[5]

Growth in the SEE region has remained steady, averaging 2.9 per cent in 2016 and 3.3 per cent year on year in the first half of 2017. In Romania, however, the annual growth rate rose to more than 5 per cent in 2016 and the first half of 2017, driven by private consumption and an accommodative fiscal stance. Growth has also picked up in the Western Balkans, supported by a gradual resumption of credit growth and a number of major infrastructure projects. Meanwhile, the Cypriot economy has exceeded expectations, achieving an annual growth rate of 2.8 per cent in 2016. In Greece, however, output stagnated in 2016 as a whole, with only modest year-on-year growth being recorded in the first half of 2017.

The gradual economic recoveries under way in Moldova and Ukraine have continued. However, recessions in Azerbaijan and Belarus resulted in output for the EEC region as a whole stagnating in 2016. Growth in the EEC region rose to close to 1.5 per cent year on year in the first half of 2017, with growth turning positive in Belarus and the recovery in Ukraine gaining further momentum.

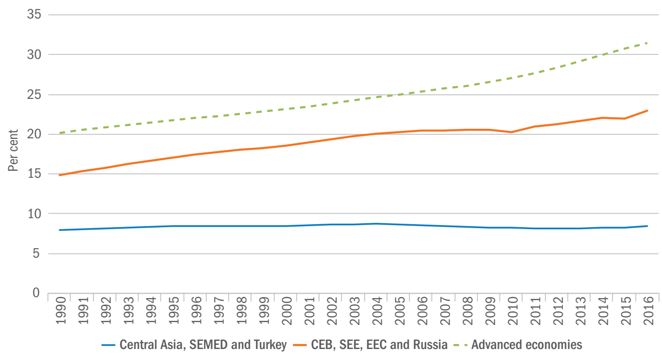
Turkey's annual growth rate fell to 3.2 per cent in 2016, down from 6.1 per cent in 2015. While a 30 per cent increase in the minimum wage in January 2016 boosted private consumption throughout the year, growth in 2016 was hit by a combination of

CHART M.3. Investment and saving in the EBRD region as a percentage of GDP



Source: IMF and authors' calculations.
Note: Data represent unweighted averages for the EBRD region as a whole.

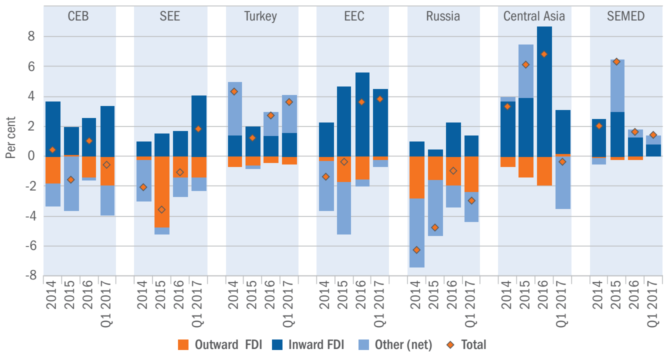
CHART M.4. Old-age dependency ratios



Source: IMF and authors' calculations.
Note: Data represent unweighted averages across countries. The old-age dependency ratio is the population aged 65 and over as a percentage of the population aged 15 to 64.

[5] See also World Bank (2017) for a discussion of this issue.

CHART M.5. Capital flows as a percentage of GDP



Source: National authorities via CEIC Data and authors' calculations.
Note: Averages are weighted by GDP. Capital flows are calculated as changes in foreign assets and liabilities. Data for Turkmenistan and Uzbekistan are not available.

sharp declines in tourism revenue, Russian sanctions and geopolitical tensions in the Middle East. Weak consumption and investment following the attempted military coup in July 2016 compounded these problems and contributed to a weakening of the lira. The introduction of various stimulus measures towards the end of 2016, including a TRY 250 billion (US$ 71 billion equivalent) Credit Guarantee Fund for small and medium-sized enterprises and various tax incentives, helped growth to recover to around 5 per cent year on year in the first half of 2017.

Russia's economy has now returned to growth, following a cumulative contraction of around 3 per cent in 2015-16, with output expanding at a rate of 1.5 per cent year on year in the first half of 2017. At the same time, investment activity remains constrained by economic uncertainty, perceived weaknesses in terms of the country's investment climate and relatively high financing costs, in addition to the global and region-wide factors discussed earlier.

The annual growth rate in Central Asia remained broadly unchanged at around 3.5 per cent in 2016. It has since showed signs of picking up again, with growth averaging around 5 per cent year on year in the first half of 2017 on the back of higher commodity prices (relative to the first half of 2016) and the improved economic outlook in Russia.

The annual growth rate in the SEMED region fell to 3.4 per cent in 2016 as high levels of inflation adversely affected consumption in Egypt, tourism revenue declined in Jordan, Morocco experienced a weak harvest, and the implementation of reforms was delayed in Tunisia. In the first half of 2017, growth averaged around 4 per cent year on year for the region as a whole, with Morocco and Tunisia regaining momentum.

Capital flows

Capital flows to emerging markets strengthened in the first few months of 2017, despite the gradual tightening of monetary policy in the USA. This probably reflects the fact that rate rises to date have been fully priced in by the markets and the pace of monetary tightening has, if anything, been slower than expected.

Bond and equity inflows in the EBRD region also strengthened in the first few months of 2017, in line with global trends, before moderating over the summer. Russia has been one of the main beneficiaries of these flows. Meanwhile, non-foreign direct investment outflows have moderated markedly relative to the levels observed in 2014-15 (see Chart M.5). Foreign direct investment (FDI) inflows in the EBRD region have remained broadly stable. Turkey remains heavily reliant on both FDI and non-FDI capital inflows – in roughly equal measure – to finance its persistent current account deficit.

Currency movements

In the aftermath of the US election, the region's currencies initially weakened against the US dollar, losing an average of around 3 per cent of their value in November and December 2016. The direction of currency movements changed in early 2017, and by April 2017 those post-election declines had been fully reversed in most countries. Those fluctuations also mirrored broader trends relating to the euro and the currencies of other advanced economies and emerging markets.

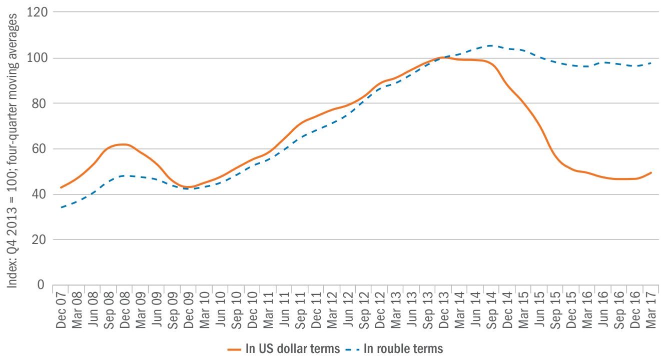
The currencies of commodity exporters – the Azerbaijani manat, the Kazakh tenge and the Russian rouble – strengthened overall as oil prices stabilised at around US$ 45-55 per barrel of Brent crude. While the tenge moved broadly in line with the price of Brent crude, the appreciation of the rouble in the second half of 2016 and the first four months of 2017 was stronger than oil price rises and the replenishment of Russia's international reserves would suggest. This, in part, reflected capital inflows in Russia's bond and equity markets.

In contrast, the Turkish lira weakened significantly against the US dollar in the fourth quarter of 2016. It has since recovered some of those losses, but in early August 2017 its value remained around 17 per cent lower than that recorded in August 2016. While Egypt and Uzbekistan liberalised their exchange rate regimes in November 2016 and September 2017, respectively, the gap between official and unofficial exchange rates has widened in Tajikistan and Turkmenistan.

Remittances

Remittances from Russia to Central Asia and the EEC region stabilised in US dollar terms towards the end of 2016 as the Russian economy returned to growth and the rouble appreciated in line with oil prices (see Chart M.6, which plots four-quarter moving averages of the levels of remittances). Remittances started to increase again in the first quarter of 2017, rising 37 per cent year on year, compared with a 19 per cent contraction a year earlier. Following three years of declines, the total value of remittances in the first quarter of 2017 was, in US dollar terms, less than 60 per cent of the value recorded four years earlier.

CHART M.6. Remittances from Russia to Central Asia and the EEC region



Source: Central Bank of Russia and authors' calculations.

Credit conditions

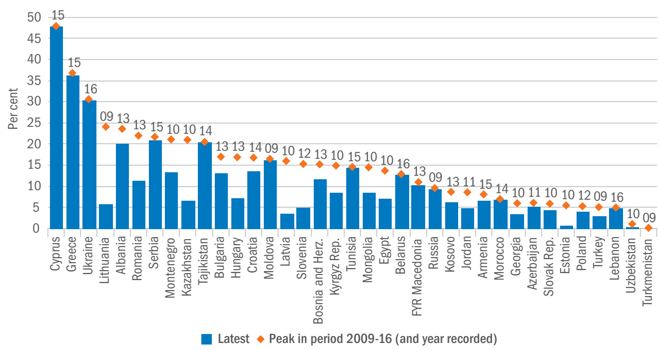
Credit conditions in the EBRD region in mid-2017 were broadly unchanged compared with a year earlier. In most countries, real credit growth (that is to say, credit growth adjusted for inflation and exchange rate movements) remained modest or negative, with the notable exceptions of Georgia, Kosovo and the Slovak Republic. In Turkey, the expansion of the Credit Guarantee Fund resulted in annualised credit growth rates of around 20 per cent in the first few months of 2017. Credit continued to contract in real terms in countries such as Azerbaijan, Belarus, Cyprus, Greece, Moldova, Tajikistan and Ukraine, reflecting weak bank balance sheets in those economies.

In around two-thirds of all countries in the EBRD region, non-performing loan (NPL) ratios – that is to say, NPLs as a percentage of total loans – peaked in double digits following the 2008-09 financial crisis (see Chart M.7). In half of those economies, NPL ratios peaked at levels close to or above 20 per cent.

In most countries, NPL ratios continued rising for a few years after the crisis, before peaking and starting to decline. There are, however, a number of exceptions in this regard. In the Baltic states, for example, NPL ratios peaked early and have now declined to around 5 per cent or less. In contrast, in several economies in the EEC region and Central Asia, NPL ratios have risen further recently, reflecting slow-downs in those economies on the back of the recent recession in Russia and declines in commodity prices.

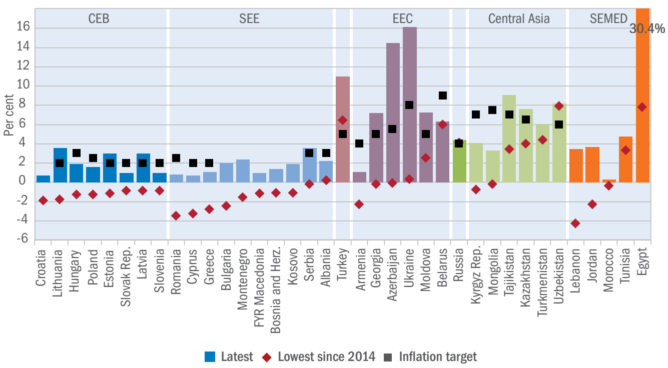
Post-peak declines in NPL ratios have tended to be modest, with NPL levels remaining elevated across much of the EBRD region. Among countries with high NPL ratios, the median post-peak decline is 3 percentage points, while the median peak ratio is around 16.5 per cent (the corresponding mean values are around 3.5 percentage points and 15 per cent, respectively). Countries that have reduced their NPL ratios by a third or more relative to their respective peak values include the Baltic states, Egypt, Hungary, Kazakhstan, the Kyrgyz Republic and Romania. Those reductions were facilitated by a combination of specific policies, the establishment of special-purpose vehicles for managing NPLs, and improvements to the economic outlook. In contrast, NPL ratios are still in excess of 30 per cent in Cyprus, Greece and Ukraine.

CHART M.7. NPL ratios now and at their peak



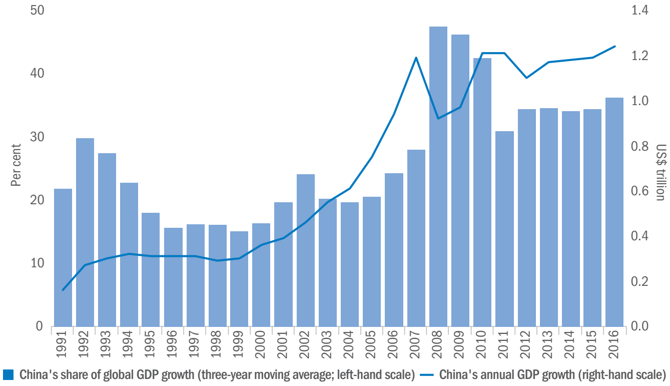
Source: National authorities via CEIC Data and authors' calculations.
Note: Peaks relate to the period 2009-16.

CHART M.8. Consumer price inflation in the EBRD region



Source: National authorities via CEIC Data and authors' calculations.

CHART M.9. China's annual GDP growth in US dollars at PPP



Source: IMF and authors' calculations.
Note: Annual increases in China's GDP are calculated by multiplying its growth rate and its GDP for the previous year. GDP is measured at PPP in 2011 prices.

Inflation

Since mid-2016, inflation has turned positive in a number of countries in central and south-eastern Europe that were previously experiencing deflation (see Chart M.8), with inflation rates rising towards average levels for emerging markets. This has been driven by increases in oil and energy prices relative to a year ago, as well as tighter labour market conditions in CEB economies. In Russia, inflation has fallen towards the central bank's target of 4 per cent, with the rouble strengthening and economic activity remaining weak. In contrast, inflation rates in Azerbaijan, Egypt, Turkey and Ukraine remained close to or above 10 per cent in July 2017, largely reflecting the weakening of their respective currencies.

3.5
percentage points
AVERAGE POST-PEAK DECLINE IN NPL RATIOS IN THE EBRD REGION

Risks to the economic outlook

The global economic environment remains challenging, with significant downside risks for economies in the EBRD region. (For a summary of the latest economic forecasts, see the most recent issue of *Regional Economic Prospects in EBRD Countries of Operations*.)

Geopolitical tensions and security threats are weighing on tourist numbers and investor confidence in a number of countries. In addition, significant uncertainty continues to surround the trade policies of the world's largest economies.

China, which is by far the most important contributor to global GDP growth, faces multiple policy challenges as its economy continues its rebalancing process, with its service sector and domestic consumption now playing a greater role in the economy. These include moderating the pace of credit expansion and reducing excess capacity in certain mining and manufacturing sectors and narrowly specialised towns. When expressed in trillions of US dollars at PPP in 2011 prices, China's annual GDP growth has been broadly constant since 2007, as its slow down in growth has been offset by the increasing size of its economy (see Chart M.9). This has provided a source of stability in terms of global demand. Were China to experience a credit crunch or a decline in the US dollar value of its annual GDP growth, that could create considerable headwinds for the global economy (see Box M.1).

Oil prices represent a major source of risk for Russia, as well as countries in the EEC region and Central Asia that have close economic ties to Russia. Were oil prices to fall back towards the levels observed in January 2016, that would have a significant impact on those economies. A faster-than-expected tapering of asset purchases by the ECB may have a profound impact on leveraged households and corporations across Europe.

Box M.1. The potential impact of a Chinese credit crunch on growth in the EBRD region

Since 2009, China has seen very strong growth in household and corporate credit. Total credit to China's non-financial private sector is now in excess of 220 per cent of GDP and significantly higher than the level that would be expected on the basis of economic fundamentals, according to recent analysis by the Bank for International Settlements (BIS).[6] This raises concerns as to whether China's current growth performance is excessively reliant on exponential increases in domestic credit.

At the same time, analysis by the Institute of International Finance shows that credit growth and quarterly GDP growth are negatively correlated in China, which is unusual in emerging markets.[7] This partly reflects the fact that the rapid credit growth observed in China since 2008 has coincided with a gradual slow-down in GDP growth. In fact, the easing of credit conditions could be seen as part of the policy package adopted in response to a weaker outlook for growth.

It is therefore interesting to look at the impact that a sharp weakening of Chinese credit growth could potentially have on the economies of the EBRD region, supplementing the analysis of the potential impact of a slow-down in China that was carried out in last year's *Transition Report*.[8] As before, spillover effects are estimated on the basis of a global vector autoregressive (GVAR) model. This model encompasses countries accounting for more than 90 per cent of global GDP and captures various channels for economic stress, modelling its transmission through international trade, financial markets and global commodity prices, both directly and through third-party economies. For each country, the external variables in the estimation represent weighted averages of estimates of domestic variables for other countries, whereby weights are based on bilateral links in terms of trade, investment and remittances.[9]

These estimates suggest that a credit crunch in China – modelled as a one-off 10 percentage point decline in quarter-on-quarter credit growth, which represents a large shock corresponding to four standard deviations of historical credit growth – would have a major impact on GDP growth in the EBRD region (see Chart M.1.1).

A credit shock of that size results in GDP growth rates declining by approximately 3-5 percentage points in Central Asia, the EEC and SEE regions, Turkey and Russia relative to a scenario with no shock to Chinese credit growth. This impact materialises within three quarters and is statistically significant. Moreover, that lost output is only partially recovered in subsequent years, with the level of output remaining around 1-1.5 percentage points lower compared with the baseline four years after the initial shock (with that impact remaining statistically significant in some cases). The impact on the CEB and SEMED regions is substantially weaker, reflecting China's less significant role as an investor, lender and trading partner in those regions.

These large spillover effects come about via multiple transmission channels, notably the important role that domestic credit plays in the funding of overseas direct investment by Chinese companies. To the extent that the model assumes that China's GDP growth is, if anything, negatively correlated with credit growth, those estimates are in fact conservative. On the other hand, the GVAR model makes no assumptions about policy responses to the credit crunch, and in that sense, it may overstate the impact on other economies. Regardless of the precise estimates, a potential credit crunch in China appears to be a significant source of risk for the economies of the EBRD region.

CHART M.1.1. Impact of a 10 percentage point decline in Chinese credit growth on GDP in the EBRD region

Source: Authors' calculations.
Note: Based on a GVAR model.

TOTAL CREDIT TO CHINA'S NON-FINANCIAL PRIVATE SECTOR IS NOW IN EXCESS OF

220%

OF GDP

[6] See BIS (2017).
[7] See IIF (2017).
[8] See EBRD (2016).
[9] See Dées et al. (2007) for a discussion of the GVAR approach. Domestic variables include GDP, inflation, exchange rates, equity market indices and both short and long-term interest rates, while global variables include commodity prices and Chinese credit growth. Data cover the period from 2001 to 2017.

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