EUROPEAN BANK FOR RECONSTRUCTION AND DEVELOPMENT

PRESS CONFERENCE

Regional Economic Prospects in EBRD Countries of Operations
November 2016

Thursday, 3 November 2016

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MR WILLIAMS: Good afternoon, ladies and gentlemen. Many thanks for coming. Welcome to you but also welcome to our new Chief Economist, Sergei Guriev, who is holding his first press conference as the new Chief Economist here at the Bank, at Headquarters. Sergei will be making a general introduction to the global economic effects that are having an impact on the EBRD region. Later, he will be joined by Artur Radziwill who is the Director for Country Strategy and Policy and he will make comments about the specific developments in individual regions and countries in the EBRD countries of operations.

I will take this opportunity to point out that next Tuesday at 4.30 we will be launching our annual *Transition Report* on Equality and Inclusion. The first such report on that subject is a fascinating read and it will formally be launched at 4.30 next Tuesday at Headquarters. Everybody is invited to come along then, but, as I think you know already, it is free for publication now. We just do not want to overshadow any other events that are happening next Tuesday and we do not want to cause embarrassment.

I will handover to Sergei for the initial introduction.

MR GURIEV: *(Slide presentation)* Thank you and I welcome you all to EBRD. This is our biennial macroeconomic forecast which we call "A return to modest growth". The reason for that is that we see that the average economic growth rate in the EBRD countries of operation recovered from what was 0.5 per cent in 2015 to go to 1.6 per cent in 2016 and the projected higher growth rate to 2.5 per cent in 2017.

In this graph you see that the growth is modest. It is below the trend of the last 20 years. It is also below the average growth rate of the global economy, yet it is rather good news that we are no longer in the area of zero growth.

The region of course is very heterogeneous and we have very different growth rates and different changes in growth rates across our region. *Here* you see the breakdown of growth rates and forecasts for the next year in our countries of operation. You see that the impact of low oil prices and therefore recession in Russia still weighs heavily on Russia and the neighbouring countries and on oil exporters. On the other hand, economies that import oil of course benefit from low commodity prices. They also benefit from a softer monetary policy stance in the eurozone. There is another factor: political, geopolitical and security risks have actually had an important impact on the tourism sector. In some of our countries of operations, tourist flows relocated from Tunisia, Egypt and Turkey to countries like Croatia and Greece and in that sense we did see a negative impact on some economies and a positive impact on others.

If we emphasise the most important terms, we should say that recession in Russia is ending as we speak, depending whether you look at the year-on-year data or the quarter-on-quarter data. We predict that Russia will return to growth of about 1 per cent per year next year. We do not think that is a very high growth rate but finally the recession is over and that is good news, not only for Russia but also for neighbouring countries.

In central Europe growth could be faster if investment were stronger; investment as a share of GDP is below expectations. We also see weak investment in Turkey but the growth is driven by consumption and Turkey in general – and we will talk about that later – continues to grow, but not as fast as previously and as expected before the turbulent events of this year.

This is a quarterly picture. We have developed a model which gives a precise estimate for quarterly developments. We see that quarter 3 is better than quarter 2 in our countries of operation. We expect a weaker quarter 4. The factors behind that are those I have already mentioned, plus some factors related to Brexit – and I will talk about that.

If you look around our countries, they are very much integrating into the global economy and therefore they are affected by global economic trends. One major post-recession trend is the slowdown of productivity and growth in all advanced economies. You see that before the crisis productivity growth was 2 percentage points but unfortunately that has disappeared and now we are talking about productivity growth of something like 1 percentage point, which of course translates into slower demand for exports from our countries of operations and also reduces opportunities for the capital flow of advanced economies into our countries of operation, and so on. This is a major problem for the whole global economy but also for our countries. Some people call it secular stagnation. I think it is still too early to say whether this is a temporary or permanent phenomenon, yet we do see slower growth in the advanced economies.

Another important change is the slower growth in trade. In the last 30 years trade always outpaced global GDP. There was of course a decline in 2009 but that decline was quickly reversed. In the last couple of years we have seen that growth of trade is slower than growth of global GDP. That indicates the general anti-trade sentiment – protectionism and isolationism – and of course to also affects our economies that are dependent on exports to advance markets.

What is happening in our region? As I mentioned, our region depends on oil prices. These have recovered in the last half a year, which has been very good news for oil exporters, including Russia. We do not see oil prices going up further. Oil futures predict that the oil price will stay below $60. Overall, the consensus in the market is that even if oil prices grow further, they will probably not exceed $65 per barrel and more likely $60 per barrel, simply because the American shale oil industry is quite efficient and agile and will expand oil supplies quickly if oil prices exceed $60 or $65. In that sense, the markets do not expect $60 or $65 to be exceeded and actually the oil futures are even below that. This is what we are going to use as our baseline scenario: around $50 per barrel.

One important thing that happened half a year ago in this country was the UK referendum on leaving the European Union. That had a very important impact on monetary policy and markets no longer expect that the US will aggressively increase interest rates.

On this chart we show the implied market expectations which you can deduce from prices in western markets. You see that the markets expect US interest rates to be lower than before Brexit. Expectations have been lowered by Brexit in the US, in the UK and even in Europe, which of course is very important for yields in the West. These are nominal, ten-year bonds. We see that yields are at zero in Germany and slightly higher in other European countries. If you look at real yields, they would be negative for Germany and the UK; not surprisingly, investors are searching for yield and they come to our countries. If you compare their net capital inflows before and after the referendum, you will see that in this year we actually have good news and capital is flowing in. This is a temporary positive impact of the UK referendum. We would not say that our countries benefited from the referendum – and I will talk about that shortly – but at least there is a silver lining to this: monetary policy has become even softer and investors searching for yield moved east.

This is our modelling of the impact of Brexit in different scenarios. We modelled two scenarios: one in a soft Brexit and the other in a hard Brexit. We decomposed the fact into a direct channel through direct financial and trade links and an indirect channel through the impact on western Europe with which our countries of operations are of course closely integrated. We also predict a certain slowdown due to lost reform momentum, especially in the accession countries, and we looked at the direct impact on the EU budget and therefore EU transfers to our countries.

To give you a benchmark, when we think about the scenarios, a soft Brexit has something like 1 per cent of GDP impact on the level of UK GDP over the next five years, so we expect this impact to happen in 2017. With the hard Brexit, and this is again something that international financial institutions agree on, the forecast scenario is for 1 per cent of GDP change every year for the next five years, so by 2021 UK GDP would be 5 percentage points lower than it would have been otherwise. In that sense, of course, the impact on our countries of operations would be much harder.

When we wrote this report, we did not price in the outcome of today's decision on the need to consult with Parliament, but if you ask me what the implication of that decision will be on this analysis, it is that we should probably look at a soft Brexit being more likely than a hard Brexit. Do not look at the scary bars but at the less scary ones. *This* is the decomposition of this effect by specific countries for the whole region.

Going forward, we also looked at inflation. Two-thirds of our countries of operation have adopted inflation targeting, which of course is something that we strongly support. We did not include in the Report and in the presentation the events of this morning in Egypt. We see that inflation in Egypt is a concern and is going to be an even greater concern post-devaluation. Devaluation is a bold move, much needed and much expected, but the government now needs to look into the issue of disinflation and support the parts of society that will be vulnerable to rising prices. Overall, of course, it is a very welcome move, which will help businesses that suffer from shortage of foreign currency; it will also unlock lending in local currency once the exchange rate is floating rather than fixed.

In other countries, inflation is coming down under control. In *this* chart we show the targets and actual inflation. We see that the region is very heterogeneous but in general if you take into account the fact that some of these countries like Egypt today, Kazakhstan or for that matter Russia, went from a major devaluation to depreciation two years ago and one year ago, there is of course an outburst of inflation. We understand that this is a temporary outburst in inflation target terms.

One issue that is very important for our countries is the legacy of the Greek recession and the accumulated stock of NPLs (non-performing loans), which are high in many countries and in some countries they are actually growing. We are working on this issue within the so-called Vienna 2 Initiative. We support the resolution of NPLs and have done research on this. We show that countries that manage to resolve NPL issues faster rather than more slowly have a higher likelihood of returning to higher growth rates compared to their counterparts. In that sense, it is a very important part of the environment in our region. In our policy dialogue we are engaging with all countries with high NPL ratios and some of them are actually taking action.

One important development is the implication of depreciation and recession in Russia on Central Asian countries. In most Central Asian countries, but not only in these countries, remittances went down after the recession. They are no longer falling; they have stabilised in roubles and in local currency. They have stabilised at a lower level, which is a major challenge for those Central Asian countries that need to address the issue not just of incomes but also of finding jobs for returning labour migrants.

Another global issue gives us concern about our growth forecast. There is a downside risk related to Chinese economic growth. Currently, the Chinese numbers are on track and they exactly match their expectations and targets but, overall, Chinese growth is slower than it was ten or five years ago and, moreover, the last eight years of growth were supported by an unprecedented expansion of credit. On this chart you see that credit to households and corporates in China went from 120 per cent of GDP to 220 per cent of GDP. This increase in debt of something like 100 trillion yuan actually is a major increase and it is hard to imagine it can continue. In that sense, there is a lot of concern around the world regarding Chinese growth in the coming years, and of course China affects all our countries of operations through commodity prices, investment and trade. In the previous Report in May we provided estimates of how each country is affected by, say, a 1 percentage point change in GDP in China. For some of our countries, the elasticity is quite high. We are talking about something like 0.3 or 0.5 percentage points of GDP in neighbouring countries if Chinese growth slows by 1 percentage point.

We foresee a pick-up of growth in 2017, which of course is good news. We think that the region could have grown faster and may grow faster in future if there are pro-growth reforms – in different countries the reform agendas are different – and yet there is a lot of unfinished business in terms of pro-growth reforms, structural reforms, that my colleague Artur will talk about when he goes through the specific countries in the regions.

MR RADZIWILL: Thank you very much, Sergei. Obviously I will not go systematically through all the countries or even all the regions. We have a team of regional economists who will be happy to answer your more country-specific and region-specific questions in detail. I plan to give a bit of colour to Sergei's presentation by discussing in a little more depth some of the key stories that are happening in the region or are expected in the second half of this year and in the coming years.

We have to start with Turkey. Turkey was growing strongly in 2015. It had growth close to 4 per cent in the first half of the year, supported by the government's spending and a hike in minimum wages, but then the country was hit by a series of serious geopolitical shocks and terrorist attacks. These have led to a fall in tourism and arrivals aggravated by conflict, disputes with Russia and sanctions, regional instability, then a coup d'état in July this year, followed by a state of emergency and a downgrade by the rating agencies. Faced with all these shocks, the economy showed remarkable resilience. The government responded with some countercyclical measures. As a result, we see that growth has been largely supported. We think it will moderate to 3 per cent this year and the next but it remains respectable, while the country still has certain vulnerabilities to the external environmental and financial markets due to its relatively high refinancing needs.

Another region that has been hit by security concerns which have had an impact of tourism is SEMED. The numbers of tourists arriving in those countries has plummeted and has contributed to lower growth in 2016. This has been aggravated by some more country-specific issues, such as a bad harvest in Morocco and Tunisia and the influx of refugees into Jordan. Because these are specific issues, we think that growth will pick up next year, that the weather will be better and refugees will fuel domestic demand in Jordan.

We hope for further recovery and export competitiveness in Egypt. The bold decision of the Central Bank of Egypt today will provide additional support and in particular better access to foreign exchange to provide local private sector growth potential. While SEMED was struggling with falling tourism numbers, south-eastern Europe benefited as many tourists decided to spend their holidays there. As a result, we were able to improve our growth forecast in 2016 for this region. Importantly, Greece is one of the countries where we see tourism supporting recovery. We estimate that Greece started to grow in the second half of the year and so while the overall annual figure will be 0, it might be as high as 2 per cent next year. Even though Greece faces many headwinds; as you see in this figure, consumer confidence is really low. Most recent high frequency indicators show that manufacturing is not doing very well and there are still problems in the financial sector and fiscal austerity challenges. However, we are really glad to see a revival in investment activity and improvement in business confidence in Greece.

This is very much like what is happening central Europe and the Baltics, the region that has been and still is, to a certain degree, the shining spot in the EBRD region. Here growth is still quite respectable at 3 per cent in most countries. Consumption is strong as the labour market improves; unemployment is falling and real wages are increasing. However, we do see a contraction of investment which is partly described by recycling the use of EU funds in those countries. However, this does not seem to be the full story. There are some problems about the business environment in countries like Poland; there are problems with access to financing in others.

Russia is another country that seems to be turning around. We expect that Russia will grow next year but the growth will appear towards the end of this year. This is obviously supported by higher oil prices. We also observe that the capital outflows of Russia have largely diminished and Russian banks and corporates are increasingly regaining their access to international financial markets, which is a positive development.

After a very deep and cumulative output decline, Ukraine started to grow in the first half of 2016, although the pace was not as strong as we previously hoped. The good news is that this is healthy growth; it is supported by macroeconomic stabilisation and the structural reforms that we believe will increasingly feed into economic performance, going forward.

The last region I would like to comment on is Central Asia. Central Asia has faced several negative shocks in the last two years: lower commodity prices hit them directly and remittances from Russia were the most important factors. Here the outlook seems to be improving. However, the negative shocks have built up, adding to challenges in the fiscal sphere, in the financial sector, leading to countries such as Tajikistan and Mongolia recently requesting the IMF programme.

That is a quick overview of the region. We are open for your questions.

MR WILLIAMS: Thank you very much, Artur. We are happy to take your questions now, general questions to Sergei and then more specific questions. We do have the regional and country economists either in the room or somewhere in the biosphere. We will take your questions. State who you are, please, when you are putting a question.

SPEAKER: This is about Brexit, the news of the day. Mr Guriev spoke briefly on the issue but I would like to hear a bit more. Why is there such a big difference when we are talking about impact, especially on countries like Ukraine, between so-called hard Brexit and soft Brexit? Would you please explain in layman's terms?

MR GURIEV: Thank you for your question. Basically, we still have no clarity on what scenario will prevail. Indeed, markets have reached a slightly higher probability, judging by today's appreciation of the pound, for a softer Brexit but there is no clear definition of soft and hard Brexit. The way we define those scenarios is by the impact on the UK economy and the impact on trade and investment flows between the UK and its partners. Pretty much none of our countries is a big trading partner of the UK. However, all our countries depend in various ways on European Union economies. As you see on *this* slide, the direct channel is relatively small. If we are talking about the impact of the UK on our countries in terms of trade, investment and remittances, it is rather limited.

We also talk about indirect channels through events in the eurozone, the euro area, and continental Europe in general that will also suffer from Brexit. The integration between western Europe and the UK is very deep and breaking those links will actually have a major impact. Of course, countries like Ukraine are now increasingly integrated with Europe and so all living standards in western Europe will affect the demand for Ukrainian exports. For investments into Ukraine and potentially also transfers to Ukraine, in the particular case of Ukraine, it is not EU transfers for new EU members but maybe other financial flows as well.

There are many channels and basically most of that impact is indirect. I think the main take-way from our analysis is that it is a mistake for people to say that countries like Ukraine and other countries in eastern Europe are not going to be affected because they do not trade with the UK. The overall impact will be much larger than the direct impact because there will be an impact through western European countries. That is where we are. That is the main take-away. It is large; it is not catastrophic, but I think we should be aware of the fact that it is not going to be trivial.

MR MARK JONES: Can I just ask you about the other issue that is obviously impacting your region and potentially bubbling away in the background: the escalation of tensions between Russia and Europe and that feel of a Cold War building. I went through some of the countries where you saw some of the biggest negative change in your forecasts: Estonia, Lithuania, Latvia, countries that border Russia. Is that a real concern for you at the moment?

MR GURIEV: You see direct economic impacts from the rhetoric really. At this point, what really led us to reduce our projections for the region, not only for the Baltics but also for the central European countries, is the slowing down of investment. Primarily, as I said, it is explained by this cycle, this gap between two multi-annual financial frameworks of the EU and in the Baltic States the access to financing contributes. Obviously, one could speculate that business confidence could suffer a bit because of the geopolitical tensions but it is very difficult to verify and we do not have the hard evidence to prove such causality.

MR JONES: Could I ask one more question on Egypt? After the devaluation today, since it is going to be positive, have you any idea how positive it could be for the economy?

MR GURIEV: I will ask Hanan who is the economist covering this.

MS MORSY: We think, as we have emphasised, that this is a really important and positive step in the right direction. We expect a positive impact in terms of reducing uncertainty, boosting investor confidence and reducing foreign exchange shortages which have really impaired private sector activity and its ability to import the inputs needed for production and to plan and repatriate profits. We see the channel by which this will impact growth is really through unlocking private sector activity and enhancing the competitiveness of exports. Net exports have really been a drag on growth for the last couple of years. We see this as positive. We have incorporated improved competitiveness into our forecast. We expect that Egypt will grow in the fiscal year 2017 at around 4 per cent. Part of that is an expected improvement in competitiveness.

SPEAKER: You guys might be the wrong group to ask this. Now we have seen this devaluation, are we going to see a pick-up of investment in Egypt by the EBRD?

MR RADZIWILL: EBRD expected devaluation to happen at some point because it was part of the prior actions for the IMF programme. That programme was necessary. Egypt is running at 11 per cent of GDP to budget deficit. In that sense, the exact timing and exact skill of devaluation is of course new and suppressed but this is something that was broadly expected by international institutions. It does not change much. We praise this move but our country strategy, which is going to be approved and developed by the end of this year, was based on the assumption that devaluation would happen at some time. We are now developing the country strategy and it will be published in January.

MR GURIEV: In our preparatory work on the strategy we identify the lack of access to foreign exchange as one of the key factors holding back the economy and making the life of our own clients much more difficult. Promoting export-oriented sectors is one of our key priorities. This move is expected and a positive one for the country but also for the potential of EBRD investment in the country.

MR WILLIAMS: Are there any more questions? I cannot believe the presentation was so comprehensive that you have not got any more thoughts.

MS LINHARDT: This is just something about your Russian forecast. You mentioned that in 2017 you expect it to pick up. Is that just related to the oil price or are there some other reasons behind that?

MR GURIEV: All recessions end eventually. This recession was driven by a combination of factors. We, together with the IMF, think about Russia and what economists would call the potential growth rate without structural reforms being quite low but still positive. If you look at the IMF forecast which goes beyond 2017, it forecasts 1.2 per cent, like our forecast for 2017, and it forecasts 1.2 per cent for 2018 and 1.5 per cent per year in the years after 2018. Generally, we agree with this forecast, even though it is not our official forecast. It is what the Russian economy is now able to achieve with the current level of political and economic institutions, business climate, investment climate and so on.

If you look back, the recession of course was mostly caused by the shock of the oil prices to which the Russian economy has adjusted in the last two years, and now it returns to potential growth, which unfortunately is quite low. If the Russian economy overcomes isolation and carries out structural reforms, we should expect faster growth and this is not something that markets expect to happen in the foreseeable future.

MR WILLIAMS: I am happy to repeat the invitation to come to the *Transition Report* launch at 4.30 on Tuesday, 8 November.

If there are no more questions, then thank you all very much for coming. We will see you on Tuesday.