The impact of global market volatility on the EBRD region

CSE and OCE
September 02, 2015

KEY RECENT DEVELOPMENTS
IN CHINA AND COMMODITY MARKETS

Emerging markets growth has been decelerating since 2009

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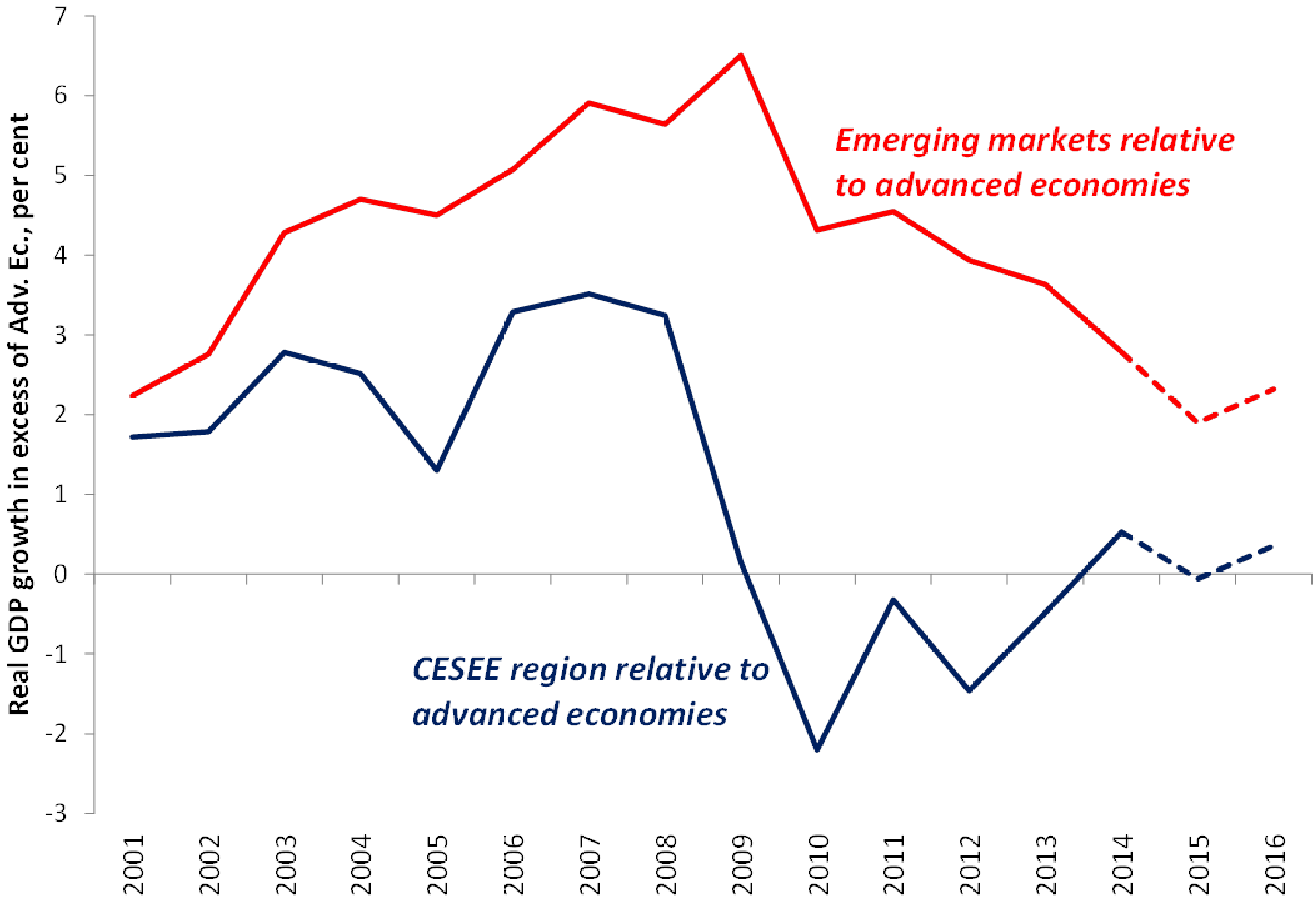

Sources: IMF WEO, EBRD REP, weighted averages.

Recently growing concerns about slowdown in China - despite continued 7% growth

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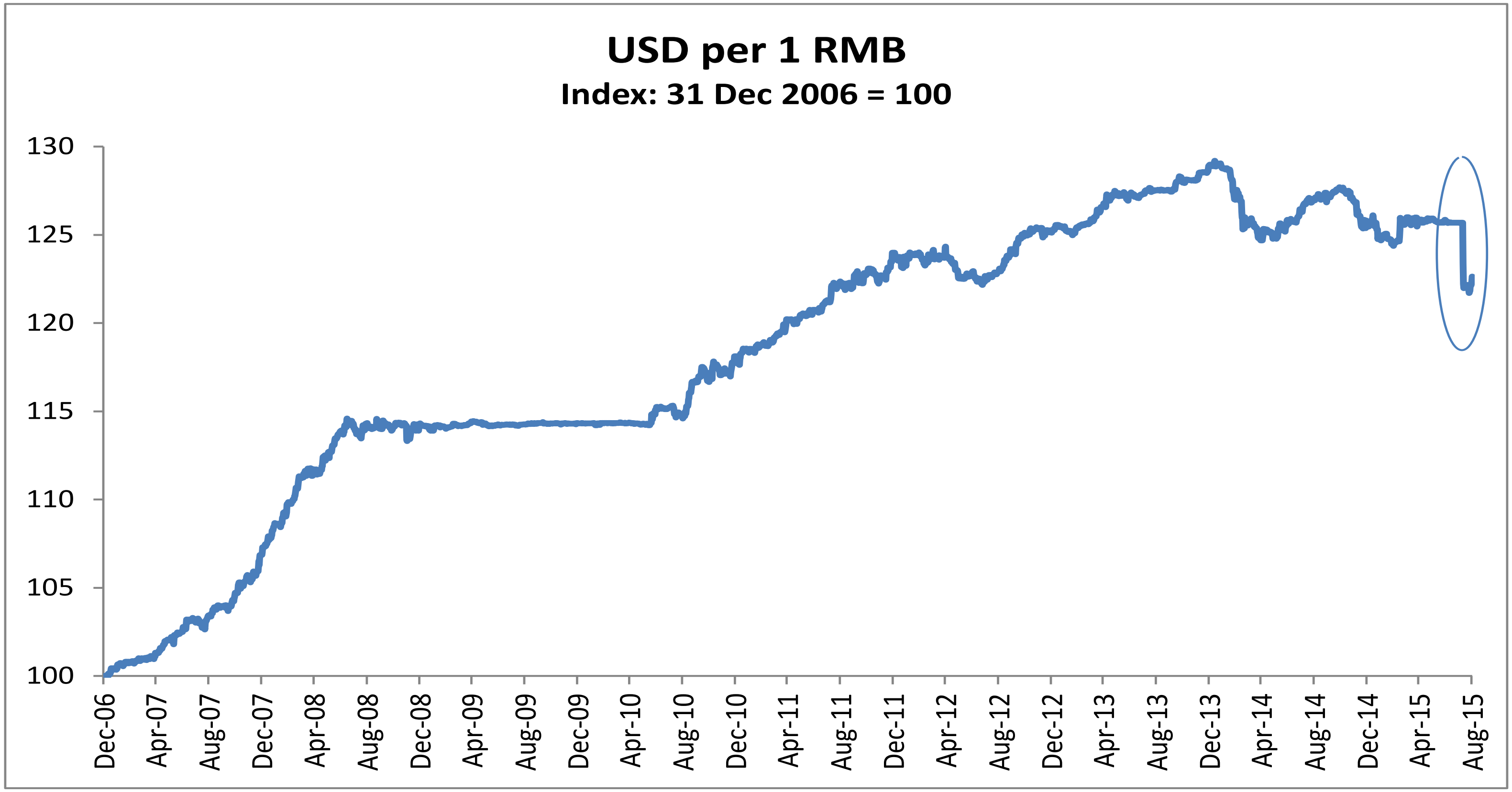
- Exports growth has been decelerating markedly
- Weaker PMI index (manufacturing orders) in July-August

Source: National Sources, IMF, authors' calculations.

China has moved towards (somewhat) more flexible exchange rate on 11 Aug 2015

- This resulted in a 3% depreciation against the US dollar, in contrast with long-term appreciation trend
- IMF is currently reviewing possible addition of yuan to SDR basket of currencies from 2016 (which would likely require China's forex markets to "mature")



Source: Bloomberg

Correction in China's stock market sparked global sell-off on 24 Aug

- Shanghai Stock Exchange index lost 8.5 per cent on 24 Aug and 7.6 per cent on Aug 25
- Overall, China's stock market has dropped 39% since its peak from June 12th, yet remains more than 40% up on a year ago

Source: Bloomberg

Global equities lost ground; emerging markets, already under pressure, additionally impacted

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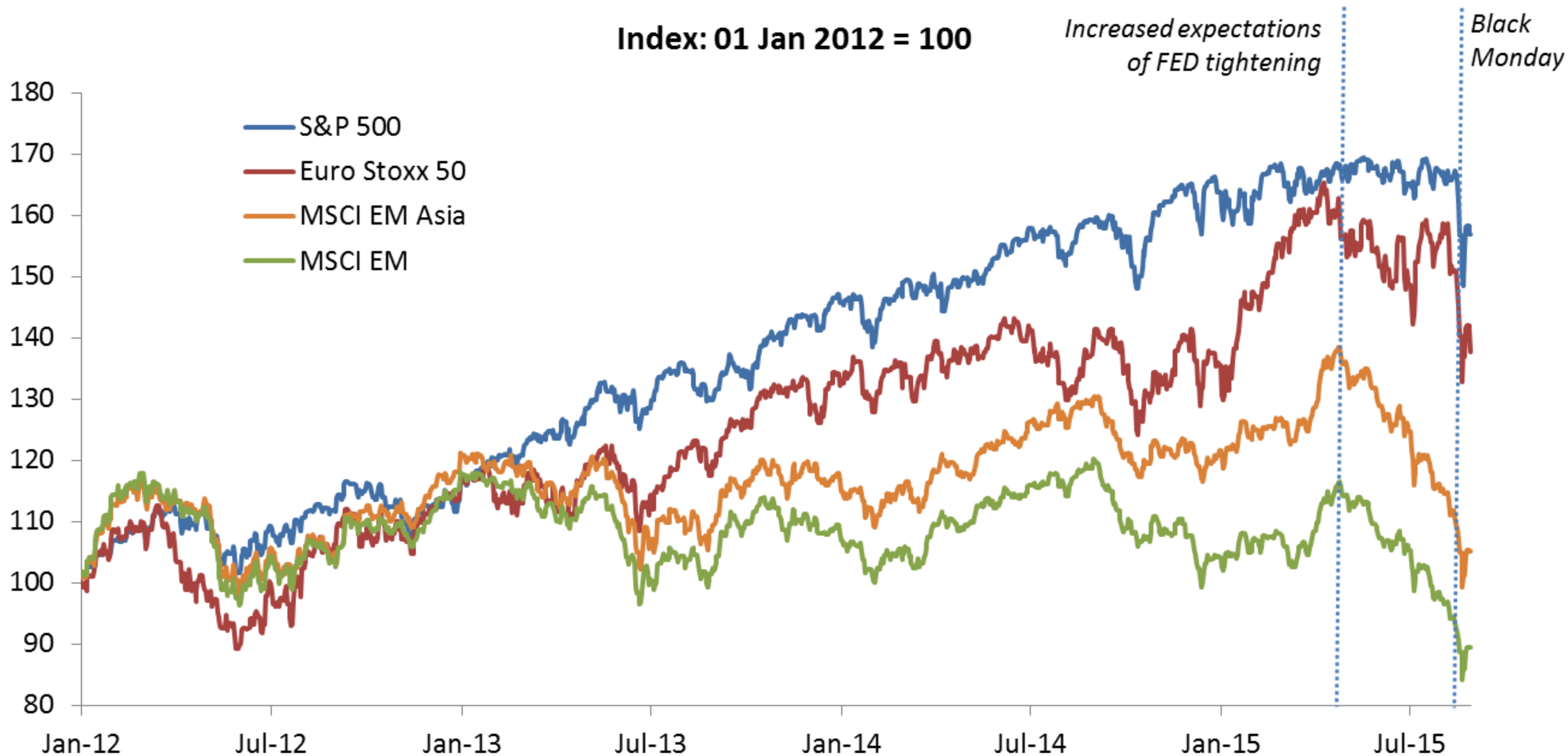
- EM pressures over the last few months reflect expectations of the US monetary tightening



Source: Bloomberg

Interest rate hike announcement by FED on 17 September 2015 now seen as less likely

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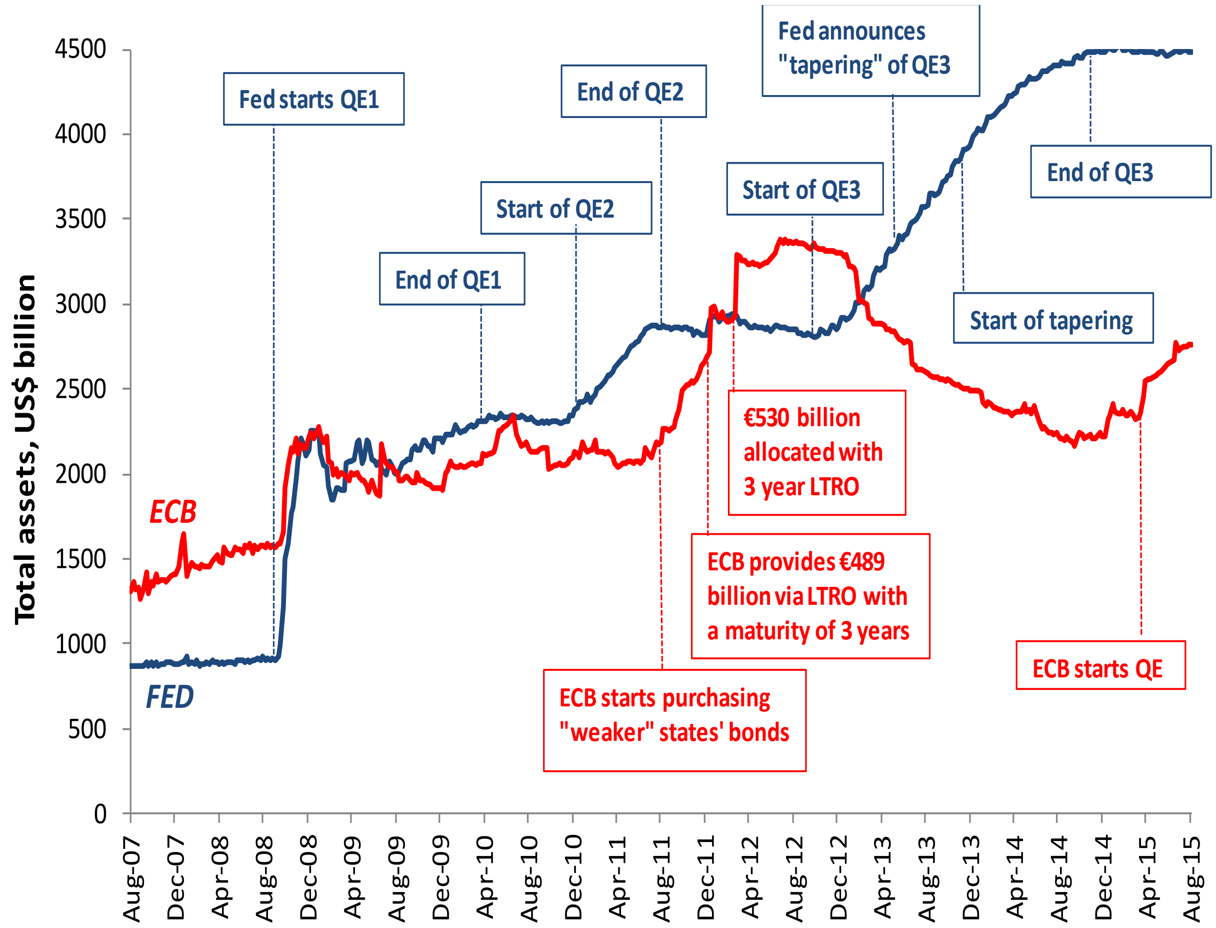
- But overall tightening in the US still expected



Source: Fed; ECB

On Aug 24th Brent oil declined to US$ 43 per barrel

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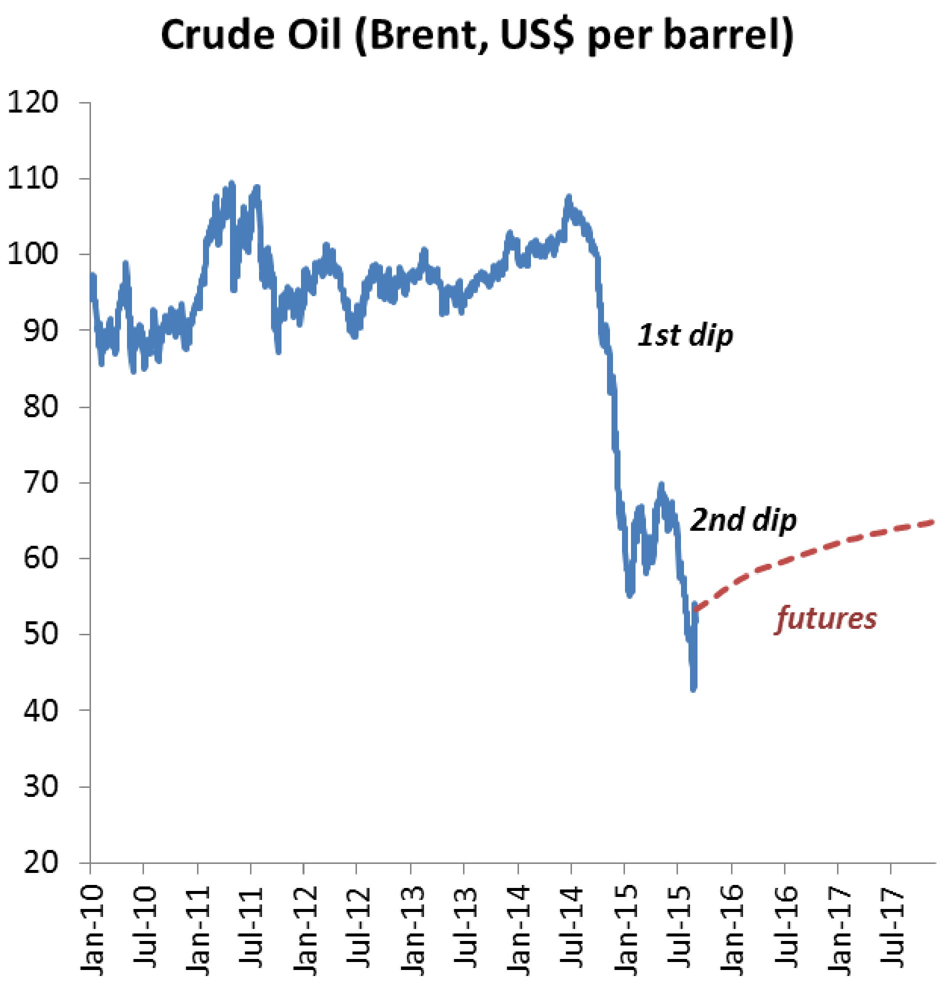
- **Current operational indicators**: refineries` maintenance period is approaching; storages are at record level; long-lead projects still coming online
- **Supply growth:** High supply by Saudi Arabia and other OPEC; US producers more resilient than expected
- **Demand slowdown:** China's demand growth is expected to slow down for the first time
- **Iran deal:** Iran's oil supply is expected to gradually return to pre-sanction levels

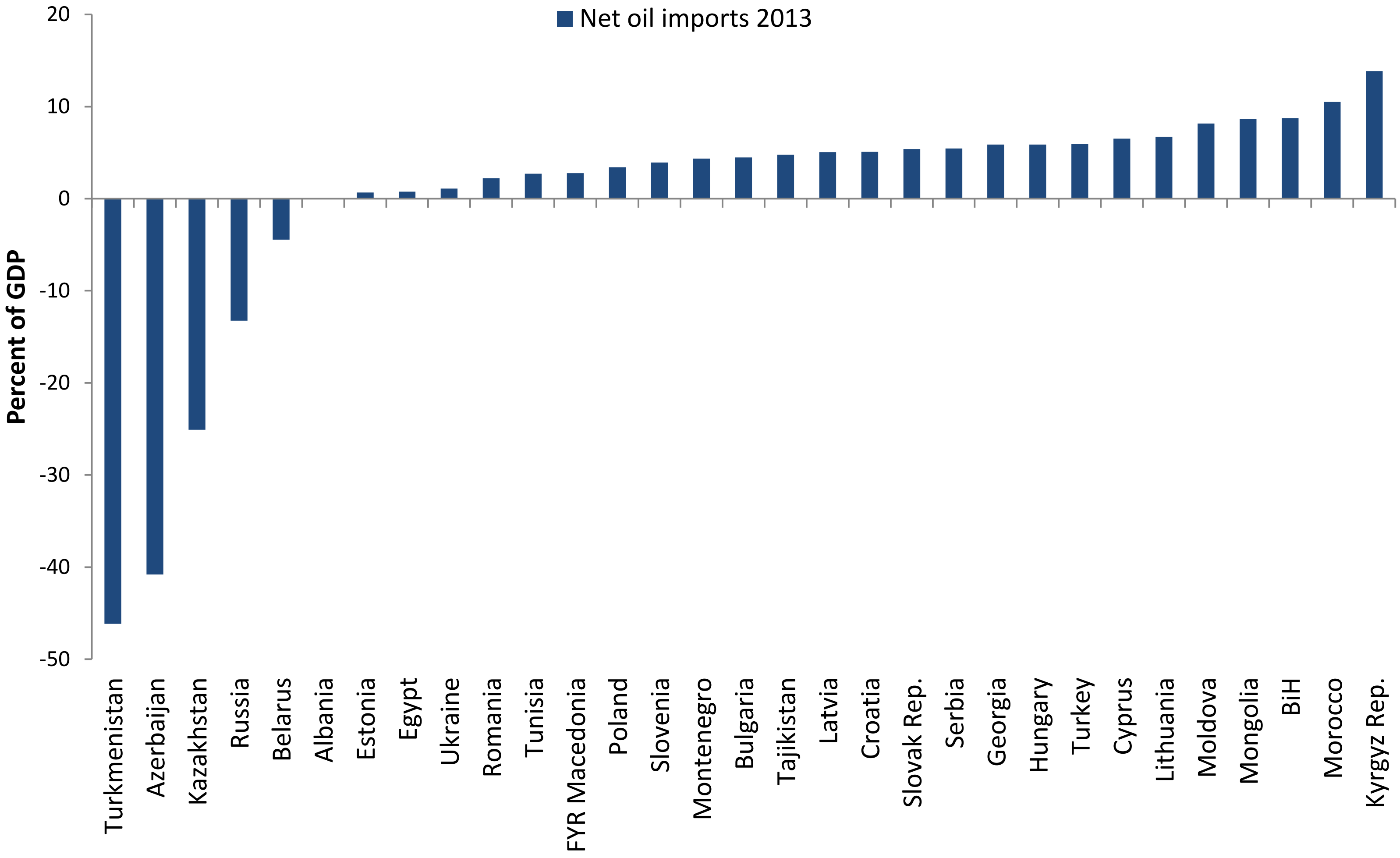


Source: Bloomberg

Spillovers to the EBRD region

Lower oil prices: gains spread, losses heavily concentrated

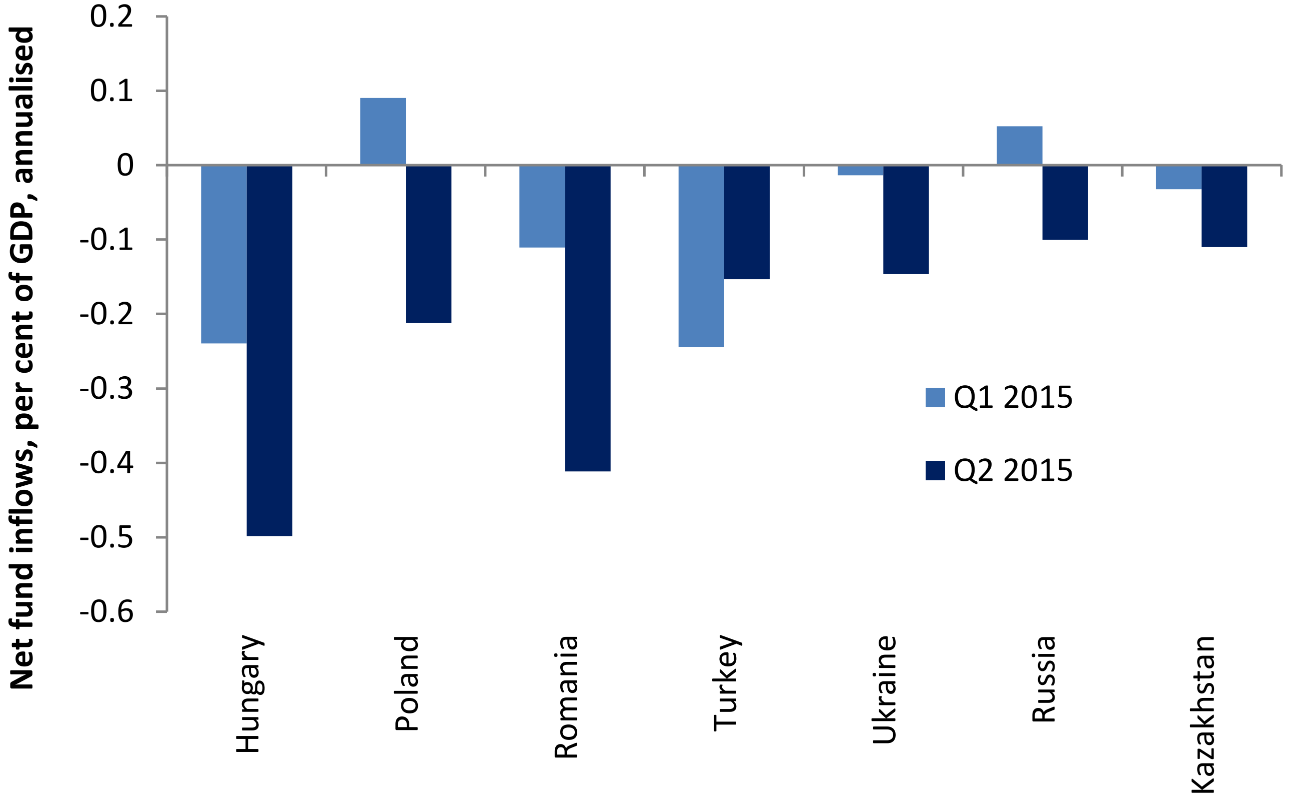
- Major commodity exporters are most immediately affected



Source: IMF World Economic Outlook

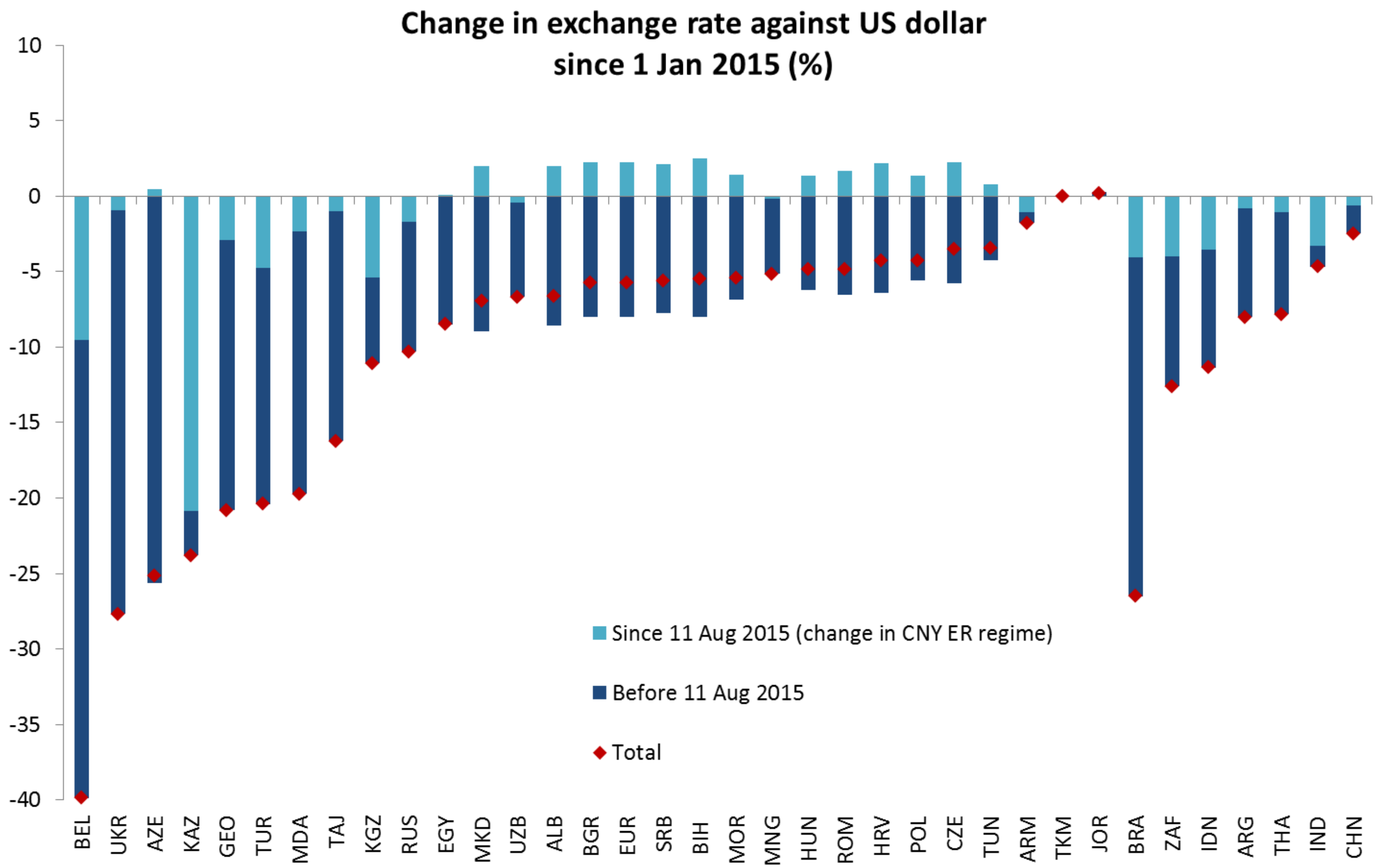
Capital outflows intensified in the second quarter of 2015

- Based on EPFR monthly mutual fund flows -- similar trends in balance of payments data (available with a long lag)



Source: EPFR

Downward pressures on currencies



High stock of total forex debt means vulnerability to capital outflows

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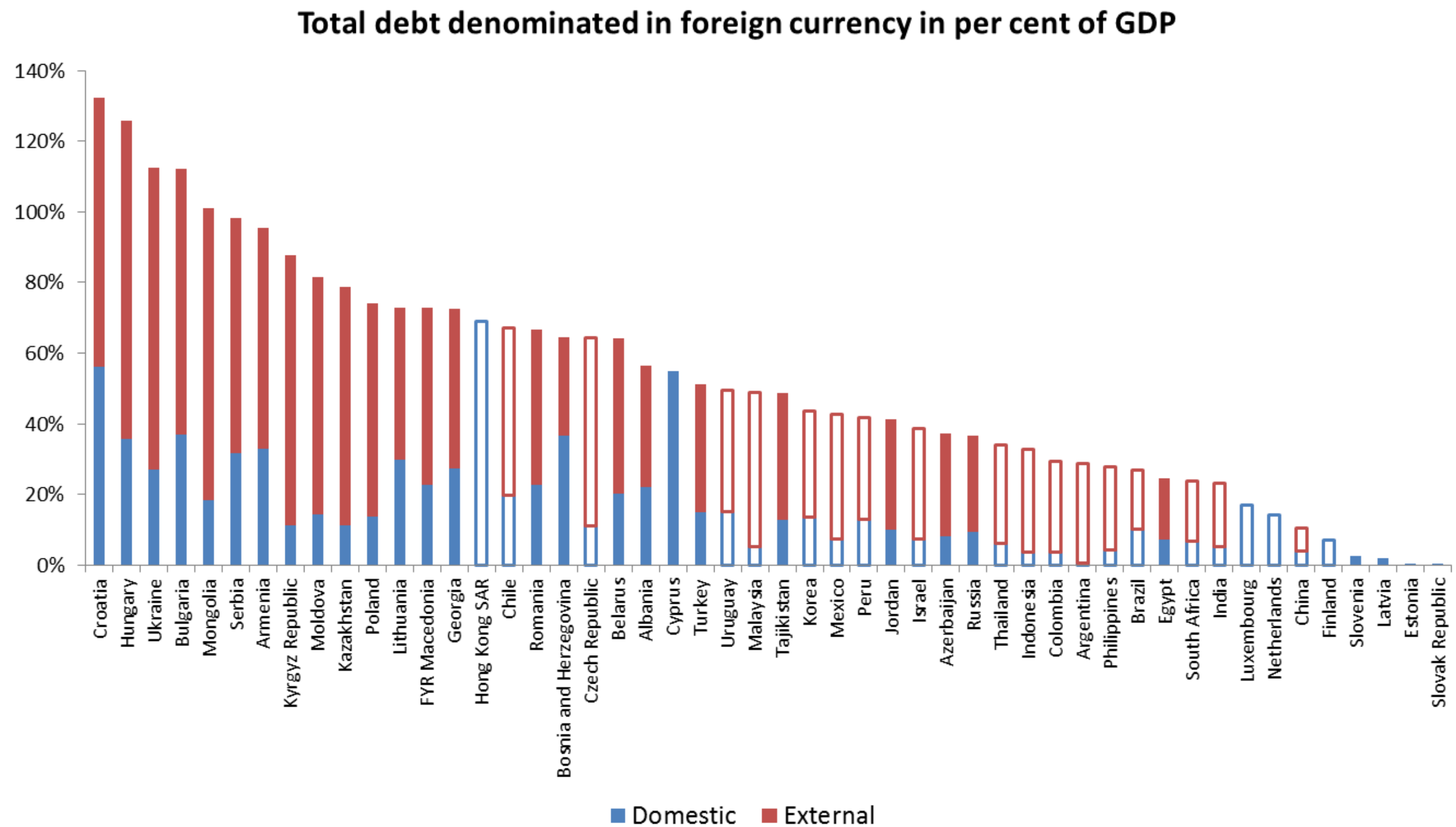
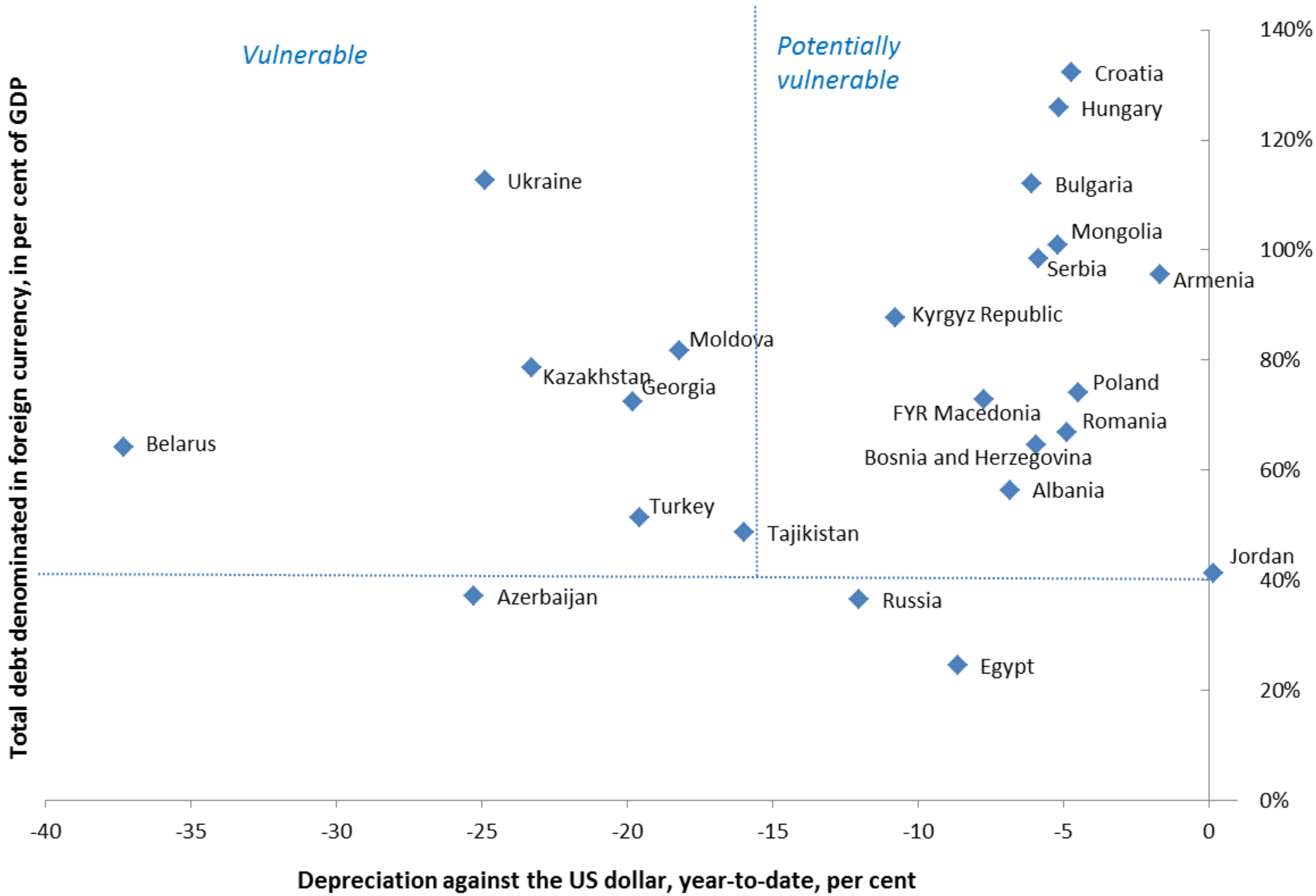
- If economies with high forex exposure adjust via exchange rate depreciation, burden of debt service rises significantly



Source: National authorities, BIS, World Bank, IMF and EBRD Staff Calculations.
Total debt denominated in foreign currency comprises public, household and corporate debt, both domestic and external.

A number of countries with high forex debt already experienced significant depreciations



Source: Bloomberg, National authorities, BIS, World Bank, IMF and EBRD Staff Calculations.
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Regional developments and vulnerabilities

Concluding remarks

- Sell-off in China sparked increased global volatility; Emerging markets negatively impacted

- At the same time, the Fed interest rate hike is now widely expected to happen later

- In the EBRD region, commodity exporters have been the most immediately affected
  - Rouble weakened further in Russia,
  - Kazakhstan floated tenge on 20 August in anticipation of low oil prices

- This may add to the pressure on currencies in the EEC region and Central Asia, given countries' strong trade, investment and financial sector linkages with Russia

- Other countries are vulnerable to increased volatility of capital flows into emerging markets

- Turkey's economy is particularly vulnerable
  - In Turkey, the situation is compounded by political uncertainty
  - Large current account deficits (around 6 per cent of GDP last year) financed by non-FDI portfolio inflows, substantial refinancing needs and significant external corporate debt denominated in US dollars

- Markets in CESEE have shown some increase in volatility in recent days; are likely to be further affected by increased global volatility

Turkey

- Turkish economy was already squeezed by expected US monetary tightening, rising regional geopolitical tensions, elevated domestic political uncertainty and domestic security issues
- Amidst this environment, news from China additionally affected Turkish markets last Monday:
- Equity market weakened, as BIST 100 index declined 2% on Monday, carrying total losses since the beginning of the year to 15.7%
- CDS rose to 295 from 280 last week and 175 at the turn of the year
- Lira weakened 0.4% against the USD and 3.7% against the Euro on Monday, bringing total losses since the turn of the year to 26% for USD and 20% for Euro
- Direct impact of Chinese slowdown on Turkish trade will likely be limited, as China makes up only 1.8% share of Turkish exports
- Low oil prices will benefit Turkey, but the effect will likely be dominated by deteriorating investors' sentiment towards emerging markets
- Given large current account deficits (around 6 per cent of GDP last year) financed by non-FDI inflows, large refinancing needs (around US$ 220 billion annually) and external corporate debt denominated in US dollars, Turkey's economy is particularly exposed to emerging market capital outflows. However, public debt remains low at around 33 per cent of GDP and banking sector well capitalized and with low NPLs, providing some buffers for reaction

Russia

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- Rouble is now trading above 70 to the dollar (and shortly touched 75), and recession is deepening: lower rouble may help exports and partially offset lower budgetary oil receipts

- Our forecast of -4.5% growth in 2015 and -1.8% in 2016 still looking valid

- The recently revised “conservative” forecast of the Ministry of Economic Development also includes continuing recession (-3.7 per cent in 2015 and -0.9 per cent in 2016) in case of sustained low oil prices (50 US$ in 2015 and 40 US$ in 2016).

- Overall reforms have stalled, with negative consequences for long-term growth prospects.

- Capital outflows in H1 below last year’s levels but still substantial.

Central Asia/Kazakhstan

- On August 20th, Kazakhstan switched from the exchange rate regime with peg to the US dollar, to a floating exchange rate regime with inflation targeting
- The switch was expected, however, the timing has been brought forward considerably, reflecting government’s/NBK’s view of the expected further decline in oil price (and to a much lesser extent deterioration of other external factors)
- Tenge is now trading at around 235 USD/KZT or around 20% below the exchange rate prior to introduction of the floating rate regime
- Weaker Tenge will support exporters, particularly oil and other commodity producers, as well as alleviate some of the pressure that domestic producers face from Russian competitors
- Our current forecast of 1.5% growth in 2015 and 2.0% in 2016 remain broadly valid, however, there are significant downside risks to growth if the oil price further weakens
- Inflation can be expected to increase, but from very low levels, and it is projected to reach 6% in 2015, although precise outcome depends on the scope and effectiveness of government’s announced anti-inflationary price control measures

EEC/Ukraine

Ukraine:

- GDP fell by 17.2% and 14.7% year-on-year in the first and second quarters of 2015. Some sequential month-on-month metrics indicate that the economy may have bottomed out in the middle of the year. Given the scale of the contraction in the first half and the ongoing fighting in Ukraine's East, we see realization of significant downside risks to our GDP growth forecast for Ukraine in 2015

- On August 26, 2015, Ukraine and Bondholders' Committee signed indicative term sheet with respect to the debt operation (20% reduction in nominal principal value, 4-year maturity extension, coupon increase from c7.2% p.a. to 7.75% p.a., GDP linked warrants in 2021-2040). Formal launch of the Exchange Offer expected no later than September 15

- Ukraine is broadly on track with structural benchmarks and prior actions under the IMF programme

- Removal of capital controls is likely to be incremental, stretching into 2016

EEC

- Currencies in the EEC region have been under pressure, including due to trade, investment and financial sector linkages with Russia and oil price adjustment. Country-specific economic trends / vulnerabilities depend on inherited domestic and external imbalances, existence of fiscal space and buffers, stability of financial sector and past record of structural reforms

SEMED

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- Limited direct effects from China – sign that countries in SEMED have not diversified much to other markets.

- Lower oil prices is directly beneficial, but important negative indirect effects, through likely drop in FDI to oil sector, and drop in support from GCC countries which are facing fiscal pressures themselves.

- Lower oil prices, better external demand from US the eurozone and economic reforms support growth

- Security and geopolitical risks remain high

CEB and SEE

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- Limited direct trade or financial linkages with China. Currency depreciation versus EUR as yet limited

- As other emerging markets gain competitiveness from depreciation CEB will need to maintain export market shares through further quality upgrades

- CEB economies play increasingly important role in ‘global value chains’ managed by western European investors, but with China and other emerging markets as ultimate source of demand

- A sustained emerging markets downturn would likely discourage further FDI, and relocation of more sophisticated production stages into the CEB economies

- Trade links between China and SEE are low but growing (e.g. Kosovo exports significant amounts of scrap metal to China)

- Lower oil imports largely beneficial (Albania is an exception – effect is approximately neutral)