EUROPEAN BANK FOR RECONSTRUCTION AND DEVELOPMENT

PRESS CONFERENCE:

Regional Economic Prospects in EBRD Countries of Operations

Monday, 19 January 2015

Chairman: Mr Axel Reiserer

THE CHAIRMAN: Good morning. Thank you for coming to our press conference about regional economic prospects. I am Axel Reiserer, and I am here because Tony is travelling to Davos. I am sitting at the head table with Piroska Nagy, our Director of Country Strategies, and Hans Peter Lankes, our Acting Chief Economist, who would like to say a few words.

MR LANKES: I will just take this opportunity to say a few words about Erik Berglöf, who left us in late December; so please bear with me before I hand over to Piroska, who will go into the substance of our presentation.

As some of you know, with nine years in office here at the EBRD, Erik was the longest serving Chief Economist of the Bank – the Bank is not that old, but nine years is a pretty impressive tenure. He left in December to start up a new institute at the LSE, the Institute of Global Affairs, and in order to build a research base – what he calls a "do tank" – focused on emerging markets. He will do this out of the LSE, and that will formally kick off in February.

During his time in office here at the EBRD Erik has led some of the Bank's most important work. You are familiar with some of that externally. He led the Bank's response to the crisis in the area of banking coordination in the Vienna Initiative. The EBRD was instrumental and he was very much the mover and shaker in the joint IFI action plan. Together with the Vienna Initiative, that coordinated approach by the IFIs was an important factor in helping to prevent a systemic banking crisis in the region and in ensuring that credit kept flowing.

Erik has also done quite a lot internally in professionalising the Chief Economist's Office in the way that economists are involved in the design and implementation of projects, in policy dialogue, and of course in shaping our thinking about transition. You are aware of the successive *Transition Reports*. Erik has led nine in total, including the one that we are all particularly proud of, *Stuck in Transition*, which was quite instrumental in getting the Bank's own strategy going in this area for the medium term.

We are very pleased that Erik will stay connected with us and remain involved in the region, and that we will work together.

We have a new Managing Director in the Chief Economist's Office responsible for the operational work, country and sector project work: Mattia Romani. Piroska, please.

MS NAGY: Hans Peter, thank you very much. Good morning everyone. This is our new forecast covering 2015, and looking back at the main trends last year.

The single most important event since we released our forecast in September has been the huge drop in oil prices. This is a picture with which you are very familiar. It has reshaped the outlook for our region as a whole.

Russia has been particularly hit. It is a country of systemic importance for the EBRD region, making up a large share of GDP, but it also has very close ties with a number of CIS neighbouring countries. Russia has obviously suffered from the drop in the oil price because oil is a major source of export revenue and is an important part of fiscal revenue. It has really just compounded the impact of long-running structural problems in the economy, for example lack of diversification; very high state intervention and ownership in the economy; weak investor confidence; but also the increasingly binding sanctions. We have always been of the view, as you might recall from our last forecast, that sanctions do have an impact. In the context of tightening liquidity, these sanctions, which effectively block Russia from external financing, are ever more powerful.

We have other major commodity producers in the region: Kazakhstan, Azerbaijan, Turkmenistan in the energy sector, and other countries producing other commodities. They have already seen a slowing of growth rates and will see further slow-down.

The systemic impact really comes from Russia. There are very significant spill-overs to countries with close economic ties to Russia, where this factor will outweigh the net gain from the decline in oil and commodity prices, for example Moldova, Kyrgyzstan, Tajikistan and the like.

Ukraine is a story in itself but of course it is linked to this geopolitical tension with Russia. Russian developments do affect Ukraine, but, to borrow a term from the economists because it hits the nail on the head: Ukraine is really on the edge. We will give a few more details on this in the presentation.

However, commodity importers with fewer ties to Russia will clearly have a net gain due to the decline in oil price. These are countries in central and south-east Europe, Turkey and, very importantly, the North Africa region where we operate in four countries – and counting. These countries, however, will experience other problems and issues with increased risk of negative impact from the Eurozone, where growth continues to be very weak and thus demand for exports for many of these small economies in central and south-east Europe and in SEMED is dependent on demand from the eurozone, and also from the eventual normalisation of US monetary policy. This will mean an eventual rise in US interest rates and external borrowing costs of emerging markets, including in our smaller countries that import commodities. The tightening of a tightening of US monetary policy will eventually lead to an increase in local interest rates, as countries are quite dependent on capital flows and will have to react to any vulnerability or volatility in capital flows.

The bottom line is that average growth in the EBRD region will turn negative, for the first time since 2009, with very, very significant country variations.

(PowerPoint presentation)

Let us look at the details. In Russia the economic outlook has clearly deteriorated. In this chart, as an illustration we have shown the collapse of Brent crude oil and the US dollar/rouble exchange rate. There are huge declines. The stock market index (lighter blue line) went down, whereas the 5-year rouble government bond yield edged higher. There have been very significant liquidity stresses. You will recall that in December the Central Bank had to raise the interest rate to 17 per cent, way above inflation or even expected inflation, in order to stem volatility and decline in reserves.

International reserves are still significant, but they continue to decline. Taken with the fact that external repayments will be significant, there seem to be increasingly biting liquidity constraints in Russia. In this chart we depict gross international reserves (light blue columns) in US dollars, which show that there is a buffer despite the recent decline; but there is also a trend of a very clear decline. This is happening against the very significant fall in the rouble. The devaluation took up some of the pressure on the exchange rate, but reserves still declined significantly, by about a quarter.

If you take a more nuanced measure, as we do here with the blue line, we get a more precise underlying picture. The blue line shows you internal reserves excluding the national welfare fund, which is part of the international reserves but where the assets are clearly less liquid and where claims on these assets have risen in the past few months as a result of the stresses in Russian financial markets. So we exclude that from international reserves and we take out the debt redemptions for two years. This year alone the debt repayment that falls due from Russia is 150 billion or so, primarily in the private sector.

If you take these measures of international reserves, excluding the national welfare fund and debt-repayment obligations for the next two years, you can see that at the end of 2014 the reserves were already below US$ 100 billion. That is a tight situation.

We had the latest news from the Central Bank of Russia over the weekend that capital flight exceeded 150 billion, which is more than in 2009, the year of the global financial crisis, and two and a half times more than the year before.

The shock coming from Russia is a combination of the structural impacts in very big economies and the ever-present constraint in regard to external financing, thanks to the sanctions – which work. All these negative spill-overs are being transmitted to countries that are very closely linked to Russia through a number of channels, where, therefore, the impact of cheaper oil and commodities will be offset by the negative events in Russia.

In this chart we depict the key channels of economic relations between Russia and a number of countries around it: Belarus, Tajikistan, Armenia, the Kyrgyz Republic, Moldova and so on.

We arrive at an exposure index to Russia. This is very similar concept to the index we developed for central and eastern European countries, to measure their exposure to the eurozone, as a share of GDP, FDI flows, exports, banking assets and remittances. Remittances have been a very important source of income for many of the smaller economies. We can see that these countries are highly exposed to Russia. In Belarus, for example, the share of GDP amounts to 50 per cent or more. Tajikistan is also very exposed, where the highest exposure comes from the remittance channel; but Armenia, Kyrgyzstan and Moldova are also quite connected.

In this chart we show the development of remittances to neighbouring eastern countries and Central Asia, which have been declining, as we have reported in our forecasts over the years. They were in positive territory until recently when many dipped into the negative area. We can see from partial data that in the last quarter of 2014 there was quite a drop in remittances.

This is very important. Of course, it is a very important source of foreign exchange but it is also a source of domestic consumption in many of the smaller economies. Normally, remittances are considered to be a stable source of foreign exchange; and we used to consider them to be more stable than official flows or private capital flows at a time of crisis; but the mother country, from where the remittances are sent, is under stress. Remittances do adjust, as you can see here.

A number of currencies are under pressure, particularly recently with developments and expectations in relation to normalisation of US monetary policy. However, the darker blue line showing exchange-rate developments in this chart are mostly in negative territory in our area, as opposed to those that are less negative, shown in green on the chart. Since November the exchange rate decline has been predominantly in countries that are very closely related to Russia.

Ukraine of course is embedded in some of this story, but it is a story in itself. It is “on the edge” and we give you more details here. Let me highlight two salient facts. The first is the dangerously low level of international reserves in Ukraine. In this chart we show the reserves in billions of US dollars, which dropped precipitously, there already having been a downward trend earlier this year. Depicted by the red line are reserves expressed as months of imports. Those of you who are familiar with crisis situations know that this is at an extremely dangerous level.

At the same time, some adjustment has already happened. Reforms are underway in important areas in Ukraine. If we just take the macro adjustment front, it is not nearly enough to balance the country's books.

In this chart, we depict the fiscal balance as a share of GDP with the dark blue line; and the current account balance, which has adjusted more significantly in 2014. Nevertheless, notwithstanding the huge collapse of imports in 2014 it was still in negative territory, which is quite unusual for an adjusting country. It is partly reflected on the fiscal accounts that the adjustment has not happened.

There is a huge adjustment to be made. Things are going on: restructuring in the banking sector; in utilities, price reform, and governance. The new government is committed but there is not the space required to close what is widely recognised as a very significant external financing need, well above what was previously envisaged. The needs are urgent. In the previous chart you will recall the reserves, and action needs to be taken or it will become more than an acute problem.

There is upside in the region. For those who do not have close ties to Russia and therefore being brought down by negative developments there, and for importers there will be a big gain. This is a huge decline. Those of us who are old enough will have seen this before. I was an economist in 1986 when there was a huge positive income shock.

In this chart showing the share of GDP and the net oil imports of our countries, in positive territory are our North African countries of operations, Jordan and Morocco, but also there are smaller countries such as the Kyrgyz Republic and Moldova.

Most of the countries will be benefiting, all other things being equal, from this positive income shock related to declining energy and commodity prices.

On the other side, countries exporting commodities are losing. This reflects the gain that is being accrued by importers but being lost by exporters.

This huge positive real-income shock to these countries opens up macroeconomic policy space to support growth and overall sustainability in these countries.

We have here four dimensions that I think are relevant in our region. One is the fiscal space, which you will already have heard about from other IFIs. In SEMED countries, in the MENA region, subsidy reform will receive a lift from a positive environment in which the reform can continue and accelerate. We believe that in general it will be important also to allow – in these countries and others – affecting positively and benefiting the fiscal sector – fiscal accounts – it will be important to focus on growth-enhancing spending because secular stagnation is such a general threat all over the world outside the US. Let us use this fiscal space to move on reforms but also to allow for growth-enhancing measures. Here, infrastructure spending is critical, as we all know.

There is also a monetary space that is opening up because the lower oil prices for a long, long time, can allow easier monetary policy for longer but of course this is subject to the US monetary policy stance, which is set to normalise. The lower oil prices in the US may push back a little bit – give a little – can be more flexibly managed the timetable of it perhaps going forward. So perhaps there is some room for manoeuvre there as well.

In some of our countries financial stability can be enhanced by inflation being lower for longer. That is because de-dollarisation is easier, moving to local currency in the context of lower local currency interest rates. It is easier.

Finally, something that has not been on the radar screen in commentaries – though I am certain it will come onto the screen – is the distribution aspects of the terms of trade. Should consumer benefit workers; should profit benefit; should the government benefit? This is a country-specific issue.
I would argue that given the material risk from secular stagnation in many countries and regions, maximising growth in the context could be good policy guidance.

This is just a chart to show how our North African countries of operations, SEMED countries, stand to benefit from easier conditions for subsidy reform with a bit here for you as a share of GDP, the fiscal deficit and as part of subsidy spending.

Again, I emphasise that reforms are ongoing, and that is why in Jordan you already see less subsidy spending, but they get a positive lift from this source.

This is a risk that I mentioned earlier but here it is clearer on this chart. Emerging market and commodity importers who will be getting these huge gains have a tight external condition on two counts. These can be summarised by the increasingly divergent economic performance in two key markets for our countries: the US and the Eurozone.

The risk is this. The US eventually will normalise its monetary policy, we hope perhaps a little bit later given the outlook for lower oil prices. Here, we can see the quickly declining unemployment rate in the US whilst it is rapidly rising in the eurozone. Eventually, interest rates will go up, which will increase external borrowing costs in our countries and emerging markets in general. Excellent borrowing costs are conditions by US interest rates, so that is a tight external financing condition down the road. Also, if our countries need to react internally by raising interest rates to stem any capital inflow, volatility, or potential outflows, which we have seen recently, they will need to increase, and domestic increase rates will also increase local borrowing costs; so there will be a double squeeze on the forecast, which is not good for growth. If the demand in the export zone is lower, the borrowing costs, domestic external, are eventually higher, and that is (inaudible).

As a footnote I also know that this is – there is (inaudible) but global question – how sustainable it might be to have only one engine of growth, however strong it could be, the US, in the world economy going forward.

Lower external demand in the eurozone has translated into declines in exports in the last three months. Seasonally adjusted figures on this chart show that in central Europe, the Baltics, south-eastern Europe (dark blue and light blue) exports are declining; and of course there are other things going on in small CIS countries in the other regions.

Domestic demand is taking over and is boosted by the oil price increase in central, eastern and south-eastern Europe. Getting also a positive lift – and for the first time we can tell you – a positive lift from labour markets. Unemployment rates are starting to come down.

In this chart we depict the latest data with a diamond, and below that is a column – the diamond was a year ago and the column is the latest number. If the column is below the diamond it means there is a decline. That is indeed what we see in most of the countries, particularly in south-east Europe. That is a good story. In many cases it is happening in the context of rising real wages; so that is indeed a positive story on the back of growth in this region.

At the same time, credit growth remains subdued and is not changing, as we have depicted in various countries. In this report we highlight one factor that is very important in this regard: credit growth is clearly constrained by persistently high non-performing loans in the region. We have found a very nice negative correlation between NPL ratios and credit growth, averages since 2012. The chart is quite telling. We believe that the crisis legacy has to be dealt with; otherwise credit growth will not resume and growth will not resume sustainably.

Inflation is lower and in some countries it is negative in central, eastern and south-eastern Europe, not in other countries that have been subjected to currency devaluations. Overall, even in countries where inflation is low, we do not see deflation as a major set.

Overall, average growth in the EBRD region has slipped into the negative at -0.3; but there are very important variations. Importers are edging up and growth is edging up, whereas it is declining massively in commodity exporters.

If you take one chart away and then one line for the overall region, the region as a whole is slipping into a mild recession, brought down by Russia and commodity exporters. At the same time, looking at 2015, there is a positive contribution from commodity importers.

Thank you very much. We are ready to take questions.

MR PAUL HANNON: I am from the Wall Street Journal. When speaking of Ukraine you referred to very significant external financing needs that were in excess of the estimates we saw late last year. Do you have a ball-park figure for that? I happened to read a George Soros piece for the New York review books last night – I do not know why – and he was talking about $50 billion.

In terms of the external constraint from monetary policy – and you mentioned the Fed a few times – when the Fed went for quantitative easing there was a positive flow effect for emerging markets; in fact to the extent that a lot of them found it difficult to deal with all the hot money coming in. Clearly, you do not think there is any chance that that is going to happen in countries to the east of the Eurozone when the ECB does its thing at the end of the month! I am just wondering why not. Is it just because the growth prospects are so grim?

MS NAGY: On Ukraine, we understand the IMF mission is there and is assessing the situation. It is very clear that the needs are greater. The shock, particularly from the eastern region, in terms of disruptions in production, in trade, in banking flows, has been much bigger than foreseen. That is a very important factor. I understand that the figures are being assessed now so I would not like to second-guess what is coming from that important exercise.

We have all seen the $50 billion figure. If we compare that with the assistance to Georgia at the time of the Russia crisis, just before the global financial crisis in the autumn of 2008, the $50 billion would be comparable.

On the effectiveness of the ECB quantitative easing policy and the impact on our region, we understand that the announcement is imminent. We hope that the impact will be significant, primarily through the exchange rate channel. We are already seeing a significant depreciation of the euro against the US dollar, but other currencies – there were of course other elements (inaudible) etc. This is the main channel. This translates into devaluation, which can feed into higher prices.

We all know that the banks in the eurozone are quite liquid, and some have excess liquidity; so an additional push may be less effective than at the time when the Fed did that. There are ways of doing this. We do not know the details, so maybe there will be a positive upside.

Having said that, for emerging markets, including for our countries, the decisive external borrowing dimension is the US market. The pricing is in that, and many of them depend on that.

MR LANKES: To add something on the Ukraine question, forecasting financing needs is partly an art and not just a science, so it depends, like everything in economics, on the assumptions you are making. You will have seen and will continue to see lots of variations here. There are three key elements. One is the current-account deficit.

The second is the extent to which financing is rolled over during the period that you look at. There is a considerable repayment coming up in the course of 2015. How much of that is going to be rolled over?

Third, to what extent do you want to rebuild international reserves, which are very low at this point? Depending on what you assume, for these three you will get different numbers. The expectations are that the more you have to presume that roll-over is not going to take place, the more you will have to resume that you need to build up your reserves to gain credibility. If you put these factors together you get much larger numbers than you used to see in the final quarter of last year.

We have Dmitri here, who is our expert, and maybe you can follow up bilaterally.

MR MARK JONES: I am from Reuters. I know it is not usual, but do you have any outlook going into next year for these economies and what might happen? I notice that your projections for Russia were based on $58 a barrel. If it does continue down to $40, what kind of contraction will we see then?

You probably have not had time yet, but do you have any assessment of the impacts from the SNB's move last weekend? I know that many of these countries have mortgages that are linked to the Swiss franc, so if you have done any preliminary work on that, that would be great.

MS NAGY: We have not done 2016. We would usually do that in the context of our May exercise, and that is what we will be doing. Clearly, if we go to a worst-case scenario and divert very significantly from our central case, which is $58 a barrel, there will be liquidity stresses in financial markets and in Russia. We have seen a version of that in December, but it could be an even stronger impact.

I have gone to lengths to explain the background of the reserves situation. Reserves declined by a quarter in 2014 notwithstanding a very significant rouble drop, which mopped up some of the pressure. If oil incomes are significantly lower, one would expect further stresses – but that is not our central case at this point.

On the decision of the Swiss National Bank, this was unexpected by all countries, including our countries. Countries, however, are much less vulnerable than they were last time when this was a big issue around the global financial crisis. At that time Hungary and Poland had very significant exposures in the Swiss franc, particularly with household mortgages but also other types of loans – less on the sovereign debt side. Since then, Hungary, through various schemes, has reduced or in some sectors eliminated Swiss franc exposures through currency conversion schemes, one after the other. The latest was announced in December and is now being completed. The vulnerability there – and it was once the most vulnerable country in this respect – has been significantly reduced, if not eliminated.

In Poland regulatory policy from the start limited more Swiss franc exposures than did Hungary, and therefore it started in a better situation. Where exposures are about 7 or 8 per cent of GDP overall, of total debt, which is not an insignificant but not a material number for a country that has very strong finances, a strong reserve position – they just got a renewal of the IMF flexible credit line last week of US$ 22 billion – they are very good performers and have strong regulatory policies. If there is any shock, Poland can really manage it, so we do not expect any major fall-out. They can manage this exposure, which is again not insignificant, but not material. I think markets have overreacted, as everywhere, and we expect some pick-up on that, but it is not a major source of concern.

MR NEIL BUCKLEY: I am from the Financial Times. I want to go back to Ukraine. Obviously, the EBRD does not provide macro financial support, but additional funding from other sources is fairly slow in coming at the moment, so I wondered if you could remind us what the EBRD is doing in

Ukraine and whether there are possibilities for further support from the EBRD, given the unexpectedly large needs this year.

MR LANKES: Last year the EBRD stepped up its operations in Ukraine. It moved from less than €556 million in 2013 and €1.25 billion last year. That was part of our response. We benefited in that from a number of projects that we had in the pipeline, especially in the infrastructure sector, which had been held up by the difficulties with the previous administration in Ukraine; and those obstacles were put aside last year. Therefore, we were able to commit and even disburse fairly quickly, so it was a fairly rapid response; but it was a response within the means of an institution that finances projects rather than budgets or a balance of payments.

From a project finance perspective, Ukraine is a very risky environment of course, and we need to be forward-leaning and cautious. That is the approach we are taking. To the extent that reforms proceed to the extent that a credible financing package can be put together, the EBRD is able to commit more. That is what we have indicated in the context of the international discussions. We are willing to commit well above historic levels to finance in Ukraine, but it depends on that overall financing package coming together. We do not have a safety net if things go wrong. Most of what the EBRD finances there does not have a sovereign guarantee or any other guarantee. Quite a bit of our Ukraine portfolio is equity, and you can imagine that the EBRD has already taken quite a hit during the course of last year, at least on paper.

The EBRD has said that it is willing to play its part, but it has to be part of that overall picture. You have heard Piroska say that we are very concerned about the financial situation. That is, in part, an issue that the Ukrainians have to tackle. There are certain reforms that are going slower than they should. It is also a part that the international community has to take very seriously. We are somewhat concerned that this equation is not coming together fast enough.

MR MARK JONES: Obviously, these are dark words about Ukraine. If we do not get a financing package from the IMF, what do you think would happen?

MS NAGY: Can I just say that it is not the central scenario in our projects.

MR LANKES: Well, it is what happens when you do not have enough money to pay your bills; and of course there have been situations like that previously around the world. In the Ukrainian context it is not something we want to see, especially in a country that is vulnerable in so many ways. It is something they can certainly do without.

Maybe you want to take this up in more detail with Dmitri. After the session he can give more details.

THE CHAIRMAN: We are certainly not going to speculate here on something that has not happened.

Are there any other questions? Thank you very much for coming. I understand a few of you would like to do follow-up interviews.
