5
MACROECONOMIC OVERVIEW

Following several years of relatively weak economic performance, growth in the EBRD regions averaged 3.8 per cent in 2017 – the second consecutive year of strengthening growth. That growth was broadly based, with support provided by stronger investment activity and increases in exports. In the longer term, the growth trajectories of countries in the EBRD regions are, to a large extent, shaped by those countries' demographic profiles. When analysing countries' economic performance, the concepts of GDP growth, per capita income growth and labour productivity growth are often used interchangeably. However, the large differences across countries in terms of rates of population growth and labour force growth imply that the relationships between these three concepts are in fact complex and country-specific. Indeed, some EBRD regions have similar rates of real output growth, despite differing considerably in terms of growth in per capita income and the underlying growth in output per worker.


OUTPUT
OUTPUT

Introduction

The first part of this Macroeconomic Overview provides a brief summary of economic developments in the EBRD regions in 2017 and the first half of 2018.[1] (For the most up-to-date information on economic performance in those regions, see the latest issue of *Regional Economic Prospects in the EBRD Regions*.) With the longer-term growth trajectories of countries where the EBRD invests being largely shaped by their demographic profiles, the second part of this overview then looks at the average economic performance of the EBRD regions and other countries around the world in relation to basic demographic variables.

Strong growth momentum

Growth in the first quarter of 2018 was the strongest seen since mid-2012

Economic growth in the EBRD regions averaged 3.8 per cent in 2017 (weighted on the basis of countries' gross domestic product (GDP) at purchasing power parity (PPP)), up from 1.9 per cent in 2016. In the first half of 2018 growth moderated somewhat overall in year-on-year terms, but remained relatively strong. Indeed, it stood at 4 per cent in the first quarter of the year on a 12-month rolling basis – the strongest rate seen since the second quarter of 2012 (albeit it remained some way short of the levels observed in the middle of the last decade, when growth rates of 6 to 8 per cent were recorded; see Chart M.1).

The growth momentum observed in 2017 was broadly based across the various EBRD regions, with more than a third of countries recording their strongest growth since 2011. Growth was supported, in particular, by a recovery in investment activity and robust export performance. Global trade grew by 4.7 per cent (the first time since 2011 that it had exceeded global GDP growth by a significant margin), aided in part by increases in investment (with investment goods more likely to be traded across borders) and a weakening of the US dollar (the dominant currency when it comes to pricing cross-border sales).[2] Indeed, exports strengthened across the board in the EBRD regions in 2017, contributing to the economic recovery. At the same time, however, global trade tensions continued to escalate, with the United States of America (USA) and China imposing large tariffs on selected imports and trade tensions deepening both between the three North Atlantic Free Trade Agreement (NAFTA) countries and between the USA and the European Union.

The broader economic environment has been supportive, with PPP-weighted global growth rising by 0.4 percentage point to stand at 3.7 per cent in 2017,[3] before showing signs of moderation in 2018. Similarly, growth in the EU-15 averaged 2.3 per cent in 2017, up from 1.8 per cent in 2016.

CHART M.1. Average annual growth rates in the EBRD regions

Source: National authorities, International Monetary Fund (IMF) and authors' calculations.
Note: Each figure relates to a 12-month period. For example, the figure for the first quarter of 2018 indicates average growth over the period from April 2017 to March 2018. The dotted line indicates short-term forecasts based on a principal component model incorporating 152 global economic indicators.

Foreign direct investment flows remain broadly stable

Gross inward foreign direct investment (FDI) in the median EBRD economy totalled 2.8 per cent of GDP in the 12 months to March 2018 – broadly equivalent to the levels observed in emerging Asia, but somewhat below those seen in Latin America. Levels of FDI have remained broadly stable over the last five years, with the increase in investment in the EBRD regions being accounted for primarily by domestic sources, as well as greater use of EU structural and cohesion funds in central and south eastern Europe. At a global level, FDI flows have exhibited a slight downward trend, partly reflecting growing hostility to globalisation and trade tensions. Diminishing returns to technological advances in telecommunications and transport – which are typically leveraged by multinational companies participating in global value chains – may also be having an impact.

Favourable financing conditions

As a result of the global search for yield, financing conditions in emerging markets have remained favourable, despite the US Federal Reserve continuing to gradually raise its policy rate. Although global stock markets experienced a correction in February 2018, followed by a period of somewhat higher volatility, equity prices in emerging Europe were, on average, 8 per cent higher in October 2018 in US dollar terms than they had been three years earlier. Russian stocks experienced a larger downward correction following the announcement of a new round of US sanctions in April 2018, with affected firms including Rusal, a major aluminium producer. Yields on emerging market bonds were not greatly affected by the increase in stock market volatility.

[1] In this section of the *Transition Report 2018-19*, data on "the EBRD regions" do not include figures for the West Bank and Gaza.
[2] See Boz et al. (2017).
[3] See IMF (2018) for a discussion and current projections.

Increases in average oil prices

The price of Brent crude oil briefly exceeded US$ 70 per barrel in January 2018, and then again in April 2018, on account of strengthening demand, cuts to production by Russia and members of the Organization of Petroleum Exporting Countries (OPEC), and concerns about disruptions to supply. As a result, the average oil price in the period from January to July 2018 was 31 per cent higher than it had been in the equivalent period in 2017, following a 24 per cent increase the previous year. So far, those higher prices have more than offset the impact of smaller production volumes for Russia and other exporters that have committed to production caps. The adverse impact on commodity importers has been limited, as global consumption of oil tends to be spread fairly evenly across countries, while global production is concentrated in a relatively small number of major oil exporters.

Growth momentum broadly based across the EBRD regions

Growth in central Europe and the Baltic states (CEB) has picked up strongly, averaging 4.3 per cent in 2017 (up from 2.9 per cent in 2016) and 4.7 per cent year on year in the first half of 2018, boosted by increases in investment and stronger wage growth. Similarly, growth in south-eastern Europe (SEE) averaged 4.1 per cent in 2017, up from 3 per cent in 2016, before moderating somewhat to stand at 3.4 per cent year on year in the first half of 2018. In particular, Romania's growth rate was close to 7 per cent in 2017, well above its estimated long-term growth potential, on the back of an expansionary fiscal policy and rising wages, before falling back to stand at 4 per cent year on year in the first half of 2018. Greece, meanwhile, saw modest levels of positive GDP growth in 2017, after two years of marginally negative growth rates.

Growth in eastern Europe and the Caucasus (EEC) rose to 2.3 per cent in 2017 and 3.6 per cent year on year in the first half of 2018, up from around zero in 2016, with Azerbaijan and Belarus returning to growth and economic activity expanding vigorously in Armenia and Georgia.

Various stimulus measures, including the establishment of a Credit Guarantee Fund for small and medium-sized enterprises (SMEs) and a variety of tax incentives, have helped to boost Turkey's growth rate, which stood at 7.4 per cent in 2017 and 6.2 per cent year on year in the first half of 2018, up from 3.2 per cent in 2016. However, the Turkish economy has been exhibiting classic symptoms of overheating, with a widening current account deficit (that is to say, investment growing faster than savings), rising inflation and a depreciating currency. In response, Turkey's central bank has simplified the framework for its monetary operations and repeatedly raised its policy rates by several percentage points. Despite these measures the lira has depreciated significantly against the US dollar.

Russia's economy has returned to growth, expanding by 1.5 per cent in 2017 and 1.6 per cent year on year in the first half of 2018, following a cumulative contraction of around 3 per cent in 2015-16. At the same time, the new round of US economic sanctions in April 2018 has added to the economic uncertainty faced by investors.

Growth in Central Asia averaged 4.8 per cent in 2017 (up from 3.6 per cent in 2016) and 4.6 per cent year on year in the first half of 2018, supported by increases in the average prices of oil and other commodities, with Uzbekistan continuing to implement an ambitious programme of liberalisation reforms.

Growth in the southern and eastern Mediterranean (SEMED) rose to 3.7 per cent in 2017 (up from 3.3 per cent in 2016) and 4.7 per cent year on year in the first half of 2018, with agricultural output rebounding in Morocco and Tunisia and improved competitiveness and greater investor confidence supporting growth in Egypt. At the same time, however, economic activity in Jordan and Lebanon continued to be negatively impacted by the geopolitical uncertainty in the region and the resulting refugee crisis.

For the most up-to-date information on developments in the economies of the EBRD regions, as well as growth forecasts for the next two years, see the latest issue of *Regional Economic Prospects in the EBRD Regions.*

COUNTRIES WHERE LABOUR FORCE GROWTH EXCEEDS POPULATION GROWTH ACCOUNT FOR ONLY

38%

OF GLOBAL GDP

IN THE EBRD REGIONS, COUNTRIES WHERE DEMOGRAPHICS ARE EXPECTED TO SUPPORT BOTH GROWTH AND CONVERGENCE BETWEEN NOW AND 2040 ARE FORECAST TO ACCOUNT FOR ONLY

17%

OF THOSE REGIONS' GDP

2.8%

OF GDP

GROSS INWARD FDI IN THE MEDIAN EBRD ECONOMY IN THE 12 MONTHS TO MARCH 2018

Wage growth picks up as labour markets tighten

As the economic recovery has taken hold, labour markets have gradually tightened. Across the EBRD regions, unemployment rates have declined from their peaks, but they remain elevated in many countries, with average unemployment rates ranging from 4 per cent in central Europe to 11 per cent in the SEE region (weighted by population). As labour markets have tightened, wage growth has picked up, particularly in countries with declining labour forces (such as Bulgaria, Latvia, Lithuania, Romania and Slovenia). That stronger wage growth has, in turn, boosted domestic demand, contributing to the stronger-than-expected economic performance in 2017.

Limited impact on inflation so far

Those falling unemployment rates have not yet resulted in strong inflationary pressures, mirroring trends in advanced economies.[4] In part, this may reflect the existence of substantial economic slack following a prolonged period of modest economic growth after the 2008-09 global financial crisis.[5] Technological change may further weaken the link between unemployment and wage growth. Technology makes it easier for workers to be matched with job openings or to be employed part time on a freelance basis in the "gig economy", reducing the structural rate of unemployment. In addition, there are many occupations where the risk of automation may be limiting workers' ability or willingness to seek pay rises, even as labour markets become tighter.[6]

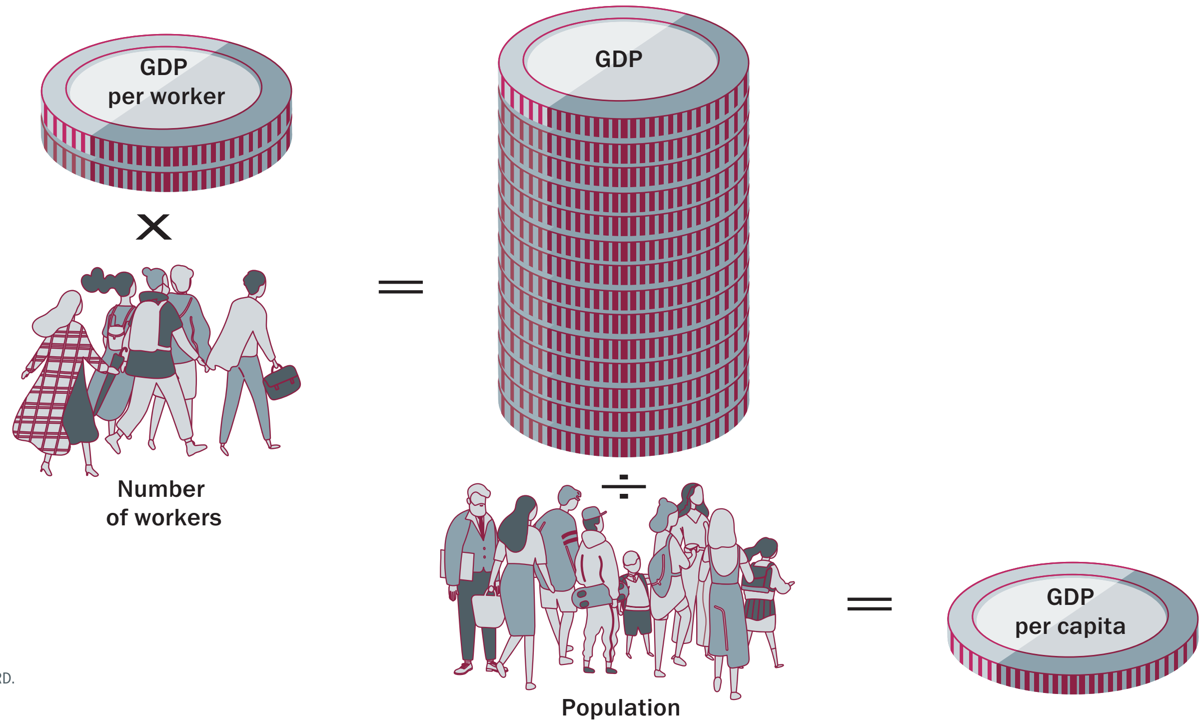
Persistently high inflation in several countries

In several countries, however, inflation has been high and rising. In Turkey, an expansionary fiscal policy and measures to increase the supply of credit and raise economic growth above its long-term potential have resulted in an overheating economy and contributed to persistent double-digit inflation. In Egypt, Ukraine and Uzbekistan, meanwhile, high inflation rates are a legacy of earlier sharp depreciations in those countries' currencies. In Egypt, inflation stood at 14 per cent in June 2018, down from an average of 30 per cent in 2017. In Ukraine, inflation stood at just under 10 per cent in June 2018, following repeated increases in the National Bank of Ukraine's policy rate in 2017 and 2018 with the aim of curbing inflationary pressures. And in Uzbekistan, an inflation rate of just under 20 per cent was recorded in early 2018.

Remittances surpass previous peak in local currency terms

Economic growth in Central Asia, Moldova and the Caucasus was also supported by growth in remittances from Russia turning positive again, with remittance growth in US dollar terms standing at 27 per cent in 2017 and 11 per cent year on year in the first quarter of 2018. While in US dollar terms (at constant US prices) the level of remittances in 2017 was still around 40 per cent below the peak observed in 2013, in real local currency terms (adjusted for local inflation) remittances surpassed that previous peak.

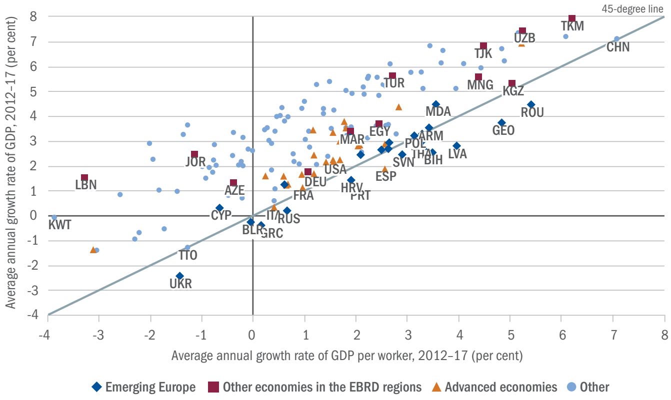
CHART M.2. Relationships between GDP growth, per capita income growth and labour productivity growth



Source: EBRD.

[4] See, for instance, McLeay and Tenreyro (2018). The concept of the inflation-unemployment curve was first proposed by Phillips (1958).
[5] See EBRD (2017) for a discussion of this issue.
[6] See IDB et al. (2018) for a discussion looking at the future of work in emerging markets.

CHART M.3. Average growth in output per worker and average GDP growth



Source: National authorities, IMF, International Labour Organization (ILO) and authors' calculations.
Note: Figures represent simple averages across the five years in question. GDP per worker is defined as output divided by the number of people in the labour force.

Rise in corporate debt denominated in foreign currencies

Across the EBRD regions, companies and governments alike have been taking advantage of favourable global financing conditions and borrowing in international financial markets, with total non-financial corporate debt in the EBRD regions averaging 63 per cent of GDP in 2017, up from 58 per cent of GDP in 2007. These trends have been broadly based, with significant increases in corporate indebtedness being observed in the median economy.

Much of that recent increase in corporate debt is accounted for by external borrowing or domestic borrowing denominated in foreign currencies, with foreign currency-denominated domestic and external debt accounting for around 79 per cent of the total debt of the non-financial corporate sector in 2017. At the same time, real growth in domestic credit (adjusted for inflation and exchange rate movements) has been moving in line with growth in real output.

Capital flows resilient to date

Such an increase in corporate indebtedness in foreign currency would represent a potential source of vulnerability if global financing conditions tightened rapidly and net capital flows to emerging markets weakened substantially. So far, capital flows to emerging markets have remained broadly resilient. For instance, net mutual fund flows to the EBRD regions in the 12 months to June 2018 equated to around 4 per cent of assets under management, according to data compiled by EPFR Global. The resilience of capital flows has, in part, been supported by the relative weakness of the US dollar, with a weaker dollar making it easier to service debt obligations denominated in that currency and increasing dollar-referenced returns for emerging market investors. Between mid-2017 and mid 2018 the currencies of the EBRD regions remained broadly stable overall, appreciating somewhat against the US dollar and depreciating slightly against the euro.

63% OF GDP

AVERAGE DEBT OF THE NON-FINANCIAL CORPORATE SECTOR IN THE EBRD REGIONS

Progress made in reducing NPLs, but much remains to be done

A combination of policy measures and an economic upswing has led to reductions in the ratio of non-performing loans (NPLs) to total loans, with that ratio declining by almost 10 percentage points relative to the peak observed after the 2008-09 financial crisis in the median economy. That being said, NPL ratios remain in double digits in around a third of all economies where the EBRD invests. Meanwhile, a banking scandal in Latvia in February 2018 highlighted other challenges in terms of the regulation and supervision of banks in the EBRD regions. Following accusations of money laundering and corruption, ABLV, Latvia's third-largest commercial bank, submitted a voluntary liquidation plan and is expected to be wound up with the assistance of independent international auditors.

All in all, the short-term economic outlook for the EBRD regions has improved. In the longer term, however, those economies' growth trajectories are, to a large extent, shaped by their demographic profiles. The next section examines the links between the demographic characteristics of countries where the EBRD invests and various economic indicators.

Growth in GDP, per capita income and labour productivity

When policymakers and economists discuss economic growth in the short term, they typically focus on headline economic growth – the change in gross value added at constant prices. Over the longer term, however, a more typical metric of economic development is the change in income *per capita*. And when looking at the challenge of improving growth performance, the focus is often on labour productivity growth, or the change in *output per worker* – a metric that is also available to individual firms.

Those three metrics – GDP growth, per capita income growth and labour productivity growth – are closely related, but may nonetheless behave differently, depending on a country's demographics (see Chart M.2).

In particular, the way in which productivity growth translates into GDP growth depends on growth in employment: similar rates of real output growth may be underpinned by very different rates of labour productivity growth. For example, Turkey and economies in the SEMED region and Central Asia tend to experience stronger GDP growth than economies in emerging Europe at a given level of labour productivity growth (see Chart M.3).

In the short term, changes in employment reflect both changes in the labour force and changes in the rate of unemployment, while changes in unemployment tend to reflect the economic cycle. Over the longer term, however, changes in employment closely track changes in the labour force. Thus, the way in which productivity translates into per capita income growth also depends on growth in the overall population – including the young, the old and adults who choose not to seek employment and are therefore not counted as part of the labour force. At the same time, inward and outward migration also affect the rate of labour force growth.

Growth and labour productivity

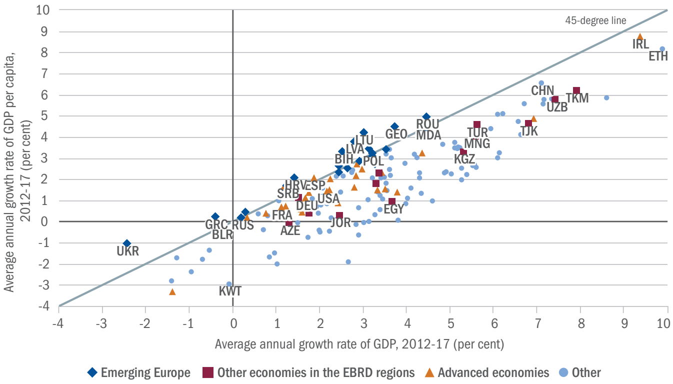
At a global level, 89 per cent of all economies have seen their labour force grow in recent years, accounting for 91 per cent of global value added. Notable exceptions include emerging Europe, southern Europe, Thailand and, most recently, China (see the economies sitting on or below the 45 degree line in Chart M.3). In these economies, headline economic growth has fallen short of productivity growth.[7] At the level of the EBRD regions, 76 per cent of economies saw their labour force grow in the 2000s, accounting for 81 per cent of total output. However, in the period 2012-17, only 24 economies experienced labour force growth, accounting for 54 per cent of total output.

By 2040, shrinking labour forces are expected to be commonplace. Around 80 per cent of economies around the world are expected to see continued labour force growth between now and 2040, but those economies currently account for only around 55 per cent of global GDP. Thus, global GDP growth can be expected to weaken accordingly unless labour productivity growth picks up. These labour force projections take account of demographic trends forecast by the United Nations (UN), as well as projected migration flows, while the labour force participation rate is assumed to remain constant over time. Chapters 1 and 2 discuss other key demographic trends and their drivers, as well as policies that influence labour force participation rates, such as pension reforms.

GDP growth and per capita income growth

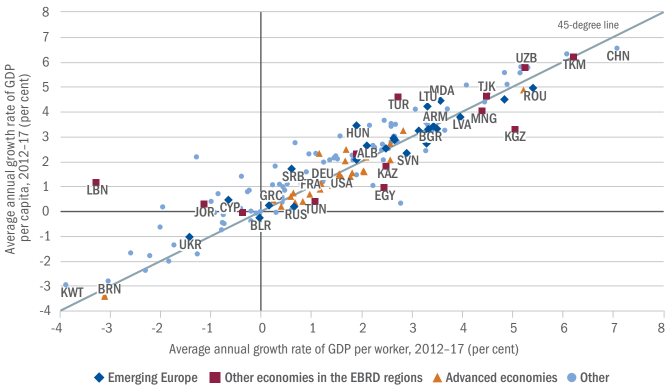
Differences in demography also shape the relationship between real GDP growth and growth in real output per capita, which determines the speed at which incomes converge with the levels seen in advanced economies (see Chart M.4). For instance, central European and SEMED economies may average similar rates of GDP growth (around 4 per cent in recent years), but their rates of population growth differ substantially. As a result, annual per capita income growth averages around 2 per cent in the SEMED region, compared with more than 4 per cent in central Europe. In other words, the SEMED region currently requires significantly higher rates of GDP growth in order to create jobs and push per capita incomes towards the levels seen in advanced economies.

CHART M.4. Average GDP growth and average growth in GDP per capita



Source: National authorities, IMF, ILO and authors' calculations.
Note: Figures represent simple averages across the five years in question.

CHART M.5. Average growth in output per worker and average growth in GDP per capita



Source: IMF, ILO and authors' calculations.
Note: Figures represent simple averages across the five years in question. GDP per worker is defined as output divided by the number of people in the labour force.

4.1%

AVERAGE GROWTH RATE IN THE EBRD REGIONS IN THE 12 MONTHS TO JUNE 2018

[7] Both here and elsewhere in this report, the term "emerging Europe" refers to a subset of emerging markets in the EBRD regions that share common demographic trends: Armenia, the countries of the CEB region, Georgia, Russia and the countries of the SEE region.

Labour productivity growth and per capita incomes: the first demographic dividend

At a given level of labour productivity growth, per capita incomes rise faster in economies where labour force growth is stronger relative to general population growth (see Chart M.5). To see why, imagine a typical EBRD economy with labour productivity growth of around 3 per cent in 2017. If the number of workers rises by 2 per cent a year, while the population rises by 1 per cent, income per capita (productivity times the number of workers, divided by the population) rises by approximately 4 per cent a year. In this scenario, demographics amplify productivity growth and deliver stronger per capita income growth.

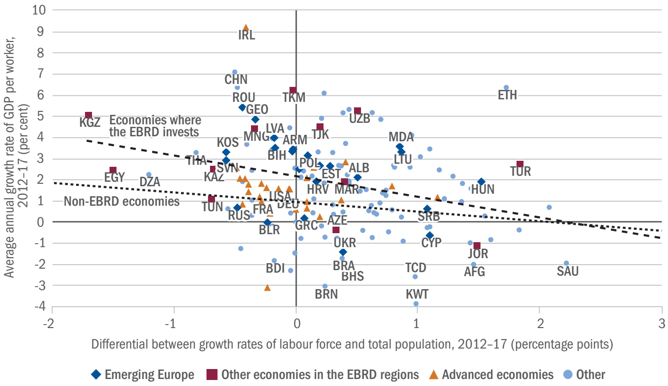
The differential between those two growth rates is sometimes referred to as the "first demographic dividend" – a term coined by Bloom, Canning and Sevilla.[8] As discussed in Chapter 1, the first demographic dividend can be large as a result of (i) the country having had a higher birth rate in the past, (ii) an influx of migrant workers or (iii) an increase in labour force participation rates (typically among women). A low old-age dependency ratio (defined as the number of people aged 65 or over as a percentage of the working-age population) also contributes to a higher demographic dividend when it comes to per capita income growth. The first demographic dividend is further reinforced by the second demographic dividend, which is reflected in higher savings rates and greater human capital, as discussed further in Chapter 1.

Leveraging the demographic dividend is often a challenge: economies with rapidly growing labour forces often struggle to achieve high levels of productivity growth (see Chart M.6). Young economies with fast-growing labour forces often have a weaker skills base, low savings and thus a lower capital stock per worker, all of which have an adverse impact on labour productivity. Thus, fully leveraging the demographic dividend in countries with fast-growing labour forces requires proactive policies aimed at speeding up the accumulation of physical and human capital. In contrast, advanced economies facing adverse demographic trends often leverage technological advances as a substitute for labour and specialise in capital- and knowledge-intensive goods and services, enabling them to achieve stronger labour productivity growth.[9] Chapter 1 discusses these adjustment mechanisms in greater detail.

79%

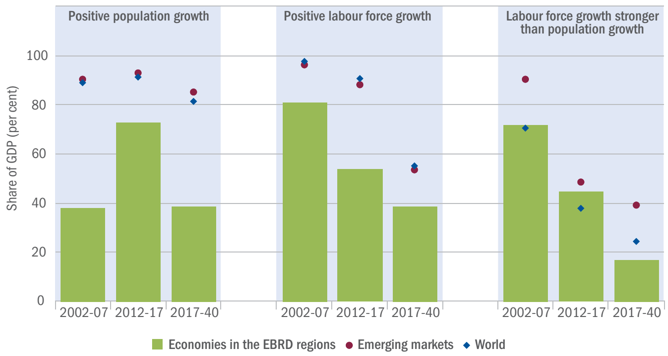
PERCENTAGE OF THE NON-FINANCIAL CORPORATE SECTOR'S DEBT THAT IS ACCOUNTED FOR BY EXTERNAL DEBT AND FOREIGN CURRENCY-DENOMINATED DOMESTIC DEBT IN THE EBRD REGIONS

CHART M.6. Growth in output per worker tends to be weaker in economies that enjoy a larger demographic dividend



Source: IMF, ILO and authors' calculations.
Note: Figures represent simple averages across the five years in question. GDP per worker is defined as output divided by the number of people in the labour force.

CHART M.7. Demographic change can occur fast



Source: UN, IMF and authors' calculations.
Note: Shares of GDP are based on GDP at PPP. Emerging markets are defined as economies where GDP per capita remains less than 50 per cent of the US level, measured at market exchange rates.

Demographic trends constraining medium-term growth potential and convergence

Today, the differential between the growth rate of the labour force and that of the population remains positive in only 64 per cent of economies, accounting for 38 per cent of world GDP. What is more, those percentages have been declining rapidly. In the years preceding the 2008-09 global financial crisis, countries experiencing a demographic dividend accounted for 70 per cent of world GDP. A similar trend can be observed by looking solely at economies that face a greater challenge in terms of per capita income convergence – defined here as countries where GDP per capita remains less than 50 per cent of the level observed in the USA. In the period 2002-07, countries where labour force growth outpaced population growth accounted for 90 per cent of those economies' contributions to GDP. By 2012-17, however, that figure had dropped to 48 per cent (see Chart M.7).

[8] See Bloom et al. (2003), which is based on earlier work on the "demographic gift" in Bloom and Williamson (1998).
[9] See Galor and Mountford (2008) and Acemoğlu and Restrepo (2018).

This illustrates the power of the recent demographic headwinds to affect per capita income convergence. Between now and 2040, countries where demographics make a positive contribution to per capita income growth are only expected to account for around 20 per cent of global GDP.

In the EBRD regions, around 75 per cent of countries enjoyed a demographic dividend in terms of per capita income growth a decade ago (see Chart M.8). However, in many of those countries, the growth rate of the labour force is projected to slow considerably or become negative by 2040. In fact, it will continue to outpace population growth in only eight countries, accounting for less than 20 per cent of the EBRD regions' GDP.

In the period 2012-17, demographics were supportive of both headline growth and per capita income growth in only 43 per cent of economies in the EBRD regions, compared with two-thirds of economies at a global level (see the economies in the upper-right quadrant of Chart M.9). What is more, the economies where the EBRD invests in which demographics are expected to remain supportive of both headline growth and per capita income growth between now and 2040 are forecast to account for only 17 per cent of the EBRD regions' GDP.

Conclusion

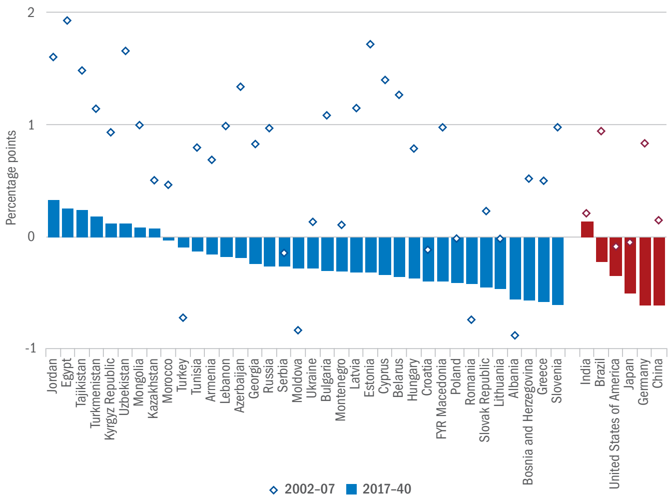
Following several years of relatively weak economic performance, growth in the EBRD regions averaged 3.8 per cent in 2017 – the second successive year of strengthening growth. That growth was broadly-based, with support provided by stronger investment activity and increases in exports.

In the longer term, the growth trajectories of economies where the EBRD invests are, to a large extent, shaped by those countries' demographic profiles. In particular, economies in the EBRD region have very different rates of population growth and labour force growth, implying that the relationships between productivity growth, per capita income growth and headline economic growth – three concepts that are often used interchangeably – are in fact somewhat complex and country-specific. For instance, while central European and SEMED economies are currently averaging similar rates of real output growth, central European economies are, on average, enjoying higher rates of per capita income growth.

In the future, both population growth and labour force growth are projected to weaken in the EBRD regions. The slow-down in labour force growth is projected to be more rapid on average, resulting in a diminishing first demographic dividend. This, in turn, will mean weaker growth in per capita income, unless labour productivity growth picks up.

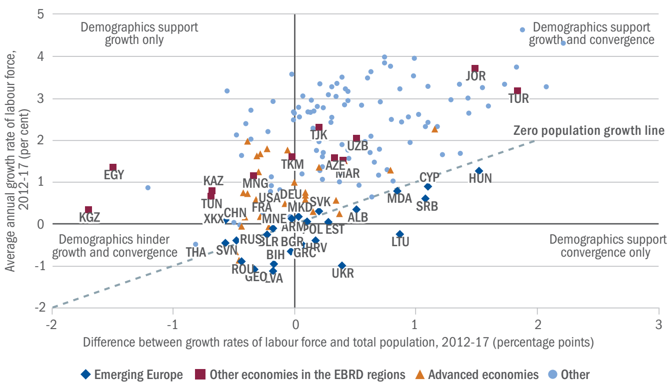
The remainder of this report looks at other ways in which the demographic transformation helps to shape growth and the ways in which it interacts with technological change and migration patterns.

CHART M.8. Declining differential between the rates of labour force growth and population growth



Source: IMF, ILO, UN and authors' calculations.
Note: For the period 2002-07, figures represent simple averages across the five years in question. Projections are based on the median scenario.

CHART M.9. Demographics support both headline growth and per capita income growth in fewer than half of all EBRD countries



Source: IMF, ILO and authors' calculations.
Note: Figures represent simple averages across the five years in question.

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