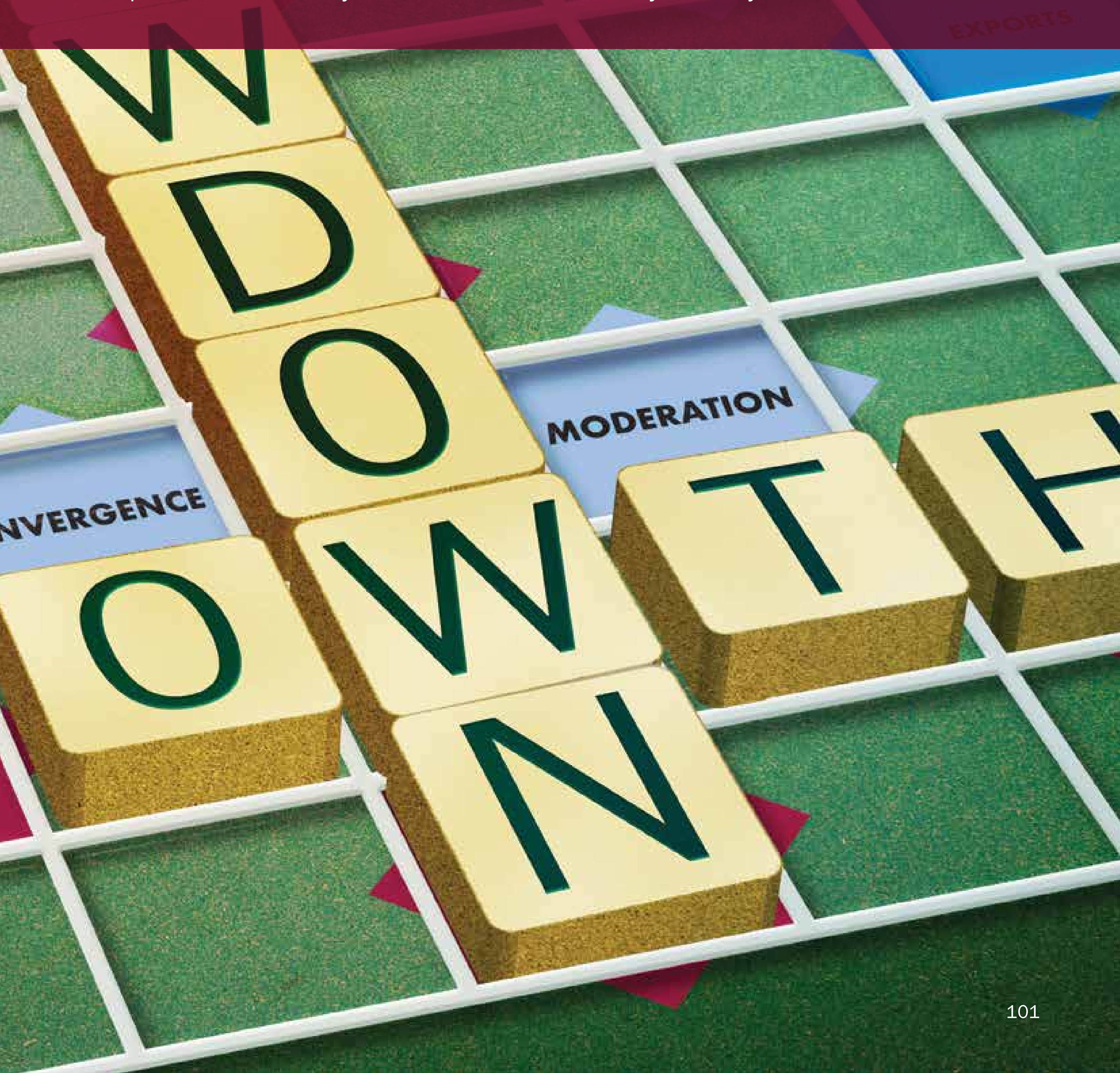
5 MACROECONOMIC OVERVIEW

Growth in the EBRD regions has been slowing since the middle of 2018. In the first half of 2019 it averaged 2.1 per cent year on year, down from 3.4 per cent in 2018 and 3.8 per cent in 2017. This deceleration has been driven by a very sharp slowdown in Turkey and weaker export growth across the EBRD regions, mirroring the global slowdown in trade. Economic growth is expected to moderate in 2019 relative to 2018, in line with less favourable external conditions, before picking up somewhat in 2020 as the recovery in Turkey takes hold.



Income convergence has slowed

Most countries in the EBRD regions have experienced stable growth in recent years, but at levels far below those seen prior to the 2008-09 global financial crisis. On average, growth rates in the period 2010-18 were less than half of those recorded in the period 2000-07, in line with the weaker growth seen in the eurozone and the global economy as a whole.

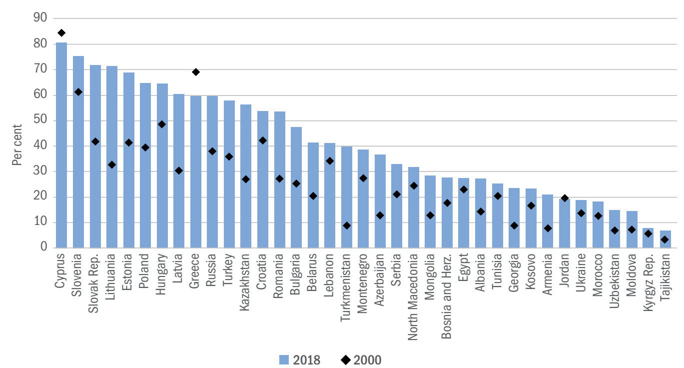
Incomes in most of the economies where the EBRD invests remain far below the levels observed in advanced economies. GDP per capita at purchasing power parity is still less than 60 per cent of G7 levels[1] in three-quarters of the EBRD regions' economies. Indeed, in some countries it remains less than one-tenth of the G7 average (see Chart M.1).

Furthermore, income convergence has slowed in recent years. On the basis of the average growth rates seen in the period 2010-18, incomes are expected to take almost 40 years to reach G7 levels in central Europe and the Baltic states (CEB) and about 140 years in the southern and eastern Mediterranean (SEMED). This is, on average, more than 25 years longer than it would have taken with the higher average growth rates observed in the period 2000-07 (see Chart M.2).[2]

There are many reasons for this slowdown in income convergence. After the recessions seen in the early stages of the transition to open-market economies in the early 1990s, most countries in the EBRD regions experienced rapid income convergence. This was driven primarily by those economies catching up in terms of total factor productivity (that is to say, the efficiency with which labour, physical capital and human capital are combined to produce final output). These efficiency gains were, in turn, driven by the liberalisation of prices, the reorientation of trade patterns and the integration of the EBRD regions into global value chains, which facilitated the introduction of new activities and technologies (see the discussion in the *Transition Report 2013*).[3]

CHART M.1.

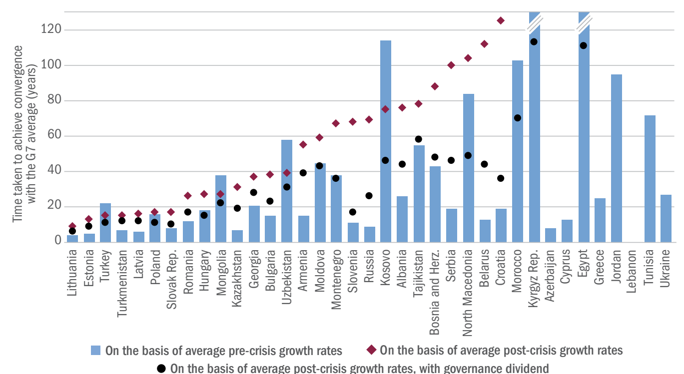
GDP per capita at PPP as a percentage of the G7 average: substantial increases since 2000



Source: IMF and authors' calculations.
Note: Based on current PPP in dollars.

CHART M.2.

Income convergence is now forecast to take longer



Source: IMF and authors' calculations.
Note: Based on income levels measured at PPP. Where data are missing, no convergence is expected on the basis of observed growth rates.

[1] The G7 comprises Canada, France, Germany, Italy, Japan, the United Kingdom and the United States of America.
[2] If convergence is calculated on the basis of market exchange rates instead of purchasing power parity, it will probably take even longer, as income gaps tend to be wider when measured using market exchange rates. In addition, calculations also assume – optimistically – that growth rates can be maintained as economies grow richer.
[3] See EBRD (2013).

By the mid-2000s, however, total factor productivity in the EBRD regions was comparable to that seen in other emerging economies. As the EBRD regions opened up and emerging Europe, in particular, became strongly integrated into global value chains, growth became much more dependent on global economic conditions. Thus, slowdowns in global growth and global trade growth began to weigh on the EBRD regions' growth prospects.

In addition, as countries develop, growth in income per capita tends to weaken, reflecting the fact that the low-hanging fruit of economic development has already been harvested.[4] Economies in the EBRD regions have also been facing additional headwinds relating to governance. As Chapter 1 of this report explains, weak governance becomes particularly problematic as income levels rise, suggesting that sustained productivity growth in the EBRD regions will require further improvements in the quality of economic institutions.

If countries were to reap the benefits of improved governance, convergence with G7 income levels could be achieved about 26 years earlier than is currently expected on the basis of average growth rates for the period 2010-18, given the governance dividend of around 1.2 percentage points per year that is estimated in Chapters 1 and 2. In other words, that governance dividend could potentially result in income convergence returning to something close to pre-crisis levels (see Chart M.2).

ON THE BASIS OF THE RECENT GROWTH PERFORMANCE OF ECONOMIES IN THE EBRD REGIONS, INCOME CONVERGENCE WILL TAKE, ON AVERAGE,
25
YEARS LONGER
THAN IT WOULD HAVE DONE WITH THE HIGHER GROWTH RATES SEEN IN THE PERIOD 2000-07

ON THE BASIS OF THE AVERAGE GROWTH RATES SEEN IN THE PERIOD 2010-18, INCOME CONVERGENCE IS EXPECTED TO TAKE
40
YEARS
IN THE CEB REGION

Slowing global growth has weighed on exports

These long-term trends are compounded by the fact that the external conditions faced by economies in the EBRD regions have become less favourable. Global growth has been slowing, hampered by a prolonged period of heightened policy uncertainty and continued trade tensions. Global growth averaged 3.6 per cent in 2018, down from 3.8 per cent in 2017, with a pronounced deceleration being observed since the middle of 2018.

While service-sector activity has held up, global manufacturing activity has been slowing since early 2018, with firms and households continuing to hold back on long-term spending as a result of high levels of uncertainty. This restraint has also been weighing on international trade, with investment goods and consumer durables making up a disproportionately large

GDP PER CAPITA AT PPP IS STILL
LESS THAN
60%
OF G7 LEVELS IN THREE-QUARTERS OF THE EBRD REGIONS' ECONOMIES

[4] See EBRD (2019) for a discussion of this issue.

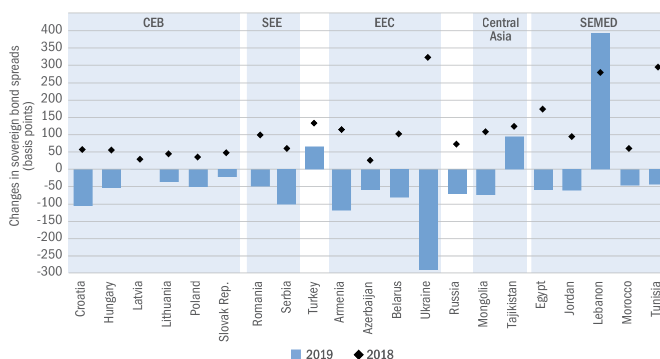
percentage of all merchandise traded across borders. Recently, global trade growth has been at its lowest level since 2012.

Economic conditions in the eurozone in particular have deteriorated sharply since the middle of 2018, reflecting a decline in exports and slowing manufacturing activity. Domestic demand has also softened – albeit to a lesser extent, since it has been buoyed by declines in unemployment (following the persistently high levels observed in the aftermath of the 2008-09 global financial crisis) and robust real wage growth.

That slowdown in global trade growth and the weakening of economic activity in the eurozone have weighed on export demand in economies where the EBRD invests. As a result, export growth in the EBRD regions has slowed further across the board, averaging just 6.3 per cent year on year in euro terms in the first half of 2019, compared with 9.6 per cent in the first half of 2018.

CHART M.3.

Sovereign bond spreads have declined in 2019, following a rise in 2018



Source: Bloomberg and authors' calculations.
Note: All bonds included in these statistics have at least one year to maturity, and they all have at least 30 months to maturity at the time of their initial inclusion.

But financing conditions have been favourable

The financing conditions faced by economies in the EBRD regions tightened throughout 2018, but have generally eased since January 2019 (see Chart M.3). That tightening of financing conditions primarily affected capital flows to economies with underlying weaknesses – notably Turkey. It also involved less cross-country variation in terms of changes in sovereign bond spreads than previous periods of financial tightening. The reduced differentiation between emerging market economies primarily benefited those countries where risks are perceived to be higher, such as Ukraine. While these economies faced significant increases in interest rates, those increases were smaller than those experienced during previous episodes (such as in 2013, when the US Federal Reserve (the Fed) announced its intention to reduce the size of asset purchases under its quantitative easing programme).

The interest rates faced by emerging market economies around the world (including the economies of the EBRD regions) have remained low from a historical perspective. The monetary policies of the United States of America and the eurozone are expected to remain accommodative. The Fed, for example, cut its policy rate in July 2019 – the first time it had done so in over a decade – and again in September 2019. It reduced the target range for its benchmark rate to 1.75-2.00 per cent, citing a weaker outlook for the US economy and the global economy as a whole. This was the first time that the Fed had begun an easing cycle with its policy rate at such a low level.

As in other emerging markets, the recovery in capital flows to the EBRD regions is ongoing. The volatility of capital flows has also declined over time, consistent with investors' increased confidence in the ability of countries' macroeconomic policy frameworks to respond to external shocks. Stock market valuations in emerging Europe have also been recovering in 2019, following a relatively weak year in 2018.

EXPORT GROWTH HAS SLOWED FURTHER ACROSS THE EBRD REGIONS, AVERAGING JUST

6.3%

YEAR ON YEAR IN EURO TERMS IN THE FIRST HALF OF 2019

Regional developments

Growth in the EBRD regions has slowed overall since the middle of 2018, averaging 2.1 per cent year on year in the first half of 2019, down from 3.4 per cent in 2018 and 3.8 per cent in 2017. This deceleration has, to a large extent, been driven by a very sharp slowdown in Turkey.

Domestic demand has continued to support economic activity in the CEB region, with annual growth in that region averaging 4.7 per cent in 2018, up from 4.4 per cent in 2017, and remaining at 4.2 per cent in the first half of 2019. Economic activity in the CEB region has been bolstered by rising wages, favourable financing conditions and improved absorption of EU structural funds.

Average growth in south-eastern Europe (SEE), however, has moderated somewhat, falling from 4.3 per cent year on year in 2017 to 3.4 per cent in 2018 and the first half of 2019, with significant variation across countries. Weak industrial production weighed on growth in Montenegro and Serbia in early 2019. Growth in Greece was also weaker than expected in 2018 and early 2019, with the country's recovery remaining fragile. Growth in Bulgaria and Romania, meanwhile, was relatively strong in 2018 and picked up further in early 2019.

Annual growth in eastern Europe and the Caucasus (EEC) has picked up overall, rising from 2.4 per cent on average in 2017 to 3.0 per cent in 2018 and the first half of 2019.

In Russia, annual growth reached a six-year high of 2.3 per cent in 2018, with rising oil prices and increases in oil production boosting government revenues and export receipts. The central bank raised its policy rate in order to contain inflation and tackle the currency depreciation resulting from the fresh round of economic sanctions imposed by the United States of America and the EU. Capital outflows reached 3-4 per cent of GDP in 2018 and early 2019 – the highest levels since 2014. Annual growth then fell to 0.7 per cent in the first half of 2019, with retail sales slowing on account of an increase in value-added tax (VAT) and oil production cuts agreed with the Organization of the Petroleum Exporting Countries taking effect.

Growth in Central Asia averaged 4.8-5.0 per cent year on year in 2018 and early 2019, up slightly from the 4.7 per cent recorded in 2017. On balance, the external economic environment remained conducive to growth, with strong export receipts and large inflows of remittances from Russia. Mongolia, Tajikistan and Uzbekistan also benefited from significant growth in gross fixed capital formation, primarily in the form of public investment and investment by foreign-owned firms.

In Turkey, annual growth slowed sharply in 2018, averaging just 2.6 per cent in that year, down from 7.4 per cent in 2017. The economy entered a recession in the second half of 2018 amid a tightening of monetary policy, private-sector deleveraging and a deterioration in consumer and investor sentiment. Output then contracted by 1.9 per cent year on year in the first half of 2019.

Average annual growth in the SEMED region rose to 4.4 per cent in 2018 and early 2019, up from 3.8 per cent in 2017, representing growth of around 2 per cent in per capita terms. This was driven by a combination of larger numbers of tourists, greater competitiveness in Tunisia and reforms in Egypt. At the same time, social unrest and political instability delayed the implementation of reforms in Jordan and Lebanon, weighing on growth.

GROWTH IN THE EBRD REGIONS AVERAGED
2.1%
YEAR ON YEAR IN THE FIRST HALF OF 2019, DOWN FROM 3.4%

Outlook for growth set to improve in 2020

Forecasts for global growth in 2019 have repeatedly been revised downwards since the middle of 2018, hampered by continued US-China trade tensions and high levels of uncertainty (see Chart M.4 showing IMF growth forecasts). Growth momentum is, in particular, expected to weaken in economies that are reliant on external demand and manufacturing exports. A projected pick-up in 2020 is conditional on recoveries taking place in stressed emerging markets (those that were in recession in early 2019) and is thus subject to significant risks.

Average growth in the EBRD regions is also expected to slow in 2019, before picking up somewhat in 2020 (see Chart M.5). In line with global trends, growth is expected to weaken more or less across the board in the EBRD regions, with few exceptions. A recovery in Turkey and a pick-up in growth in Russia are then expected to contribute to stronger average growth in 2020.

Despite some strong data in the first half of 2019, average growth in the CEB region is projected to slow in 2019 and 2020, mirroring weakening growth in the eurozone. Similarly, growth momentum is also expected to weaken in the SEE region. A recovery in Greece is likely to be slower than previously anticipated on account of weaker demand for the country's exports.

Growth in Russia is projected to decline in 2019, hampered by interest rate rises, the increase in VAT and the tightening of economic sanctions imposed by the United States of America and the EU. Growth is expected to start picking up in 2020, driven partly by an ambitious public investment plan for the period 2019-24.

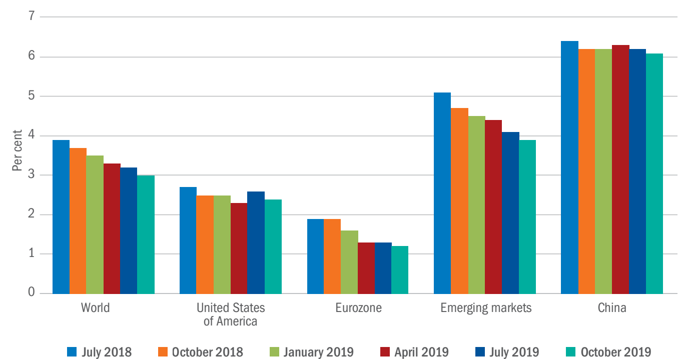
The weakness of Russian growth in 2019 will also weigh on growth in eastern Europe, the Caucasus and Central Asia. While stronger fiscal policy frameworks and moves towards greater exchange rate flexibility will facilitate adjustments to external shocks in many of the economies in these regions, in most cases growth remains too weak in per capita terms to raise living standards to a meaningful extent in the short term.

Following a recession, growth in Turkey is expected to recover in 2020 (reflecting, among other things, a lower base value for output in 2019). This forecast is in line with Turkey's rapid recoveries following previous recessions, but remains subject to significant uncertainty.

Growth in the SEMED region is expected to remain modest in per capita terms, reflecting the higher rates of population and workforce growth in these economies (see the discussion in the *Transition Report 2018-19*).[5] Since 2010, GDP per capita measured at purchasing power parity has grown at levels below, or on a par with, the G7 average in Egypt and Tunisia, implying an absence of income convergence. And in Jordan and Lebanon, GDP has actually contracted in per capita terms over that period.

CHART M.4.

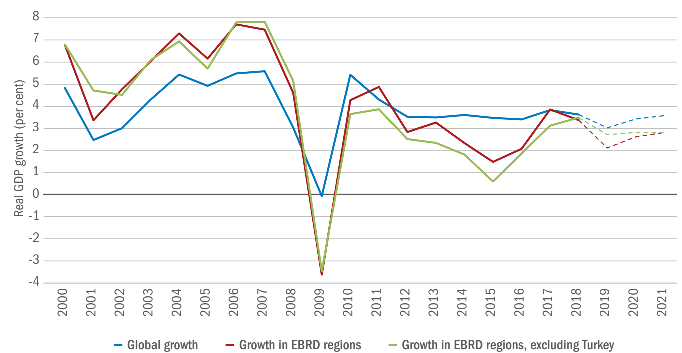
IMF growth forecasts for 2019



Source: IMF and authors' calculations.
Note: Dates correspond to the publication of IMF projections.

CHART M.5.

GDP growth in EBRD regions projected to pick up in 2020



Source: IMF, EBRD and authors' calculations.
Note: Projections are based on EBRD forecasts weighted using GDP measured at PPP.

RECENT GROWTH RATES IN THE SEMED REGION CORRESPOND TO AROUND

2%

IN PER CAPITA TERMS, IMPLYING AN ABSENCE OF INCOME CONVERGENCE

[5] See EBRD (2018).

Risks to growth lie on the downside

The outlook for the EBRD regions remains subject to significant downside risks, including a further moderation in global growth and, in particular, a sharper-than-expected slowdown in the eurozone. Trade tensions between the United States of America and its major trading partners and possible further disruptions to global supply chains remain major concerns. Moreover, as this report went to press, there was still significant uncertainty surrounding Brexit in the United Kingdom and global policy uncertainty remained elevated. The security situation in the Middle East and geopolitical tensions also represent significant sources of risk for the economies of the EBRD regions.

On the upside, many of the economies where the EBRD invests have strengthened their macroeconomic frameworks, and many have fiscal space available that will facilitate an appropriate policy response in the event of an adverse external shock.

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