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Press Briefing:
Regional Economic Prospects

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THE CHAIRMAN: Good afternoon, ladies and gentlemen. Thank you for coming to our presentation of the latest Regional Economic Prospects Report. As usual, our Chief Economist, Sergei Guriev, will present the broad global picture for our economies, and then Artur Radziwill will go into a more detailed description of the economic outlook in our various regions and countries.

MR GURIEV: Let us start with the overall regional picture.

(Slide presentation) The basic picture is positive, good, even though we reported a slowdown coming up in 2019 and a slight recovery in 2020 relative to 2017 and 2018. The slowdown is pretty much driven by one country, namely Turkey. Otherwise the region is doing well. Turkey, as you know, grew at more than 7 per cent in 2017 and slowed down to 3.5 per cent in 2018. Now it is undergoing a recession. We expect this recession to finish this year, and so Turkey will grow next year. That is an important factor for the overall average picture in the region, as Turkey is a big part of our region.

Another factor is deceleration in advanced Europe and China, some of which is driven by the trade war between the US and China, which of course affects exporters to China. For example, Germany is an exporter to China, which is also an importer from our countries and an investor in our countries. This issue also contributes to the slowdown, even though the main factor is Turkey.

The other important issue is that, last year, it was difficult for emerging markets in financing terms. Interest rates in those years were going up and there were expectations that European interest rates would go up. This year is going in the opposite direction: American interest rates are not likely to go up, nor are European interest rates; and costs of funding for our regions are also relaxed.

One of the things we discussed in this report is policy response to potential risks and overall macroeconomic policy response. We discussed cyclicality and counter-cyclicality of fiscal policy. We discussed flexibility of the exchange rate and inflation targeting, and our special box on evidence from recent recessions in our region. We also talked about risks related to trade wars, as this is the week after potential new tariffs were announced by the US President, and before the resolution of this conflict through trade talks with China.

This is the forecast in our region overall. If you look at our region, on average, growth slows down in 2019 and 2020. It is much slower than in 2017 and 2018. If you look at the region except for Turkey, the slowdown is really marginal and our economies continue to grow, on average, at 3 per cent.

If you look at it region by region, all countries have normal growth rates. Some countries see a deceleration, especially countries that are exporting to countries like Germany, which are affected by the trade war with China.

If you look at other countries, you see that growth accelerated, in some cases on the back of reforms, and then of course Turkey stands out.

On this chart we also show population growth rates. This is a topic that is very important for us for this region, but not only that; in many of our countries, demographics is a major concern, either because the growth rate of the population is very high, so you need to produce jobs for young people, or because immigration is very high and fertility rates are low, as in central, eastern and southern Europe. In some countries, we have zero or negative population growth rates. When we talk about 3 per cent or 4 per cent GDP growth, it is a 3 per cent or 4 per cent or even growth rate in terms of *per capita* incomes. However, in some other countries in Central Asia and the central and eastern Mediterranean countries the population growth rate is 2 per cent, so the 4 per cent growth is actually just 2 per cent *per capita*. So this is just to have it in mind.

When we look within the year, the picture is very similar; the first half of 2019 especially registered reasonably fast growth. Again, much of that was still driven by boom and bust in Turkey. We expect the situation to improve in 2020, but overall, if you exclude Turkey, then you can see that the situation is reasonably stable.

As I have already mentioned, much of that is driven by exports. In many of our countries export growth today is slower than export growth a year ago. That is not surprising given that the world is experiencing trade wars.

This is the issue that is very important for our countries, as I mentioned, and that is the cost of financing. Last year the cost of financing for emerging markets and for our countries was going up. Half a year ago, we said that it was going up but that by historical standards it was not too high, and that we had seen a higher cost of capital for our countries. However, compared to the end of 2018, this year has brought good news so far, and the cost of capital, the cost of funding, has actually come down. The spread with the US Treasury has also come down a little bit.

We also look at previous episodes regarding the risk of spikes when spreads in emerging markets went up. We see that last year the spike, by historical standards, was not that scary for emerging markets on average, and for our regions in particular. If you compare it to the spike of 2013, for example, our countries are doing reasonably well in terms of spread and the volatility of spread.

Overall, the trend is downwards, as financial markets and other emerging markets get better governed and more integrated with the world. We see that spreads and volatility of mutual fund flows are draining down.

An important factor for our countries is oil. Last year we saw oil rebounding a bit. This year is no exception, partly because of supply disruptions due to events in Venezuela, or American sanctions against important oil exporters. As usual, we foresee the oil price staying where the market expects it to stay, which is at the current level. However, interestingly for some of our countries, a rebounding oil price has not led to a strengthening of currencies, because of sanctions and outflow of capital, in particular for our largest country of operations, Russia.

Russia remains a very important source of remittances. Remittances in most countries are still below, either in dollars or as a percentage of GDP, their peaks in 2013 and early 2014.

However, in many countries, they have gone up to previous levels. The one thing which we would like to say is that, in our countries, remittances matter much more than other emerging markets at a similar level of development. Tajikistan and Kyrgyzstan in particular are low-income countries that have a third of their GDP coming from remittances in neighbouring countries. But actually, some other countries are also sending 10 per cent or

20 per cent of remittances, which is more than countries at a similar level of development would send.

Let me talk a little bit about policies. Right now, the global financial community is revisiting the role of flexible exchange rates. The new President of the World Bank, David Malpass, has been talking about the importance of a fixed anchor. The new Chief Economist of the IMF, Gita Gopinath, has done a lot of research in the past about the role of the dollar as an invoicing currency, as an international finance end-trade currency, and how, if your prices are sticking in dollars, the adjustment channels may be different when you have external shocks.

Overall, the conventional wisdom of having a flexible exchange rate and inflation targeting is not overturned, but there will be more and more debate about this in the coming months.

Overall, the emerging markets, in our regions in particular, have moved to a greater extent to a flexible exchange rate. Ukraine and Russia in 2014 observed major episodes of volatility, as well as Turkey and Argentina last year.

Overall, if you have sound inflation targets in fiscal policies, then that is good. The shock is absorbed by your currency and not by the purchasing power of your households.

This is the picture country by country. The dashes show inflation targets where they exist. We see that, in some countries, inflation targets are not introduced – in Uzbekistan in particular, even though there are hints that the central bank of Uzbekistan may actually move to inflation targeting in the coming years.

You also see that in most countries, central banks managed to get inflation to the target, or below the target. There are some countries where inflation is very high above the target. These are the countries that went through major depreciation in recent years – Turkey, Uzbekistan, Egypt and Ukraine – and which still have inflation above or close to 10 per cent.

The other response to shocks is fiscal policy. Overall in our region we do observe that fiscal policy is, in general, countercyclical, which is good, because that is how it should be. We measure the elasticity of the response of government spending to changes in GDP in our countries, and in advanced economies and other emerging markets. If the elasticity is below 1, that means that fiscal policy is countercyclical, which means that if GDP is growing fast, your spending does not expand as fast as GDP. So the share of spending per GDP shrinks. When GDP shrinks, your spending does not go down as fast as GDP, so the ratio of spending to GDP grows.

You see that our countries are in the countercyclical territory. Not as countercyclical, unfortunately, as some other emerging markets or advanced economies. But on average, our countries deliver countercyclical fiscal policy, especially those countries that have flexible exchange rates.

I should say that there is no clear theoretical argument as to why these two should be linked. Maybe they are linked just because countries with inflation targeting and flexible exchange rates are the countries that have a better macroeconomic policy framework, and therefore conduct monetary policy and fiscal policy in a more reasonable way.

We also talk about debt sustainability and fiscal space in the report. We show that in most of our countries that sustainability is not the most important issue. In all countries, that is important. Only very few countries have very low debt. There are some countries where debt is very, very high, and that would be Greece and Lebanon where the debt is above 150 per cent of GDP; but there are many countries where debt is above or just below 60 per cent of GDP. The good news is that for most of our countries this is a stock problem rather than a flow problem. In this chart, countries that are high on the chart are countries that are high in terms of interest rates, payments, adjusted for a nominal growth rate. Countries that are below the horizontal lines are the ones where the interest rate is below the nominal GDP rate, so the share of interest rates to GDP is shrinking over time.

Let me say a few words about our analysis of recessions. We looked at recessions in our countries of operations. Overall, there is nothing super special about our regions. Recessions in our countries, on average, last for seven quarters, not just from the beginning of recession to the bottom of the GDP levels, but to recovery to the previous session's GDP levels.

You can see that some recessions are longer than others. Greece and Croatia went through multi-year recessions, but most recessions are within a 2-year or 2.5-year interval.

We also look at what drives growth and recessions in our countries. We argue that in the post-crisis period, our countries are much more sensitive than before to external shocks from China or the Euro area. In *this* chart, the bars are the sensitivities before the crisis, and the diamonds are the sensitivities after the crisis. You can see that, in general, the diamonds are above the bars.

We look at global policy uncertainty and US trade policy uncertainty. And unfortunately, this year – especially this week (you will probably not be surprised) – there is a lot of uncertainty going on in the world. This is something that investors care about. Luckily, the US does not matter as much for our countries as Germany, and we foresee zero disruptions within the European Customs Union. However, if the US starts a trade war with Europe, that will have a major direct effect on European countries that are major partners of our countries as well.

Let me sum up. We see slowdown in growth, which is mainly driven by Turkey. In Turkey we foresee a recession this year, but growth next year. Therefore, our region will grow faster in 2020. We see rather good news in 2019 relative to 2018 in terms of the cost of financing and access to capital markets. Much of that is driven by monetary policy authorities in the West, which were not as hawkish as people feared last year. We also see that our countries are more exposed to global shocks, in the sense that they are more connected and more integrated into global trade investment, capital markets. In that respect, it is the right choice to be better prepared for those shocks. That is the title of our report *More Exposed and Better Prepared*, because our countries are now much more serious about countercyclical fiscal policy, and flexible exchange rates and inflation targets. That is, of course, the right way to prepare for shocks.

The good news is that they do have space for countercyclical fiscal policy. Most of our countries, with some exceptions, are close to 60 per cent of GDP or below 60 per cent of GDP. That means that they have fiscal space if they need to borrow.

Let me stop here and pass the floor to Artur.

MR RADZIWILL: It is indeed remarkable, given the volatile history of our region, how stable our growth rates were last year, and in the two years of our predictions. It was also quite remarkable how similar the growth rates were across and within EBRD regions.

However, those broad similar trends mask a couple of interesting stories that are specific to countries and the regions. I would like to highlight a few of them for you today.

Starting from the Western Balkans – we will obviously discuss it in more detail in the next session – I want to draw your attention to this big-picture message. While the region is growing at stable rates of around 3 per cent – which is good news – the speed of this growth is not really sufficient to make sure that these countries converge with the EU; that living standards improve quickly enough to mitigate migration from the region; that employment rates, in particular for the young, are going down fast enough. The region is not doing well, particularly if we compare it with the central European countries.

However, if we look at the central European countries of the EU Member States more broadly, and where EU Member States are also EBRD countries of operations, we also see some worrying trends, which will be increasingly important in the medium and longer term. On demographics, we see a shrinking labour force in most of those countries. While we are happy to see wages growing at a respectable rate, these wage increases are increasingly out of tune with productivity improvements. Right now, we do not have strong fundamentals for these relatively strong rates of growth to continue over a longer period, unless things improve.

Eastern Europe and the Caucasus have been particularly volatile over the last few years. I am talking about Ukraine, Belarus and Moldova, as well as three Caucasus republics. We see those stable growth rates, and this is really good news for this region. But even more encouragingly, we see that the health of this growth is improving with the sustainability of those countries in fiscal terms, and also in terms of the external position systematically improving.

The region that offers a more diverging, and maybe more interesting, picture going forward is SEMED. We see the differences between two sub-regions. We see the North African countries – Morocco, Tunisia and Egypt – that have introduced reforms, working closely with the IMF, with flexible exchange rates that help them to maintain and, where necessary, regain competitiveness. We see those countries growing at quite respectable rates. As you see from the projections, we expect those rates of growth to improve further, going forward.

On the other hand, we have Jordan and Lebanon, where reform has proved to be more difficult, and where exchange rate effects do not really help them to grow faster through export-orientated activities.

We cannot avoid talking about Turkey. That is the only country in the EBRD region that is predicted to be in recession in 2019, following the crisis last year, when there was a big depreciation of the exchange rate and a tightening of macroeconomic policies. We saw the country entering recession in the last two quarters of 2018, and that is likely to continue in the first quarter of this year. We see some good news here, namely the rebalancing of the economy, changing current account and export-driven activity. However, headwinds are obviously quite strong, quite apart from the political risk, which is still very present in the country. We see continued deleveraging, which is only partly offset by the state policy of providing loans through state-owned banks. Obviously, dependence on short-term external financing continues to be a risk for Turkey. Thank you very much.

THE CHAIRMAN: I am very happy to take questions now. As you know, we will be having a separate session, specifically on the Western Balkans, once this session is over. But we are happy to take questions on the broad economic outlook, and any other specific questions that you have.

MR FUSTER (Neue Zuercher Zeitung): A question on Turkey. Since you have finalised your outlook, we have seen the cancellation of local elections in Istanbul. What is your assessment on the impact of this event on the economic outlook for Turkey?

MR GURIEV: It is always very hard to predict the policy response to recession in a country like Turkey. And indeed, the fact that there will be new elections suggests that structural reforms are not likely to be resumed soon. If you follow the public statements made by the Turkish authorities, you will see that their attitude was always: “This is the last election. We will have a quiet time after the election, so we will handle the non-performing loan situation and relaunch the structural reforms.” I think that that may be delayed. It is too early to judge. We have monitored the situation and we will see what the policy response is. We still maintain our forecast, because we think that, so far, there is no reason to think that policies will change one way or the other.

MR EGLITIS (Bloomberg News): What advice would you give to the Turkish central bank on how to handle the fall of the lira, and also inflation?

MR GURIEV: We provide the same advice to every central bank: be credible; stick to your commitments; maintain your inflation targets. With the central bank of Turkey the inflation target is not achievable this year. The official inflation target is not, but it may be achievable in 2022 or 2021. The central bank has so far made a statement that it will stick to the policy of disinflation and keep interest rates high if needed, maintaining the path to disinflation. There is no change to that advice. The question is to what extent geopolitical risks, which are also a factor in Turkey, could create a shock to which the central bank may react by raising interest rates. That is a good question.

There is also the issue of stress-testing the quality of banks' portfolios – specialist and other banks. This is the issue, but I guess your question is about monetary policy.

On non-performing loans, we always give the same advice. And I guess that is not a question for this press conference, but we have a special initiative called the Vienna Initiative where we exchange best practices and advise governments how to handle their non-performing loan issues. That will be a big issue in Turkey.

THE CHAIRMAN: Any more questions? If any questions come to light over the next day or so, do not hesitate to come to the press office. We have a whole array of regional country experts who are sitting there and can go into greater detail, including Roger Kelly, who I am sure would thank me for telling you that you can carry on the Turkey conversation with him at any time over the next 36 hours.

MR GURIEV: And also Russia.

THE CHAIRMAN: If there are no further questions right now, we will be having a session specifically on the Western Balkans in a little while. In the meantime, thank you very much for coming. Thank you, Sergei, and thank you Artur. *(Applause)*
