The economic outlook for Europe and Central Asia, including the impact of China

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Kiev, Ukraine
• Low growth is expected in Europe and Central Asia (ECA), as global headwinds remain strong.

• The headwinds are of structural, rather than cyclical nature. They are part of the new normal.

• This is also true for the slowdown in China, which has a pervasive impact on ECA. The impact creates both opportunities and challenges.

• Policies have to adjust to new circumstances.
### Subdued growth in new forecast

<table>
<thead>
<tr>
<th>Region</th>
<th>GDP growth, % annual</th>
<th></th>
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<th>Change in forecast since October 2015</th>
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</table>
Consumption has sharply declined in Eastern Europe and Central Asia

Annual growth rates, 2015

- GDP growth (%)
- Private consumption growth (%)

Countries: Ukraine, Belarus, Russia, Azerbaijan, Moldova, Kazakhstan, Armenia, Georgia, Kyrgyz Republic, Turkey, Tajikistan, Uzbekistan
Euro Area export growth now outpaces global average

Percentage points difference between growth export volume euro area and global export growth, 12m/12m

2003m12  2006m12  2009m12  2012m12  2015m12
Strong growth of agriculture in the east

Percentage change in 2015

- Agriculture
- Industry
- Services
- GDP
Big shifts in relative prices are affecting consumption and exports

• Collapse in oil revenues amounts to large terms-of-trade losses and sharp depreciations.

• Reductions in remittances (deflated by import prices) imply large declines in household incomes.

• Diverging monetary policies and reversals of capital flows lead to changes in competitiveness.
Ruble exchange rate closely follows oil price

Monthly percentage change

Daily percentage changes

US$ per ruble  Brent oil price in US$
Sharp declines in remittances in 2015

Percentage growth in 2015 of remittances, deflated by import price
European export growth accelerates as U.S. and Chinese exports slow down
Central Banks need to rethink monetary policy

Relative price changes might require changes in monetary policy regimes:

• Oil-exporting and remittance-receiving countries need flexible exchange rate in wake of fall in oil prices.

• Central Banks in oil-exporting countries might consider oil price in local currency as a new policy target.

• Other Central Banks could reconsider inflation target, with more emphasis on the GDP deflator and housing prices.
Large differences in 2015 between GDP and CPI deflators

<table>
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<tr>
<th></th>
<th>GDP deflator</th>
<th>CPI</th>
<th>difference</th>
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<tr>
<td></td>
<td>percent</td>
<td>percent</td>
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<tr>
<td>Sweden</td>
<td>2.0</td>
<td>0.0</td>
<td>2.0</td>
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</table>
Home prices recovering in most countries, but falling in oil-exporting countries.
• Unemployment in European Union is declining as the EU enters fourth year of recovery.

• Crisis in many countries in eastern part of region starts showing in rising unemployment.

• Digital technologies, sharing economy, migration, and globalization will fundamentally change labor markets, and requires new social contract.
Unemployment falling in the west and rising in the east
• Slowdown is result of slower expansion of production capacity

• Rebalancing entails
  – Shift from investments to consumption
  – Shift from low-skilled to high-skilled production
  – Shift from inward FDI to outward FDI
Slowdown in China coincides with decelerating potential growth
China is catching up to the European Union

China’s nominal GDP as percentage of EU’s nominal GDP
China’s share of imports by ECA has expanded rapidly

*Share of imports from China in total imports, percent*

- Central Asia: 30% (1996), 30% (2014)
- Central Europe: 5% (1996), 5% (2014)
- Eastern Europe: 7% (1996), 7% (2014)
- Northern Europe: 4% (1996), 4% (2014)
- Russia: 15% (1996), 15% (2014)
- South Caucasus: 2% (1996), 2% (2014)
- Southern Europe: 6% (1996), 6% (2014)
- Turkey: 3% (1996), 3% (2014)
- Western Balkans: 1% (1996), 1% (2014)
- Western Europe: 1% (1996), 1% (2014)
• Exports are not as big as gravity model predicts. There seem to be special factors impeding exports to China.

• Sharp real depreciations vis-à-vis China have made producers much more competitive.
Eastern ECA may have greater potential than western ECA to increase exports to China

Exports to China by sector from ECA sub-regions, US$ million
China’s potential to increase import penetration in ECA is limited

Imports from China by sector from ECA sub-regions, US$ million

- Agriculture
- Low Skill Manufacturing
- High Skill Manufacturing
- Natural Resources

Actual vs Predicted for different sectors and regions.
ECA currencies depreciated sharply over past year

Percent change in real exchange rate with China, Jan-Feb 2015 to Jan-Feb 2016
Exchange rate depreciation has created opportunities to compete with imports

Percent change in potential imports as a result of real exchange rate depreciation in ECA

Agriculture

High Skill Manufacturing

Natural Resources

Low Skill Manufacturing
Exchange rate depreciation could boost ECA’s exports to China

Percent change in volume of total exports

Agriculture

Natural Resources

Low Skill Manufacturing

High Skill Manufacturing
China’s slowdown has a mixed impact on ECA’s exports

*Percentage difference in export volumes in slowdown compared to business as usual scenario*
Change in private consumption relative to business as usual scenario

<table>
<thead>
<tr>
<th>Country</th>
<th>Full Rebal</th>
<th>Slow Down</th>
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</thead>
<tbody>
<tr>
<td>Russian Federation</td>
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<tr>
<td>EU and EFTA</td>
<td>1.6</td>
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</table>
China’s slowdown improves wages, particularly of unskilled workers

Percent change in China slowdown versus business as usual scenarios

-0.1
0
0.1
0.2
0.3
0.4
0.5
0.6
0.7
0.8
0.9

Russia

Kazakhstan

Azerbaijan

Kyrgyz Republic

Ukraine

Poland

Bulgaria

Turkey and Other ECA

EU and EFTA

wage/rental rate

unskilled/skilled wages
• Expected slow GDP growth tells only part of the story. Big changes in relative prices have far-reaching consequences.
• Slowdown and rebalancing in China are key elements of structural changes in global environment.
• There are some silver linings in the outlook. Unemployment is declining in EU and export opportunities are improving.
• Policies challenges most complicated for Eastern Europe and Central Asia.
Thank you!

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