

A REBALANCING ACT IN EMERGING EUROPE AND CENTRAL ASIA

April 17, 2015

A Rebalancing Act in Emerging Europe and Central Asia

ECA is expected to be the slowest growing region worldwide with almost no growth forecast for 2015

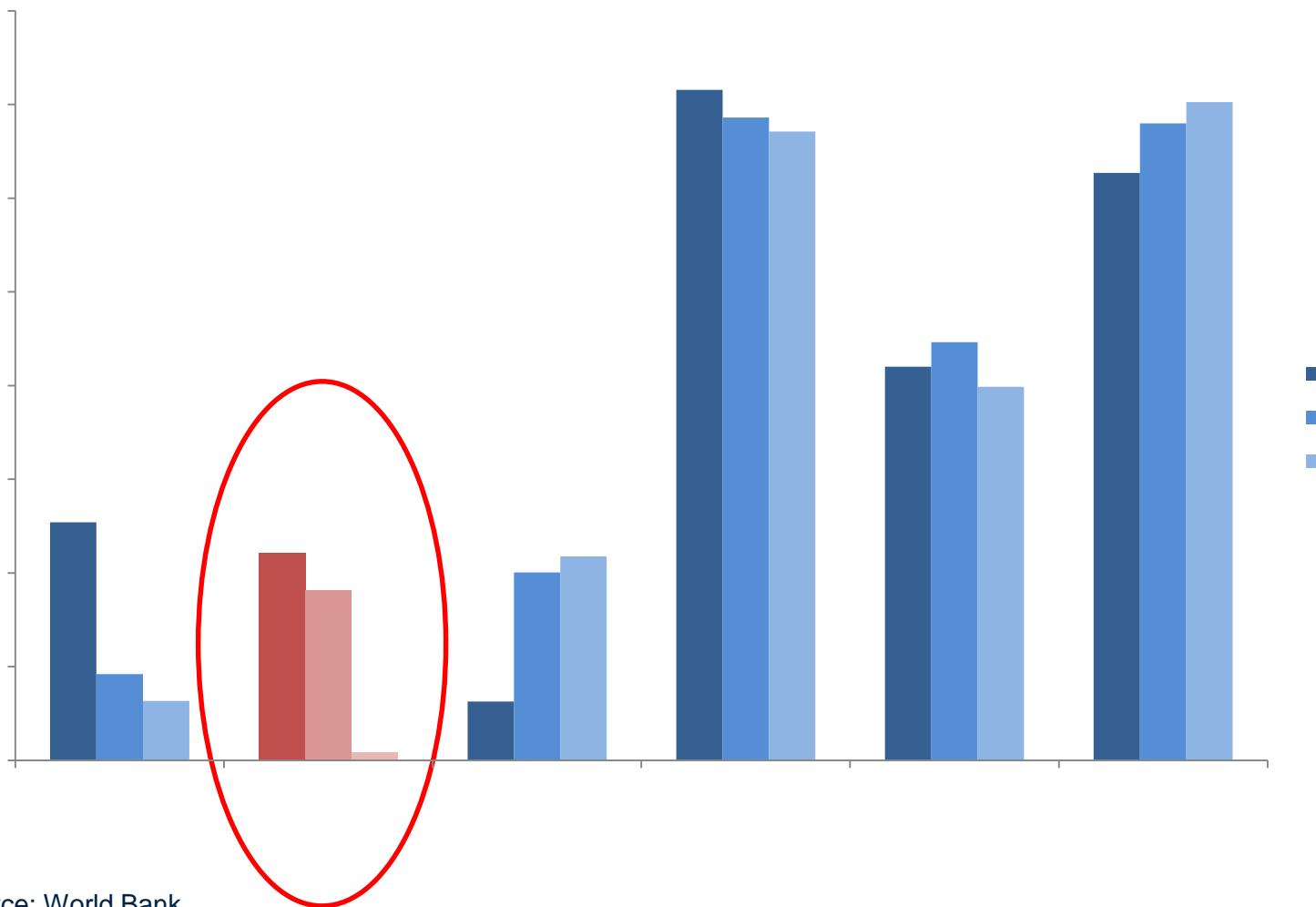
- Stable to moderately improving outlook in western part of region is being offset by the direct and indirect impact of the oil shock and uncertainty in the eastern part of the region
- The poor are hard hit by the oil shock due to the sharp decline in real spending power from weaker output, reduced remittances, as well as the lower terms of trade

Bottom-line:

- Countries that are performing the rebalancing act to lower oil prices and changing exchange rates can benefit from new opportunities in the tradables sectors, but ongoing reforms to improve the business climate as well as prudent macro and financial sector policies are also key.

Economic Growth in ECA remains weakest among developing regions 2015

GDP Growth (%), weighted average by region



Source: World Bank

Drilling-down into ECA Trends

Outlook:

- **Stable to moderately improving growth in western part of region, but concerns remain**
- **The direct and indirect impact of the oil shock and uncertainty in the eastern part of the region are hitting the poor hard**

Bottom line:

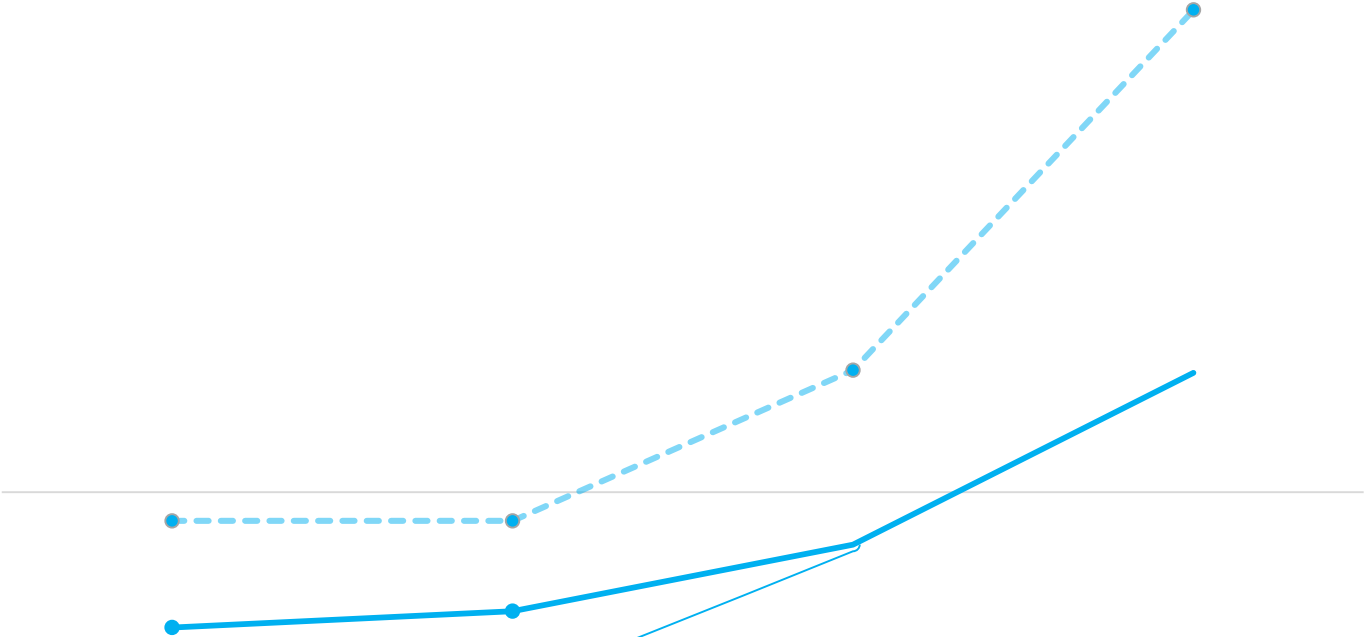
- **Countries that are performing the rebalancing act to lower oil prices and changing exchange rates can benefit from new opportunities in the tradables sectors, but ongoing reforms to improve the business**

Stable to moderately improving growth in western part of region

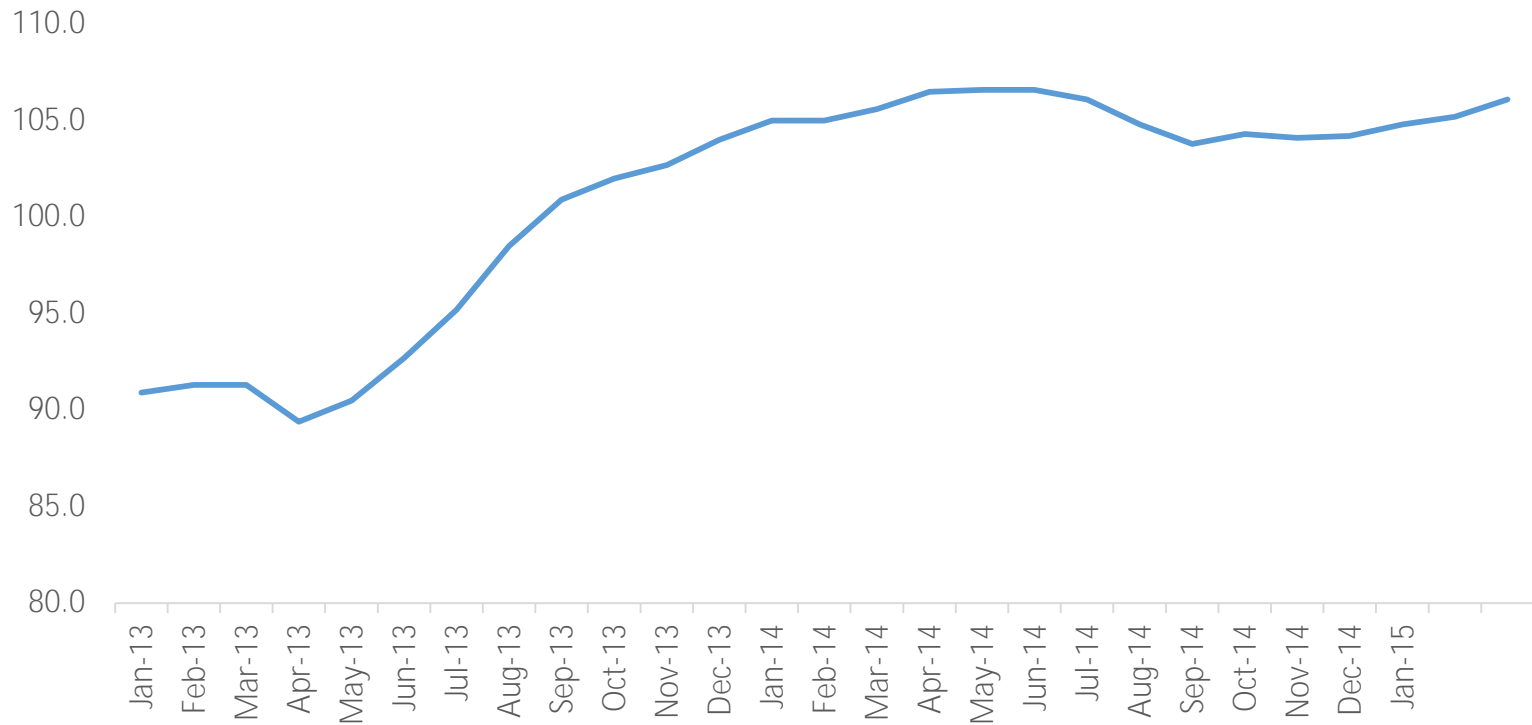
ECA countries close to Eurozone are benefiting from:

- Monetary policy easing (QE) in Europe with lower interest rates
- Depreciating currencies, boosting demand for import competing sectors and exports
- Lower cost of energy
- To date, limited spill-over from uncertainty in Greece and Ukraine

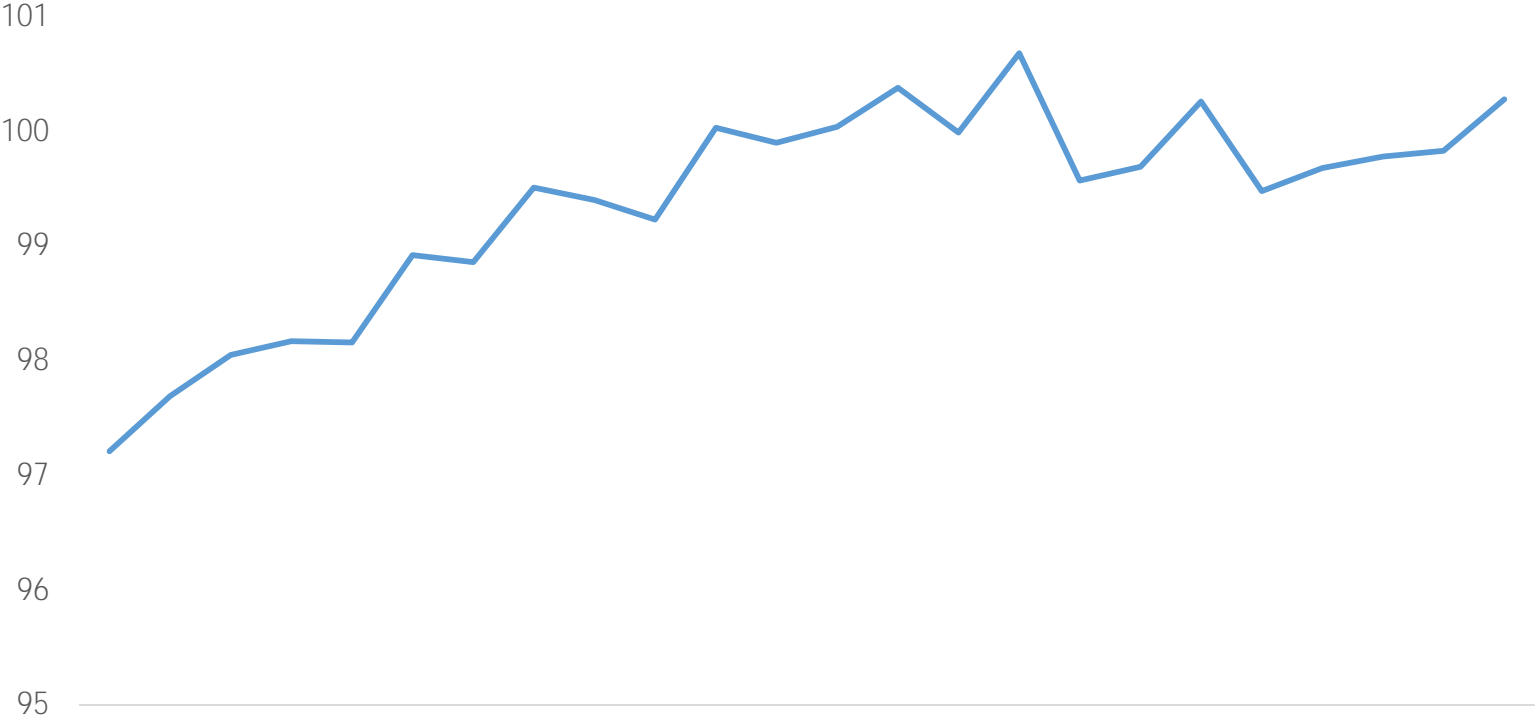
Lower interest rates are a boost to ECA countries with close ties to the Eurozone



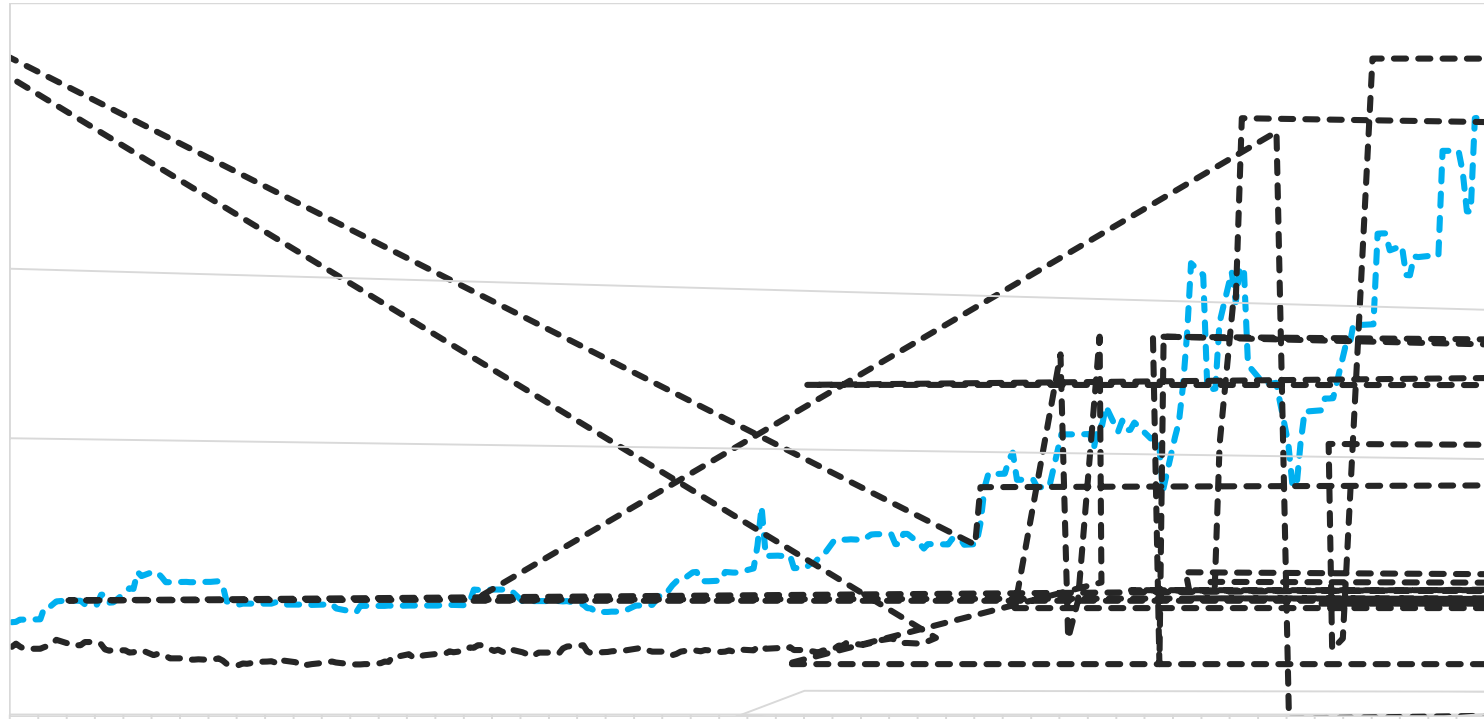
Along with lower oil prices, there are tentative signs that Eurozone confidence is picking up



With modest growth in industrial production



Limited spill-over in country risks from the uncertainty in Greece and Ukraine

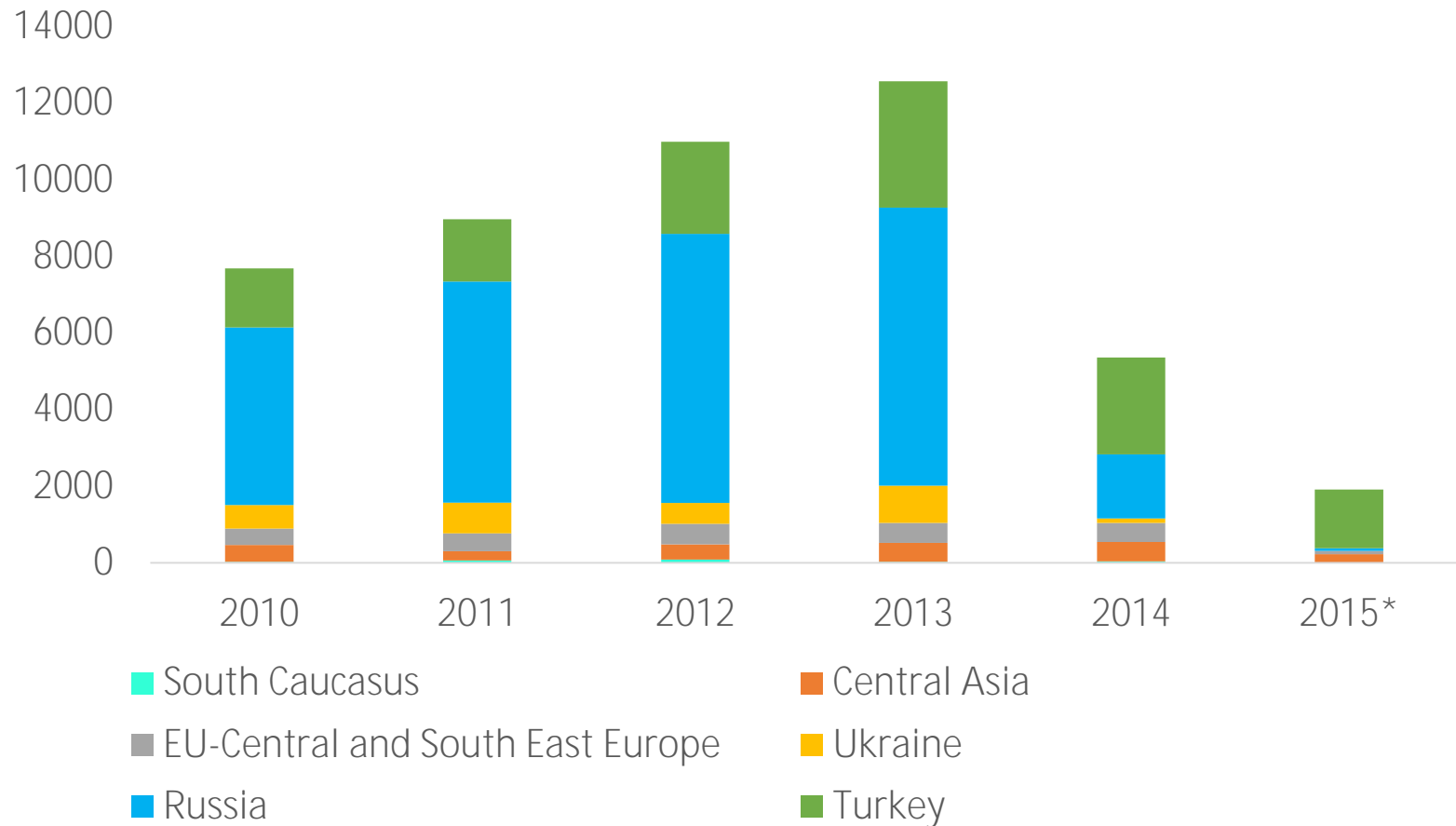


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- Labor markets have a long way to recover, especially youth employment
 - ECA average youth unemployment greater than 25% compared to about 13% for the rest of developing world
- Uncertainties linger on fundamental structural policies while the debt overhang still stifles growth
 - Non performing loans in ECA nearly 10% (W. Balkans 16.4%), other regions average between 2% to 6%.
- Gross capital flows remain weak

Private capital flows remain weak, particularly for regions hit by oil shock

Average Monthly Gross Capital Flows by Subregion

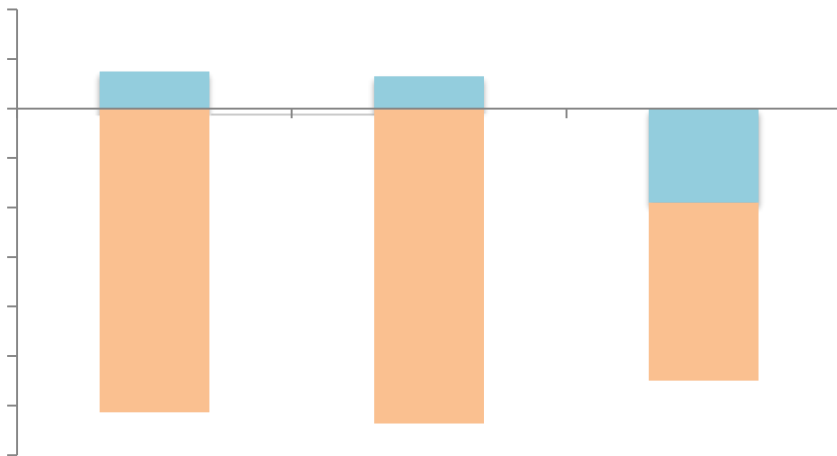


The direct and indirect impact of the oil shock and uncertainty in the eastern part of the region are hitting the poor hard

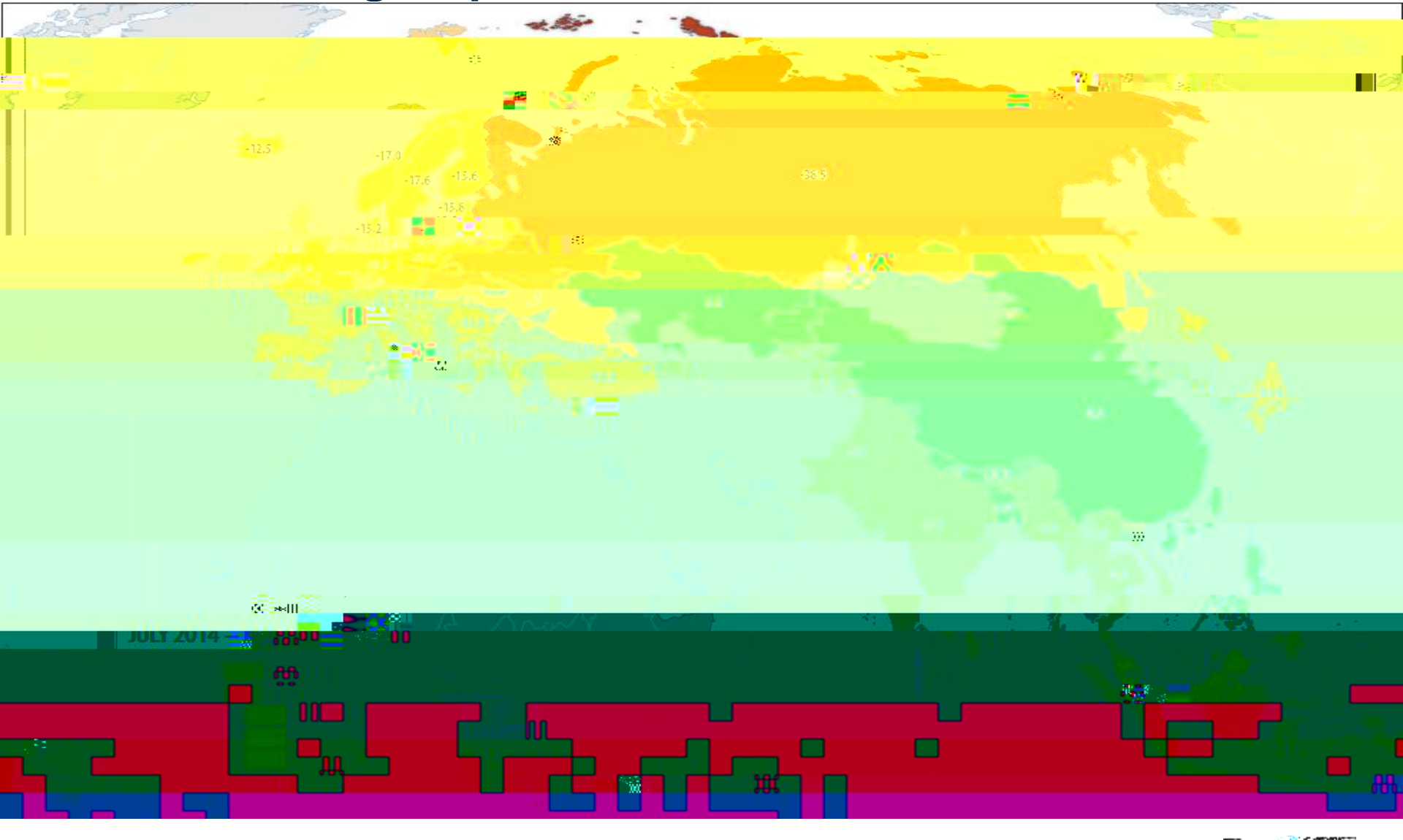
Countries highly dependent on oil exports, or on trade and remittances from oil exporting countries, are seeing a sharp decline in income

- Starting in the early 2000s, oil revenues, remittances, and capital inflows had boosted domestic demand and raised costs of production
- The reversal of these trends has come fast and hit income hard, and this is particularly concerning for the poor

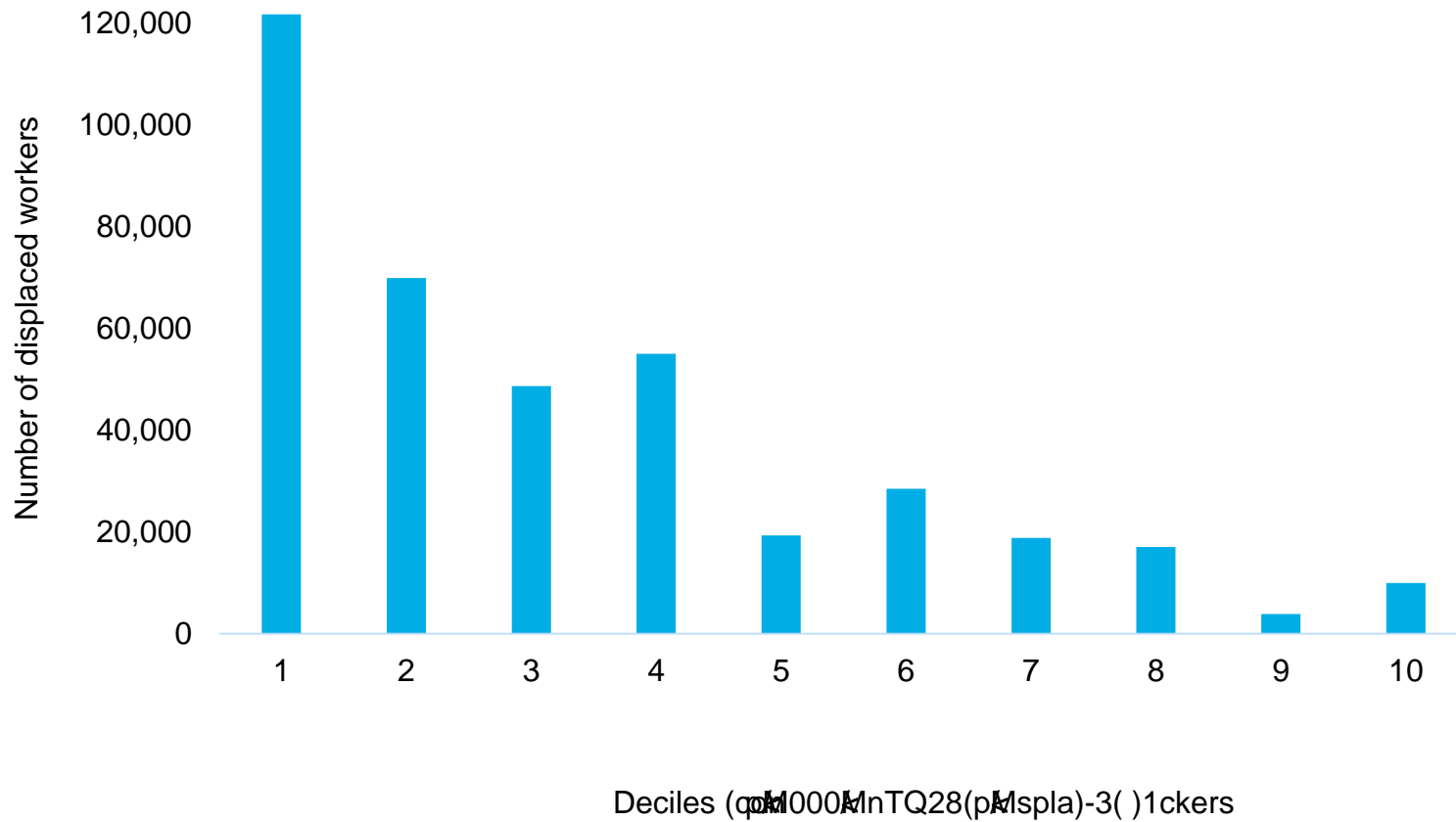
The oil price shock has had a much stronger adverse impact on buying power than what is reflected by GDP alone, through remittances and changes in export and import prices



Which have largely been reversed in the last year with falling oil prices and lower remittances

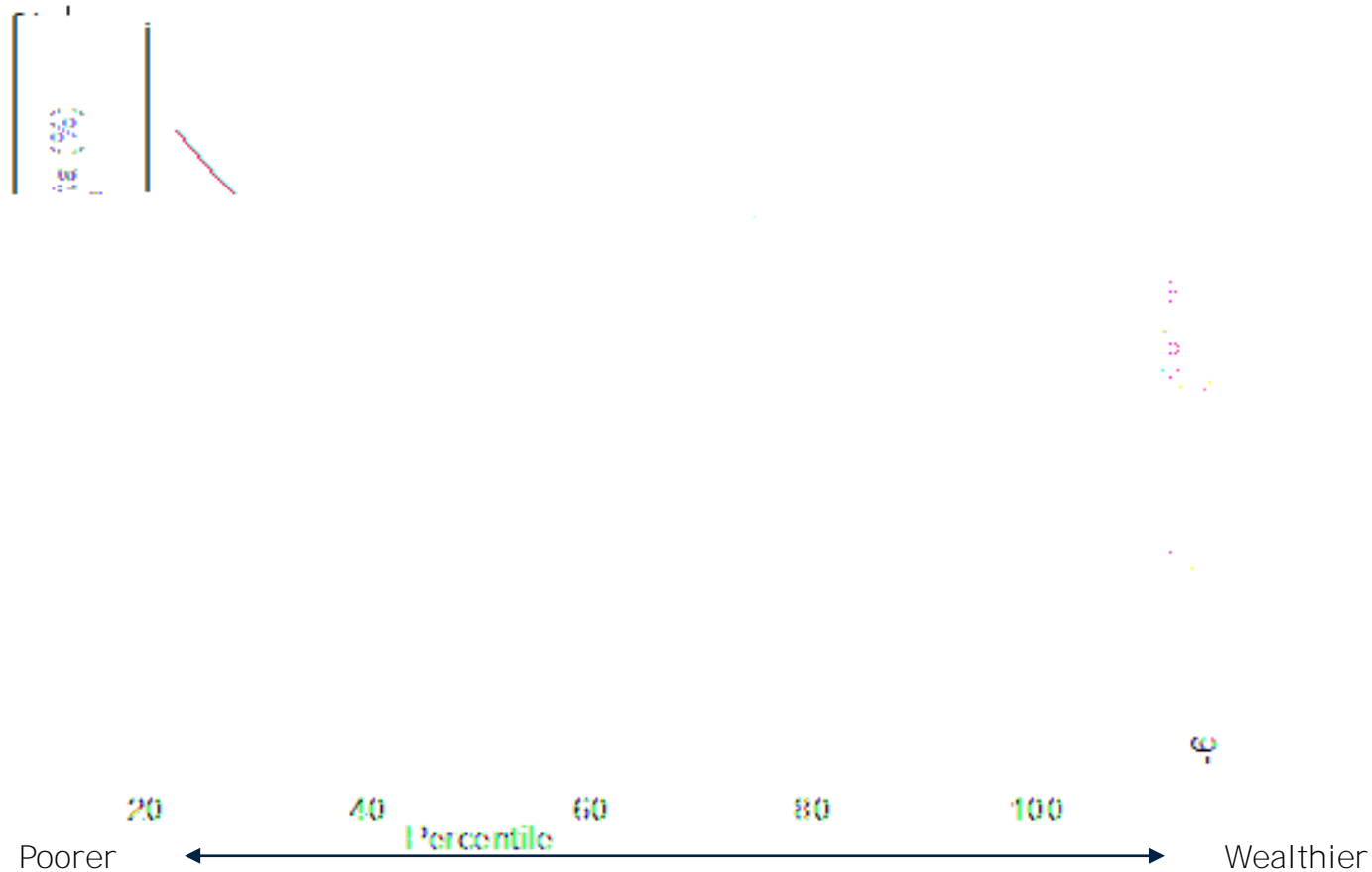


Remittances represent a large share of GDP in many Eastern European countries and Central Asia and expected declines are large



In remittance dependent countries, the impact drives some of the middle class and near poor into poverty

Kyrgyz Republic: Incidence curve as a result of 50% reduction in remittances



Source: Kyrgyz Integrated Household Survey and micro-simulations

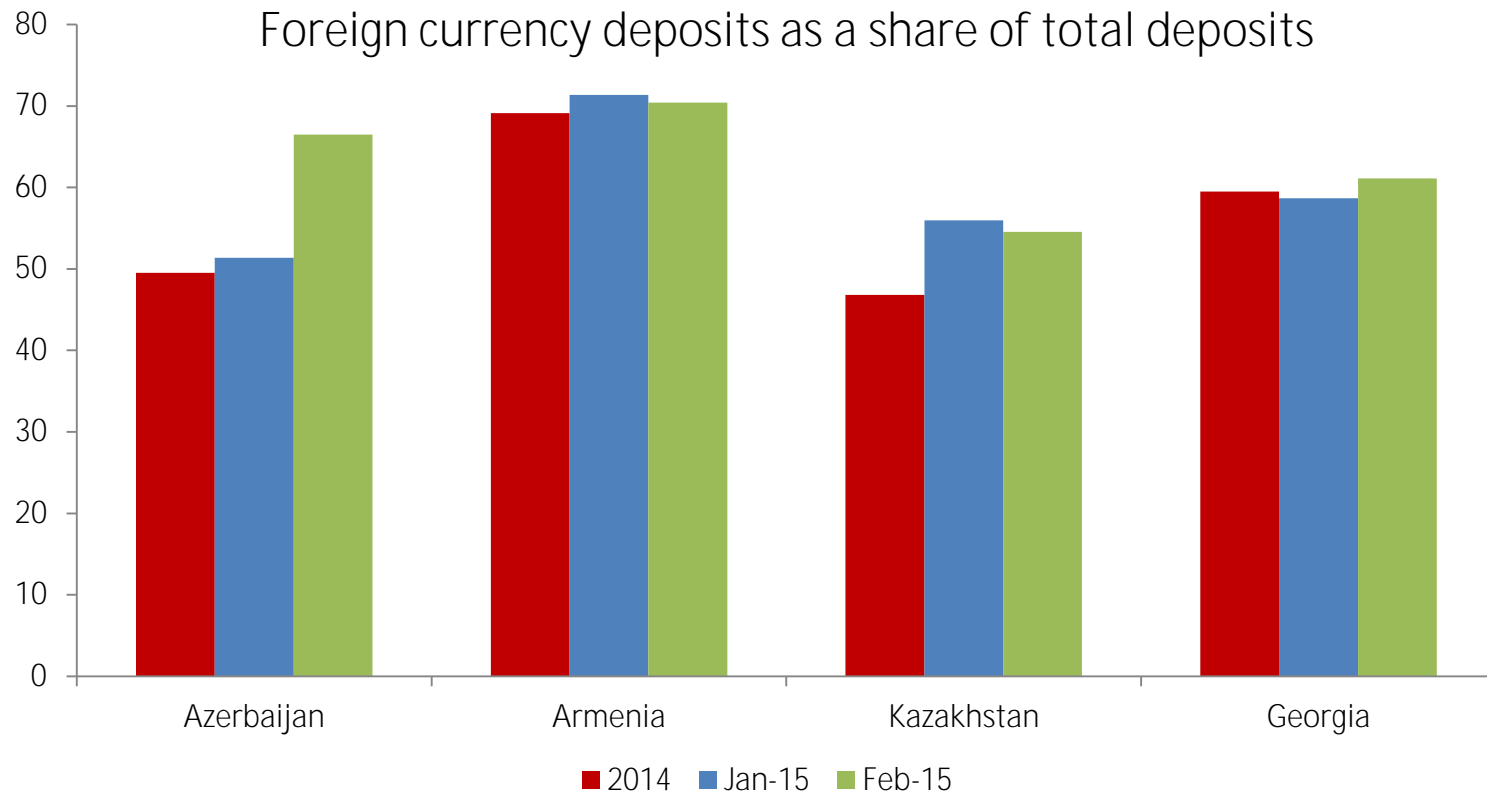
Oil shock is not cyclical and domestic prices will need to fall relative to foreign prices

- Oil prices are expected to stay low in the medium-term. The shock is not a temporary blip due to reduced demand
- Many oil exporters have allowed the nominal exchange rate to make the needed adjustment in real domestic prices and this will allow them to benefit from the new opportunities in tradable sectors.

Countries that are performing the rebalancing act to lower oil prices and changing exchange rates are expected to benefit from new opportunities

- To seize the new opportunities in tradable sectors, allowing prices to adjust will help competitive sectors to grow and others to contract
- Ongoing reforms to improve the business climate as well as prudent financial sector and macro management in dollarized economies.
- Adjustments to lower oil prices are painful, but postponement can be very costly and may backfire

Dollarization is high in some countries so authorities would want to monitor risks in the banking sector



Source: Central banks of Armenia, Azerbaijan, Georgia, and Kazakhstan.

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- Stable to moderately improving growth in western part of region, but concerns remain
- Direct and indirect impact of the oil shock and uncertainty in the eastern part of the region are hitting incomes hard and raising concerns for poverty
- Countries that are performing the rebalancing act to lower oil prices and changing exchange rates are expected to seize new opportunities in the tradables sectors, but ongoing reforms to improve the business climate as well as prudent macro and financial sector policies are also key.

Thank you!