

Speaking Points for the Gaidar Forum

Economic Perspective for Europe and Russia

It is my pleasure and honor to take part in this panel to discuss the economic perspectives for Europe and Russia. Given that the economic landscape in Europe is not homogeneous, I will distinguish in my remarks two main economic blocks: the Euro zone, and then Eastern Europe, and finally Russia.

First, the Euro zone.

The recovery in the Euro zone remains on track but risks have shifted to the downside.

We forecast growth of slightly above 1½ percent in 2016, supported by domestic demand. Inflation remains low, pulled down by plunging oil prices and lower inflation expectations. Given increased downside risks from the slowdown in emerging markets and domestic political uncertainty, there is an urgent need for a more balanced and comprehensive policy mix. The ECB's policy actions have helped ease credit conditions, lift asset prices and compress spreads, providing space for countries to embark on structural reforms to improve competitiveness. Nonetheless, more is needed to jumpstart growth and strengthen the union, including:

- Using available (albeit limited) fiscal space, SGP flexibility, and centralized investment to reinforce the demand stimulus provided by the ECB's accommodative monetary stance.
- Expediting the cleanup of bank and corporate balance sheets to unlock greater lending and investment.
- Strengthening the economic governance framework to incentivize necessary structural reforms, for example through outcomes-based benchmarking.

Finally, collective action, including on EMU reform is still needed. The Euro zone continues to face the challenge of reducing high unemployment and closing economic divergence among member states. For instance, Germany, the Netherlands and a few others are operating close to full employment, while Spain, France and Italy (to name just three) still have slack in their economies. Faster progress towards completing the banking and fiscal elements of the monetary union are of great importance. Collective action would help reduce the over-reliance on monetary policy and limit moral hazard and financial stability risks.

Let me now move to Eastern Europe.

Central, Eastern, and Southeastern Europe, excluding CIS countries and Russia, are growing at a healthy pace again. Growth is expected to remain solid, largely domestic-demand driven in 2015–16. There are also some external tailwinds, such as lower oil prices and improved external demand from Western Europe. Furthermore, several Eastern European countries have benefited from a temporary boost to investment resulting from a sharp increase in utilization of EU Structural and Cohesion Funds.

The key policy challenges are addressing crisis legacies, rebuilding buffers against external shocks, and improving the business environment to boost investment and long-term growth. Country-specific priorities depend on how far along these economies are in the post-crisis adjustment and their exposure to external risks.

Finally, on Russia.

Russia has experienced two major shocks: oil and sanctions. These shocks hit at a time when Russia was already slowing down due to structural bottlenecks, weak investment and declining total factor productivity.

The policy response was key to stabilize the situation. The central bank allowed the exchange rate to float, tightened monetary policy significantly and expanded its FX liquidity

facilities. The government introduced an anti-crisis plan, including a 2 percent of GDP bank capital support program, and revised its 2015 budget to reallocate spending to priority sectors.

As a result, we are starting to see tentative signs of economic stabilization. In addition, the current account adjustment is progressing rapidly, supporting the ongoing external deleveraging process. The depreciation of the real exchange rate is also improving competitiveness. And we see already some interesting divergences with respect to the experience during the 2008-2009 slump. For instance, employment has held up well in sectors such as manufacturing and agriculture while industrial production did not decrease as much as in 2008.

Despite the initial success to avert a crisis, the recovery is likely to be slow, and is vulnerable to additional shocks. First, oil prices are expected to remain low for long. Second, the effect of sanctions on investment and financing conditions is expected to linger. And third, fiscal policy will be constrained by the needed adjustment to lower oil prices. As a result, the output gap will only close slowly while potential output growth will remain depressed, at around 1.5 percent of GDP in the medium-term, absent a more forceful push for structural reforms.

Now, let me move to the main risks to the outlook for Europe and Russia.

There are several risks to the outlook, including tighter global financial conditions, uncertainty due to the refugee crisis and geopolitical tensions. However, I would like to highlight one significant risk that is common to all the diverse countries in the European sphere, namely that of a sharper slowdown in China.

Europe

Although the direct trade channel via exports to China is small, accounting for only 6 percent of Euro area exports, the impact could be larger through indirect trade channels,

such as supply chain effects and stronger competition with some euro area countries as China moves up the value added chain. Moreover, lower expectations of growth in China combined with a “bumpy” landing would have significant implications through negative spillovers to investor confidence and other emerging market economies, and via lower commodity prices.

Simulations of a China slowdown using our main global models suggest that a 1 percentage point decline in China’s growth is associated with 0.2 percentage point lower growth in the Euro area and the effect would rise to 0.3 if China’s slowdown spills over to other emerging markets. The effects of this shock are amplified by the inability to adjust the policy rate in the Euro area at the zero lower bound, which could tighten domestic financial conditions and strengthen the euro (assuming that EM currencies depreciate).

Russia

A slowdown in the Euro zone would have a negative impact on growth in Russia, since the Euro zone remains the major trading partner. In addition, weaker growth in China would affect oil prices, compounding this effect on Russia. Our estimates suggest that a 1 percent drop in real GDP in China could lead to an initial negative impact of 0.5 percent in real output, and up to 1.9 percent cumulative output losses over the medium term.

In conclusion, I would like to say that

Overall, the cyclical position is improving in the Euro zone and Eastern Europe, abstracting from Russia and CIS countries. The Euro zone, however, still faces significant challenges to reach full employment and more so to complete the union. On the other hand, Central and Eastern Europe, excluding Russia and CIS countries, is leaving behind the crisis times, but legacy problems and a need to rebalance their growth strategy call for further momentum on the reform front.

Finally, on Russia, it’s clear that the policy response to the oil and capital account shocks averted what could have been a much dire balance of payment crisis. Of course,

the buffers built during the good years helped too. Nonetheless, the recovery will be slow, well below that experienced in the past, and the recent fall in energy prices, weakening exchange rate presents potential risks to the outlook. The challenge is to navigate the uncertain outlook related to oil prices, adjust fiscal policies to account for the new reality of lower oil prices while preserving growth enhancing spending, and use buffers wisely. The more competitive real effective exchange rate, if complemented by structural reforms, could plant the seeds for a lasting rebalancing of the economy that would support new sources of growth beyond oil.