EU Regular Economic Report

MODEST RECOVERY, GLOBAL RISKS

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Sweden Slovakia Greece Romania Czech Republic Poland France Cyprus Ireland Latvia Hungary Finland Denmark Austria Croatia Netherlands Lithuania Italy Portugal Spain United Kingdom Estonia Luxembourg Belgium Malta Bulgaria Slovenia Germany

MODEST RECOVERY, GLOBAL RISKS

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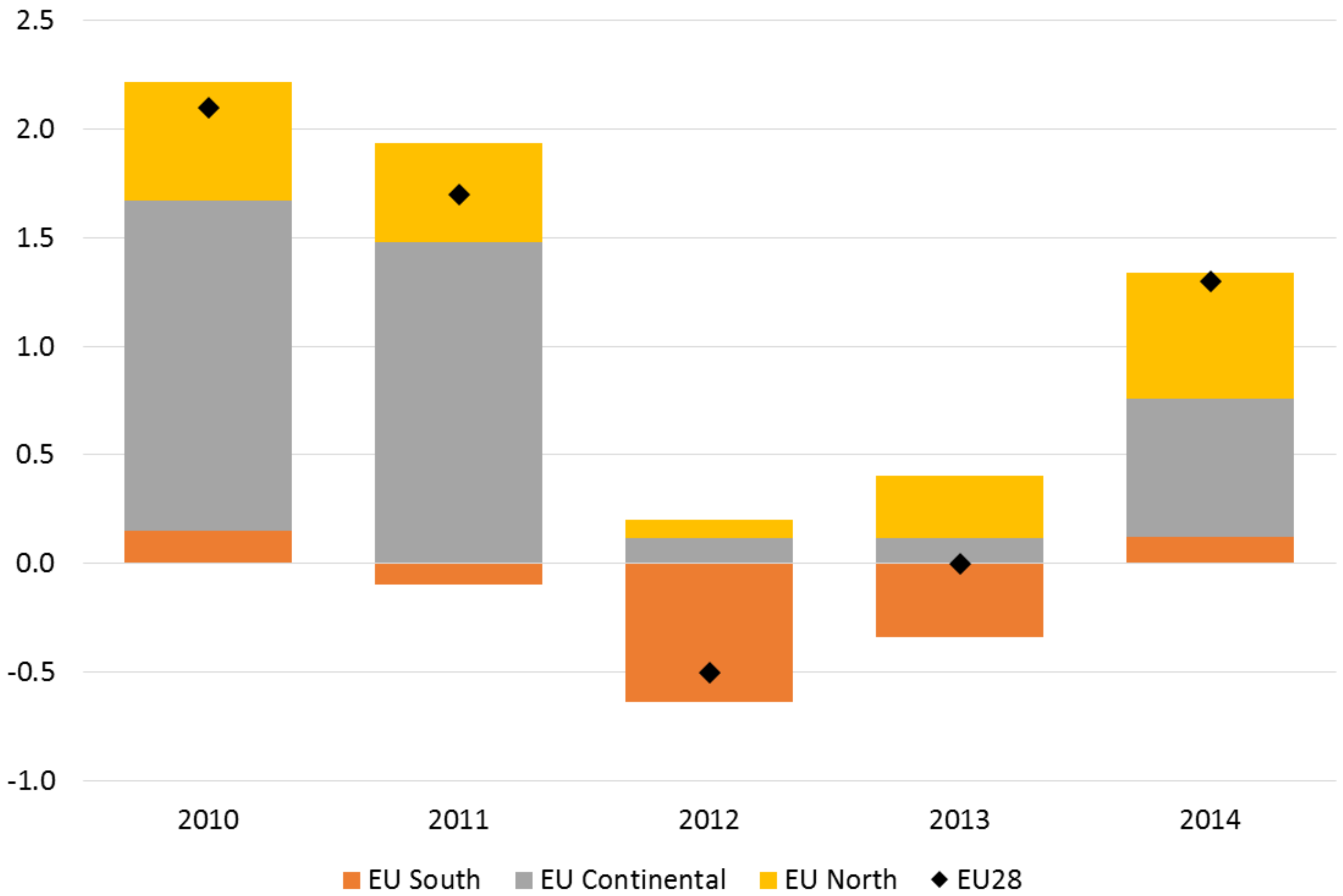
- **Growth slowly picking up in Europe**: EU North and Continental are leading the modest recovery; EU South finally returned to growth in 2014
- **Balanced risks to the outlook:**
    - **Some concerns**:
        - Upsurge in financial market volatility (divergent monetary policies);
        - Pressure on public finances due to sustained period of low growth and subdued inflation;
        - Availability of new lending for investment;
        - Geopolitical risks (Greece, the planned EU-referendum in the UK, and ongoing tensions in Ukraine).
    - **Some favorable:**
        - Lower oil prices;
        - ECB's QE;
        - Firming labor markets.

GROWTH CONTINUES TO STRENGTHEN

The Big Picture: Recovery, Recovery, Recovery



Contribution to GDP growth, percentage points and percent
Source: Eurostat, World Bank staff calculations

- EU North and Continental countries are leading the recovery
- The impact of the euro-crisis looks to be finally starting to abate
- Growth has gradually become more balanced, as private consumption strengthens and investment slowly returns
- EU-CEE countries are benefiting most from revitalized EU growth

EMPLOYMENT CONTINUED TO GROW, BUT SLOWLY

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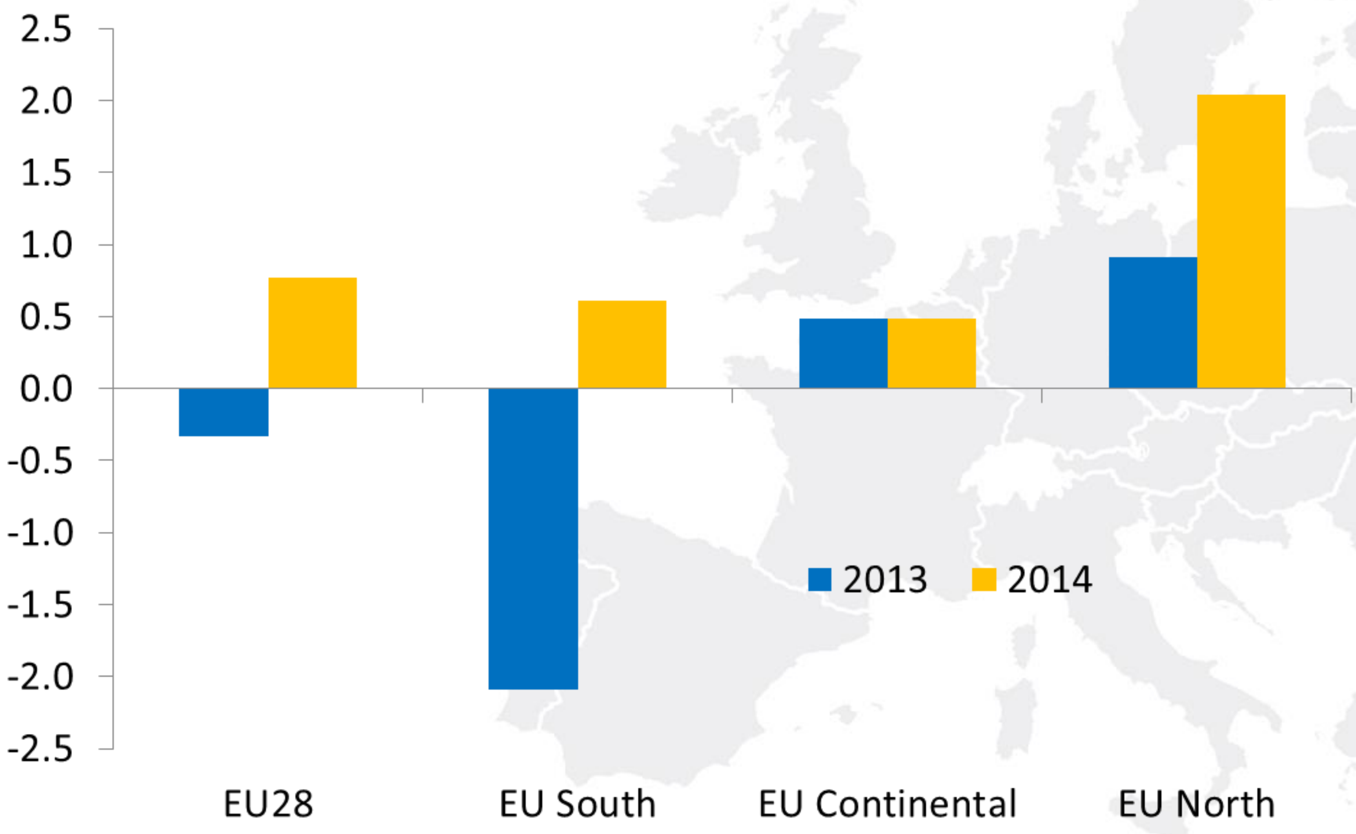
It's All About The Labor Market

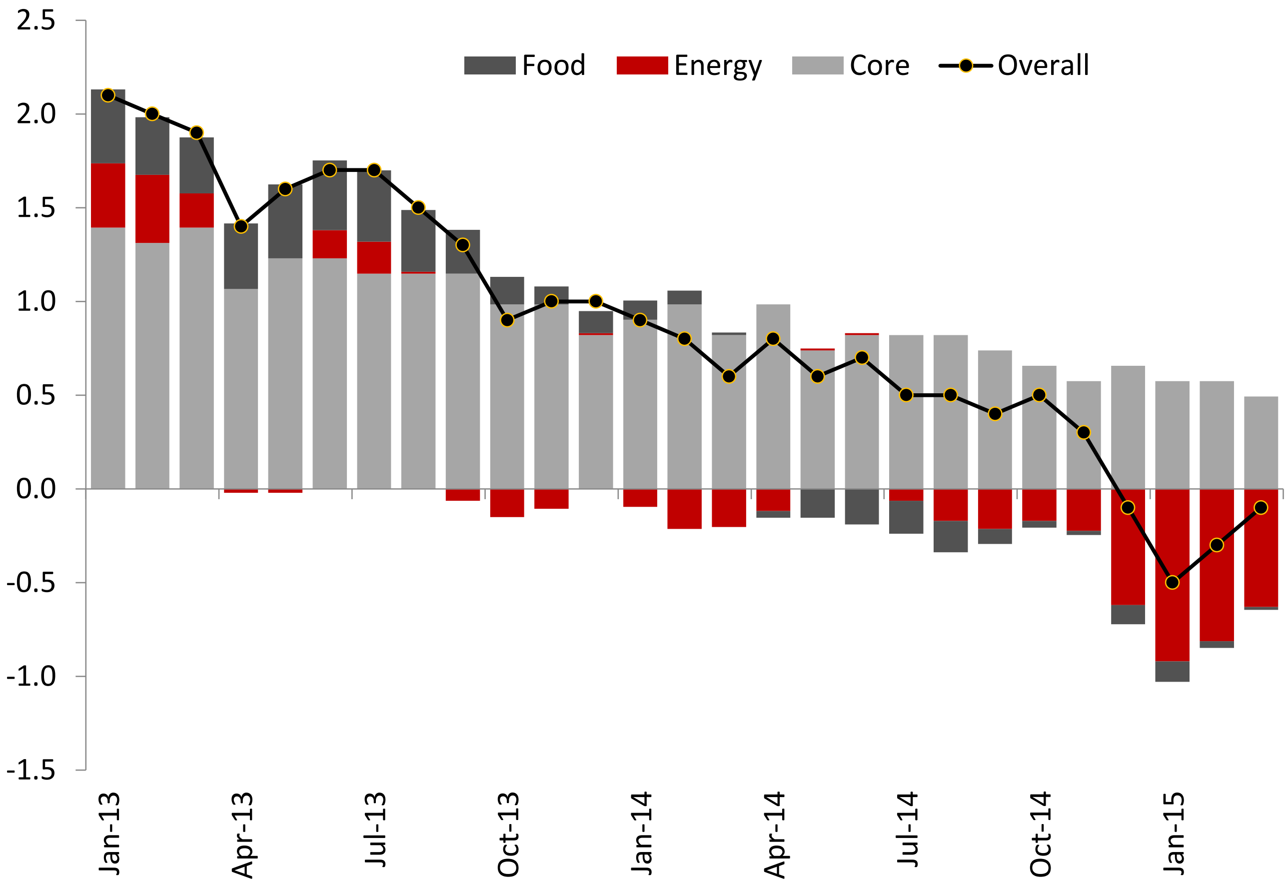


Employment growth, percent change, annualized
Source: Eurostat, World Bank staff calculations

- Jobs are being created across the EU (full-time jobs and broad-based) ...
- … though unemployment rates remain high compared to others (US unemployment at 5.5% vs. 11.2% Eurozone rate -- US participation rate has fallen sharply from 67% to 63% while rising from 67% to 72.4% in Eurozone)
- Job growth is driven to a large extent by improvements in countries with relatively high unemployment rates
- Long-term unemployment started falling too

INFLATION HAS PROBABLY BOTTOMED OUT

Boost from cheaper oil



Contribution to headline inflation in EU, percentage points and percent
Source: Eurostat, World Bank staff calculations

- Inflation fell in 2014 because of lower energy and food prices and sustained output gaps
- Decline in food prices reflects a combination of regional developments, introduction of embargoes and countersanctions on European food exports to Russia, as well as global price declines
- Recovery benefits from low inflation: more real purchasing power of consumers, cheaper inputs for companies
- No deflationary spiral: households are not postponing purchases

EASIER FINANCING CONDITIONS SUPPORT LENDING

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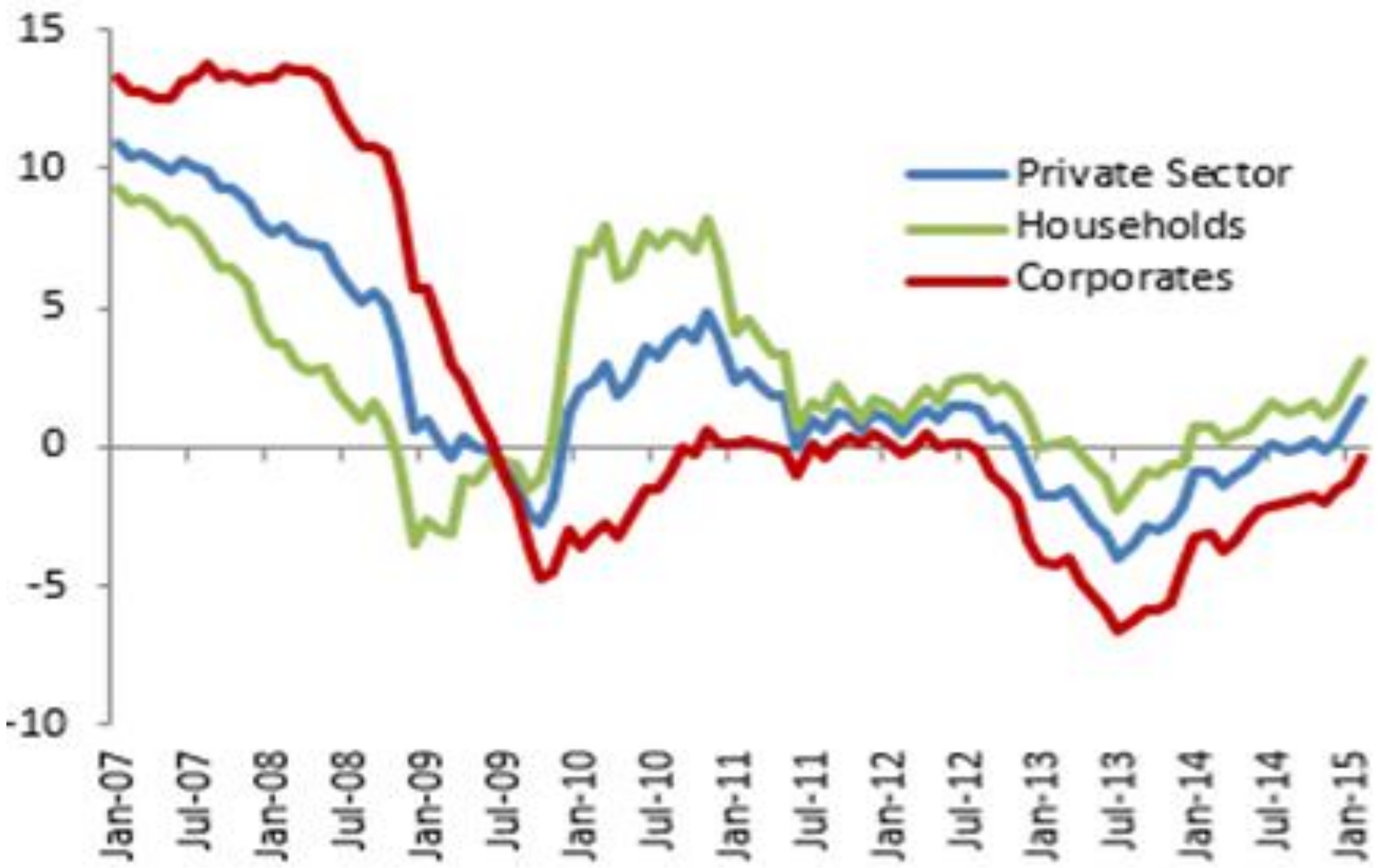
Private credit is modestly recovering

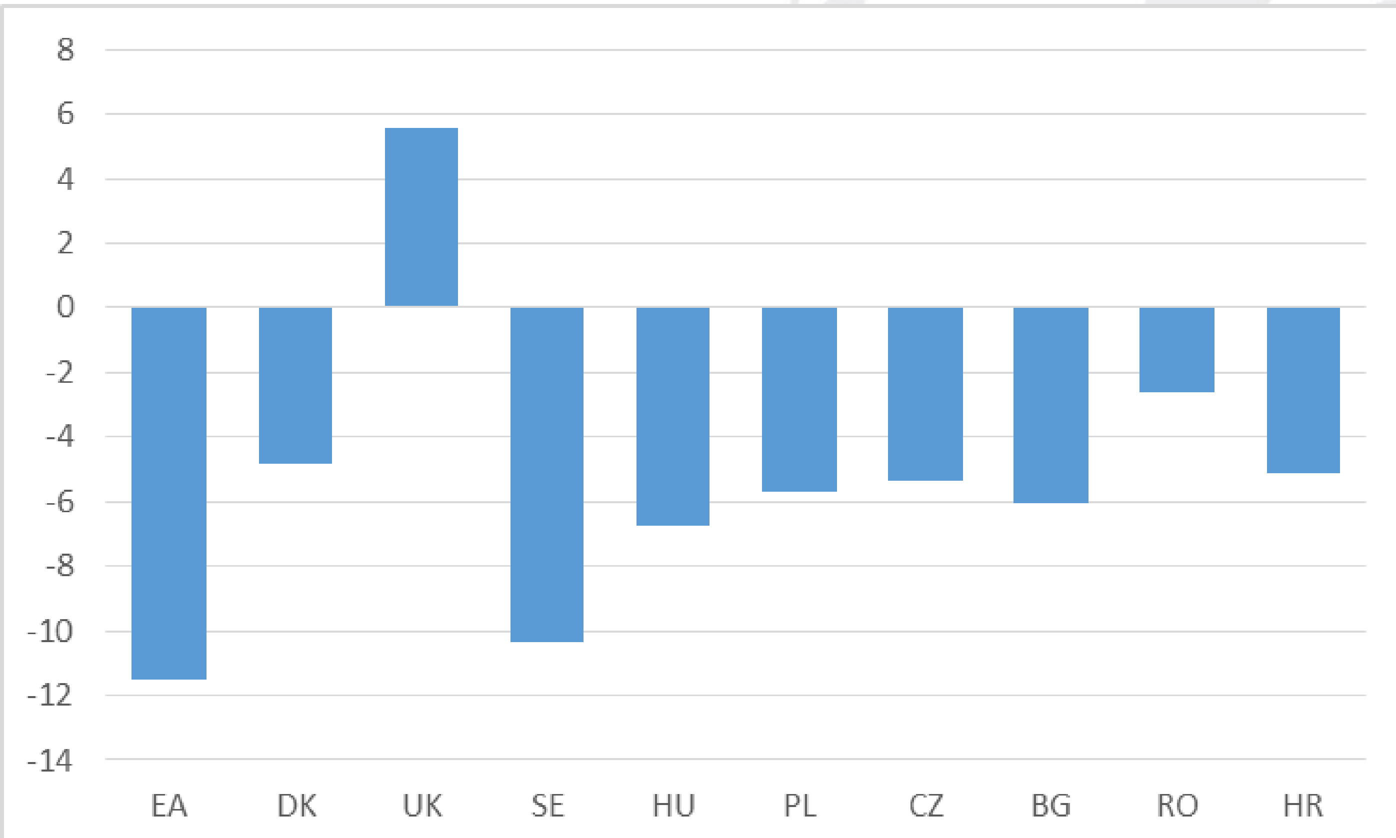


EU28 Private sector annual growth, annualized
Source: ECB, World Bank staff calculations

- Real financing costs for governments have come down dramatically
- There are welcome signs that credit is picking up and starting to support investment
- Lower bank lending rates have supported credit growth
- Credit conditions are slowly improving
- Supply tensions are gradually easing and point to rising demand for loans
- Encouraging signs can be seen in the resolution of NPLs

MONETARY STIMULUS IS WORKING

The Power of Money

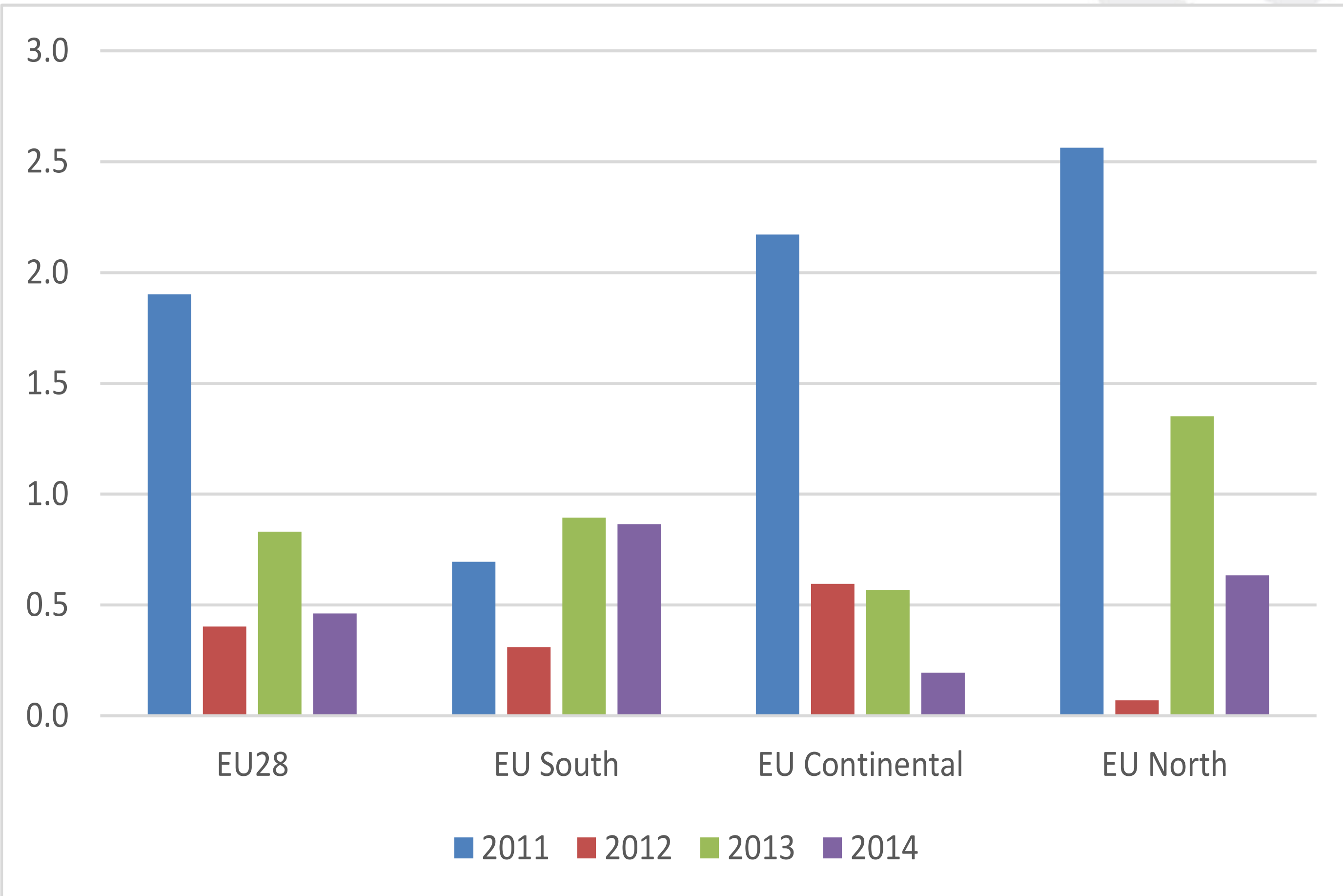


Percent change in real effective exchange rate, Jan. 2014 – Mar. 2015
Source: BIS, World Bank staff calculations

- ECB's QE aims to stimulate activity and bring inflation back to target
- QE program has begun to feed through to the economy via a number of channels
- REER of the Euro area has depreciated by around 10 percent since the start of the year.
- Impact has been much less pronounced outside the Euro area, in countries like Hungary, Poland, Romania and the Czech Republic

SLOWER PACE OF FISCAL CONSOLIDATION

Austerity Is Largely Over

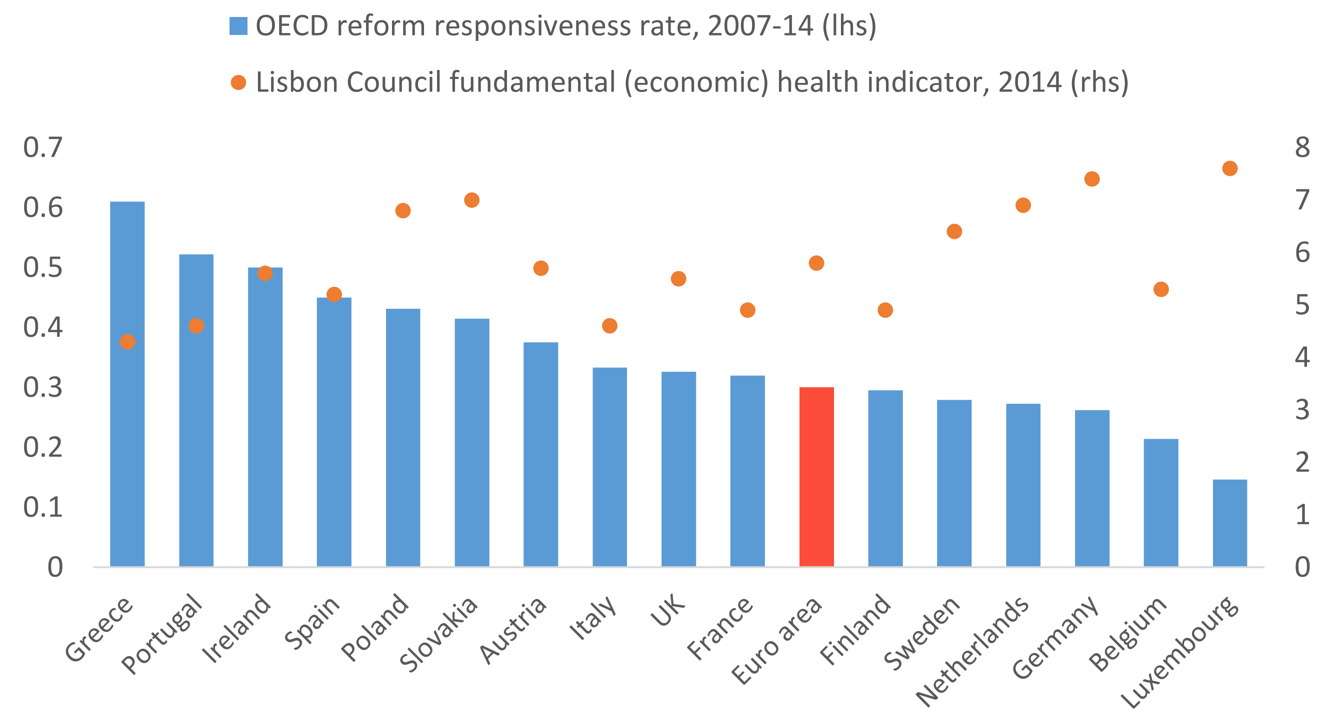


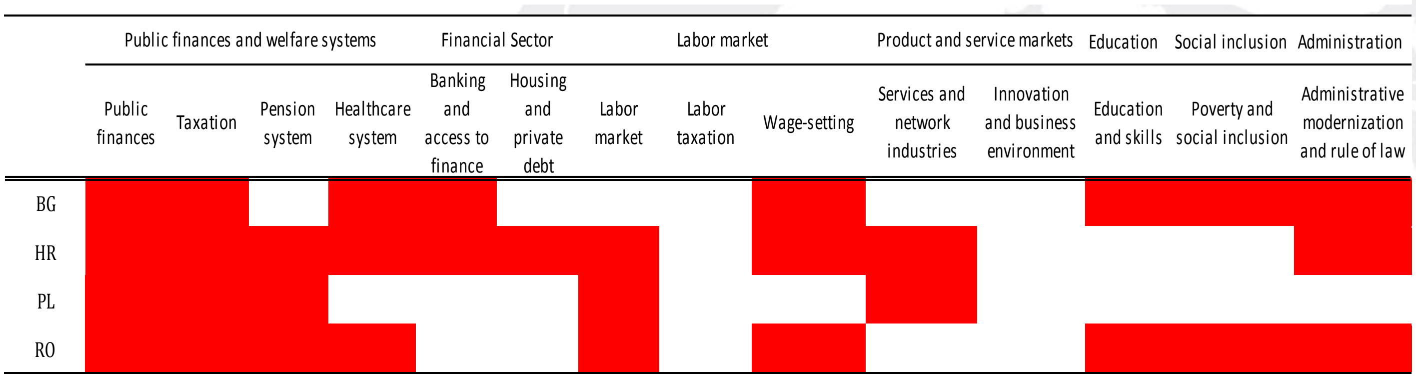
Fiscal deficit reduction, percentage of GDP
Source: AMECO, World Bank staff calculations

- In 2014 the pace of fiscal consolidation in Europe was significantly slower than a year before
- The economic cycle was conducive to fiscal adjustment in 2014 especially in EU South and North, while in Central and Eastern Europe fiscal developments were almost entirely driven by structural measures
- The pace of debt accumulation in Europe slowed markedly in 2014, reflecting better fiscal positions of many countries and higher economic growth

SIGNIFICANT STRUCTURAL CHALLENGES STILL NEED TO BE ADDRESSED

Structural Reforms Remain Incomplete





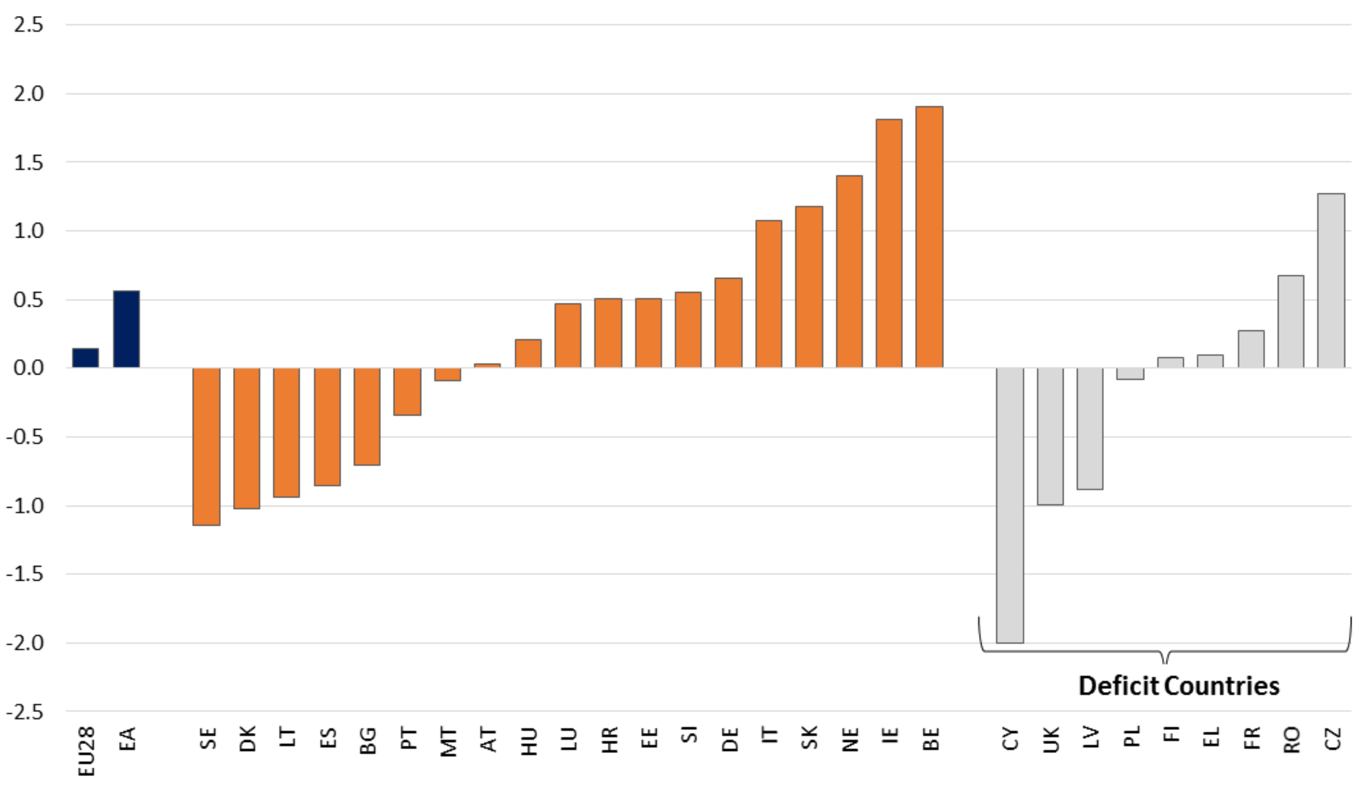
Note: EC's recommendations presented on May 13, 2015 for 2015-2016.

Source: http://ec.europa.eu/europe2020/index_en.htm

- Of concern for the EU is the decline in potential growth rates in recent years
- Who is implementing pro-growth structural reforms?
- Challenges in many countries shifting from fiscal and macroeconomic adjustment and towards structural measures to promote growth and competitiveness
- The crisis countries are enacting sweeping reforms, but need to continue to catch up with the most dynamic and resilient countries

CURRENT ACCOUNT BALANCES IMPROVED FURTHER

Adjustment Progresses



Balance on current transactions with the RoW, Change in 2014 compared to 20143, % of GDP
Source: AMECO, World Bank staff calculations

- Current and capital account surplus increased largely due to an increasing surplus in the overall trade balance
- Exports between EU countries are growing more strongly
- Global conditions remain challenging for countries exporting to the rest of the world
- The five euro crisis countries have turned their external accounts
- Exports and imports have continued to pick up in most of the EU-CEE, reflecting the rebalancing of the recovery

EXPORTS AND GROWTH RECOVERY

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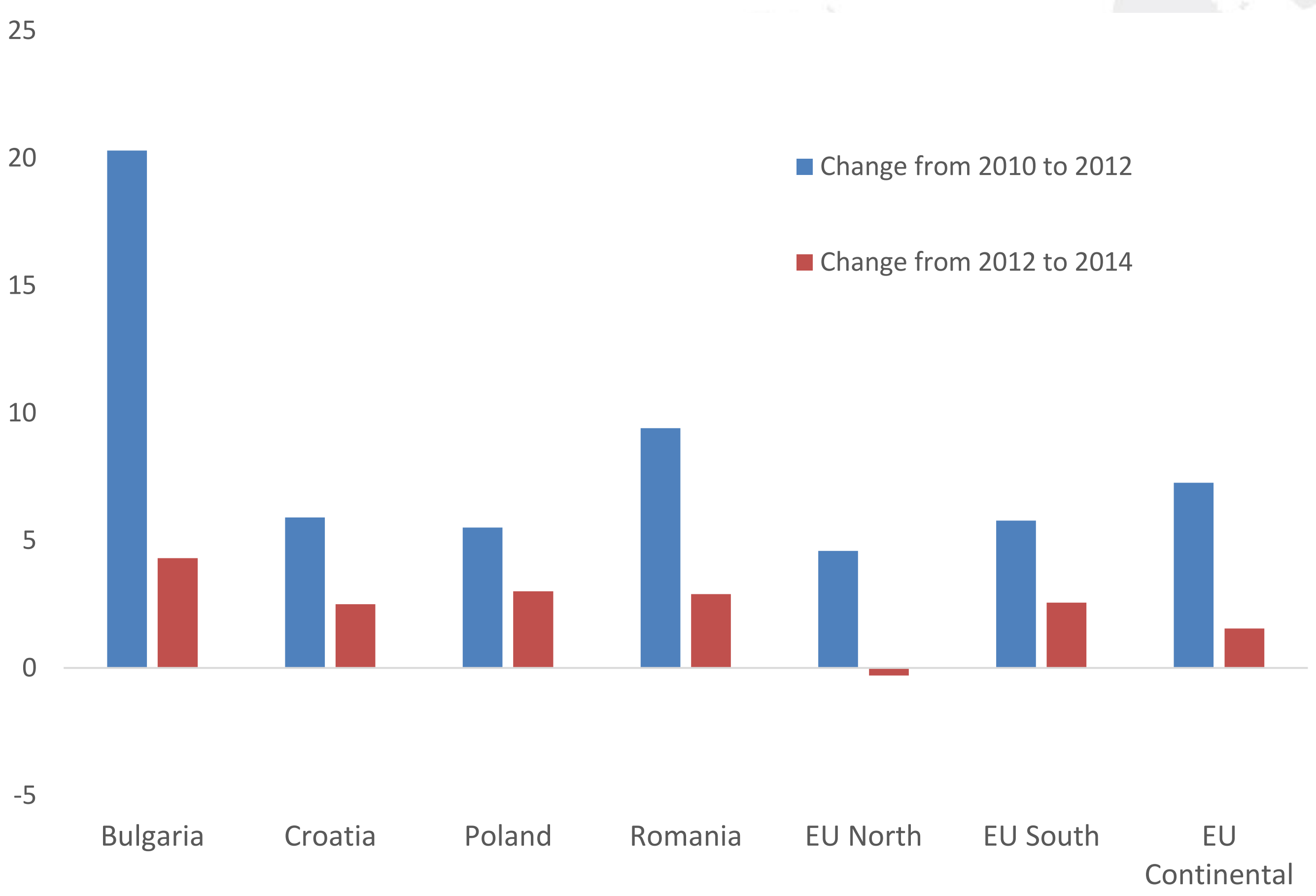
Exports - Important Growth Driver



Change in share of exports in GDP, percent
Source: EUROSTAT, World Bank staff calculations

- Driven by growth in both goods and services
- Bulgaria's, Poland's and Romania's goods exports grew significantly more than in other EU countries
- In Bulgaria and Croatia most exports are from traditional services
- Poland's share of modern services climbed from 24 percent to 42 percent, while Romania's share of modern services rose from 43 percent to 63 percent
- Bulgaria, Romania and Poland experienced largest gains in market share between 2010 and 2014 among EU countries
- Largely driven by shipments of existing products to established markets

THE WEAKNESS IN INTRA EU28 EXPORTS HAS GRADUALLY DISSIPATED

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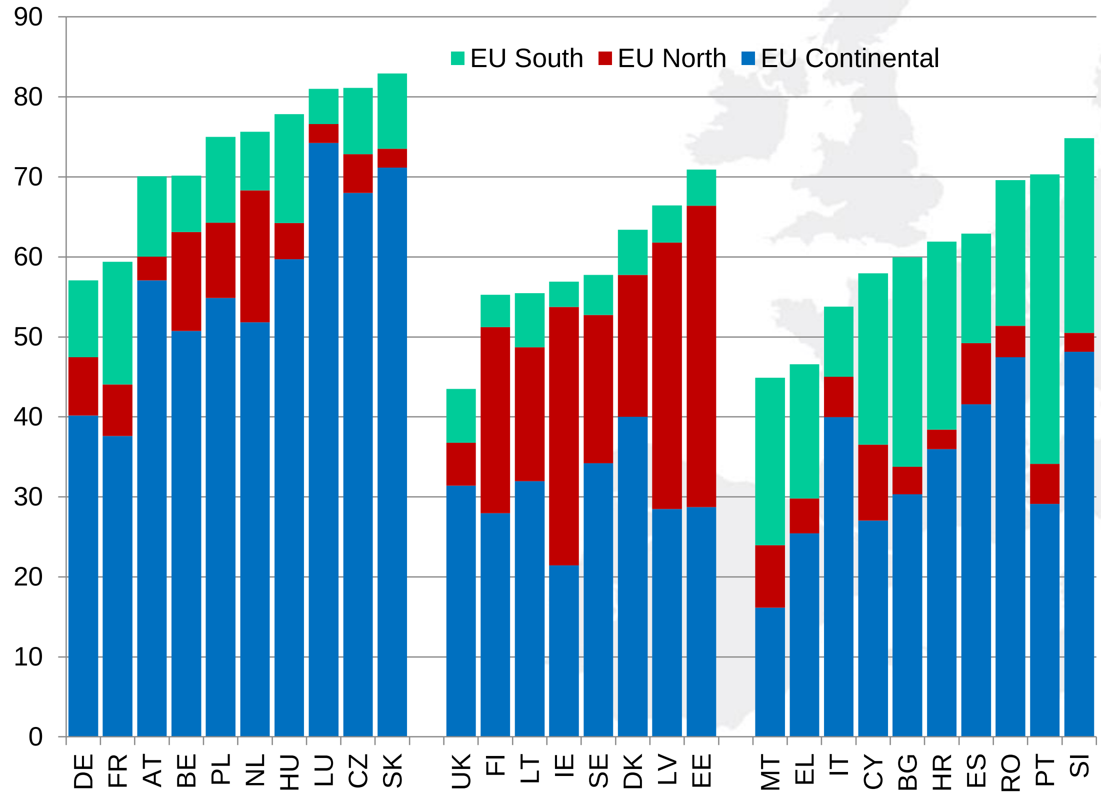
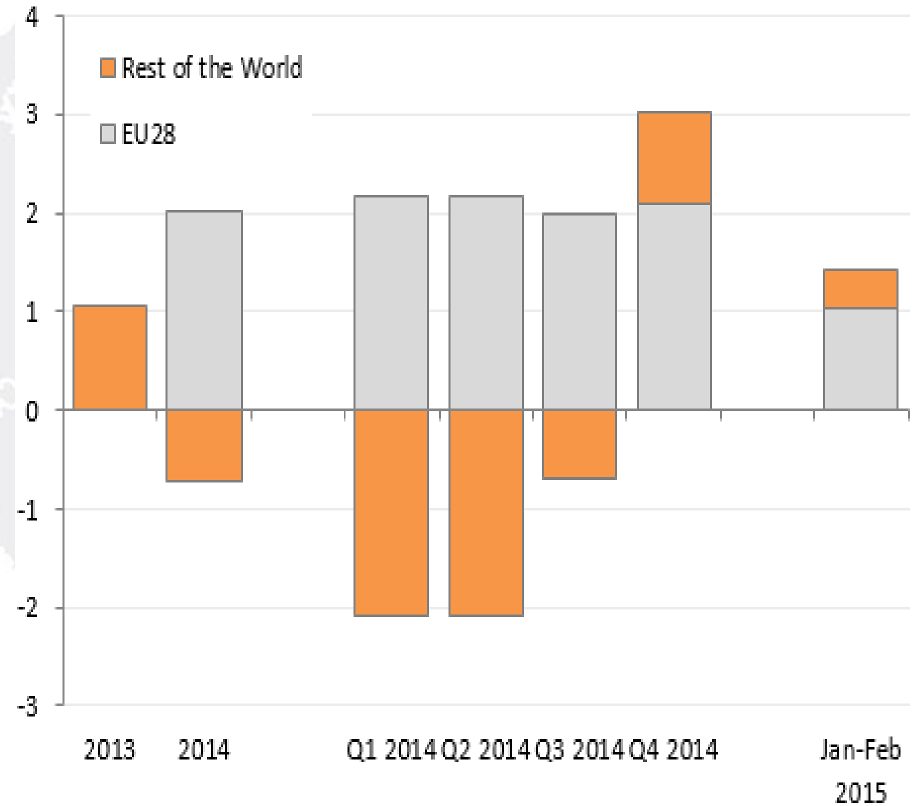
Trade Integration Within the EU





Share of intra EU28 exports in overall exports

Geographical structure of EU28 export growth, in percent, y/y

Source: EUROSTAT, World Bank staff calculations

DECOMPOSING EXPORT MARKET SHARE

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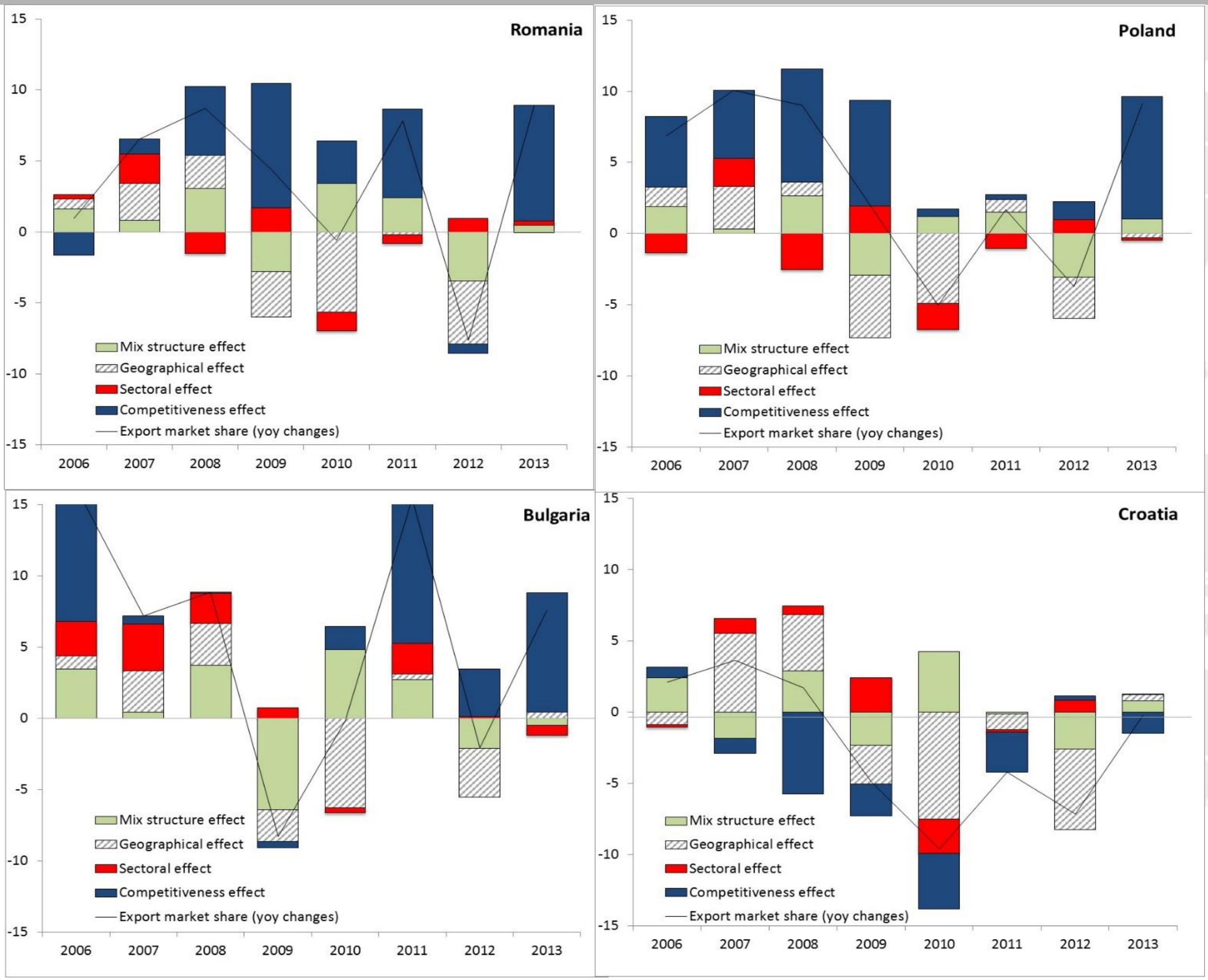
It Is Competitiveness!

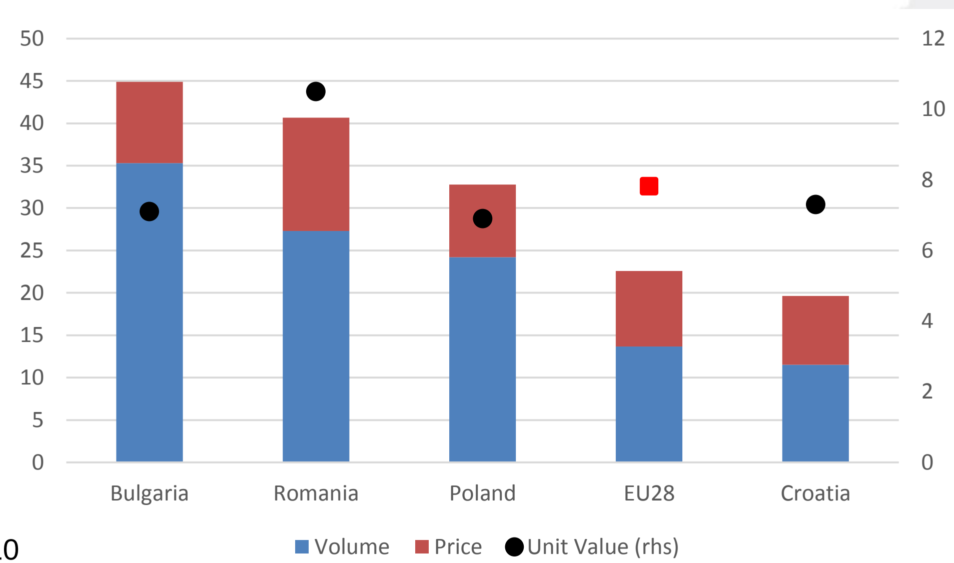


- Europe’s weak growth performance has significantly depressed export growth in all four countries since 2009 (geographical effect)
- Global demand for the type of goods these countries export has suffered (sector effect)
- World trade growth almost halved in the period between 2011 and 2014 (structural effect)
- Improvements in competitiveness have been a key driver of export growth in Bulgaria, Poland and Romania

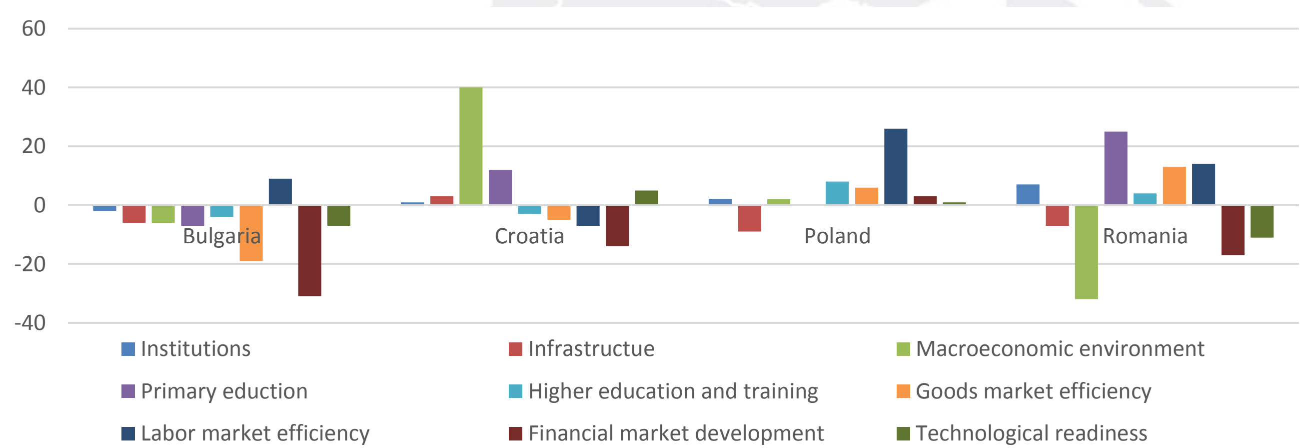
Decomposition of export growth, percentage points and percent
Source: WITS, World Bank staff calculations

PRICE-BASED COMPETITIVENESS DOESN'T EXPLAIN THE COMPETITIVENESS EFFECT

Non-price Competitiveness Matters…



Export growth 2014/2010
Source: Eurostat, World Bank staff calculations



Source: Global Competitiveness Report

- All four countries upgraded the quality of their export products, Romania in particular
- Increase in the export unit value of Bulgaria, Croatia and Poland remained below the average increase in EU
- Poland has been most successful in improving its ranking with respect to a variety of dimensions that are relevant for a country's competeveness

FDI HELPED COUNTRIES TO FURTHER INTEGRATE INTO GLOBAL VALUE CHAINS AND "PUSH" EXPORTS

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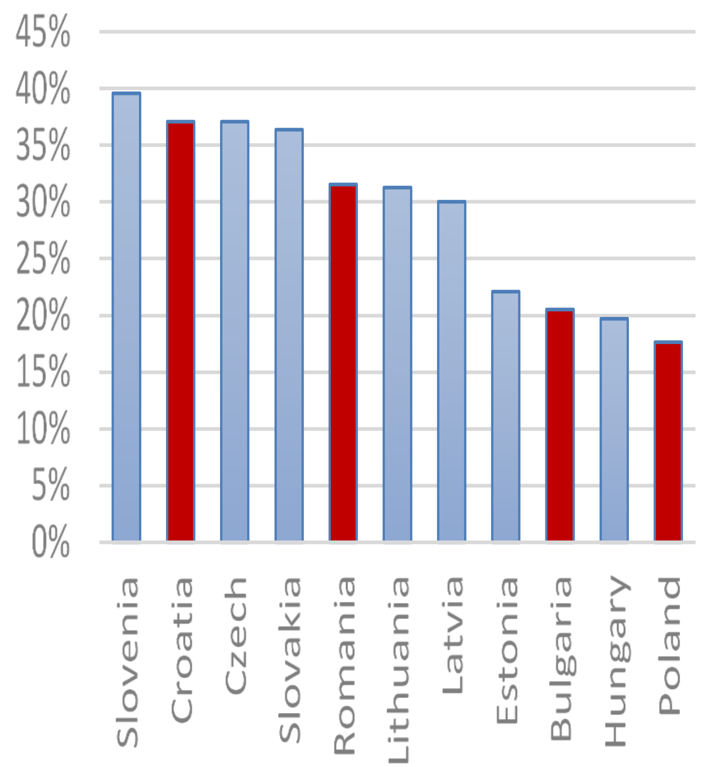
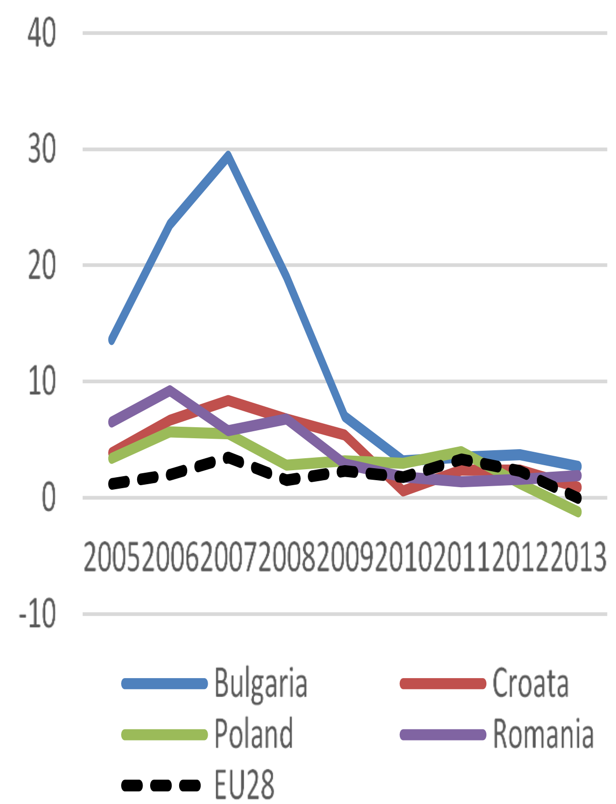
Boost exports = Removing Constraints of Domestically-Owned Firms and Attracting FDI



Share of domestically owned exporting firms, percent



Inward FDI to GDP ratio, percent

Source: BEEPS, World Bank staff calculations

- Most exporting firms in Bulgaria, Croatia, Poland and Romania are foreign-owned.
- In Bulgaria, one in four innovating firms that are exporting goods have significant FDI, compared to one in fifteen firms in the non-exporting innovative group .
- FDI has declined significantly since the 2008 global financial crisis,
- Higher share of FDI is now destined for sectors with export potential, such as manufacturing and services, rather than construction and financial services.

WHAT NEXT? …QUESTIONS…

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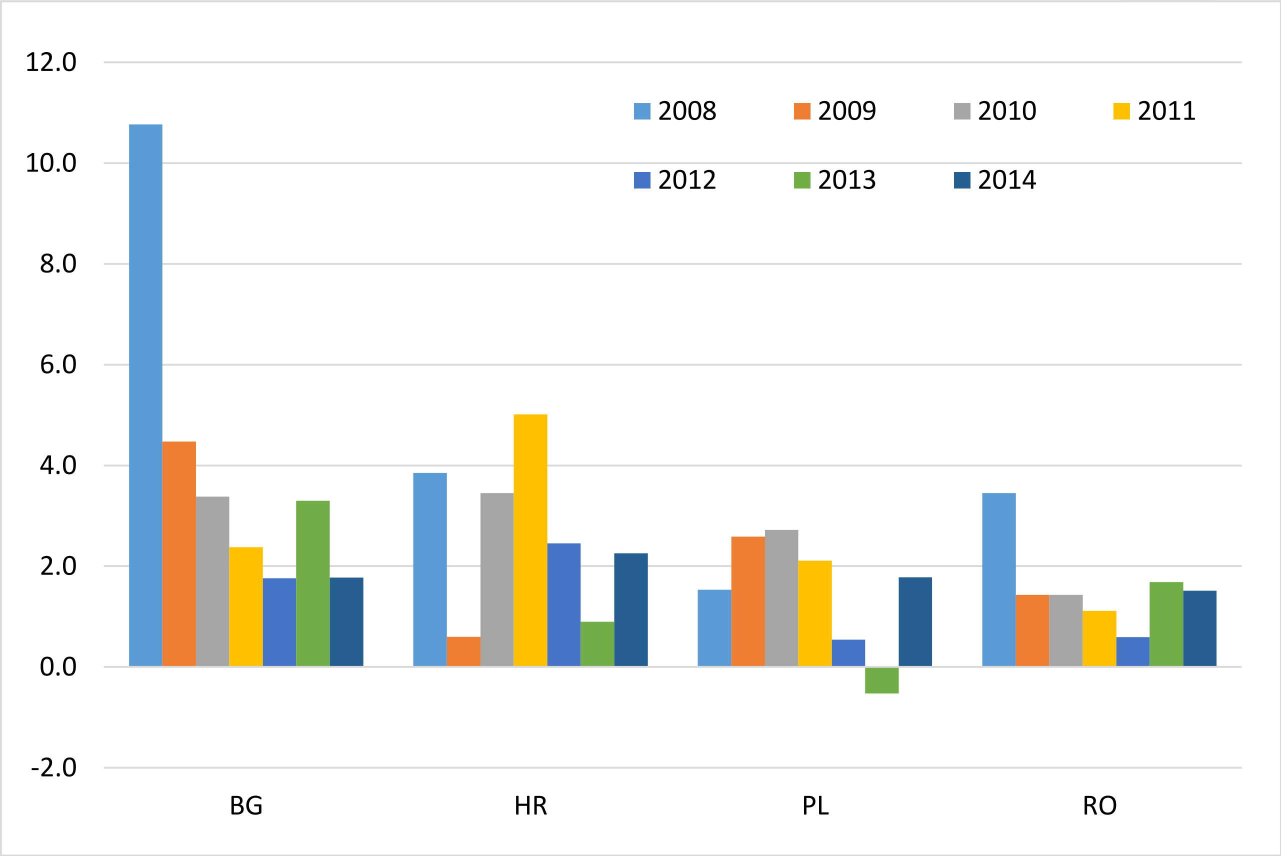
Non-debt creating direct investment “new normal”?



- Importance of FDI and structural reforms in promoting exports
- Financing Productive Investments – debt or equity?
- Does the financial account drive the current account, or vice versa?
- Debate between the “Trade Ministry”, which is focused on maintaining employment and the growth of employment in export industries, and the “Finance Ministry and Central Bank”, which are focused on the health of the overall economy and financial system and the economic, financial, and political consequences.
- Growth—balanced growth—key variable in the nexus of trade and finance

Direct investments excluding debt instruments, in percent of GDP
Source: Eurostat, World Bank staff calculations

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Thank You!

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