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EUROZONE CRISIS CLOUDS RECOVERY IN EMERGING EUROPE AND CENTRAL ASIA

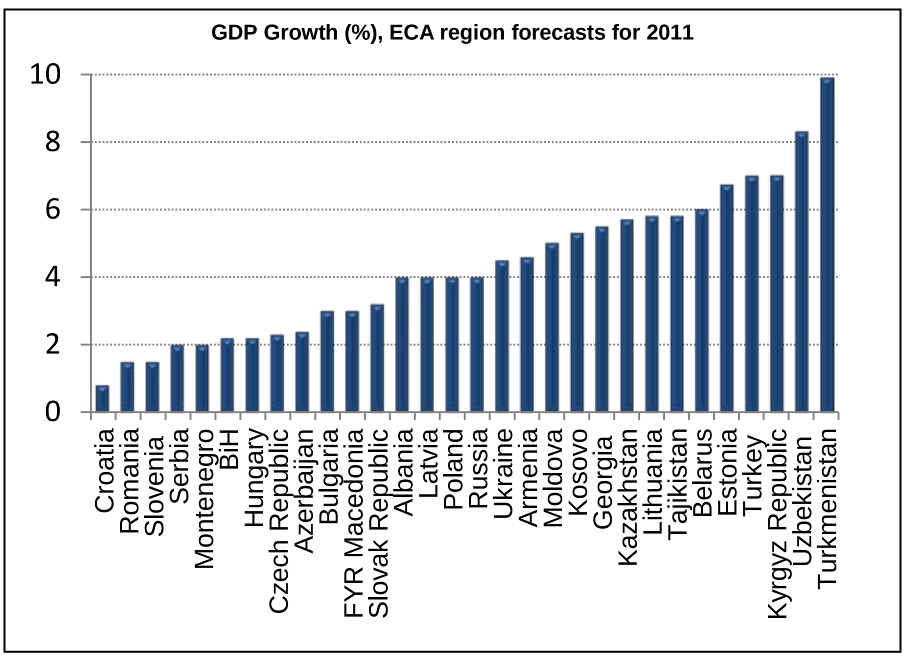
WASHINGTON, September 23, 2011—Economic recovery is underway in the Emerging Europe and Central Asia (ECA) region, but at a slow pace and is at risk from the troubled Eurozone, according to the World Bank at a press briefing during the World Bank/IMF Annual Meetings 2011.

"Most countries in Emerging Europe and Central Asia have recovered from the global economic crisis, but growth has returned at lower rates than pre-crisis trends in most of the region. The region is expected to record a real growth rate of 4.3 percent in 2011, which is one of the lowest of any developing region," said **Philippe Le Houérou, World Bank Vice President for the Europe and Central Asia Region**. *"The slow recovery in the region may be establishing a 'new normal' of lower economic growth rates in many of the region's countries."*

Le Houérou cautioned, *"The sovereign debt problems in Western Europe pose challenges to the sustainability of this relatively tepid recovery. The Eastern Europe and Central Asia region is especially dependent on Western Europe as an export market and a source of finance and migrant remittances, so slower growth in the West will hurt. The region's strong financial linkages to Western Europe, which were a source of growth during the boom years in Central and Eastern Europe, are now a source of vulnerability for some countries."*

According to the briefing, most countries in the region have recovered the output losses suffered during the 2008-9 global economic crisis. In fact, GDP remains below its 2007 level in only eight out of 30 ECA countries. Helped by high commodity prices, the countries farther to the east in the region have done much better since the crisis than those to the west.

But ECA's recovery signals a lower growth gradient than the pre-crisis rates. There has been a noticeable reduction in growth prospects: countries in the region may need to prepare for growth rates that are 2 percentage points of GDP less than what they were before the global crisis.



GDP Growth (%), ECA region forecasts for 2011

Job losses remain a concern throughout the region

Unemployment increased significantly during the crisis — in 2008 it was about 10 percent, while as of about early 2011, the overall unemployment rate for the region is at 13 percent. Meanwhile, youth unemployment remains a particular concern at 27 percent. To address this, governments have been trying to limit the effects of the crisis on labor markets through a wide range of employment programs.

Some jobs are returning and unemployment has dropped since the early 2010 peak, with only a few exceptions (Bulgaria, Croatia, Slovenia, Moldova, and Hungary). But the job turnaround will remain gradual even if the economic recovery is sustained. Increases in output per worker are driven by increases in hours worked, but these are still below their pre-crisis levels. Therefore, the room for further increases in productivity and hours worked could delay the recovery in employment.

Public finances have weakened, especially in the west

The global crisis has had a severe negative impact on public finances. During pre-crisis times, structural fiscal imbalances were masked by revenue over-performance, as buoyant economies yielded more taxes than governments often expected. During the crisis, there was sharp fiscal deterioration in most countries in the region. Public debt has gone up in many countries, leaving governments less room to counter any economic slowdown than they had in 2007.

Fiscal adjustment has often been in the form of ad hoc expenditure cuts. The immediate challenge in many countries is to begin more systematic fiscal consolidations that are socially sustainable and growth-friendly. Most countries in the region have to prepare for aging populations, which are adding to the fiscal pressures in health care and pension expenditures even as the economic turbulence over the last three years has left governments deeper in debt.

Banking flows have been stable in the west but have fallen in the east

According the briefing, financial flows have been stable in Central and Southeastern Europe, but have not been growing. Western European banks have so far maintained operations in the member and candidate countries of the European Union. In the countries further to the east, including oil and commodity exporters, there have been pullbacks, with the developments in these economies mimicking those in East Asia during the 1997-98 crisis.

The decline in credit to firms and households from pre-crisis levels was sharp, but necessary in some countries. While credit has been slow to recover, there are encouraging signs in most countries in the region. Only five countries in the region are still experiencing contractions in credit.

Risks are rising again

The main risk is that of spillovers from the sovereign debt crisis in some of the Euro area economies. The rescue packages have not assured markets, and uncertainty has spread to larger economies. The sovereign debt problems in southern Europe and Ireland can affect the region in both direct and indirect ways, operating through both financial and nonfinancial transmission channels.

Given the importance of Greek banks in the Balkans and Italian banks in Central Europe, any problems they have would have direct effects in those countries. Some of the banks most active in emerging Europe — especially those based in Austria and Sweden — have limited exposure in Greece, Italy, Ireland, Portugal, and Spain, but interconnectedness on funding markets could result in adverse consequences.

Western European countries are the most important trade partners for most countries in the region, and weaker economic prospects in Europe will dampen their recovery. There are already signs of declines in export demand. Export levels in 2011 were expected to be above those reached in 2008, but recovery of exports has so far been sluggish. Now a slowdown in global activity has increased the downside risks, most sharply for countries with close economic linkages with the Eurozone.

According to **Indermit Gill, World Bank Chief Economist for the Europe and Central Asia Region**, *“Governments in Emerging Europe have to again become fiscally resilient. Public debt buffers have shrunk in most of the region. With the sovereign debt crisis in advanced economies, markets are paying more attention to fiscal vulnerabilities. They have to do this now, both to prepare for a possible economic slowdown and to deal with the rising fiscal burden of pensions and healthcare of aging populations. Much of the region needs to make transparent plans for reforming public expenditures, and begin implementing them soon.”*

Gill emphasized that, *“The most pressing problem facing many countries is persistently pervasive joblessness. The private sector has to be freed to generate economic growth and jobs — the rules and regulatory structures for* *doing business can be greatly improved with no additional expense for taxpayers. With almost a third of all young adults out of work, governments in the region should put the modernization of labor market regulations and social welfare systems at the top of their reform agenda. Such structural reforms to increase entrepreneurship and inclusion are simultaneously an immediate, medium-term, and long-run priority."*

The World Bank is supporting the recovery

World Bank support reached $6.1 billion this fiscal year, including $5.5 billion from the International Bank for Reconstruction and Development (IBRD) and $650 million from the International Development Association (IDA). Turkey ($1.4 billion), Romania ($1.1 billion), and Poland ($1.1 billion) were the largest borrowers. The sectors receiving the most funding were energy and mining ($1.9 billion), public administration ($1.7 billion), and health and social services ($1.2 billion).

Along with funding, the Bank provides over 180 economic and technical reports every year in the Emerging Europe and Central Asia region to inform government reform efforts and prioritize its own financial support. It offers analytical support and encouragement to governments to improve labor market and social security systems and expand selected social safety net programs. The Bank is advising governments on how to fix less efficient public programs and improve social services so that their benefits reach those who need them most.

For more information on the World Bank's work in Emerging Europe and Central Asia, please visit: www.worldbank.org/eca

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