Regional Summary: Europe and Central Asia

Overview

GDP growth in **Europe and Central Asia** remained stable at 5.3 percent in 2011, despite the disruptive effects of the global financial turmoil since August 2011 and weakening external demand, especially from the Euro Area. Although the global economic slowdown in the second quarter also affected the region, the third quarter saw activity rebound, driven by robust domestic demand, in several large middle-income countries, notably Russia, Romania and Turkey.

However, a projected recession in high-income Europe, still troublesome inflationary pressures in the Europe and Central Asia region and reduced capital inflows (due to the deepening Euro Area debt crisis) are projected to slow regional GDP to 3.2 percent in 2012, before a modest recovery begins in 2013 with growth projected at 4.0 percent. In Russia, growth is estimated at 4.1 percent for 2011, 3.5 percent for 2012 and 3.9 percent in 2013. Turkey's growth, estimated at 8.2 percent in 2011, is projected to shrink to 2.9 percent in 2012, before firming to 4.2 percent in 2013.

Industrial production growth rebounded strongly in the region in October, particularly in Romania, Ukraine, and Turkey. Similarly, the sharp fall in region's export growth that continued since the first quarter was reversed also in October supported by strong export growth in Turkey and Romania. Other countries continue to suffer from a loss of momentum, however, with sharpest slowdown in Russia and Ukraine.

Signs of contagion from the European debt crisis were evidenced by the widening in risk premia for the region, proxied by median credit default swaps (CDS) spreads, which were the highest in Europe and Central Asia amongst all developing regions. The largest jumps in the spreads, since July, were in Ukraine, Romania, Bulgaria and Kazakhstan. Increased risk aversion also led to the steepest stock market declines, around 20 percent since July, with Ukraine, Serbia, Bulgaria and Lithuania experiencing the sharpest falloffs. Portfolio investment flows to Turkey registered net outflows of $4.7 billion between August and September, while Russia also experienced large capital outflows despite high oil prices.

Although budget balances continued to improve in 2011, with the exception of Azerbaijan due to increased non-oil deficit and Kyrgyzstan, there is limited fiscal space to support growth, particularly if commodity prices fall in response to a global slowdown.

Risks and Vulnerabilities

There are considerable downside risks to the region's economic outlook. The primary risk facing the global economy is a deterioration of the situation in high-income Europe, which could result in a significantly weaker external environment for Europe and Central Asia's main trading partners but also a significant exacerbation of negative confidence effects. Such deterioration would magnify a number of pre-existing vulnerabilities in the region, including those arising from direct trade and banking-sector exposures, as well as more indirect effects running through both financial and real channels, including possibly sharp reductions in global external financing conditions, lower commodity prices and weaker remittances.

High-income European deleveraging. The region has unusually strong banking-sector linkages with high-income Europe, both in terms of ownership links and dependencies for day-to-day financing. Foreign claims of European banks are particularly large in Latvia, Romania, Bulgaria, Lithuania and Albania relative to the size of their economies. Should the crisis in Europe accelerate the deleveraging among parent banks or a tightening of credit conditions, transmission of these conditions to the financial markets in developing Europe and Central Asia would likely be swift and potentially very damaging.

Short-term debt and current account financing requirements. Several countries in the region are also vulnerable to generalized risk aversion by both foreign and domestic investors. Should conditions deteriorate substantially, international capital flows could weaken much further and borrowing costs could rise sharply. Countries with high levels of short-term debt or maturing long-term debt and those with large current account deficits are particularly vulnerable to such a tightening in financial conditions. Turkey is particularly vulnerable with its large current account deficit and large short-term debt vis-à-vis its reserves. In a similar fashion, Belarus and Montenegro are also vulnerable to a freezing-up of global credit as well as Georgia, Bulgaria, and Romania with their heavy reliance on short-term debt. Moldova is also at risk since it finances its large current account deficit with flows other than FDI, which tend to be volatile.

Trade. The European Union remains a key export market for countries in Eastern Europe and Central Asia, accounting for more than half the region's exports, with Romania, Lithuania and Latvia particularly vulnerable to a sharp downturn in European demand.

Commodity Prices. A substantial faltering of global growth may disproportionately impact commodity exporters through a possible reduction in commodity prices. Based on current export volumes, in an event of a sharp fall in oil prices the hardest hit economies in the region are likely to include Russia and Azerbaijan.

Remittances. Remittances, which are a very important source of both foreign currency and domestic incomes for several countries in the region, may be severely affected since 40 percent of remittances emanate from high-income Europe. Also, remittances outflows from Russia are particularly important for the region, which would decline considerably if oil prices fall sharply. Such reduction in migrant remittances will pressure on current account positions in several countries that rely heavily on remittances, in particular in Tajikistan, Kyrgyz Republic, and Moldova.

Policy Recommendations

Countries in the region should evaluate their vulnerabilities and prepare contingencies to deal with both the immediate and longer-term effects of an economic downturn.

Most countries in the region have less fiscal space available for counter-cyclical policies to cope with a sharp deterioration in global conditions as compared with 2008/09. In such eventuality, where fiscal space exists, governments could use countercyclical policy to support growth, by increasing spending on social safety nets that would limit poverty impacts, and on infrastructure projects that would benefit growth. Countries with limited fiscal space could increase the effectiveness of countercyclical fiscal policy, improving the targeting of social safety nets and prioritizing infrastructure programs necessary for longer-term growth. In such situation, monetary policy could also become more accommodative provided that inflation expectations remain anchored.

Countries where credit has increased rapidly in recent years should engage in stress testing of their domestic banking sectors. A much weaker external environment could result in sharply lower domestic growth and falling asset prices that could result in a rapid increase in the number of non-performing loans and domestic banking stress.

Countries with large external financing needs should pre-finance these needs to avoid abrupt and sharp cuts in government and private sector spending.

With growth in high-income countries likely to remain subdued for an extended period, countries in the region may need to identify new drivers of growth and to address structural problems that negatively affect competitiveness.

Europe and Central Asia forecast summary

(annual percent change unless indicated otherwise)

	98-07[a]	2008	2009	Est. 2010	Forecast 2011	2012	2013
GDP at market prices (2005 US$) [b]	5.4	3.9	-6.5	5.2	5.3	3.2	4.0
Albania	5.5	7.7	3.3	3.5	3.0	2.0	3.5
Armenia	9.6	6.9	-14.1	2.1	4.6	4.3	4.2
Azerbaijan	14.2	10.8	9.3	5.0	0.2	3.1	3.0
Belarus	6.9	11.3	0.2	7.6	5.0	0.5	3.5
Bulgaria	4.8	6.2	-5.5	0.2	1.9	1.2	3.3
Georgia	6.6	2.3	-3.8	6.4	6.5	5.0	5.2
Kazakhstan	8.3	3.3	1.2	7.3	6.6	5.5	5.8
Kosovo		6.9	2.9	3.9	5.3	5.0	4.7
Kyrgyz Republic	4.2	7.6	2.9	-1.4	7.0	5.5	5.7
Lithuania	3.4	2.9	-14.7	1.3	5.8	3.2	3.5
Moldova	4.1	7.8	-6.0	6.9	6.0	4.0	4.3
Macedonia, FYR	2.6	5.0	-0.9	1.8	3.0	2.5	3.5
Montenegro		6.9	-5.7	2.5	2.5	1.8	2.5
Romania	4.3	7.3	-7.1	-1.3	2.2	1.5	3.0
Russian Federation	6.3	5.2	-7.8	4.0	4.1	3.5	3.9
Serbia	3.1	3.8	-3.5	1.0	2.0	1.5	4.0
Tajikistan	7.9	7.9	3.9	6.5	6.0	6.0	5.0
Turkey	3.7	0.7	-4.8	9.0	8.2	2.9	4.2
Ukraine	5.9	2.1	-14.8	4.2	4.5	2.5	4.0
Uzbekistan	5.6	9.0	8.1	8.5	8.3	8.0	6.5

Source: World Bank.

World Bank forecasts are frequently updated based on new information.

Bosnia and Herzegovina, Turkmenistan, Serbia, Montenegro are not forecast owing to data limitations.

a. Growth rates over intervals are compound average; growth contributions, ratios and the GDP deflator are averages.