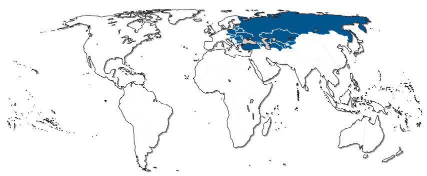
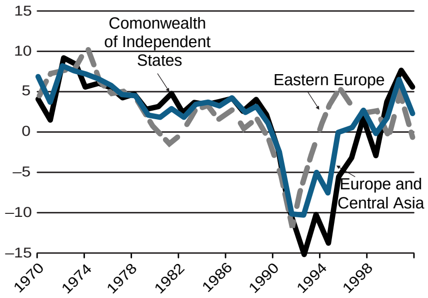


Europe and Central Asia

GNI per capita, 2000: $2,010

GDP growth rates, 1970–2001

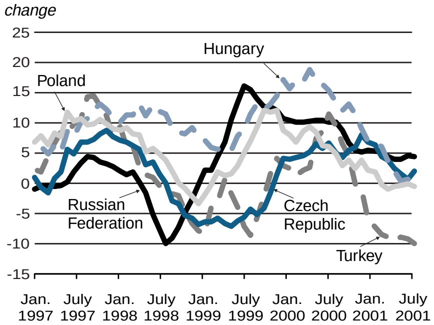
Annual percentage change



Source: World Bank.

Industrial production, 1997–2001

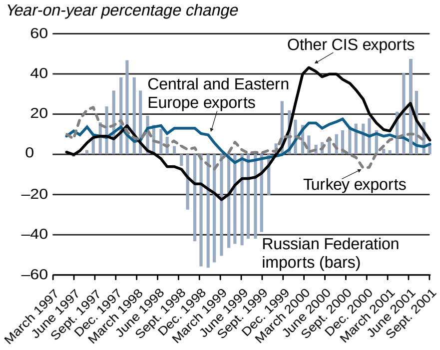
Three-month moving average, year-over-year percentage change



Source: Datastream.

Russian imports and partner exports, 1997–2001

Year-on-year percentage change



Source: International Monetary Fund, *International Finance Statistics*; and World Bank.

Recent developments

Output growth in Europe and Central Asia slowed markedly to an estimated 2.2 percent in 2001 from 6.4 percent in 2000. A sharp deceleration in export markets contributed to this slowdown, but domestic factors were more significant—with a particularly pronounced downturn in Turkey and a notable deceleration of growth in Poland. While performance varied across countries, the general trend was an easing of growth during 2001. Most European and Central Asian countries experienced declining inflation—particularly in the Commonwealth of Independent States (CIS), where the median rate fell from 17.3 percent in 2000 to 8.8 percent in 2001—and falling interest rates, reflecting a drop in import prices and international interest rates. At the same time, a number of European and Central Asian countries (the Czech Republic, Kazakhstan, Poland, Ukraine, and Uzbekistan, among others) witnessed some deterioration in fiscal balances, generally because of the adoption of more expansionary fiscal policies.

The Central and Eastern European countries (including the Baltics and Turkey) experienced a contraction in output of 0.8 percent in 2001, following a robust 5 percent expansion in 2000. Pulling down the outturn for this group, the severe banking and currency crises in Turkey in February 2001 ushered in a sharp contraction of its economy over the year. Growth in the Central and Eastern Europe, excluding Turkey, declined to 2.9 percent in 2001 from 3.8 percent in 2000. This moderate deceleration reflected a slowdown in domestic demand in a few countries, especially in Poland, which had pursued a tight monetary policy through much of 2001; the former Yugoslav Republic of Macedonia, where civil war disrupted economic activity; and Slovenia, which witnessed a contraction in investment that was due in part to an increase in interest rates. Declining exports to Western Europe contributed to softening growth, given the Central and Eastern European economies' high exposure to Euro Area import demand. For example, Hungary, Poland, and the Slovak Republic's export volume growth decelerated markedly in 2001. However, import compression in a number of Central and Eastern European countries, including Turkey and Poland, mitigated weaker export performance from a balance of payments perspective.

The countries seeking accession to the European Union (EU) received a boost in November 2001, when the European Commission released its regular annual reports on the 10 European and Central Asian candidates—all Central and Eastern European countries.[1] The commission reported that all candidates made substantial progress in adopting the *aqcuis communautaire* (body of European Community law) over the year and that most of the countries (excluding Bulgaria and Romania) are expected to be ready to join in the near term. Some hurdles remain, as EU members have yet to formalize agreements in a number of important areas, mainly pertaining to agriculture and budgetary issues.

The CIS achieved strong 5.5 percent growth in 2001, though this is a significant moderation from the exceptionally robust 7.9 percent output advance of 2000. The slowdown mainly reflected easing energy prices from the highs witnessed in 2000. In

Russia, some of the Caucasus countries, and Central Asia, firm energy prices funded increased fiscal outlays and investment. Further, domestic demand in Russia continued to benefit, albeit moderately, from ongoing import substitution spurred by the 1998 devaluation, as the ruble remains below precrisis levels. However, the 7 percent appreciation of the real effective exchange rate in 2001—culminating in the ruble losing roughly half of the competitive advantage it had gained because of the 1998 devaluation—is eroding this impetus. Firm growth in Russia, the CIS's largest economy, has also been key to generating strong external demand for other countries in Europe and Central Asia, especially those of the CIS and the Baltics.

Contagion from the financial crisis in Turkey was not notably apparent in the rest of Europe and Central Asia. For the region, excluding Turkey, spreads on secondary market debt instruments declined from an average of 1,020 basis points during 2000 to an average of 854 points during 2001. For example, spreads declined significantly in Russia from just below 1,340 basis points in 2000 to 955 for 2001, and in Croatia, from 380 basis points to 225. In Turkey, the average spread increased sharply from just over 530 basis points in 2000 to over 900 in 2001, and stabilized in the beginning of 2002 near 650 points.

Aside from rating downgrades for Turkish debt early in the year because of concerns about fiscal policy and the banking sector, (to B– from B+, according to Standard and Poor's [S&P]), credit ratings elsewhere in the region were upgraded. The Slovak Republic's rating was raised to investment grade by S&P, tied to progress in EU accession negotiations and the restructuring of state banks. A number of other European and Central Asian sovereigns were upgraded during 2001, including Bulgaria, Estonia, Kazakhstan, Romania, and Russia. The shifts in credit quality were attributed to various factors, including improvements in economic structure (Bulgaria, Estonia, and Russia), in the banking sector (Romania), or in external liquidity (Kazakhstan and Romania).

Gross capital market flows and foreign direct investment

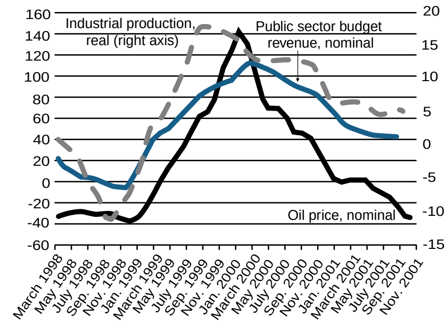
Capital market commitments (bonds, bank lending, and portfolio equity) to Europe and Central Asia experienced a massive 34 percent decline during 2001 to $28.2 billion from a total $43 billion in 2000. The sharp drop-off is a reflection of the currency and banking sector crisis in Turkey, where flows fell by nearly $15 billion in the year, while gross capital market commitments to the rest of the region were flat at $21 billion. The largest decline for the region in aggregate was posted in banking flows, down from over $25 billion in 2000 to about $17 billion in 2001. Again, the decline in flows to Turkey of $6.5 billion accounts for the bulk of the reduction, though Poland and Russia experienced a moderate decline in banking flows.

Bond and equity flows to the region also fell sharply, both posting a drop-off of close to $3 billion. A large $6.3 billion decline in bond flows to Turkey was partially offset by substantial upswings in bond issuance by Hungary, Poland, Romania, and Russia. And a fall of $3 billion in equity placement from the region is almost wholly attributable to declines in flows to Turkey.

Foreign direct investment (FDI) flows remained much more resilient, totaling $28.5 in 2001, the same level

Russian Federation: Oil prices, fiscal linkage, and growth, 1998–2001

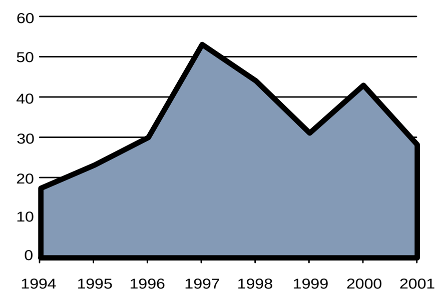
Three-month moving average, year-over-year percentage change



Source: World Bank.

Gross capital market commitments, 1994–2001

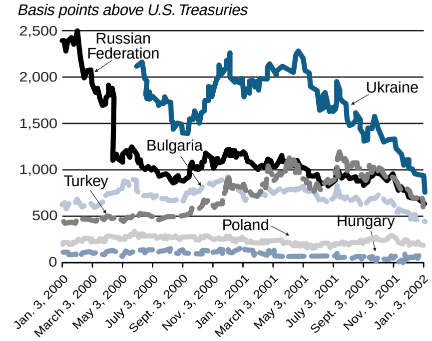
Billions of dollars



Source: World Bank.

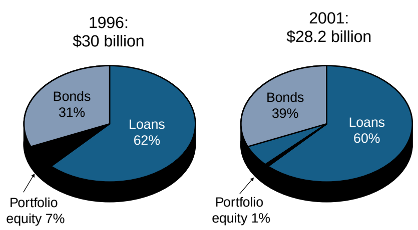
Secondary market spreads for selected European and Central Asia countries, 2000–2002

Basis points above U.S. Treasuries



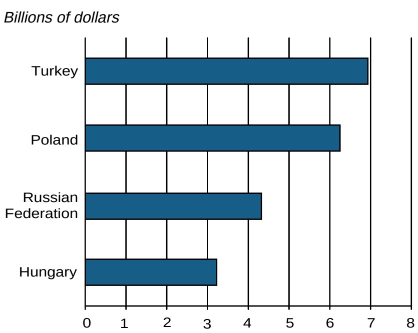
Source: J.P. Morgan Chase

Composition of gross capital market commitments, 1996 and 2001



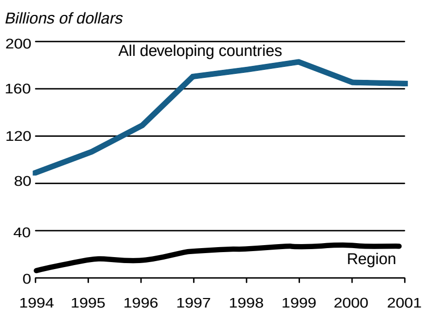
Source: World Bank.

Gross capital market commitments, 2001



Source: World Bank.

Net foreign direct investment, 1994–2001



Source: World Bank.

as posted in 2000. However, a majority of countries in Europe and Central Asia witnessed a decline in FDI from year-earlier levels. Poland experienced the largest falloff—nearly $3 billion in 2001 to $6.5 billion—followed by the Slovak Republic with a $1 billion decline, half the 2000 level. A $2.5 billion increase to $3.5 billion in FDI flows to Turkey and an increase of $1.3 billion to Kazakhstan (to $2.5 billion) served to offset the decline in flows to Poland and the Slovak Republic.

Debt negotiations

Georgia, Ukraine, and the Federal Republic of Yugoslavia concluded external debt-restructuring agreements with Paris Club creditors during 2001. These agreements are expected to reduce 2000 debt service to Paris Club creditors from $88 million to $33 million for Georgia, and from an initial amount of $800 million in 2001 to $285 million for Ukraine in 2002. For the Federal Republic of Yugoslavia, the debt-restructuring agreement is expected to restrict debt service to below $100 million per year through 2005. Russia was unsuccessful in its bid early in 2001 to restructure its external debt with Paris Club creditors, and has been paying its commitments in full under the existing agreement. In June 2001, the Turkish Treasury conducted a domestic swap auction to extend the maturity profile of domestic borrowing and reduce the financing requirement for 2001. And the Kyrgyz Republic is expected to begin negotiations for debt restructuring with the Paris Club creditors in March 2002.

Prospects and risks

Growth in the region is expected to firm moderately to about 3.2 percent in 2002 and to strengthen to 4.3 percent in 2003. An assumption of stabilization and recovery to positive growth in Turkey, together with firming external demand for the region, should provide the foundation for reacceleration of growth. And monetary easing in a number of countries following a period of policy tightening (for example, as pursued in Poland since late 2001) is expected to boost growth over the period. But for hydrocarbon exporters, growth is anticipated to slow moderately in 2002, reflecting lower oil prices and a concomitant slowdown in government spending and investment.

Aggregate growth in Europe and Central Asia is forecast to decelerate marginally to 4 percent in 2004, in part due to an expected moderation of external demand. For countries seeking accession to the EU (almost all of Central and Eastern Europe), deepening reforms, continued significant inflows of FDI, as well as steady external demand should provide continued strong impetus to growth. Growth for the Central and Eastern European countries is forecast to average 4.7 percent by 2004. The main threats to the forecast for Central and Eastern Europe emanate from fiscal and external deficits. There is also a modest risk that the EU accession process might be delayed, should remaining negotiations (such as on agricultural and budgetary issues) run into difficulties.

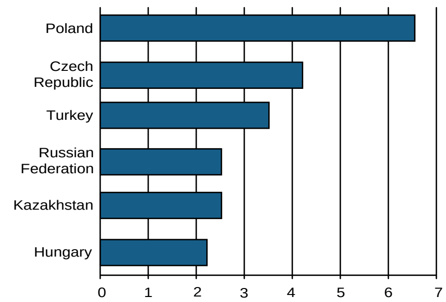
The outlook is more clouded for the CIS, with threats to the forecast on both the up- and downsides. These reflect the uncertainty in global oil markets and political factors. Growth in the CIS is projected to slow to close to 3 percent by 2004. One adverse factor is lower oil prices in real terms through 2004, down from the high levels witnessed in 2000 and 2001. The hydrocarbon-exporting countries of the CIS will need to manage commodity price volatility if they are to see stable growth. And in a number of CIS countries, large public sectors, overextended social security systems, and significant off-budget expenditures remain important challenges to achieving fiscal balance, which is essential for sustained growth. On the upside, the recent cooperation of a number of Central Asian countries with the U.S.-led intervention in Afghanistan is expected to lead to increased foreign assistance.

Note

1. The 10 countries are Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic, and Slovenia. Turkey is also seeking EU membership.

Net foreign direct investment by country, 2001

Billions of dollars



Source: World Bank.

Europe and Central Asia forecast summary

(percent per year)

Growth rates/ratios	1991–2000	1999	2000	Estimate 2001	Baseline forecast 2002	2003	2004
Real GDP growth	–2.3	1.6	6.4	2.2	3.2	4.3	4.0
Consumption per capita	–2.7	–1.9	5.0	0.8	3.2	3.6	3.5
GDP per capita	–2.5	1.5	6.2	2.1	3.1	4.2	3.9
Population	0.2	0.2	0.1	0.1	0.1	0.1	0.1
Gross domestic investment/GDP[a]	22.0	20.9	21.4	20.5	21.0	21.4	21.6
Inflation[b]	347.7	7.6	7.4	5.9	6.1	6.3	6.9
Central government budget balance/GDP	–4.8	–4.5	–2.5	–1.7	–2.8	–3.0	–3.1
Export market growth[c]	5.3	–0.8	11.7	6.1	3.4	7.6	7.2
Export volume[d]	0.6	–0.7	12.0	9.8	7.0	10.8	9.8
Terms of trade/GDP[e]	–0.3	0.2	–1.3	0.2	–2.0	–0.5	–0.1
Current account/GDP	–0.4	0.2	2.2	2.2	–0.4	–0.8	–0.9
Memo items							
GDP growth: transition countries	–3.2	3.3	6.2	4.4	3.4	4.0	4.0
Central and Eastern Europe	1.6	–0.6	5.0	–0.8	2.6	4.8	4.7
Central and Eastern Europe[f]	0.7	2.1	3.8	2.9	2.8	4.1	4.9
CIS	–5.2	4.3	7.9	5.5	3.8	3.9	3.3

a. Fixed investment, measured in real terms.
b. Local currency GDP deflator, median.
c. Weighted average growth of import demand in export markets.
d. Goods and nonfactor services.
e. Change in terms of trade, measured as a proportion of GDP (percent).
f. Excluding Turkey.
Source: World Bank baseline forecast, February 2002.