Europe and Central Asia

Recent developments

In 2007 Europe and Central Asia[1] achieved a remarkable 6.8 percent GDP advance, down moderately from 7.3 percent in 2006, against a background of global financial turmoil, rapid changes in commodity prices, and incipient slowing of demand in the Euro Area. Growth was supported by robust domestic demand, whose contribution to regional growth peaked at 10.7 points in 2007. Private consumption and fixed capital formation grew by 8 percent and 15.8 percent, respectively, during 2007. At the same time, net exports asserted increasing drag on the region's growth, from minus 0.6 points of growth in 2002 to almost minus 4 points by 2007, reflecting buoyant import demand that fostered a larger regional current account shortfall—and increasing dependence on foreign financing. Both central and eastern European (CEE) and Commonwealth of Independent States (CIS) countries sustained double-digit growth in investment and imports, while private consumption growth exceeded 8 percent (table A.4).

GDP growth for the CEE economies, at 6.1 percent during 2007, remained sturdy, but the group's current account deficit spiked to a new high of 7.8 percent of GDP. CIS countries, many of which are commodity exporters taking advantage of surging prices, recorded their second-strongest growth in a decade at 8.6 percent, to which domestic demand contributed 16.4 percentage points. Commodity revenues have allowed strong expansionary fiscal policies in CIS countries, pushing wage and credit growth up. Across the region, the growth situation has been diverse: while five countries enjoyed double-digit GDP advances, Hungary achieved a meager 1.3 percent gain (figure A.4). Moreover, quarterly data show diverging trends: for some countries growth continued, some showed a gradual easing, and others (Kazakhstan and the Baltic states) saw a sudden falloff in the final quarter of 2007.

Hungary has shown no sign of economic recovery since its fiscal austerity measures depressed domestic demand. It appears more fragile than it did earlier, given its worrisome levels of public and external debt (about 70 percent and 90 percent of GDP, respectively) in the current unfavorable external environment. Meanwhile, growth of three other Central European countries (the Czech Republic, Poland, and the Slovak Republic) accelerated into 2007. The Slovak Republic's 10.4 percent performance was especially notable. The Baltic States are cooling: the end of real estate booms in all countries has turned the direction of concern from overheating to "hard landing." The abrupt slowing of growth in Latvia, from 10.9 percent year over year in the third quarter of 2007 to 3.6 percent during

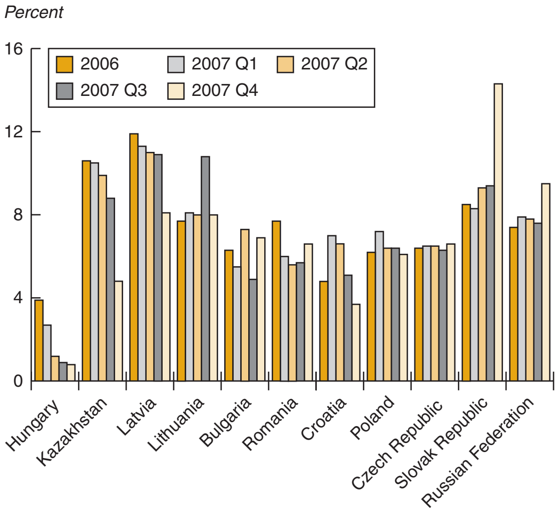
Table A.4 Europe and Central Asia forecast summary

annual percentage change unless indicated otherwise

					Forecast		
Indicator	1991–2000[a]	2005	2006	2007	2008	2009	2010
GDP at market prices (2000 $)[b]	−1.0	6.3	7.3	6.8	5.8	5.4	5.4
GDP per capita (units in $)	−1.1	6.3	7.2	6.8	5.8	5.4	5.3
PPP GDP[c]	−0.9	6.2	7.4	7.2	6.1	5.6	5.5
Private consumption	0.6	7.6	7.3	8.0	7.5	6.9	6.9
Public consumption	0.0	3.1	5.0	3.8	3.8	3.6	3.5
Fixed investment	−6.6	11.5	14.3	15.8	14.8	13.6	13.4
Exports, GNFS[d]	0.9	6.7	9.8	9.7	7.7	8.4	9.0
Imports, GNFS[d]	−1.6	10.4	14.4	16.8	13.2	13.0	13.4
Net exports, contribution to growth	0.9	−1.7	−2.4	−3.9	−3.6	−3.6	−3.9
Current account bal/GDP (%)	—	1.8	1.0	−0.9	0.1	−0.8	−1.4
GDP deflator (median, LCU)	118.5	5.9	8.3	7.2	7.2	7.9	5.0
Fiscal balance/GDP (%)	−5.1	2.0	2.3	1.9	1.7	0.6	0.6
Memorandum items: GDP							
Transition countries	2.1	5.9	6.5	5.5	4.8	4.6	4.8
Central and Eastern Europe	1.2	4.4	6.2	6.1	5.2	4.9	4.8
Commonwealth of Independent States	−4.2	6.8	8.3	8.6	7.2	6.5	6.0
Russia	−3.9	6.4	7.4	8.1	7.1	6.3	6.0
Turkey	3.7	8.4	6.9	4.5	4.0	4.3	5.0
Poland	3.8	3.6	6.1	6.5	5.7	5.1	5.0

Source: World Bank.
— Not available.
a. Growth rates over intervals are compound averages; growth contributions, ratios, and the GDP deflator are averages.
b. GDP is measured in constant 2000 $.
c. GDP is measured at PPP exchange rates.
d. Exports and imports of goods and nonfactor services.

Figure A.4 Real GDP growth rates for selected Europe and Central Asia countries



Source: World Bank.

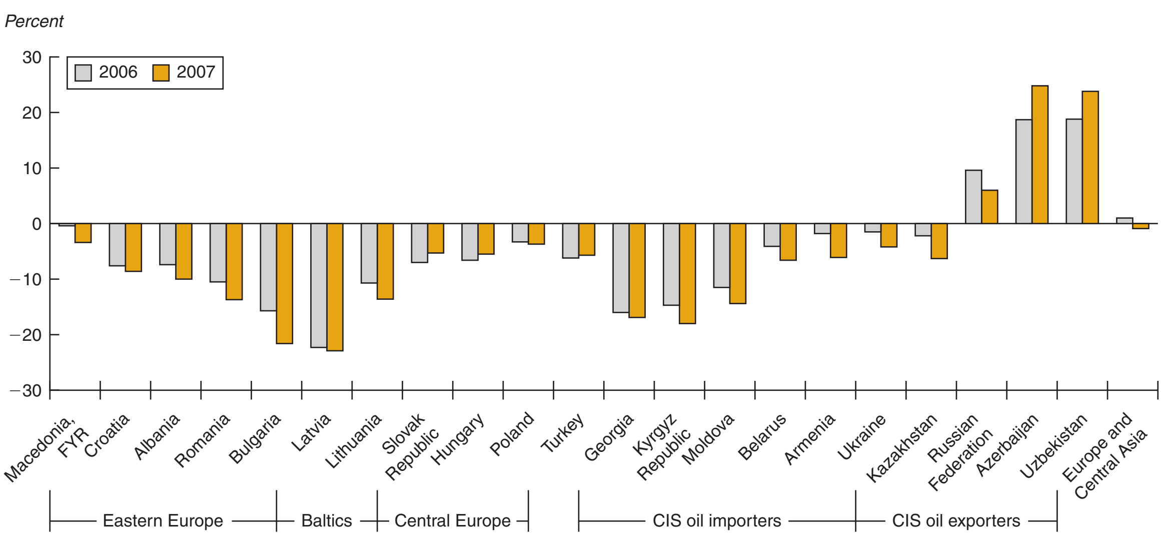
the first quarter of 2008, shows that the risk is significantly biased toward the downside. Other economies tending toward overheating—Bulgaria and Romania—seem to have performed well during 2007, but they have become more vulnerable given difficulties in financing large current account deficits in an anxious global financial environment. After experiencing a volatile exchange rate in mid-2006, Turkey tightened its monetary policy, which dampened domestic demand. Growth dropped by more than 2 points and depressed import demand. Still-strong export and investment growth supported 4.6 percent GDP gains in 2007.

Among CIS countries, the Russian Federation grew by a strong 8.1 percent during 2007; it retained that momentum into the first quarter of 2008, thanks in part to higher-than-expected oil prices, registering an 8 percent GDP advance year over year. Russia's budget surplus stood at 5.4 percent of GDP during 2007 and increased to 6.6 percent during the first quarter of 2008. The country's current account surplus rose to $37 billion in the quarter, up from $23 billion a year earlier. Net FDI inflows to Russia reached $52 billion in 2007. At the same time, the strength of domestic demand, rapid increases in liquidity, and hikes in food and fuel costs have seen inflation ramp up to 12.8 percent year over year in the first quarter—the highest rate in several years.

But Russia's oil production advanced only 2.3 percent in volume terms during 2007, compared with average growth of 9 percent earlier this decade; natural gas production declined 0.5 percent during the year. The current stagnancy in energy output may be attributable to an uncertain investment environment for foreign direct investment in energy, as well as high tax burdens on the sector: the overall tax burden on natural gas is 46 percent and is as much as 62 percent on crude petroleum.

A notable vulnerability facing the region is deteriorating current account deficits in many countries (figure A.5). With the exception of CIS

Figure A.5 Current account as a share of GDP in Europe and Central Asia, 2006–07



Source: World Bank.
Note: CIS = Commonwealth of Independent States.

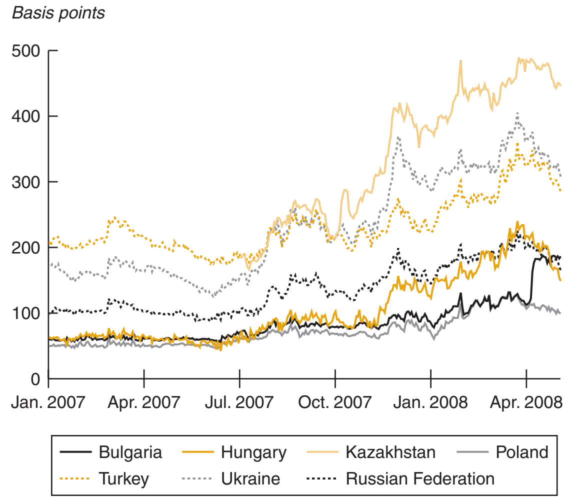
hydrocarbon exporters, almost all economies showed deterioration in current account balances during 2007. The deficit has reached more than 10 percent of GDP in the Baltics, Bulgaria, Romania, Georgia, the Kyrgyz Republic, and Moldova, underscoring existing worries about unsustainable growth in several economies. Substantial inflow of remittances to the smaller countries of the CIS, however (which in 2006 accounted for 18.3 percent of GDP in Armenia, 6.4 percent in Georgia, 27.4 percent in the Kyrgyz Republic, and 36.2 percent in Moldova), have helped to finance demand for imported goods.

Net FDI flows to the region established a record in 2007 but are expected to decline in 2008 due to the global credit crunch, covering a smaller portion of current account deficits. Moreover, an increasing reliance on foreign bank borrowing suggests that should external finance dry up on the back of a sharp deterioration in international markets, households and businesses would be unable to roll over debts created by the current credit boom and would be forced to consolidate, with an ensuing—potentially substantial—drag on economic activity.

Contagion from high-income countries' financial and real-side troubles to the region would be passed through the trade link and external financing, so the impact on the countries of Europe and Central Asia will differ depending on the country's trading pattern and its reliance on external finance. The region's export growth is expected to be negatively affected particularly by an easing of import demand in the European Union in 2008. This effect is likely to be more pronounced in the CEE (where a large portion of exports is shipped to the Euro Area) than in the CIS (where export destinations within the group, such as Russia, and emerging markets, such as China, remain resilient and commodity prices are projected to remain at elevated levels).

International investor perceptions of the apparent increase in risk in several countries in the region have been reflected in widening spreads on credit default swaps and government bonds for these countries. Sovereign Emerging Markets Bond Index (EMBI) spreads widened across all countries since the start of the financial turmoil, peaked in March, and then declined slightly, but with much differentiation among them (figure A.6). Between mid-2007 and the end of April 2008, spreads increased for Russia (63 basis points, or bp), Bulgaria (93bp), Hungary (95bp), Turkey (110bp), Ukraine (169bp), and Kazakhstan (270bp), in contrast with Poland (42bp), which has recently displayed stronger fundamentals and less reliance on external financing.

Figure A.6 Spreads rising for selected Europe and Central Asia countries



Source: Thomson/Datastream.

Capital flows. After a big surge in 2006, net capital flows to the Europe and Central Asia region continued to increase in 2007—by $72 billion—reaching $404 billion and accounting for about 40 percent of total flows to developing countries. Net private capital flows reached $409 billion, representing a moderate increase of $44 billion from 2006. Repayments to official creditors continued to outstrip lending, although by a smaller magnitude ($5 billion) than in 2006 ($33 billion, mostly due to Russia's prepayment to Paris Club creditors).

Net FDI inflows to the region increased to $162 billion in 2007 from $125 billion in 2006, with Russia accounting for the largest share with $52 billion, followed by Turkey ($22 billion) and Poland ($18 billion). Despite a lack of improvement in Russia's investment climate, FDI continued to increase on the back of higher oil prices and growth potential in domestic consumption. FDI flows to Turkey continued to be driven by privatization and mergers and acquisitions, with half of the total targeted on the financial sector. Net portfolio equity inflows almost doubled to $21 billion in 2007, from $11 billion in 2006, with Russia

Table A.5 Net capital flows to Europe and Central Asia
$ billions

Indicator	1999	2000	2001	2002	2003	2004	2005	2006	2007p
Current account balance	0.5	19.6	21.3	11.0	6.8	13.3	38.1	25.2	−27.3
as % of GDP	0.1	2.2	2.3	1.1	0.5	0.8	1.8	1.0	−0.9
Net equity flows	24.7	25.5	26.2	26.2	34.2	68.6	80.1	135.7	182.2
Net FDI inflows	23.1	24.8	26.6	26.1	34.9	63.5	72.2	124.6	161.6
Net portfolio equity inflows	1.6	0.7	−0.4	0.1	−0.7	5.1	7.9	11.1	20.7
Net debt flows	19.0	21.7	2.4	24.8	52.9	77.1	92.3	196.3	222.1
Official creditors	−0.4	0.1	2.2	2.7	−6.7	−10.0	−36.2	−33.0	−4.7
World Bank	1.9	2.1	2.1	1.0	−0.6	0.4	−0.7	0.3	−0.3
IMF	−3.1	−0.7	6.1	4.6	−2.0	−5.9	−9.8	−6.2	−4.0
Other official	0.8	−1.3	−6.0	−3.0	−4.0	−4.5	−25.6	−27.0	−0.4
Private creditors	19.4	21.6	0.2	22.1	59.5	87.1	128.4	229.3	226.8
Net medium- and long-term debt flows	18.9	13.3	6.2	17.9	29.1	68.8	103.0	173.8	166.8
Bonds	7.7	5.5	1.1	3.6	8.9	23.6	28.2	33.9	52.0
Banks	11.8	9.3	7.2	15.9	20.4	46.5	76.0	139.5	115.9
Other private	−0.7	−1.5	−2.2	−1.6	−0.2	−1.3	−1.2	0.4	−1.0
Net short-term debt flows	0.6	8.3	−6.0	4.2	30.4	18.3	25.5	55.5	60.0
Balancing item[a]	−38.3	−48.1	−37.8	−23.1	−33.5	−82.4	−117.3	−184.3	−134.7
Change in reserves (− = increase)	−5.9	−18.7	−12.1	−39.0	−60.3	−76.6	−93.2	−172.9	−242.3
Memorandum item									
Worker's remittances	11.9	13.1	12.7	14.0	16.7	21.3	29.6	35.4	38.6

Source: World Bank.
Note: p = projected.
a. Combination of errors and omissions and net acquisition of foreign assets (including FDI) by developing countries.

($15 billion) and Turkey ($5 billion) accounting for most of total (table A.5).

Net private debt flows to the region eased to $227 billion in 2007 from $229 billion in 2006, with a decrease in net cross-border bank lending to $116 billion from $140 billion in 2006. This compares with an increase of bank lending to developing countries of $215 billion in 2007, up from $172 billion in 2006. The current credit market crisis has had some negative impacts on the private debt flows to the region as a whole. Both gross international bond issuance and gross syndicated loan borrowing decreased in the fourth quarter of 2007 and first quarter of 2008. As external financing conditions deteriorated, some countries in the region experienced more negative effects than others. Some of these countries, for example, Bulgaria, the Kyrgyz Republic, Latvia, Lithuania, and Romania, have been financed largely by record capital inflows in recent years. In other countries, such as Hungary, Kazakhstan, Russia, and Ukraine, the banking sector had been borrowing large sums from external debt markets to finance domestic lending before the current turmoil. Continued credit woes and re-pricing of risks in the international markets may continue to affect cross-border debt flows and the financing of domestic consumption and investment, and thus carry a negative impact on economic growth.

Current account balances deteriorated across the region in 2007, falling to deficit from surplus in 2006. But as capital and financial accounts still registered large surpluses, foreign reserves increased by $242 billion in 2007 (of which Russia accounted for over two-thirds with $169 billion).

The threat of inflation also looms alongside the global phenomenon of surging commodity prices. Monthly inflation reached double digits at the beginning of 2008 in nine of ten CIS countries, as well as in the Baltic States and FYR Macedonia. In Azerbaijan, Kazakhstan, the Kyrgyz Republic, and Ukraine, inflation breached 20 percent (year over year). Strong domestic demand and high global food and energy prices are common factors behind the widespread upturn in inflation. Among the CEE countries, other factors, such as increased taxes and duties, are contributing to inflation, while in the CIS, high food and energy import prices play a big role, as does the substantial pickup in wage growth. Moreover, the imported gas price from Russia to CIS members is being increased to catch up with the price of shipments to Europe.

Table A.6 Europe and Central Asia country forecasts

annual percentage change unless indicated otherwise

					Forecast		
Country/indicator	1991–2000[a]	2005	2006	2007	2008	2009	2010
Albania							
GDP at market prices (2000 $)[b]	1.4	5.5	5.0	6.0	5.8	6.2	6.2
Current account bal/GDP (%)	−5.6	−6.8	−7.4	−10.0	−11.9	−9.7	−8.6
Armenia							
GDP at market prices (2000 $)[b]	−3.8	13.9	13.3	13.7	10.0	8.1	7.3
Current account bal/GDP (%)	−12.0	−1.1	−1.8	−6.1	−8.6	−7.9	−7.2
Azerbaijan							
GDP at market prices (2000 $)[b]	−5.2	26.2	34.5	25.0	16.7	12.3	8.1
Current account bal/GDP (%)	−15.8	1.3	18.7	24.8	46.6	42.7	35.7
Belarus							
GDP at market prices (2000 $)[b]	−1.2	9.4	10.0	8.2	7.4	6.3	6.0
Current account bal/GDP (%)	—	1.4	−3.9	−6.6	−7.0	−9.0	−7.6
Bulgaria							
GDP at market prices (2000 $)[b]	−1.7	6.3	6.3	6.2	5.6	5.3	5.1
Current account bal/GDP (%)	−2.3	−12.1	−15.7	−21.6	−21.9	−19.0	−16.9
Croatia							
GDP at market prices (2000 $)[b]	−1.5	4.3	4.8	5.6	4.5	4.7	5.0
Current account bal/GDP (%)	1.0	−6.6	−7.6	−8.6	−9.6	−9.5	−9.0
Georgia							
GDP at market prices (2000 $)[b]	−9.3	9.6	9.4	12.4	9.8	8.9	8.0
Current account bal/GDP (%)	—	−11.9	−16.0	−16.9	−18.8	−15.7	−13.1
Hungary							
GDP at market prices (2000 $)[b]	0.8	4.1	3.9	1.3	2.3	3.3	3.5
Current account bal/GDP (%)	−5.4	−6.8	−6.6	−5.5	−4.3	−4.0	−3.7
Kazakhstan							
GDP at market prices (2000 $)[b]	−3.6	9.7	10.7	8.5	6.1	6.3	6.7
Current account bal/GDP (%)	−2.1	−1.8	−2.2	−6.3	−1.1	−2.7	−4.7
Kyrgyz Republic							
GDP at market prices (2000 $)[b]	−4.0	−0.2	3.1	8.2	6.6	6.2	5.8
Current account bal/GDP (%)	−10.6	−2.2	−14.7	−18.0	−18.5	−14.5	−11.6
Lithuania							
GDP at market prices (2000 $)[b]	−3.3	7.9	7.7	8.8	6.0	5.5	5.8
Current account bal/GDP (%)	−5.9	−7.1	−10.7	−13.6	−11.7	−11.2	−10.2
Latvia							
GDP at market prices (2000 $)[b]	−2.8	10.6	11.9	10.3	3.0	2.5	3.5
Current account bal/GDP (%)	−1.6	−12.4	−22.3	−22.9	−16.5	−11.3	−9.3
Moldova							
GDP at market prices (2000 $)[b]	−9.8	7.5	4.8	3.0	6.5	5.5	5.0
Current account bal/GDP (%)	—	−8.3	−11.5	−14.4	−17.3	−13.6	−10.5
Macedonia, FYR							
GDP at market prices (2000 $)[b]	−0.9	4.1	3.7	5.1	5.0	5.4	5.4
Current account bal/GDP (%)	—	−1.4	−0.4	−3.4	−8.6	−8.4	−8.3
Poland							
GDP at market prices (2000 $)[b]	3.8	3.6	6.1	6.5	5.7	5.1	5.0
Current account bal/GDP (%)	−3.5	−1.6	−3.3	−3.7	−5.5	−5.4	−5.4
Romania							
GDP at market prices (2000 $)[b]	−1.7	4.1	7.7	6.0	6.0	5.0	4.3
Current account bal/GDP (%)	−4.8	−8.5	−10.5	−13.7	−15.7	−14.5	−13.3
Russian Federation							
GDP at market prices (2000 $)[b]	−3.9	6.4	7.4	8.1	7.1	6.3	6.0
Current account bal/GDP (%)	—	10.9	9.6	6.0	6.8	4.6	2.9
Slovak Republic							
GDP at market prices (2000 $)[b]	0.3	6.6	8.5	10.4	7.3	6.0	5.3
Current account bal/GDP (%)	—	−8.5	−7.0	−5.3	−5.2	−4.7	−4.2
Turkey							
GDP at market prices (2000 $)[b]	3.7	8.4	6.9	4.5	4.0	4.3	5.0
Current account bal/GDP (%)	−1.1	−4.7	−6.2	−5.7	−7.3	−7.5	−6.8
Ukraine							
GDP at market prices (2000 $)[b]	−8.0	2.7	7.3	7.3	5.5	5.0	4.5
Current account bal/GDP (%)	—	2.9	−1.5	−4.2	−9.4	−9.5	−8.4
Uzbekistan							
GDP at market prices (2000 $)[b]	−0.2	7.0	7.2	9.5	7.7	7.5	6.8
Current account bal/GDP (%)	—	14.3	18.8	23.8	26.8	23.6	20.6

Source: World Bank.
Notes: Growth and current account figures presented here are World Bank projections and may differ from targets contained in other Bank documents. Bosnia and Herzegovina, Tajikistan, Turkmenistan, and the former Yugoslavia (Serbia/Montenegro) are not forecast owing to data limitations. — Not available.
a. Growth rates over intervals are compound averages; growth contributions, ratios, and the GDP deflator are averages.
b. GDP is measured in constant 2000 $.

Medium-term outlook

Despite the array of uncertainties and risks, the region's outlook seems likely to feature a gradual slowing from recent peaks, but performance is likely to become more diverse across countries. Improved fundamentals have made it more likely that Turkey will weather the financial-market storm and continue its growth after 2008 (table A.6). The cooling of growth in the Baltics may expose hidden problems in their banks, nonperforming loans, and other elements that might exacerbate the situation. Hungary sacrificed current growth for a more sustainable path in the future, and the change of the central bank's focus to inflation points to less monetary support for the economy; thus it is projected to recover only slowly. Other central European countries should remain healthy, as long as they continue their commitment to improve their fiscal positions, and increasingly reap the benefits of EU integration.

Current assumptions that high oil and commodity prices will persist should allow CIS oil exporters to maintain momentum through 2008, and neighboring countries will benefit from the exporters' import demand, especially from a thriving Russia.

Risks and uncertainties

The major risk facing Europe and Central Asia is the unfavorable and uncertain external financing environment. External financing requirements from the region will not abate, and current account positions are unlikely to turn around in 2008, largely because the slowdown in Western Europe offers fewer export opportunities, while Europe and Central Asia's import demand will not slow as much as its exports. In Russia, rising real incomes underpinned by mounting oil revenues imply a possible decrease in surplus position in 2008. Although higher inflation is a global phenomenon, the situation in the region is more subtle, and harder to contain; unlike other regions where inflation is mainly caused by high food and energy prices with second-round effects still unclear, the Europe and Central Asia region has already experienced strong real wage growth (due to tightening labor markets).

Should the global economy enter into a prolonged recession and commodity prices plunge, the pain will be acute for many CIS countries, In particular, economies are either reliant on certain types of commodity exports (Russia and Azerbaijan on oil, Ukraine on steel, and Armenia on metals), focused on only a few export destinations, or dependent on one particular importer for critical recourses (Belarus and Moldova on Russian energy).