GLOBAL ECONOMIC PROSPECTS | June 2013 | Annex

EUROPE and CENTRAL ASIA REGION

Overview

The Europe and Central Asia region suffered a significant economic slowdown in 2012 as the region faced significant headwinds, including weak external demand, deleveraging by European banks, poor harvest and inflationary pressures. As a result, growth fell to 2.7 percent in 2012, compared with 5.6 percent in 2011 with a sharp slowdown in developing Europe and less severe adjustments among Commonwealth of Independent States.

External conditions have significantly improved in 2013 with calmer financial markets and the recovery in global trade. As a result, capital flows to the region have increased with the sharpest improvement in cross-border syndicated bank lending. The pick-up in bank-lending partly reflects the moderation in the pace of Euro Area bank deleveraging and going forward, this should ease the supply-side credit constraints. In addition, several sovereigns and corporates successfully tapped international bond markets. Similarly, following the sharp decline in 2012, FDI in the region is expected to rebound this year. Despite the recovery in global trade, the region's export performance has been mixed. Export growth has been weak in Russia and Latvia but considerably strong in Romania, Lithuania and Turkey. Several countries have benefited from the increased diversification in terms of export destination in recent years.

Outlook for 2013-2015: GDP growth in Europe and Central Asia is projected to rise only slightly in 2013 to 2.8 percent. While growth in the region will be supported by better harvest and improved external conditions, the rebound will be constrained by the weak carry-over from last year, ongoing fiscal adjustments, and high unemployment in several countries, particularly in developing Europe. Growth in the two biggest economies in the region—Russia and Turkey—has been held back by supply bottlenecks. While growth in Russia is projected to slow to 2.3 percent in 2013, from 3.4 percent in 2012, growth in Turkey is expected to increase to 3.6 percent from 2.2 percent, supported by relatively loose macroeconomic policies. As a result, Turkey's current account deficit is expected to widen further to 6.9 percent in 2013.

Box ECA.1 **Country coverage**

For the purpose of this note, the Europe and Central Asia region includes 21 low– and middle-income countries with income of less than $12,276 GNI per capita in 2010. These countries are listed in the table ECA.3 at the end of this note. This classification excludes Croatia, the Czech Republic, Estonia, Hungary, Poland, Slovakia, and Slovenia. The list of countries for the region may differ from those contained in other World Bank documents.

Going forward, growth in the region should firm to 3.8 percent in 2014 and 4.2 percent in 2015 as the fiscal and financial restructuring that has been a drag on growth within the region and in the Euro Area loses intensity. Several domestic factors, including fiscal and monetary policies and policies addressing structural issues, are expected to generate differentiation in economic performance among countries in the region.

Risks and vulnerabilities: While overall risks are less pronounced than a year ago, the region's economic outlook is still subject to various challenges. First, although the risk of a serious Euro Area crisis has diminished, outturns in developing Europe will remain sensitive to the speed of the recovery in the region's high-income neighbors. Another risk is related with commodity prices. The growing supply and demand substitution brought on by high prices have recently weakened commodity prices. A sharper decline in commodity prices would have potentially important adverse consequences for commodity exporting countries in the region.

Developments in the global financial markets remain important for the region. A sudden reversal of global financial conditions—due to unexpected developments in Euro-area or in the United States—might affect significantly those countries with high external financing needs (current account deficits and amortization of external debt). In the longer term, the cost of capital is likely to rise as high-income countries step back from quantitative easing. Initially this could expose vulnerabilities in the region that have built up during periods of sustained low borrowing costs. In the long-term, it will reduce growth, capital flows and FDI to the region.

Recent Developments

After the significant headwinds of the past two years, there are signs of a rebound during the first quarter of this year

Hit hard by the weakness in high-income Europe, the Europe and Central Asia region suffered a significant economic slowdown in 2012 (box ECA.1). The region's growth fell to 2.7 percent in 2012 compared with 5.6 percent the year before. The slowdown was particularly severe in Eastern European countries, whose GDP grew less than 1 percent and actually declined in the case of Serbia. While the adjustment among Commonwealth of Independent States (CIS) countries was less severe, they also grew less quickly in 2012 than in 2011.

The early months of 2013 suggest that economic activity may have bottomed out for the Eastern European countries. While first quarter GDP data is available for only a few countries, they point to a rebound in economic activity. In Lithuania, for example, the real GDP grew 3.5 percent (y/y saar) in 2013Q1, up from 3 percent in the 2012Q4. The acceleration was boosted by strong export growth at 14.9 percent (3m/3m saar), which helped offset slowing retail sales. In Serbia, GDP growth rebounded strongly to about 1.7 percent (y/y saar) in the first quarter, mainly due to Fiat production, exports and base effects. Ukraine's growth remained negative at -0.7 percent (y/y saar), but the pace of decline was significantly slower than the 2.5 percent (y/y saar) fall in the final quarter of 2012, suggesting that output picked up in the fourth quarter.

Higher frequency data for industrial production also point to strengthening activity in the region, with annualized growth of 2.4 percent rate in 2013Q1 (figure ECA.1). Industrial output grew particularly strongly in Serbia (rising at a 19 percent annualized pace). Other countries also reported positive growth including Romania (8.1 percent, 3m/3m saar), Turkey (3.8 percent), Kazakhstan (3.4 percent), Bulgaria (3 percent), Lithuania (1.8 percent) and Russia (1.4 percent). The strong rebound mostly reflects base effects, especially for Bulgaria and Serbia, following the contraction during the second half of 2012. The acceleration in economic activity in these countries was more than offsetting a 10.6 percent decline in Ukraine.

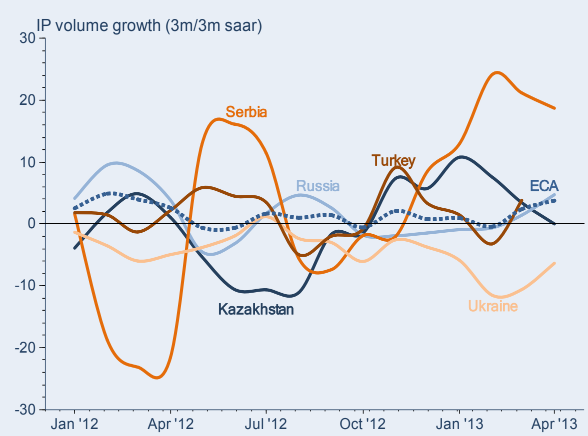
The USD value of imports in the region accelerated sharply during the first quarter, rising at a 25.2 percent annualized pace (3m/3m saar) in March suggesting significant firming of domestic demand. The rebound was particularly evident in Romania where the USD value of imports grew at a 3 percent pace (3m/3m saar) after a strong contractions in 2012Q4. That said there has been some easing in import value growth in Latvia during the same time.

While remaining above the expansion/ contraction level of 50, business confidence indicators such as Markit's Purchasing Manager Index (PMI) suggest a slight easing in economic activity for Russia and Turkey in April.

Despite the recent pick-up in global trade, the region's exports have contracted so far in 2013

As discussed in the main text, much of volatility that characterized the period from 2008 until June 2012 appears to have eased, and after declining sharply in mid-2012 global trade is recovering, driven by developing countries import demand (see trade annex). Even in the Euro Area, import demand growth has turned positive during the first few months of 2013.

Fig ECA.1 Rebound in economic activity in most economies



Source: World Bank; Datastream; Haver.

The recovery in import demand, particularly developing-country import demand has led a recovery in high-income and developing-country exports (see main text), but these benefits have not been shared by developing countries in Europe & Central Asia (figure ECA.2). In contrast, the USD value of their export contracted at a 0.4 percent (3m/3m saar) annualized rate in the three-months ending in March, with weak foreign sales in Russia and Latvia the main explanation. A 11.3 percent annualized decline in the value of Russian exports mainly reflected weaker commodities sales, particularly natural gas, which were hit by a slump in the European market where Russian natural gas is facing newfound competition.

For several other countries, the USD value of exports did surge, by an annualized 14.5 percent in the case of Romania and 9.4 percent in the case of Lithuania. The growth in Romania's exports reflected steady improvement in the share of the car parts industry and transport equipment in total foreign sales. Lithuania's exports were supported by robust oil exports—the country's biggest traded commodity, while exports in manufacturing also picked up due to improved competitiveness following a large devaluation.

Similarly, Turkey's exports bounced back in March by 4.8 percent annualized rate after declining sharply earlier in the year. The earlier sharp contraction was because of a decline in gold exports (and prices) with no sale to Iran in January and weakening exports to Europe—mainly to Germany, UK and Italy. That said gold exports to Iran (as payment for natural gas import) resumed in February but at a much slower pace than in 2012.FN1

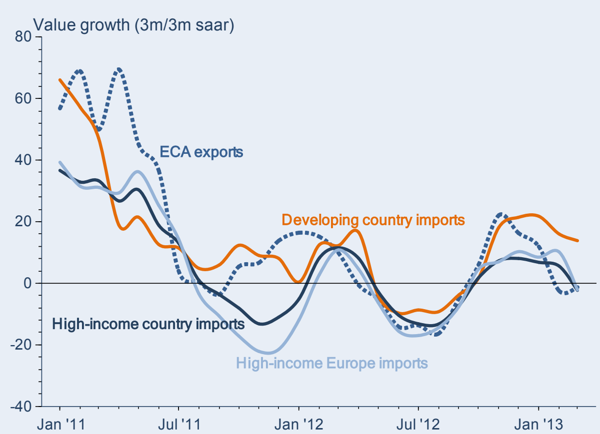
All three countries benefited from their rising sales to countries outside high-income Europe. In fact, many countries in the region have managed to diversify their export destinations in recent years, which should benefit the export performance of the region in coming months (see box ECA.2).

Improved access to international debt markets…

Global financial markets have been significantly calmer since July 2012, including during the first four months of 2013 (see the Finance Annex for details). Market risk perceptions have remained relatively stable, despite continued economic weakness in the Euro Area, political gridlock in Italy that has stalled reforms, and the Cyprus crisis that culminated in the imposition of capital controls—a first in the Euro Area.

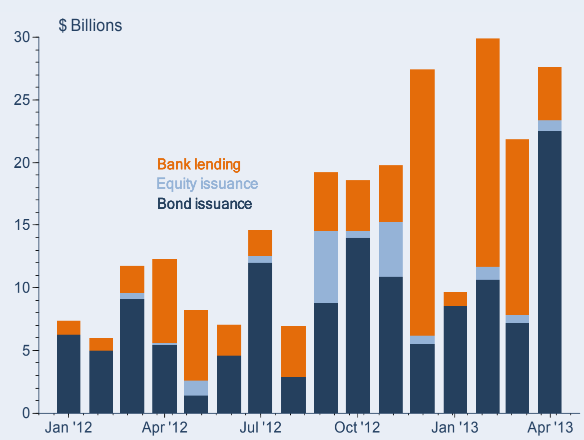
In this improved environment, gross cross-border capital flows (international bond issuance, cross-border syndicated bank loans and equity issuance) to the Europe and Central Asia region strengthened in the second half of 2012 and into 2013, with inflows in during the first four months of 2013 reaching $88.5 billion, more than double their year earlier levels of $37.4 billion (figure ECA.3). While equity issuance remained subdued, both bank lending and bond issuance

Fig ECA.2 **Export from the region slowed exports**



Source: World Bank; Datastream; Haver.

Fig ECA.3 **Improved access to international debt markets**



Source: World Bank; Dealogic.

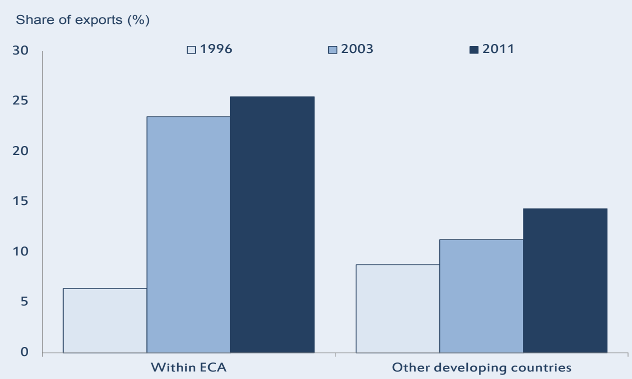
Box ECA.2 **Increased diversification of exports**

Trade has been a central mechanism through which the high-income country debt crisis has affected developing countries in the Europe and Central Asia region. High-income European countries are particularly important export destinations for Romania, Lithuania and Latvia, with Albania, Macedonia FYR, and Bulgaria having close trade ties with some of the hardest-hit high-spread Euro Area economies.

Several countries in the region have managed to diversify their export destinations in recent years. As discussed in the main text, South-South trade has grown rapidly since 2000, although Europe and Central Asia region exports to other developing regions has grown at 16 percent per annum on average slightly less rapidly than the 19 percent for all developing countries. As a result, the share of exports to other developing-countries in total exports of the region rose to 39.8 percent in 2011 from 31 percent in 2000 (box figure).

Today China is the second largest export destination for Russia after the European Union. Turkey has successfully diversified its export markets over the last two years, exporting more to Middle Eastern economies including Iran, Iraq and the United Arab Emirates, with Iraq share in Turkey's exports having increased to 9 percent so far in 2013 from 2 percent in 2004. Similarly, according to estimates in 2013, Romanian exports to other developing countries including to Mexico (mostly tires, carpets, steel products, optical instruments, accessories), Brazil (cars and car parts, rolling stock, oil equipment) and Turkey has been growing rapidly. Romania's exports to Russia increased at a 42.8 percent annualized pace and to Ukraine by more than 10 percent in the first two months of the year. Similarly, both Latvia and Lithuania have been increasing is exports to Russia and other CIS economies. Turkey continues to be a major destination for exports from the South Caucus region as is China for countries in Central Asia.

Box figure ECA 1.1



Source: World Bank; Comtrade.

rebounded. Despite these improvements, inflows into the region remain low relative to pre-crisis flows.

Syndicated bank lending to the region, at $37 billion, showed the sharpest improvement, increasing three folds from its level a year-ago. Even excluding the mega loans to the Russian company Rosnefte Gaz for their large acquisition in 2012, bank lending to the region was still more than twice as high as in during the first four months of 2012. The rebound in syndicated bank lending reflected a global phenomenon as the acute phase of Euro Area deleveraging appears to have passed[FN2]. The moderation in its pace has been easing lending conditions in the region (see the discussion later).

Bond flows to the region were also robust. Several sovereigns and corporates successfully tapped international bond markets taking advantage of strong appetite for higher-yield developing-country debt, encouraged by low yields in high-income countries because of quantitative easing. For example, despite the downgrading of Ukraine's sovereign credit rating by Moody's and S&P in December 2012, the government and several companies issued $5.7 billion of combined international bonds. Regular regional emitters included Russia ($26 billion), Turkey ($8.7 billion), Kazakhstan ($3.5 billion) and Romania ($1.5 billion), while infrequent issuers such as Azerbaijan ($1 billion), and Serbia ($1.5 billion) also took advantage of conditions. Improved access to international bond markets is particularly important for countries with large external financing needs (current account deficit and amortization of debt). This year, this includes Ukraine with financing needs totaling 42.6 percent of GDP, Bulgaria (39.5 percent of GDP), Turkey (30.8 percent of GDP) and Romania (27.1 percent of GDP).

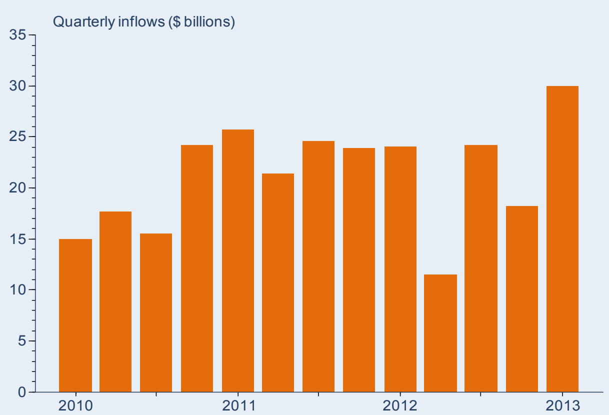
…with portfolio investments coming with their challenges

Several countries in the region also received large portfolio investment flows (foreign investment in local stock markets and local currency debt securities). During the first three months of this year, flows to local bond markets were particularly strong in Turkey ($7.3 billion), Romania ($4.7 billion), and Serbia ($1.9 billion) putting upward pressure on their currencies. As these flows tend to be volatile, managing the fluctuations can be quite challenging, and to the extent that countries rely on these flows to finance current account deficits they constitute a source of vulnerability.

After the sharp decline in 2012, FDI inflows to Europe and Central Asia are expected to rebound this year

Foreign direct investment (FDI) inflows to Europe & Central Asia region totaled only $109 billion in 2012, a 9 percent decline compared with 2011 (figure ECA.4). The sharp fall in FDI mostly reflects a 25 percent contraction in direct

Fig ECA.4 **FDI inflows are estimated to have risen in 2013Q1**



Source: World Bank; Haver.

investment flows from high-income European economies— traditionally the region's main source of FDI. In a process somewhat akin to the earlier episode of banking-sector deleveraging, multinationals from Greece, and the Netherlands repatriated substantial sums from their foreign holdings, including investments in the region. In addition, in contrast to other years, reinvested earnings were limited due to weak profitability and intercompany loans slowed down sharply.

Serbia experienced the sharpest (86 percent) decline in FDI inflows, followed by Macedonia, FYR (71 percent), Moldova (43 percent), Lithuania (32 percent) and Turkey (22 percent). In contrast, FDI increased in oil-exporting economies Azerbaijan (18.5 percent) and remained high at its 2011 level in Kazakhstan.

Limited high frequency data suggest a mixed picture so far in 2013. While FDI inflows to Russia surged in the first quarter because of a special acquisition deal (for $15 billion) and methodological changes, flows to other countries have been weak.[FN3] Nevertheless, FDI inflows are projected to rebound in the second half of the year for other economies as well. Several countries including Romania, and Serbia might accelerate privatization efforts this year. With the sharp increase in FDI to Russia, FDI inflows to the region are forecast to increase by 20 percent—reaching $132 billion in 2013. In 2014, FDI flows to the region is expected to slow down mainly on the account of Russia following an adjustment for the 2013 mega deal. Excluding Russia, FDI flows are expected to rebound by 6 percent in the region in 2014. The recovery in FDI, may be particularly important for countries such as Georgia and Albania, where FDI accounts more than 30 percent of gross domestic capital formation.

With strong bond flows, rebounds in bank lending and FDI flows, net private capital flows (debt flows net of disbursements and equity flows net of disinvestments) to the Europe and Central Asia region are forecast to rebound to $255 billion (6.5 percent of the region's GDP) in 2013 from an estimated $208 billion (5.7 percent) in 2012 (table ECA.1). Going forward, assuming there is no major set-back in financial markets confidence, net capital flows to the region are expected to strengthen along with global growth to reach $279 billion in 2015—around 5.9 percent of region's

GDP. By 2015, all flows are expected to increase, with bond issuance expected to level off slightly as bank-lending picks up the pace, with the latter supported by increased South-South flows.

Supply-side credit constraints in the region have eased along with improved global financial conditions

As discussed in the January edition of GEP 2013, credit growth in the region was very weak during the second half of 2012. Real domestic credit growth has been negative for Latvia and Lithuania since early 2009, and sharply declined in Albania, Bulgaria, Macedonia FYR, and Romania. The intense deleveraging by European banks over the last two years has contributed to the tight credit conditions and weak credit growth, especially in countries with strong European bank presence (BIS December 2012). The recent pick up in international bank flows to the region, likely signals the end to the most intense phase of Euro Area deleveraging. While expected to continue, the slower pace of deleveraging should ease the supply side constraints when demand for loans picks up with the economic activity.

Recent data show a modest increase in real credit in Bulgaria (0.5 percent year-over-year in February) and Macedonia (2.2 percent) after contacting in 2012, and less rapid declines in Latvia and Lithuania. The rebound has been more robust for Turkey, where after slowing due to domestic monetary policy tightening, real credit growth rose 7.8 percent in the 12 months ending February. A large part of the increase was funded by foreign loans, with Turkish banks aggressively seeking wholesale financing abroad. Although the credit growth (nominal annualized growth of 20 percent) is much higher than its central bank's official target at 15 percent, the central bank has not yet acted to restrain it as inflation pressures have subsided.

Remittances flows to Europe and Central Asia are also expected to bounce back this year

Remittances are an importance source of foreign currency and income for several countries in developing Europe and Central Asia. Remittance flows to the region are estimated to have fallen by 3.9 percent in US dollar terms to about $40 billion (1.1 percent of GDP) in 2012 (table ECA.1). The fall partly reflects the Euro depreciation against the dollar as remittances declined by a smaller 2 percent in Euro terms. Remittances flows declined in most countries in the region in USD terms (Migration and Development Brief 20). The exceptions were Tajikistan, Kyrgyz Republic, Moldova and Armenia, where flows increased by 28 percent, 14 percent, 10 percent and 8.5 percent, respectively as flows were supported by strong growth in Russia and high oil prices (Migration and Development Brief 17).

The weakness of the flows in the rest of the region mainly reflects that the preponderance of their migrants are in Western Europe, where economic growth has been weak and unemployment rising. Remittances to Romania have gyrated in recent years. They surged after accession into the EU in 2004 but dropped significantly after the crisis in 2008, partly due to increasing numbers of migrants returning home. Still, migrants are showing resilience in the face of these dampening effects, and are nearly sustaining remittances in euro terms.

As economic conditions improve in the European Union, officially recorded remittances to the region are expected to keep up with the region's nominal GDP growth in 2013-2015, reaching $52 billion (1.1 percent of GDP) in 2015. Despite the projected slowdown in Russia (see the discussion later), still high oil price should continue to support remittance outflows.

Output gaps and unemployment represent persistent problems in many countries with limited policy space

Since the 2008/09 and European crises, several countries in the region—particularly developing Europe, had to deal with declining exports, European bank deleveraging, and high levels of external debt. As growth rates sharply declined, unemployment soared to record levels, as banks deleveraged and households and firms cut into spending in an effort to repair damaged balance

Table ECA.1 Net capital and workers' remittances flows to Europe and Central Asia*

	2008	2009	2010	2011	2012e	2013f	2014f	2015f
Capital Inflows (official+private)	288.0	98.5	180.9	200.1	206.2	253.9	255.0	277.6
Private inflows, net	276.0	62.9	157.3	194.6	207.9	255.2	257.2	278.8
Equity inflows, net	153.8	96.7	87.2	108.6	113.3	139.0	130.7	143.0
Net FDI inflows	169.0	90.4	88.0	118.7	108.8	132.8	121.3	131.3
Net portfolio equity inflows	-15.3	6.4	-0.8	-10.1	4.5	6.2	9.4	11.7
Private creditors, net	122.2	-33.9	70.1	86.0	94.6	116.2	126.5	135.8
Bonds	-18.0	2.9	21.3	13.6	34.4	46.4	38.2	30.4
Banks	151.6	-14.3	-5.8	33.2	26.7	37.2	49.4	59.7
Short-term debt flows	-16.9	-34.9	45.9	24.5	23.1	25.2	29.7	40.0
Other private	5.5	12.4	8.8	14.7	10.4	7.4	9.2	5.7
Official inflows, net	12.0	35.6	23.5	5.5	-1.7	-1.3	-2.2	-1.2
World Bank	0.7	3.0	3.5	2.4	-0.1			
IMF	7.0	20.5	9.4	-1.0	-5.0			
Other official	4.3	12.1	10.7	4.1	3.4			
Memo item:								
Migrant remittance inflows		37.0	38.0	39.0	40.0	43.0	47.0	52.0
Central and Eastern Europe & Turkey		19.8	18.9	16.1	16.7			
Commonwealth of Independent States		17.2	19.1	22.9	23.3			

Source: The World Bank

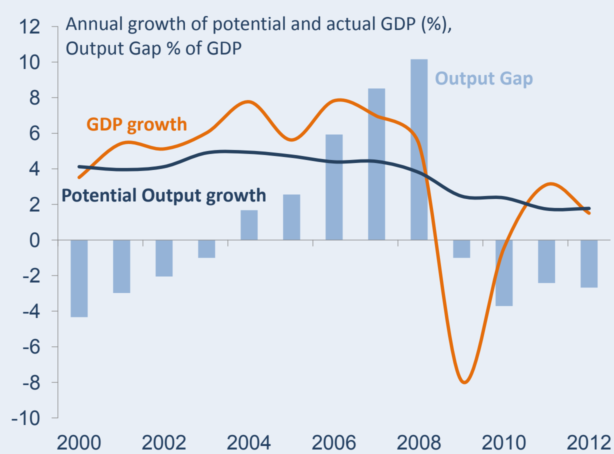
Note: e = estimate, f = forecast.
**The regional FDI numbers have been revised historically since some countries including Russia have started to report their balance of payment data under BMP6 methodology.*

sheets. Fiscal conditions deteriorated throughout the region, with severe consequences in a few countries where public debt levels had risen during the boom years.

The good news is that growth rate for many of the hardest-hit countries have recovered to levels close to their underlying potential output. Unfortunately, growth so far has not been strong enough to make significant inroads into existing unemployment and spare capacity in many countries (figure ECA.5). Several countries including Romania, Ukraine and Bulgaria have still large economy-wide output gaps (3 to 4 percent of their GDP). Several economies continue to suffer from high levels of unemployment. The unemployment rate is still in excess of 10 percent in Albania, Bulgaria, Latvia and Lithuania. More than 20 percent of the labor force remain unemployed in Serbia, Kosovo, and Macedonia FYR. Arguably, these economies have been caught in a high unemployment equilibrium. In the short run, policy options have been limited. Many of these economies are already constrained by high fiscal deficits. Inflationary pressures of last year's bad crop and necessity of restoring banking-sector balance sheets have constrained the scope of monetary policies to stimulate growth.

On the contrary, Russia, Turkey and Kazakhstan remain among the exceptions in the region as their output gaps are relatively small (or positive). Russia

Fig ECA.5 Developing Europe grows at potential rate but output gap remains



Source: World Bank; Datastream; Haver.

has been growing at or above its potential growth rate indicated by its tight labor market and high capacity utilization. Similarly, Turkey's current acceleration in growth has been generating inflationary pressures, and increasing current account deficits. For these economies, efforts to increase growth through monetary and fiscal stimulus risk being ineffective while adding to debt or inflationary pressures without any sustained progress in terms of increased output.

Inflationary pressures have recently moderated in most economies

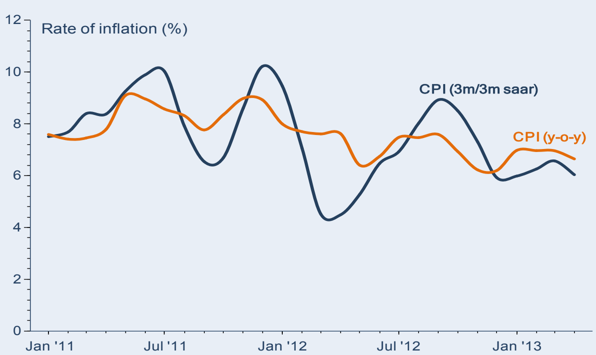
Inflation has moderated in most economies due to declines in food prices following last summer's poor crop, and the passing through of earlier administrative tariff and tax increases (figure ECA.6) [FN4]. Further inflation declines are expected among countries that suffered the biggest food price shocks. That said inflation remains at high levels in several middle-income countries. In Russia, inflation although down was 7.2 percent year-over-year in April, well above the central bank's target of 5-6 percent. However, inflation is expected to decline to within this range as the adverse base effect from last year's drought disappears and a better crop could even cause food prices to decline. In Turkey, despite the recent easing, pressures are likely to build in the later part of the year due to robust domestic demand and supply-side capacity constraints. In the absence of any significant relief from global commodity prices (Turkey is an energy importer) or any local food prices as it did last year, inflation is expected to rise beyond the central bank's target of around 5 percent. Inflation in Romania remained at 5.7 percent year over year in February (5.8 percent in January) driven mainly by foods and services (due to regulatory tariff hikes), but is expected to go down toward the central bank's target rate in the second half of the year. Inflationary pressures have eased slightly in Belarus, but inflation remains in double-digits.

In contrast, consumer prices fell in Azerbaijan and Georgia towards the end of 2012 due to weak domestic demand; decline in food prices; and due to the earlier nominal appreciation of Georgian lari against currencies of its main trading partners. While inflation has picked up in Azerbaijan, Georgia's deflation continued in April, the sixth month in a row with falling prices, with prices down by 1.7 percent due to the weak economic activity.

…allowed central banks cut their policy rates

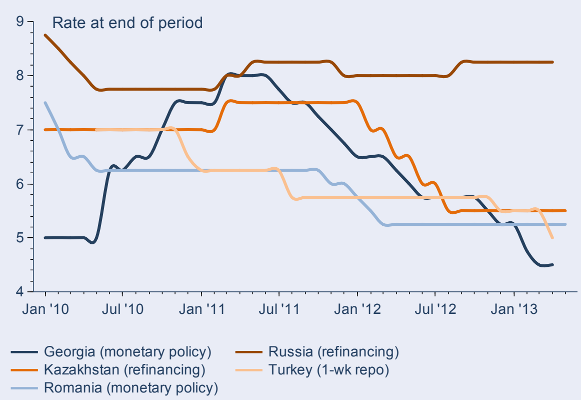
Against the backdrop of easing inflation, spare capacity, high unemployment and moderate growth, several central banks in the region including Albania, Azerbaijan, Belarus, and Georgia have cut their policy rates (figure ECA.7). Turkey's central bank has been narrowing its interest rate corridor since last year and recently cut its main policy rate in April. The rate was cut despite a small output gap, the acceleration in credit growth, and persistent inflation in part to support growth and discourage the inflow of portfolio investment (see the discussion earlier).

Fig ECA.6 **The regional inflation momentum has subsided in recent months***



*Excluding Belarus
Source: World Bank; Datastream; Haver.

Fig ECA.7 **Several countries cut their policy rates**



Source: World Bank; Haver.

In contrast, the Russian central bank has kept its main policy rates unchanged since December 2012 despite weakening growth. Similarly, the monetary policy in Ukraine remains restricted by its de-facto currency peg to the dollar. Maintaining the peg might be increasingly challenging with economic contraction.

Outlook: A rebound with increasing differentiation among countries

Despite the improved global environment, growth in the region is expected to rebound only slightly in 2013

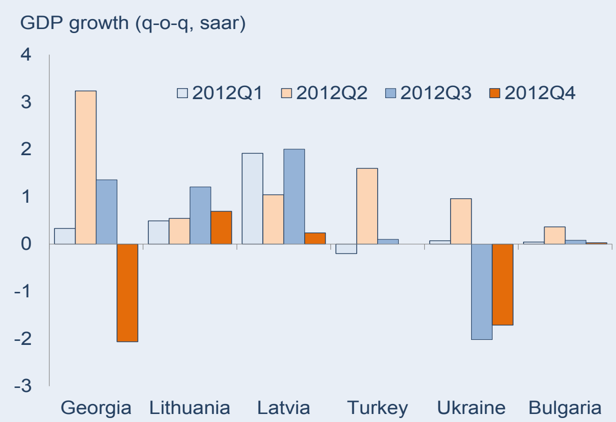
Although the global environment has become less volatile and growth appears to be strengthening, GDP growth in Europe and Central Asia is projected to rise only gradually in 2013 to 2.8 percent from 2.7 percent in 2012 (table ECA.2). Growth should firm further to 3.8 percent in 2014 and 4.2 percent in 2015 as the fiscal and financial restructuring that has been a drag on growth within the region and in the Euro Area loses intensity. Several domestic factors including fiscal and monetary policies and structural issues will generate differentiation in economic performance among countries.

The apparently anemic acceleration in 2013 mainly reflects the weakness of growth at the end of 2012. The quarterly profile of growth during 2013 is stronger than the annual growth rate because growth in the final quarters of 2012 was so weak (figure ECA.8). This low base effect reduces carryover[FN5] into 2013, resulting in weak annual growth even if quarterly growth rates are relatively strong. While carry-over from 2012 is generally low in many economies in the region, it is negative for Ukraine and Georgia, and weak for Turkey and Bulgaria.

On the plus side, agricultural production is expected to be better this year in several countries. The summer and winter droughts in 2012 cut the growth rates significantly and generated inflationary pressures in several countries. Countries including Albania, Georgia, Kazakhstan, Romania, Russia, Serbia, and Ukraine will benefit from a higher contribution of agriculture this year.

Growth in developing *Central and Eastern Europe* is expected increase only slightly to 1.9 percent in 2013 from 1.5 percent as most of the factors that weighed down the growth last year continue to hinder the economic growth this year, but less intensively in some countries (see the table ECA.2 for the list of countries; table ECA.3 for individual country forecast). Monetary policy remains accommodative in most countries, while the pace of fiscal consolidation has eased in Romania, Latvia and Lithuania, reducing the drag on overall growth[FN6]. However, major fiscal adjustments are still needed in several others, including Serbia and Montenegro. In addition, although there are signs of improvement, economic growth in high-income Europe still remains weak and is expected to pick up only gradually toward the end of the year. Thus although developing European economies will benefit from a gradual improvement in high-income countries and are therefore expected to see a firming in quarterly growth rates, this will have only a modest impact on whole-year growth in 2013. As a result, growth is expected slightly increase in almost all Central and Eastern European countries. The only exceptions are Latvia and Lithuania where economic growth is expected to ease in Latvia after more than 5 percent growth

Fig ECA.8 Growth was weak in 2012Q4



Source: World Bank; Datastream; Haver.

Table ECA.2 **Europe and Central Asia forecast summary**

(annual percent change unless indicated otherwise)	00-09[a]	2010	2011	Est. 2012	Forecast 2013	2014	2015
GDP at market prices b	4.2	5.3	5.7	2.7	2.8	3.8	4.2
(Sub-region totals-- countries with full NIA + BOP data)c							
GDP at market prices c	4.1	5.4	5.7	2.8	2.8	3.8	4.1
GDP per capita (units in US$)	4.0	4.9	5.2	2.3	2.4	3.4	3.7
PPP GDP	4.3	5.1	5.4	2.8	2.7	3.8	4.1
Private consumption	5.9	4.7	6.9	4.3	4.9	4.5	4.9
Public consumption	2.3	-0.1	2.6	2.3	3.0	2.4	2.2
Fixed investment	6.5	13.6	9.0	2.2	3.0	6.8	6.5
Exports, GNFS d	5.2	7.5	4.7	3.9	2.8	4.6	5.5
Imports, GNFS d	7.0	17.3	15.0	4.7	5.5	6.2	6.6
Net exports, contribution to growth	-0.3	-2.7	-3.4	-0.4	-1.0	-0.8	-0.7
Current account bal/GDP (%)	2.3	0.6	0.7	0.6	-0.3	-1.1	-1.7
GDP deflator (median, LCU)	9.2	10.0	8.4	3.9	5.1	5.1	5.3
Fiscal balance/GDP (%)	-0.6	-3.0	0.9	-0.3	-1.1	-0.1	-0.7
Memo items: GDP							
Transition countries e	4.6	3.9	4.4	3.0	2.5	3.5	3.9
Central and Eastern Europe f	4.1	-0.4	3.1	1.5	1.9	2.5	3.1
Commonwealth of Independent States g	4.7	4.7	4.6	3.2	2.6	3.7	4.0
Russia	4.4	4.3	4.3	3.4	2.3	3.5	3.9
Turkey	3.0	9.2	8.8	2.2	3.6	4.5	4.7
Romania	4.2	-1.6	2.5	0.7	1.7	2.2	2.7

Source: World Bank.
a. Growth rates over intervals are compound weighted averages; average growth contributions, ratios and deflators are calculated as simple averages of the annual weighted averages for the region.
b. GDP at market prices and expenditure components are measured in constant 2005 U.S. dollars.
c. Sub-region aggregate excludes Bosnia and Herzegovina, Kosovo, Montenegro, Serbia, Tajikistan and Turkmenistan. Data limitations prevent the forecasting of GDP components or Balance of Payments details for these countries.
d. Exports and imports of goods and non-factor services (GNFS).
e. Transition countries: CEE and CIS (f + g below).
f. Central and Eastern Europe: Albania, Bosnia and Herzegovina, Bulgaria, Georgia, Kosovo, Lithuania, Macedonia, FYR, Montenegro, Romania, Serbia.
g. Commonwealth of Independent States: Armenia, Azerbaijan, Belarus, Kazakhstan, Kyrgyz Republic, Moldova, Russian Federation, Tajikistan, Turkmenistan, Ukraine, Uzbekistan.

over the last two years, and in Lithuania mainly due to the base effect from 2012's exceptionally good harvest and projected weak growth in main trading partners including Russia and Latvia.

Going forward, growth in developing Europe is expected to rise in the medium-term to 3.1 percent by 2015 but will remain below their 2000-2009 average (table ECA.2). As discussed earlier, several economies still suffer from high unemployment rates and spare capacity. Prospects for the region critically depend on the progress in addressing external (large current account deficits) and domestic (large fiscal deficit, unemployment, and inflation) imbalances. Serbia has the widest twin deficits in the region. While spare capacity remains in the region, countries must focus on redressing structural weaknesses if they wish to return to the relatively robust growth rates of the pre-crisis period. Areas of focus should include increasing labor market flexibility, strengthening the business environment and financial market efficiency.

After the sharper than expected slowdown in 2012, growth is likely to pick up in *Turkey* on rising domestic demand, supported by robust domestic credit growth and relatively loose macroeconomic policies. Nevertheless, the growth in 2013 will be constrained by the weak carryover from 2012. The growth rate is expected to rebound to 3.6 percent from 2.2 percent in 2012. With the economy operating very close to its potential output growth, the rising domestic demand and declining tourism receipts will widen the current account deficit to 6.9 percent of GDP in 2013 from 6 percent in 2012. While access to external financing has been comfortable so far 2013 with the recent upgrade of its credit rating to investment grade, the heavy reliance on portfolio and short-term debt flows is an important vulnerability. Monetary policy is expected to remain active in balancing external and domestic demand while growth picks up with the forecasted global recovery, reaching 4.7 percent by 2015.

Growth in *Russia* is expected to slow down to 2.3 percent in 2013 from 3.4 percent in 2012 after continuously weakening over the last five quarters (on a year-over-year basis). In addition to disappointing export growth, domestic demand has been weak—partly due to increasing prices and easing in oil prices, which has constrained incomes, corporate profits and investment. At the same time, despite the increased capital flows, investment has not picked considerably. Similar to Turkey, Russia's economy is operating close to its potential and faces high inflation, a tight labor market, and capacity constraints. But unlike Turkey, the Russian central bank has pursued a less accommodative stance keeping its main policy rates unchanged. However, this stance might change if inflationary pressures start to ease in the second half of the year with adverse base effect disappearing. In addition, starting this year fiscal policy will be constrained by a newly accepted budget rule. The rule implies that spending cannot exceed revenues more 1 percent of GDP, while revenues are calculated as a function of past long-term average oil price. Growth is expected to pick up together with the global economy only modestly to 3.9 percent by 2015 as the pace of expansion will be held back by potential output growth.

Growth in *Kazakhstan* is expected to remain stable at 5 percent in 2013 following the weak first quarter growth. Government consumption is expected to compensate for moderating private consumption and the economic slowdown in Russia. While expected to pick up by 2014 after a new oilfield becomes operational, medium-term growth in Kazakhstan will be held back by supply-side constraints.

Growth in *Ukraine* is forecast to remain weak at 1.0 percent in 2013, up from 0.2 percent in 2012. The increase will be supported by robust consumer demand with increasing retail sales, while industry continues to contract and global steel prices remain weak. The overall outlook remains challenging, with a high fiscal deficit, persistent current account deficit, high external debt, and the currencies de-facto peg to the dollar and declining foreign reserves all sources of concern. Reforms that may stem from ongoing discussions with the EU/IMF and Russia will be crucial factors determining the shape of growth going forward.

Growth rates in *Azerbaijan and Kyrgyzstan* are forecast to be higher in 2013 as high public investment spending boosts domestic demand and a recovery in Kyrgyzstan's gold production. On the other hand, *Armenia*'s growth is expected to moderate after the strong growth in 2012, as prudent fiscal and monetary policies permit the economy to avoid overheating.

Risks and vulnerabilities

While risks are less pronounced, the region's economic outlook is still subject to various challenges.

Although the risk of a serious Euro Area crisis has diminished, outturns in developing Europe will remain sensitive to the speed of the recovery in its high-income neighbor. Both a significantly stronger and weaker recovery in high-income Europe would have significant knock on effects for the region, including through the financial channel.

The recent easing in commodity prices in response to growing supply and demand substitution brought on by high prices, is a further source of uncertainty as to the pace of decline toward long-term equilibrium prices. As discussed in the main text and the Commodity Annex, if prices ease more quickly than the baseline, government revenues, incomes and current account positions in exporting countries could come under pressure, even as lower prices benefitted importing nations. According to the simulations highlighted in table 5 in the main text, a rapid decline in oil prices might reduce the growth rate by 0.8 percentage points, the current account balance by 2.3 percentage points, and the fiscal balance by 1.8 percentage points in 2014 from the baseline scenario for oil-exporters in the region. The impact will be positive for oil-importers with increasing growth by 0.4 percentage points and improving both the current account and fiscal balance by 0.8 and 0.2 percentage points, respectively from the baseline scenario. The scenario for the metal price declines show smaller impact for the region.

Several countries have accessed international capital markets this year as cost of bond financing fell. Nevertheless, a sharp drop in confidence in financial markets—due to unexpected developments in Euro Area debt resolution and US fiscal situation—can lead to a sudden reversal of global financial conditions and adversely affect significantly the countries with high external financing needs (current account deficits and amortization of external debt).

In the longer term, developing country financial conditions may become more difficult as high-income countries step back from quantitative easing and base interest rates and spreads rise. The cost of capital in developing countries is likely to rise amid rising long-term yields in high-income countries. Initially this could expose vulnerabilities that have built up during periods of sustained low borrowing costs, intensifying financial market pressures in the region and even in a worst case scenario provoking local crises. Longer-term, higher borrowing costs would raise the cost of capital and cause firms and foreign investors to reduce investment levels with negative consequences for growth (see main text), capital flows and FDI (see World Bank, 2010 for an in depth discussion of channels)

Aside from these global risks for the region's economies, banking systems in several countries have been under pressure by sharp slowdown in economic activity, weak credit demand and increase cost of foreign funding have increased pressures on profits. Non-performing loans (NPL) remain higher than 10 percent in several countries including Kazakhstan, Albania, Ukraine, and Serbia. The high levels of NPL in region's banking system may constrain credit growth going forward, which has already been weak. Nevertheless, there is some level of resilience in most banks in the region with their capital adequacy ratios in excess of 10 percent by the end of 2012.

Table ECA.3 Europe and Central Asia Country forecasts

	00-09[a]	2010	2011	Est. 2012	Forecast 2013	2014	2015
Albania							
GDP at market prices (% annual growth) b	4.9	3.5	3.0	1.6	1.8	2.0	3.0
Current account bal/GDP (%)	-8.6	-11.4	-12.0	-10.7	-9.5	-8.3	-7.1
Armenia							
GDP at market prices (% annual growth) b	7.7	2.2	4.7	7.2	5.0	5.0	5.0
Current account bal/GDP (%)	-7.4	-14.8	-10.9	-10.6	-9.6	-9.4	-9.4
Azerbaijan							
GDP at market prices (% annual growth) b	14.4	5.0	0.1	2.2	4.8	4.8	2.9
Current account bal/GDP (%)	2.9	28.4	26.5	21.7	13.6	11.9	9.4
Belarus							
GDP at market prices (% annual growth) b	6.6	7.7	5.5	1.5	2.5	2.8	3.0
Current account bal/GDP (%)	-4.6	-15.0	-8.5	-2.9	-4.7	-5.6	-6.1
Bulgaria							
GDP at market prices (% annual growth) b	4.0	0.4	1.8	0.8	1.2	2.1	3.0
Current account bal/GDP (%)	-11.3	-1.5	0.1	-1.0	-1.6	-1.6	-2.5
Georgia							
GDP at market prices (% annual growth) b	5.6	6.3	7.2	6.1	4.0	6.3	6.0
Current account bal/GDP (%)	-12.6	-10.2	-12.8	-11.5	-9.0	-7.8	-7.4
Kazakhstan							
GDP at market prices (% annual growth) b	7.5	7.3	7.5	5.0	5.0	5.3	5.5
Current account bal/GDP (%)	-2.0	0.9	6.5	3.8	3.2	3.2	3.1
Kosovo							
GDP at market prices (% annual growth) b	5.8	3.9	5.0	2.3	3.1	4.0	4.2
Current account bal/GDP (%)	-18.2	-25.9	-26.2	-21.3	-21.0	-18.8	-16.0
Kyrgyz Republic							
GDP at market prices (% annual growth) b	4.8	-0.5	6.0	-0.9	7.4	7.5	5.3
Current account bal/GDP (%)	-6.0	-6.4	-6.5	-15.3	-8.0	-6.0	-5.6
Latvia							
GDP at market prices (% annual growth) b	3.7	-0.3	5.5	5.6	3.6	4.1	3.7
Current account bal/GDP (%)	-10.2	3.0	-2.1	-1.7	-2.8	-2.8	-3.6
Lithuania							
GDP at market prices (% annual growth) b	4.2	1.3	5.9	3.7	3.0	3.5	4.2
Current account bal/GDP (%)	-7.1	1.6	-1.8	-0.9	-1.4	-1.7	-2.0
Moldova							
GDP at market prices (% annual growth) b	4.4	7.1	6.8	-0.8	3.0	4.0	5.0
Current account bal/GDP (%)	-8.4	-7.7	-11.3	-7.0	-7.4	-7.9	-8.9
Macedonia, FYR							
GDP at market prices (% annual growth) b	2.3	1.8	3.0	-0.3	1.4	2.5	3.5
Current account bal/GDP (%)	-6.1	-2.2	-3.0	-3.9	-5.0	-5.5	-5.2
Montenegro							
GDP at market prices (2005 US$) b	-	2.5	3.2	-0.5	0.8	1.8	2.0
Current account bal/GDP (%)	-11.4	-22.9	-17.7	-17.9	-19.0	-18.3	-17.0
Romania							
GDP at market prices (% annual growth) b	4.2	-1.6	2.5	0.7	1.7	2.2	2.7
Current account bal/GDP (%)	-7.6	-4.5	-4.6	-3.8	-3.7	-3.6	-3.6
Russian Federation							
GDP at market prices (% annual growth) b	4.4	4.3	4.3	3.4	2.3	3.5	3.9
Current account bal/GDP (%)	9.3	4.8	5.3	3.9	3.0	1.6	0.6
Serbia							
GDP at market prices (% annual growth) b	3.6	1.0	1.6	-1.7	2.0	3.1	3.6
Current account bal/GDP (%)	-9.7	-6.7	-9.2	-10.9	-9.9	-9.0	-8.8
Tajikistan							
GDP at market prices (% annual growth) b	7.7	6.5	7.4	7.5	7.0	6.0	6.0
Current account bal/GDP (%)	-4.8	-1.2	-4.7	-1.9	-2.2	-2.4	-2.5
Turkey							
GDP at market prices (% annual growth) b	3.0	9.2	8.8	2.2	3.6	4.5	4.7
Current account bal/GDP (%)	-3.3	-6.4	-9.7	-6.0	-6.9	-7.1	-7.2
Ukraine							
GDP at market prices (% annual growth) b	3.9	4.2	5.2	0.2	1.0	3.0	4.0
Current account bal/GDP (%)	2.2	-2.2	-5.5	-8.4	-7.4	-6.8	-6.2
Uzbekistan							
GDP at market prices (% annual growth) b	6.1	8.5	8.3	8.2	7.4	7.1	6.7
Current account bal/GDP (%)	7.5	6.2	5.8	1.0	1.1	1.3	2.2

Source: World Bank.

World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not significantly differ at any given moment in time.

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

a. GDP growth rates over intervals are compound average; current account balance shares are simple averages over the period.

b. GDP measured in constant 2005 U.S. dollars.

Notes

1. Turkey did not sell any gold to Iran in January as banks and dealers waited until early February for the implementation of U.S. sanctions that tightened control over precious metal sales. The trade has resumed in February as the United States has given Turkey a six-month waiver exempting it from sanctions on trade with Iran, which is now due to expire in July

2. By June 2012, three quarters of European banks had complied with the ECB's capital ratio requirements. Moreover, according to the April ECB Bank Lending Survey, Euro Area banks are beginning to loosen credit standards. Euro Area banks have begun repaying ECB crisis loans and have already started to repay some of the loans well in advance (See Finance Annex).

3. The regional FDI numbers have been revised up historically since several countries including Russia have started to report their balance of payment data under BMP6 methodology. FDI flows to Russia surged in the first quarter of 2013 as the deal between Rosneft and BP around the TNK-BP sale that eventually resulted in the acquisition of 18.5 percent of Rosneft, worth almost $15 billon. Adjusted for this one-off deal, the FDI remained fairly stable during the first quarter of 2013.

4. The figure excludes Belarus because of its outlier status in terms of 2011 inflation, which reached 108.7 percent, after almost threefold devaluation of the national currency.

5. Carry over (or statistical overhang) is defined as the rate of growth that would be observed if quarterly GDP in year t remained unchanged from the level of the fourth quarter of the previous year. It therefore measures the contribution to annual growth in year t, of the quarterly expansion during the previous year (GEP 2012 June).

6. The EU required adjustment has been completed in Romania, Latvia and Lithuania to reach the 3 percent deficit target.