EUROPE and CENTRAL ASIA

Growth in the Europe and Central Asia region is anticipated to ease to 3.2 percent in 2018, down from 4.0 percent in 2017, as one-off supporting factors wane in some of the region's largest economies. By 2020, growth is expected to gradually moderate to 3.0 percent due to less supportive external conditions, intensifying capacity constraints, and less accommodative fiscal and monetary policy in commodity importers. Growth in commodity exporters is expected to continue strengthening amid higher commodity prices. Regional risks remain tilted to the downside, reflecting the possibility of a disorderly tightening of financing conditions, renewed policy uncertainty, and rising trade protectionism.

Recent developments

Regional growth was strong in 2017, reaching 4.0 percent, with broad-based recoveries across both commodity importers and commodity exporters (Figure 2.2.1).[1] Despite robust activity in late 2017 and early 2018, momentum has eased amid moderating export growth and less accommodative policies.

For commodity importers, the significant pickup in activity in 2017 was driven by strengthening demand from the Euro Area and disbursements of EU structural funds in Central Europe, but these factors have started to wane gradually.[2] In Turkey, growth sharply accelerated to 7.4 percent in 2017 from 3.2 percent in 2016, as it rebounded from the 2016 failed coup attempt and benefited from supportive policy measures including tax cuts, public transfers, and credit support measures for small and medium-sized enterprises (World Bank 2018d). The effect of supportive fiscal measures in Romania, which fueled a strong pickup in growth in 2017, have gradually faded in 2018. Meanwhile, activity is improving in commodity importers which experienced weak growth in 2017 due to domestic issues, such as rising political tensions (e.g., FYR Macedonia) and weaker public investment (e.g., Serbia).

Commodity exporters in the region continue to experience a cyclical upturn, supported by higher oil prices, a pickup of domestic demand, and strengthening export growth. In Russia, growth turned positive in 2017 after two years of contraction, reaching 1.5 percent. The improvement was marked by robust real wage gains, which supported a recovery in private consumption amid declining inflation and stabilizing labor markets. Rising confidence encouraged a significant rebound in investment growth—especially in the mining, transport, and manufacturing sectors—following four years of contraction. The recovery in Russia generated positive spillovers to neighboring economies in Central Asia, South Caucasus, and Eastern Europe.[3] New U.S. sanctions announced in April against Russian

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Note: The author of this section is Yoki Okawa. Research assistance was provided by Ishita Dugar.

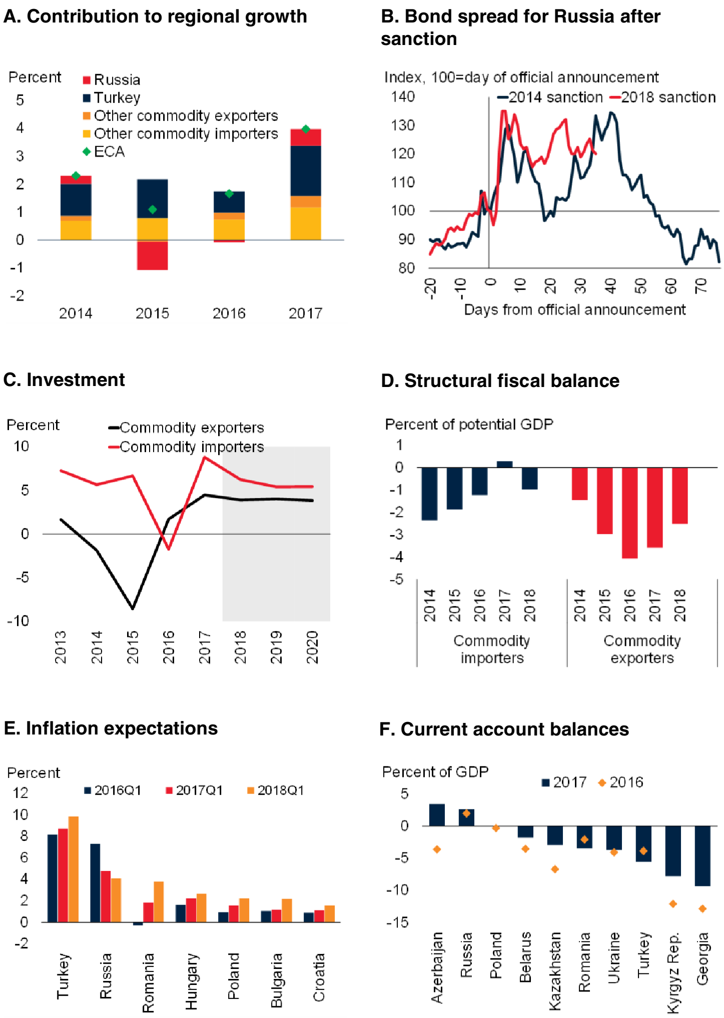
[1] Commodity importers are Bulgaria, Belarus, Bosnia and Herzegovina, Croatia, Georgia, Hungary, Kosovo, Former Yugoslav Republic of Macedonia, Moldova, Montenegro, Poland, Romania, and Serbia. Commodity exporters are Albania, Azerbaijan, Armenia, Kazakhstan, Kyrgyz Republic, Russian Federation, Tajikistan, Turkmenistan, Uzbekistan, and Ukraine.

[2] Central European countries are Bulgaria, Croatia, Hungary, Poland and Romania.

[3] Eastern Europe countries are Belarus, Moldova, and Ukraine. South Caucasus countries are Armenia, Azerbaijan and Georgia. Central Asia countries are Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan.

FIGURE 2.2.1 ECA: Recent developments

Growth in the region strengthened in 2017, but high-frequency indicators suggest slowing momentum in 2018. Economic sanctions on Russia led to some increase in bond spreads, as in the previous episode in 2014. Investment in commodity-importing economies was particularly strong in 2017, but is expected to moderate in 2018. Fiscal policy is loosening and inflation expectations have risen in many commodity importers. Current account positions have deteriorated in some cases.



Sources: Consensus Economics, International Monetary Fund, J. P. Morgan, World Bank.
A. Aggregate growth rates calculated using 2010 U.S. dollar GDP weights.
B. Index value of Emerging Market Bond Index (EMBI) spread for Russia. EMBI spread is a measure of sovereign bond risk premiums. Index values are normalized to 100 (as reflected by the horizontal line) for the official date of the announcement of sanctions from the United States. Official dates are March 6 for 2014 sanctions and April 6 for 2018 sanctions. Last observation for the 2018 sanction is May 23, 2018.
C. Total investment growth for each group. Shaded area indicates forecasts.
D. Values are general government structural balance as a percent of potential GDP. Median for each group.
E. Average one-year-ahead inflation forecasts for given time from Consensus forecasts.
F. Current account balance as a percent of GDP for selected countries.
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organizations and individuals led to a depreciation of the Russian ruble and to increasing bond spreads.

In Kazakhstan, activity also rebounded in 2017, supported by expanding oil production and recovering activity in the non-oil sector (World Bank 2018e). Growth in Kazakhstan was further boosted by rising output from the new Kashagan oil field, which is exempt from the production cuts agreed to by some OPEC and non-OPEC countries. In Azerbaijan, curbs on oil production were offset by stronger non-oil sector activity and fiscal stimulus measures. While slow progress with structural reforms and lingering geopolitical uncertainty dampened confidence and growth in Ukraine in 2017, conditions have started to improve in 2018.

Inflation, current account, and public finances

The recovery in some commodity importers has been associated with persistent or widening imbalances. Inflation rates are above or close to target in some countries, and closing output gaps are contributing to rising domestic inflation pressures (e.g., Romania, Turkey). Inflation expectations are trending upward in the largest countries in Central Europe (e.g., Bulgaria, Croatia, Hungary, Poland, Romania), as well as in Turkey. Current account deficits have either worsened or remain persistently large amid rising oil prices and robust imports, while fiscal policy continues to be procyclical in some commodity importers (e.g., Romania, Turkey).

Among commodity exporters, inflation has generally moderated, reflecting the unwinding effects of past exchange rate depreciations or persistent economic slack (e.g., Azerbaijan, Kazakhstan, Russia). Current account positions have improved, supported by a rebound in oil prices, and the stabilization of inflation have allowed monetary policy to ease in some countries. In contrast, Uzbekistan, which devalued its currency in September 2017, subsequently tightened its monetary policy.

Outlook

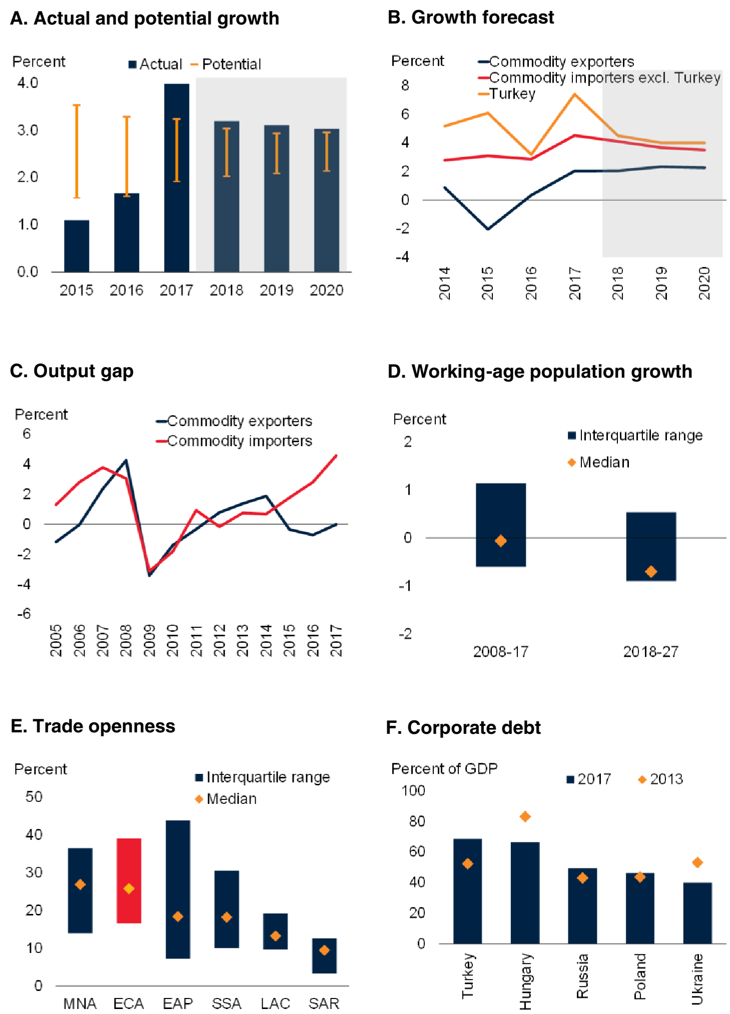
Growth in the region is projected to moderate from 4.0 percent in 2017—which was significantly above potential—to 3.2 percent in 2018 and 3.0 percent in 2020 (Figure 2.2.2). The modest recovery continues among commodity exporters, supported by a further recovery in oil prices, but only partially offsets a slowdown in commodity importers. Despite the moderation, growth is expected to remain slightly above potential over the forecast horizon. The outlook for the region is predicated on stabilizing oil prices; more moderate, yet still-robust, growth in the Euro Area; an orderly tightening of global financing conditions; and an absence of rising geopolitical tensions.

Growth for commodity importers is expected to moderate from 5.9 percent in 2017 to 4.3 percent in 2018. Monetary and fiscal policies are expected to tighten as economies operate above capacity. Tighter labor market conditions and higher oil prices are expected to lead to rising inflation and tighter monetary policy, while past fiscal stimulus measures are expected to gradually unwind. External conditions are expected to become less supportive as well. Euro Area imports are projected to decelerate gradually, leading to more modest export growth in Central Europe, the Western Balkans, and Turkey. Global interest rates are expected to rise, increasing borrowing costs and affecting net capital inflows to the region, while rising oil prices could exacerbate current account vulnerabilities in some countries.

In Turkey, delays in fiscal consolidation and the extension of the credit support program is expected to temper the expected slowdown in 2018, amid tightening financing conditions and currency pressures. Inflation continues to be above target. In Central Europe, the positive effects from the accelerated disbursement in 2017 of EU structural funds—which are equivalent to more than 4 percent of GDP for some countries—are expected to wane in 2018. Procyclical fiscal measures in Romania are projected to continue in 2018.

FIGURE 2.2.2 ECA: Outlook and risks

Growth is expected to moderate towards potential over the projection period. Extensive trade openness, large current account deficit and elevated corporate debt levels leave the region vulnerable to external shocks.



Sources: Bank for International Settlements, International Monetary Fund, Institute of International Finance (IIF), United Nations, World Bank.

A. Blue bars refer to GDP weighted average actual growth and vertical orange line show minimum-maximum range of potential growth estimates based of five different methodologies (production function approach, multivariate filter, IMF *World Economic Outlook* five-year-ahead forecast, Consensus Forecasts, and potential growth estimates in OECD *Economic Outlook* and OECD Long-Term Baseline Projections).

A.B. Shaded areas indicate forecasts.

B.C. Aggregate growth rates calculated using 2010 U.S. dollar GDP weights.

D.E. Bars indicate 25th and 75th percentiles.

D. Annual population growth for age 15-64 given period. Forecasts are taken from the medium forecast by the United Nations.

E. Value of trade over GDP in 2016 for each region. EAP = East Asia and Pacific, ECA = Europe and Central Asia, LAC = Latin America and the Caribbean, MNA = Middle East and North Africa, SAR = South Asia, and SSA = Sub-Saharan Africa.

F. The data used are IIF end-of-period estimates of non-financial corporate debt as a percentage of GDP.

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Among commodity exporters, the recovery from weak or negative growth in 2014-16 is expected to continue in 2018-20. In Russia, growth is projected to remain unchanged in 2018 at 1.5 percent as the effects of rising oil prices and monetary policy easing are offset by oil production cuts and heightened uncertainty associated with the latest sanctions. As dampening factors wane, growth in Russia is anticipated to strengthen to 1.8 percent in 2019-20, providing some support to activity in Central Asia, the South Caucasus region, and Eastern Europe (World Bank 2018f).

Assuming an easing of geopolitical tensions and progress in structural reforms, growth is projected to pick up in Ukraine. Azerbaijan is projected to emerge from two years of disappointing growth, mainly in response to fiscal stimulus measures supported by higher oil prices and expanded natural gas production. However, in Kazakhstan, growth is expected to slow in 2018, as the effect of the opening of the Kashagan oil field fades.

Over the long term, potential growth in the region is expected to decline further. Slower growth in the working-age population is expected to weigh on potential growth across the region. Delays or reversals to needed structural reforms have affected long-term growth prospects in a number of countries (e.g., Azerbaijan, Croatia, Russia, Ukraine). In Uzbekistan, far-reaching structural reforms—including exchange rate liberalization, tax reform, privatization of state owned enterprises, and banking sector reform—are expected to improve long-term growth prospects.

Risks

The outlook continues to be subject to considerable risks. While stronger-than-expected growth among major trading partners remains a possibility, risks remain tilted to the downside. These include a disorderly tightening of financing conditions, heightened currency pressures, and renewed geo-political tensions and policy uncertainty.

A disorderly tightening of global financial conditions combined with a further appreciation of the U.S. dollar could trigger a sharp deterioration of external financing conditions and lead to a reversal of capital flows and weakening activity, particularly in countries with growing vulnerabilities. Current account deficits remain substantial in a number of countries (e.g., Georgia, Kazakhstan, Kyrgyz Republic, Romania, Turkey, Ukraine), and are financed by volatile portfolio investment flows in some cases (World Bank 2018g, 2018h). Filling external financing needs could become challenging, while currency pressures could intensify. Despite recent progresses in reforms, banking sectors remain vulnerable to external shocks (e.g., Azerbaijan, Kazakhstan, Moldova, Tajikistan).

An escalation of policy uncertainty and geopolitical tensions could also negatively affect activity in the region. Moreover, intensification of policy disagreements between some EU members and EU institutions—including in areas such as immigration policy and constitutional issues—could deter international investors. The region is also vulnerable to a rise in global protectionism, given its openness to trade and integration in global supply chains (World Bank 2018i).

Over the medium term, a weaker-than-expected energy price outlook would undermine the recovery in large energy-exporting countries, including Kazakhstan, Russia, and Uzbekistan. The slowdown could generate negative spillovers to neighboring countries, such as Armenia, Belarus, Georgia, Kyrgyz Republic, Moldova, and Tajikistan.

TABLE 2.2.1 Europe and Central Asia forecast summary

(Real GDP growth at market prices in percent, unless indicated otherwise)

	2015	2016	2017e	2018f	2019f	2020f	Percentage point differences from January 2018 projections: 2018f	2019f	2020f
EMDE ECA, GDP[1]	**1.1**	**1.7**	**4.0**	**3.2**	**3.1**	**3.0**	**0.3**	**0.1**	**0.0**
EMDE ECA, GDP excl. Russia	3.6	2.9	5.5	4.2	3.9	3.8	0.6	0.1	0.1
(Average including countries with full national accounts and balance of payments data only)[2]									
EMDE ECA, GDP[2]	1.0	1.6	4.0	3.2	3.1	3.0	0.3	0.1	0.1
GDP per capita (U.S. dollars)	0.6	1.2	3.6	2.8	2.8	2.7	0.3	0.1	0.0
PPP GDP	0.8	1.6	3.9	3.2	3.1	3.0	0.3	0.1	0.1
Private consumption	-2.4	1.1	4.4	3.1	3.2	3.1	-0.2	-0.1	-0.2
Public consumption	0.1	3.1	1.5	1.5	1.4	1.3	0.2	-0.2	-0.3
Fixed investment	0.4	-0.2	6.8	5.2	4.8	4.7	1.5	0.9	0.9
Exports, GNFS[3]	3.9	3.6	6.5	4.8	4.7	4.7	0.1	0.0	0.1
Imports, GNFS[3]	-5.5	3.4	9.0	5.5	5.5	5.2	0.0	0.1	0.0
Net exports, contribution to growth	3.0	0.2	-0.4	0.0	0.0	0.0	0.0	0.0	0.0
Memo items: GDP									
Commodity exporters[4]	-2.0	0.3	2.0	2.0	2.3	2.3	-0.1	0.0	0.0
Commodity importers[5]	4.5	3.0	5.9	4.3	3.8	3.7	0.6	0.1	0.1
Central Europe[6]	3.7	3.2	4.8	4.2	3.7	3.5	0.2	0.2	0.3
Western Balkans[7]	2.1	3.1	2.5	3.2	3.4	3.8	-0.1	-0.2	0.0
Eastern Europe[8]	-7.6	0.8	2.5	3.3	3.6	3.5	0.2	0.1	0.0
South Caucasus[9]	1.7	-1.6	2.0	2.6	4.0	3.7	0.7	1.5	0.4
Central Asia[10]	3.3	3.3	4.7	4.4	4.2	4.0	0.6	0.1	-0.3
Russia	-2.5	-0.2	1.5	1.5	1.8	1.8	-0.2	0.0	0.0
Turkey	6.1	3.2	7.4	4.5	4.0	4.0	1.0	0.0	0.0
Poland	3.8	2.9	4.6	4.2	3.7	3.5	0.2	0.2	0.4

Source: World Bank.

Notes: e = estimate; f = forecast. EMDE = emerging market and developing economy. 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 differ at any given moment in time.

1. GDP at market prices and expenditure components are measured in constant 2010 U.S. dollars.
2. Sub-region aggregate excludes Bosnia and Herzegovina, Kosovo, Montenegro, Serbia, Tajikistan, and Turkmenistan, for which data limitations prevent the forecasting of GDP components.
3. Exports and imports of goods and non-factor services (GNFS).
4. Includes Albania, Armenia, Azerbaijan, Kazakhstan, the Kyrgyz Republic, Kosovo, Russia, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan.
5. Includes Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Georgia, Hungary, FYR Macedonia, Moldova, Montenegro, Poland, Romania, Serbia, and Turkey.
6. Includes Bulgaria, Croatia, Hungary, Poland, and Romania.
7. Includes Albania, Bosnia and Herzegovina, Kosovo, FYR Macedonia, Montenegro, and Serbia.
8. Includes Belarus, Moldova, and Ukraine.
9. Includes Armenia, Azerbaijan, and Georgia.
10. Includes Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan.

For additional information, please see www.worldbank.org/gep.

TABLE 2.2.2 Europe and Central Asia country forecasts[1]

(Real GDP growth at market prices in percent, unless indicated otherwise)

	2015	2016	2017e	2018f	2019f	2020f	Percentage point differences from January 2018 projections 2018f	2019f	2020f
Albania	2.2	3.4	3.8	3.6	3.5	3.5	0.0	0.0	0.0
Armenia	3.2	0.2	7.5	4.1	4.0	4.0	0.3	0.0	0.0
Azerbaijan	1.1	-3.1	0.1	1.8	3.8	3.2	0.9	2.3	0.6
Belarus	-3.8	-2.5	2.4	2.9	2.7	2.5	0.8	0.3	0.1
Bosnia and Herzegovina[2]	3.1	3.1	3.0	3.2	3.4	4.0	0.0	0.0	0.5
Bulgaria	3.6	3.9	3.6	3.8	3.6	3.6	-0.1	-0.4	-0.3
Croatia	2.3	3.2	2.8	2.6	2.7	2.8	0.0	-0.1	-0.2
Georgia	2.9	2.8	5.0	4.5	4.8	5.0	0.3	0.1	0.0
Hungary	3.1	2.0	4.0	4.1	3.2	3.0	0.3	0.1	0.1
Kazakhstan	1.2	1.1	4.0	3.7	3.3	2.8	1.1	0.5	-0.2
Kosovo	4.1	4.1	4.4	4.8	4.8	4.8	0.0	0.0	0.1
Kyrgyz Republic	3.9	4.3	4.6	4.2	4.8	5.0	0.0	0.0	0.4
Macedonia, FYR	3.9	2.9	0.0	2.3	2.7	3.0	-0.9	-1.2	-1.0
Moldova	-0.4	4.5	4.5	3.8	3.7	3.5	0.0	0.1	0.2
Montenegro	3.4	2.9	4.4	2.8	2.5	2.1	0.0	0.0	0.0
Poland	3.8	2.9	4.6	4.2	3.7	3.5	0.2	0.2	0.4
Romania	3.9	4.8	7.0	5.1	4.5	4.1	0.6	0.4	0.6
Russia	-2.5	-0.2	1.5	1.5	1.8	1.8	-0.2	0.0	0.0
Serbia	0.8	2.8	1.9	3.0	3.5	4.0	0.0	0.0	0.0
Tajikistan	6.0	6.9	7.1	6.1	6.0	6.0	1.1	0.5	0.3
Turkey	6.1	3.2	7.4	4.5	4.0	4.0	1.0	0.0	0.0
Turkmenistan	6.5	6.2	6.5	6.3	6.3	6.3	0.0	0.0	0.0
Ukraine	-9.8	2.3	2.5	3.5	4.0	4.0	0.0	0.0	0.0
Uzbekistan	7.9	7.8	5.3	5.0	5.1	5.5	-0.6	-1.2	-1.0

Source: World Bank.

Notes: e = estimate; f = forecast. 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.

1. GDP at market prices and expenditure components are measured in constant 2010 U.S. dollars, unless indicated otherwise.

2. GDP growth rate at constant prices is based on production approach.

For additional information, please see www.worldbank.org/gep.