EUROPE and CENTRAL ASIA

Economic activity in Europe and Central Asia (ECA) is estimated to have contracted 2.9 percent in 2020 in the wake of disruptions related to the COVID-19 pandemic. The pandemic is expected to erase at least five years of per capita income gains in about a fifth of the region's economies and raise the poverty headcount. Economies with strong trade or financial linkages to the euro area and those heavily dependent on services and tourism have been hardest hit. Due to a resurgence of COVID-19, the pace of recovery in 2021 is projected to be slower than originally anticipated, at 3.3 percent. Growth is then expected to rise to 3.9 percent in 2022, as the effects of the pandemic gradually wane and the recovery in trade and investment gathers momentum. The outlook remains highly uncertain, however, and growth could be weaker than envisioned if the pandemic takes longer than expected to fade, external financing conditions tighten, or geopolitical tensions escalate again.

Recent developments

The COVID-19 pandemic has generated a major health and economic crisis in Europe and Central Asia (ECA), which has been further compounded by social unrest and conflict. COVID-19 has infected nearly 9.5 million people in the region, making ECA the second hardest hit region in per capita terms after Latin America and the Caribbean. After stabilizing in mid-2020, the rate of new cases sharply accelerated starting in the fourth quarter, forcing governments to maintain or reintroduce mitigation measures (figure 2.2.1.A). Although the Russian Federation accounts for about a quarter of the region's total cases, cumulative cases per capita are higher in half of other ECA economies, including in those that had previously made progress in containing domestic outbreaks (Central Europe, Georgia).

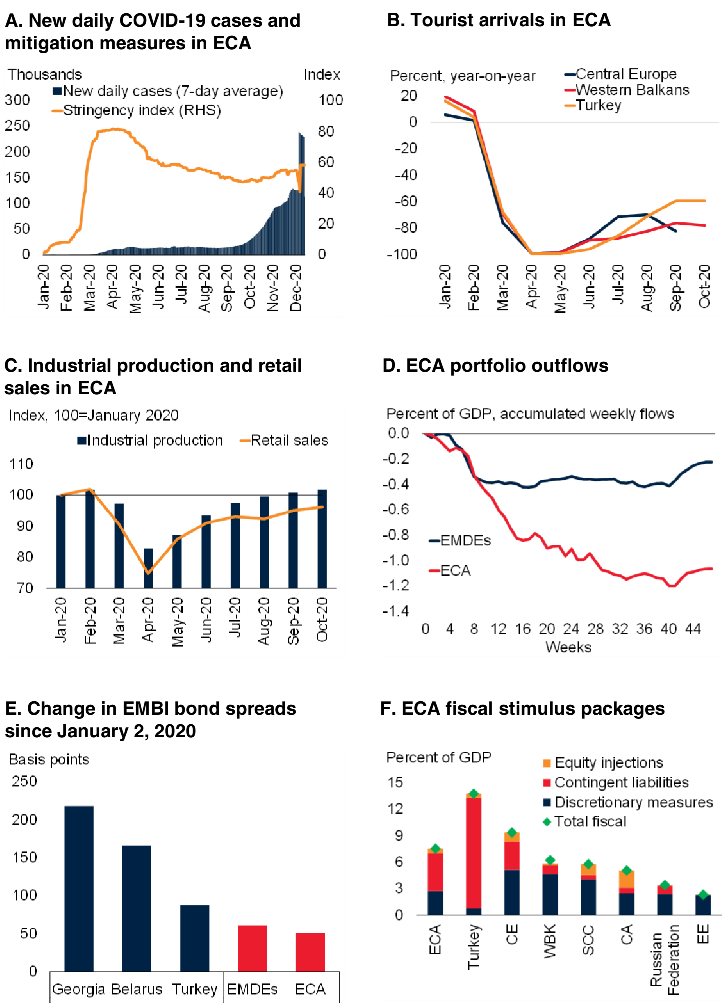
Regional GDP is estimated to have contracted 2.9 percent in 2020, with nearly all economies in recession and roughly two-thirds expected to experience deeper contractions than during the global financial crisis. Output in ECA fell sharply in the first half of the year as risk aversion, combined with pandemic-related restrictions, contributed to a decline in domestic demand and dented services and manufacturing activity. Sustained weakness in global trade dampened regional exports, while tourist arrivals all but evaporated (figure 2.2.1.B). Mounting job losses in Europe and the impact of the oil price collapse in Russia weighed heavily on remittance inflows (Quayyum and Kpodar 2020; World Bank 2020c). As restrictions gradually eased, however, indicators such as industrial production and retail sales firmed in the third quarter of 2020, particularly in economies that had quickly controlled domestic outbreaks (figure 2.2.1.C; Demirgüç-Kunt, Lokshin, and Torre 2020).

A sharp resurgence of COVID-19 in late 2020 interrupted the incipient recovery, with mobility trends deteriorating and composite and manufacturing PMIs faltering across the region. The economies hardest hit by the pandemic are those with strong trade or financial linkages to the euro area and those heavily dependent on services and tourism (Croatia, Kosovo, Montenegro). In all, the pandemic is estimated to push an additional 2.2 million under the $3.20 a day poverty line in the region, with household surveys in some countries, particularly in Central Asia, reporting an uptick in food insecurity (World Bank 2020d).

Note: This section was prepared by Collette Mari Wheeler. Research assistance was provided by Damien M. V. Boucher.

FIGURE 2.2.1 ECA: Recent developments

Activity in Europe and Central Asia (ECA) is estimated to have contracted 2.9 percent in 2020, as the region suffered the second-highest number of COVID-19 cases per capita among the EMDE regions. Tourist arrivals came to a halt as a result of the pandemic, and remain depressed, while industrial production and retail sales have gradually improved. Substantial portfolio outflows and above-average EMBI spread increases reflected escalating geopolitical tensions and rising financial pressures. To counter economic disruptions, nearly all ECA economies have implemented fiscal stimulus packages, with varying size and composition.



Sources: Hale et al. (2020); Haver Analytics; Institute of International Finance; International Monetary Fund; Johns Hopkins University; J.P. Morgan; World Bank.

Note: CA = Central Asia; CE = Central Europe; ECA = Europe and Central Asia; EE = Eastern Europe; EMDEs = emerging market and developing economies; SCC = South Caucasus; WBK = Western Balkans.

A. Figure shows 7-day moving average of new daily COVID-19 cases. "Stringency" refers to daily number of measures of the following policy actions: School closings, workplace closings, cancellation of public events and public transport, restrictions to gatherings, restrictions to international and domestic travel, and stay-at-home requirements. Last observation is December 17, 2020.

B. Sample includes 10 ECA EMDEs due to data limitations. Last observation is September 2020 for Central Europe and October 2020 for Western Balkans and Turkey.

C. Last observation is October 2020.

D. The start date of the COVID-19 episode is January 24, 2020. ECA sample includes Hungary, Poland, Turkey, and Ukraine due to data limitations. Last observation is December 18, 2020.

E. EMBI bond spread refers to the J.P. Morgan Emerging Market Bond Index. Figure shows the evolution of EMBI bond spread relative to January 2, 2020. EMDE and ECA aggregates show median values. Last observation is December 15, 2020.

F. Fiscal stimulus measures are derived from the October 2020 IMF Fiscal Monitor Database. Aggregates are the GDP-weighted average of the total fiscal package and its components. "Discretionary measures" includes revenue and expenditure measures; "Equity injections" includes equity injections, loans, and asset purchases; and "Contingent liabilities" includes loan guarantee and other quasi-fiscal measures.

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ECA's EMDEs have experienced larger portfolio outflows than others since the early stages of the pandemic, reflecting a loss of investor confidence and a flight to safety (figure 2.2.1.D). These outflows reignited currency depreciation and reserve losses. Despite retreating somewhat since the onset of the pandemic, bond spreads remain higher than in early 2020, and in some cases have spiked again due to geopolitical tensions or external financing pressures. Borrowing costs have risen most in economies with elevated foreign-currency-denominated debt or where nonresident investors account for a sizable share of the local bond market (figure 2.2.1.E). Current account pressures were exacerbated by the collapse in exports caused by falling external demand.

Fiscal support packages have been announced in nearly all ECA economies, with several governments receiving aid from official sources, ramping up borrowing in debt markets, and prioritizing spending to bolster health care systems, strengthen safety nets, support the private sector, and counter financial market disruptions. Job retention and labor market support schemes have also been implemented to sustain employment. Despite these measures, the pandemic is estimated to have triggered the working-hour equivalent of 106 million job losses in the first three quarters of 2020 in Europe (ILO 2020). Increases in the number of unemployed were particularly pronounced in some Central European countries and Russia. Although the average fiscal response has been larger in ECA than in most other EMDE regions, there is wide variation within the region (figure 2.2.1.F). In all, the fiscal response and contraction in output is expected to raise average debt levels to over 50 percent of GDP by 2022—roughly 8 percentage points higher than in 2019.

Monetary policy has become more expansionary as economic conditions deteriorated. Several central banks have intervened in foreign exchange markets to stabilize their currencies and mitigate volatility (Croatia, Kazakhstan, Kyrgyz Republic, Serbia, Turkey), while others have tapped sovereign wealth funds (Azerbaijan, Kazakhstan). Recent currency depreciation has put further upward pressure on inflation and reduced the scope for additional policy rate cuts, especially for countries with inflation near or above target ranges. Some countries have also used unconventional policies, such as asset purchases (Croatia, Hungary, Poland, Romania, Turkey).

Outlook

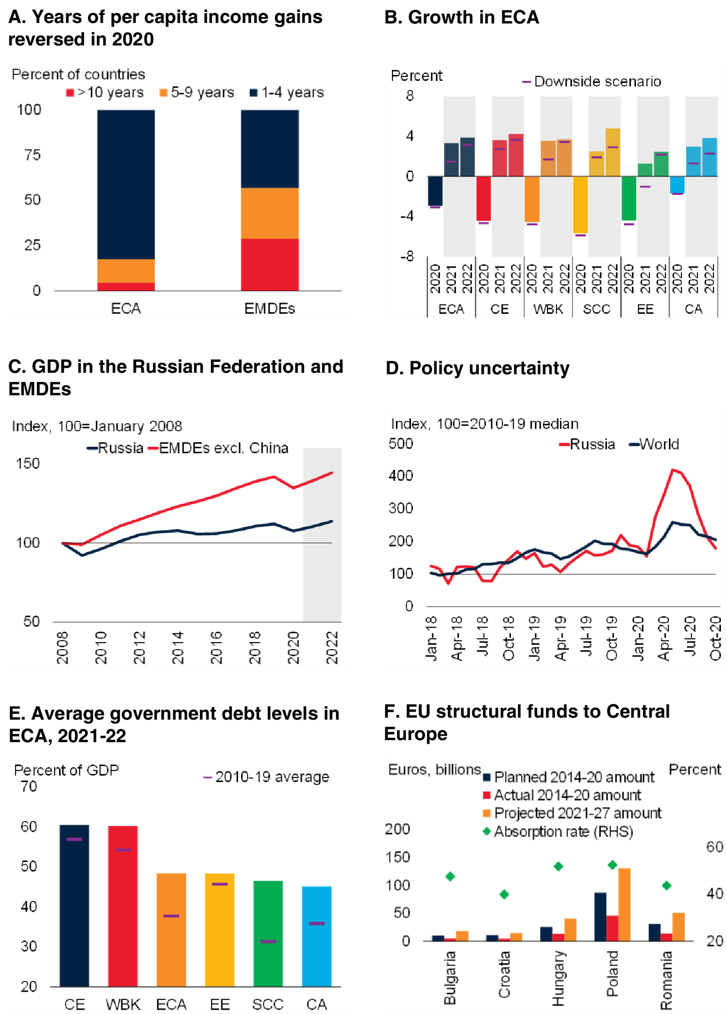
The regional economy is projected to expand by a moderate 3.3 percent in 2021, as the resurgence of COVID-19 causes persistent disruptions to activity. The regional forecast has been downgraded in 2021, reflecting downward revisions in nearly 75 percent of ECA's economies amid the rapid spread of the virus and elevated geopolitical tensions. Growth is expected to pick up in 2022, to 3.9 percent, as the economic effects of the pandemic gradually wane and the recovery in trade and investment gathers momentum (tables 2.2.1 and 2.2.2). Despite the improvement in 2022, GDP is projected to remain over 3 percent below pre-pandemic forecasts. Five or more years of per capita income gains are estimated to have been erased due to the pandemic in about one-fifth of the economies in 2020 (figure 2.2.2.A). The pandemic is also expected to further exacerbate the slowdown in productivity growth over the long run, through its damaging effects on investment and human capital accumulation (chapter 3; Dieppe 2020; World Bank 2020e).

The outlook is predicated on the distribution of effective vaccines gathering pace in early 2021 in advanced economies and major EMDEs, including Russia, then later in the year for others. It also assumes that geopolitical tensions will not re-escalate in the region. Due to considerable uncertainty surrounding the pandemic and subsequent growth forecasts, a downside scenario is considered, where the vaccine rollout is delayed by one to two quarters and financial conditions tighten substantially (figure 2.2.2.B; box 1.4).

Growth in Russia is envisioned to pick up only modestly in 2021, to 2.6 percent, as the country grapples with a renewed acceleration in COVID-19 infections. Vaccine deployment in early 2021, however, is expected to aid the recovery, with growth eventually rising to 3 percent in 2022. Growth will be further supported by a rise in

FIGURE 2.2.2 ECA: Outlook and risks

The recovery in ECA is forecast to be a modest 3.3 percent in 2021 as the region recovers from the current rapid acceleration in COVID-19 cases. Growth is then expected to rise to 3.9 percent in 2022 as the impact of the pandemic wanes and domestic demand strengthens. The pandemic is expected to erase at least five years of per capita income gains in about a fifth of the region's economies and to raise the poverty headcount. The region's recovery, however, is constrained by structural challenges, heightened financial pressures, and limited fiscal space. In addition, the recovery could be interrupted by a re-escalation of geopolitical tensions. In Central Europe, however, policies that increase the absorption of EU structural funds could boost investment.



Sources: Baker, Bloom, and Davis (2015); International Monetary Fund; World Bank.

Note: CA = Central Asia; CE = Central Europe; ECA = Europe and Central Asia; EE = Eastern Europe; EMDEs = emerging market and developing economies; SCC = South Caucasus; WBK = Western Balkans. Aggregates calculated using U.S. dollar GDP per capita at 2010 prices and market exchange rates. Shaded areas indicate forecasts.

A. Figure shows the percentage of EMDEs by number of years of lost per capita income gains, measured as the difference between 2020 and the latest year of per capita income that is below 2020 value over the 2000-19 period.

B. Figure shows the downside scenario as presented in box 1.4.

D. Policy uncertainty is the Economic Policy Uncertainty Index computed by Baker, Bloom, and Davis (2015). Black horizontal line denotes 2010-19 median.

E. Aggregates are 2021-22 unweighted averages of general government gross debt. Horizontal line corresponds to 2010-19 unweighted averages. Sample includes 23 ECA countries.

F. Figure shows the total amount of EU funds that were planned to be disbursed as part of the Multiannual Financial Framework 2014-20, the total net payments that occurred, and the resulting absorption rate calculated as the ratio of net payments over planned amount. Absorption rates are calculated over 2014-20 but funds could continue to be absorbed over the next three years, thus final rates could be higher. Projected 2021-27 amount calculated using the pre-allocated amount of the Multiannual Financial Framework 2014-20, which does not include Next Generation EU funds.

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industrial-commodity prices, as well as the continuation of supportive policy measures. These include sustaining the policy interest rate at a record low and more accommodative fiscal policy. As has been the case in past recoveries, the rebound will be constrained by structural rigidities (figure 2.2.2.C).

Turkey's economy avoided a contraction in 2020, with activity growing an estimated 0.5 percent amid a substantial expansion in credit. Growth is projected to rise to 4.5 percent in 2021, as a recovery in domestic demand takes hold. Despite hikes in the policy interest rate, the lira hit new lows against the U.S. dollar, which eroded balance sheets and limited the space available for additional countercyclical policy responses. The outlook has been downgraded as the sharp acceleration in new COVID-19 cases, weaker-than-expected international tourism, and tighter-than-anticipated monetary policy weigh on the recovery.

Growth in Central Europe is envisioned to firm in 2021, to 3.6 percent, supported by the recovery in trade as activity rebounds in the euro area. The outlook has been downgraded, however, amid the recent surge in COVID-19 cases. Exceptional policy accommodation is expected to continue throughout 2021, including near-zero policy interest rates (Hungary, Poland). Among the ECA subregions, fiscal support packages have been largest in Central Europe, at 9 percent of GDP, reflecting sizable discretionary measures and loan guarantees and other credit measures. The European Union (EU) structural fund package to Central Europe as part of its COVID-19 response could help support medium-term growth.

Growth in the Western Balkans is expected to rebound to 3.5 percent in 2021, assuming that consumer and business confidence are restored as COVID-19 is brought under control and that political instability eases. Tourism-dependent economies, particularly Albania and Montenegro, are projected to experience a more robust rebound in activity than the subregion's other countries. Rising fiscal liabilities in the subregion have reduced space for fiscal support, while at the same time, government budgets will be further stretched by additional spending necessary to counter the damaging economic effects of the COVID-19 outbreak. Despite these headwinds, medium-term growth and productivity in Albania and North Macedonia should be boosted by accelerating structural reforms in preparation for EU membership, assuming negotiations surrounding the accession process are not further delayed (Rovo 2020; World Bank 2020f). The subregion is also expected to benefit from the EU's recently adopted Economic and Investment Plan, which will mobilize funding to support sustainable connectivity, human capital, competitiveness and inclusive growth, and green and digital transition.

The sub-regional economy of Eastern Europe is projected to rise to a tepid 1.3 percent in 2021, reflecting continued challenges related to the pandemic, heightened political tensions in Belarus, subdued domestic demand, and ongoing structural weakness. Substantial forecast downgrades in Eastern Europe were driven by the intensification of political tensions and the associated deterioration in investor sentiment, which is expected to weigh heavily on investment.

Growth in the South Caucasus subregion is projected to rise to 2.5 percent in 2021, as the shocks related to the pandemic and conflict dissipate, and as tourism recovers alongside improving consumer and business confidence. Activity is expected to expand in Azerbaijan over the forecast horizon as oil prices stabilize and the economy benefits from investment and reconstruction spending. The peace statement between Armenia and Azerbaijan is expected to help alleviate geopolitical tensions in the region.

In Central Asia, growth is expected to recover to 3 percent in 2021, supported by a modest rise in commodity prices and foreign direct investment as the subregion deepens its integration with China's Belt and Road Initiative. Forecasts for a rebound, however, have been downgraded due to rising policy uncertainty in Central Asia, particularly in the Kyrgyz Republic, following political tensions and social unrest.

Risks

Risks to the outlook are markedly tilted to the downside, despite the development of multiple COVID-19 vaccines with high efficacy rates in trials. The near-term growth outlook for ECA is clouded by the sharp rise in uncertainty over the surge in new cases, which has contributed to social unrest in some countries, as well as the risk of geopolitical tensions re-escalating (figure 2.2.2.D). Several euro area countries have been forced to re-impose nationwide lockdowns, which may weaken external demand in ECA. Similarly, rising cases within ECA could also lead to more stringent restrictions and responses by households and firms, which would weigh on private consumption and investment. If the downturn in travel is prolonged, growth outcomes could be much weaker, particularly in tourism-dependent economies (Central Europe, Turkey, the Western Balkans). Delays in the production, procurement, or distribution of COVID-19 vaccines, lower-than-expected vaccine effectiveness, or the continuation of pandemic-related restrictions could also delay the economic recovery. The challenges of distribution and inoculation are particularly elevated in Central Asia, where health care capacity is weaker than in other parts of ECA.

In the context of capital outflows, foreign exchange reserves have been drawn down sharply in some ECA economies, constraining the capacity of central banks to buffer the impact of further negative external shocks. A sudden reassessment of investor sentiment could lead to cascading defaults and rising non-performing loans, especially given the sharp increase in government debt (figure 2.2.2.E; chapter 1). Despite exceptional liquidity support, corporate balance sheet pressures in ECA have continued to rise in the wake of COVID-19 due to lower earnings and substantial exchange-rate depreciation, putting strain on the banking sector. For banks that are undercapitalized or operate in countries with narrow fiscal space, borrower assistance has intensified stress (Demirgüç-Kunt, Pedraza, and Ruiz-Ortega 2020). The pandemic has also amplified the risk that contingent liabilities will be realized, which could further strain public finances.

The pandemic also poses medium-term risks if protracted spells of unemployment and school closures have a significant impact on human capital development through lost opportunities to acquire skills and gain knowledge (Dieppe 2020; Shmis et al. 2020; World Bank 2020e). Renewed school closures in response to a worsening of the pandemic would exacerbate these risks. Investment prospects have eroded further in response to the slowdown in capital expenditures, with the exception of Central Europe. The sizable EU structural funds package to Central Europe as part of its COVID-19 response could help mitigate the weakness in investment, but the boost could be tempered by low absorption of funds due to challenges surrounding administrative capacity and governance (figure 2.2.2.F).

The rise in geopolitical tensions in ECA also presents headwinds to growth. An unraveling of the peace statement between Armenia and Azerbaijan, further political pressures in Belarus or the Kyrgyz Republic, or renewed involvement by the region's largest economies in conflicts in Libya, the Syrian Arab Republic, or Ukraine could trigger additional sanctions and generate substantial financial market pressures. A protracted deterioration in investor sentiment—whether from uncertainty related to the pandemic, geopolitical tensions, or delays in EU accession negotiations—could have material implications for ECA and erode the outlook (World Bank 2016).

TABLE 2.2.1 Europe and Central Asia forecast summary

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

	2018	2019	2020e	2021f	2022f	Percentage point differences from June 2020 projections: 2020e	Percentage point differences from June 2020 projections: 2021f
EMDE ECA, GDP[1]	**3.4**	**2.3**	**-2.9**	**3.3**	**3.9**	**1.8**	**-0.3**
GDP per capita (U.S. dollars)	2.9	1.9	-3.2	3.1	3.7	1.8	-0.3
EMDE ECA, GDP excl. Turkey	3.5	2.7	-4.0	2.9	3.5	1.0	-0.3
(Average including countries with full national accounts and balance of payments data only)[2]							
EMDE ECA, GDP[2]	3.3	2.1	-2.9	3.4	3.9	2.0	-0.3
PPP GDP	3.4	2.2	-3.0	3.3	3.8	1.8	-0.4
Private consumption	3.2	3.1	-3.6	3.6	3.0	0.1	0.7
Public consumption	3.0	3.0	3.2	-0.6	0.9	-2.0	-2.6
Fixed investment	2.8	0.4	-6.6	4.8	6.6	1.9	-1.9
Exports, GNFS[3]	5.8	2.6	-13.5	5.9	5.9	-1.7	1.9
Imports, GNFS[3]	3.3	3.6	-11.4	6.8	7.3	-0.7	2.1
Net exports, contribution to growth	1.0	-0.2	-1.3	-0.1	-0.2	-0.4	-0.1
Memo items: GDP							
Commodity exporters[4]	2.8	1.9	-3.9	2.7	3.2	1.2	-0.2
Commodity importers[5]	3.9	2.6	-2.0	3.9	4.5	2.3	-0.4
Central Europe[6]	4.9	4.3	-4.4	3.6	4.2	0.6	-0.2
Western Balkans[7]	4.0	3.5	-4.5	3.5	3.7	-1.3	-1.1
Eastern Europe[8]	3.4	2.6	-4.4	1.3	2.5	-0.8	-1.1
South Caucasus[9]	2.7	3.6	-5.7	2.5	4.8	-2.6	-0.5
Central Asia[10]	4.5	4.9	-1.7	3.0	3.8	0.0	-0.7
Russia Federation	2.5	1.3	-4.0	2.6	3.0	2.0	-0.1
Turkey	3.0	0.9	0.5	4.5	5.0	4.3	-0.5
Poland	5.4	4.5	-3.4	3.5	4.3	0.8	0.7

Source: World Bank.

Note: e = estimate; f = forecast; PPP = purchasing power parity; 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. Due to lack of reliable data of adequate quality, the World Bank is currently not publishing economic output, income, or growth data for Turkmenistan, and Turkmenistan is excluded from cross-country macroeconomic aggregates.

1. GDP and expenditure components are measured in 2010 prices and market exchange rates.
2. Aggregates presented here exclude Azerbaijan, Bosnia and Herzegovina, Kazakhstan, Kosovo, Montenegro, Serbia, Tajikistan, and Turkmenistan, for which data limitations prevent the forecasting of GDP components.
3. Exports and imports of goods and nonfactor services (GNFS).
4. Includes Armenia, Azerbaijan, Kazakhstan, the Kyrgyz Republic, Kosovo, the Russian Federation, Tajikistan, Ukraine, and Uzbekistan.
5. Includes Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Georgia, Hungary, Moldova, Montenegro, North Macedonia, Poland, Romania, Serbia, and Turkey.
6. Includes Bulgaria, Croatia, Hungary, Poland, and Romania.
7. Includes Albania, Bosnia and Herzegovina, Kosovo, Montenegro, North Macedonia, and Serbia.
8. Includes Belarus, Moldova, and Ukraine.
9. Includes Armenia, Azerbaijan, and Georgia.
10. Includes Kazakhstan, the Kyrgyz Republic, Tajikistan, and Uzbekistan.

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TABLE 2.2.2 Europe and Central Asia country forecasts[1]

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

	2018	2019	2020e	2021f	2022f	Percentage point differences from June 2020 projections: 2020e	2021f
Albania	4.1	2.2	-6.7	5.1	4.4	-1.7	-3.7
Armenia	5.2	7.6	-8.0	3.1	4.5	-5.2	-1.8
Azerbaijan	1.5	2.2	-5.0	1.9	4.5	-2.4	-0.3
Belarus	3.1	1.2	-1.6	-2.7	0.9	2.4	-3.7
Bosnia and Herzegovina[2]	3.7	2.7	-4.0	2.8	3.5	-0.8	-0.6
Bulgaria	3.1	3.7	-5.1	3.3	3.7	1.1	-1.0
Croatia	2.7	2.9	-8.6	5.4	4.2	0.7	0.0
Georgia	4.9	5.1	-6.0	4.0	6.0	-1.2	0.0
Hungary	5.1	4.6	-5.9	3.8	4.3	-0.9	-0.7
Kazakhstan	4.1	4.5	-2.5	2.5	3.5	0.5	0.0
Kosovo	3.8	4.2	-8.8	3.7	4.9	-4.3	-1.5
Kyrgyz Republic	3.8	4.5	-8.0	3.8	4.5	-4.0	-1.8
Moldova	4.3	3.6	-7.2	3.8	3.7	-4.1	-0.2
Montenegro	5.1	4.1	-14.9	6.1	3.9	-9.3	1.3
North Macedonia	2.7	3.6	-5.1	3.6	3.5	-3.0	-0.3
Poland	5.4	4.5	-3.4	3.5	4.3	0.8	0.7
Romania	4.4	4.1	-5.0	3.5	4.1	0.7	-1.9
Russian Federation	2.5	1.3	-4.0	2.6	3.0	2.0	-0.1
Serbia	4.4	4.2	-2.0	3.1	3.4	0.5	-0.9
Tajikistan	7.3	7.5	2.2	3.5	5.5	4.2	-0.2
Turkey	3.0	0.9	0.5	4.5	5.0	4.3	-0.5
Ukraine	3.4	3.2	-5.5	3.0	3.1	-2.0	0.0
Uzbekistan	5.4	5.6	0.6	4.3	4.5	-0.9	-2.3

Source: World Bank.

Note: 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. Data are based on GDP measured in 2010 prices and market exchange rates, unless indicated otherwise.

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

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