

EUROPE and CENTRAL ASIA



Regional growth is expected to decelerate to 1.8 percent in 2015 from an already weak 2.4 percent in 2014. Plunging oil prices and geopolitical tensions, and related spillovers, including from the Russian Federation, are only partly offset by a moderate recovery in the Euro Area and the benefits from low fuel prices to net fuel importers. Recently, confidence has improved slightly, reflecting the stabilization of oil prices, the peace agreement reached in Ukraine, and policy measures implemented in several economies. Assuming a marginal recovery of oil prices in 2016-17, continued implementation of stabilization measures, and no major deterioration in geopolitical tensions, growth is expected to strengthen to an average of 3.5 percent in 2016-17. Key risks include a deepening recession in the Russian Federation and Ukraine, declining oil prices, and abrupt tightening of global financial conditions.

Recent Developments

After slowing to 2.4 percent in 2014 from 3.7 percent in 2013, regional growth weakened further in early 2015. This reflected spillovers from the oil price decline and geopolitical tensions, which more than offset the benefits from the moderate recovery in the Euro Area. In the eastern part of the region (Eastern Europe, South Caucasus, and Central Asia), growth slowed sharply to 1.5 percent in 2014 (one-fifth of the average in 2000–10), reflecting recessions in the Russian Federation and Ukraine, and downturns in oil-exporting economies. In contrast, growth accelerated modestly in the western part of the region, supported by tailwinds from the recovering Euro Area.¹

Growth in Russia continued to slide in 2015 (a 1.9 percent contraction 2015Q1), following a modest 0.6 percent expansion in 2014. This reflected the impact of sharply lower oil prices (oil accounts for

54 percent of Russia's exports) and the adverse impact of sanctions amid an ongoing trend growth slowdown related to structural bottlenecks (Figure 2.6). A plunge in export revenues, a sharp devaluation of the ruble, and trade restrictions on food imports in Russia lifted inflation into double-digits. The contraction of real incomes and purchasing power weighed on consumer spending, which had been the single largest contributor to growth since 2012.² Investment also shrank on falling business confidence, tightened financing conditions, and restricted access to international capital markets as a result of sanctions.

Decisive policy actions and resources from the Reserve Fund have cushioned the contraction in Russia in 2015 (World Bank 2015f), but resulted in significantly eroded buffers. Key stabilization policy measures included the switch to the free-float on November 10, 2014, a policy rate hike in December 2014 which helped to bolster confidence in currency markets, and the swift bank recapitalization program in December 2014.³ Trade and current account balances improved, helped by the weaker ru-

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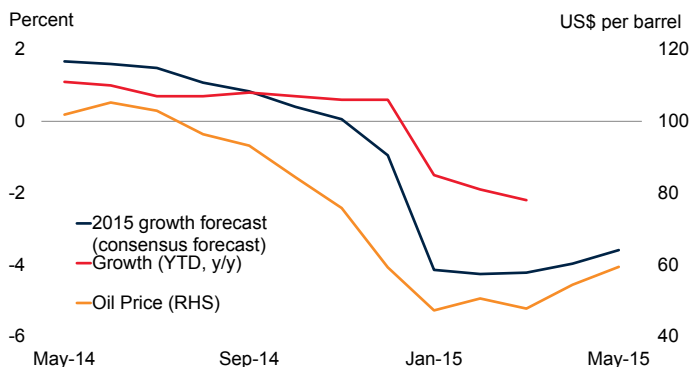
¹The eastern part of the region comprises Eastern Europe (Belarus, Moldova, and Ukraine), South Caucasus (Armenia, Azerbaijan and Georgia), and Central Asia (Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan). The western part of the region includes Central and Southeastern Europe (Bulgaria, Hungary, and Romania) and the Western Balkans (Albania, Bosnia and Herzegovina, the Former Yugoslav Republic of Macedonia, Montenegro, Serbia), and Turkey.

²The share of consumption in GDP increased from 62.3 percent in 2001 to 83.3 percent in 2014.

³Net capital outflows from Russia slowed to US\$32.6 billion in the first quarter of 2015, compared to US\$77.4 billion in 2014Q4, and US\$48 billion in 2014Q1.

FIGURE 2.6 Russian Federation: Growth and oil price

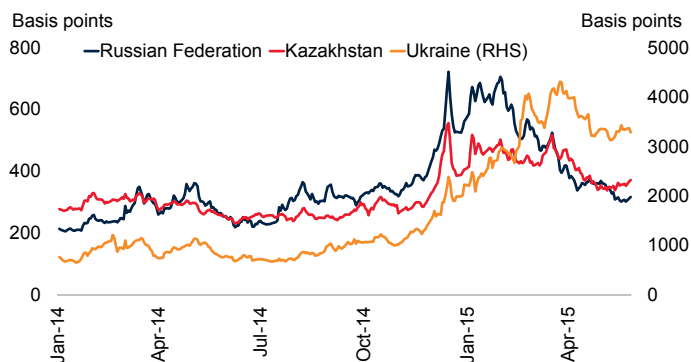
A sharp decline in oil prices and the impact of sanctions have dampened activity in Russia.



Source: World Bank and Consensus Forecasts.

FIGURE 2.7 Selected economies, EMBI spreads

Confidence has improved and spreads eased on a peace agreement in Ukraine, stabilization of oil prices and policy actions.



Source: Bloomberg; J.P. Morgan; Haver.

Note: J.P. Morgan Emerging Market Bond Index global sovereign spreads.

ble, related decline in imports and expansion of exports, despite a 34 percent decline in the nominal value of oil exports. Beginning in February, the ruble and asset prices recovered some of their earlier losses, monthly inflation eased, and interest rate spreads declined to their October 2014 levels (Figure 2.7). The fiscal deficit is projected to increase to 3.5 percent of GDP in 2015, from 1.3 percent in 2014, even though proposed amendments to the 2015 federal budget imply some consolidation of expenditures, and could severely deplete the Reserve Fund (currently equal to 4.7 percent of GDP).

In Kazakhstan, growth declined to 4.3 percent in 2014, half of the average rate in 2000–10, and continued to ease in 2015, despite fiscal stimulus mostly

financed from the country's oil fund.⁴ This reflects the combination of falling oil prices (crude petroleum oil accounts for about 70 percent of exports), recession in Russia (exports to Russia accounted for around 7 percent of exports in 2010–14), declining confidence and lower capital inflows. Unlike Russia, Kazakhstan relied heavily on foreign exchange reserves to defend the exchange rate peg after a 19 percent devaluation implemented in February 2014. This was done to mitigate depreciation-induced inflation, and to buffer corporate and household balance sheets with large liabilities denominated in U.S. dollars. Despite weaker domestic demand and slower import growth, the current account surplus has narrowed, as a result of the sharp drop in commodity exports. Fiscal balances have deteriorated significantly. A 3 percent deficit is projected in 2015, largely reflecting lower revenues from oil exports (World Bank 2015g). Spreads eased from December 2014 peaks, but as of April 2015 are higher than in Russia.

In Azerbaijan, growth decelerated to 2.8 percent in 2014, reflecting low oil prices, interruptions in oil sector output, and a sharp deceleration of non-oil GDP growth due to declining public investment. Both current account and fiscal surpluses declined sharply. The current account surplus is projected to decline to 3.9 percent of GDP in 2015, from 14.1 percent in 2014, despite a 34 percent devaluation of the manat in February 2015.

In Ukraine, output contracted by 6.8 percent in 2014, reflecting a deep decline in the conflict-affected East and a moderate recession in the rest of the country. Exports fell sharply, as exports to Russia (one-quarter of exports in 2010–14) dropped by one-third. Despite a drawdown of official reserves to 1.6 months of imports (January 2015), the exchange rate of the hryvnia against the U.S. dollar tripled between end-December 2013 and end-February 2015. Depreciation and administered price increases contributed to an increase in inflation to 60.9 percent in April 2015 (Figure 2.8). Banks have come under considerable stress, facing worsening asset quality (with nonperforming loans exceeding 30 percent of

⁴Additional fiscal resources—amounting to about 7 percent of GDP, to be implemented over the period 2015–19, from the oil fund and international financial institutions—have been allocated to cushion the impact of lower oil prices on activity in the medium term.

total loans), weakening profitability and large deposit withdrawals amounting to one-quarter of deposits (12 percent of GDP) since January 2014.⁵ Following the ceasefire agreement signed in February, the IMF approved a four-year support program for Ukraine in March 2015.⁶ This, together with the immediate disbursement of the first US\$5 billion tranche in March, led to stabilization of Ukrainian hryvnia and easing of spreads from their February peaks.⁷

Almost all economies in the region, have been negatively affected by the spillovers from the recession in Russia and Ukraine, weakening confidence related to the on-going geopolitical tensions, and growth slowdown in oil-exporting Azerbaijan and Kazakhstan, to various degrees. Only Uzbekistan and Turkmenistan, two relatively closed, resource-rich economies with strong buffers and linkages with the East and South East Asia regions, were reportedly less affected by the commodity price declines and regional headwinds. In the eastern part of the region, these regional headwinds had significant negative repercussions on the region's oil-importing economies through trade, investment, and remittances (Figures 2.9, 2.10, and 2.11), which more than offset the benefits of low oil prices. Activity weakened and exchange rate pressures increased in Armenia, Belarus, Georgia, the Kyrgyz Republic, Moldova, and Tajikistan. Exports slowed in Armenia, Belarus, and Georgia, as did remittance flows to Georgia, the Kyrgyz Republic, Moldova, and Tajikistan. With most imports invoiced in U.S. dollars, and foreign exchange receipts in rubles, the slide of the ruble and the strengthening of the U.S. dollar triggered a deterioration in the terms of trade. The resulting depreciation of local currencies raised inflation in several countries, despite lower oil prices. Central banks have responded to depreciation pressures with interest rate hikes (Armenia, Belarus, the Kyrgyz Republic, Moldova, and Tajikistan; see Figures

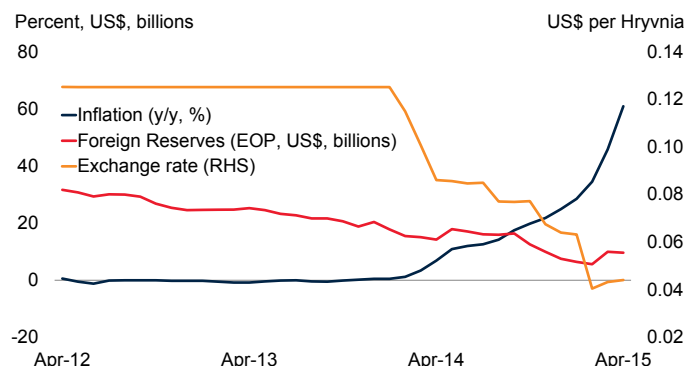
⁵Estimates of nonperforming loans vary significantly from 19 percent of total loans (WDI, National bank of Ukraine, IMF Financial Stability Indicators) to 40 percent (pre-2008 definition).

⁶The IMF estimated as part of the Extended Fund Facility (EFF) program that Ukraine faces a financing gap of about US\$40 billion (one-third of 2014 GDP) for 2015-18 and identifies sources to meet the financing gap (IMF 2015b).

⁷Despite this improvement, Ukrainian spreads are still among the highest globally.

FIGURE 2.8 Ukraine: Recent developments

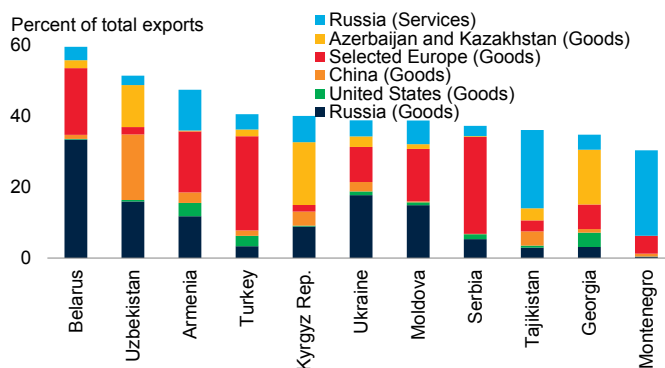
Despite a drawdown of official reserves, the hryvnia depreciated sharply and inflation spiked above 45 percent.



Source: World Bank and Haver Analytics.

FIGURE 2.9 Selected economies: Exports by selected destinations (average 2011–14)

Almost all economies in the region have been affected by spillovers from oil exporters in the region through trade.



Source: World Bank; IMF; Bank of Russia.

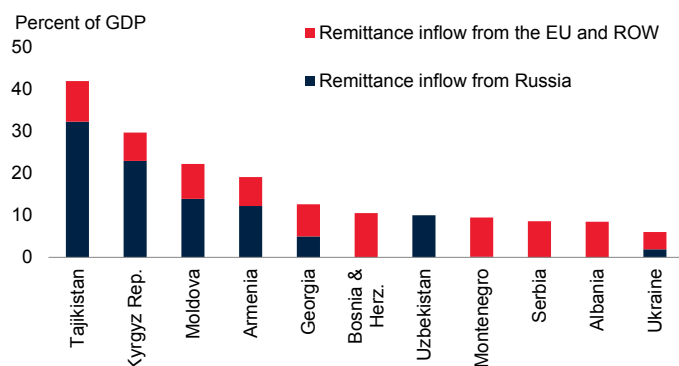
Note: Average does not capture the structural shifts (e.g. in Georgia, Moldova, Ukraine). Selected Europe includes ten largest European importers including Germany, France, UK, Italy, Belgium, Spain, Switzerland, Austria and Sweden.

2.12 and 2.13) further dampening domestic demand and activity.

In the western part of the region, a stronger-than-expected recovery in the Euro Area offset other headwinds, reflecting closer integration with the Euro Area. Growth accelerated to 2.8 percent in 2014 from 2.4 percent in 2013, led by Hungary and several high-income countries (Czech Republic, Poland, the Slovak Republic and Slovenia). The nascent recovery has reflected a pick-up in consumer and business confidence and has been supported by lower fuel and food prices, and accommodative policies.

FIGURE 2.10 Selected economies: Remittances inflows, 2014

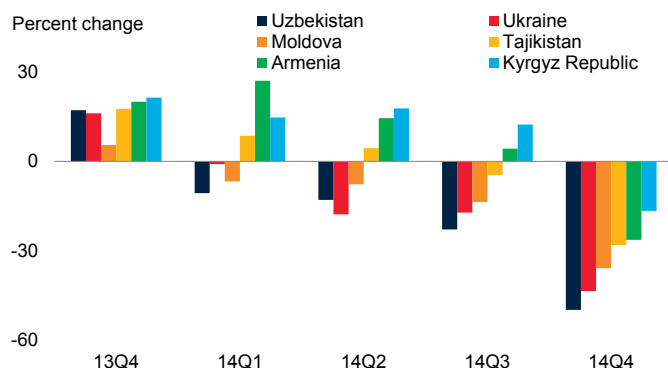
Several smaller oil-importing countries have been affected by spillovers from oil exporters through falling remittances.



Source: World Bank; national central banks, and national statistic agencies.

FIGURE 2.11 Selected economies: Remittances inflows from Russia

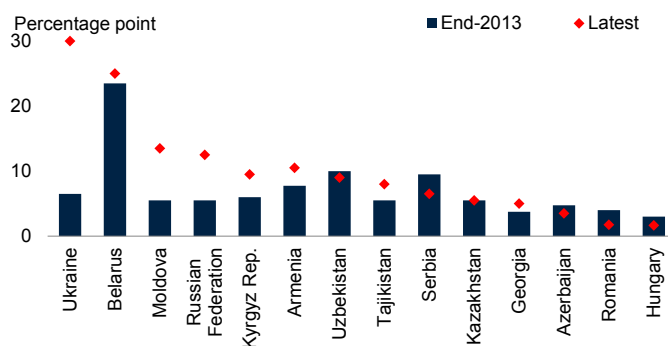
Remittances slowed sharply in the last quarter of 2014.



Source: World Bank; Central Bank of Russia.

FIGURE 2.12 Selected economies: Central bank policy rates

Local currencies in the affected economies came under pressure, prompting central banks to hike interest rates.



Source: Central Bank News.

Note: "Latest" values are policy rates as of May 26, 2015.

Headline inflation has fallen to near zero in several countries thanks to lower energy prices (Figure 2.14). With output well below potential levels, core inflation also remains generally low. The recovery has been uneven across the sub-region, held back by legacies of the global financial crisis, especially still-stretched balance sheets (Bulgaria, Serbia and to a lesser extent Romania). Investment has remained subdued, as high corporate debt overhangs, non-performing loans, and weak demand have continued to constrain lending to the corporate sector, notwithstanding lower interest rates. The Former Yugoslav Republic of Macedonia has performed relatively better than its neighbors over the past few years, thanks to foreign direct investments in its free technological zones, and public investment stimulus. For some economies in the region, investor confidence has also been dented by the conflict between Russia and Ukraine, and economic and financial stress in Greece. The contribution from net exports has been weak, despite the better than expected recovery in the Euro Area (Figure 2.15). This reflects stronger competitive pressures from the economies that have undergone sharp devaluations and a contraction in exports to Russia. Country-specific factors, such as a banking sector turmoil in Bulgaria in mid-2014, the after-effects of floods in Serbia, and high unemployment in the Western Balkan economies, account for the weakness in economic activity.

Turkey's economy has slowed, gaining little support from lower oil prices and tailwinds from the global recovery. Softer-than-expected activity reflects tighter macroprudential measures and policy uncertainty, compounded by weak investor confidence as reflected in widening five-year credit default swaps spreads, rising yields of 10-year Turkish government bonds, and capital outflows (World Bank 2015h). Inflation declined from its mid-2014 peak in line with the decline in oil prices, but remains above-target as a result of capacity constraints and depreciation. Weak domestic demand, low oil prices, and resilient exports have improved the current account balance. However, vulnerabilities remain, especially the large share of the current account deficit (still above 5 percent of GDP) financed by volatile portfolio flows.

Outlook

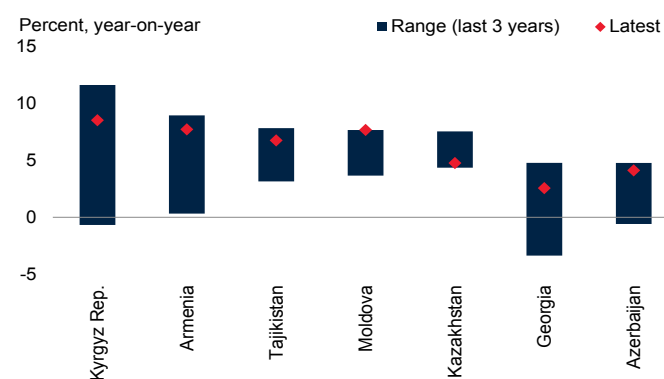
The outlook for the region has deteriorated markedly, with growth in developing Europe and Central Asia expected to drop to 1.8 percent in 2015 despite the on-going global recovery. The main factors are spillovers from low oil prices, geopolitical tensions, and recessions in Russia and Ukraine (World Bank 2015i). Assuming slightly stronger oil prices in 2016–17 (World Bank 2015j), effective macroeconomic and growth-stabilizing policy actions, and no further deterioration of the geopolitical climate, regional growth is expected to strengthen to an average 3.5 percent in 2016–17.

In Russia, a contraction in economic activity by 2.7 percent this year is expected to be followed by a modest recovery in 2016, supported by policies which will continue to facilitate the adjustment of the economy to a new low oil price environment. Growth should strengthen to 2.5 percent in 2017 as investment recovers. However, it will remain below potential, at about half of the average in 2000–10, held back by remaining structural bottlenecks. This outlook is highly uncertain and assumes a modest recovery in oil prices and no major deterioration in geopolitical tensions. For the other oil exporters in the region, prospects also remain closely tied to oil prices. The modest strengthening of prices expected over the forecast horizon should gradually support activity in these economies. In Kazakhstan, growth is projected to decline to 1.7 percent in 2015 as production delays in the Kashagan oil field persist, but strengthen to an average of 3.5 percent in 2016–17. Lower oil prices are expected to result in a current account deficit in 2015, for the first time since 2009. In South Caucasus and Central Asia (including Kazakhstan), growth is expected to bottom out in 2015 and gradually strengthen to 2.9 percent and 4.9 percent in 2016–17, respectively, as conditions in the regions normalize.

Ukraine’s economy is projected to contract by 7.5 percent in 2015. The prospects for a recovery in 2016–17 are highly uncertain, hinging upon a continued ceasefire and eventual peaceful resolution of the conflict in the East, a closing of the large financing gap, and continued implementation of the reform agenda under the IMF program. The conflict has destroyed or damaged sizeable parts of the production and export base in the eastern regions of Ukraine, disrupted trade and investment links, and

FIGURE 2.13 Selected economies: Inflation

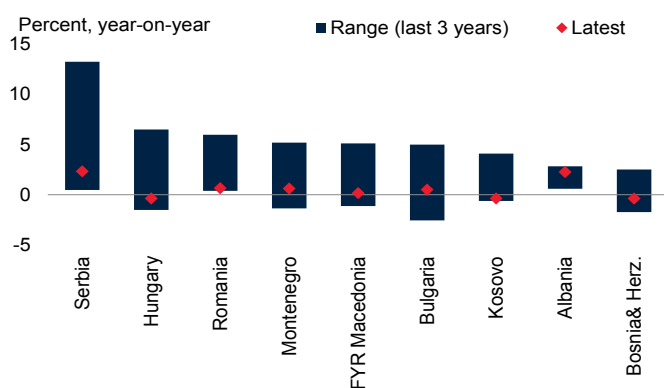
Inflation spiked, reflecting sharp depreciation of local currencies.



Source: World Bank and Haver Analytics.
Note: "Latest" values are for April 2015 except for Kyrgyz Rep. (March) and Tajikistan (February).

FIGURE 2.14 Selected economies: Inflation

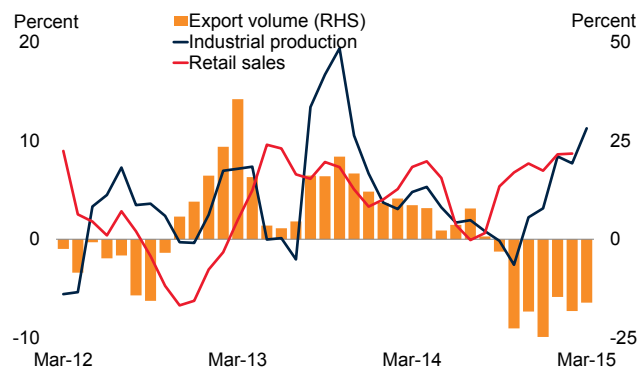
In the western part of the region, more closely integrated with the Euro Area, inflation fell sharply with lower oil prices.



Source: World Bank and Haver Analytics.
Note: "Latest" values are for April 2015 except for Montenegro (February).

FIGURE 2.15 EU-Central and Southeastern Europe: Drivers of growth

The recovery in the western part of ECA was helped by a pick-up in consumer and business confidence.



Source: World Bank and Haver Analytics.
Note: The figure reflects growth rates of 3 month moving averages. Weighted average of available series for Albania, Bulgaria, Bosnia and Herzegovina, Hungary, Kosovo, FYR Macedonia, Montenegro, Romania, and Serbia.

reduced medium-term potential growth. Domestic demand will be dampened by fiscal consolidation measures, including cuts in pensions and utility subsidies. Some price and structural reforms—including sizable energy tariff increases, bank restructuring, governance reforms of state-owned enterprises, and legal changes aimed at combating corruption and strengthening the rule of law—are underway. They are necessary for restoring macroeconomic stability, boosting investor confidence, and anchoring inflation expectations but are likely to weigh on growth in the short-term.

The western part of the region is expected to see growth remaining flat in 2015 (2.8 percent). While a significant improvement from the previous two years, it remains below the region's potential and is insufficient to significantly reduce high and persistent unemployment. Activity is projected to strengthen gradually to 3.3 percent in 2016–17. Domestic demand is expected to continue to recover, as household real disposable incomes rise, energy cost remains low, and low inflation allows further monetary policy rate cuts. As activity in the Euro Area gains momentum, exports are expected to pick up. Some countries in the region should also benefit substantially from EU structural funds (Croatia, Romania, and Slovenia). Nonetheless, at least over the short term, high non-performing loans (NPLs) and a heavy debt burden, will continue to limit credit growth. Elevated government debt will limit room for fiscal support to growth (Albania, Croatia, Hungary, FYR Macedonia, Montenegro, and Serbia). The nature and impact of these financial constraints varies considerably across countries. In Bulgaria, for example, the effects of the 2014 domestic banking turmoil linger. Growth in the Western Balkans is expected to be a modest 1.5 percent in 2015 (up from 0.4 percent in 2014), as a pick-up in net exports is expected to offset slowing investment and consumption. The Western Balkans remain weighed down by the lack of new credit and non-performing loans are the highest in the ECA region (above 16 percent).

In Turkey, activity is expected to be subdued in the first half of 2015, but growth is projected at 3 percent in 2015. Households and corporations are expected to postpone spending due to policy uncertainty and in advance of the June elections.

Fiscal policy is expected to remain accommodative until June. Private spending is expected to recover after the June elections, assuming that political uncertainty is resolved. Soft fuel prices and robust exports will contribute to a further reduction in Turkey's trade deficit. External financing requirements are expected to decline by US\$20 billion (to about US\$200 billion) in 2015. Maturing external debt totaling US\$166 billion in 2015 will be rolled over.

Risks

The risks for the region remain tilted to the downside. Key risks include further declines in oil prices, escalation of geopolitical tensions, and abrupt tightening of global financial conditions. A weaker-than-expected global recovery and unfavorable resolution of problems between Greece and its creditors present additional risks to the outlook.

Should oil prices decline or geopolitical tensions in the region escalate, the consequence could be a deeper recession in the Russian Federation in 2015 which could also extend to 2016, growth slowdown in other major oil exporters, and a delayed recovery in Ukraine—and a sharp slowdown in regional growth. Policy changes related to the establishment of the Eurasian Economic Union, specifically the restrictions on migrant workers to the Russian Federation from non-member states may lead to a significant number of labor migrants returning to Tajikistan and Uzbekistan. Net energy exporters in the region would struggle to adjust to further falls in oil prices. For the region's oil importers, the windfall to households via higher disposable incomes and to firms via lower production costs would accelerate the tailwinds of a recovery, but this will not fully offset the opposing forces.

Any faltering in the global economic recovery, especially in the Euro Area, would pose risk to the region's predicted expansion (Chapter 1). It would impact exports and undermine business confidence. With investment already constrained by deep-rooted structural factors (including high NPLs, elevated debt, and weak competitiveness), domestic demand alone will be insufficient to bolster growth.

A disorderly adjustment in global financial markets to the anticipated tightening of U.S. monetary pol-

icy could disrupt financial markets in the region. Turkey and other economies in Central Asia remain particularly exposed as their economies are relatively more reliant on dollar inflows than those in the Central and South Eastern Europe region, which carry more euro or Swiss franc liabilities on their balance sheets.

Economic and financial stress in Greece presents an additional risk to the regional outlook, although the exposures of other parts of the Euro Area have diminished since 2010. Foreign bank exposures to Greek sovereign and non-sovereign debt have declined sharply. The ECB's quantitative easing program, which began in March, has shielded sovereign bonds in other peripheral countries from contagion risks. Several new institutional mechanisms could help contain contagion.⁸ Finally, the Euro Area has emerged from recession, with recoveries gathering strength in Spain, Portugal, and (especially) Ireland. There are pockets of vulnerabilities among developing countries, however. Banking systems in Albania, Bulgaria, FYR Macedonia, Romania, and Serbia remain vulnerable to contagion through sizeable local subsidiaries of Greek banks. In Bulgaria and Albania, for example, a respective 23 percent and 18 percent of banking assets are held by Greek banks, presenting risks of spillovers from potential banking system stress in Greece. Bulgaria's exposure to Greece through trade has declined over the past few years, but is still significant. Exports to Greece declined from 4.1 percent of GDP in 2008 to 3.6 percent of GDP in 2014, the highest share of any country in the ECA region.⁹ Albania receives remittances from Greece equivalent to 3.7 percent of its GDP.

Recent floods in Bosnia and Serbia, which destroyed about 15 percent of Bosnia's output and 2 percent of Serbia's, point to the wider vulnerabilities unfavorable weather conditions pose to the region. Many of the countries in the region are facing warmer temperatures, a changing hydrology, and more extreme climatic conditions (droughts, floods, heat waves and

forest fires) with increased frequency. In addition to the impact on crops and livestock, the changing seasonality of river flows undermines hydropower production, a particularly important sector in Albania.

Policy Challenges

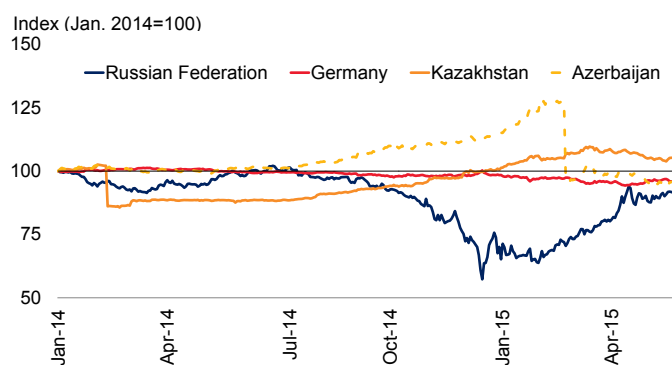
Monetary policy challenges

Spillovers from the plunge in oil prices and geopolitical tensions have complicated monetary policies in the eastern part of the region, but eased monetary policy constraints in the west.

In two relatively large oil-exporting economies of the region, Azerbaijan and Kazakhstan, policy flexibility has been constrained by elevated inflation and balance sheet concerns (Figures 2.16 and 2.17). Efforts to stem currency depreciations in these countries resulted in some losses of reserves and slow external adjustments (current account balances are expected to deteriorate in both countries in 2015). Russia, where external pressures were stronger, allowed greater exchange rate flexibility. This facilitated current account adjustments, but contributed to higher inflation and increased financial stability risks because of the large share of foreign currency-denominated debt. In general, such debt has risen considerably in the region since 2011 and poses a significant

FIGURE 2.16 Selected economies: Real effective exchange rates

Exchange rates helped absorb external shocks in Russia, but policy flexibility has been constrained by elevated inflation and balance sheet concerns in other oil-exporting economies, particularly Kazakhstan.



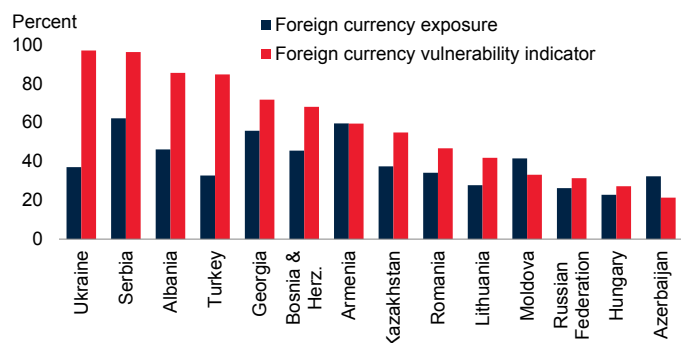
Source: World Bank and Haver Analytics.
Note: Decline denotes depreciation.

⁸The €500 billion European Stability Mechanism may serve as a buffer to mitigate short-term volatility and pressures on periphery banks and sovereign debt issuers; the new bank resolution system could help insulate sovereign debt issuers from banking system stress; the new single supervisory system and the 2014 asset quality review have improved confidence in Euro Area banks and removed uncertainties about Greek debt holding.

⁹Germany has replaced Greece as Bulgaria's main export destination, with exports to Germany accounting for 6.3 percent of GDP. Greece is now the fifth largest export destination for Bulgaria's exports after Germany, Turkey, Italy, and Romania.

FIGURE 2.17 Foreign currency exposure and foreign currency vulnerability indicators, 2013

In oil-importing economies, high dollarization constrains policy flexibility.



Sources: Moody's Statistical Handbook.

Note: Foreign currency exposure is measured as total foreign currency deposits in the domestic banking system/ total deposits in the domestic banking system. Foreign currency vulnerability indicator is defined as (total foreign currency deposits in the domestic banking system)/ (official foreign exchange reserves + foreign assets of domestic banks). Belarus's dollarization was 62.2, its dollarization vulnerability 193.7 in 2013. Alternative estimates show dollarization in Azerbaijan at 50%, in Kazakhstan around 55%, in Georgia above 60%, and in Armenia above 70 percent. The World Bank team estimates dollarization vulnerability in Belarus at 82.6% on the net basis.

challenges to policy makers. Tightening global financial conditions over the medium term will intensify these challenges. With commodity prices expected to remain low, diversification will benefit from greater exchange rate flexibility and stricter macroprudential regulations will help contain risks related to private sector balance sheets.

In contrast, in the western part of the region, low oil prices contributed to lower inflation and improved trade and current account deficits, and eased constraints on monetary policy. In many countries in Europe (Hungary, Croatia, FYR Macedonia, Montenegro, and Slovenia), lower oil prices have added to the deflationary pressures. Central banks in a number of countries cut policy rates to support activity in 2015 (Hungary, Romania, Serbia, and Turkey). Interest rate cuts in oil-importing countries (especially those with a rapidly rising stock of external debt such as Turkey), however, may have to end once the gradual normalization of U.S. monetary policy gets under way.

Need to reassess fiscal policies

Many economies affected by regional spillovers relaxed fiscal policies to avoid sharp slowdowns. Oil-importing countries not affected by the regional spillovers took the opportunity to reform energy taxes, and to build fiscal space.

Almost all oil-exporting countries in the region have significant buffers in the form of foreign assets. This has allowed them to avoid steep spending cuts, despite significant loss in oil revenues, or implement countercyclical expenditure increases. Fiscal break-even oil prices are estimated to remain at or over US\$90 per barrel (Kazakhstan and Azerbaijan), and considerably above the US\$58–64 projected for 2015–16 to cover government spending, which has increased in recent years in response to rising social pressures and infrastructure development goals. As a result of the oil price decline, all countries in the region are expected to run fiscal deficits in 2015 except Turkmenistan and Uzbekistan. With buffers eroding rapidly, and lower oil prices expected to persist for a prolonged period, most countries will need to re-assess medium-term spending plans and will need to adjust gradually to the new realities in the global oil market (IMF 2015c).

Oil-importers with close economic ties to oil exporters may need to tighten fiscal policy in the medium-term to ensure the sustainability of high government or quasi-government debt, despite slowing growth (Armenia, Georgia, Kyrgyz Republic, and Moldova). In contrast, for oil-importers not affected by the regional spillovers, the fall in oil prices could generate substantial fiscal savings: In this way, the tailwinds of low oil prices provide an opportunity for these countries to either build fiscal space, which would allow an effective counter-cyclical response during the next cyclical slowdown, or to invest in critical infrastructure or human capital.

Structural reforms

As growth in high-income countries picks up, convergence of GDP per capita between high-income and developing countries of the region is expected to slow. Sustained lower oil prices will reduce real incomes and purchasing power in many oil-exporting economies and the economies closely linked to them. Unemployment in oil-importers, particularly in the Western Balkans, remains high (Figure 2.18). To accelerate growth and job creation, and to avoid a significant widening of the income gap, requires stepping up the implementation of structural reforms in the entire region.

Many countries in the ECA region remain well below the frontier of best practices with regard to creating a business environment conducive to productiv-

ity growth. Barriers to open markets and access to finance are well above-average in Azerbaijan, the Kyrgyz Republic, and Ukraine (World Bank 2015k). Reducing these barriers would spur productivity and increase resilience to external shocks. While reform needs are country specific, they fall into a few categories. These include shifting the composition of growth away from consumption (Georgia, Turkey, and Ukraine), or natural resources (Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan); easing infrastructure bottlenecks; improving education; reforming labor markets; enhancing competition and easing administrative burdens; improving access to private and multilateral financing; reducing barriers to trade and facilitating regional integration; and reforming energy subsidies.

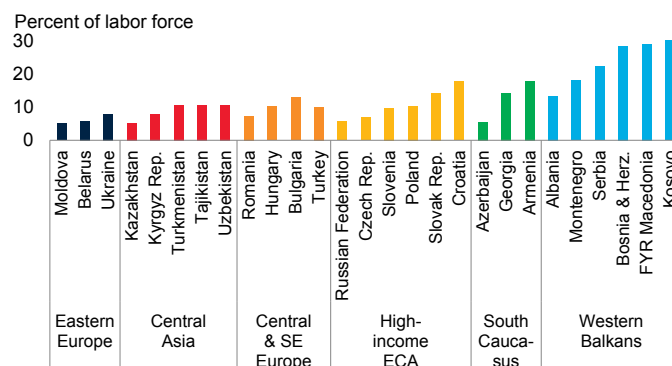
A cross cutting theme for the region is the need for a comprehensive financial sector reforms to clean up bank balance sheets. Although bank capital and provisioning are above regulatory minimums, high non-performing loans (Figures 2.19) continue to weigh on growth—despite recent improvements in Hungary and Romania—by reducing the profitability of banks and constraining new lending for productive activities. High foreign liabilities pose additional risks to the banking sector (Figure 2.20). This could result in significant contingent liabilities to the public sector (IMF 2015d). Measures to improve bank balance sheets could include better collateral enforcement, fostering more out-of-court debt restructuring, strengthening insolvency frameworks, and clearing bottlenecks in overloaded court systems.

Current low commodity prices are also a reminder to commodity-exporting countries of the importance of diversification. Diversification efforts could include efforts to build institutions that reduce economic volatility, change incentives away from non-tradables, encourage export diversification, and build human capital (see Chapter 1 for additional discussion).

Some reforms can take a long time to feed into higher productivity and sustained growth. However, some reforms can have a considerable effect on economic activity even in the short term. For example, policies can ease short-term transition costs by assisting workers to move to new jobs, or they can speed up the repair of capital bases of lending institutions (see Chapter 1 for additional discussion).

FIGURE 2.18 Unemployment, 2013

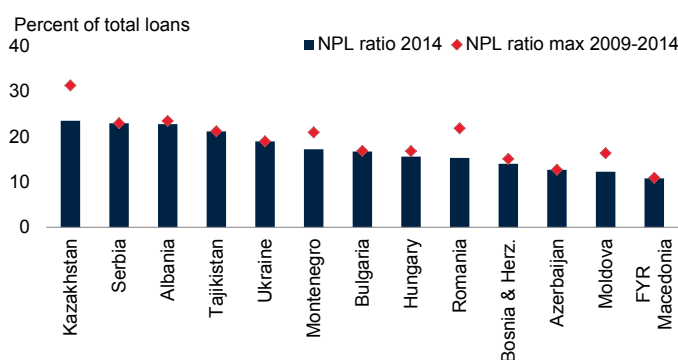
Despite the nascent recovery, output remains below potential and unemployment rates high in the western part of the region.



Source: World Bank, Haver Analytics, Eurostat, Kosovo Agency of Statistics.
 Note: Informal sector (often large) may not be included in the data. ILO definition. May differ from the official estimates, particularly for Belarus.

FIGURE 2.19 Non-performing loans (NPL) ratios

Comprehensive financial sector reforms are needed to strengthen bank balance sheets.



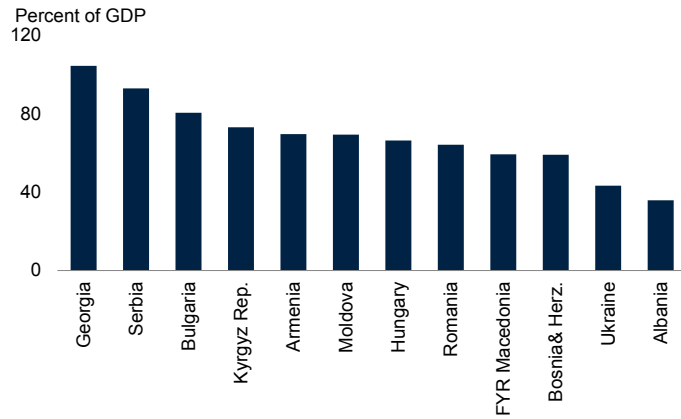
Source: IMF, Financial Soundness Indicators.
 Note: Alternative estimates (using strict definitions) for Ukraine assess nonperforming loans at around 32 percent of total loans in 2014.

In Ukraine, which faces extraordinary challenges, the reform agenda should focus on governance reforms, including anti-corruption and judicial measures, deregulation and tax administration reforms, and reforms of state-owned enterprises to improve corporate governance and reduce fiscal risks. Broader energy sector reforms will increase energy efficiency and foster energy independence.

Finally, recent floods in Bosnia and Serbia, which destroyed about 15 percent of Bosnia’s output and 2 percent of Serbia’s, point to the wider vulnerabilities unfavorable weather conditions pose to the region. Many of the countries in the region are facing

FIGURE 2.20 Net foreign liabilities, 2014

High foreign liabilities pose risks to the banking sector.



Source: World Bank and IMF International Financial Statistics.

Note: Latest data available for Albania, Bosnia and Herzegovina, Bulgaria, Kyrgyz Republic, Romania, Serbia, and Ukraine is for 2013.

warmer temperatures, a changing hydrology, and more extreme climatic conditions (droughts, floods, heat waves, forest fires, earthquakes), some of them with increased frequency. In addition to the impact on crops and livestock, the changing seasonality of river flows undermines hydropower production, a particularly important sector in Albania, the Kyrgyz Republic, and Tajikistan. Planning for extreme weather events will help to support preparedness for a variety of other emergencies.

TABLE 2.3 Europe and Central Asia forecast summary

(Annual percent change unless indicated otherwise)

	00-10 ^a	2011	2012	2013	2014e	2015f	2016f	2017f
Developing ECA, GDP at market prices ^b	4.6	6.1	1.9	3.7	2.4	1.8	3.4	3.6
Developing ECA, GDP at market prices, excl. Ukraine	4.6	6.2	2.1	4.1	3.2	2.6	3.5	3.7
(Average including countries with full national accounts and balance of payments data only)								
Developing ECA, GDP at market prices	4.6	6.2	1.9	3.7	2.4	1.8	3.3	3.6
GDP per capita (units in US\$)	4.1	5.4	1.2	3.0	1.7	1.2	2.7	3.0
PPP GDP	4.8	5.9	2.0	3.6	2.2	1.5	3.3	3.6
Private consumption	5.2	7.0	2.3	5.1	2.1	2.4	3.5	3.8
Public consumption	3.1	2.7	4.1	3.8	4.3	3.9	3.5	3.7
Fixed investment	6.1	10.2	-0.7	1.4	1.8	0.1	2.6	3.1
Exports, GNFS ^c	5.9	8.4	4.7	2.0	3.0	4.3	5.0	5.0
Imports, GNFS ^c	6.6	11.0	2.3	4.7	1.5	4.6	5.6	6.4
Net exports, contribution to growth	-0.3	-1.2	0.8	-1.1	0.5	-0.2	-0.4	-0.7
Consumer prices (annual average)	13.9	8.2	8.7	6.2	7.3
Fiscal balance (percent of GDP)	-4.3	0.7	-0.6	-1.2	-1.8	-2.2	-1.7	-1.5
Memo items: GDP								
Broader geographic region ^d	4.6	4.8	2.2	2.2	1.8	0.3	2.3	3.1
EU, Central and Southeastern Europe, West Balkans, and Turkey ^e	3.7	4.9	1.0	2.4	2.8	2.8	3.3	3.4
EU-Central and Southeastern Europe	3.5	2.8	0.4	1.2	2.8	2.8	3.0	3.2
Eastern Europe ^f	5.1	5.6	0.6	0.6	-4.1	-6.1	1.1	2.4
Western Balkans ^g	3.8	1.9	-0.3	2.5	0.4	1.5	2.5	2.9
South Caucasus ^h	12.0	1.8	3.5	5.1	3.2	1.5	2.7	3.1
Central Asia ⁱ	8.2	8.1	5.9	6.8	5.5	3.4	4.4	5.4
Russian Federation	5.1	4.3	3.4	1.3	0.6	-2.7	0.7	2.5
Turkey	3.9	8.8	2.1	4.2	2.9	3.0	3.9	3.7
Ukraine	4.3	5.5	0.2	0.0	-6.8	-7.5	2.0	3.0

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 differ at any given moment in time.

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 2010 U.S. dollars.

c. Exports and imports of goods and non-factor services (GNFS).

d. Broader geographic region includes developing ECA and 6 recently transitioned high-income countries (Croatia, Czech Republic, Poland, Russian Federation, Slovak Republic, and Slovenia.)

e. EU: Croatia, Czech Republic, Poland, Slovak Republic, Slovenia. Central and Southeastern Europe: Bulgaria, Hungary, Romania.

f. Eastern Europe: Belarus, Moldova, Ukraine.

g. Western Balkans: Albania; Bosnia and Herzegovina; FYR Macedonia; Montenegro; Serbia.

h. South Caucasus: Armenia; Azerbaijan; Georgia.

i. Central Asia: Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan, Uzbekistan.

TABLE 2.4 Europe and Central Asia country forecasts

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

	00–10 ^a	2011	2012	2013	2014e	2015f	2016f	2017f
Albania	5.2	2.5	1.6	1.4	1.9	3.0	3.5	3.5
Armenia	7.9	4.7	7.2	3.5	3.4	0.8	2.7	3.0
Azerbaijan	14.9	0.1	2.2	5.8	2.8	1.5	2.6	2.7
Belarus	7.4	5.5	1.7	1.0	1.6	-3.5	-1.0	1.0
Bosnia and Herzegovina	4.0	1.0	-1.1	2.5	0.4	2.0	2.3	2.9
Bulgaria	4.0	2.0	0.5	1.1	1.7	1.1	2.0	2.7
Georgia	6.2	7.2	6.2	3.3	4.8	2.0	3.0	5.0
Hungary	2.1	1.8	-1.5	1.5	3.6	2.4	2.5	2.7
Kazakhstan	8.3	7.5	5.0	6.0	4.3	1.7	2.9	4.1
Kosovo	6.1	4.4	2.8	3.4	2.5	3.0	3.5	3.7
Kyrgyz Republic	4.1	6.0	-0.1	10.9	3.6	1.7	3.2	4.0
FYR Macedonia	1.6	2.3	-0.5	2.7	3.5	3.5	3.8	4.0
Moldova	5.1	6.8	-0.7	9.4	4.6	-2.0	1.5	4.0
Montenegro	3.6	3.2	-2.5	3.3	1.5	3.4	2.9	2.9
Romania	4.1	1.1	0.6	3.5	2.9	3.0	3.2	3.5
Serbia	3.6	1.4	-1.0	2.6	-1.8	-0.5	1.5	2.0
Tajikistan	8.3	7.4	7.5	7.4	6.7	3.2	4.4	5.2
Turkey	3.9	8.8	2.1	4.2	2.9	3.0	3.9	3.7
Turkmenistan	13.6	14.7	11.1	10.2	10.3	8.0	9.0	9.0
Ukraine	4.3	5.5	0.2	0.0	-6.8	-7.5	2.0	3.0
Uzbekistan	6.9	8.3	8.2	8.0	8.1	7.6	7.8	8.0

	00–10 ^a	2011	2012	2013	2014e	2015f	2016f	2017f
Recently transitioned to high-income countries ^b								
Croatia	2.5	-0.3	-2.2	-0.9	-0.4	0.5	1.2	1.5
Czech Republic	3.2	2.0	-0.8	-0.7	2.0	2.4	2.5	2.8
Poland	3.8	4.8	1.8	1.7	3.4	3.6	3.6	3.6
Russian Federation	5.1	4.3	3.4	1.3	0.6	-2.7	0.7	2.5
Slovak Republic	4.8	2.7	1.6	1.4	2.4	2.4	2.7	3.2
Slovenia	2.7	0.6	-2.6	-1.0	2.6	1.7	2.5	2.0

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.

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

b. The recently high-income countries are based on World Bank's reclassification from 2004 to 2014.