# EUROPE and CENTRAL ASIA

*GDP growth in the Europe and Central Asia (ECA) region is estimated to have eased to 2.1 percent in 2015 from 2.3 percent in 2014. The eastern part of the region was hit hard by sharply lower oil prices, geopolitical tensions (resulting, inter alia, in an output collapse in Ukraine), and intra-regional spillovers, especially from the Russian Federation. The western part of the region is benefiting from lower fuel import costs and a moderate recovery in the Euro Area. Growth is projected to accelerate to 3 percent in 2016, helped by a steadying of oil prices, a smaller contraction in Russia, and a recovery in Ukraine that is being underpinned by an IMF-supported stabilization program. The projection assumes a reduction in geopolitical tensions. Risks remain biased to the downside. A deterioration in the geopolitical environment, further falls in oil prices, or financial market turbulence associated with the U.S. interest rate tightening cycle, among other factors, could darken the outlook. Key policy challenges include addressing high domestic and external imbalances, adjusting to low commodity prices, implementing structural reforms to support investment and strengthen market mechanisms, and reducing elevated levels of non-performing loans in banking systems.*

## Recent developments

Regional growth has slowed in recent years, decelerating from 3.9 percent in 2013 to 2.3 percent in 2014, and to an estimated 2.1 percent in 2015 (Table 2.2.1, Figure 2.2.1). Geopolitical tensions associated with Russia-Ukraine relations led to the imposition of international sanctions on Russia, and contributed to a weakening of confidence and investment. The combination of sanctions and lower oil prices have strongly affected Russia, generating adverse spillovers for the region as a whole (Box 2.2.1). Sustained low oil prices continue to dampen activity and expose vulnerabilities. The impact varies considerably within the region. The eastern part has been hit more heavily than the western part, and commodity exporters more than importers.[1] The trajectories of current account balances, foreign reserves, and exchange rates reflect these differences.

The region continues to grapple with a substantial debt overhang from the global financial crisis of 2008, as reflected in high levels of non-performing loans. Both monetary and fiscal policy are constrained by the weakness of output and employment. High inflation and downward pressure on exchange rates, including in the largest economies, limit the scope for more accommodative monetary policy (Figure 2.2.2). Central banks in the eastern part have even had to raise interest rates (Figure 2.2.3). Eroding fiscal buffers and the recognition that part of the slowdown may be structural in nature are increasing the need for consolidation. Uncertainty associated with the tightening cycle by the U.S. Federal Reserve, among other factors, are making external financing conditions more difficult, as evidenced by elevated sovereign spreads.

The eastern part of the region (Central Asia, Eastern Europe, and South Caucasus) has suffered acutely from low commodity prices (Kazakhstan), spillovers from Russia (Belarus, Georgia, Moldova), and conflict (Ukraine). Commodity exporters, especially of oil, are under pressure as persistent low prices move current accounts into

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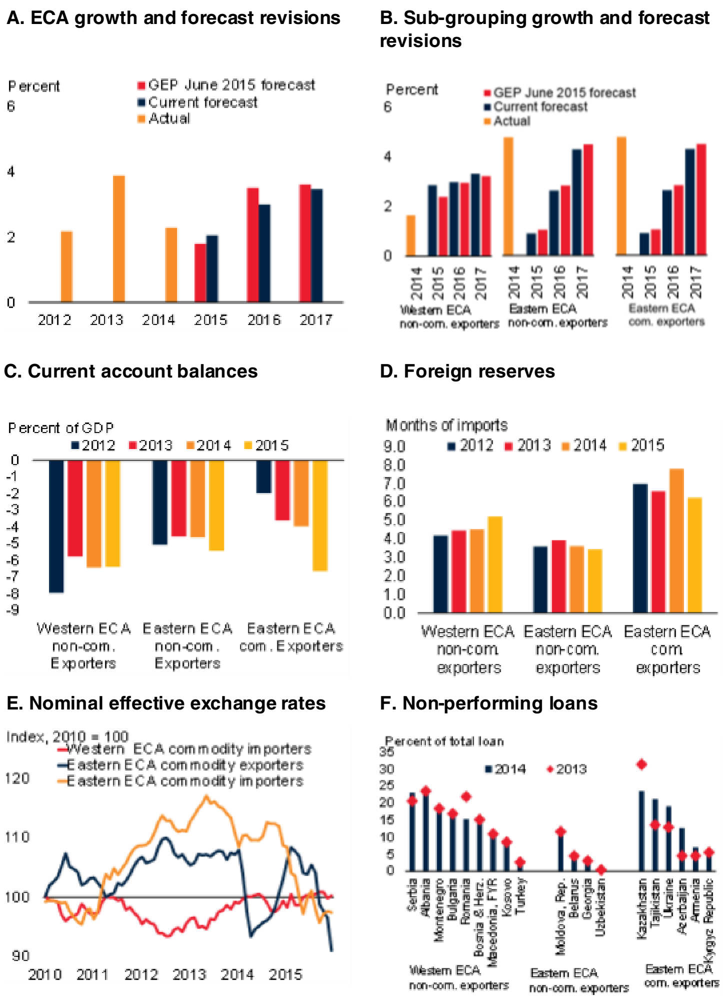
Note: The authors of this section are Christian Eigen-Zucchi and Ekaterine Vashakmadze. Research assistance was provided by Trang Nguyen.

[1] The 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 includes Bulgaria, Romania, and Turkey, as well as the Western Balkans (Albania, Bosnia and Herzegovina, Kosovo, the Former Yugoslav Republic of Macedonia, Montenegro, and Serbia).

**FIGURE 2.2.1 Key indicators**

*Growth has decelerated since 2013. While a pickup is anticipated in the forecast period, prospects have weakened, leading to downward forecast revisions. There are significant differences across the region. Eastern commodity exporters have seen more slippage in current account balances and reserves (but from a stronger starting position), and have faced greater pressure on their currencies. Elevated non-performing loans are a concern mainly among western non-commodity exporters and eastern commodity exporters.*




Sources: World Bank; Haver Analytics; IMF World Economic Outlook, October 2015.
B. C. D. Data for groupings are simple averages for all countries where data is available.
E. The nominal effective exchange rate (NEER) of the grouping is calculated as the median of all countries data.

deficit, push down high levels of reserves, and weaken currencies. Although currency depreciation and exchange rate flexibility may help economies adjust, it can result in accelerating inflation, necessitating tighter monetary policy. As regards fiscal policy, while several commodity exporters had built substantial buffers during the commodity boom years, these are being eroded as budgets swing into deficit, narrowing the space for significant further stimulus.

The economic contraction in Russia is generating negative spillovers to neighboring countries, through trade, investment, and remittances (ADB 2015). Eastern countries, including Armenia, Kyrgyz Republic, Moldova, Tajikistan, and Ukraine, receive substantial remittances from Russia, and these are a consumption-sustaining source of income for many households (World Bank 2015k, Figure 2.2.4). Because of the downturn in Russia and exchange rate effects, remittance flows to the ECA region (expressed in U.S. dollars) contracted in 2014, and are projected to fall sharply again in 2015: more than 15 percent in Ukraine, 30 percent in Tajikistan, and 59 percent in Uzbekistan (World Bank 2015l).

Several countries in the eastern part of the region are especially exposed to weakening external demand, with a large share of exports destined to contracting Russia and Ukraine, or to slowing China and Kazakhstan (Figure 2.2.5). Commodity exporters are exposed to the economic slowdown in China directly through lower export volumes and indirectly through weakened commodity prices in all export markets. Only Turkmenistan and Uzbekistan have been able to sustain robust expansion in 2015 (deploying substantial fiscal buffers to boost spending), though even in these countries growth is slowing as the low price of commodities and steep falls in remittances from Russia reverberate through their economies. Russia is also a key source of foreign direct investment to eastern countries, which may be slowing as Russia grapples with recession.

Economies in the western part of the region are more diversified, have closer economic links with the Euro Area, and tend to be oil importers. With a consumption-led pickup of growth in their largest trading partners in the Euro Area (World Bank 2015m), and the persistence of low fuel prices, the western part has seen strengthening external accounts, firming exchange rates, and easing inflation. These positive factors have helped to maintain a modest rate of growth. Although progress has been made in some countries, elevated levels of non-performing bank loans remain a financial stability concern (Albania, Bulgaria, Romania, and Serbia). Turkey, accounting for about half of developing ECA

GDP, is posting solid growth, despite headwinds from political uncertainty and escalating tensions, especially in the southeast of the country.

Russia has experienced an intensifying recession since late 2014, with GDP off an estimated 3.8 percent in 2015 (Figure 2.2.6). Plunging oil export revenues precipitated a deterioration of the external trade balance and a depreciation of the ruble. This has stoked inflation and undermined consumer confidence. International sanctions imposed in connection with the conflict in Ukraine are restricting access to external finance, which combined with uncertainty around U.S. interest rate tightening has led to elevated sovereign risk spreads. Russian domestic demand, especially investment, has fallen precipitously because of policy uncertainty, lack of confidence, and the high cost of capital. At the same time, the room for policy maneuver has steadily declined. Since an emergency hike of the policy interest rate to 17 percent in December 2014, it was cut by 6 percentage points to 11 percent during 2015. But the scope for further reductions is limited by high inflation. On the fiscal side, the surplus has swung into deficit mainly due to falling oil and gas revenues, which account for over 40 percent of government receipts. The 2015 budget has been revised to reflect more realistic oil prices and macroeconomic assumptions. Budgetary resources in the Reserve Fund were used aggressively to support activity at the beginning of 2015, and continue to be eroded.

Growth in Turkey is estimated to have accelerated to 4.2 percent in 2015 from 2.9 percent in 2014. Activity has been substantially above expectations, despite geopolitical tensions (violence in the Southeast and the refugee crisis emanating from Syria), as well as continuing policy uncertainty that was amplified by the inconclusive June elections. The November elections gave the ruling Law and Justice Party a majority in Parliament, enabling the formation of a government without coalition partners, but policy uncertainty remains, as key economic policy decisions of the new government are awaited. Growth in the third quarter was led by higher government and private consumption. Lower fuel import costs have provided support to the current account balance and to output, but the lira has depreciated substantially so far this year, stoking inflation. Weak exports (especially to Russia, which will fall further with the Russian imposition of sanctions on Turkey) kept the current account deficit at around 5.0 percent of GDP in 2015, despite a substantially lower fuel import bill. Confidence-sensitive portfolio flows play an important role in the external financing picture.

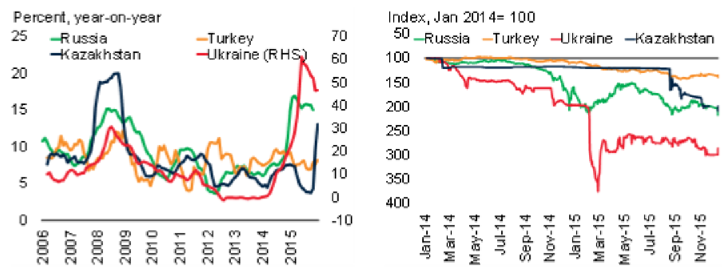
Growth in Kazakhstan is estimated to have slowed to about 0.9 percent in 2015 from the high rates since the 2008 global financial crisis, largely due to weakening external and domestic demand. The fall in oil revenues (crude oil accounts for about

**FIGURE 2.2.2 Inflation and exchange rates for selected countries**

*Inflation remains elevated in the largest ECA economies, as exchange rates have come under pressure against the U.S. dollar.*

**A. Inflation rates**

**B. Exchange rates against the U.S. dollar**



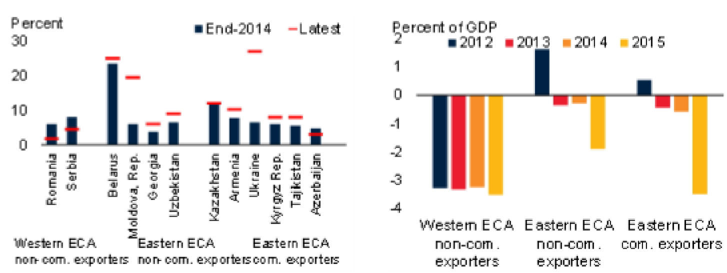

Sources: World Bank; Haver Analytics.
A. Latest observation is November 2015.
B. Latest observation is December 01, 2015. An increase denotes an appreciation.

**FIGURE 2.2.3 Monetary and fiscal policy**

*The scope for countercyclical monetary policy has declined in eastern ECA commodity exporters, as the authorities seek to stem currency depreciation and address elevated inflation. Low energy costs are easing inflationary pressures in western ECA, enabling the maintenance of low policy interest rates. Fiscal buffers have eroded, constraining potential stimulus initiatives.*

**A. Selected countries: Central bank policy rates**

**B. Fiscal balances**

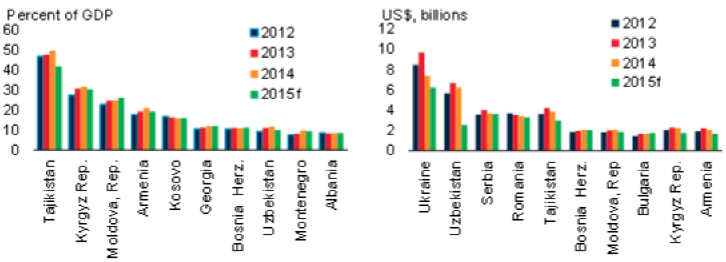



Sources: World Bank; Haver Analytics; IMF World Economic Outlook, October 2015.
B. The data on sub-groupings is a simple average of all countries in each grouping.

### FIGURE 2.2.4 Remittances

*Remittance flows to ECA are large. In many countries they are equivalent to a substantial share of GDP and sustain consumption spending. The combination of recession or weak growth in key remittance sending countries (like Russia) and exchange rate depreciations against the U.S. dollar has translated into declines in remittance flows expressed in U.S. dollars.*

**A. Remittance inflows** **B. Remittance inflows**

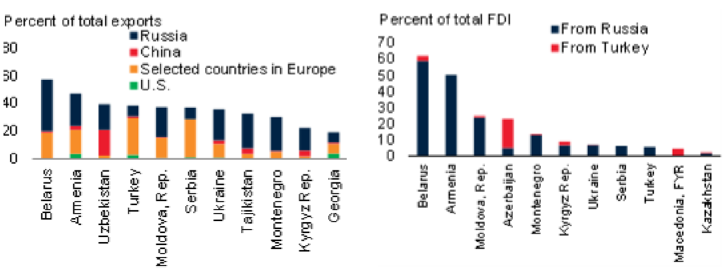



Source: World Bank 2015l.

### FIGURE 2.2.5 Exposure to spillovers through trade and foreign direct investment

*Several countries are exposed to weak external demand, both from the largest economies within the region and from China, and rely on Russia and Turkey for much of their foreign direct investment.*

**A. Export destinations, 2014** **B. FDI inflows for selected countries, 2014**




Sources: World Bank; Haver Analytics.
A. Selected countries in Europe are the 10 largest importers: Austria, Belgium, Germany, France, Italy, Netherlands, Spain, Sweden, Switzerland, and United Kingdom.

70 percent of exports) have combined with spillovers from the deepening recession and currency depreciation in Russia, and the slowdown of growth in China, to reduce export receipts. Domestic demand was slowed by tighter credit, as the authorities raised policy interest rates in defense of the exchange rate. As a result, industrial production stagnated during 2015. The Kazakh tenge has been under severe pressure in exchange markets. The central bank intervened aggressively, spending about 23 percent of official reserves in 2014 and 2015 in order to maintain the rate. In August 2015, the authorities moved to a floating exchange rate, but continued to intervene to steady the market. The tenge depreciated by more than 40 percent against the U.S. dollar in the last 4 months of 2015. Buffers remain large, with reserves still equivalent to more than 15 months of imports (goods and services). Spending from the oil fund helped provide a cushion in 2014, but was reined in during 2015 in recognition that with persistent low oil prices, a large part of the slowdown of growth may be structural rather than just cyclical. Like other oil exporters in the region, Kazakhstan is in the midst of a challenging adjustment period. Progress has been made to bolster the stability of the banking system, with a restructuring that lowered non-performing loans from 23.5 percent at the beginning of 2015 to below 10 percent in August.

With the conflict in the east and the challenging external economic environment, output in Ukraine is estimated to have contracted by 12 percent in 2015, after falling by 6.8 percent in 2014. Industrial activity fell by even more. With the continued depreciation of the exchange rate and a utility tariff adjustment, the inflation rate stood over 50 percent (y/y) for much of 2015. Amid the economic contraction, banks have become increasingly stressed, and their capacity to lend sharply constrained. Exports are down due to disruptions in trade with Russia (which accounted for one-quarter of Ukraine's exports on average in 2010-14), conflict in the east (which damaged metals and mining production), and low commodity prices for metals and agricultural goods (which comprised more than 30 percent of exports in 2012-14). While the current account has been broadly in balance since April, helped by lower fuel costs, the capital account has seen net outflows, as external debt payments have exceeded financing assistance from abroad. Ukraine reached agreement on an $18 billion private debt restructuring deal in September (including a 20 percent write-down for creditors), but remains in a debt dispute with Russia. The authorities announced a moratorium on $3 billion in bond repayments due to Russia in December; negotiations are ongoing. Low investor confidence is reflected in sovereign spreads that are an order of magnitude larger than the wide spreads faced by Kazakhstan and Russia. Through these challenges, the authorities are endeavoring to implement a stabilization program, and fiscal consolidation was ahead of targets noted in the four-year IMF program agreed in March 2015.

## Outlook

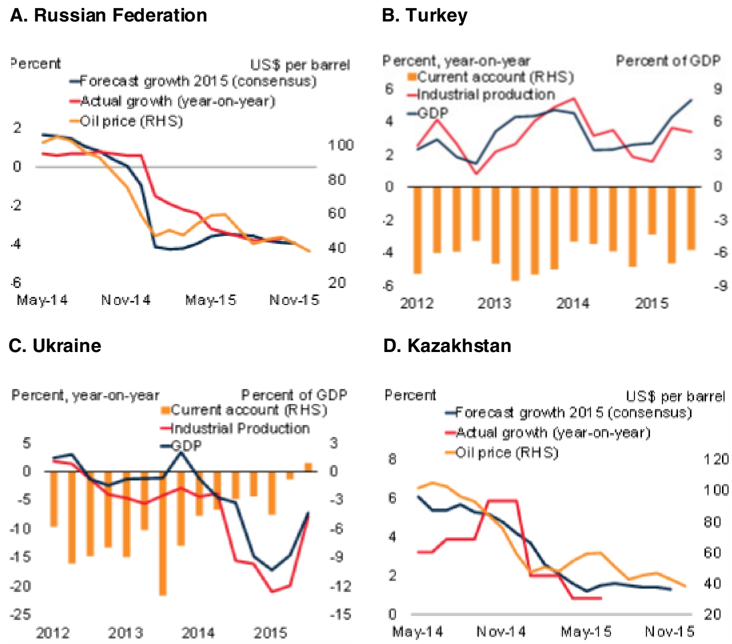
In light of the weaker-than-expected expansion in 2015, the forecast strengthening of growth for 2016-17 has been scaled back and is now expected to average about 3.3 percent in 2016-17, compared with a projection of 3.8 percent made in January 2015. The moderate growth improvement in the forecast period over 2015 depends on the management and mitigation of several key vulnerabilities, including persistent geopolitical tensions, sustained low oil prices, continuing policy uncertainty, and challenging external financing conditions. Prospects vary substantially across the eastern and western parts of the region, and between commodity exporters and importers.

After the sharp fall in 2014 and 2015, commodity prices may decline modestly in 2016 and stabilize in 2017 and 2018, helping support a modest growth pickup in the eastern part of the ECA region in 2016-18. Much depends on Russia, where the forecast assumes that a bottoming out of the ongoing recession in 2016 and the beginning of a recovery in 2017 will help support growth in the rest of the sub-region, including through the provision of FDI. Ukraine's contribution to the regional growth aggregate is likely to swing significantly, as it rebounds from the large 2015 contraction. Still, growth will be subdued compared to the average rates of the previous decade, and vulnerabilities remain.

The western part of ECA should grow moderately in 2016-18—with GDP increases ranging from an average of 2.5 percent in Serbia to 4 percent in Romania. Economic activity and trade balances of the sub-region will benefit from the recovery in the Euro Area, where output is projected to expand by an average of 1.7 percent in 2016-17 with the support of accommodative ECB policies. Some countries also receive direct support for capital spending from European Structural and Investment Funds.[2] Private consumption growth

**FIGURE 2.2.6 Recent developments at the country level**

*Weakening or contracting activity in Kazakhstan, Russia and Ukraine may have bottomed out. Pressures on Turkey have eased despite policy uncertainty.*




Sources: World Bank; Haver Analytics; IMF Regional Economic Outlook Update.
A: Latest observations are December 2015 for oil prices, November 2015 for forecast growth (consensus), and Oct 2015 for actual growth.
B: Latest observations are Q3 2015.
C: Latest observations are November 2015.
D: Latest observations are December 2015 for oil prices, November 2015 for forecast growth (consensus), and June 2015 for actual growth.

will be helped by easing unemployment, lower borrowing costs, and cheaper fuel. However, high reliance on bank finance and weak alignment of legal, tax, and regulatory regimes (both prudential and corporate), have contributed to delays in resolving the debt overhang. These need to be addressed in order to sustain credit growth and boost investment to pre-crisis levels.

In Russia, a fall in economic activity by 3.8 percent this year is expected to be followed by a further 0.7 percent contraction in 2016, before growth turns positive in 2017. Prospects are weighed down by sustained low oil prices and international sanctions. Weakening investor confidence and elevated interest rates are hampering investment, and the steep fall in consumer purchasing power is undermining consumption. Fiscal buffers are strained and the Reserve Fund may be drawn down by about two-thirds by the end of 2016 if, as planned, it is used as the main source of financing for the federal budget deficit in 2016 (projected at about 3

[2] European Structural and Investment Funds comprise five funds aiming "to support economic development across all European Union countries, in line with the objectives of the Europe 2020 strategy." See the European Commission website at http://ec.europa.eu/regional_policy/en/funding/.

percent of GDP). Recovery would be helped by structural reforms that diversify the economy, improve resource allocation, and strengthen corporate governance, as well as by an easing of geopolitical tensions.

In Turkey, growth could remain at about 3.5 percent in 2016-18. Vulnerabilities center on currency depreciation and elevated inflation, which are weakening private consumption. In addition, the continuing need for large capital inflows is a concern, especially since net reserves are modest. While the November elections have returned the ruling party to power with a majority adequate to form a government without coalition partners, policy uncertainty persists. Moreover, lira depreciation raises the debt service burden of the corporate sector, which has large foreign currency exposures. This dampens investment and impinges on growth. Low oil prices and a firming of activity in the Euro Area are helping stabilize the current account deficit at below 5 percent of GDP. An acceleration of growth hinges on de-escalating tensions in the southeast and managing the refugee crisis emanating from Syria.

Growth in Kazakhstan is projected to remain flat in 2016 and pickup in 2017-2018, with the Kashagan off-shore oil field coming online and Russia's economy improving. Weak domestic demand may limit industrial and services growth, however, as households seek to restore savings, firms endeavor to strengthen balance sheets, and the government moves to consolidate fiscal accounts. External demand may also remain weak, as non-commodity trade volumes are subdued. Hence, growth is likely to be less than half the average seen in 2011-14, and far below the 8.3 percent rate averaged between 2000 and 2010.

After a 12 percent contraction in 2015, Ukraine's economy may rebound modestly in 2016-18, supported by an easing of the conflict in the east and continued progress on its IMF-backed reform program. Fiscal consolidation measures have been introduced aiming to lower the deficit from 4.2 percent of GDP in 2015 to 3.2 percent of GDP in 2017. These include cuts in pension benefits, reductions in the government workforce, and an increase in utility tariffs combined with more targeted social assistance. This fiscal tightening may weaken private consumption. Lower fuel costs are helping narrow the current account deficit, but external financing needs remain substantial. While the bulk of Ukraine's debt has been restructured, the moratorium on payments to Russia raises uncertainty around the resolution of the debt dispute. The costs of restructuring banks and reforming state-owned enterprises may pose further challenges to fiscal consolidation.

## Risks

The ECA region faces numerous risks, including possible intensification of geopolitical tensions, persistent low commodity prices, and weakening remittance flows. A new shock associated with the U.S. interest rate tightening cycle could lead to less favorable external financing conditions. Overall, risks appear to be weighted on the downside, and could undermine expectations of continuing moderate growth, improving public finances, and firming external accounts.

Several countries in the region face significant geopolitical risks. An escalation or failure to resolve the conflict in eastern Ukraine would harm the prospects of one of the largest economies in the region and undermine confidence. It might also lead to sustained or sharpened sanctions on Russia, with additional negative spillovers. Similarly, intensified violence and instability in Syria, with the attendant refugee crisis, would have direct impacts on Turkey, the Western Balkans, and other parts of ECA. The economic effects of the refugee crisis over the next 1-2 years may be predominantly fiscal. Over time, as refugees integrate into host countries and find productive employment, the overall economic effects need not be negative (EC 2015, World Bank 2015l).

The structural adjustment to lower commodity prices, especially for oil, has been challenging for the region. With global markets well supplied and demand subdued, commodity prices could remain soft for some time, with a risk of further declines if the slowdown in major emerging markets sharpens and the agreement with the Islamic Republic of Iran leads to a significant rise in oil supplies on world markets over the medium term. This could increase pressure on commodity exporters and generate spillovers on economic partners. Low commodity prices are already complicating the efforts of commodity exporters to sustain buffers and pursue diversification strategies, and a further softening of prices would make this more difficult.

Modest growth and weak exchange rates of remittance sending countries, especially Russia, may delay any rebound in remittances (now at comparatively low levels). This would increase vulnerabilities in countries like Tajikistan that are highly dependent on remittance inflows. The weakness in flows is being compounded by political factors, such as the repatriation of Tajik migrants from Russia after Tajikistan chose not to join the Eurasian Economic Union.

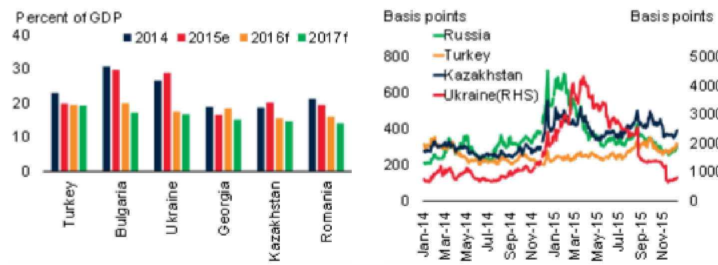
Many ECA countries have substantial external financing needs (Figure 2.2.7), and external credit conditions may become more difficult in part as a result of the U.S. interest rate tightening cycle. An instructive example is the "taper tantrum" in mid-2013, when market participants reassessed the timeframe of the tapering of quantitative easing in the United States, and developing countries quickly felt the impact. At that time, the "Fragile Five" countries came under severe currency pressure as a result of a loss of investor confidence.[3] Today, Kazakhstan, Russia, and Ukraine face similar macroeconomic vulnerabilities, and spreads remain elevated. While a U.S. tightening cycle has been widely anticipated for some time, the first increases in U.S. policy interest rates since 2006 could bring bouts of financial market volatility, uncertainty, and shifts in risk aversion, which could combine with differences in near-term growth expectations to raise financing costs and curtail external financial flows in some countries. Elevated funding costs may also complicate efforts to repair balance sheets and address high non-performing loan levels (EBRD 2015a). In the western part of ECA, challenges in Greece may generate spillovers (especially through financial sector channels) and weaken investor confidence.

[3] The "Fragile Five" comprised Brazil, India, Indonesia, Turkey, and South Africa. Turkey's position is now somewhat improved, but remains vulnerable (Arteta et al. 2015).

**FIGURE 2.2.7 External financing**

*In a context of elevated risk spreads and lift-off of U.S. interest rates, meeting external financing needs may become significantly more costly.*

**A. External financing needs** **B. EMBI spreads**




Sources: World Bank; Haver Analytics; IMF Regional Economic Outlook Update.
B. Latest observation is December 01, 2015.

## Policy challenges

Policy needs to be aimed squarely at mitigating risks and addressing vulnerabilities, while boosting growth trajectories. Helped by stabilizing commodity prices and a more favorable economic impetus from Russia, the authorities will need to rebuild buffers, including the scope for implementing countercyclical monetary and fiscal policy (IMF 2015f). Structural reforms will also be essential to boosting long-term growth potential.

The scope for countercyclical monetary policy is mixed across the region, as the authorities seek to balance growth and stabilization goals (Figure 2.2.3). In many instances, this depends on whether or not the country is a commodity exporter, and how the vulnerabilities associated with low prices have been managed.

Some oil exporters (Kazakhstan and Russia) have had to implement pro-cyclical policy tightening to contain accelerating inflation and bolster weakening currencies. Allowing further currency depreciation could raise financial stability issues to the extent that debt is denominated in foreign currencies and debt service becomes more difficult. Countries with sizable reserves have intervened aggressively in foreign exchange markets in order to support their currencies and smooth the adjustment process (Kazakhstan in 2014 and 2015, Russia in 2014). In countries where reserves may be insufficient for credible and sustained foreign exchange market intervention, and foreign currency exposures threaten financial stability in the event of depreciation, capital outflow restrictions could be considered—as long as they are accompanied by credible macroeconomic, financial, and structural policies to restore long-term growth and reduce vulnerabilities.

In the western part of ECA, composed mainly of oil-importing countries, sustained low oil prices are easing pressure on exchange rates and helping dampen inflation. This has provided room to maintain low interest rates or reduce them further to support growth (Romania and Serbia).

Monetary policy going forward may be complicated by the U.S. interest rate tightening cycle. Higher U.S. rates could limit the scope for accommodative monetary policy in some ECA countries, which has been helping reduce borrowing costs and support efforts to repair bank balance sheets. Distressed assets held by banks are a cause for concern, calling for measures to recapitalize banks and address problem loans, as well as longer-term reforms to improve governance, particularly in state-owned banks. Enhanced supervision and prudential monitoring are needed where credit and solvency risks are exacerbated by dollarization of the banking system, as in several countries of the South Caucasus and Central Asia.

Fiscal policy has varied considerably across the region. Many countries that were negatively affected by the oil price declines (and spillovers from Russia) implemented expansionary fiscal policy to cushion their slowdowns. Those less affected (or benefiting from smaller fuel import bills) used the opportunity to build fiscal buffers and lower fuel subsidies. Hence, there is substantial heterogeneity across the region, with eastern commodity exporters and others seeing a significant erosion of fiscal buffers from positions of surplus in 2012, while western countries strengthened public accounts but with deficits still averaging between 3 and 4 percent of GDP (Figure 2.2.3).

Many oil exporters have had to tap into their reserve funds. But with buffers falling and the recognition that the growth slowdown may be in large part structural rather than cyclical, these countries are entering a period of fiscal consolidation that may further dampen growth. They face particular challenges in seeking to rebuild fiscal space, as the fiscal break-even oil prices in many instances are far above the 2015 average of under $51/bbl.

Much of western ECA has benefitted from easing fiscal pressures in 2014 and 2015, helped by lower fuel costs. Still, several countries (Albania, Bosnia and Herzegovina, Kosovo, Former Yugoslav Republic of Macedonia, and Serbia) have had substantial budget deficits for much of the post-2008 period, and will need to accelerate fiscal consolidation in order to build fiscal space and strengthen buffers. These will be important not only to enable counter-cyclical fiscal policies going forward, but also to enhance the effectiveness of fiscal stimulus, should it be needed in the future.

In a context of slowing growth, structural reforms aimed at addressing supply side bottlenecks and boosting potential growth become all the more important. Developing and articulating a clear program of reforms can help differentiate investor sentiment and support growth. While implementation remains challenging, with benefits typically felt only in the medium and long term, they are essential and can play an important role in addressing vulnerabilities.

In the eastern part of ECA, there is substantial scope to enhance competition and ease administrative burdens (Belarus, Moldova and Ukraine), reduce energy subsidies (Azerbaijan, Tajikistan and Uzbekistan), and facilitate regional integration (as through the Eurasian Economic Union). Governance reforms will also be important to improving medium-term prospects, especially restructuring state-owned enterprises (Belarus) and implementing legal changes aimed at combating corruption and strengthening the rule of law (Turkmenistan and Ukraine).

More rapid growth in the western part of the region will hinge on supporting a rebound of investment, which remains subdued compared to pre-crisis levels. Public investment in several countries is constrained by limited fiscal space. Private investment faces headwinds from firms still working off their debt overhangs, and would be helped by improving the business environment and easing regulatory burdens (Albania, Bosnia and Herzegovina, Serbia, and Turkey). In European Union member states (Bulgaria and Romania), investment is being supported by European Structural and Investment Funds, though absorptive capacity remains a challenge. In view of the heavy reliance on the banking sector to fund investment in the region, financial sector reforms can also play an important role in strengthening the capacity to intermediate credit, thereby boosting investment and job creation (Bulgaria, Romania, and Serbia).

**TABLE 2.2.1 Europe and Central Asia forecast summary**

(Annual percent change unless indicated otherwise)

| | 2013 | 2014 | 2015e | 2016f | 2017f | 2018f | 2015e | 2016f | 2017f |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | (Percentage point difference from June 2015 projections) | | |
| **Developing ECA, GDP**[a] | 3.9 | 2.3 | 2.1 | 3.0 | 3.5 | 3.5 | 0.3 | -0.4 | -0.2 |
| **Developing ECA, GDP excl. Ukraine** | 4.3 | 3.1 | 3.3 | 3.1 | 3.6 | 3.6 | 0.7 | -0.4 | -0.2 |
| (Average including countries with full national accounts and balance of payments data only)[b] | | | | | | | | | |
| **Developing ECA, GDP**[b] | 3.9 | 2.3 | 2.1 | 2.9 | 3.4 | 3.4 | 0.4 | -0.5 | -0.3 |
| GDP per capita (U.S. dollars) | 3.0 | 1.5 | 1.4 | 2.3 | 2.9 | 3.0 | 0.3 | -0.4 | -0.2 |
| PPP GDP | 3.8 | 2.1 | 1.5 | 2.8 | 3.4 | 3.4 | 0.1 | -0.5 | -0.3 |
| Private consumption | 5.1 | 0.5 | 1.8 | 3.3 | 3.6 | 3.6 | -0.7 | -0.3 | -0.3 |
| Public consumption | 5.0 | 4.8 | 4.6 | 3.9 | 4.3 | 4.3 | 0.2 | 0.1 | 0.3 |
| Fixed investment | 2.1 | -2.2 | 1.1 | 1.7 | 3.4 | 3.5 | 1.2 | -0.9 | 0.2 |
| Exports, GNFS[c] | 0.6 | 1.2 | -0.3 | 4.7 | 4.8 | 4.9 | -4.1 | 0.0 | -0.1 |
| Imports, GNFS[c] | 4.2 | -3.6 | -1.2 | 4.2 | 5.0 | 5.1 | -5.4 | -1.4 | -1.7 |
| Net exports, contribution to growth | -1.4 | 1.7 | 0.3 | 0.1 | -0.2 | -0.2 | 0.6 | 0.6 | 0.7 |
| **Memo items: GDP** | | | | | | | | | |
| Broader geographic region[d] | 2.2 | 1.8 | 0.2 | 1.7 | 2.7 | 2.8 | -0.1 | -0.6 | -0.4 |
| Central Europe, Western Balkans, and Turkey | 2.4 | 2.8 | 3.6 | 3.3 | 3.4 | 3.4 | 0.8 | 0.0 | 0.0 |
| Central Europe[e] | 1.3 | 2.8 | 3.3 | 3.2 | 3.4 | 3.4 | 0.5 | 0.2 | 0.2 |
| Western Balkans[f] | 2.5 | 0.4 | 1.9 | 2.6 | 3.0 | 3.5 | 0.4 | 0.1 | 0.1 |
| Eastern Europe[g] | 0.6 | -4.0 | -9.1 | 0.5 | 1.7 | 1.7 | -3.0 | -0.6 | -0.7 |
| South Caucasus[h] | 5.0 | 3.2 | 2.1 | 1.3 | 2.0 | 3.1 | 0.6 | -1.4 | -1.1 |
| Central Asia[i] | 6.8 | 5.6 | 2.8 | 3.2 | 4.8 | 4.9 | -0.6 | -1.2 | -0.6 |
| Russian Federation | 1.3 | 0.6 | -3.8 | -0.7 | 1.3 | 1.5 | -1.1 | -1.4 | -1.2 |
| Turkey | 4.2 | 2.9 | 4.2 | 3.5 | 3.5 | 3.4 | 1.2 | -0.4 | -0.2 |
| Ukraine | 0.0 | -6.8 | -12.0 | 1.0 | 2.0 | 2.0 | -4.5 | -1.0 | -1.0 |

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. GDP at market prices and expenditure components are measured in constant 2010 U.S. dollars.

b. Sub-region aggregate excludes Bosnia and Herzegovina, Kosovo, Montenegro, Serbia, Tajikistan, and Turkmenistan, for which data limitations prevent the forecasting of GDP components.

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

d. Includes developing ECA and the following high-income countries: Croatia, Czech Republic, Hungary, Poland, Russian Federation, Slovak Republic, and Slovenia.

e. Includes Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania, Slovak Republic, and Slovenia.

f. Includes Albania, Bosnia and Herzegovina, Kosovo, FYR Macedonia, Montenegro, and Serbia.

g. Includes Belarus, Moldova, and Ukraine.

h. Includes Armenia, Azerbaijan, and Georgia.

i. Includes Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan.

## TABLE 2.2.2 Europe and Central Asia country forecasts

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

| | 2013 | 2014 | 2015e | 2016f | 2017f | 2018f | (Percentage point difference from June 2015 projections) 2015e | 2016f | 2017f |
|---|---|---|---|---|---|---|---|---|---|
| Albania | 1.4 | 2.0 | 2.7 | 3.4 | 3.5 | 3.5 | -0.3 | -0.1 | 0.0 |
| Armenia | 3.3 | 3.5 | 2.5 | 2.2 | 2.8 | 3.0 | 1.7 | -0.5 | -0.2 |
| Azerbaijan | 5.8 | 2.8 | 2.0 | 0.8 | 1.2 | 2.7 | 0.5 | -1.8 | -1.5 |
| Belarus | 1.1 | 1.6 | -3.5 | -0.5 | 1.0 | 1.0 | 0.0 | 0.5 | 0.0 |
| Bosnia and Herzegovina | 2.5 | 0.8 | 1.9 | 2.3 | 3.1 | 3.5 | -0.1 | 0.0 | 0.2 |
| Bulgaria | 1.3 | 1.5 | 2.9 | 2.2 | 2.7 | 2.7 | 1.8 | 0.2 | 0.0 |
| Georgia | 3.3 | 4.8 | 2.5 | 3.0 | 4.5 | 5.0 | 0.5 | 0.0 | -0.5 |
| Kazakhstan | 6.0 | 4.4 | 0.9 | 1.1 | 3.3 | 3.4 | -0.8 | -1.8 | -0.8 |
| Kosovo | 3.4 | 1.2 | 3.0 | 3.5 | 3.7 | 4.0 | 0.0 | 0.0 | 0.0 |
| Kyrgyz Republic | 10.9 | 3.6 | 2.0 | 4.2 | 3.4 | 4.3 | 0.3 | 1.0 | -0.6 |
| Macedonia, FYR | 2.7 | 3.5 | 3.2 | 3.4 | 3.7 | 3.7 | -0.3 | -0.4 | -0.3 |
| Moldova | 9.4 | 4.6 | -2.0 | 0.5 | 4.0 | 4.0 | 0.0 | -1.0 | 0.0 |
| Montenegro | 3.5 | 1.8 | 3.4 | 2.9 | 3.0 | 2.9 | 0.0 | 0.0 | 0.1 |
| Romania | 3.5 | 2.8 | 3.6 | 3.9 | 4.1 | 4.0 | 0.6 | 0.7 | 0.6 |
| Serbia | 2.6 | -1.8 | 0.8 | 1.8 | 2.2 | 3.5 | 1.3 | 0.3 | 0.2 |
| Tajikistan | 7.4 | 6.7 | 4.2 | 4.8 | 5.5 | 5.5 | 1.0 | 0.4 | 0.3 |
| Turkey | 4.2 | 2.9 | 4.2 | 3.5 | 3.5 | 3.4 | 1.2 | -0.4 | -0.2 |
| Turkmenistan | 10.2 | 10.3 | 8.5 | 8.9 | 8.9 | 8.9 | 0.5 | -0.1 | -0.1 |
| Ukraine | 0.0 | -6.8 | -12.0 | 1.0 | 2.0 | 2.0 | -4.5 | -1.0 | -1.0 |
| Uzbekistan | 8.0 | 8.1 | 7.0 | 7.5 | 7.7 | 7.7 | -0.6 | -0.3 | -0.3 |

| | 2013 | 2014 | 2015e | 2016f | 2017f | 2018f | 2015e | 2016f | 2017f |
|---|---|---|---|---|---|---|---|---|---|
| **Recently transitioned to high income countries[a]** | | | | | | | | | |
| Croatia | -1.1 | -0.4 | 1.0 | 1.4 | 1.7 | 2.0 | 0.5 | 0.2 | 0.2 |
| Czech Republic | -0.5 | 2.0 | 4.0 | 2.5 | 2.9 | 2.9 | 1.6 | 0.0 | 0.1 |
| Hungary | 1.9 | 3.7 | 2.8 | 2.5 | 2.7 | 3.0 | 0.4 | 0.0 | 0.0 |
| Poland | 1.7 | 3.4 | 3.5 | 3.7 | 3.9 | 3.9 | -0.1 | 0.1 | 0.3 |
| Russian Federation | 1.3 | 0.6 | -3.8 | -0.7 | 1.3 | 1.5 | -1.1 | -1.4 | -1.2 |
| Slovak Republic | 1.4 | 2.5 | 3.1 | 3.3 | 3.5 | 3.5 | 0.7 | 0.6 | 0.3 |
| Slovenia | -1.1 | 3.0 | 2.4 | 2.1 | 2.0 | 2.0 | 0.7 | -0.4 | 0.0 |

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. Based on the World Bank's reclassification from 2004 to 2015.

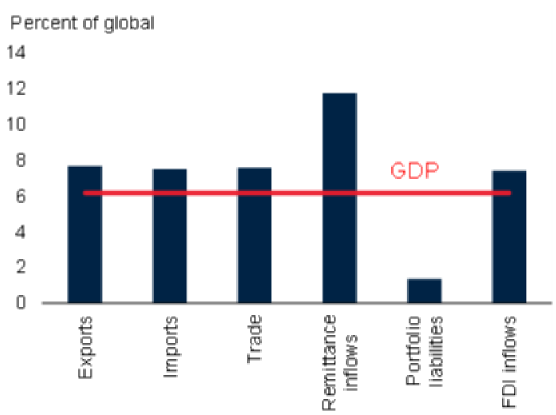
## BOX 2.2.1 Regional integration and spillovers: Europe and Central Asia

*As a region with a generally high degree of openness, Europe and Central Asia (ECA) is vulnerable to spillovers from major advanced economies and emerging markets. Although there is wide heterogeneity, spillovers reflect the region's increasing integration with the European Union and dependence of several large economies in ECA on commodity exports. China is gaining prominence as a trading partner especially for energy exporting economies. Within-ECA ties are pronounced with the Russian Federation, particularly in the eastern part of the region. Estimates suggest that a 1 percentage point growth slowdown in Russia could set back growth in other ECA countries by an average of 0.3 percentage point over two years. Spillover effects from Turkey, the second largest emerging market economy in the region, are small and limited to a few neighboring countries. Encouraging investment into internationally competitive sectors and increasing geographic diversification could lessen vulnerabilities to growth shocks.*

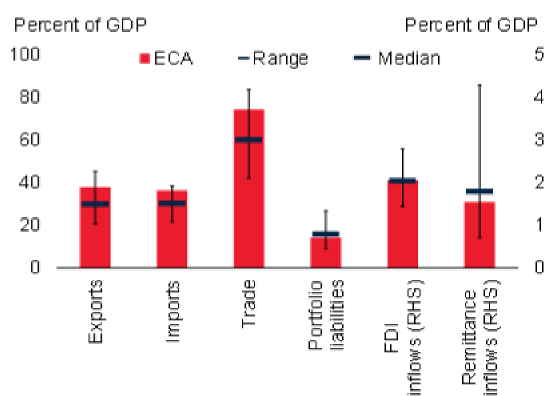
### FIGURE 2.2.1.1 Cross-region comparison

*The ECA is generally very open, despite wide within-region heterogeneity. The region accounts for about 8 percent of world trade flows and 12 percent of international remittances. Exposures to global financial investment tend to be lower, with the exception of Turkey.*

**A. ECA: Share of global activity, trade and finance, 2014**




**B. ECA: Trade and finance in regional comparison, 2014**




Sources: IMF October 2015 World Economic Outlook; IMF International Financial Statistics; IMF Direction of Trade Statistics; IMF Coordinated Portfolio Investment Survey; UNCTAD FDI/TNC database; World Bank Remittance and Migration Database; World Bank World Development Indicators.
B. The red bar denotes exports, imports, trade, remittance inflows, portfolio liabilities and FDI inflows in percent of GDP on average across ECA countries. The vertical line denotes the range of averages for all six developing country regions.

## Introduction

The Europe and Central Asia region is generally very open, despite wide within-region heterogeneity. Its economy represents about 6 percent of global GDP, broadly similar to that of the Latin America and Caribbean region, but about a third less than that of the East Asia and Pacific region. The region accounts for about 8 percent of world trade flows, and 12 percent of international remittances (Figure 2.2.1.1). Trade is equivalent to 74 percent of GDP and remittance inflows about 1.5 percent of GDP. Exposures to global financial investment tend to be lower, with the exception of Turkey.

The region's openness reflects increasing integration with the European Union (EU) and the presence of several large commodity-exporting economies. The latter makes ECA vulnerable to global commodity price fluctuations. Goods and factor market integration with the rest of the world stems from extensive trade and economic agreements, as well as well-linked transportation networks. The Western part of the region includes several members of the EU and is integrated with EU supply chains and labor markets (Figure 2.2.1.2). In the eastern part, notwithstanding trade and economic agreements with Russia, trade and investment from China are gaining prominence (Chapter 3). Meanwhile, the share of the U.S. in regional trade has gradually diminished.

Russia is a prominent source of within-region trade and remittance flows and, to a lesser extent, foreign direct investment. These linkages are tighter in the Eastern part of the region. Integration with Turkey—the second largest regional economy—is limited, and associated spillovers are correspondingly modest.

This box discusses the main spillovers from outside the region, as well as from the two largest economies inside the region, Russia and Turkey. Specifically, it discusses the following questions:

Note: Prepared by Ekaterine Vashakmadze and Duygu Guven, with contributions from Raju Huidrom and Jesper Hanson. Research assistance was provided by Trang Nguyen and Qian Li.

## BOX 2.2.1 Regional integration and spillovers: Europe and Central Asia *(continued)*

- How open is the ECA region to global and regional trade and financial flows?
- How large are the potential intra-regional spillovers from the region's two largest economies, Russia and Turkey?

### How open is the ECA region to global and regional trade and financial flows?

Despite wide regional variation, the majority of ECA countries are highly open to global trade (Figure 2.2.1.3). They also receive substantial FDI and remittance inflows, especially from the Euro Area. Most countries in the region, with the exception of Turkey, receive limited portfolio inflows.

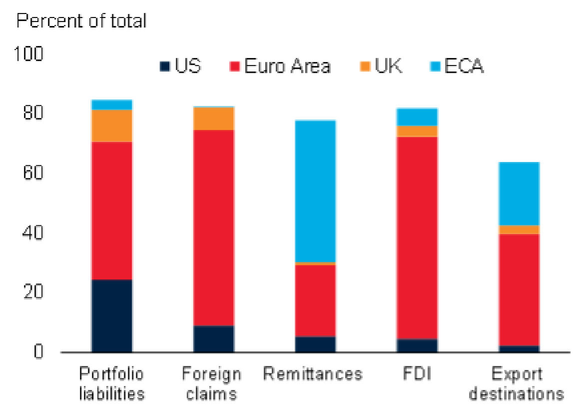
**Integration with the Euro Area.** ECA countries, like those in other developing regions, are predominantly linked to the major advanced countries in their proximity: the Euro Area is the single largest trading partner and source of financial flows to ECA. In addition to geographical proximity, interlinkages with the Euro Area also reflect that most countries in the western part of the region are members of the EU or have European Association Agreements in place. This has deepened supply-chain integration and encouraged labor mobility. ECA's trade with the Euro Area rose from negligible levels in the 1990s to over 50 percent of total trade in 2014, including for the eastern part of the region (over 40 percent in Azerbaijan, Kazakhstan, and Russia, and over 25 percent in Armenia, Belarus, Georgia, and Ukraine). The EU is the primary source of remittances for the Western Balkans (Albania, Bosnia and Herzegovina, Kosovo, FYR Macedonia, Montenegro, Serbia) and to a lesser extent, for Armenia, Georgia, and Moldova. They amount to around 10 percent of GDP in Kosovo and Moldova, 7 percent of GDP in Albania, and about 2 percent of GDP in Armenia and Georgia.

**A tilt towards China.** Trade with China has increased sharply since 2009, especially for energy-exporting economies like Azerbaijan, Kazakhstan, Russia, and Turkmenistan, where exports to China surpassed 10 percent of total exports in 2014 (Figure 2.2.1.4). Over the medium term, trade with China should continue to grow as new pipelines between the major energy exporters (Kazakhstan, Uzbekistan, Russia) and China are constructed, and the on-going negotiations of free trade agreements between China, Georgia, and Moldova are approved and implemented.

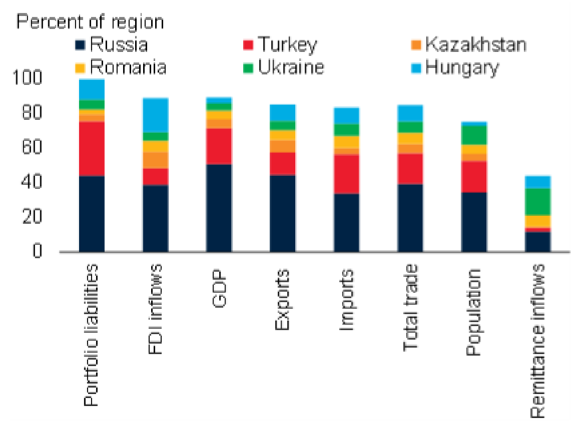
**FIGURE 2.2.1.2 Main features of the ECA region**

*There are deep trade and remittance networks within the region and with the Euro Area. Intra-region flows of remittances are large. Russia and Turkey together account for more than 50 percent of the region's GDP and exports.*

**A. Regional Integration, 2014**




**B. Six largest economies of the region (average 2011-14)**



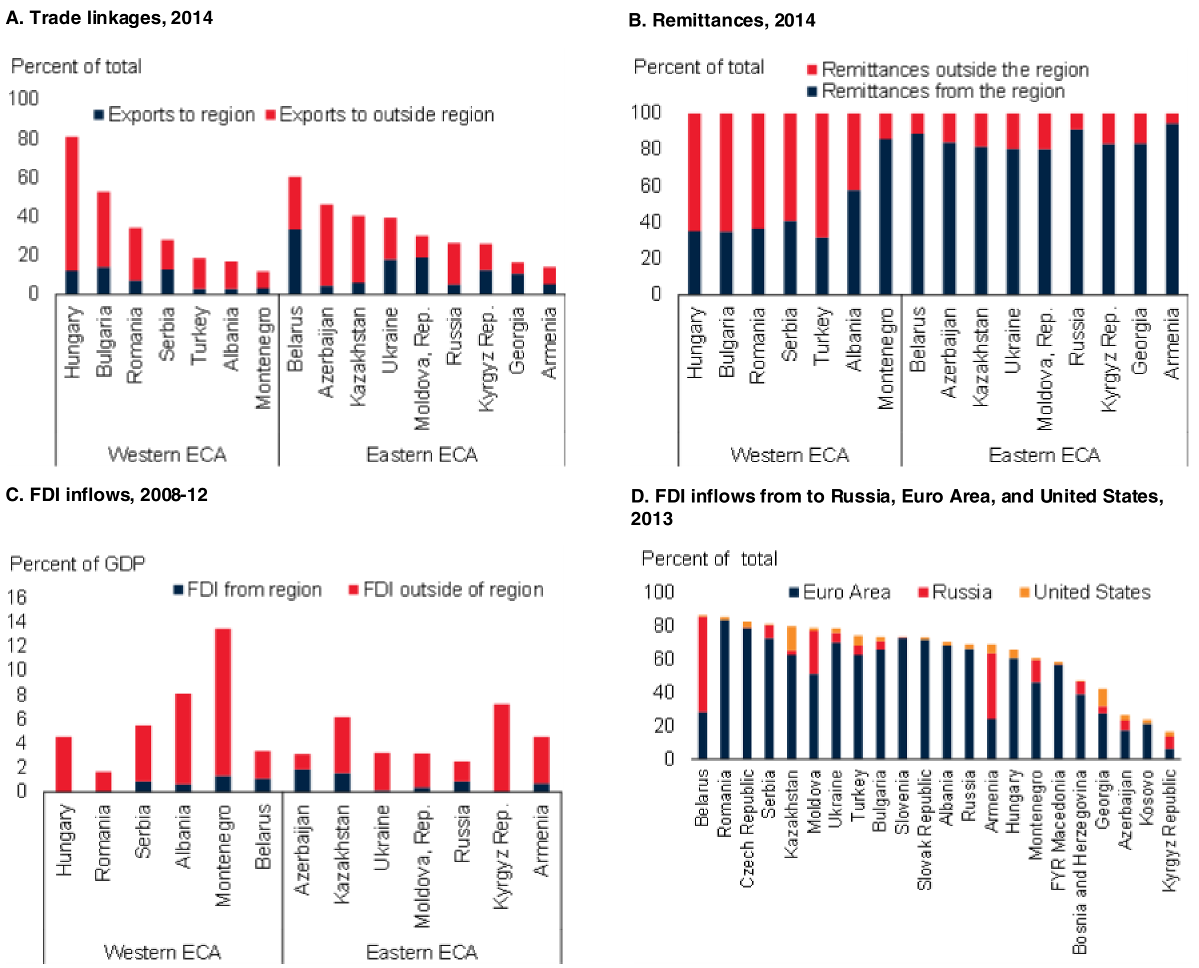

Sources. IMF World Economic Outlook; IMF International Financial Statistics; IMF Direction of Trade Statistics; IMF Coordinated Direct Investment Survey; World Bank; International Investment Position.
A. ECA countries include: Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Czech Republic, Georgia, Hungary, Kazakhstan, Former Yuguslav Republic of Macedonia, Moldova, Montenegro, Poland, Romania, Serbia, Tajikistan, Turkey, Turkmenistan, Ukraine, Uzbekistan, and Russia.
A. B. Portfolio liabilities denote stock of portfolio investment liabilities.

**Within-region ties.** Within-region ties to Russia are particularly strong regarding trade and remittance flows. Direct economic ties with other large economies in the region, which are predominantly trade-based, have grown rapidly from a low base. Thus, the share of exports to Turkey increased substantially in the 2000s, reaching 20

## BOX 2.2.1 Regional integration and spillovers: Europe and Central Asia *(continued)*

### FIGURE 2.2.1.3 Trade, remittances, and foreign direct investment

*Intra-regional trade integration is divided between east and west. The eastern part of the ECA region is integrated with the rest of the region—especially Russia—through trade and remittances. The western part of the region is integrated with the Euro Area through trade, portfolio flows, FDI, and remittances.*




Sources: IMF; World Bank; UN Comtrade.
Note: Region includes Russia. Euro Area is considered outside the region.

percent of total trade for Georgia and is around 7 percent for Bulgaria, Tajikistan, and Uzbekistan.

**Ties with Russia.** Intra-regional ties are deepest in the Eastern part of the region, mainly reflecting the close links between Russia and its Eurasian Economic Union trade partners (Armenia, Belarus, Kazakhstan, and the Kyrgyz Republic), despite a declining share of Russia in the region's trade.

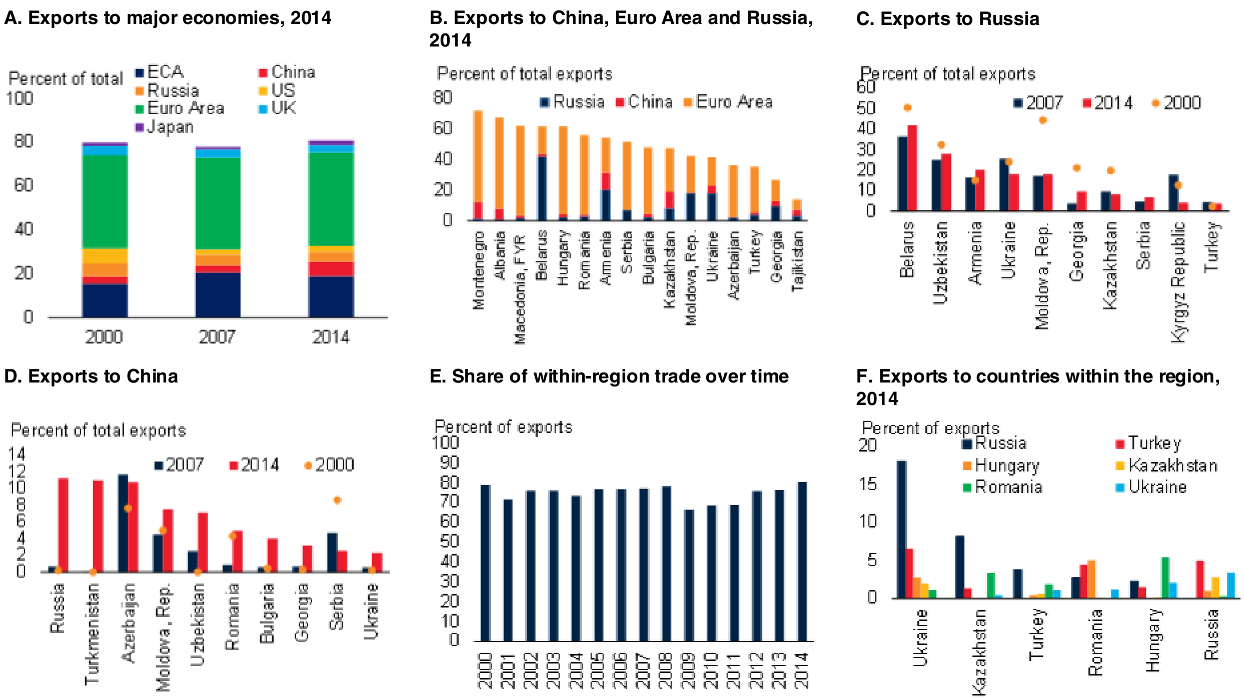
- *Trade*. Russia remains a major trading partner for regional economies, accounting for 8 percent of ECA's trade and 30 percent of trade in some Central Asian countries (Figure 2.2.1.4).[1] This reflects the large size of the Russian economy and the legacy of

[1]In Central Asia, the share of exports to Russia was 15.4 percent of total exports in 2014. Exports to Russia account for about half of Azerbaijan's non-oil exports, while for Armenia, exports to Russia, mostly food and brandy, constitute about 20 percent. Turkmenistan and Uzbekistan export gas to Russia, though they have been increasingly diversifying toward other markets, primarily China. Imports from Russia, especially energy, are also relatively large. For Armenia and Tajikistan, energy imports from Russia amount to about 30 percent of their total energy consumption (IMF 2015g).

## BOX 2.2.1 Regional integration and spillovers: Europe and Central Asia *(continued)*

### FIGURE 2.2.1.4 Main export markets

*Russia is an important export market for the eastern part of the region, whereas the Euro Area is the main export destination for the western parts of the region. Over the 2000s, there has been a gradual shift towards exports to China and, for countries in the South Caucasus, exports to Turkey.*




Sources: IMF; World Bank; UN Comtrade.
Note: Region includes Russia. Euro Area is considered outside the region.

trade integration and economic agreements within the region. The Eurasia Economic Union (EEU) among Armenia, Belarus, Kazakhstan, the Kyrgyz Republic, and Russia, came into force in 2015, aiming to promote closer economic integration. Still, Russia's share in the region's trade has diminished steadily over the past two decades, following trade liberalization and expansion with Europe and more recently with China.

- *Tourism*. Russia's rapidly growing tourism industry has created economic opportunities for the region. Providing tourism-related services to Russia has become an important source of external earnings for several countries in Southeastern Europe (Bulgaria, Croatia, Romania, and the Western Balkans) and the South Caucasus (Azerbaijan, Belarus, Bulgaria, Kazakhstan, Montenegro, Turkey) (World Economic Forum 2015; Figure 2.2.1.5).

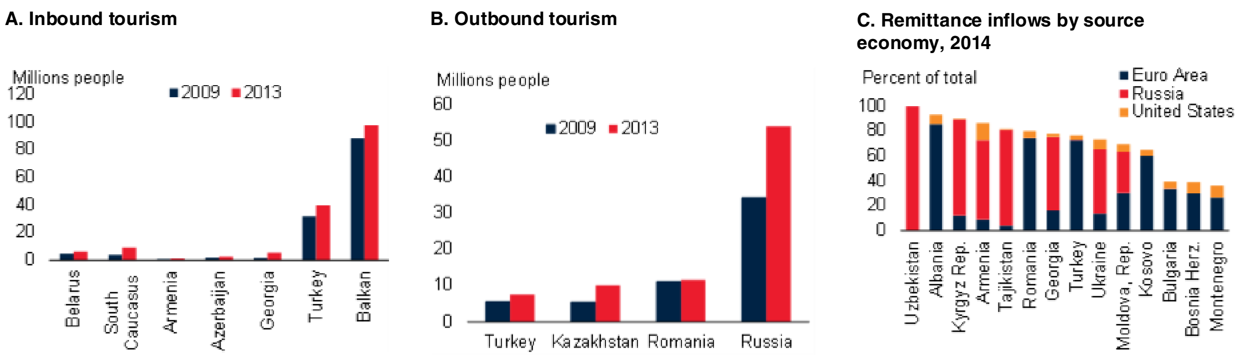
- *Migration and remittances*. Remittances from Russia account for about 62 percent of remittance inflows to the eastern part of the region. Large migration movements have been fostered by free or liberal visa regimes, strong historic ties, and a common language. Opportunities created by a shrinking Russian working -age population in contrast to a growing Central Asian one have also encouraged migration of workers to Russia. Remittances from Russia represent an important source of income for several regional economies in Central Asia (the Kyrgyz Republic, Tajikistan, Uzbekistan), South Caucasus (Armenia, Georgia), and Eastern Europe (Moldova, Ukraine).[2] In 2015, these remittance flows and their real value dropped sharply with the steep recession in Russia and

[2]In 2014, remittances from Russia accounted for about 43 percent of GDP in Tajikistan, 30 percent in the Kyrgyz Republic, and 20 percent in Armenia.

## BOX 2.2.1 Regional integration and spillovers: Europe and Central Asia *(continued)*

### FIGURE 2.2.1.5 Tourism and remittances

*Central Asia relies heavily on remittances from Russia, whereas countries in the South Caucasus receive large remittances from the Euro Area. Outbound tourism from Russia is an important source of income for several countries in the region, including Bulgaria, Georgia, Montenegro, and Turkey.*




Source: World Bank; World Tourism Organization.
A. Inbound tourism denotes non-resident visitors within the economic territory of the country of reference.
B. Outbound tourism denotes resident visitors outside the economic territory of the country of reference.

the large ruble depreciation (World Bank 2015l). In addition, new Russian regulations, which took effect in January 2015, bar immigrants who overstay their one year visas from re-entering Russia for the next ten years, as well as raising fees for migrant laborers and migrants from non-EEU countries. These regulations may encourage many, especially for non-EEU countries, to leave earlier than they had planned.[3] Absorbing returning workers into domestic economies could pose challenges.

- *Bank lending*. Direct cross-border lending by Russian banks is limited, but Russian-owned banks account for about 10 percent of banking system assets in several countries (Belarus, Kazakhstan, Ukraine) (Stepanyan et al. 2015). Some Azerbaijani and Kazakh banks have subsidiaries in Russia, but their assets are small (about 2 percent of the home country's GDP). Latvia is the recipient of large non-resident deposits, equivalent to about 50 percent of total deposits, much of which is presumed of Russian origin (Stepanyan et al. 2015).

- *Foreign direct investment*. Russian foreign direct investment accounts for a sizeable share of foreign direct investment in Armenia, Belarus, and the Kyrgyz Republic (all members of the EEU), as well as in Tajikistan.

### How large are the potential intra-regional spillovers from the region's two largest economies, Russia and Turkey?

Reflecting openness and substantial commodity exports, the ECA region is more vulnerable to growth shocks originating outside the region than within (Chapter 3). Nevertheless, strong within-region trade, finance and remittance links are reflected in sizeable spillovers, especially from Russia.

In addition to the trade and financial channels for the transmission of growth shocks within the region, there may be significant spillovers through less measurable channels, including through policy and confidence (Clinton et al. 2010). To capture direct as well as indirect effects, a Bayesian structural vector autoregression model is estimated for 1998Q1-2015Q2. For each country, the variables included are as follows, in order they are used in the model: growth in the rest of the world; the JPMorgan Emerging Market Bond Index; growth in Russia and Turkey; trade-weighted average commodity

[3] Hundreds of thousands of migrant workers are reported to have returned to Tajikistan, Uzbekistan and, to a lesser extent, the Kyrgyz Republic (EBRD 2015b).

**BOX 2.2.1 Regional integration and spillovers: Europe and Central Asia *(continued)***

prices; growth in the affected country; and the real effective exchange rate of the affected country. Explicit trade linkages should not affect estimation results, since the VAR model does not explicitly include variables for direct trade links, it is rather estimating direct growth on growth impact. The exercise focuses on estimating the impact of growth shocks in the two largest economies—Russia and Turkey—on other countries in the region. Spillovers are estimated as the response of growth in a country to a 1 percentage point decline in growth in the source country of the shock (Russia or Turkey).[4]

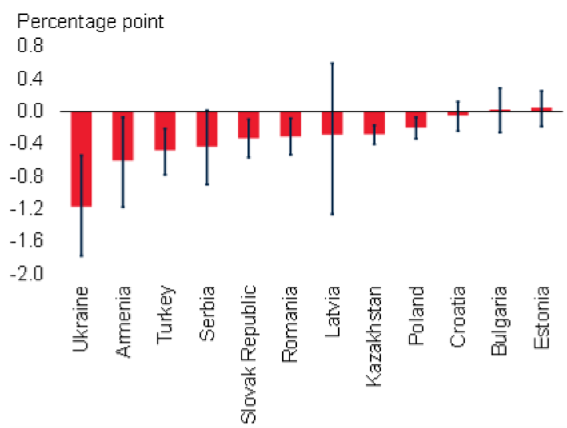
Russian growth shocks have sizeable effects across the region. The estimates suggest that a 1 percentage point decline in Russian growth reduces growth in other ECA countries by an average of 0.3 percentage point over two years (Figure 2.2.1.6). The estimated impact is larger in countries in the South Caucasus (0.6 percentage point in Armenia). The estimated impact for Kazakhstan (0.3 percentage point)—the only central Asian economy where data was available for the estimation—was in line with the average impact for the region. In other countries, the impact is more modest.

Other authors report similar findings (see summary table below). The remittances channel is particularly important for oil importers in the eastern part of the region; the trade channel has weakened over time; the FDI channel is significant for Armenia and Tajikistan; and the financial sector channel is limited, because of the modest presence of Russian banks (Ilahi et al. 2009, IMF 2015g). Overall, the study finds that Russian growth shocks are associated with sizable effects on growth in Belarus, Kazakhstan, and Tajikistan.[5] These authors find that a severe simulated shock, involving a 4 percent decline in Russian GDP, a deterioration in confidence, an increase in capital cost, and a slowdown in the productivity growth of the Russian tradable goods sector, could reduce GDP in CIS countries by 2.5-3 percent below the baseline over one year (IMF, 2015f). This is broadly proportional to the results presented above and the magnitude of spillovers is broadly in line with trade links (Stepanyan et al. 2015). Effects are amplified by remittances from Russia (for Armenia, Moldova and other oil importers in Caucasus and Central Asia) and the impact of depreciations on banking sectors (Kazakhstan). The ongoing crisis in Russia and Ukraine has had limited spillovers on Europe (Husabø 2014). The

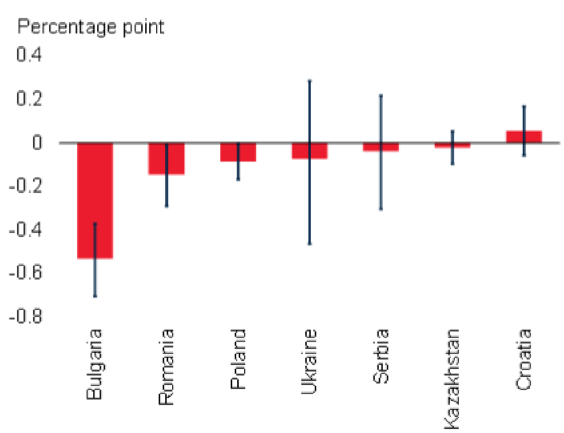
**FIGURE 2.2.1.6 Regional spillovers**

*Spillovers from Russia are sizeable, particularly in the eastern part of the region, which is deeply integrated with Russia through trade and remittances. Spillovers from Turkey are smaller, and mostly local, but may be gaining importance.*

**A. Impact on growth of a 1 percentage point decline in Russia's growth**




**B. Impact on growth of 1 percentage point decline in Turkey's growth**




Source: World Bank.
Note: Cumulative impact response after two years of each country's real GDP growth to a 1 percentage point decline in Russia's or Turkey's growth. Based on estimates of a structural VAR using data from 1998Q2-2015Q2.

[4]To facilitate comparisons across models, responses are scaled by the cumulative change in the source country in the same quarter (1 percentage point, by definition), after one year and after two years. The estimations require quarterly data .

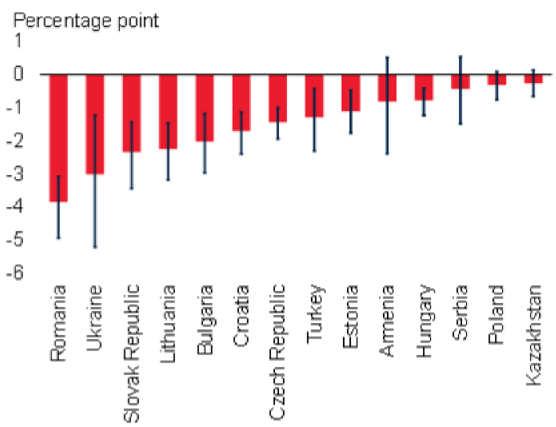
[5]The estimated spillover effects of a one standard deviation shock to the Russian GDP (about 2 percent) peak after two quarters to reach 0.6 percent in Belarus, 1.7 percent in Kazakhstan, and 2 percent in Tajikistan. The impact would last between 3 and 6 quarters. The estimated effects are less significant in Georgia and the Kyrgyz Republic and not significant in Moldova and Uzbekistan.

**BOX 2.2.1 Regional integration and spillovers: Europe and Central Asia *(continued)***

**FIGURE 2.2.1.7 Spillovers from the rest of the world**

*Global spillovers are larger than within-region spillovers, reflecting the openness of the region, especially to the Euro Area and to world commodity markets.*

**Impact on growth of 1 percentage point decline in the rest of the world growth**




Source: World Bank.
Note: Cumulative impulse response after two years, scaled by cumulative impulse response of growth in source country of shock.
Solid bars represent the median responses and the errors bars represent the 33-66 percent confidence bands.

largest estimates are for countries with sizeable export exposures to Russia (Finland, Latvia, Lithuania, Slovakia, and Slovenia), but even in these cases there is less than 0.5 percentage point decline in growth in response to a negative 1 percent shock in Russia. Others have also found that the effects of shocks from Russian GDP on activity in Baltic countries are not large (Obiora 2009). At most, a 1 percent decline in Russia's GDP reduces Lithuania's GDP by about 0.5 percentage point. These spillovers are relatively weak because of increasing trade and financial integration with the EU and declining trade with Russia (Shiells et al. 2005).

Our estimates suggest that growth shocks in Turkey have smaller, and mostly local, repercussions for countries in the neighborhood. A 1 percentage point decline in growth in Turkey reduces growth in other ECA countries by an average of 0.1 percentage point over two years. The estimated impact is larger in Bulgaria and Romania where a 1 percentage point decline in growth in Turkey reduces growth by 0.5 and 0.2 percentage point, respectively, over two years. Spillovers to other ECA countries are smaller.

Estimated spillovers from the rest of the world are larger than those from either Russia or Turkey. A 1 percentage point decline in the rest of the world growth would reduce growth in ECA countries by 1.7 percentage points over two years (Figure 2.2.1.7). This broadly reflects the deep integration of the western part of the region with the Euro Area, and of the eastern part of the region with global commodity markets.

## Conclusion

ECA is one of the most open developing regions to trade, remittances, and FDI. For historical reasons, it has vibrant intra-regional trade and financial networks, especially in the East of the region, which retains strong ties to Russia despite a gradual shift towards China. The West of the region is deeply integrated into supply chains and, to some extent, labor markets in the EU. Because of this openness, and the presence of several large commodity exporters, the ECA region is more vulnerable to global growth shocks than to shocks originating from within the region. The rapid expansion of economic links with China is shifting the potential source of external disturbances. The eastern part of the region remains vulnerable to a growth slowdown in Russia, through trade and remittances links.

Planned infrastructure investment into regional road and rail corridors, combined with continued trade liberalization and improved business environments, could help diversify the region's trade partners and sources of finance. Barriers to open markets are particularly significant in Central Asia (World Bank 2015f). Reducing these barriers would spur productivity and increase resilience to external shocks. Tariffs remain high in Uzbekistan and Turkmenistan; non-tariff barriers require streamlining in Kazakhstan and Russia; and trade facilitation can be further improved across the region. Current low commodity prices heighten the importance of diversification in commodity-exporting countries, by initiatives to build institutions that reduce economic volatility, change incentives away from non-tradables, penetrate new and dynamic export markets, encourage FDI in new industries, and build human capital (Gill et al. 2014).

**TABLE 2.2.1.1 Summary of the literature**

| Author | Methodology | Results |
|---|---|---|
| World Bank (2016) | Bayesian structural vector autoregression | A 1-percentage-point growth decline in Russia reduces GDP in Armenia and Kazakhstan by 0.6 and 0.3 percentage point, respectively, after two years. Growth shocks in Turkey have a smaller effect on growth in other countries in the region. A 1-percentage-point decline in growth in Turkey reduced growth in the region by 0.1 percentage point on average after two years. |
| Ilahi et al. (2009) | Panel regression; Vector autoregression (VAR). 1997-2008<br><br>Panel: annual data. VAR: quarterly data. | Russian growth shocks have strong effects on Belarus, Kazakhstan, Tajikistan, and, to some extent, Georgia and the Kyrgyz Republic. In Belarus, Kazakhstan, and Tajikistan the spillover effects on GDP growth are 0.6 percent to 2 percent, respectively. The effects are less significant in Georgia and the Kyrgyz Republic, and not significant in Moldova and Uzbekistan. |
| Obiora (2009) | VAR | There are significant cross-country spillovers to the Baltics with those from the EU outweighing spillovers from Russia. Lithuania's GDP response to a one percent shock from Russia occurs contemporaneously with growth of about ½ percent. |
| Husabø (2014) | VAR | Spillovers from Russian GDP growth are largest for Finland, Latvia, Lithuania, Slovakia, and Slovenia (i.e., countries with the largest export exposures to Russia). |

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