EUROPE and CENTRAL ASIA

Growth in Europe and Central Asia is projected to fall sharply from 3.1 percent in 2018 to 1.6 percent in 2019. The slowdown partly reflects a sharp weakening of activity in Turkey, which fell into recession in the wake of acute financial market stress in 2018. Regional growth is projected to pick up in 2020-21 as Turkey recovers and the Russian Federation strengthens. Excluding these economies, the rest of the region is expected to moderate. In particular, growth in Central Europe is projected to soften as economies grapple with the slowdown in the Euro Area and binding domestic capacity constraints. Key external risks to the region include spillovers from weaker-than-expected activity in the Euro Area and from escalation of global policy uncertainty, particularly in relation to trade tensions and the United Kingdom's exit from the European Union. Renewed financial pressures in Turkey could also disrupt regional growth.

Recent developments

Growth in Europe and Central Asia (ECA) moderated in 2018 to 3.1 percent—close to its potential rate—while the start of 2019 has been slow amid weakening investment and trade growth. The slowdown followed a strong expansion in 2017, driven by both domestic demand and exports (Figure 2.2.1.A; World Bank 2019c). Regional growth in 2018 suffered from marked weakness in Turkey, where GDP contracted sharply in the second half of 2018. Activity in Central Europe also slowed toward the end of 2018, reflecting weakening domestic demand and challenging external factors amid a slowdown in the Euro Area (Poland, Romania). In contrast, growth in Russia accelerated due to several temporary factors.

Trade weakened across the region in early 2019, as goods trade volumes slowed in tandem with activity in the Euro Area, which is the region's largest export destination (Figure 2.2.1.B). The region's three largest economies—Russia, Turkey, and Poland—faced softening trade prospects amid slowing industrial production growth (Figure 2.2.1.C).

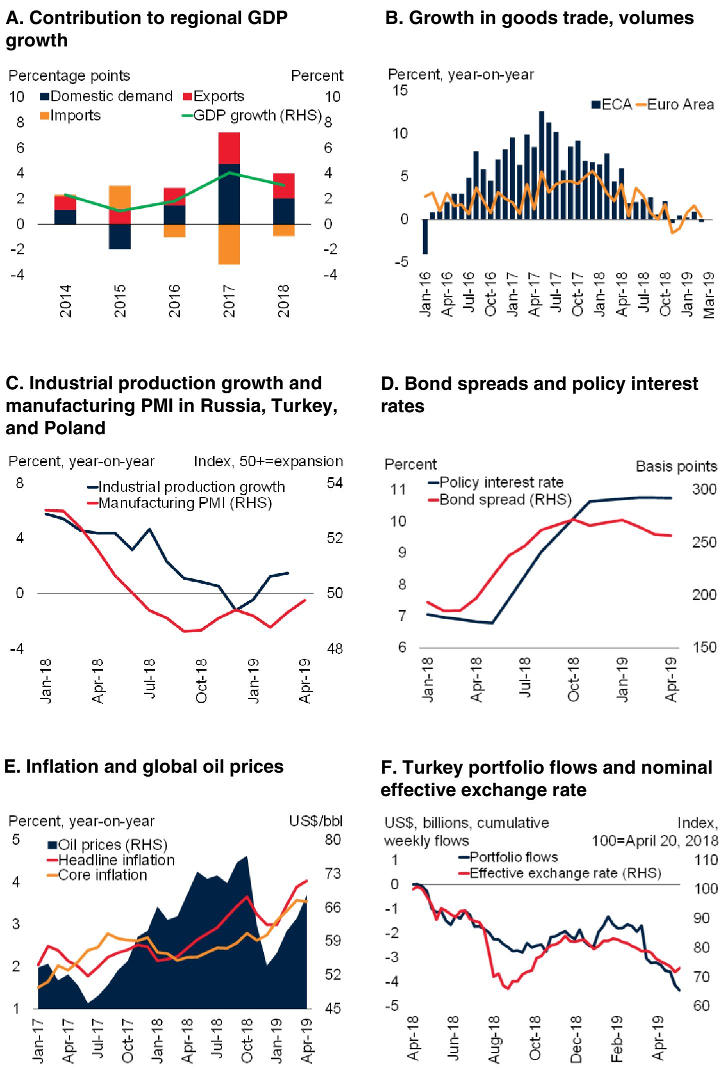
In response to deteriorating global growth prospects, central banks in major economies have provided additional monetary policy accommodation since the start of 2019, resulting in easing global financing conditions. The tightening cycle in monetary policy in 2018 has paused in ECA, with some economies cutting policy rates (Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyz Republic, North Macedonia, Ukraine) or leaving them unchanged in 2019, but overall policy rates in some large ECA economies remain higher than in 2018 (Figure 2.2.1.D; Russia, Turkey). Fiscal policy has also loosened in 2019, resulting in widening government deficit-to-GDP ratios (Belarus, Kyrgyz Republic, Poland, Romania). Public debt has increased by over 10 percentage points of GDP since the global financial crisis, reaching 45 percent at the end of 2018. Inflation has been trending up in the region since the start of 2019 (Armenia, Azerbaijan, Bulgaria, Croatia, Georgia, Hungary, Kosovo, Moldova, Montenegro, Poland, Romania, Russia, Serbia, Tajikistan), driven in part by rising oil prices (Figure 2.2.1.E).

Activity strengthened somewhat in Eastern Europe, the South Caucasus, and Central Asia in 2018, with all three subregions benefiting from firming growth in Russia via close trade and financial linkages. However, the earlier boosts in Eastern Europe from improved agricultural

Note: This section was prepared by Collette M. Wheeler. Research assistance was provided by Mengyi Li and Julia R.R. Norfleet.

FIGURE 2.2.1 ECA: Recent developments

Growth in ECA eased in 2018 and early 2019 on weakening exports to the tightly linked Euro Area. Inflation has risen owing to a combination of oil price movements and currency depreciations, which has forced many central banks to maintain higher policy interest rates in 2019. Turkey's financial market stress was accompanied by large financial outflows, and the subsequent weakness in Turkish economic activity has weighed on regional growth.



Source: CPB Netherlands Bureau for Economic Policy Analysis, Haver Analytics, Institute of International Finance, J.P. Morgan, World Bank.

Note: For sample coverage, refer to Table 2.2.1.

A. Aggregate growth rates calculated using 2010 constant U.S. dollar GDP weights. Data for 2018 are estimates. Sample includes 18 economies, for which GDP components are available.

B. Last observation is March 2019.

C. Manufacturing PMI are 3-month moving averages. PMI is the Purchasing Managers' Index (PMI). Readings above 50 indicate expansion, readings below indicate contraction. The aggregates are calculated using constant 2010 U.S. dollar GDP weights. Last observation is April 2019 for manufacturing PMI, and March 2019 for industrial production growth.

D. Data are 3-month moving averages and calculated using 2010 U.S. dollar GDP weights. Bond spread denotes the average spread of ECA sovereign debt (measured by J.P. Morgan's Emerging Markets Bond Index) over its equivalent maturity U.S. Treasury bond. Sample includes Georgia, Hungary, Kazakhstan, Poland, Russia, Serbia, Turkey, and Ukraine, for which EMBI spreads are available. Last observation is April 2019.

E. Figure shows median inflation values. Headline inflation measured as the percent change in the consumer price index. Sample includes Belarus, Croatia, Hungary, North Macedonia, Poland, Romania, Russia, and Turkey, for which data are available. Last observation is April 2019.

F. Cumulative weekly flows since April 20, 2018. Last observation is May 17, 2019.

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harvests (Ukraine) and robust domestic demand (Moldova) have already begun to fade, as private consumption is dampened by inflationary pressures and weaker remittances in 2019. Robust services sector activity continues to underpin growth in the South Caucasus, with an additional boost coming from manufacturing in Armenia. In Central Asia, strong production in the Kashagan oil field supported the cyclical recovery in Kazakhstan in 2018, but production has flattened in 2019 due to agreed upon cuts with OPEC, as Kazakhstan is a non-OPEC partner. Strong tourist arrivals have continued in early 2019 in the Western Balkans (Albania, Montenegro), while the rebound in Serbia from earlier weather-related disruptions fades.

In Russia, growth picked up to a six-year high of 2.3 percent in 2018, despite tightening international economic sanctions and financial market pressures. The acceleration of activity was supported by the rise in oil prices, a solid contribution from net exports, as well as one-off factors such as energy-related construction projects and the hosting of the World Cup. Industrial activity slowed at the start of 2019, as compliance with agreed upon oil production cuts took effect as a non-OPEC partner. Retail sales volume growth also declined with the onset of the value-added tax hike.

Following strong growth of 7.4 percent in 2017 and solid momentum at the start of 2018, the Turkish economy slowed sharply and entered a recession in the second half of 2018. The downturn was triggered by corporate fragility stemming from rising levels of debt, often denominated in foreign currency, and exacerbated by policy uncertainty. This led to significant pressure on financial markets and the value of the lira. Growth was 2.6 percent for 2018 as a whole. The deceleration of activity was partly driven by significant financial outflows from Turkey amid market concerns about high current account deficits and policy developments, which led to sharp falls in investment and private consumption (Figure 2.2.1.F).

Growth in Poland was a robust 5.1 percent in 2018, partly reflecting European Union (EU) fund transfers and the strongest labor market since the 1990s. Despite this, low inflation and borrowing rates enabled the authorities to undertake accommodative monetary policy and fiscal policy expansion. However, since the end of 2018, core inflation has nearly tripled, accelerating to a 6-year high in April.

Outlook

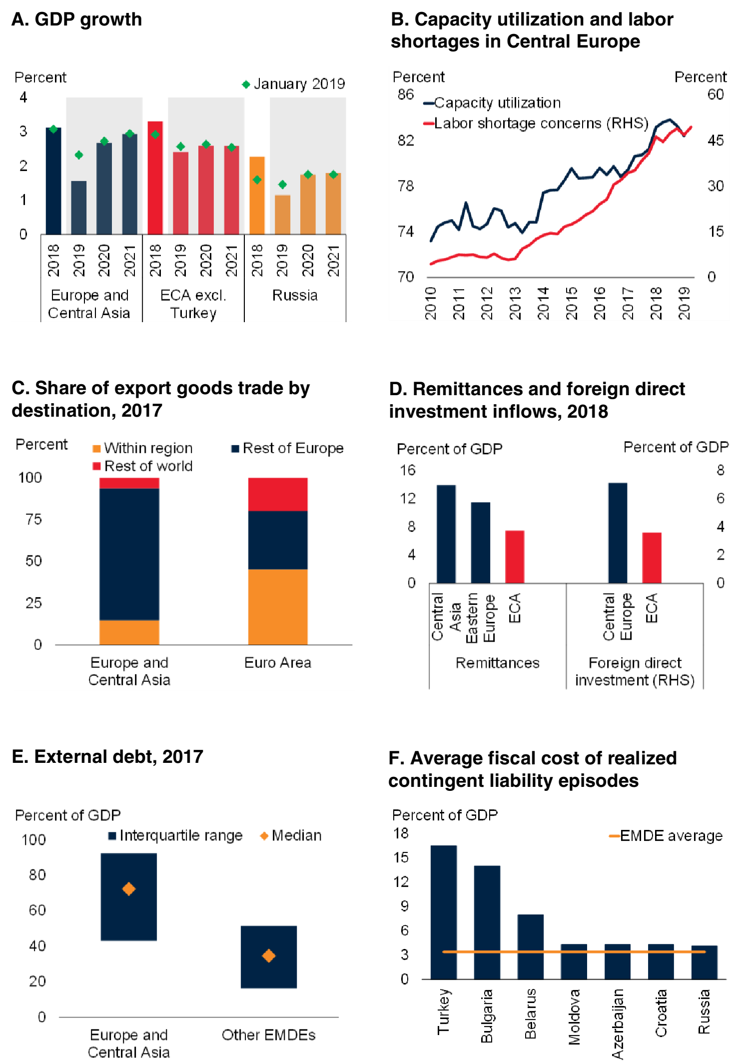
Regional growth is projected to sharply decelerate to a four-year low in 2019, to 1.6 percent, down from 3.1 percent in 2018. This is 0.7 percentage point lower than previous forecasts, reflecting weaker-than-expected activity in Turkey and Russia, as well as some smaller economies. Energy exporters in the region (Azerbaijan, Kazakhstan, Russia) should benefit from the recent rise in oil prices. Regional growth is expected to firm in 2020-21 as Turkey recovers (Figure 2.2.2.A). Excluding Turkey, regional activity is expected to stabilize, with modest growth in domestic demand and a small drag from net exports.

The baseline projection for regional growth is predicated on the assumption that Turkey's economy bottoms out in 2019 and that spillovers from slowing growth in the Euro Area are limited. The baseline also assumes no further escalation in trade tensions between the United States and China or other major trading partners, no disorderly exit from the European Union by the United Kingdom, and an absence of policy missteps in economies that recently suffered acute financial stress—mainly Turkey. Trade relations between the United States and China remain fragile, however, and further escalation in tariffs or retaliatory action could adversely affect economies in the region, particularly energy and metals exporters. Similarly, a deterioration in trade relations between the United States and Europe, particularly with respect to auto tariffs, could also be detrimental to the ECA region. Regional growth also depends on oil prices remaining relatively stable, moderating gradually over the forecast horizon.

The projected weakening of growth is more pronounced in Central Europe than in other ECA subregions because of closer linkages with the

FIGURE 2.2.2 ECA: Outlook and risks

Growth in ECA is projected to fall to 1.6 percent in 2019, reflecting the effects of Turkey's financial stress and weakening activity in other large economies. Capacity constraints are expected to hinder growth in Central Europe, while a further deceleration in the Euro Area or Russia could dent activity in tightly connected subregions. Large external debt leaves regional economies susceptible to sudden shifts in investor sentiment, while the realization of contingent liabilities could pose additional fiscal costs in ECA.



Source: Bova et al. (2016), European Commission, Kose et al. (2017), Organisation for Economic Co-operation and Development, United Nations Conference on Trade and Development, World Bank.

A. Aggregate growth rates calculated using constant 2010 U.S. dollar GDP weights. Shaded areas indicate forecasts. Data for 2018 are estimates. Green diamonds correspond to forecasts from the January 2019 edition of the *Global Economic Prospects* report.

B. Data are calculated using constant 2010 U.S. dollar GDP weights. Sample includes Hungary, Poland, and Romania. Labor shortage is the percentage of manufacturing firms pointing to labor shortages as a factor limiting production. Last observation is 2019Q1.

C. Shares are calculated from exports in millions of U.S. dollars.

D. Figure shows the 2018 averages for remittances, and the 2016-17 averages for foreign direct investment, based on data availability.

E. Figure shows total public and private external debt stocks as a share of GDP in 2017, as in Kose et al. (2017). "Other EMDEs" are all other EMDEs that are not in the Europe and Central Asia region.

F. Fiscal cost is measured as gross fiscal outlays and the change in the government financial position due to a contingent liability realization, as estimated by Bova et al. (2016). The data cover episodes from 1990 to 2014. Types of contingent liabilities include those that involved public sector bailouts for the financial sector, SOEs, the private non-financial sector, PPPs, and others, as defined by Bove et al. (2016).

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Euro Area and increasingly binding domestic capacity constraints (Figure 2.2.2.B). Fiscal stimulus, and the resulting boost to private consumption, will begin to fade in some of the subregion's largest economies by 2020 (Hungary, Poland, Romania). Shrinking working-age populations, partly reflecting emigration to western Europe in recent years, limits medium-term growth prospects in Central Europe. Tepid private investment growth could weaken further in the absence of sustained progress on structural reforms.

Growth is expected to moderate over the forecast horizon in both Eastern Europe and Central Asia. These regions face a more challenging external environment as growth decelerates in major trading partners, such as the Euro Area and Russia. The pace of future growth in both subregions depends on the successful implementation of structural reforms to improve the business environment, achieve debt sustainability, and restructure state-owned enterprises (Belarus, Kyrgyz Republic, Moldova, Ukraine, Uzbekistan; EBRD 2017; Funk, Isakova, and Ivanyna 2017). In Central Asia, modest growth in Russia and low productivity will weigh on activity in the region's largest economy, Kazakhstan.

Growth in the South Caucasus subregion is projected to strengthen to 4.2 percent by 2021, from 2.6 percent in 2018, assuming the continued implementation of domestic reforms and infrastructure investment. Activity in the region's largest economy, Azerbaijan, will be boosted by a new natural gas pipeline coming on stream, although this will be partly offset by the effects of weak credit growth arising from problems in the financial sector. In Armenia and Georgia, growth is expected to firm, partly on account of increased government investment.

Growth in the Western Balkans is projected to be broadly stable, dipping to 3.5 percent in 2019 but returning to 3.9 percent by 2021. This forecast is predicated on political stability and policy uncertainty remaining in check. Infrastructure investment and private consumption will help deliver robust growth in some economies (Kosovo, North Macedonia, Serbia), while a deceleration in public and private investment will slow growth in others (Albania, Montenegro; World Bank 2019d).

In Russia, the projection for 2019 has been downgraded to 1.2 percent, reflecting oil production cuts. Tighter monetary policy, combined with a value-added tax hike at the beginning of 2019, are also contributing to weaker growth momentum in the remainder of 2019. Private investment remains tepid due to policy uncertainty and prospects for slowing potential growth over the longer term due to worsening demographic pressures.

In Turkey, growth is expected to be weighed down by increased inflation and associated pressure on real incomes, banking and corporate sector deleveraging following several years of rapid credit growth, and low business and consumer confidence. Activity is expected to bottom out in 2019, with annual growth contracting 1 percent, but the recent flare up in financial market pressures highlight that downside risks remain sharply elevated. The recovery is assumed to strengthen in 2020 through gradual improvement in domestic demand and continued strength in net exports, provided that fiscal and monetary policy avert further sharp falls in the lira and corporate debt restructurings help avoid serious damage to the financial system.

In Poland, growth in 2019-20 will be buoyed by a recently announced fiscal stimulus package, amounting to roughly 2 percent of GDP. This fiscal expansion aims to boost private consumption through various social transfers and income tax reduction schemes. Nevertheless, growth is expected to slow over the forecast horizon, to 3.3 percent by 2021 from a peak of 5.1 percent in 2018, as domestic capacity constraints and slowing investment weigh on growth.

Over the long term, regional growth could be hindered by worsening demographic trends, in conjunction with tepid productivity and investment growth (World Bank 2018c; Bussolo, Koettl, and Sinnott 2015; EBRD 2018).

Structural reforms that close remaining investment gaps, encourage privatization, and promote FDI and greater participation in global value chains could help boost productivity in the region (EBRD 2015; Gould 2018; Chapter 1). Greater economic integration and regional coordination could also help spur innovation and competition, unleashing the region's growth potential (Kunzel et al. 2019).

Risks

The region's outlook remains subject to significant downside risks. Chief among these is a sharper-than-expected slowdown in ECA's most important trading partner, the Euro Area. The Euro Area purchased the majority of ECA exports in 2017, while total foreign direct investment inflows accounted for over 7 percent of GDP in Central Europe (Figure 2.2.2.C). In Central Asia and Eastern Europe, slowing activity in Russia could impact remittance inflows, which account for an important proportion of income (Kyrgyz Republic, Moldova, Tajikistan, Ukraine; Figure 2.2.2.D).

The financial stress in Turkey has had limited spillovers to the other economies in the region. However, the experience of Turkey is a stark reminder of the risk of sudden shifts in investor sentiment—in particular for countries with large current account deficits or reliance on potentially volatile capital inflows, high external debt loads, or sizable foreign-currency-denominated debt (Belarus, Croatia, Georgia, Kyrgyz Republic, Moldova, Tajikistan, Ukraine; Figure 2.2.2.E).

Increases in policy uncertainty could undermine business and investor confidence in the region. Policy disagreements between the European Union and some Central European countries could deter international investors and reduce fiscal transfers. Election outcomes in some of the region's largest economies could also elevate policy uncertainty. Further escalation of international trade restrictions could have a negative impact on the region, given its openness to trade and capital flows. A reversal of structural reforms remains a risk in many countries, especially Armenia, Azerbaijan, Belarus, Turkey, and Ukraine. Renewed conflict in the Syrian Arab Republic or Ukraine could trigger new sanctions.

Fiscal risks have increased in the ECA region despite more benign global financing conditions in 2019, as corporate debt has risen, with large shares of foreign-currency-denominated debt (Belarus, Kyrgyz Republic, Moldova, Ukraine). The rapid increase in private sector debt in ECA over the past decade has come with growing contingent liabilities for the public sector—potential bailouts of systemic private liabilities would come at a high cost. Past episodes of realized contingent liabilities have imposed large fiscal costs in the region (Figure 2.2.2.F; Bova et al. 2016).

TABLE 2.2.1 Europe and Central Asia forecast summary

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

Percentage point differences from January 2019 projections

	2016	2017	2018e	2019f	2020f	2021f	2019f	2020f	2021f
EMDE ECA, GDP[1]	**1.9**	**4.1**	**3.1**	**1.6**	**2.7**	**2.9**	**-0.7**	**0.0**	**0.0**
EMDE ECA, GDP excl. Turkey	1.5	3.0	3.3	2.4	2.6	2.6	-0.2	0.0	0.1
(Average including countries with full national accounts and balance of payments data only)[2]									
EMDE ECA, GDP[2]	1.8	4.1	3.1	1.5	2.6	2.9	-0.8	-0.1	0.0
GDP per capita (U.S. dollars)	1.4	3.7	2.7	1.2	2.4	2.7	-0.8	0.0	0.0
PPP GDP	1.8	3.9	3.1	1.6	2.7	2.9	-0.7	0.0	0.0
Private consumption	1.4	4.8	3.0	1.4	2.6	2.7	-1.0	-0.6	-0.2
Public consumption	3.1	3.1	1.6	1.6	1.6	1.8	-0.9	-0.6	-0.3
Fixed investment	-0.1	6.3	2.6	-0.8	3.3	3.6	-3.1	-1.3	-1.2
Exports, GNFS[3]	4.0	7.1	5.7	4.0	4.2	4.0	-1.3	-0.1	-0.5
Imports, GNFS[3]	3.5	10.7	3.2	3.2	5.4	5.8	-1.9	-0.4	0.0
Net exports, contribution to growth	0.3	-0.7	1.0	0.5	-0.2	-0.4	0.2	0.0	-0.2
Memo items: GDP									
Commodity exporters[4]	0.7	2.1	2.7	1.8	2.2	2.3	-0.2	0.0	0.0
Commodity importers[5]	3.1	6.0	3.6	1.4	3.1	3.5	-1.2	-0.1	-0.1
Central Europe[6]	3.4	5.0	4.6	3.7	3.3	3.1	0.1	0.0	0.1
Western Balkans[7]	3.2	2.6	3.9	3.5	3.8	3.9	0.0	0.0	0.1
Eastern Europe[8]	0.9	2.6	3.2	2.4	2.7	3.0	-0.5	-0.4	-0.4
South Caucasus[9]	-1.6	2.0	2.6	3.7	3.9	4.2	-0.3	0.1	0.8
Central Asia[10]	2.9	4.6	4.7	4.2	4.0	4.1	0.0	0.0	0.0
Russia	0.3	1.6	2.3	1.2	1.8	1.8	-0.3	0.0	0.0
Turkey	3.2	7.4	2.6	-1.0	3.0	4.0	-2.6	0.0	-0.2
Poland	3.1	4.8	5.1	4.0	3.6	3.3	0.0	0.0	0.0

Source: World Bank.

Note: e = estimate; f = forecast. EMDE = emerging market and developing economies. World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not differ at any given moment in time.

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

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

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

4. Includes Albania, Armenia, Azerbaijan, Kazakhstan, the Kyrgyz Republic, Kosovo, Russia, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan.

5. Includes Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Georgia, Hungary, Moldova, Montenegro, North Macedonia, Poland, Romania, Serbia, and Turkey.

6. Includes Bulgaria, Croatia, Hungary, Poland, and Romania.

7. Includes Albania, Bosnia and Herzegovina, Kosovo, Montenegro, North Macedonia, and Serbia.

8. Includes Belarus, Moldova, and Ukraine.

9. Includes Armenia, Azerbaijan, and Georgia.

10. Includes Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan.

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TABLE 2.2.2 Europe and Central Asia country forecasts[1]

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

	2016	2017	2018e	2019f	2020f	2021f	Percentage point differences from January 2019 projections 2019f	2020f	2021f
Albania	3.3	3.8	4.1	3.7	3.7	3.8	0.1	0.2	0.3
Armenia	0.2	7.5	5.2	4.2	4.9	5.2	-0.1	0.3	0.6
Azerbaijan	-3.1	0.1	1.4	3.3	3.5	3.7	-0.3	0.2	1.0
Belarus	-2.5	2.5	3.0	1.8	1.3	1.2	-0.9	-1.2	-1.3
Bosnia and Herzegovina[2]	3.1	3.2	3.1	3.4	3.9	4.0	0.0	0.0	0.0
Bulgaria	3.9	3.8	3.1	3.0	2.8	2.8	-0.1	-0.2	0.0
Croatia	3.5	2.9	2.6	2.5	2.5	2.4	-0.3	-0.3	-0.2
Georgia	2.8	4.8	4.7	4.6	4.8	5.0	-0.4	-0.2	0.0
Hungary	2.3	4.1	4.9	3.8	2.8	2.6	0.6	0.0	0.2
Kazakhstan	1.1	4.1	4.1	3.5	3.2	3.2	0.0	0.0	0.0
Kosovo	4.1	4.2	4.2	4.4	4.5	4.5	-0.1	0.0	0.0
Kyrgyz Republic	4.3	4.7	3.5	4.3	4.0	4.1	0.9	0.1	0.1
Moldova	4.4	4.7	4.0	3.4	3.6	3.8	-0.4	0.1	0.6
Montenegro	2.9	4.7	4.9	2.9	2.4	2.3	0.1	-0.1	-0.2
North Macedonia	2.8	0.2	2.7	2.9	3.2	3.6	0.0	0.0	0.3
Poland	3.1	4.8	5.1	4.0	3.6	3.3	0.0	0.0	0.0
Romania	4.8	7.0	4.1	3.6	3.3	3.1	0.1	0.2	0.3
Russia	0.3	1.6	2.3	1.2	1.8	1.8	-0.3	0.0	0.0
Serbia	3.3	2.0	4.3	3.5	4.0	4.0	0.0	0.0	0.0
Tajikistan	6.9	7.1	7.3	6.0	6.0	6.0	0.0	0.0	0.0
Turkey	3.2	7.4	2.6	-1.0	3.0	4.0	-2.6	0.0	-0.2
Turkmenistan	6.2	6.5	6.2	5.6	5.1	4.9	0.0	0.0	0.0
Ukraine	2.4	2.5	3.3	2.7	3.4	3.8	-0.2	0.0	0.0
Uzbekistan	6.1	4.5	5.1	5.3	5.5	6.0	0.2	0.0	0.0

Source: World Bank.

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

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

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

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