

Executive Summary

The Europe and Central Asia (ECA) region has been hit by a crisis on multiple fronts. Countries in ECA are facing major, interrelated, external macro-financial shocks. The first is the global growth slowdown leading to falling export market demand. In addition, the prospects for inflows of remittances to low-income countries have been downgraded as economic activity in migrant host countries has declined. The second is the financial deleveraging by major banks and other financial institutions in developed economies, which has markedly reduced the availability, and increased the cost, of external finance across public, corporate, and financial sectors. The third is the recent commodity price changes, which have involved a reversal of much of the commodity price boom of 2007 and 2008. As a result, countries whose exports are focused on commodities have suffered adverse terms of trade pressures, in addition to the quantity shock to export demand. Across countries in the region, unemployment levels have risen while economic activities have collapsed.

The crisis risks reversing the region's recent gains and exposes ECA to significant adverse

economic and social impacts. Over the recovery period following the 1998 Russian crisis through 2006, more than 50 million people moved out of poverty in the region. Poverty fell throughout all the sub-regions of ECA, with the middle-income countries of the Commonwealth of Independent States (CIS) experiencing the largest declines in poverty. Poverty reduction in ECA has been driven largely by growth in mean incomes and rising real wages among the working poor. However, the rapidly deteriorating global economic environment is eroding the region's substantial recent gains, and is threatening the welfare of about 160 million people—close to 40 million people who are poor and about 120 million people who are just above the poverty line.

A. Objectives of the Study

The main objective of the study is to understand the impact of these macroeconomic shocks on household well-being. In particular, it seeks

to understand the key macroeconomic shocks confronted by the region and the impact of such shocks on household welfare, including the effect on household income flows, consumption levels, and liabilities. It will also assess possible strategies to cope with the crisis and manage the adverse social impact.

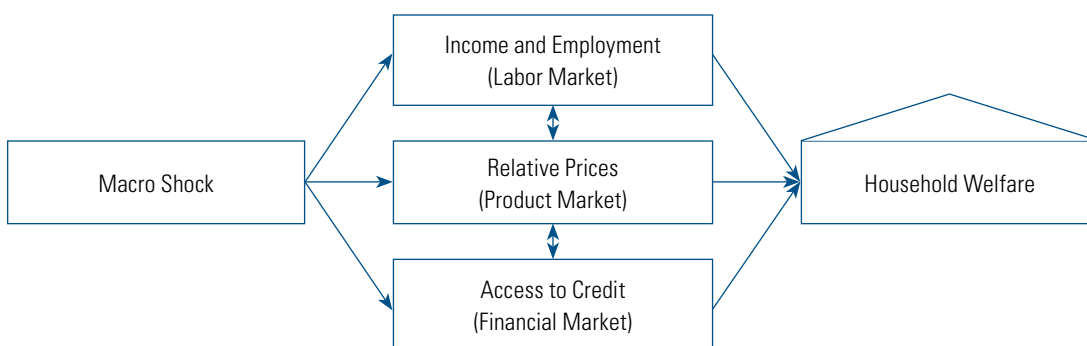
The report examines household vulnerabilities along three main transmission channels. Figure 1 represents a stylized diagram for understanding the impact of macroeconomic shocks to date on household welfare. It reflects a summary of the emerging conceptual and empirical understanding of the social effects of macroeconomic crises experienced in various parts of the world over the past three decades. In brief, the diagram focuses on three main channels through which major macroeconomic shocks—such as the regional growth slowdown or the credit crunch—are transmitted to household welfare. These are the income and employment of members of the household; the relative prices of goods and services they purchase; and their access to finance (including the cost of credit and the burden of servicing debt).

The diagram is stylized and abstracts from several important elements. It is simplified and ignores second-round effects and the consequences of multiple shocks, and does not indicate how the social effects are distributed.

Neither does the diagram take into account the role of wealth effects as a transmission channel of the crisis to households, such as via changes in the prices of property, the value of equity holdings (directly or in pension funds), or indeed expectations of future labor income. Changes in wealth may directly lead to adjustments in the consumption behavior of households or indirectly through the role of certain assets, such as property, as collateral that affects a household's ability to access credit. The heterogeneous asset positions of households mean that such wealth changes will lead to redistributions within the household sector, such as between those long or short in a particular asset. Unfortunately, lack of data on household wealth levels and composition precludes detailed stress testing of such wealth effects. However, the build-up of mortgage indebtedness detailed in the report provides some indirect insight into the growing exposure of households' asset positions to property holdings. The above diagram also does not address the role of government policy (including fiscal and monetary) and social assistance (though social assistance may be thought of as a source of income). Government policy can, in fact, either mitigate shocks or exacerbate them, depending on how it is formulated and implemented. A further transmission channel of the real and financial impacts of the crisis through to household welfare, though not explicitly addressed, is

FIGURE 1

Macroeconomic Shocks and Household Welfare: Stylized Transmission Channels



pension provision. The nature and magnitude of the effects of the crisis via this channel depend crucially on the structure of the pension system, in particular the mix between pay-as-you-go, funded, and voluntary pension systems.

The report analyzes household vulnerabilities by examining credit markets, external prices (food and fuel), and income shocks to date and by assessing their impact on household welfare. Because actual household survey data over the crisis period will typically not be available for some time to come, we use the most recent pre-crisis household data along with aggregate macroeconomic outturns to simulate the impact on households of key economic shocks already taking place. The impact on household well-being is quantified as the change in the household debt service burden, the fall in real income, or movements into poverty, as appropriate. The report presents regional overviews along with cross-country comparisons and contrasts. It also presents selected country examples, depending on data availability and relevant economic developments, to illustrate the incidence and distribution of specific vulnerabilities within countries.

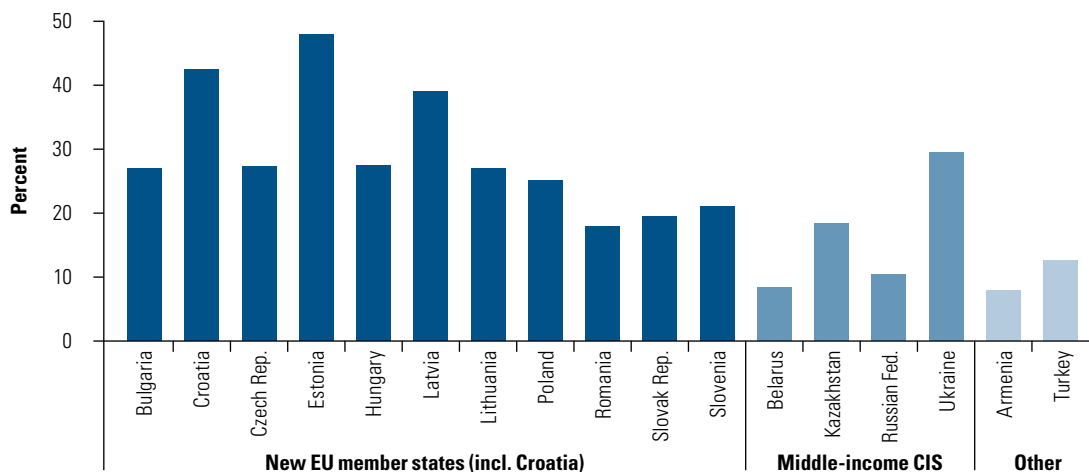
The microeconomic simulation in the report draws on a large, cross-country database of household surveys. The report brings together for the first time comparable cross-country data on household indebtedness for a large group of ECA countries using the European Union Survey of Income and Living Conditions and Household Budget Surveys. The report also highlights newly updated information on household consumption from the ECA Household Data Archives. Comparisons with Western Europe and other advanced economies are also used to inform the analysis when relevant data are available.

B. Main Findings

The results of the analysis suggest that the adverse effects of the crisis on households—via credit market shocks, food/fuel price shocks, and income shocks—are widespread. Both poor households and nonpoor households are vulnerable depending on the economic shock, the specific transmission channel, and selected household characteristics.

FIGURE 2
Household Debt in ECA, 2008

In percent of GDP



Credit Market Shocks

The rapid rise in household indebtedness—in the new EU member states as well as in some Western Balkan countries, such as Albania and Serbia, and CIS countries such as Ukraine—has exposed households to a number of credit market shocks. There is no doubt that household debt holding has improved the lives of many, allowing them to smooth consumption and share risks, purchase durables, and invest in housing stock. At the same time, the nature of household debt in ECA is such that households are now facing exchange rate and interest rate shocks, with few opportunities for hedging and with little prior knowledge of their vulnerability.

Within countries, household indebtedness is more common than previously understood. Mortgage loans, in particular, have grown rapidly in recent years among poorer and middle-income households in a number of EU10 countries. Both poor households and nonpoor households are exposed to the risks of unsustainable debt service burdens.

The results of stress tests on household indebtedness in selected countries suggest that ongoing macroeconomic shocks may significantly expand the pool of households that

will be unable to meet debt service obligations. Interest rate shocks in Estonia, Lithuania, and Hungary, for example, increase the share of vulnerable households or borrowers at risk (in percent of all indebted households) by up to 20 percentage points, depending on the magnitude and severity of the shock. Unemployment and exchange rate shocks also expand the share of vulnerable households (out of all indebted households) by several percentage points. Many of those household borrowers at risk of unsustainable debt burdens are from the richer income quintiles. Although the shares of indebted households and households at risk in the ECA region still lag behind those of richer countries, the aggregate effects of rising debt service burdens are already being seen in rising household loan delinquency rates, as unemployment has increased.

External Price Shocks

The food and fuel crisis may not be over. Food and fuel prices have abated worldwide because of the worsening global financial crisis—the economic recession or slowdown in many countries across regions—and, as a result, global demand for commodities has fallen. In addition, increased agriculture production activity

FIGURE 3

The Share of Vulnerable Households Before and After an Unemployment Shock

In percent of indebted households

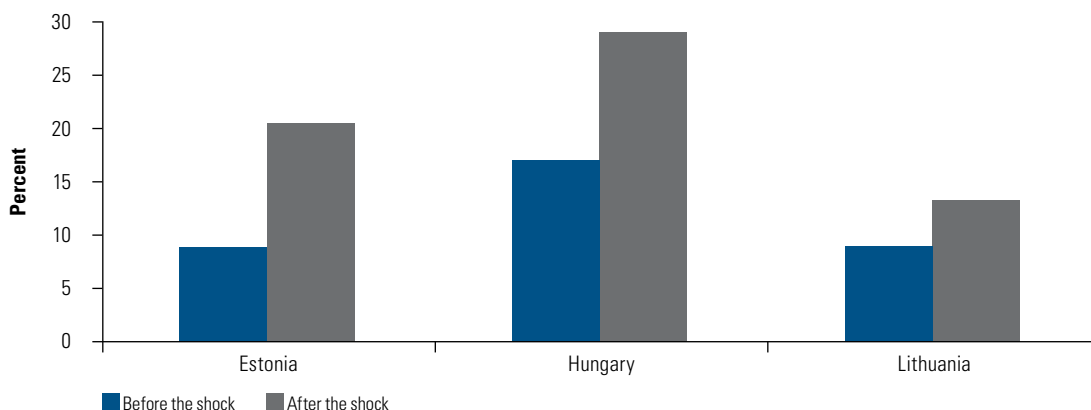
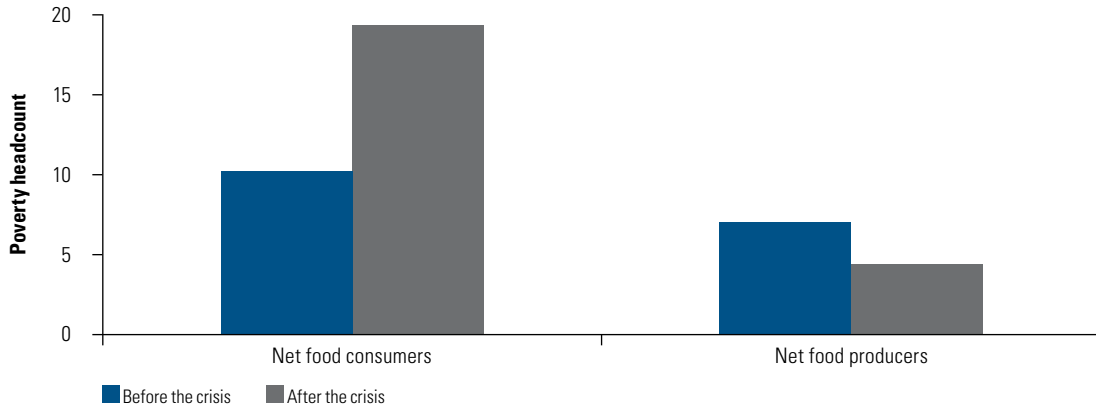


FIGURE 4
Kyrgyz Republic: Poverty and the Food Price Crisis



led to a bountiful 2008 harvest and eased global commodity shortages. However, international commodity price levels have not returned to pre-2007 levels. Specialists have also pointed to longer-term challenges in global food production that are yet to be addressed. In addition, falling currencies in some EU10 countries are resulting in a new round of price increases, depending on the share of imported food and fuel in local consumption and the degree of pass-through of exchange rate changes in domestic prices. Finally, in a number of countries such as Belarus, Moldova, and Ukraine, the utility reform program remains largely incomplete. As a result, for reasons of economic efficiency or fiscal consolidation, a number of countries will have to adjust their tariffs to cost-recovery levels in the coming years.

There is significant heterogeneity within countries in the welfare impact of commodity price shocks. The net effect of a food price shock depends on whether households are net producers or net consumers of food, it depends on their intensity of food consumption and the availability of cheaper substitutes, and it depends on their livelihood strategies, access to agriculture assets and inputs, and their ability to take advantage of profitable opportunities in agriculture. These multiple considerations

suggest that, at least in principle, the poor are not necessarily the hardest hit. However, the food share of total household consumption typically falls with income; in some of the low-income countries in the region, the food share of consumption among the poor is 70 to 80 percent. Moreover, in reality, the poor are the worst hit, as many of the poor in Albania, Kyrgyz Republic, and Tajikistan, for example, are also observed to be net consumers, with limited access to agricultural assets and inputs.

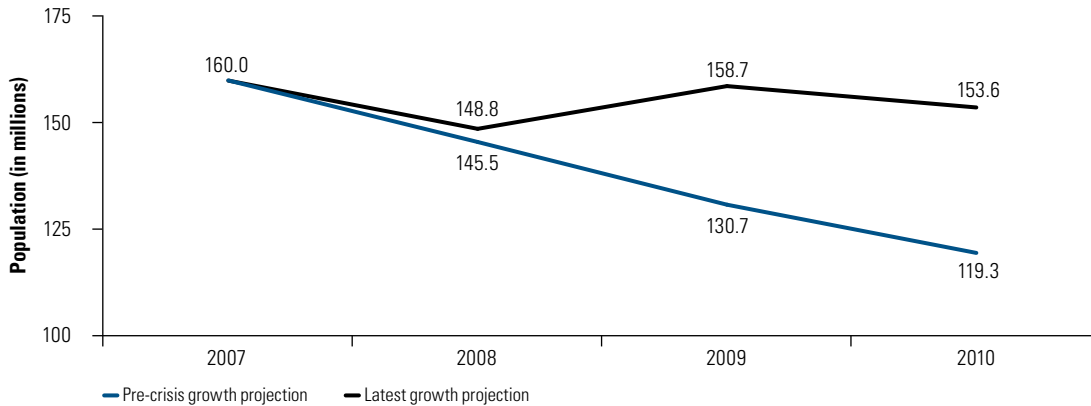
Income Shocks

Poverty will rise. Simulations suggest that by 2010, there will be 11 million *more* people in poverty, and *more* than 23 million more people will find themselves just above ECA's international poverty line, relative to baseline pre-crisis projections. The growth in poverty would represent a fifth of the ECA population who moved out of poverty between 1998 and 2006. This is not surprising given that poverty in ECA is shallow, characterized by large numbers of individuals susceptible to falling into poverty even with modest falls in average income. Alternatively, one could think of them as the recent-poor, with tenuous links to the labor market, with little precautionary savings, and

FIGURE 5

The Poor and Vulnerable Population, 2007–10

Using the \$5-a-day measure of poverty



who are likely to have benefited from recent credit and construction booms.

The magnitude of the poverty impact varies by sub-regions. The middle-income CIS countries, on average, have seen the largest and most significant downward revisions to their gross domestic product growth projections. As a result, and by construction, they are also seeing the largest percentage point increases in the projected poverty headcount. They are followed closely by the low-income CIS.

The aggregate results mask the heterogeneity of impact within countries, including the concentration of the poverty impact in selected economic sectors. Country studies recently completed suggest that for economic shocks transmitted primarily through the labor market, poverty will rise especially among households that have been dependent on remittance inflows and those previously employed in booming construction sectors where economic activity is now projected to decline sharply.

The results of the analysis are indicative of how vulnerabilities are distributed across countries and, within countries, across broad types of households. In some ways, the estimated effects may be understated because they capture only some of the first-round

effects. On the other hand, general equilibrium effects will either dampen or worsen some of these effects.

The second-order effects on human capital accumulation and social capital will be significant. Lessons from the region's own experiences suggest that transitory shocks' long-term toll on human capital has been substantial because families curbed their education and health investments in response to a banking or exchange rate crisis. Crises may lead to increased social unrest, criminal activity, and human trafficking; disrupt communal and ethnic relations; or bring down fragile governments and fledgling democracies.

Coping with the Crisis

Compared to previous crises, the scope for households to engage in their traditional coping strategies may be more limited. During previous crises, households found secondary employment, relied on transfers from friends and families, or left for work abroad to augment family income. Because of the global nature of the crisis, and because macroeconomic shocks are hitting households on multiple fronts, many of these coping strategies

are no longer viable. For the poorest households, subsistence farming may still be feasible, though evidence from the recent food price shock suggests that many of the poorest households do not have access to agricultural assets and inputs. For some, transitions into informal sector employment may be possible, though for many households, earnings from informal sector activity will be insufficient to offset the poverty impact of the crisis.

Policy Responses

Fiscal policy responses in the short term are constrained by rapidly falling revenues. Substantial government deficits are currently projected for the region. It would be essential to determine the overall fiscal adjustment warranted for macroeconomic stability and debt sustainability, taking into account initial conditions and the likely impact of the crisis on public finances. Economies that experienced strong initial fiscal and external positions are likely to have more room for expansionary fiscal policy and can afford a fiscal stimulus package, while those with weaker initial positions may require substantial fiscal adjustment. Where there are no new official or alternative sources of financing and little scope exists to mobilize revenues, some countries will likely resort to across-the-board cuts in spending. Although social safety nets will be among those items likely to be cut as revenues fall, protecting these programs—and possibly expanding some of them, where some reallocation of resources is possible—will be an important element in the response to the crisis.

Inappropriate policy responses to economic shocks may have welfare consequences far larger than the welfare losses resulting directly from the shocks themselves. In 2007–08, some countries imposed trade restrictions and price controls in response to rising food prices. Such policies redistribute income away from rural food producers (who tend to be poorer) to urban consumers (who tend to be richer). The net social

impact may be even larger when considering the impact of such policies on production incentives and the likely spillover impacts of restrictive trade policies on neighboring countries, thus exacerbating regional welfare consequences.

The region's social assistance systems vary in size and targeting performance, and not every program can and should be scaled up. In addition, some of these programs will have to be cut as revenues fall. The response to the crisis will vary across countries and may include, among other things, expanding some well-performing programs and reforming relatively less effective interventions. Some of those who will fall into poverty because of the crisis—the “new poor”—may not be easily reached by existing social protection programs. For example, returning migrants do not qualify for unemployment insurance.

The ECA region should consider new instruments of social protection. Social safety nets in ECA need to be strengthened to handle the challenges of global and domestic risks. The experiences of other countries suggest that programs such as workfare and public works programs can be appropriate instruments for protecting the vulnerable from immediate as well as longer-term (second-round) consequences of transitory shocks on nonincome dimensions of welfare, including human capital accumulation. There are a few, albeit limited, country experiences with workfare in ECA—in Bulgaria, Poland, the Slovak Republic, and Slovenia. Some insights from these country experiences can inform the broader application of workfare in ECA so that they can be efficient instruments for social risk mitigation while minimizing displacement effects.

The prioritization of labor-intensive public investments could be an important response to the crisis while creating the conditions for medium-term growth. Such a strategy can create employment opportunities, as in workfare and public works programs, while creating the

infrastructure that supports economic recovery and economic growth in the medium term.

Longer-Term Policy Responses

Over the longer term, there are various measures for limiting the risks borne by households as financial markets deepen. On the demand side, promoting financial literacy may help households to understand the risks they expose themselves to because of their consumption, employment, or borrowing choices. In addition, a whole host of macro-financial policies, such as prudential norms as adopted by some EU10 countries to limit foreign currency exposures of households, can be used in combination to help mitigate the potential risks associated with increased exposures of households to credit and financial markets.

It is important that policy responses do not conflict with the key longer-term reform agenda. For example, authorities should guard against reversal of efforts to lower quasi-fiscal deficits in the energy sector, which is an ongoing challenge in many ECA countries, and they should maintain an open and transparent trading regime. Some countries in ECA adopted restrictive trade and price controls in response to the food price increases in 2007 but many of them have now been reversed.

Diversified sources of economic growth will be critical in helping dampen ECA countries' vulnerability to macroeconomic shocks. In

some countries in ECA, recent growth performance has been underpinned by economic activity concentrated in a few sectors, such as the housing or construction sector, or income flows from some dominant source, such as migrant labor.

Monitoring systems are important. Guaranteeing that statistical monitoring systems are in place and that relevant household data are collected regularly and made available for analysis are important measures for ensuring that household vulnerabilities to a range of potential shocks are understood in a timely manner and that those households at risk can be reached by a country's social protection system.

The resilience of households to macroeconomic shocks ultimately depends upon the economy's institutional readiness, the flexibility of the economic policy regime, and the ability of the population to adjust. Policy and institutional preparedness is essential so that countries can manage the adverse social impacts of macroeconomic shocks. This requires ex ante analysis of risks, a good understanding of their possible transmission channels if triggered, and their possible impacts on households; developing approaches that ensure that the state does not intervene excessively in terms of detrimental longer-term distortions to incentives or fiscal sustainability; and having a comprehensive social safety net system that provides for countercyclical and scalable interventions.