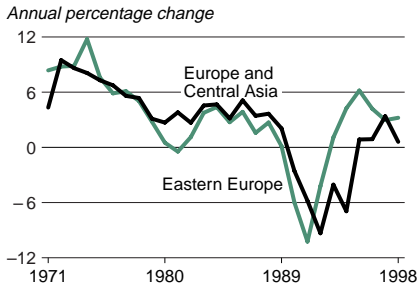


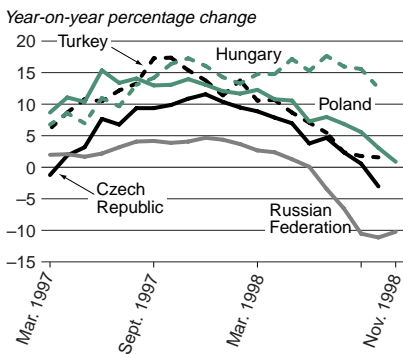
GNP per capita, 1997: \$2,310

GDP growth rates, 1971–98



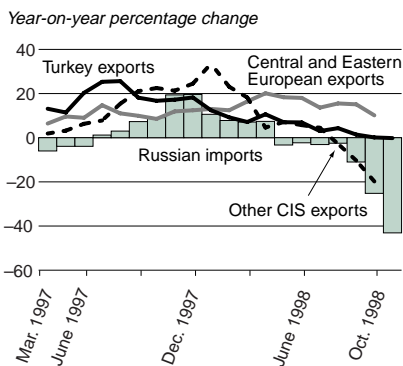
Source: World Bank.

Industrial production, 1997–98



Note: Calculated as a three-month moving average.
Source: Datastream.

Russian imports and partner exports 1997–98



Note: Calculated as a three-month moving average, in current U.S. dollars.
Sources: IMF and Datastream.

Europe and Central Asia

Recent developments

REAL GDP IN EUROPE AND CENTRAL ASIA fell by 0.3 percent in 1998, compared to 2.5 percent growth in 1997. The reversal was precipitated by the liquidity crisis in Russia, which reduced output in the Commonwealth of Independent States (CIS) by 3.4 percent in 1998. Oil producers in the region, particularly in Central Asia and the Caucasus, further suffered from the 32 percent decline in world oil prices, and optimism regarding medium-term prospects has diminished. Financial market volatility increased in the region in the wake of the Russian liquidity crisis, but the effect on the real economy was limited outside of the CIS and the Baltic countries. GDP growth in the Central and Eastern European countries in 1998 equaled the 1997 rate of just above 2 percent. Diversification of trade links to Western Europe, combined with the market reforms introduced in recent years, appears to have provided some protection from the instability generated by the Russian crisis.

The Russian economy has contracted sharply since the August 1998 ruble devaluation and debt moratorium, while efforts to formulate a budget and financing plan have been slow. By year-end, the ruble had lost 70 percent of its value, and equity market prices plunged 80 percent from precrisis levels, while inflation soared to an annual rate of 85 percent. Industrial production relapsed into double-digit declines, and GDP fell by 5.5 percent for the year. Consumers have been hardest hit: real incomes have fallen by one-third, contributing to massive import compression. Both exports and imports declined by 17 percent in dollar terms, with weaker oil prices exacting a heavy toll on export (and central government) revenues.

The main spillover effects of the Russian crisis in the region have been

increases in secondary market spreads, credit rating downgrades, and a tightened external capital constraint. Secondary market spreads on Russian benchmark sovereign bonds increased by more than 6,000 basis points, following the partial external debt moratorium in August 1998. Spreads on bonds in the CIS and elsewhere in the region also rose. For example, in Ukraine and Romania spreads increased to as much as 9,000 and 5,700 basis points, respectively. In Kazakhstan and Turkey spreads reached as high as 2,300 and 1,000, respectively. However, spreads on Hungarian and Polish sovereign bonds increased by only about 80 and 100 basis points respectively, much less than in many countries both inside and outside the region.

The Russian crisis also contributed to substantial exchange rate declines and lower worker remittances in a number of neighboring CIS countries and, as previously noted, sharp declines in export demand for countries with strong trade links to Russia. Kyrgyzstan's exchange rate fell by one-third in November 1998, while the trade deficit expanded tenfold, and Armenian exports and workers' remittances fell sharply. Regional equity markets tumbled, led by an 87 percent decline in Russia, followed by a 52 percent decline in Turkey and a 26 percent decline in Hungary (in dollar terms). Before the Russian financial crisis, Central European and Russian equity markets had performed well, benefiting from portfolio shifts of private capital from East Asia to "alternative" markets.

Debt indicators

Russian authorities imposed a 90-day moratorium on repayments of a significant portion of the country's external debt liabilities in August 1998, following mounting fiscal and financial diffi-

culties, ongoing weakness in oil prices, and the failure of a large international support program in July. The liquidity crisis reverberated throughout the region, and aggregate net flows to Europe and Central Asia fell to \$49 billion in 1998 from \$59 billion in 1997. The drop in capital flows, which was precipitous in the months following the Russian devaluation, followed a period of remarkable double-digit, year-on-year gains and a 160 percent rise in flows to the region from 1994 to 1997.

The region's long-term external debt rose from \$310 billion in 1997 to \$343 billion in 1998. This increase reflects the rise in debt owed to private creditors, which rose from \$175 billion to \$203 billion in 1998, driven by the \$20 billion jump in bond debt to \$70 billion. While private debt has been growing in recent years, official external debt has remained relatively stable, at about \$140 billion since 1994. Close to 80 percent of official debt is owed to bilateral creditors.

Debt indicators deteriorated significantly, owing to a substantial increase in debt and a generally poor export and growth performance. The region's average ratio of debt to exports increased markedly from 108 percent in 1997 to an estimated 127 percent in 1998, partly reversing the improvement witnessed since the early 1990s. The average ratio of interest payments to exports increased to 6 percent in 1998 from 4.7 percent in 1997. The majority of the region's economies are classified by the World Bank as less indebted. The exceptions are Bosnia and Herzegovina and Bulgaria, which are classified as severely indebted, and Georgia, FYR Macedonia, Slovak Republic, Hungary, and Turkey, which are classified as moderately indebted.

Aggregate resource flows

Aggregate long-term resource flows to Europe and Central Asia declined from

\$59 billion in 1997 to \$49 billion in 1998, reflecting a \$6 billion drop in private capital flows. The share of private capital flows in the total increased for the fourth consecutive year to 90 percent in 1998, compared with 48 percent in 1994.

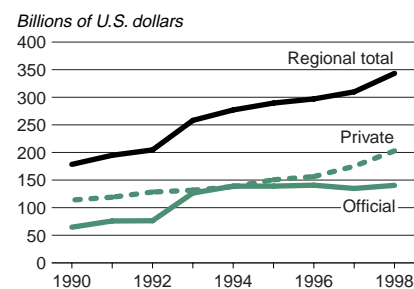
Net private long-term debt flows fell to \$20 billion in 1998 from \$23 billion in 1997, as net commercial bank lending fell by \$10 billion (to \$4 billion). Bond flows registered a third consecutive year of increase to \$15 billion, following \$9 billion in 1997, constituting 74 percent of private lending.

Portfolio equity flows increased during the mid-1990s, responding to the emergence of stock markets in several countries in the region. Portfolio equity flows peaked at \$8 billion in 1996, before falling to \$5 billion in 1997 and to \$2.5 billion in 1998, when equity prices fell sharply throughout the region.

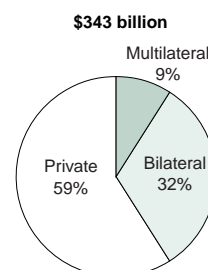
In contrast to the volatility of portfolio flows, net foreign direct investment (FDI) declined by only \$1 billion from the peak 1997 level of \$22 billion. FDI to Europe and Central Asia increased markedly in the mid-1990s, and now represents close to half of external flows to the region. In particular, the Czech Republic, Hungary, and Poland have benefited from strong FDI in recent years and continued to attract buoyant flows in 1998. After peaking at \$6 billion in 1997, FDI to Russia fell to \$3 billion in 1998, but remained above the \$2.5 billion level of 1996.

Official development finance flows declined to \$5 billion in 1998 from \$9 billion and \$12 billion in 1997 and 1996, respectively. The declines reflect reductions in peacekeeping assistance to Bosnia and Herzegovina and the Federal Republic of Yugoslavia (Serbia/Montenegro), a winding down of increased special flows to the former Soviet Union (following the breakup), and completion of the debt reduction accorded to Poland under the 1991 Paris Club agreements. Official grants declined from \$5 billion in 1997 to \$3 bil-

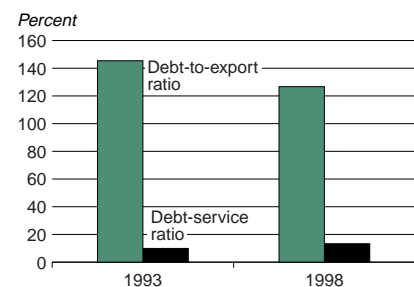
Long-term debt outstanding, 1990–98



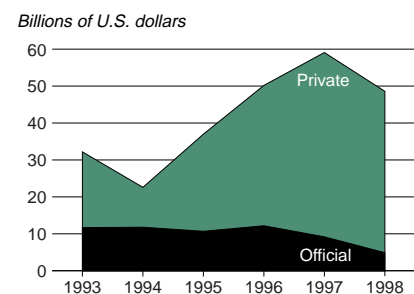
Sources of long-term debt, 1998



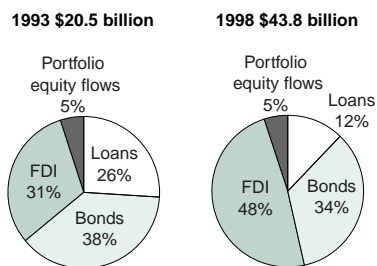
Debt indicators, 1993 and 1998



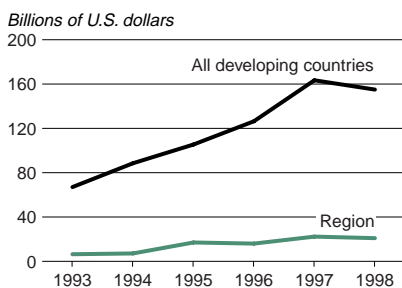
Aggregate net resource flows, 1993–98



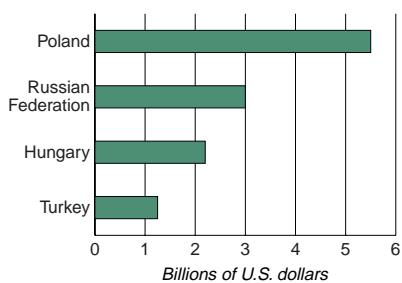
Composition of private flows



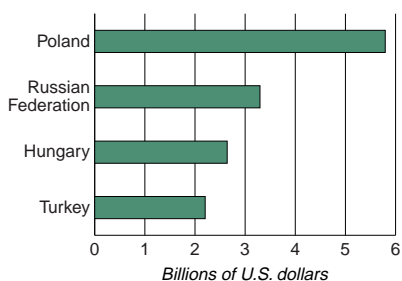
Foreign direct investment, 1993–98



FDI by country, 1998



Net private flows, 1998



lion in 1998, while official nonconcessional loans declined from \$3.5 billion in 1997 to less than \$1 billion.

Prospects and risks

Regional GDP is projected to fall by 1.5 percent in 1999. Output is plummeting in Russia, and Central Asia will be hit hard by the consequent import compression in Russia, as well as by weak prices for oil and other commodities. By contrast, countries in Central and Eastern Europe should experience only a modest slowdown, with Turkish output rising by 3 percent (although this is well down from the 7 percent pace of the mid-1990s). Growth for Europe and Central Asia as a group should recover to around 3 percent in 2000–2001—a turnaround that hinges on policy developments in Russia and the degree to which these will facilitate restructuring of existing debt. In addition, some resumption of external financing is assumed.

Private capital flows to many of these countries are expected to remain near the low levels experienced since the Russian debt moratorium. It will

take considerable time before investors are willing to return. However, Central and Eastern European countries, particularly those with the prospect of membership in the EU, may experience a modest recovery of flows. Overall, net flows to the region are likely to fall sharply in 1999 compared with the levels for 1998, in part reflecting the significant flows received prior to the Russian moratorium. The outlook for official flows will depend heavily on the outcome of discussions concerning a rescue package for Russia.

The potential for a weaker and more protracted recovery than the baseline forecast is substantial. Near-term risks include a less favorable than expected out-turn in Russia and a more pronounced slowdown in the EU, both of which would have widespread consequences for the region. Ongoing declines in commodity prices instead of the anticipated stabilization would also affect major exporters of the CIS. Finally, Turkey's near-term situation appears fragile, as export revenues are falling, conditions in international financial markets are difficult, and debt service requirements remain large.

Europe and Central Asia forecast summary (percent per annum)

Growth rates/ratios	1988–97	1996	1997	1998	Baseline forecast		
					1999	2000	2001
Real GDP growth	-2.7	0.0	2.5	-0.3	-1.5	2.3	3.6
Consumption per capita	-1.1	1.9	3.0	-0.1	-3.0	1.5	2.9
GDP per capita	-3.2	0.0	2.3	-0.8	-2.0	1.8	3.0
Population 16–65 years	0.6	0.1	0.3	0.6	0.6	0.7	0.8
Median inflation ^a	36.0	45.6	49.9	84.1	32.5	23.7	17.8
Gross domestic investment/GDP	32.1	27.8	27.4	26.3	26.4	27.0	27.3
Budget balance	-7.5	-6.6	-6.2	-5.7	-4.5	-4.0	-3.5
Export volume ^b	-0.4	6.4	7.9	4.0	4.0	5.9	6.0
Current account/GDP	1.3	0.5	1.0	0.1	0.8	1.0	0.9
<i>Memo items</i>							
GDP of Central and Eastern Europe	-0.9	3.3	2.1	2.2	2.3	3.8	4.6
GDP of former Soviet Union	-5.3	-4.3	1.2	-3.4	-5.5	0.6	2.4

a. GDP deflator.
 b. Goods and nonfactor services.
 Source: World Bank baseline forecast, March 1999.