Global Economic Prospects and the Developing Countries 2000

Appendix 1

Regional Economic Prospects

Europe and Central Asia

Recent developments

Economic output contracted by 0.2 percent in 1998 for the Europe and Central Asia (ECA) region as a whole, largely reflecting Russia's liquidity crisis in August 1998 and subsequent regional contagion. The ensuing economic downward spiral in Russia reverberated throughout the Commonwealth of Independent States (CIS), as these economies in particular retain strong trade links with the Russian market. Trade-finance and payments systems arrangements were interrupted and trade declined sharply as Russian demand collapsed (figure A1.2a) Central and Eastern European countries (CEECs) exports and balance of payments deteriorated as well, as sluggish growth in Western Europe translated into weak external demand for the more diversified regional exporters, dampening the internal dynamics of the region (figure A1.2b).

The region's weak growth performance is likely to improve during 1999. The firming of oil prices is improving prospects for the petroleum exporting countries of Russia and the Caspian Sea basin. While oil importers, such as Turkey and the Central European countries, are experiencing some terms of trade losses, many of these countries are benefiting from the incipient strengthening of demand in western Europe. The end of the war in the Federal Republic of Yugoslavia (Serbia/Montenegro) has allowed reconstruction efforts to begin and cross-border trade to resume, albeit constrained by the need to rebuild the transportation infrastructure. The Russian Federation has made some progress on debt restructuring and on gaining another round of funding from the International Monetary Fund (IMF). Inflationary pressures have been reduced significantly, such that monthly inflation has slowed to 1.4 percent in September from 11 percent in December 1998. A reflection of improving international financial market sentiment, bond spreads throughout the region in secondary markets have generally narrowed. For example, Poland's spread returned to early 1998 precrisis levels. The most striking exception to this trend is Ukraine, where the economy remains vulnerable and Eurobond spreads are still elevated at close to 8,300 basis points in mid-November 1999, up from about 3,000 points in June 1999. Spreads for Russia remained above 2,300 basis points in November 1999, down from 5,200 basis points in April 1999.

Estimates for growth in the ECA region for 1999 have been revised upward, from the 1.5 percent decline expected in *Global Development Finance (GDF) 1999* to plus 0.3 percent. Russian GDP is now forecast to increase by close to 1.0 percent (compared with the 5 percent contraction anticipated in *GDF 1999*), due largely to higher than expected oil prices and increased production for import substitution. While GDP and industrial production contracted in the first quarter of 1999, both posted gains in the second and third quarters. With positive spillover effects anticipated in neighboring countries, the forecast for growth in the Commonwealth of Independent States (CIS) has been revised from minus 5.5 percent to a 0.7 percent advance. The most notable exception to the region's generally lackluster output is Turkmenistan, where double-digit growth is expected as a large natural gas project comes onstream. In contrast to the CIS, expectations for growth in 1999 in the Central Eastern European countries (CEECs) have been revised downward, from 2.3 percent to 1 percent, reflecting weaker than anticipated growth in Europe and higher prices for these countries' energy imports. Also, the war in Kosovo has greatly reduced economic prospects in the Balkans. Not only must the region bear the direct consequences of the destruction and disruption in the theater of conflict, but it must also absorb the impact of the movement of refugees into neighboring countries, the disruption of regional and transit trade, and a sharp fall in tourism revenues.

Near-term outlook

Accelerating world trade and stabilizing commodity prices should contribute to a stronger recovery in the ECA region in 2000, and real GDP is expected to increase by 2.5 percent. A recent history of high real investment growth (in double digits for some countries since the mid-1990s), boosted by strong FDI inflows (albeit tied in part to one-off privatization sales), should provide additional impetus for future growth in the CEECs and the Baltic countries. Greater integration with the European Union, as the CEECs progress at varying stages toward EU membership, will also improve growth prospects. Average national production growth for the CEECs is forecast at 3.2 percent in 2000. Output in most CIS countries is projected to recover more gradually, owing to expected slow growth in Russia, where the aggressive implementation of structural reforms is likely to await the results of the June 2000 presidential elections. Nevertheless, the depreciation of the ruble and of other CIS countries' currencies is expected to boost their exports to a degree which, combined with more positive external demand and sustained higher oil prices, should contribute to more positive growth of 1.3 percent in 2000 (table A1.2).

Long-term prospects

The long-term growth forecast (2002–2008) for the ECA region has been reduced from 5 percent per annum to 4 percent. This change is due largely to a downward revision to the projections for Russia, which continues to under-perform relative to its underlying potential. Despite stabilizing more quickly than anticipated in 1999 after the August 1998 financial collapse, the fundamentals required to support longer term growth have deteriorated. Savings and investment rates have fallen; the financial sector and state enterprises are in need of significant restructuring; the level of FDI remains constrained; and capital outflows continue. Population growth is projected to continue to fall by 0.3 percent per year, with the labor force contracting by 0.5 percent. While fiscal and monetary policies are likely to improve in the coming years, the degree of support for implementing far-reaching reforms to address the many imbalances in the economy is uncertain.

Risks to the forecast are mainly on the downside and are primarily linked, within the region, to achieving a sustainable recovery in Russia, where the situation remains fragile. A further downturn in Russia would have significant negative repercussions in the rest of the CIS and in Turkey, in particular, as occurred in the aftermath of the 1998 crisis. The economic situation in both Ukraine and Romania is tenuous, reflecting high debt- servicing payments. Turkey also faces significant economic challenges, as its economy is suffering from a sharp slowdown in growth, a growing budget deficit, and high short-term debt turnover requirements. The disruption of the August earthquake (estimated to cost between 2.5 percent and 5 percent of GDP) has compounded the situation. Throughout the region, slippage in reforms and failure to address significant financial and enterprise sector problems represent an ongoing risk. ECA's relationships with the EU pose both opportunities and challenges. A slowdown in Europe could weaken growth in ECA, especially in the CEECs. In the longer term, however, favorable prospects for several countries are tied to EU enlargement.