

Global Economic Prospects

Managing the Next
Wave of Globalization

Europe and Central Asia regional prospects

2007

rapid growth of oil exporters (estimated at 7.3 percent in 2006) generating substantial export demand for regional oil importers. The latter's economies are expected to have expanded by 5.9 percent. Growth is broad-based in the region. Only 2 of the 23 European and Central Asian countries covered in these projections (Moldova, growing at 3 percent, and Hungary at 3.8 percent) are expected to experience growth below 4 percent in 2006.

While the growth picture is very similar for oil importers and oil exporters (including natural gas exporters), the situation on current accounts is strikingly different. Oil exporters are enjoying an estimated average surplus of nearly 10 percent of GDP in 2006, while importers are facing an estimated average deficit of 5.9 percent of GDP. Similar, albeit less extreme, is the fiscal situation, with a projected 7.9 percent of GDP surplus in oil-exporting countries and a projected 2.6 percent deficit in oil-importing countries. As a consequence of these different positions, the challenges facing these countries are very different. While oil exporters have to focus on management of surpluses in a sustainable way, oil importers, having become vulnerable to swings in conditions in international financial markets, need to focus on consolidating their fiscal positions and hastening adjustment to high oil prices.

Domestic demand continues to drive the expansion among oil exporters, as oil revenues are channeled into the domestic economy via government transfers, the wage bill of civil servants, and various investment programs. Domestic demand rose an estimated 11.3 percent among regional oil exporters in 2006, with private consumption up 12.4 percent. Notwithstanding growing constraints on foreign partnerships in the energy sector, investment in the Russian Federation expanded by an estimated 13.4 percent. Overall, exports rose for oil exporters by 7.8 percent, reflecting expanded output and production capacity, including the opening of the Baku-Tbilisi-Ceyhan (BTC) pipeline. Nevertheless, volume growth of imports outstripped that of exports by a wide margin, expanding by an estimated

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Recent developments

GDP growth in Europe and Central Asia is estimated to have accelerated to 6.4 percent in 2006, up from 6 percent in 2005 (table A.3). Growth in the region continued to be heavily influenced by high oil prices, with the very

Table A.3 Europe and Central Asia forecast summary*Annual percent change (unless otherwise indicated)*

	1991–2000 ^a	2003	2004	2005	Estimate	Forecast	
					2006	2007	2008
GDP at market prices (2000 US\$) ^b	–0.2	5.9	7.2	6.0	6.4	5.7	5.5
GDP per capita (units in US\$)	–0.4	5.9	7.2	6.0	6.3	5.6	5.5
PPP GDP ^c	–0.4	6.2	7.4	5.9	6.5	5.8	5.6
Private consumption	1.2	6.0	8.1	7.9	7.8	6.3	5.8
Public consumption	0.5	2.9	2.3	2.9	3.1	3.0	2.9
Fixed investment	–4.6	10.4	12.7	11.7	10.9	8.9	7.9
Exports, GNFS ^d	3.8	12.7	13.4	7.3	10.0	9.5	9.9
Imports, GNFS ^d	2.8	15.7	17.7	10.5	12.8	10.6	10.2
Net exports, contribution to growth	0.5	2.2	0.5	–1.1	–2.5	–3.2	–3.5
Current account balance/GDP (%)		–1.0	0.3	0.9	0.8	–0.6	–1.4
GDP deflator (median, LCU)	104.7	4.3	6.2	4.0	6.0	5.1	5.0
Fiscal balance/GDP (%)		–2.6	–0.6	1.4	1.9	2.2	1.5
<i>Memo items: GDP</i>							
Transition countries	2.6	4.8	6.7	5.5	5.8	5.2	5.2
Central and Eastern Europe	2.2	4.3	5.5	4.6	5.7	5.3	5.3
Commonwealth of Independent States	–3.7	7.7	8.0	6.7	7.3	6.4	6.0
Poland	4.5	3.8	5.3	3.4	5.4	5.1	5.2
Russia	–3.4	7.3	7.2	6.4	6.8	6.0	5.5
Turkey	3.5	5.8	8.9	7.4	6.0	5.0	5.0

Source: World Bank.

a. Growth rates over intervals are compound averages; growth contributions, ratios, and the GDP deflator are averages.

b. GDP is measured in constant 2000 U.S. dollars.

c. GDP is measured at PPP exchange rates.

d. Exports and imports of goods and nonfactor services.

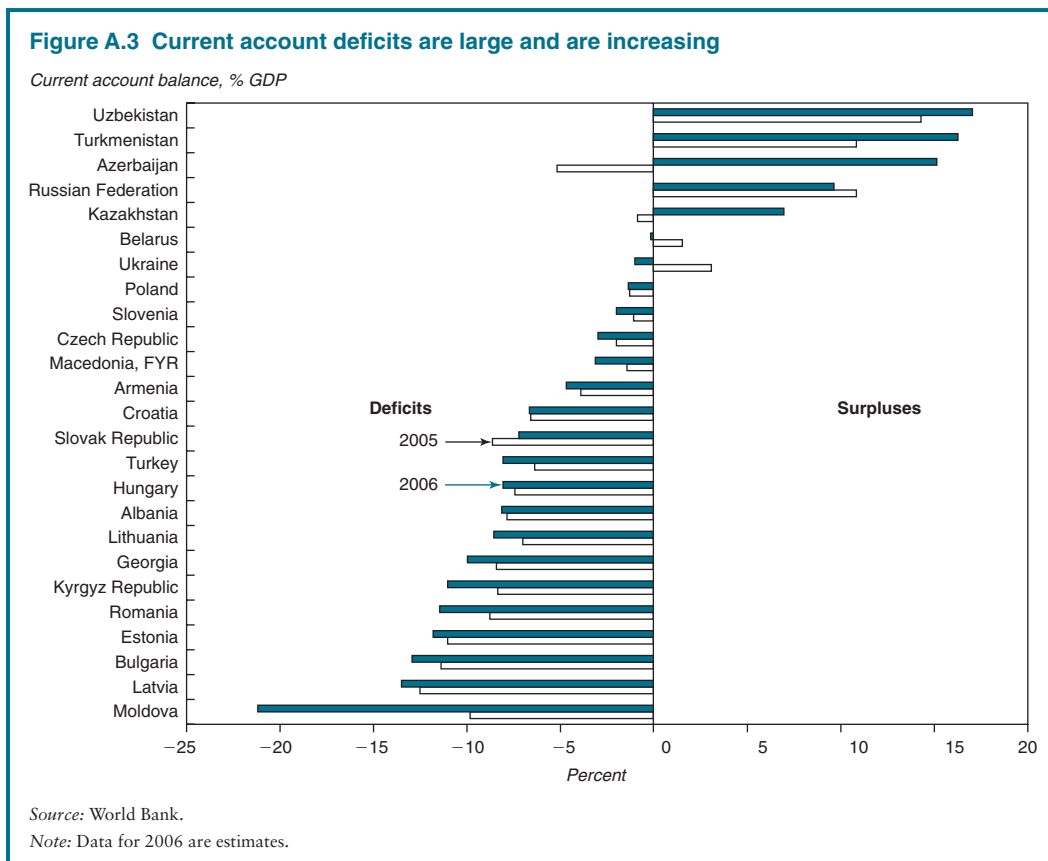
17.3 percent for all regional oil exporters. Excess domestic demand—in part driven by the stimulus deriving from higher energy prices—resulted in strong net imports, with an estimated –3.2 percent contribution to GDP growth. Nevertheless, higher oil prices meant that the current account position of these countries improved further, moving to an estimated surplus of 10 percent of GDP.

Oil revenues bolstered the fiscal positions of oil exporters, although increased spending limited the extent to which fiscal balances improved. In Russia, surging oil revenues are expected to result in a record fiscal surplus of 8.4 percent of GDP in 2006. Part of this surplus has been funneled into foreign currency reserves, which reached over \$250 billion (as of end-August), as well as the repayment of \$22 billion in Soviet-era debt to the Paris Club in August 2006.

Growth among regional oil importers has remained stable as a result of two offsetting

trends. While domestic demand slowed, growth in exports picked up from 7.9 percent in 2005 to 11.1 percent, fueled in part by very strong import demand by oil exporters and the strengthening recovery in industrialized Europe. Increased export volumes were particularly important for GDP growth in Bulgaria, the Czech Republic, and Poland; all three experienced an export acceleration of 5 percentage points or more. In addition, remittance inflows emanating from regional oil exporters supported growth in Armenia (with GDP growth of 9.5 percent), Georgia (7.5 percent), the Kyrgyz Republic (4.3 percent), Moldova (3 percent), and Tajikistan (8 percent). On the downside, Russia's imposition of import restrictions and elimination of "friendship pricing" of hydrocarbon fuels dampened outturns in Moldova and Ukraine (6 percent).

Strong FDI and capital inflows have been a further factor underpinning the rapid expansion of domestic demand among oil importers.

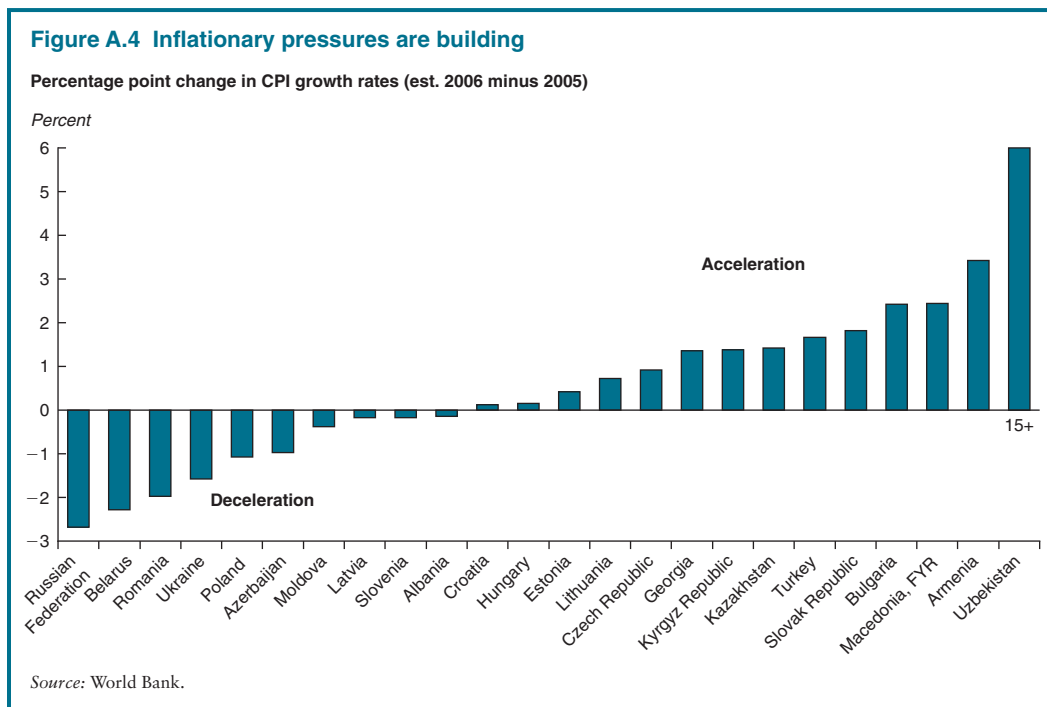


For Bulgaria and Romania, whose admission to the European Union (EU) has been approved for 2007, as well as Turkey (which began accession negotiations at the end of 2005), investment inflows have boosted domestic demand, wages, and employment. Inflation is up in Bulgaria and Turkey, and current account deficits have ballooned in all three countries. In Turkey, this combination—along with other factors, including political tensions and concerns about the pace of reforms—contributed to a 16 percent depreciation of the currency during May and June of this year, which led the central bank to raise policy rates by a cumulative 549 basis points up to 19.24 percent between May and July.

Current account balances deteriorated in a number of other oil importers, surging to more than 20 percent of GDP in Moldova (due to

Russian trade restrictions and rising gas prices), reaching deficits of an estimated 12–15 percent of GDP in Bosnia and Herzegovina, Bulgaria, Estonia, and Latvia, and of 4 percent or more in Albania, Armenia, Croatia, Georgia, Hungary, the Kyrgyz Republic, Lithuania, Romania, the Republic of Serbia, the Slovak Republic, and Turkey (figure A.3). Deficits in these countries have been mainly driven by surging imports fueled by capital inflows, rapid investment growth, and higher energy prices. In the Czech Republic, the former Yugoslav Republic of Macedonia, Poland, and Slovenia, current account deficits are relatively low, equivalent to 3 percent of GDP or less.

Strong regional growth over the last four years has contributed to an increase in median consumer price inflation (figure A.4) from 3.6 percent in 2003 to 4.8 percent in the third



quarter of 2006. Rapid credit growth (due in part to capital inflows) has been an important driver, as have supply-side pressures and tighter labor markets—the latter especially evident in the Baltics.

Inflation in Turkey picked up substantially after the depreciation of the lira during the financial turbulence in the spring. Nevertheless, the recent tightening of monetary policy has helped to stabilize inflation at just above 10 percent, and the authorities aim to reestablish the broad downward trend achieved in recent years that reduced inflation from 55 percent in 2000 to single digits in 2004.

Russia has succeeded in controlling prices, with inflation averaging 9.4 percent during the third quarter of 2006, down from 12.7 percent in 2005, reflecting relatively small increases in administered prices and ruble appreciation. Problems in meeting inflation criteria in the Baltic countries and the Slovak Republic led them to postpone adoption of the euro and Lithuania's bid to join in January 2007 was

rejected. Slovenia, however, is on track to adopt the euro in January 2007. The Baltics, the Czech Republic, Poland, and the Slovak Republic have no firm target dates.

While central banks in a number of countries—including the Czech Republic, the Slovak Republic, and Turkey—have responded by raising nominal interest rates, in several countries higher interest rates have generated capital inflows and additional credit expansion, which forced the authorities to rely on fiscal tightening to restrain demand. Azerbaijan, Bulgaria, Bosnia and Herzegovina, Estonia, Kazakhstan, Russia, Serbia and Montenegro,⁴ Turkmenistan, and Uzbekistan are running fiscal surpluses ranging from about 1 percent to 12 percent of GDP, with the oil exporters benefiting from significant inflows tied to high oil prices. Additionally, there has been extensive sterilization, notably in Romania.

Nevertheless, the average government deficit of oil importers in the region rose from 2.2 percent of GDP in 2005 to an

estimated 2.6 percent in 2006. Tax cuts and increased outlays tied to elections boosted deficits and contributed to overheating in most of the new EU member countries (with the key exception of the Slovak Republic) and in a number of other oil importers. In Hungary, a relaxed fiscal stance has inflated domestic demand and contributed to the estimated 8 percent of GDP current account deficit.

Medium-term outlook

Growth in the region is projected to decelerate to about 5.5 percent in 2007 and 2008. The slowdown reflects both weaker export growth and an expected dampening of domestic demand, owing to tighter monetary policy within and outside the region, and some tightening of fiscal policies. Higher interest rates and slower growth, coupled with a decline in oil prices, are expected to reduce inflationary pressures over the forecast horizon, although inflation is likely to remain well in excess of 5 percent in many countries. While external demand is projected to ease in 2007—in part reflecting weaker growth in Germany—import demand is expected to slow in line with weaker domestic demand, and net exports are projected to have only a limited effect on GDP growth.

The anticipated growth cycle among the oil importers, from 5.9 percent in 2006 to 5.1 percent in 2007 and back to 5.2 percent in 2008, mainly reflects an expected decline in import demand from Germany (especially for countries in Central and Eastern Europe). Weaker domestic demand, due to an assumed tightening of macroeconomic policy (in Hungary and to a lesser extent in the Baltics) will also play a role, and, together with lower oil prices, should be reflected in a reduction in current account deficits over the forecast period. In Turkey, similar factors will be at work in 2007. For most regional EU member countries (including soon-to-be-member Romania), fiscal policy is expected to remain broadly expansionary, which along with continued robust private investment activity—financed both domestically and from abroad—should keep growth strong. For countries with closer

economic ties to oil exporters, such as Georgia, the Kyrgyz Republic, and Tajikistan, lower oil prices are expected to be reflected in weaker exports and a more protracted slowing in growth rates.

For the oil-exporting economies, growth is projected to slow progressively from 7.3 percent in 2006 to 6.2 percent by 2008 (from 6.8 to 5.5 percent for Russia). Because of the strength of domestic demand and non-oil-sector capacity constraints, import volume growth is expected to continue to outpace exports. Strong import demand, coupled with declining oil prices, is projected to reduce the current account surpluses of oil exporters from an estimated 10 percent of GDP in 2006 to 3.6 percent in 2008. At the same time, lower oil prices will serve to reduce government revenues, without having a comparable impact on spending. As a result, fiscal surpluses are expected to decline over the projection period, from an estimated average of 7.9 percent of GDP in 2006 to 5.9 percent of GDP in 2008.

Risks and policy challenges

Large current account deficits in a number of countries in the region make them vulnerable to changes in capital flows, which history demonstrates can occur rapidly. While FDI forms an important component of financial inflows to the region and is normally thought to be less likely to reverse direction, much of the inflows have gone into the banking sector where such reversals are easier. Moreover, given the extent of current account deficits, a simple pause in inflow could generate sufficient pressure to force a substantial adjustment—either in exchange rates or to the real side of the economy.

If private capital flows were to suddenly dry up, many countries might be vulnerable. That is especially true for countries with relatively inflexible exchange-rate regimes, such as Bulgaria, Croatia, Estonia, and Lithuania. Countries with flexible exchange rates, such as Turkey, might also find it difficult to absorb reversals in capital flows, as their current account deficits require sustained inflows of

foreign capital. Measures of liquidity risk—such as broad money to foreign exchange reserves (which is especially relevant for currency boards and fixed exchange rate regimes)—are high. The coexistence of large government deficits and sizeable current account deficits suggests that there remains considerable scope for a tightening of fiscal policy in Croatia, Hungary, and the Slovak Republic.

For oil exporters, the possibility that oil prices will decline by more than projected does not appear likely to threaten their financial stability over the forecast horizon, given large current account and fiscal surpluses.

For these countries the main policy challenge concerns managing oil revenues, so as to prevent an overheating of the economy, contain inflationary pressures, and limit the impact of the so-called Dutch disease on the international competitiveness of the non-oil sector. Steps over the last decade to establish oil funds that accumulate and invest windfall

revenues should help reduce upward pressure on prices and currencies, to the benefit of the competitiveness of the non-oil sector. They should also help minimize the potential economic consequences should oil prices drop. Nevertheless, improving transparency and accountability for the management of fund holdings, including safeguarding funds for future generations, remain important tasks.

Additional steps need to be taken to encourage investment in these economies. Improving the investment climate by strengthening governance, modernizing decaying infrastructure, and preventing the further erosion of human capital will remain critical. In Russia, the oil sector would benefit from additional investment to overcome capacity constraints due to outdated facilities and infrastructure. There, and in other resource-rich countries, special efforts will be required to promote growth in the non-oil non-resource sectors of the economy.

Table A.4 Europe and Central Asia country forecasts

Annual percent change (unless otherwise indicated)

	1991–2000 ^a	2003	2004	2005	Estimate	Forecast	
					2006	2007	2008
Albania							
GDP at market prices (2000 US\$) ^b	4.7	6.0	5.9	5.5	5.0	6.0	5.8
Current account balance/GDP (%)	-5.6	-8.1	-5.5	-7.8	-8.1	-7.1	-6.5
Armenia							
GDP at market prices (2000 US\$) ^b	-2.6	13.9	10.5	14.0	9.5	8.5	7.5
Current account balance/GDP (%)		-6.8	-4.5	-3.9	-4.7	-4.6	-4.5
Azerbaijan							
GDP at market prices (2000 US\$) ^b	-5.1	11.2	10.2	26.2	22.7	25.7	19.9
Current account balance/GDP (%)		-27.8	-30.0	1.1	15.1	25.6	34.1
Belarus							
GDP at market prices (2000 US\$) ^b	-1.1	7.0	11.0	9.2	9.3	4.5	3.3
Current account balance/GDP (%)		-2.2	-5.2	1.5	-0.2	-3.2	-3.9
Bulgaria							
GDP at market prices (2000 US\$) ^b	-0.9	4.5	5.7	5.6	5.6	5.6	5.6
Current account balance/GDP (%)	-2.3	-5.5	-5.8	-11.3	-12.5	-12.0	-11.3
Croatia							
GDP at market prices (2000 US\$) ^b	0.8	5.3	3.8	4.3	4.5	4.0	4.0
Current account balance/GDP (%)		-7.2	-5.4	-6.6	-6.7	-5.1	-5.0
Czech Republic							
GDP at market prices (2000 US\$) ^b	1.5	3.2	4.2	6.1	6.8	6.0	6.3
Current account balance/GDP (%)		-6.4	-6.2	-2.1	-3.0	-3.1	-3.0

(continued)

Table A.4 (continued)
Annual percent change (unless otherwise indicated)

	1991–2000 ^a	2003	2004	2005	Estimate	Forecast	
					2006	2007	2008
Estonia							
GDP at market prices (2000 US\$) ^b	0.0	6.7	7.8	9.8	9.2	8.0	6.8
Current account balance/GDP (%)		-12.1	-13.0	-11.0	-11.8	-11.2	-10.5
Georgia							
GDP at market prices (2000 US\$) ^b	-7.2	11.1	6.2	8.5	7.5	6.5	6.0
Current account balance/GDP (%)		-7.2	-8.3	-8.4	-9.9	-11.5	-11.0
Hungary							
GDP at market prices (2000 US\$) ^b	2.1	3.4	5.2	4.1	3.8	2.5	3.2
Current account balance/GDP (%)	-5.4	-8.7	-8.6	-7.4	-8.0	-6.7	-6.0
Kazakhstan							
GDP at market prices (2000 US\$) ^b	-2.5	9.3	9.6	9.4	9.0	9.0	8.9
Current account balance/GDP (%)		-0.9	1.1	-0.9	7.0	2.4	-1.9
Kyrgyz Republic							
GDP at market prices (2000 US\$) ^b	-3.2	7.0	7.1	-0.6	4.3	5.5	4.8
Current account balance/GDP (%)		-5.2	-3.4	-8.3	-11.0	-9.8	-7.7
Latvia							
GDP at market prices (2000 US\$) ^b	-1.6	7.2	8.5	10.2	9.8	7.5	6.0
Current account balance/GDP (%)		-8.2	-12.9	-12.4	-13.5	-12.0	-11.5
Lithuania							
GDP at market prices (2000 US\$) ^b	-2.8	9.7	7.0	7.5	7.0	6.5	6.0
Current account balance/GDP (%)		-7.0	-7.7	-7.0	-8.5	-8.4	-8.0
Macedonia, FYR							
GDP at market prices (2000 US\$) ^b	-0.3	2.8	4.1	4.0	4.0	4.0	4.5
Current account balance/GDP (%)		-3.3	-7.7	-1.4	-3.1	-3.9	-3.9
Moldova							
GDP at market prices (2000 US\$) ^b	-8.2	6.6	7.4	7.1	3.0	3.0	5.0
Current account balance/GDP (%)		-7.1	-2.0	-9.8	-21.2	-17.6	-9.8
Poland							
GDP at market prices (2000 US\$) ^b	4.5	3.8	5.3	3.4	5.4	5.1	5.2
Current account balance/GDP (%)	-3.5	-2.1	-4.2	-1.4	-1.5	-1.9	-2.4
Romania							
GDP at market prices (2000 US\$) ^b	-0.3	5.2	8.3	4.1	5.8	6.2	6.3
Current account balance/GDP (%)	-6.7	-5.8	-8.2	-8.7	-11.4	-12.9	-13.6
Russian Federation							
GDP at market prices (2000 US\$) ^b	-3.4	7.3	7.2	6.4	6.8	6.0	5.5
Current account balance/GDP (%)		8.2	10.2	10.9	9.7	5.2	2.9
Slovak Republic							
GDP at market prices (2000 US\$) ^b	1.9	4.5	5.4	6.1	6.7	7.1	5.7
Current account balance/GDP (%)		-0.9	-3.1	-8.5	-7.2	-4.2	-3.5
Turkey							
GDP at market prices (2000 US\$) ^b	3.5	5.8	8.9	7.4	6.0	5.0	5.0
Current account balance/GDP (%)	-1.1	-3.4	-5.2	-6.4	-8.0	-7.5	-6.4
Ukraine							
GDP at market prices (2000 US\$) ^b	-7.2	9.4	12.1	2.6	6.0	4.5	5.5
Current account balance/GDP (%)		5.8	10.5	3.1	-1.0	-3.4	-4.1
Uzbekistan							
GDP at market prices (2000 US\$) ^b	-0.2	4.2	7.7	7.0	6.0	4.0	4.0
Current account balance/GDP (%)		8.7	9.9	14.3	17.0	17.2	14.8

Source: World Bank.

Note: Growth and current account figures presented here are World Bank projections and may differ from targets contained in other Bank documents. Bosnia and Herzegovina, the Republic of Montenegro, the Republic of Serbia, Tajikistan, and Turkmenistan are not forecast owing to data limitations.

a. Growth rates over intervals are compound averages; growth contributions, ratios, and the GDP deflator are averages.

b. GDP is measured in constant 2000 U.S. dollars.