

# E. Europe & C. Asia

## GDF 2003 Summary



### Global themes

- Global growth is projected to accelerate steadily from 1.7% in 2002 to 2.3% in 2003 and 3.2% in 2004. Importantly, this view incorporates the effect of a relatively quick military conflict in Iraq. While very much a recovery, the expansion now underway is quite subdued by historic standards, especially given the sizeable stimulus from policy.
- The past few years has seen a fundamental shift in the pattern of private sector financing for developing countries, away from debt flows to equity-related FDI flows. The drop in debt finance has been partly driven by lower demand on the part of many developing countries seeking to lessen their vulnerability to swings in volatile debt finance, as well as a reduced supply of debt from banks and bondholders. The rise in FDI reflects greater optimism about globalization, the spread of FDI in services and heavy privatization.
- While this rotation from debt to equity should continue, the signs are that the low point in the current private debt cycle came in 2002Q3, and that net debt flows to developing countries are likely to turn positive again in 2003 for the first time in three years. While most likely, the overall buoyancy of FDI flows should not be taken for granted, however. Flows are already off their peak; privatization-related revenues have fallen sharply; and FDI in telecom and other areas of infrastructure has slumped. Moreover, rates of return on both FDI and in the corporate sectors of developing countries have generally fallen in recent years.
- Workers remittances have become an increasingly important component of global development finance, having risen to \$80 billion in 2002. They have some very attractive financial features. They are more stable than private debt flows and are less concentrated in the major middle-income countries than FDI flows.
- Aid flows to developing countries probably rose in 2002 and will continue to do so in 2003 and beyond, in line with the commitments made at the Monterrey Conference in March 2002. Emergency financial support (e.g. IMF) is likely to fall in 2003, on the presumption that no new major debt crises are in the offing. In between, official non-concessional lending (which includes the IBRD) is generally quite weak. Note that net IBRD lending was -\$4.1 billion in 2002 and is on track for an even larger decline in 2003.

### Regional themes

- GDP growth in the region was 4.1 percent in 2002, up from 2.5 percent in 2001. This impressive increase in the growth rate was mainly due to the sharp recovery of economic activity in Turkey following its 2001 crisis and growth induced by high and rising oil prices in Russia and CIS countries. However, growth in transition countries in the region actually slowed down by a full percentage to 3.6 percent due to slowing growth in Euro Area.
- GDP growth is expected to hold near present rates of 3.5 to 4 percent in the near term. Growth is expected to moderate in Turkey as political problems remain and the conflict in

Iraq takes its toll. The problems in the Middle East can benefit Russia and CIS countries, however, as they may receive more oil-related investments. The build up to EU accession should help boost growth in the 10 accession countries.

- There has been something of a shift in the region's external financing pattern that is counter to the pattern seen in many other regions. The major source of external finance to the region since 1999 had been net equity flows, which remained stable at \$30.4 billion in 2002. Net debt inflows, on the other hand, rose to \$14.4 billion in 2002, up from \$3.3 billion in 2001. This came despite weak overall private sector debt flows to developing countries. Private debt investors have been attracted by the prospects for yield convergence between the region and the Euro area.
- The region received \$10 billion in workers' remittances in 2002, somewhat low relative to other regions. Turkey has been among the top 10 recipients since the 1980s. Turkey's inward remittances declined significantly to \$2.8 billion in the crisis year of 2001 from \$4.6 billion in 2000, underlining the growing sensitivity of these flows to economic factors.

### **Other key regional points to note**

- Local-currency bond markets have grown considerably in recent years in major emerging economies including Hungary, Poland, and Turkey, leading to an important rotation from external to domestic debt in these countries' public sector debt. In recent quarters, foreign investors have also shown considerable interest in domestic bond markets of transition economies of Eastern Europe.
- The ECA region has the highest share of debt-based liabilities among the external liabilities of developing countries as foreign equity-ownership was generally not possible until the early 1990s. The debt to equity rotation is still evident, however. The region's external debt to equity ratio has dropped significantly in recent years as the region has received significant amounts of FDI through the second half of the 1990s.
- FDI flows to the region have been reasonably stable most recently. There has been a notable drop in privatization-related flows. One helpful stabilizing factor is the high propensity to reinvest earnings from FDI. Almost 50 percent of earnings stay in the region, the highest ratio in developing countries.
- The region is expected to receive an estimated \$30 billion in FDI in 2003.
- Overall corporate profitability has also been relatively strong. That said, however, the average rate of return on FDI has been moderate at 4.2 percent, the lowest among other regions except Middle East and North Africa.
- The EU accession of these countries (scheduled for mid-2004) is also likely to increase inward workers' remittances to the region. Key votes on accession in the 9 remaining countries (Slovenia has already passed) are due in 2003.
- The bounce back of the Russian economy after the turmoil of 1998 continues to be remarkable. The Russian Federation is finally emerging as an attractive destination for foreign investment.

Table A.3 Europe and Central Asia outlook in summary, 1981–2003

| <b>Real economy</b><br>(percent change, unless stated)                    | 1981–90 | 1991–00 | 1997 | 1998 | 1999  | 2000  | 2001  | 2002e | 2003f |
|---|---------|---------|------|------|-------|-------|-------|-------|-------|
| Real GDP growth   | 1.6     | −1.5    | 3.1  | 0.1  | 1.8   | 6.5   | 2.3   | 4.1   | 3.7   |
| Private consumption per capita  | 0.1     | 0.4     | 5.3  | 0.6  | −1.2  | 8.7   | 5.0   | 5.6   | 3.6   |
| GDP per capita  | 0.7     | −1.7    | 3.0  | −0.1 | 1.6   | 6.4   | 2.2   | 4.0   | 3.5   |
| Population  | 0.9     | 0.2     | 0.1  | 0.1  | 0.2   | 0.1   | 0.1   | 0.1   | 0.1   |
| Gross domestic investment/GDP <sup>a</sup>                                | 32.1    | 24.2    | 22.3 | 22.3 | 21.3  | 22.0  | 21.5  | 21.4  | 21.5  |
| Inflation <sup>b</sup>  | 1.1     | 52.5    | 17.5 | 11.9 | 7.6   | 9.7   | 7     | 3.8   | 5.7   |
| Central government budget balance/GDP                                     | −0.5    | −4.4    | −4.4 | −4.5 | −5.6  | −5.3  | −8.4  | −7.8  | −6.9  |
| Export market growth <sup>c</sup>   | 3.3     | 10.2    | 8.0  | 4.8  | −1.0  | 11.9  | 2.6   | 2.0   | 6.6   |
| Export volume <sup>d</sup>  | 0.1     | 3.1     | 9.4  | 4.6  | −0.1  | 13.1  | 1.7   | 5.9   | 7.9   |
| Terms of trade/GDP <sup>e</sup>   | 0.1     | 0.2     | 0.2  | −0.6 | −0.4  | 0.8   | 2.9   | −3.0  | 1.8   |
| Current account/GDP   | −0.5    | −0.7    | −2.5 | −2.7 | −0.3  | 2.0   | 1.9   | 0.8   | 0.6   |
| Workers remittances (billions of dollars)                                 | —       | —       | 7.1  | 9.2  | 8.1   | 8.7   | 8.9   | 10.0  | —     |
| <b>Memorandum items</b>   |         |         |      |      |       |       |       |       |       |
| GDP growth: Transition countries  | 1.2     | −2.4    | 2.1  | −0.7 | 3.5   | 6.3   | 4.5   | 3.6   | 3.6   |
| Central and Eastern Europe  | 1.1     | 0.7     | 3.4  | 2.8  | 2.2   | 3.9   | 2.8   | 2.7   | 3.0   |
| CIS   | 1.3     | −4.4    | 1.0  | −3.6 | 4.6   | 8.4   | 5.8   | 4.4   | 4.1   |
| <b>External Financing and Debt</b><br>(billions of dollars unless stated) |         |         |      |      |       |       |       |       |       |
|   | 1995    | 1996    | 1997 | 1998 | 1999  | 2000  | 2001  | 2002e | 2003f |
| Net inward FDI  | 17.0    | 16.3    | 21.8 | 26.0 | 28.3  | 29.2  | 30.1  | 29.0  | 30.0  |
| Net inward portfolio equity flows   | 1.7     | 4.3     | 4.0  | 4.0  | 2.0   | 1.2   | 0.3   | 1.4   | 2.0   |
| Net inward debt flows   | 23.4    | 22.7    | 32.6 | 40.4 | 15.8  | 22.0  | 3.3   | 11.2  | 17.0  |
| From public sources   | 6.8     | 8.6     | 6.7  | 7.4  | −0.8  | −0.1  | 2.8   | 3.9   | 2.0   |
| From private sources  | 16.6    | 14.1    | 25.9 | 33.1 | 16.6  | 22.2  | 0.5   | 7.2   | 15.0  |
| Gross market-based capital inflows  | 21.9    | 26.9    | 51.2 | 43.4 | 31.0  | 40.7  | 27.7  | 35.5  | 44.0  |
| Total external debt   | 350     | 367     | 387  | 484  | 494   | 504   | 498   | —     | —     |
| Medium- and long-term   | 305     | 315     | 331  | 413  | 422   | 423   | 422   | —     | —     |
| Short-term  | 44      | 52      | 56   | 71   | 72    | 80    | 76    | —     | —     |
| Owed by public-sector borrowers   | 287     | 287     | 289  | 321  | 316   | 305   | 291   | —     | —     |
| Owed by private-sector borrowers  | 63      | 80      | 98   | 163  | 178   | 198   | 207   | —     | —     |
| Owed to public-sector creditors   | 157     | 161     | 157  | 173  | 171   | 166   | 159   | —     | —     |
| Owed to private-sector creditors  | 193     | 206     | 230  | 312  | 323   | 338   | 339   | —     | —     |
| Gross foreign exchange reserves   | 81.1    | 83.4    | 90.7 | 95.6 | 102.8 | 119.6 | 130.0 | 164.0 | 189.0 |

— Not available.

Note: e = estimate, f = forecast.

a. Fixed investment, measured in real terms.

b. Local currency GDP deflator, median.

c. Weighted average growth of import demand in export markets.

d. Goods and non-factor services.

e. Change in terms of trade, measured as a percentage of GDP.

**Table A.24 External financing: Europe and Central Asia, 1997–2003**

(billions of dollars)

|  | 1997  | 1998  | 1999  | 2000  | 2001  | 2002e | 2003f |
|--|-------|-------|-------|-------|-------|-------|-------|
| Current account balance                                    | -27.8 | -26.6 | -2.9  | 18.3  | 18.3  | 8.9   | 6.7   |
| as a percentage of GDP                                     | -2.5  | -2.7  | -0.3  | 2.0   | 1.9   | 0.8   | 0.6   |
| <b>Financed by:</b>  |       |       |       |       |       |       |       |
| Net equity flows   | 25.9  | 29.9  | 30.2  | 30.4  | 30.4  | 30.4  | 32.0  |
| Net FDI inflows  | 21.8  | 26.0  | 28.3  | 29.2  | 30.1  | 29.0  | 30.0  |
| Net portfolio equity inflows                               | 4.0   | 4.0   | 2.0   | 1.2   | 0.3   | 1.4   | 2.0   |
| Net debt flows   | 32.6  | 40.4  | 15.8  | 22.0  | 3.3   | 11.2  | 17.0  |
| Official creditors   | 6.7   | 7.4   | -0.8  | -0.1  | 2.8   | 3.9   | 2.0   |
| World Bank   | 3.9   | 1.6   | 1.9   | 2.1   | 2.1   | 0.9   | —     |
| IMF  | 2.4   | 5.3   | -3.1  | -0.7  | 6.1   | 4.8   | —     |
| Others   | 0.3   | 0.5   | 0.4   | -1.5  | -5.4  | -1.8  | —     |
| Private creditors  | 25.9  | 33.1  | 16.6  | 22.2  | 0.5   | 7.2   | 15.0  |
| Net medium- and long-term debt flows                       | 17.4  | 28.7  | 17.6  | 12.7  | 5.8   | 10.8  | —     |
| Bonds  | 9.2   | 16.0  | 8.2   | 6.1   | 0.7   | 5.1   | —     |
| Banks  | 8.1   | 13.8  | 10.3  | 8.4   | 7.2   | 7.1   | —     |
| Others   | 0.1   | -1.1  | -1.0  | -1.7  | -2.1  | -1.3  | —     |
| Net short-term debt flows                                  | 8.5   | 4.4   | -1.0  | 9.5   | -5.3  | -3.6  | —     |
| Balancing item <sup>a</sup>                                | -23.5 | -38.8 | -36.7 | -51.6 | -41.6 | -16.5 | -30.7 |
| Change in reserves (- = increase)                          | -7.3  | -4.9  | -6.5  | -19.1 | -10.3 | -34.0 | -25.0 |
| Memo items:  |       |       |       |       |       |       |       |
| Bilateral aid grants<br>(ex. technical cooperation grants) | 5.4   | 5.8   | 8.0   | 8.3   | 7.4   | 9.6   | 10.0  |
| Net private flows (debt + equity)                          | 51.8  | 63.0  | 46.8  | 52.6  | 30.9  | 37.6  | 47.0  |
| Net official flows (aid + debt)                            | 12.1  | 13.2  | 7.2   | 8.2   | 10.2  | 13.5  | 12.0  |
| Workers' remittances                                       | 7.1   | 9.2   | 8.1   | 8.7   | 8.9   | 10.0  | —     |

— Not available.

Note: e = estimate; f = forecast.

a. Combination of errors and omissions and net acquisition of foreign assets (including FDI) by developing countries.