EUROPE and CENTRAL ASIA

Growth in the Europe and Central Asia (ECA) region is estimated to have accelerated from 1.7 percent in 2016 to 3.8 percent in 2017, up from 2.5 percent expected in June 2017. The recovery was broad-based and supported by revitalized domestic demand and robust external demand. Growth is expected to moderate to 2.9 percent in 2018 and stabilize at 3 percent in 2019-20. Risks appear more balanced than in June 2017 but continue to be tilted to the downside. Domestic fiscal, external, and financial sector vulnerabilities, as well as policy uncertainty, amplify risks.

Recent developments

In 2017, the ECA region emerged from three years of subpar growth, following the 2014-16 oil price plunge (Special Focus 1). Growth is estimated to have strengthened to 3.8 percent, 1.3 percentage point higher than projected in June, supported by a broad-based recovery across the region. Growth strengthened in the commodity-exporting eastern part of the region as well as the commodity-importing western part (Figure 2.2.1). The acceleration of activity was largely driven by private consumption and investment, though in the western part net exports also contributed.

The stabilization and partial rebound of oil prices since early 2016 and supportive macroeconomic policies buttressed the recovery of large energy exporters in the eastern part of the region. Their recovery was facilitated by easing inflation, rising real incomes, improving financing conditions, and improved investor confidence. Growth momentum in the western part of the region was supported by tightening labor markets, as manifested in declining unemployment rates and robust real wage growth, as well as improving consumer confidence and investment bolstered by increased absorption of EU structural funds (IMF 2017e). In addition, the pickup in growth in the advanced economies of Europe from late 2016 provided tailwinds to the region's economies through increased export demand.

The two largest economies, the Russian Federation and Turkey, accounted for most of the improvement in the region's expansion in 2017. However, growth picked up in most ECA countries as well, with particularly notable advances in Armenia, Belarus, Kazakhstan and Poland. In contrast, growth weakened in the Kyrgyz Republic, the former Yugoslav Republic of Macedonia, Moldova, Serbia, Ukraine, and Uzbekistan. Azerbaijan continued contracting, albeit at a slower pace.

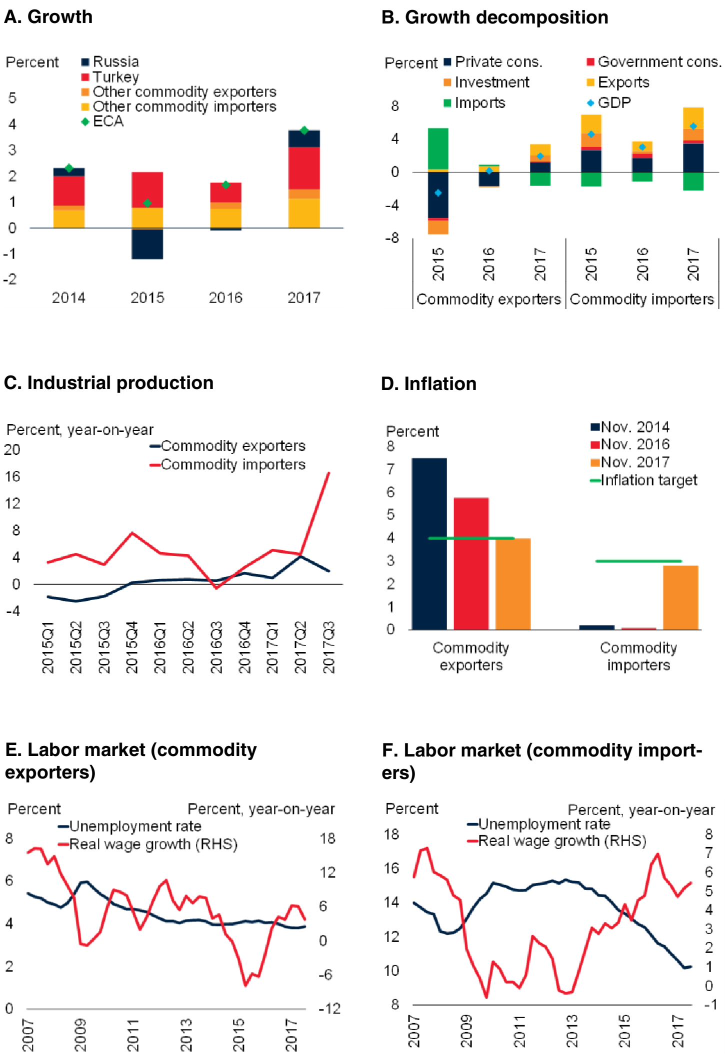
In Russia, after a two-year recession, output expanded by 1.7 percent in 2017, bolstered by higher oil prices and supportive monetary policies amid lower inflation (World Bank 2017n). Floatation of the currency in 2014 helped cushion the impact of the oil price plunge and international sanctions, as did financial sector support. The decline in inflation from a 17 percent peak in early 2015 to below the 4 percent target in late 2017 buttressed disposable income and consumption growth. Stabilizing oil prices supported private investment, primarily in energy and transportation.

The significant rebound in Turkey's growth last year—to 6.7 percent, from 3.2 percent in 2016—was supported by fiscal stimulus aimed at expe-

Note: The author of this section was Yoki Okawa. Research assistance was provided by Shituo Sun.

FIGURE 2.2.1 ECA: Recent developments

Growth continued to rise in 2017 in a broad-based recovery. The acceleration has been largely driven by private investment and consumption, though exports have also contributed to commodity importers. Labor markets have remained robust. Inflation in commodity exporters is slowing as depreciation pressures ease, while inflation in commodity importers is gathering speed.



Sources: Haver Analytics, national central banks, World Bank.

A. GDP-weighted averages. Other commodity exporters include Albania, Armenia, Azerbaijan, Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan. Other commodity importers include Belarus, Bulgaria, Bosnia and Herzegovina, Croatia, Georgia, Hungary, Kosovo, FYR Macedonia, Montenegro, Moldova, Poland, Romania, and Serbia.

B. GDP-weighted averages. Commodity exporters include Albania, Armenia, Azerbaijan, Kazakhstan, the Kyrgyz Republic, Russia, Ukraine, and Uzbekistan. Commodity importers include Belarus, Bulgaria, Croatia, Georgia, Hungary, FYR Macedonia, Moldova, Poland, Romania, and Turkey.

C. GDP-weighted averages. Commodity exporters include Albania, Armenia, Azerbaijan, Kazakhstan, the Kyrgyz Republic, Russia, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan. Commodity importers include Belarus, Bulgaria, Bosnia and Herzegovina, Croatia, Georgia, Hungary, Kosovo, Moldova, FYR Macedonia, Montenegro, Poland, Romania, Serbia, and Turkey.

D. Inflation and target are median in each sub-grouping. Commodity exporters include Albania, Azerbaijan, Kazakhstan, the Kyrgyz Republic, Russia, Ukraine, and Armenia. Commodity importers include Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Georgia, Hungary, Kosovo, FYR Macedonia, Moldova, Poland, Romania, Serbia, and Turkey.

E. F. Averages among the country group. Real wage growth is year-on-year growth. Commodity exporters include Kazakhstan, Russia, and Ukraine. Commodity importers include Bulgaria, Croatia, Hungary, FYR Macedonia, Poland, Romania, Serbia, and Turkey.

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diting recovery from the economic repercussions of the 2016 failed coup attempt. Export growth also rose on the back of strengthening demand from the European Union and competitiveness gains from the 2016 currency depreciation.

In Kazakhstan, growth is estimated to have rebounded to 3.7 percent in 2017 from 1.1 percent in 2016. The recovery was boosted by increased production at the Kashagan oil field (exempt from production cuts agreed by OPEC and some non-OPEC producers) and supportive macroeconomic policies. The latter included fiscal stimulus (the authorities' flagship "Nurly Zhol" initiative, which provided funding to infrastructure, SMEs, and housing), greater exchange rate flexibility, and easing monetary policy. Declining inflation helped support private consumption (World Bank 2017m). Recovery in Russia and Kazakhstan generated positive spillovers for commodity-importing countries in the region through remittances and exports (e.g., Armenia, Belarus, Georgia, Moldova).

The economy of Azerbaijan continued contracting albeit at a slower pace of 1.4 percent in 2017 compared to 3.1 percent in 2016. The economy is weighed down by the legacies of the 2014-16 oil price plunge, including a damaged banking sector, subdued credit growth, and lower government revenue. Weak monetary policy transmission, impaired by shallow financial markets, limited the effectiveness of monetary policy in fighting inflation, damaging real income growth. There were, however, signs of recovery in the non-oil sector and an increase in investment. The economic contraction in Belarus abated, as inflation declined and the economy benefited from the resumption of growth in Russia.

In Ukraine, growth weakened in 2017 in the wake of the trade blockade with eastern Ukraine, which disrupted mining and electricity production. Growth in the Kyrgyz Republic was adversely affected by a slowdown at the Kumtor gold mine. Despite recent improvements, a still-weak business environment continued weighing on growth in Uzbekistan.

Continued expansion in the advanced economies of Europe supported growth in the western part of the region. Export and strong consumption helped raise growth in Central Europe, from 3.2 percent in 2016 to 4.7 percent in 2017.[1] Consumption rose supported by robust labor markets and, in some cases, fiscal stimulus (e.g., child subsidies in Poland, VAT cuts in Romania). Investment growth also strengthened, partly reflecting increased absorption of EU structural funds.

The impact of the recent recovery on labor markets varied across countries. The unemployment rate for commodity exporters declined by only 0.2 percentage points from the peak in 15Q2 to 17Q3, while real wage growth recovered from -8 percent to 4 percent over the same period. In contrast, the unemployment rate for commodity importers declined more significantly on the back of strengthening growth and labor market reforms (World Bank 2018o).

Amid tightening labor markets, inflation rose somewhat in the western part of the region in 2017 but continued falling in the eastern part of the region as exchange rate depreciation pressures eased. Inflation rates were generally below central bank target ranges in both parts of the region.

Outlook

Regional growth is expected to moderate to 2.9 percent in 2018 and stabilize at 3 percent in 2019-20 (Figure 2.2.2). The relatively stable overall growth forecast, however, masks considerable cross-country differences. The forecast is predicated on a modest recovery in commodity prices, a gradual moderation of growth in the Euro Area following a strong cyclical pickup in 2017-18, an orderly tightening of global financing conditions, and the absence of new geopolitical tensions.

In the eastern part of the region, growth is expected to continue strengthening during 2018-20, in line with firming commodity prices and strengthening domestic demand supported by remittances (Armenia, Azerbaijan, Belarus, the Kyrgyz Republic, Tajikistan). Commodity exporters that have already adjusted to current oil price levels are expected to follow a somewhat different path. Growth in Russia is expected to stabilize at around 1.8 percent in 2018-20. Growth in Kazakhstan is projected to moderate to 2.6 percent in 2018 as the one-off effects of increased production at the Kashagan oil field and the fiscal stimulus wane. It is set to rise to 3 percent by 2020 as the country reaps the benefits of structural reforms. Ukraine's economy is expected to continue mending as geopolitical tensions subside, with growth strengthening to 4 percent in the medium term. In Uzbekistan, exchange rate liberalization in September 2017, which resulted in a significant currency depreciation, will help improve competitiveness, enhance market efficiency, and economic growth.

Growth in the western part of the region is projected to slow in line with the maturing recovery in the Euro Area. The gradual slowdown in EU growth (Chapter 1) will weigh on the region's export growth, particularly in Central Europe, where growth is projected to decelerate from 4.7 percent in 2017 to 3.2 percent in 2020, with growth weakening in Hungary, Poland, and Romania. Growth in Turkey is projected to moderate to around 3.5 percent in 2018, as the impact of the 2017 fiscal measures fades.

Risks

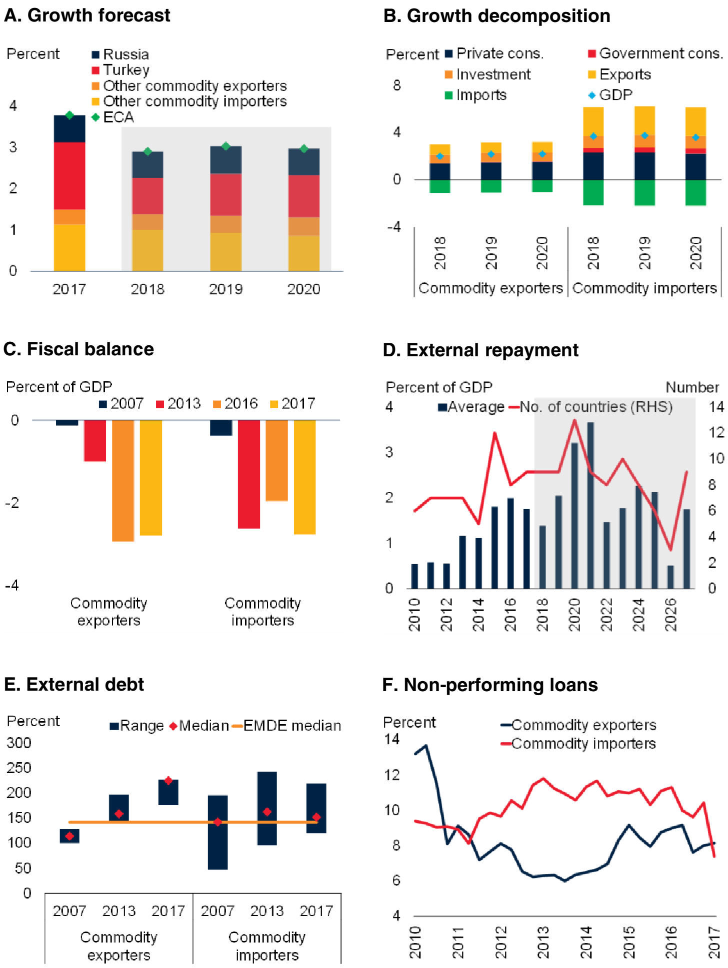
The risks to growth in the region have become more balanced but continue to be tilted to the downside. On the upside, a more favorable external environment than assumed, including faster-than-expected growth in the EU—the largest trading partner and financing source for ECA countries—as well as other major economies, could benefit growth in the region. Acceleration in structural reforms could also boost growth by more than is projected.

However, downside risks remain significant. A disorderly tightening of global financing conditions could raise financing costs and suppress capital inflows and growth. Lower-than-projected oil prices could adversely affect oil

[1] Central Europe includes Poland, Hungary, Bulgaria, and Romania.

FIGURE 2.2.2 ECA: Outlook and risks

Regional growth is expected to remain stable in 2018-20. Fiscal vulnerabilities remain elevated throughout the region, though lower external debt repayments over the next few years will provide some breathing space. For commodity exporters, external debt in relation to exports has increased above the level of EMDE peers in the wake of the 2014-16 oil price plunge and financial vulnerabilities persist. In contrast, for commodity importers, external debt has remained on par with other EMDEs and financial indicators have continued improving.



Sources: Bloomberg, Haver Analytics, International Monetary Fund, World Bank.

A. GDP-weighted averages. Other commodity exporters include Albania, Armenia, Azerbaijan, Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan. Other commodity importers include Belarus, Bulgaria, Bosnia and Herzegovina, Croatia, Georgia, Hungary, Kosovo, FYR Macedonia, Montenegro, Moldova, Poland, Romania, and Serbia.

A. D. Shaded areas indicate forecasts.

B. GDP-weighted averages. Commodity exporters include Albania, Armenia, Azerbaijan, Kazakhstan, the Kyrgyz Republic, Russia, Ukraine, and Uzbekistan. Commodity importers include Belarus, Bulgaria, Croatia, Georgia, Hungary, FYR Macedonia, Moldova, Poland, Romania, and Turkey.

C. Median of general government net lending/borrowing over GDP in each sub group. Commodity exporters include Albania, Armenia, Azerbaijan, Kazakhstan, the Kyrgyz Republic, Russia, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan. Commodity importers include Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Georgia, Hungary, Kosovo, FYR Macedonia, Moldova, Montenegro, Poland, Romania, Serbia, and Turkey.

D. The average of total sovereign/local authority international bond repayments over GDP among countries who are scheduled to repay that year. Because countries who are not scheduled to repay in a given year are excluded from the average, the number of countries for each year is reported as well. Country sample includes 18 countries.

E. Total external debt over exports of goods and services plus primary income. Commodity exporters include Armenia, Russia, and Ukraine. Commodity importers include Belarus, Croatia, Georgia, Hungary, FYR Macedonia, Moldova, Poland, Romania, Serbia, and Turkey.

F. Average share of non-performing loans in percent of total loans. Commodity exporters include Armenia, Kazakhstan, the Kyrgyz Republic, Russia, Tajikistan, Ukraine, and Uzbekistan. Commodity importers include Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Georgia, Hungary, Kosovo, FYR Macedonia, Moldova, Poland, Romania, and Turkey.

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exporters, undermining their still-fragile recoveries and spilling over into smaller neighboring countries through trade and financial channels. An escalation of geopolitical tensions in Ukraine, a tightening of international sanctions on Russia, or an intensification of disagreements of some countries with the EU could deter international investors. The latter could lead to expectations of an end to EU accession protocol for Turkey and of disruptions in EU funding to some countries during the next budget cycle.

These risks may be amplified by various country-specific vulnerabilities, which include:

- *External vulnerabilities*: large external deficits (e.g., Belarus, Bosnia and Herzegovina, Georgia, Kosovo, the Kyrgyz Republic, Moldova, Montenegro, Serbia, Turkey) and high external debt (Tajikistan), which increased in the wake of the 2014-16 oil price plunge in the eastern part of the ECA region.

- *Fiscal vulnerabilities*: limited room for fiscal maneuvering, partly stemming from the fiscal stimulus implemented in the wake of the 2014-16 oil price plunge by both oil exporters (Kazakhstan, Russia) and some oil importers (Romania, Turkey). Lower external debt repayments coming due over the next few years, however, will reduce financing requirements and mitigate rollover risks.

- *Financial sector vulnerabilities*: weak asset quality of banks and other financial institutions in some countries (e.g., Belarus, Bosnia and Herzegovina, Croatia, Moldova) and deteriorating asset quality in others (e.g., Kazakhstan, Russia, Ukraine). Public funds injected into the troubled banks of Azerbaijan, Kazakhstan, Russia, Ukraine, and Uzbekistan in 2017 attest to continued challenges faced by the financial systems of these countries.

In the medium and long term, slower-than-expected productivity growth, partly as a result of low investment and delays in structural reforms, could reduce potential growth and slow down income convergence (Box 2.2.1, Chapter 3).

Major energy exporters, in particular, may suffer from lower growth if they fail to diversify their economies away from oil—for example, if the medium-term strategies recently adopted to that aim in Azerbaijan, Kazakhstan, Russia, and Uzbekistan fail to materialize.

TABLE 2.2.1 Europe and Central Asia forecast summary

(Real GDP growth at market prices in percent, unless indicated otherwise)

	2015	2016	2017e	2018f	2019f	2020f	Percentage point differences from June 2017 projections: 2017e	2018f	2019f
EMDE ECA, GDP[1]	**1.0**	**1.7**	**3.8**	**2.9**	**3.0**	**3.0**	**1.3**	**0.2**	**0.2**
EMDE ECA, GDP excl. Russia	3.6	2.9	5.1	3.6	3.8	3.7	1.8	0.1	0.1
(Average including countries with full national accounts and balance of payments data only)[2]									
EMDE ECA, GDP[2]	0.9	1.6	3.8	2.9	3.0	2.9	1.3	0.2	0.2
GDP per capita (U.S. dollars)	0.5	1.2	3.4	2.5	2.7	2.7	1.1	0.0	0.1
PPP GDP	0.6	1.6	3.6	2.9	3.0	2.9	1.1	0.2	0.2
Private consumption	-2.7	0.0	4.2	3.3	3.3	3.3	0.8	-0.6	-0.7
Public consumption	0.2	1.7	1.3	1.3	1.6	1.6	-1.0	-0.6	-0.5
Fixed investment	0.4	0.5	4.7	3.7	3.9	3.8	0.9	-0.5	-0.4
Exports, GNFS[3]	3.8	2.7	5.8	4.7	4.7	4.6	2.1	0.8	0.9
Imports, GNFS[3]	-5.7	1.5	6.6	5.5	5.4	5.2	1.2	-0.4	-0.6
Net exports, contribution to growth	3.0	0.5	0.1	0.0	0.0	0.0	0.4	0.4	0.5
Memo items: GDP									
Commodity exporters[4]	-2.3	0.3	2.1	2.1	2.3	2.3	0.4	0.2	0.3
Commodity importers[5]	4.5	3.0	5.5	3.7	3.7	3.6	2.1	0.2	0.1
Central Europe[6]	3.7	3.2	4.7	4.0	3.5	3.2	1.2	0.7	0.3
Western Balkans[7]	2.1	2.9	2.7	3.3	3.6	3.8	-0.5	-0.2	-0.1
Eastern Europe[8]	-7.6	0.8	2.0	3.1	3.5	3.5	0.6	0.5	0.3
South Caucasus[9]	1.7	-1.6	0.3	1.9	2.5	3.3	0.2	0.3	0.3
Central Asia[10]	3.3	3.3	4.6	3.8	4.1	4.3	0.7	-0.3	-0.4
Russia	-2.8	-0.2	1.7	1.7	1.8	1.8	0.4	0.3	0.4
Turkey	6.1	3.2	6.7	3.5	4.0	4.0	3.2	-0.4	-0.1
Poland	3.8	2.9	4.5	4.0	3.5	3.1	1.2	0.8	0.3

Source: World Bank.
Notes: e = estimate; f = forecast. EMDE = emerging market and developing economy. World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not differ at any given moment in time.
1. GDP at market prices and expenditure components are measured in constant 2010 U.S. dollars.
2. Sub-region aggregate excludes Bosnia and Herzegovina, Kosovo, Montenegro, Serbia, Tajikistan, and Turkmenistan, for which data limitations prevent the forecasting of GDP components.
3. Exports and imports of goods and non-factor services (GNFS).
4. Includes Albania, Armenia, Azerbaijan, Kazakhstan, the Kyrgyz Republic, Kosovo, Russia, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan.
5. Includes Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Georgia, Hungary, FYR Macedonia, Moldova, Montenegro, Poland, Romania, Serbia, and Turkey.
6. Includes Bulgaria, Croatia, Hungary, Poland, and Romania.
7. Includes Albania, Bosnia and Herzegovina, Kosovo, FYR Macedonia, Montenegro, and Serbia.
8. Includes Belarus, Moldova, and Ukraine.
9. Includes Armenia, Azerbaijan, and Georgia.
10. Includes Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan.
For additional information, please see www.worldbank.org/gep.

TABLE 2.2.2 Europe and Central Asia country forecasts[1]

(Real GDP growth at market prices in percent, unless indicated otherwise)

	2015	2016	2017e	2018f	2019f	2020f	Percentage point differences from June 2017 projections 2017e	2018f	2019f
Albania	2.2	3.4	3.8	3.6	3.5	3.5	0.3	0.1	-0.3
Armenia	3.2	0.2	3.7	3.8	4.0	4.0	1.0	0.7	0.6
Azerbaijan	1.1	-3.1	-1.4	0.9	1.5	2.6	0.0	0.3	0.2
Belarus	-3.8	-2.6	1.8	2.1	2.4	2.4	2.2	1.6	1.2
Bosnia and Herzegovina[2]	3.0	3.1	3.0	3.2	3.4	3.5	-0.2	-0.5	-0.6
Bulgaria	3.6	3.9	3.8	3.9	4.0	3.9	0.8	0.7	0.7
Croatia	2.3	3.2	3.0	2.6	2.8	3.0	0.1	0.1	0.2
Georgia	2.9	2.8	4.3	4.2	4.7	5.0	0.8	0.2	0.2
Hungary	3.4	2.2	3.9	3.8	3.1	2.9	0.2	0.1	0.1
Kazakhstan	1.2	1.1	3.7	2.6	2.8	3.0	1.3	0.0	-0.1
Kosovo	4.1	3.4	4.4	4.8	4.8	4.7	0.5	0.6	0.4
Kyrgyz Republic	3.9	3.8	3.5	4.2	4.8	4.6	0.1	0.2	0.0
Macedonia, FYR	3.8	2.4	1.5	3.2	3.9	4.0	-1.3	-0.1	0.1
Moldova	-0.4	4.3	3.5	3.8	3.6	3.3	-0.5	0.1	0.1
Montenegro	3.4	2.9	4.2	2.8	2.5	2.1	0.9	-0.2	0.5
Poland	3.8	2.9	4.5	4.0	3.5	3.1	1.2	0.8	0.3
Romania	3.9	4.8	6.4	4.5	4.1	3.5	2.0	0.8	0.6
Russia	-2.8	-0.2	1.7	1.7	1.8	1.8	0.4	0.3	0.4
Serbia	0.8	2.8	2.0	3.0	3.5	4.0	-1.0	-0.5	0.0
Tajikistan	6.0	6.9	5.2	5.0	5.5	5.7	-0.3	-0.9	-0.6
Turkey	6.1	3.2	6.7	3.5	4.0	4.0	3.2	-0.4	-0.1
Turkmenistan	6.5	6.2	6.4	6.3	6.3	6.3	0.1	-0.2	-0.2
Ukraine	-9.8	2.3	2.0	3.5	4.0	4.0	0.0	0.0	0.0
Uzbekistan	8.0	7.8	6.2	5.6	6.3	6.5	-1.4	-2.1	-1.5

Source: World Bank.
Notes: e = estimate; f = forecast. World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not differ at any given moment in time.
1. GDP at market prices and expenditure components are measured in constant 2010 U.S. dollars, unless indicated otherwise.
2. GDP growth rate is based on production approach.
For additional information, please see www.worldbank.org/gep.

BOX 2.2.1 Potential growth in Europe and Central Asia

Potential growth in Europe and Central Asia has declined by around 1.4 percentage point in 2013-17 from pre-crisis period, to 2.3 percent. The decline is mostly attributable to weaker productivity growth, but shrinking labor supply have played a role. Although population aging and slowing productivity growth are expected to continue weighing on potential growth over the next decade, there are policy options available to offset the decline.

Introduction

Growth in Europe and Central Asia (ECA) has slowed considerably since the global financial crisis, reversing the rapid convergence to advanced EU per capita incomes seen in prior years. To a large extent, this slowdown reflected cyclical factors—including the global financial crisis in 2007-08, the European debt crisis in 2010-11, and the oil price collapse in 2014-16—which triggered deep output contractions in some ECA countries.

Concurrent with the cyclical slowdown, potential growth appears to have slowed as well. Historical evidence suggests that steep output contractions can leave a lasting dent in potential growth through legacies such as human capital loss in extended unemployment spells, weakened investor confidence about growth prospects, and slower productivity gains resulting from weak investment (Chapter 3).[1]

Against this backdrop, this box discusses the following questions.

- How has potential growth evolved in the region and what were its main drivers?
- What are prospects for potential growth?
- What are the policy options to lift potential growth?

Evolution of potential growth and its drivers

Potential output growth in ECA has declined significantly since the global financial crisis, from 3.7 percent in 2003-07 to 2.3 percent in 2013-17 (Figure 2.2.1.1). About three-quarters of the decline reflected slowing total factor productivity (TFP) growth, and the remainder due to slowing labor supply growth. The decline in potential growth over the previous decade was steeper among commodity exporters (-1.7 percentage points) than among commodity importers (-0.9 percentage points). Spillovers from severe output contractions from falling commodity prices and geopolitical tensions in large commodity exporters such as Russia and Ukraine weighed on investment and potential growth for commodity exporters. Potential growth in Russia and Poland showed a decline after 2008-09, reflecting weak investment and demographic trends (Narodowy Bank Polski 2017). The exception was Turkey, where potential growth was largely unchanged during 2013-17 due to large numbers of youth entering the labor force.

Total factor productivity growth

Total factor productivity (TFP) growth in the region declined to 0.8 percent in 2013-17, about 0.4 percentage points below the long-term average. The deceleration of TFP growth reflected three factors (Figure 2.2.1.2):

- *Slowing foreign direct investment (FDI) inflows.* Growth in FDI flows to the region slowed to 1 percent per year in 2013-16 from 37 percent in 2005-07 (EBRD 2015). This likely adversely affected TFP growth in light of evidence that FDI has fostered technological transfers and productivity gains in the ECA region as a whole and particularly in Central Europe (Goldberg, Goddard, and Kuriakose 2011; Bijsterbosch and Kolasa 2010; IMF 2016c).
- *Slowing sectoral reallocation.* The reallocation of labor from the agriculture sector to services and industry has been an important source of economy-wide productivity gains over the past two decades (IMF 2016c). However, in the Western part of the region, the shift from agricultural to non-agricultural employment slowed after the global financial crisis.
- *Slowing reform momentum.* Over the past decade, countries in the ECA region have made large strides in improving their business environments, and the relevant indexes in Central and Eastern Europe, the Western, Balkans, and the South Caucasus are approaching the levels in advanced EU countries. However, reform momentum appears to have slowed after EU accession in the mid-2000s for Central Europe. Business climates in Central Asia continue to lag well behind those elsewhere in the region (EBRD 2014).

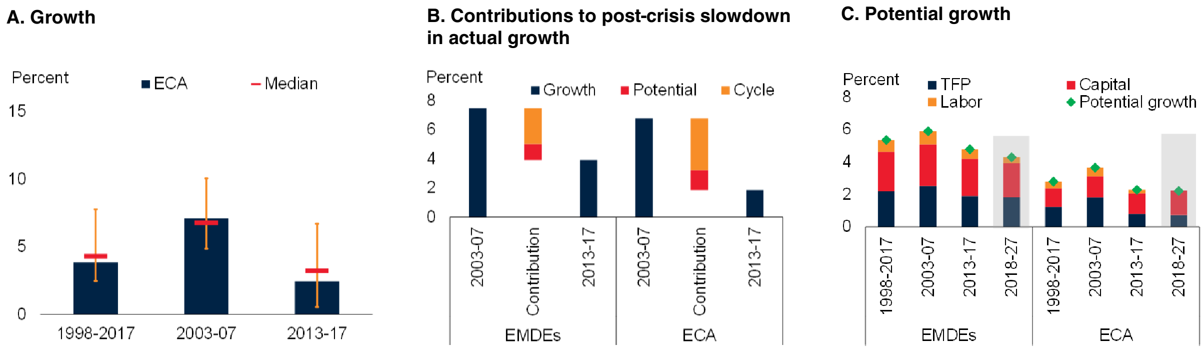
Note: This box was prepared by Yoki Okawa, Sinem Kilic Celik, and Modeste Some. Shituo Sun provided research assistance.

[1] The recent slowdown of potential growth and its implications for long-term growth prospects have been highlighted by EBRD (2014) for the region as a whole, IMF (2016c) for Central and South-Eastern Europe, and by ADB (2016) for Central Asia and the Caucasus.

BOX 2.2.1 Potential growth in Europe and Central Asia *(continued)*

FIGURE 2.2.1.1 Regional growth and drivers of potential growth

The growth slowdown in the region reflects both cyclical and longer-term structural factors. Unfavorable demographic trends, easing productivity growth, and weak investment have weighed on potential growth.



Source: World Bank.
Notes: GDP-weighted averages.
A. Blue bars indicate GDP-weighted average of 24 ECA countries. Vertical lines indicate range of averages for all EMDE regions.
B. C. Based on potential growth estimates using the production function approach (Chapter 3).
C. Shaded areas indicate forecasts.
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Capital accumulation

Post-crisis, investment growth in the ECA region slowed from double-digit rates in 2011 to near-zero in 2015-16. In most Western ECA countries, investment growth has remained well below the EU average, reflecting weak activity in Euro Area trading partners, external borrowing constraints especially during the Euro Area debt crisis, and structural and institutional impediments that slowed productivity growth (World Bank 2017b). Elsewhere in the region, low commodity prices, slowing growth in China, and weak activity in major advanced economies have softened growth prospects and weighed on investment (EBRD 2015). The oil price plunge of 2014-16 also had negative spillovers for investment in the mining sector.

Labor Supply

Working-age population growth, which has long been well below the EMDE average, has turned negative in the ECA region (Figure 2.2.1.3). This demographic shift began in the late 2000s and is attributed to collapsing fertility rates in the 1990s in the aftermath of the collapse of the Soviet Union. Slowing emigration and rising female labor force participation have only partially mitigated the effects of population aging.

- *Immigration to EU.* Although proximity to the EU has encouraged large-scale emigration from ECA countries since 1990, these flows have slowed since the global financial crisis amid weak Euro Area activity. While emigration has helped reduce unemployment and poverty in origin countries (partly by generating large remittance inflows), it has weighed on growth in these countries, especially where high-skilled workers have left (Docquier, Ozden, and Peri 2014; IMF 2016c; Mansoor and Quillin 2006; Hausmann and Nedelkoska 2017). In addition, large remittance inflows have generated currency appreciation pressures and further dampened competitiveness of origin countries (World Bank 2017b; Meyer and Shera 2017).

- *Immigration to Russia.* Linguistic, family, cultural, and economic ties with Russia and neighboring countries created strong migration flows to Russia, especially from Central Asia (World Bank 2017s). This has helped slow the decline in working-age population growth in Russia, but accelerated the slowdown in Central Asia. However, immigration to Russia slowed sharply in the steep recession of 2015-16.

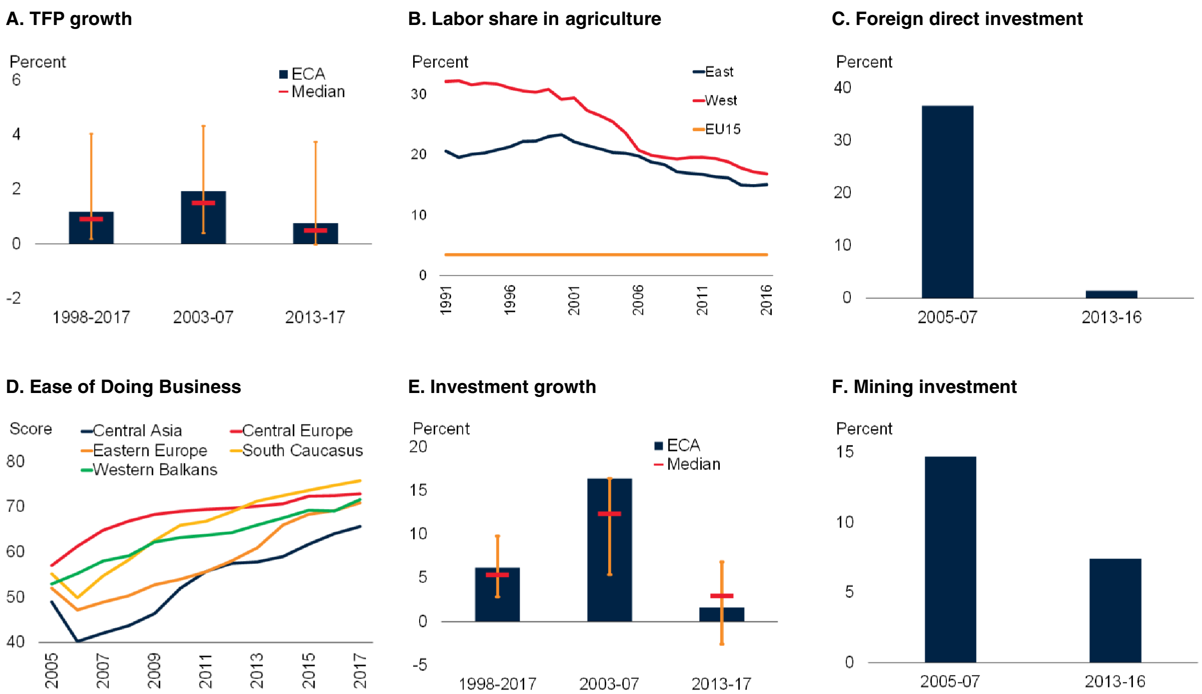
Potential growth prospects

Regional potential growth is expected to remain subdued in 2018-27 at 2.2 percent, slightly down from 2.3 percent in 2013-17 (Figure 2.2.1.4). This reflects a combination of weak productivity growth and unfavorable demographic trends in many countries. Population aging, which leads to

BOX 2.2.1 Potential growth in Europe and Central Asia *(continued)*

FIGURE 2.2.1.2 Factors contributing to the slowdown in productivity

Total factor productivity growth has slowed below its long-term average. In the western part of the region, the reallocation of labor from agriculture to the more productive industry and service sectors slowed, as did FDI inflows. In Central Europe, reform momentum slowed after 2007 as well. Investment growth decelerated sharply following the crisis. Among commodity exporters, a slowdown in the mining sector played a significant role.



Sources: European Bank for Reconstruction and Development, Haver Analytics, International Labor Organization (ILO), Ministry of the National Economy of the Republic of Kazakhstan, Organization for Economic Co-operation and Development, Penn World Tables, Russian Federation Federal State Statistics Service, World Bank.

A. GDP-weighted average of TFP growth from Chapter 3. Blue bars indicate average for 10 ECA countries; vertical lines indicate range of averages for all EMDE regions.

B. Percent of agricultural employment in total employment in each region. “East” includes Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, the Kyrgyz Republic, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan. “West” include Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Hungary, FYR Macedonia, Poland, Montenegro, Romania, Serbia, and Turkey. “EU15” includes Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, and the United Kingdom.

C. Average annual growth in FDI inflows to Belarus, Croatia, Georgia, Hungary, Kazakhstan, FYR Macedonia, Moldova, Poland, Russia, Romania, and Ukraine.

D. Distance to frontier in Doing Business Indicators, with a higher index denoting easier business environments. Central Asia includes Kazakhstan, the Kyrgyz Republic, Tajikistan, and Uzbekistan. Central Europe includes Bulgaria, Croatia, Hungary, and Romania. Eastern Europe includes Belarus, Moldova, Russia, and Ukraine. South Caucasus includes Armenia, Azerbaijan, and Georgia. Western Balkan includes Albania, Bosnia and Herzegovina, Kosovo, FYR Macedonia, Montenegro, Serbia, and Turkey.

E. GDP-weighted average annual growth rates.

F. Average annual growth rates of mining sector investment in Kazakhstan and Russia.

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both a shrinking labor force and a growing share of older workers, will weigh particularly heavily on potential growth in the Eastern part of the ECA region. Increasing share of older workers tends to reduce aggregate labor market participation rate and productivity growth. A notable exception is Turkey, where continued strong growth in the working-age population supports a positive outlook for potential growth.

Among commodity-exporting economies, limited prospects of the substantial recovery in commodity prices could continue to adversely affect investment. In turn, lower investment growth would cap potential growth through slower capital deepening and embodied technological improvements.

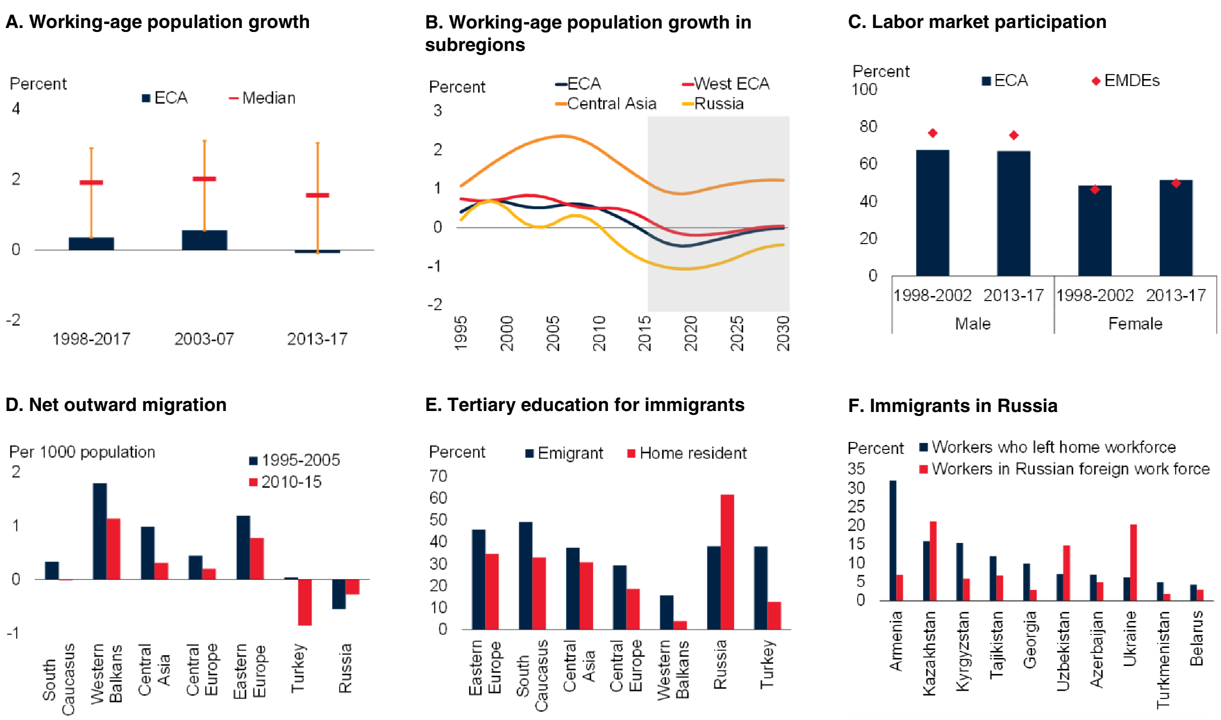
Policy options to lift potential growth

A wide range of policy options is available to help stem the decline in potential growth in the ECA region. A simulation suggests that increasing investment and labor market reforms can reverse the expected slowdown (Figure 2.2.1.5).

BOX 2.2.1 Potential growth in Europe and Central Asia *(continued)*

FIGURE 2.2.1.3 Labor supply

Working-age population growth, which has long been well below the EMDE average, declined across the region in the late 2000s. Rising female labor force participation has only partially mitigated the effects of unfavorable demographic trends and outward migration (except Russia). People who live outside their native country are better educated than those who remain. Russia saw net immigration from neighboring countries.



Sources: International Labor Organization, Organization for Economic Co-operation and Development, Russian Federation Federal State Statistics Service, United Nations, World Bank.

A. GDP-weighted average shares of population aged 15-64 years as a percent of total population.

B. Annual growth rate of total population aged 15-64 aggregated by subregions. ECA includes Albania, Armenia, Azerbaijan, Belarus, Bulgaria, Bosnia and Herzegovina, Georgia, Croatia, Hungary, Kazakhstan, the Kyrgyz Republic, Moldova, FYR Macedonia, Montenegro, Poland, Romania, Russia, Serbia, Tajikistan, Turkmenistan, Turkey, Ukraine, and Uzbekistan. West ECA includes Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Hungary, FYR Macedonia, Montenegro, Poland, Romania, Serbia, and Turkey. Central Asia include Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan. Shaded areas indicate forecasts.

C. Simple average of 24 ECA countries. EMDE average includes 151 countries.

D. -E. Central Asia includes Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan. Central Europe includes Bulgaria, Croatia, Hungary, Poland, and Romania. Eastern Europe includes Belarus, Moldova, and Ukraine. South Caucasus includes Armenia, Azerbaijan, and Georgia. Western Balkans includes Albania, Bosnia and Herzegovina, FYR Macedonia, Montenegro, and Serbia.

D. Number of total emigrants per 1,000 population during the sample period. Number is simple average across countries in each sub-region.

E. Percentage of the population above age 24 who completed some tertiary education in 2010 or closet year available. Emigrant is defined as a person who lives outside of their birth country. Numbers are simple averages across birth countries in the sub-region.

F. Number of total immigrant workers who arrived in Russia during 1997-2016 divided by the total labor force of the origin country in 2016. Number of total immigrant workers who arrived in Russia from each country during 1997-2016 divided by total immigrant workers who arrived in Russia during 1997-2016. For Tajikistan, data suggested by the domestic survey may differ from the data used here. For details, see Strokova and Ajwad 2017.

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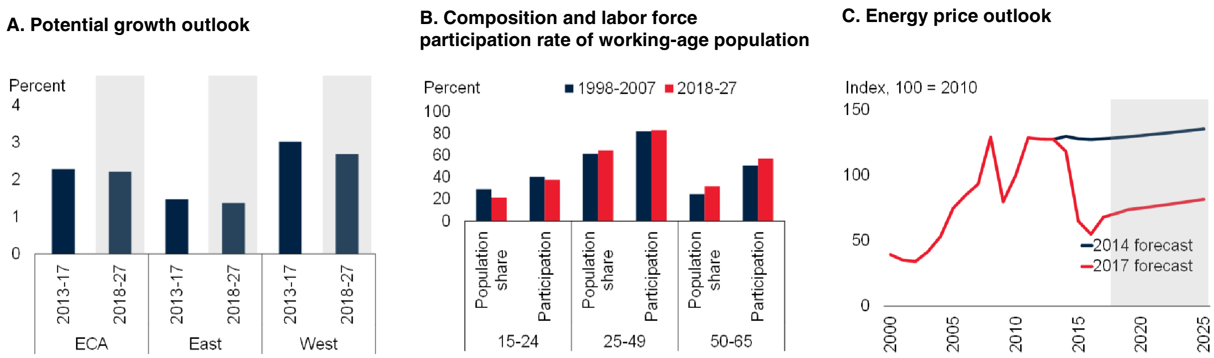
Raise capital accumulation

Increase public investment efficiency. Infrastructure needs are sizable in the ECA region. Investment gaps are estimated to be the equivalent to 1.3 percent of GDP (EBRD 2015). Although there is limited fiscal space available for governments to fill these gaps, there is scope to improve the efficiency of public investment (World Bank 2017p). This could be achieved with more strategic, rigorous, and transparent project selection mechanisms, and by strengthening the institutional capacity to fund, manage, execute, and monitor project implementation. For example, by introducing a rate-of-return criterion for public investment, Azerbaijan has reduced the completion time of key projects by 26 percent (World Bank 2016h).

BOX 2.2.1 Potential growth in Europe and Central Asia *(continued)*

FIGURE 2.2.1.4 Regional potential growth outlook

Regional potential growth is expected to slow marginally to 2.2 percent in 2018-27 from 2.3 percent in 2013-17. The raising share of older workers will result in lower labor participation and could contribute to slower productivity growth. The lower energy price outlook could further weigh on investment and capital accumulation in energy exporters.



Sources: International Labor Organization, World Bank.

A. GDP-weighted averages. East includes 12 countries in Central Asia and Western Balkan. West includes 11 countries in Eastern Europe, South Caucasus, and Central Asia.

A. C. Shaded areas indicate forecasts.

B. Population share refers to the average share of the population of certain age ranges over the total population aged 15-65, weighted by the population of each country. Participation is a simple average of the labor market participation rate.

C. Index of energy prices and outlook published in "Commodity Markets Outlook" (World Bank 2014, 2017q).

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Increase savings. The financing available for private investment could be expanded by raising household savings. In the western part of the region, for example, household savings rates are low by EU standards. Pension reforms, development of the mutual fund industry, and efficiency improvements in pension administration would yield benefits (IMF 2016c; World Bank 2011b).

Expand labor supply

Raise labor force participation. Male labor force participation in ECA lags behind that in other EMDE regions; female labor force participation, while higher than the EMDE average, lags behind that in advanced economies. Female labor force participation is responsive to steps to improve the educational attainment of women and to better access to child care services (Chapter 3). In Western Balkan countries, where multiple barriers and disincentives discourage female labor force participation, increased parental leave, decreased labor taxes, and lower childcare costs could significantly increase female labor force participation rates (World Bank 2016i, 2016j, 2017r; Atoyan and Rahman 2017).

Attract and retain skilled labor. Brain drain is a significant problem in the ECA region, especially in the Western Balkans where rates of emigration among the highly educated are high. Steps to mitigate the loss of skilled workers could pay considerable dividends (IMF 2016c; World Bank 2017s). Several countries have launched initiatives to retain skilled workers or to encourage their return after years of absence. In 2006, Albania implemented a "brain gain" program to promote return migration by offering employment in public administration and improving the work environment in universities and research institutions (Agolli and Gugu 2010). Youth workforce development projects, such as entrepreneurship training programs and provision of micro credits, have created opportunities for skilled young people in the Western Balkans, the South Caucasus, and Central Asia (International Labor Organization 2017; World Bank 2013b).

Increase productivity

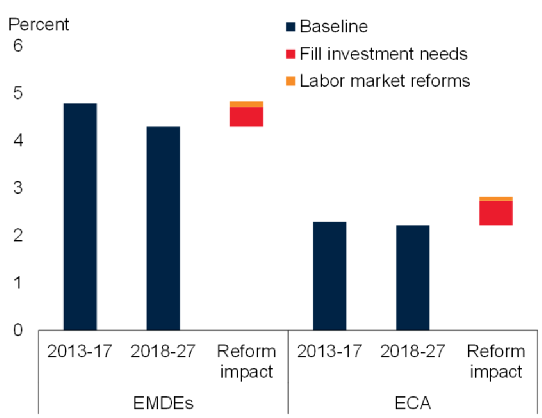
Reform state-owned enterprises. Public firms tend to be less efficient than private firms in ECA (Böwer 2017). While Central European has attained a private sector share of the economy similar to that in advanced economies, the private sectors for the rest of the region account for considerably smaller shares of the economy. Further privatization in these regions presents an opportunity to raise economy-wide productivity, especially if it is accompanied by improved management and corporate governance, open access to world markets, and well-functioning legal and institutional frameworks (Estrin et al. 2009). Short of privatization, there are important

BOX 2.2.1 Potential growth in Europe and Central Asia *(continued)*

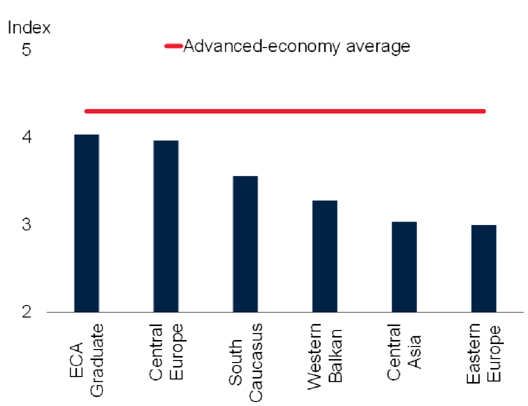
FIGURE 2.2.1.5 Policies to stem declining potential growth

A range of policy options is available to help stem the decline in potential growth in the ECA region, including measures to raise capital and increase labor force participation. Privatization in the ECA region continues to lag behind advanced economies, particularly countries in Eastern Europe.

A. Potential growth under reform scenarios



B. Privatization



Sources: European Bank for Reconstruction and Development, World Bank.
A. GDP-weighted averages. Derived using the methodology described in Chapter 3.
B. Privatization index from EBRD. "ECA graduate" refers to regional economies no longer categorized as "emerging and development economies." These include Estonia, Latvia, Lithuania, Slovak Republic, and Slovenia.
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opportunities to strengthen the governance and therefore the productivity of state-owned enterprises, as illustrated by the efforts being made by Romania and FYR Macedonia.[2]

Make more business-friendly environments. Efforts to improve the business environments in commodity-importing Central European economies to EU15 standards stalled after the global financial crisis (World Bank 2017l; IMF 2016c). International integration or external standards such as the Doing Business Index can anchor reforms. Improvement in local-level transparency and accountability standards can be politically easier than national-level reform and can lead to national-level reform (EBRD 2014).

Integrate into global value chains. Cross-country evidence shows that exporting firms tend to benefit from faster productivity growth, especially through their participation in global value chains (Ruta, Constantinescu, and Mattoo 2017).[3] Over the past two decades, Central European countries have developed a comparative advantage in knowledge-intensive manufacturing, including as part of the German supply chain (Figure 2.2.1.6; IMF 2013). Policies to foster the integration of domestic industry into global supply chains go beyond tariffs and quotas. They include coordination of intellectual property rights protection, competition laws, FDI frameworks, and transportation infrastructure (Baldwin and Lopez-Gonzalez 2015). Moreover, manufacturing productivity can also be improved by lowering barriers to services trade (Beverelli, Fiorini, and Hoekman 2017). For countries in the South Caucasus and Central Asia, the Eurasian Economic Union and China's Belt and Road Initiative present opportunities to adopt a regional approach to building productivity-enhancing value chains (Ustyuzhanina 2016).

[2] In Romania, a number of state-owned enterprises depoliticized and professionalized their boards in 2013-16. Romania also passed a law on state-owned enterprise governance (Law 111/2016), which improved the criteria for the selection and evaluation of state-owned enterprise managers and introduced performance monitoring for others (Capannelli 2017). However the implementation of the law is lagging behind and resistance to change is significant. In FYR Macedonia, institutional and organizational reform combined with capital investment improved the operational effectiveness of the state-owned railway company (World Bank 2012).

[3] In the ECA region, a positive relationship between exports and productivity has been documented for Poland, Romania, and Russia. Cross-country studies in the region also find a positive relationship. (Goldberg, Goddard, and Kuriakose 2011; Gabrielczak and Serwach 2014; Stefanescu and Dumitriu 2014; Krasnopeeva et al. 2016).

BOX 2.2.1 Potential growth in Europe and Central Asia *(concluded)*

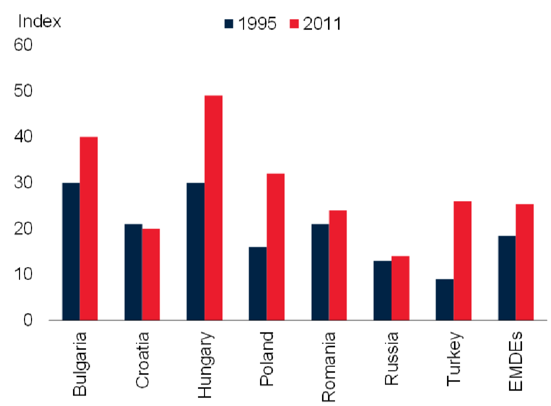
Promote FDI. Inward FDI stands to boost productivity in ECA by accelerating technology absorption. In Serbia, for example, firms with foreign capital have more efficient production technology, better foreign marketing, and more research and development activity than firms that do not have foreign capital. Foreign-owned firms initiated greater plant modernization and automation than domestically-owned firms, raising labor productivity (Goldberg, Goddard, and Kuriakose 2011). Such productivity-enhancing foreign investment can be encouraged by liberalizing FDI and merger and acquisition rules. Moreover, spillovers to domestically-owned firms can be encouraged by building public research and development infrastructure that bridges the gap between foreign entrants and domestic research capacity. In addition, improving domestic human capital by training and high-quality education encourages technological transfer to domestic firms that received FDI (Fu 2008; Teixeira and Fortuna 2010).

Diversify resource-intensive economies. Increasing specialization in global trade raised the share of commodities in exports for commodity-exporting ECA countries (van Eeghen et al. 2014). Reliance on natural resources poses several policy challenges. By concentrating on a few commodities, economies remain vulnerable to negative prices shocks. Even positive price shocks can be disruptive by weakening the competitiveness of other sectors in resource-intensive economies ("Dutch disease"). Strong policy frameworks to manage commodity revenues can promote long-term investment and job creation by reducing cyclical fluctuations and mitigating the adverse effects of Dutch disease. For example, in Russia, new public spending rules based on oil prices should help reduce pressures for procyclical fiscal policy responses to commodity price shocks from 2019 onwards. Moreover, governments in commodity-dependent economies are often slow to promote competition and entrepreneurship, favoring a known revenue stream over that which may develop from non-commodity sectors (van Eeghen et al. 2014). Creating a level playing field by improving the rule of law, reducing corruption, and broadening access to finance can help creating more resilient and balanced growth.

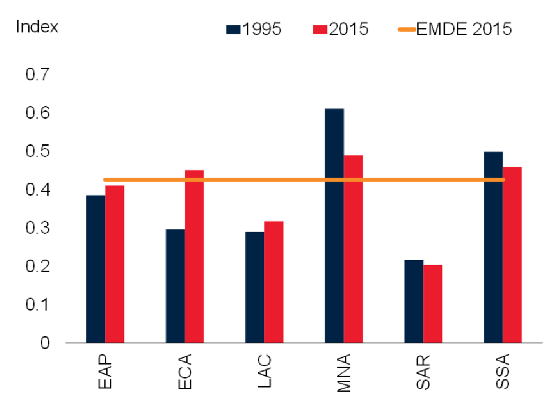
FIGURE 2.2.1.6 Policies for more connected economy

Commodity dependence for ECA countries increased most among EMDE regions, reflecting the increased participation and specialization in global trade. Global value chain integration substantially increased in most of the countries.

A. Global value chain integration



B. Commodity dependence



Sources: Organization for Economic Co-operation and Development, United Nations Conference on Trade and Development (UNCTAD).
A. Backward participation index in global value chains from OECD. It is measured by share of foreign value added content in gross exports.
B. Average trade concentration index for commodity exporters in each region. The trade concentration index is a measure of the degree of product concentration from UNCTAD. An index value closer to 1 indicates higher concentration. EAP = East Asia and Pacific, ECA = Europe and Central Asia, LAC = Latin America and the Caribbean, MNA = Middle East and North Africa, SSA = Sub Saharan Africa, and EMDE = Emerging Market and Developing Economies.
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