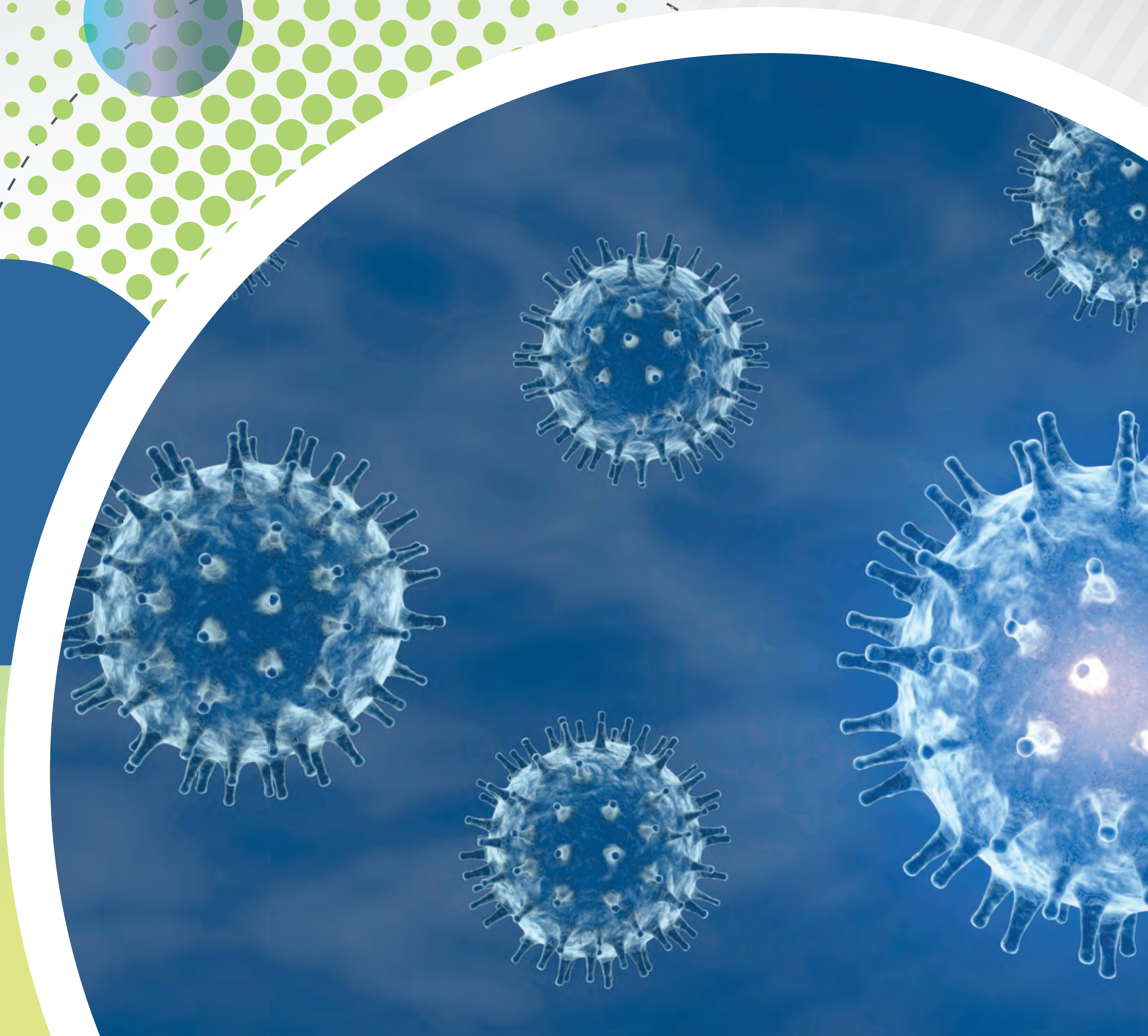
WORLD BANK GROUP

Fighting COVID-19

Europe and Central Asia Economic Update

Office of the Chief Economist

Spring 2020



The global outlook is very uncertain. This outlook reflects information available at the time of its preparation. The data and analysis presented are as of March 23, 2020. As more information becomes available, these projections will be revised. They are presented now to assist policymakers to design alternative policy responses.

UZBEKISTAN

Table 1	2019
Population, million	33.6
GDP, current US$ billion	58.0
GDP per capita, current US$	1726
School enrollment, primary (% gross)[a]	103.7
Life expectancy at birth, years[a]	71.4

Source: WDI, Macro Poverty Outlook, and official data.
Notes:
(a) Most recent WDI value (2017).

Strong investment growth, higher agricultural output, and increased construction activity sustained real GDP growth in Uzbekistan in 2019. The economic outlook has substantially worsened as a result of the COVID-19 crisis, creating challenges to the market transition and creating a high risk that poverty levels will rise. Anti-crisis policy measures and the drawdown of Uzbekistan's strong buffers will be critical to help offset the worst effects of the crisis, especially on the poorest citizens.

Recent developments

Real GDP growth increased marginally to 5.6 percent in 2019 (from 5.4 percent in 2018). Growth was supported by a 34-percent year-on-year increase in investment (mainly lending to state-owned enterprises), more robust agricultural growth, and increased construction activity. Private consumption increased as a result of a 6-percent rise in personal incomes and increased lending to households. Higher crop payouts to farmers, an increase in minimum wages, a large wage tax cut, and higher remittance inflows supported higher income growth.

Annual inflation remained high at 15.2 percent in December 2019 but was lower than a year earlier (17.5 percent). Price liberalization measures—which led to sharp rises in food and energy costs—as well as higher import costs (due to exchange rate depreciation), contributed to inflation.

Strong export growth and increased remittance inflows resulted in a smaller current account deficit of 4.2 percent of GDP in 2019 (from 7.1 percent in 2018). Even though traditional exports like natural gas and chemicals declined in 2019, overall export growth nearly doubled (up 25.2 percent year on year), reflecting substantial increases in exports of gold, food, and textiles. Capital goods—linked to state-led investment projects in infrastructure, industry, and housing—continued to dominate import spending in 2019. Foreign direct investment, which more than doubled (to 2.8 percent of GDP) in 2019, was destined mainly for projects in oil and gas, metallurgy, food processing, and textiles. Foreign exchange reserves increased by $2.1 billion in 2019, or about 14 months of import cover. Total external debt was about 43 percent of GDP.

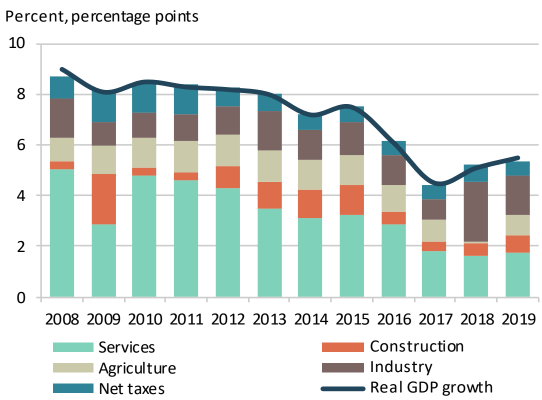
The central bank kept its policy interest rate unchanged at 16 percent since September 2018. However, the rate has a limited impact on monetary policy due to the significant volume of subsidized state-directed lending at below the reference rate. Directed lending contributed to a second consecutive year of high credit growth (47.8 percent in 2019 and 51.5 percent in 2018).

The som depreciated by 14 percent against the U.S. dollar in 2019. Weaker trading partner currencies and further reforms to liberalize the foreign exchange market contributed to the som's depreciation.

Despite significantly higher revenues, the overall fiscal deficit widened to 3.9 percent of GDP in 2019 (from 2.3 percent in 2018), reflecting higher public investment, increased farmer payouts for cotton and wheat, and higher social spending. Despite a large tax cut in 2019, revenue collection was strong as more informal businesses joined the value added tax system. Public debt, while low, increased to 29.2 percent of GDP in 2019.

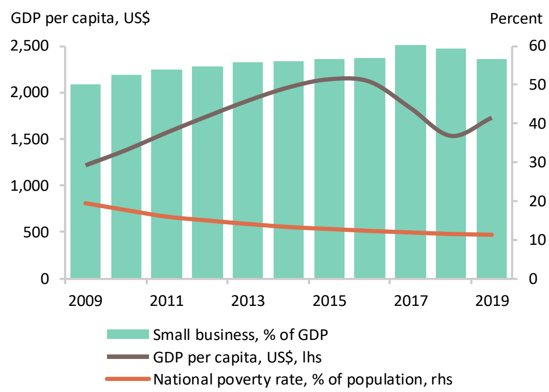
Uzbekistan's banking sector remains state-dominated. The country's 13 state-owned banks (out of 30 banks total) generate 90 percent of total lending. Capital adequacy and liquidity buffers are above regulatory minimums. However, both indicators

FIGURE 1 Uzbekistan / Real GDP growth and contributions to real GDP growth



Source: Uzbekistan official statistics.

FIGURE 2 Uzbekistan / Poverty, GDP per capita, and small business development



Source: Uzbekistan official statistics. Due to the lack of data access, the Bank cannot validate the official figures.

have deteriorated over the past two years on account of high bank lending growth, increasing the financial system's vulnerability to asset quality deterioration and liquidity shocks. Nonperforming loans remained steady at 1.3 percent of gross loans in 2019.

Rising incomes and strong GDP growth reduced the official poverty rate to 11.4 percent in 2018, from 11.9 percent in 2017. The World Bank estimates that poverty at the lower-middle-income country poverty line was 9.6 percent in 2018. The official unemployment rate was slightly lower at 9 percent in 2019, from 9.3 percent in 2018. Unemployment was higher among youth (16–30 years old; 15 percent) and women (12.8 percent). Income growth among the bottom 40 percent of the income distribution was driven by wage growth, increased remittances, social protection payments that matched inflation, and government programs to boost employment.

Outlook

The COVID-19 outbreak is a severe disruption to Uzbekistan's economy and its transition to a market economy. Growth is projected to reduce sharply (to around 1.6 percent based on latest estimates) in 2020 as a result of significantly lower external trade and widespread domestic economic disruption. Stay-at-home orders and non-critical business closures are now in place across the country. It is uncertain when these restrictions will be lifted as efforts intensify to reduce local transmission. An increasingly likely downside scenario is that more prolonged disruption could contract the economy in 2020. On the positive side, demand for gold and food exports is projected to remain robust, but it may be subject to significant price volatility. Annual inflation is expected to be 15.8 percent in 2020 as a result of supply chain disruptions and higher food prices. The current account deficit is expected to widen to around 8.5 percent of GDP in 2020 due to a sharp contraction in external trade and remittance inflows. A drawdown on reserves and development partner assistance is expected to finance the deficit. The government recently announced a $1 billion package to increase health and social spending, and ease tax, debt, and cash flow constraints on businesses. This will help temper the negative effects of the crisis on households and firms. Lower tax revenues and additional crisis spending are expected to increase the fiscal deficit to 5.6 percent of GDP in 2020 and 4.7 percent of GDP in 2021. The effect of the COVID-19 outbreak on the drivers of poverty reduction, such as income growth and remittances, is likely to increase poverty levels in 2020.

Risks and challenges

The COVID-19 outbreak is the biggest threat yet to Uzbekistan's ambitious market transition. Promising signs of private sector growth and job creation in tourism, horticulture, and services are now at risk. These sectors are among the worst affected as the crisis has wiped out the tourist and high-value horticulture export seasons. Efforts to attract foreign investment – through PPPs and the imminent launch of an ambitious SOE reform and privatization strategy – will be disrupted by the highly uncertain economic conditions. Remittances, a vital income source for many of the poorest households, are projected to fall by more than 50 percent. Lower remittances, rising unemployment, and inflationary risks from a sustained COVID-19 outbreak pose a significant threat to poverty reduction. Uzbekistan's macroeconomic buffers, safety nets, and community institutions; and anti-crisis policy measures, are expected to help mitigate the worst effects of the crisis on the poor.

TABLE 2 Uzbekistan / Macro poverty outlook baseline scenario (annual percent change unless indicated otherwise)

	2017	2018	2019 e	2020f	2021f	2022 f
Real GDP growth, at constant market prices	4.5	5.4	5.6	1.6	6.5	5.5
Private Consumption	1.3	3.8	5.4	0.4	6.1	5.4
Government Consumption	6.1	3.7	5.5	6.5	5.2	4.6
Gross Fixed Capital Investment	7.1	18.1	33.8	3.1	10.4	10.0
Exports, Goods and Services	1.3	10.7	10.9	1.2	6.7	10.1
Imports, Goods and Services	2.2	26.8	47.3	3.2	11.2	14.2
Real GDP growth, at constant factor prices	4.5	5.4	5.6	1.6	6.5	5.5
Agriculture	1.2	0.3	2.5	2.6	2.8	3.4
Industry	5.4	11.5	8.9	2.1	5.2	5.8
Services	6.3	5.2	5.5	0.6	9.7	6.6
Inflation (Private Consumption Deflator)	13.9	17.5	15.2	15.8	14.8	12.0
Current Account Balance (% of GDP)	2.5	-7.1	-4.2	-8.5	-5.3	-2.6
Fiscal Balance (% of GDP)	-1.9	-2.1	-3.9	-5.6	-4.7	-2.5
Debt (% of GDP)	20.2	20.6	29.0	32.1	33.1	33.0
Primary Balance (% of GDP)	-1.8	-1.7	-3.5	-5.1	-4.3	-2.2

Source: World Bank, Poverty & Equity and Macroeconomics, Trade & Investment Global Practices.
Notes: e = estimate, f = forecast.

Global Context

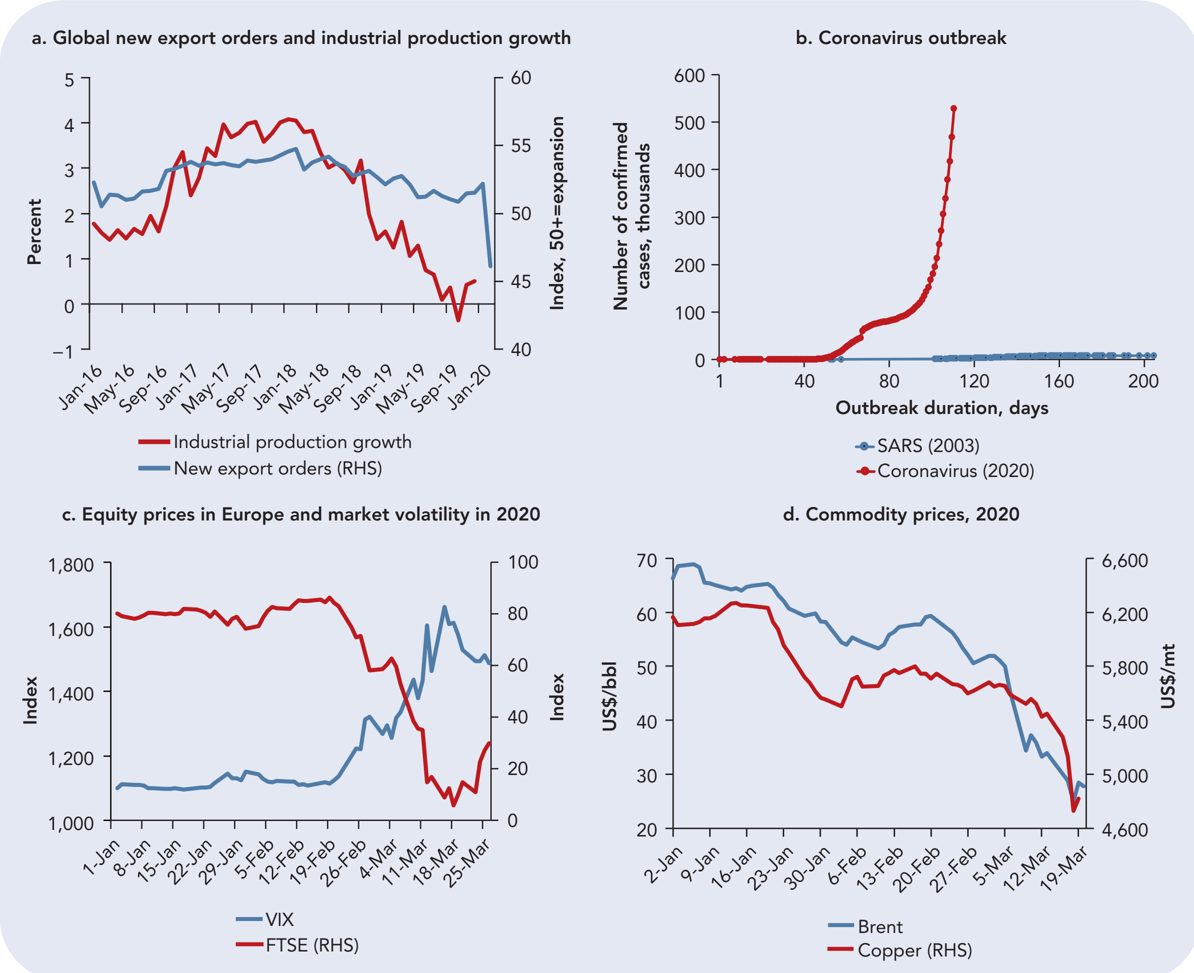
Global growth slowed to an estimated 2.4 percent last year—a post-crisis low—amid weak trade and manufacturing activity, and it was envisaged to firm in 2020 in January forecasts. Since then, the coronavirus outbreak has dealt a massive blow to global activity, and the associated costs and spillovers will significantly erode the global outlook. The pandemic also compounds other downside risks, such as further disruptions to trade relations, spillovers from sharp downturns in major economies, and disorderly commodity and financial market developments. Against this backdrop, many economies are not adequately prepared to confront the negative shocks related to the materialization of these risks.

COVID-19 Pandemic and Overall Trends

According to January projections, global growth fell to an estimated 2.4 percent in 2019—its slowest pace since the global financial crisis—with key indicators, such as industrial production and trade, declining in parallel. This weakness was broad-based across countries, with nearly 90 percent of advanced economies and 60 percent of emerging market and developing economies (EMDEs) experiencing decelerating growth in 2019. Manufacturing activity slowed sharply over the course of last year, and, to a lesser extent, services activity also moderated. A prolonged period of rising trade disputes between the United States and China weighed on international trade, confidence, and investment for most of 2019. Trade tensions eased in some instances, however, following the signing of a

Phase One agreement earlier in January, under which the United States and China halved tariffs on nearly $190 billion worth of goods in mid-February. In response, financial market sentiment improved in late 2019. January projections saw global growth edging up to 2.5 percent in 2020 and firming thereafter, reaching to 2.6 percent by 2021, as investment and trade gradually recover (figure 1.1, panel a) (World Bank 2020a). Similarly, EMDE growth was expected to pick up to 4.1 percent this year and stabilize at 4.3 percent in 2021, with the pace of the recovery restrained by soft global demand and structural constraints. However, this recovery will be interrupted by the coronavirus outbreak (figure 1.1, panel b).

FIGURE 1.1 Global economic outlook



Source: Bloomberg; Energy Information Administration (EIA); Haver Analytics; Institute of International Finance; International Energy Agency (IEA); Johns Hopkins University; J.P. Morgan; OPEC; World Bank.
Note: In panel a, the last observation for new export orders is February 2020, and for industrial production it is December 2019. In panel b, the last observation is March 27, 2020. In panel c, the last observation is March 26, 2020. In panel d, the last observation is March 19, 2020.
FTSE = Financial Times Stock Exchange.

The coronavirus pandemic is the most significant negative shock since the global financial crisis and is causing severe damage to global activity. At first, the outbreak led to a sharp slowdown in China—the original epicenter of the outbreak—as well as disruption to global value chains (GVCs), particularly in Europe. The immediate impact propagated through commodity channels and financial markets, with global energy and metals prices falling to multi-year lows and many large EMDEs facing financial market pressures. The outbreak's subsequent worldwide propagation, including to major advanced economies, has led to a massive worsening of the global outlook. Global trade flows have been disrupted by international border closures and weakened demand from China, while tourism is suffering significantly. In response, market-based forecasts for global growth have sharply deteriorated since the start of the year. The coronavirus outbreak will weigh on EMDE growth prospects and delay the near-term recovery, particularly for EMDE commodity exporters, given China's large role in global commodity markets. EMDEs with tight trade and financial linkages to the euro area and China and their manufacturing sectors will also face negative spillovers.

The coronavirus pandemic has also triggered substantial stock market losses, with one-tenth of European equity values wiped away and the S&P 500 down by as much as one-quarter since its early February high. The impact has been broad-based, with markets initially agitated in East Asia but their focus quickly shifting to Europe following news that Italy had suffered the largest coronavirus outbreak outside Asia in early March. The VIX volatility index jumped to its highest level since the global financial crisis, with officials pausing intraday trading several times due to volatility (figure 1.1, panel c). EMDEs, particularly those with low sovereign credit ratings, have faced unprecedented capital outflows and exchange rate pressures amid heightened risk aversion. Corporate debt for riskier categories, such as lending to highly leveraged firms in the United States, also suffered a sharp selloff, with the spread on U.S. junk bonds rising over 600 basis points since the start of 2020.

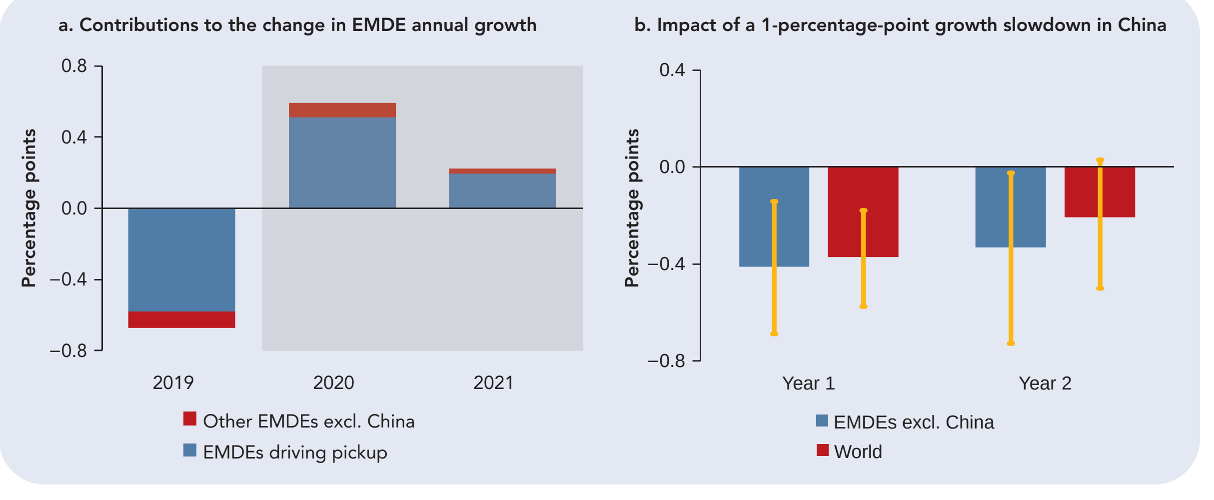
Subdued inflation in the six months leading up to February had allowed monetary authorities in several economies, including EMDEs, to begin or extend policy rate cuts to buoy growth in light of the earlier trade tensions. However, inflationary pressures are building in some EMDEs, which may limit the space for further monetary policy accommodation going forward. Sizable currency depreciation could also pass through to inflation and amplify these pressures, while decreased activity from worsening economic conditions could offset increases in inflation. Policy makers in some EMDEs, notably China, have provided fiscal support measures to stabilize growth in the wake of the coronavirus outbreak.

Commodity market developments, particularly oil, have been disorderly in 2020, as the coronavirus outbreak has triggered a sudden collapse in demand. Oil prices plunged further in March, reflecting the abandonment of OPEC+ production cuts amid rising disagreement with its partner countries, most notably the Russian Federation. The ongoing coronavirus outbreak has put additional downward pressure on commodity prices, particularly for energy, which will be further amplified by a glut of oil supply as OPEC+ members resume full capacity of oil production. Brent crude oil prices fell sharply in March, to a 17-year low of roughly $25 per barrel, after experiencing one of its largest losses on record in a single trading day (figure 1.1, panel d). The recent fall also reflects expectations that demand will be weaker than previously envisioned, as the coronavirus outbreak has already reduced air travel and shipping, a major source of oil demand. Other industrial commodity prices have weakened in response to the coronavirus outbreak, with copper prices down by over 20 percent since early January. Overall, metals prices are expected to decline in 2020, reflecting subdued industrial commodity demand, particularly from China. Agricultural prices are envisioned to stabilize in 2020, after declining in the second half of 2019 due to improved supply conditions.

Global Risks

The recovery in the global outlook envisioned in January projections hinged on a growth pickup in a few large EMDEs, some of which were tentatively emerging from deep recessions or severe slowdowns (figure 1.2, panel a). However, the coronavirus outbreak has derailed the projected recovery in EMDEs. A longer-lasting and more widespread outbreak of the coronavirus could lead to even weaker growth, especially as efforts to contain the virus—including international border, business, and school closures; within-country restrictions on movement; and quarantine measures—hamper activity. Manufacturing weakness could further deteriorate if substantial disruptions to supply chains are extended, particularly in Europe. A severe growth deceleration in China stands to have a

FIGURE 1.2 Global risks



Sources: Bloomberg; Haver Analytics; J.P. Morgan; World Bank; World Health Organization.
Note: In panel a, data for 2019 are estimates. Aggregate growth rates are calculated using GDP weights at 2010 prices and market exchange rates. The shaded area indicates forecasts. "EMDEs driving pickup" includes the eight largest EMDEs that account for 90 percent of the acceleration in EMDE growth between 2019 and 2020 (Argentina, Brazil, India, the Islamic Republic of Iran, Mexico, the Russian Federation, Saudi Arabia, and Turkey). In panel b, the bars are the impulse response to a 1-percentage-point decline in China. The yellow error lines are the 16-84 percent confidence intervals, based on the vector autoregression model presented in World Bank (2016a). The sample includes 22 advanced economies and 19 EMDEs. The figure shows the last observation, which is January 2020. EMDEs = emerging markets and developing economies; GDP = gross domestic product.

pronounced impact on EMDEs with substantial trade linkages to China and EMDE commodity exporters, reflecting China's role as a major commodity importer (figure 1.2, panel b).

More generally, a deterioration in investor sentiment—whether, for instance, from a reassessment of risk related to the severity of the coronavirus outbreak, re-escalation of trade tensions, or a rise in geopolitical uncertainty—could further trigger disorderly financial market movements, including additional capital outflows from EMDEs and exchange rate pressures, and generate tighter global financing conditions. An even deeper global downturn could result from prolonged financial stress in large EMDEs, heightened geopolitical tensions, or a higher incidence of extreme weather events. A disruption to progress on the trade negotiations between the United Kingdom and the European Union could also weigh on Europe's outlook.

Europe and Central Asia: Recent Developments and Outlook

Growth in EMDEs in Europe and Central Asia decelerated to an estimated 2.2 percent in 2019, reflecting weakness in the region's two largest economies, Turkey and Russia. Earlier financial market stress resulted in a sharp growth slowdown in Turkey, while activity in Russia was tepid amid weak demand and cuts in oil production. Scenarios suggest regional growth will fall into a recession in 2020, contracting between −4.4 to −2.8 percent, held back by the coronavirus pandemic, and rebound subsequently to roughly 5.6 to 6.1 percent in 2021 as policy measures are introduced, global commodity prices gradually recover and trade strengthens. The outlook faces unprecedented downside risks related to the coronavirus, with these scenario ranges reflecting large unknowns on the ultimate severity and duration of the pandemic. Although the magnitudes are uncertain, the pandemic is certain to derail the near-term outlook by weighing on domestic demand, putting further downward pressure on commodity prices, disrupting tightly-linked global and regional supply chains, reducing travel and tourist arrivals, and decreasing demand for exports from the region. Policy makers across the region face a difficult trade-off between the health benefits of social distancing and quarantine measures and the economic costs of these actions. They need to act quickly and decisively to save lives, while also introducing policies to cushion the economic downturn and ensure a V-shape recovery.

Recent Developments: The Coronavirus Outbreak, Transmission Channels, and Policy Responses

Growth in the EMDEs in Europe and Central Asia is estimated to have decelerated markedly in 2019, to 2.2 percent. The lackluster regional performance predominantly reflected slowdowns in the region's two largest economies, Russia and Turkey. Sustained weakness in export growth was accompanied by slowing manufacturing activity and investment. Sluggish new export orders prior to the coronavirus outbreak suggest that export growth will fall sharply in the near term, especially in economies with deep trade and financial linkages to the euro area, such as those in Central Europe.

Table 1.1 reports results from two simulation exercises that measure the range of growth outcomes in response to the coronavirus pandemic. In the baseline COVID-19 scenario, regional growth is projected to contract in 2020, to −2.8 percent; in the downside scenario, the recession is deeper, with growth shrinking −4.4 percent (table 1.1). The range reflects the uncertainty surrounding the impacts of the coronavirus pandemic, notably concerns about the duration of the pandemic and the extent of economic disruption it will generate (see box 1.1).[1] Although initially the outbreak dampened prospects in Europe and Central Asia vis-à-vis trade, financial, and commodity channels, the spike in cases in the region has amplified the negative impact through the domestic economy, particularly as containment measures to tackle the outbreak weigh heavily on private consumption and investment. The overall outlook remains highly uncertain and will ultimately depend on which epidemiological scenario develops. If the outbreak is contained in the first half of the year, the economic damage from

1. Projections of the economic implications of COVID-19 are subject to significant uncertainty. Table 1.1 reports a range of estimates using assumptions of growth in major economies and key commodity prices as of March 20, 2020. In the baseline growth scenario, policy makers lift containment measures during the second quarter, but earlier financial market volatility continues to weigh on investment and commodity prices remain low. In the downside scenario, policy makers lift containment measures in the second half of the year, which will continue to severely dampen activity and suppress commodity prices amid weak demand. Country-specific projections may deviate from the baseline scenario, in so far as country-specific knowledge may lead country experts to be more or less optimistic.

TABLE 1.1 Europe and Central Asia growth scenarios

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

	Baseline growth scenario					Downside growth scenario				
				Revisions from January 2020 projections (pp)					Revisions from January 2020 projections (pp)	
Category	2019[e]	2020[f]	2021[f]	2020[f]	2021[f]	2019[e]	2020[f]	2021[f]	2020[f]	2021[f]
EMDE ECA, GDP[a]	2.2	−2.8	5.6	−5.4	2.7	2.2	−4.4	6.1	−7.0	3.2
Central Europe and Baltic States[b]	4.0	−1.0	5.5	−4.3	2.5	4.0	−2.5	5.9	−5.8	2.9
Western Balkans[c]	3.6	−1.1	4.4	−4.7	0.6	3.6	−3.8	4.5	−7.4	0.7
Eastern Europe[d]	2.6	−3.6	3.0	−6.5	−0.1	2.7	−7.1	2.8	−10.0	−0.3
South Caucasus[e]	3.6	0.1	3.4	−3.0	0.3	3.6	−0.9	2.2	−4.0	−0.9
Central Asia[f]	5.0	0.1	4.8	−4.3	0.2	5.0	−1.3	5.6	−5.7	1.0

Source: World Bank.
Note: Scenarios for 2020-21 were generated using the World Bank's Global Spillover model and its MacroFiscal Model MFMod. The numbers in this table were generated on the basis of specific assumptions about the inherently uncertain progress of COVID-19 and the policy responses to it. As such, they should be interpreted as illustrative rather than predictive. World Bank numbers are frequently updated based on new information and changing (global) circumstances. Consequently, the numbers presented here may differ from those contained in other World Bank documents, even if basic assessments of countries' prospects do not differ at any given moment.
e = estimate; ECA = Europe and Central Asia; EMDE = emerging market and developing economy; f = forecast; GDP = gross domestic product.
a. GDP and expenditure components are measured in 2010 prices and market exchange rates.
b. Includes Bulgaria, Croatia, Estonia, Hungary, Latvia, Lithuania, Poland, and Romania.
c. Includes Albania, Bosnia and Herzegovina, Kosovo, Montenegro, North Macedonia, and Serbia.
d. Includes Belarus, Moldova, and Ukraine.
e. Includes Armenia, Azerbaijan, and Georgia.
f. Includes Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan.

BOX 1.1 The Coronavirus Outbreak: Regional Growth Effects, Transmission Channels, and Policy Responses

Background

Coronavirus (also known as COVID-19) has infected more than 700,000 people globally across at least 180 countries.[a] Although initially a majority of the confirmed cases were concentrated in Hubei province in China—the original epicenter of the outbreak—the number of cases sharply spiked in northern Italy toward the end of February, with the number of deaths there surpassing those in China by mid-March. Europe accounts for three-fourths of the new daily coronavirus cases worldwide, with several countries experiencing large outbreaks—in particular, France, Germany, and Spain, while cases in the United States had risen dramatically by the end of March. In March, the World Health Organization declared COVID-19 a global pandemic. Although the number of confirmed cases has been more limited for emerging market and developing economies (EMDEs) in Europe and Central Asia, the situation continues to evolve and will likely have worsened by the time of publishing (figure B1.1.1, panel a). Regardless of the number of cases in the region, domestic measures to contain the virus have already been implemented and will hinder activity this year.

The COVID-19 pandemic is unfolding at a fragile time for the global economy, particularly Europe. In the last quarter of 2019, growth in the euro area fell to its slowest pace since 2013, reflecting an unexpected contraction in France and Italy. Meanwhile, activity in the region diverged toward the end of 2019, as deeply integrated Central Europe weakened in tandem with the euro area, while the Russian Federation and Turkey—the region's largest EMDEs—experienced an incipient recovery. The near-term recovery that had been envisioned for the region at the start of the year will be delayed by international spillovers and domestic disruptions related to the pandemic. Growth slowdowns in the euro area and China in response to the outbreak will weigh on external demand, while domestic activity, including private consumption and investment, will be dampened by containment measures, such as international border closures, travel restrictions, and mandatory quarantines.

Europe and Central Asia is one of the most exposed EMDE regions to spillovers from global shocks, given its openness to trade and financial flows, but the magnitudes and sources of spillovers vary across countries within the region. Likely to be hardest hit are economies that are tightly connected to the euro area or China through trade linkages, including global value chains (GVCs); those heavily dependent on tourism; or those that export industrial commodities, such as energy and metals. That said, recent containment measures put in place in Europe—in some cases a full countrywide lockdown, while in others a ban on public events, the closure of public buildings, and limitations to public transport—will have a first-order effect on activity, especially if sustained throughout the year.

This box examines the impact of the coronavirus on growth in countries in Europe and Central Asia, with the help of baseline and adverse scenarios. It discusses the potential channels of transmission, provides estimates of spillovers, and concludes with a discussion of necessary policy responses.

Channels of Transmission

In the EMDEs in the region, domestic outbreaks of the coronavirus were initially limited, but have since grown alongside measures to contain the virus. The domestic impact of the virus will vary by country, depending on the severity of the outbreak, the capacity of the health care system, and the policy responses to contain the virus and limit its economic effect. Growth prospects are likely to deteriorate further as domestic outbreaks become more widespread and trigger a decline in domestic demand and supply disruptions. Additional impacts will stem from adverse spillovers from the euro area and China, as well as the effects on global asset and commodity prices. The main global channels in the transmission of the eco-

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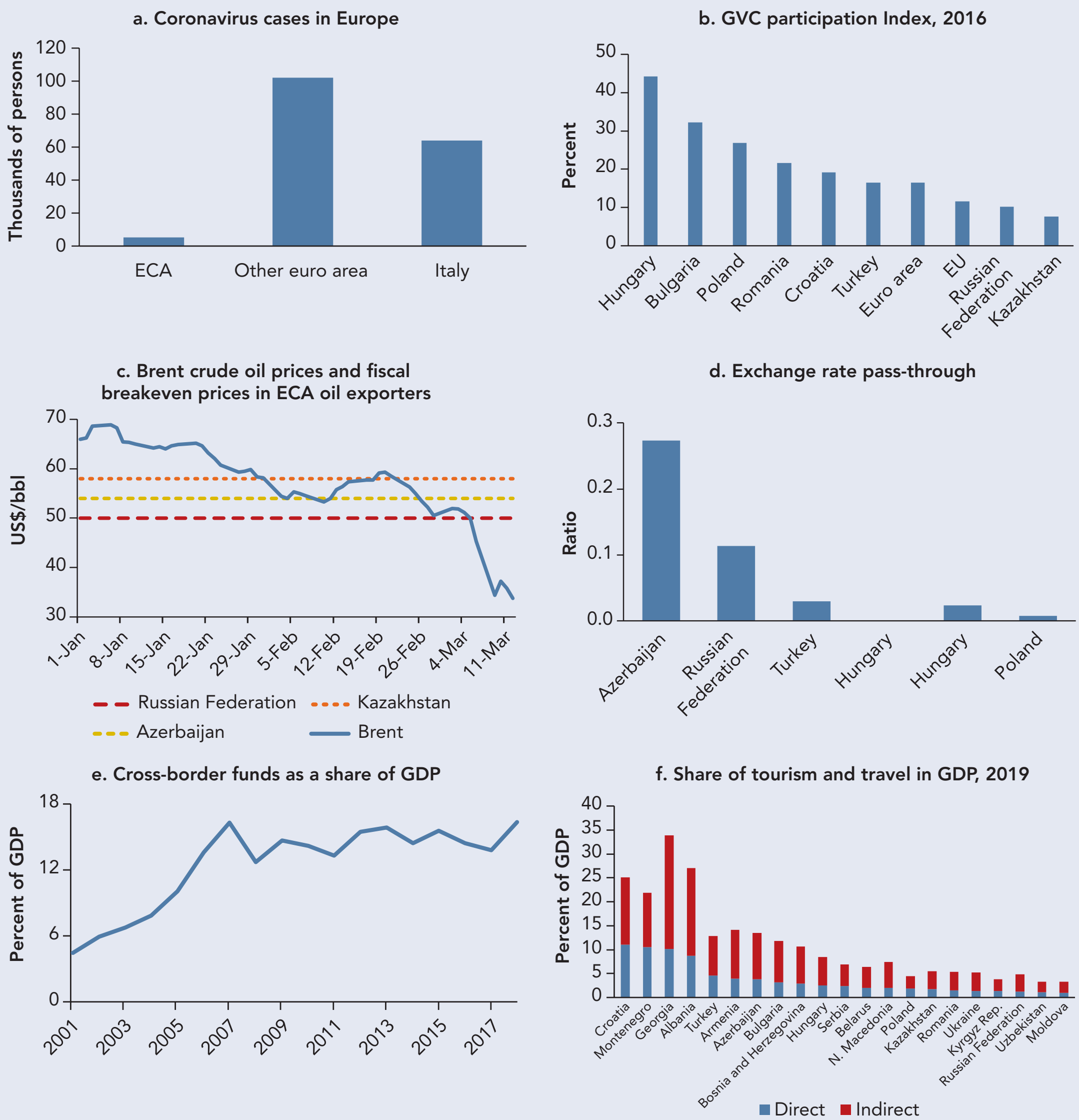
BOX 1.1 (continued)

FIGURE B1.1.1 Number of confirmed cases and potential channels of transmission



Sources: Bloomberg; European Centre for Disease Prevention and Control; Organisation for Economic Co-operation and Development; World Travel and Tourism Council; World Bank.
Note: In panel a, the last observation is March 24. In panel 6, 2020.c, the last observation is March 12. In panel d, values are the 2020 elasticity of prices of international goods to changes in exchange rates, as in Ha, Stocker, and Yilmazkuday (2019). In panel f, GDP is generated by industries that deal directly with tourists, including hotels, travel agents, airlines, and other passenger transport services, as well as the activities of restaurant and leisure industries that deal directly with tourists. It is equivalent to total internal travel and tourism spending within a country less the purchases made by those industries (including imports). In terms of the United Nation's Tourism Satellite Account (TSA) methodology, it is consistent with total GDP, as calculated in table 6 of the TSA RMF 2008. BiH = Bosnia and Herzegovina; ECA = Europe and Central Asia; EU = European Union; GDP = gross domestic product; GVC = global value chain.

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BOX 1.1 (continued)

nomic fallout from the coronavirus outbreak are trade links, including through disruptions to GVCs and external demand; commodity and financial markets; and transport and tourism.

Trade linkages. Europe and Central Asia is deeply embedded in global and regional value chains, which exposes the region's economy to international developments and spillovers. For many economies in the region, including Russia, the two most important external trading partners are the euro area and China. As a destination, the euro area accounts for over 40 percent of the region's exports, while China represents about 5 percent—but for the economies in Central Asia, this rises to 20 percent. Mandatory quarantines and idle workers are expected to dampen euro area and Chinese demand, which could negatively impact exports from Europe and Central Asia.

The coronavirus outbreak has stalled production and triggered factory shutdowns in China and Europe, with estimates placing as few as 35 percent of Chinese workers on the job in mid-February, while the countrywide quarantine in Italy in early March will have a deep impact on northern Italy's large manufacturing hub.[b] Given the presence of large, open economies, widespread disruptions to GVCs are expected to affect the region, particularly as they relate to sourcing of capital and intermediate goods. Further aggravating the situation are low inventories going into the coronavirus, as measured by subcomponents of manufacturing Purchasing Managers' Index. Compared with other subregions, the impact will be noticeably larger for Central Europe, where manufacturing accounts for nearly a fifth of the gross value added to gross domestic product (GDP), while 20 to 40 percent of the value added of exports is derived from foreign content (figure B1.1.1, panel b).[c] Exposure to China also flows through these indirect GVC channels—the amount of value added that is dependent on final demand in China is significant in Europe.[d]

Commodity markets. Europe and Central Asia is home to several energy exporters, including Russia, Kazakhstan, and Azerbaijan, which together account for over 40 percent of the region's GDP. Since the coronavirus outbreak, Brent crude oil prices have plunged by nearly 60 percent since January's peak, partly reflecting concerns that the virus will dampen energy demand through reduced air travel and shipping, as well as quarantine measures. The magnitude also reflects China's large role in global commodity markets as the world's largest energy importer. The fall in prices in early March also reflects a positive supply shock from the abandonment of the OPEC+ oil production cuts, which will likely generate an oil glut.[e] The potential positive impact of abandoned production caps for growth is likely to be more than offset by the steep fall in prices, however, which will strain fiscal positions, with oil prices now far below fiscal breakeven prices for energy exporters in the region (figure B1.1.1, panel c).

Given that China accounts for half of the global demand for metals, the region's metals exporters will also be impacted. Initially, the effects were more nuanced, as gold tends to be a safe haven asset—prices have fluctuated considerably, however, so the overall impact may be negligible. For exporters of gold, such as the Kyrgyz Republic and Uzbekistan, an increase in gold prices would help offset the fall in the prices of other metals exported by the country. For other economies in the region, however, the exposure can be twofold, as is the case for Russia, given its large share of energy and iron ore exports.

Financial markets. The broad deterioration in global investor sentiment triggered by COVID-19 could have material implications for Europe and Central Asia's financial markets and banking system, even with limited domestic outbreaks. Volatility shocks can lead to adverse short-term effects on activity, investment, and industrial production—this is especially the case in countries with large exposure to international financial markets, such as countries in Central Europe, Turkey, and Russia, all of which tend to be bellwethers for other EMDEs.[f]

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BOX 1.1 (continued)

Several economies in the region have suffered sharp currency depreciations, which could pass through to inflation and constrain future monetary space (figure B1.1.1, panel d).[g] Furthermore, economies in the region face tightening external financing conditions, as flight to safety attracts flows into U.S. Treasuries. In economies with higher external imbalances, this could generate pressure on corporate balance sheets and increase rollover risks.

The region is also vulnerable to spillovers from other parts of the region, particularly Russia, due to historical trade and financial linkages, as well as from the euro area. Financial linkages within the European Union, which includes Central European economies, have gained significance as a result of integration of financial markets and cross-border exposure among financial institutions (figure B1.1.1, panel e).

Finally, a prolonged downturn would affect the financial sectors in the region by adversely affecting nonperforming loans and weakening earnings and profitability, particularly for banks that are already undercapitalized. Some banks may also experience mark-to-market losses due to sharp declines in financial markets. This would constrain banks' ability to lend and support real activity during this difficult time. In the extreme, it could lead to erosion of bank buffers and further undermine their resilience.

Transport and tourism. Europe is a popular international tourist destination, with a large share of overnight stays from tourists within the region—over 80 percent of international arrivals are from other European Union countries (European Commission). The negative impact of the coronavirus on Europe is expected to be large, as containment measures to address domestic outbreaks dent tourist arrivals and hamper air travel, especially as a growing list of countries are imposing mandatory quarantines, travel restrictions, and international border closures. In the past month alone, reportedly more than 300,000 flights have been canceled globally.[h]

Transport and tourism represent a substantial share of GDP in several of the region's economies, including Croatia, Georgia, Montenegro, and Turkey, and the direct and indirect effects are in some cases in excess of 20 percent of GDP (figure B1.1.1, panel f). The share is also high in Albania, but tourist activity was already expected to fall sharply this year due to the devastating impact of last year's earthquakes—likewise, the recent earthquake in Croatia could have similar consequences. For the economies in the region that are part of the European Union, mainly those in Central Europe, 85 percent of EU tourists are from other member countries. Sweeping quarantine efforts in Italy and other euro area economies could thus disproportionately affect Central Europe. Overall, the decline in tourism in the first half of 2020 will likely be steep, but the impact on annual GDP will depend on the duration of the pandemic. The impact of the pandemic on tourism could be much larger if the outbreak extends into the summer holiday season.[i]

Estimated Impact on Europe and Central Asia under Baseline and Adverse Scenarios

Assumptions and impact under the baseline scenario. In the baseline scenario, containment measures, including quarantines, travel restrictions, and international border closures, are lifted by the end of the second quarter of the year, allowing for the resumption of economic activity. Financial market and GVC disruptions are assumed to ease, while commodity prices are expected to improve, albeit to low levels, from earlier volatility and weakness. The results of a global spillovers model find that global growth will be much weaker than previously envisioned.[j] Simulations suggest that the estimated impact under these baseline assumptions could reduce GDP growth in Europe and Central Asia by -5.4 percentage points in 2020. This would bring growth to -2.8 percent, as large economies such as Russia, Turkey, and Poland are affected through

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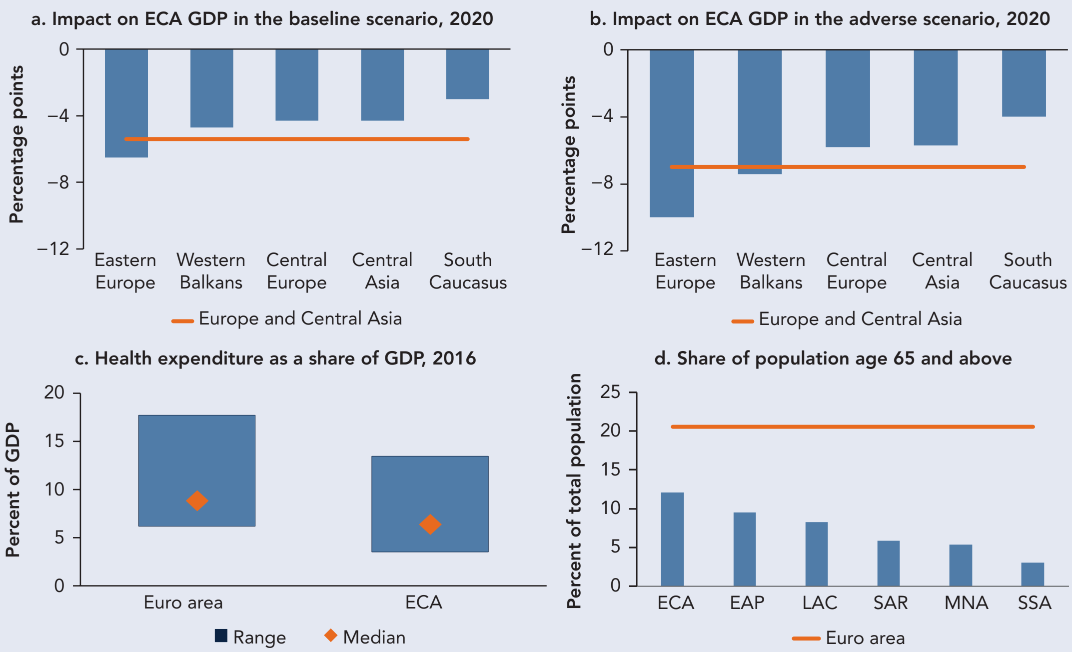
BOX 1.1 (continued)

commodity and GVC channels (figure B1.1.2, panel a). In this scenario, growth would accelerate to 5.6 percent in 2021, as a robust cyclical recovery would underpin growth in Russia and Turkey.

Assumptions and impact under the adverse scenario. In the adverse scenario, efforts to contain the outbreak spill into the third quarter of 2020, with growth constrained by the continuation of quarantines, travel restrictions, and international border closures. Financial market pressures continue in EMDEs, while commodity prices remain weak. Government resources are diverted from key development priorities to fight the outbreak and potentially support strained domestic health care systems. The negative impact on global growth would be substantially greater in 2020, and the rebound in 2021 would be weaker as commodity exporters continue to adjust to terms of trade shocks. In Europe and Central Asia, the adverse scenario assumes a deep recession, with the overall estimated impact reducing growth by -7.0 percentage points in 2020, to -4.4 percent. The recession reflects sizable negative spillovers to Russia due to low energy prices, Turkey from weak external demand, and substantial domestic outbreaks in several economies (figure B1.1.2, panel b). The recovery would be stronger than previously expected in 2021, at 6.1 percent, as large commodity importers rebound.

As this report goes to press, the baseline scenario is becoming less likely and the downside scenario is looking more optimistic. Although the magnitudes are uncertain, what is clear is that the pandemic is likely to derail the near-term outlook significantly, as past pandemics have done (Barro, Ursua, and Weng 2020).

FIGURE B1.1.2 Impact on GDP growth, demographics, and health system vulnerabilities



Sources: World Travel and Tourism Council; United Nations; World Bank.
Note: In panel b, aggregate growth rates are calculated using GDP weights at 2010 prices and market exchange rates. In panel c, the sample includes 20 ECA economies. EAP= East Asia and Pacific; ECA = Europe and Central Asia; GDP = gross domestic product; LAC = Latin America and the Caribbean; MNA = Middle East and North Africa; SAR = South Asia; SSA = Sub-Saharan Africa.

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BOX 1.1 (continued)

Policy Trade-offs and Priorities

Policy makers face a difficult trade-off in dealing with the pandemic. The health benefits of social distancing, closing businesses, and imposing quarantines are clear, as the spread of the disease is slowed down, which saves lives by preventing health systems from being overwhelmed. However, the more successful these measures are, the greater the resulting economic costs become (figure B1.1.3).[k] Furthermore, there is the downside risk that these containment measures will be extended for longer than currently envisioned, which would subsequently cloud the outlook (Atkeson 2020). The challenge facing policy makers is to employ policies that minimize the economic downturn while prioritizing health benefits, so that lives are saved and the recovery is V-shaped rather than prolonged once the pandemic is over.

Policy response and options. The availability of macroeconomic policy space varies across Europe and Central Asia, but overall, the region is ill-prepared to cope with widespread domestic outbreaks of the coronavirus, given the vulnerabilities in health care systems, including in available hospital beds and health care spending (figure B1.1.2, panel c). Additionally, parts of the region are characterized by a large share of individuals age 65 and above, which could result in a heavier strain on the health care system than observed in regions with younger populations (figure B1.1.2, panel d). Dissemination campaigns on prevention and emergency response plans have been employed in the region to raise awareness and slow the spread of the viral outbreak. Many countries have closed international borders, restricted travel from heavily hit areas, and imposed quarantine on travelers returning from affected countries. Despite limited fiscal space after years of lackluster growth, policy makers should use existing buffers or reprioritize spending to bolster health care systems effectively, strengthen safety nets, support the private sector, and counter financial market disruptions to save lives and limit the economic downturn.

Bolstering health care systems remains a critical challenge in Europe and Central Asia, particularly in the face of a public health pandemic. Although the region boasts the highest rate of hospital beds among the EMDE regions, at 6.4 beds per 1,000 people, health systems in some economies are far less equipped to respond to the rapid spread of the pandemic. Albania, Georgia, and Turkey, for instance, have a hospital bed rate of less than 3 beds per 1,000 people—less than half the regional average. Despite notable improvement in recent years, Turkey's health expenditures trail the regional average of 5.2 percent of GDP by nearly 1 percentage point. According to WHO's Capacity Rating of preventing, detecting, and responding to a public health emergency, Bosnia and Herzegovina, the Kyrgyz Republic, Tajikistan, and Uzbekistan have the lowest capacities in the region.

In other economies, health care capacity is limited by a lack of quality primary health care (Kosovo) or ability to respond due to ongoing reforms (Ukraine). Resources have been designated to establish crisis plans and public health campaigns across the region, and most economies have adopted preventative measures, such as bans on large public gatherings, travel restrictions, and border closures. Temporary school closures have also been implemented. Although prevention is important for reducing the spread of the virus and limiting the burden on health care systems, targeted funding can help strengthen response preparedness and the ability to treat and contain the virus effectively. In economies with fiscal space (Bulgaria, Bosnia and Herzegovina, Hungary, Poland, Serbia, Russia), expenditures could be prioritized to boost health investment, which could strengthen the capacity of health systems by increasing personnel training, expanding clinical facilities, and meeting medical supply needs.

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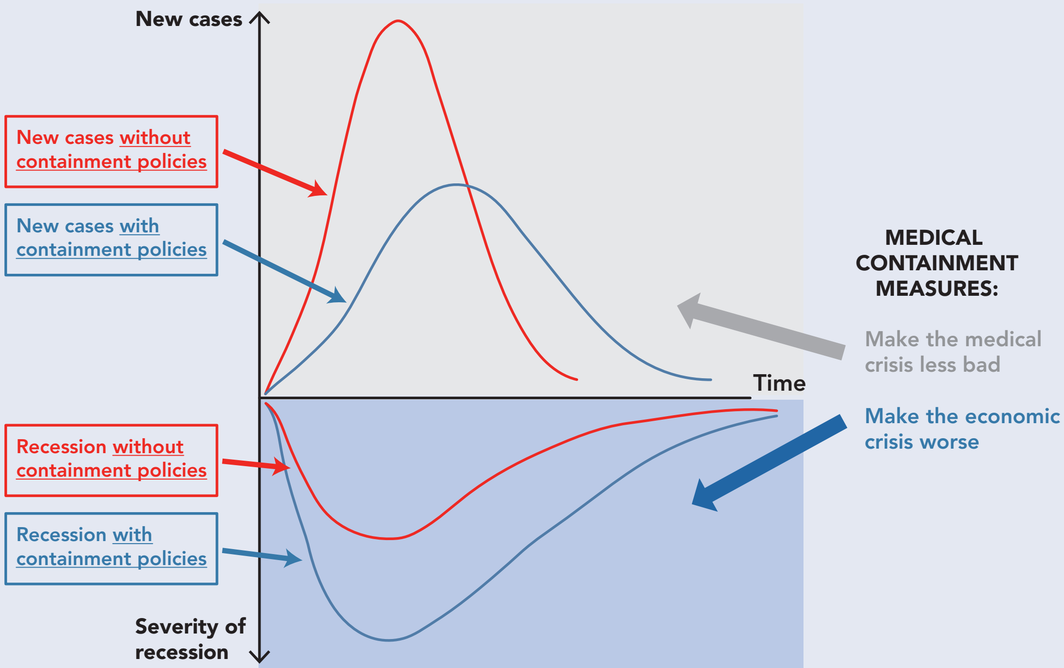
BOX 1.1 (continued)

FIGURE B1.1.3 Trade-off between health benefits and economic costs of containment policies



Source: Based on the figure illustrated by Baldwin and Weder di Mauro (2020), inspired by Gournichas (2020).

Strengthening safety nets by tapping into emergency funds or reprioritizing public expenditures could help offset the coronavirus's negative impact on the most vulnerable. Disruptions to supply chains, domestic outbreaks, and preventative measures to contain the virus may leave many of the region's workers idle or without jobs. This could have ramifications across the region due to the heavy reliance on remittances for personal consumption in some economies in the Western Balkans, Eastern Europe, and Central Asia. Supportive measures that provide relief to households—such as cash transfers or health care subsidies, particularly to low-income households—would help ease the associated difficulties with loss of work, cushion private consumption, and increase access to much-needed medical care. Where paid sick leave and family leave are not among standard benefits, governments should consider providing funding to allow unwell workers or their caregivers to stay home without fear of losing their jobs during the pandemic. To ensure that the region's most vulnerable population is not left behind, existing safety net programs can be expanded to new beneficiaries to include those most affected by the coronavirus, geographically and in particular economic sectors. Programs can also focus on expanding coverage for informal workers, families with young or elderly members, or individuals with preexisting medical conditions. Ensuring access to food, especially in underserved areas, is also critical and can be facilitated through public procurement and distribution of food. Finally, digitalization and mobile finance can be leveraged to distribute cash and transfers to people, directly and quickly.

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BOX 1.1 (continued)

In some economies—Russia, Turkey, Bulgaria, and Poland—low levels of government debt provide room to employ countercyclical fiscal support if needed. Broad-based fiscal stimulus can help lift aggregate demand, but it will probably be more effective after the immediate crisis has passed and business operations begin to normalize. In Central Europe, adherence to EU budget rules has been relaxed to allow for targeted relief measures for firms and workers to help offset the negative impact on activity. In a handful of commodity exporters (Russia, Kazakhstan, Azerbaijan, Uzbekistan), sizable sovereign wealth funds could be drawn upon to provide targeted social spending.

However, fiscal space remains limited in much of the region due to efforts to align budgets to fiscal rules amid low commodity prices; low domestic resource mobilization (Albania, Kyrgyz Republic, Moldova, North Macedonia, Tajikistan), large debt repayments and delays on key reforms (Ukraine), high government debt (Montenegro), significant financing needs (Belarus), post-disaster reconstruction efforts (Albania), and delayed budgets on the back of late government formation (Kosovo). Instead, policy makers in these economies could employ measures on the revenue side to provide relief, such as temporary income and value-added tax cuts.

Supporting the private sector is also important in countering the impact of the coronavirus pandemic by saving jobs. Such measures could include temporary business credits, tax cuts, tax payment deferrals, or subsidies to help sustain activity. Small and medium-size enterprises could face cashflow challenges and, in turn, potentially render the banking sector vulnerable, especially in economies with rising levels of nonperforming loans. In the immediate term, ensuring liquidity could help banks provide relief to sound borrowers via loan restructuring, debt service deferment, or bridge financing.

Policy makers could target the firms or sectors that are most impacted, including those in manufacturing hubs (Central Europe), tourist sectors (Hungary, Turkey, Russia, the South Caucasus, the Western Balkans), or natural resource extraction (Russia, Kazakhstan). In Croatia, for instance, which has a substantial tourism sector, the government has announced plans to subsidize domestic tourism in the absence of international arrivals. The government has also implemented tax payment deferrals for all businesses.

Overall, support will need to be carefully calibrated to ensure that limited resources are used efficiently and effectively, with the focus primarily on the firms and sectors that are most impacted by the ongoing pandemic rather than a blanket bailout. Policy makers should also ensure that frameworks are in place to bolster resilience in the financial system, such as having measures to identify stressed assets and support a smooth insolvency process.

Countering financial market disruptions will also be critical for policy makers in Europe and Central Asia, given the region's openness to trade and financial flows, which, in turn, exposes it to global confidence shocks. Policy makers should carefully monitor exchange rate volatility and be prepared to respond to disorderly financial market movements. The availability of external buffers varies considerably, however, with some economies suffering from shrinking international reserves amid earlier financial pressures, and others maintaining sizable reserves coverage (Russia, Uzbekistan).

Importantly, central banks should also ensure that the banking sector remains adequately liquid to help avoid a credit crunch. Although several economies have lowered policy interest rates to support growth this year (Poland, Russia, Turkey, Ukraine, Serbia), additional cuts may be warranted, particularly in the economies most affected by the coronavirus pandemic and where inflation expectations are well-anchored and below target. Policy makers should also monitor insurance markets, which may come under strain, particularly in economies with large domestic outbreaks and where payments of premia are suspended.

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BOX 1.1 (continued)

However, monetary space has been mostly exhausted in the region's largest economies after months of policy easing (Russia, Turkey) or as a result of building price pressures after years of growing capacity constraints. Policy makers were forced to hike interest rates this year to counter rising inflation expectations in light of the steep decline in oil prices and currency depreciation (Kazakhstan, Kyrgyz Republic). The room for policy rate cuts could become further eroded from renewed financial market pressures and currency depreciation pass-through to inflation (Russia, Turkey, Poland, Georgia, Kazakhstan, Serbia). For energy importers, however, lower global oil prices could help counter some inflationary pressures. High dollarization (Belarus) or euroization (Kosovo, Montenegro), as well as currency boards (Bulgaria, Bosnia and Herzegovina) or managed currency arrangements (Croatia, North Macedonia), prevent a handful of economies from having active monetary policy.

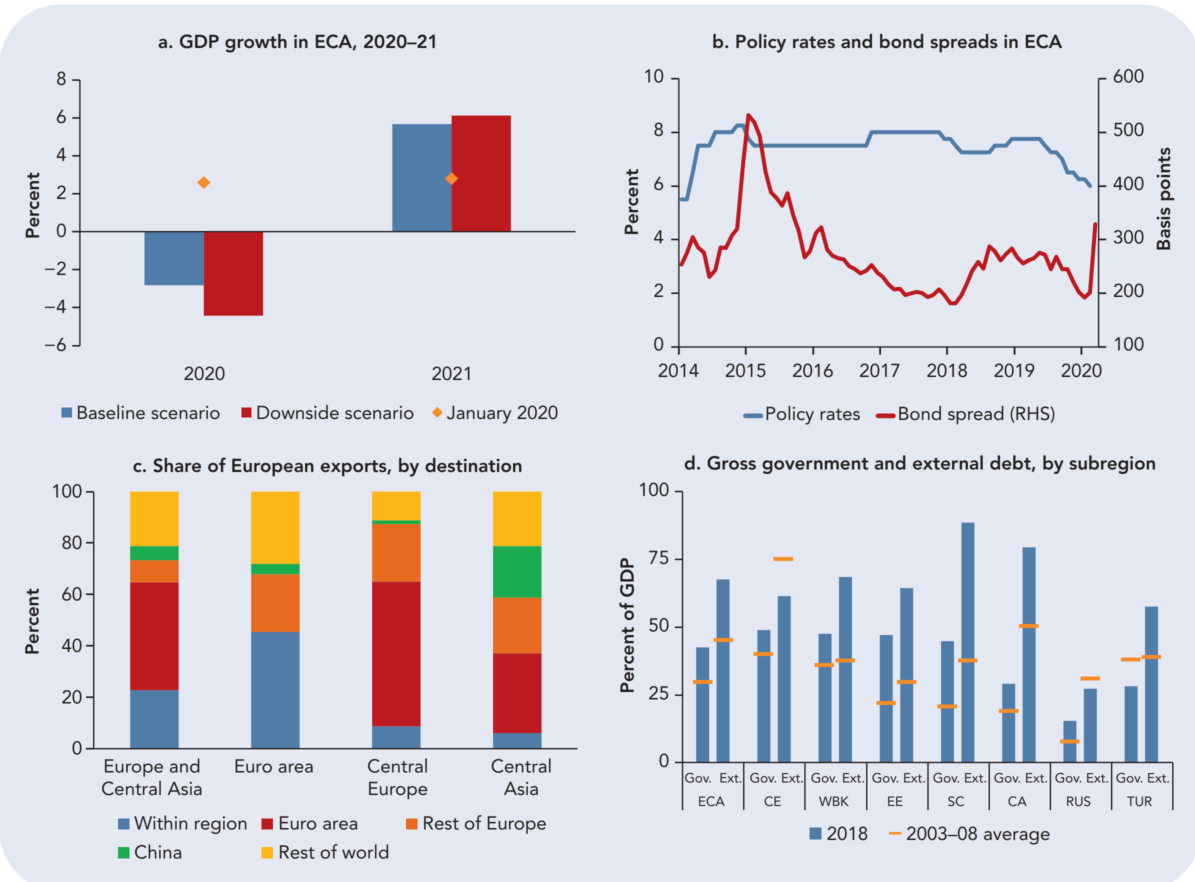
Notes:
a. The data and scenarios presented in this box are as of March 20, 2020.
b. https://www.ft.com/content/0e916322-5a12-11ea-abe5-8e03987b7b20.
c. OECD Trade in Value Added statistics.
d. Dieppe et al. (2018).
e. For a technical discussion of these market dynamics, please refer to the forthcoming April edition of the *Commodity Markets Outlook*.
f. For details, please refer to the January 2016 *Global Economic Prospects* report; Adrian, Stackman, and Vogt (2016); Levchenko and Pandalai-Nayar (2015).
g. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3360138.
h. https://www.flightstats.com/v2/global-cancellations-and-delays
i. Jonung and Roeger (2006).
j. The spillovers are based on cumulative impulse responses after one year from a Bayesian VAR model using (in this order) U.S. growth, euro area growth, the 10-year U.S. government bond yield, VIX, China's growth, oil price, and growth in EMDEs (excluding China), with four lags and data from 2000Q1 to 2019Q2. Aggregates are weighted using GDP at 2010 prices and market exchange rates. For details, please refer to the January 2016 *Global Economic Prospects.*
k. Baldwin and Weder di Mauro (2020); Gournichas (2020); Eichenbaum, Rebelo, and Trabandt (2020).

containment measures and international spillovers will be more limited than if, for instance, the outbreak is sustained or reemerges in a second wave later this year and thus requires longer containment measures.

Regardless of the path of the pandemic, the outbreak has already weighed on commodity prices, disrupted deeply-integrated global and regional supply chains, and generated financial market volatility. Growth is projected to rebound sharply to roughly 5.6 to 6.1 percent in 2021 (figure 1.3, panel a). However, the forecast path will largely depend on the timing of when containment measures are lifted, the pace of improvement in commodity prices, and the speed of the economic recovery in the euro area. The projections for regional growth are also predicated on several assumptions, namely that Turkey's recovery resumes, growth in Russia firms on the back of policy support, trade tensions between the United States and China do not re-escalate, and the United Kingdom's exit from the European Union is orderly.

Aggregate headline inflation in the region eased in the second half of last year, mainly reflecting the fading impact of the value-added tax (VAT) hike in Russia and base effects from high inflation the previous year in Turkey. This, combined with weakening growth momentum, allowed Russia and Turkey, as well as other large economies, such as Romania and Ukraine, to pause or reverse previous monetary policy tightening last year (figure 1.3, panel b). Since the start of this year, central banks have responded to deteriorating growth prospects by providing further monetary support (Turkey, Poland, Ukraine, Serbia, Moldova). However, recent currency depreciation could put further upward pressure on inflation and limit the scope for further policy rate cuts, especially for countries with inflation near or above target ranges (Belarus, Georgia, Hungary, Kazakhstan, Moldova, Romania, Turkey). In some cases, inflationary pressures have already led to policy tightening (Kazakhstan, Georgia). Core inflation is also rising in some economies, especially those with increasing wages as a result of labor shortages and other capacity constraints (Hungary, Poland, Romania).

FIGURE 1.3 Recent developments, outlook, and risks in Europe and Central Asia



Sources: Consensus Economics; Haver Analytics; J.P. Morgan; OECD; UNCTAD; World Bank.
Note: In panel a, aggregate growth rates are calculated using GDP weights at 2010 prices and market exchange rates. Shaded areas indicate forecasts. Yellow diamonds correspond to forecasts from the January 2020 *Global Economic Prospects* report. In panel b, bond spreads are from the J.P. Morgan Emerging Market Bond Index. The sample includes Hungary, Poland, the Russian Federation, Turkey, and Ukraine, due to data availability. The last observation is February 2020 for policy rates and March 2020 for bond spreads. In panel c, shares are calculated from exports in millions of dollars. CA = Central Asia; CE = Central Europe; ECA = Europe and Central Asia; EE = Eastern Europe; GDP = gross domestic product; RUS = Russian Federation; SC = South Caucasus; TUR = Turkey; WBK = Western Balkans.

Trends in Europe and Central Asia: Major Economies and Subregions

The Russian Federation

Growth in Russia is estimated to have slowed to 1.3 percent in 2019, reflecting softer-than-expected investment and trade, together with a continuation of international economic sanctions. Industrial activity also softened, as oil production cuts that were agreed earlier with OPEC took effect and pipeline-related disruptions occurred (World Bank 2019a). Retail sales volumes weakened substantially following a VAT hike, while consumer confidence remained low. The central bank reversed a previous tightening stance, cutting the key policy rate six times since June amid decelerating inflation trends and weak growth dynamics. In light of the sharp depreciation of the ruble and short-term inflationary concerns, the central bank left its policy rate unchanged in its last policy meeting, thereby pausing its monetary easing cycle.

Based on the scenario results of the global spillovers model, growth in 2020 is expected to contract, reflecting substantial growth headwinds due to the sharp fall in oil prices, triggered initially by the coronavirus outbreak and exacerbated in March by the abandonment of the OPEC+ oil production cuts. The previously projected improvement later this year may prove unachievable if oil prices remain below the level assumed by the fiscal rule ($42.40 per barrel in current Urals prices). The proposed increase in social spending, assuming the budget is executed, could partially offset the downward pressures on growth. The shortfall in government revenues from low oil prices is expected to be compensated by the National Wealth Fund, which is roughly 9 percent of gross domestic product (GDP). Still, a contracting economy in 2020 is inevitable, and the outcome could be far worse if containment measures are increased to confront a domestic outbreak.

In the baseline scenario, growth is projected to firm moderately in 2021. National Projects, which are partly funded by the 2019 VAT hike and include a series of investments in infrastructure and human capital, are expected to buoy growth over the forecast horizon. Nevertheless, private investment remains tepid in the baseline outlook, due to policy uncertainty and slowing potential growth over the long term as demographic pressures increase and structural problems, such as the lack of competition, accumulate.

Turkey

Following the lingering disruptions from earlier financial market pressures, growth in Turkey accelerated to about 6 percent (year over year) in the last quarter of 2019, as private consumption was boosted by a rebound in credit. Still, growth slowed sharply in 2019, to a 10-year low of 0.9 percent. Elevated inflation and associated pressures on real incomes, as well as rising unemployment, dampened consumption for most of the year. Investment contracted deeply, to rates comparable to those during the global financial crisis, partly reflecting economic policy uncertainty. Although the contribution of net exports to growth was positive, this was due in large part to import compression. The central bank sharply reversed its policy stance in mid-2019, cutting the policy rate from 24 percent to 9.75 percent, most recently to support growth.

The incipient recovery that had been underway in Turkey has been halted by the coronavirus pandemic. The baseline COVID-19 scenario suggests that growth could contract in 2020, reflecting a continued fall in investment, shrinking exports amid weak external demand, and disruption to activity due to social distancing efforts to contain the coronavirus outbreak. In response, Turkey announced a $15 billion economic package in March, which includes support to low-income households and pensioners, as well as tax breaks and financial support for firms. Gradual improvement in domestic demand is expected to support growth over the forecast horizon. This outlook assumes that fiscal and monetary policies remain steady and do not revive earlier external imbalances, the currency does not come under sustained pressure, and corporate debt restructurings proceed smoothly.

Central Europe and the Baltics

Growth in Central Europe and the Baltics slowed to an estimated 4 percent in 2019, despite a robust start to the year. In Central Europe, rising real wages and government transfers helped boost private consumption. This impact dissipated by the end of the year, however, despite an investment-led construction sector pickup in some economies (Hungary, Romania). The slowdown in the euro area weighed on activity in Poland and exports in some cases (Bulgaria, Romania).

Near-term activity is expected to decline as the coronavirus pandemic spreads in Europe, reducing travel and associated tourist activity in the subregion; domestic containment measures will also contribute to this decline, as disruption to activity weighs on private consumption and investment. The outbreak has already disrupted deeply embedded value chains in Central Europe, with the production delays in China affecting the closely linked manufacturing sector in Germany. Supply chains in Central Europe have also been interrupted by the spread of the virus, leading to shipment delays of intermediate goods amid border closures and restrictions.

Given the challenging growth environment, Poland's central bank cut the policy interest rate to 1 percent in March—the first rate cut since 2015. However, the acceleration in inflation may limit additional cuts and will weigh on real wages. Poland has announced a large fiscal support package amounting to about 9 percent of GDP; although full details are sparse at the time of publication, the package will provide support to help counter domestic and international headwinds from the coronavirus outbreak by extending credit to firms and partial wage compensation for workers. In Croatia, which is likely to be one of the economies in the region most affected by the coronavirus pandemic, due to its heavy reliance on tourism, the economy will also be negatively impacted by the earthquake in late March—the largest to hit its capital in 140 years.

As a result of the coronavirus pandemic, the model scenarios suggest that subregional growth could shrink in 2020, to −2.5 to −1.0 percent, before improving in 2021, to 5.5 to 5.9 percent. Fiscal support and the subsequent boost from private consumption will fade in some of the largest economies, with limited fiscal space available for fully offsetting potential adverse spillovers from the euro area. Shrinking working-age populations, reflecting aging and emigration to Western Europe in recent years, limit growth prospects. Progress on structural reforms is key to support private investment growth over the medium term. Growth in the subregion is highly dependent on the continued absorption of EU structural funds, with the current cycle expected to end in 2020.

The Western Balkans

In the Western Balkans, a deceleration of public investment (Kosovo, Montenegro), manufacturing (Serbia, Montenegro), and export growth (Albania) contributed to a moderation of growth to an estimated 3.6 percent in 2019. Temporary factors related to weather and energy production dampened activity in Albania, while strong import demand for public investment projects led to a negative contribution of net exports in North Macedonia.

The impact of the containment measures to address the coronavirus is affecting the Western Balkans' outlook through dampened domestic demand, as well as disruptions in regional value chains (Serbia, North Macedonia) and lower tourism activity (Montenegro, Albania). Overall, model scenarios suggest that growth could fall to −3.8 to −1.1 percent in 2020—the first contraction since the euro area debt crisis in 2012. Growth in 2021 is projected to rebound to 4.4 to 4.5 percent in the Western Balkans, assuming political instability, policy uncertainty, and the coronavirus outbreak all remain contained. Rising fiscal liabilities in the subregion in the past few years, in some cases due to large public sector wage increases, social transfers, or higher-than-expected costs for infrastructure projects, have reduced space for countercyclical fiscal stimulus and weakened the business climate (Kosovo, Montenegro, North Macedonia). Additionally, the recent earthquake in Albania took a heavy toll on human life and physical infrastructure; the budget will be further stretched to counter the damaging economic effects of the coronavirus outbreak, with a recently announced support package that includes an increase in unemployment benefits and transfers. The outlook for the subregion remains challenging, as falling business confidence and heightened uncertainty coincide with a worsening external environment and the coronavirus pandemic.

The South Caucasus

Firming growth in the South Caucasus, to an estimated 3.6 percent in 2019, was supported by private consumption, and on the supply side by strong manufacturing growth and a recovery in mining production in Armenia. Expanding natural gas production and steady growth in non-energy sectors supported Azerbaijan's economy in 2019. In Georgia, growth strengthened despite the imposition of travel restrictions by Russia, as labor markets improved, credit growth remained robust, and the number of tourists from other countries increased.

The model scenarios suggest that growth in the South Caucasus could fall to −0.9 to 0.1 percent this year, as the subregion faces growth headwinds from the coronavirus outbreak and, subsequently, low commodity prices. Activity is projected to pick up to 2.2 to 3.4 percent in 2021, as the impacts of the shocks dissipate and tourism recovers alongside improving consumer and business confidence in Armenia and Georgia. Activity is expected to recover in Azerbaijan as oil prices modestly improve but at low levels; dampened commodity prices, along with lingering structural rigidities, will mute the overall recovery. Longer-term growth depends on continuation of domestic reforms to enhance private sector development and address fragilities emanating from the financial sector, as well as investment in human capital to boost the quality of education and reduce skills mismatches.

Eastern Europe and Central Asia

In Eastern Europe, industrial production growth softened, reflecting marked weakness in manufacturing amid slowing export growth, particularly in Belarus. In Ukraine, economic growth stabilized at 3.2 percent in 2019, driven by strong consumption growth, wages, and remittances, but investment growth and the manufacturing sector showed weakness. In Moldova, growth lost momentum toward the end of the year, falling to 3.6 percent overall in 2019, despite support from private investment and consumption. In Central Asia, the cyclical expansion strengthened, with robust growth at 5.0 percent in 2019. In Kazakhstan, the largest sub-regional economy, slowing exports from lower oil prices were offset by fiscal support.

Over the forecast horizon, the scenarios suggest that growth in 2020 could decline sharply to between −7.1 and −3.6 percent in Eastern Europe and −1.3 to 0.1 percent in Central Asia, and improve in 2021 as the impact of the coronavirus fades. However, growth in both subregions is subject to considerable policy uncertainty, as well as uncertainty relating to domestic outbreaks of the coronavirus. These subregions face a challenging external environment, as growth remains weak in key trading partners and critical sources for remittance flows, including the euro area and Russia (for Eastern Europe) and China (for Central Asia).

The growth outlook for Ukraine in 2020 remains highly uncertain and will depend on the duration of the health crisis, progress on major pending reforms, and the ability to mobilize adequate financing to meet major repayment needs. In Moldova, growth is expected to contract in 2020, assuming sharp disruptions to activity as recently announced containment measures take effect—quick improvements in consumer and business confidence are assumed to follow in the second half of the year. In Central Asia, growth will likely face negative spillovers from the euro area and China through trade, commodity, and remittance channels amid the coronavirus pandemic. Activity in Kazakhstan will likely be dampened by the waning effect of earlier fiscal stimulus, slowing growth in key trading partners (Russia, China), and low productivity.

Risks to the Regional Outlook

The regional outlook remains subject to significant downside risks. Intensification of the spread of the coronavirus across the economies in Europe and Central Asia would worsen the outlook, while containment measures could weigh on private consumption and investment more than expected. The coronavirus pandemic also poses risks to growth in the region through international spillovers, as the outbreak is accompanied by a sharp growth slowdown in the euro area and China, which could further propagate to Europe and Central Asia through trade and commodity price channels, as well as through disruptions to supply chains and tourist activity. Energy and metals exporters in the region are increasingly reliant on China as an export destination. An unexpected tightening of global financing conditions could generate financial market pressures in the region, renewing capital outflows and currency volatility, particularly in economies with large external financing needs. Other risks include slowing growth in other major trading partners, geopolitical turbulence, and heightened policy uncertainty. Renewed involvement in conflicts in the Syrian Arab Republic, Libya, or Ukraine could trigger additional sanctions against large economies in the region. The region's energy exporters—Azerbaijan, Kazakhstan, and Russia—remain vulnerable to large swings in global commodity prices, particularly when accompanied by heightened volatility (van Eyden et al. 2019).

An even sharper-than-expected slowdown in the euro area, Europe and Central Asia's most important external trading partner, could generate negative spillovers in economies with tightly linked trade, financial, and remittance ties (figure 1.3, panel c). Although policy uncertainty surrounding the United Kingdom's exit from the European Union has dissipated somewhat, the process remains vulnerable to disruption until the end of the transition period, currently scheduled for the end of the year (Bank of England 2018; H.M. Government 2018). For Central European economies, the potential redirection of EU structural funds to Southern European member states after 2020 could hinder growth. In several countries, structural fund payments represented 5 percent or more of GDP over the last program period, 2014–20. Historically, when the remaining EU funds left to absorb were low, activity also decelerated substantially, as was the case in Poland in 2016. In Central Asia and Eastern Europe, slowing activity in the European Union and Russia could impact remittance inflows, which account for a nonnegligible proportion of income (Kyrgyz Republic, Moldova, Tajikistan, Ukraine); the slowdown in the euro area will similarly impact the Western Balkans.

In some Central European economies, particularly Romania, the policy space to confront negative shocks is limited by persistent budget deficits driven by increasing public sector wages, rising government transfers, and low tax capacity. Across Europe and Central Asia, public sector debt relative to GDP is higher than it was prior to the global financial crisis, with the largest increases observed in Eastern Europe and the South Caucasus (figure 1.3, panel d). This makes it particularly challenging to address the economic costs associated with the pandemic.