REGIONAL ECONOMIC PROSPECTS

European Bank
for Reconstruction and Development

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UPDATE

Not out of the woods yet

Regional Economic Prospects in the EBRD Regions

European Bank
for Reconstruction and Development

Not out of the woods yet

February 2023 Update

Output in the EBRD regions is estimated to have grown by 3.2 per cent year-on-year in January-September 2022 (and around 2.4 per cent in the year as a whole), slower than in 2021 as the war on Ukraine took its toll and the post-Covid recovery has mostly run out of steam (in 2020, the region's output contracted by 2.4 per cent).

This outcome nonetheless exceeded expectations, as private savings accumulated during Covid-19 lockdowns have been actively spent in Emerging Europe. This temporarily boosted consumption despite falling real wages while resulting in a sharp widening of current account deficits in central Europe. Economies in Central Asia and the Caucasus benefitted from intermediating trade to Russia as well as inflows of capital and educated migrants from Russia.

Output in the EBRD regions is expected to grow by 2.1 per cent in 2023 as high gas prices and persistent inflation weigh on the economic outlook. The current forecast represents a downward revision compared with the baseline scenario published in September 2022, although it is stronger than in the previous downside scenario, which assumed no Russian gas delivered through pipelines. Growth forecasts have been adjusted down in more than half of economies in the region, with virtually no upward revisions. Growth is expected to pick up to 3.3 per cent in 2024, broadly in line with estimates of medium-term potential growth.

Commodity prices have eased from their recent peaks. The price of gas increased sharply in 2022 as supplies of pipeline gas from Russia to Europe fell by more than 70 per cent year-on-year in the second half of the year. The reduction reflects the cancellation of Nord Stream 2, closure of Nord Stream 1 (running to Germany), suspension of shipments through Belarus (to Poland) as well as reduced transhipment through Ukraine (to Hungary and the Slovak Republic) and, more recently, Turk Stream (a pipeline under the Black Sea to the Turkiye-Greece border). However, reduced consumption (reflecting mild weather in Europe and higher prices) has helped to maintain gas in storage in Europe above corresponding 2021 levels. Additional liquefied natural gas (LNG) supplies and deliveries from Norway and Algeria have also reduced price pressures. As a result, gas prices in Europe were back to their pre-war levels as of end January. However, those levels are comparable in real terms to highs last seen in the 1980s and exceed the US price by a factor of six.

Markets expect high prices in Europe to persist throughout the 2020s, consistent with previous episodes of high prices in Europe lasting 7-13 years. In the long term, elimination of inefficient use of gas is likely to be positive for Europe's competitiveness. In the short term, consumers heating their dwelling, firms in gas-intensive industries and governments (providing subsidies) remain squeezed by historically high gas prices. Government energy subsidies in central and south-eastern EU economies are estimated at around 3.6 per cent of GDP on average.

Pushed up by high energy prices, average inflation in the EBRD regions peaked at 17.5 per cent in October 2022 (the level last seen in 1998, at the end of the transition recession), dropping to 16.5 per cent in December 2022. While in 26 economies in the EBRD regions inflation was down (or unchanged) in December relative to November, in eight economies it was still going up. As a result of high inflation, real incomes have been falling, with the exceptions of Central Asia and the Caucasus, where real wage growth *has been strong. Analysis of disinflation episodes since the late 1990s suggests that disinflation is likely to be more gradual than markets currently expect.*

High real wage growth in economies in Central Asia and the Caucasus has been underpinned by the rise in export-import flows as well as inflows of capital and educated migrants from Russia and high commodity prices. Exports from the European Union, United Kingdom and United States to Central Asia and the Caucasus increased dramatically, hinting at the rise of 'intermediated trade', whereby goods are being exported to Central Asian economies and are then sold onwards to Russia. While this intermediated trade represents a small fraction of the reduction in Russia's direct imports from the West, it amounts to 4 to 6 per cent of GDP (annualised) in the Kyrgyz Republic and Armenia. A burgeoning logistics industry has sprung up to facilitate this trade, contributing to the inflows of capital that have underpinned the appreciation of local currencies against the US dollar.

Fiscal and external vulnerabilities are high in some economies in the EBRD regions. The median (typical) bond yield in the EBRD regions increased by 3.8 percentage points since early February 2022 (of which 1.4 percentage points on account of the increased spread vis-a-vis US/German bonds). Debt vulnerabilities are high in Egypt, where the cost of servicing public debt is forecast to exceed 40 per cent of government revenues, and Mongolia, where total debt in foreign currency reaches almost 230 per cent of GDP.

*Output in **central Europe and the Baltic states** is expected to increase by 0.6 per cent in 2023. In 2022, the region's economies proved more resilient than expected, but falling purchasing power, weaker external demand from advanced Europe and elevated financing costs are expected to weigh on growth. Growth is forecast to pick up to 2.7 per cent in 2024, still below medium-term potential reflecting continued high energy prices and short-term costs associated with the green transition.*

*Countries in the **south-eastern European Union** have also been resilient to shocks, but experienced sharply lower growth rates in the second half of 2022. Growth of 1.5 per cent is expected in 2023, picking up to 3.1 per cent in 2024.*

*While economic growth in the **Western Balkans** moderated in 2022, household consumption proved resilient. Growth in 2023 is expected to slow to 2.2 per cent reflecting weak external demand, persistently high inflation and tighter financing conditions. Growth is expected to pick up to 3.4 per cent in 2024.*

*Output in **eastern Europe and the Caucasus** (excluding Ukraine) exceeded expectations in 2022 driven by high growth in Armenia and Georgia. Growth is, however, expected to slow to 2.7 per cent in 2023 before picking up moderately in 2024, to 3.6 per cent, as the impact of extraordinary factors related to rerouting of trade around Russia and inflow of capital and skilled migrants wanes. Real output in Ukraine is expected to stabilise at around 70 per cent of its 2021 level in 2023.*

*Output in **Central Asia** is expected to grow by 4.9 per cent in 2023. A slight upward revision relative to September reflects the boost from high oil and gas prices in commodity exporters and increased inflows of labour, capital and remittances and increased intermediated trade. Output growth is expected to pick up to 5.4 per cent in 2024, on planned infrastructure investments, high commodity prices and relocation of Russian businesses.*

*GDP growth in **Turkiye** slowed down significantly in 2022, and is expected to fall further, to 3 per cent in 2023 and 2024 as the growing external financing requirements and political uncertainty associated with elections in 2023 create significant economic vulnerabilities. These forecasts do not incorporate the potential effects of the February 2023 earthquake and it is very early to be making any firm predictions about the impact on overall economic activity in 2023. A reasonable estimate would be a loss of up to 1 per cent of GDP as the boost from reconstruction efforts in the later months of the year is expected to partially offset the negative impact from the damage to supply chains and infrastructure.*

*Output in the **southern and eastern Mediterranean** is expected to grow by 4 per cent in 2023 and 4.2 per cent in 2024. While growth decelerated sharply in 2022 on higher inflation and tighter financing conditions, it is expected to pick up in 2023 as agricultural output rebounds and much-needed structural reforms advance.*

Table 1. GDP growth in real terms

Table 1. Real GDP growth, in per cent per annum								
	Actual		Forecast (Feb'23)			Revision since Sep'22		
	2021	Jan-Sep'22	2022 est	2023	2024	2022	2023	2023 down
EBRD Regions	**7.1**	**3.2**	**2.4**	**2.1**	**3.3**	**0.1**	**-0.9**	**0.4**
Central Asia	**5.1**	**4.3**	**4.3**	**4.9**	**5.4**	**0.0**	**0.1**	**-0.1**
Kazakhstan	4.1	3.0	3.1	3.5	4.0	0.1	0.0	0.0
Kyrgyz Republic	3.7	7.2	7.0	7.0	7.2	0.0	0.0	0.0
Mongolia	1.6	3.7	3.7	7.0	7.5	0.2	0.0	0.0
Tajikistan	9.2	7.8	7.3	8.0	8.0	0.3	0.0	0.0
Turkmenistan	6.2	6.2	6.2	6.5	7.0	-0.8	0.5	-1.0
Uzbekistan	7.4	5.8	5.7	6.5	7.0	0.2	0.0	0.0
Central Europe and the Baltic states	**6.2**	**5.2**	**4.0**	**0.6**	**2.7**	**0.3**	**-0.7**	**1.0**
Croatia	13.1	7.1	6.5	1.5	2.3	0.0	-0.5	0.5
Czech Republic	3.6	3.2	2.5	0.2	2.2	0.0	-0.3	0.7
Estonia	8.0	0.7	0.3	0.2	2.5	-1.2	-0.8	0.7
Hungary	7.1	6.1	5.0	-0.2	2.5	0.0	-1.7	0.3
Latvia	4.1	2.4	2.0	-0.2	2.0	-0.5	-1.0	0.3
Lithuania	6.0	2.7	2.3	0.0	1.7	0.3	-1.5	0.5
Poland	6.8	6.6	4.8	1.0	3.0	0.8	-0.5	1.5
Slovak Republic	3.0	1.9	1.5	0.5	3.4	-0.5	-0.5	1.5
Slovenia	8.2	7.0	6.0	1.0	2.3	0.0	-0.8	0.2
Eastern Europe and the Caucasus	**4.9**	**-17.4**	**-17.6**	**1.6**	**3.2**	**0.2**	**-4.6**	**1.1**
Armenia	5.7	12.6	13.5	4.0	4.8	5.5	0.0	1.0
Azerbaijan	5.6	5.6	4.6	2.5	2.7	0.1	0.0	0.0
Georgia	10.4	10.2	9.9	5.0	5.3	1.9	0.0	1.0
Moldova	13.9	-4.1	-4.7	-1.3	3.5	-3.7	-1.3	6.7
Ukraine	3.4	-30.0	-30.0	1.0	3.0	0.0	-7.0	1.0
South Eastern EU	**7.0**	**5.1**	**4.7**	**1.5**	**3.1**	**-0.3**	**-0.5**	**0.1**
Bulgaria	7.6	3.7	3.0	1.0	2.6	0.0	-0.5	0.5
Greece	8.3	5.9	5.2	1.5	3.0	0.0	-0.7	-0.5
Romania	5.8	4.9	4.7	1.7	3.3	-0.7	-0.2	0.5
Southern and Eastern Mediterranean	**6.1**	**3.3**	**3.3**	**4.0**	**4.2**	**0.4**	**-0.7**	**0.0**
Egypt	7.1	4.4	4.4	4.6	5.0	0.5	-1.0	-0.1
Jordan	2.2	2.7	2.6	2.7	2.5	0.6	0.0	0.2
Lebanon	-10.0	-4.0 e	-4.0	2.0	3.0	-2.0	-2.0	-1.8
Morocco	7.9	1.3	1.3	3.3	3.2	0.2	0.0	0.3
Tunisia	4.3	2.6	2.7	2.5	2.7	1.0	-0.4	-0.2
Turkiye	**11.4**	**6.1** e	**4.5**	**3.0**	**3.0**	**0.0**	**-0.5**	**0.0**
Western Balkans	**7.6**	**3.5**	**3.0**	**2.2**	**3.4**	**-0.2**	**-0.8**	**1.5**
Albania	8.5	4.3 e	3.7	2.5	3.3	0.7	-0.5	0.5
Bosnia and Herzegovina	7.5	4.6 e	4.0	2.0	3.0	1.0	-0.3	1.7
Kosovo	10.5	2.8	3.2	3.0	4.0	-0.8	-0.7	0.3
Montenegro	12.4	7.1	6.3	3.3	3.7	2.6	-0.7	0.3
North Macedonia	4.0	2.7 e	2.5	2.0	3.0	-0.2	-0.3	2.7
Serbia	7.4	2.8 e	2.3	2.0	3.5	-1.0	-1.3	1.7
Memo: Egypt (fiscal year to June)	3.3	4.4	6.6	4.7	5.0	0.0	0.0	0.1
EEC excl. Ukraine	7.7	6.2	5.6	2.7	3.6	0.7	-0.1	1.3
Belarus	2.3	-4.7	-4.7	-1.0	1.3	0.8	0.0	0.0
Russia	4.7	-1.7	-3.5	-3.0	1.0	1.5	0.0	0.5

Sources: National authorities and EBRD. Notes: Weights are based on the values of gross domestic product in 2020 at market exchange rates. Jan-Sep ‘22 estimates from national authorities and Refinitiv Eikon/Oxford Economics. 2023 down refers to the ‘no Russian gas’ scenario from the September 2022 Regional Economic Prospects.

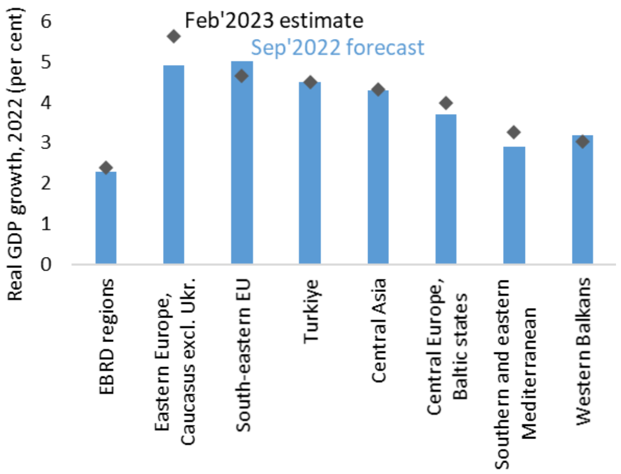
Output in the EBRD regions is estimated to have increased by 2.4 per cent in 2022

Output in the EBRD regions is estimated to have grown by 3.2 per cent year-on-year in January-September 2022 and around 2.4 per cent in the year as a whole. While this was slower than in 2021 as the war on Ukraine took its toll and the post-Covid recovery has mostly run out of steam, this outcome nonetheless exceeded expectations, in particular in central Europe, the Caucasus and Central Asia (see Chart 1).

In central Europe, private savings accumulated during the Covid-19 lockdowns have been actively spent. This temporarily boosted consumption despite falling real wages, while resulting in a sharp widening of current account deficits in central Europe.

Economies in Central Asia and the Caucasus benefitted from intermediating trade to Russia as well as inflows of capital and educated migrants from Russia.

Chart 1. Growth in 2022 in central Europe and the Caucasus surprised on the upside

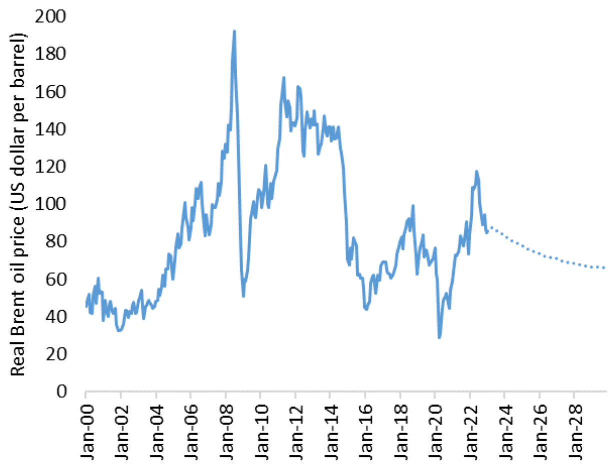


Sources: National authorities via CEIC, EBRD Regional Economic Prospects September 2022 and authors' calculations.

Commodity prices have eased from their recent peaks

Having increased sharply in 2022, the oil price has recently eased to its pre-war level. At around US$ 85 per barrel as of end-January 2023, it remains well below its historical peaks in inflation-adjusted terms (see Chart 2). Urals oil continued to trade at a discount relative to Brent as some buyers discontinued purchases of oil from Russia. Based on oil futures, markets expect prices to decline slowly over the next 5 years.

Chart 2. Oil prices eased to pre-war levels, but are expected to decline only slowly



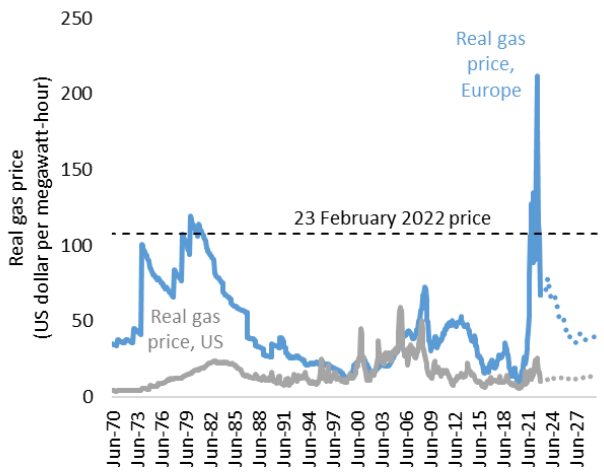
Sources: Bloomberg, Refinitiv Eikon and authors' calculations.
Notes: Prices adjusted for US inflation. Dashed line denotes futures.

The price of gas increased sharply in 2022 as supplies of pipeline gas from Russia to Europe fell by more than 70 per cent year-on-year in the second half of the year. The reduction reflects the cancellation of Nord Stream 2, closure of Nord Stream 1 (running to Germany), suspension of shipments through Belarus (to Poland) as well as reduced transhipment through Ukraine (to Hungary and the Slovak Republic) and, more recently, Turk Stream (a pipeline under the Black Sea to the Turkiye-Greece border).

Reduced consumption (reflecting mild weather in Europe and higher prices) has helped to maintain gas in storage in Europe above the corresponding 2021 levels. Additional liquefied natural gas (LNG) supplies and deliveries from Norway and Algeria have also reduced price pressures (total gas imports in 2022 were 4 per cent lower than in 2021). As a result, gas prices in Europe, at around US$ 63 per megawatt-hour as of end-January 2023, were back to their pre-war levels (see Chart 3). However, those levels are comparable to highs last seen in the 1980s and exceed the US price by a factor of six.

Markets expect high prices in Europe to persist throughout the 2020s, consistent with previous episodes of high prices in Europe lasting 7-13 years.

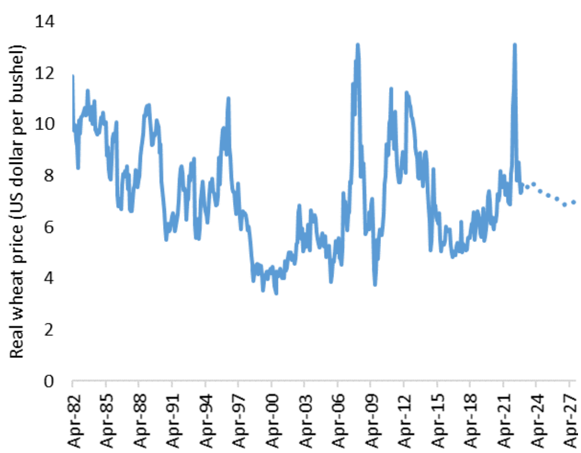
Chart 3. Gas prices in Europe declined to pre-war levels, but are expected to remain high



Sources: Bloomberg, CEIC and authors' calculations.
Notes: Prices adjusted for US inflation. Dashed lines denote futures.

Wheat prices also returned to below their pre-war levels but are expected to edge up in 2023 on high fertiliser costs as Belarus and Russia were large fertiliser exporters (see Chart 4).

Chart 4. Wheat prices normalised, but are expected to edge up in 2023 on high fertiliser costs



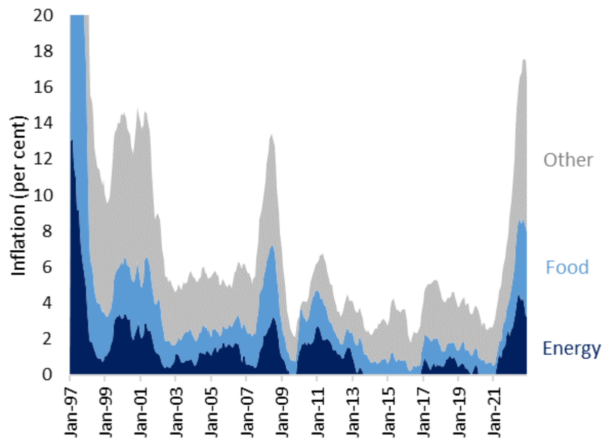
Sources: Bloomberg, Refinitiv and authors' calculations.
Notes: Prices adjusted for US inflation. Dashed line denotes futures.

Inflation may have peaked

High food and energy prices contributed to inflationary pressures throughout 2022, adding to the pressures from the rebound in global demand as Covid-19 restrictions were phased out. Average inflation in the EBRD regions peaked at 17.5 per cent in October 2022 (the level last seen in 1998, at the end of the transition recession).

As energy and food prices came down from their peaks, average inflation in the EBRD regions also fell to 16.5 per cent in December 2022 (see Chart 5). Energy and food together accounted for about 50 per cent of price increases, down from about 60 per cent in July.

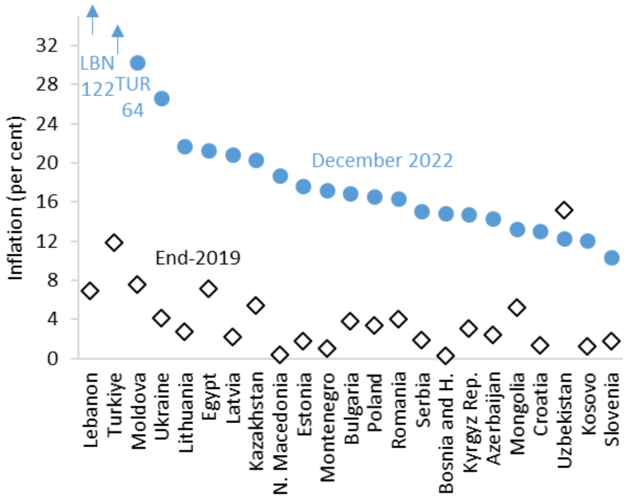
Chart 5. Inflation fell to 16.5 per cent in the EBRD regions in December 2022



Sources: Bloomberg, national authorities via CEIC and authors' calculations.
Notes: Year-on-year changes. Headline inflation is a simple average across 33 economies in the EBRD regions. The decomposition is based on an unbalanced panel ranging from 5 economies in 1997 to 11 economies from 2001. The decomposition is scaled to overall inflation in the EBRD regions.

Inflation was in double digits in 80 per cent of economies in the EBRD regions, reaching over 120 per cent in Lebanon and over 60 per cent in Turkiye (see Chart 6).

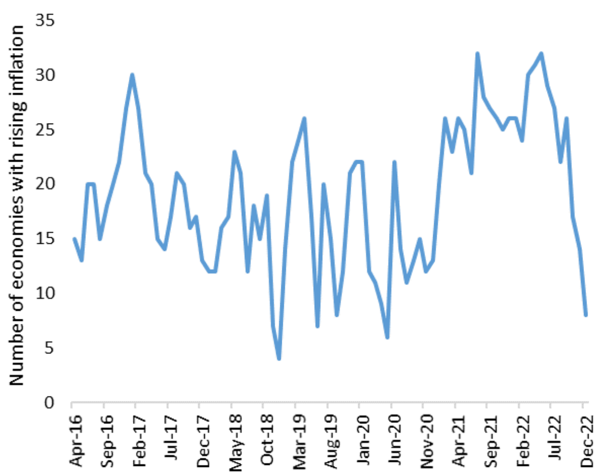
Chart 6. Inflation was in double digits in 80 per cent of economies in the EBRD regions



Sources: National authorities via CEIC and authors' calculations.
Notes: Year-on-year changes. Select economies shown.

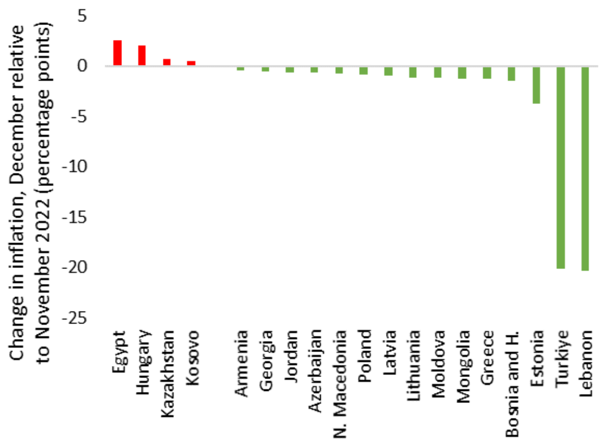
In 26 economies in the EBRD regions inflation measured year-on-year was down (or unchanged) in December relative to November (see Chart 7). In Egypt, Hungary and six other economies it was still rising, in some cases reflecting inflationary pressures from currency depreciations (see Chart 8).

Chart 7. In 26 economies in the EBRD regions inflation was down in December relative to November



Sources: Bloomberg, national authorities via CEIC and authors' calculations.
Notes: Number of economies where year-on-year inflation in a given month is strictly higher than year-on-year inflation in the previous month.

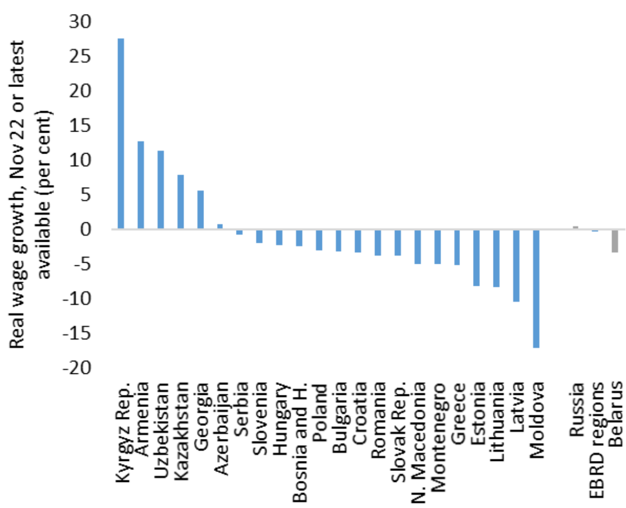
Chart 8. In some economies inflation continued to increase



Sources: National authorities via CEIC and authors' calculations.
Notes: Changes in year-on-year inflation. Economies with changes of at least 0.5 percentage points shown.

In most economies in the EBRD regions, wage growth lagged behind inflation (see Chart 9). Real wage growth has been strong, however, in Central Asia and the Caucasus, boosted by intermediated trade and the associated logistics industry as well as capital inflows from Russia.

Chart 9. Real wage growth has remained strong in Central Asia

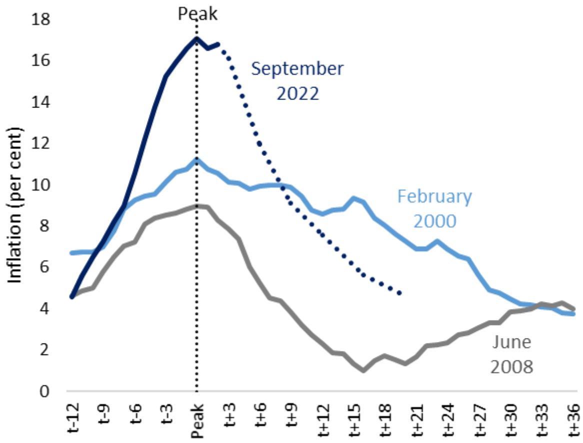


Sources: Bloomberg and authors' calculations.
Notes: October or November 2022. September 2022 for Belarus, Estonia, Greece, Latvia, Lithuania, the Slovak Republic, Slovenia and Uzbekistan.

Disinflation may take longer than markets expect

Past episodes of high inflation suggest that disinflation may take longer to achieve than currently expected. After inflation in central and south-eastern EU peaked at around 11 per cent in early 2000, it was slow to come down against the background of robust economic growth in the region (see Chart 10). After peaking at around 9 per cent in June 2008, it declined by 7 percentage points within a year. During that time, output contracted by 7 per cent on average (based on the sample of 11 economies shown in Chart 10). Disinflations tend to be faster if economic conditions are weaker and unemployment is high and rising as in these circumstances inflation expectations feed into rising wages to a lesser extent.

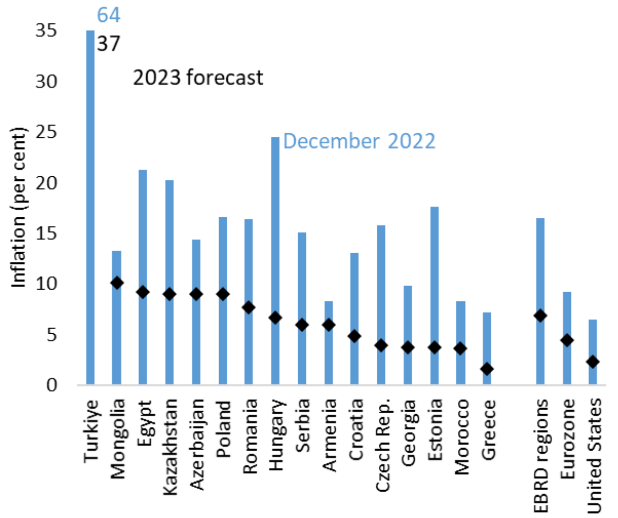
Chart 10. Past experience points to slow disinflation



Sources: Bloomberg and authors' calculations.
Notes: Simple average across 11 economies in central and south-eastern EU. Dashed line denotes forecast based on 6 economies.

Markets currently expect disinflation faster than that following the 2008 peak, with inflation expected to come down by about 10 percentage points in a year, even though food or energy prices are not expected to fall further in a significant way. Likewise, IMF forecasts from October 2022 expect inflation in the EBRD regions to decline to around 7 per cent by end-2023 (still averaging to inflation of almost 10 per cent for 2023 as a whole; see Chart 11).

Chart 11. Inflation is expected to decline in 2023



Sources: Bloomberg, IMF WEO October 2022 forecasts and authors' calculations.
Notes: End-of-period inflation for 2023. Select economies shown.

Changing patterns of trade in Central Asia and the Caucasus[1]

Exports from the European Union, the United Kingdom and United States to Russia declined rapidly since Russia's invasion of Ukraine and the subsequent introduction of sanctions against Russia. In May-July 2022, exports from the European Union, the United Kingdom and United States to Russia were all more than 50 per cent lower than their average in the same period between 2017 and 2019.

In part, this represents direct application of sanctions (which limit exports of technology as well as transactions with specific counterparties). In part, it reflects individual decisions of many companies to stop selling goods and services to Russia as well as Belarus (see Sonnenfeld et al., 2022, who show such decisions were associated with improved stock market performance, and Evenett and Pisani, 2023).

Increased complexity of clearing payments from Russia (including those required to settle import-

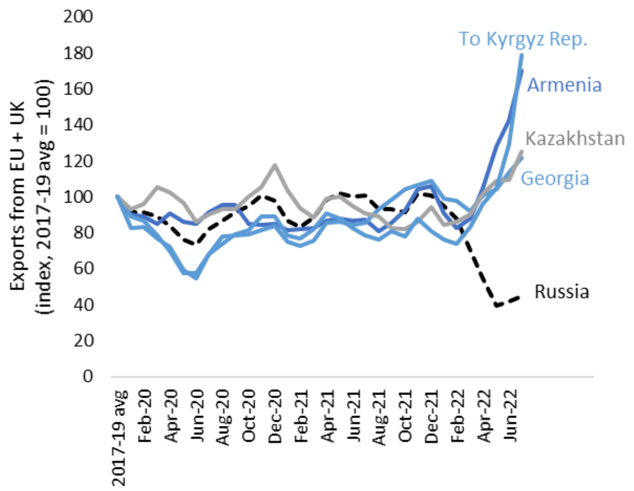
[1] This section is based on Chupilkin et al. (2023).

export transactions) may also have played a role (see Demir and Javorcik, 2018, on the role of trade finance in supporting cross-border trade).

At the same time, exports from the European Union, the United Kingdom and United States to Central Asia and the Caucasus increased dramatically, hinting at the rise of 'intermediated trade', whereby goods are being exported to Central Asian economies and then sold onwards to Russia.

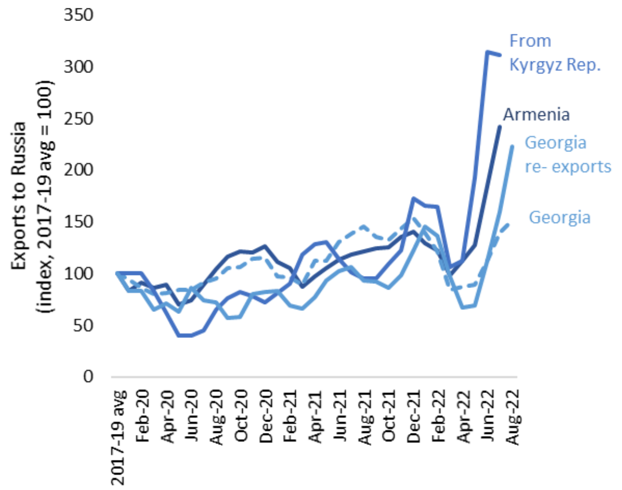
Exports from the European Union, the United Kingdom and United States to some economies in Central Asia and the Caucasus increased by more than 80 per cent over the same period. These increases were particularly pronounced for the Kyrgyz Republic and Armenia, both members of the Eurasian Economic Union providing for customs-free trade with Russia (see Charts 12 and 13).[2]

Chart 12. EU and UK to Russia exports more than halved – their exports to Armenia and the Kyrgyz Republic increased markedly



Sources: Chupilkin et al. (2023) based on data from Comtrade.
Notes: As reported by exporters. Trade in nominal US dollars is adjusted for US inflation. 3-month moving average. Monthly average taken across all months in 2017-19.

Chart 13. Exports to Russia from Armenia and the Kyrgyz Republic increased substantially



Sources: Chupilkin et al. (2023) based on data from Comtrade.
Notes: As reported by exporters. Trade in nominal US dollars is adjusted for US inflation. 3-month moving average. Monthly average taken across all months in 2017-19.

While this additional (intermediated) trade represents a small fraction of the reduction in Russia's direct imports from the West, it amounts to 4 to 6 per cent of GDP (annualised) in Armenia and the Kyrgyz Republic. This trade has also boosted the development of associated logistics industry and financial services.

An additional analysis shows that these patterns of intermediated trade through neighbouring economies are stronger and more extensive than those observed in the earlier episodes of economic sanctions, for instance, after re-imposition of sanctions against Iran in 2018.

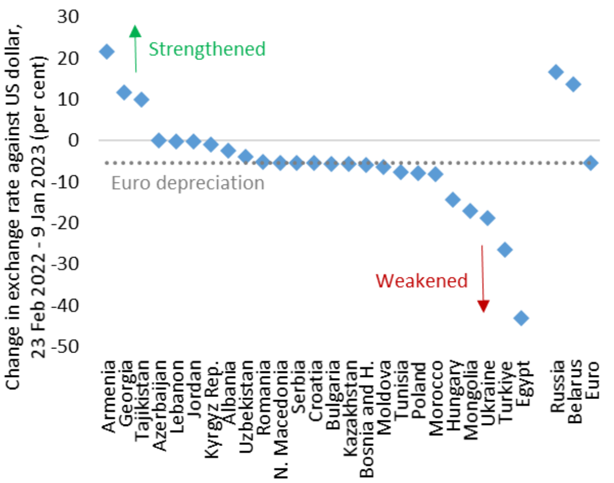
Exchange rate pressures

Most currencies in the EBRD regions depreciated against the US dollar between February 2022 and January 2022, reflecting the US dollar's strength against other major currencies (see Chart 14). Notable exceptions are currencies in Central Asia and the Caucasus, where revenues from intermediated trade combined with inflows of

[2] See Isakova et al. (2016) for a discussion.

capital underpinned the appreciation of local currencies.

Chart 14. Most currencies in the EBRD regions weakened against the US dollar; Central Asia and the Caucasus are notable exceptions



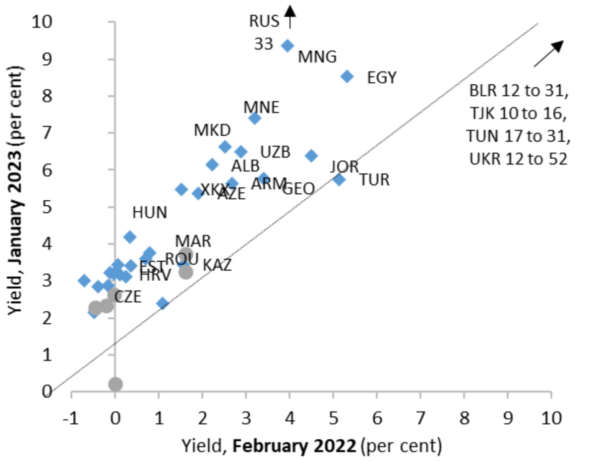
Sources: National authorities via CEIC and authors' calculations.

As depreciation of the Turkish Lira outpaced inflation since 2015, Turkiye's exports have been growing fast, benefitting from lower costs expressed in US dollars. In 2022, Turkiye's global exports were 20 per cent higher than in 2017-19 (in US dollar terms, adjusted for US inflation); its exports to Russia and Belarus almost doubled over the same period as goods from Turkiye filled the void left by other exporters. Its exports to Central Asia and the Caucasus also increased by 20 to 80 per cent relative to pre-Covid levels. At the same time, imports have also grown rapidly and the trade deficit has widened substantially.

Fiscal vulnerabilities increased

As of end-January 2023, the median yield on 5-year government bonds in the EBRD regions increased by 3.8 percentage points relative to February 2022. This reflects an increase in yields on German and US bonds (by 1.4 percentage points), as well as an increase in the spread between the EBRD regions and Germany/ the United States on reassessment of emerging market economy risks including geopolitical risks (around 2.4 percentage points). Yields were especially high in Tajikistan and Tunisia as well as Belarus, Russia and Ukraine (see Chart 15).

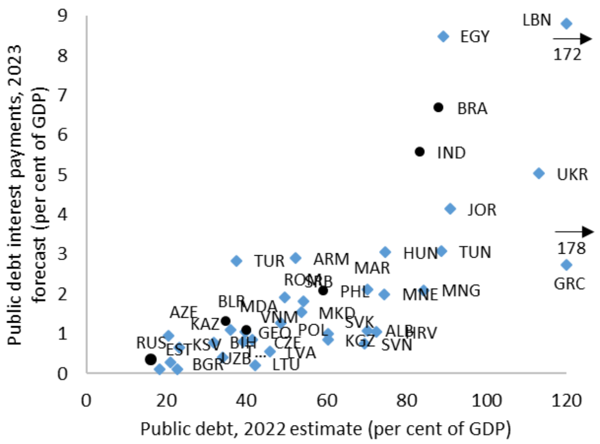
Chart 15. The median yield in the EBRD regions increased by 3.8 percentage points since February 2022



Sources: Bloomberg and authors' calculations.
Notes: Yields on 5-year government bonds in US dollars or closest benchmark available, 24 Jan 2023 and 23 Feb 2022.

Reflecting high borrowing costs, interest payments on public debt as a share of GDP are also high and rising in a number of economies in the southern and eastern Mediterranean and Ukraine (see Chart 16). In Egypt, interest payments are forecast to exceed 8 per cent of GDP in 2023, which would constitute 43 per cent of total government revenues.

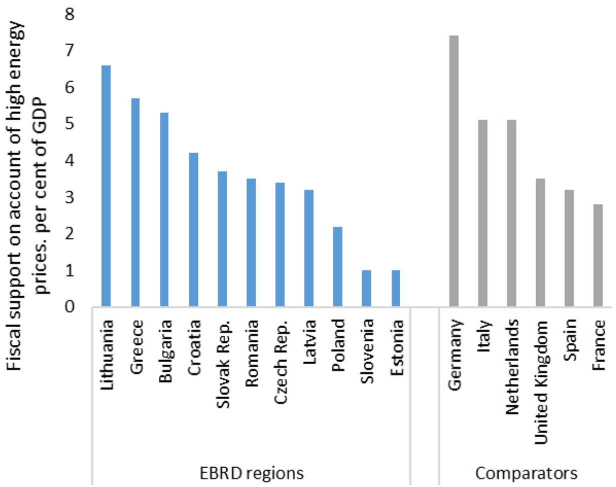
Chart 16. Interest payments are especially high in the southern and eastern Mediterranean



Sources: IMF WEO October 2022, IMF Staff Reports, Oxford Economics and authors' calculations.
Notes: Public debt for Lebanon is based on 2020 numbers, for Ukraine forecast of Oxford Economics is used.

Many economies in the EBRD regions have turned to various support measures to mitigate the impact of high energy prices on households and firms. Government energy subsidies in central and south-eastern EU economies, for instance, are estimated at around 3.6 per cent of GDP on average. In some cases, such as Bulgaria, Greece, Lithuania as well as Germany, Italy or the Netherlands, these are estimated to have exceeded 5 per cent of GDP (see Chart 17). As high subsidies helped 'socialise' the immediate impact of the energy shock, consumers and producers are yet to factor in higher energy prices fully into their spending decisions.

Chart 17. Support measures have shielded consumers and producers from the full impact of the energy shock, at a high cost to governments

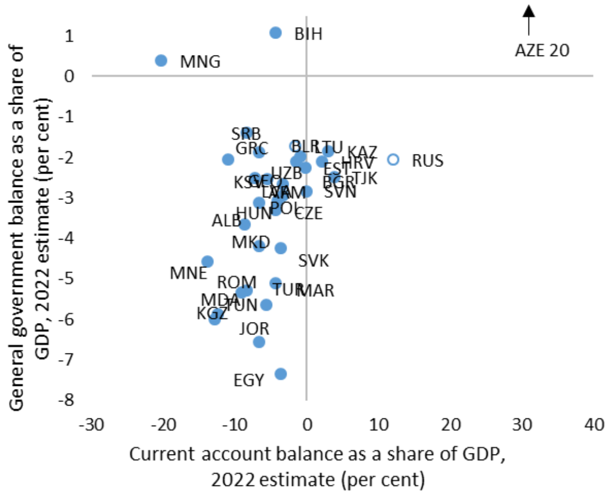


Sources: Bruegel, Fitch Ratings.
Notes: Data as of 29 November 2022.

Twin deficits

Around 80 per cent of economies in EBRD regions run both fiscal and external ('twin') deficits on account of high energy prices (see Chart 18). Both general government deficits and current account deficits exceed 5 per cent of GDP in Jordan, the Kyrgyz Republic, Moldova, Romania, Tunisia and Turkiye.

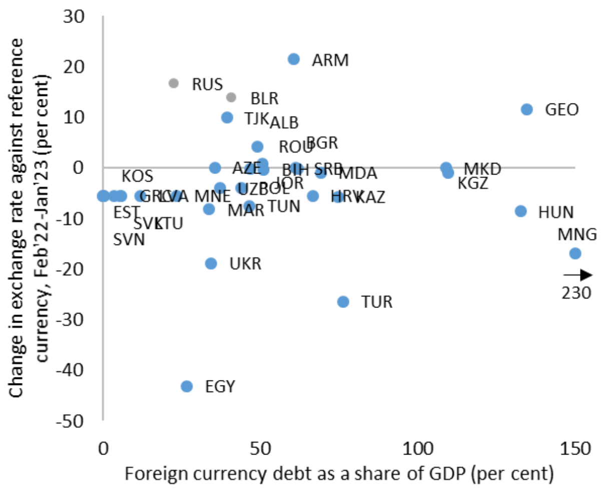
Chart 18. The majority of economies in the EBRD regions have 'twin' deficits



Sources: IMF WEO October 2022 and authors' calculations.

Weak exchange rates can make domestic producers more competitive and boost exports (as the recent experience of Turkiye illustrates). However, depreciations can also raise debt servicing burdens in cases where debt is high and much of it is denominated in foreign currency. Foreign currency debt accounts for high shares of GDP in Hungary, Mongolia and Turkiye, all of which have recently experienced significant currency depreciations (see Chart 19).

Chart 19. Exchange rate depreciations can significantly raise debt servicing burdens



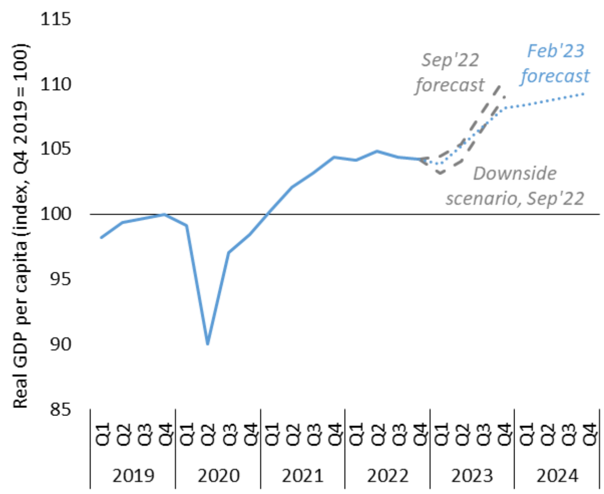
Sources: Bloomberg, CEIC, IMF, World Bank, national authorities and authors' calculations.
Notes: Euro used as reference currency for Albania, Bosnia and Herzegovina, Bulgaria, Hungary, Moldova,

North Macedonia, Poland, Romania and Serbia; US dollar used for all other economies. Foreign currency debt is calculated based on latest available estimates of external public debt, household and corporate loans in foreign currency.

Output in the EBRD regions is expected to grow by 2.1 per cent in 2023

Output in the EBRD regions is expected to grow by 2.1 per cent in 2023 as high gas prices and persistent inflation weigh on the economic outlook. The current forecast represents a downward revision of 0.9 percentage points compared with the baseline scenario published in September 2022 (see Chart 20). Growth forecasts have been adjusted down in more than half of economies in the region, with virtually no upward revisions (see Table 1). At the same time, the projection is 0.4 percentage points higher than in the downside scenario published in September 2022, which assumed no Russian gas delivered through pipelines.

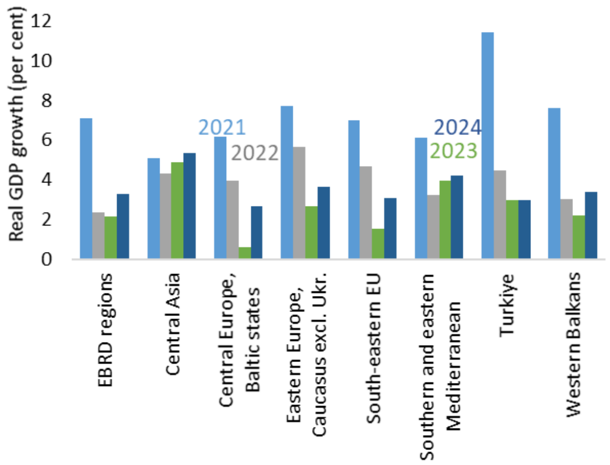
Chart 20. Growth forecasts have been revised down relative to the September 2022 baseline scenario



Sources: National authorities via CEIC, Refinitiv Eikon and EBRD forecasts.
Notes: EBRD average based on the values of gross domestic product in 2020 in current US dollars from the IMF.

Growth is expected to pick up to 3.3 per cent in 2024, broadly in line with estimates of medium-term potential growth (see Chart 21).

Chart 21. Growth is expected to pick up to 3.3 per cent in 2024

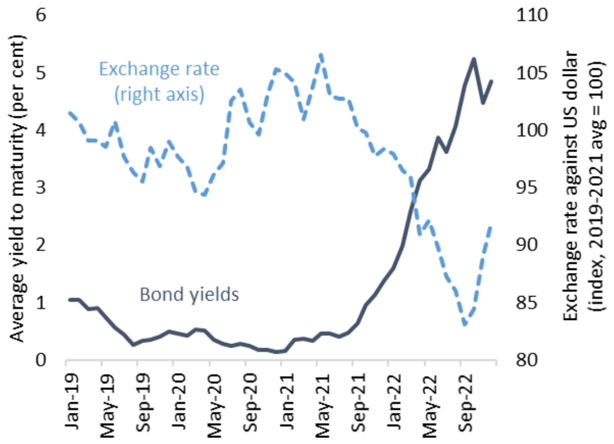


Sources: National authorities via CEIC and EBRD forecasts.
Notes: EBRD average based on the values of gross domestic product in 2020 in current US dollars from the IMF.

Regional outlooks

Output in central **Europe and the Baltic states** is expected to increase by 0.6 per cent in 2023. In 2022, the region's economies proved more resilient than expected. Exchange rates strengthened again somewhat and bond yields stopped rising in October 2022 (see Chart 22). At the same time, falling purchasing power, weaker external demand from advanced Europe and elevated financing costs are expected to weigh on growth this year. Growth is forecast to pick up to 2.7 per cent in 2024, still below medium-term potential, reflecting continued high energy prices and short-term costs associated with the green transition.

Chart 22. Bond yields in central Europe stopped rising in October



Sources: Bloomberg and authors' calculations.
Notes: Bond yields is an average of 5-year government bond yields in local currency based on 8 economies (Croatia, Czech Republic, Hungary, Latvia, Lithuania, Poland, Slovak Republic and Slovenia).

Countries in the **south-eastern European Union** have also been resilient to shocks, but experienced sharply lower growth rates in the second half of 2022. Growth of 1.5 per cent is expected in 2023, picking up to 3.1 per cent in 2024.

Similarly, while economic growth in the **Western Balkans** moderated in 2022, household consumption proved resilient. Growth in 2023 is expected to slow to 2.2 per cent reflecting weak external demand, persistently high inflation and tighter financing conditions. Growth is expected to pick up to 3.4 per cent in 2024.

Output in **eastern Europe and the Caucasus** (excluding Ukraine) exceeded expectations in 2022 driven by high growth in Armenia and Georgia. Growth is, however, expected to slow to 2.7 per cent in 2023 before picking up moderately in 2024, to 3.6 per cent, as the impact of extraordinary factors related to rerouting of trade around Russia and inflow of capital and skilled migrants wanes. Real output in Ukraine is expected to stabilise at around 70 per cent of its 2021 level in 2023.

Output in **Central Asia** is expected to grow by 4.9 per cent in 2023. A slight upward revision relative to September reflects the boost from high oil and gas prices in commodity exporters and increased inflows of labour, capital and remittances and increased intermediated trade. Output growth is expected to pick up to 5.4 per cent in 2024, on planned infrastructure investments, high commodity prices and relocation of Russian businesses.

GDP growth in **Turkiye** slowed down significantly in 2022, and is expected to fall further, to 3 per cent in 2023 and 2024 as the growing external financing requirements and political uncertainty associated with elections in 2023 create significant economic vulnerabilities. These forecasts do not incorporate the potential effects of the February 2023 earthquake and it is very early to be making any firm predictions about the impact on overall economic activity in 2023. A reasonable estimate would be a loss of up to 1 per cent of GDP as the boost from reconstruction efforts in the later months of the year is expected to partially offset the negative impact from the damage to supply chains and infrastructure (see Box 1).

Output in the **southern and eastern Mediterranean** is expected to grow by 4 per cent in 2023 and 4.2 per cent in 2024. While growth decelerated sharply in 2022 on higher inflation and tighter financing conditions, it is expected to pick up in 2023 as agricultural output rebounds and much-needed structural reforms advance.

Russia's economy contracted less than initially expected in 2022, reflecting in part high energy prices which mitigated some of the sanctions impact. However, the economy is likely to contract by 3 per cent in 2023 due to declining oil prices, continued impact of the sanctions and fiscal pressures related to the war on Ukraine. The economy of **Belarus** is more dependent than before on the Russian economy. GDP decreased by an estimated 4.7 per cent in 2022 and is expected to fall by 1 per cent in 2023. A moderate recovery of 1.3 per cent growth is forecast in 2024.

Box 1. Likely impact of the February 2023 earthquake on Turkiye's GDP

On 6 February 2023, a series of violent earthquakes struck southern and central Turkiye and northern and western Syria, resulting in widespread damage and fatalities in the region. This box discusses the economic impact of the earthquake drawing on the experience of the 1999 earthquake in Turkiye. That earthquake resulted in a loss of GDP of around 0.5 to 1 per cent in the year it occurred, with reconstruction activities boosting growth in the following year by around 1.5 per cent. As the 2023 earthquake took place early in the year, the boost to output from reconstruction activities may largely offset the negative impact of the disruption to economic activity. Overall, the net impact on growth is likely to be less than 1 percentage point in 2023.

On 6 February 2023, a series of violent earthquakes struck southern and central Turkiye and northern and western Syria. A magnitude 7.8 earthquake and numerous aftershocks resulted in widespread damage and tens of thousands of fatalities in the region.

In terms of the likely impact of these tragic events on economic activity, the closest comparison is the earthquake that took place in Turkiye in 1999. That earthquake was of a slightly lower magnitude but occurred in Turkiye's industrial heartland. It is estimated to have resulted in a loss of GDP of around 0.5 to 1 per cent in the year it occurred, on account of disrupted supply chains, loss of physical capital and labour force, loss of inventories, depressed consumption and lower investment in the immediate aftermath of the earthquake.

The four regions worst affected by the 1999 earthquake (Kocaeli, Sakarya, Bolu and Yalova) contained only about 4 per cent of the country's population, but were directly responsible for around 7 per cent of GDP and 14 per cent of industrial value added. They had significant economic linkages with the rest of the country, including Istanbul (Turkiye's largest city) and Bursa (Turkiye's fourth largest city). As a result, there was significant damage to energy, transport and communications infrastructure in the broader region.

Together, the regions that experienced major disruptions as a result of the earthquake accounted for 35 per cent of GDP and half of industrial output. Many small businesses failed because they did not have earthquake insurance. This had a knock-on effect on the banking sector, which saw a sharp increase in non-performing loans.

The wider region hit by the 2023 February earthquakes in south-east Turkiye (Kahramanmaras, Gaziantep, Malatya, Diyarbakir, Kilis, Sanliurfa, Adiyaman, Hatay, Osmaniye, Adana) experienced substantial damage to pipelines, roads, airports and electricity infrastructure, including a major fire in Iskenderun port, Turkiye's largest. However, economic linkages of the affected areas with the rest of the country are more limited than in the case of the 1999 earthquake. The affected areas are home to 15 per cent of the country's population but only contribute approximately 9 per cent of GDP and 10 per cent of industrial value added. Its contribution to agricultural value added is higher, at 15 per cent, although interruptions to agricultural production are likely to be mitigated by the winter timing of the earthquake.

At the time of writing, the authorities have pledged more than TL 100 billion (US$ 5 billion) towards the recovery effort and international support can further help to finance reconstruction. As earthquake insurance has become more widespread than it was in 1999, the impact on the banking sector is expected to be more limited.

In 1999, reconstruction activities boosted growth in the following year by around 1.5 percentage points. As the 2023 earthquake occurred early in the year, the reconstruction impact will largely materialize in the same calendar year, offsetting the negative impact of the earthquake-related disruptions on GDP to a significant extent.

The economic impact of the earthquake will to a significant extent depend on the fiscal response. The authorities have fiscal space to fund various support measures as the level of public debt and the cost of servicing it remain modest relative to GDP.

Overall, the net the impact on growth is likely to be less than 1 percentage point in 2023, although these estimates are subject to major uncertainty as recovery efforts continued at the time of writing. It should also be noted that the impact on GDP — value added generated in a given year— understates the total cost of the disaster, which would also include damage to physical assets.

The inflationary impact of the earthquake is likely to be limited, and largely felt through prices of food (given the agricultural importance of the affected areas) and construction materials used in reconstruction. Reconstruction efforts are likely to drive up imports, further widening the current account deficit, while any reduction in exports is likely to be short-lived. Aid inflows can support the balance of payments and hence the level of international reserves and the lira.

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Regional updates

Central Asia

Central Asia, on average, has seen a rather modest impact from Russia’s war on Ukraine. **Kazakhstan** and **Turkmenistan** are enjoying windfall oil and gas revenues on the back of elevated prices, while the **Kyrgyz Republic, Tajikistan and Uzbekistan** have seen significant increases in inflows of labour, capital and remittances. With many Western companies exiting the Russian market and Russian ports being sanctioned, Central Asian economies are also seeing significant gains in trade with Russia and China, both by exporting own products (for instance, textiles and consumer electronics) and by providing transportation and re-exporting services. **Mongolia** was off to a rather slow start in 2022, but China's progressive reopening in the second half of 2022 has led to a rapid acceleration of the country’s coal exports and overall growth. Strong growth is likely to continue across the region in the short term, but all Central Asian economies face the challenges of inflation and high debt-service costs.

Central Europe and the Baltic states

In 2022, the EU economies of central Europe and the Baltic states proved more resilient than anticipated at the onset of the Russia’s war on Ukraine. At end-2022, economic activity remained stable, with employment rates high, especially in countries receiving a large number of refugees from Ukraine, such as **Poland**. In 2023, however, a technical recession is anticipated over the winter, driven by falling purchasing power (especially in **the Baltic states**, which had the highest inflation rates in the EU in 2022), weakening demand from Western Europe and elevated financing costs. Companies are expected to further reduce their inventories built up in 2020-22, with destocking contributing to a GDP growth deceleration throughout the EU region. Terms-of-trade deterioration, driven by high prices of energy imports in 2022, eased at the turn of 2022-23, and substantially elevated inflation rates are anticipated to pass their peak in most countries by the first quarter of 2023, reflecting a base effect of high inflation last year. While risks related to a severe winter have almost passed, markets expect commodity prices to remain high relative to the pre-Covid-19 period. The final year for EU funds absorption from the previous budget and fresh inflows of the Recovery and Resilient Funds (RRF) money will boost public sector investment, especially in green infrastructure and digital economy projects.

Eastern Europe and the Caucasus

The region of eastern Europe and the Caucasus is facing enormous uncertainty in the short term because of the ongoing war on Ukraine. In 2023, under the assumption that combat activities in **Ukraine** will remain limited to the current territory, which pre-war generated less than 20 per cent of GDP, it is likely that real output will stabilise at around 70 per cent of the 2021 level. In **Moldova**, lower real incomes and continued energy disruptions will likely lead to a second year of output decline, though milder compared with 2022. The extraordinary growth factors present in the **Caucasus** in 2022 are likely to dissipate in 2023, bringing down the growth rates in these countries close to their medium-term potential. Inflation will continue to decelerate but stay at elevated levels in the whole region. Improved global prospects in 2024 will have a positive impact on the economic recovery in **Moldova** and should bolster economic activity in the **Caucasus**. Ukraine’s economy, however, will continue to be heavily affected by wartime considerations. Unless there is a significant strategic change on the ground, growth in **Ukraine**’s GDP in 2024 is likely to be sluggish, but positive at least. Inflation throughout the region may also remain above target rates, especially in **Ukraine** and **Moldova** where the normalisation path is likely to be longer. The whole region remains highly vulnerable not only to prolonged war in **Ukraine** but also to the tensions between **Armenia** and **Azerbaijan**, and risks to growth are therefore skewed to the downside.

South Eastern EU

Countries in south-eastern European Union have been resilient to shocks, but faced sharply lower growth rates in the second half of 2022, along with a resurgence in inflation (as elsewhere in the EU). Generous energy subsidies and other government measures are helping to support household consumption, and public investment is being boosted by Recovery and Resilience funds, notably in **Greece**. Positive but low growth is expected in all three countries in this region in 2023, picking up in 2024.

Southern and eastern Mediterranean

In the southern and eastern Mediterranean region, growth decelerated sharply in 2022, as the war on Ukraine negatively affected all countries through higher imported inflation and increasing fiscal and external vulnerabilities, as tighter global monetary conditions exerted pressure on external accounts. Global supply chain disruptions and the slowdown in Europe further held back growth in some countries. In 2023, a pick-up in average regional growth is expected as countries adapt to the impact of the war and agriculture rebounds. The implementation of the much-needed reforms could boost private sector investment and growth, but some downside risks exist as well, including the continued global volatility and its impact on inflation and the tourism sector. Recovery is expected to gather pace in 2024, with average growth above 4 per cent, as reforms advance in all countries.

The **Egyptian** economy recovered strongly from the pandemic in fiscal year (FY) 2021/22. The growth rate doubled to 6.6 per cent, driven by the manufacturing sector, as well as a rebound in the Suez Canal and tourism revenues. However, growth decelerated to 4.4 per cent in the first quarter of FY 2022/23, down from 9.8 per cent in the corresponding period of the previous year. This slowdown resulted from the impact of the war on Ukraine on commodity prices (Egypt is a major food importer, mostly from Russia and Ukraine), coupled with lower investor sentiment, higher borrowing costs and greater pressure on external accounts. The pound depreciated by close to 50 per cent against the US dollar since early March 2022 and inflation accelerated to a five-year-high of 21.3 per cent year-on-year in December 2022. Growth is expected to slow down to 4.3 per cent in FY 2022/23, amidst reduced government spending (especially investment) and lower domestic demand. However, the implementation of structural reforms, supported by the IMF programme, and the shift to a durably flexible exchange rate regime are expected to relieve the pressure on external financing and accelerate reforms. As a result, growth is expected to improve over the medium term, as it becomes increasingly led by the private sector.

The **Tunisian** economy was hit hard by the pandemic and the recovery has been modest. After growing by 4.3 per cent in 2021, GDP growth slowed down to 2.6 per cent in the first 3 quarters of 2022, as construction and mining contracted and manufacturing slowed down, despite the recovery in tourism, transport and agriculture. The outlook for 2023 is subdued, as growth is expected to decelerate further to 2.5 per cent. The main risks to the outlook arise from further delays in implementing reforms, deteriorations in the political situation, elevated food and energy prices (Tunisia is dependent on importing both), and weak demand from Europe, Tunisia's main economic partner. A final agreement on the IMF-supported programme could provide much-needed financing, technical assistance and boost credibility for tackling much-needed reforms.

Turkiye

In Turkiye, growth slowed down significantly in 2022, and is expected to fall further in 2023 and 2024. Inflation has been coming down from its peak in October 2022, in part as a result of base effects. However, a series of fiscal and credit stimulus measures, along with a significant minimum wage hike for 2023, suggest that growth has taken priority over macroeconomic stability ahead of the presidential elections scheduled for May 2023. While the government has built up, to some degree, external buffers in recent months, the growing external financing requirements, and political uncertainty associated with elections in 2023, create significant vulnerabilities.

Western Balkans

In the Western Balkans, economic growth moderated in 2022, but household consumption showed resilience to fast-increasing inflation rates, helped by steady increase in remittances, credit growth, fiscal support measures and, in some cases, minimum wage hikes and public-sector wage increases. Export growth has slowed down after a strong performance in the first half of 2022, while the hospitality sector has performed robustly. Countries in this region are expected to continue growing in 2023, but at a slower pace as risks remain firmly tilted towards the downside. While surging inflation rates have started to decelerate, prices are set to remain elevated in 2023. This will continue to erode disposable incomes and slow down the consumption impetus. Higher domestic and global interest rates put further pressure on domestic demand as well as government finances. High energy prices are affecting both external and fiscal accounts, as a large portion of the energy shock continues to be absorbed by the public sector. Given the Western Balkans' close ties to the eurozone through trade, investment and tourism, the anticipated slowdown of the European market is set to dampen external demand, particularly so for North Macedonia, Serbia and Bosnia and Herzegovina, where industrial production plays a key role in growth outcomes.

About this report

The Regional Economic Prospects are published at least twice a year, along with occasional updates. The report is prepared by the Office of the Chief Economist and the Department for Policy Strategy and Delivery and contains a summary of regional economic developments and outlook, alongside the EBRD's growth forecasts for the economies where it invests. The estimates and projections are based on statistical information available through January 27, 2023. Box 1 incorporates information available until February 10, 2023.

For more comprehensive coverage of economic policies and structural changes, see the EBRD's country strategies and updates, as well as the Transition Report, which are all available on the Bank's website at www.ebrd.com.

Acknowledgements

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