Europe and Central Asia Economic Update “Weak Growth, High Inflation, and a Cost-of-Living Crisis”

Spring 2023

Executive Summary
The Russian Federation’s invasion of Ukraine has had devastating economic and social consequences for Ukraine and profound impacts on development and poverty alleviation in Europe and Central Asia (ECA). Growth in economic activity in the emerging markets and developing economies of ECA slowed substantially in 2022 to 1.2 percent, as surging inflation, energy and value chain disruptions, and marked monetary tightening weighed on the economic expansion.

Economic growth is set to remain mediocre in 2023, with real GDP projected to increase to 1.4 percent, as the contraction in Russia eases and the fall in Ukraine’s output subsides. The economic expansion in Türkiye will soften as the impact of the two devastating earthquakes the country suffered in February, as well as weakening external demand and private consumption, present drags on growth. The February earthquakes, along with more than 9,000 aftershocks and several additional earthquakes, have resulted in over 50,000 deaths in Türkiye. The affected areas comprise nearly a tenth of the country’s output and are expected to suffer considerable economic damage, with direct physical damages amounting to an estimated $34.2 billion, or 4 percent of GDP. The resulting economic destruction in these regions further exacerbates the immense human tragedy from the earthquakes.

Excluding Russia and Ukraine, growth in ECA is projected to fall to 2.4 percent in 2023 from 4.7 percent in 2022, reflecting the impact of tighter financial conditions, persistent inflation, and subdued external demand. Growth in 2023 may be weaker still if there is an escalation of the war in Ukraine, further increases in food and energy prices, an accelerated tightening of monetary policy globally or in the region, or a sudden reversal of capital flows into the region.

Inflation surged in 2022, with large increases in food and fuel prices following Russia’s invasion of Ukraine, building on an already large increase in 2021 as
economies reopened after the COVID-19 pandemic. Inflation remains stubbornly high in the region. Core inflation—excluding food and fuel prices—is projected to remain elevated, and efforts to reduce it will take longer than most market participants and policy makers expect.

Tighter financial conditions will continue to weigh on private investment in most economies, with sustained core inflation pressures raising the possibility of additional policy rate hikes by major central banks. The risk-off environment that characterized most of 2022 has resulted in volatile market movements, generating an increasing risk of financial turmoil that has continued into 2023. Following substantial outlays of government support to protect households and firms from two back-to-back crises, fiscal consolidation will be a priority to restore fiscal space and rebuild fiscal buffers in most of the region.

Over the medium to long term, structural constraints amid an incomplete market transition in many countries, weak productivity, problematic education outcomes, limited innovation, and a rapidly aging population need to be addressed to help expand the region’s productive capacity. The recent energy crisis presents an opportunity for the region to accelerate green transition goals. By enacting policies to support a steady and sensible transition away from a high dependence on fossil fuels, ECA countries can facilitate a reduction in the region’s high energy intensity and ameliorate environmental degradation.

Against the background of slow growth and high inflation, this ECA Economic Update also focuses on the cost-of-living crisis—the impact of high inflation on the standards of living of people in the region. A sharp rise in consumer prices, particularly for food and energy, resulted in median annual inflation in the emerging markets and developing economies of ECA of 15.9 percent in September 2022, a level not recorded since 1999.

Rising food prices and energy bills, higher mortgages and rents, and elevated prices for services are eroding the standards of living for a large part of the population of ECA. Households have become vulnerable to various income shocks that have pushed them into poverty or substantial vulnerability. The cost-of-living crisis in the region is so acute that 93 percent of Europeans identify inflation as their most pressing concern.

The analysis conducted for this Update shows that the high inflation of 2022 had a heterogeneous impact on the population of ECA. Due to differences in both consumption patterns and price increases across goods and services, the poorest households faced significantly higher inflation than the wealthiest households in almost every country in ECA in 2022. In the emerging markets and developing countries in the region, households in the bottom decile of the consumption distribution faced cost of living increases that were on average more than 2 percentage points higher than those faced by households in the top decile, with the difference reaching 5 percentage points in some countries.

In addition, the average inflation estimated using the cost-of-living increases for different households was higher than Consumer Price Index (CPI) inflation measured using an aggregate consumer price basket. In most countries in the region, the poverty headcount rate, the poverty gap, and the Gini index of inequality were all higher when using household-specific cost-of-living indexes than when using the CPI. Using the CPI to measure inflation in such situations
could lead to policies with potentially unintended redistributional consequences. Not considering diverging inflation patterns might be especially harmful in today’s times of lower growth.

These findings have strong policy implications, because many public programs targeting vulnerable populations link eligibility and benefit levels to the average CPI-based inflation rate and not the (higher) cost-of-living increase that disproportionately affects the poor. Policies to protect vulnerable groups and promote economic growth should account for the heterogeneity of inflation across households. Using inflation indicators that capture more precisely the actual costs of living of the poor are essential for designing efficient poverty alleviation policies.