Executive Summary

Growth in the emerging markets and developing countries of Europe and Central Asia (ECA) increased to 3.3 percent last year from 1.5 percent in 2022, reflecting a shift from contraction to expansion in the Russian Federation and Ukraine and a more robust recovery in Central Asia. This compares with average growth of 3.1 percent a year during 2010–19 and 5.1 percent a year during 2000–09.

Excluding Russia and Ukraine, growth in the region weakened to 3.1 percent in 2023 from 4.8 percent in 2022 because of the sharp slowdown in major trading partners, substantial tightening of financial conditions, and lingering effects of the cost-of-living crisis. Headwinds from the lackluster recovery in China and moderating global commodity prices also weighed on growth in some ECA commodity exporters. In about two-thirds of the countries in ECA, economic growth was slower last year than in 2022, and in almost a third the growth estimates for 2023 were downgraded relative to the January 2024 projections.

Inflation—the main shock to living standards and consumption in 2022—has fallen sharply and much faster than earlier expected, owing to lower global food and energy prices and tighter monetary policies. The median annual consumer price inflation dropped to 4.2 percent by February 2024 from a peak of almost 16 percent in September 2022. Although inflation has declined, price levels are 40 percent higher than in 2018–19, and food prices are 50 percent higher. The 2022 cost-of-living crisis continues to affect households despite the significant increases in real incomes last year.

Economic activity in the region is likely to remain resilient but is projected to slow this year as a weaker global economy, slowdown in China, and lower commodity prices weigh on the region’s growth outlook. Regional growth is expected to slow to 2.8 percent on average in 2024–25. The slowdown primarily reflects weaker expansions in Russia and Ukraine and moderation of growth in Türkiye as policies there remain tight. Growth in Central Asia and the South Caucasus is likely to decline as well amid the easing of remittances. However, growth is expected to pick up strongly in Central Europe and the Western Balkans because of strong recoveries in labor markets, wages, and investment boosted by EU funds.
The outlook faces multiple headwinds. A slower-than-expected recovery in key trading partners, especially in the euro area, restrictive monetary policies, and an exacerbation of geopolitical developments could further dampen growth across the region. Further delays of fiscal consolidations could limit fiscal space and may keep borrowing cost elevated. A sharp escalation of regional and geopolitical tensions could dampen growth by eroding consumer and investor confidence.

With heightened geopolitical risks and substantial policy uncertainty, investment growth in ECA, already much slower than before the global financial crisis, could weaken further, especially if progress in advancing structural reforms remains sluggish. Weak investment will depress long-term growth in ECA and further delay income convergence.

Against the background of slowing growth and convergence, this ECA Economic Update focuses on the role of business dynamism and innovation in boosting prosperity and productivity in the region.

Economic development in ECA has been the story of the transition from plan to market, the advance of broad and deep structural reforms, and the emergence of private initiative as the main driver of growth. In less than three decades, a dozen ECA countries joined the European Union. The successful transition of these countries to EU-integrated market economies with robust institutions and production structures illustrates just how far reforms have taken some countries in the region, including to high-income status. But the ambitious structural reform agenda of the 1990s has slowed in many middle-income countries in ECA, and their transition to market is still ongoing.

Weaker productivity growth in ECA over the past decade has slowed income convergence with advanced economies. While there was a broad-based slowdown in productivity across emerging markets and developing economies after the global financial crisis, and in most advanced economies since the 1970s, the decline was steepest in ECA. Fundamental drivers of productivity growth, including progress in advancing institutional and market reforms, and technology adoption and innovation, which are all key for enabling private sector led growth, have weakened in ECA. Many countries in the region have made limited progress in establishing more effective corporate and market institutions in recent years.

The region has plenty of room for improving business dynamism and innovation. Firms in ECA are less productive and less innovative than those in the advanced economies in Europe. Firm entry and exit rates are lower and firms do not grow much over time, pointing to a less competitive and dynamic business environment where firms tend to innovate less, absorb less knowledge, and often become less productive over time.

Boosting business dynamism in ECA will require addressing several challenges, including upgrading the competition environment, reducing state involvement in the economy, dramatically boosting the quality of education, and strengthening the availability of finance. Although meeting these challenges will look different in different countries, addressing them is an essential condition for stronger economic growth and overcoming the middle-income trap. Further, deepening integration into global markets will be crucial to help to accelerate both the adoption of new technologies and firms overcoming the limits to potential firm growth due to the small size of many economies in the region. Adverse demographics are also a challenge in the countries in the western part of the region, where tightening labor supply due to declining populations is exacerbated by high emigration rates of young and skilled workers.