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EU REGULAR ECONOMIC REPORT 8

WORLD BANK REPORT
ON THE EUROPEAN UNION

Living Up to Potential in the Wake of Adverse Shocks

PART 1

Inclusive Growth—Tested Again

WORLD BANK GROUP

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WORLD BANK GROUP

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Abbreviations

ALMP	Active Labor Market Policies
BPS	Business Pulse Survey
ECB	European Central Bank
EU	European Union
FDPs	Forcibly Displaced Persons
GDP	Gross Domestic Product
GHG	Geenhouse Gas
HICP	Harmonised Index of Consumer Prices
ICT	Information and Communications Technology
IOM	International Organization for Migration
NRRPs	National Recovery and Resilience Plans
R&D	Research and Development
SOEs	State-Owned Enterprises
TFP	Total Factor Productivity
UNHCR	United Nations Refugee Agency

Country Groupings Used in this Report

Central and Southeast Europe (CEE):
Bulgaria (BG), Croatia (HR), Czech Republic (CZ), Hungary (HU), Poland (PL), Romania (RO), Slovak Republic (SK), Slovenia (SI)

Northern Europe (NE):
Denmark (DK), Estonia (EE), Finland (FI), Latvia (LV), Lithuania (LT), Sweden (SE)

Southern Europe (SE):
Cyprus (CY), Greece (EL), Italy (IT), Malta (MT), Portugal (PT), Spain (ES)

Western Europe (WE):
Austria (AT), Belgium (BE), France (FR), Germany (DE), Ireland (IE), Luxembourg (LU), Netherlands (NL)

Depending on data availability, the report zooms in on four selected countries:
Bulgaria, Croatia, Poland and Romania.

Executive Summary

The world has been hit by two destabilizing shocks in quick succession. The COVID-19 pandemic induced the sharpest peacetime recession in the European Union (EU) in 2020, reversing recent progress in rising living standards and leaving deep economic scars among the vulnerable populations. The economic recovery was robust, with most of the EU member economies recovering to pre-pandemic levels in 2021 (Figure ES1, panel a). With strong growth prospects, the resumption of income convergence was in sight. Then, in February 2022, the Russia – Ukraine war began, and the global impact of the war has been substantial. Part I of this report discusses the trends in inclusive growth in the EU over the past year with a focus on the following four regions: Northern Europe, Western Europe, Southern Europe and Central and Southeast Europe. Depending on data availability, it also zooms in on a set of selected countries: Romania, Bulgaria, Croatia and Poland. Part I of this report also discusses short-term prospects, highlighting the key risks to the outlook.

While the overall EU economy recovered in 2021, the labor markets still left some of the more vulnerable groups behind. Both employment and labor force participation rates recovered to pre-pandemic levels by 2021. However, the overall trend masks the considerable heterogeneity across groups. Employment among the younger, less skilled, the self-employed and those on temporary contracts is still below pre-pandemic levels, with implications for poverty and inequality (Figure ES1, panel b). Firm-level evidence[1] in selected countries also showcase that while sales are recovering, the patterns between smaller and larger firms are uneven, and the recovery is less "jobs-friendly" than desired.

Some measures of people's wellbeing are also yet to return to pre-pandemic levels. Rapid response surveys in selected countries show that many households still earn lower incomes than before the COVID-19 shock, and the poorest struggle to make ends meet (Figure ES1, panel c).[2] In addition, most households do not foresee an improvement in their financial condition going forward (Figure ES1, panel d), especially given the fallout from the war. Moreover, the recent spikes in inflation rates, particularly in food and in energy, are eroding real incomes and purchasing power of the households.

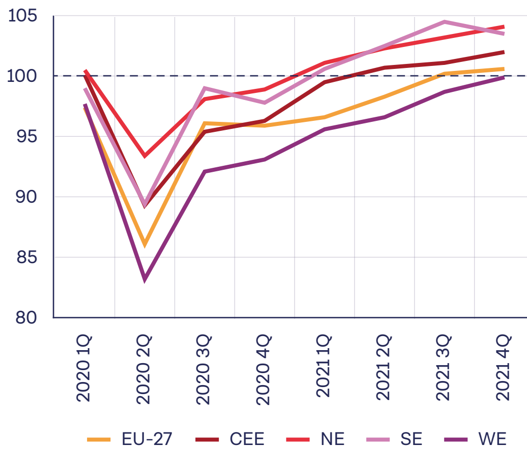
The rebound from the pandemic has been disrupted by the war in Ukraine which has led to an unprecedented humanitarian crisis. In the first 3 months of the war, nearly 14 million people in Ukraine fled their homes, of which 8 million were internally displaced.[3] 6.8 million[4] of the forcibly displaced persons (FDPs) have left Ukraine, most of them crossing into the EU member states, where they have been granted temporary protection. The speed of the displacement — primarily of women, children and the elderly — is unprecedented, requiring equally unprecedented policy and individual responses in host countries and communities.

The economic spillovers of the war along with the accompanying uncertainty risks stalling the recovery in the EU. The war has resulted in economic consequences that are being felt around the globe, and in Europe. Already prior to Russia's invasion of Ukraine, the pace of recovery in the EU was tempered by COVID-19 flare-ups and low vaccine uptake in some member states, as well as the phasing-out of policy support and persistent supply disruptions. More recently, countries globally have also been impacted by the war in Ukraine and sanctions, extended lockdowns in China, and monetary policy tightening across several countries, especially the United States. The repercussions include disrupted commodity and goods trade, rising commodity prices, impacts on financial flows and remittances, and higher uncertainty. The impact for EU countries is amplified by the strong economic and migration links with Russia and Ukraine.

Figure ES1 Socioeconomic developments during 2021

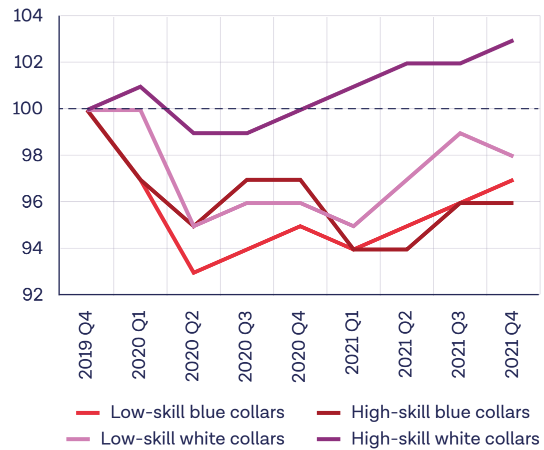
a. The EU economy rebounded in 2021, after an unprecedented economic contraction.

Real GDP (2019 =100); EU27 average, by country groupings



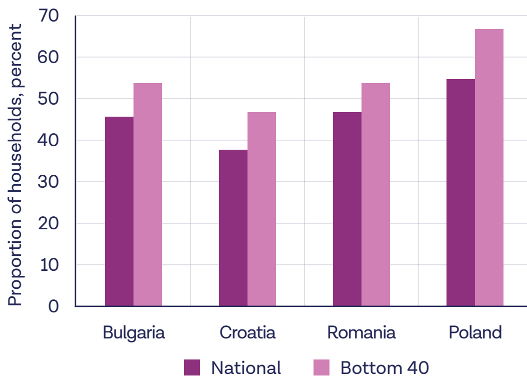
b. But the labor markets still left some of the more vulnerable groups behind.

Persons employed, (2019=100), EU27 average, by level of skills



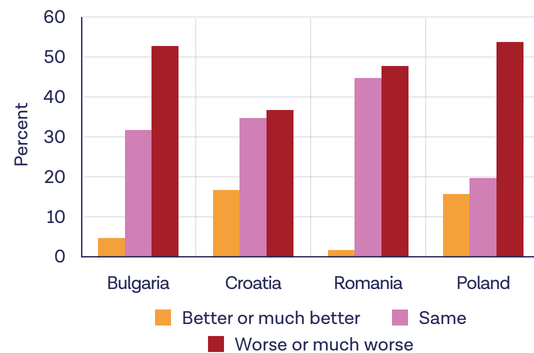
c. Households — especially the poorest ones — struggled to make ends meet prior to the war

Households' increased difficulty in making ends meet in Fall 2021 compared to pre-crisis level (February 2020); selected countries (Bulgaria, Croatia, Romania, Poland)



d. And even before the war and the spikes in inflation — which will disproportionately hit the poor — few of the vulnerable households expected things to improve

Expectations of poorest 40 percent households for their financial position over the next 12 months, during Fall 2021; selected countries (Bulgaria, Croatia, Romania, Poland)



Sources: a. Eurostat; b. Eurostat data [LFSQ_EGAIS], unadjusted data, 20-64 years old; c. and d. World Bank Rapid Household Surveys

The economic downturn and the rise in energy and food prices will affect everyone, but the poorest households will be hit the hardest. Growing consumer prices have eroded real wages and may stymie labor supply and reduce standards of living. These price increases have a greater impact among vulnerable populations because the share of food and energy in their budgets is proportionately higher than among the rest of the population, and more likely to reflect necessities that are difficult to shift away from. Even during the first year of the pandemic, many households in the EU — and especially in Southern and Central and Eastern Europe — were grappling with energy affordability and food insecurity. Households continued to face difficulties in paying their utility bills in 2021, with even more households reporting falling into arrears. With food and energy prices 6 and 30 percent higher in 2022 than in 2020 respectively, the proportion of households facing energy and food insecurity — and risk of poverty — is likely to rise.

Going forward, EU member states face considerable headwinds from a multitude of factors. Heightened uncertainty as a result of the war is likely to dampen investment and consumer sentiment. Inflation

continues to rise, with higher likelihood of further tightening of monetary policy in many EU member states, with implications for growth. In addition, the fiscal consolidation process is likely to be delayed as governments have stepped in with packages to support vulnerable households and firms from increasing prices; yet most governments will be facing higher borrowing costs. The war has also brought to the fore the discussion on energy security and independence, given the significant dependence of many EU countries on Russian gas and oil.

Getting the policy mix to support growth, tame inflation and support those in need while maintaining fiscal sustainability will be a tough balancing act, particularly considering the uncertainty ahead. Policy support will be essential to counter the recessionary pressures and shield the most vulnerable from a broad range of economic consequences from the war in Ukraine. As the additional fiscal needs come at a time of already heightened fiscal vulnerability, selectivity and targeting of measures will be key, as will be the coordination with monetary policy. Targeted measures (such as cash transfers) — rather than across the board price caps and reductions in indirect taxation — work best in providing support to the vulnerable. Effective implementation of the EU-funded programs can help support the economy through the uncertain times ahead.

With some signs of tightening of the labor market, protecting employment and increasing job creation in coming quarters requires policies in three main areas. First, epidemiological vigilance and vaccination campaigns need to continue in order to avoid new lockdowns and dislocation of labor markets. Second, job-training and job-intermediation policies need to be accelerated to provide workers with the skills needed to transition to green jobs. Third, retraining policies for workers that may be affected by the ongoing digitalization need to be strengthened. These policies would not only render benefits in the short and medium term by creating jobs, but also make jobs more resilient to foreseeable changes in the labor market.

Notes

[1] World Bank Business Pulse Surveys in Romania, Bulgaria and Poland.
[2] World Bank Rapid Household Surveys.
[3] May 3, 2022, Ukraine Internal Displacement Report, Round 4.
[4] May 30, 2022, UNHCR

Part 1

Inclusive Growth — Tested Again

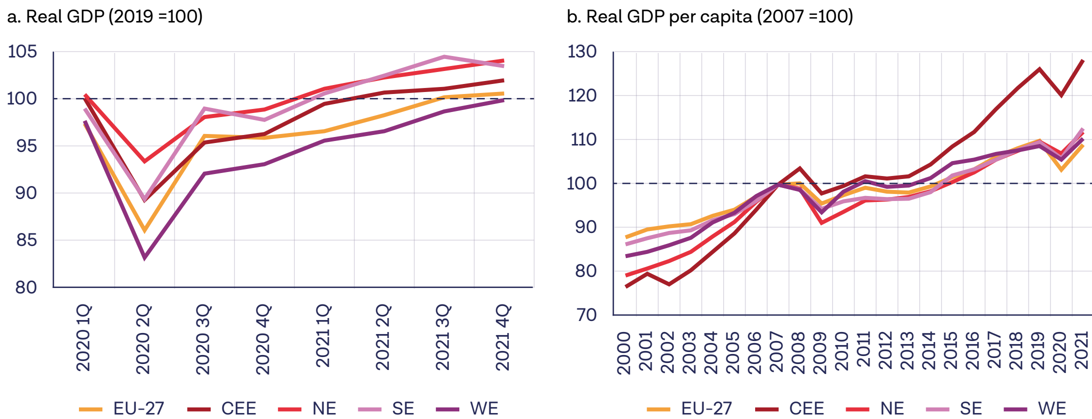
Chapter 1

Robust recovery facing headwinds

Recovery in the EU is being tested by the war in Ukraine

Most of the EU member economies recovered to pre-pandemic levels in 2021, although at an uneven pace (Figure 1.1). After contracting by 5.9 percent in 2020, the EU27 economic growth surged to 5.4 percent in 2021, its strongest post-recession recovery to date (Figure 1.2). The relaxation of the pandemic-related lockdowns bolstered demand while the unprecedented policy support, increased adaptation, and high vaccination uptake supported recovery. Growth was positive in all EU27 countries in 2021, with 17 countries returning to pre-pandemic output levels. Notably, some of the export-driven EU economies remain below pre-pandemic levels as supply chain disruptions have affected domestic production, limiting (goods) export recovery to just below pre-pandemic levels. Western and Southern European countries experienced the strongest recovery, averaging 6.6 percent and 6.8 percent, respectively (Figure 1.1 and 1.2).

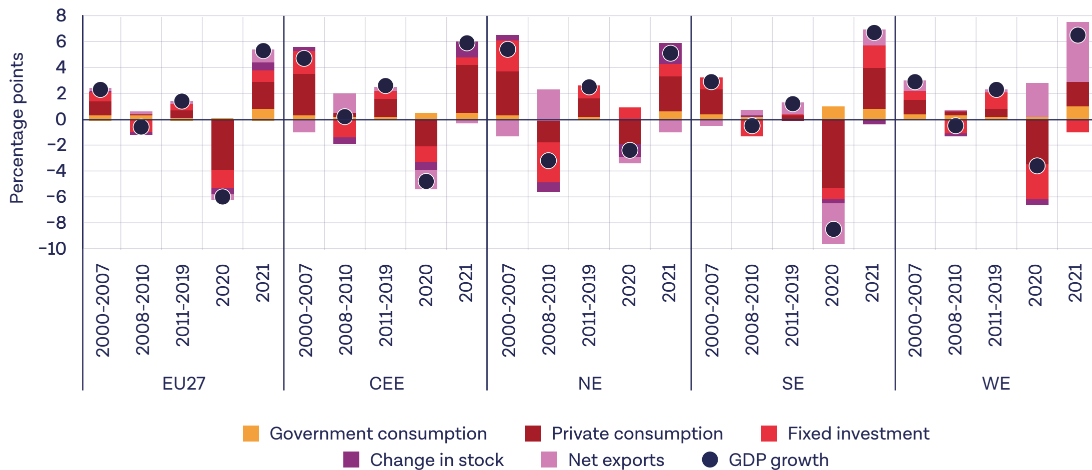
Figure 1.1 The EU economy rebounded in 2021, after an unprecedented economic contraction



Note: Unweighted average across countries
Source: Eurostat, World Bank calculations

Figure 1.2 Private consumption was the main driver of the economic rebound

Contribution to GDP growth, expenditure side



Note: Unweighted average across countries
Source: Eurostat, World Bank calculations

Lower COVID-19 restrictions supported the vigorous rebound in private consumption and higher trade volumes, but investment remained below pre-pandemic levels impeding future growth prospects. The relaxation of the pandemic-related lockdown measures helped boost private consumption and supported recovering trade volumes in 2021 (Figure 1.2). Southern and Eastern European countries recorded the largest increase in private consumption, reflecting a mixture of higher pandemic-related restrictions in 2020 and greater reliance on consumption as a driver of growth. Trade balances turned positive in Western and Southern Europe, as major EU exporting countries benefited from increased trade volumes. However, trade volumes remain below pre-pandemic levels in some of the countries. Investment remains below the pre-pandemic levels in around one-third of the EU countries, with Western European countries recording on average a negative contribution of investment to growth, lowering the potential growth going forward. This is discussed in greater detail in Part 2 of the report.

Softer stringency measures bolstered the recovery across sectors, but significant headwinds in the second half of 2021 slowed output expansion. Retail trade benefited from the gradual reopening of the economy posting the most significant growth in countries with a sizeable tourism sector. Southern and Western European countries recorded, on average, the strongest recovery, with retail trade growing in double-digits. Industrial output recovered to pre-pandemic levels in almost two-thirds of the EU countries. Although firm performance has been improving, the recovery remained uneven and not very "job friendly" even prior to the war in Ukraine (Box 1.1). However, industrial output growth momentum slowed down towards the end of 2021 as supply-chain bottlenecks and rising commodity prices took a toll.

Box 1.1 Firm recovery — 5 findings from World Bank Business Pulse Surveys[a] in Bulgaria, Romania and Poland

There are clear signs of firm recovery but also signs that this recovery is fragile and uneven. Early during the pandemic firms experienced a very significant drop in sales, by 25 percent on average. This significantly improved throughout the last two years; however, firms had not fully recovered by December 2021 – February 2022 (average change in sales during previous 30 days in Wave 4 was still -6 percent compared to the year before) (Figure B1.1.1). More importantly we see that smaller firms have struggled to recover compared to the larger ones (Figure B1.1.2).

Figure B1.1.1 Firm sales are yet to fully recover....

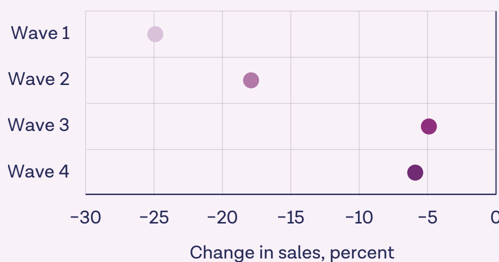
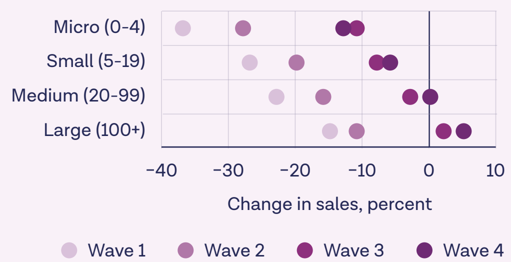


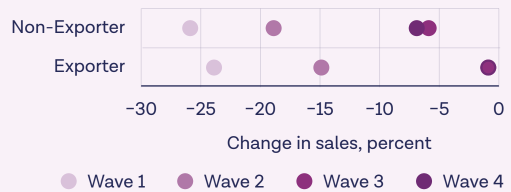
Figure B1.1.2 ...especially among smaller firms



Firms are very different in how they recovered, with trade and productivity playing a key role in driving these differences. We find that firms that are integrated in trade (exporters, Figure B1.1.3) and firms that are more productive, tend to have recovered significantly better than others. Better-managed firms also showed stronger recovery.

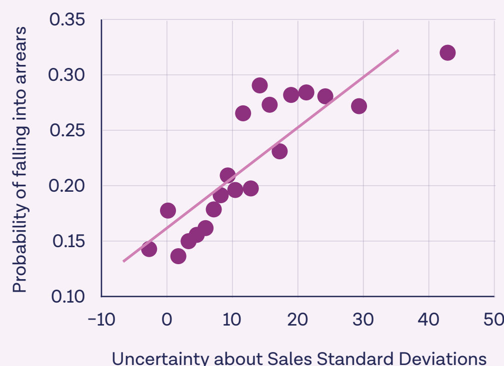
While financial fragility has improved, persistent uncertainty adds to firms' financial risks. Analysis of firm financial vulnerability, measured as likelihood of firms to be already in arears or expected to be in arrears during the coming 6 months, shows

Figure B1.1.3 Exporters recovered faster



some positive signs. While at the outset of the pandemic more than a third of firms were in this situation, the number decreased to 11 percent by the end 2021/ beginning of 2022. However, in line with the finding that recovery is still fragile, we find that uncertainty while has improved it is still very high and did not go down in the same manner as financial vulnerability, which points towards significant risks during the coming 12 months. Concerns about uncertainty are especially important because of clear and very positive correlation between uncertainty and financial fragility (Figure B1.1.4).

Figure B1.1.4 Uncertainty points to significant financial risks for the firms over the coming year



Employment conditions have improved in parallel with demand (and sales), but the recovery may be less "jobs friendly" than desired. Business Pulse Surveys show that when firms experience a 10 percent drop in sales, this is correlated with a 3.1 percent drop in employment; but when firms experience a 10 percent increase in sales this is correlated with a much smaller increase in employment, just 1.3 percent.

Accelerated take up of digital technologies has been a silver lining but evidence points to more focus on "low hanging (adoption) fruits" than longer terms investments, with a potential widening of the digital gap. Throughout the crisis an accelerating adoption of digital technologies has clearly been a silver lining. However, the data indicates that firms, especially smaller ones, have focused on adopting and using existing digital solutions while much fewer firms have invested in new solutions. The finding that the behavior is very different when it comes to investing in new digital solutions is in line with the finding that firms with higher digital capacities at the onset responded very differently. This suggests the possibility of a widening digital gap between "digitalized" or "digital capable" firms, and the rest.

Figure B1.1.5 Firm recovery is less "jobs friendly" than desired

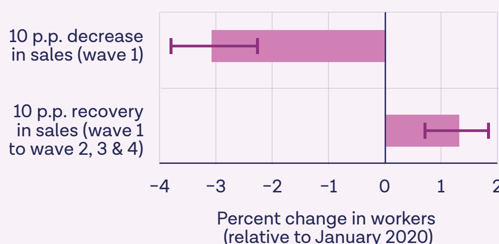
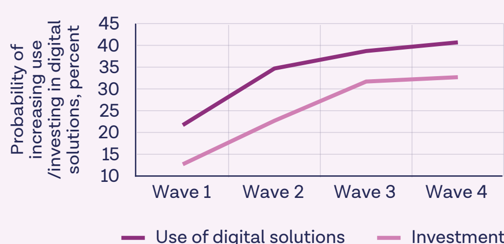


Figure B1.1.6 Digital technologies — use and investment over time



a. Throughout the pandemic, World Bank has conducted a series of Business Pulse Survey (BPS) to assess the impact of the COVID-19 shocks on firms. Data was collected since May 2020, shortly after the onset of the COVID pandemic, until January 2022 in Poland, Romania and Bulgaria. The data allows assessing how firms have fared through the crisis and entered a recovery period, evaluate multiple channels of impact and also study how firms have responded, with a specific focus on digital and green led recovery. The data were collected in four different waves and are representative at national, sectoral level as well as among the different size class (small, medium and large firms. In Bulgaria, the wave 1 data collection was done between May 2020 – September 2020, the wave 2: November 2020 – December 2020, wave 3: March 2021 – June 2021, wave 4 December 2021 – February 2022. In Poland, the wave 1 data collection was done between May 2020 – August 2020, the wave 2: September 2020 – December 2021, wave 3: April 2021 – June 2021, and wave 4: November 2021 – January 2022. In Romania, the wave 1 data collection was done between May 2020 – September 2020, the wave 2: November 2020 – January 2021, wave 3 March 2021 – June 2021, and wave 4 December 2021 – February 2022. Data for wave 1, 2 and 3 comes from both the BPS and World Bank Enterprise Surveys, while data for wave 4 come solely from the BPS. The results presented are averages after controlling for size, sector, country and waves.

Energy and producer price hikes are leading to historically high inflation across the EU. Persistent supply chain bottlenecks coupled with domestic demand recovery led to rising inflation in the EU economies even prior to Russia's invasion of Ukraine in February 2022. The war and the related policy actions exacerbated the inflationary pressures, primarily through higher commodity prices, reflecting Russia's and Ukraine's importance in

global commodity markets, especially in natural gas, coal, crude oil, wheat, fertilizer, aluminum, iron ore, and palladium. The increase in commodity prices is feeding into other sectors, raising core inflation and weighing on consumer confidence. Natural gas prices in Europe are expected to reach record highs in 2022, threatening the competitiveness of EU economies, especially for energy-intensive sectors. Northern and Central and Eastern Europe countries recorded on average the highest increase in headline inflation in recent months, with countries in closer geographical proximity to the conflict and with more significant economic linkages with Russia and Ukraine among the hardest hit. Annual inflation rates could edge to double digits in many EU countries in 2022, leading to additional monetary policy tightening, further slowing the economic recovery.

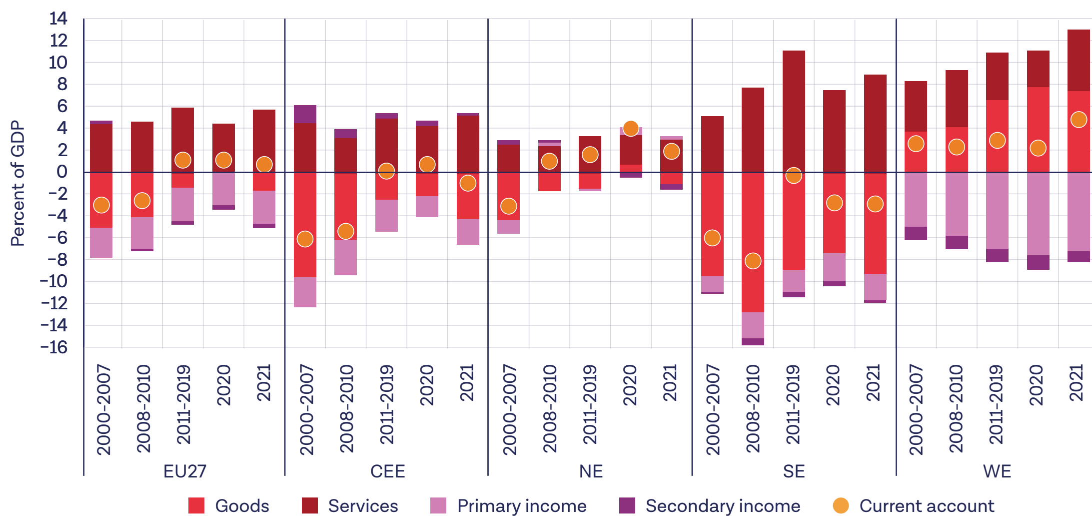
Rising price levels triggered monetary policy tightening after an exceptionally accommodative stance, but the Central Banks remain cautious not to stifle the economic recovery. Expansionary monetary policy supported the EU economies during COVID-19 in an environment of low inflation. Against the background of rising inflation, Central Banks began the monetary tightening cycle, as long-term asset purchases were unwound, and policy rates were raised in some of the countries. The European Central Bank (ECB) is also contemplating similar measures in the near future but remains flexible in conducting its monetary policy, given the high degree of global uncertainty.

Tighter global financial conditions in the context of monetary policy normalization and market repricing could also affect debt servicing costs and access to funding in the banking sector. Increased uncertainty, deteriorated consumer and business sentiment, and higher financing costs are leading to higher corporate and household credit risks adding to the pressures on the banking sector. These developments are likely to weigh on consumer spending and corporate investment. The impact on lending of the war in Ukraine may primarily be reflected in banks' increased risk aversion, which could materialize in a decline in the volume of loans granted to companies that have exposures and trade relations in the region. While the demand for working capital loans may increase, the demand for investment loans may decline. The interest rate and inflation paths may curb the growth dynamics of the loan portfolio as well.

In 2021, current account positions remained relatively stable for EU27 as a whole, with markedly higher services surplus in tourism-dependent countries (Figure 1.3). Trade volumes increased, benefiting from

Figure 1.3 Current account positions remain relatively stable

Balance of payment components



Note: Unweighted average across countries

Source: Eurostat, World Bank calculations

the gradual reopening of the EU member states' economies. The services surplus increased for EU27 as a whole with the highest increase registered for Southern Europe and tourism-dependent countries. This surplus alongside reduced primary and secondary income deficits supported the strong current account performance in Western European countries. The reduction of the current account surplus in the case of Northern European countries was led by the underperformance of the goods balance, which turned negative in 2021. EU international trade in goods surplus decreased in absolute terms by around 70 percent in 2021 compared to 2020, its lowest level since 2011 when it was negative, reflecting the rise in the price of energy imports in the latter half of 2021. The economic recovery supported investment income, partially aiding primary income dynamics, especially for Euro Area countries.

The war in Ukraine, the associated policy response and the accompanying uncertainty risk stalling the recovery. The war has led to an unprecedented humanitarian crisis (Box 1.2). It is accompanied by economic consequences that will be felt in Europe and around the globe. Already, prior to the war in Ukraine, the pace of recovery in the EU was tempered by COVID-19 flare-ups, phasing-out of policy support and persistent supply disruptions. These disruptions and increased commodity prices decelerated output expansion towards the end of 2021, with Eastern European countries registering, on average, the largest slowdown. More recently, countries are also being impacted by the Russia–Ukraine war and sanctions, which have disrupted commodity and goods trade, fed into rising commodity prices, affected financial flows and remittances, and induced uncertainty. The impact for EU countries is amplified by the strong economic and migration links with Russia and Ukraine.

Box 1.2 Ukrainian Forcibly Displaced Persons

About a third of Ukraine's population is estimated to have fled their homes since February 24th 2022, making this the fastest growing refugee crisis since World War II.[a] As of May 30th, nearly 6.8 million people, or 15 percent of the population, have been externally displaced. The impact has been strongly felt in countries neighboring Ukraine, with nearly 50 percent of arrivals — 3.6 million — into Poland.[b] Romania has received the second largest share of arrivals, with approximately 1 million arrivals as of late May 2022, of which approximately 115,000 have remained in country, while Bulgaria has received over 280,000 people of which 107,000 have registered for temporary protection status. Due to free movement in Schengen, there is a lack of full clarity on how many people have moved further within the European Union and beyond. However, as of May 19th, an estimated 2.9 million people have moved beyond the countries neighboring Ukraine, flowing into Germany, Czech Republic, Italy, Spain, France and Bulgaria, among others.[c] The International Organization for Migration (IOM) and UNHCR estimate about 8 million internally displaced persons in Ukraine, of which 2.8 million are in the west of Ukraine in areas neighboring the European Union.

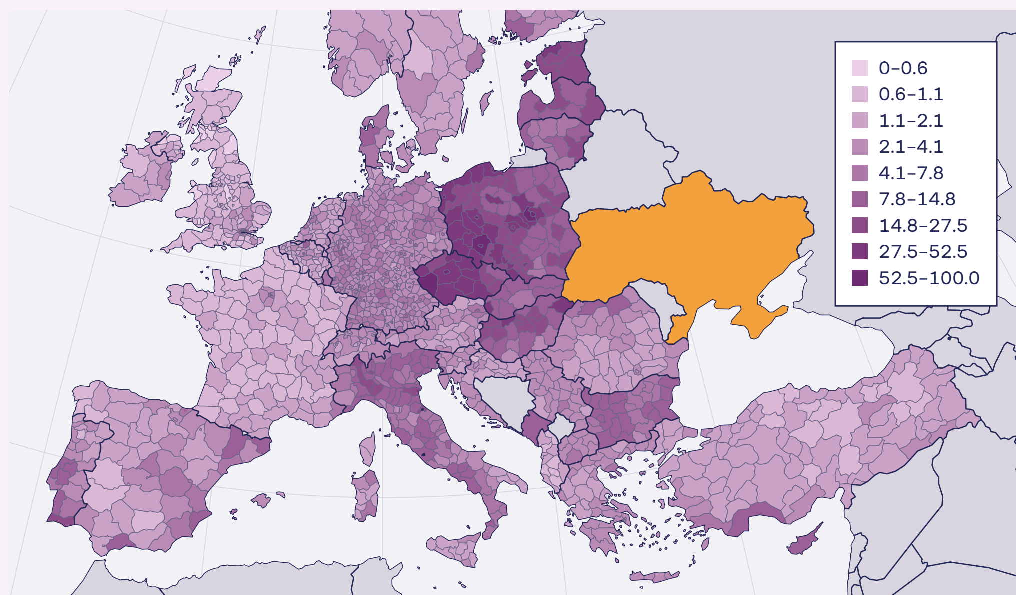
Ukrainian refugees are overwhelmingly young, educated, mothers with children. Precise information on demographic profiles and needs still remains limited, although more information is emerging as registration proceeds. Registration data from Poland show that 49 percent of those registered are children, 44 percent women aged 18–65, 3 percent over 65 and 3 percent males aged 18–65, while that from Romania suggests that 50 percent of those arriving are women and 32 percent children. The evidence emerging suggests that elderly populations are less likely to be among those externally displaced, potentially indicating that older people are less able or less willing to cross the border.

Displaced populations from Ukraine have congregated in larger cities and urban areas more broadly, placing pressures on local service provision. Some cities, such as Warsaw and Krakow, have seen 15–20 percent increases in population at the peak of the crisis and have registered 8 percent increases in enrollments in education. This has placed significant pressures on delivery of public services and on housing infrastructure. Displaced populations appear to be concentrated in areas with greater social connectiveness (Figure B1.2.1), signaling localized support structures may be available to those in need. However, housing pressures are emerging as host community fatigue sets in, limited social or public housing is available to support those in need and integration of refugees into private housing proves difficult due to the fluidity and evolution of

flows. Findings from the recent Rapid Assessment Survey conducted by the World Bank in March 2022 show that 22 percent of Romanians were concerned about the crowd out of public services as the direct results of the FDP arrivals. About 10 percent expressed concerns about job competition with FDPs.

Figure B1.2.1 Locations with strong social connectedness to Ukraine have seen the largest influx of displaced populations

Index of Social Connectivity based on degree of interlinked accounts on social media prewar



Source: Jones, Nicholas, Takahiro Yabe, and Samuel Heroy. Ed. Chris Oates. "Cities on the move: How analysis of human movement patterns can inform resilient, inclusive and sustainable cities. A technical guidance note." (2022). Publication forthcoming.

a. UNHCR 27 April 2022, Ukraine Situation Flash Update # 10

b. UNHCR data report on April 1st 2022: https://data2.unhcr.org/en/situations/ukraine

c. Movement from neighboring countries into other EU member states is not tracked in the Schengen area, but UNHCR May 19 estimates suggest that 2.9 million people have moved beyond countries neighboring Ukraine.

The spillovers from the war are likely to decelerate the fiscal consolidation process

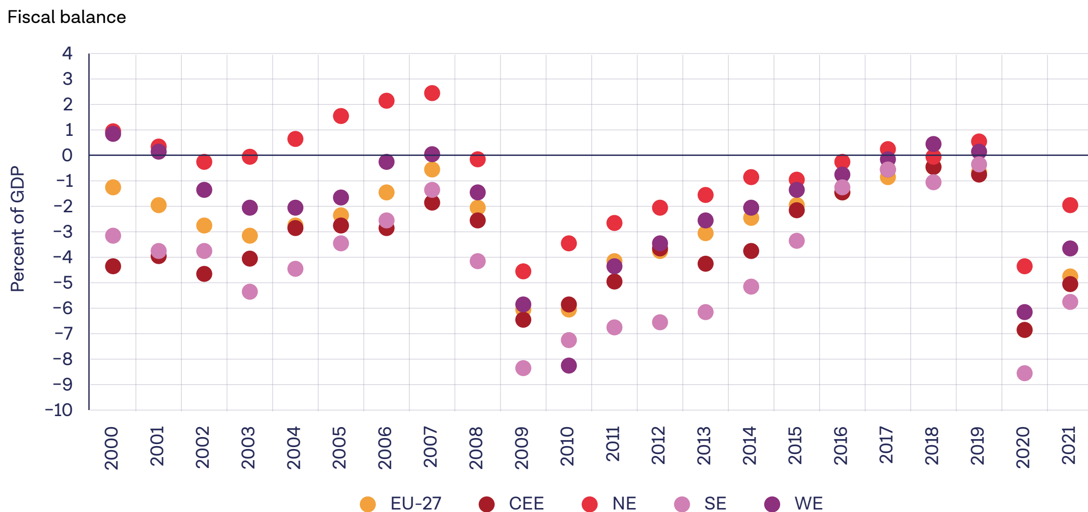
Government support in EU countries continued in 2021, albeit at a slower pace, aiding the recovery of households and firms. Supranational and national support continued in 2021 in the form of credit guarantees, liquidity facilities, loan moratoria, enhanced unemployment insurance, job retention schemes, and tax relief. Fiscal support to households and firms played a crucial role in averting a significant rise in unemployment and bankruptcies. Early evidence (Bighelli et al. 2021, Lalinsky and Pal 2021) also suggests that government support to firms was broadly well targeted, reaching mainly medium productive firms, and only a small part went to declining (or "zombie") firms. Job retention schemes played a substantial role in limiting the loss of human capital and reducing long-lasting economic scarring. Government support and the economic recovery helped lower the unemployment rate in 2021 for the whole region to slightly below the level at the end of 2019. However, the regional average hides important

heterogeneity across countries: in 16 EU countries unemployment rates are still above pre-pandemic levels and employment rates remain below pre-pandemic levels in 8 EU countries. Job vacancies recovered to or above pre-pandemic levels in all but five of the 16 countries in the region that report job vacancies by the end-2021.

To shield consumers and firms from the impact of higher prices, governments in the EU and elsewhere introduced fiscal and social protection measures, primarily through energy subsidies. Subsidies and price controls are being put in place, primarily for fuel, food, and fertilizers; some countries also introduced additional social assistance measures. Early estimates[1] show that globally and across the European region, almost 80 percent of the early response is in the form of subsidies, with cash (mostly unconditional) and food transfers accounting for less than one-fifth of the response measures. Many EU countries are part-financing this support through a surcharge on the windfall profits of energy companies and higher dividends from energy state-owned enterprises (SOEs). Meanwhile, the support provided by EU countries to FDPs from Ukraine is also adding to fiscal costs. The cost of provision of public services to FDPs varies between countries and could reach as high as 2.7 percent of 2022 GDP in Poland. The magnitude of the overall fiscal costs — including on accommodating the FDPs — will depend on the evolution of the war in Ukraine and is subject to high uncertainty. In the current context, it is important to maintain the complementarity of fiscal and monetary support, which is increasingly challenged by rising inflationary pressures and the reverberations of the war in Ukraine.

The nascent fiscal consolidation is challenged by the impact of the war in Ukraine. Increased revenues boosted by the economic recovery and lower pandemic-related support led to an improved fiscal position in most of the EU countries in 2021 (Figure 1.4, Figure 1.5). On average, the highest adjustments in the fiscal deficit were registered in Southern European countries, which had relatively higher deficits pre-COVID and experienced revenue recovery above pre-pandemic levels. The main driver of fiscal consolidation was tax revenue increases, while restrained expenditures helped to keep the deficit in check. Further fiscal consolidation is threatened by the war in Ukraine as governments have enacted a mix of measures, including energy subsidies, transfers to vulnerable groups, social services to FDPs, and increased defense spending, that will lead to higher expenditures. Revenues will also be affected by the economic recovery slowdown triggered by the war and sanctions.

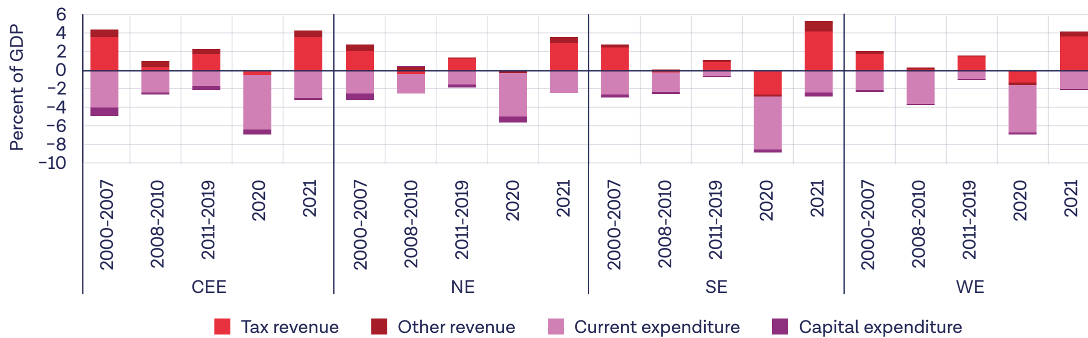
Figure 1.4 Nascent fiscal consolidation across the board



Note: Unweighted average across countries
Source: Eurostat

Figure 1.5 Tax revenues were the main driver behind improvements in the fiscal balance

Contribution to changes in fiscal balance



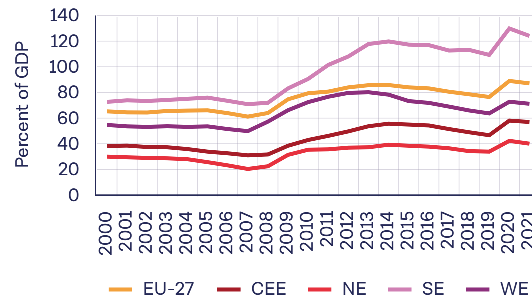
Note: Unweighted average across countries

Source: Eurostat, World Bank calculations

Debt sustainability faces growing challenges amidst increased fiscal pressures and rising borrowing costs. A supportive environment of strong economic recovery, lower fiscal deficits, and favorable financing conditions aided public debt dynamics as the public debt-to-GDP ratio decreased in 23 out of the 27 EU countries in 2021 (Figure 1.6, Figure 1.7). Increased inflationary pressures towards the end of 2021 and the subsequent reverberations of the war in Ukraine led to a tightening of financing conditions. This has led to an increase in debt servicing costs for many EU countries. With the slowdown in the fiscal consolidation process, the reduction in debt levels will also be tempered.

Figure 1.6 Improvements to public debt-to-GDP ratio across the board

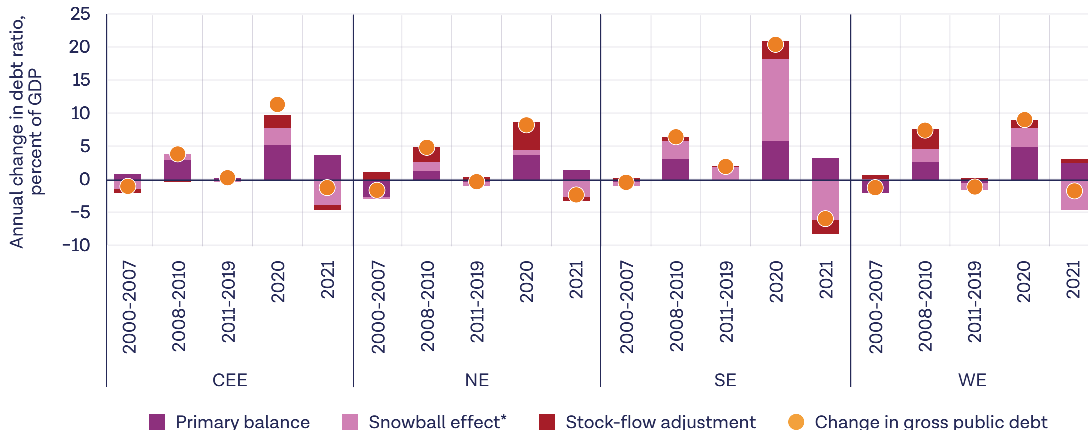
Gross public debt



Note: Unweighted average across countries

Source: Eurostat, World Bank calculations

Figure 1.7 GDP recovery and lower fiscal deficits contributed to better debt dynamics



Note: Unweighted average across countries, estimates of stock-flow adjustment and snowball effect for 2021, *captures the joint impact of interest payments on the outstanding stock of debt, real GDP growth, inflation rate and the exchange rate effect linked to the interest rate

Source: Eurostat, AMECO, World Bank calculations

Note

[1] World Bank living paper 'Tracking Global Social Protection Responses to Shocks' (April 29, 2022, version).

Chapter 2

Inclusion has improved with economic recovery, but challenges remain

Labor market conditions have returned to pre-pandemic levels on average, but some vulnerable groups have been left behind

The recovery in the economy in 2021 was mirrored in the labor market. By the last quarter of 2021, employment in all regions had either recovered to or surpassed employment levels in Q4 of 2019, signaling an almost complete recovery in the labor market. This compares to a 3-percentage point dip in employment rates at the height of the crisis in Q2 of 2020 compared to the same period of 2019. Southern Europe is the champion of this employment upturn, after having encountered the steepest and most persistent hit through the first three waves of the pandemic. This region — being more dependent on tourism and hospitality industries — was the most heavily affected at the beginning of the pandemic because of the total disruption of travel and leisure activities. With a resumption of these activities, there has been a swift recovery in employment (Figure 2.1, panel a).

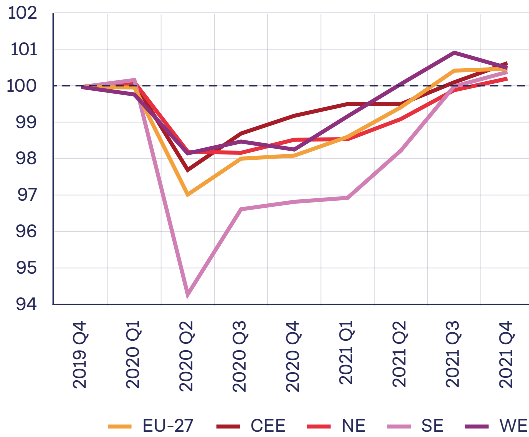
While employment across all economic activities was impacted by the crisis, their trajectories diverged during the recovery phase. On average, in the EU27, employment in the public sector, education and health services increased throughout the pandemic, and remained above the pre- pandemic levels by the end of 2021. On the other hand, industry and construction, as well as other services, experienced significant employment losses between the second quarter of 2020 and the first quarter of 2021. Since then, employment in these sectors has also recuperated and reached pre-pandemic levels. Meanwhile, agriculture has experienced a secular decline (Figure 2.1, panel b).

The employment recovery has also been unequal across the population, leaving the more vulnerable groups behind: younger, less skilled, the self-employed and temporary workers, with implications in terms of households' labor earnings and then on poverty/inequality indices for the region. By the end of 2021, the number of jobs among working age individuals aged over 30 (30 to 64 years old) have exceeded the pre-pandemic (2019 Q4) levels. In contrast, the number of younger working age individuals employed (20 to 29 years old) is still 2.7 percent below pre-pandemic levels, despite higher participation rates and lower unemployment rates for this group and is mostly a demographic trend due to a smaller share of this cohort within total population (Figure 2.1, panel c) . A striking divergence epitomizes the evolution of employees and self-employed on the European labor market. Self-employed with employees (i.e. employers) were hit more severely by the crisis but have in Q4 of 2021 fully recovered and outpaced their 2019 level, while self-employed working on their own account endured a delay and their employment declined only in Q1 of 2021 but with a more persistent downward trend and is 4.3 percent lower than prior to the crisis. The number of employees is only slightly above the number before the pandemic. In terms of type of contracts, the number of part-time workers is still well below 2019 levels (3.4 percent). On the other hand, the number of full-time workers has increased by 0.5 percent, exhibiting the stark vulnerability and elasticity of precarious contracts in response to labor market disruptions.

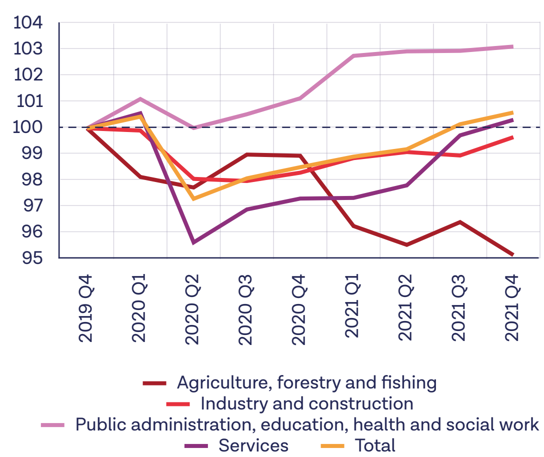
While highly skilled workers largely avoided the worst of the pandemic, lower-skilled[1] workers continue to suffer from lower employment levels. Only high-skill white-collar workers have experienced an increase in total number of jobs in 2021 (of 2.8 percent) compared to 2019 (Figure 2.1, panel d). Lower skilled workers — blue-collar and low-skill white-collar — are still in a market with jobs that are 2 to 4 percent below pre-pandemic levels. Service sectors — including accommodation, transport, food service activities, wholesale and trade sectors — which were most severely impacted by labor market disruptions, employ more low-skilled white- and blue-collar workers. Meanwhile, the rebound in the high-skill white collar jobs can be explained by easier transition to working from home given the higher use of digital platforms.

Figure 2.1 Employment edging close to pre-pandemic levels, but unequal across sectors and population groups

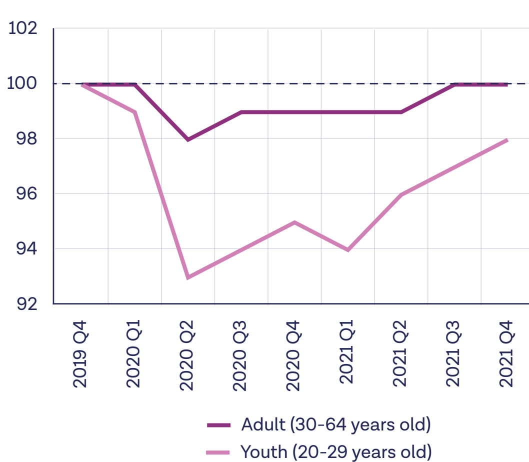
a. Persons employed, (2019=100); EU27 average, country grouping, by region



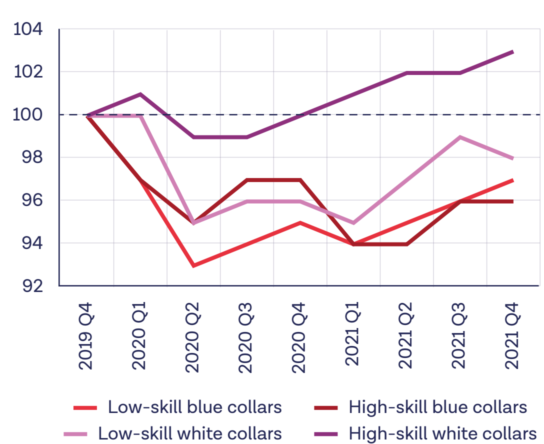
b. Persons employed, (2019=100), EU27 average, by sector



c. Persons employed, (2019=100), EU27 average, by age



d. Persons employed, (2019=100), EU27 average, by level of skills



Note: Employment and working hours for 20–64 age group. All figures refer to employment in terms of number of people employed in the corresponding quarter of 2019 and not to employment rates. Employment refers to resident population for all graphs except economic activity, where employment refers to domestic population. Low-skill blue collars (ISCO codes 8 and 9) include plant and machine operators and assemblers and elementary occupations; High-skill blue collars (ISCO codes 6 and 7) include skilled agricultural and fishery workers and craft and related trades workers; Low-skill white collars (ISCO codes 4 and 5) include clerks and service workers and shop and market sales workers; High-skill white collars (ISCO codes 1,2 and 3) include legislators, senior officials and managers, professionals and technicians and associate professionals. It excludes employment in the armed forces and no-responses.

Sources: a. Eurostat data [LFSQ_EMP_Q], unadjusted data, 20-64 years old; b. Eurostat data [NAMQ_10_A10_E], unadjusted data, 20-64 years old; c. Eurostat data [LFSQ_EGAED], unadjusted data, 20-64 years old; d. Eurostat data [LFSQ_EGAIS], unadjusted data, 20-64 years old; World Bank calculations

Labor force participation rates were disrupted by the COVID-19 crisis, but at the EU level, on average, they have recovered to their pre-pandemic levels since mid-2021. Women's activity rates have rebounded at a faster pace than their male counterparts. In Q4 of 2021, women's labor force participation was 2 percentage points higher than in Q4 of 2019, whereas it was only a 0.3 percent higher for men (Figure 2.2, panel a). Yet, women's labor force participation rates (68.9 percent, on average by Q4 of 2021) remain substantially below that of men (79.4 percent) in the EU. Variation can, however, be seen by country in the magnitude of these rebounds.

Similarly, by the end of 2021, the unemployment rate for the EU had fallen slightly below the level at end-2019. Female unemployment rates peaked in Q3 of 2020 but declined in Q4 of 2021 to below those recorded in Q4 of 2019, showing a fast recovery. Male employment rates show a slightly milder evolution in magnitude but followed the same rapid trends (Figure 2.2, panel b). Actual unemployment rates for men returned to where they were at the end of 2019 (at 6.1 percent) and 0.3 percentage points lower for women (at 6.5 percent) by Q4 2021, vis-à-vis the same period of 2019, helped by government support and the economic recovery. There is significant variation across countries however: in 16 of the 27 EU countries unemployment rates are still above pre-pandemic levels.

Figure 2.2 Labor force participation and unemployment rates returned to pre-pandemic levels

Source: Eurostat data [LFSQ_ERGAN, 20 – 64 years], [UNE_RT_Q, unadjusted data, 20 – 64 years, percentage of population in the labor force]

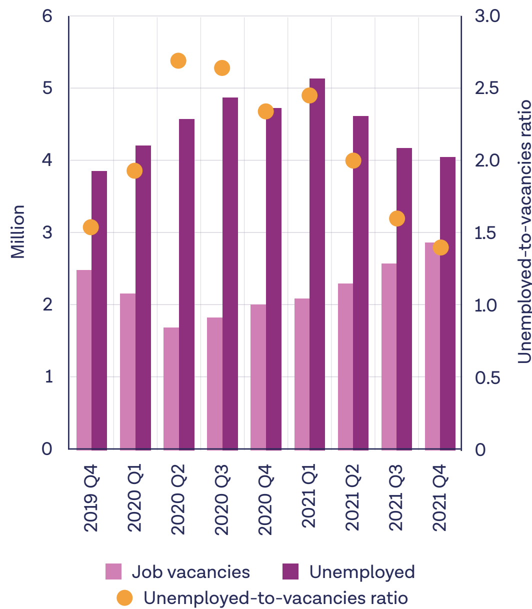
Note: Graphs on the refer to labor force participation and unemployment rates compared to the corresponding quarter of 2019.

This rapid reduction of unemployment rates contrasts with the long delay in the return to pre-crisis labor market conditions experienced during the 2008 financial crisis. Then, the unemployment rate for the EU27 rose from 7.2 percent in 2008 to 9.1 percent in 2009, stayed above 10 percent in the early part of the decade and only returned to single digits in 2016. The figures above show that in the case of the COVID-19 pandemic, on the other hand, the unemployment rates returned to pre-pandemic levels after less than two years. Labor force participation rates have also recuperated rapidly. These trends seem to be the result of two factors. First, the nature of this crisis — due to a health emergency — is different from the previous one — a financial crisis; the latter had longer-lasting effects because of its lingering impact on balance sheets of firms and banks. Second, the policies implemented during the pandemic — with important transfers to workers and firms to weather the crisis, particularly various furlough schemes — prevented a significant destruction of employment and labor force participation.

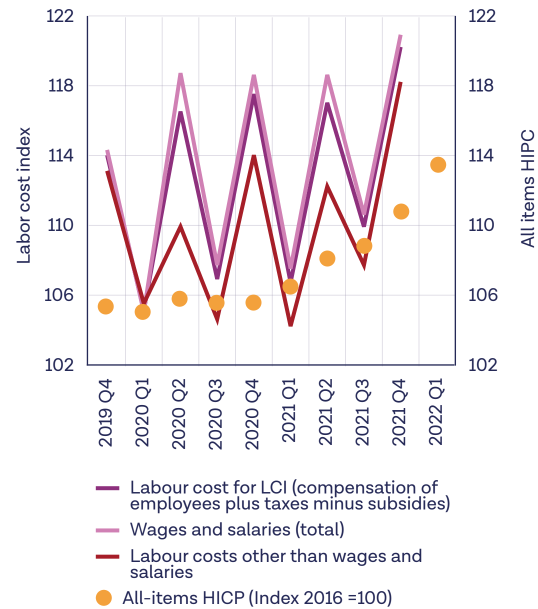
The reduction of unemployment rates and rising vacancies hint to some tightening of the labor market. The number of job vacancies has increased in recent quarters in the EU (Figure 2.3, panel a), outpacing the decline in the number of people actively looking for a job (i.e., the unemployed) and compressing the ratio of unemployed to job vacancies to 1.4 in Q4 of 2021, from 2.7 at the peak of the crisis. However, the labor cost indexes anchored in 2016 only reflect a slightly increasing trend (Figure 2.3, panel b). In addition, inflation is rising rapidly, eroding the real value of wages. Therefore, despite a reduction of the unemployment-to-jobs ratio, real wages are not accelerating.

Figure 2.3 Amidst rising vacancies and falling unemployment, the labor costs are rising, but slower than inflation

a. Number of Job Vacancies and Unemployed (EU total)



b. Labor cost index and consumer price index (2016=100)



Source: Eurostat data [JVS_Q_NACE2, UNE_RT_Q, unadjusted data, 20 – 64 years], [LC_LCI_R2_Q, Calendar adjusted data, not seasonally adjusted data, PRC_HICP_MIDX]

Note: Job vacancies data is only available in 16 countries (Bulgaria, Czechia, Germany, Estonia, Croatia, Latvia, Lithuania, Luxembourg, Hungary, Netherlands, Poland, Portugal, Romania, Slovenia, Slovakia, Sweden), number of unemployed was thus taken in the same sample of countries. Labor cost index are calculated for Industry, construction and services (except activities of households as employers and extra-territorial organizations and bodies). The Harmonised Index of Consumer Prices (HICP) is an economic indicator comparable across countries that measures the changes over time in the prices of consumers goods and services acquired by households.

The average recovery masks the lingering effects of the pandemic on households

The rebound in the labor market was followed by the fourth wave[2] of the COVID-19 pandemic during Fall 2021, plunging households back into economic distress. Off the back of a rebound in the third quarter of 2021, the fourth wave of the COVID-19 crisis saw a return to containment measures, though less severe than in the prior quarters, owing largely to increased rates of vaccination, a less potent strain of the virus, and adaptation on the part of the government, businesses and households.

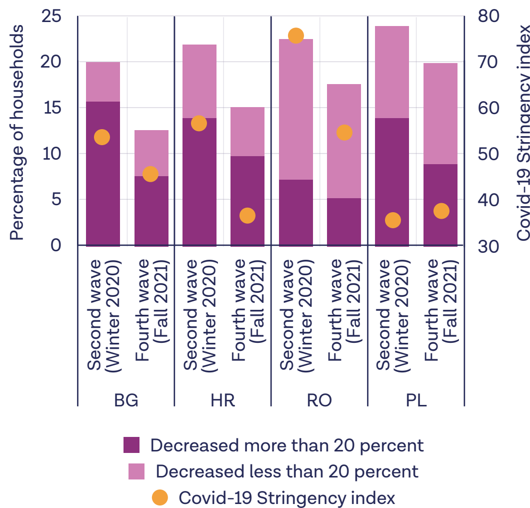
Despite the economic recovery, many households still face lower incomes than before the pandemic. In a subset of countries with rapid response surveys conducted during the pandemic[3], households continued to report substantial income declines, though over time fewer households reported shrinking incomes. By the fourth wave of the pandemic — towards the end of 2021 — 12.3 percent of households in Bulgaria, 14.2 percent in Croatia and 17.7 percent in Romania reported lower incomes compared to before the pandemic. Although compared with previous waves of the crisis the income declines were generally of a lower magnitude, a substantial share of households report a larger than 20 percent fall in their incomes, compared to 2019: 7.7 percent of Bulgarian, 9.9 percent of Croatian, and 5.3 percent of Romanian households (Figure 2.4, panel a).

Even more households — especially the poorest ones — struggle to make ends meet. In the fall of 2021, nearly half (47 percent) of Romanian households declared increased difficulty in making ends meet compared to pre-crisis level (February 2020), with even a higher proportion (54) of the poorest 40 percent households struggling financially (Figure 2.4, panel b). The proportion is comparable in Bulgaria and Croatia, with 54 percent and 47 percent of poorest household, respectively. This predicament translates into arrears in paying utility bills, about three times higher for the bottom 40 percent than the top 20 percent (Figure 2.4, panel c), revealing households' unequal struggles across the income distribution.

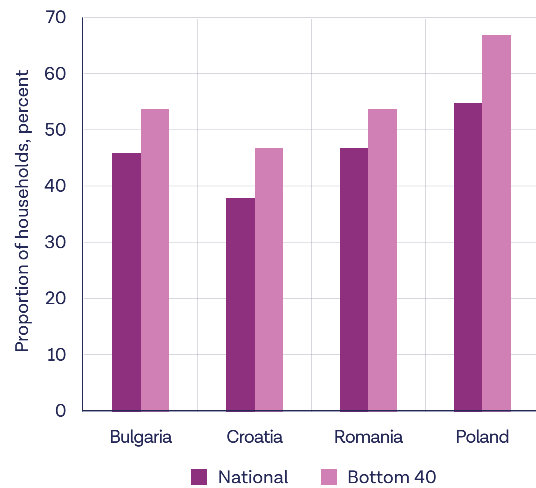
Most households expect the adverse impact of the pandemic on their financial situation to persist. When asked about their future financial situation in the next 12 months, few houselholds (8 percent in Bulgaria, 17 percent in Croatia, and only 3 percent in Romania) expect their financial situation to improve over the coming year. More alarmingly, about half of the poorest Bulgarian and Romanian households and more than one third of Croatian households expect their finances to be worse or much worse (Figure 2.4, panel d). This data was collected before the war in Ukraine which may have affected the population sentiment even more.

Figure 2.4 Impact of the pandemic on households

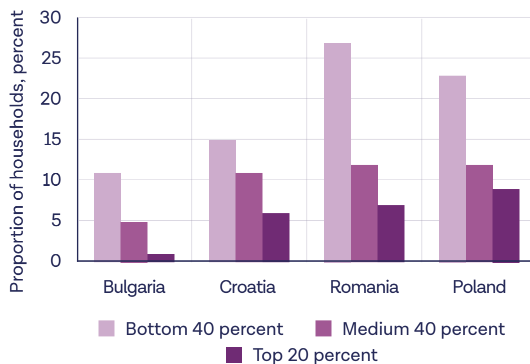
a. Percent of households reporting decline in income of more or less than 20 percent compared to February 2020



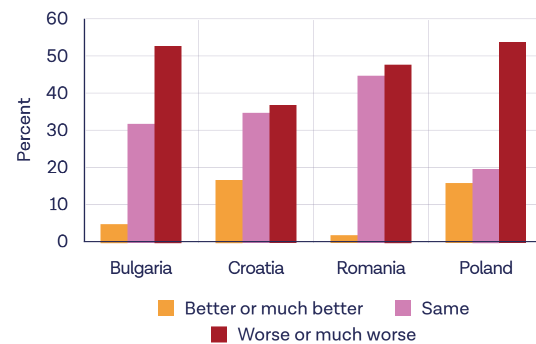
b. Households' increased difficulty in making ends meet in Fall 2021 compared to pre-crisis level (February 2020); selected countries (Bulgaria, Croatia, Romania)



c. Arrears in utility during Fall 2021



d. Expectations of poorest 40 percent households for their financial position over the next 12 months, during Fall 2021



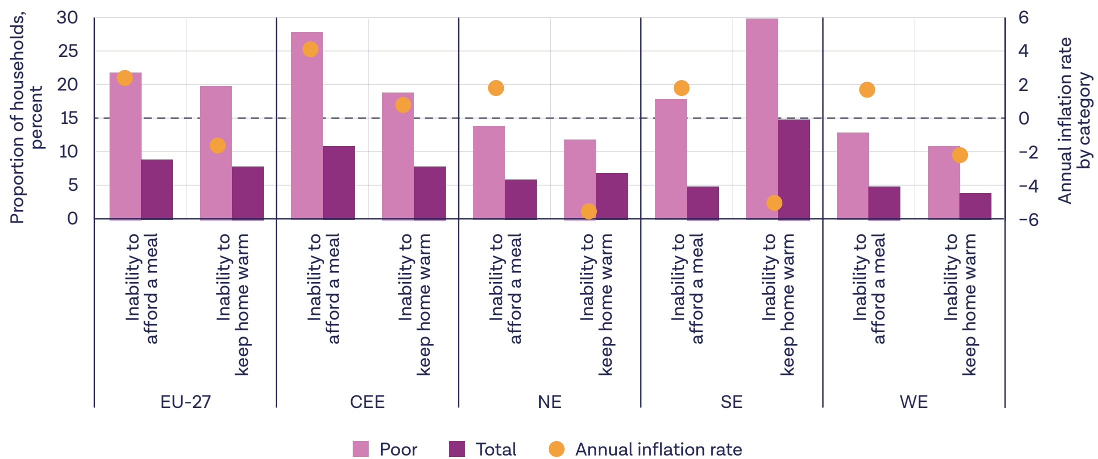
Source: World Bank COVID-19 Rapid Response Surveys

Note: Panel a Respondents were asked directly by what percentage their monthly household income had changed compared to February 2020, just before the COVID-19 pandemic started.

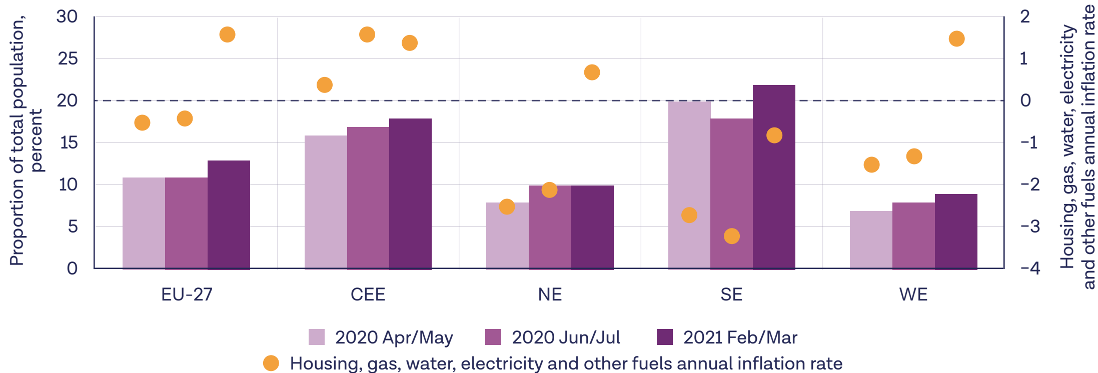
In this context, while the rising energy and food prices will hit everyone, the poorest households will be hit the hardest. Even during the first year of the pandemic, a relatively higher proportion of households in Southern and Central and Eastern Europe were grappling with energy affordability, with 15 and 8 percent of households, respectively, reporting an inability to keep their homes adequately warm. Energy affordability is even more pronounced among poor households in these regions, with 30 and 19 percent, respectively, of poor households reporting an inability to keep their homes adequately warm (Figure 2.5, panel a). Similar concerns arise in these regions surrounding food security — 5 percent of households in Southern Europe and 11 percent of households in Central and Eastern Europe reported an inability to afford a meal with meat, chicken, fish (or vegetarian equivalent) every second day. Among poor households in those regions, these figures rise to 18 and 28 percent, respectively. Households' difficulties to pay their utility bills continued in 2021 following the same regional and temporal trends: 22 percent of Southern European and 18 percent of Central and Eastern European households declared arrears in utility, housing, gas, water and electricity in 2021 (Figure 2.5, panel b). With food and energy prices 6 and 30 percent higher in 2022 than in 2020, respectively, the proportion of households facing energy and food insecurity is likely to have increased.

Figure 2.5 Affordability of food and utilities, EU 2020 – 2021

a. Inability to sustain basic needs in 2020, by sub-region



b. Arrears in utility and housing, gas, water and electricity, by sub-region



Source: Eurostat data [ILC_MDES01 , ILC_MDES03, PRC_HICP_MIDX] and Eurofound Living, working and COVID-19 dataset (2020)

Note: Poor households are defined as earnings below 60 percent of equivalized median income at the country level. The full labels are "Inability to afford a meal with meat, chicken, fish (or vegetarian equivalent) every second day" and "Inability to keep home adequately warm". Annual inflation rates are plotted by category: Food; Electricity, gas, solid fuels and heat energy; Housing, gas, water and electricity.

Notes

[1] As defined in terms of occupation.

[2] The EU was hit by the first wave of COVID-19 in Spring 2020, the second wave in Winter 2020, the third wave in Spring 2021 and the fourth wave in Fall 2021.

[3] The latest available data collected in Fall 2021 provide a snapshot of households' well-being during the fourth wave of the pandemic. The World Bank has conducted panel phone surveys in three countries during the COVID-19 pandemic to have a rapid assessment of the impact of the pandemic in selected countries of the region.

Chapter 3

Risks are tilted downwards, with high uncertainty and significant headwinds eroding growth, inclusion and convergence prospects

EU growth prospects have been moderated by the war in Ukraine, sporadic COVID-19 flare-ups, and lingering supply-chain bottlenecks. Prior to the war in Ukraine, the EU economy rebounded forcefully, notwithstanding substantial headwinds in the form of increasing energy prices, continued supply bottlenecks, and COVID-19 reverberations. The war in Ukraine has exacerbated inflationary pressures and supply chain constraints and heightened global uncertainty. The slowdown of the economic recovery in the EU will be significant and will depend on the duration of the conflict. Box 3.1 outlines the key channels through which the war will impact the EU, zooming in on the selected CEE countries.

Box 3.1 Economic channels of the impact of war on growth in selected countries

Central and Eastern European countries are among the hardest hit by the war in Ukraine. The higher impact reflects the geographical proximity of the countries to the conflict, as well as strong trade, financial, and migration links with Russia and Ukraine. The effect of commodity price increases is exacerbated by the high share of energy and food items in households' income, which is more significant in Central and Eastern Europe than in the rest of the EU countries. This is leading to a greater impact on poverty and elevated fiscal costs to shelter against commodity price increases. The unprecedented inflow of FDPs adds to the existing fiscal pressures. The proximity to the conflict also increases the geopolitical risks impacting investments.

The war affects the selected EU countries—Poland, Romania, Bulgaria and Croatia—through multiple channels, including the humanitarian crisis, commodity price increases, and second-round trade effects. As a result, growth prospects were adjusted downward to reflect the impact of the war.

Humanitarian crisis. Poland is the main recipient of FDPs in the EU and, compared to other countries neighboring Ukraine, has a greater share of FDPs remain in country due to close linguistic ties, social connectivity and geographical proximity.[a] The large inflow of displaced people from Ukraine has caused a significant increase in demand for public services and housing, adding significant fiscal pressures in the short term but has also contributed to increased consumption. Over the medium term, the economic impact of the influx of FDPs will likely be positive, boosting labor supply and supporting labor contribution to growth.

Commodity prices. The selected countries are affected by increased commodity prices, mainly oil and gas. Natural gas import dependency is highest in Bulgaria and Poland. The two countries also rely to a larger extent, above the EU average, on Russian gas imports to cover their energy consumption needs. The suspension of gas supplies from Russia to Bulgaria and Poland at the end of April has accelerated the efforts to identify alternative sources. All four countries are actively pursuing alternative gas and energy supply sources, with Romania having the option of using the more mature domestic gas fields while exploring new onshore and offshore fields in the Black Sea in the medium term.

Trade. Direct trade linkages with Russia and Ukraine are low in all selected countries. The main impact stems from sector-specific exposure, mainly energy and second-round trade effects. Apart from energy, all four countries are affected by the dependency on fertilizer imports, especially potassium fertilizer. Additionally, Croatian export exposure to Russia for medical and pharmaceutical products is high, reaching 7.6 percent of total exports in this category in 2019. The second-round effects could be significant given the substantial trade linkages with the other EU countries. A significant slowdown in EU main economies will negatively impact export performance in all four analyzed countries. Additional pressures will steam from higher import prices, which will add to the inflationary pressures and affect the competitiveness of the economies.

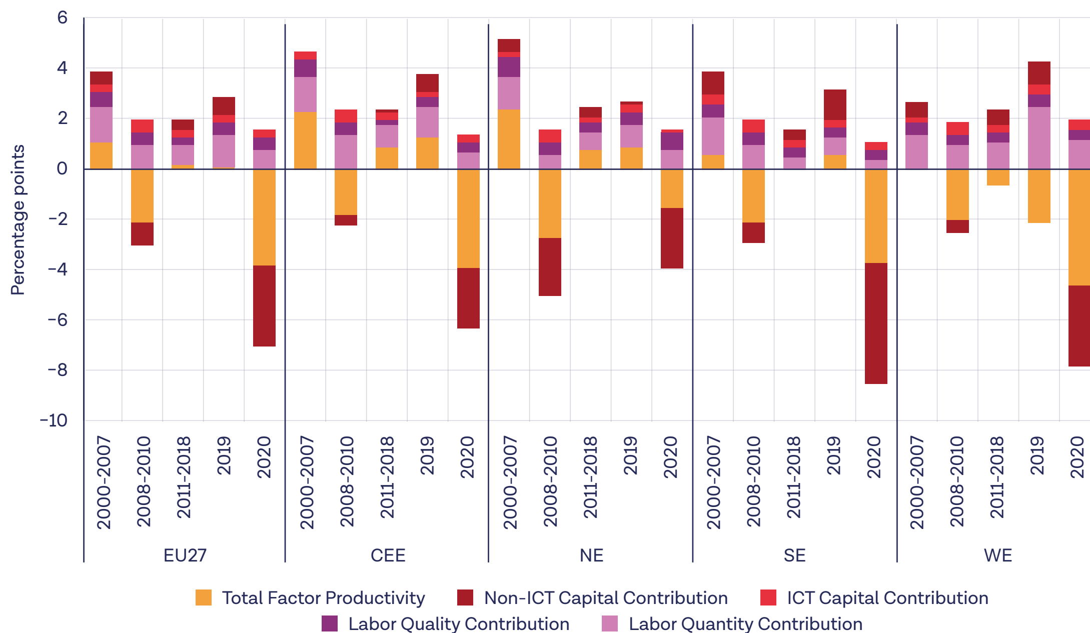
a. Poland already was home to a large number of Ukrainian economic migrants, estimated at more than 1.3 million, with more than 300,000 Ukrainians holding resident permits. This is complemented by a large number of Ukrainian migrants that were in Poland temporarily under the visa-free regime or on the basis of visas.

Going forward, EU countries face considerable risks to growth and inclusion. Heightened uncertainty as a result of the war is likely to dampen investment and growth prospects. Inflation has risen considerably, leading to a tightening of monetary policy in many EU member states, with implications for growth. In addition, the fiscal consolidation process is likely to be delayed as governments have stepped in with packages to support vulnerable households and firms from increasing prices. The war has also brought to the fore the discussion on energy security and independence, given the significant dependence of many EU countries on Russian gas and oil.

Heightened uncertainty is lowering investments which could affect potential growth. The pandemic has deepened the decline of total factor productivity (TFP) [1], with Western and Central Europe registering the steepest declines (Figure 3.1). The war in Ukraine could further reduce productivity growth as lower aggregate demand, tighter financing conditions, and increased uncertainty impact R&D expenditures and reduces investment and knowledge spillovers. The pandemic and associated measures have resulted in a lower contribution of labor to growth, rising worries of labor market hysteresis, and prolonged scarring of potential output. In case the FDPs remain in EU countries for a longer period of time, facilitating labor market integration could provide a boost to growth by partially offsetting the decline in labor supply over the medium to long term, supporting labor's contribution to growth, while also supporting human capital retention and the continued labor market attachment of FDPs. Education outcomes depressed by prolonged school closures will most likely affect human capital growth in the long term, impacting labor quality contribution to growth. Against this background, the investments and reforms under the Recovery and Resilience Facility play a crucial role in bolstering productivity and ensuring a green and inclusive growth by accelerating technology adoption and reducing the digital divide. Part 2 of this report looks into these issues in detail.

Figure 3.1 Declining productivity is threatening a sustainable economic recovery

Contribution to GDP growth



Note: Unweighted average across countries
Source: The Conference Board Total Economy Database, April 2022, World Bank calculations

Trade disruptions and higher import prices are likely to result in a deterioration in current account balances. Trade flows face significant risks as the war and sanctions add to the pressures on global supply chains. The high EU exposure to Russian energy imports affects EU economies and increases nominal energy imports due to soaring energy prices. Reducing the dependency on imports from Russia will entail significant adjustments of existing supply chains and trade links. This will affect trade flows in the short to medium term. Increasing global uncertainty also affects investment income, adding to primary income pressures.

Inflation is likely to remain elevated as commodity price increases, mainly energy, propagate to other headline inflation components. Inflation is expected to remain high in 2022, driven by the spike in energy

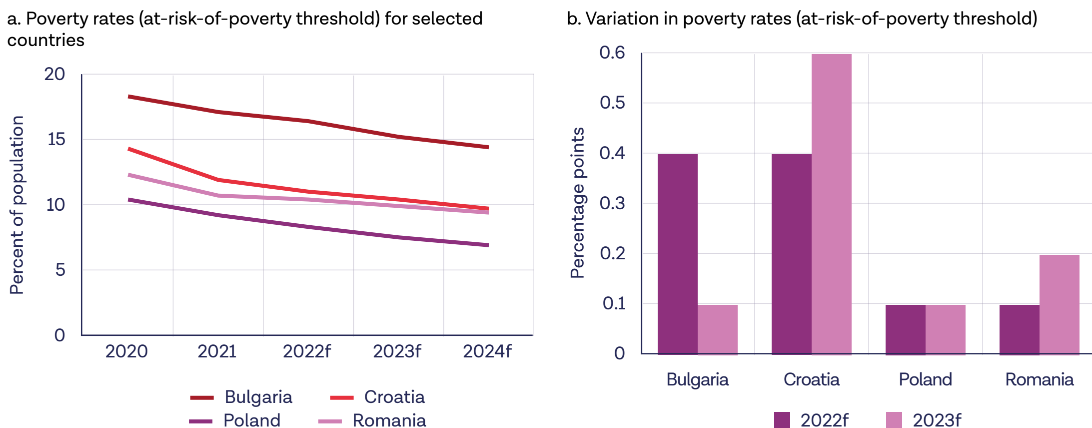
prices and second-round effects stemming from the impact of the war in Ukraine. Unless the war is significantly prolonged, the price pressures are expected to moderate in the medium term.

The war in Ukraine has raised issues of energy security and independence, adding to the debate on the sector's role in achieving reduced greenhouse gas (GHG) emissions. In 2021, Russia was the largest supplier of gas and oil to the EU, accounting for 39 percent of extra-EU imports of natural gas and 25 percent of extra-EU imports of petroleum oil (Eurostat). Similarly, in 2021 close to half of coal imports came from Russia.[2] While countries vary in their dependence on Russian energy imports, countries with a high share of coal, gas and oil imports from Russia and a high share of these hydrocarbons in their final consumption energy mix are likely to be the countries that face the greatest energy insecurity as a result of the ongoing conflict. While in the short term, prioritizing energy security may lead to higher emissions, including from extending the lifetime of coal power plants to minimize disruptions to industrial production and heating, the energy security and decarbonization objectives are aligned in the medium to long term as countries increase domestic power generation through renewables.

Financial sector stability and resilience will remain critical to support the recovery. The war in Ukraine and the sanctions on Russia's financial sector have impacted financial flows. While the banking systems' liquidity and capital positions provide strong protection amid increased risks, the deepening of geopolitical tensions had an adverse impact on the valuation of the most affected EU banks. However, direct exposure of the euro area and non-euro area financial sector is low, limiting financial stress. Additional risks stem from cyberattacks on financial institutions and infrastructures, which could cause significant disruptions and warrant improved operational resilience. Under current conditions, financial sector health and risks will need to be monitored very closely.

Although poverty is expected to continue to decline over time given the still positive growth outlook, the pace of poverty reduction is likely to decelerate. Using the at-risk-of-poverty poverty threshold (i.e., 60 percent of the median income, anchored to its value in 2016 and updated by annual average inflation) poverty rates for the four selected countries also show a slight decline in poverty Figure 3.2, panel a). Variations in projections before and after the war fall within a 0.1–0.5 percentage points range. Namely, projected inflation rates in years 2022 and 2023 are 0.1 to 0.5 percentage points higher than the previously predicted(Figure 3.2, panel b). This is because short-term GDP growth projections are slightly slower than before the war, but still positive for the selected countries.

Figure 3.2 Poverty rate projections through 2024 (using at-risk-of-poverty thresholds)



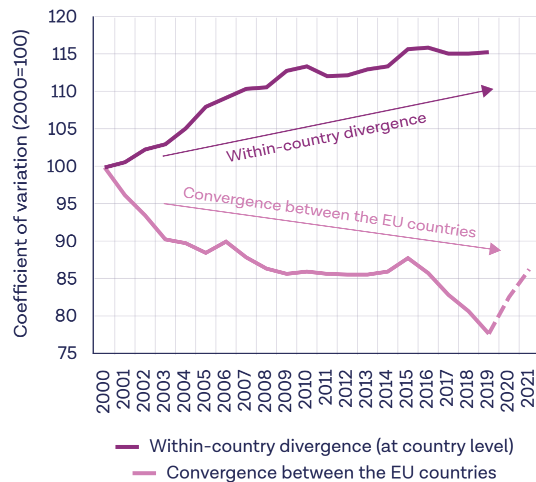
Source: World Bank staff estimates

Note: The variation in poverty rate is computed as a difference in the poverty rate projections based on growth forecast in in the June 2022 minus the poverty rate projection based on growth forecasts in December 2021.

An important caveat is needed regarding these poverty projections. They are produced assuming that inflation rates are similar across products and household types. But the recent inflation acceleration, with especially intense price rises in food and energy products, alter these usual assumptions. Poorer households, because of a larger share of food and energy within household expenditures, may be disproportionately affected by the increase in food and energy prices. On the other hand, middle-class households, with a larger share of transport expenditures, would feel an additional hit. The net effect on real incomes and poverty rates depends not only on income levels, but on consumption patterns within and across countries, and different inflation rates for different population groups.

The divergence among and within countries is likely to increase as EU countries are on different recovery paths and are being affected to different degrees by the war in Ukraine. Overall, specific impacts and their magnitudes vary in the EU. Countries that are geographically closer to the conflict will experience increased pressures on their fiscal position and in the delivery of public services as they accommodate a higher number of FDPs. Inflation pressures on households and firms are also not homogeneous as the pass-through from energy prices to other headline inflation varies across the EU countries (Box 3.2). Government capacity to shield firms and households against external shocks differs and is a function of the flexibility of their public finance. This is likely to lead to higher divergence among countries. The shock on growth and inflation is also disproportionately impacting poorer households, which were also worse off in terms of learning outcomes as a result of the COVID-19 pandemic. Lower real disposable income in the current high inflation environment will add to the existing pressures affecting employment and income prospects of people from poorer households. This is likely to lead to increased divergence not only across but also within countries.

Figure 3.3 The economic impact of the pandemic reversed the convergence of income in the EU27



Source: World Bank calculations using Eurostat, Ameco data

Note: Computations based on GDP per capita in PPS for the EU27 countries; within-country variation calculated based on NUTS 3 level data.

Box 3.2 "Shared prosperity" index: more realistic poverty and inclusion projections using group-specific inflation rates

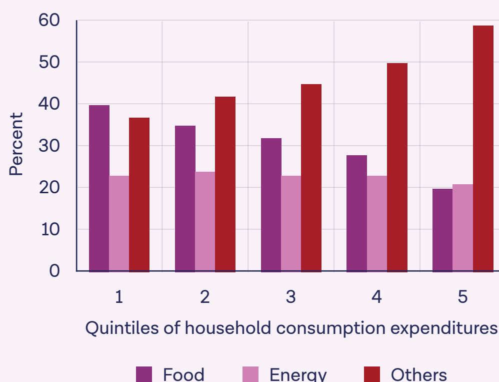
Poverty rate estimates and projections may fail to capture the differential impacts of inflation on standards of living across different groups. Using a unique price deflator for all groups effectively assumes that all households have the same consumption composition. If this assumption does not hold in reality, then households that spend larger share of their incomes on goods and services especially affected by price rises would suffer a larger decline in purchasing power and will be mistakenly assumed less poor than they are. In reality — for example, in Poland — 2019 household data shows that poorer households spend a higher proportion of their (lower) income on food and energy compared to richer ones (Figure B3.2.1). The households in the bottom two quintiles of the distribution (the "bottom forty") spend 35 percent or more of their budget on food, and 25 percent or more on energy. In contrast, households in the top quintile of the distribution spend less than 20 percent of their budgets on these items.

To gauge differential growth in standards of living for different groups of the population, the World Bank uses the "shared prosperity" index. It compares the growth in household incomes (or consumption expenditures) for the "bottom forty" percent of the population (the poorer, most vulnerable groups) to the national

average. If the former is larger than the latter, growth is said to be "inclusive" or "pro-poor". Usually, the indicator is influenced by real rates of growth at different groups of the income distribution. A similar approach can be used to assess losses in real incomes due to differential inflation.

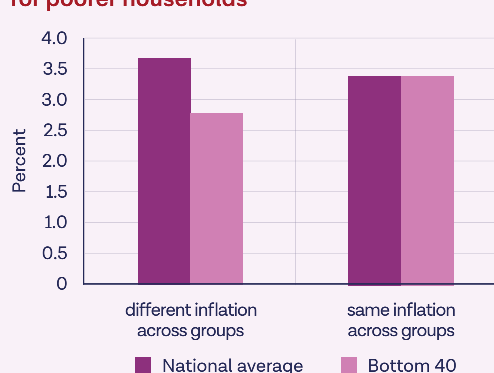
An example for Poland showcases the difference from using the "shared prosperity" approach. Using World Bank GDP growth data and projections, and recent inflation by components, we compute an estimate of shared prosperity for Poland for 2022 (Figure B3.2.2). If using the same deflator for all groups and current economic growth forecast, the standard projections of real growth in household consumption would be 3.4 percent for the "bottom 40" households — the same as for the national average (lower part of Figure B3.2.2). In contrast, taking into account different consumption composition across the income groups, and an estimate of inflation for 2022 that takes into consideration the most recent annual inflation rates for Poland, i.e., 9.2 percent in food, 24.3 percent in energy, and about 7 percent for all the other goods and services, as of March 2022, the real growth in household consumption is projected to grow by only 2.8 percent for the poorest 40 percent of households, while the average for the economy will be 3.7 percent (left part of Figure B3.2.2).

Figure B3.2.1 Poorer households spend more of their income on food and energy



Source: 2019 Household Surveys, Poland

Figure B3.2.2 Different consumption patterns lead to differing impact of inflation for poorer households



Source: World Bank estimates

This approach underpins the insight that poorer households will be disproportionately affected by the currently high food and fuel prices. This differential impact of inflation is due to differences in the share of different consumption goods within total household consumption expenditures. Differential inflation rates involve widening real purchasing power differences across population groups. This creates worsening inequality in standards of living and higher poverty rates. However, if using a single price deflator for estimates of poverty and inequality rates, these differences would pass unnoticed.

Notes

[1] Total Factor Productivity (TFP) captures the share of economic growth attributable to factors such as technological progress, efficiency of resource allocation, management quality, and quality of institutions, among many intangible factors. Other drivers of growth include investment in ICT and traditional capital accumulation and changes to labor quantity and quality.

[2] As per Eurostat

Chapter 4

Well-crafted and coordinated policies will be needed to support growth and inclusion in a fiscally sustainable manner while progressing on the green and digital objectives

Policy support will be essential to counter the recessionary pressures and shield the most vulnerable from a broad range of economic consequences of the war in Ukraine. Governments already stepped in to accommodate the influx of the FDPs, ease pressures on the host communities and help shield the populations from the full impact of the energy and food price rises. With the FDP inflows still increasing, and the timeline still highly uncertain, the breadth and depth of services they will require is rising. As the war continues, it is likely that there will be a shift from the emergency measures to a more extended package of healthcare, education, and labor market integration measures for the FDPs. At the same time, the pressures on host communities need to be eased, and those most vulnerable shielded through fiscal measures from the rising prices of necessities. In addition, with increased uncertainty and monetary tightening, governments will also need to support the still nascent recovery from the pandemic.

As the additional fiscal needs come at a time of already heightened fiscal vulnerability, selectivity and targeting of measures will be key, as will be the coordination with monetary policy. While inflation will help to stabilize debt-to-GDP ratios, it has already raised borrowing costs at a time when fiscal deficits are again widening. It will be important for governments to leverage the lessons from the COVID-19 pandemic to inform the targeting of support measures to shield consumers and firms against high prices. In addition, it will be critical to coordinate monetary and fiscal policies such that they support growth and equity.

Targeted cash transfers — rather than across the board price caps or reductions in indirect taxation — work best in providing support to the vulnerable. Growing consumer prices have eroded real wages and may stymie labor supply and reduce standards of living. These price increases have a stronger impact among vulnerable population because the share of food and energy in their budgets is proportionately higher than among the rest of the population. Special transfers for public transportation and heating may also contribute to preventing worsening living conditions among the more vulnerable. Food and energy price increases will be temporary but will disproportionately affect the poor, thus the targeted and transitory transfers are an efficient and equitable tool to prevent increases in poverty in the short term.

Since most countries in the region have an ongoing Guaranteed Minimum Income scheme, targeting of resources should be administratively feasible. However, the share of households currently covered by social assistance programs is smaller than the shares that are — or may become — energy poor, so there may need to be an expansion in the coverage of support offered. Since governments are operating in limited fiscal space, making these transfers targeted and temporary would increase the efficiency and equity in the use of public resources. Some countries (our selected countries of analysis: Bulgaria, Croatia, Poland and Romania, among others) have also used a mix of price controls, reduction in VAT, and targeted transfers to reduce the impact of high prices. This spending is being financed through tax on windfall profits of energy companies, dividends from energy SOEs and higher indirect tax collections because of higher prices. However, this type of assistance is not targeted at the most vulnerable and is therefore more expensive than it needs to be to prevent poverty and/or inequality from worsening.

Effective implementation of the EU-funded programs can help support the economy through the uncertain times ahead. Alongside the Multiannual Financial Framework, the Next Generation EU funds provide substantial funding to EU member states to support their economies, not just via grant financing that can help ease fiscal pressures in the short term, but also through support to key structural reforms that can boost growth in the longer term. In line with the guidance from the European Commission, the member states are allocating a substantial share of resources to climate (37 percent) and digital (20 percent) spending under the Recovery and Resilience Facility, the largest component of the Next Generation EU funds. The full implementation of the planned reforms and investments under the Facility will help to narrow the digital divide and accelerate technology adoption, which in turn should bolster a more inclusive growth.[1] Part 2 of this report provides a deeper analysis of how impactful these funds can be

in some of the most vulnerable economies. However, countries will need to improve their absorption capacity to ensure optimal utilization of these funds.

The energy security objectives are aligned with green transition objectives in the medium term, although in the short term some bridge measures that increase emissions might be necessary. The energy transition to alternative suppliers (in the short term) and sources of energy (in the medium to long term) may temporarily require countries to turn to more polluting energy sources to limit the disruptions on industrial activity and heating. But in the medium term, energy security and the green transition are well-aligned, in particular as the existing generation cost structures allow for greater diversification of the energy mix towards renewables. In addition, regulatory and policy measures need to be in place to support private investment in renewables and greater energy efficiency in the economy.

Complementary measures to ensure that the green transition is just, are even more important. More ambitious decarbonization goals require complementary policy actions to limit the adverse impact on the poor and vulnerable. Raising energy efficiency, in both the household and firm sector, can both lower household energy bills while advancing energy security objectives. Targeted support will be needed to ensure that investments to raise the energy efficiency of the housing stock are affordable for all. As the industries transition to greener business models and away from brown production, one way job losses could be minimized is by governments proactively investing in active labor market policies geared at re- and up-skilling workers whose jobs are most at risk during the decarbonization process in order to facilitate smooth transitions to other sectors of the labor market. Targeted transfers will also be needed to mitigate impacts on the poorest households.

In addition, policy measures to equip the population with digital skills will be essential to ensure that the digital transition can benefit the entire workforce, including the poorest, the disadvantaged, and the lowest-skilled workers. The Recovery and Resilience Facility requires that Member States allocate at least 20 percent of the funds to measures fostering the digital transition and addressing digital challenges. This means that EU countries have significant resources to invest in expanding digital services (e.g. broadband access) and modernizing key infrastructure (e.g. upgrade of school and healthcare equipment, streamline of social services) to rural and lagging areas to speed up the spatial convergence of digital access. But inclusive digital transformation will also require more public spending and efficiency improvements in labor market services and policies to boost digital skills, especially among disadvantaged labor groups, and to better match workers and firms in the ever-changing job markets. As of now, Central and Eastern Europe has the lowest budget allocation on active labor market policies (ALMP) in terms of share of GDP, corresponding to their lowest performance in digital skills in the EU. Besides a greater budget allocation, other complementary measures are needed to advance the type of services provided. These include reskilling and upskilling the workforce with a focus on workers at highest risk of being replaced by automation, improving the efficiency of public employment services, developing skill forecast instruments to facilitate investments in skills, and scaling up social benefits and unemployment benefits to support, at least temporarily, workers affected by the transition.

Although the geopolitical and post-pandemic challenges are testing the value chains, global trade relationships and cooperation still promise net gains. The shift in energy and other imports will inevitably be driven by the energy security and broader geopolitical considerations. The uncertainty on the timeframe and evolution of the war will likely complicate the value chain decisions facing European businesses, that are sourcing inputs from outside the EU, or considering reorienting their production or looking to supply to the EU market. The EU's value chains have been resilient during the pandemic and European industries stand to gain more from the diversification of supply chains rather than on/reshoring. While more trade integration within the EU is likely, turning away sharply from global value chains are likely to yield net losses for everyone in the longer term.

Note

[1] The implementation of the Next Generation EU funds is still at an early stage. In 2021, 26 member states submitted their National Recovery and Resilience Plans (NRRPs) with 22 receiving positive assessments. As of mid-April 2022, around 3 percent of the milestones and targets under the Recovery and Resilience Facility were fulfilled.

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