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in Europe and Central Asia*

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## *Stress-Testing Households in Europe and Central Asia*

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## Background

Over the recovery period following the 1998 Russian crisis, some 50 million people moved out of poverty in the Europe and Central Asia (ECA) region. Poverty fell throughout all the sub-regions of ECA led by the populous middle-income countries of the Commonwealth of Independent States (CIS). They experienced the largest fall in poverty, particularly in Russia where the share of the poor and vulnerable has fallen rapidly in recent years. Such a massive reduction in poverty was driven by rising incomes everywhere, particularly through rising real wages among the working poor.

The global financial crisis, which has led to a sharp slowdown in economic activity everywhere, including the emerging markets in ECA, now risks reversing the substantial gains and improvements in living standards achieved by the region over the last few years. Countries in the region are facing a number of major and interrelated economic shocks. The first is the global slowdown in economic activity leading to diminishing export revenues. In addition, remittance inflows to low-income countries such as Moldova and Tajikistan have been falling as economic activity has declined in the major host countries. Meanwhile, as major banks and financial institutions in developed economies have been left reeling, the crisis has drastically reduced the availability, and increased the cost, of external finance

across public, corporate and financial sectors. Finally, as commodity prices have fallen, commodity-exporting countries have suffered. As a result of these shocks, unemployment levels have been rising across countries in the region while economic activities have collapsed.

All in all, the crisis threatens the well-being of close to 40 million people who are still poor. It also threatens the welfare of an additional 120 million people who are living just above the poverty line and at risk of easily falling into poverty as economies contract.

The global crisis threatens the well-being of over 160 million people in the region who are poor or are just above the poverty line.

A World Bank team recently sought to understand the consequences of the crisis for households in the region. The diagram below is a simplified representation of the analysis of the impact of macroeconomic shocks to date on household welfare. Three main transmission channels are investigated: access to financial markets (including the cost of borrowing and the burden of debt service payments), the relative prices of goods and services, and,

## The Impact of the Crisis on Households: Main Transmission Channels



the income and employment of members of the household.

The crisis is hitting households on multiple fronts.

The focus on these three mechanisms reflects the lessons from analyzing the social effects of macroeconomic crises experienced in various parts of the world over the last three decades as well as data availability constraints. However, the diagram is highly simplified and ignores several important elements. For example, it overlooks second-round effects of the crisis, the consequences of multiple shocks, and the distribution of social effects among households. Neither does the diagram take into account the role of wealth effects as a transmission channel of the crisis to households, for example, through changes in the prices of property or the value of equity holdings (directly or in pension funds). The above diagram also does not address the role of government policy and social assistance (though social assistance may be thought of as

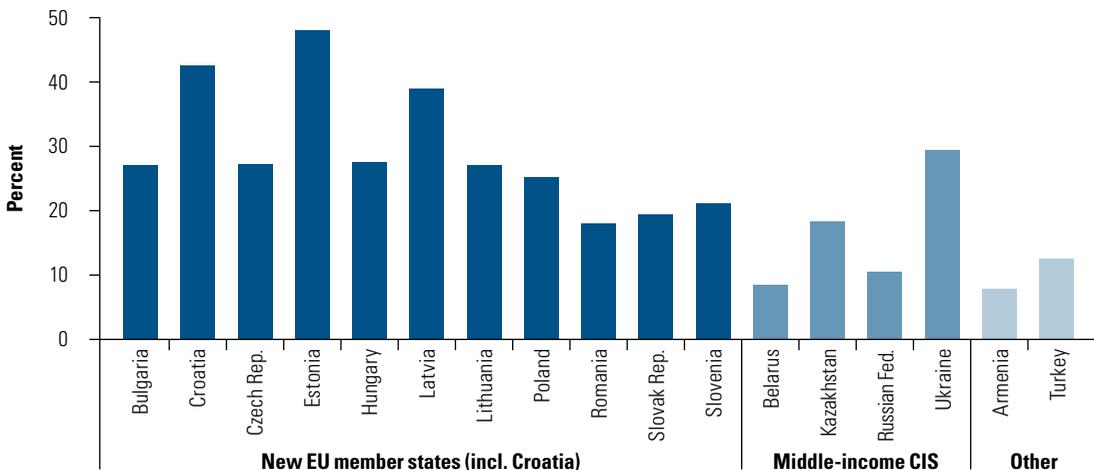
a source of income). Government policy can, in fact, either dampen the impact of shocks or worsen them, depending on how such policies are formulated and implemented. Pension provision is also not accounted for. The nature and magnitude of the effects of the crisis via this channel depend very much on the structure of a country's pension system.

### Credit Market Shocks

The rapid rise in household access to credit—in the new EU member states as well as in some Western Balkan countries, such as Albania and Serbia, and CIS countries such as Ukraine—has both brought benefits to households and exposed them to a potential credit market shocks. There is no doubt that the lives of many have improved because it has become much easier for households to borrow. Borrowing allows them to meet their needs, purchase durable goods, and invest in housing. It means being able to sustain a stable living standard, in good times and bad times. However, because of the specific characteristics of household loans in the region, this rise in household indebtedness means that payment obligations may increase very sharply, as a result of the crisis. First, many households

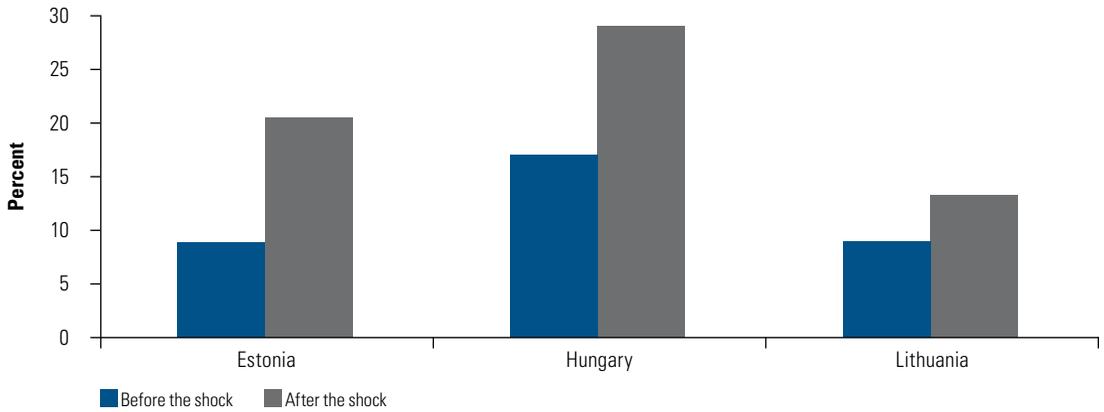
### Household Debt in ECA, 2008

In percent of GDP

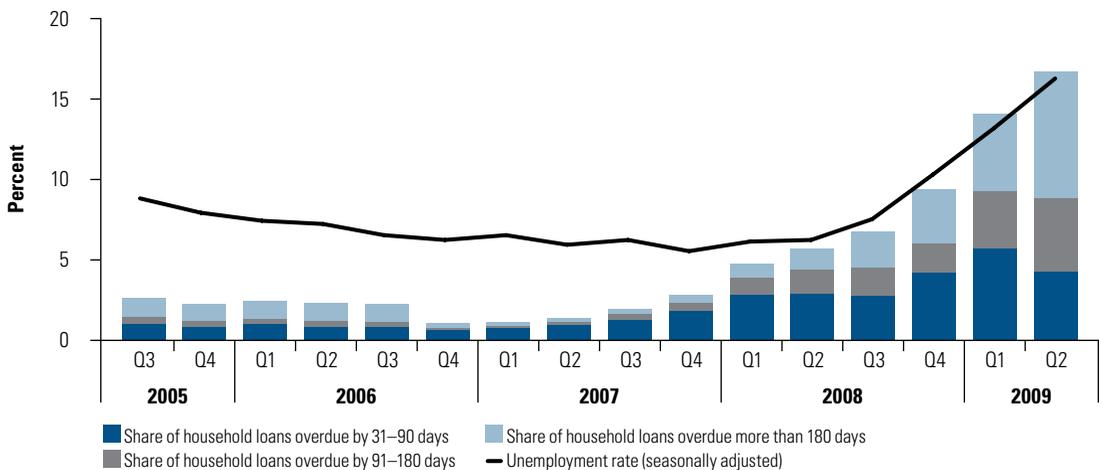


### The Share of Vulnerable Households Before and After an Unemployment Shock

In percent of indebted households



### Latvia Household Loan Delinquency Rates and Unemployment Rate



borrowed in foreign currency and are now exposed to exchange rate depreciations. As the value of the local currency falls, the payment obligations in local currency terms will rise. Second, many households have loans that have variable interest rates, which means that their interest payment obligations may rise as average interest rates rise. Those who have recently lost their jobs will have an even more difficult time meeting their payment obligations.

The results of stress tests on household loans recently conducted by the World Bank suggest that ongoing macroeconomic shocks,

to interest rates, exchange rates and household income, may expand the pool of households that are unable to service their debt. The share of vulnerable households or borrowers at risk

The debt service burden of households will rise. Many households will risk defaulting on their debt service obligations.

(in percent of all indebted households) will grow, depending on the severity of the shock. Although the share of indebted households and households at risk in the ECA region still lag behind those of richer countries, the aggregate effects of rising debt service burdens are already being seen in rising household loan delinquency rates.

### Price Shocks

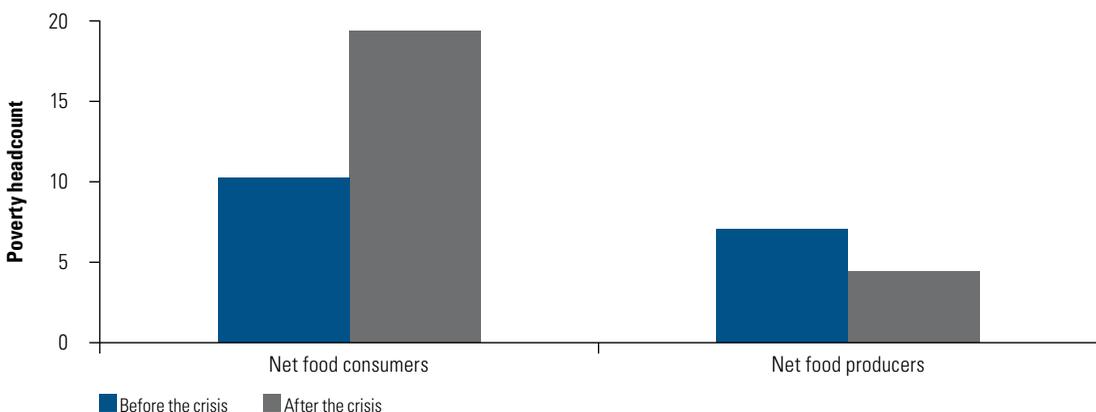
Global food and fuel prices have fallen because of the slowdown in economic activity worldwide, and, as a result, falling global demand for commodities. In addition, increased agriculture production activity led to a bountiful 2008 harvest and eased global food shortages. However, international commodity price levels have not returned to pre-2007 levels. Specialists have also pointed to longer-term challenges in global food production that are yet to be addressed. In addition, falling currencies in some countries are resulting in a new round of price increases, depending on the share of imported food and fuel in local consumption and the degree of pass-through of exchange rate changes in domestic prices. Finally, in a number of countries such as Belarus, Moldova, and Ukraine, the utility reform program remains largely incomplete. As a result, for reasons of economic efficiency or fiscal consolidation, a

number of countries will have to adjust their energy tariffs to cost-recovery levels in the coming years.

The food and fuel crisis may not be over. In some countries, food and fuel prices will rise as the value of currencies fall. The poorest consumers will again be vulnerable.

The impact on households of a food or fuel price crisis is not straightforward. The experience with the recent food price crisis, for example, tells us that the net effect of a rapid food price increase depends on whether households are net producers or net consumers of food, it depends on how much food they consume and whether there are cheap substitutes, and it depends on their sources of livelihood and their ability to take advantage of profitable opportunities in agriculture. These considerations suggest that, at least in principle, the poor are not necessarily the hardest hit. However, food represents a very large share of the poor's total consumption.

### Kyrgyz Republic: Poverty and the Food Price Crisis



In low-income countries of the region, the food share of consumption among the poor is 80 percent. Moreover, in reality, the poor are the worst hit, as many of the poor in Albania, Kyrgyz Republic, and Tajikistan, for example, are also observed to be net consumers, with limited access to agricultural assets and inputs.

Poverty will rise. About 11 million more people will be in poverty and over 23 million more people will find themselves just above the poverty line because of the crisis.

population who recently moved out of poverty. This is not surprising given that regional poverty is shallow, with many individuals susceptible to falling into poverty even with modest falls in average income. Alternatively, one could think of them as the recent-poor, with fragile links to the labor market, little savings, but benefited from recent credit and construction booms.

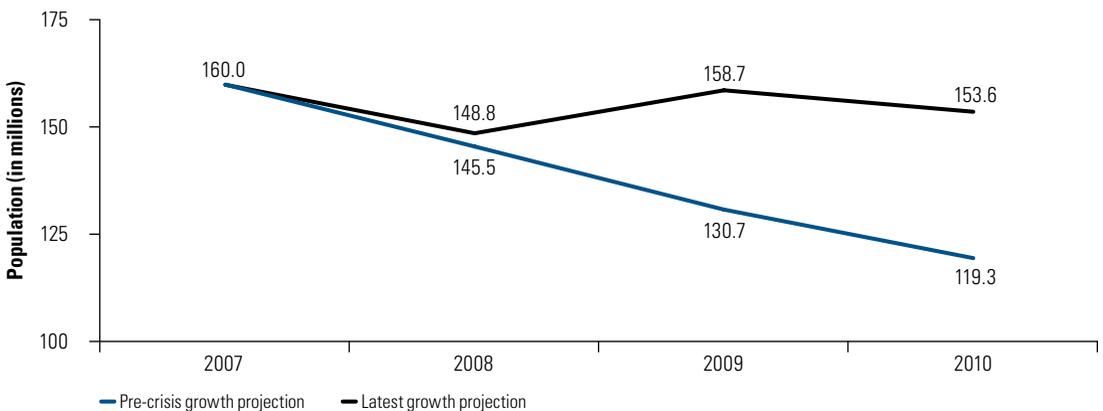
The magnitude of the poverty impact varies by sub-regions. The middle-income CIS countries, on average, have seen the largest and most significant downward revisions to their GDP growth projections. As a result, they are also seeing the largest percentage-point increases in the projected poverty headcount. They are followed closely by the low-income CIS. The overall results mask the variety of possible effects within countries, including the concentration of the poverty impact in selected economic sectors. Country studies recently completed suggest that for economic shocks transmitted mainly through the labor market, poverty will rise especially among households that have been dependent on remittance inflows and those previously employed in booming construction sectors where economic activity is now projected to decline sharply.

### Employment and Income Shocks

The poverty impact of the regional recession will be enormous. The results of simulations suggest that by 2010, there will be 11 million more people in poverty and over 23 million more people just above the international poverty line, relative to pre-crisis projections for growth and poverty. The growth in poverty would represent a fifth of the region's

### The Poor and Vulnerable Population, 2007–10

Using the \$5-a-day measure of poverty



## Percent Change in Poverty and Vulnerability, 2010

In percent of the population, most recent versus pre-crisis growth projection



## Coping with the Crisis

The results of the preceding analysis are indicative of how risks and vulnerabilities are distributed across countries and, within countries, across broad types of households. In some ways, the simulated effects may be understated, as they capture only some of the first-round effects. The second-round effects on access to education, health and social services, in particular, will be significant. Lessons from the region's own experiences with previous crises suggest that temporary economic shocks have a lasting impact on human development, as families cut back their education and health investments in response to a banking or exchange rate crisis. Crises may also lead to increased social unrest, criminal activity and human trafficking, disrupt communal and ethnic relations, or bring down fragile governments and fledgling democracies.

How will households protect themselves? Households in the region have employed a variety of coping strategies to protect their well-being during previous crises. These strategies include household members holding secondary jobs to augment income or family members migrating to foreign countries where well-paid

jobs are available. Some households draw down their savings or borrow money, in places where credit is available. And besides turning to the government for assistance, households suffering from the impact of an economic shock turn for help to friends and family. In some cases, households that have access to private land plots use it to supplement their income by selling home-produced goods or to augment their own consumption with such home production.

The scope for households to engage in their traditional coping strategies will be limited.

In the current global crisis, the scope for households to engage in their traditional coping strategies may be limited. Because of the global nature of the crisis, and because economic shocks are hitting households on multiple fronts, these coping strategies may no longer be feasible. For the poorest households, subsistence farming may be a viable alternative, though evidence from the recent

food price crisis suggests that many of the poorest households do not have agricultural assets and inputs. For some, transitions into informal sector employment may be possible, though for many households, earnings from informal sector, which has also been hit hard by the crisis, will likely be insufficient to offset the poverty impact of the crisis. This means that the policy response to the crisis will be critical.

### Appropriate Policy Response

The immediate fiscal policy response is constrained by rapidly falling revenues. Substantial government deficits are currently projected for the region. Where there are no new sources of financing and where there is little scope to mobilize revenues, many countries will have to resort to across-the-board cuts in spending. Such blunt adjustments will likely substitute for efforts to improve the efficiency of public spending. The prioritization of labor-using investment expenditures—either from countries' own budgets or from resources provided by donors—could be one option for addressing the labor market consequences of the crisis, while accounting for constrained fiscal resources. Such investments could include rural roads projects or irrigation systems rehabilitation projects that can create short-term employment opportunities while creating the conditions for longer-term growth. Improving the efficiency of public spending may also create some additional fiscal space.

Although social safety nets will be among those items likely to be cut as revenues fall, protecting these programs—and possibly expanding some of them, where some reallocation of resources are possible—will be an important element in the response to the crisis. Countries in the region operate a combination of safety net programs, typically in the form of cash transfers with an emphasis on family allowances, social pensions, heating and

Fiscal policy responses are constrained by falling revenues throughout the region. Protecting social safety nets—and expanding some of them, where sufficient resources are available—will be an important element in the response to the crisis.

housing allowances, and targeted anti-poverty programs. Some countries in the region are yet to reform a range of categorical benefits left over the pre-transition period.

The region's social protection systems current vary in size and targeting performance across countries. However, most countries in the region have at least one targeted safety net program that can possibly be scaled-up in response to the crisis. Expanding such programs can take place either by increasing the value of benefits they provide or by expanding their coverage to reach those households still currently outside the system. However, in some countries, including Belarus, Bosnia, Hungary, Kazakhstan, Moldova and Russia, the targeting performance of existing programs remains weak. Depending on a country's initial conditions, the response to the crisis in terms of social assistance may involve expanding some well-performing programs, reforming relatively less effective interventions or, alternatively, introducing new programs as appropriate. The experiences of other countries suggest that programs such as conditional cash transfers (CCTs), workfare schemes, and public works programs can be effective instruments for protecting the vulnerable from immediate as well as longer-term (second-round) consequences of transitory shocks on nonincome dimensions of welfare, including human capital accumulation.







The global financial crisis, which has led to a sharp slowdown in economic activity everywhere, including the emerging markets in Europe and Central Asia, now risks reversing the substantial gains and improvements in living standards achieved by the region over the past few years. It threatens the well-being of millions of people in the region who are poor or who are living just above the poverty line and at risk of easily falling into poverty as economies contract. This book seeks to understand the key macroeconomic shocks confronted by the region and the impact of such shocks on household welfare, including the effect on household income flows, consumption levels, and liabilities. It draws on a large, cross-country database of recent household surveys and presents regional overviews as well as relevant country examples to illustrate the incidence and distribution of specific vulnerabilities.

