Accelerate Change

Higher saving is the key to higher growth for new EU members

Witold M. Orlowski

FOR THE EIGHT Central and Eastern European countries (CEE-8) that have just joined the European Union (EU), membership marks the fulfillment of their main political and economic goal of the past decade. Without doubt, meeting all the EU's entry conditions required an enormous modernization effort. Indeed, after the initial period of liberalization and stabilization during the transformation from centrally planned to market-based economies, their wish to join the EU was a major factor driving further adjustment and reforms.

Now that the eight—Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia—have joined the EU, are their problems over? Not necessarily. While membership brings with it big business opportunities and clear financial benefits, the key question remains whether the CEE-8 can really catch up with the established EU members. In my view, this question is still open.

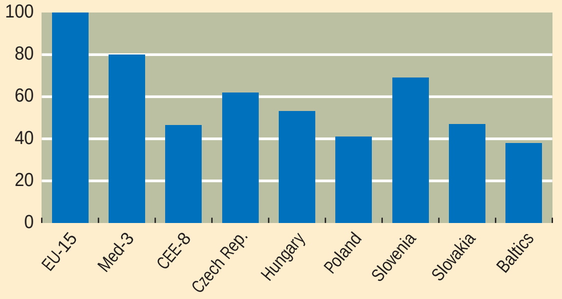
EU membership does not change the fact that there is a big gap in the economic development, productivity levels, and living standards of the CEE-8 and Western Europe (see Chart 1). The average per capita GDP in the CEE-8 is just 46 percent that of the EU-15, measured at purchasing power parity (PPP). That is not the only difference. Their economic structure is less modern, their institutions less efficient, their technology less advanced, the skills of the population lower, and the market infrastructure much less developed. In a nutshell, the new member states need policies that will accelerate structural change and long-term GDP growth.

Chart 1

Big gap

The CEE-8 countries have an average per capita GDP less than half that of the established EU countries.

(GDP per capita, at purchasing power parity; EU-15=100)



Source: Eurostat.
Notes: EU-15: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, and United Kingdom.
Med-3: Greece, Portugal, and Spain.
CEE-8: Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia.
Baltics: Estonia, Latvia, and Lithuania.

Growth too slow

The CEE-8's performance during the past decade has been somewhat disappointing. In 1995–2003—after the recession stemming from the transition period was over—these countries recorded an average annual GDP growth rate of 3.6 percent. This was only slightly better than that of the three established EU member states that are least well off (Greece, Portugal, and Spain, or the Med-3). But the Med-3 had an initial per capita GDP almost twice as high as the CEE-8's, so the new members could have expected a much stronger growth rate.

Why was growth disappointing? Obviously, one could blame the ongoing restructuring process. But the CEE-8 countries benefited enormously from economic liberalization and from their growing attractiveness as places for investment. In my view, the main macroeconomic explanation may be found in their very low level of domestic saving.

On the surface, CEE-8 countries save a share of GDP similar to comparable Western European economies. The CEE-8's ratio of domestic saving to GDP was 19 percent in 2001. That, together with significant inflows of foreign direct investment, allowed for relatively high investment-to-GDP ratios. In some countries, such as the Czech Republic, Estonia, and Slovakia, the rates approached 30 percent.

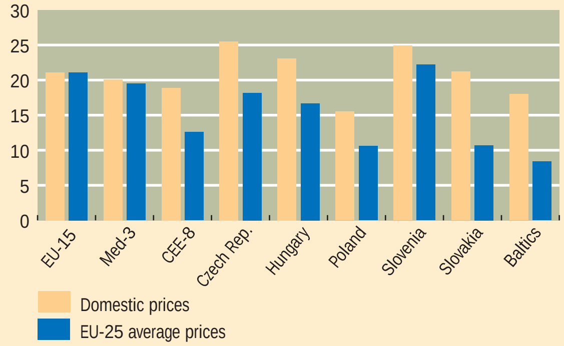
The problem, however, is how the values of consumption, investment, and GDP are measured. All the above-mentioned ratios were calculated using domestic prices. Compared with the EU average, the prices of consumer goods in the CEE-8 are much lower while the prices of capital goods—particularly machinery and equipment—are roughly the same. Seen in this light, the relative prices of consumption are depressed in the CEE-8, while the relative prices of investment are overstated, thus boosting the ratios of investment and saving to GDP. One could argue that, for the sake of international comparison, one should use PPP prices in making intercountry comparisons of saving and investment rates. The point is that we should try to compare the relative volumes of resources that a given country spends for consumption and investment. Consider, for example, two countries, A and B, that spend exactly the same real amounts on goods for consumption and investment. Common sense tells us that the investment-to-GDP ratio in both countries would be identical. If, however, prices of capital goods are equal in both countries, but prices of consumer goods are lower in Country B, the relative price of investment

Chart 2

Not saving enough

Using EU averages to compare prices and ratios shows domestic saving to be even lower than it seems.

(measured at domestic and international prices, 2001; percent)



Source: Eurostat.
Note: For key to country groupings, see Chart 1.

in Country B is higher than in Country A. By using the domestic price structure, we would obtain a much higher investment-to-GDP ratio in Country B than in Country A.

Therefore, the investment-to-GDP and saving-to-GDP ratios in the CEE-8 should be calculated using comparable data. If such an adjustment is made, the ratios observed in the CEE-8 fall dramatically (see Chart 2). Ratios of domestic saving to GDP, measured with EU-25 average prices, range from 8 percent in the Baltic states and 10 percent in Poland and Slovakia to 18 percent in the Czech Republic (the only exception is Slovenia with 22 percent). The region as a whole saves 12.6 percent of GDP and invests 17 percent of GDP—considerably less than the Med-3 countries and even the EU-15 as a whole.

Why do low domestic saving rates matter? First, low saving makes capital expensive, slowing investment, particularly in small and medium-sized domestic firms with restricted access to financing sources other than domestic banks. Second, any acceleration of investment demand leads to a rapid deterioration in the current account, as investment in excess of domestic savings can be financed only with foreign capital. That, in turn, would lead to serious economic imbalances in the CEE-8, forcing the governments to apply tough stabilization policies to counteract an excessive buildup in the external deficit. All the economies of the CEE-8—except for high-saving Slovenia—have suffered serious growth setbacks caused by such imbalances (Hungary in 1995–96, the Czech Republic in 1997–99, the Baltic states in 1999, Slovakia in 1999–2000, and Poland in 2001–02).

No coincidence

Obviously, the CEE-8's low saving rate is not a coincidence. The household sector was discouraged from saving and building wealth, first by central planning and then by economic instability—especially high inflation—associated with the transition. The enterprise sector has suffered from low profitability, resulting partly from the unfinished restructuring and privatization of loss-making, state-owned firms. The government sector has run up big deficits. In 2003, only the Baltic states and Slovenia had public sector deficits of less than 2 percent of GDP; Poland, Slovakia, and Hungary had deficits ranging from 3.6 percent to nearly 6 percent, and the Czech Republic logged 12.9 percent.

Will the opportunities created by EU membership change this situation quickly? That cannot be taken for granted, as previous rounds of enlargement have shown. When Greece joined the EU in 1981, its per capita GDP was 70 percent of the EU-15 average. Over the next decade, slow growth relative to the EU-15 meant that per capita GDP was only 58 percent of the EU-15 average by 1990—in fact, it is only recently that the figure has risen to 71 percent. Similarly, when Ireland joined the EU in 1973, its GDP was 60 percent of the EU-15's. Over the next decade, this figure still hovered at 66 percent. Only a radical change of domestic policy—as was needed by Greece—changed Ireland into a "Celtic tiger," enabling it to greatly outperform all the other EU countries and achieve ultrarapid real convergence (that is, catch up in per capita GDP) by the mid-1990s.

The key for Ireland was to boost domestic saving dramatically by implementing radical public sector reforms and drastic reductions in the public sector deficit. It is a lesson the CEE-8 countries must take to heart if they hope to generate the higher saving, investment, and GDP growth necessary for real convergence. EU membership—and, in the future, the adoption of the euro—creates an enormous opportunity for the accelerated development of the eight. However, the key to success is still in the hands of the CEE-8's policymakers. ■

Witold M. Orlowski is Chief Economic Advisor to the President of Poland.

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