FALL 2016 REGIONAL ECONOMIC ISSUES REPORT
On Central, Eastern, and Southeastern Europe (CESEE)

Effective Government for Stronger Growth

- Growth remains solid and cyclical recovery is near completion outside the Commonwealth of Independent States (CIS), while the CIS economies are gradually exiting from recession. Yet, trend growth remains much lower than before the crisis.
- Macroeconomic policies should strike a balance between supporting near-term growth and rebuilding fiscal buffers. Sustaining strong growth requires further structural reforms, focused on strengthening institutions and raising government efficiency.
- Improving public investment management and tax administration can help free up 2–4 percent of additional resources that can be used to boost public investment or to reduce fiscal deficits.

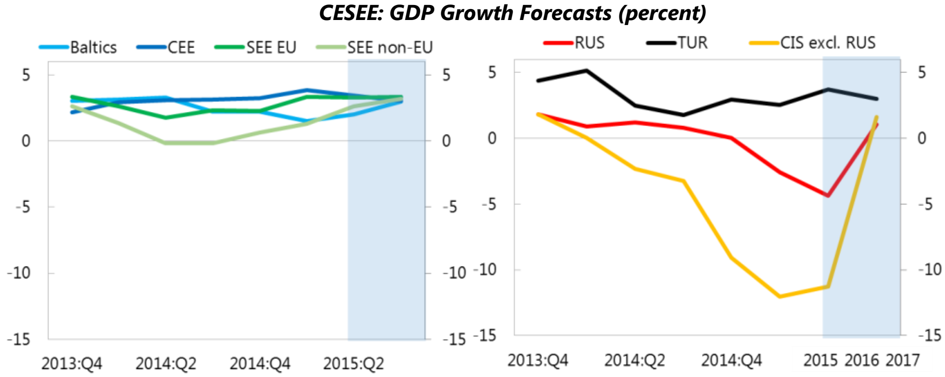
Growth momentum remains strong

Cyclical recovery is near completion in much of the Central, Eastern and Southeastern Europe (CESEE). Outside the Commonwealth of Independent States (CIS), growth continued at a good pace supported by accommodative policies and led by buoyant consumption. Despite the still low inflation, cyclical recovery appears to be near completion in this part of the region, with unemployment rates falling to pre-crisis levels, wages growing strongly, and credit recovery picking up. In the CIS, the pace of contraction has been moderating in Russia as oil prices edged up from their lows, while the rest of the CIS is gradually exiting from recession, on the back of improved external demand. For the region as a whole, GDP growth is projected to reach 1.3 percent in 2016 and 2.1 percent in 2017, largely reflecting the improved outlook in the CIS.

Real GDP Growth Forecasts *(percent)*

	CESEE[1]	Baltics[1,2]	Central and Eastern Europe (CEE) [1,3]	Southeastern Europe EU (SEE-EU) [1,4]	Southeastern Europe non-EU (SEE-non-EU)	Other CIS[1,6]	Russia	Turkey
2015	**-0.2**	**1.8**	**3.7**	**3.3**	**2.2**	**-4.2**	**-3.7**	**4.0**
2016	**1.3**	**2.3**	**2.8**	**4.1**	**2.9**	**-0.7**	**-0.8**	**3.3**
2017	**2.1**	**3.0**	**3.0**	**3.3**	**3.2**	**1.1**	**1.1**	**3.0**

CESEE: GDP Growth Forecasts (percent)



Source: IMF World Economic Outlook database.
1/ Weighted average by GDP valued at purchasing power parity. 2/Estonia, Latvia, Lithuania; 3/ Czech Republic, Hunagry, Poland, Slovak Republic, and Slovenia; 4/Bulgaria, Croatia, and Romania; 5/ Albania, Bosnia and Herzegovina, Kosovo, Macedonia FYR, Montenegro, and Serbia; 6/Belarus, Moldova, and Ukraine.

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Risks remain tilted to the downside. Some risks, such as the pace of monetary policy normalization in advanced economies and the refugee crisis in Europe, appear less prominent than six months ago. Other risks, such as those associated with rising political discord, inward-looking sentiments and policy uncertainty, have become more pronounced. Despite its modest impact so far, Brexit's longer-term effects are unclear, given the uncertainties surrounding the new economic arrangements between the United Kingdom and the European Union.

Macroeconomic policies need to strike a balance between supporting near-term growth and rebuilding fiscal buffers. Over the near-term, *monetary policy* should remain accommodative, given low expected inflation. *Fiscal policy* is generally expected to be neutral or expansionary, with most countries running structural fiscal deficits. In countries where solid growth has continued for a number of years and unemployment rates are back to pre-crisis levels, the relatively good times should be used to rebuild fiscal buffers relying as much as possible on growth-friendly measures.

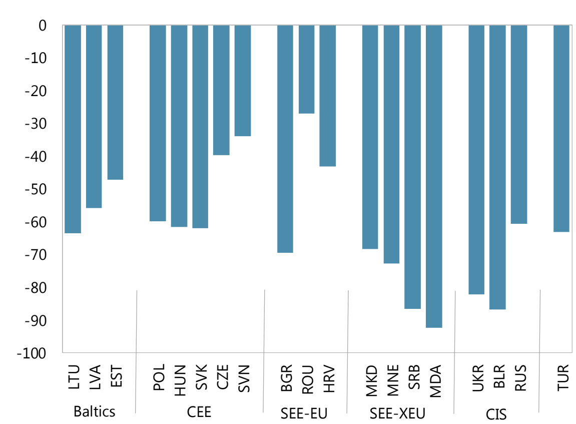
However, strong medium-term growth requires further structural reforms

Trend growth is appreciably below pre-crisis levels. Given low investment and adverse demographics, CESEE countries may not be able to maintain current strong growth without either significantly boosting productivity or facing a renewed widening of external imbalances. Lifting investment and productivity may require further structural reforms focused on strengthening institutions and raising government efficiency. The latter is the focus of the *Fall 2016 Regional Economic Issues* report.

More effective government can help support growth

The need to lift potential growth and rebuild fiscal buffers puts a premium on improving public investment management and tax administration in CESEE. Given that most countries in the region have large gaps in public capital stock and infrastructure relative to advanced Europe (see Figure), there is a significant scope for public investment, which—if carried out efficiently—would boost potential growth in the region. At the same time, many CESEE countries are still facing sizeable fiscal deficits. In this context, improving public investment management institutions and tax administration can help to free up additional resources that can be used to boost public investment or reduce the elevated fiscal deficits.

Public Capital Stock Gaps, Per Capita
(Percent of EU-15 capital stock per capita, 2015)



Source: IMF Investment and Capital Stock Dataset (ICSD).
Note: CEE = Central and Eastern Europe; CIS = Commonwealth of Independent States; SEE-XEU = Southeastern European countries outside the European Union.

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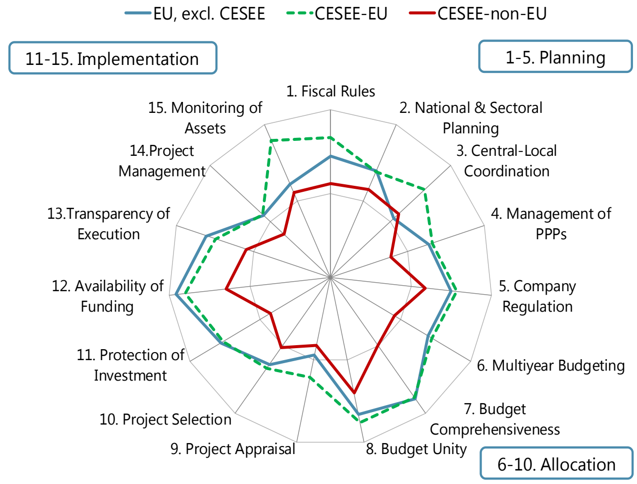
Making public investment more efficient would require improvements in public investment management. Further upgrades should focus on allocation and implementation frameworks and procedures, where room for improvement is relatively large in most countries in the region (see Figure). The non-EU CESEE countries would also benefit from increasing transparency of implementation, ensuring timely availability of funding, as well as improving company regulation and management of public-private partnerships (PPPs). In the CESEE EU countries, stronger public investment management institutions are associated with higher absorption of the EU funds.

CESEE vs. Peers: Strength of Public Investment Management Institutions

(score 0 to 10, 10 = best)

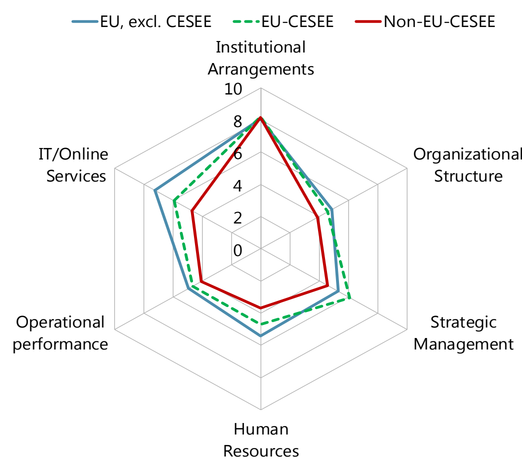


Source: IMF Staff assessments.

Improvements in tax administration should aim at reducing compliance gaps. Although many countries in the region have core elements of modern tax administration (see Figure), tax compliance gaps are still large. Reform efforts should focus on bringing institutional arrangements in line with best practices (in countries where tax collection is not unified in a single body or where a functional structure is lacking), upgrading information technology (IT) systems, strengthening the risk management approach to compliance and improving operational performance (especially in countries where tax debt is high).

Tax Administration Strength in Core Areas

(10 = most efficient)



Sources: OECD; and IMF staff calculations.

Raising efficiency of public investment and tax administration can bring sizable benefits. By reducing efficiency gaps (estimated relative to the income level-specific benchmarks), CESEE countries could generate between 2 and 4 percent of GDP in fiscal savings over the medium term that could be used either for public investment or for fiscal consolidation. Using standard estimates for public investment multipliers (see October 2014 *World Economic Outlook)*, suggests that the boost to the GDP level from such additional investment could be 2–4 percent over the medium term. There are also broader benefits from having better public institutions, including a smaller shadow economy.

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