Regional Economic Issues in CESEE

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Outlook for CESEE
Within CESEE dichotomy: CIS was in recession, but non-CIS fairly strong.
CIS was hit by oil price decline, sanctions and conflict in Ukraine, but is now recovering.
By contrast, EU new member states continue to recover from 2009 crisis.
October 2016 WEO projections: pick-up in CIS in 2017, and continued strong growth in rest of CESEE
After projections were made Donald Trump was elected, which was not quite expected by markets.
Since the election there has been a sharp increase in US long-term interest rates.
...as financial markets have become more optimistic...
Dollar appreciated strongly

Exchange rate of USD against G20* currencies
(Day of US Elections=100, GDP-weighted)

*DEU, FRA, ITA and EU are replaced by EA.
Financial conditions for EMs have tightened, but spreads broadly unchanged
In CESEE, exchange rates have depreciated vis-à-vis dollar, except RUB (oil prices up)

Exchange rates of USD against selected currencies (Day of US Elections=100, 5-day moving average)
Markets seem to anticipate US fiscal stimulus and higher US growth. What does this mean for CESEE?

- **Stronger US growth**
  - Will boost exports, but at risk of more protectionism
  - May boost commodity prices

- **Stronger dollar**
  - Helps exporters ✓
  - Negative balance sheet effects for dollar-indebted ✗

- **Higher financing costs**
  - Hurts countries with weak growth ✗
  - May help countries that are advanced in the cycle ✓
For CESEE overall impact likely to be modest

- But this will depend on US policies, which are not quite clear at this stage.
- There are also risks:
  - Increase in US protectionism, which could lead to trade war
  - With already low unemployment, large fiscal stimulus could lead to much faster than expected monetary tightening.
Indeed, projections for CESEE roughly unchanged.

GDP growth in 2017 according to different WEO vintages
(Percent)

<table>
<thead>
<tr>
<th>Country</th>
<th>WEO Oct-16</th>
<th>WEO Jan-17</th>
</tr>
</thead>
<tbody>
<tr>
<td>CIS</td>
<td>1.0</td>
<td>1.1</td>
</tr>
<tr>
<td>Euro area</td>
<td>1.0</td>
<td>1.2</td>
</tr>
<tr>
<td>Baltics</td>
<td>3.0</td>
<td>3.2</td>
</tr>
<tr>
<td>CE-5</td>
<td>3.0</td>
<td>3.2</td>
</tr>
<tr>
<td>SEE non-EU</td>
<td>3.0</td>
<td>3.2</td>
</tr>
<tr>
<td>SEE EU</td>
<td>3.0</td>
<td>3.2</td>
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</tbody>
</table>
Bigger risk may be Europe. Unhappiness with EU has increased sharply in past decade...

Level of confidence in the European Union
(Percent of population surveyed by Eurobarometer)
Further fueled by concerns about migrations and economy

Most important issues facing the EU countries in 2016
(According to Eurobarometer)

Immigration

Unemployment or economic situation
There are a number of important elections in 2017

- French presidential elections
- German federal elections
- Dutch general elections
- (Possibly) Italian general elections
How will this affect further expansion to Western Balkans?
Remaining and future challenges
The 2009 crisis was deep, but most CESEE countries have recovered to above pre-crisis levels.
Unemployment in the EU New Member states is coming down rapidly.
However, there are crisis legacies

- Financial sector:
  - High share of non-performing loans
- Government sector:
  - Rebuild fiscal buffers
Clean up banks’ balance sheets: NPLs have come down (although they are still high in SEE and Ukraine)

Non-performing loans to total loans, 2016
(Percent)

Note: for MNE and BGR data for 2012 and 2015.
How to deal with high NPLs?

IMF STAFF DISCUSSION NOTE

A Strategy for Resolving Europe’s Problem Loans

Shekhar Aiyar, Wolfgang Bergthaler, Jose M. Garrido, Anna Ilyina, Andreas Jobst, Kenneth Kang, Dmitriy Kevtun, Yan Liu, Dermot Monaghan, and Marina Moretti

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Fiscal deficits have declined to more modest levels...
But public debt is no longer low.
In past 25 years, region has made tremendous progress
But more recently, convergence has slowed
Further convergence will require both higher labor *input* and labor *productivity*.

Labor productivity and employment to total population ratio, 2015

Flags size reflects GDP per capita in 2015 (PPP-adjusted).

Labor productivity (PPP adjusted 2014 USD, thousands)
Labor input looks relatively high, but this is partly because a large share of the population is between 15 and 64 (working age).

Note: Simple average of given countries.
If we compare employment to working age population rate differences in labor input with Germany are more pronounced.

Labor productivity and utilization, 2015

Flags size reflects GDP per capita in 2015 (PPP-adjusted).
Indeed, employment rates are still well below Germany—with the exception of Baltics.

Note: Simple average of given countries.
Aging will accelerate in the next decade

Working age (15-64) population growth (percent)
Emigration exacerbates the labor supply problem

Net migration rate, 2015
(Migrants per 1000 population)
It will be important to increase labor force participation, including of women.

Labor force participation rate, 2015
(percent of either male or female population ages 15-64)
While higher labor input will help, higher capital stock and thereby labor productivity may be even more important.

**Capital stock and GDP per capita, 2015** (thousands of 2010 EUR)

\[
y = 0.3451x + 1.6927 \\
R^2 = 0.8514
\]

**Employment to population ratio and GDP per capita, 2015** (percent and thousands of 2010 EUR)

\[
y = 0.7094x - 6.5368 \\
R^2 = 0.0276
\]
However, growth of capital stock has slowed...

Net capital stock per worker growth
(3-year annualized change, percent)
...as investment rates post-crisis are (too) low.

Investment to GDP ratio, 2015
(percent)

Emerging markets and developing economies
Low investment not only problem: TFP growth has slowed as well...

**Average total factor productivity growth (percent)**

![Map of Europe showing TFP growth from 2000-04 and 2010-14](image)
So what should be done?
Address factors that might constrain productivity (REI May-16)

- Insufficient protection of property rights and
- Inefficient legal systems and other government services
- Limited access to financial services (e.g. for SMEs)
- Infrastructural gaps
Closing efficiency gaps in public investment and tax collection could bring sizable benefits.

Further upgrades of public investment management should focus on improving allocation and implementation frameworks and procedures.

Improvements in tax administration should aim at reducing compliance gaps.

Design of reforms should include elements that help reduce resistance to reforms and build the support base for their successful completion.
Thank you