Central, Eastern, and Southeastern Europe: The Past and Future of Convergence

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Global growth in 2018 is highest since 2011

Global Real GDP growth according to various WEO vintages (Percent)
Advanced economies are growing around 2 ¼ percent, China and India, 7, other EMCs, 3½
USA will grow by 2.7 percent, euro area by 2.2, and Japan by 1.2
Unemployment rate in advanced countries is near pre-crisis low
Fed has started to tighten, ECB rates are expected to remain low for longer.

US and EA Policy Rates and Forecasts (Percent)

- Fed
- ECB
- FOMC Projections
- ECB Survey of Professional Forecasters
In CESEE, CIS recovering and non-CIS growing strongly

Real GDP growth (Percent)

CIS
Other CESEE
NON-CIS CESEE
Growth is rapid, and unemployment is falling sharply

Real GDP growth
(Percent)

Unemployment Rate
(Percent)
Unemployment is now below pre-crisis levels in many countries
Growth in the region is not as high as in the pre-crisis years.

Real GDP growth in CESEE excl. CIS (Percent)
But employment growth in many countries is as high as during pre-crisis peaks.
Inflation, which was very low in 2015-16 has picked up recently.
Energy and food prices played key role in pick-up of inflation
But wage growth has also accelerated
Growth in 2018 will continue to be strong

- External demand expected to remain strong in the next quarters...

- Consumption is solid as employment is growing rapidly and wages are accelerating

- Investment further boosted by pick-up of EU funds
What will this imply for labor markets?

Employment and Working Age Population Growth in CESEE (Excl. TUR and CIS, percent)
This would be the good time to create fiscal space and reduce structural deficits.

- Particularly given that debt is much higher than pre-crisis levels.

**General Government Debt (Percent of GDP)**

- 2007
- 2017
Unfortunately, many countries with too high structural deficits are reverting to pro-cyclical loosening.
In 2014-15, Russia and Ukraine suffered from shocks, and Belarus from spillovers

- Collapse of commodity prices
- Sudden stop in capital flows to Russia, result of sanctions on Russia
- Conflict in Ukraine
Exchange rate flexibility was unavoidable given the limited buffers…
...but increased inflation and reduced real wages
Ukraine and Russia are now recovering (helped by rising oil prices)

Real GDP growth in Russia, other CIS countries and changes in oil prices (Percent, y/y)
Near-term prospects show solid growth

Real GDP Growth Projections (Percent)
CONVERGENCE: PAST
Since the abolition of communism, most of CESEE has become much richer—both in absolute and relative terms.
But not all countries have done equally well

Change in GDP PPP per capita between 1989 and 2017

(Percent)
Compare Poland vs Ukraine

- Poland has done much better than Ukraine
- In 1989 they were equally rich
- Now Poland is three times as rich
- Why?
  - Poland more macro-stability
  - Poland reformed more and earlier
  - Poland has better institutions
Difference is clearly visible on satellite pictures.
Macro-stabilization occurred much earlier in Poland
Poland has not had any crisis; Ukraine has had three.
Poland reformed earlier and deeper

Average of EBRD Transition Indicators

- Poland
- Ukraine

Max

1989 1991 1993 1995 1997 1999 2001 2003 2005 2007 2009 2011 2013
Poland has much better institutions

Worldwide Governance Indicators, 2016
(CESEE countries in global ranking)
CONVERGENCE: FUTURE
After deep crisis in 2009, convergence has resumed (except in CIS)
But growth is slower than pre-crisis…

GDP growth
(Percent, 3 year moving average)
As investment rates are lower (except CIS)
The working age population is declining (leading to less labor supply)
And TFP growth is lower

TFP Growth
(Percent, 5-year moving average)
Productivity is too low to sustain rapid GDP growth
As employment growth cannot continue to grow so much faster than the working age population.

**Employment and Working Age Population Growth in CESEE**
(Excl. TUR and CIS, percent)
What can be done to boost TFP growth?

- Improve institutions
- Improve legal systems and government effectiveness
- Improve tax efficiency
- Address infrastructural gaps
Government effectiveness not as strong as in Western Europe

World Governance Indicators, 2016
(Ranges from -2.5 (weak) to 2.5 (strong) governance performance)
Judicial systems are also weaker

Judicial Independence, 2015

Impartial Courts, 2015

- Below 25 percentile
- Between 25 and 75 percentile
- Above 75 percentile

Source: World Economic Forum. Note: Worldwide distribution excluding LICs
How would institutional reforms help?

- Better institutions hold the promise of retaining emigration of skilled workers

- Effective protection of property rights provides stronger incentives for investment

- Institutions affect innovation and productivity through enhanced trust, cooperation, commitment, and contract enforcement
CONCLUSION
Concluding thoughts

- CESEE has done nicely in recent years with strong growth and rapidly declining unemployment.
- Growth is not as high as pre-crisis.
- The challenge will be to continue current growth rates.
- Productivity growth will need to pick up; at some stage labor market will become constraint.
- Reforms and improvements of institutions will help.
Thank you