

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



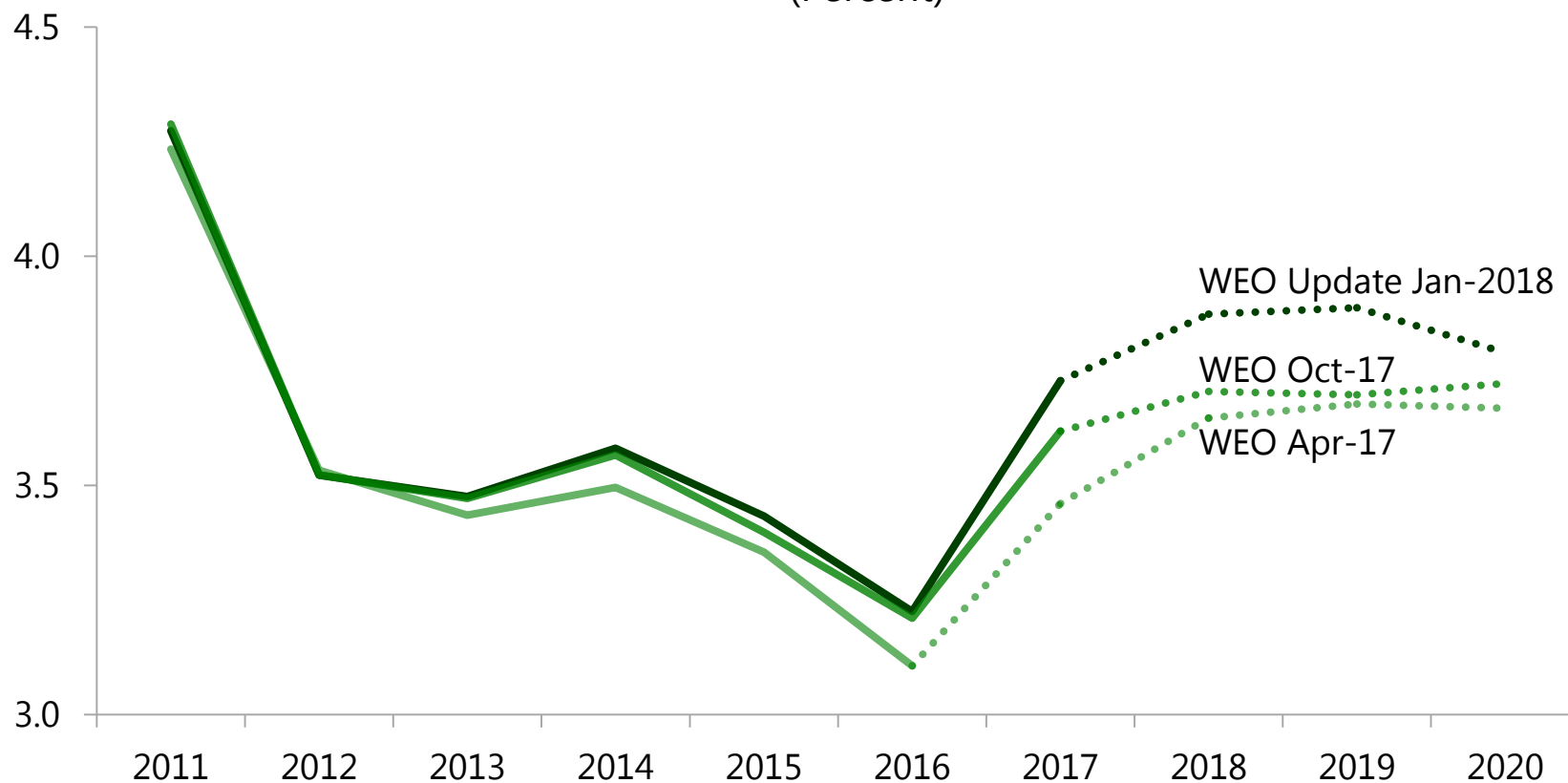
LSE SU Emerging Markets Forum
London, March 10, 2018

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for Central, Eastern and Southeastern Europe

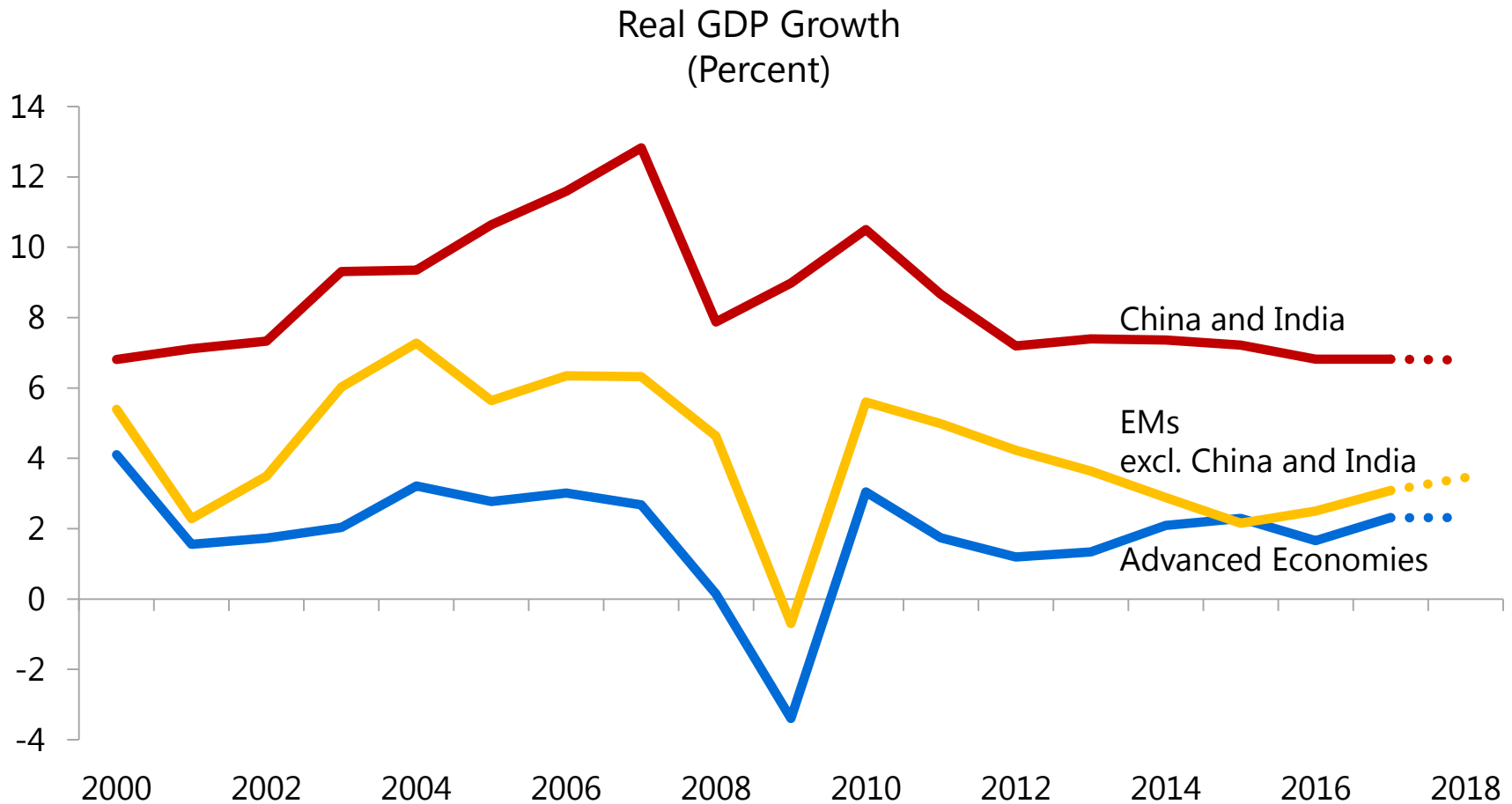
Global growth in 2018 is highest since 2011



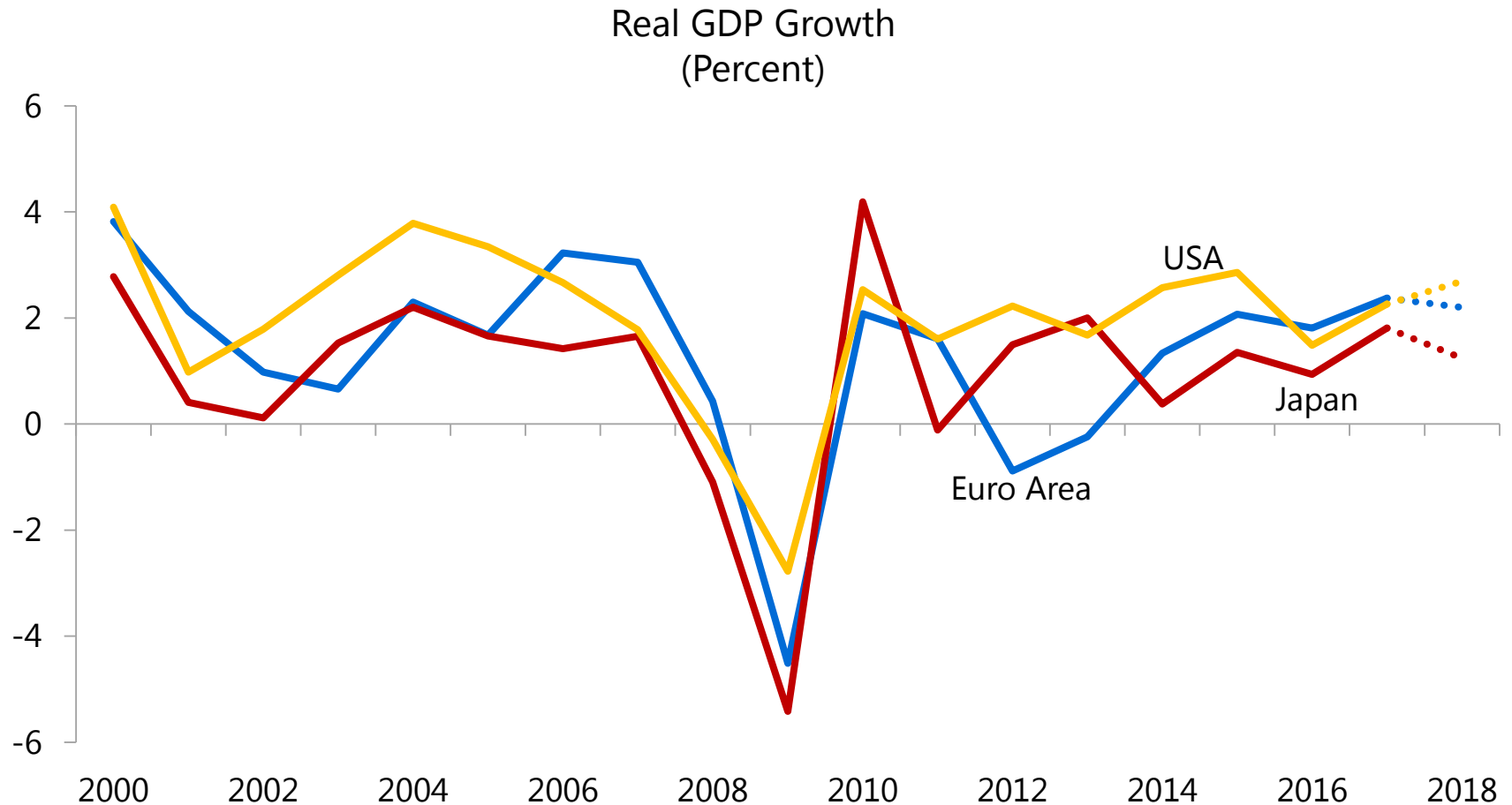
Global Real GDP growth according to various WEO vintages
(Percent)



Advanced economies are growing around 2 ¼ percent, China and India, 7, other EMCs, 3½



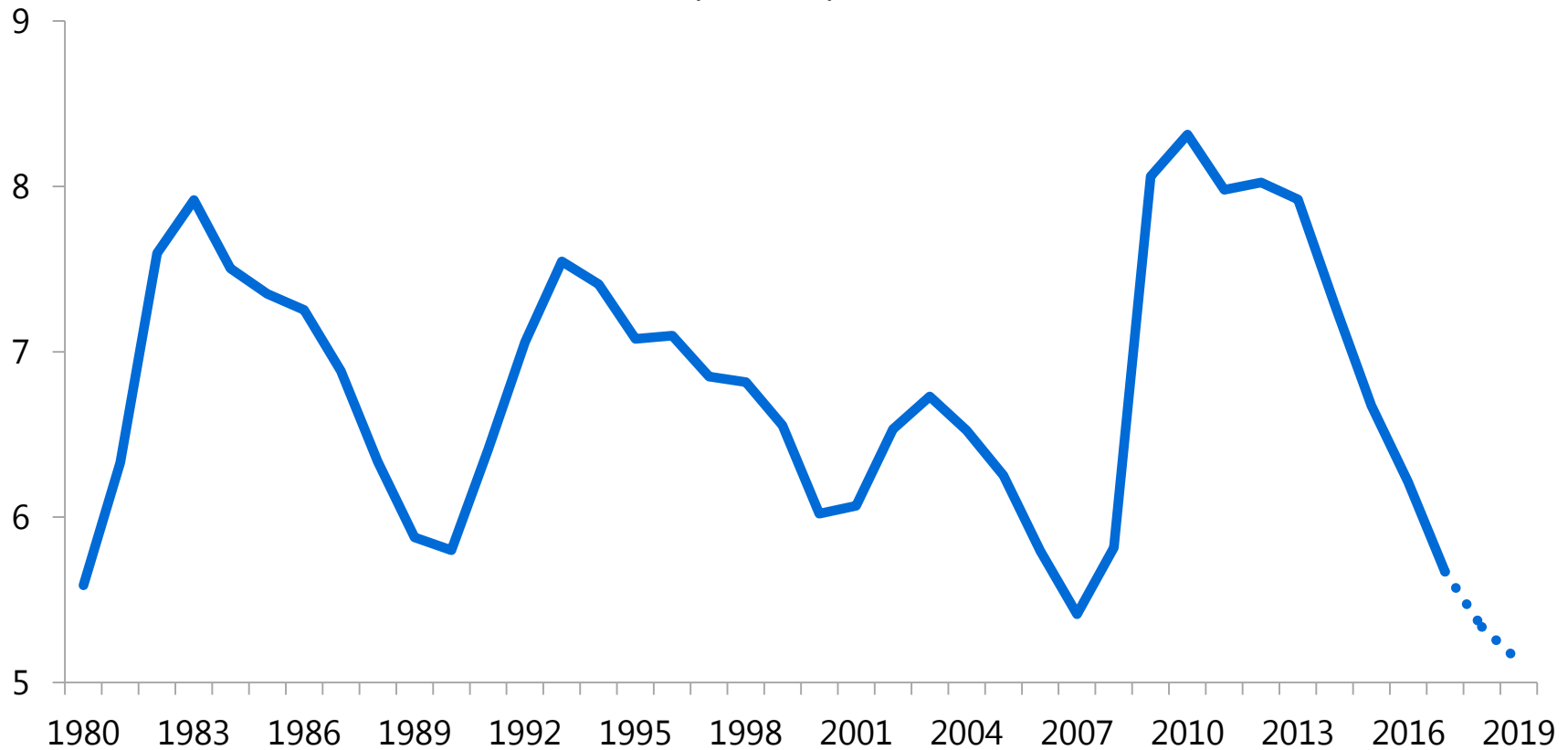
USA will grow by 2.7 percent, euro area by 2.2, and Japan by 1.2



Unemployment rate in advanced countries is near pre-crisis low



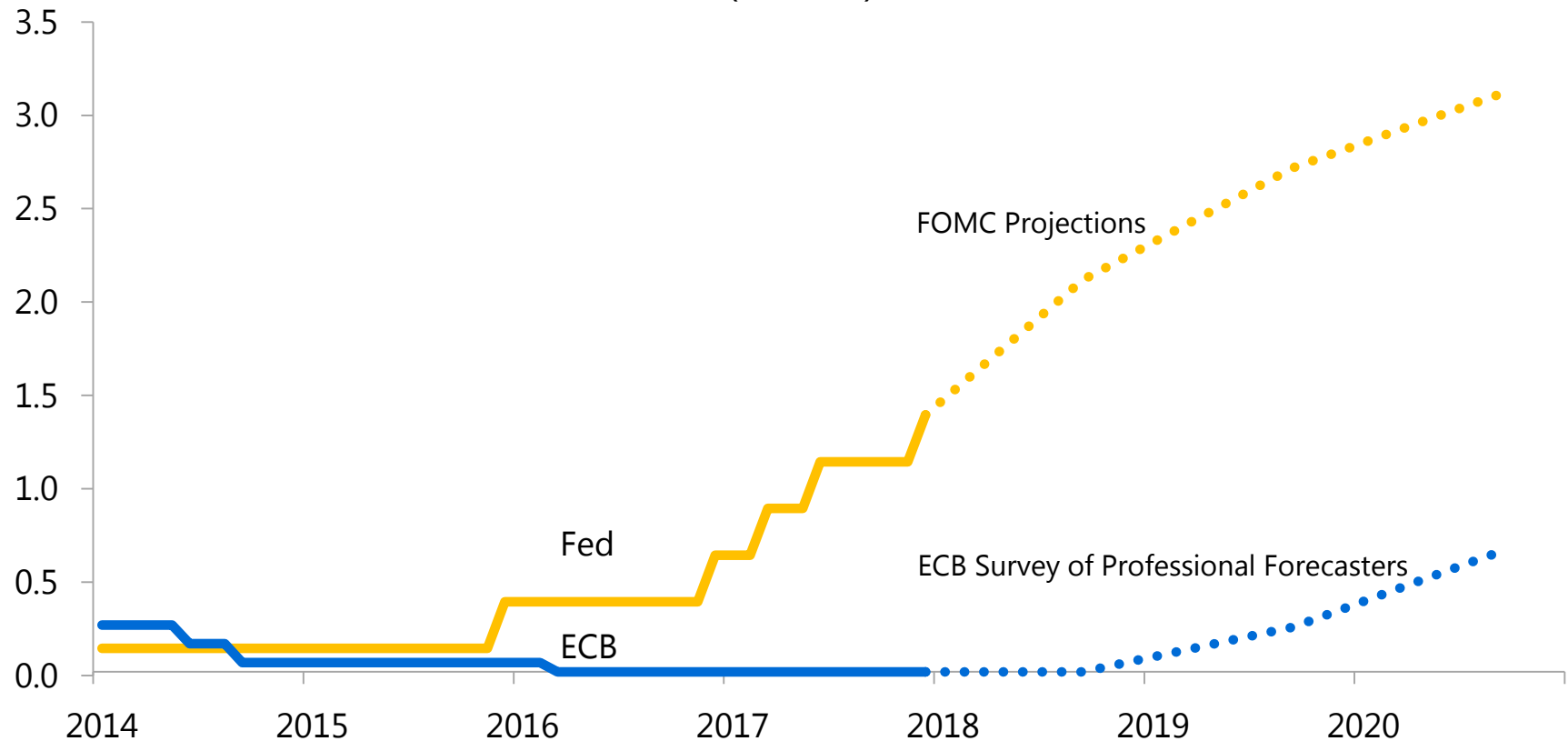
Unemployment Rate in Advanced Economies
(Percent)



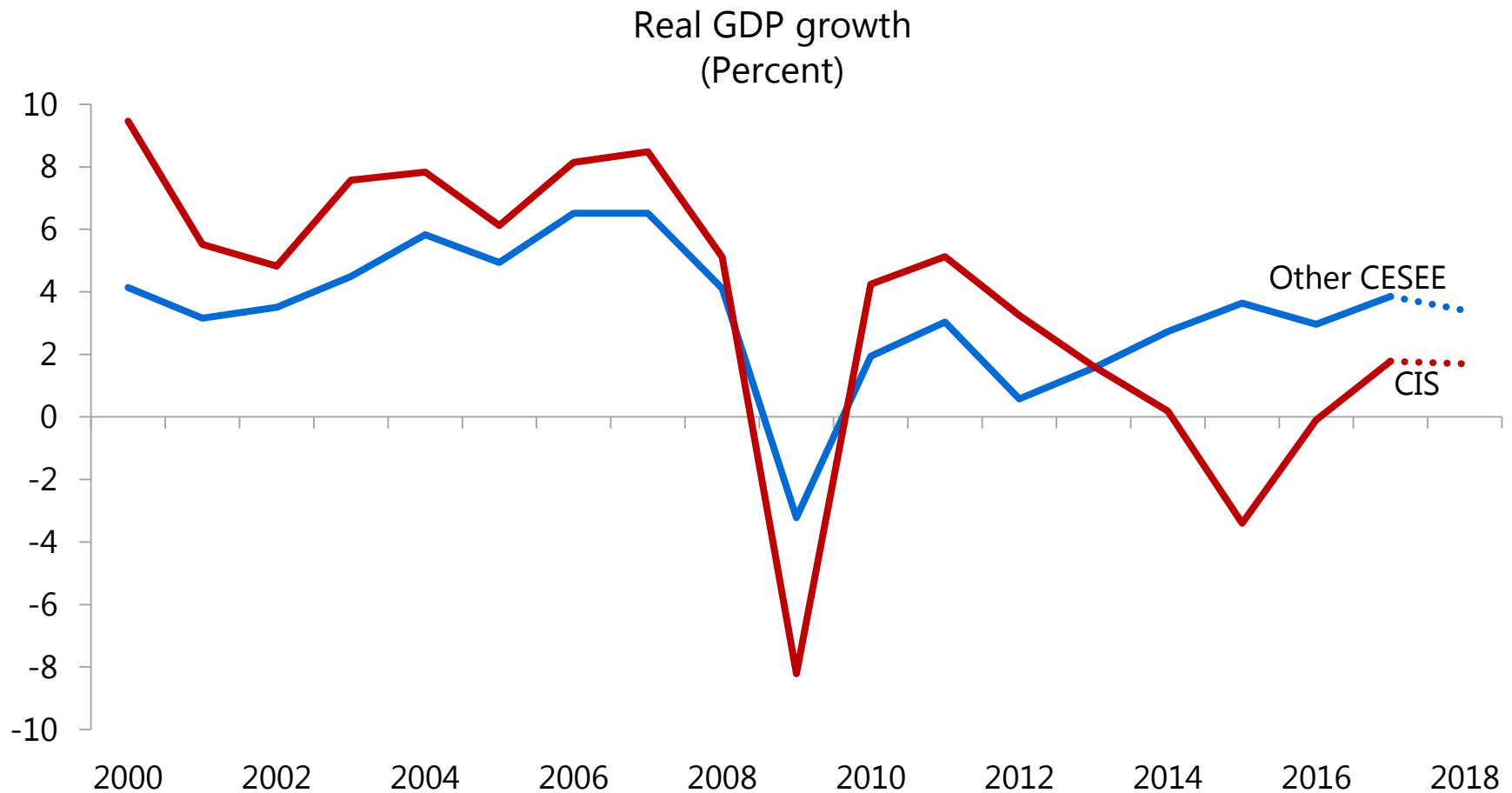
Fed has started to tighten, ECB rates are expected to remain low for longer



US and EA Policy Rates and Forecasts
(Percent)



In CESEE, CIS recovering and non-CIS growing strongly



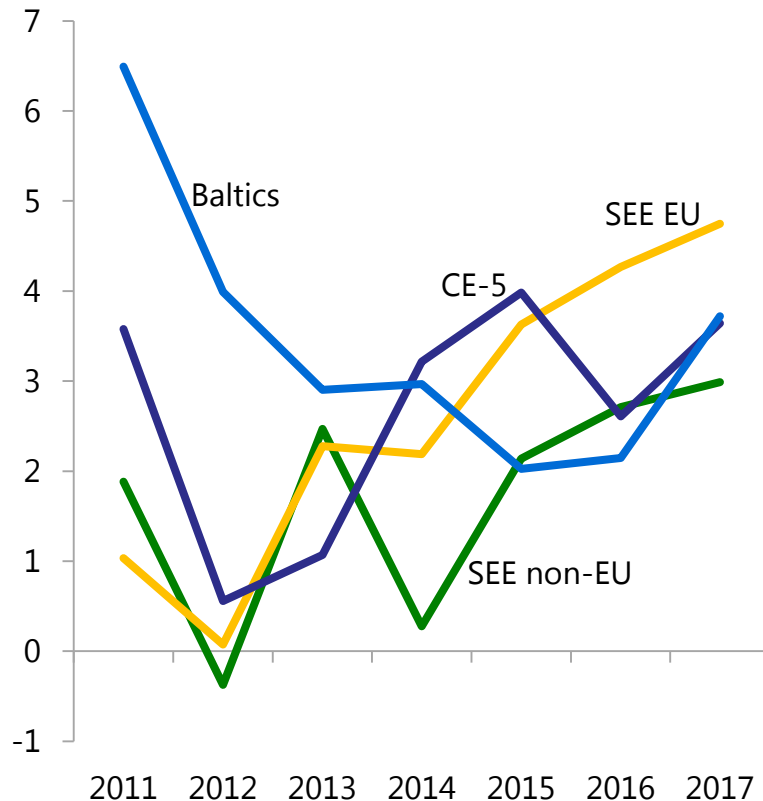


NON-CIS CESEE

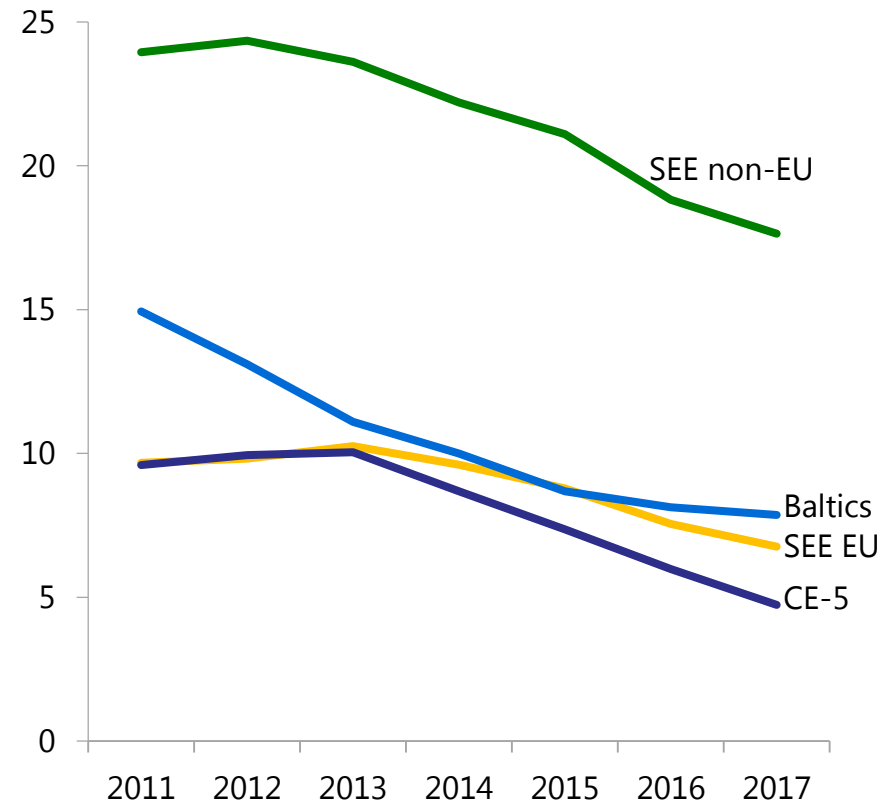
Growth is rapid, and unemployment is falling sharply



Real GDP growth
(Percent)



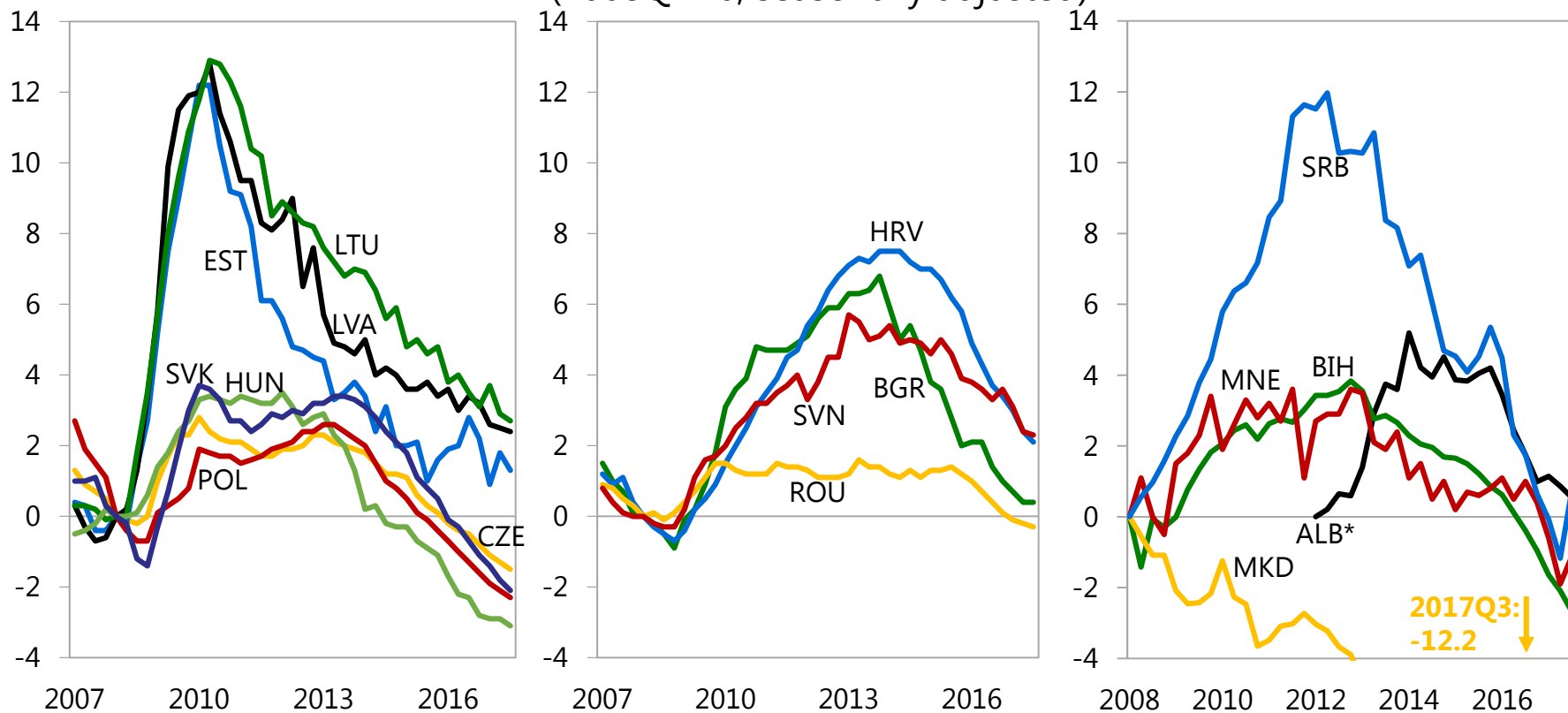
Unemployment Rate
(Percent)



Unemployment is now below pre-crisis levels in many countries

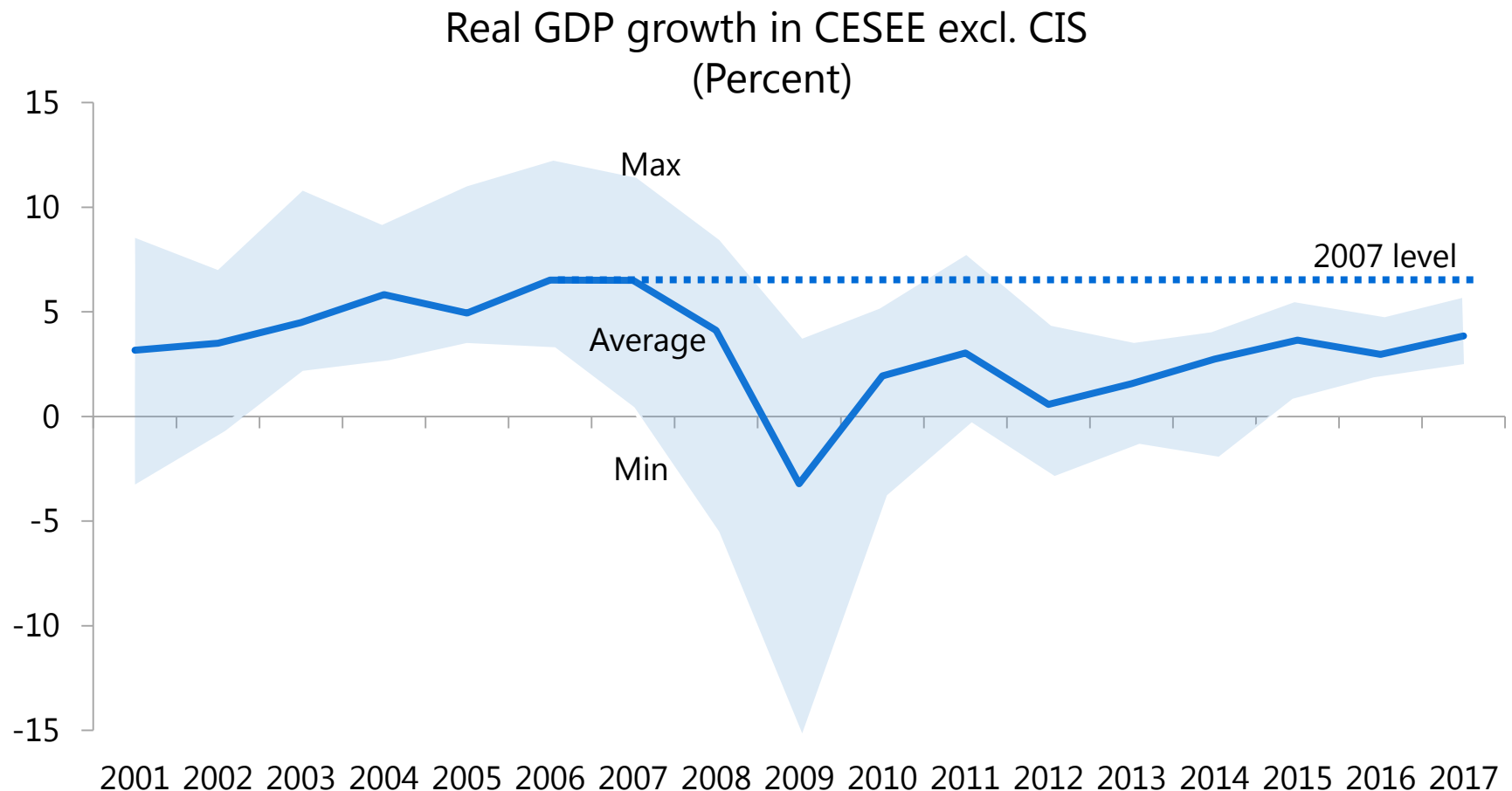


Cumulative Changes in Unemployment Rate
(2008Q1=0, seasonally adjusted)



*For ALB 2012Q1=0 10

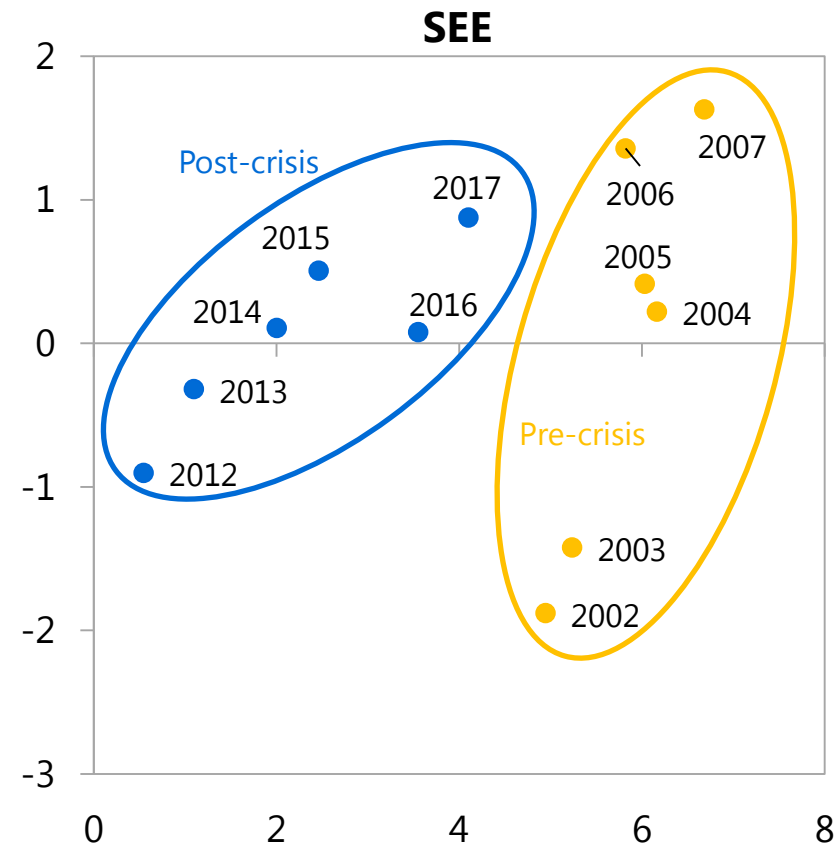
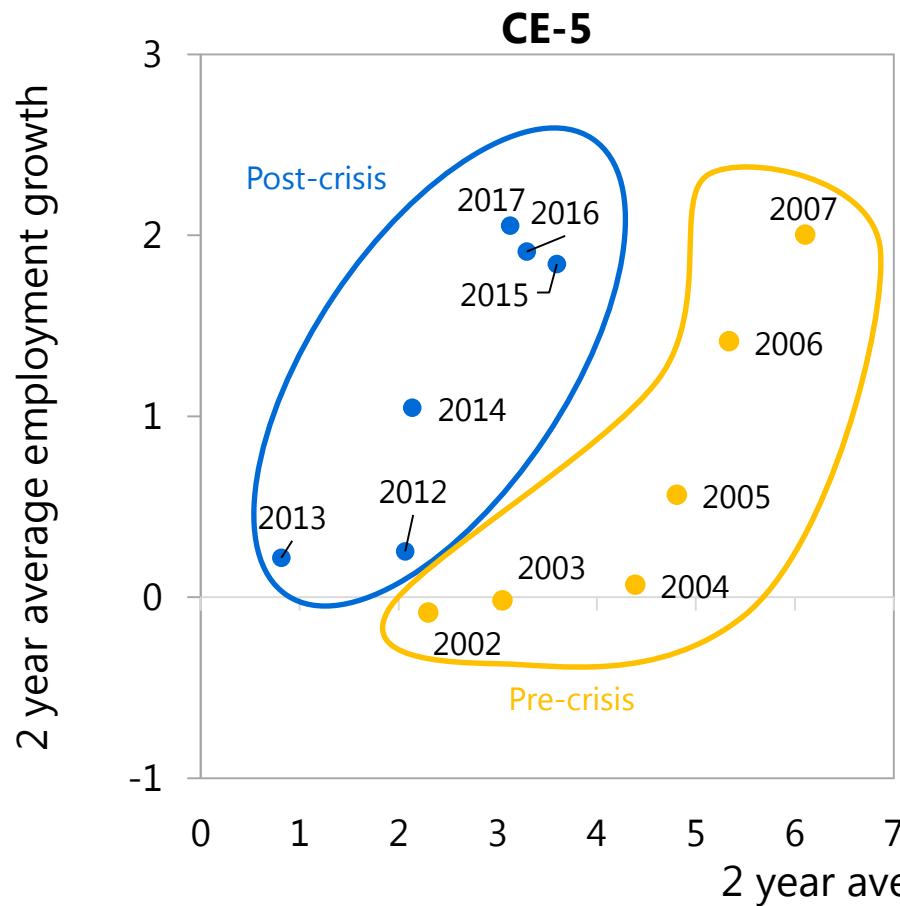
Growth in the region is not as high as in the pre-crisis years



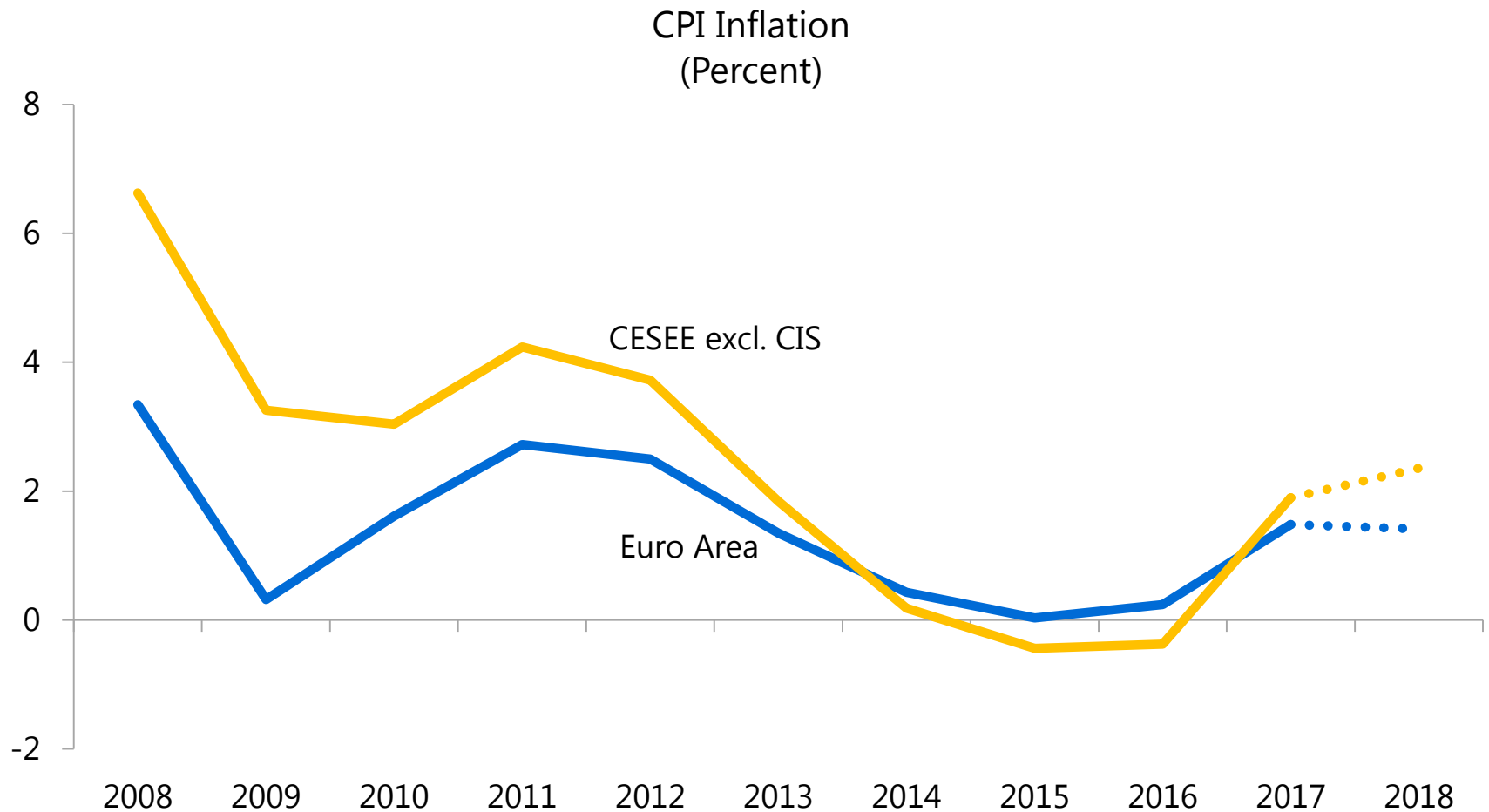
But employment growth in many countries is as high as during pre-crisis peaks



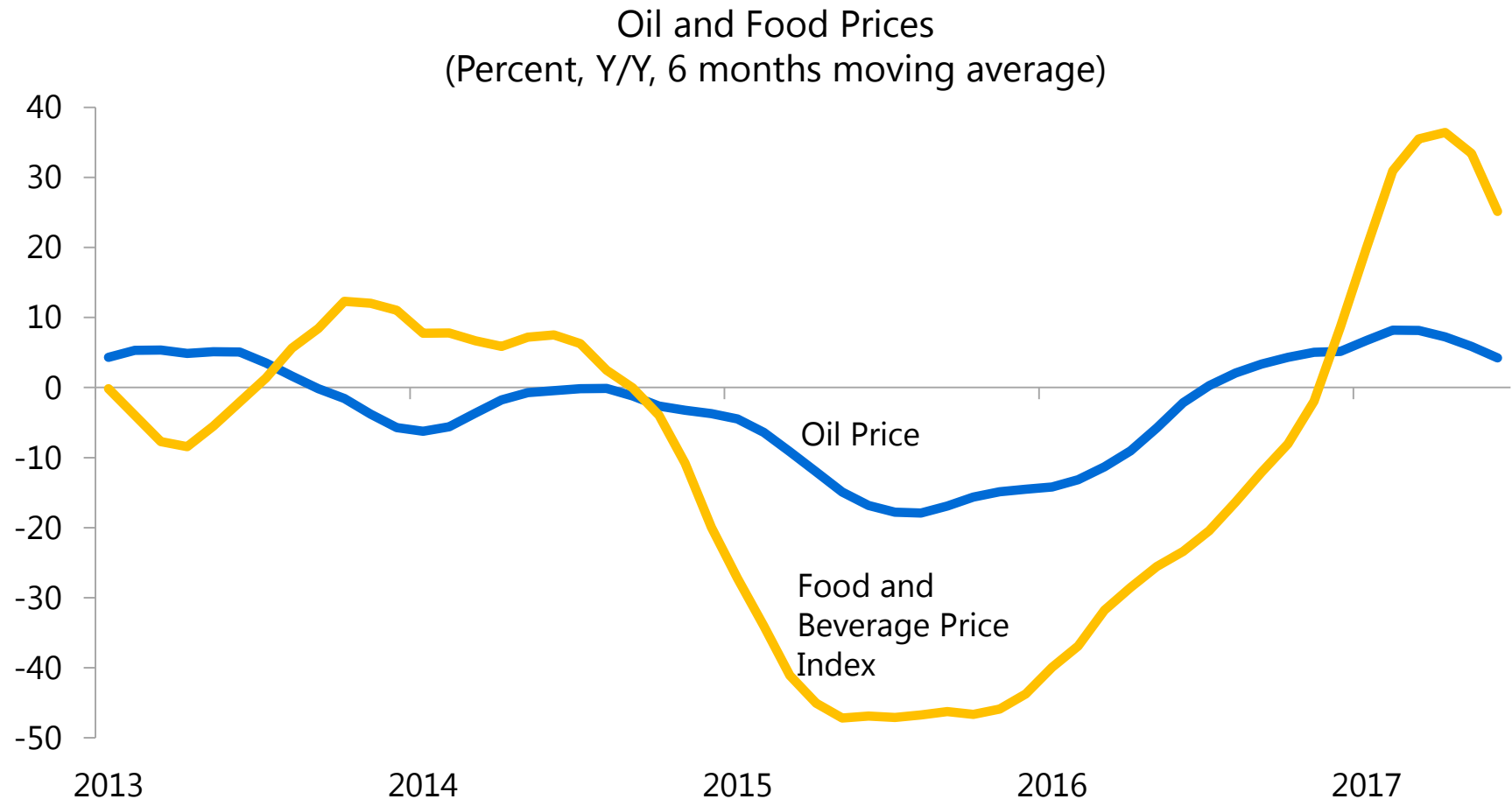
GDP growth vs. employment growth
(Percent, 2 year average)



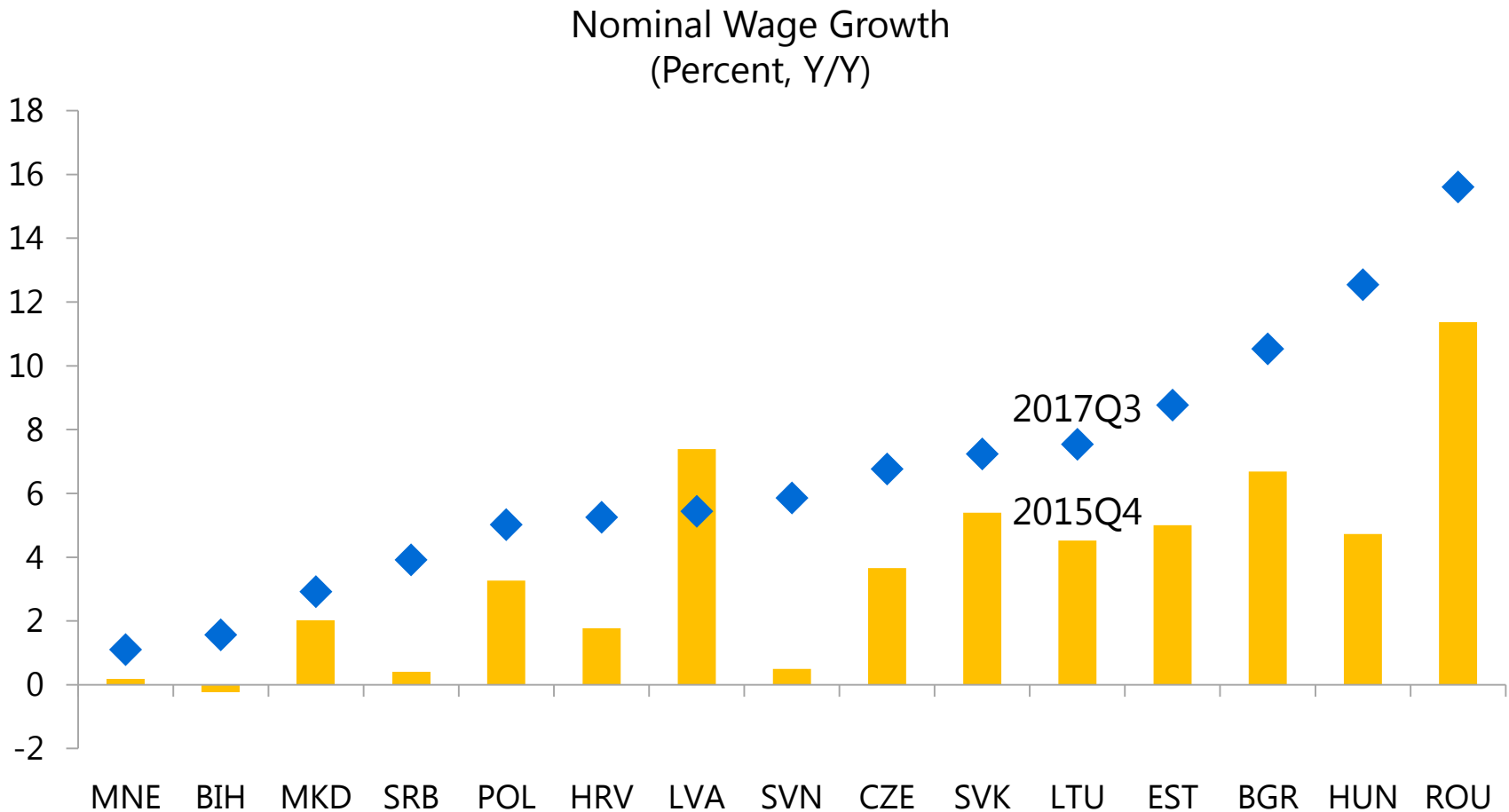
Inflation, which was very low in 2015-16 has picked up recently



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

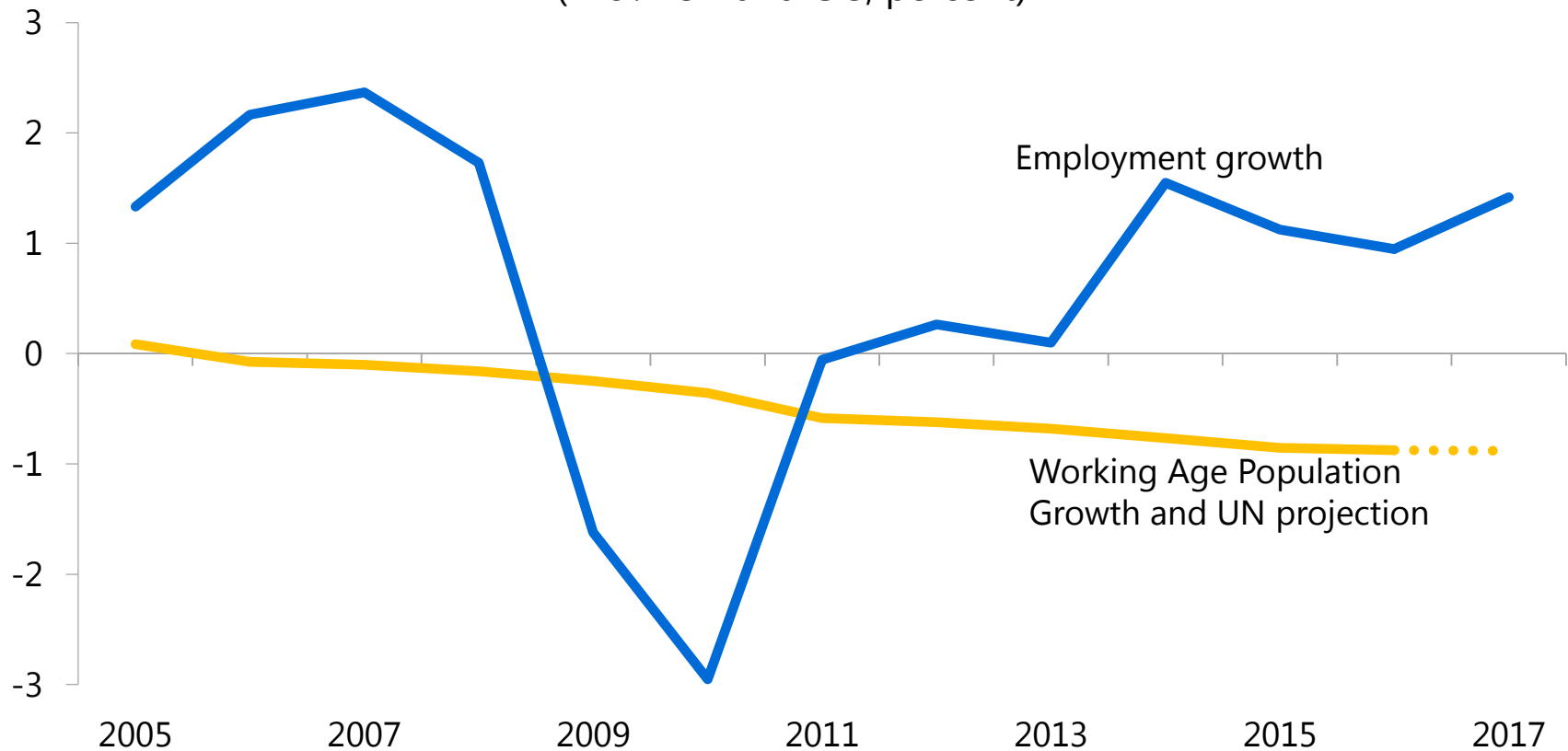


- External demand expected to remain strong in the next quarters...
- Consumption is solid as employment is growing rapidly and wages are accelerating
- Investment further boosted by pick-up of EU funds

What will this imply for labor markets?



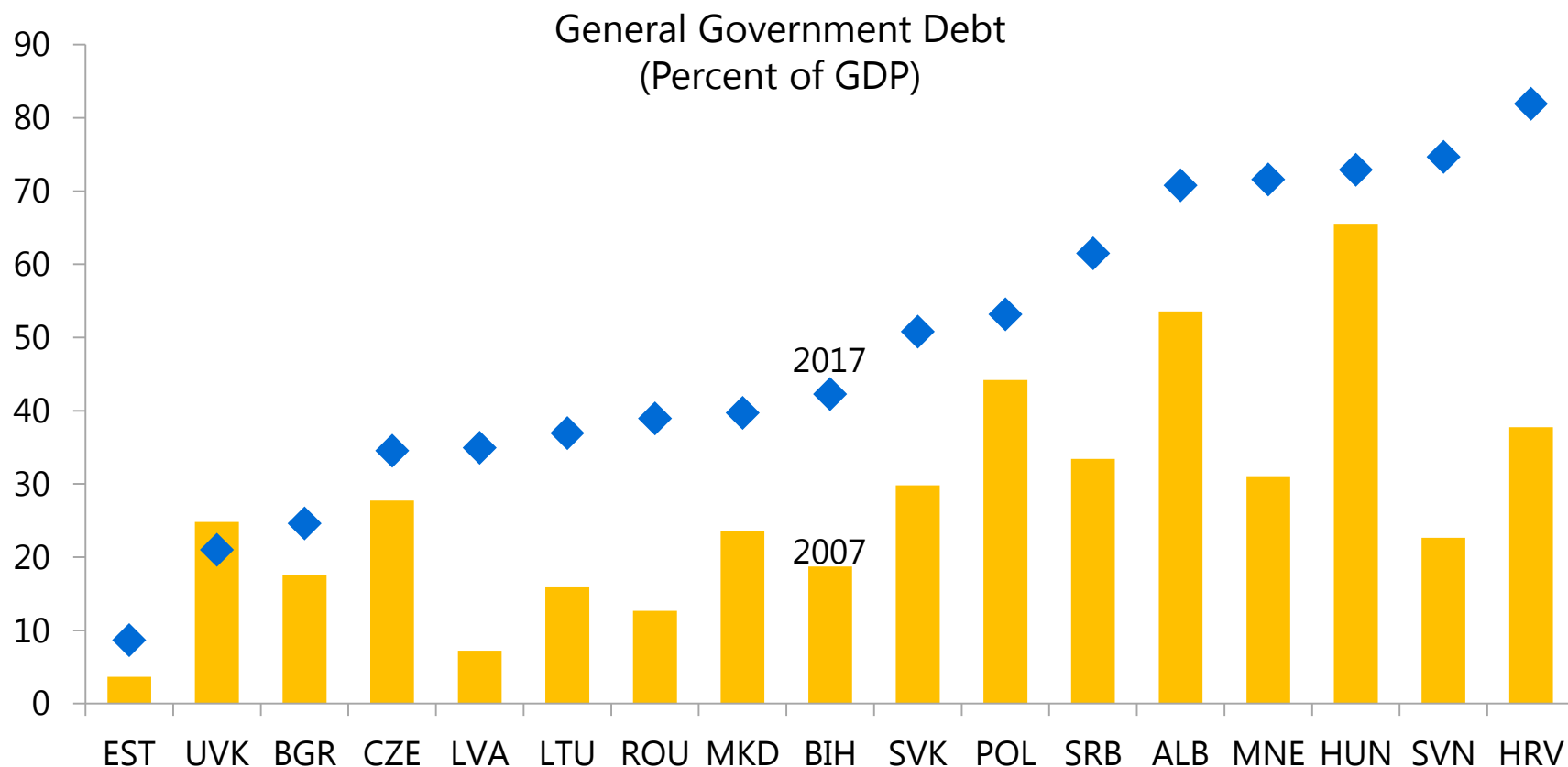
Employment and Working Age Population Growth in CESEE
(Excl. TUR and CIS, percent)



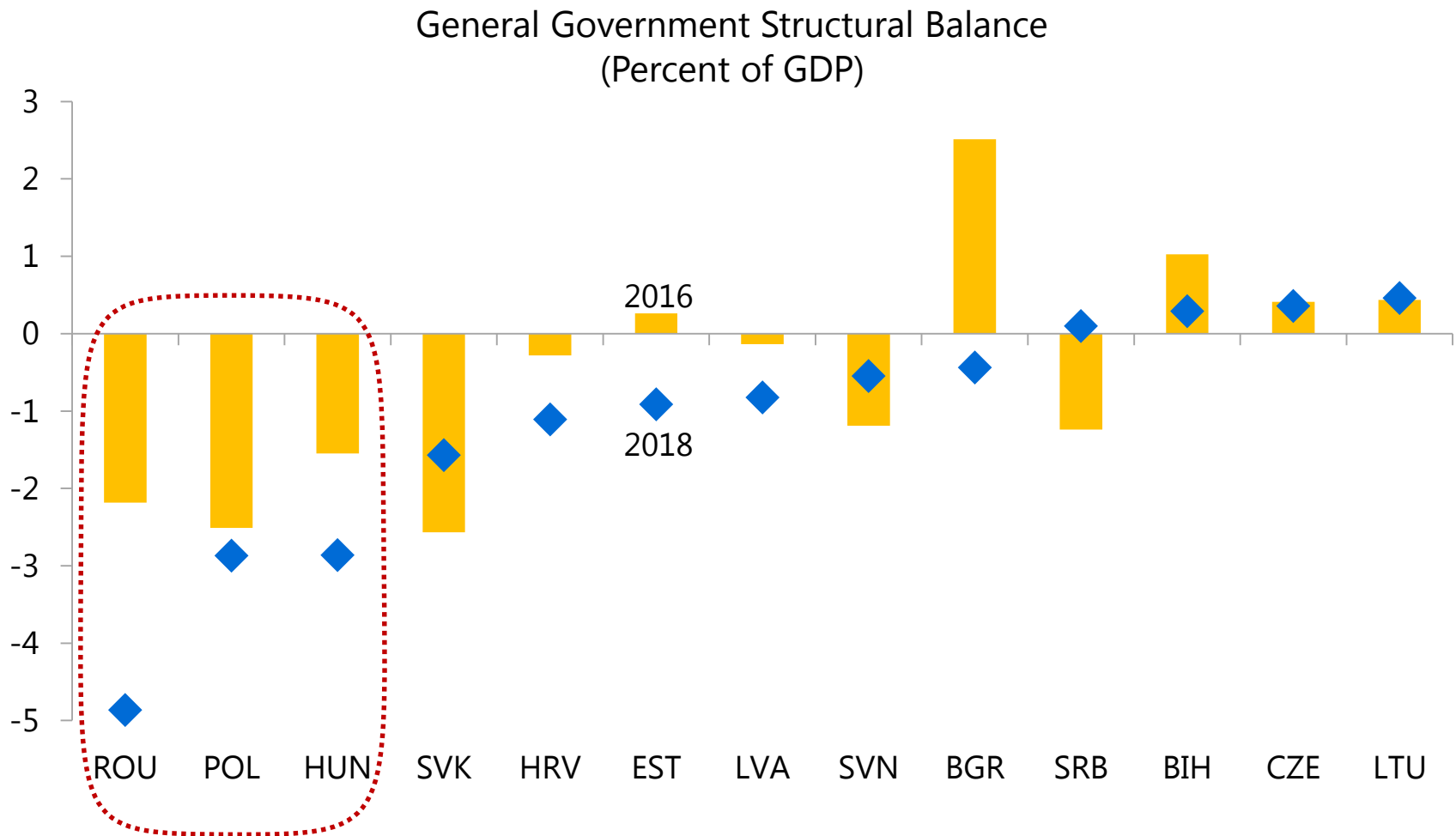
This would be the good time to create fiscal space and reduce structural deficits



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



Unfortunately, many countries with too high structural deficits are reverting to pro-cyclical loosening



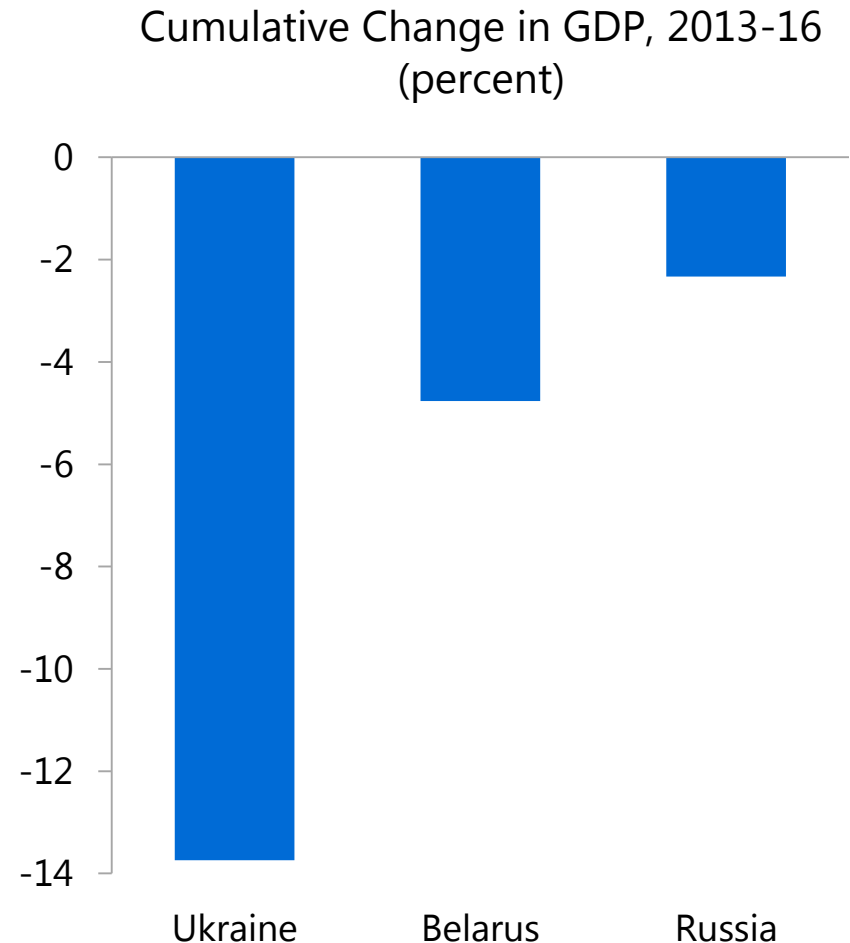


CIS

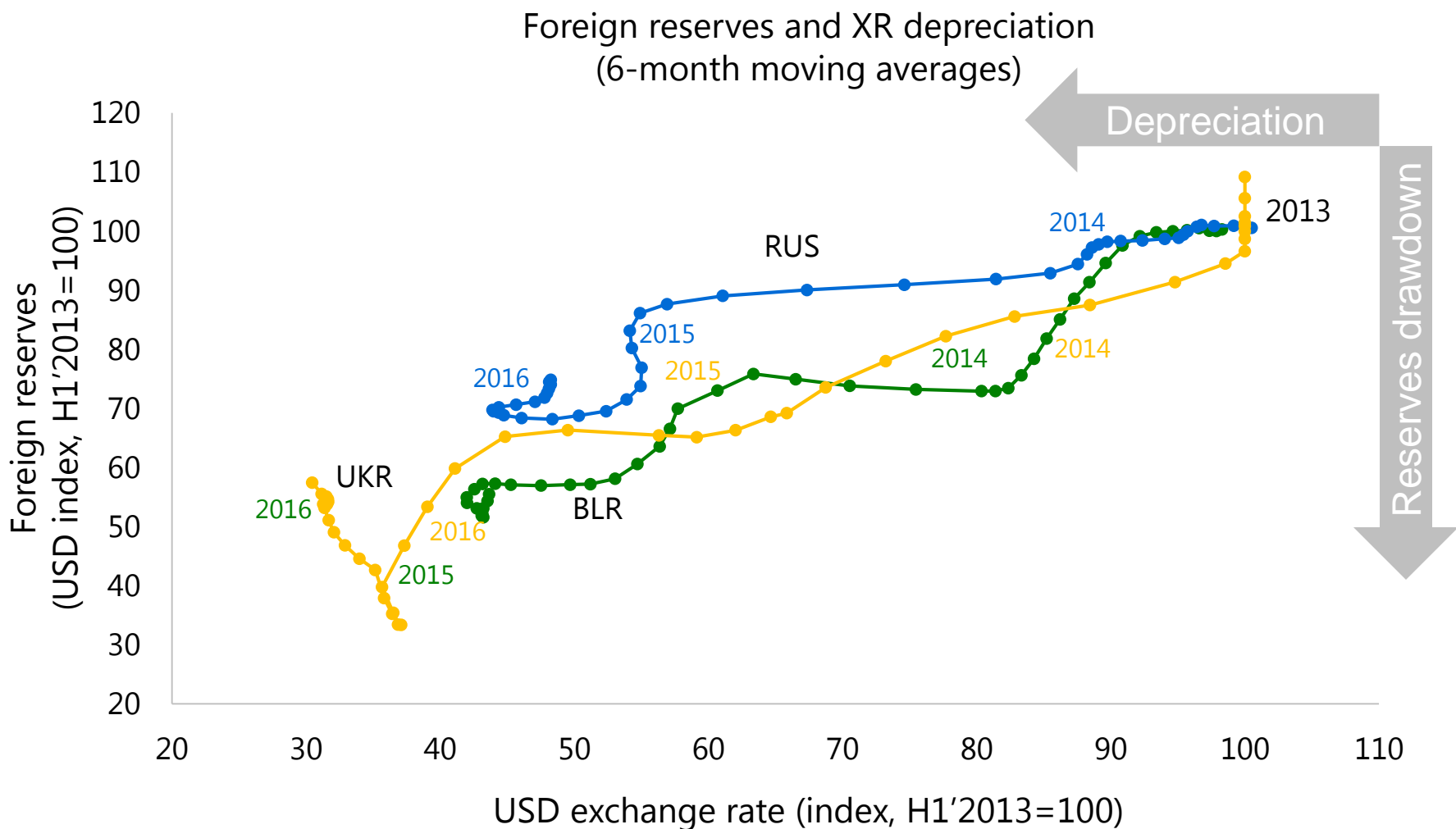
In 2014-15, Russia and Ukraine suffered from shocks, and Belarus from spillovers



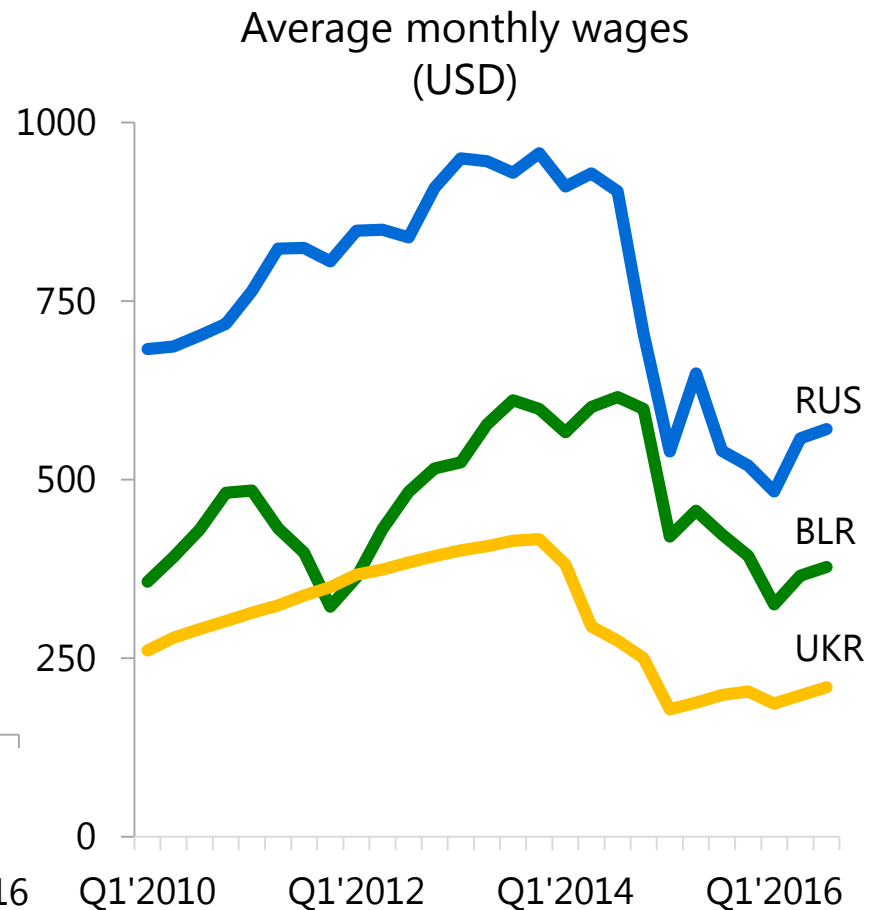
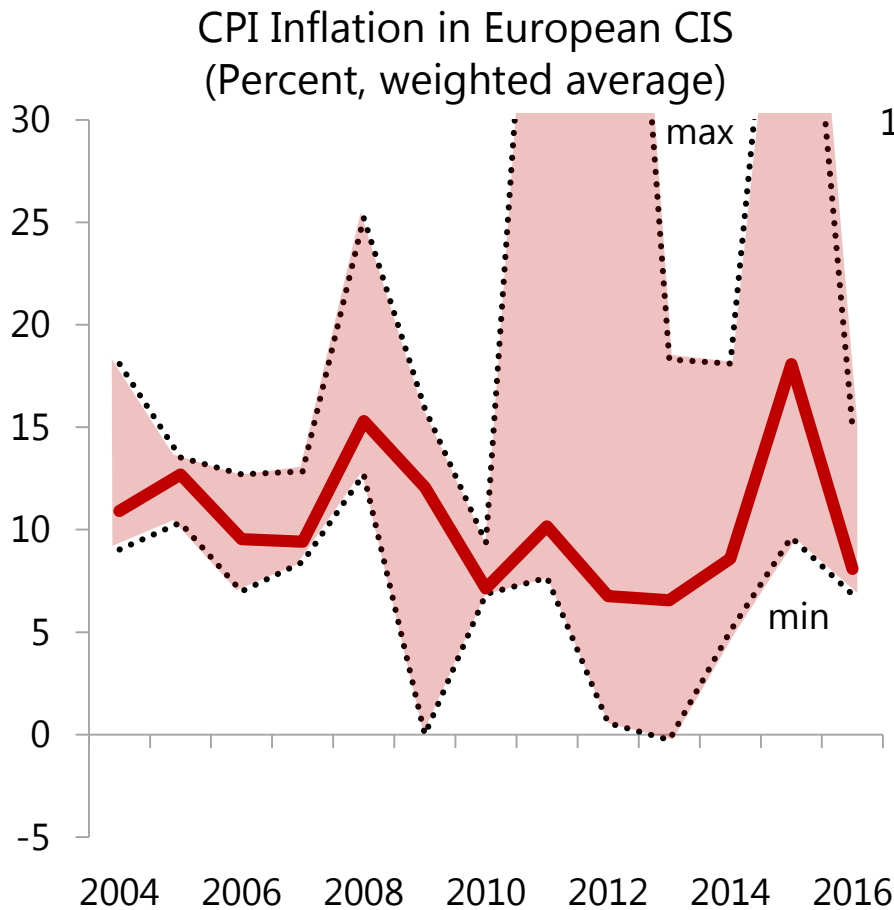
- Collapse of commodity prices
- Sudden stop in capital flows to Russia, result of sanctions on Russia
- Conflict in Ukraine



Exchange rate flexibility was unavoidable given the limited buffers...



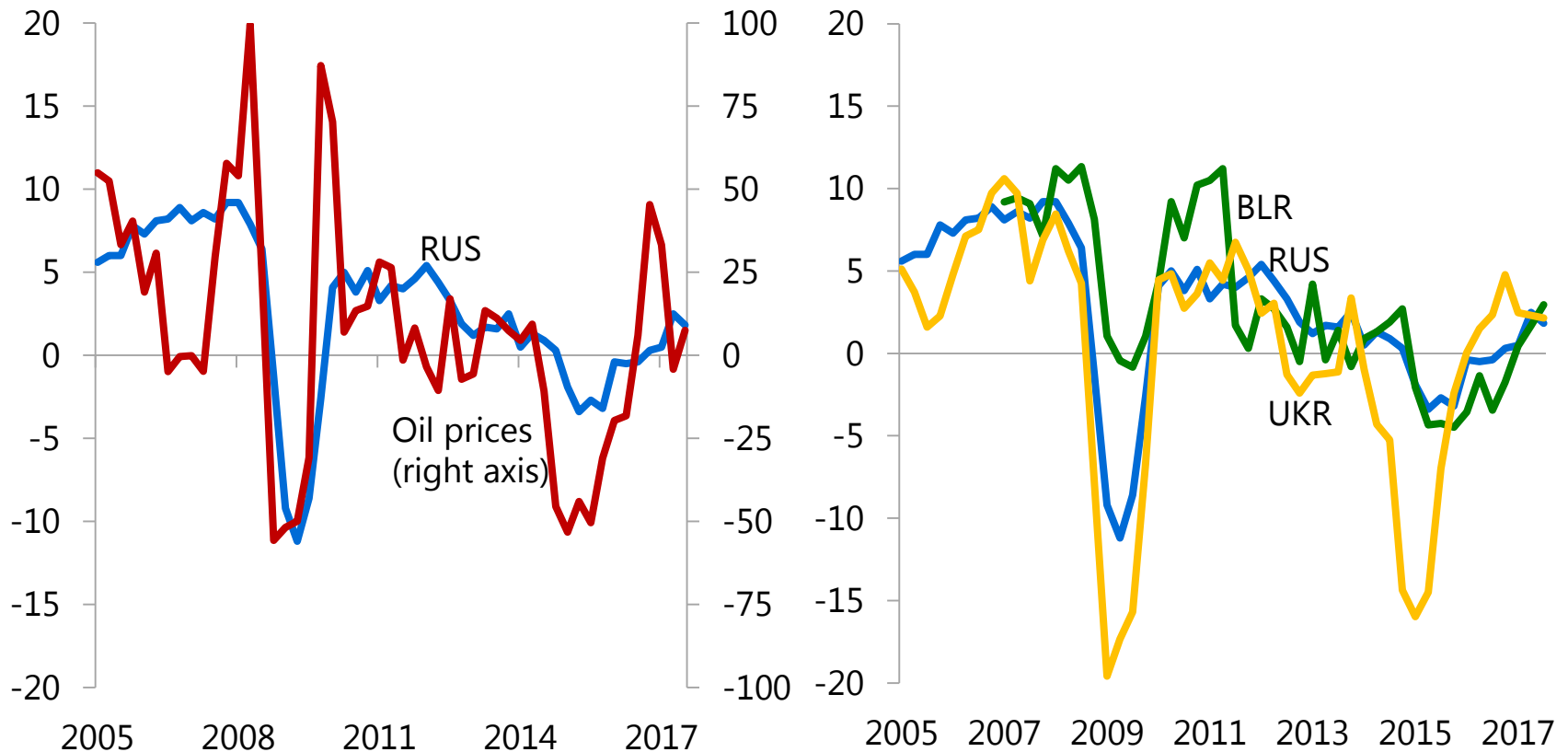
...but increased inflation and reduced real wages



Ukraine and Russia are now recovering (helped by rising oil prices)



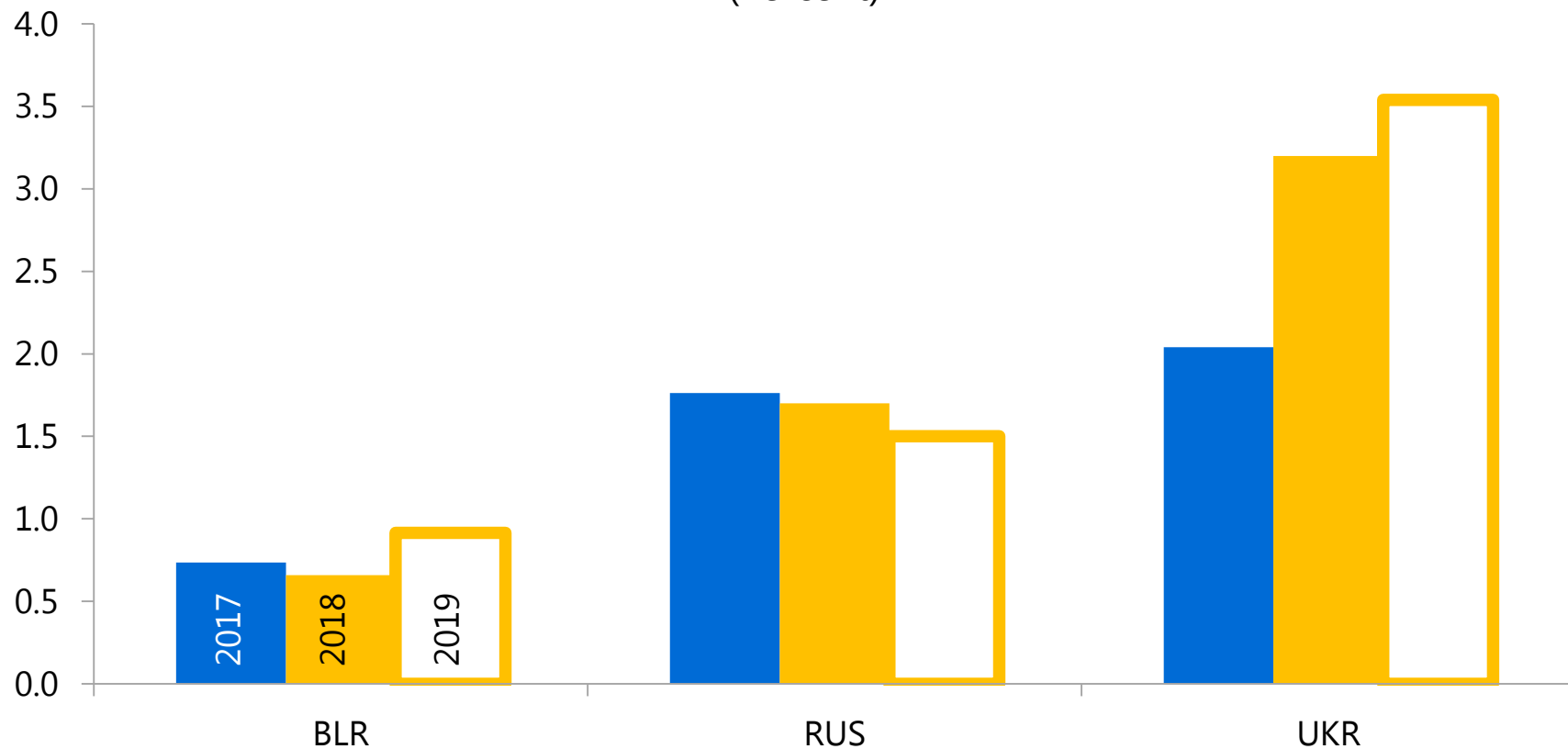
Real GDP growth in Russia, other CIS countries and changes in oil prices
(Percent, y/y)



Near-term prospects show solid growth



Real GDP Growth Projections
(Percent)





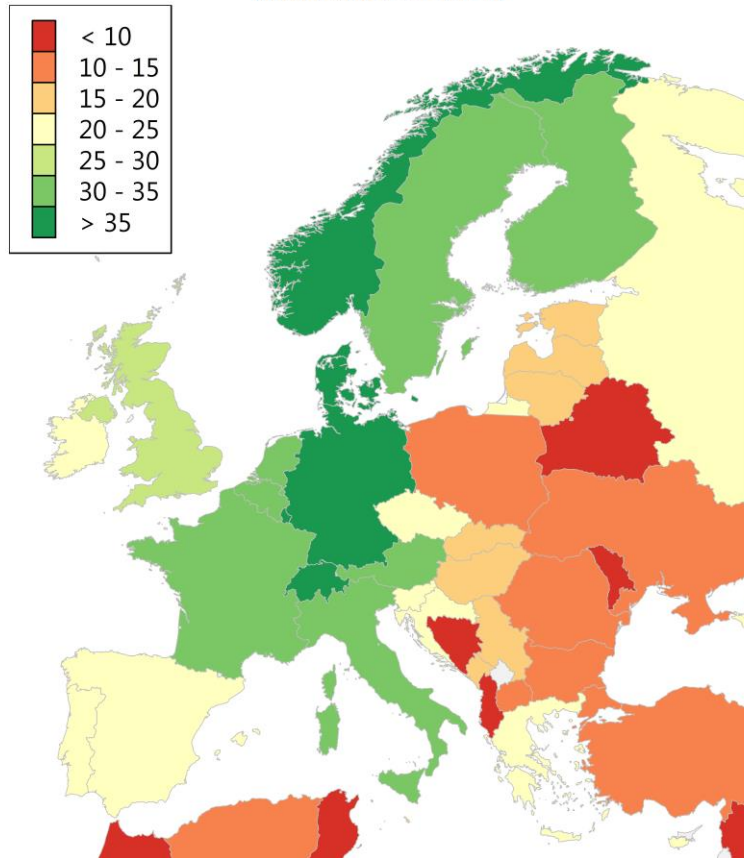
CONVERGENCE: PAST

Since the abolition of communism, most of CESEE has become much richer—both in absolute and relative terms



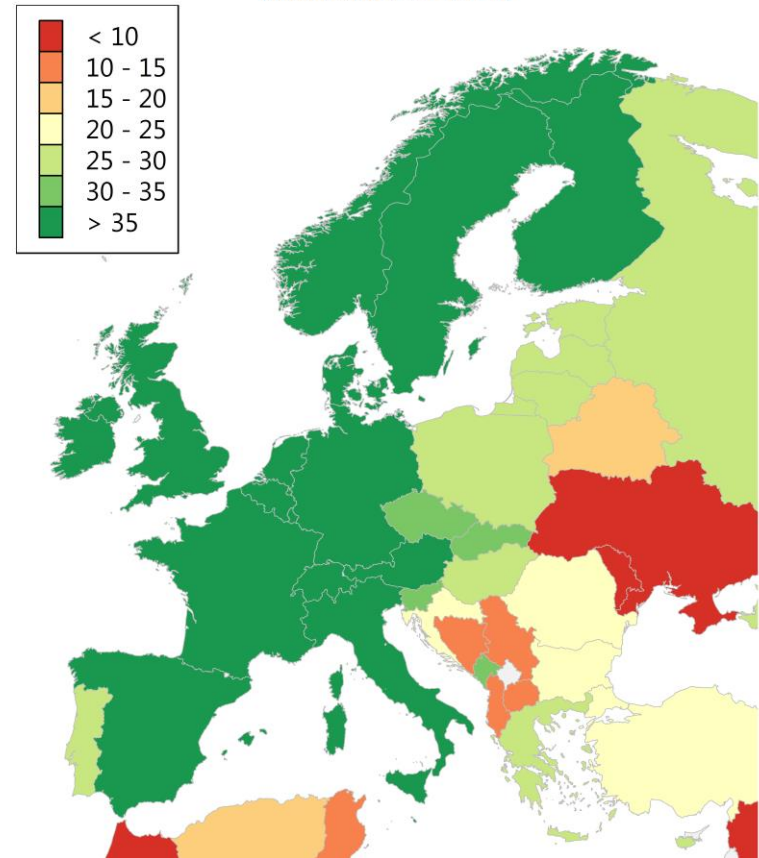
GDP PPP per capita in 1989

(In thousands of 2016 USD)



GDP PPP per capita in 2016

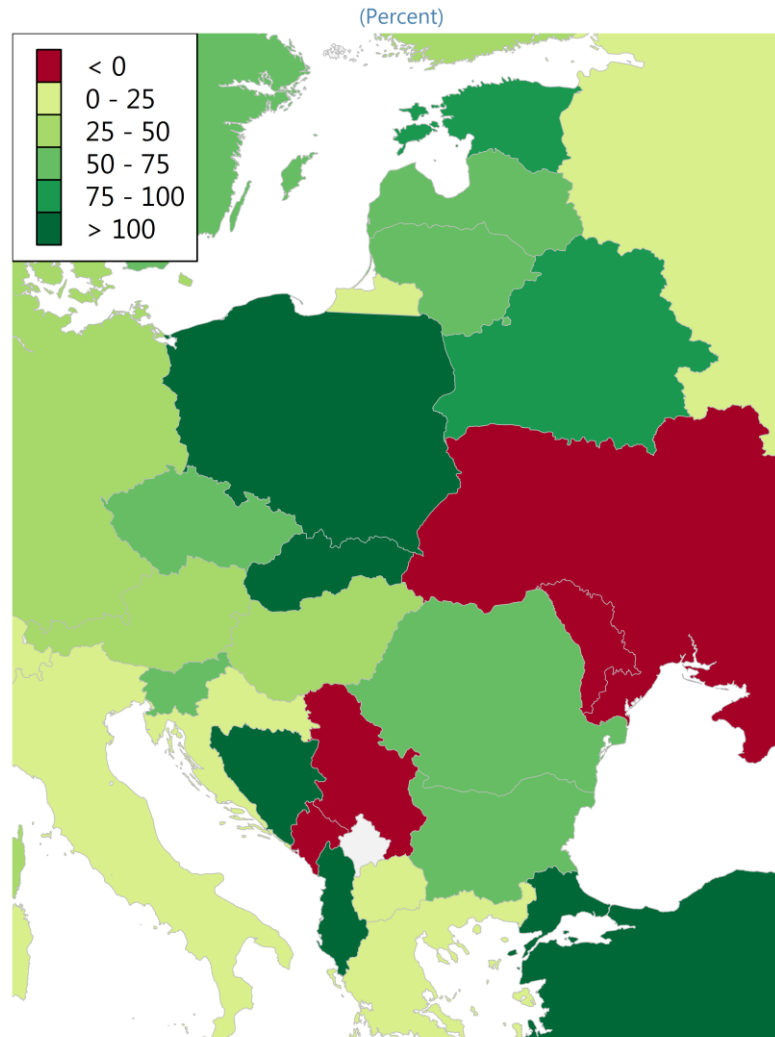
(In thousands of 2016 USD)



But not all countries have done equally well



Change in GDP PPP per capita between 1989 and 2017



Compare Poland vs Ukraine

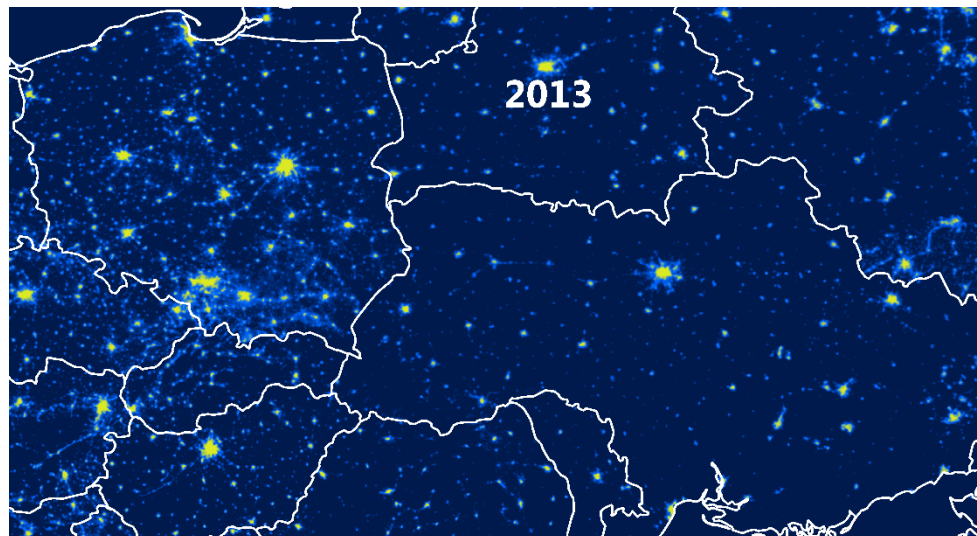
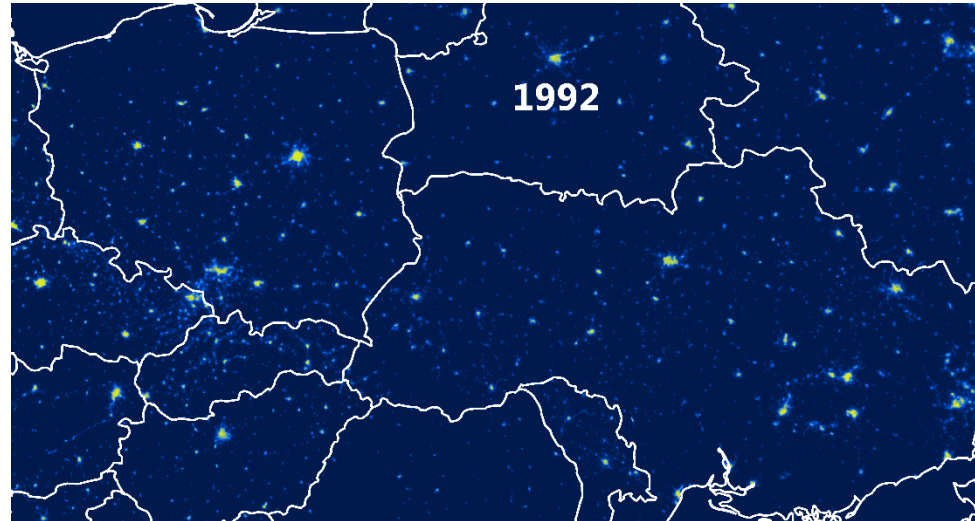


- Poland has done much better than Ukraine
- In 1989 they were equally rich
- Now Poland is three times as rich
- Why?
 - Poland more macro-stability
 - Poland reformed more and earlier
 - Poland has better institutions

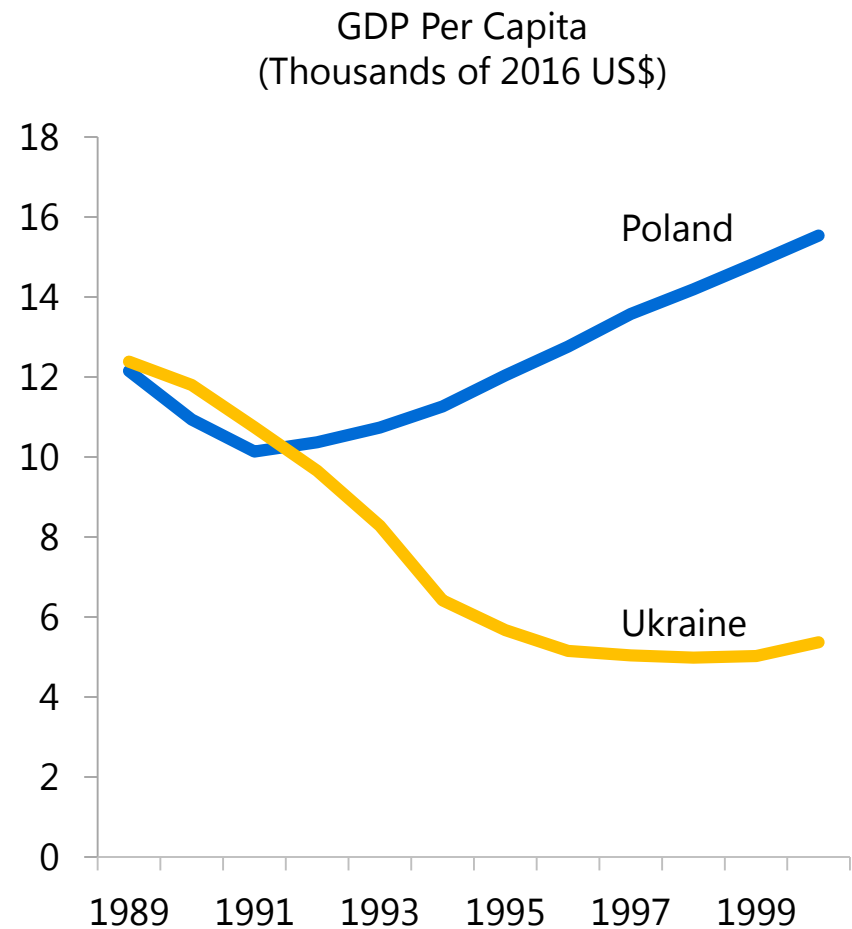
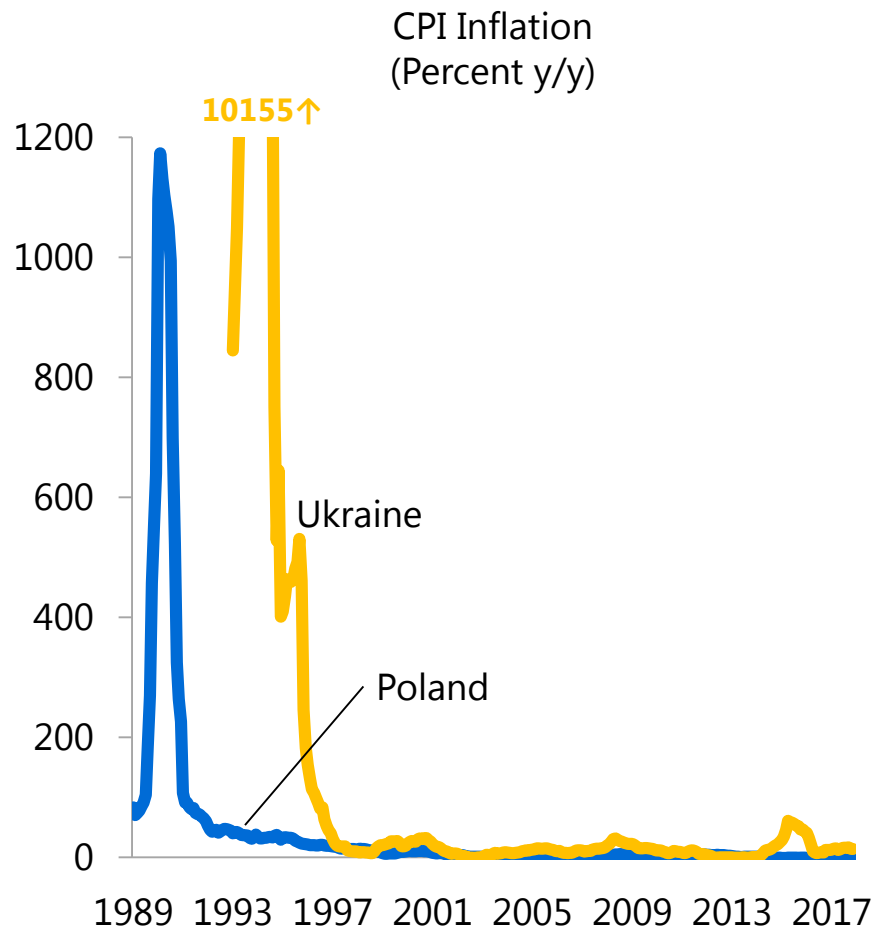
Difference is clearly visible on satellite pictures.



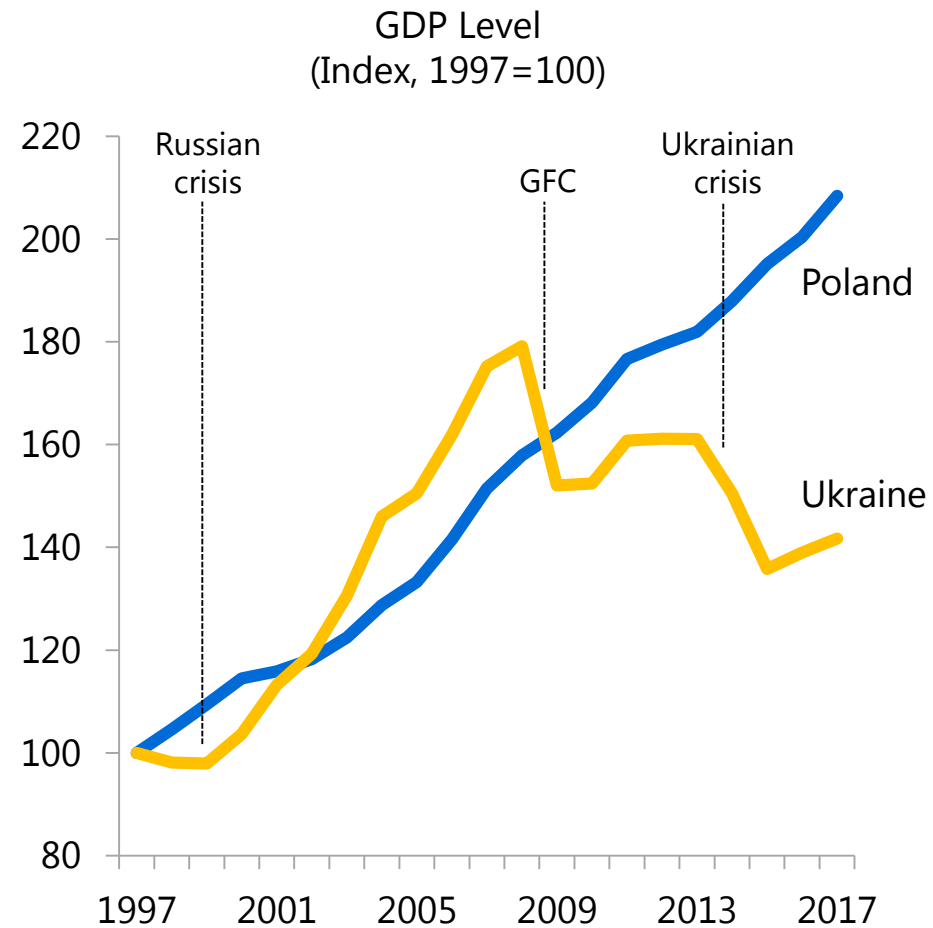
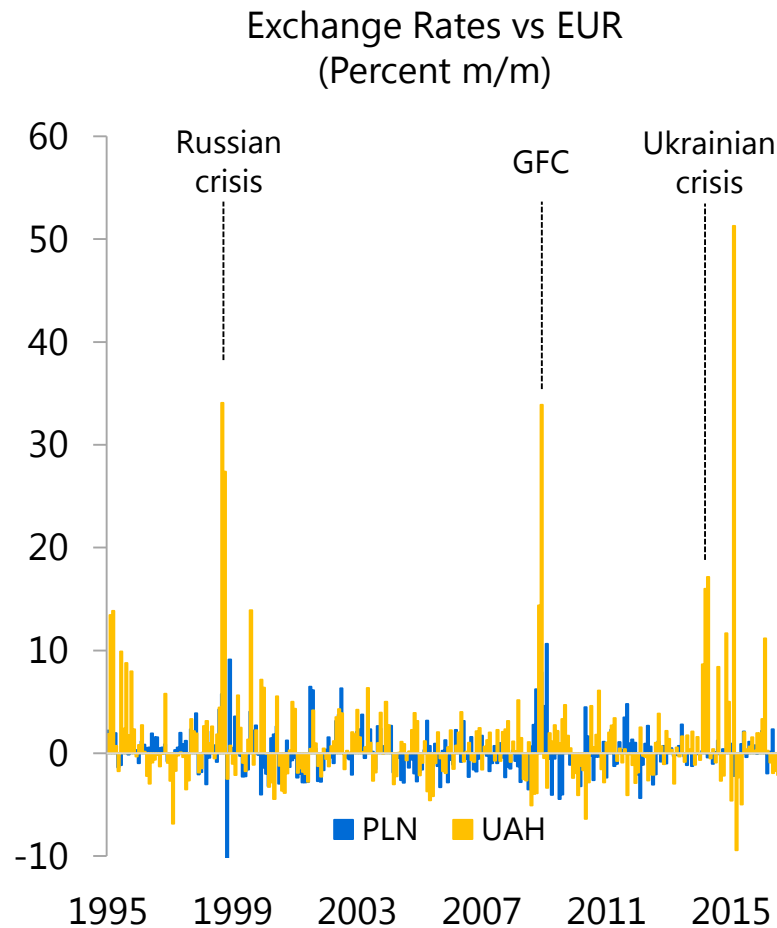
Nightlights intensity



Macro-stabilization occurred much earlier in Poland



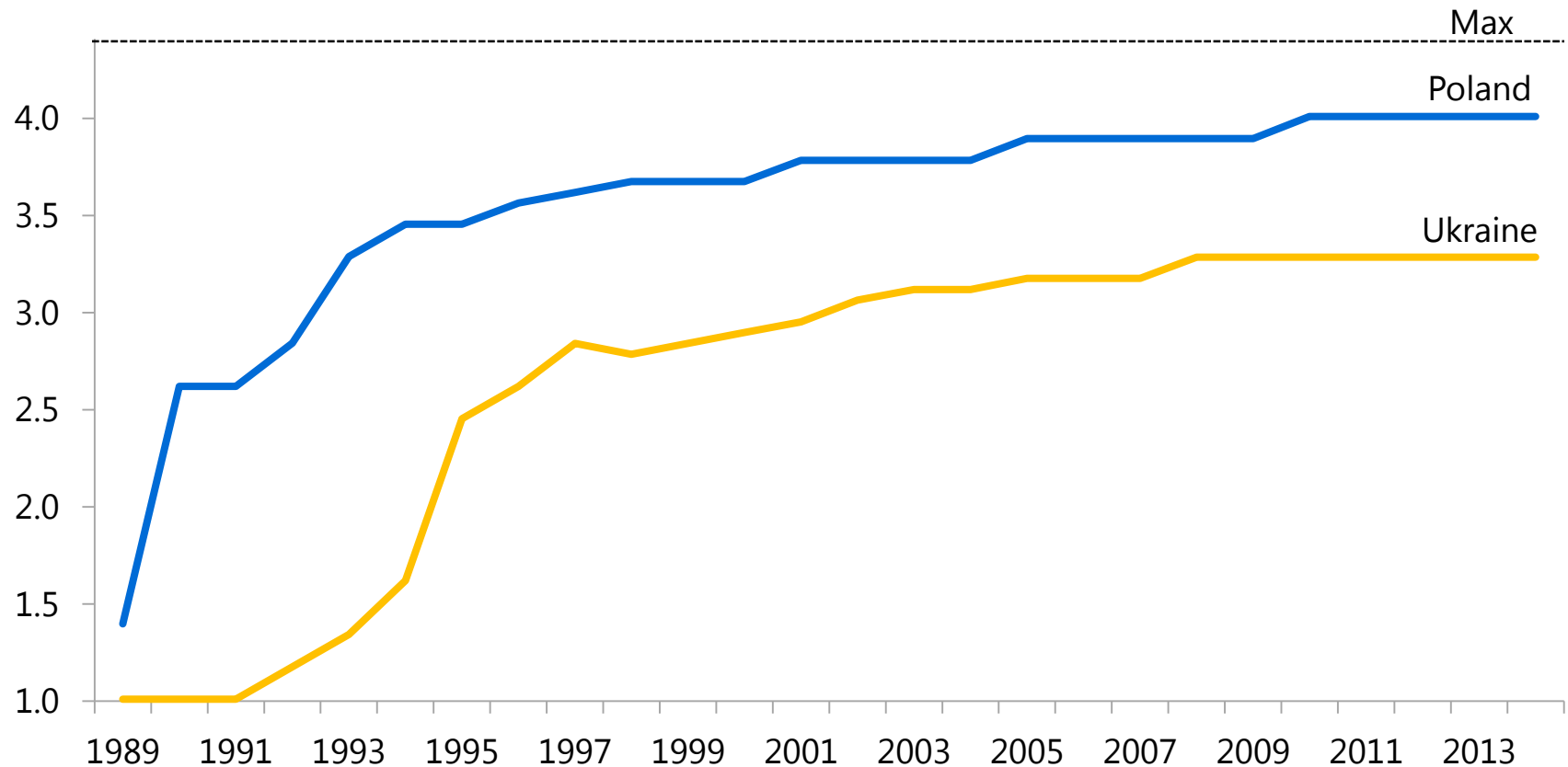
Poland has not had any crisis; Ukraine has had three



Poland reformed earlier and deeper



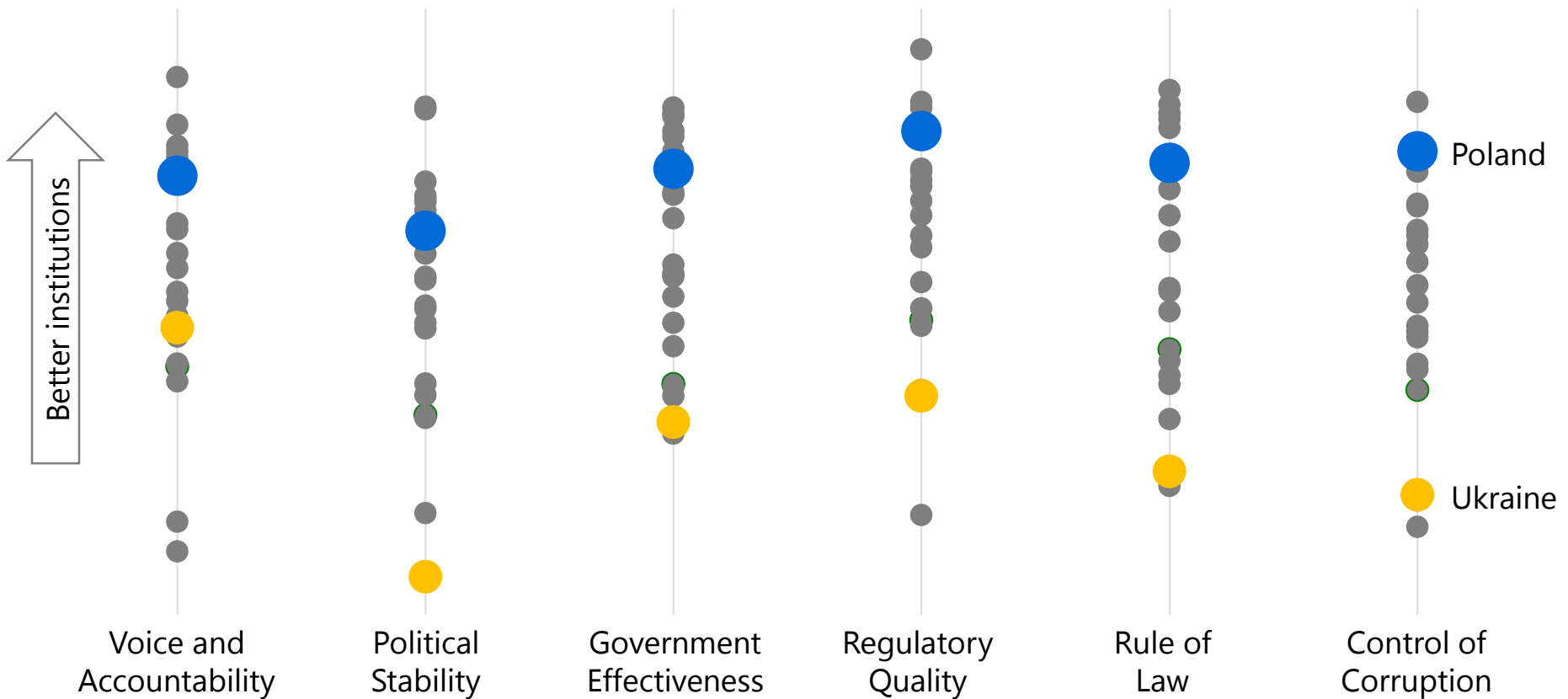
Average of EBRD Transition Indicators



Poland has much better institutions



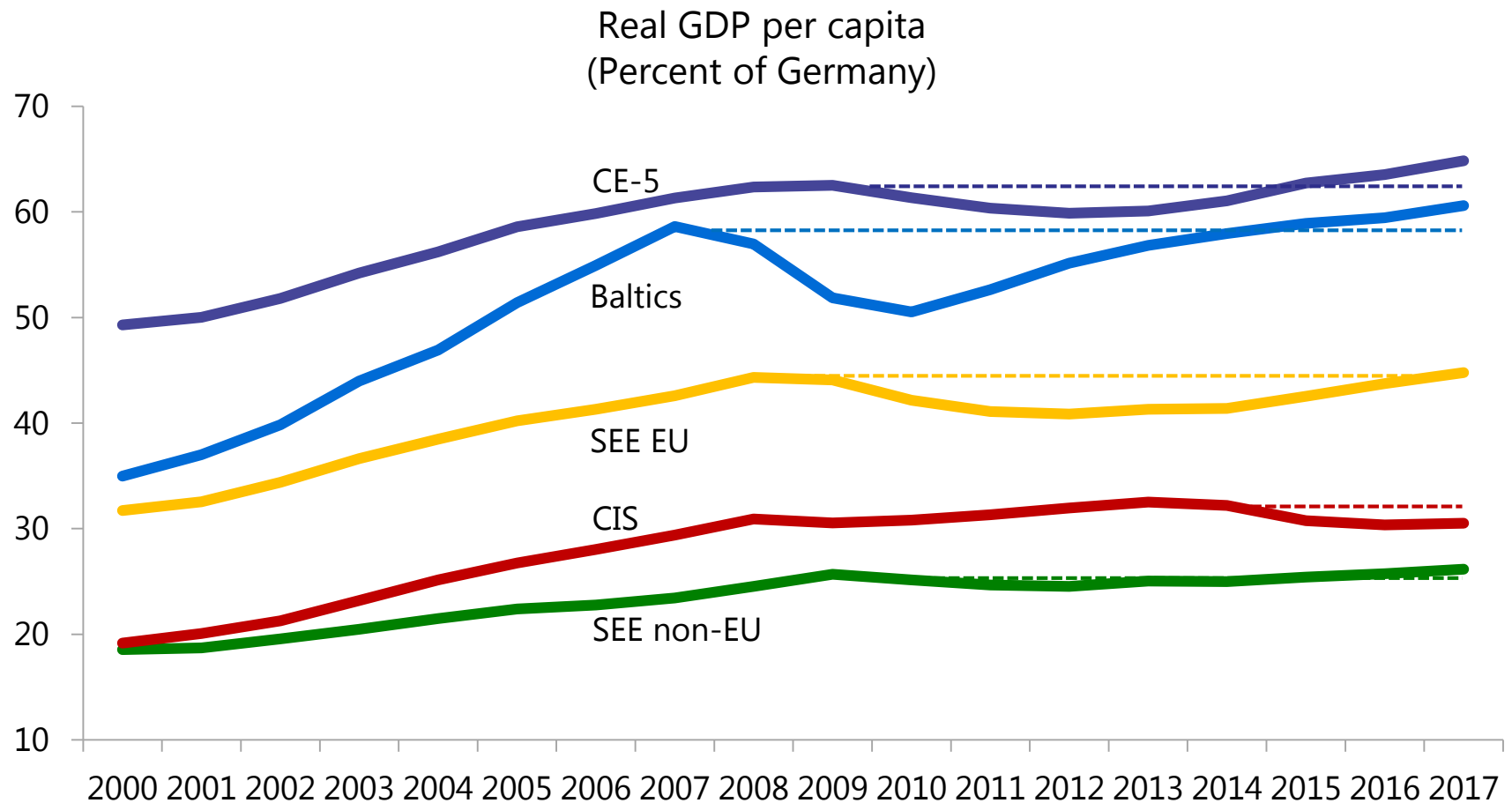
Worldwide Governance Indicators, 2016
(CESEE countries in global ranking)



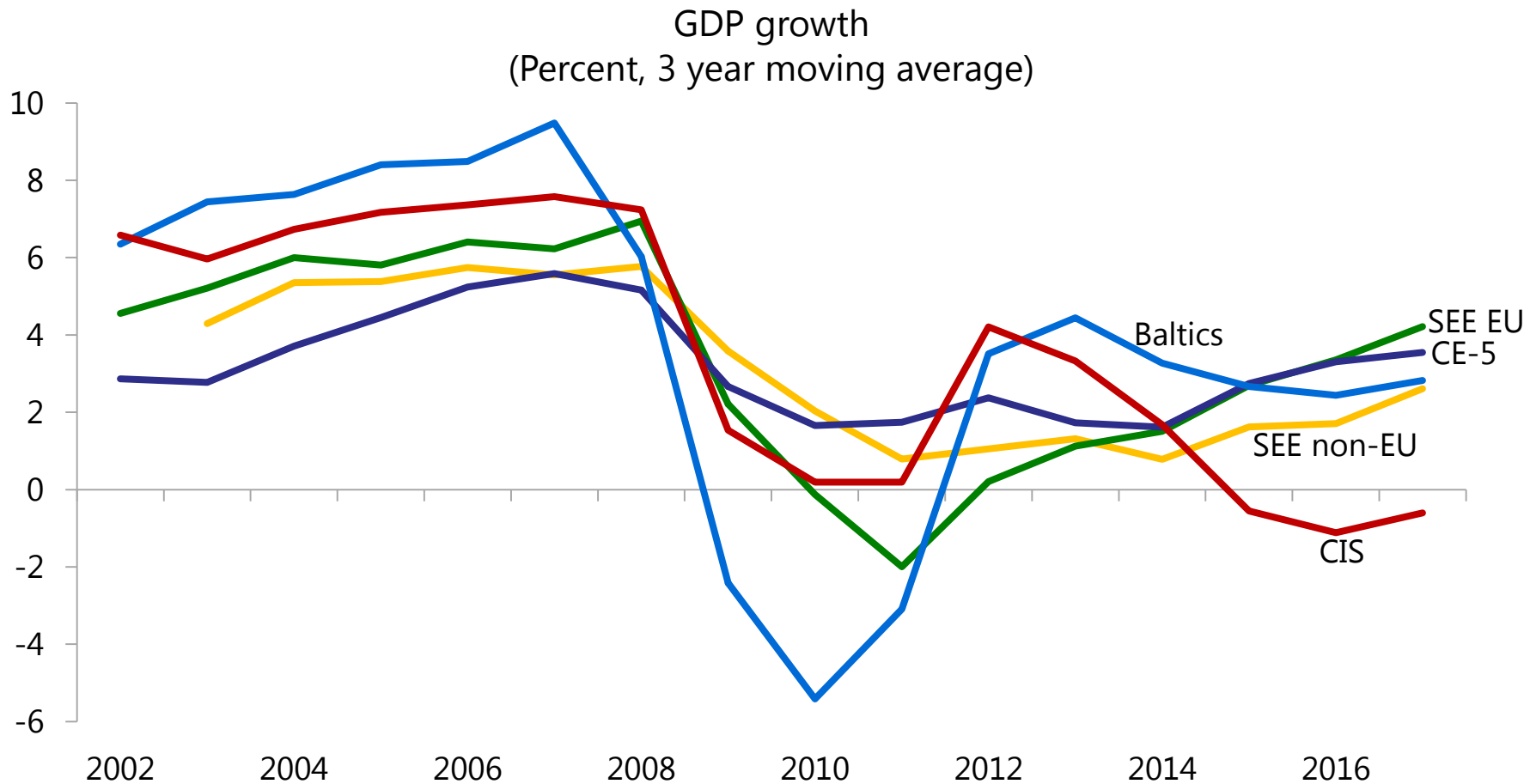


CONVERGENCE: FUTURE

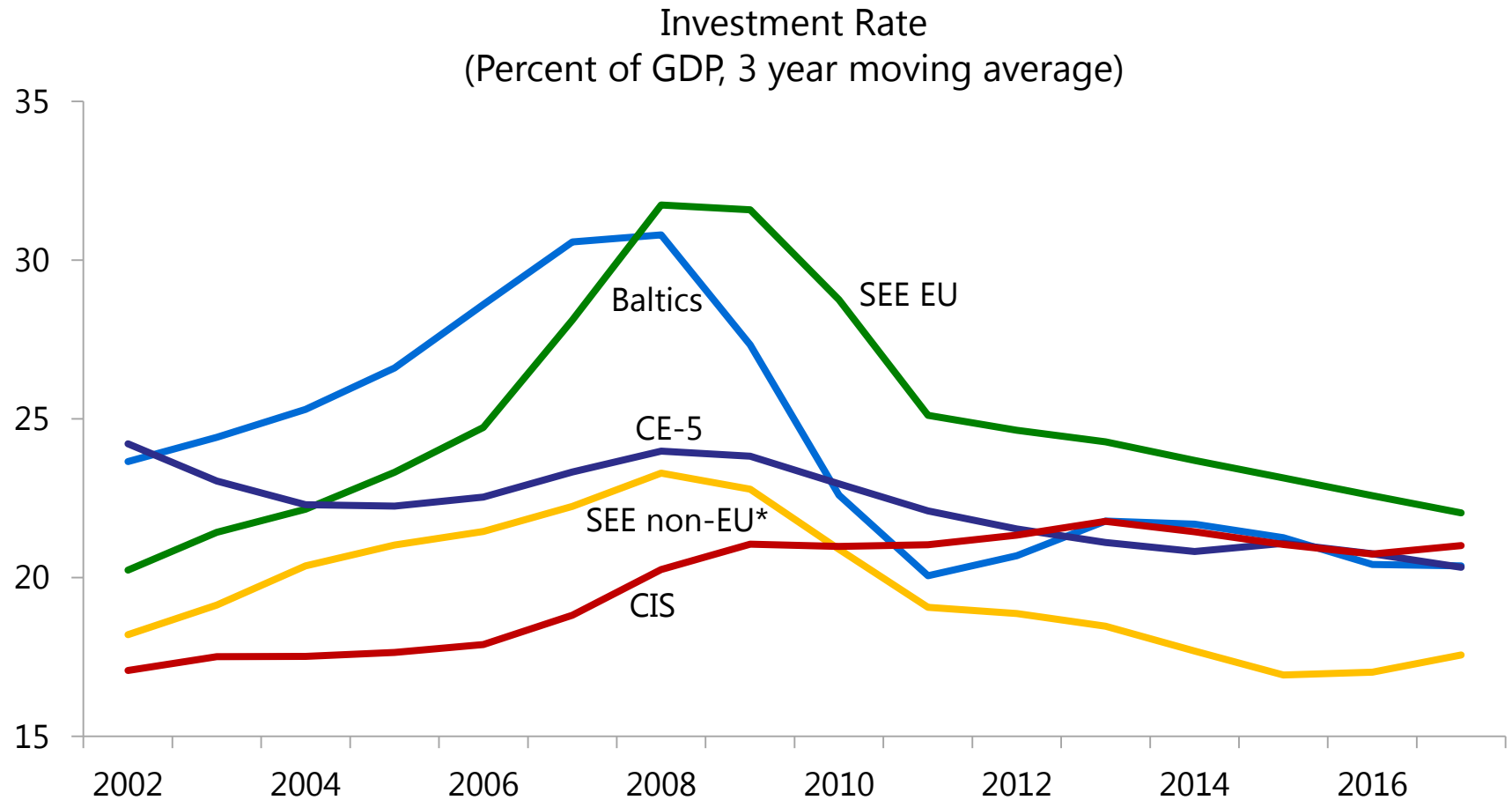
After deep crisis in 2009, convergence has resumed (except in CIS)



But growth is slower than pre-crisis...

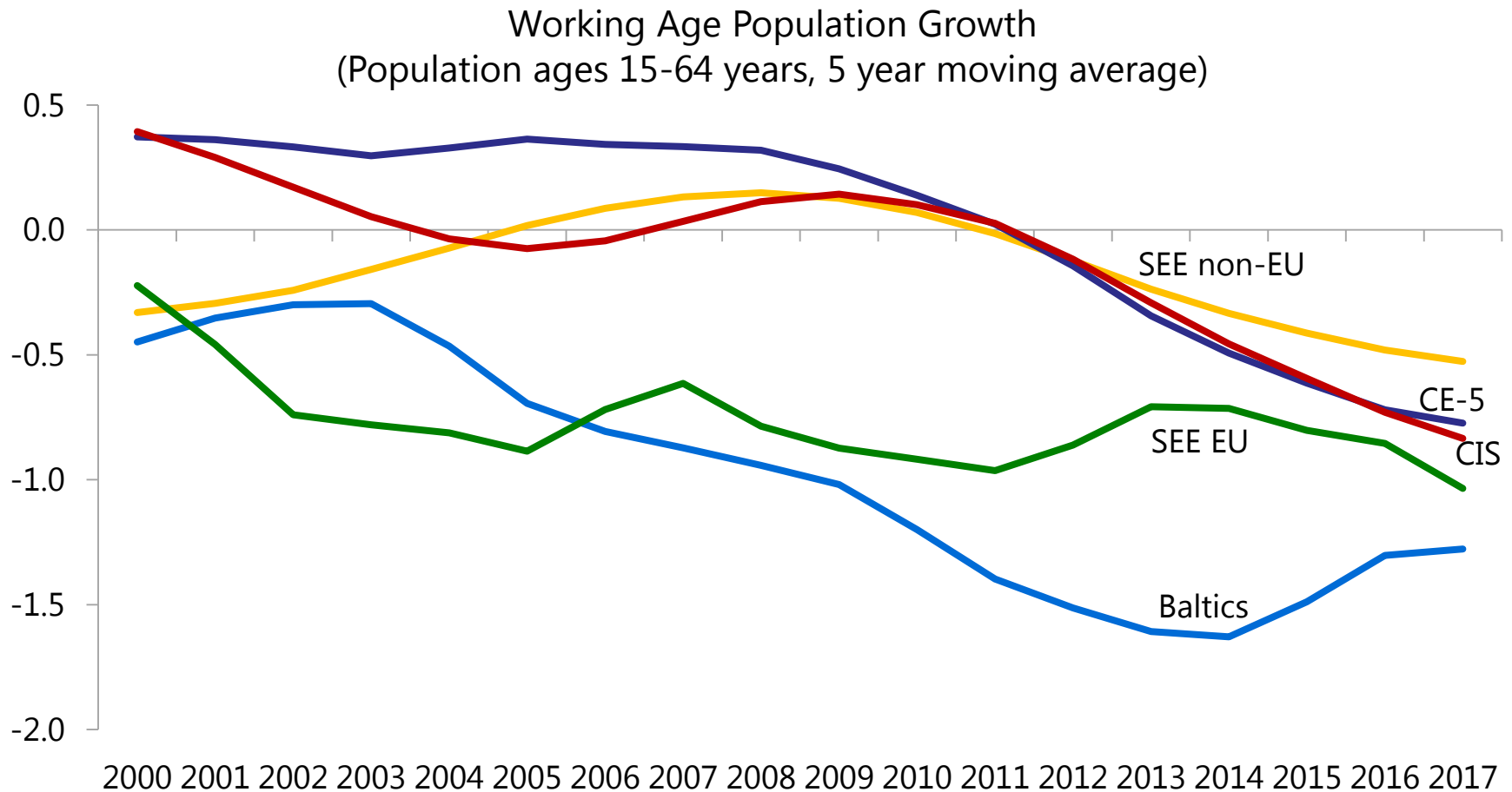


As investment rates are lower (except CIS)

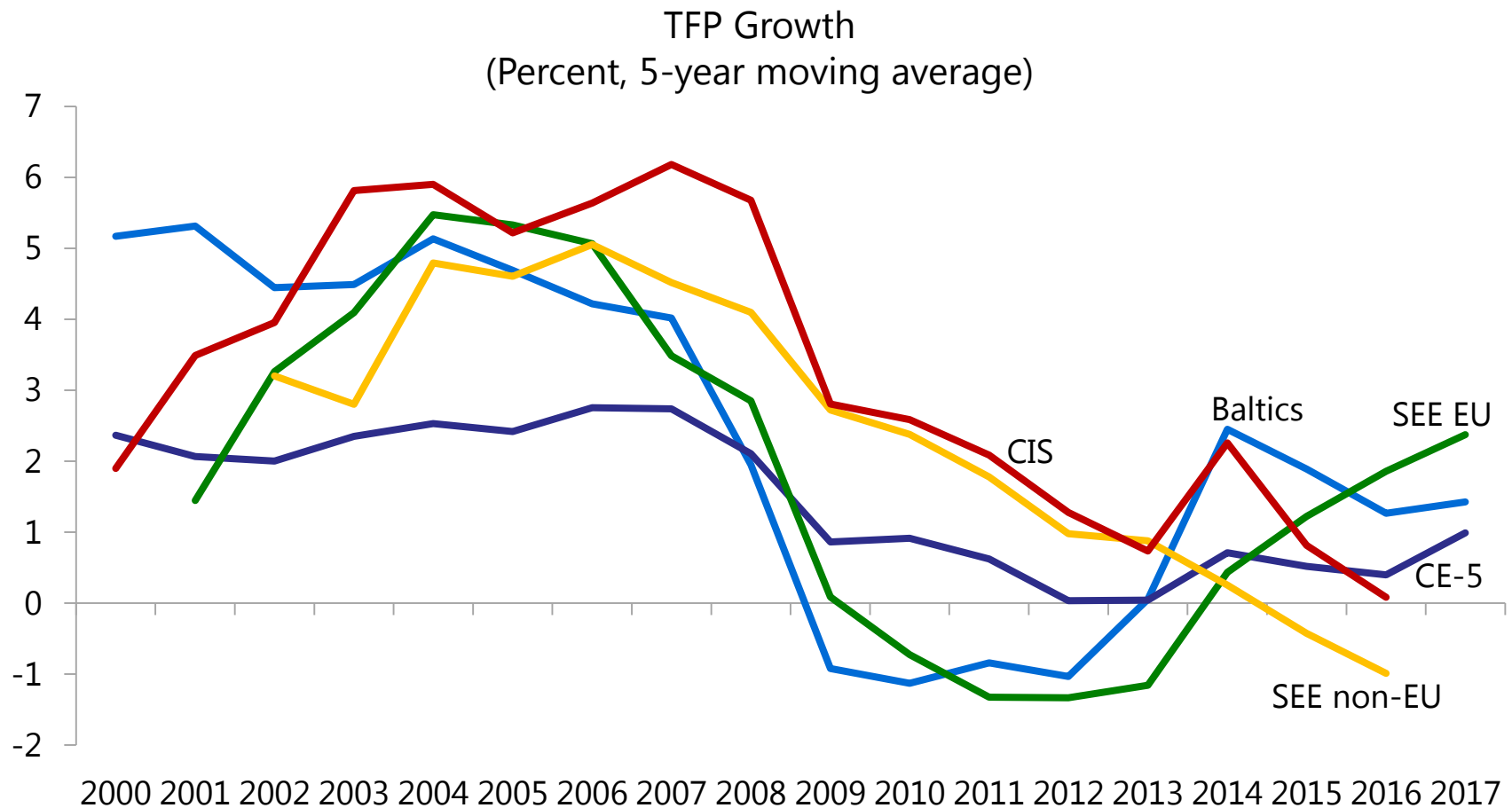


*Excl. MKD

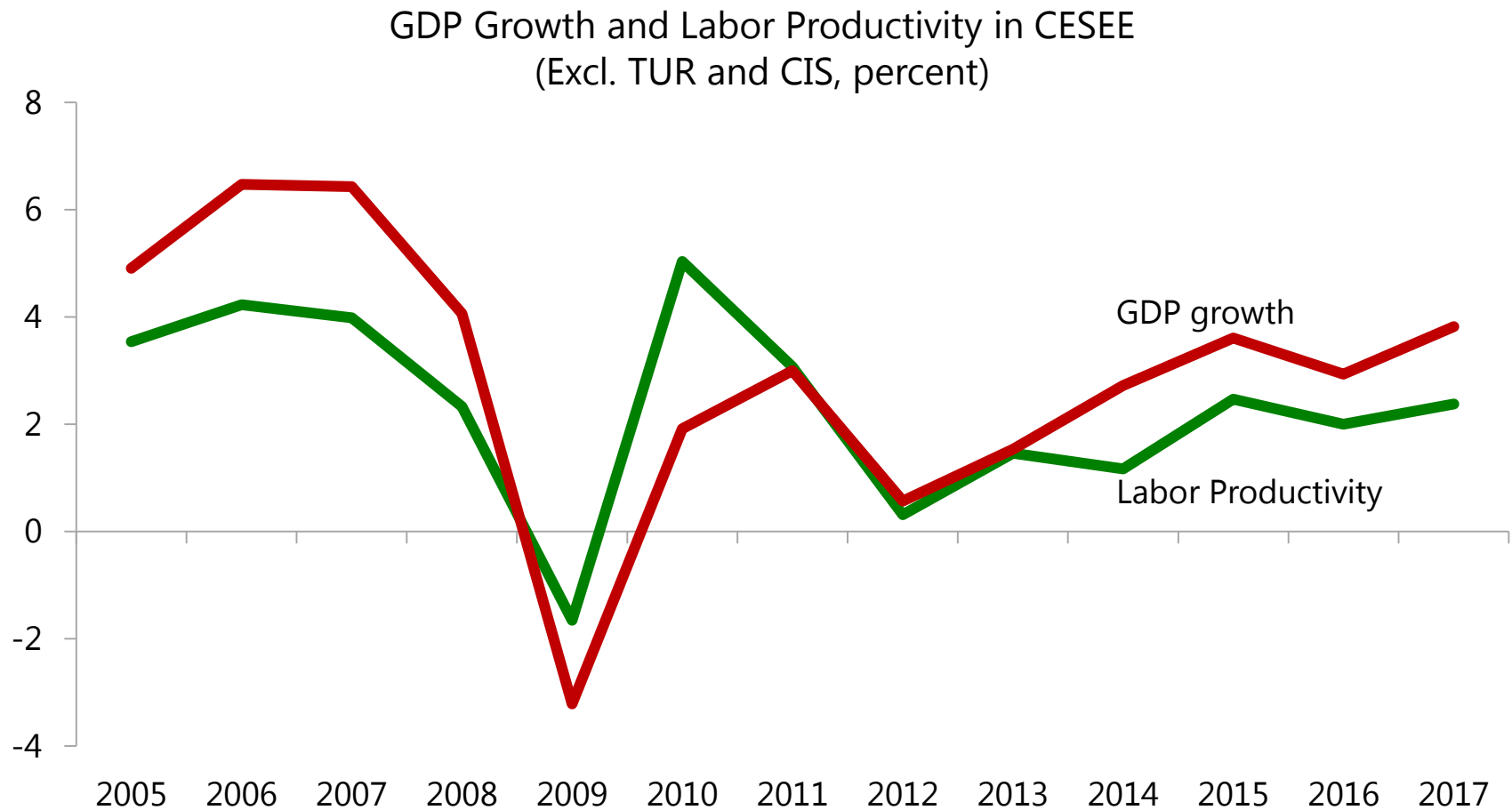
The working age population is declining (leading to less labor supply)



And TFP growth is lower



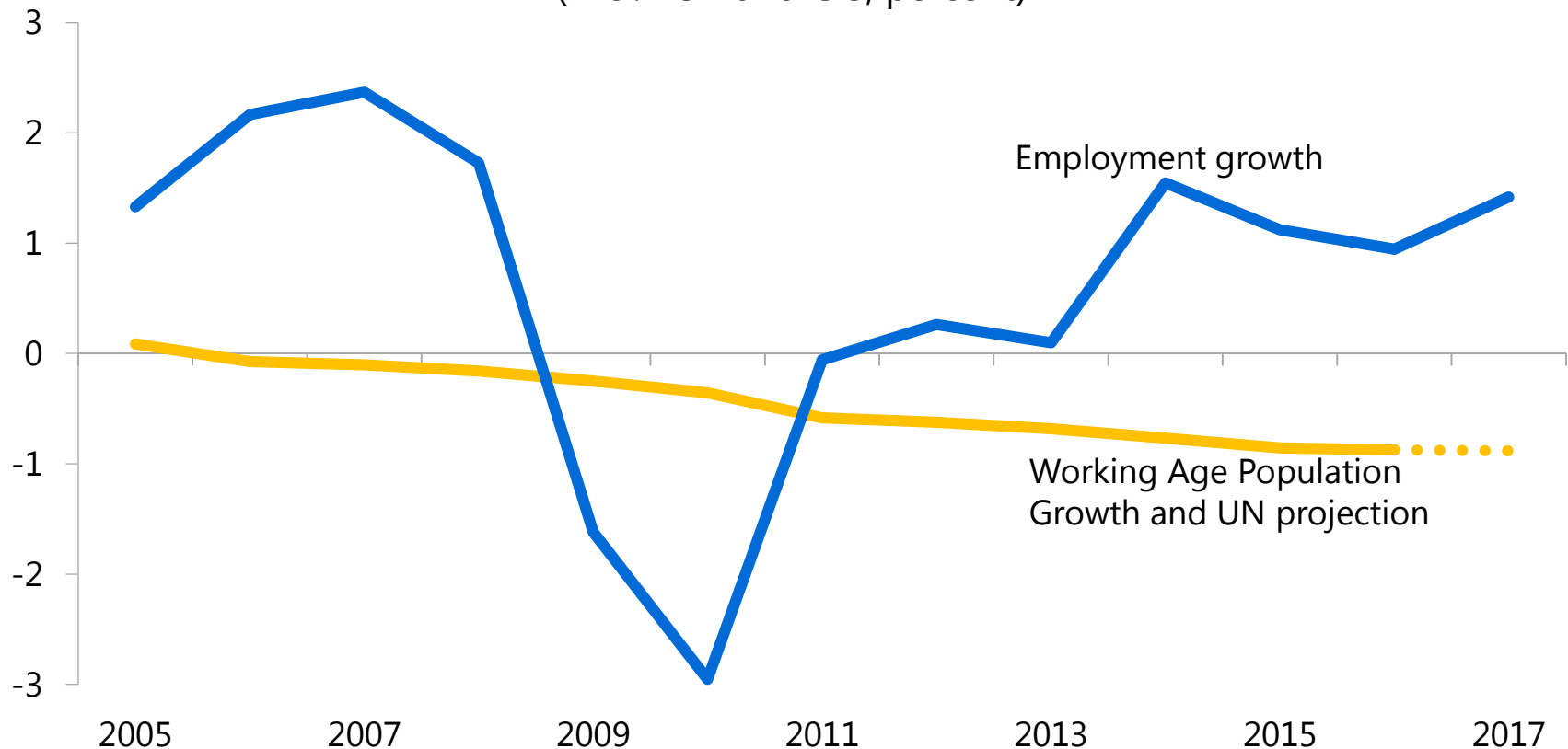
Productivity is too low to sustain rapid GDP growth



As employment growth cannot continue to grow so much faster than the working age population



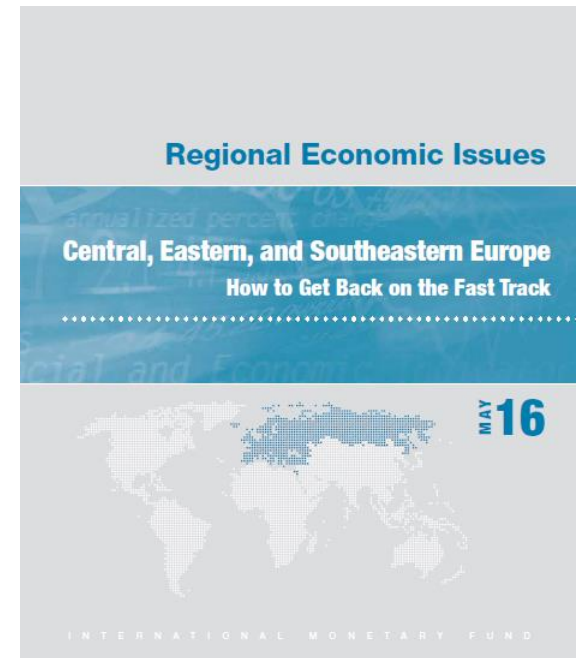
Employment and Working Age Population Growth in CESEE
(Excl. TUR and CIS, percent)



What can be done to boost TFP growth?



- Improve institutions
- Improve legal systems and government effectiveness
- Improve tax efficiency
- Address infrastructural gaps

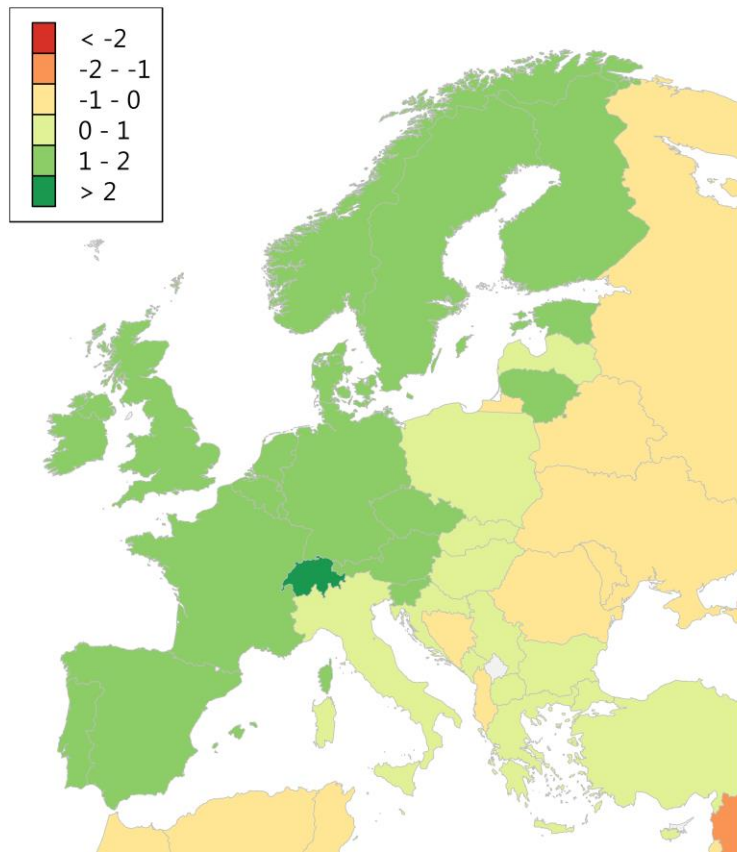


Government effectiveness not as strong as in Western Europe

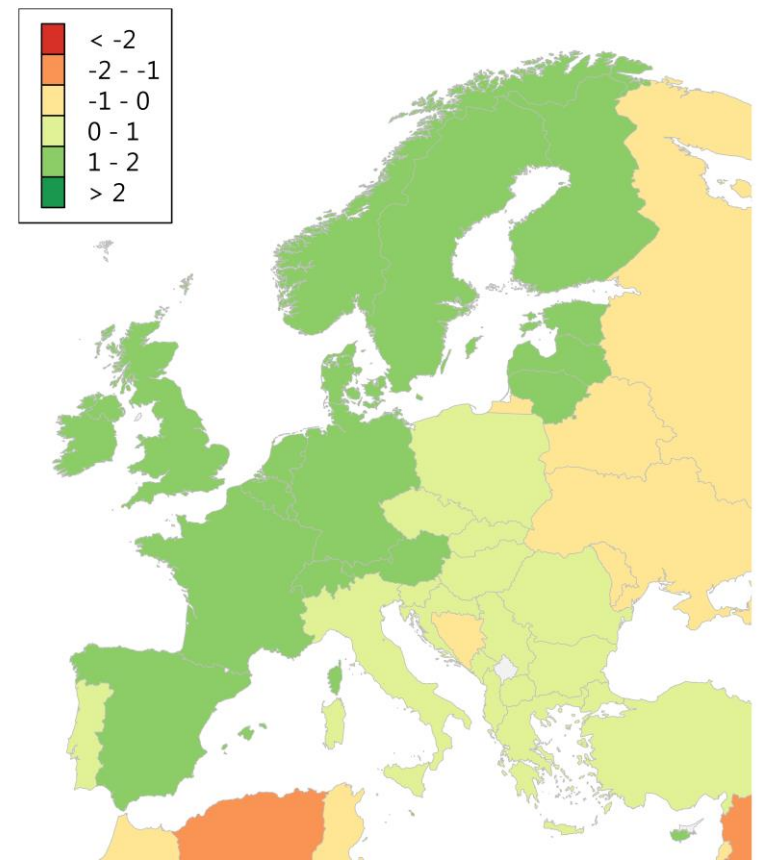


World Governance Indicators, 2016
(Ranges from -2.5 (weak) to 2.5 (strong) governance performance)

Government Effectiveness



Regulatory Quality

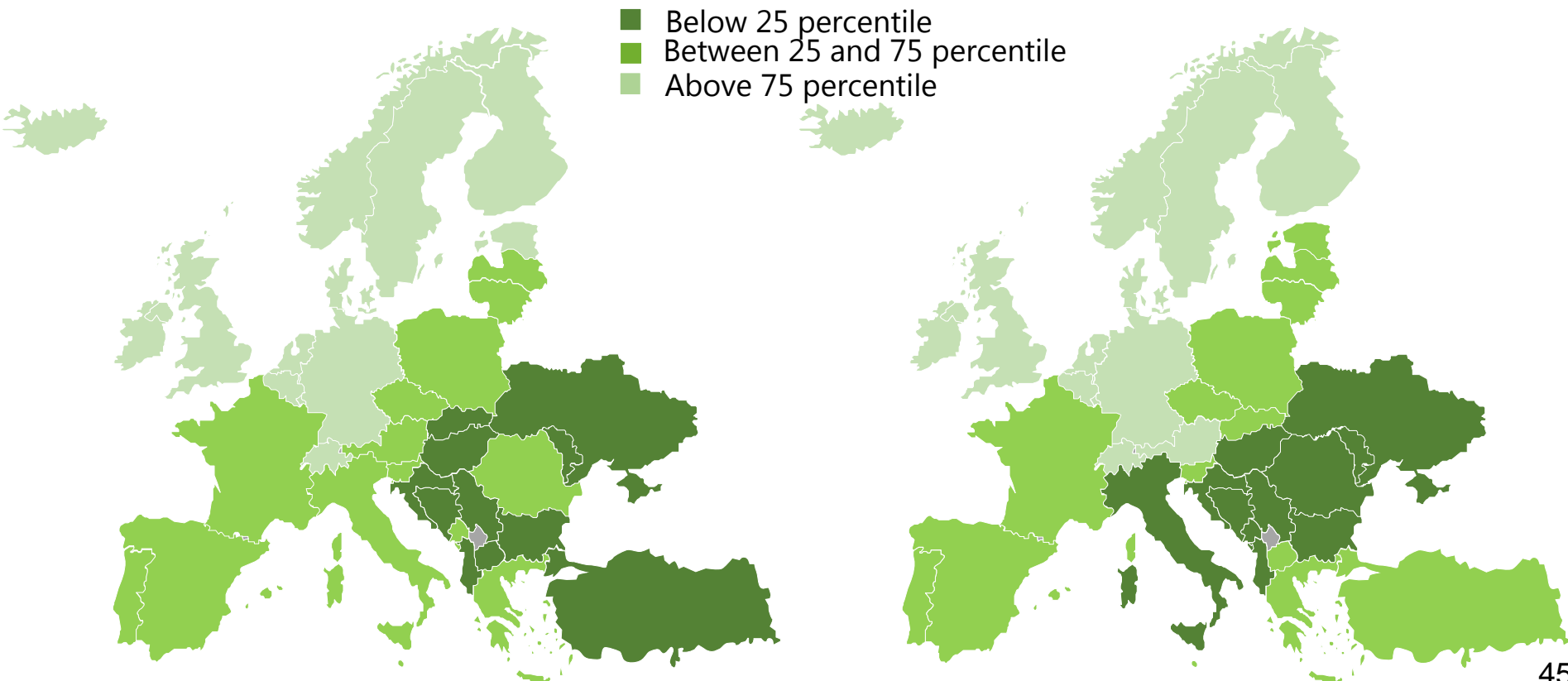


Judicial systems are also weaker



Judicial Independence, 2015

Impartial Courts, 2015



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