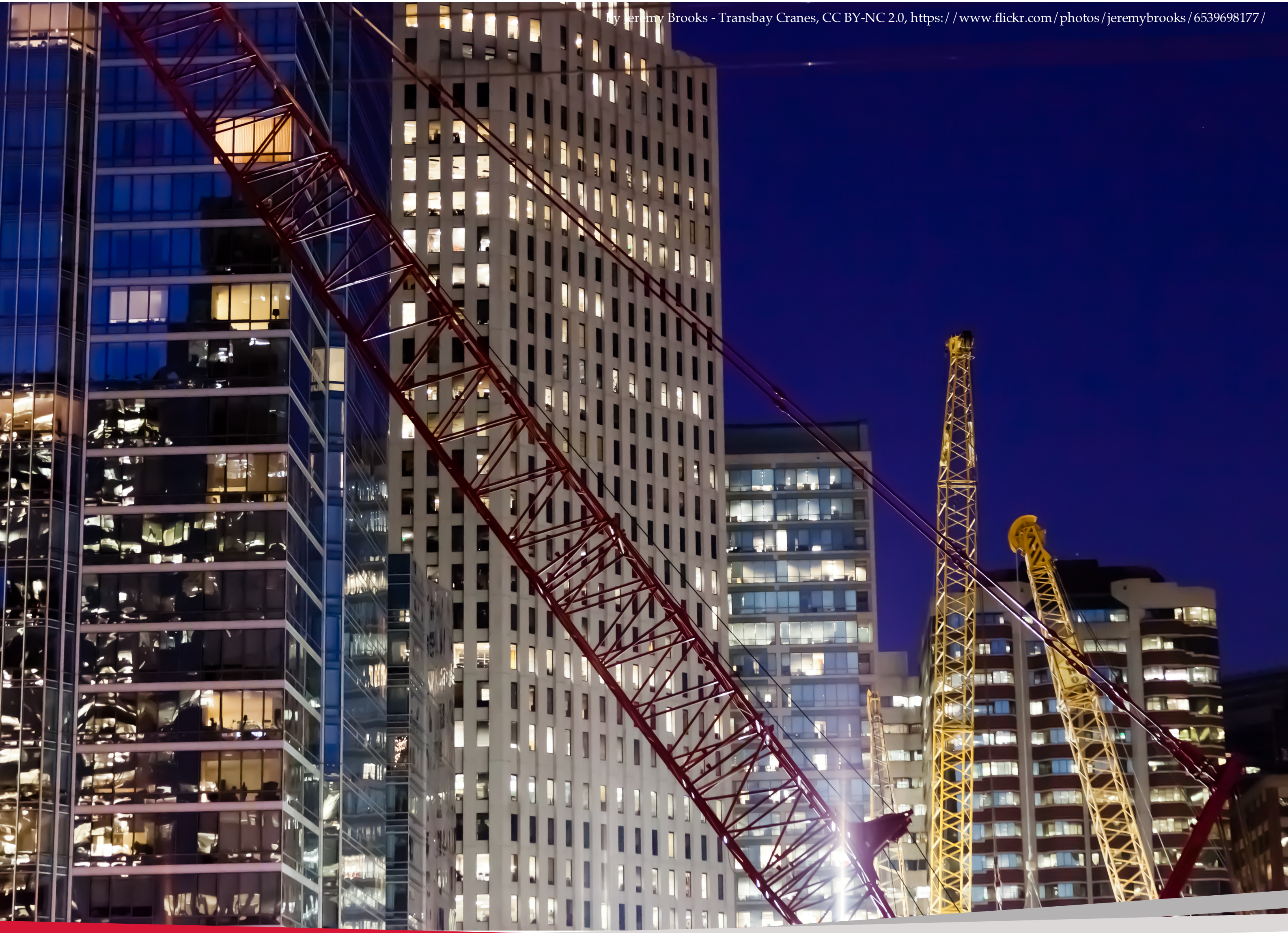

Bas B. Bakker, Marta Korczak and Krzysztof Krogulski
February 2018

Remaining Challenges for Faster Growth in CESEE[1]

[1] Bas Bakker is the IMF's Senior Resident Representative for Central and Eastern Europe; Marta Korczak and Krzysztof Krogulski are economists in the IMF's regional office for Central and Eastern Europe in Warsaw. The views expressed in this paper are those of the authors and do not necessarily represent those of the IMF or IMF policy. Comments by [Jorg Decressin] on an earlier version are gratefully acknowledged.

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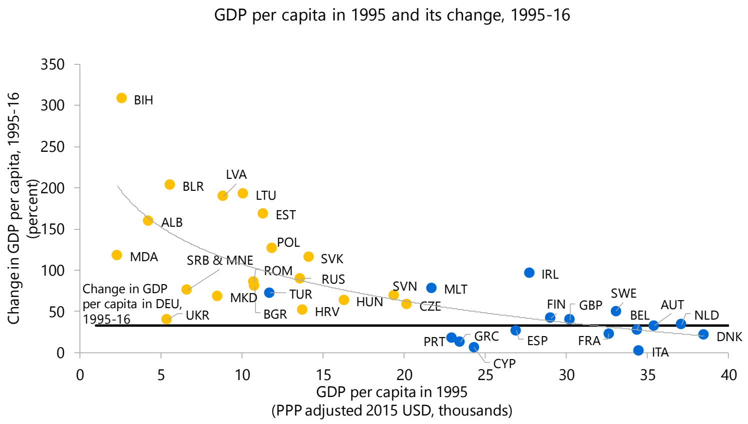
Between 1995 and 2016, per capita GDP levels in Europe have converged, as countries that had lower income levels in 1995 on average have seen faster growth rates between 1995 and 2016 (Figure 1).

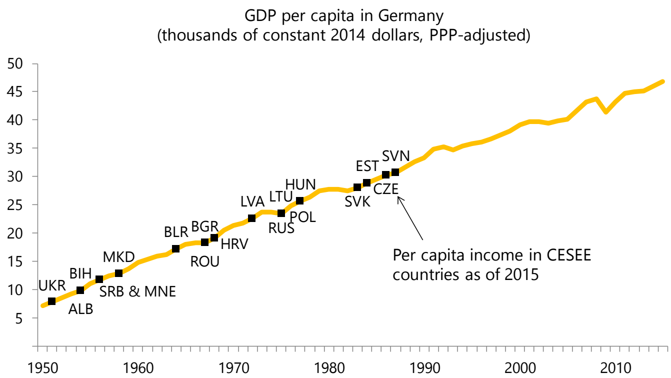
Figure 1



Income differentials between CESEE and Germany have narrowed significantly during this time. If we look at CESEE *as a whole*, in 1995 GDP per capita of CESEE was only a third of Germany. By 2016 it has increased to almost half. If we look at *individual countries*, all countries in CESEE have seen faster GDP growth than in Germany, but there have been important cross-country differences. For example, growth has been relatively rapid in the EU New Member States and very slow in Ukraine.

Nevertheless, CESEE is still much poorer than Germany. The richest country in CESEE – Slovenia – has the income level per capita Germany had in 1990 (Figure 2). Poland is as rich as Germany was in the late 1970s. And Ukraine, which in early transition had similar level of income to Poland, is now as rich as Germany was in the early 1950s.

Figure 2

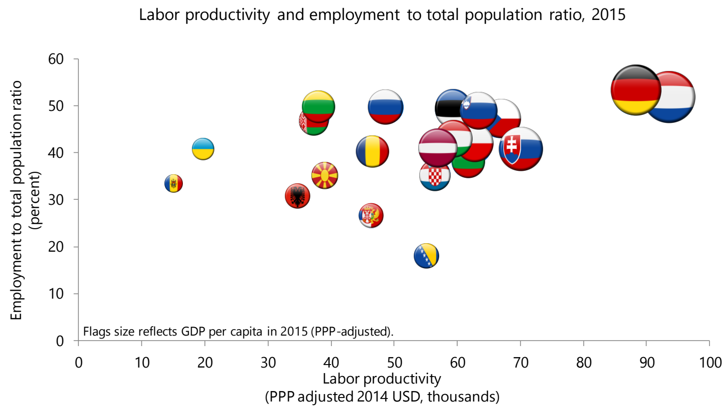


CESEE is poorer both because labor productivity is lower and a smaller share of the population works. GDP per capita is the product of GDP per worker and the employment to population rate:

$$\frac{GDP}{POP} = \frac{GDP}{E} \times \frac{E}{POP}$$

In 2015, labor productivity in CESEE was still well below that in Germany and the Netherlands (Figure 3, x-axis). Employment rates were also lower, but those differences were less pronounced (Figure 3, y-axis).

Figure 3

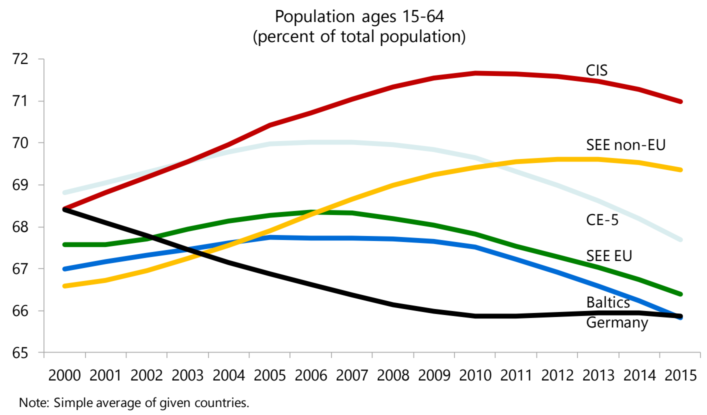


Differences in employment rates are, however, more pronounced if we take into account that in CESEE a higher share of the population is of working age. The employment to population rate is the product of the employment to working age population[2] rate:

$$\frac{E}{POP} = \frac{E}{POPWA} \times \frac{POPWA}{POP}$$

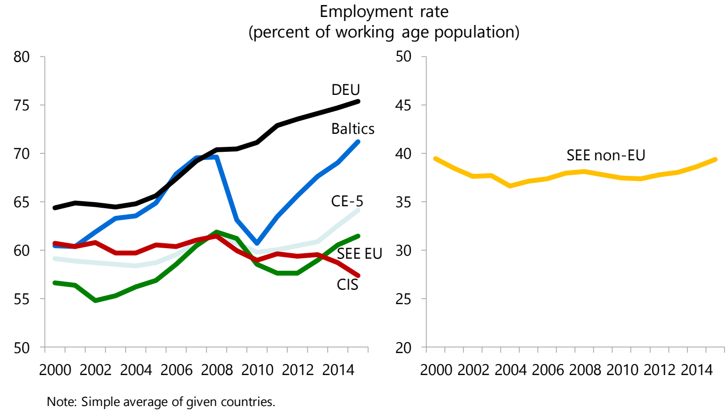
The share of the working age population in CESEE is relatively high (Figure 4), although it is now declining. The employment ***to working age*** ratios in CESEE are well below those in Germany (Figure 5); only the Baltics come close.

Figure 4



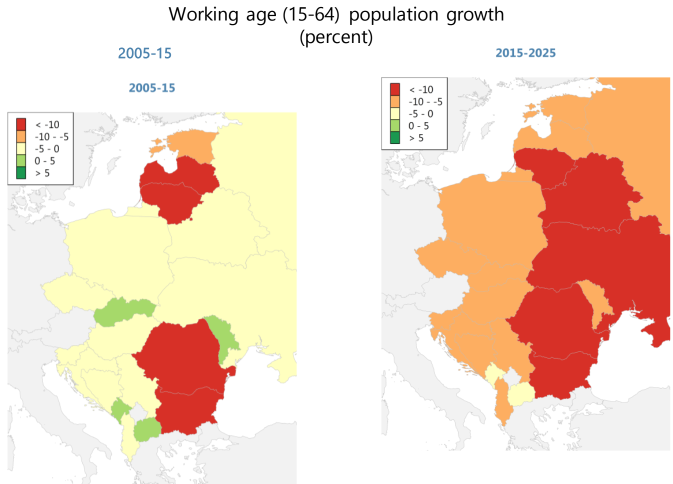
[2] The working age population is the population ages between 15 and 64.

Figure 5



It will be challenging to further increase the employment to total population rate, given the impact of aging and the already relatively low level of unemployment. The decline of the working age population will accelerate in the next decade (Figure 6) as the baby-boom generation is retiring; in a number of countries the working age population is set to decline by more than 1 percent annually.[3] If the share of the working age population that works remains constant, the share of the employment to total population rate will fall sharply. At the same time, the unemployment rate in many countries is already close to pre-crisis lows (Figure 7). It will therefore be key to increase labor force participation rates, which in most countries are still below those of Germany, particularly those of women (Figure 8).

Figure 6



[3] In many countries, demographics pressures have been exacerbated by the net emigration. A reduction in emigration, or even reversal, would also help. See IMF Staff Discussion Note "Emigration and Its Economic Impact on Eastern Europe" available at https://www.imf.org/external/pubs/ft/sdn/2016/sdn1607.pdf

Figure 7

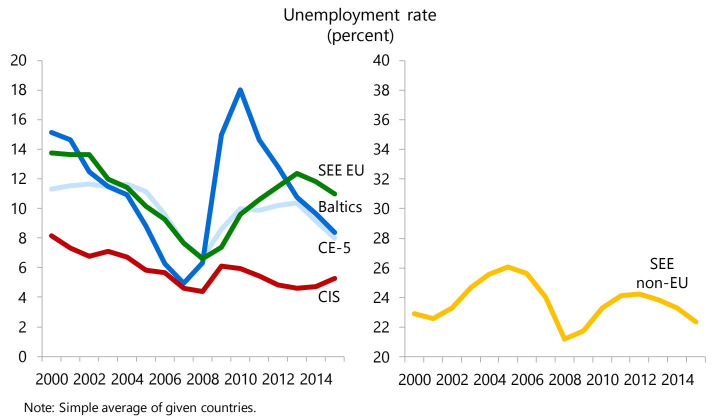
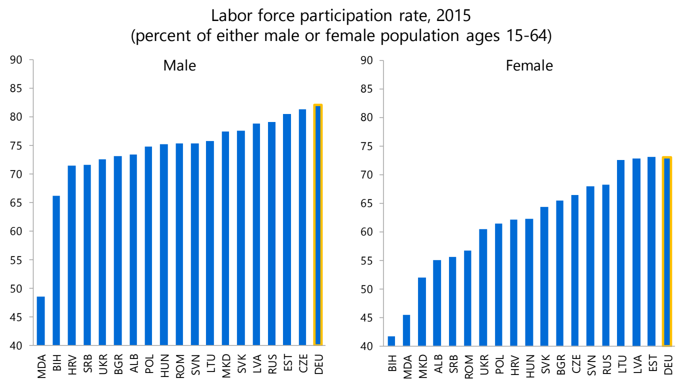


Figure 8



A higher capital stock may be even more important than raising the employment rate. There is a strong correlation between the level of capital stock per capita and GDP per capita (Figure 9, left panel). The relationship between the employment rate and GDP per capita is much weaker (Figure 9, right panel). Further convergence of CESEE will thus require capital deepening. As of 2015, the capital stock per capita in CESEE region is on average only a quarter of that in Germany.

Figure 9

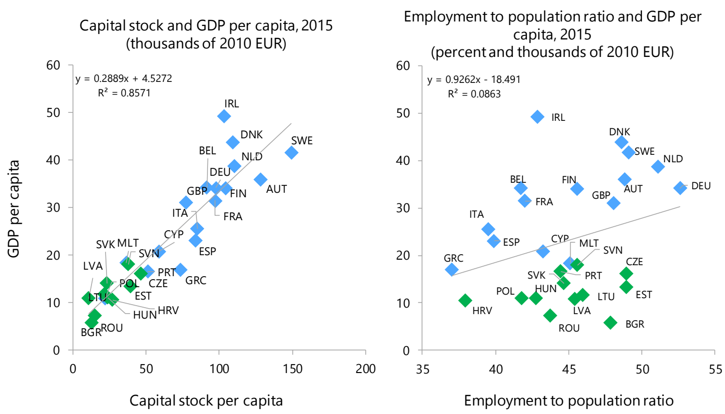


Figure 10

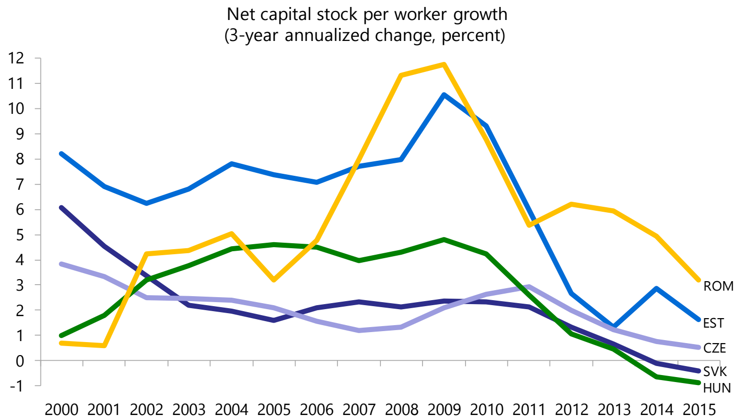


Figure 11

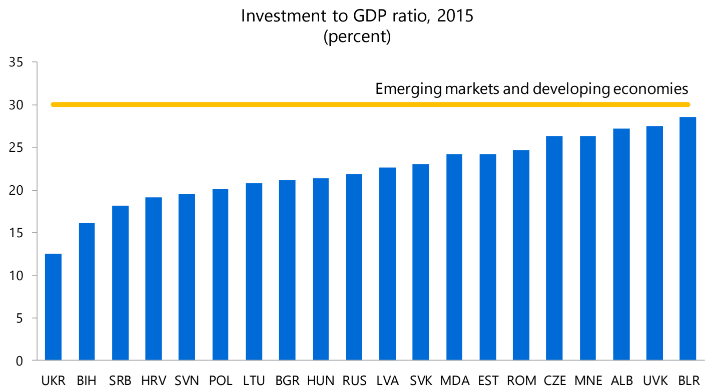
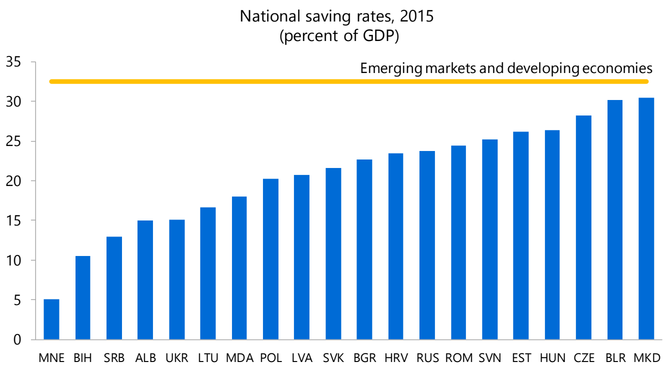


Figure 12



Unfortunately, the growth of the capital stock per capita has slowed (Figure 10), which reflects the decline in investment rates. Investment rates are low compared with other emerging market countries (Figure 11). Saving rates are low too (Figure 12), which suggests that a rebound of investment could lead to a re-emergence of high current account deficits, unless savings increases as well. Yet it may be challenging to boost saving. With labor markets tightening, wages shares are likely to increase, which is likely to reduce corporate profits. Indeed, in a number of countries this is already happening (Figure 13).

Household savings are difficult to influence. Boosting public savings would help, yet even though unemployment rates are falling, few countries plan a meaningful fiscal tightening (Figure 14).

Figure 13

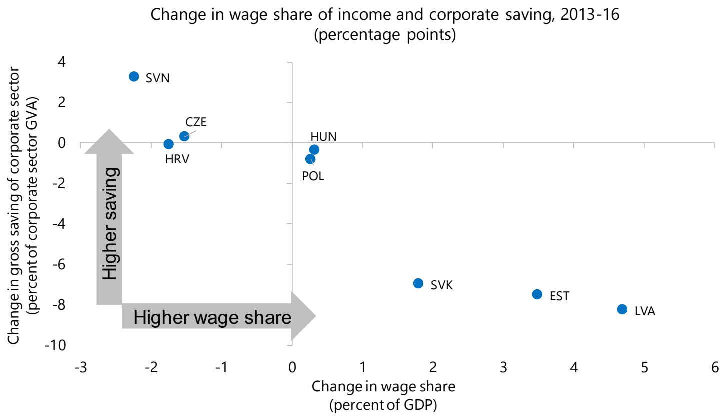
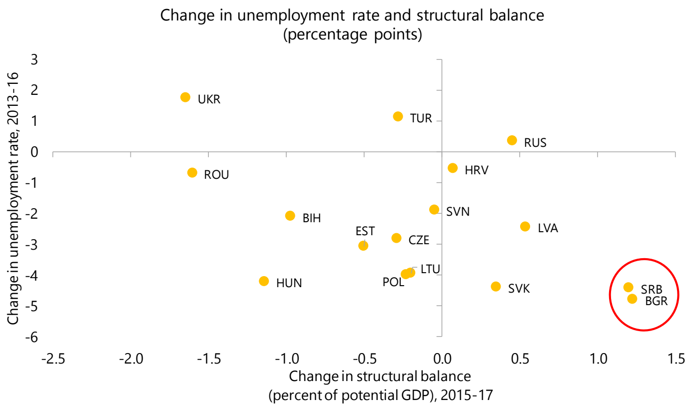


Figure 14



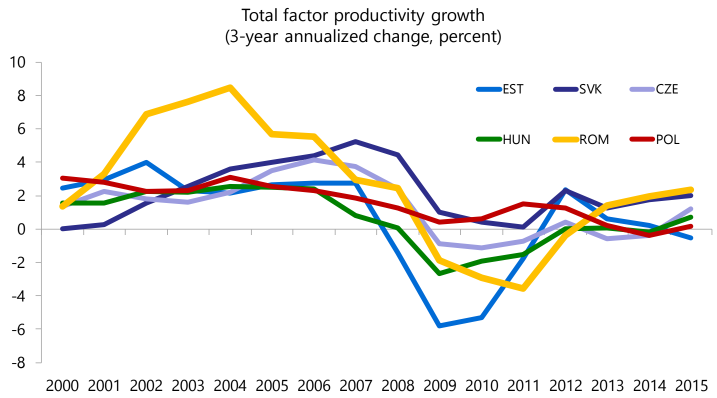
TFP growth has slowed as well. TFP growth has recovered somewhat in recent years, but it is still much slower than in the pre-crisis years (Figure 15). The TFP slowdown might be a result of both the decrease of productivity in main trading partners and unfinished post-crisis adjustment.

The IMF's CESEE Regional Economic Issues have identified several factors that might restrain productivity and investment. The May 2016 and November 2016 IMF CESEE Regional Economic Issues[4] analyzed several areas where reforms are needed in CESEE, and recommended to improve institutions to boost productivity. The May 2016 REI suggested the largest efficiency gains might come from increasing protection of property rights, upgrading legal systems and other government services. In this context, the November 2016 REI discussed the need to improve public investment management and tax administration. Given the large gaps in infrastructure and capital stock to Western Europe, improving the efficiency of public investment by improving its allocation and the implementation of frameworks

[4] In many countries, demographics pressures have been exacerbated by the net emigration. A reduction in emigration, or even reversal, would also help. See IMF Staff Discussion Note "Emigration and Its Economic Impact on Eastern Europe" available at https://www.imf.org/external/pubs/ft/sdn/2016/sdn1607.pdf

and procedures could boost potential growth significantly. Regarding tax administration, reducing compliance gaps, would help improve tax collection, which could generate more fiscal revenues and allow for higher public investment.

Figure 15



In short, further catch-up is possible but challenging. Labor force participation could be further increased, which would also help to offset declining share of working age population. A slowdown or even reversal of net emigration would also contribute. The capital stock is relatively low, and higher investment is needed especially in infrastructure, but raising the saving rate will be a challenge. Since the crisis the TFP has slowed considerably, and re-igniting TFP growth will be crucial for boosting growth. For all this, improving the quality of institutions and legal frameworks will help.

Bas B. Bakker

International Monetary Fund
BBAKKER@imf.org
www.imf.org

Bas B. Bakker is the IMF's Senior Regional Resident Representative for Central and Eastern Europe in Warsaw. He joined the IMF in 1993 and has held in four IMF departments, working on a range of countries, and policy and research issues. He has worked extensively on central and Eastern Europe, including as head of the Emerging Europe Regional Division and as mission chief for Bulgaria, and is the co-author of the book "How Emerging Europe Came Through the 2008/09 Crisis: An Account by the Staff of the IMF's European Department." He is a national from the Netherlands and obtained his PhD in economics from the University of Groningen.

Marta Korczak

International Monetary Fund
Mkorczaki@imf.org
www.imf.org

Marta Korczak is an economist in the IMF's regional office for Central and Eastern Europe in Warsaw.

Krzysztof Krogulski

International Monetary Fund
KKrogulski@imf.org
www.imf.org

Krzysztof Krogulski is an Economist in the International Monetary Fund's Regional Office for Central and Eastern Europe in Warsaw. He is responsible for surveillance and analysis of cross-regional developments and supports outreach of the IMF in the region. He graduated from the Warsaw University.

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