Regional Economic Outlook and Regional Economic Issues – Focus on CESEE

IMF Macroeconomic Policy Seminar
Vienna, June 13, 2018

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THE WORLD ACCORDING TO THE APRIL 2018 WEO
In CESEE, CIS recovering and non-CIS growing strongly
GDP per capita is well above pre-crisis level (except Ukraine)
NON-CIS CESEE
Growth is rapid, and unemployment is falling sharply

Real GDP growth (Percent)

Unemployment Rate (Percent)

SEE EU

SEE non-EU

Baltics

CE-5

SEE non-EU

SEE EU

Baltics

CE-5
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.
Even if we exclude peak pre-crisis years: current growth is lower but employment growth higher than pre-crisis.
Inflation, which was very low in 2015-16 has picked up recently.
Energy and food prices played key role in pickup of inflation

Oil and Food Prices
(Percent, Y/Y, 6 months moving average)
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)

- Employment growth
- Working Age Population Growth and UN projection
In the EU NMS wage growth has accelerated, while it has remained more modest in the Western Balkans.
In Western Balkans unemployment rates are still very high and employment rates low.
Unemployment is coming down rapidly and is now below pre-crisis levels in many countries.
The wage Phillips curve is flat in Western Europe and steep in NMS countries.

Wage Phillips Curve (based on panel regression)

Selected EU15 countries

Wage growth vs. Unemployment gap

Slope = -0.4

NMS countries

Wage growth vs. Unemployment gap

Slope = -0.9

Source: Spring 2018 Regional Economic Outlook for Europe
Rapid decline of unemployment suggests that GDP is growing faster than potential

- At some stage, labor market shortages will become constraint on growth

- Growth can only continue at this pace if productivity picks up
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.
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

Change in GDP (percent)

- Between 2013-15
- Between 2013-16

Ukraine  Belarus  Russia
Exchange rate flexibility was unavoidable given the limited buffers...

Foreign reserves and XR depreciation (6-month moving averages)

USD exchange rate (index, H1’2013=100)

Foreign reserves (USD index, H1’2013=100)

Depreciation

Reserves drawdown
...but increased inflation and reduced real wages

CPI Inflation in European CIS
(Percent, weighted average)

Average monthly wages
(USD)

RUS
BLR
UKR
Ukraine and Russia are now recovering (helped by rising oil prices)
Moldova had a banking crisis in 2014

- Three large banks collapsed as a result of their long-lasting abuse by the shareholder(s)
- Supervisory action was slow to come
- Supervisory forbearance increased the ultimate resolution costs to the budget
But is now also recovering

Real GDP Growth in Moldova
(Percent, y/y)
Near-term prospects show solid growth

Real GDP Growth Projections (Percent)

<table>
<thead>
<tr>
<th>Country</th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
</tr>
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<tbody>
<tr>
<td>RUS</td>
<td></td>
<td>1.8</td>
<td>1.4</td>
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<tr>
<td>BLR</td>
<td>2.7</td>
<td>3.0</td>
<td></td>
</tr>
<tr>
<td>UKR</td>
<td>3.1</td>
<td>3.5</td>
<td>3.8</td>
</tr>
<tr>
<td>MDA</td>
<td>3.6</td>
<td>3.7</td>
<td>3.8</td>
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But growth is low in comparison to pre-crisis period.

Real GDP Growth
(Percent, 3-year moving average)
RISKS TO THE OUTLOOK
Since WEO was published we have seen

- Weaker than expected growth in euro area
- Increased market turmoil, both in
  - Euro area periphery
  - Emerging market countries
Since the WEO was published, growth in the EA in Q1 came in lower than expected.
So far, consensus forecast for this year has not changed much.
For the USA, forecasts of growth and inflation have been increasing.
With a new government in Italy, interest rates in euro area periphery have been rising.
Currencies of large EM have been under pressure

Emerging Markets Currencies
(May 2017=100)
Outside Russia and Turkey, currencies in CESEE have remained stable.
THE FUTURE OF CONVERGENCE
Convergence has resumed (except in CIS)

Real GDP per capita (Percent of Germany)

- CE-5
- Baltics
- SEE EU
- CIS
- SEE non-EU
But CESEE is still much poorer than Western Europe.

GDP PPP per capita in 2017
(As percent of Germany)
As fewer people work and there is less capital per worker.
Growth is slower than pre-crisis...
As investment rates are lower (except CIS)

Investment Rate
(Percent of GDP, 3 year moving average)

*Excl. MKD
Technological progress and efficiency advance much more slowly.
Further exacerbated by the decline of the working age population
Fall in TFP is a global problem

TFP growth
(Percent, 5 year moving average)
Why has global TFP growth slowed?

Gone with the Headwinds: Global Productivity

Gustavo Adler, Romain Duval, Davide Furceri, Sinem Kiliç Çelik, Ksenia Koloskova, and Marcos Poplawski-Ribeiro

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Several interrelated factors have played a role

- To some extent measurement issues
- Weak corporate balance sheets, tight credit conditions which constrain investment in intangible assets
- An adverse feedback loop of weak aggregate demand, investment, and capital-embodied technological change
- Elevated economic and policy uncertainty
What can be done to boost TFP growth

Address several problems

- Limited access to financial services (e.g. for SMEs)
- Infrastructural gaps
- Inefficient legal systems and other government services
Improve institutions, especially judiciary

Judicial Independence, 2015

Impartial Courts, 2015

Source: World Economic Forum. Note: Worldwide distribution excluding LICs
Other institutional indicators also show a room to catch up to Western Europe

World Governance Indicators, 2016
(Ranges from -2.5 (weak) to 2.5 (strong) governance performance)
EU accession process should lead to improved institutions / completion of transition

Average of Six EBRD Transition Indicators in 2014

Note: 2007 for Czech Republic.
Institutional reforms provide large efficiency gains

- 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