



The catching-up process in CESEE countries: Experiences and drivers

Dimitar Bogov,
Governor

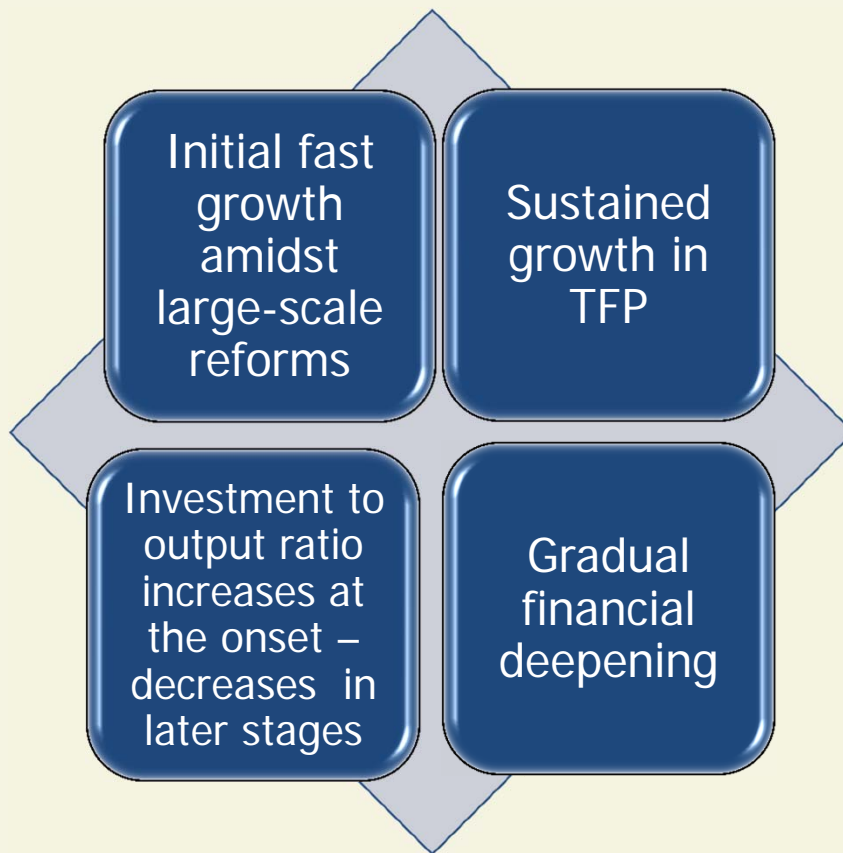
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Brief Reminder of the Convergence Features

Successful and rapid convergence historical episodes reveal four features of a convergence process



Is CESEE group different?

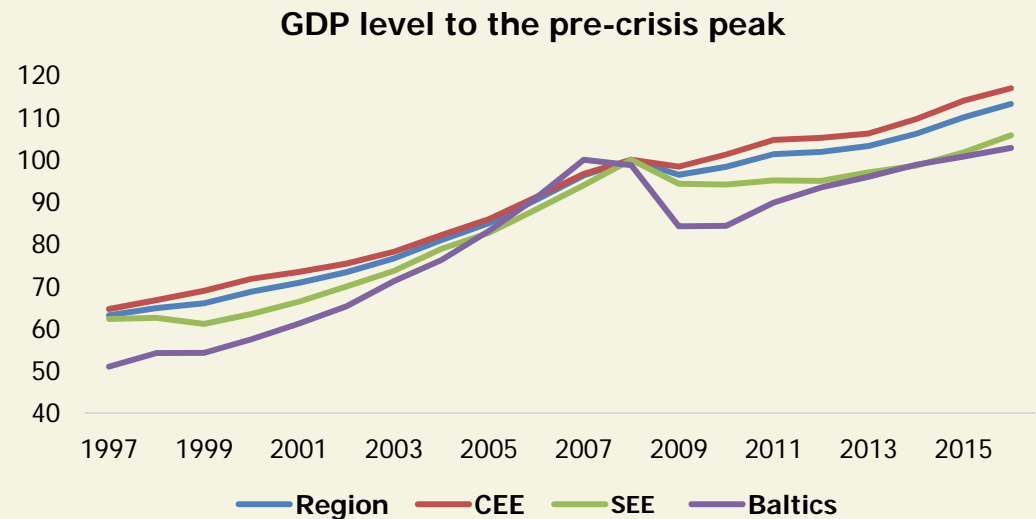
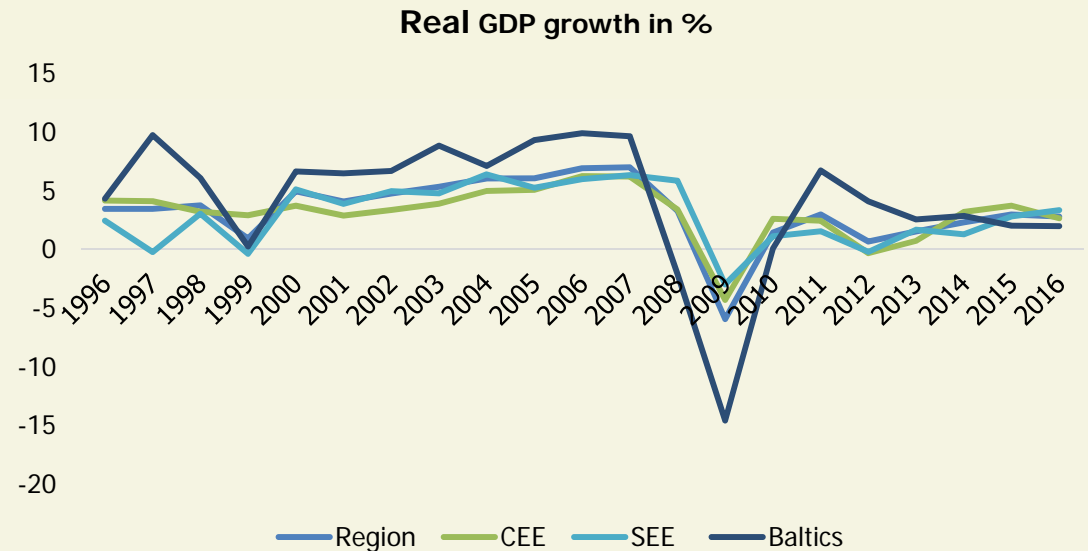
- Strong recovery after notable output losses at the onset of transition (similar speed to fast growth economies)
- Many countries embarked on large scale reforms
- Stronger and sustained TFP growth, and more rapid financial deepening, but...
- ...slower growing labor force and slower capital deepening
- The convergence process “caught” by the emergence of the global crisis



Stocktaking of the Real Convergence Stages of the CESEE countries

Facts:

- Almost 60% of the post-transition convergence occurred within 2003-2008 period...
- ...on the backdrop of remarkably **growth conducive global surrounding** and **favorable EU prospects**
- Financial crisis put a halt on growth, as the magnitude of the **crisis** was immense
- However, post-crisis cyclical recovery in place, and the GDP level exceeds the pre-crisis peak in almost all of the countries (except for Croatia and Slovenia)





Stocktaking of the Real Convergence Factors

Advantages of the CESEE group compared to some other "convergence examples" ...

Unusually favorable global environment –

global liquidity glut, low interest rates, rapid expansion of global supply chains and buoyant trade:

- Enabled financial inflows,
 - Financial and trade deepening and

Fostered the real convergence process

EU prospects

- very strong economic and political anchor

Disadvantages of the CESEE group compared to some other "convergence examples" ...

Obsolete capital stock

Low saving rates

Already old population, no room for fast labor force growth

Political turbulence (war, changing borders)



Stocktaking of the Real Convergence Factors

- How was the growth generated?
- Positive contribution from all factors, but TFP, predominant
- Modernization of production and new technologies, resulted in **rapid productivity catch-up across the board**
- Differences across region – with CEE and Baltics surpassing the levels in 1980, while the SEE group lagging behind

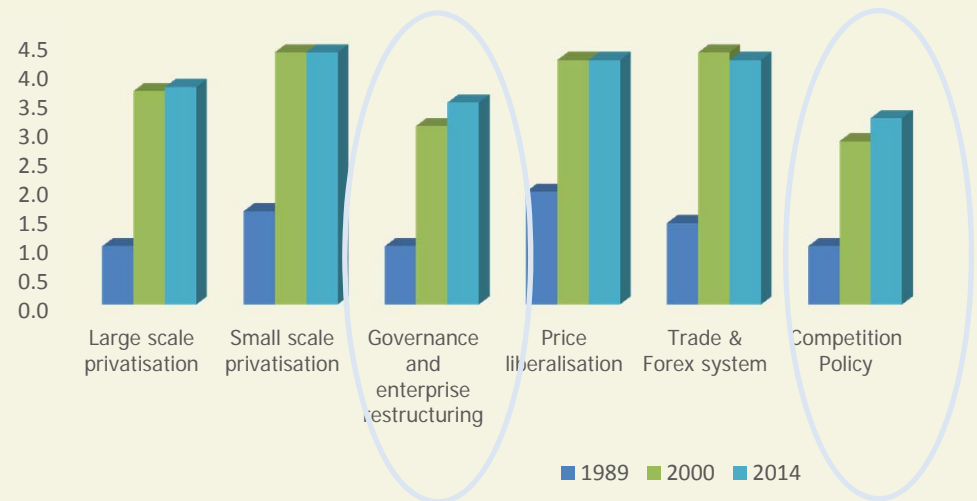




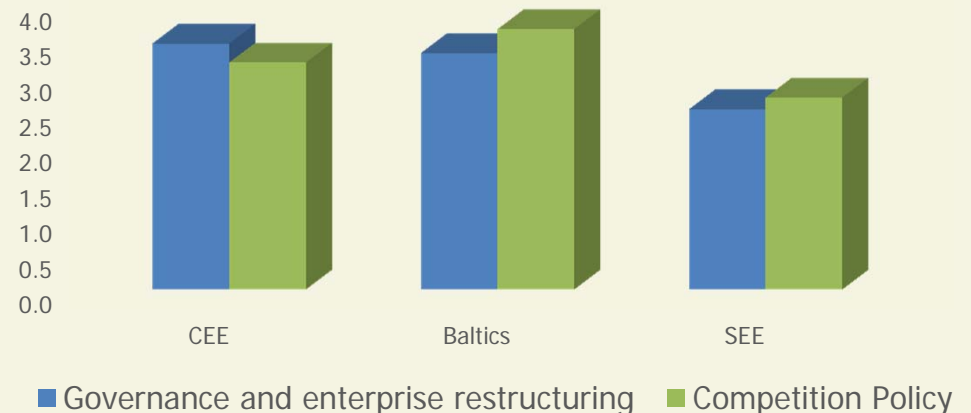
TFP growth supported by market reforms

- Productivity convergence, strongly underpinned by structural reforms
- Rapid increase of the reform indices until the end of the decade
 - momentum was lost and stagnation occurred in mid 2000s
 - natural stagnation in areas with substantial convergence
 - but reforms stalled in areas where gaps were still present, as well – governance and competition policies
- Notable differences in the progress in these two areas achieved in the Baltics and CEE countries on one hand and SEE group on the other
 - The latter group lagging behind

EBRD Transition scores - average for the region



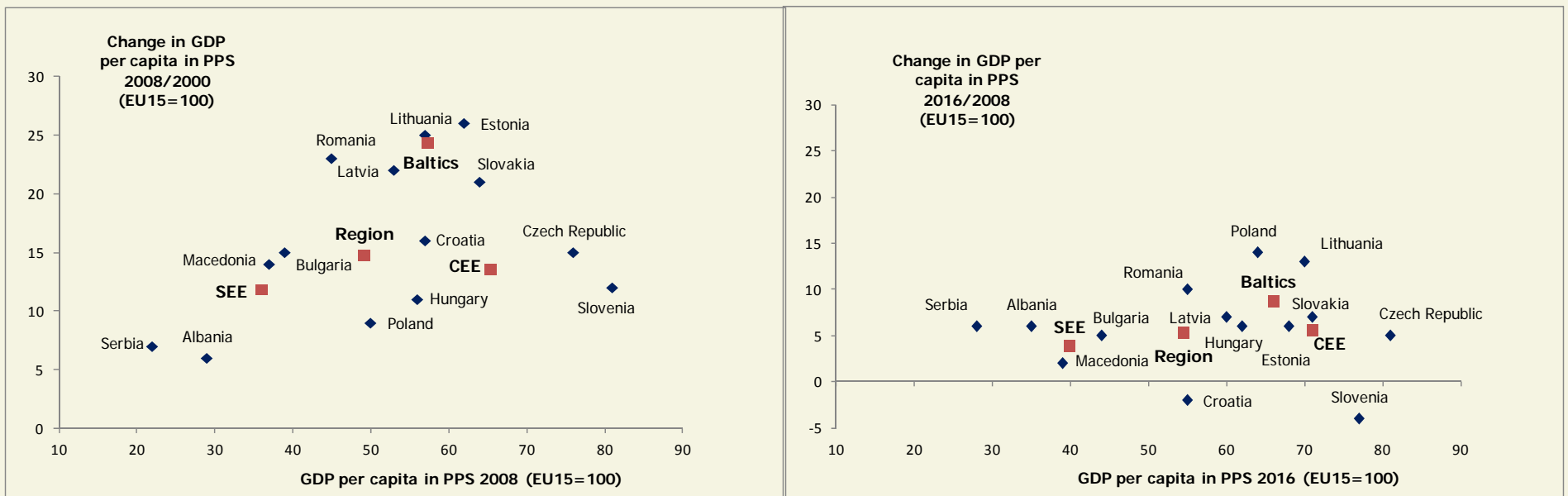
Transition Scores





The global financial crisis – effects on the speed of convergence

- Despite the growth, real convergence process lost steam - with exception of Poland where convergence remained on a fast track
- Convergence slowed even in some of the countries which are below or close to 50% convergence level (the SEE region in particular)

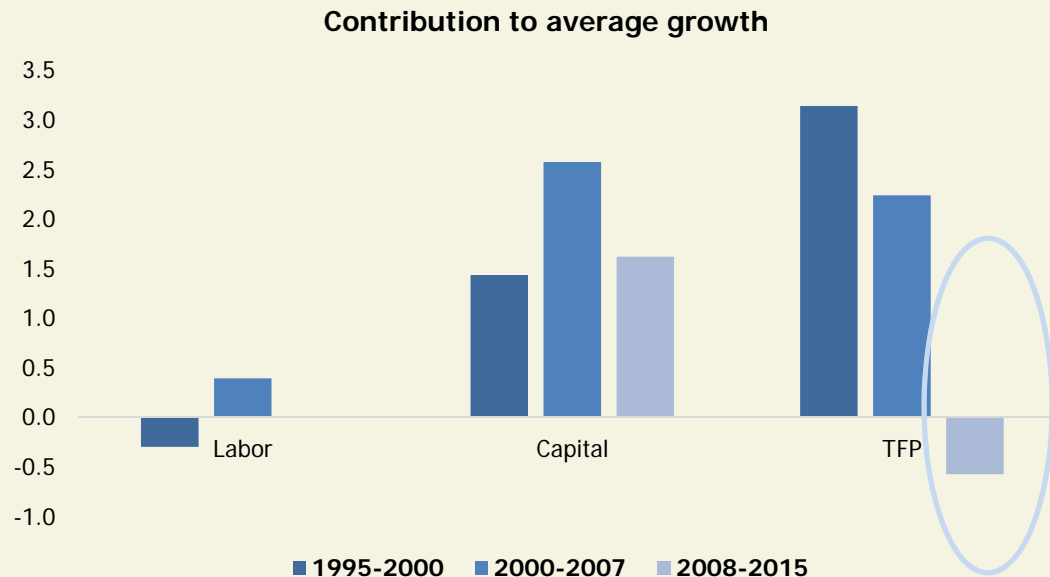


- Some countries reverted from the convergence path after the crisis (Croatia, Slovenia), being growth-constrained by mounted vulnerabilities



Where do we stand now?

- **Income convergence at risk?**
- **The main issue:** How to bolster convergence, with prolonged lower global growth, less trade and financial flows, less room for expanding global supply chains
- Though the need for labor and investment revival is valid, **the post-crisis drop in TFP urges the need for productivity catch-up**





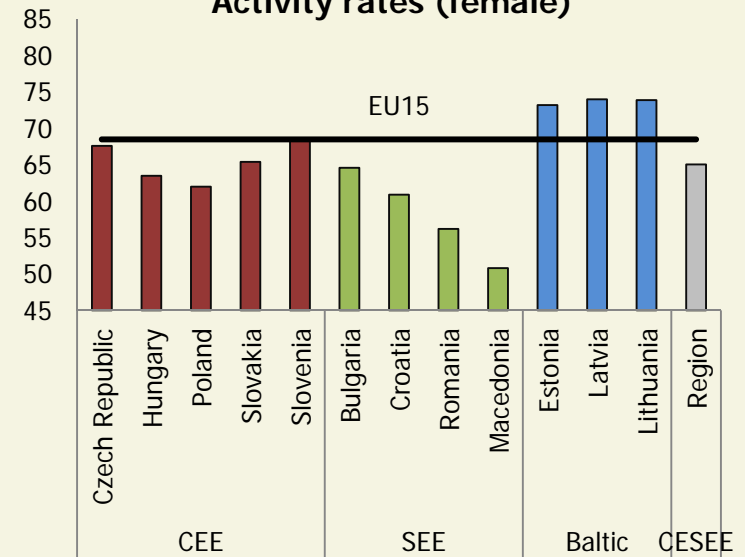
Labor and Capital as Future Growth Drivers (1)

- CESEE countries face many challenges in terms of labor, as a growth factor
- Decline in working age population, reflecting migration and lower life expectancy
- Participation rates and quality of human capital comparable to more advanced countries...
- ...but some structural bottlenecks remain:

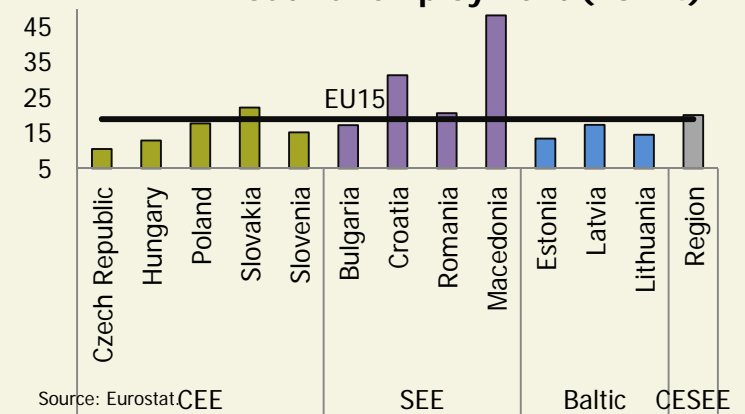
-lower female and senior participation rates, higher structural and youth unemployment, skills mismatches

- Areas which should be set as policy priorities

Activity rates (female)



Youth unemployment (15-24)



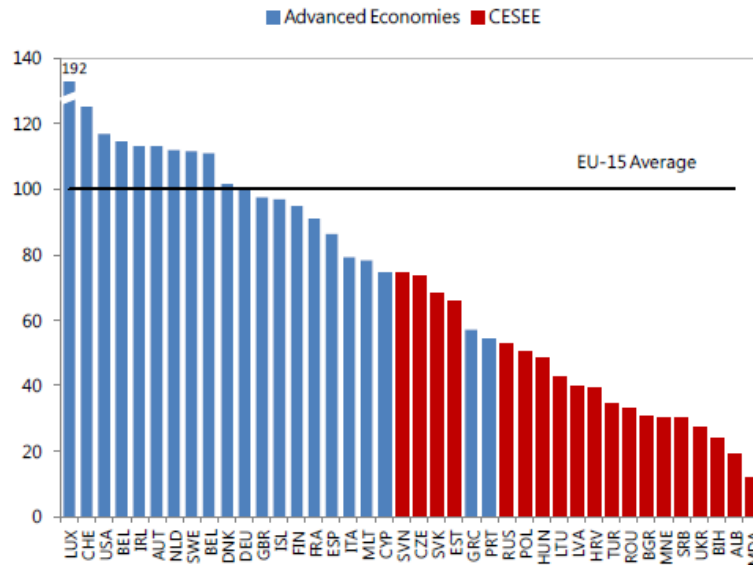
Source: Eurostat



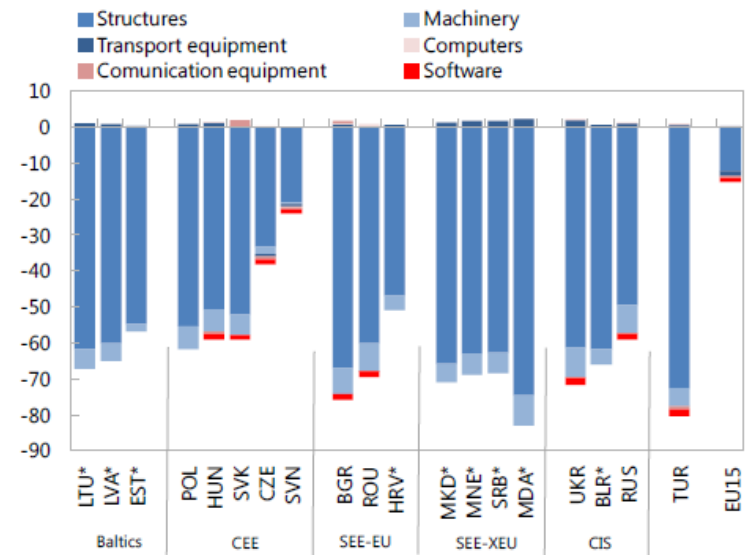
Labor and Capital as Future Growth Drivers (2)

- **Existent gaps in capital stock**, reflection lower savings rates, narrower borrowing space after the crisis and lower return on investments...
- ...urging for policies to boost saving and increase productive investments.

1. Capital Stock, Per Capita, 2014
(Percent of EU-15 average)



2. Capital Gaps, Per Capita, 2011
(Percent of U.S. capital stock per capita)



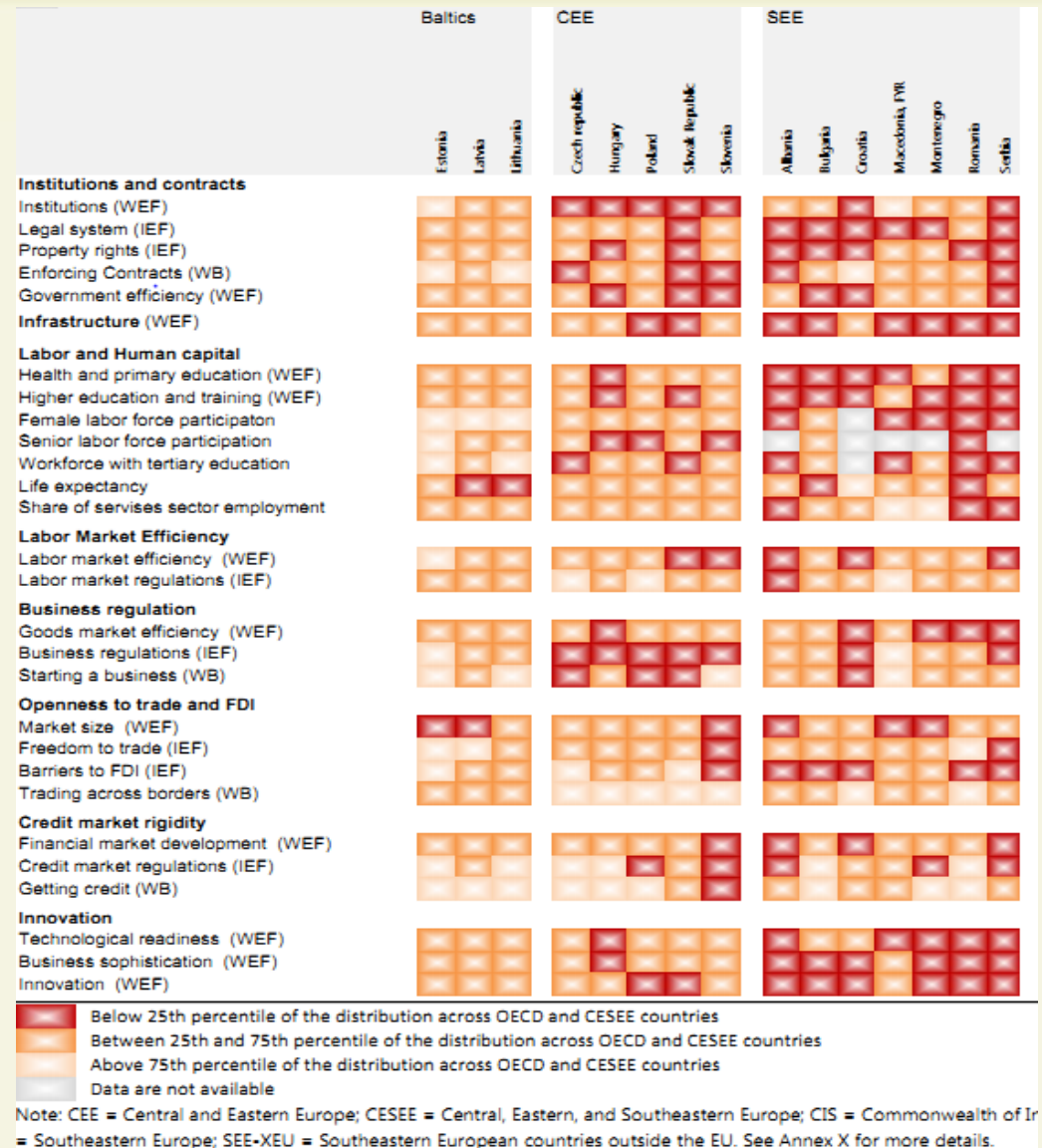
Source: Penn World Tables, Version 8.1.

Notes: Capital gap is the difference between the capital stock of country X and the U.S. capital stock. Asterisks denote countries that report only the basic structure of capital stock.



Comprehensive reforms – important growth driver!

- Structural reforms could bring significant **productivity** gains
- **The heat map of Institutional Quality** reveals a large space for convergence in many areas (**institutions, human capital and innovations, in particular**)...
- ...it also reveals differences among country groups, with Baltic countries leading on the reform stage, while SEE countries lagging behind in many areas...
- ...thus, indicating a close relation between the level of real convergence and institutional quality among countries





EU area membership

- How did the incorporation of the *acquis*, or the membership help in the convergence process?
- Adopting the *acquis* is demanding and costly – example: as of 8 March 2006, new 10 Member States had, on average, notified the implementation of 2654 Directives, of a total of 2683 Directives which they were obliged to implement
- The cost of compliance with the *acquis* difficult to estimate.
 - In particular in **environment**, **infrastructure** and **transport** the *acquis* obliges new Member States to significant investment expenditure in order to reach minimum standards provided for in the respective EU legal framework.
- Most estimates agree that the *acquis* on environment (Hager, 2002), and to a minor part that on transport, incurs to new Member States the by far most significant costs.



EU area membership

- However effects of the accession are profound!
- The most important effects through three main channels:
 - liberalization of trade, capital and labor flows;
 - institutional and legal development and integration;
 - and access to EU funding in part compensating costly transposition of the EU acquis in national legislation .

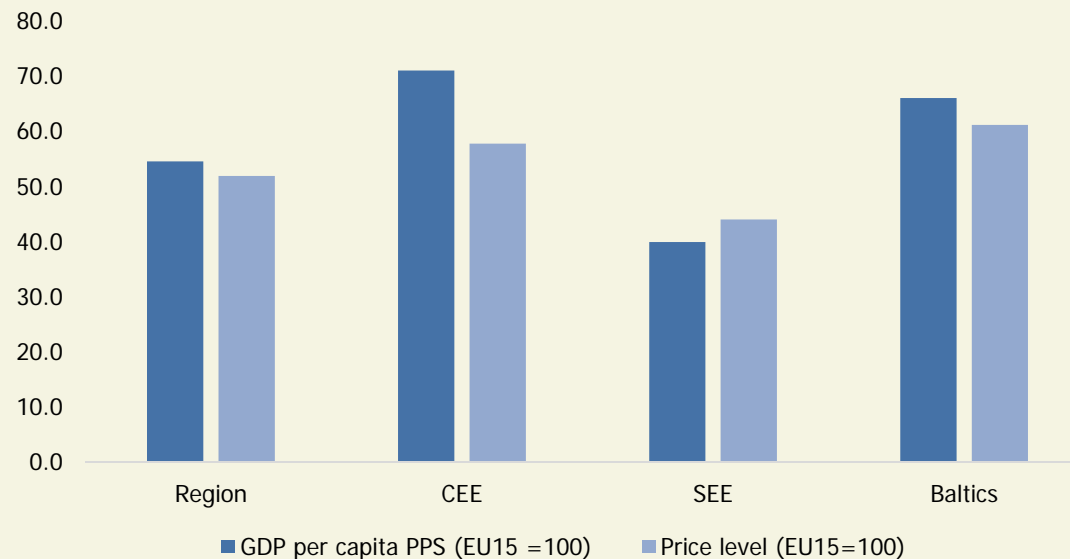
These effects were not felt only at the time of joining, but rather as a process, starting well before accession and continuing well after.



How do real and nominal convergence interact?

- **Rapid real convergence impacted the price level convergence as well** – many well known spill-over channels with opposite effects
- **Currently, comparable levels of real and nominal convergence on average**, but large differences among countries
- **CEE price level convergence below the real convergence level**, possibly suggesting productive growth pattern with less of a price pressures
- **Only few countries with significantly higher price level convergence compared to the income convergence** (Serbia, Bosnia, Montenegro) – possibly suggesting presence of shocks or existing vulnerabilities creating price pressures not supported with equivalent growth

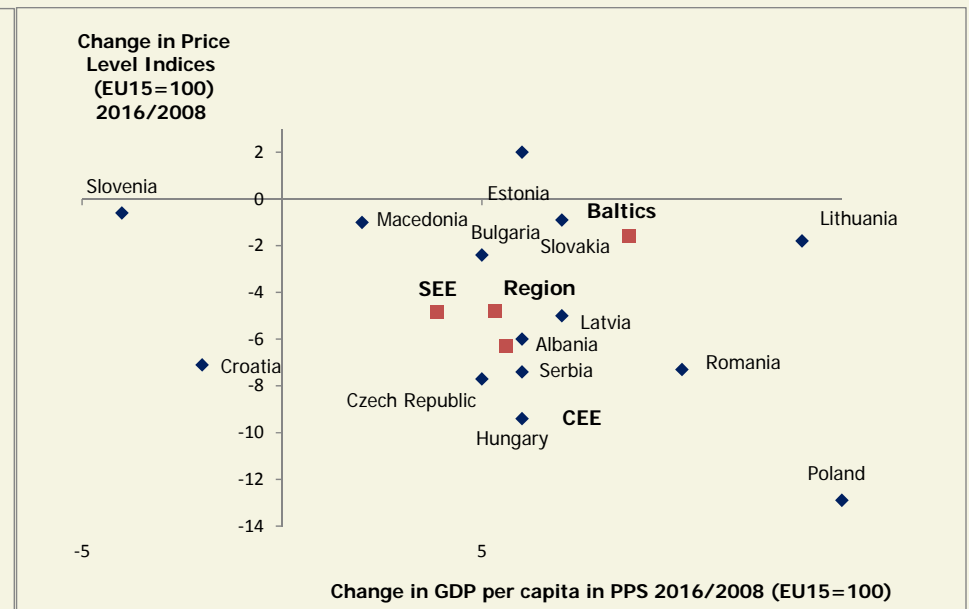
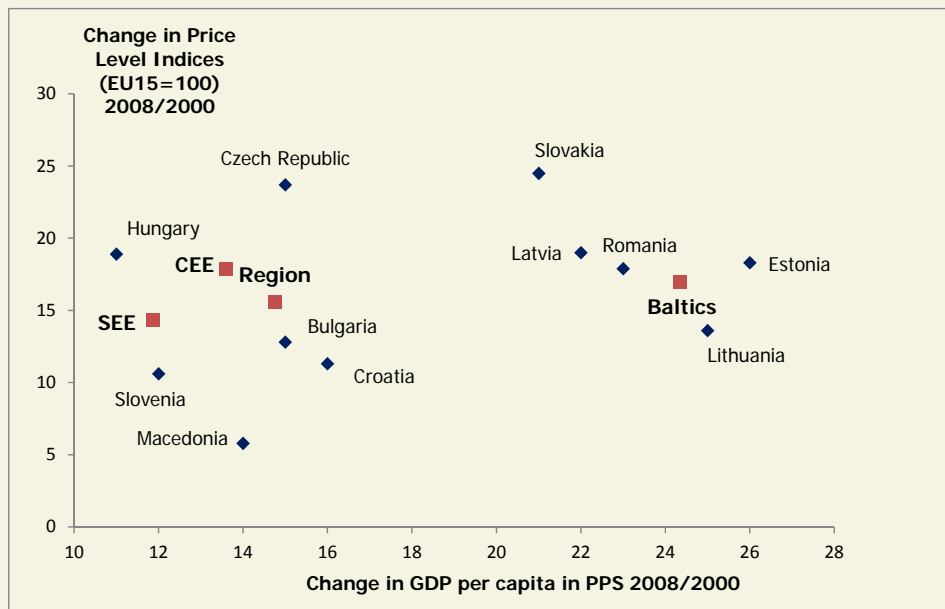
Real and Price level convergence in 2016





Positive shifts in the post – crisis period, growth without price pressures

- On average, comparable convergence in income and prices in the pre – crisis period
- After the crisis, real convergence proceeded, while price level convergence reversed...
- ...indicating growth sources, with no price pressures and less of vulnerabilities?





Conclusion

- The region made tremendous progress in the real convergence process in the last 25 years on the backdrop of the intense reform agenda, conducive global environment and favorable EU prospects
- Large part of the convergence occurred before the occurrence of the global crisis, and the process slowed markedly afterwards
- Further convergence challenging at the current juncture, of less supportive external environment...
- ...urging for structural and institutional changes in the weakest areas to support further productivity growth...
- ...while embedding the dimension of the economic inclusion more tightly at the policy agenda