Catching-up in Central and Eastern Europe: progress, prospects and policies

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26 March 2008

The views expressed herein are only those of the presenter and do not necessarily reflect the view of the European Central Bank.

Outline

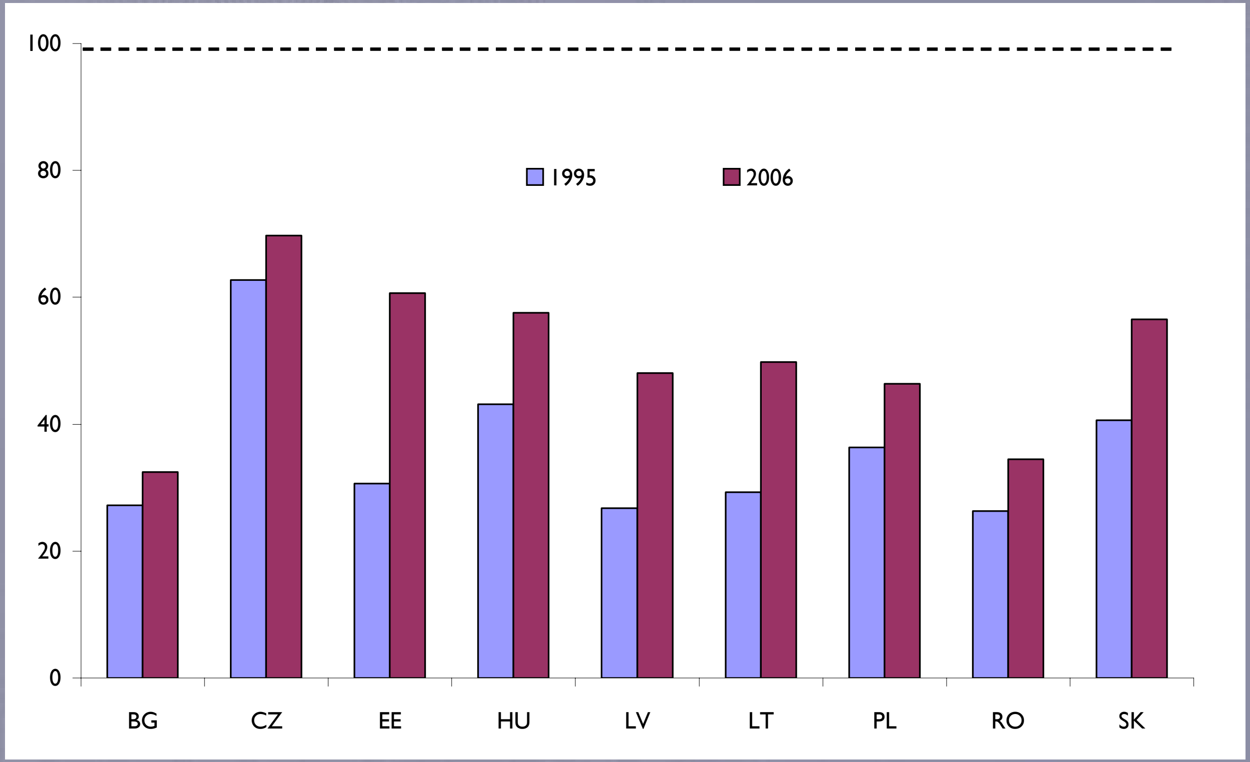
I. Recent economic developments

II. Determinants of growth in Central and Eastern Europe

III. Prospects for growth and policy measures to foster potential growth

I. Recent economic developments: GDP per capita

GDP per capita (euro area=100), in PPP terms, 1995 and 2006

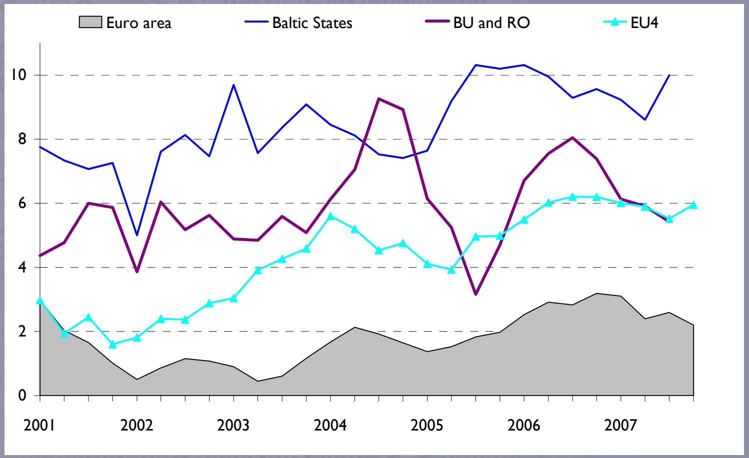


Source: Eurostat.

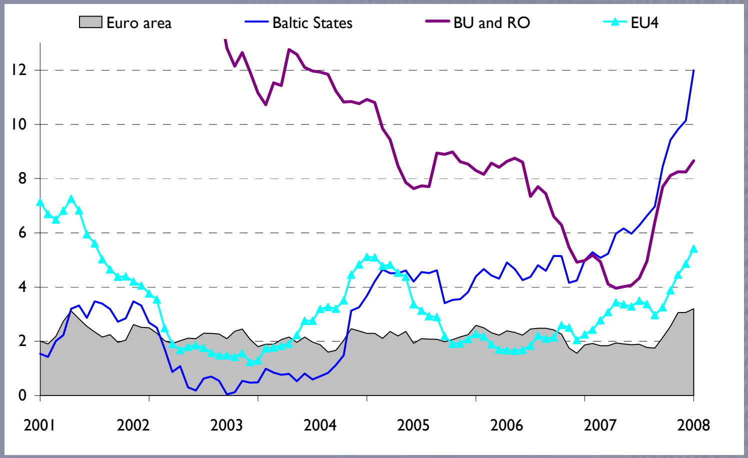
- GDP per capita levels increased in EU9, in particular in the Baltic States.
- Yet, income gaps with the euro area remain significant.

I. Recent economic developments

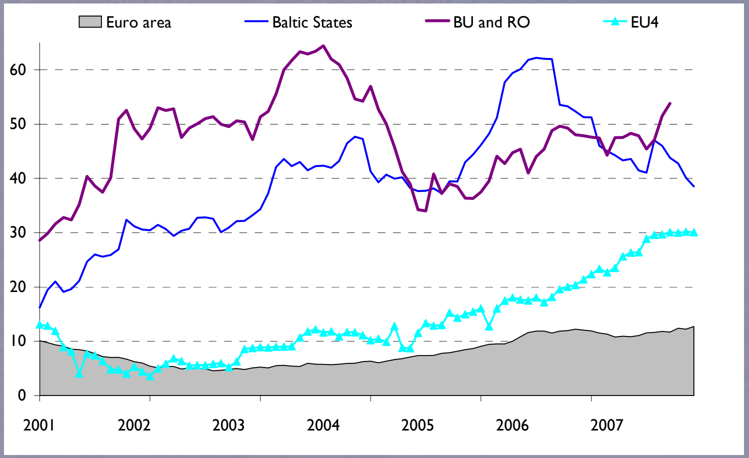
Real GDP growth, in %



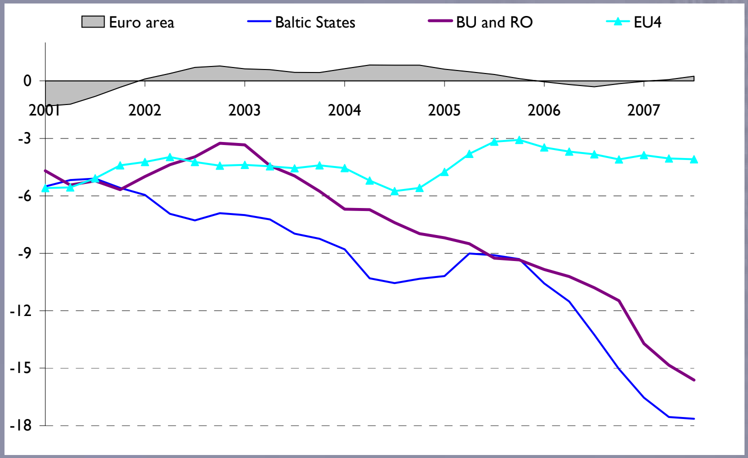
HICP inflation, in %



Credit growth to the private sector, in %



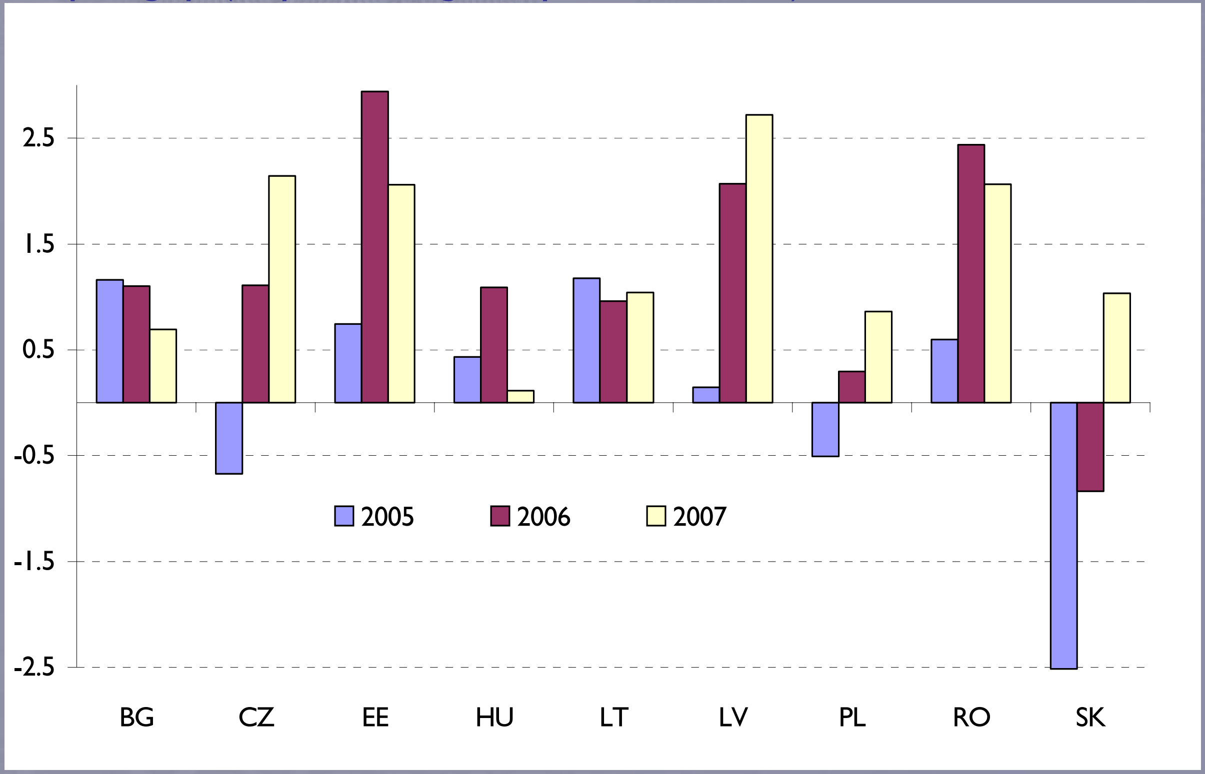
Current account (in % to GDP, moving average)



Source: Eurostat.

I. Recent economic developments: output gap

Output gap (in percentage of potential GDP), 2005-07



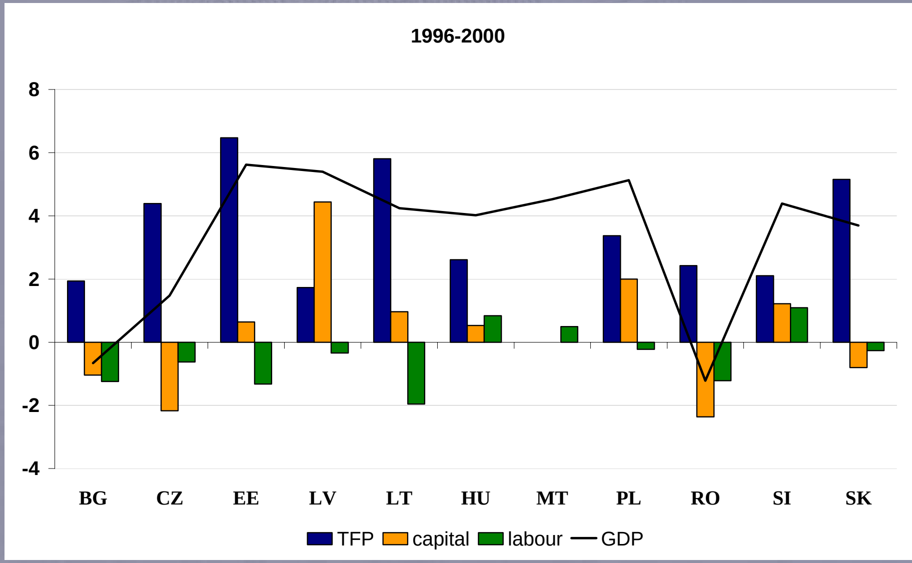
Source: European Commission.

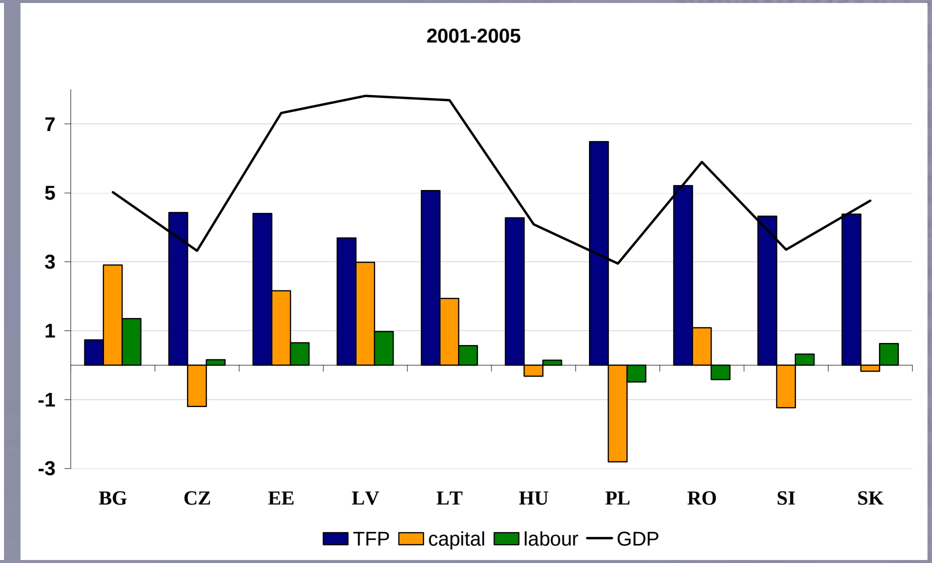
- Actual GDP growth mostly exceeded Commission's estimates of potential growth in EU9 countries.
- Estimates of output gap has been large and rising in several countries.
- Moreover, potential GDP growth estimates have increased in recent years

II. Determinants of growth: growth contributions

- Total factor productivity (TFP) made a significant contribution to GDP growth, reflecting large efficiency gains due to the transition process (privatisation, restructuring, higher competition).
- Labour utilisation was limited or even declined (labour shedding).
- Capital accumulation has contributed modestly to growth.

Contribution of TFP, capital and labour to average GDP growth (annual percentage changes)





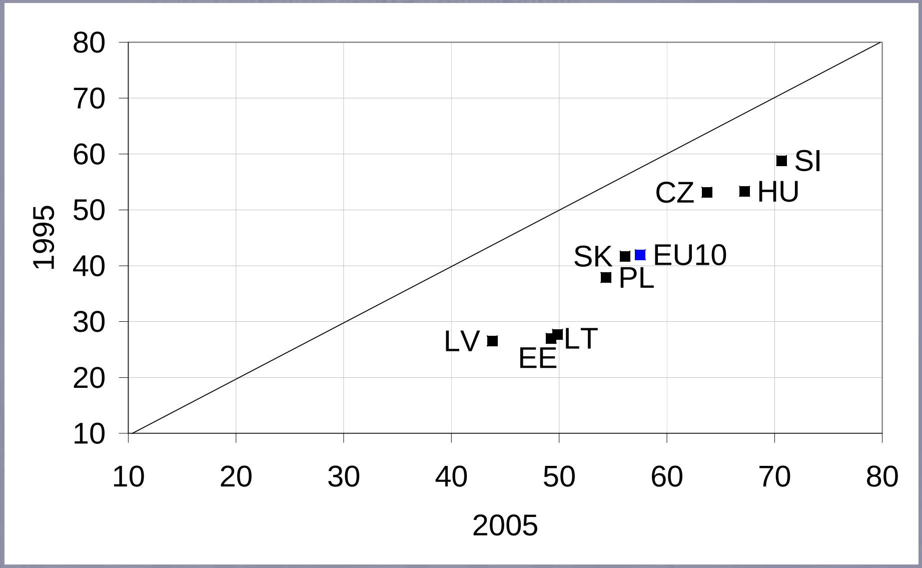
Source: GGDC Total Economy Database..
See Arratibel et al. (2007), ECB Occasional Paper 61.

II. Determinants of growth: labour productivity

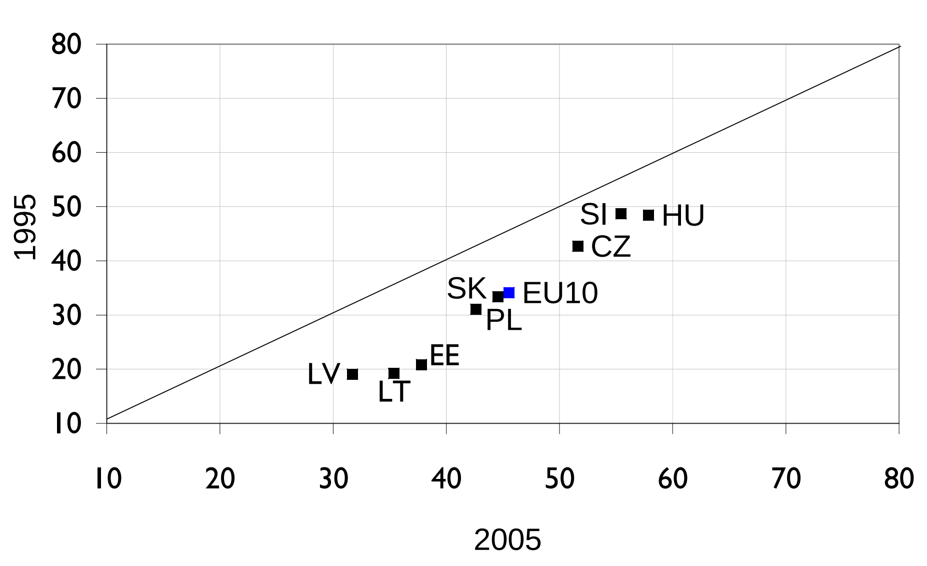
- Labour productivity levels improved in the last decade
- However, they remained diversified across countries, reflecting differences in labour market performance.

Relative labour productivity levels in the EU9 (euro area = 100)

(per worker)



(per total hours worked)



Source: ECB staff calculations based on GGDT Total Economy database. No data available for BG and RO.

II. Determinants of growth: labour markets

Employment rates, in % of population

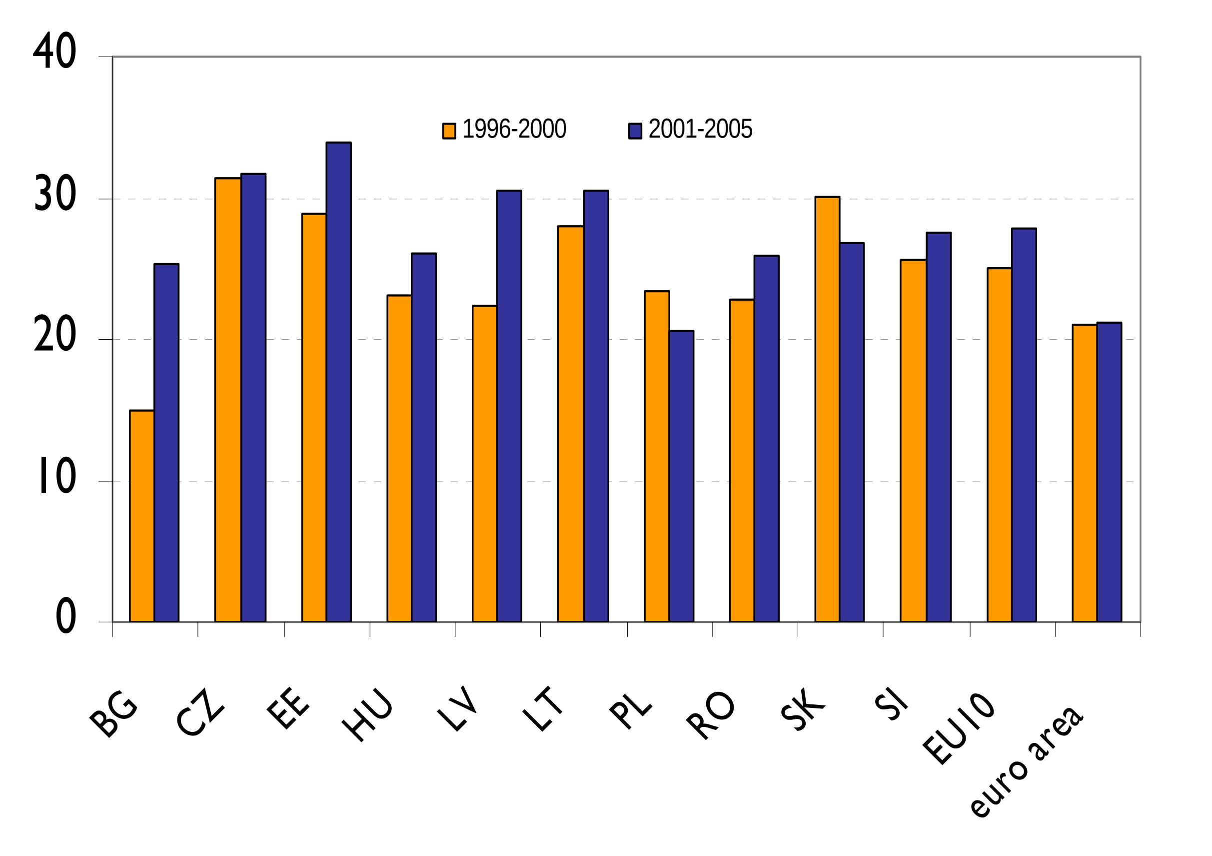
	1997	2006
Bulgaria	-	58.6
Czech Republic	68.6	65.3
Estonia	65.3	68.1
Latvia	59.7	66.3
Lithuania	62.3	63.6
Hungary	52.4	57.3
Poland	58.9	54.5
Romania	65.4	58.8
Slovakia	60.6	59.4
euro area	58.6	64.8

Source: Eurostat.

- Employment rates declined in a number of EU9 countries, standing mostly below the euro area average.
- Labour market performance deteriorated due to structural changes (transition from agriculture to services), but started to improve more recently.
- Labour mismatch in particular for skilled labour force; this usually has a downward impact on potential growth.

II. Determinants of growth: investment

Investment rates (in % of GDP)



Source: Eurostat.

- High and rising investment rates in EU9.
- Capital accumulation supported by improved profitability and declining costs of capital.
- However, high administrative burden was hampering business investment.
- Investments are largely financed through foreign savings.

II. Determinants of growth: innovation

R&D spending (in % of GDP)

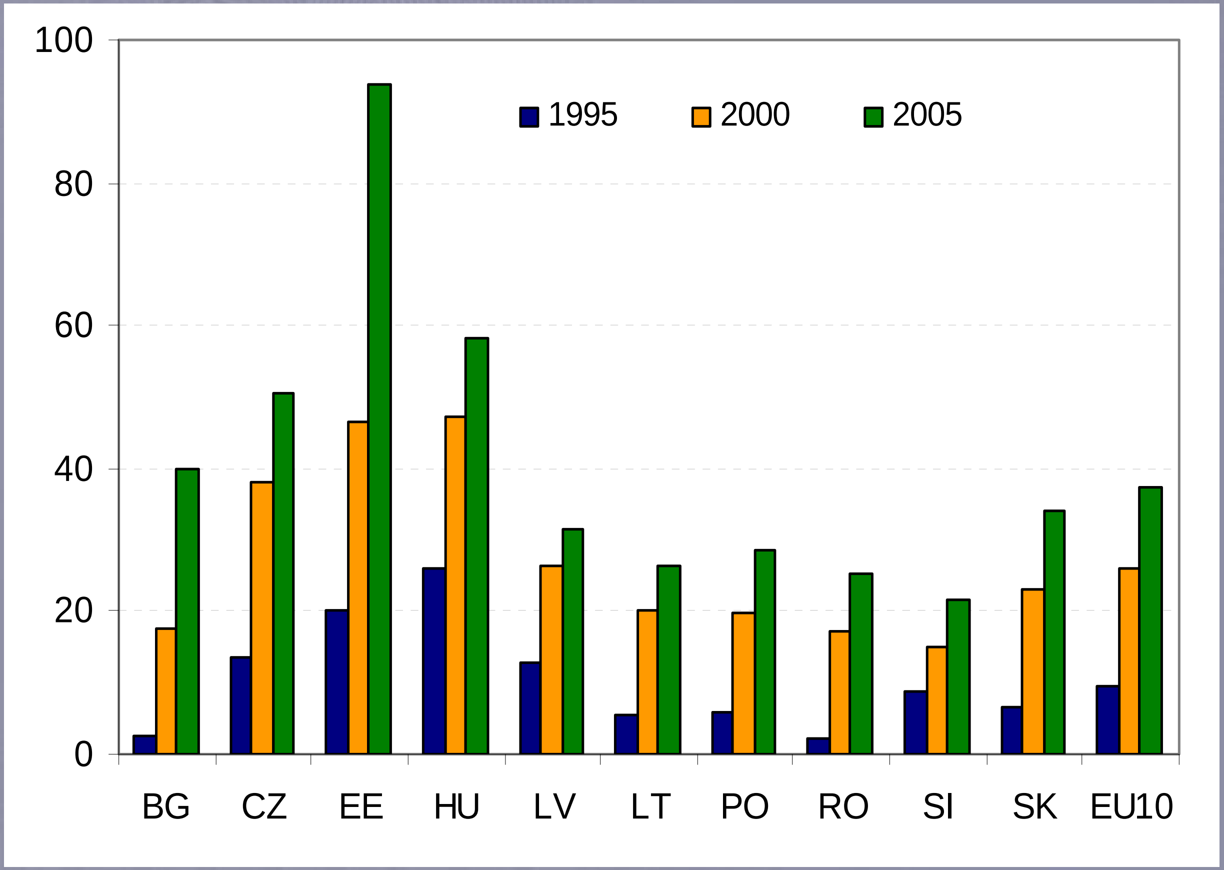
	1996	2006
Bulgaria	0.52	0.48
Czech Republic	0.97	1.54
Estonia	-	1.14
Latvia	0.42	0.69
Lithuania	0.50	0.80
Hungary	0.65	1.00
Poland	0.65	0.56
Romania	-	0.46
Slovakia	0.90	0.49
euro area	1.90	1.85

Source: Eurostat.

- R&D expenditures and number of patent applications are relatively low in EU9.
- Weak R&D involvement of the private sector as large companies are mostly foreign-owned.
- Moreover, lack of financing opportunities for SME (venture capital involvement is limited).

II. Determinants of growth: FDI inflows

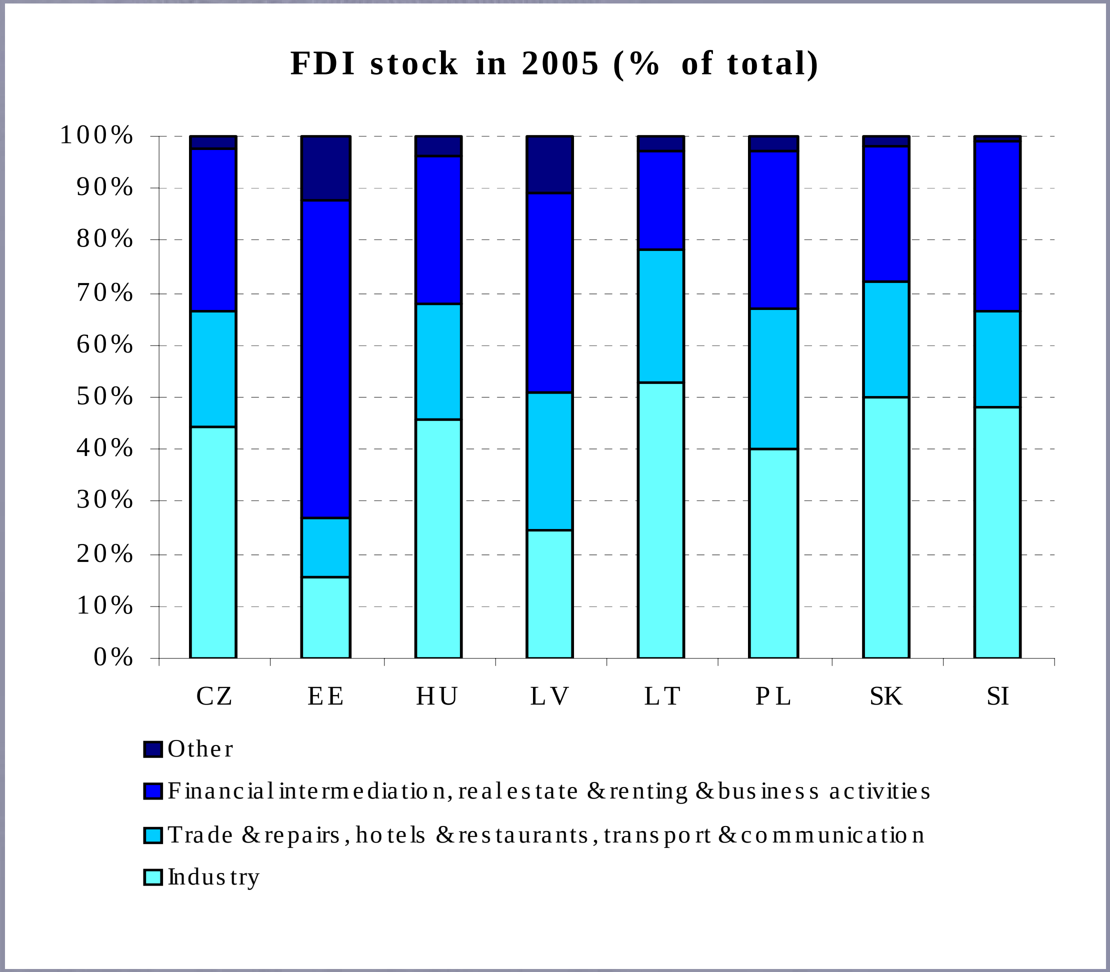
Inward FDI stock (in % of GDP)



Source: WiiW Database and Eurostat.

- The FDI stock increased sharply in EU9 countries.
- FDI inflows first mainly related to privatisation, while greenfield FDI picked up only recently.
- FDIs are key for capital accumulation and productivity growth due to spill-over of technology and knowledge.
- This requires, however, sufficient absorption capacity.

II. Determinants of growth: FDI inflows



Source: WiiW Database and Eurostat.

- FDI inflows mostly concentrated in the service sector.
- In the manufacturing sector, FDI inflows mostly to transport equipment and metals, which are key sub-sectors for exports.

III. Prospects for growth – main questions

- Real convergence was driven by remarkable increases in TFP growth. As the potential for "fast" efficiency gains is shrinking, this is not likely to continue in the future. What would become the main driver of growth?
- Catching-up has been rapid, at times possibly too rapid. Recently there have been signs of some growth moderation. At which speed will real convergence continue?
- Strong growth in potential GDP is crucial for a sustainable and healthy catching-up process. What is the outlook for potential growth?
- The convergence process has been hampered by some structural problems, in particular in the labour market. What needs to be done to bolster the catching-up process?

III. Prospects for growth – policy issues

- Overall, the prospects for real convergence in the EU9 countries are good.
- However, labour market bottlenecks (due to sectoral shifts and migration) are likely to have an adverse impact on real convergence in particular if combined with strong wage pressures. Also, problems might arise due to demographic developments.
- To foster potential growth in the future the EU9 countries need to address labour market problems, in particular regional and skill mismatches.

III. Prospects for growth – policy issues

- Capital accumulation will be a key factor for real convergence. To foster investment, administrative burden needs to be lowered and barriers to trade abolished.
- Moreover, to foster real convergence, the production structures need to be shifted towards higher value added goods and services. To ensure the availability of skilled workers human capital investment is essential.
- Incentives are needed for the business sector to become more involved in R&D activities. This would help to foster the innovation potential, increase the diffusion of technologies and to improve the human capital endowment.
- Macroeconomic stability and fiscal policy sustainability are essential for real convergence.

Thank you for your attention!