SPRING 2016 REGIONAL ECONOMIC ISSUES REPORT
on Central, Eastern and Southeastern Europe (CESEE)

How to Get Back on the Fast Track

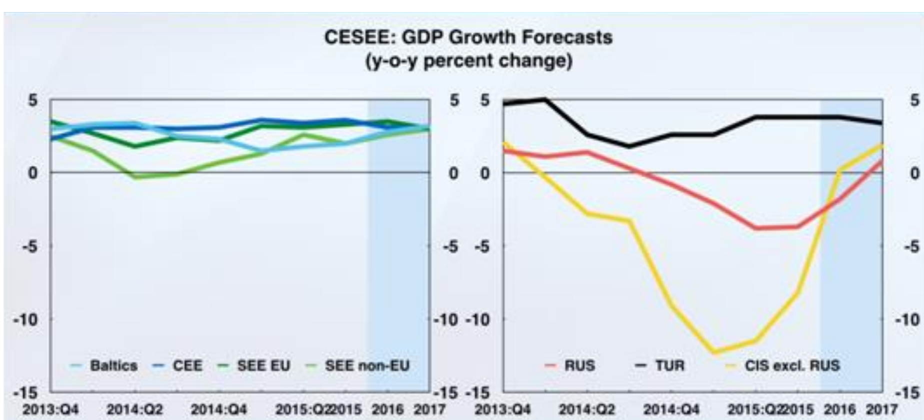
- *Growth is robust in most of the region, except the Commonwealth of Independent States (CIS) economies that are gradually coming out of recessions.*
- *But trend growth remains well below pre-crisis levels across CESEE, implying much slower pace of convergence to the income levels of advanced Europe.*
- *With less supportive global environment, structural reforms offer the best hope for CESEE to lift growth and speed up convergence. Policies should focus on productivity-enhancing reforms and measures to boost private savings and investment. Active labor market policies to counter the decline in the working-age population and skill mismatches may also be needed to support growth.*

Robust growth continues in most of Central, Eastern and Southeastern Europe (CESEE). Outside the Commonwealth of Independent States (CIS), supportive macroeconomic policies and rising real wages have been behind strong consumption growth, while private investment and external demand remain weak. In 2016-17, CESEE countries outside the CIS are expected to grow by 3 to 4 percent.

The CIS countries are gradually coming out of recessions, as negative shocks are receding. The oil price decline in mid-2015 and the need to address growing fiscal imbalances likely mean that the Russian economy will record negative growth in 2016.

Real GDP Growth Forecasts *(in percent)*

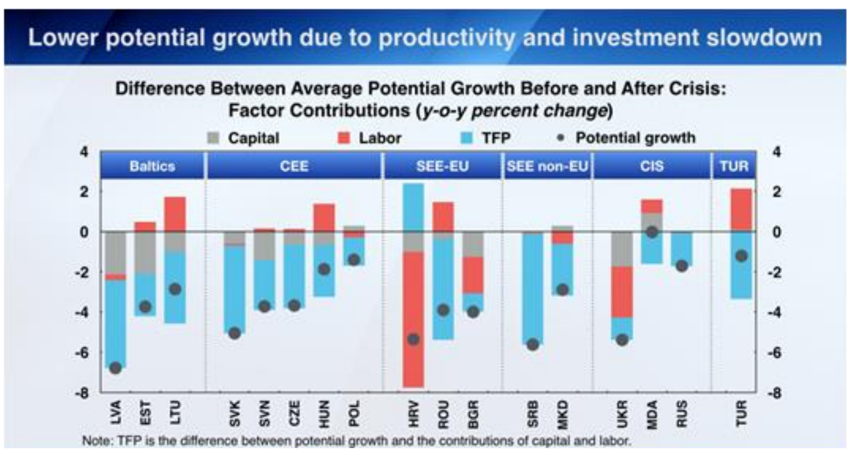
	CESEE[1]	Baltics[1,2]	Central and Eastern Europe (CEE)	Southeastern Europe EU (SEE-EU) [1,4]	Southeastern Europe non-EU (SEE-non-EU)	Other CIS[1,6]	Russia	Turkey
2015	**-0.4**	**1.8**	**3.6**	**3.3**	**2.1**	**-8.2**	**-3.7**	**3.8**
2016	**0.9**	**2.8**	**3.1**	**3.5**	**2.7**	**0.2**	**-1.8**	**3.8**
2017	**2.1**	**3.2**	**3.1**	**3.1**	**3.0**	**1.9**	**0.8**	**3.4**



Source: IMF World Economic Outlook database.
1/ Weighted average by GDP valued at purchasing power parity. 2 /Estonia, Latvia, Lithuania; 3/ Czech Republic, Hunagry, Poland, Slovak Republic, and Slovenia; 4 /Bulgaria, Croatia, and Romania; 5/ Albania, Bosnia and Herzegovina, Kosovo, Macedonia FYR, Montenegro, and Serbia; 6 /Belarus, Moldova, and Ukraine.

While the recovery has taken hold, risks to the outlook have risen and policies should remain supportive. Lower euro area and U.S. growth, tighter global financial conditions, and continued weakness in many emerging economies are the main headwinds. In addition, political risks have been on the rise across the region. Countries with low inflation, relatively good growth (but with downside risks) and still elevated fiscal deficits and debt should maintain accommodative monetary policy and aim to gradually rebuild fiscal buffers, relying as much as possible on growth-friendly fiscal consolidation measures. In the event of a negative growth shock, monetary policy should be the first line of defense. In case of a major shock, fiscal policy should ease within medium-term adjustment plans that dispel concerns about fiscal sustainability.

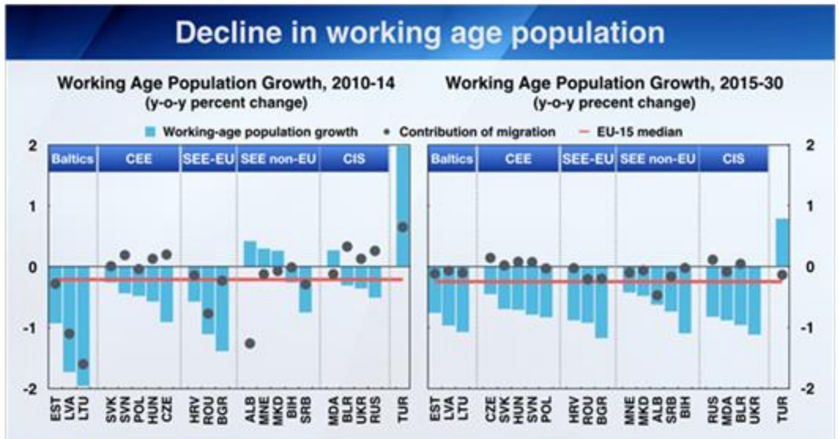
Furthermore, trend growth in CESEE remains well below pre-crisis levels, implying a much slower pace of income convergence with advanced Europe. From 1990 to 2008, CESEE countries made significant progress along the convergence path, on the back of strong total factor productivity (TFP) growth and to a lesser extent, capital accumulation. After the crisis, TFP growth slowed significantly across most advanced and emerging economies, including CESEE. Some of the factors that may have boosted TFP growth in CESEE before the crisis, such as robust growth in advanced Europe, or expansion of global trade and supply chains, appear to have stalled or gone into reverse after the crisis.



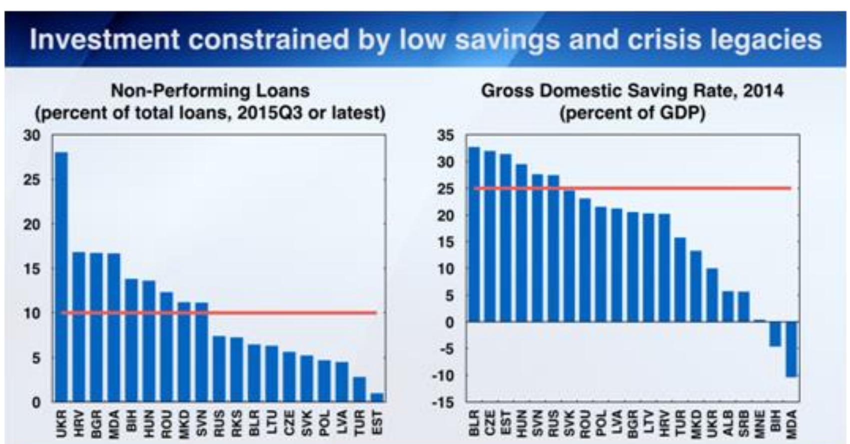
How Can CESEE Countries Get Back on the Fast Convergence Path?

With mediocre growth prospects for the global economy over the medium-term, greater reform efforts to increase productivity, support further capital deepening, and counter the decline in the working-age population may be needed to re-accelerate convergence. The reforms could be directed toward:

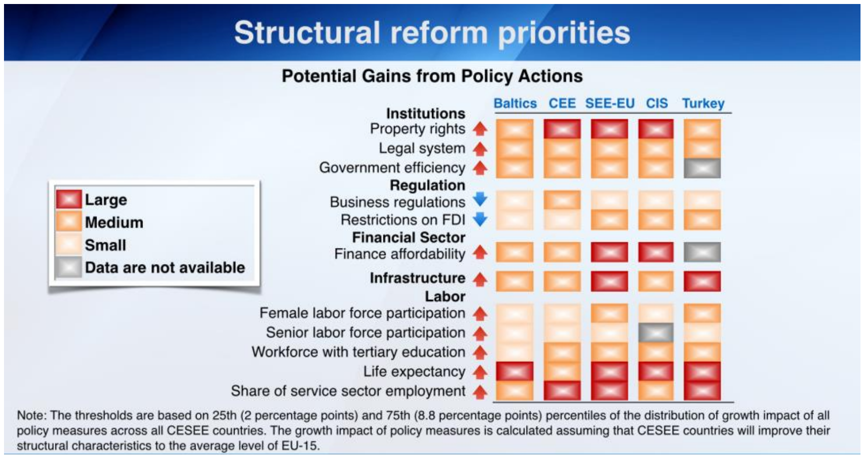
Improving the labor supply: CESEE countries are facing some of the worst declines in the working-age population in Europe, reflecting both unfavorable demographics and emigration—a trend that is expected to continue or worsen. Policies should aim at increasing participation rates (women and seniors), reducing structural unemployment and skill mismatches, and raising life expectancy. Better institutions would also help CESEE countries to retain and attract skilled workers.



Boosting investment: Capital stock per capita in a typical CESEE economy is still about a third of that in advanced Europe. Investment gaps are particularly wide in infrastructure, where public investment could help, but on its own would not be enough. While investment is still held back by crisis legacies (high debt burdens and nonperforming loans) and exceptionally high uncertainty about global growth, most CESEE countries need to cure deeper structural issues in order to lift private investment. In most countries domestic saving rates are not high enough to sustain investment rates required for successful convergence within a generation or so and without hitting external debt sustainability limits. Policies should therefore focus on institutional reforms that reduce inefficiencies and increase returns on private investment and savings.



Raising productivity: Achieving faster income convergence with advanced Europe would require CESEE countries to maintain higher TFP growth rates than in advanced Europe, which would increase the return on capital as well as incentives to save and invest. To ensure a sustained positive TFP growth differential with advanced Europe, CESEE countries may have to address structural and institutional obstacles that prevent efficient use of available technologies, or lead to inefficient allocation of resources. While it is hard to estimate precisely the quantitative impact of structural reforms on productivity and growth, the analysis in this report suggests the largest efficiency gains are likely to come from improving the quality of institutions (protection of property rights, legal systems, and healthcare), increasing the affordability of financial services (especially for small but productive firms), and improving government efficiency.



What are the key takeaways? The cyclical recovery is near completion outside the CIS. The CIS countries are gradually emerging from negative growth and high inflation. But, the region faces heightened downside risks. Despite the cyclical recovery, convergence has stalled on the back of unfavorable demographic trends and weak investment and productivity growth. Reform priorities include rebuilding fiscal buffers; putting in place policies to increase labor force participation and reduce structural unemployment; and advancing structural reforms to boost productivity.