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Growth in the Central and Eastern European Countries of the European Union

Susan Schadler, Ashoka Mody, Abdul Abiad, and Daniel Leigh

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The following conventions are used in this publication:

- In tables, a blank cell indicates "not applicable," ellipsis points (. . .) indicate "not available," and 0 or 0.0 indicates "zero" or "negligible." Minor discrepancies between sums of constituent figures and totals are due to rounding.
- An en dash (–) between years or months (for example, 2005–06 or January–June) indicates the years or months covered, including the beginning and ending years or months; a slash or virgule (/) between years or months (for example, 2005/06) indicates a fiscal or financial year, as does the abbreviation FY (for example, FY2006).
- "Billion" means a thousand million; "trillion" means a thousand billion.
- "Basis points" refer to hundredths of 1 percentage point (for example, 25 basis points are equivalent to ¼ of 1 percentage point).

As used in this publication, the term "country" does not in all cases refer to a territorial entity that is a state as understood by international law and practice. As used here, the term also covers some territorial entities that are not states but for which statistical data are maintained on a separate and independent basis.

Preface

Having smoothly acceded to the European Union (EU) in May 2004, the overarching objective for the EU's new member states is to continue raising living standards to Western European levels. This Occasional Paper examines the progress toward income convergence achieved by the the EU's eight Central and Eastern European countries thus far, the prospects for further income convergence over the medium term, and the policy challenges that these countries will face in facilitating the catch-up process.

The paper was prepared by a team led by Susan Schadler and Ashoka Mody, with Abdul Abiad and Daniel Leigh. The paper benefited from comments by various departments of the IMF; by participants at a September 2005 conference on "European Enlargement: Implications for Growth" in Washington, D.C., and at a March 2006 conference on "New Europe, New Frontiers, New Challenges, New Opportunities" in Prague; and by participants at seminar presentations in Tallinn and Warsaw and at the IMF's European Department. Material presented in this study was originally prepared as background for an IMF Executive Board seminar held in February 2006. The Acting Chair's concluding remarks are reproduced on pages 53–54 of this publication.

The authors would like to thank Indra Mahadewa, Lina Shoobridge, Sylvia Young, and Indira Bhimani for assistance in preparing the manuscript; David Velazquez-Romero for excellent research assistance; and Esha Ray of the External Relations Department for editing the manuscript and coordinating production of the publication. The opinions expressed in the paper are those of the authors and do not necessarily reflect the views of national authorities, the IMF, or IMF Executive Directors.

Abbreviations

CE-5	Refers to Czech Republic, Hungary, Poland, Slovakia, and Slovenia
CEEC	Central and Eastern European country
EBRD	European Bank for Reconstruction and Development
EU	European Union
FDI	Foreign direct investment
GDP	Gross domestic product
GFS	*Government Finance Statistics*
ICRG	*International Country Risk Guide*
ICT	Information and communication technology
OECD	Organization for Economic Cooperation and Development
PPP	Purchasing power parity
PWT	Penn World Tables
TFP	Total factor productivity
WDI	*World Development Indicators*
WEO	*World Economic Outlook*

I Overview

The paramount economic objective of the Central and Eastern European countries (CEECs) is to raise living standards to Western European levels.[1] After a half century of largely misdirected development, the task is formidable and will require concerted macroeconomic and structural policies focused on achieving strong growth with due regard for vulnerabilities inherent in any rapid catch-up. In many respects, this process resembles that in other regions, and the CEECs will be well advised to draw lessons from experiences elsewhere. But, in other respects—particularly the advantages of membership in the European Union (EU)—the CEECs have unique opportunities from trade-induced competition, pressures for policy reform, and greater financial integration.

The strength of the growth record in the CEECs since the end of central planning is open to interpretation. From a 15-year perspective—that is, including the initial transition shock—the record is no better than average by the standards of emerging market countries. In the past decade, however, growth in most of the CEECs has been clearly above the average of emerging market countries; in fact, the three Baltic countries (Estonia, Latvia, and Lithuania) have been in the top five emerging market performers. Evaluating the performance of the CEECs is complicated by three developments that are difficult to disentangle: a recovery from the immediate post-central-planning drop in output; the emergence of policies and institutional conditions (including EU membership) that enhanced catch-up potential; and global economic developments favorable to investment and growth in emerging market countries. Thus, determining whether the strength of the past decade has been more a bounce back from the initial posttransition setbacks in a period relatively favorable for emerging market countries or more the result of conditions that will support continuing growth requires an examination of the underlying influences.

In several respects, the CEECs' growth experience during the past decade was unusual by emerging market country standards.

- *Massive labor shedding occurred* alongside relatively rapid output growth. Employment rates dropped from among the highest in emerging market countries at the end of central planning to well below average.
- *Relatively low domestic savings rates were supplemented by foreign savings*, particularly in the three Baltic countries.
- *Nevertheless, capital accumulation made modest contributions to growth*—on average smaller than in the most dynamic Asian countries, though larger than in Latin America.
- *Growth was dominated by remarkable increases in total factor productivity (TFP)*. TFP growth was almost double that in other emerging market country groups. This is not surprising in view of the inefficiencies inherited from central planning, which left much scope for managerial improvements, labor shedding, and gains from interindustry resource reallocation.
- *The recent record, however, suggests the possibility of a two-speed catch-up:* growth in the three Baltic countries having pulled substantially ahead of that in the five Central European countries (the Czech Republic, Hungary, Poland, Slovakia, and Slovenia; henceforth, CE-5).

Looking ahead, the critical question is whether TFP growth can be sustained, and, if not, what would replace it as the underpinning of a rapid catch-up. Differing time lines of transition may shed light on this question. On average, countries that recovered earliest from the transition shock—broadly the CE-5, but especially Poland and Slovenia—have seen a substantial diminution in TFP growth (though it remains higher than in other emerging market country groups). This is broadly reflected in lower output growth, although a halt or slowing in labor shedding has been a mitigating influence. In contrast, TFP growth in the later-to-recover Baltics has continued to rise. Assuming that the slowdown in TFP continues in the CE-5 and spreads to the Baltic countries, other sources of growth will be essential to sustain a rapid catch-up. Greater labor use is an obvious candidate: to live up to its growth poten-

[1]The CEECs comprise the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic (henceforth, Slovakia), and Slovenia.

tial, every country—particularly Poland, Hungary, and Slovakia—must decisively turn around its labor market performance. Also, investment rates will need to rise. Finally, financing will be the major challenge in these generally low-saving countries.

Whatever the source of growth, prospects will depend on how well countries do in establishing macroeconomic and structural conditions conducive to sustained growth. Building on global studies of links between growth and a variety of environmental and policy characteristics, some broad conclusions emerge on the conditions for a rapid catch-up. Robust linkages come from certain environmental features (such as initial income gaps, population growth, and historical trade relationships), as well as conditions more subject to policy influence (such as the quality of legal and economic institutions, size of government, real cost of investment, educational attainment, openness to trade, and inflation). In general, the CEECs do reasonably well in meeting these conditions (relative, for example, to an East Asian sample[2]). On average, however, the differences tend to favor growth in the Baltic countries over the CE-5, reinforcing other indications that a two-speed catch-up may be emerging. Some broad conclusions stand out.

- Initial income gaps vis-à-vis advanced economies—reflecting catch-up potentials—were generally smaller in the CEECs than in East Asia, though in three countries (Poland, Latvia, and Lithuania) the gaps were larger than the East Asian average even as of 2004.
- Slow population growth has favored catch-up in the CEECs (especially the Baltics) over East Asia, although, over time, aging could shift this advantage.
- The Baltics and East Asia have benefited decisively relative to the CE-5 from faster growth in their historical export markets—Baltic exports are more oriented toward the Nordic countries and Russia and CE-5 exports more toward Germany and its immediate neighbors.
- The CE-5 have had the edge on institutional development (regulatory frameworks and governance) relative to East Asia and even the Baltics, though the latter have been catching up rapidly.
- On other policy variables, the CEECs have had differing strengths, which taken together have had roughly comparable effects on growth. All countries are highly open to trade. East Asian countries on average have smaller governments, although the Baltics come a close second. Years of schooling are highest on average in East Asia, but more complex educational considerations, which are undoubtedly important, may stack up differently. Relative prices of investment goods are broadly similar.

Moreover, European integration stands to play a pivotal role in supporting a rapid catch-up in the CEECs. At one level, of course, are the opportunities offered by substantial EU transfers—likely to be some 2–3 percent of GDP a year for some time. Probably more important but less easy to quantify will be the benefits from closer institutional, trade, and financial integration with Western Europe. These are already evident in growing trade volumes, low risk premia, and rising use of foreign savings in the CEECs; further changes in these directions are likely, especially for countries that commit to early euro adoption. But alongside the scope for hastening the catch-up are the risks that foreign savings will finance insufficiently productive spending or that the consumption smoothing turns into excessive private or government spending.

Estimates of a simple growth and current account framework, using European data, provide some comfort in this regard. They indicate that thus far foreign savings have contributed significantly and appropriately to growth in most CEECs. Most, even with large current account deficits, have growth rates within ranges that should result (according to the experience of the countries included in the sample) from the foreign savings used. Moreover, distinctions between the effects of foreign direct investment (FDI) and non-FDI financing are not large—both have contributed significantly to growth. In other words, to the extent that integration is facilitating increased use of foreign savings even when it is not FDI, it appears to be giving CEECs a growth advantage over other emerging market countries. Variations across countries are, however, large—from Estonia, where current account deficits exceed the range indicated as consistent with recent growth rates, to Poland, where they fall short of that range.

Nevertheless, some measures of vulnerabilities, especially in the Baltic countries and Hungary, are worrisome. Various combinations of high external debt ratios, rapid credit growth (a sizable share in foreign currency), and, in the Baltics, low reserve coverage of short-term debt create a picture similar, for some countries, to that in East Asia prior to 1997. Some mitigating factors—high reserves in the CE-5, strong fiscal positions in the Baltics, relatively high standards of transparency and governance, well-supervised and predominantly foreign-owned banks—are reassuring. While a full analysis of vulnerabilities is beyond the scope of this paper, even the summary picture of vulnerability indicators points to challenges for IMF surveillance.

Rapid income convergence will be the essential context of IMF surveillance in the CEECs for the foresee-

[2]The East Asian economies considered are China, Hong Kong SAR, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan Province of China, and Thailand.

able future. Sound near-term macroeconomic policies are needed to foster a benign setting for growth. Equally important will be identifying and supporting conditions that spur growth and position countries to benefit from European integration; some of these, such as institutional development and the appropriate role of government, will be at one remove from the traditional focus of surveillance. Nevertheless, they are critical to outcomes for growth, and, all told, sustaining high growth is the ultimate economic objective for each CEEC.

Within this context, a key role for surveillance will be to keep a sharp eye on vulnerabilities. A rapid catch-up inherently involves risks, whether from the large-scale use of foreign savings, the rapid growth in financial markets and bank intermediation, or simply the rapid pace of economic change. Certainly, policies to mitigate these risks and make them more transparent are critical. In this vein, the IMF needs to press governments to establish cushions against shocks; contribute to domestic savings appropriately through sizable fiscal surpluses when catch-ups are rapid; avoid disincentives to private saving; support strong financial supervision; ensure strong corporate governance and efficient bankruptcy procedures; and increase transparency across the spectrum of economic activities. The IMF also needs to be an advocate of policies that will enable the early adoption of the euro—the growth-enhancing and vulnerability-reducing opportunity unique to the CEECs.

But, fundamentally, rapid catch-up will be associated with vulnerabilities. The use of foreign savings entails exposure to foreign creditors and investors; in countries that started with minimal banking systems, rapid credit growth is almost inevitable, and where households had little or no access to credit, growing confidence in the future means sizable borrowing to smooth consumption. The macroeconomic picture of any successful CEEC will not be free from risks. The task for surveillance will be to distinguish when policies with an overarching orientation of supporting a rapid catch-up are and are not appropriate, identify policy changes that are needed, and recognize that some developments, which in more advanced or less opportunity-laden countries would indicate serious vulnerabilities, are an inescapable part of the catching-up process.