Restarting growth in Europe after the Great Recession: CEE vs. other countries

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Seppo Honkapohja
Bank of Finland
I. Introduction
My objective is to provide an overview of economic growth issues in the CEE countries.

- Discussion relies on comparisons to the EU / Euro area countries.

I first look at the past:

- Did the EU membership facilitate the convergence process by speeding up economic growth in CEE countries?
- Are the per capita GDP levels converging to the EU average in line with the convergence hypothesis?
- How did CA and public sector balances develop in CEE countries?
- What about unemployment in CEE countries vs. other EU/euro countries?
Second, I consider the impact of the financial crisis on the growth performance of the CEE countries?

– How deep was the decline in GDP caused by the Great Recession?
  • How did the CEE countries adjust to the recession relative to other EU / euro countries.

Third, what are the current directions of development in CEE countries?

– Have the CEE countries been able to resume growth?
– How are they doing in terms of export performance?
II. Convergence and growth
Figure 1 shows the ratios of per capita GDP to EU average from 1995 to 2011. Early period:

- Most CEE countries turned into positive growth in the second half of 1990’s.
- Most countries (Slovenia, Slovak Republic, Poland, Estonia, Hungary, Lithuania, Latvia) had achieved turnaround in growth already in 1995.
- For a few countries (Czech Republic, Bulgaria, Romania) reaching steady positive growth took a few years longer.

EU membership from 2004 seems to have provided a boost to the CEE economies, as rates of convergence accelerated.

- Hungary is an exception here.
Per capita GDP, ratio to EU average (PPP)

Source: World Bank
The Great Recession led to a short episode of non-convergence toward EU average for most of the CEE countries:
- Some countries continued convergence (Czech Republic, Slovak Republic, Poland, Bulgaria).

In the recovery period GDP convergence was resumed for most CEE countries:
- This is the case for Poland, Slovak Republic, Estonia, Latvia, and Lithuania.
- There is weak convergence for Czech Republic and Bulgaria.
- Divergence has continued for Slovenia, Hungary and Romania.
Growth performance

♦ A related but different viewpoint obtains from looking at absolute GDP levels.

♦ Figure 2 considers GDP levels of the euro area, the high-rated countries, the crisis (or GIIPS) countries and a group of non-euro CEE countries.

– For both the high-rated euro countries and these CEE countries the level of GDP in 2012 is on average higher than the pre-recession peak.
  • These CEE countries have done even better than high-rated euro countries.
  • I conjecture that these CEE countries have maintained competitiveness or done needed adjustments. I will consider adjustments later.

– In contrast, the euro area average level of GDP is currently below the pre-recession peak.
**GDP levels**

- **High rated countries**: Germany, France, Netherlands, Belgium, Austria and Finland
- **GIIPS**: Greece (11-12 estimate), Italy, Ireland, Portugal and Spain
- **CEE**: Bulgaria, Czech Republic, Hungary, Poland and Romania

Sources: Eurostat and Bank of Finland
III. Inflation and cost competitiveness
Looking at inflation, it is seen that inflation in these CEE countries has been higher than in the euro area.

- This is to be expected by the convergence hypothesis.
- The overheating period saw some widening in the inflation differential.
- There is also some narrowing of the inflation differential right after the 2009 recession.
  - Most recently the gap has begun to widen again.

Another notable feature is that there are clear inflation differentials inside the euro area.

- The difference between the high-rated crisis euro countries is visible, except for the recession period in 2009.
- Right now the differential is close to one percent per annum.
Inflation

* High rated countries*  
**GIIPS**  
Euro area  
CEE***

% change y-o-y

-1 0 1 2 3 4 5 6 7

2005 2006 2007 2008 2009 2010 2011 2012

* Germany, France, Netherlands, Belgium, Austria and Finland  
** Greece (11-12 estimate), Italy, Ireland, Portugal and Spain  
*** Bulgaria, Czech Republic, Hungary, Poland and Romania  

Sources: Eurostat and Bank of Finland
The next slide shows the development of unit labor costs from year 2000 to 2012 in the CEE and the GIIPS countries.

- Until about 2005, there were steady increases in ULC.
  - Poland and Lithuania are exceptions.
  - In the boom years ULC’s rose a lot, Poland is the exception.

There are big differences in the ULC movements after the boom.

- Some countries have carried out major downward adjustments, notably Latvia, Lithuania, Estonia among CEE countries.
- All GIIPS countries except Italy have also improved.
- A few countries show steady increase, Romania, Bulgaria, Hungary, Slovenia, Slovakia, and Poland (where level is low).

Adjustments in labor market are occurring.
Unit labor costs

Source: Eurostat and European Commission
IV. Imbalances: external, public, private
As regards external balances, for most CEE countries CA deficits widened somewhat before the boom and this widening increased significantly during the boom.

- Czech Republic and Poland are exceptions.
- Strong capital inflows led to higher demand for non-tradeables and loss of competitiveness.
- For Baltic countries this development was strongest and resulted in nearly 25% CA deficit in 2006-7 in worst cases.

When the Great Recession hit, the improvements were quite fast, reflecting a sudden stop in capital inflows.

- CA deficits are now in the 0-5 percent range.
- Bulgaria and Romania even have small CA surplus.

In GIIPS countries CA deficits also increased in the boom, but now the GIIPS countries are adjusting toward balance.
Current account balances in CEE

% of GDP

Source: European Commission, ECB and Bank of Finland
Current account balances

*Germany, France, the Netherlands, Belgium, Austria and Finland.
** Greece, Ireland, Italy, Portugal and Spain.

Sources: European Commission, ECB and Bank of Finland calculations.
Next, I consider fiscal balances of CEE and EU countries.

The CEE countries are divided into two groups: countries with floating exchange rate and those with a fixed exchange rate (Baltics and Bulgaria).

- Public sector balances move in tandem in the three groups.
- EU countries and floating CEE countries had deficits in the first half of last decade.
  - CEE countries with fixed exchange rate had small deficits or surpluses.
  - In the recession deficits worsened a lot, after which there have been improvements.
- Currently, deficits still prevail in the 2-4.5 percent range.
Public sector balance

% of GDP

Source: European Commission and Bank of Finland calculations
Private sector indebtedness

- We already took a look at the current account, which tells the deficit or surplus in the overall – both private and public – balance of saving minus investments of an economy.
  - During the boom years the current account deficits reflected high private consumption and investments.

- What about the private sector imbalances? How has private sector indebtedness developed over time in the CEE vs. the euro area?
Since year 2000 private sector debt in the euro area has increased from 130% of GDP to 170%.

- This reflected mainly the developments in the GIIPS countries.
- But indebtedness increased also in the high rated countries.

Although the level in the CEE countries is way below the “old EU countries”, also there the private debt/GDP level increased from 70% to 100% (over 40% / 30 pp).

- Within the CEE countries the differences are large.
- In Hungary and Bulgaria the private debt/GDP ratio is almost twice as high (150%) as in Czech and Poland (80%).
Private sector indebtedness

Source: European Central Bank.
* Germany, France, Netherlands, Belgium, Austria and Finland
** Greece, Italy, Ireland, Portugal and Spain
*** CEE = Bulgaria, Czech Republic, Hungary and Poland
V. Unemployment
Last part of my overview concerns unemployment.

As is well-known, the CEE countries had relatively high rates of unemployment in the first years of last decade.

- The group of CEE countries here consists of Bulgaria, Czech Republic, Hungary, Poland and Romania.
- It was even higher than average unemployment in the crisis countries of the euro area.
- CEE unemployment crept up initially, but from 2004 onward – when most CEE countries joined the EU – unemployment started to decline fairly rapidly.
- The boom made the rate of decline in unemployment even faster.
  - By 2008 the unemployment rates in these CEE countries was the same as in the euro area.
    - Poland dominates the data to some extent.
Unemployment

- High rated countries*
- GIIPS**
- Euro area
- CEE***

* Germany, France, Netherlands, Belgium, Austria and Finland
** Greece (11-12 estimate), Italy, Ireland, Portugal and Spain
*** Bulgaria, Czech Republic, Hungary, Poland and Romania

Sources: Eurostat and Bank of Finland
After the 2009 recession the CEE unemployment rate climbed above the unemployment rate of the high-rated euro countries.
- but it remained below the euro area average.

Looking at GIIPS countries, the rate of unemployment went below that of the high-rated euro countries in 2004.
- Unemployment in GIIPs countries shot up in the recession.
  - It has continuously increased ever since.

Overall, unemployment development in the CEE countries, shows their ability to carry out adjustment.
- Adjustment in CEE was substantial. The figure does not include Baltics, which we know adjusted very fast.
- In contrast, GIIPS countries have had difficulties. Adjustment are gradual.
Part of the ability to carry out domestic adjustments is connected to the degrees of market regulation and rigidities.

- The CEE countries have more flexibility in labor market regulation (OECD index of employment protection).
- The CEE countries (shown in red) tend to have lower degree of regulation. Comments:
  - Data is missing for some CEE countries.
  - Ireland, the Nordics and the Netherlands have also low degrees of employment protection.
  - Other GIIPS countries are among the more regulated economies.
Labor market regulation
OECD employment protection index

Source: OECD
An indicator of product market regulation tells a similar story.

- CEE countries that belong to OECD tend to have low regulation. Poland is an exception.

There exist, of course, a variety of indicators about business conditions. Ease of Doing Business rankings:

- Performance of the CEE countries shows wide variation in this respect.
- The Baltics and Slovenia do well, while several more central and southern countries (Bulgaria, Romania, Hungary, Poland) get a relatively low score on par with Italy and Portugal.

The EBRD transition indicator shows an improving trend in financial systems for most CEE countries.
Regulatory impact

Wholesale and retail trade; repairs

Source: OECD
VI. Openness and integration
Finally, I take a look at the future in terms of openness and foreign trade.

The CEE countries have been open economies with export/GDP ratios mostly 40-70 percent range in years 2000-2004.

  - In this period there are no clear trends on average.

After joining the EU, these countries have on the whole become even more open.

  - Romania and Estonia are exceptions to some extent.
  - This can be contrasted with the degree of openness of the GIIPS countries.
    - The average export/GDP ratio of GIIPS has remained constant around 30 percent in the period 2000-2007.
Exports/GDP

% of GDP

Source: Eurostat and Bank of Finland calculations
♦ There was some decline in openness in the recession.
  – Export shares of Poland, Romania and Latvia did not decline in the recession.

♦ The recovery years 2009-2011 show a remarkable increase in exports/GDP ratio for most CEE countries.
  – Poland and Romania are exceptions here.
  – Development in the GIIPS countries different in this period.
    • The average export/GDP ratio is basically flat at 30 percent.
I next look at the destinations of the CEE exports.

- The share of CEE exports to the euro area has mostly been on a declining trend.
  - The 2009 recession was an exception, but trend has reappeared after it.
- Exports to EU give a partly different picture (not shown).
  - For some countries this share has increased,
  - for others (Czech, Hungary, Latvia, Lithuania) there is a decreasing trend.
- Looking at export destinations in more detail reveals that Russia’s role has been increasing for most CEE countries.
  - Slovakia and Slovenia are exceptions here.
Share of exports going to the euro area

Source: IMF Direction of Trade database
Conclusions

♦ It is comforting that the CEE countries have, on the whole, been able to resume growth after the Great Recession.
♦ The necessary ability to adjust downward was in place, so that the adverse consequences of the recession were relatively moderate.
♦ The important sources that have helped the adjustment are:
  – The labor and product markets were relatively flexible.
  – The levels of private and public indebtedness were lower than in other European countries, especially GIIPS countries.
As regards the future, it must be emphasized that these economies are open, so that success in foreign trade is critical:

- the current export performance shows improvement,
- and share of exports to euro area is going down indicating perhaps some more diversity.

This performance suggests that the outlook for most CEE countries is comforting.

Maintaining and improving competitiveness of the economy is the key challenge to CEE countries.
Thank you!