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?

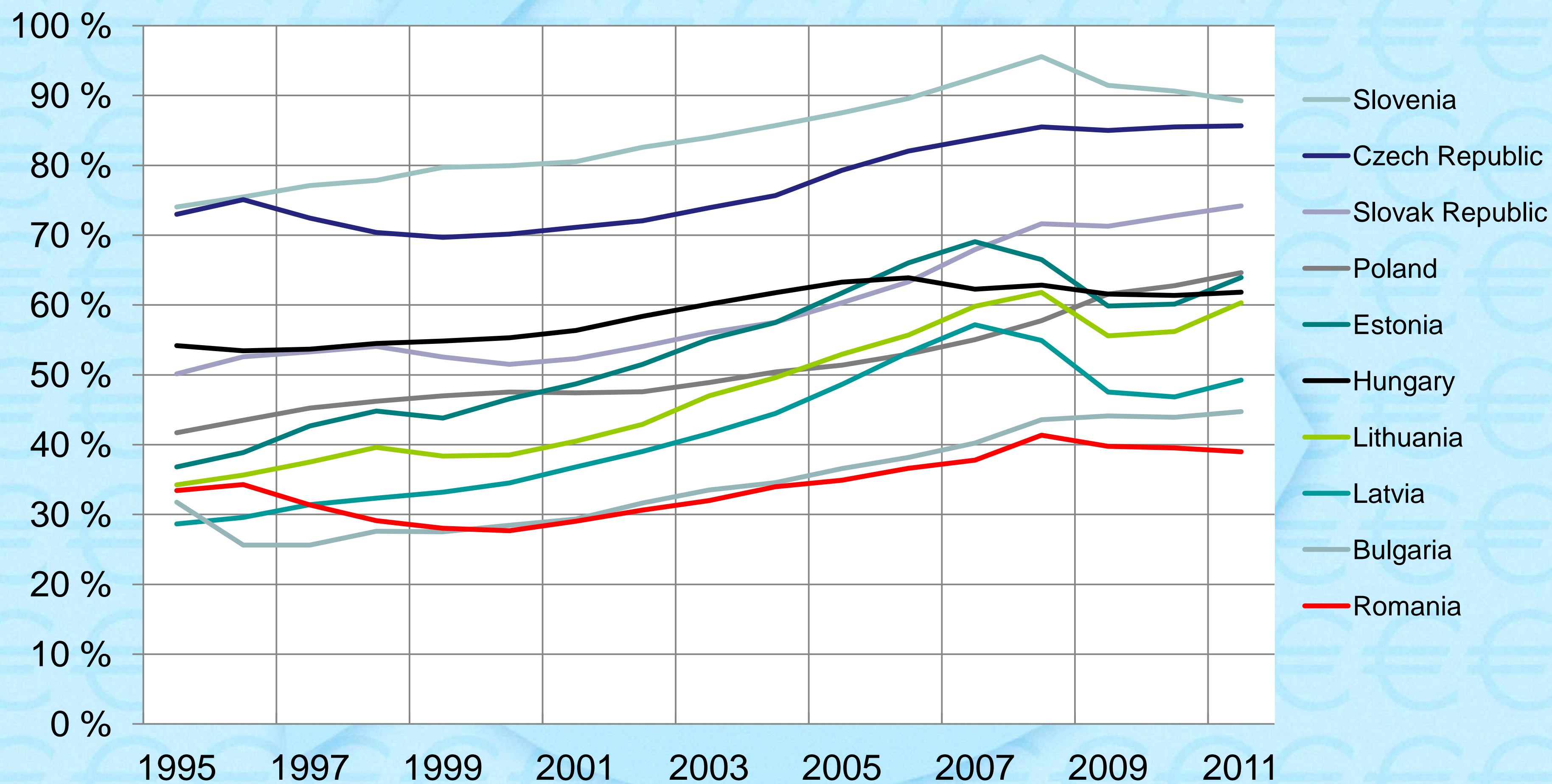
- Second, I consider the impact of the financial crisis on the growth performance of the CEE countries?
  - How deep was the decline in GDP caused by the Great Recession?
    - How did the CEE countries adjust to the recession relative to other EU / euro countries.
- Third, what are the current directions 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)



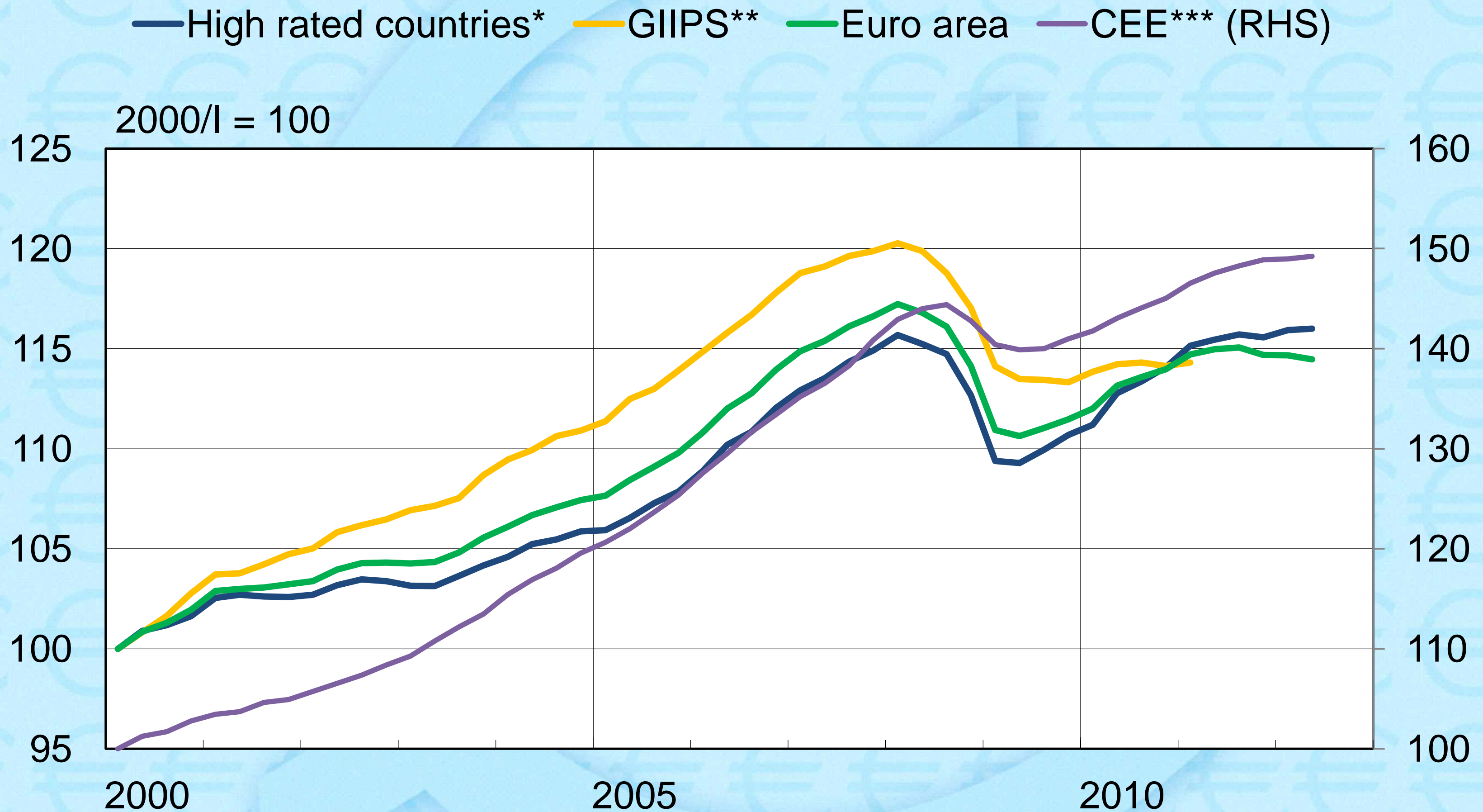
- The Great Recession led to a short episode of non-convergence toward EU average for most of the CEE countries:
  - Some countries continued convergence (Czech Republic, Slovak Republic, Poland, Bulgaria).

- 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



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

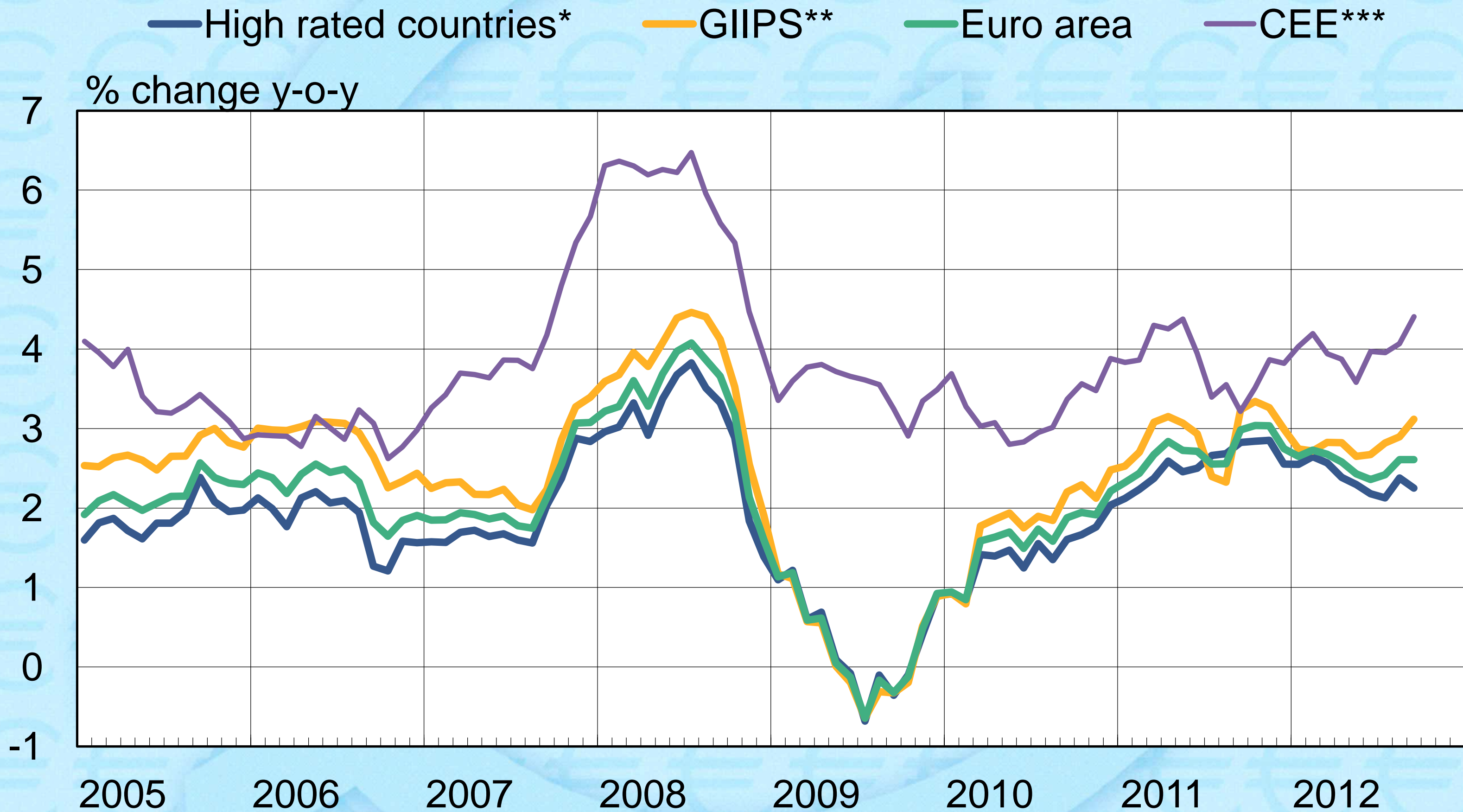
Sources: Eurostat and Bank of Finland

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



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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 occuring.

Unit labor costs

2000/I = 100

240 220 200 180 160 140 120 100 80 60

450 400 350 300 250 200 150 100 50 0

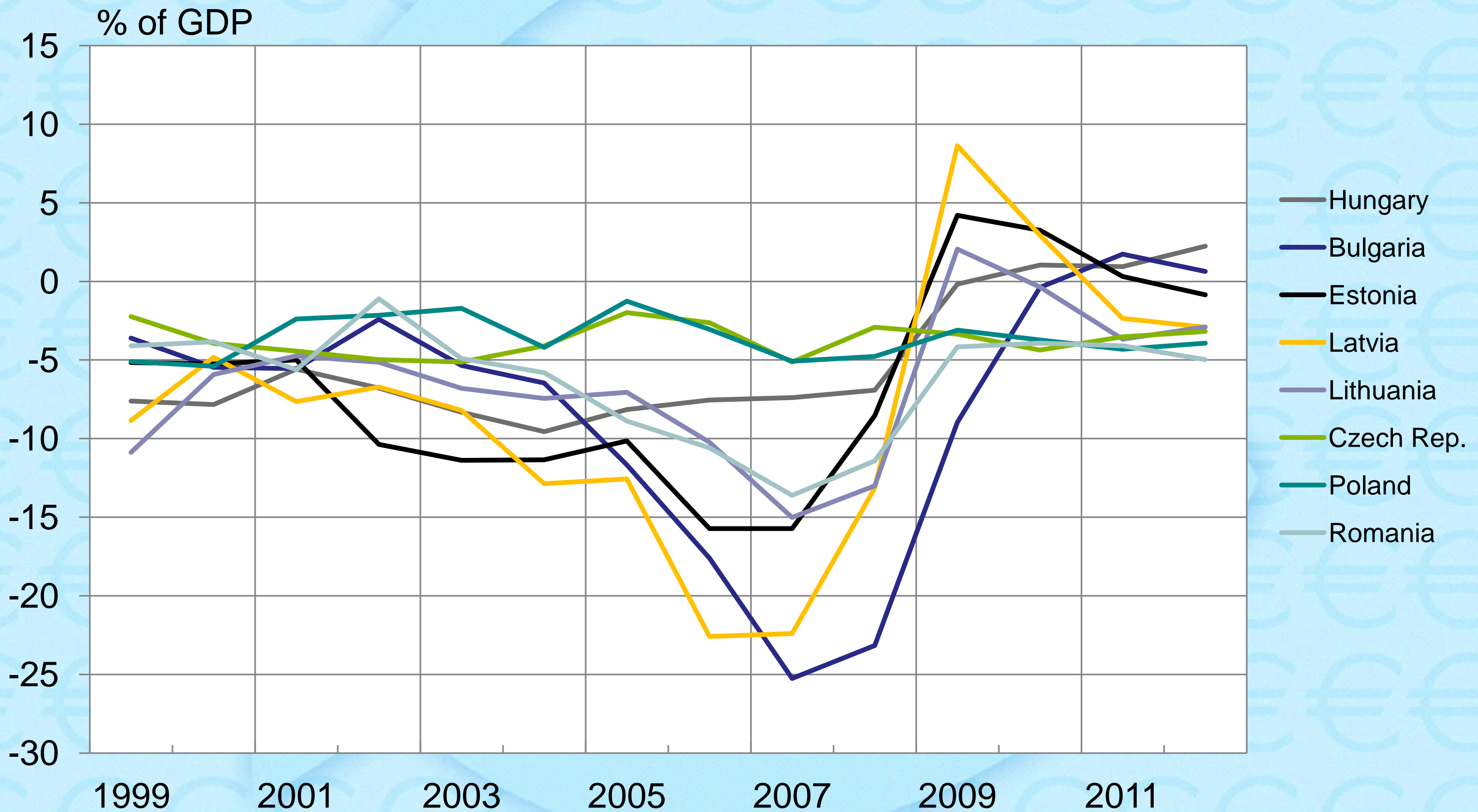
2000 2005 2010

Source: Eurostat and European Commission

IV. Imbalances: external, public, private

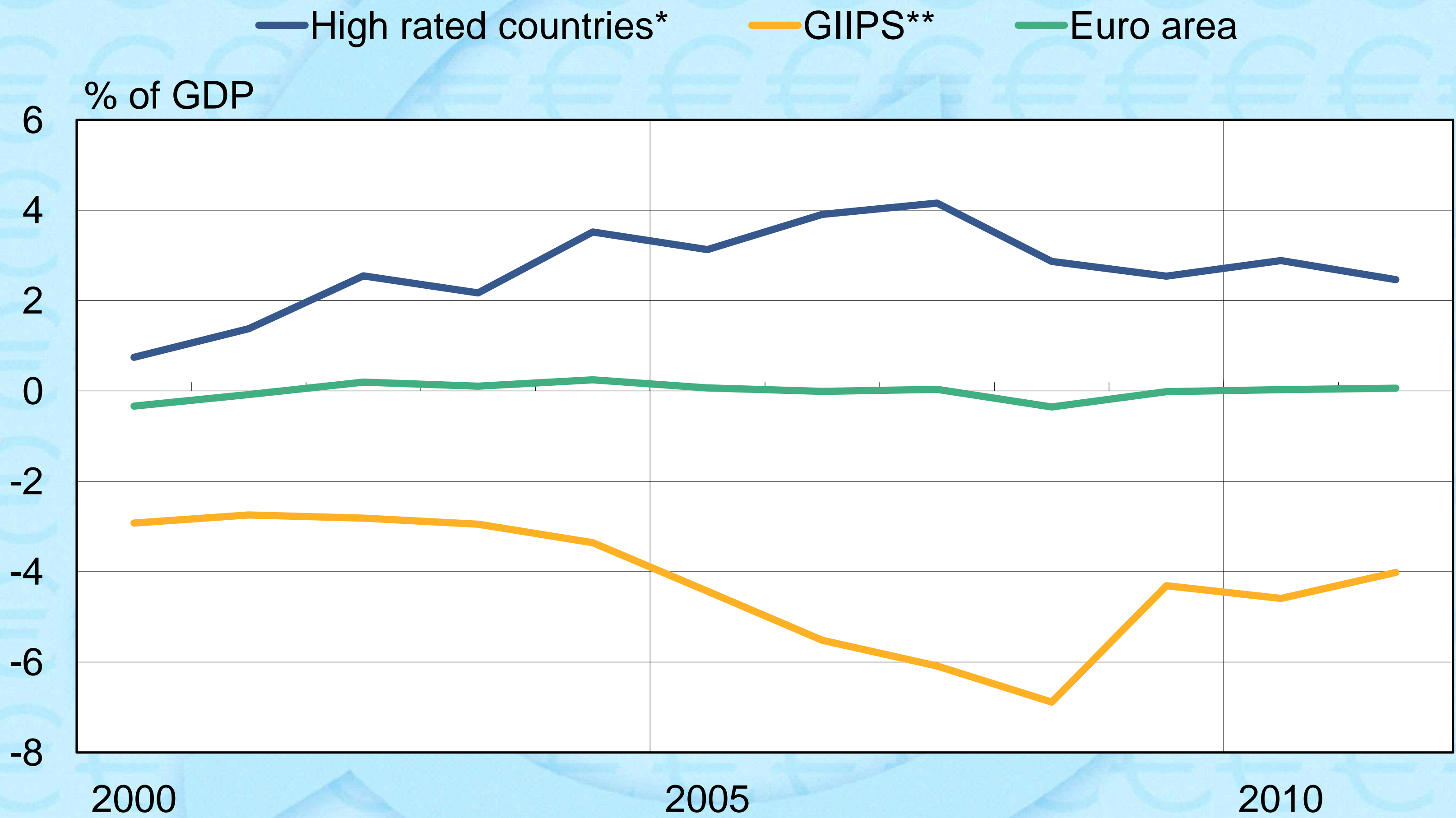
- As regards external balances, for most CEE countries CA deficits widened somewhat before the boom and this widening increased significantly during the boom.
  - Czech Republic and Poland are exceptions.
  - Strong capital inflows led to higher demand for non-tradeables and loss of competitiveness.
  - 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



Source: European Commission, ECB and Bank of Finland

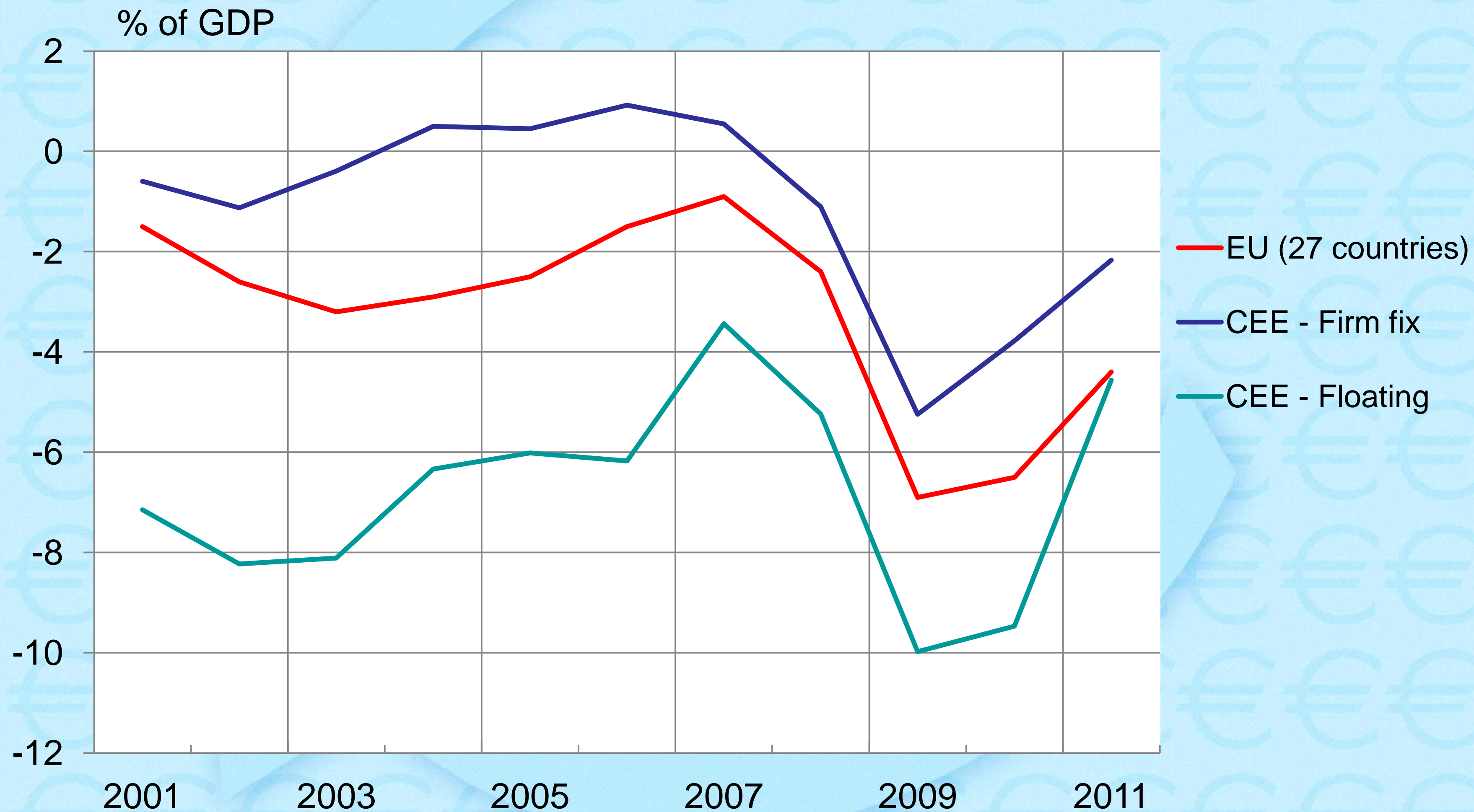
Current account balances



*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.
  - The deficits became smaller in the boom years 2005-2007.
  - 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



Source: European Commission and Bank of Finland calculations

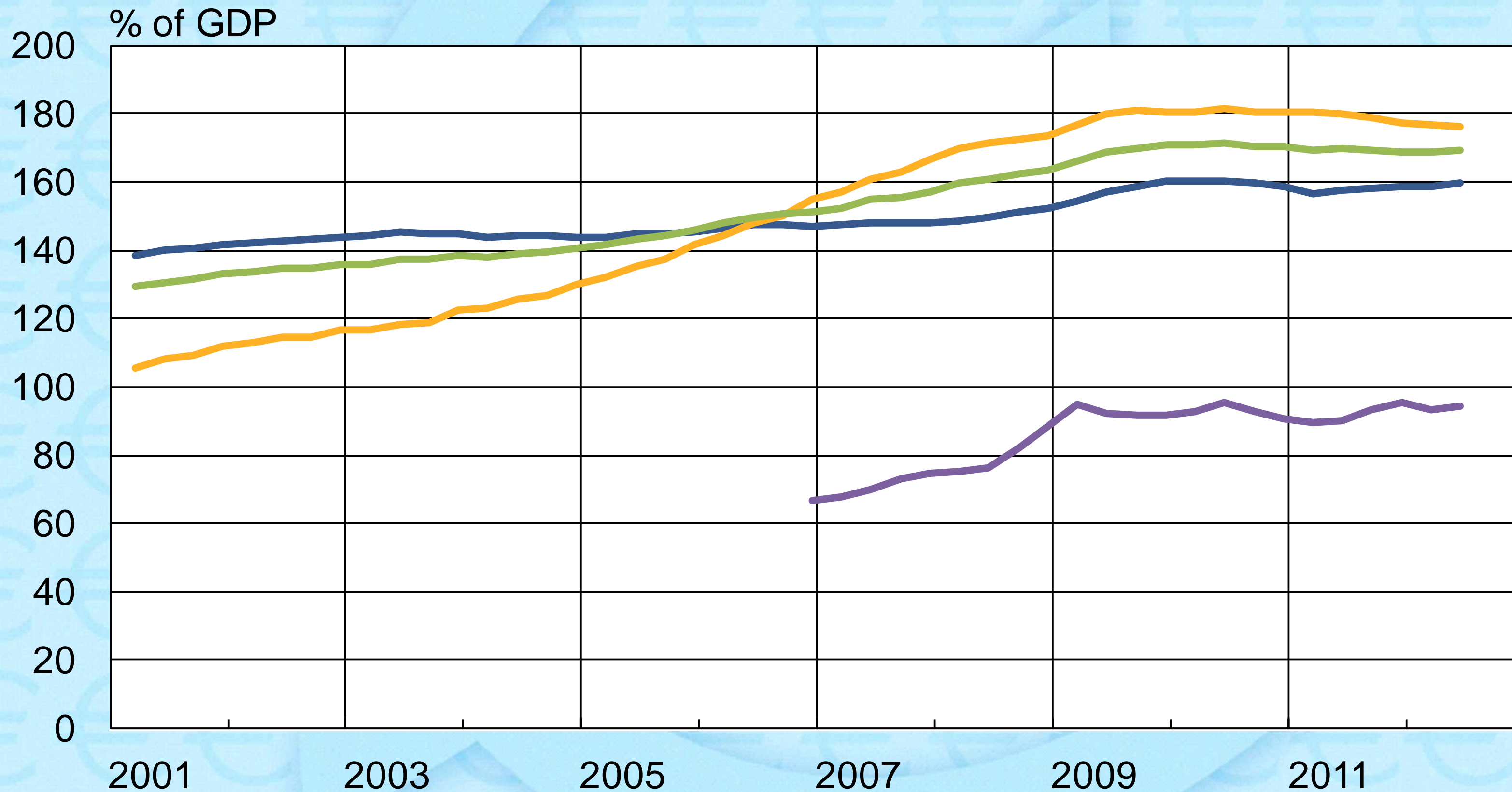
Private sector indebtedness

- 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

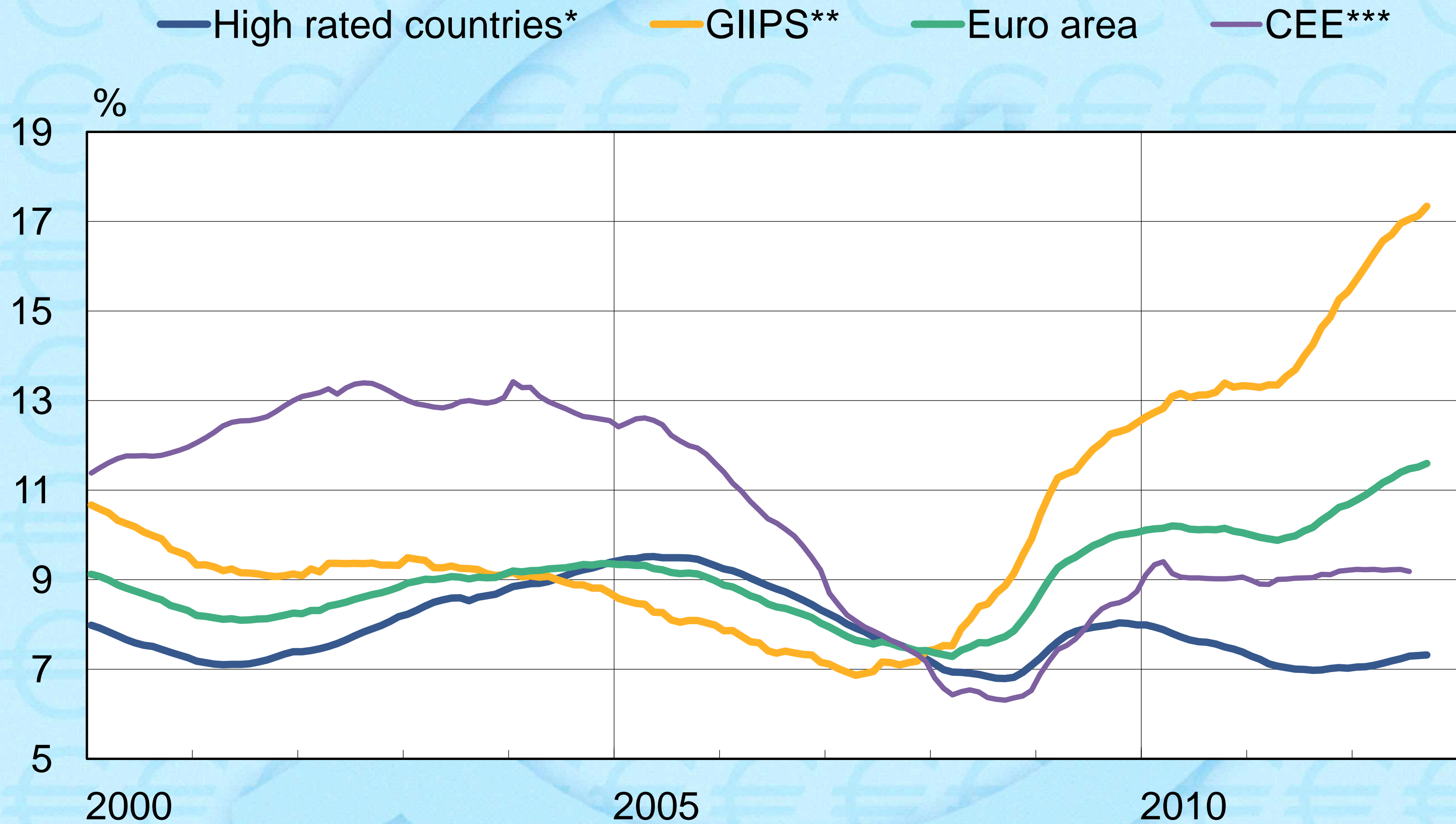
** Greece, Italy, Ireland, Portugal and Spain

*** 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



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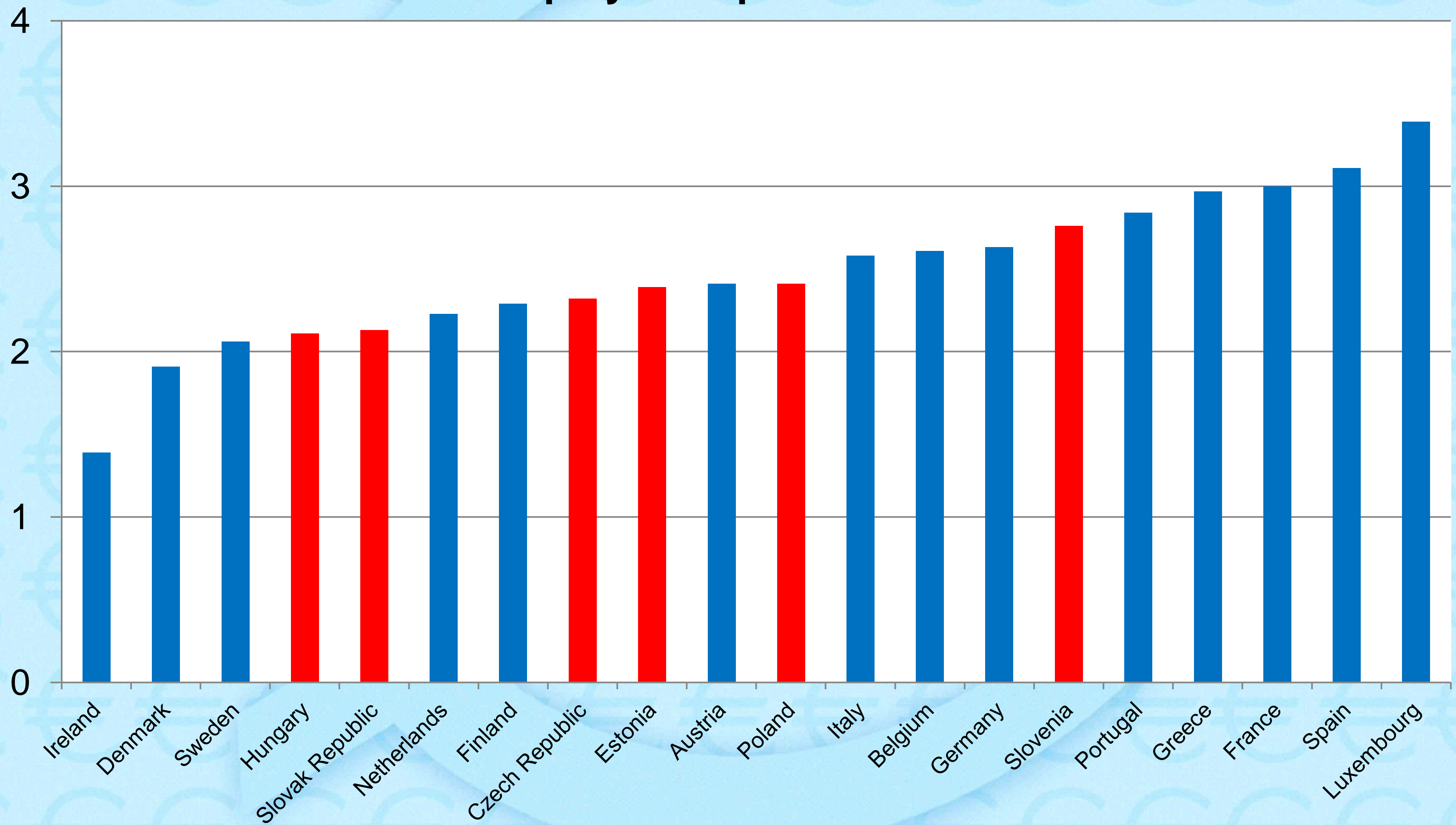
Sources: Eurostat and Bank of Finland

- 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.

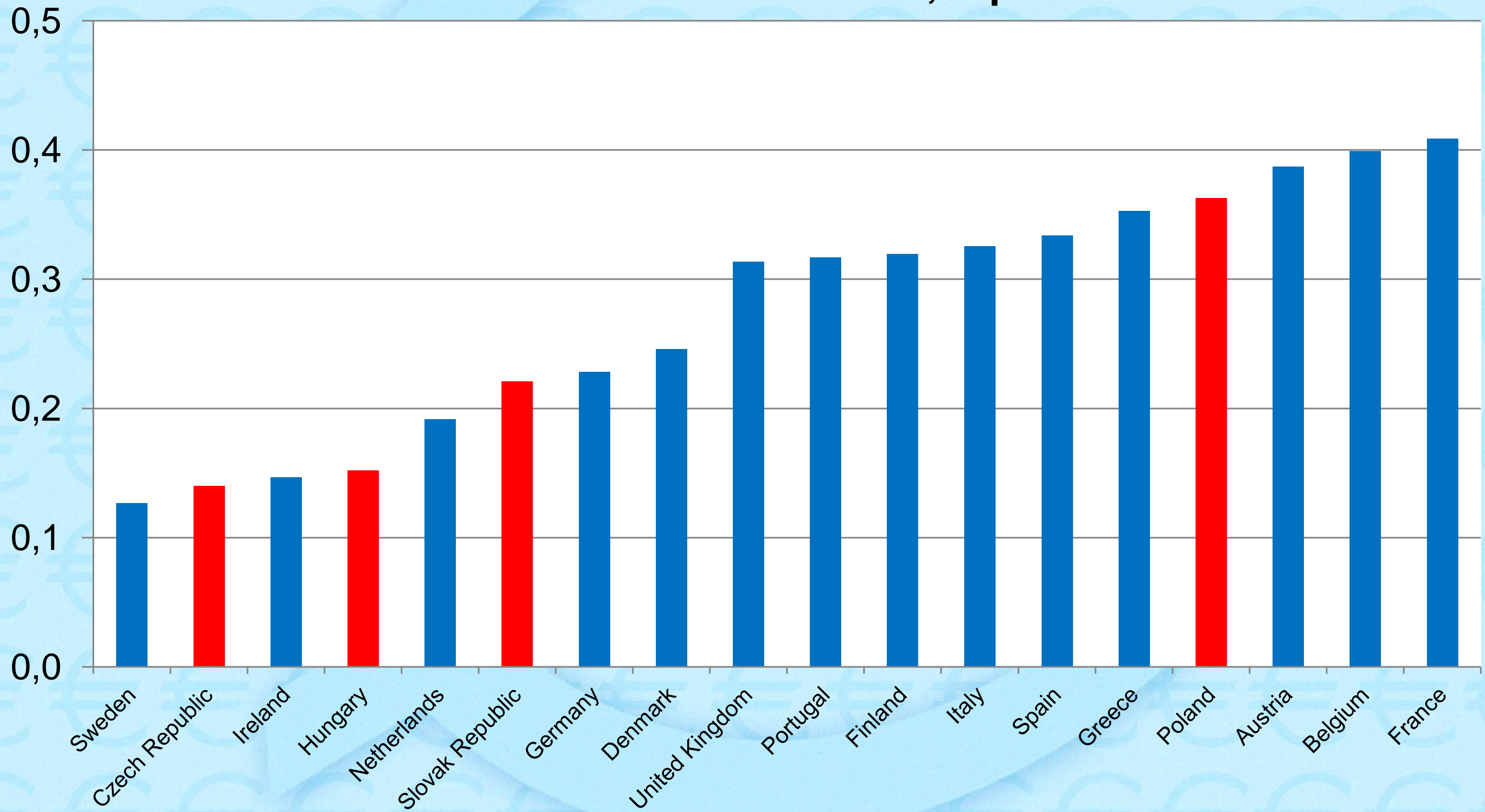
Labor market regulation



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.

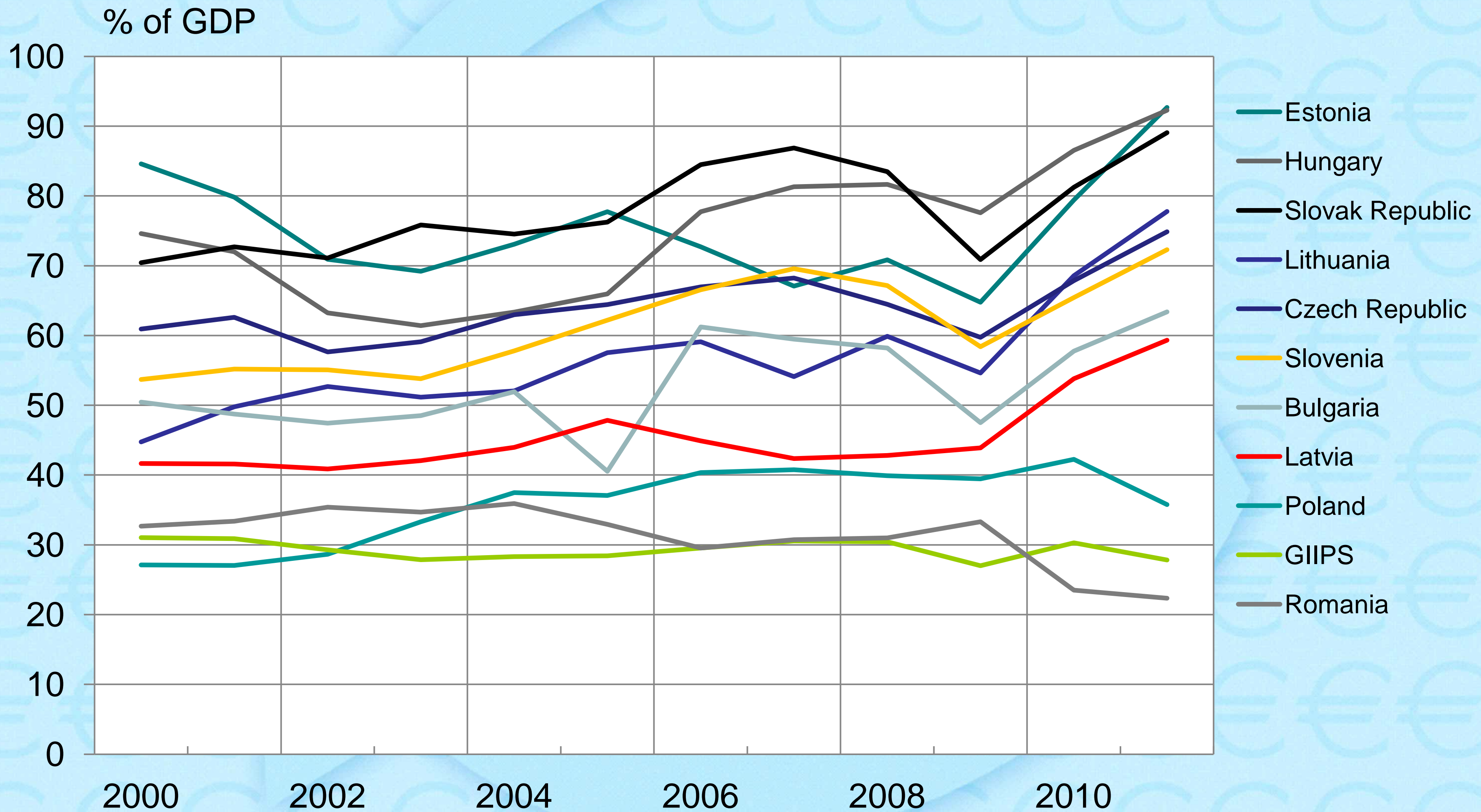
Regulatory impact



Source: OECD

VI. Openness and integration

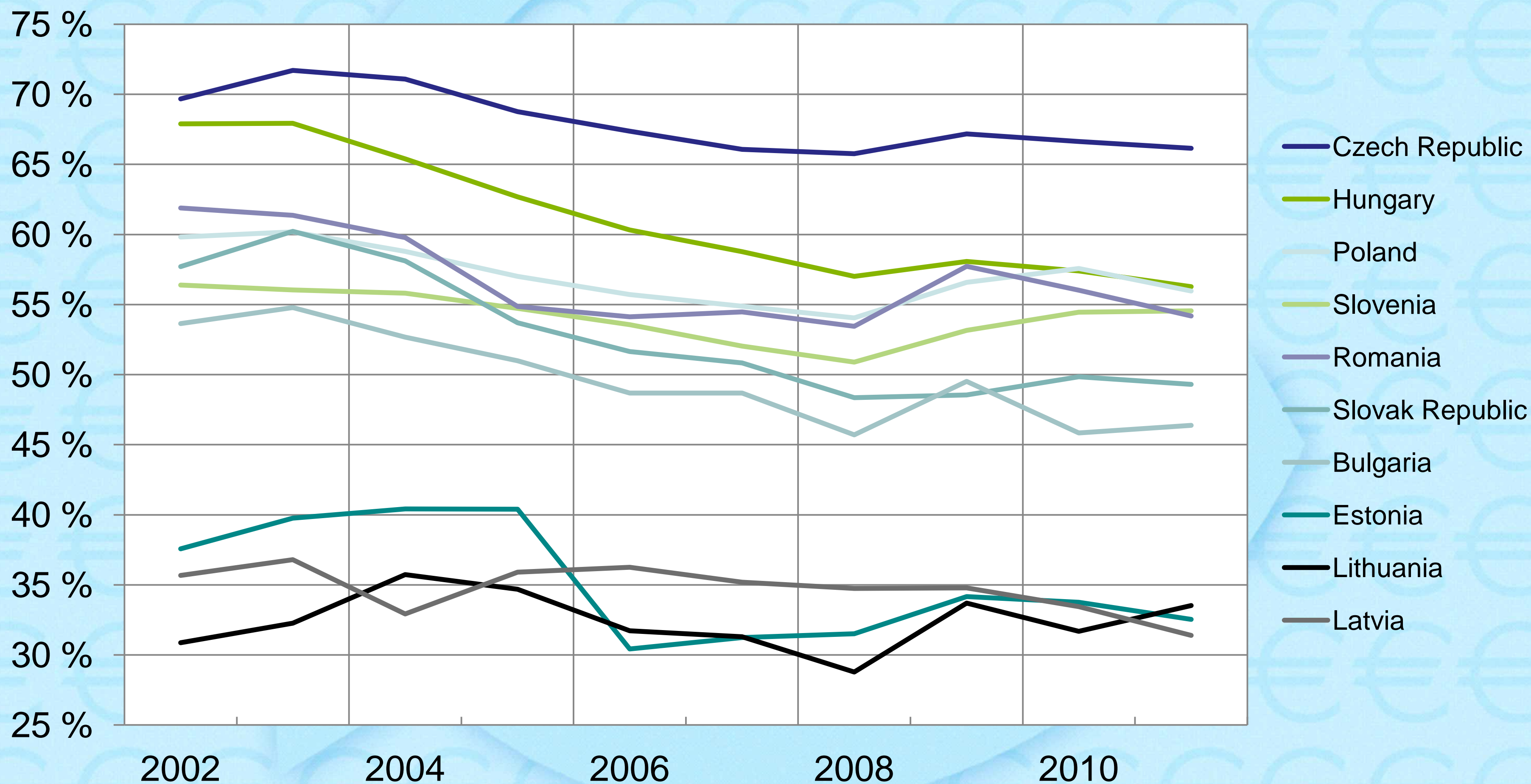
- Finally, I take a look at the future in terms of openness and foreign trade.
- The CEE countries have been open economies with export/GDP ratios mostly 40-70 percent range in years 2000-2004.
  - In this period there are no clear trends on average.
- After joining the EU, these countries have on the 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
100
90
80
70
60
50
40
30
20
10
0
2000
2002
2004
2006
2008
2010
Estonia
Hungary
Slovak Republic
Lithuania
Czech Republic
Slovenia
Bulgaria
Latvia
Poland
GIIPS
Romania
Source: Eurostat and Bank of Finland calculations

- There was some decline in openess 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.

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Thank you!