4. CESEE monitors

4.1. CONVERGENCE MONITOR: POSITIVE TRENDS BUT LONG-TERM CHALLENGES

by Leon Podkaminer

4.1.1. The income gap separating CESEE from the highly developed countries has narrowed since 2000

The first article of faith among theoreticians of economic growth is that lower-income countries will eventually catch up with higher-income ones. However, the theory does not guarantee that there will be no reversal or halt to convergence, or that some lower-income countries will not end up in a 'medium-income trap'. Moreover, it has often been observed that the higher the income level in a 'converging' country, the slower it advances toward convergence (this is the gist of the 'beta convergence' hypothesis).[15]

Table 6 below indicates that in terms of per capita GDP (at purchasing power parity, PPS), CESEE countries still trail far behind Austria. In 2017, the Czech Republic was the most prosperous country in CESEE, with per capita GDP in PPP terms just above 69% of the Austrian level. Of the 11 EU Member States in CESEE, the poorest was Bulgaria (at 39.5% of the Austrian level). The average for these EU-CEE countries was 54.5%. Non-EU CESEE countries were much poorer in 2017 (with an average level of 43.7%). Turkey was the most affluent (50.8%) and Ukraine the poorest (16.5%).

Table 6 / CESEE GDP per capita and compensation per employee in comparison with Austria, 2017

	BG	CZ	EE	HR	HU	LT	LV	PL	RO	SI	SK	EU-CEE-11
GDP per capita at PPP, Austria=100	39.5	69.1	62.0	48.2	53.7	61.8	52.9	54.7	49.0	66.0	60.2	**54.5**
Compensation at PPP, Austria=100	42.2	62.1	61.7	57.9	51.4	58.6	56.3	56.7	48.0	77.2	59.6	**.**
	AL	**BA**	**BY**	**KZ**	**ME**	**MK**	**RS**	**RU**	**TR**	**UA**	**XK**	**NON-EU-CEE-11**
GDP per capita at PPP, Austria=100	22.8	24.3	35.9	51.3	36.4	28.8	30.6	49.2	50.8	16.5	20.7	**43.7**
Compensation at PPP, Austria=100	22.6	.	.	.	.	29.5	.	.	.	.	.	**.**

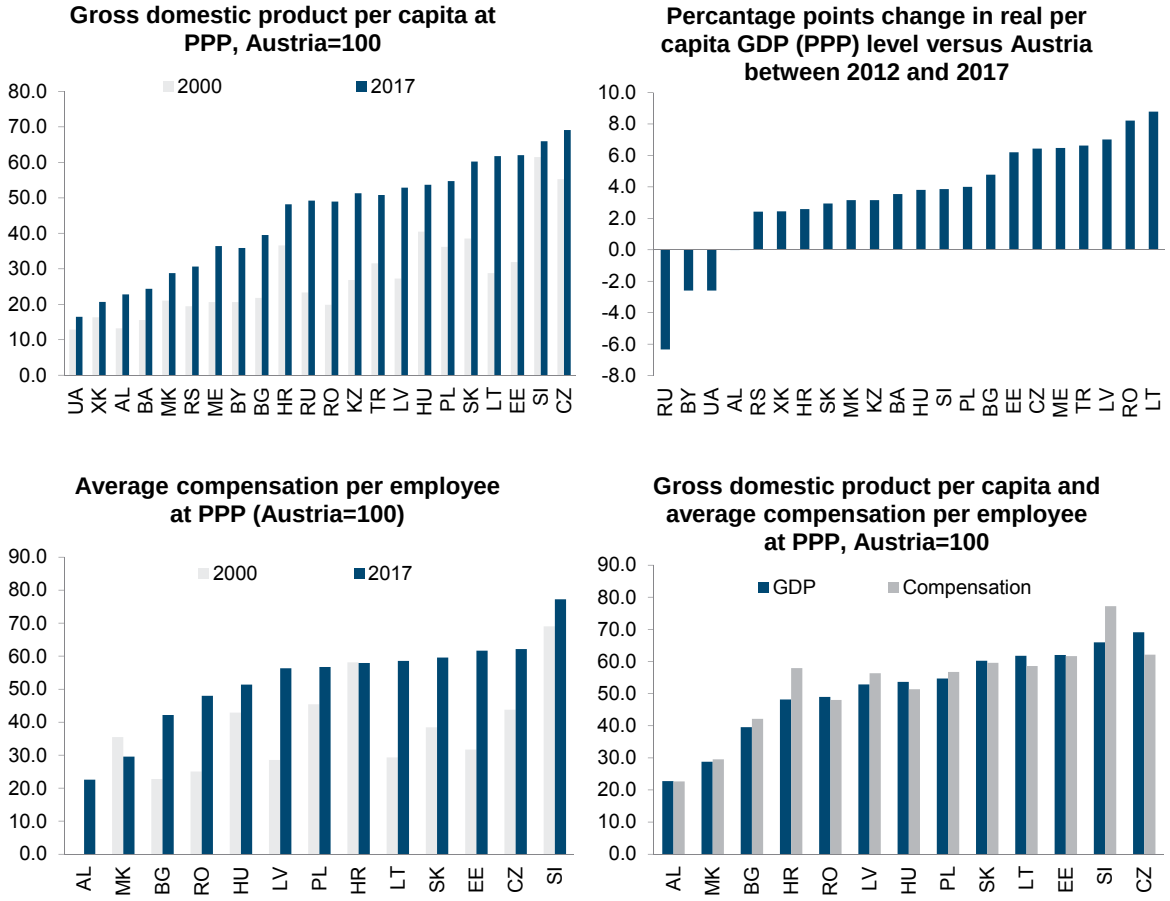
Source: wiiw Annual Database incorporating national statistics and Eurostat, AMECO.

The upper left-hand panel in Figure 25 compares the positions of CESEE countries and Austria in 2000 and 2017. As can be seen, over this period all countries narrowed the gap with Austria. The least progress was made by countries that had suffered violent political turmoil (Ukraine and Kosovo). It is quite obvious that the progress (in terms of convergence speed) made by the Czech Republic and Slovenia – the two most-developed countries in 2000 – was also rather moderate. The largest longer-term gains were made by those countries that started out from lower positions (for example, Romania,

[15] The relevance of the 'beta convergence' hypothesis for CESEE countries is documented in Gligorov et al. (2017).

Slovakia and the Baltic states) and that did not experience much internal or external political disruption. Some of the very low-income countries (Albania, Montenegro and Bulgaria) also advanced strongly (nearly doubling their GDP level vis-à-vis Austria). This longer-term pattern is consistent.

Figure 25 / Convergence trends



Source: Source: wiiw Annual Database incorporating national statistics and Eurostat, AMECO.

It should be remembered that convergence in per capita income levels in some CESEE countries is, to an extent, a statistical artefact reflecting fast population decline since the early 2000s, rather than a rapid rise in production and incomes. Ongoing depopulation (linked to intensified migration to the EU-15) has been quite essential for the Baltic states, Poland, Bulgaria and Romania, for instance, as well as for the Western Balkan countries. Without very large outward migration, their per capita income levels in 2017 would have been much lower (and unemployment rates much higher).[16] Also, it ought to be remembered that in many CESEE countries (especially those with lower income levels), a much-delayed structural transformation has taken place, whereby the large, backward and inefficient agricultural sector has shed excess labour. Part of that labour is then employed more productively in industry and services. For example, in Romania the share of agriculture in total employment fell from 45% in 2000 to 24% in 2016. The higher-income parts of CESEE, where the share of agriculture in employment is very low (such as the Czech Republic, where it is just 3%), do not have that sort of labour (and growth) reserve.

[16] For more on this issue, see Dobrinsky and Havlik (2014).

4.1.2. The last five years: diverse trends indicate different stages of the business cycle, rather than changes in convergence speed

As can be seen from the upper right-hand panel in Figure 25, convergence in Russia, Belarus and Ukraine went backwards in 2012–2017. This primarily reflects the recession and stagnation suffered by each of these countries over that period – partly on account of the collapse of oil prices, but also because of unfavourable political developments (conflicts over Crimea and the Donbas area, and economic sanctions affecting Russia and indirectly Belarus).

Most EU-CEE countries, by contrast, converged with Austria by about 3.5–4 percentage points over the same period. Progress was much less impressive in Croatia, Serbia and Albania, where real GDP growth was rather weak during that period. On the other hand, a group of countries including Lithuania, Latvia, Romania, the Czech Republic and Turkey recorded rather large gains (6.5–8 percentage points) versus Austria.

The large gains made by this group of countries do not justify an expectation of accelerated convergence in the future, and likewise the moderate gains made by the majority of CESEE economies do not justify an expectation of the latter falling behind relatively speaking. The large gains made by the Czech Republic, Latvia, Lithuania and Romania represent recovery from the recessions (absolute and also in relation to Austria) suffered by these countries prior to 2012 (in most cases since 2009). By contrast, Poland, Hungary and Bulgaria did not suffer from such recessions, while Slovakia and Slovenia experienced periods of stagnation rather than recession. (In Turkey the large gains recorded were largely driven by excessive credit expansion. The credit has now dried up and the economy is going into recession, and so some of the past convergence will be undone.)

It should be remembered that shorter-term variations in the speed of catch-up are quite natural, as they can reflect differences in the phases of business cycles (still uncoordinated between countries). In reality, convergence is a long-term matter. Its analysis is most productive when conducted in the context of secular developments. One such piece of analysis (available from wiiw) indicates that it will take many decades for CESEE to approach West European income levels.[17] The box below further highlights the need for caution when projecting the convergence of the CESEE countries.

4.1.3. Longer-term convergence in the average 'wage' rates: in search of a balance between per capita GDP and average compensation levels

The lower left-hand panel of Figure 25 compares average compensation relative to Austria, at PPP. (Average compensation covers an average employee's net wages plus employee-paid taxes, as well as social security contributions paid on his/her behalf by the employer.) Since 2000, most CESEE countries have witnessed a quite remarkable catch-up in terms of compensation level. However, in Croatia (where the compensation level was very high in 2000) there was no increase at all up to 2017, and in Macedonia the relative level of compensation even declined. Compensation gains were relatively low in Hungary, Poland and Slovenia, where the compensation levels were already quite high in 2000, and relatively large in the remaining countries, where the levels were initially depressed.

[17] See the Special Section ('Convergence: A long-term matter') in Gligorov et al. (2017).

Table 6 (line 2) shows the average compensation in comparison to Austria in 2017. As can be seen, in most cases previous developments have brought average compensation into a rough balance with average per capita GDP. However, for some countries the imbalance between the two items is quite remarkable: thus, in the Czech Republic, per capita GDP is over 69% of the Austrian level, whereas average compensation is only 62.1%. This 7 percentage point imbalance may indicate that Czech wage rates are still too low, and are therefore likely to experience stronger upward adjustments in the future. Such a wage push would also increase Czech gross national product (GNP), which right now falls far short of Czech GDP (the big difference between GDP and GNP representing income earned by foreign-owned firms).

In Slovenia, Bulgaria, Latvia and Croatia, average compensation in relation to Austria is much higher than per capita GDP. The reasons for this imbalance may be country specific: Slovenia and Croatia are heirs to Yugoslavia, whose economic system was based on the strong involvement of labour in the management of a company.[18] The ideology of 'labour-managed firms' may still survive in those two countries, resulting in compensation being relatively higher than elsewhere in CESEE. In addition, the relatively low level of foreign direct investment's penetration of Slovenia may be a factor.

It is less clear why rather large imbalances can be observed in Latvia and Bulgaria. Definitional differences (in the coverage of persons earning wages or in the components of compensation) may account for some of the discrepancies. Another reason may have to do with the persistent differences in economic structures. The share of farming in the total employment of Bulgaria is very high (18% in 2016). In addition, the share of retail trade in employment is also very high. 'Regular' contractual employment – typical in Austria and the Czech Republic – may not yet have developed in Bulgaria. Instead, self-employment may be more prevalent there (as in other countries with large agricultural or informal sectors), with wages playing a less important role as a GDP component. Under such circumstances, one need not expect a tight correspondence between average compensation and average GDP. Such a correspondence will probably develop over time – in parallel with the inevitable structural changes.

References

R. Dobrinsky and P. Havlik (2014), 'Economic convergence and structural change: The role of transition and EU accession', wiiw Research Report No. 395, Vienna.

S. Estrin (1991), 'Yugoslavia: The case of self-managing market socialism', Journal of Economic Perspectives, Vol. 5, No. 4, pp. 187–194.

V. Gligorov, R. Grieveson, P. Havlik and L. Podkaminer (2017), 'CESEE back on track to convergence', wiiw Forecast Report, Autumn, Vienna.

[18] Under the Yugoslav economic system, employees participated in managerial decisions (including on investment). See, for example, Estrin (1991).

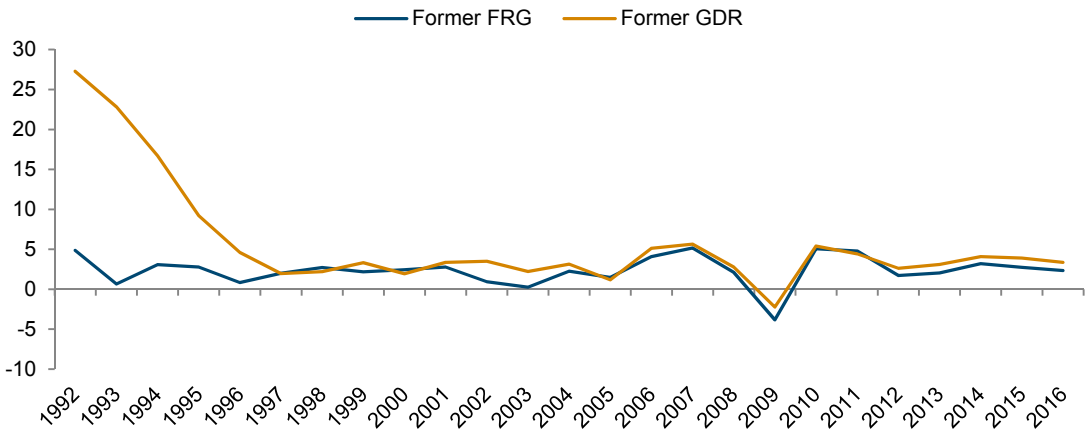
BOX 1 / A TALE OF TWO GERMANYS: CONVERGENCE LESSONS FOR CESEE

by Leon Podkaminer

The income gaps separating the CESEE countries from Western Europe have narrowed substantially since the early 1990s. The catch-up is quite impressive, especially for most of the generally less-affluent CESEE countries admitted to the European Union (e.g. Romania or Poland). Economic growth in the new EU Member States is believed to have been supported not only by quite massive financial transfers 'from Brussels', but also by the institutional harmonisation involved and economic integration (including free trade, as well as free capital and labour movement within the enlarged EU). These developments seem to bode well for the future of CESEE countries, justifying the expectation of their fairly rapid convergence with Western European income levels. On the other hand, some experts invoke the propensity of middle-income countries generally to get stuck in a 'middle-income trap'. Obviously, these writers are less optimistic (see the charts and tables above).

The controversy over the future of CESEE countries' catch-up with the West is unlikely to be resolved anytime soon. But it may be instructive to reflect on what has happened to income convergence between the former East Germany (the German Democratic Republic or GDR) and the former West Germany (the Federal Republic of Germany or FRG). The German unification of 1991 was followed by the former GDR's speedy integration into the FRG – with complete liberalisation of trade, capital and labour movement – and monetary unification. These economic transitions were accompanied by the abrupt imposition of FRG institutional and economic policy frameworks on the 'new' *Länder* (federal states). Unification was also accompanied by huge financial transfers. The consensus view is that the 'new' *Länder* received the equivalent of about EUR 1,600 billion in (net) financial transfers between 1991 and 2013. That corresponds to about 57% of 2013 German GDP.

Box Figure 1 / Growth rates of per capita nominal GDP, %, former FRG and former GDR, 1992–2016



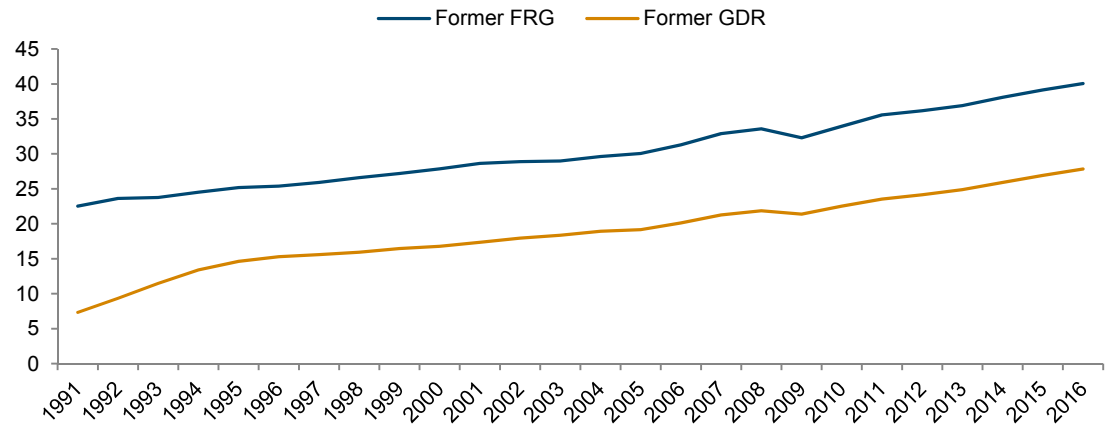
Source: Own calculations based on data from the German Statistical Office and Eurostat.

Given this, one would expect rapid convergence between the two parts of Germany. However, the facts do not support that expectation. It turns out that, although there was a period of rapid convergence, it was relatively short and had ended by the late 1990s (see Box Figure 1).

As can be seen, faster relative growth in the former GDR's nominal per capita GDP ended in 1996. Part of the initially rapid growth in the former GDR may reflect an adjustment in prices (artificially suppressed pre-1991), rather than in real output. Since 1997, the growth rates for both parts of Germany have been close to one another (average growth was about 0.7 percentage points higher in the former GDR than in the former FRG over the period). It may be added that per capita GDP growth in the former GDR came at the same time as a falling population. In the former FRG, both output and population rose over the period in question.

German unification has so far left absolute per capita income differentials roughly unchanged (see Box Figure 2). Of course, in relative terms there has been convergence (thanks to the already noted growth rate differential of about 0.7 percentage points per annum in the former GDR's favour). However, if per capita income in the former GDR continues to rise at about 3.05% per year, against the 2.32% for the former FRG (the average rates between 1997 and 2016), it will take over 50 years for complete catch-up.

Box Figure 2 / Per capita nominal GDP (EUR 000s), former FRG and former GDR, 1991-2016



Source: Own calculations based on data from the German Statistical Office and Eurostat.

What lessons for CESEE can be drawn from the German experience? First, it appears that huge transfers from the West – even if coupled with complete unification (institutional, as well as 'real') – are not necessarily a guarantee of fast convergence. The period of rapid convergence (in the former GDR until 1997) may might come to an end, sooner or later. Second, one wonders whether it was not the complete unification that was ultimately responsible for the failure of the German experiment. Arguably, a less radical real integration (through free trade, capital and labour flows, and monetary and economic policy unification) may have produced better end results. For example, giving GDR firms adequate protection for some time could have helped them to adapt to market conditions, restructure and develop

'organically', rather than end up as pieces of scrap. With a large part of the GDR's production capacities saved from liquidation, the local labour force may have stayed in the East – instead of swelling the army of the permanently unemployed, or being induced to migrate to the West.[19]

CESEE countries have been steadily integrating into the EU's institutional, monetary, fiscal and 'real' frameworks (the latter through large-scale trade and high foreign direct investment penetration by the West). In addition, most of them have drawn rather large (in relation to their GDP) funds 'from Brussels' – and stand ready to enjoy further cash flows in the future. Do these facts justify the expectation that CESEE countries will continue their accelerated economic convergence in the future? In the light of the GDR experience, such an expectation may be frustrated. For CESEE countries – as for any middle-income country – successful catch-up seems to require much more than a passive integration into the existing economic order.

[19] After only 11 years of separation, Saarland (under French administration after the Second World War) was returned to the FRG. Its initial reintegration took almost three years (1956–1959), during which time the Deutschmark was *not* the legal tender there, a customs border with the FRG was maintained and the freedom of foreigners (i.e. 'Federal Germans') to settle and acquire assets was restricted. By contrast, the GDR was annexed overnight and the GDR economy was subject to immediate takeover by the 'West Germans'.