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Strengthening Recovery in Central and Eastern Europe

EU11 Regular Economic Report

Notes and acknowledgments

This Regular Economic Report (RER) is a semiannual publication of the Europe and Central Asia Region, Poverty Reduction and Economic Management Department (ECA PREM), The World Bank. It covers economic developments, prospects, and policies in 11 European Union (EU) member states that joined after 2004 (excluding Cyprus and Malta)—Estonia, Latvia, and Lithuania (North); the Czech Republic, Hungary, Poland, and the Slovak Republic, (Continental); and Bulgaria, Croatia, Romania and Slovenia (South). Throughout the RER, for simplicity, we refer to this group of eleven countries as the EU11. The EU15 comprise Denmark, Finland, Ireland, Sweden, and the United Kingdom (North); Austria, Belgium, France, Germany, Luxembourg and the Netherlands (Continental); and Greece, Italy, Portugal, and Spain (South), with the EU17 adding Cyprus and Malta.

The RER comprises a Macroeconomic Report, and a Focus Note on an issue of economic policy interest in EU11. The Macroeconomic Report is co-authored by Ewa Korczyc, Matija Laco, and Theo Thomas (team lead), with inputs from: Sanja Madzarevic-Sujster, Suzana Petrovic, Stella Ilieva, Catalin Pauna, Paulina Hołda, Emilia Skrok, Christian Bodewig and Indhira Santos.

EU11 and EU15 aggregates are calculated as either weighted averages, sums, or simple averages. The following conventions apply: (i) aggregates for data relating to the domestic economy, growth rates and ratios, contributions to gross domestic product growth or value added growth, external trade indicators, as well as fiscal accounts—deficit and debt—are weighted by GDP valued at purchasing power parities (PPPs) in 2012 as a share of total GDP, (ii) aggregates for short-term high frequency indicators, retail sales and industrial production, are weighted by applying Eurostat's turnover and production weightings for total retail trade and total industry; (iii) aggregates of economic sentiment indicators, Doing Business indicators, non-performing loans, are calculated as simple averages, (iv) aggregates for labor market indicators, employment and unemployment rates, are weighted by labor force in 2012; (v) aggregates for inflation are weighted by final consumption expenditure in 2012; (v) and aggregates of financial sector indicators (credit, deposits) are weighted by their shares in the total.

The data appearing in the EU11 Regular Economic Report are compiled by the World Bank staff and reflect data available by June 2014. Data on gross domestic product reflects data released by June 10, 2014.

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SUMMARY

Economic growth is expected to almost double in EU11[1] in 2014, and continue to strengthen in 2015. Overall EU11 GDP growth is forecast to strengthen from 1.4 percent in 2013 to 2.6 percent in 2014. The initial reliance on net export growth, with rising demand from the rest of the EU, is gradually giving way to more balanced growth as domestic demand picks-up, notably in Romania, Slovakia and Poland. The northern countries of Estonia, Latvia, Lithuania (EU11-North) will continue to be amongst the fastest growing countries in the EU, despite the negative impact of falling external demand as growth slows in their main trading partners. Croatia is the only country expected to remain in recession, for a sixth consecutive year, in 2014, as declining domestic demand, in part stemming from the need for further fiscal consolidation, continues to outweigh export growth. Encouragingly investment is expected to pick up, having declined for the last two years, as business and consumer confidence continue to rise.

Nonetheless, the recovery is expected to be gradual, with growth not reaching pre-crisis rates for some time. Inflation rates are expected to remain below targets during 2014, with some countries already experiencing deflation, but as global commodity prices stabilize, activity increases and output gaps diminish, inflation is expected to gradually rise. Despite the continued easing of monetary policy in EU11, both the demand and supply of credit appear constrained by existing corporate liquidity, low investment rates, continued external deleveraging and high rates of non-performing loans.

Fiscal consolidation will continue in 2014 and 2015, but at a more gradual pace than in the previous years. The overall EU11 fiscal deficit is expected to drop to 2.9 percent of GDP in 2014 and to 2.5 percent of GDP in 2015. However, there is a need for larger adjustments in Croatia and Slovenia to achieve sustainable deficit and debt levels.

Economic growth forecasts in the EU11 are subject to multiple risks, mainly on the downside, as the global financial situation remains fragile. Rising global interest rates coupled with volatile capital markets, or an extended period of regional geopolitical tensions could slow the European recovery and constrain exports, credit and investment in EU11.

While labor market conditions have started to improve, the pace of job creation and reduction in unemployment rates are likely to be gradual. Many of economies in the EU11 face the twin challenge of high youth unemployment and rapidly ageing populations. Countries with high rates of young people that are neither in employment, education or training (NEET) also tend to be those with the fastest population declines, i.e. Bulgaria, Romania, Croatia and Hungary. EU11 countries also struggle with equipping the next generation with the skills necessary to achieve their full potential e.g. in literacy, math and science. The persistence of large numbers of inactive and unemployed youth therefore poses unique risks of creating a "lost generation" of workers. Understanding the cyclical and structural nature of youth unemployment is therefore important to mitigate the potentially damaging cycle between youth unemployment and broader economic growth and productivity.

Real GDP growth (percent)	2013	2014(f)	2015(f)
EU11	**1.4**	**2.6**	**3.0**
Bulgaria	0.9	1.7	2.4
Croatia	-1.0	-0.5	1.2
Czech Republic	-0.9	2.0	2.4
Estonia	0.8	2.0	3.0
Latvia	4.1	3.8	4.0
Lithuania	3.3	3.3	4.0
Hungary	1.1	2.4	2.5
Poland	1.6	3.3	3.5
Romania	3.5	2.8	3.2
Slovenia	-1.1	0.6	1.3
Slovak Republic	0.9	2.2	3.1
memo:			
Euro Area	**-0.4**	**1.1**	**1.5**

Source: Eurostat, EC and World Bank

[1] **EU11** comprises the following countries that joined the EU after 2004: Estonia, Latvia, and Lithuania (**North**); the Czech Republic, Hungary, Poland, and the Slovak Republic (**Continental**); and Bulgaria, Croatia, Romania and Slovenia (**South**).

Recent Economic Developments

Growth rates continue to recover

Growth in the EU11 region[2] strengthened from 0.8 percent in 2012 to 1.4 percent in 2013, due to favorable external conditions and a rebound in EU11-South, in particular in Romania, which benefitted from strong export growth and a good harvest. Domestic demand also began to recover during the year, although investment remained muted.

The economic recovery strengthened in the EU11, bolstered by the gradual upturn in the EU15 during 2013. EU11 growth rose to 1.4 percent in 2013, from 0.8 percent in 2012, as the pace of contraction in EU15 eased to 0.1 percent in 2013, having declined by 0.6 percent in 2012. Despite the slightly slower pace than in 2012, the EU11-North countries remained the fastest growing countries in the EU at 3 percent. In EU11-Continental the moderate slowdown in Poland and Slovakia was offset by the strong performance of Hungary as growth rose to 0.9 percent, up from 0.7 percent. EU11-South continued to rely heavily on external trade, as Romania's robust industrial output and an abundant harvest led to double-digit export growth.

Figure 1. Contribution to growth rates across the EU

(annual growth rates by sub-region, percent)

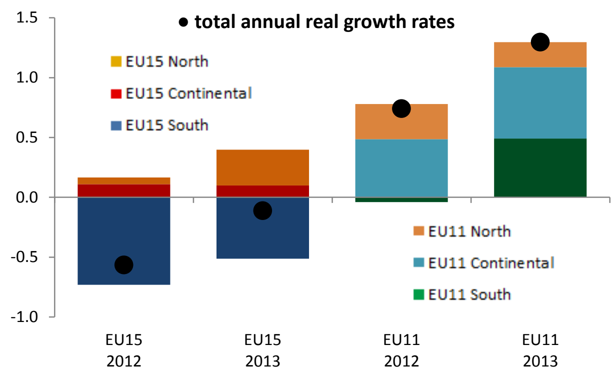
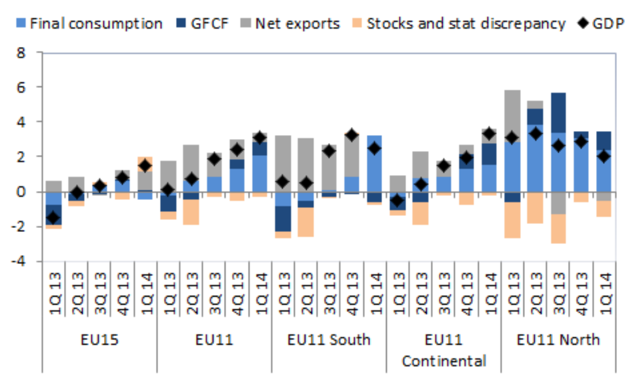


Figure 2. Contribution to GDP growth in EU11

(1Q13-1Q14, percentage point)



Source: Eurostat, World Bank staff estimates and calculations.

During 2013, growth in EU11 started to become more balanced between external and domestic demand. The main driver of the recovery in 2013 was initially net exports—with exports to the euro area increasing as demand turned positive in the second quarter of the year—and imports falling due to weak consumer confidence and negative investment. However, as growth in the Euro area gradually recovered and labor market conditions in the EU11 improved, growing real wages and renewed consumer confidence boosted private consumption toward the end of the year. However, investment remained muted, though no longer negative, as credit conditions remained tight and ongoing fiscal consolidation constrained public investment. Only towards the end of 2013 and in early 2014, there have been strong signs of recovering investment activity in EU11, especially EU11-Continental. EU11-South growth continued to rely on external trade, particularly in Romania. In

[2] **EU11** comprise: Estonia, Latvia, and Lithuania (**North**); the Czech Republic, Hungary, Poland, and the Slovak Republic (**Continental**); and Bulgaria, Croatia, Romania and Slovenia (**South**). The **EU15** comprise Denmark, Finland, Ireland, Sweden, and the United Kingdom (**North**); Austria, Belgium, France, Germany, Luxembourg and the Netherlands (**Continental**); and Greece, Italy, Portugal, and Spain (**South**), with the **EU17** adding Cyprus and Malta.

EU11-North private consumption and investment offset the falling contribution of exports, while in EU11-Continental domestic demand and investment gradually picked-up to complement ongoing export growth.

Short-term, high-frequency indicators suggest that growth continued to accelerate into the first half of 2014. In the first four months of 2014, aggregate EU11 industrial production expanded by 5.6 percent, up from 0.4 percent the previous year. However, the expansion was not uniform across the EU11 countries. While production expanded strongly in EU11-South and EU11-Continental, as the Euro area gradually recovered with production turning positive in the second half of the year, EU11-North production was constrained by slowing exports, partly reflecting the slowdown in traditional export markets further East. Retail sales grew uniformly across EU11, in advance of improvements in EU15, as business and consumer confidence surveys have been on rise since late 2012.

Figure 3. Industrial production growth, yoy, percent, 3M moving average

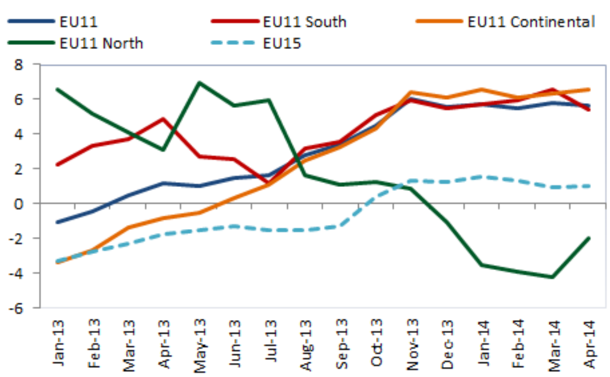
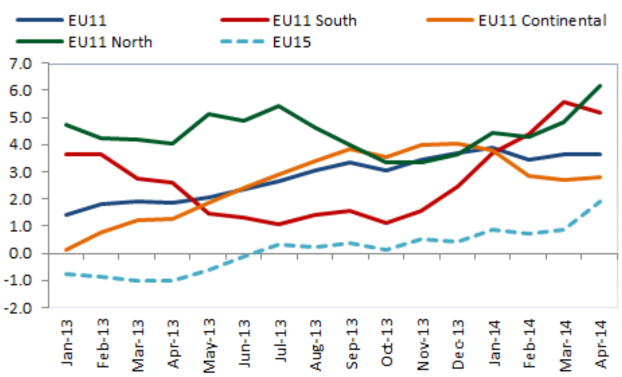


Figure 4. Retail sales growth, yoy, percent, 3M moving average



Source: Eurostat, World Bank staff estimates and calculations.

First quarter data in 2014 confirmed ongoing economic recovery. Growth in EU11 strengthened to above 3 percent in the first quarter driven by strong improvements in EU11-Continental, as Poland's GDP expanded by some 3.8 percent driven by stronger consumption and recovering investment. Czech Republic's and Hungary's growth in the first quarter surprised on the upside and confirmed that Czech and Hungarian manufacturers continue to benefit from robust momentum in Germany. Growth in EU11-North and EU11-South lost some momentum amid diminishing contribution from net exports.

Box 1: External Developments

Growth in high-income countries has continued to strengthen in 2014, including in the Euro Area. While 2013 was a difficult year for high income countries, particularly with the Euro Area in a second year of recession, in the US, Euro Area and Japan private spending has started to rebound, job markets improved and balance sheet adjustments continued. Despite a slowdown in the first quarter of 2014 in the US, following unusually cold weather, growth and confidence have rebounded. Around 2.4 million jobs have been added since the start of 2013, while the pace of fiscal consolidation has moderated and household incomes and wealth have begun to rise, boosting business productivity, investment and hiring. In developing countries, industrial output growth weakened despite surging exports, mainly reflecting weaknesses in Brazil, China, and India.

Growth in the Euro Area nearly doubled to 1.1 percent annualized in Q4, reflecting a broadly-based acceleration in activity. Of the five troubled periphery economies, four exited recession during 2013 and the fifth (Greece) is showing signs of bottoming out. The initial estimate of the Purchasing Managers Index for April suggest that Euro Area business activity is growing at its fastest pace in just under three years, with both manufacturing and services increasing for the last nine months, resulting in modest job creation. While the resurgence has been led by Germany, output in France expanded for two consecutive months and the rest of the region expanded at the fastest pace in early 2011. However, while the Euro Area is in the early phases of recovery a return to full employment will require continued monetary support given persistent low inflation, high public debt burdens and still high levels of private sector indebtedness in some periphery economies. GDP and private consumption spending in some periphery economies remains nearly 10 percent below pre-crisis peaks and investment is 40-50 percent lower in Spain, Portugal and Ireland, reflecting the damage inflicted by the crisis.

The US Federal Reserve began tapering its Quantitative Easing (QE) program in January 2014, prompted by improving growth and employment prospects in the U.S.. The initially calm reaction of financial markets was briefly interrupted at the end of January when negative news, notably slowing growth in China, political tensions in several middle income countries and the devaluation of the Argentinian peso, led to a sell-off in developing country equity markets and modest capital flight to the US and other safe havens. Gross capital flows to developing and emerging countries reached a record low in February, and several large middle-income economies, notably Argentina, Brazil, India, Indonesia, Turkey, and South Africa, tightened monetary policy to bolster their currencies and contain domestic inflation. While capital flows to developing and emerging economies rebounded in March, they continue to remain sensitive to global developments. Foreign direct investment (FDI, which account for about 60 percent of overall flows) remains the most sizeable and the least volatile form of capital flow, stabilizing overall financial flows to developing countries, although FDI has continued to decline in EU11.

Growing geopolitical tension in Ukraine has so far caused relatively limited disruption in financial or commodities markets, except in grain markets. Wheat and maize prices have risen by 17 and 12 percent, respectively, since February, in part reflecting market concerns surrounding Ukraine's production, as well as dry weather in North and South America.

EU11 employment began to rise in the second half of 2013, as economic prospects started improving. Given the usual lagged response of employment to changes in output—due to spare capacity and the need for confidence in the outlook—limited net job creation occurred in 2013, but with notable differences across the subregions. Employment picked more strongly in EU11-Continental with the exception of Slovakia, where the recovery on the labor market has not yet materialized. Employment dynamics lost some momentum in EU11-North, as the labor market conditions tightened on the back of growing wages, skills mismatches, and unfilled vacancies. Labor shedding continued in EU11 South, especially in Romania, in spite of strong growth.

Figure 2. Employment growth and unemployment rates in EU11 and EU15, yoy, percent

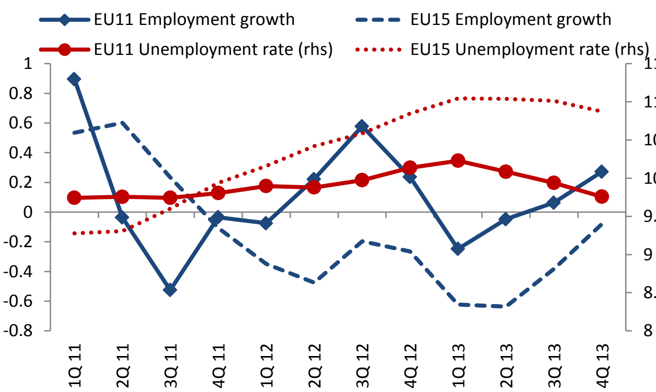
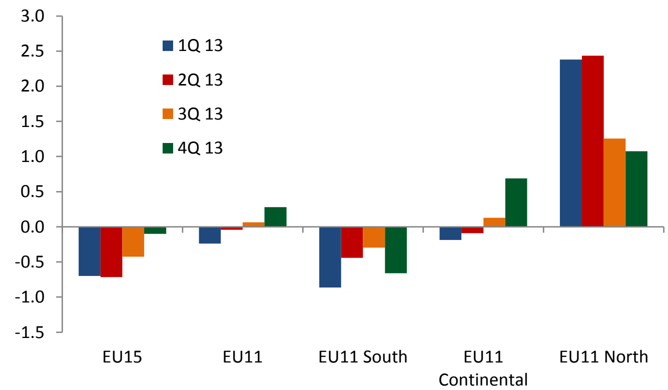


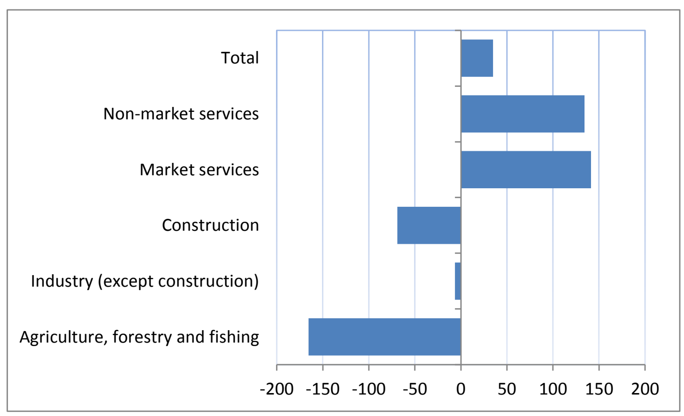
Figure 3. Employment growth in EU11 by subregion, yoy, percent



Source: Eurostat, World Bank staff estimates and calculations.

The new jobs are being created in the services sector. Both market and non-market services provided roughly 140 thousands new jobs in EU11. In contrast, labor shedding was concentrated in the agriculture and construction sectors. Overall industry employment was virtually flat, as declines in EU-South more than offset growth in EU-Continental. At the end of 2013, aggregate employment in EU11 stood at almost 44 million, roughly 1.6 million below their peak 2008 level.

Figure 4. Jobs, Lost or Gained in EU11 in 2013, Thousands of jobs



Source: Eurostat, World Bank staff estimates and calculations.

The more stable economic outlook brought about a decline in EU11 unemployment rates. Unemployment rates peaked in mid-2013, at around 10.3 percent in EU11, before dropping to 9.5 percent in March 2014, a much faster decline than in EU15 where unemployment rates remain around 10.7 percent, only slightly below the peak of 11.1 percent during the first eight months of 2013. There has also been a wide variety of experiences, with unemployment in EU11-North having peaked in 2010, before declining markedly. In EU11 unemployment rates at the end of the first quarter of 2014 ranged from a low of 6.6 percent in the Czech Republic, to a high of 17.1 percent in Croatia. In April 2014, the EU11 recorded a further decline in the unemployment rate to some 9.3 percent on the back of large reduction in unemployment rate of Croatia, which dropped from 17.1 percent in March to 16.6 percent in April.

The modest reduction in unemployment rates occurred across various groups of unemployed. Low-skilled labor appeared to be the first to benefit from the reduction in unemployment rates across the region – the drop in the unemployment rate for this particular group was the largest in all EU11 subregions with the exception of EU11-South. Youth seems to have also benefitted from the recovery, while in the case of elderly workers (55-64 years of age) the improvement was less visible. In fact, in EU11-South, unemployment rates for elderly continued to increase in 2013.

Long-term unemployment across EU11 remains a challenge. The recent decrease in unemployment did not lead to a drop in long-term unemployment. In fact, the share of long-term unemployed in total unemployed increased in 2013, suggesting that those who were without a job for less than one year, were the first ones to benefit from the economic recovery. Only in the case of EU11-North, has the recovery brought a visible reduction in the long-term unemployment.

Figure 5. Reduction in unemployment rates across EU11 in 2013, percentage points

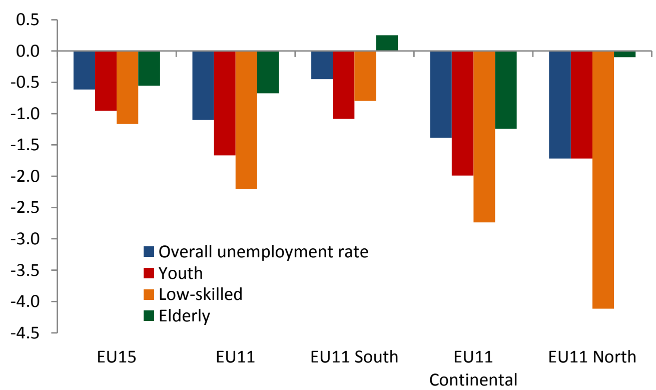
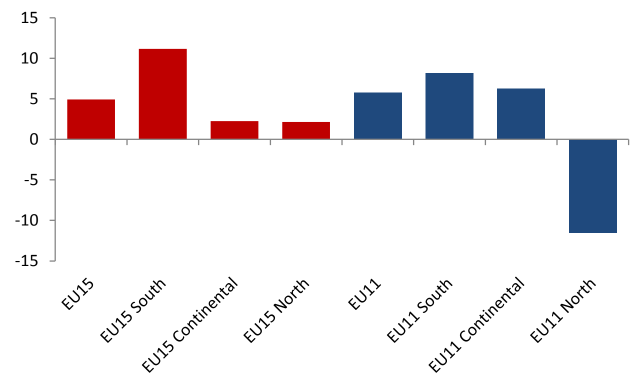


Figure 6. Change in share of long-term unemployment in total unemployment, 2012Q1- 2013 Q4, percent points



Source: Eurostat, World Bank staff estimates and calculations.

Real unit labor costs (RULC) have also begun to grow in EU11, bolstering incomes. After a long period of decline, RULCs began rising in late 2012 and the trend continued in 2013, driven by increases in wages amid moderate increases in employment. In EU11-North, in particular, the gap between increases in labor productivity and unit labor costs became large, perhaps reflecting a degree of tightness in the labor market which could signal concerns over competitiveness.

Figure 7. Change in real labor productivity per person and real labor unit costs, percent

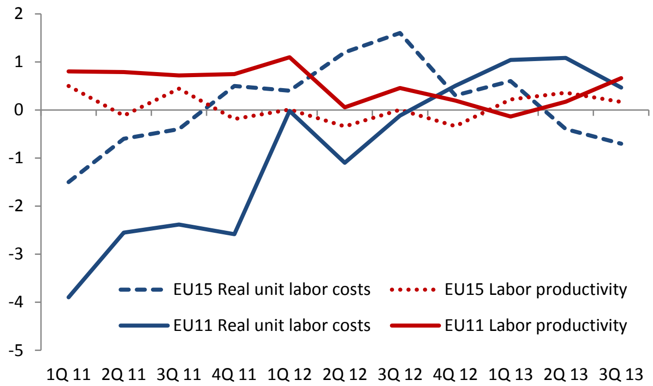
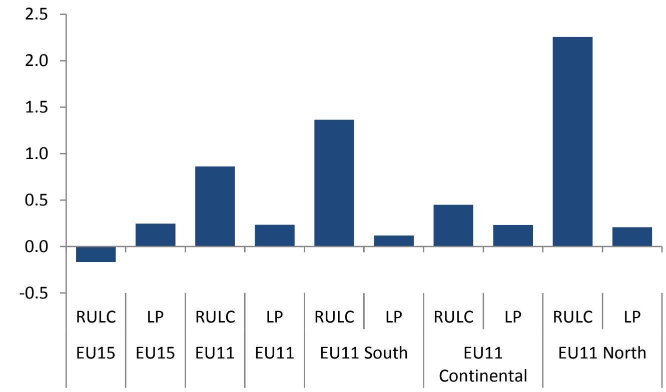


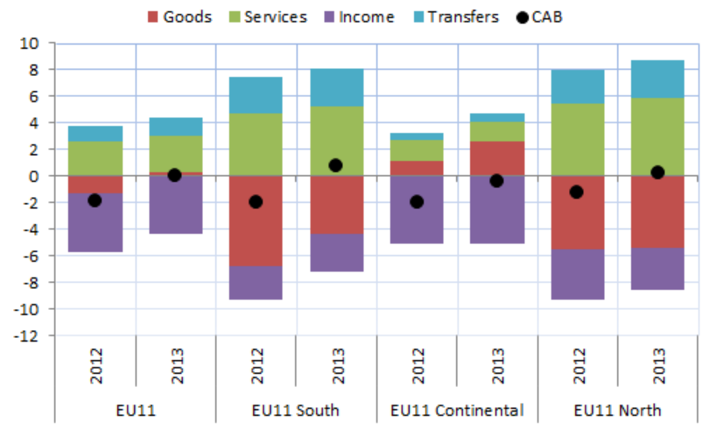
Figure 8. Change in real labor productivity per person and real labor unit costs in the first three quarters of 2013, percent



Source: Eurostat, World Bank staff estimates and calculations.

Current account balances continued to narrow in 2013 as a result of favorable trade balances. The regional current account deficit improved significantly, declining to a mere 0.1 percent of GDP in 2013. Both EU11-South and -North were in surplus, while the deficit in EU11-Continental declined to 0.5 percent of GDP, despite the surplus in Hungary rising to 3 percent of GDP. All countries except Estonia, Lithuania and Croatia improved their external trade positions, as a result of growing exports, particularly within Europe, and as imports remain relatively subdued due to weak domestic demand. Trade in services remained buoyant in both EU11-South and North. In the EU11-South, this is by and large related to tourism revenues, while in the EU11-North this reflects large exports of transportation services related to goods passing through countries, and the growing ICT sector in Estonia.

Figure 9. Cumulative Current Account Composition (Percent of GDP)



Source: Eurostat, World Bank staff estimates and calculations.

In EU11 countries, exports of goods, particularly with Europe, rose by 4 percent during 2013. As economic conditions improved in the EU, the share of EU11 exports to EU28 countries grew significantly. By the second quarter of 2013, EU11 trade with EU28 had turned from a decline to positive growth in both EU11-South and, to an event greater extent, EU11-Continental. Exports continued to outpace imports, although the gap has been narrowing since the second half of 2013. Imports started to recover in the second half of 2013 in the EU11-South and EU11-Continental, reflecting recovery of domestic demand. In EU-North both imports and exports declined in the last quarter of 2013 and first quarter of 2014, due to the slowdown in export markets outside EU28 and a moderation of domestic demand growth.

Figure 10. Geographical structure of export growth by quarters (percent q/q)

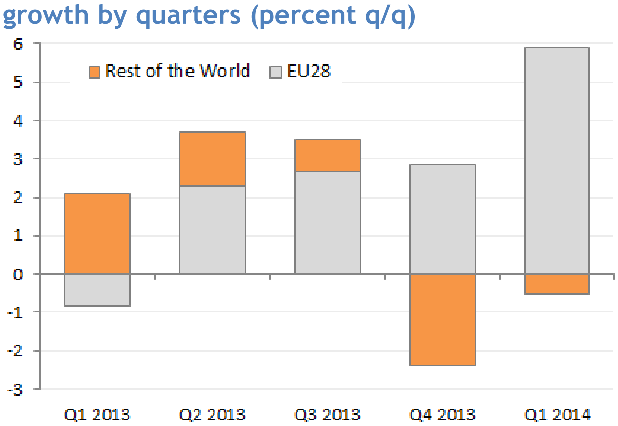
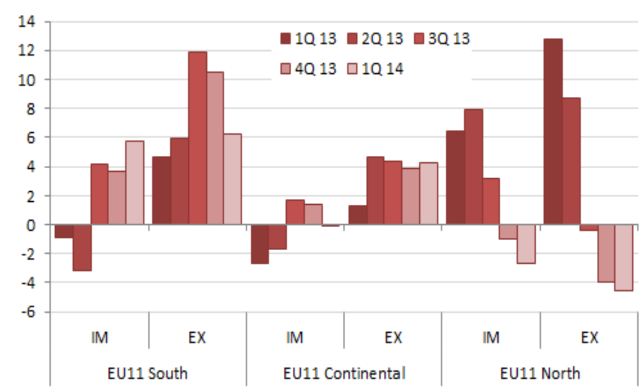


Figure 11. Imports and exports of goods (Percent, Year-on-Year)

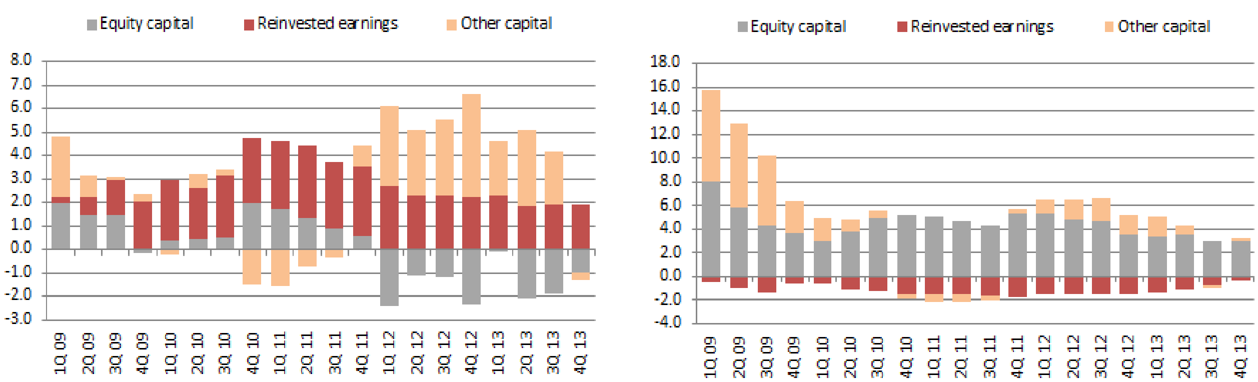


Source: Eurostat, World Bank staff estimates and calculations.

Net Foreign Direct Investment (FDI) dropped further in 2013. Net FDI inflows to the region plummeted to 2.3 percent of GDP in 2013, compared to 6.8 percent in 2012, as both inward and outward investment rates contracted, e.g. FDI was virtually zero in Poland in 2013. As intercompany lending (other capital) and equity investment dropped, reinvested earnings remained the main source of FDI. The regional aggregate conceals important differences among countries: in EU11-South equity capital remained the main source of FDI, while EU11-Continental and EU11-North relied on reinvested earnings as other sources declined.

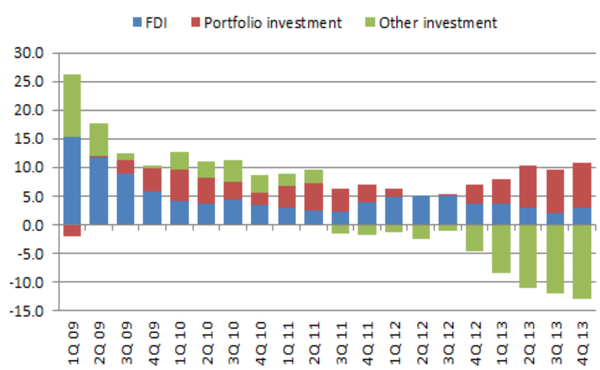
Figure 12. Cumulative net FDI, by source, in percent of GDP

EU11-Continental **EU11-South**



Source: Eurostat; World Bank staff calculations.

Figure 13. Cumulative capital inflows in EU11 South, in percent of GDP



Source: Eurostat, World Bank staff estimates and calculations.

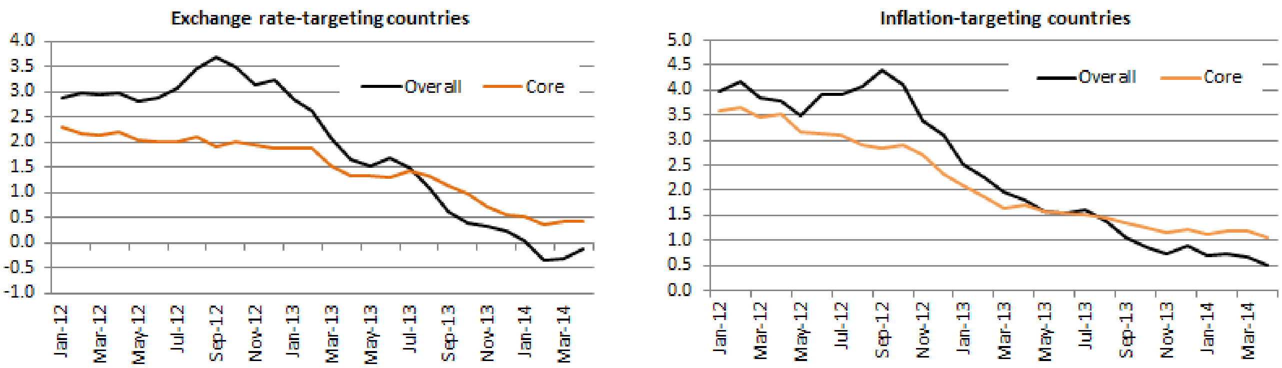
Portfolio investments, stemming mainly from acquisitions of government bonds by non-residents, remained the main source of foreign capital in most countries. Overall, portfolio investment amounted 2 percent of GDP in 2013, down from 3.2 percent in 2012. Only in EU11-South did portfolio investment continue to increase, as financing needs remained high. In particular, Slovenia's portfolio investment increased to 11.3 percent of GDP as a result of financing the fiscal deficit and recapitalization of the banking sector. In contrast, portfolio investments declined sharply in EU11-North, reflecting a decline in liabilities to non-residents. The financing needs, covered by bonds, of EU11-Continental countries also steadily declined, although portfolio investments remain an important source of capital.

The pace of corporate and banking sector deleveraging eased in most EU11 countries. The reduction in risk aversion and favorable levels of liquidity has translated into somewhat improved bank-related borrowing from abroad, but after outflows peaked at the beginning of 2013, rates started to ease throughout the year. Both EU11-Continental and EU11-North witnessed declines in the pace of deleveraging, while EU11-South continued to reduce its exposure to bank financing, particularly in Romania and Bulgaria.

Inflation has fallen rapidly

Inflation declined across EU11 over the last year and a half. EU11 countries that have adopted the Euro currency, including Latvia, which adopted the currency in January 2014, as well as countries that peg their currencies to the euro have experienced sharper declines in inflation since June 2013 and, in some cases, price declines (i.e. Bulgaria, Croatia and Slovakia). Inflation also remains below national targets in the Czech Republic, Hungary, and Poland, and to a lesser extent in Romania. Overall and core rates of inflation in EU11 remain lower than in the EU15.

Figure 14. EU11 Harmonized Consumer Price Index (HICP), Overall and Core, (Percent, Year-on-Year)



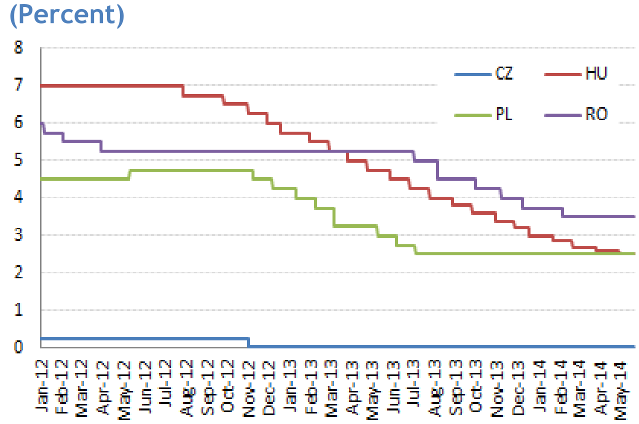
Note: Exchange rate-targeting countries include Bulgaria, Croatia (de facto), Lithuania, and EU11 Euro area countries—Estonia, Latvia, Slovakia and Slovenia; Inflation targeting countries include Czech Republic, Hungary, Poland, and Romania. Core inflation is defined as overall index excluding energy and unprocessed food

Source: Eurostat; World Bank staff calculations.

Falling energy and food prices have been the main driver of declining inflation across the region. During the first quarter of 2014, energy prices were the main drag on prices, reflecting both base effects and very moderate monthly increases. In addition, the substantial decline in food price inflation, from 3.8 percent in mid-2013 to 1 percent in April 2014, was mainly driven by a marked slowdown in unprocessed food price inflation, from an average of 7 percent in the first half of 2013 to 0.1 percent in April 2104, as the impact of last year's adverse weather on fruit and vegetable prices dissipated. Global factors, such as commodity price shocks, had a relatively larger downward impact on non-energy industrial goods price inflation, whereas the cyclical weakness of the Euro area economy, combined with the appreciation of the euro, eased services inflation.

Central banks in Romania and Hungary continued to reduce interest rates. The central bank of Hungary reduced its policy rate to 2.4 percent in May 2014, with the rate being lowered every month since August 2012 (a cumulative 460 basis points thus far). The Romanian central bank reduced its policy rate in 2014 only once, by 25 basis points, to reverse a lending contraction and support economic growth. Poland's Monetary Policy Council has kept rates on hold since July 2013, after the central bank indicated that interest rates will likely remain unchanged until at least mid-2014.

Figure 15. Policy Interest Rates in selected EU11 (Percent)



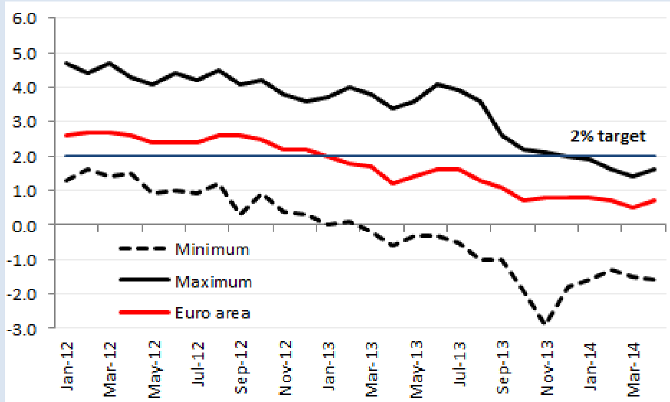
Source: Central banks; World Bank staff calculations

Box 2: Euro area inflation has fallen and monetary policy remains accommodative

In the euro area inflation has also fallen rapidly. The annual average inflation rate stood at 1.4 percent in 2013, compared to 2.5 percent in 2012. The marked drop in inflation throughout the year (from 2 percent, year-on-year, in January to 0.8 percent in December) reflected a decline in energy prices and low domestic pressures associated with high unemployment levels and low capacity utilization.

The ECB decreased policy rates twice in 2013 in an effort to bolster economic activity and support prices. In May 2013, the ECB decreased the interest rate on the main refinancing operations by 25 basis points and the interest rate on the marginal lending facility by 50 basis points. In November, the ECB decreased both rates again by 25 basis points. Thus, at the end of 2013, the rate on the main refinancing operations stood at 0.25 percent, the interest rate on the marginal lending facility at 0.75 percent and the deposit facility rate at zero.

Figure 16. Euro area Inflation (HICP), (Percent, Year-on-Year)



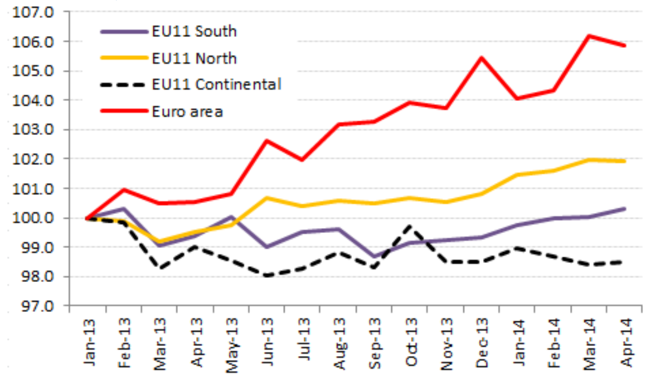
Source: EUROSTAT, World Bank staff calculations.

At its early June meeting, the ECB unveiled a package of strong and comprehensive measures that should have a positive effect on both investor expectations and the broader recovery.

- As widely expected, to cap the Euro exchange rate appreciation and mitigate the risk of deflation, key policy rates have been lowered. The ECB cut the policy rate by 10 basis points to 0.15 percent, marginal lending facility rate by 35 basis points to 0.40 percent, and deposit facility interest rate by 10 basis points to -0.10 percent. In addition, ECB decided, in line with forward guidance and determination to maintain a high degree of monetary accommodation to: (i) continue conducting the Main Refinancing Operations as fixed rate tender procedures with full allotment for as long as necessary; (ii) conduct the 3-month longer-term refinancing operations (LTROs) to be allotted before the end of the reserve maintenance period (December 2016) as fixed rate tender procedures with full allotment; and (iii) suspend the weekly fine-tuning operation sterilizing the liquidity injected under the Securities Markets Program (this constitutes a "mini Quantitative Easing" program worth just under EUR 165 billion).
- In addition, to enhance the functioning of the monetary policy transmission mechanism, the ECB announced a series of Targeted Longer Term Refinancing Operations aiming at supporting the private sector. The very low cost of these operations (interest rates equal to the refinancing rate plus a spread of 10 bp,) the duration (4 years), conditional on lending to the private sector, could make them extremely useful to enhance credit. As a result, the ECB intends to provide the liquidity the banks might need if demand for credit picks up later this year. The idea is not to make liquidity available now given the poor demand. ECB wants to ensure that a lack of liquidity does not act as a brake on the recovery later in the year, given credit lags the recovery by 6-12 months. However, is unlikely to be a game-changer given the initial EUR 400 billion limit on the size of these operations and banks have yet to see the final results of the ECB's Asset Quality Review of bank balance sheets.
- Finally, the ECB demonstrated its readiness to "do more" if needed by announcing "intensification of preparatory work" related to outright purchases of asset-backed securities (ABS). Under this initiative, the Eurosystem (ECB + Euro area Central Banks) will consider purchasing simple and transparent ABS with underlying assets consisting of claims against the Euro area non-financial private sector.

While external price competitiveness continues to improve in EU11-Continental, currencies have appreciated in EU11-North, and recently in EU11-South. Compared to January-2013, the appreciation was most pronounced in the EU11-North (1.9 percent by April 2014) where economic growth has been strongest. In the EU11-South the REER in both Romania and Slovenia appreciated by 0.6 and 2.5 percent, respectively. In contrast, EU11-Continental countries the REER depreciated by 1.6 percent since the beginning of 2013. Particularly strong depreciation occurred in the Czech Republic and Hungary, by 6.7 and 3.6 percent, respectively as the Czech National Bank used exchange rate depreciation to ease monetary conditions, while in Hungary the weaker exchange rate is partially a result of central bank forward guidance towards looser monetary policy. However, the Euro currency has appreciated significantly over the period, improving the competitiveness of the non-Euro EU11 in the broader European market.

Figure 17. Real Effective Exchange Rate, CPI Deflated, Jan-2013=100



Note: Movements upward denotes real appreciation.
Source: BIS; World Bank staff calculations

Foreign banks continued to reduce their exposure[3] to EU11 countries in 2013. International banking activity was characterized by declining credit to both banks and non-banking private sector in 2013. However, international claims started to pick up in EU11-Continental as a result of public sector borrowing in the Czech Republic and Poland. Foreign bank claims dropped further, decreasing by 13.5 percent to €31 billion, driven by large drops in Hungary and Latvia.

Figure 18. Total International Claims, Q4 2012=100

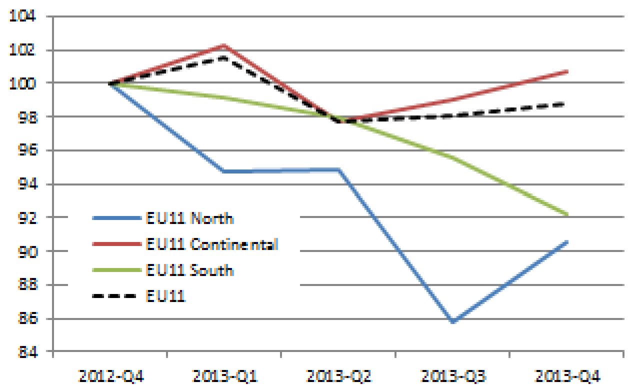
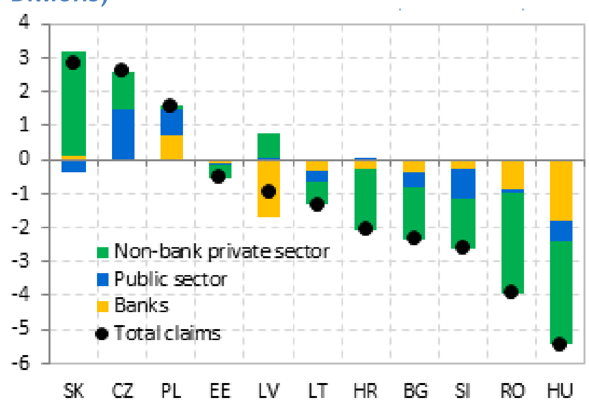


Figure 19. Change in Total International Claims by Country and Sector in 2013(€ Billions)



Source: Bank for International Settlements; World Bank staff calculations.
Note: International claims include cross-border and foreign currency claims on local residents.

Foreign banks remained cautious about allocating funds to EU11. Compared to December 2012, international claims from European banks increased modestly, by 1.4 percent to €670 billion. Spain increased its exposure by as much as 46 percent or €10 billion, through the acquisition of a Polish bank that had been partly owned by a Belgian bank[4]. Austrian banks continued to be the most active in rebalancing exposures in the region, reducing their exposure in Hungary, Slovenia, Romania and Poland, while increasing in Slovakia. Overall, European banks continued to withdraw funds from Hungary, Slovenia and Croatia, while Poland continued to benefit from increased exposure, particularly from Germany, France and Italy. France also increased its exposure in Czech Republic.

The gradual shift in funding sources toward local deposits continued in 2013, partially offsetting the decline in foreign funding. In most EU11 countries, loan-to-deposit (LTD) ratios were still adjusting downward as a consequence of deposit growth, with the notable exception of Slovenia where adjustment is via a significant decline in lending. To a lesser extent, this has also been the case in Hungary. Foreign funding still accounts for 60 and 30 percent of liabilities in Latvia and Lithuania, respectively. During 2013, growth in local deposits only partially offset the decline in foreign funding, with the exception of Poland, Slovakia and Czech Republic, where both sources of funding increased[5].

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[3] Cross-border institutions such as EBRD and EIB as well as institutional investors are excluded in these flows.
[4] Santander acquired Bank Zachodni WBK SA in 2012 and merged it with Kredyt Bank SA in January 2013 to create Poland's third largest bank by assets.
[5] The increase in foreign liabilities in Czech Republic is likely related to the UniCredit subsidiary in Slovakia changing its legal status to a branch of UniCredit Czech Republic.

Figure 20. Annual growth in deposits, loans, and loan-to-deposit ratios, 4th Quarter of 2013 (Percent)

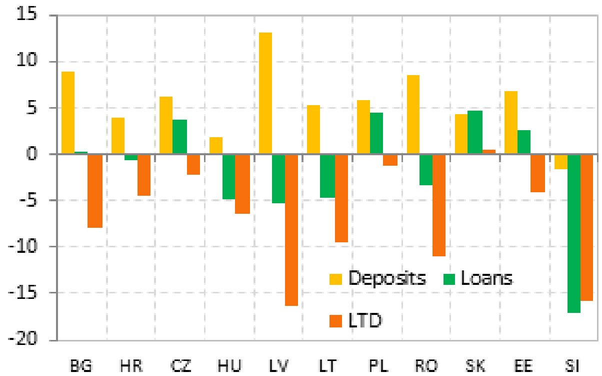
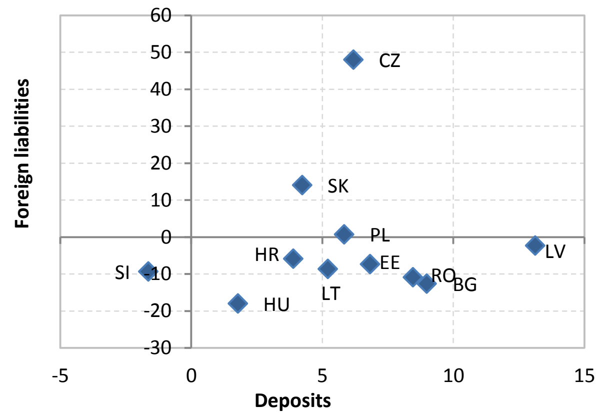


Figure 21. Annual Growth in Deposits and Foreign Liabilities, 4th Quarter of 2013 (Percent)

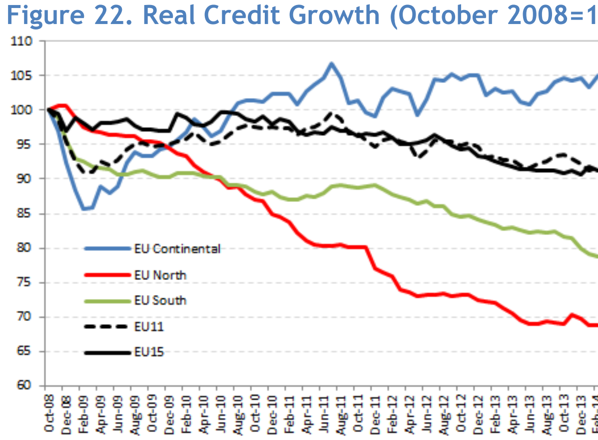


Source: IMF International Financial Statistics; World Bank staff calculations.
Note: Foreign liabilities of Euro area countries are liabilities to non-Euro area residents. For Croatia: excluding one-time effects (Centar banka bankruptcy, a new book-entry system for fees and the sale of one bank's placements to a connected company), loans in Croatia in 2013 grew by 0.8 percent (instead of drop of 0.7 percent).

While increased reliance on domestic deposits to finance lending may represent a more stable source of funding than foreign capital, there is a concern regarding the extent to which this might constrain credit growth once demand begins to grow. During 2013, the growth in deposits declined considerably from previous years, increasing by only 0.5 percentage points of GDP, compared to 8 percentage points a year earlier. Overall, with the exception of Slovakia and Poland, EU11 countries did not use the funds collected domestically to lend more to the private sector. This was particularly the case in Romania, where practically all the deposits mobilized by banks in the past 12 months were put into sovereign bonds, and this occurred to a lesser extent in Croatia and Lithuania.

Bank lending was muted, particularly in EU11-North and EU11-South. While credit activity in EU11 did pick up during the summer of 2013, it was driven by a significant recovery in EU11-Continental. Real credit grew in Slovakia and Poland due to rising household lending, while in Bulgaria, the expansion in credit was mostly as a result of corporate lending. In contrast, Slovenia experienced a 17 percent decline in corporate lending, as banks grappled with large non-performing loan (NPL) portfolios and high levels of corporate indebtedness. Significant credit contractions were also registered in Latvia and Hungary, in both household and corporate sectors despite the easing of credit to small and medium sized enterprises in Hungary through a '*Funding for Growth*' scheme introduced by the central bank that has allocated up to 6.6 percent of GDP.

Figure 22. Real Credit Growth (October 2008=100)



Source: European Central Bank; World Bank staff calculations.
Note: In countries with floating exchange rates, exchange rate effects are excluded. Data on credit growth is CPI deflated.

Bank lending surveys show that overall lending conditions in EU11 deteriorated in the first quarter of 2014, attributed to tightening funding conditions and rising NPLs. According to the Institute of

International Finance (IIF), credit standards tightened across all categories of loans, particularly consumer loans, while a sharp deterioration in both domestic and external funding conditions was registered as geo-political tensions in the region increased market volatility. Following a temporary decline in the previous quarter, NPLs rose again and are expected to rise further in the second quarter of 2014. Demand for corporate loans continued to increase while the decline in demand for commercial real estate loans moderated. Also, demand for consumer and housing loans plunged. The ECB bank lending survey, despite not covering the same countries[6], showed a similar trend in the first quarter of 2014, with no significant improvement in credit standards. The demand is both weak, and of poor quality, as most of new lending remains refinancing previous loans on more advantageous terms. On the supply side, the factor that was considered as the most likely to limit lending activities was the quality of the existing credit portfolio, as banks remain worried about NPLs in the subsidiaries and at parent company level and this is constraining their ability to lend.

Figure 23. Emerging Europe Bank Lending Conditions Index, by Categories

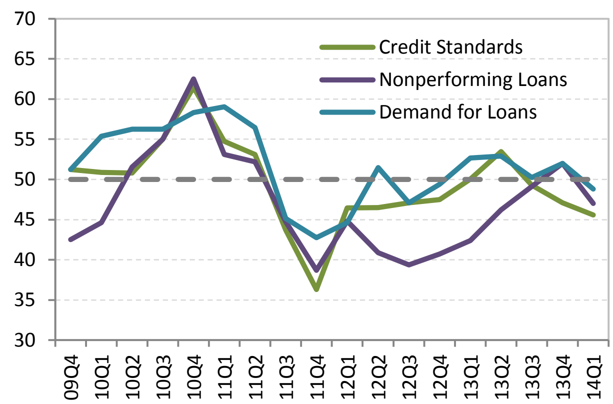
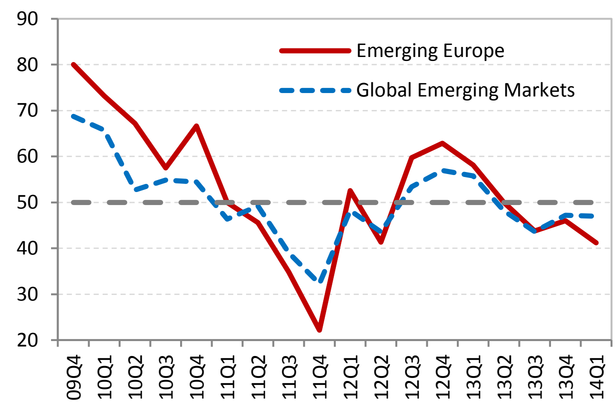


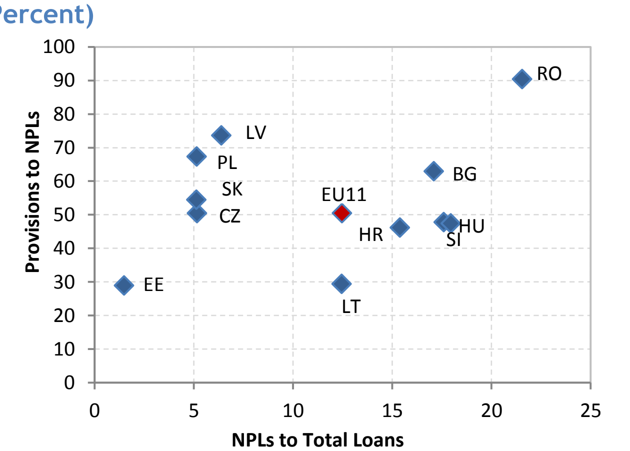
Figure 24. Funding Conditions in Local Markets, by Region



Source: Institute of International Finance, IIF, World Bank staff calculations.
Note: 50=neutral

Resolving the high level of NPLs remains one of the major priorities to bolster credit growth. NPLs reached 21.6 percent in Romania by September 2013, and although well provisioned, they constrained banks' ability to provide new credit to the economy. In Slovenia, bad loans remained stubbornly high even after a significant portion of NPLs held by the largest –and state-owned- banks were transferred to an asset management company in December 2013. Of concern is the low provisioning of NPLs in Lithuania, a situation that may be underestimating banks' capital needs. Concerted effort by regulators and banks is needed to speed up write-offs and facilitate loan restructuring to reduce NPLs.

Figure 25. Nonperforming Loans and Provisioning to Total Loans, EU11 countries, 2013 or latest available (Percent)



Source: IMF Global Financial Stability Report April 2014; EU11 central banks; World Bank staff calculations. Data are not fully comparable due to differences in national classification.

[6] The ECB bank lending survey covers eurozone countries only, of which Estonia, Latvia, Slovakia and Slovenia are members. Moreover, it covers countries of origin of the most important banks with subsidiaries in EU11, like Austria, Italy, France and Germany.

The EU11 maintained the fiscal consolidation effort for a fourth consecutive year by 2013. While the largest fiscal consolidation was delivered in 2011 as the aggregate fiscal deficit of the region dropped by some 2.5 percentage points of GDP, fiscal adjustment continued through 2013, in spite of much weaker economic growth. The EU11 fiscal deficit shrank in 2013 by some 0.4 percentage points to 3 percent of GDP, reflecting improvements in fiscal balances across EU11 subregions (excluding the fiscal impact of the bank recapitalization in Slovenia[7]). Fiscal adjustment continued in EU15 countries at a slightly faster pace, with fiscal deficits narrowing to 3.4 percent of GDP in 2013 from 4.1 percent of GDP in 2012.

Figure 26. Reduction in the fiscal deficit in EU11 by year and subregions, 2010-2013, percent of GDP

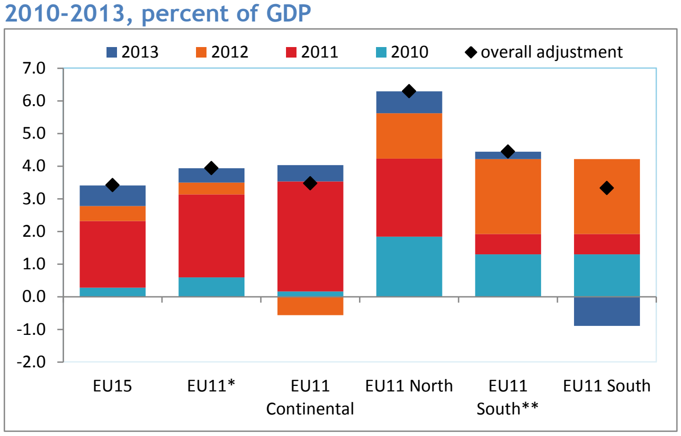
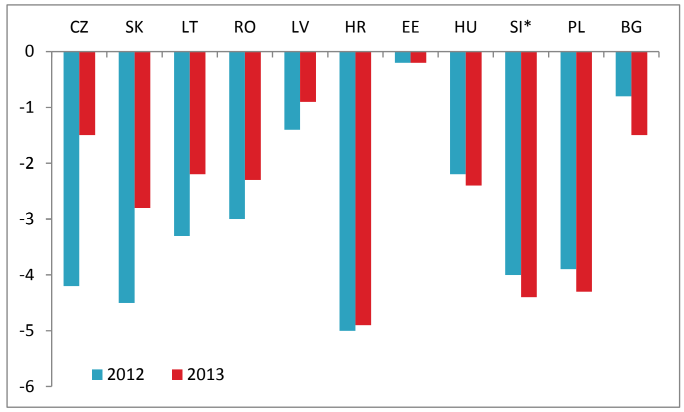


Figure 27. Fiscal deficits in EU11 countries, 2012-2013, percent of GDP



Source: Eurostat, World Bank staff estimates and calculations. Notes: EU11 and EU11 South** aggregates and SI* exclude Slovenia's one-off expenditure on bank recapitalization equivalent to 10.3 percent of GDP.*

Countries with large fiscal consolidation needs generally pursued faster fiscal adjustments, although a few also allowed automatic stabilizers to cushion the impact of the downturn. There was a strong relationship between the initial fiscal position and public debt levels in 2012 and the scale of fiscal consolidation in 2013 both for EU11 and EU15 countries. The Czech Republic recorded the highest deficit reduction in 2013, as the economic contraction was milder than anticipated, bolstering revenues, along with significant church restitution payments, while expenditure declined due to a large drop in public investment, and interest payments. Slovakia's deficit fell by 1.7 percent of GDP also amid strong VAT collection and lower co-financing of the EU projects. In contrast, the fiscal deficit in Slovenia expanded in 2013 primarily as a result of the restructuring of the banking system, but also due to restitution obligations following court rulings on public wages and compensation paid to people who had their citizenship wrongly removed after independence. To mitigate some of the impact of the economic slowdown, the fiscal deficits increased in Poland and Bulgaria, due to weaker than expected revenue collection in the former, and increased discretionary spending on social benefits in the latter.

The gradual fiscal consolidation focused on containing spending. The share of revenue to GDP in EU11 remained unchanged at 38.4 percent of GDP, despite consumption taxes like VAT falling faster than expected as domestic demand fell. The average expenditure to GDP ratio dropped in the region from around 41.8

[7] Fiscal deficit of EU11 South widened in 2013 from 3 to 3.9 percent of GDP on account of one-off increase in Slovenia's expenditures due to bank recapitalization. The report excludes this transaction while calculating regional and subregional aggregates.

percent of GDP to 41.4 percent of GDP, partly due to cuts in capital expenditures (most prominently capital transfers), while spending on wages increased in the EU11-South as did social benefits in the EU11-Continental as countries aimed to protect poorer groups.

Figure 28. Contribution to deficit reduction in 2013 by revenue and expenditure, percent of GDP

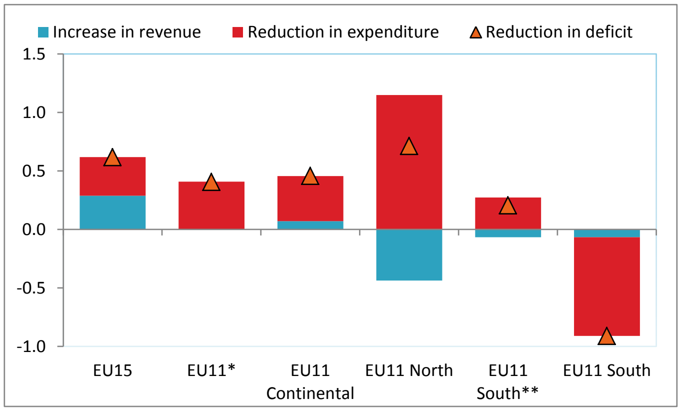
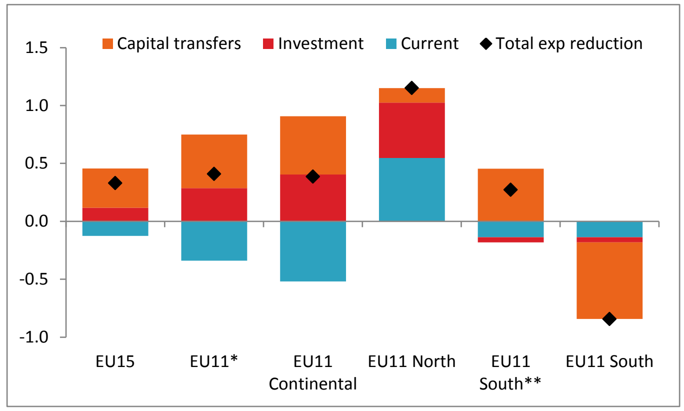


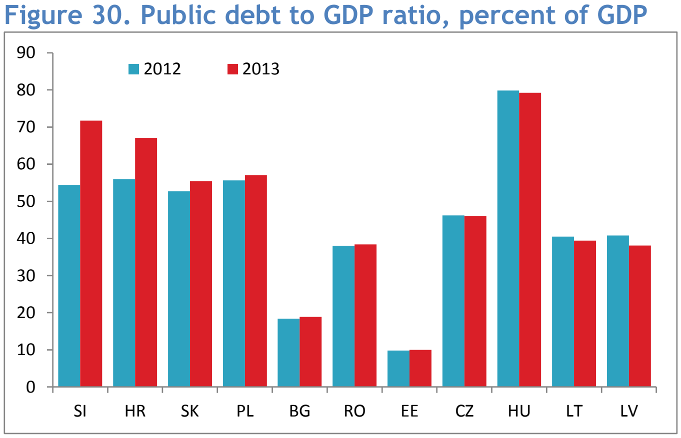
Figure 29. Reduction in expenditures by type in 2013, percent of GDP



Source: Eurostat, World Bank staff estimates and calculations.

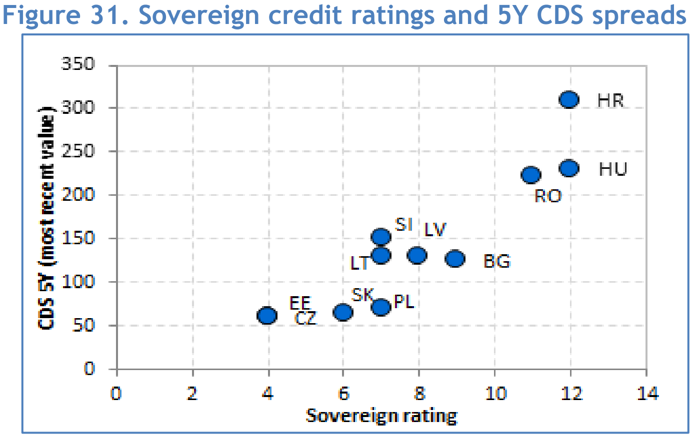
Public debt reached 52 percent of GDP in 2013, amid increases in EU11-South and EU11-Continental, offsetting a decline in EU11-North. Public debt increased in all EU11-South countries, most notably in Slovenia and Croatia due to large bank recapitalizations in the former and the large deficit in the later. In EU11-Continental the modest decline in public debt in Hungary and Czech Republic was offset by increases in Poland and Slovakia, both of which ran more stimulative fiscal policy. As the perception of risk declined, credit default swap (CDS) spreads moderated, with the exception of Croatia, whose credit rating was downgraded due to concerns over the rapid increase in public debt and weak growth prospects. In Hungary and Slovenia, CDS spreads continued to decline in 2014, signaling that markets are more comfortable with these countries fiscal consolidation efforts, current account surpluses, and low inflation. In the case of Slovenia, its CDS spread was aligned with its sovereign rating, after the recapitalization of its banking sector.

Figure 30. Public debt to GDP ratio, percent of GDP



Source: Eurostat, World Bank staff estimates and calculations.

Figure 31. Sovereign credit ratings and 5Y CDS spreads



Note: Sovereign ratings were converted into points, with a lower value indicating a higher sovereign rating. The ratings range from 4=AA- to 12=BB

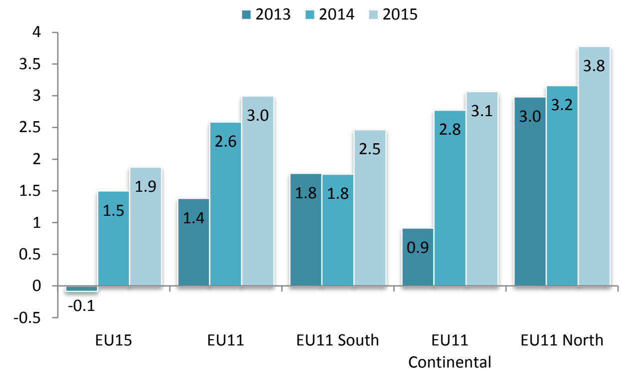
Source: Reuters; Bloomberg; World Bank staff calculations.

Near-Term Outlook

The recovery is strengthening, but risks remain

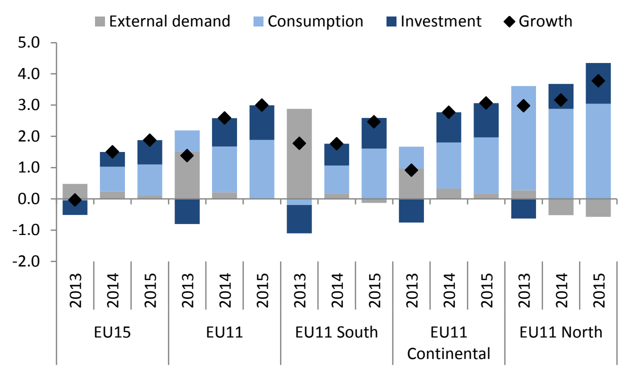
Economic growth is expected to almost double in EU11 in 2014. Overall EU11 GDP growth is forecast to strengthen from 1.4 percent in 2013 to 2.6 percent in 2014, driven by improving external and domestic conditions. EU11-Continental is expected to benefit most from accelerating domestic and external demand, particularly in the Euro Area, with GDP growth tripling in 2014 to 2.8 percent from 0.9 percent in 2013.

Figure 32. GDP growth forecasts 2014-15, percent



Source: Eurostat, World Bank staff estimates and calculations.

Figure 33. GDP growth contributions , 2013-2015



Source: Eurostat, World Bank staff estimates and calculations.

Domestic demand looks set to become the main engine of growth across EU11 as confidence in the global recovery grows. Consumption, both private and public, is set to accelerate markedly in 2014 as the purchasing power of households increases amid improved labor market conditions (i.e. low inflation and growing real wages), while drag from fiscal consolidation is also set to moderate. After two years of declines, investment may have finally reached a turning point and is expected to start contributing positively to growth, due to growing business confidence, increased industrial production, and EU-funded investment projects. The continued recovery in EU11's main trading partners in the Euro Area is also expected to maintain the demand for exports.

All countries in EU11 are expected to grow faster in 2014 than 2013, with the exception of Latvia and Romania. The improvement in growth rates among all EU11-Continental countries is expected to be above the regional average: in particular, growth in the Czech Republic is projected to improve by almost 3 percentage points, as it is set to turn positive in 2014 after a two-year recession; Poland, Slovakia and Hungary are also projected to expand strongly in 2014 on the back of a strong rebound in domestic demand. In EU-North, Latvia's domestic demand growth is expected to moderate, while all three countries face weaker net external demand. In EU-South Slovenia is also expected to exit from recession, driven by increasing EU-funded investments and net exports. Growth in Romania will slow marginally, as the temporary increase in exports from the good harvest dissipates; while Croatia is expected to be the only EU11 country in recession in 2014 as domestic demand weakness continues to outweigh export growth.

While labor market conditions have started to improve, the pace of job creation and reduction in unemployment rates are likely to be very gradual. Unemployment is expected to continue to decline from historically high levels with a slight lag to overall growth. Employment is expected to continue to grow most strongly in EU-North, as domestic demand remains robust, while in other regions the pace is expected to be more modest, in line with the gradual pick-up in growth, and as existing underutilized capacity is initially used.

Figure 34. Employment growth in EU11, 2013-2015, percent

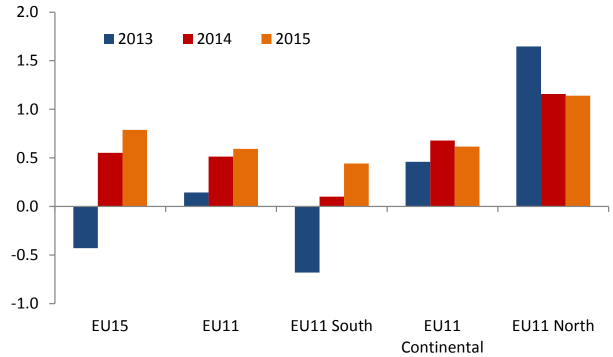
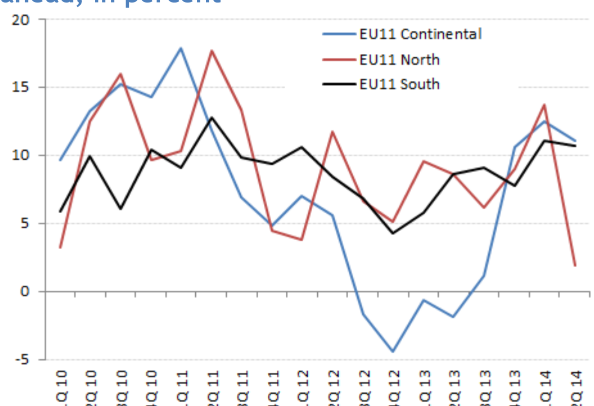


Figure 35. Export expectations for the months ahead, in percent



Source: European Commission, World Bank staff estimates and calculations.

Trade is projected to gain momentum in 2014 and 2015 as export order books continue to improve, with the exception of EU11-North where export expectations have fallen due to the slowdown in their main trading partners. Nonetheless, the overall EU11 region continues to benefit from stronger demand from advanced economies—particularly the Euro Area. Short-term prospects for imports into the EU11 show positive signs of increasing in all sub-regions, supported by a gradual pick up in domestic demand. With import volumes set to grow, outpacing export growth, current account deficits are likely to grow modestly or in some countries re-emerge.

Inflation rates are expected to remain low during 2014, but as activity increases and output gap diminishes, inflation is expected to gradually rise. Short-term inflation expectations continue to be tilted downwards, signaling low but positive inflation developments. As the recovery gradually gathers pace, inflation is set to rise, although at a gradual pace, reflecting the remaining slack in the economy and benign external price pressures.

Monetary policy will remain accommodative, but weak credit growth in the EU11 reflects ongoing credit risks and the likelihood of further adjustments of financial and non-financial sector balance sheets. The improvement suggested by survey data looks set to be gradual, and, as domestic deposit growth may well prove insufficient to support a meaningful revival of credit growth, supply side constraints may become more binding as growth accelerates. In order to ensure an adequate transmission of monetary policy to the financing conditions and growth-supporting real sector activity, it is essential to strengthen the resilience of banks where needed. Banks should take full advantage of this exercise to improve their capital and solvency position, thereby contributing to overcome any existing credit supply restriction that could hamper the recovery. It remains urgent to tackle persistently high NPLs in several countries in the region, thereby improving conditions for new lending.

Bank balance-sheet repair and the results of the asset quality review (AQR), remains a precondition for the normalization of credit growth. While designed to restore confidence in the banking sector over the long term, in the short run, banks' efforts to shrink their balance sheets to resolve NPLs may constrain new credit growth and result in an effective tightening of credit conditions. Given that parent banks of EU11 subsidiaries are subject to the ECB assessment, this may also imply short-term volatility, and the EU11 subsidiaries of affected banks could be subject to new rounds of deleveraging, as parent banks seek to shrink assets to reduce their capital needs.

Box 3: Is there a risk of prolonged deflation in Europe?

So far there are few signs of deflation becoming entrenched across the Euro Area. While a number of countries in Europe have already experienced periods of declining prices, including Bulgaria, Croatia and Slovakia in EU11, long--term inflation expectations remain anchored in line with the ECB definition of price stability around 2 percent. Notably:

- Inflation was negative in no more than five euro area member states in any month of 2013 and 2014. It is negative or slightly above zero among the countries hardest-hit by the crisis suggesting it may be a result of weak domestic demand and corrective measures that could improve competiveness through an internal devaluation. Nonetheless, all Euro area countries remain below the 2 percent ECB target.
- As regards product groups, Euro area prices in January-April 2014 fell in two of the standard 12 categories, corresponding to less than 5 percent of the overall index.
- Both survey-based measures and implied inflation expectations (derived from bond swap rates) have shown a declining trend for inflation over a 1-3-year horizon, although expectations are well-anchored at around 2 percent over a 5-year horizon. Nonetheless, a price shock or a sustained period of low inflation, or even a dip into deflation, could depress expectations.

Nonetheless, fear of low inflation, and the risk of deflation, could harm the nascent recovery. Low inflation expectations are likely to feed into spending and wage decisions and although this may benefit net savers in the economy, it makes it more difficult to stimulate domestic demand or reduce high levels of household, corporate or public indebtedness. This may constitute a growing drag on the nascent recovery in the Euro area, especially in more fragile economies, which are struggling to regain competitiveness and create jobs.

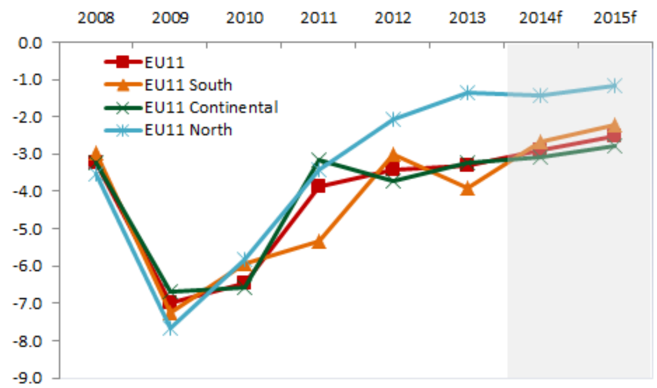
The ECB has demonstrated its readiness to "do more" if needed. With the refinancing rate close to zero, Quantitative Easing (QE) may be seen as a next policy step to ease monetary conditions. There are four main transmission channels for QE: (1) a signaling effect to the market, (2) by providing liquidity to financial markets, (3) by promoting bank lending channel, and (4) by balancing financial institutions portfolios. The structure of QE differs depending on which channel is perceived to be the most effective. For example, at the beginning of the QE programs in both the UK and the US, the credit channel was considered the most relevant, with the US not buying any US Treasuries to begin with, and the UK announcing purchases of corporate bonds. Over time, the focus shifted to the portfolio effect, with the UK abandoning its purchases of corporate credit, and the US through Operation Twist.

Overall the effectiveness of any form of QE will depend on the robustness of banks' balance sheets. One of the main issues for a smooth transmission of any type of monetary policy to the real economy is the degree to which banks may still need to reduce the amount of unprofitable assets on their balance sheets, or to bolster their capital, which is likely to entail further deleveraging and recapitalizing. However, the ECB can accelerate the deleveraging process through the 'Comprehensive Assessment', or by purchasing assets once the Assessment is completed, while as regulator it can also require raising capital if necessary.

The European Parliament also approved the Single Resolution Mechanism (SRM), which will have direct and indirect implications for EU11 countries. Provisions setting up the Single Resolution Board (SRB) will take effect in January 2015, while provisions for setting up the Single Resolution Fund (SRF) will take effect in January 2016, being fully capitalized by 2024. Several EU11 countries are –or will soon become- Euro area members and therefore will fall under the SRM, while the rest are non-Euro area members with Euro area parent banks operating in their domestic markets, owning a significant share of their banking sectors. If one of these banks needs to be resolved, they would be subject to SRM rules, and the selection of a specific resolution method could affect the stability and the structure of the financial sector of the host country. In this regard, formal procedures for the participation of non-Euro area countries in the SRM should be developed.

Fiscal consolidation will continue in 2014 and 2015 as governments rebuild their fiscal policy buffers. The adjustment in government's fiscal deficits is projected to be more gradual than in the previous years, as the fiscal situation across EU11 has improved markedly over the past few years. The overall EU11 fiscal deficit is expected to drop to 2.9 percent of GDP in 2014 and to 2.5 percent of GDP in 2015.

Figure 36. Projected Fiscal balances in EU11



Source: European Commission, World Bank staff estimates.

The modest fiscal consolidation in EU11 region will continue to rely on expenditure containment amid improving economic conditions. After a rapid period of restructuring, EU11-North is enjoying the best fiscal outcomes among EU11 sub-regions: Estonia has scope to expand fiscal policy in 2014 while remaining almost in balance (consistent with structural surplus targets in the new State Budget Law of March 2014), while Latvia and Lithuania will maintain their current low fiscal deficit stance. Poland, Slovenia and Croatia, are all committed to reducing deficits under the EU excessive deficit procedure (EDP). Poland will resume fiscal consolidation in 2014, with the aim of reducing the fiscal deficit to below 3 percent of GDP by 2015, through a combination of changes to the pension system, a continued freeze on the wage bill (and other current spending) and changes to VAT and excise duties. The fiscal deficit in Slovenia is expected to drop to around 4 percent of GDP, from close to 15 percent of GDP in 2013, reflecting much smaller bank recapitalization needs as compared to last year (0.9 percent of GDP in 2014 as compared to 10.3 percent of GDP in 2013), as well as a series of fiscal measures on both revenue (full-year impact of VAT rate increase, revenues from telecom licenses, increase in certain excise duties and a stop in lowering the corporate income tax rate) and expenditure side (containment of wages, pensions, and subsidies, smaller capital transfers). Croatia's fiscal deficit is also set to improve, from 4.9 percent of GDP in 2013 to below 4 percent of GDP in 2014, reflecting budget amendments from March 2014 to contain wages and social spending and other fiscal adjustment measures. The fiscal deficit in Romania will shrink marginally, while Bulgaria's fiscal policy will continue to be expansionary, reflecting increases in pensions, various current expenditure and public investment.

There are significant downside risks for the EU11

Economic growth forecasts in the EU11 are subject to multiple risks, mainly on the downside, as the global financial situation remains fragile. There are significant external risks that are no longer dominated by the prospects of the Euro Area economies. As the immediate risk of contagion from the Euro Area sovereign debt crisis and recession has subsided, the growth prospects for emerging markets, whose growth rates slowed in 2013, are more uncertain and a slowdown could impact European exports and growth. Another factor affecting the economic prospects of the EU11 is the volatility in international financial markets, triggered by announcements of future tapering of US bond purchases and over the US budget and debt ceiling and uncertainty related to the path of monetary and fiscal policy in the US. Shocks in the US could lead to larger spillovers through financial markets, confidence and links to the real economy, particularly if long-term interest rates continue to rise.

At the same time, depressed labor markets across the EU11 may undermine the fragile confidence and will continue to be a drag on domestic demand and growth. While growth rates are expected to pick up across the EU11 in 2014, they will remain well below the pre-2008 levels in most countries, which suggests that unemployment rates are likely to remain high, particularly among the low-skilled youth and long-term unemployed.

Domestic financing conditions and further bank and corporate deleveraging also pose risks to the domestic demand pick up in the EU11. As highlighted above, the continued withdrawal of foreign capital and equity from many countries across the EU11 would further increase the reliance of companies on internally generated resources and banks on domestic deposits for providing loan funds for investment. In addition, while further reforms to the banking sector, notably the establishment of a more integrated EU-wide monetary union and a reduction in the high level of NPLs in the EU11, would support long-term growth they could initially expose weaknesses that require banks to raise additional capital. This in turn would reduce the availability of new lending and tighten credit conditions until the problems are resolved, which could hamper lending for new investment and constrain growth.

Overall risks to the growth forecast for EU11 are tilted to the downside. Growth in Euro Area hinges on governments' ability to implement structural, fiscal and institutional reforms at the countries' and the EU level, which are crucial to sustain and strengthen the ongoing recovery. Risks to the outlook for emerging market economies persist, especially for those most exposed to tighter financial conditions. Uncertainty has increased regarding China's growth prospects and possibly its financial stability, while geopolitical tensions in the ECA region have increased risks. Risks related to US Federal Reserve bank tapering have diminished recently as the hitherto market reaction in EU11 region was calm. Sliding inflation in Euro Area has raised real interest rates, potentially slowing the recovery. Medium to long-term inflation expectations remain anchored so far, but downward adjustments could unleash a pernicious debt-deflation cycle and undermine the ability of monetary policy to support the economy.

Box 4: Geopolitical tensions in ECA and its impact on the EU11

Ongoing geopolitical tensions and economic developments between the European Union, Ukraine and Russia will affect the EU11 region through trade, financial and energy supply channels. Moreover, an extended period of regional geopolitical tension could affect confidence throughout Europe, which would feed through into external demand and confidence in the EU11. Ukraine's economy is expected to contract sharply in 2014, by around 5 percent, while Russia's GDP is also expected to continue its slowing trend to 0.5 percent in 2014, from 1.3 percent in 2013.

The EU11 region is more integrated with both Russia and Ukraine than EU15 due to both geographical proximity and existing supply chains. Overall, 5 percent of EU11 exports go to Russia and close to 2 percent to Ukraine, while in the case of EU15 it is 2.4 percent and 0.3 percent, respectively. Among the EU11 sub-region, EU11-North is most exposed to a slowdown in growth and trade in Russia and Ukraine, but even for this sub-region, there are large cross-country differences. Close to 20 percent of Lithuanian's exports go to Russia, predominantly foodstuff, and 3.5 percent go to Ukraine. Estonia, which is more closely connected to Finland and Sweden, has less reliance on exports to Russia, but still above 10 percent. In all three countries, external services accounts are in surplus, reflecting large exports of transportation services related to goods that are landed in Baltic ports and transported to their final destinations. EU11-Continental and EU11-South have fewer trade relations with Russia and Ukraine, as they send between 3-5 percent of their exports to those markets. Among the EU15 countries, Finland and Germany have trade links to Ukraine and Russia comparable to those in EU11 countries. Interconnectedness through FDI channels is also limited as both inward and outward links to Russia and Ukraine account for less than 1 percent of the overall FDI stock.

Russia supplies about 30 percent of the natural gas consumed in Europe, with an average of about 60 percent of in EU11. Among the EU11 countries, Lithuania, Estonia, Latvia, Bulgaria, Slovakia and Czech republic rely almost entirely on Russian gas for their gas consumption. However, the share of natural gas in total primary energy consumption is much lower, at around 40 percent in Latvia and Lithuania and over 20 percent in Estonia and Slovakia, indicating that the impact on the economics in the region of any supply disruptions could vary greatly, and in some cases be more sector specific. In addition, since Russia's economy relies heavily on revenue from gas exports to Europe (9 percent of GDP, a quarter of government revenues, and nearly two-thirds of export revenues), the mutual dependency in energy markets will likely deter protracted supply disruptions.

Figure 37. Share of Russia and Ukraine in EU11's exports, percent

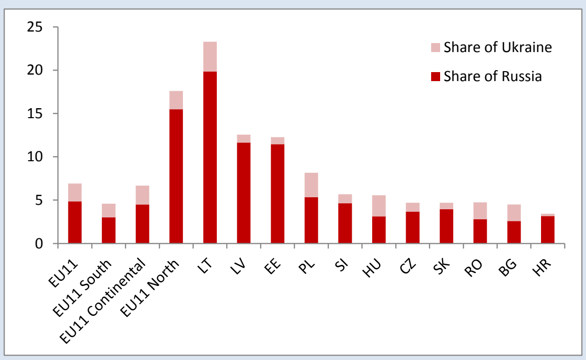
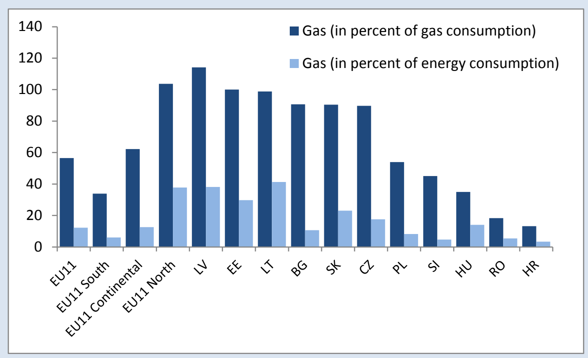


Figure 38. Role of gas from Russia in gas and energy consumption in EU11 countries, percent



Source: Eurostat, IMF, World Bank staff calculations. Note: Imports can be higher than consumption due to replenishing of gas stocks and loses in distribution

Direct financial links with Russia and Ukraine are limited. However, given EU banks have sizeable exposures to Russia and to a lesser degree Ukraine, EU11 countries might be vulnerable to contagion emanating from parent bank linkages. Many EU banks, which are present in EU11 countries, are relatively heavily exposed to Russia, and in particular Russian corporates, and to a lesser extent to Ukraine. Total EU bank exposure to Ukraine is estimated to be around US$ 23bn with Austrian and Italian banks the most exposed. EU bank exposure to Russia is $184bn, with France, Italy, Netherlands and German banks among the most exposed. US bank exposure to Russia is estimated to be $37bn.

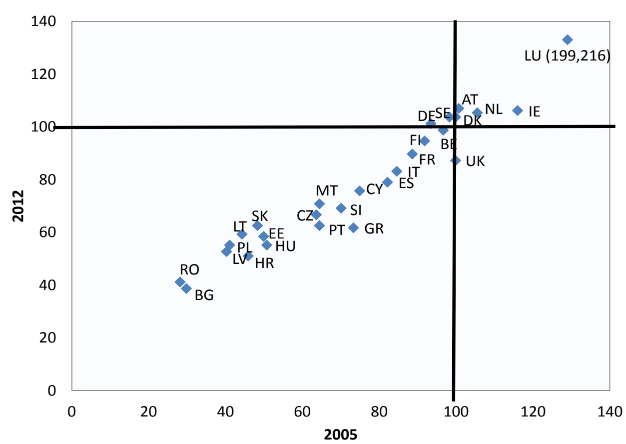
Given limited direct exposures to both Russia and Ukraine, the impact of geopolitical tensions on EU11 region is modest. However, the aggregate picture conceals varied implications for particular countries and industries, which could face more serious repercussions from an escalation in the situation. In addition, the impact on the fragile recovery in Western Europe is an additional risk factor for EU11 growth prospects.

Spotlight 1. 10 years of EU membership

Eight countries in Central and Eastern Europe have now been members of the European Union for 10 years. On balance, this has been a positive decade remarkable for their rapid economic convergence despite the global and European crises. The process of European integration has left its imprint on their financial markets and foreign trade as well as labor markets and regulatory frameworks. Accession to the EU has also fundamentally changed the institutional landscape not only of the new member states (NMS) but also of Europe as a whole. Accession was the catalyst for renewal; without it, many structural adjustments would probably have occurred either later or not at all. What is now necessary is to ensure that convergence is durable and to distribute more equally its benefits?

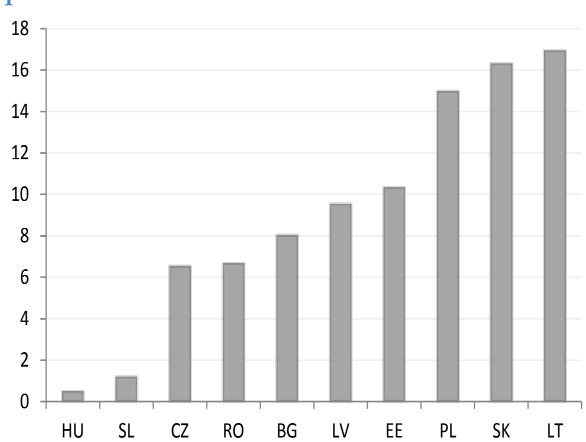
Since accession to the European Union (EU) the new member states (NMS) have narrowed the income gap with the "old" member states, particularly those countries that had already put in place appropriate policies. Between 2005 and 2013 all NMS[8] were able to narrow the income gap with the EU15[9] average. Average per capita GDP in the NMS, which amounted to about 50 percent of the EU15 in 2005, reached almost 60 percent in 2013. Lithuania, Slovakia, and Poland narrowed the gap the most, by more than 15 percentage points. The convergence of other NMS was also remarkable, except for Slovenia, which has not managed to get its income closer to the EU15 average over the last 10 years. The impressive growth of NMS benefited from "beta-convergence"[10] but was not solely dependent on it; what seemed to matter more was an enabling policy mix. For example, the Czech Republic entered EU with much higher per capita income than Hungary and was much more successful in closing the income gap than Hungary (Figure 39, Figure 40). It is also noteworthy that during the same period about half the EU15 countries themselves fell behind; only Germany, Sweden, and Austria improved their relative position significantly. Since the latter three, however, already had higher per capita income than the EU15 average in 2005, it appears that an appropriate policy mix mattered also for the old member states (OMS).

Figure 39. Per capita GDP in the EU



Source: Eurostat

Figure 40. The reduction in individual EU-10 countries' income gap toward the EU-15 in the period 2005-2013



Source: Own calculations based on the IMF data.

[8] The term New Member States (NMS) or alternatively the EU10 refers to the eight countries that joined the European in 2004 (Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, Slovenia) and the two that joined in 2006 (Bulgaria and Romania).
[9] EU15 countries (Old Member States, OMS) are Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden and the United Kingdom.
[10] This inverse relationship between growth and the level of income is called "beta-convergence." When it is present, poorer countries are able to draw nearer to their richer peers (EC 2009).

Although the NMS have been catching up relatively quickly in recent years, they still have significantly lower income per capita than the EU15 average. EU accession speeded up convergence for the EU10; the speed of income convergence in the pre-accession period was 2.3 percent (EC 2009) and increased to 2.6 percent between 2005 and 2013, the period after EU enlargement. The recent financial and debt crises, however, slowed the catching-up process in the EU (see Table 1, where the β-coefficient is reduced from 2.78 percent in 2005–09 to 2.43 percent in 2009–13). The income convergence that took place in the last decade as a result of the NMS accession process revealed divergent tendencies. From 2005 to 2013 there was a negative relationship between the incomes of NMS and their growth rate, with the β-coefficient at 3.17 percent[11]. At the same time the EU15 countries have not developed in line with the β-convergence coefficient hypothesis. The results confirm rather income divergence than convergence. Income differences between individual EU-15 countries diminished only in 2007–09; in 2005–07 and 2009–13, they increased, suggesting greater income disparities. Finally, although the NMS have been catching up fairly quickly in recent years, the process is not yet over. Most of the NMS still have significantly lower income per capita than the EU15 average. In 2013, only Slovenia and the Czech Republic had per capita income that was more than 75 percent of the average.

Table 1 Estimation results for beta-convergence in EU-26

Estimated equation: $\Delta\ln(\text{GDP per capita}) = \alpha - \beta \cdot \ln(\text{GDP per capita}(-1))$

Period	□ 0	□ 1	*t*-stat. (□ 0)	*t*-stat. (□ 1)	*p*-value (□ 0)	*p*-value (□ 1)	R^2	□ - convergence	□
26 countries of the enlarged EU									
2005-2013	0.2483	–0.0237	4.58	–4.44	0.000	0.000	0.4506	yes	**0.0263**
2005-2009	0.2747	–0.0263	4.72	–4.58	0.000	0.000	0.4667	yes	0.0278
2009-2013	0.2437	–0.0232	2.40	–2.33	0.024	0.029	0.1842	yes	0.0243

Regression results for □-convergence, EU-11 countries

Period	□ 0	□ 1	*t*-stat. (□ 0)	*t*-stat. (□ 1)	*p*-value (□ 0)	*p*-value (□ 1)	R^2	□ - convergence	□
2005-2013	0.2928	–0.0280	2.05	–1.90	0.071	0.090	0.2861	yes	**0.0317**
2005-2009	0.3070	–0.0294	1.53	–1.43	0.159	0.188	0.1843	yes (?)	0.0313
2009-2013	0.3366	–0.0323	1.26	–1.18	0.240	0.268	0.1341	yes (?)	0.0345

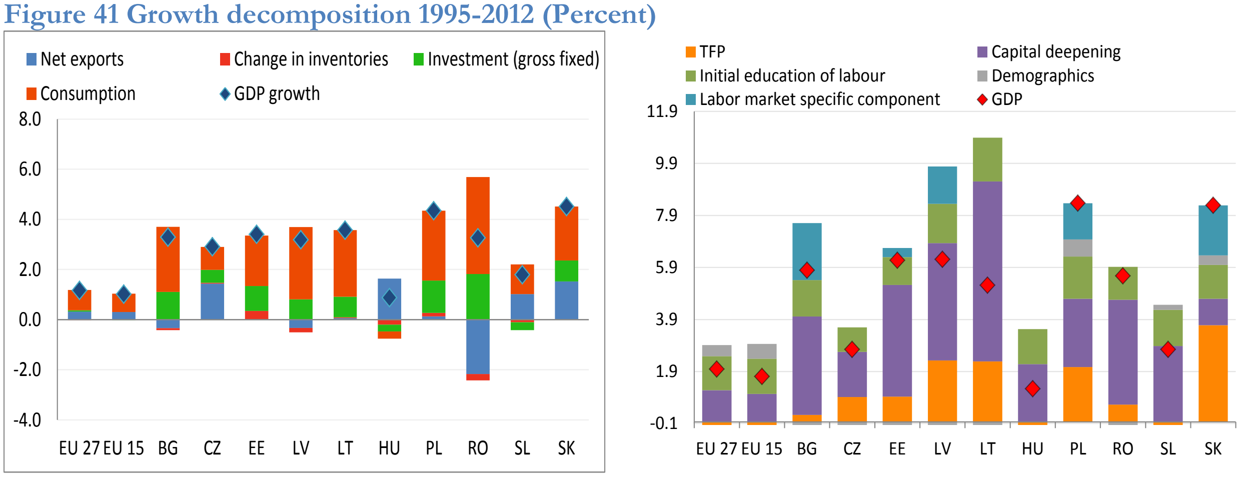
Source: Próchnik, 2014 (Background paper for WB, based on the IMF data)

[11] However, for both shorter subperiods (2005-2009 and 2009-2013) the results are inconclusive because the trend line is negative; however, the slope of the regression line is statistically insignificant at reasonable significance levels (p-values amount to 0.188 for the years 2005-2009 and 0.268 for 2009-2013).

The institutional and legal frameworks and the common policies of the EU were central to this success. One aspect that is often given short shrift compared with macroeconomic performance is the institutional dimension of EU accession. NMS economic frameworks have been heavily influenced by the sweeping changes associated with integration into the EU's institutional landscape. Macroeconomic stabilization, institution-building, regulatory convergence, improvements in governance, trade integration, and capital movement liberalization not only took place throughout the accession process but also continued after EU entrance. EU accession anchored economic policies, created a stable and competitive economic environment, and spurred public investment in human capital and infrastructure, creating ample opportunities for private initiatives. Investors from the OMS and throughout the world quickly seized these new opportunities, bringing an unprecedented inflow of private capital into the NMS. The acceleration in financial integration caused by introduction of the euro created a particularly supportive environment. The full and successful integration of the NMS into EU employment and social policy was also vital. Finally, with accession to the EU and the objective of monetary union, EU-related objectives came to dominate NMS fiscal and monetary policies. Since that time, convergence criteria for participation in monetary union, later the Stability and Growth Pact, and the totality of EU economic policy coordination mechanisms all came to define the parameters within which NMS economic policymakers could act.

Rapid integration brought many benefits for growth but also created vulnerabilities for some of the EU10. The catching-up process has relied on significant capital deepening, productivity gains, and better education of the labor force (Figure 41). In the Baltic States and Romania, which of the EU10 had the least inherited capital stock, the contribution of capital to growth after EI accession amounted to more than 4 percentage points. Total factor productivity (TFP) contributed the most to growth in Slovakia, Poland, Lithuania, and Latvia (more than 2 percentage points). Part of the catching-up process, however, relied on exuberant demand, financed by cheap credit, which outpaced the supply potential of some economies. This eventually led to an abrupt reversal in the real convergence prospects in states that had the largest macroeconomic imbalances. After enlargement, growth in most of the NMS was driven by private consumption and investment; the positive contribution of exports to growth was offset by an even bigger rise in imports. The Czech Republic and Hungary were the only states where the growth composition was more balanced. The emergence of macroeconomic imbalances as a consequence of the increased reliance on domestic demand put a brake on economic expansion. Deteriorating financing conditions, a reversal of sentiment and plunging external demand led to a severe deceleration of growth in 2008 in all NMS that had large imbalances.

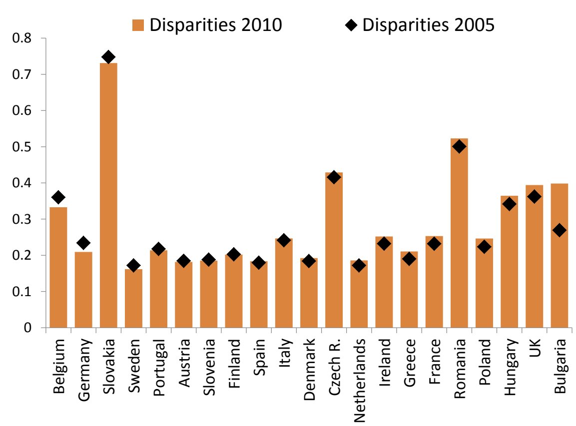
Figure 41 Growth decomposition 1995-2012 (Percent)



Source: Staff calculations based on updated LAF database (available at http://ec.europa.eu/economy_finance/db_indicators/laf/index_en.htm).

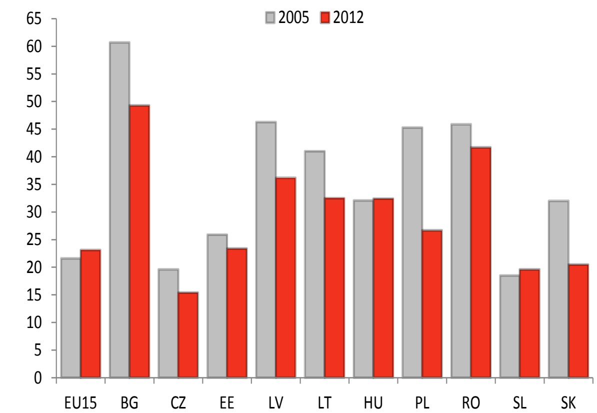
Many NMS still face severe income inequalities as well as geographic disparities. From the most recent data available (2010), within-country regional inequalities are high in Slovakia, Romania, the Czech Republic, and Bulgaria (Figure 42)[12]. Moreover, between 2005 and 2010 in most of the NMS regional disparities increased or did not budge, although Slovakia and Slovenia were minor exceptions. It is also still difficult for economic growth to benefit citizens of the NMS more equally, although since EU entrance the risk of poverty has fallen in most NMS—those countries that managed to raise the level of per capita income. The risk of poverty[13] has almost halved in Poland and Slovakia, for instance. In contrast, in Hungary and Slovenia poverty has risen, albeit only marginally (Figure 43). Finally, in some countries (e.g., Latvia, see RER December) the poorest among the population have benefited the least from convergence.

Figure 42 Regional Disparities in selected EU countries*)



Note: * where data available
IRD[14] = [(SUM((GDPpc_r - GDPpc)^2)/N)^1/2]/GDPpc
Source: Eurostat

Figure 43 People at risk of poverty or social exclusion, % total population



Source: Eurostat

It is undoubtedly true that EU accession has caused a positive change in both economic performance and institutions in the NMS. At the same time, to benefit even more from EU enlargement the NMS need to address remaining challenges. The main one is to ensure that convergence in these countries is durable—in other words, to avoid vulnerabilities that might have been created in the convergence process. This requires that the NMS pursue solid macroeconomic policies to restore stability, transparency, and confidence in the financial sector. In particular, fiscal policy should contribute more to macroeconomic and financial stability as well as promoting integration and income convergence. Compliance with reformed fiscal and macro surveillance should facilitate these efforts.

[12] It is worth noting that regional disparities can be exacerbated by the inclusion of capital cities, such as Prague (and Bratislava) that rank among the richest regions in terms of GDP (in Purchasing Power Standards) per capita in the whole EU. Excluding Prague, the GDP/capita disparities among the remaining regions of the Czech Republic are much lower.
[13] The poverty measure used—"At Risk of Poverty"—is a multidimensional measure that is standard in Europe and had both income poverty and non-income dimensions of well-being, such as eating protein, shelter, owning a phone, and having a job. While the multiple dimensions blurs the tight link between income growth and poverty reduction, it does capture an overall sense of well-being that arguably derives from more than just income ("Man does not live by bread alone").
[14] IRD denotes the regional disparities index, N is the number of regions in the country, GDPpc stands for the GDP per capita in the country while GDPpc_r indicates GDP per capita in the region r

Spotlight 2. EU membership Structural Policies for Building Growth[15]

According to the European Commission's recommendations, substantial improvements have been made in 2013 in the area of public finances. In the 2014 Semester the Czech Republic and Slovakia closed their excessive deficit procedure (EDP), after the EDP was ended in Latvia, Lithuania, Hungary and Romania in June 2013. Three EU11 countries are still subject to an EDP: Poland and Slovenia with deadline to exit in 2015, and Croatia with and expected exit in 2016. The Commission has concluded that two countries, Poland and Croatia, have taken effective action in response to the EDP. Revenue and spending measures were in the policy mix:

- Eight out of eleven countries have worked on some measures to improve tax compliance and four of them on the quality of tax administration. Also some progress was made in shifting taxation away from labor in Latvia, Lithuania and Hungary which reduced the tax burden especially for low-wage earners.
- To strengthen the long-term sustainability of the pension system and improve the efficiency, eight countries within EU11 took some steps in the area of pension reform. Increasing pension age in the Czech Republic, Croatia, Latvia, Lithuania, Poland, Slovenia and Slovakia is accompanied by an equalization of pension ages between men and women. Slovakia has also introduced an explicit link between pension age and future gains in life expectancy.
- Reforms to improve the efficiency of the healthcare sector and its financial sustainability have begun in Slovakia with adopting a 2014-30 Strategic Framework for Health, Romania, as well as in Croatia with presenting the master plan for the reorganization of hospital care.

EU11 countries have also taken measures to secure the lasting growth through strengthening productivity and competitiveness:

- Three countries have started public administration reforms to strengthen administrative capacities and to improve the client-orientation of public services for citizens and businesses. In Romania and Slovenia, a 2014-20 strategy on strengthening public administration is currently under preparation. Also, some progress has been made in improving competition in public procurement in Hungary and Slovakia. Latvia has taken significant action to improve capacities in the judiciary to reduce the backlog and length of proceedings. Also Slovenia managed to reduce the number of pending cases thus improving the efficiency and transparency of its judicial system.
- Lithuania is the only country which has been undertaking an ambitious reform of the state-owned enterprises for the last four years. The government has put in place the regulatory framework of a state-owned enterprise reform and significantly improved transparency.

Over the last year, some progress has been achieved in terms of employment and social policies:

- Bulgaria, Estonia, Hungary and Slovakia have strengthened and improved the efficiency of their active labor market policies. Hungary has introduced, while Croatia has embarked on, labor market reforms to increase hiring flexibility. Substantial progress has been made in reducing youth and long-term unemployment in Estonia. In Slovenia, labor market reform reduced duality of the labor market by making temporary employment more restricted while simplifying administrative dismissal procedures.
- Five out of eleven countries have taken measures to align education to the requirements of the labor market.

[15] Based on the EC Country-Specific Recommendations, June 2, 2014

- Lithuania adopted the 2014-20 Action Plan for Enhancing Social Inclusion, while Latvia has taken some steps to reform social assistance, significantly increased various child-related benefits, and raised the non-taxable thresholds in personal income tax for dependents. Croatia consolidated several social benefit programs and applied means-tested targeting.

Although growth is expected to return in almost all countries in 2014 (except in Croatia among EU11), it is still fragile so the momentum for structural reforms must be maintained. Member State's medium-term convergence programs for sound public finances and national reform programs to boost growth and jobs have identified five priority structural reform areas:

Table: Structural Reform Plans of the EU11, 2014

	Public finance					Human capital development		
Country	Pension system	Social safety nets	Health system	Other (Tax compliance, Fiscal responsibility framework, etc)	Public administration and judiciary	Labor market	Education and R&D	Business environment and SOEs reform
BG	√	√	√	√	√	√	√	√
CZ	√		√	√	√	√	√	
EE				√	√	√	√	
HR	√	√	√	√	√	√	√	√
HU		√		√	√	√	√	
LT	√	√		√	√	√	√	√
LV		√		√	√	√	√	√
PL	√	√	√	√	√	√	√	√
RO	√	√	√	√	√	√	√	√
SI	√			√	√	√	√	√
SK			√	√	√	√	√	√

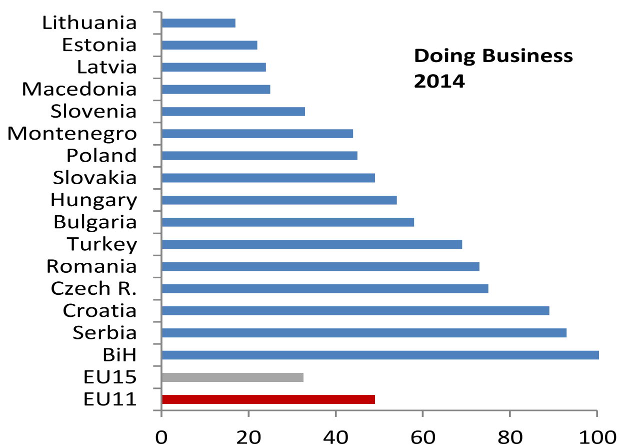
Source: European Commission, World Bank staff.
Note: This summary table is based on the European Commission country specific recommendations under the European Semester 2014 accessible at: http://ec.europa.eu/europe2020/making-it-happen/country-specific-recommendations/

- **Pursuing differentiated, growth-friendly fiscal consolidation.** EU11 countries need to continue fiscal consolidation and structural adjustment until the medium-term objective is achieved. In order to strengthen fiscal frameworks, most of the countries, including Bulgaria, the Czech Republic, Poland, and Slovenia, need to set up an independent fiscal body or strengthen existing watchdogs (Hungary , Croatia). On the revenue side, **tax systems** in EU11 countries should be more efficient and less distortive, with the tax burden shifted from labor to more growth friendly recurrent taxes on housing, environmental taxes to increase incentives to work and to reduce the relatively high tax wedge, especially for low-skilled workers. In almost all EU11 countries improvement in tax compliance is necessary. On the expenditure side, due to large share in public expenditures and the cost of population ageing, reform of healthcare, pension as well as social protection systems is needed. In order to provide access to high-quality care in a cost-effective manner and to secure their financial sustainability Bulgaria, Croatia, the Czech Republic, Poland, Romania and Slovakia were recommended to conduct the reform of **healthcare system**. Eight out of eleven countries have to take some measures to ensure financially sustainable **pension systems** encompassing adjustments of key parameters, such as linking the statutory retirement age to gains in life expectancy. Also, for seven of EU11 countries is important to continue with strengthening the **social protection systems** by ensuring better coverage, adequacy of benefits, strengthened activation and targeted social services. Depending on the available fiscal space, the challenge of public finances is to enhance **public investment** in infrastructure, research, innovation and human capital (especially recommended to the Czech Republic and Poland).

- **Restoring the normal lending to the economy and boosting the private investment.** The banking sector experienced some restructuring in 2013 but the adjustment needs to continue. Slovenia should complete the privatization of two banks, continue the prompt implementation of restructuring plans of the banks in receipt of state aid and consolidate the banking sector. To contribute to restoring the normal lending flows Hungary needs to improve the design of and gradually reduce the burden of taxes imposed on financial institutions in line with the recovery of the economy. Further enhancing financial regulation and supervision combined with further repairing banks' balance sheets and equity buffers will contribute to restoring the bank lending and promoting investment.

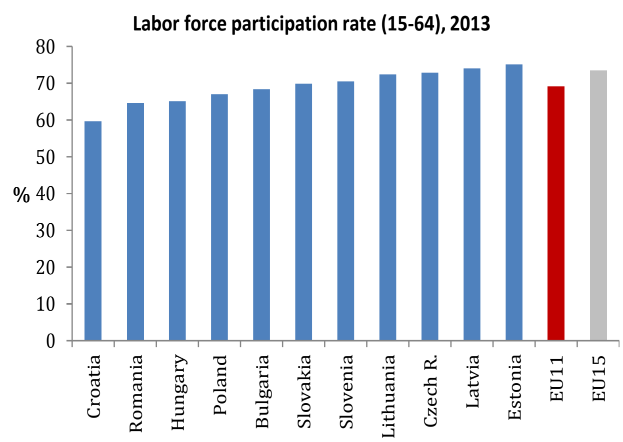
- **Promoting growth and competitiveness.** Progress on structural reforms of key sectors remains limited so recommendations to EU11 countries push for further reforms in the services, energy and transport sector as well as in R&D which play an essential role for economic growth. Nine out of eleven countries were suggested to reform the **energy sector** in order to increase competition, market efficiency, transparency and also to improve energy efficiency. That can be done by removing barriers, creating a transparent market and strengthening the independence of the energy regulator. Promoting efficiency and competition is necessary in **transport industries** as well. In five countries **business environment** reforms are needed. Countries need to take steps to fight corruption at all levels, accelerate efforts to improve the efficiency and quality of judiciary system and enhance transparency and accountability. EU11 countries need to further improve **absorption and management of EU funds** what can be done by simplifying implementing structures and improving capacities.

Figure 44. Ease of Doing Business, 2014



Source: World Bank

Figure 45. Labor Force Participation



Source: Eurostat

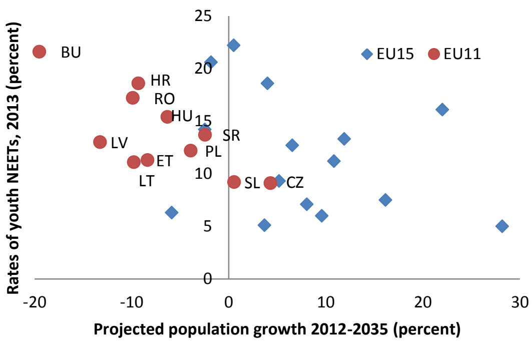
- **Tackling unemployment, inequality and poverty.** Labor market conditions worsened in almost all EU11 countries. Although experience varies widely, structural unemployment and labor market mismatches have been on growing trajectory and special attention needs to be paid to youth and older population, as well as long-term unemployment. For almost all EU11 countries may be necessary to strengthen the effectiveness and reach of **active labor market policies**. It is also important to improve coverage and performance of **education**. In line with the objectives of a youth guarantee, to combat youth unemployment, countries were recommended to increase relevance of education to labor market needs, quality of education and training including availability of apprenticeships and to better outreach to inactive young people. There is also a need to continue efforts to increase female labor market participation.

- **Modernizing public administration.** EU11 countries need to improve the quality, efficiency and transparency of public administration through e-government, e-procurement, e-services, one-stop-shop principle. Modernizing public administration can have a significant role for reducing the administrative burden, simplifying administrative procedures, corruption control and at the same time streamlining public administration processes and achieving the efficiency and cost-effective service delivery to citizens and entrepreneurs.

Focus Note 1. Youth unemployment in the EU11[16]

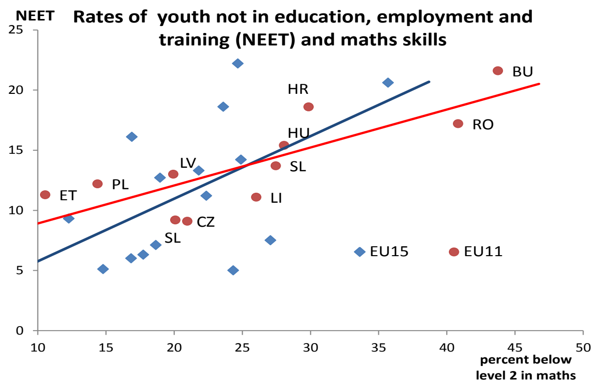
***Many of the economies in the EU11 face the twin challenge of high unemployment rates amongst young people and rapidly ageing and declining populations**. Some of the countries that face the highest rates of young people that are neither in employment, education or training (NEET) also tend to be those with the fastest population declines, i.e. Bulgaria, Romania, Croatia or Hungary (Fig. 1). These countries also tend to struggle most with equipping the next generation with the skills necessary to achieve their full potential e.g. in literacy, math and science competencies (Fig. 2).*

Figure 46. Many EU11 countries are ageing rapidly, while youth inactivity rates are high



Source: Eurostat, UN and authors calculations

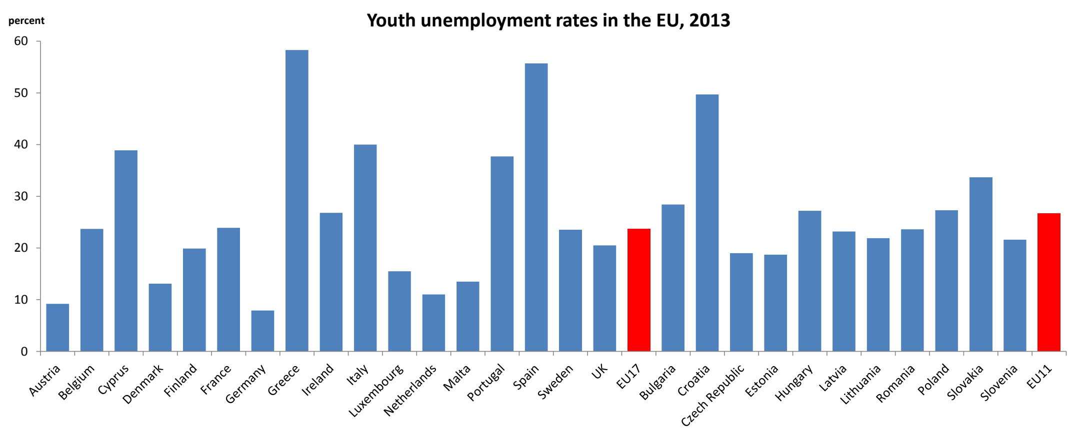
Figure 47: Inactivity is often associated with low skills



Source: Eurostat, OECD PISA and authors calculations

The level of youth unemployment varies widely across the EU, but has been significant since the crisis in 2008 (Fig. 3). The youth unemployment rate in 2013 ranged from a low of 7.9 percent in Germany to the extremes in the countries most affected by the crisis: Greece (58.3 percent), Spain (55.7 percent), and Italy (40 percent). Similarly in the EU11 countries Slovakia and Croatia recorded the highest rates, 33.7 and 49.7 percent respectively. Despite the large impact of countries most affected by the crisis across the EU, EU11's youth unemployment rate at 26.8 percent is higher than EU17 average of 23.7 percent. Overall, more than 5.5 million15 -24 year olds across the EU were unemployed in 2013, with just over 1 million in EU11 countries.

Figure 48. The crisis has widened the disparity in youth unemployment rates

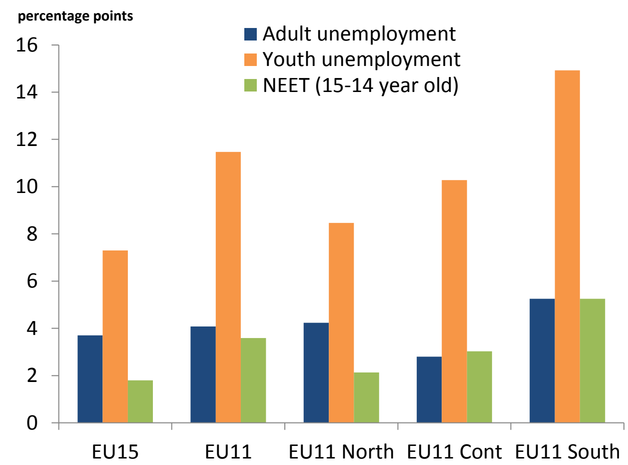


Source: Eurostat and staff calculations

[16] This Focus Note draws from work for a forthcoming World Bank publication on Youth Unemployment in the EU and South East European countries. This note defines 'youth' as ranging from 15-24 years of age. The EU17 refers to all countries in the EU28 outside of EU11.

Youth unemployment has risen faster and to higher levels than for adults during the crisis. Youth unemployment has traditionally been more responsive to output shocks in Europe than adult unemployment and this has also been witnessed since 2008, as highlighted in Figure 4. This is consistent with Verick (2009), who looked at past crisis and concluded that the young segment of the workforce is disproportionately affected by large recession shocks, both in terms of its immediate impact and the duration of the recovery. Between 2008 and 2012, the adult employment rate in the EU11 rose by an average of 4.1 percent, while youth unemployment rose by 11.5 percent. The fastest rise was in the EU11 south countries, where youth unemployment rose by almost fifteen percent.

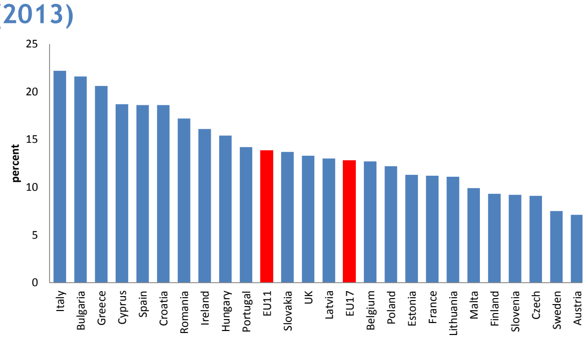
Figure 49. Change in unemployment and NEET rates, 2008-13



Source: Eurostat

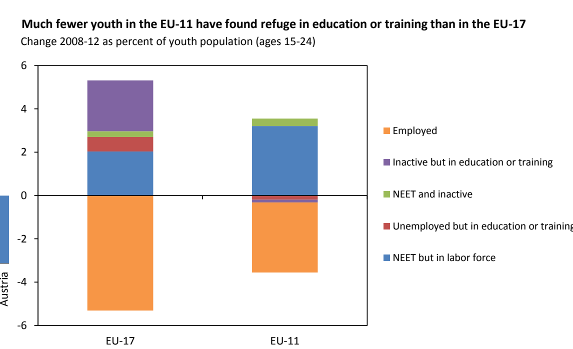
Many EU11 countries have high rates of young people neither in employment, education or training (NEET).[17] In the aftermath of the crisis, the ability of unemployed youths to find refuge in education in training has varied considerably across the EU. For young workers who remained in the labor force after losing their job, the majority over the 2008-2012 period went into NEET status (Figure 5) and were thus dealt a double blow – they remained unemployed, thus failing to acquire on-the-job skills, and also missed an opportunity to accumulate human capital through education and training. In the EU17, however, about a quarter did manage to return to education or training programs while still actively seeking a job, whereas in the EU11, the share of those unemployed but in education or training declined (Figure 6). For those choosing to leave the labor force altogether, very few became NEET in the EU17, and most found refuge in education or training. Meanwhile, in the EU11, few become inactive in the first place, but those who did were also NEET. In other words, education or training programs, on average, did not absorb either active or inactive workers in the EU11. To some extent, this likely reflects structural differences between the two regions: a greater share of countries in the EU17 have well-established traineeship or vocational education programs to absorb young workers, while in the EU11 the outlets for education and training maybe more limited, pushing youth into NEET status regardless of whether or not they remain in the labor force.

Figure 50. Share of 15-24 year olds neither in employment, education or training, NEET (2013)



Source: Eurostat and authors calculations

Figure 51: Change in labor status of the EU youth population (2008-12)



Source: Eurostat and authors calculations

[17] See Dan Gross, "Combating Youth Unemployment: The latest European fad?" in Economic Policy, CEPs Commentaries, June 2013, for a discussion of why youth unemployment rates are not the best measure of youth inactivity.

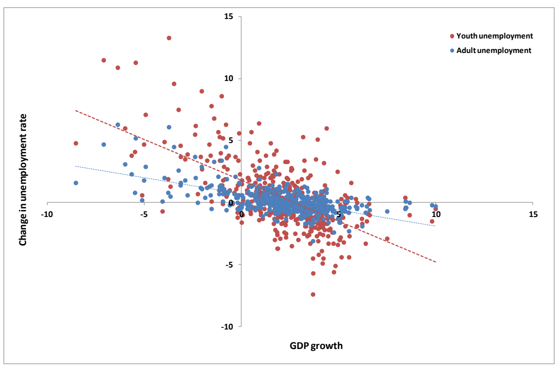
In the context of rapidly aging populations across Europe, and particularly in the EU11, high youth unemployment also presents significant demographic and fiscal challenges. By 2030, the share of people aged 65 and over in the working age population is projected to increase across the EU and even double in many countries. This makes the reduction in high youth unemployment an even more pressing policy priority, both in terms of preventing a dramatic drop in the labor supply and containing the fiscal cost of pensions and health care in addition to the considerable fiscal drain in terms of foregone future tax revenues from long-term unemployment.

Economic growth is necessary to reduce youth unemployment

Youth unemployment tends to be more sensitive to economic growth than adult employment. The relationship between the annual changes in youth and adult unemployment against GDP growth for all European countries in the period 1980–2012 supports the view that youth unemployment tends to be "supercyclical" (see for instance Ryan 2001), responding more to both positive and negative economic shocks than does adult employment (Fig. 7). In Europe, the within-country standard deviation of youth unemployment rates is almost three times larger than that of adult unemployment rate (3.5 percentage points versus 1.4 percentage points).

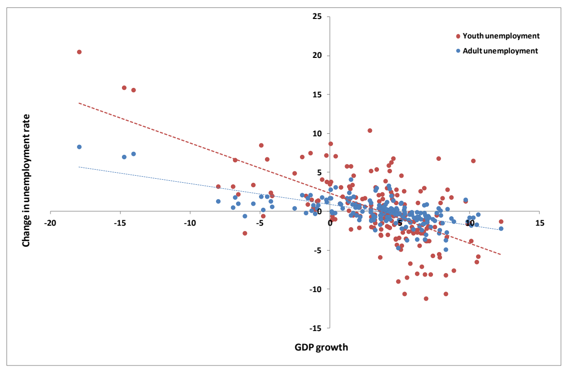
Figure 52. Annual change in youth and adult unemployment rate versus GDP growth

EU17



Source: ILO and WDI

EU11



Source: ILO and WDI

Closing the gap in youth unemployment will require higher growth rates over a sustained period. In EU17 and EU11 countries, estimates of the growth rate of GDP needed to reduce unemployment, i.e. the average elasticity of unemployment changes to GDP growth, is homogeneous, where an extra percentage point of GDP growth is found reduce youth unemployment on average by approximately 0.85 percentage points and adult unemployment by approximately 0.29 percentage points. Given the large differences in the youth unemployment rates between countries the economic growth differentials required to close the gaps existing between countries and regions in Europe are therefore large and will require relatively high growth rates over a sustained period.

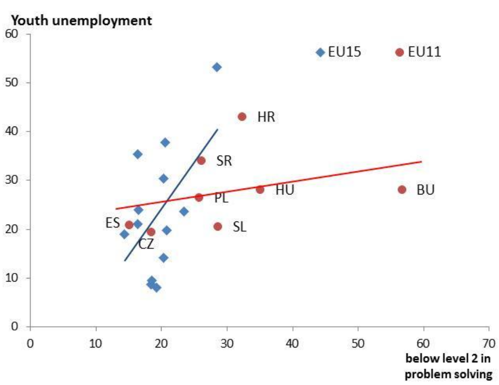
Promoting economic growth therefore appears a necessary, but not a sufficient requirement for improving youth employment in Europe. For the overall sample of European countries, changes in the rate of economic growth explain around half of the changes in youth and adult unemployment since 1998 (see forthcoming Bank paper). For the individual groups of countries, differences in education and labor market policies (mostly in the former ones) appear particularly important to explain differences in youth unemployment changes.

Skills and labor market policies matter

Beyond overall economic growth and general labor demand, youth face multiple disincentives and barriers to work that can keep them out of productive employment and activity. These include skills, labor market rigidities and taxation, and other barriers related to limited access to productive inputs, information and networks, exclusionary labor regulations and institutions, poor access to affordable child care services and obstacles to internal labor mobility. Most of these barriers, while not exclusive to youth, can affect them disproportionately. Moreover, these disincentives and barriers co-exist (and could reinforce each other), especially among particular youth groups. Youth are not a monolithic group: young women or youth from ethnic minorities or with poor skills are likely to face more and more severe barriers to productive employment.[18]

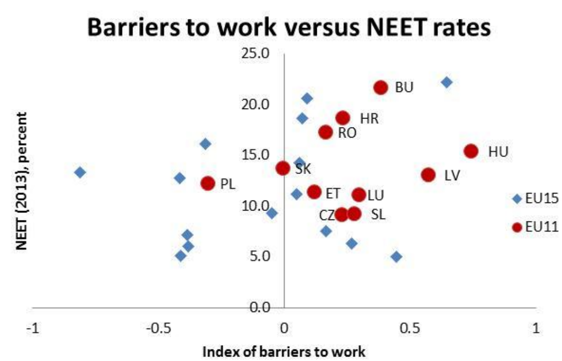
The returns to job-relevant skills are potentially large since labor demand has shifted towards higher new-economy skills, but education performance lags particularly in the EU11-south. The young would appear to be better placed than older workers to take advantage of a shift towards more demand for new economy skills, and particularly as countries increasingly aim to produce higher value-added goods and service. Youth can more easily benefit from this structural change, since many are still in or can return to education. Therefore, the returns may be large from efforts to strengthen education systems to develop cognitive, behavioral and technical skills, starting from early childhood development/education through general education to higher education and lifelong learning[19]. In this regard, EU11 countries would appear to equip too few young people with the necessary cognitive and behavioral foundation skills (Fig. 8). In the regard the continental EU11 countries appear to perform relatively well within Europe, while the EU11 South countries generally perform less well in addition to ageing more quickly.

Figure 53. Share of 15-24 unemployment, and low problem solving skills (2013)



Source: Eurostat, OECD PISA and authors calculations

Figure 54. EU11 countries have high barriers to work[20]



Source: World Bank (2014), and authors calculations

Labor market rigidities and regulations can particularly affect youth. Labor market rigidities and regulation, protection of existing workers and barriers to entry partly determine the cost for firms of hiring and firing new workers (Fig. 9). They can also affect individuals' and firms' decisions related to the type of employment or contract (informal vs. formal, full time vs. part time) or the length of hours worked. However,

[18] Arias, et.al (2013).
[19] See Hanushek, E. et al (2013), "Returns to Skills Around the World: Evidence from PIAAC", OECD Education Working Papers, No. 101, OECD
[20] See Omar. A et al, "Back to Work: Growing with Jobs in Europe and Central Asia", World Bank, 2014, Chapter 3, for information on measuring indices for disincentives, barriers and protection for workers.

while restrictive labor regulations in the form of labor taxes, the regulation of professions, restrictions on hiring and firing do protect those who have a job this can be to the detriment of "outsiders", that is, potential new labor market entrants who are disproportionately youth. While many EU11 countries have been taking measures to reduce the barriers and improve the incentive to work—for example young people are targeted in the context of larger labor market programs among others in Hungary, Czech Republic, Estonia, Lithuania, and Slovenia while Poland is in the process of an extensive deregulation of professions—labor markets remain relatively restrictive and there is a strong relationship with youth unemployment (Fig. 9). In addition, enterprise surveys suggest that, on average, around a quarter of firms identify skills shortages as a "major constraint" to doing business in the EU11[21], highlighting the need to ensure that training and education policies could be more closely coordinated with private sector employers to improve labor market outcomes.

Finally, without actions to reduce youth unemployment there is a risk of scarring/hysteresis for the young, which means that they may not exploit their full potential at a time when aging/population decline necessitates that they exceed their potential. While empirical studies tend to differ depending on the specific characteristics of the group and country, there is strong evidence that youth unemployment can have long-term consequences in terms of future employment prospects and earnings, with the cost of long-term unemployment on skills depreciation, the building of human capital and negative signaling to prospective employers. The persistence of large numbers of inactive and unemployed youth therefore poses unique risks of creating a "lost generation" of workers with weaker job prospects and economic potential. Furthermore, it tends to differ structurally from adult unemployment, meaning the policy measures needed to address it may also have to be substantively different. Understanding both the cyclical and structural idiosyncrasies of youth unemployment is therefore important to mitigating the potentially damaging cycle between youth unemployment and broader economic growth and productivity.

[21] World Bank and IFC, Enterprise Survey, latest available data range from 2009-2013.

Box 3. Bulgaria's three challenges: Population decline, youth unemployment and cognitive skills gaps

Bulgaria's population is aging and declining fast and yet its next generation is losing out: Bulgaria has one of the largest shares of young people neither in employment, education or training in the EU. Poor labor market and further education prospects among youth are driven in part by their poor cognitive foundation skills such as in mathematics, reading and science measured in the OECD's Program of International Student Assessment (PISA). Despite some recent improvements, Bulgaria has not made significant progress in PISA since 2000 and its performance gap with the OECD average accounts for the equivalent of more than one year of schooling. According to PISA 2012, around 39 percent of 15-year-old students in Bulgaria are considered functionally illiterate, as they are not able to understand and analyze what they read. About 44 percent of Bulgarian students are considered functionally innumerate.

Performance differences are wide across Bulgaria's student population: The PISA math score differential between students in the richest and poorest socioeconomic quintiles is the equivalent of almost three years of schooling, much higher than OECD standards. Students' predetermined characteristics play a disproportionately high role in explaining PISA scores. Gender, age, and socioeconomic status (measured in PISA with the OECD's Economic, Social, and Cultural Status Index) explain almost one third of students' differences in reading performance. There are large differences in test scores between students living in urban and rural areas. This difference can be as large as an equivalent of over two years of schooling. Inequalities exist across linguistic minorities as well. Bulgarian-speaking students perform the equivalent of three years of schooling higher in reading and two years of schooling higher in math and science than students who speak another language at home.

Wide performance inequalities are associated with Bulgaria's education system being one of the most stratified education systems among PISA participating countries. The performance of a child in the PISA test depends more on the type of his or her classmates than on his or her own individual factors. This suggests that the system significantly sorts students into schools populated by other students with similar socioeconomic status. Indeed, students are streamed into either general "profiled" (elite), non-profiled or vocational tracks after taking a high-stakes national exam at age 13. Most countries do this at a later stage, usually when students are 16 years old. Students in general profiled schools, which have a very low share of disadvantaged students, tend to fare quite well. In contrast, over half of Bulgaria's 15-year-old student population struggles in lower performing vocational or general non-profiled schools. The difference in PISA 2012 between students in general profiled and vocational schools is the equivalent of 2 years for reading and one and a half years for mathematics.

Improving education is one of the most critical economic reform priorities for Bulgaria. Given its fast population decline, Bulgaria cannot afford to turn out as many as a third of its 15 year-olds functionally illiterate and innumerate. Bulgaria needs to make its education system more inclusive and provide more equal opportunities to its precious youth, including by delaying the sorting of sorting of students into different tracks. Bulgaria can benefit from the example of Poland which saw its performance in PISA increase significantly following a delay in the sorting of students into vocational and general streams.

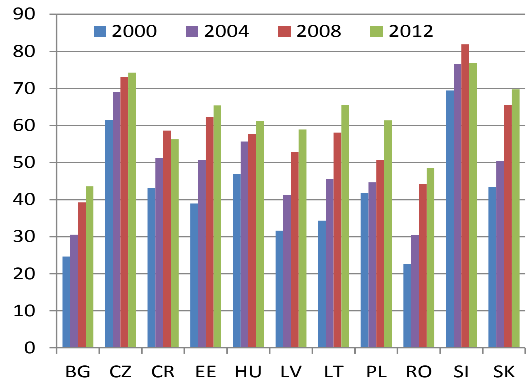
Source: World Bank (2014), How can Bulgaria improve its education system: An analysis of PISA 2012 and past results.

Focus Note 2. Are EU11 countries saving enough? [22]

The global financial crisis highlighted vulnerabilities in the growth patterns of many EU11 countries, notably the reliance on credit-fuelled consumption, external capital flows and exports to the EU15. Sustaining income convergence will require more high-skilled patterns of growth and productivity. In this context, increasing national saving may bring a range of benefits to support the required investment in productive capacity and also ensure adequate retirement income for aging populations.

The past two decades of economic growth in EU11 countries has been impressive. From early 1990s until the global financial crisis starting in 2008 the EU11 economies recorded economic growth, averaging 4.3 percent a year (1995-2008), led primarily by growth in total factor productivity (TFP) and capital deepening (**Error! Reference source not ound.**). Productivity growth supported sustained competitiveness, growing incomes, and improving living standards. Income per capita has increased from about 44 percent of the EU15 average in 2000 to 62 percent in 2012.

Figure 55. GDP per capita 2000 and 2012 (in PPS as percent of EU15 average)



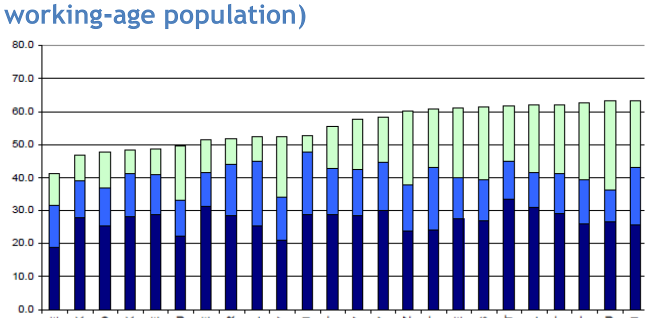
Source: Eurostat.

However, the financial crisis has exposed vulnerabilities. Prior to the crisis high levels of domestic consumption in EU11 was fuelled by borrowing, while countries continued to be highly reliant on EU15 for exports and capital inflows, given relatively low national savings to fund investment (McKinsey Global Institute, 2013). The crisis triggered a sharp reduction in inflows of interbank and foreign direct investment flows that are forecast to remain below pre-crisis levels in the future (EBRD, 2013). In addition, EU structural funds, an important source of public investment, are expected to gradually decline over the long-term.

Growth prospects of EU11 will also be challenged by two long-term trends – a rapidly aging population and the need to continue to boost productivity:

- **Population aging will be particularly challenging in most of EU11 countries**. For example, the old-age dependency ratio (population aged 65 and more as a percentage of the population aged 20-64) is projected to increase from around 20 percent in 2010 in Poland (currently among the lowest in EU) to over 70 percent in 2060. The magnitude and pace of these changes will have important implications for the EU11 economies and societies. Furthermore, cohorts older than 40 in the 1990s and approaching retirement mostly failed to accumulate sufficient savings, apart from real estate.

Figure 2. Old-age dependency ratio (ratio of people aged 65 or above relative to the working-age population)



- **Productivity growth—one of the key determinants of economic growth, convergence and competitiveness[23]—is likely to slow.** Following

[22] This Focus Note draws from work for a forthcoming World Bank publication on Savings in Poland.

the transition to market economies, by the mid-2000s, productivity levels in EU11 had caught up to other emerging economies with similar income levels. Productivity growth is currently mainly driven by efficiency gains within individual firms, and sustaining robust TFP growth, even at a level only slightly above the long-term global projection of 1.5 percent, will require significant ongoing structural reform[24].

Most of the gap in GDP per capita relative to the average OECD level reflects gaps in labor productivity. For example per capita income and productivity in Poland were both about 40 percent below the OECD average in 2012. While this suggests significant potential for productivity 'catch-up', progress will require flexibility to shift resources across sectors, to reduce resource misallocation within sectors, and the capacity to innovate and apply knowledge and skills-intensive production techniques[25]. Boosting productivity growth will also require a deepening of capital markets, more competitive and flexible product and labor markets, fostering human capital accumulation, and investing in research and new technologies.[26] This requires long-term investment to finance infrastructure, innovation, education and environmental projects to increase competitiveness (SWD, 2013).

Financing investment and sustained economic growth?

EU11 investment has been financed in large part with external financing, which is not negative *per se*, but can create vulnerabilities to external shocks. Since at least 1995 domestic savings have been insufficient to cover investment in EU11 countries, with external flows reaching very high levels in some countries (Fig. 5). Investment has therefore been financed with foreign direct investment, and more recently by portfolio and interbank flows. Financing investment with net foreign saving is not negative *per se*, and may even be beneficial for a converging economy—as a more efficient way of expanding and upgrading productive capacity, especially if such funding comes with positive externalities like technological transfers. However, external financing can also create vulnerability to external shocks, as evidenced after the financial crisis. Following the financial crisis in 2008, foreign banks have been rebalancing their balance sheets and deleveraging away from the EU11, with further impetus coming from EU regulation, aimed at strengthening balance sheets and the resolvability of large cross-border banking groups, as well as new guidance from regulators against high loan-to-deposit ratios in subsidiaries (IMF, 2013).

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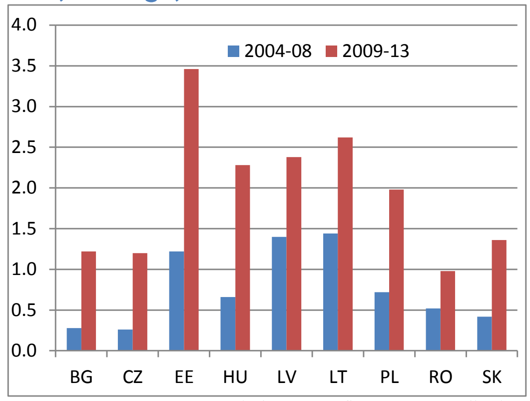
[23] In the last fifteen years, differences in GDP per capita growth across OECD countries can be mainly attributed to variance in labor productivity growth (growth in GDP per hour worked), OECD, 2013.
[24] Expected average annual TFP growth globally over the next 50 years (Johansson, et. al., 2012).
[25] See also Égert, Kierzenkowski (2013).
[26] Dabla-Norris, Ho, Kochhar, Kyobe, Tchaidze (2013).

Since the EU accession significant part of investment financing have come as net capital transfers, mostly reflecting flows related to EU cohesion and structural funds. Net capital transfers from abroad have been significant in EU11 (exceeding 1 percent of GDP a year after 2009 in all countries), providing strong support for public investment. While the European Union has agreed on a level of financing for 2014-2020 that is largely unchanged from the earlier perspective, the amount of such funding that will be available to EU11 in the future is likely to fall, reflecting the success in convergence. But this convergence still leaves many of the EU11 with a long way to go in upgrading its infrastructure and investing in its economy, and EU funds will need to be replaced with higher domestic saving.

Figure 56. Net capital account, percent of GDP, average, 2004-08 and 2009-13



Source: Eurostat. Note: Capital account flows were smaller in Slovenia and Croatia.

Why national saving is important

In the long run, a sustained increase in national saving could produce a range of macroeconomic and development benefits for the economy, including:

- **An additional source of funding to match EU11 investment needs**. In favorable circumstances, and when channels by which saving translates into growth are not blocked, increased national saving can translate into higher investment and economic growth.
- **Increasing the resilience of the economy by reducing reliance on potentially more volatile external funding**. National and foreign savings are not perfect substitutes for financing domestic investment. The latter can come at the cost of creating external vulnerability for the economy i.e., the possibility of a reversal in capital inflows or possible appreciation of the currency, putting pressure on the profitability and competitiveness of tradable sectors. Thus, in a case where low national saving implies higher external financing of investment, the sustainability of economic growth may be at risk.
- **Helping to develop a sounder and deeper financial system**. A strong base of national saving could help rebalance sources of bank financing, thus reducing the vulnerability in the banking system. That could also mean the deepening of the entire financial system, particularly the stock market and the market for corporate debt, with beneficial knock-on effects on local firm's growth and productivity. National saving could also promote financial innovation, by creating demand for new financial instruments that would allow for increased diversification of household balance sheets (reducing the current bias towards saving via housing).
- **From the microeconomic perspective, savings would support future incomes in an aging society, helping address the issue of the adequacy of retirement incomes**. Higher national saving could supplement state-provided pensions, improving financial resilience before retirement and incomes of individuals after retirement.

Increasing national saving involves also some costs, which should be carefully balanced against the potential benefits. Firstly, precautionary savings sacrifice current consumption and reduce domestic demand, which could be a further drag on economies recovering from recession, so timing is important. Secondly, there may be some fiscal costs in the case of possible government interventions to support saving (i.e. compulsory saving programs or tax incentives). There may also be economic efficiency costs of incentives or regulations to promote saving that significantly distort behavior.

Box 4. What is the saving-growth transmission mechanism?

The economic literature suggests a variety of mechanisms through which national saving can affect economic growth, whilst acknowledging the simultaneity between investment, saving and growth[27]. One of the main transmission channels can be from savings to the accumulation of fixed capital. Investment is an important influence on both the demand and the supply sides of an economy. On the demand side, it is one of the more variable components of expenditure, with swings in investment contributing significantly to fluctuations in the economic cycle. On the supply side, investment in business assets and infrastructure boosts the productive potential of the economy, supporting rising productivity and living standards.

The positive association between national saving and investment was discussed in a landmark paper by Feldstein and Horioka (1980), in which they showed that investment and saving are highly correlated in advanced economies, despite the reduction in barriers to international capital mobility. The results of their research showed that the so-called saving-retention coefficient, which measured the level of capital mobility in 21 member states of the Organization of Economic Cooperation and Development (OECD), was between 0.871 and 0.909, which indicated a relatively low level of capital mobility in these countries. Although the so-called **Feldstein-Horioka puzzle** has been confirmed by further empirical research, the direction of the causal relationship between national saving and investment is not clear. Hence, it is perfectly possible in principle that investment can be high even without matching national saving, which can be replaced by foreign saving attracted to the economy by higher returns to capital than offered elsewhere.

On the other hand, national and foreign saving are not perfect substitutes, as financing investment with **foreign capital may create vulnerabilities for the economy** (i.e., the possibility of a reversal in capital inflows or possible appreciation of the currency, putting pressure on the profitability and competitiveness of tradable sectors). More recent research (Rajan, Subramanian and Prasad, 2007) suggests that national and foreign saving are complements rather than substitutes as national saving supports investment and finance of the ancillary businesses that are needed to support the large-scale activity financed by foreign capital.

Furthermore, there seem to be **significant differences in the relationship between saving and investment between developed and developing countries**. In advanced economies the integration of financial markets has substantially weakened the correlation between investment and national saving. The coefficient for high-income countries on the investment-savings regression has been declining since 1997, and by 2007 it had become negative (see Hevia (2010)). This would confirm the view that in the short run, saving and investment has become decoupled in high-income countries[28]. However, the Feldstein-Horioka puzzle, even if somewhat weaker than before, can still be observed in developing countries, at least in the short run.

Importantly, the extent to which the level of saving can affect capital accumulation, and hence growth, depends **on the capacity of an economy to channel saving into productive use, including the ability of financial markets to effectively channel resources** efficiently to the right users and uses. An efficient financial system means that the best investment opportunities can be matched with available savings (see Levine, 2005). In particular, the financial system can affect saving and investment decisions (and hence capital accumulation and technological innovation) by reducing information and transaction costs, creating mechanisms for risk-sharing, facilitating trade and payments among economic agents, and providing a range of supporting services.

[27] For a comprehensive review see Schmidt-Hebbel and Serven (eds.) 1999.

[28] WB (2011).Turkey CEM

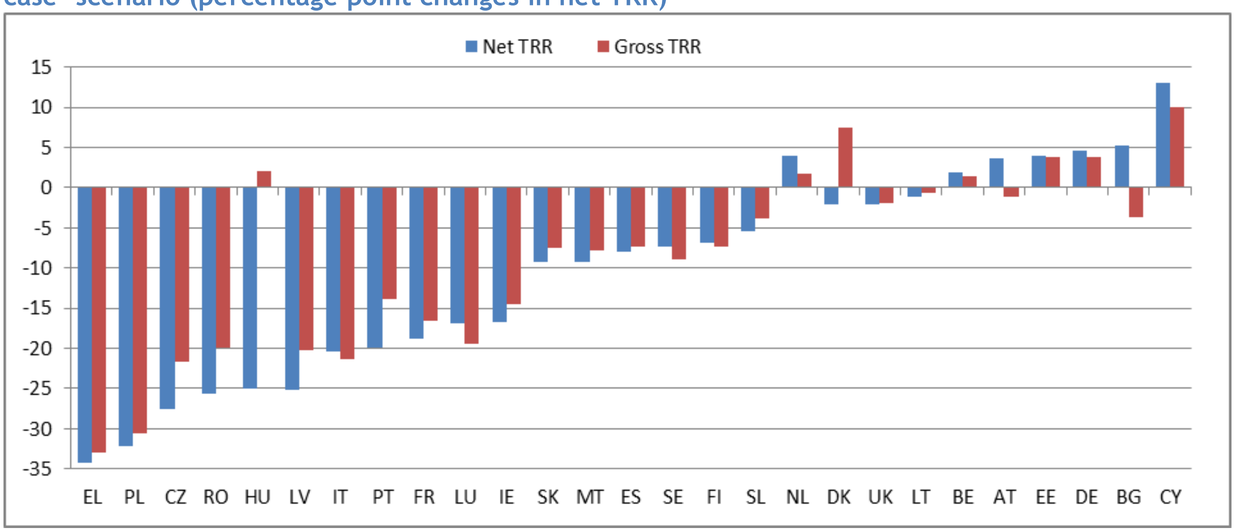
Why saving more is particularly important for individuals in EU11?

Given the projected labor force decline, EU11 countries need to take full advantage of its human capital stock by prolonging working lives. Currently employment rates among older workers in EU11 remain very low, with another challenge to maintain and even increase older workers' productivity.

Prospects for active and prosperous aging can be undermined by the burden of care responsibilities, which are likely to increase with population aging, and which can have especially detrimental effects on female lifetime earnings. In the absence of quality and affordable child care and elder care services, prime age and older household members are expected to provide informal child care while working-age members (mostly women) provide informal care for elderly ones. These arrangements, while often following traditional social norms and bringing fulfillment and satisfaction to grandparents, undermine the incentives of older workers to participate actively in the labor market and can take women at their prime working age out of the labor force for several years, which can affect their lifetime earnings and accumulated pensions.

The adequacy of pensions may become a serious issue in a number of EU countries. The scale of challenge differs, depending population ageing profile and the character of pension provision. While all but a few EU member countries will experience declining net replacement rates, the declines in Poland, Czech Republic, Romania, Hungary and Latvia are likely to exceed 25 percent and are among the sharpest in the EU. Importantly, lower replacement rates can be to some extent offset by changes in people's retirement and long-term savings behavior (EC, 2012). Therefore ensuring that elderly people have decent standards of living requires encouraging household savings in the medium term, including supplementary voluntary pension insurance.

Figure.56. Trends in net and gross Theoretical Replacement Rates (TRR) 2010-2050, the "base-case" scenario (percentage point changes in net TRR)[29]



Source: EC (2012).

[29] Replacement rates show the level of pension income in first year after retirement as a percentage of individual earnings, either net or gross of tax.

Recent trends in saving in EU 11 – saving rates in EU11 remain relatively low

Saving rates in EU11 are below or around the EU15 average (20 percent). Only in the Czech Republic, Estonia and Slovenia have savings rates substantially exceeded this level. Notably, saving rates have been lower than in EU countries when controlling for levels of income i.e. for periods when they were at the similar level of development, measured by GDP per capita.

Figure 57. Gross Saving Rates, percent, average 2000-12

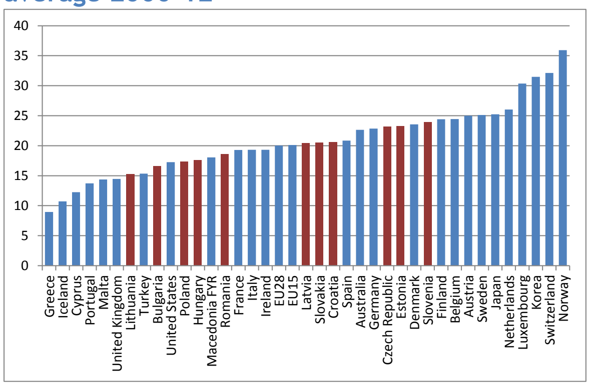
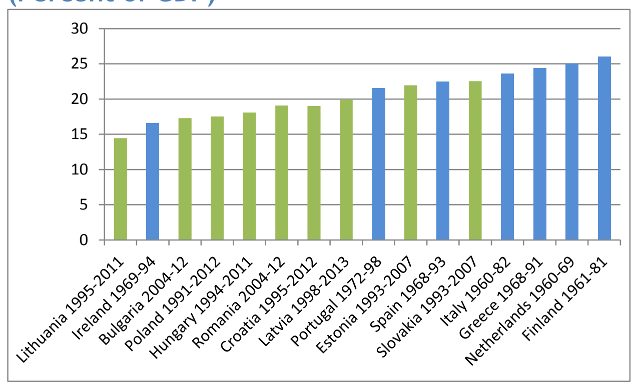


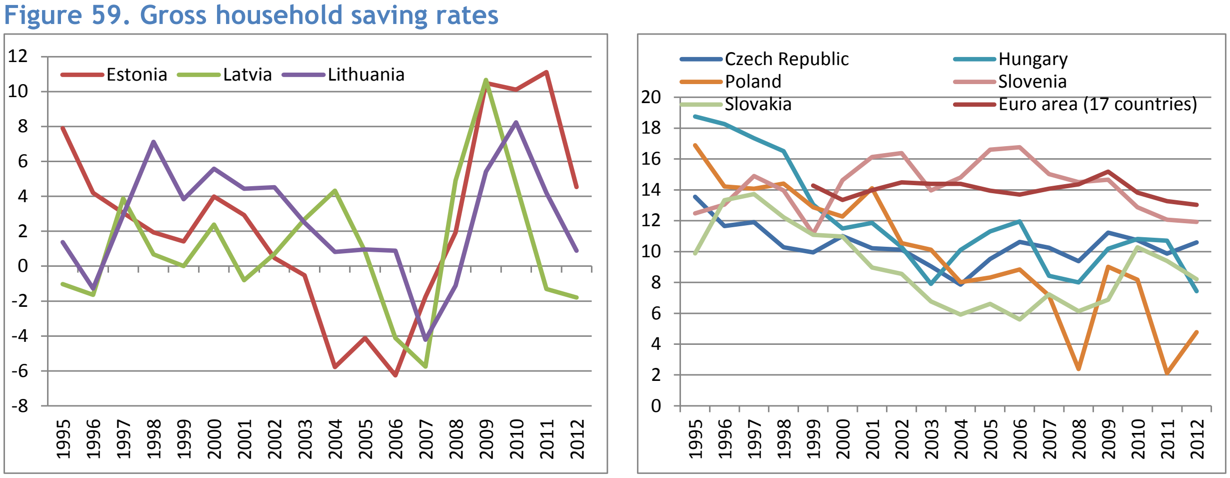
Figure 58. Saving Rates, Selected EU Economies (Percent of GDP)



Source: AMECO.

The national saving rate has been relatively stable for the last decade but the structure of saving has changed significantly, with declining household saving offset by rising (non-financial) corporate saving (a trend observed in many countries). The household saving rate has trended down in most countries, with some temporary pick-up in particular in Estonia, Latvia and Lithuania around the global financial crisis (Figure 59). In many countries corporate saving has increased significantly during the crisis, in part due to delays in investment, with corporates holding higher cash reserves.

Figure 59. Gross household saving rates



Source: Eurostat.

How to increase saving?

The analysis of saving policy is challenging, thus policy recommendations to promote saving must be tentative and country specific. The analysis of saving policy is difficult for three reasons: (1) high-quality data about saving (at both macro and micro levels) is elusive, especially for household saving; (2) international evidence about the effectiveness of possible interventions to lift saving is often ambiguous; (3) interventions that are effective in achieving one objective usually have downsides measured against other objectives; (4) measuring the economic impact of saving policies is a challenge as they are difficult to quantify. Given these challenges, any recommendations are bound to come with a considerable dose of caveats.

Sustained increase in national saving may need a number of complementary policy changes, including in the following areas: i) Policies to support incomes and growth; ii) Policies to encourage households to save; iii) Policies to limit government dis-saving; iv) Policies to substitute for foreign savings; and v) Policies to develop a long-term local currency capital market. Therefore the recommended policy measures cover a wider range of measures, aiming at building up national assets held as claims on non-residents, strengthening the balance of payments, limiting fiscal dis-saving, encouraging banks to be more assiduous in soliciting deposits and domestic borrowings, improving tax treatment of assets, developing a more functional domestic capital market, and encouraging individuals to save more, for their own retirement or for precautionary purposes.[30]

Importantly, higher national saving alone is not sufficient to promote sustainable growth. In the long-run the main driver of sustainable economic growth is productivity[31]. This may depend a number of factors, such as the investment in skills and lifelong learning to support innovation, on the quality of the financial system, including the availability of financial instruments to mobilize savings and direct them to the best investment opportunities, as well as the quality of public institutions in general, to guarantee economic stability and promote a favorable business environment.

Another issue would be to share the fiscal burden of aging (increasing expenditure on healthcare, long-term care and pensions and decreasing tax revenues due to a declining workforce and private saving) across generations in an equitable way, allowing for an acceptable standard of living for the old without excessively infringing the financial prospects of the younger generations.

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[30] For more details on the proposed policy package for Poland please see CEM Saving in Poland.
[31] See discussion below and Johansson, et. al. (2012) and OECD (2013). See also Hevia and Loayza (2012, 2013).

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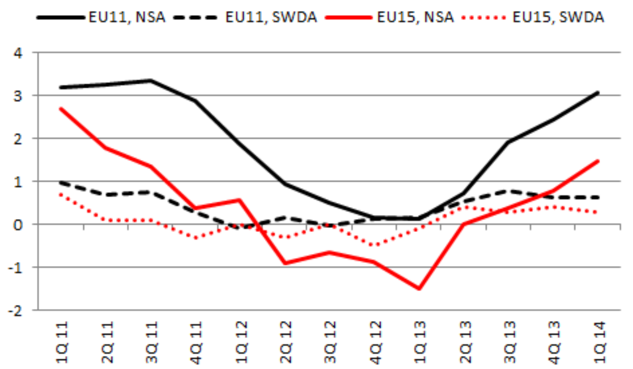
Annex 1. Key Charts

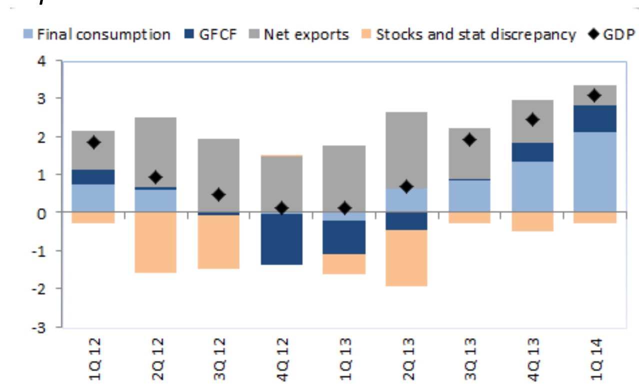
Growth continues to strengthen and become more balance

Growth gradually strengthened during 2013…

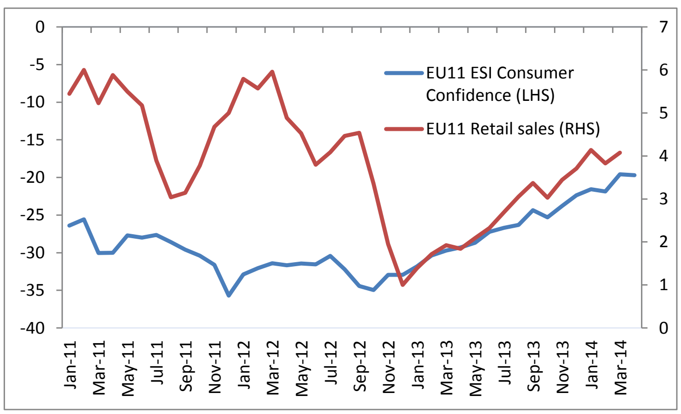


NSA – not seasonally adjusted, SWDA seasonally work day adjusted

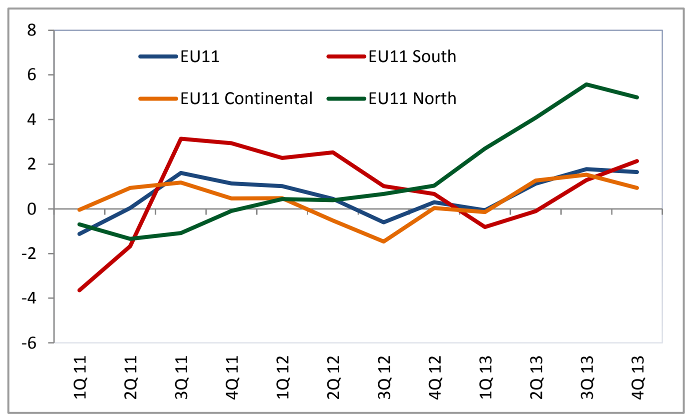
…as domestic demand rose to compliment net exports



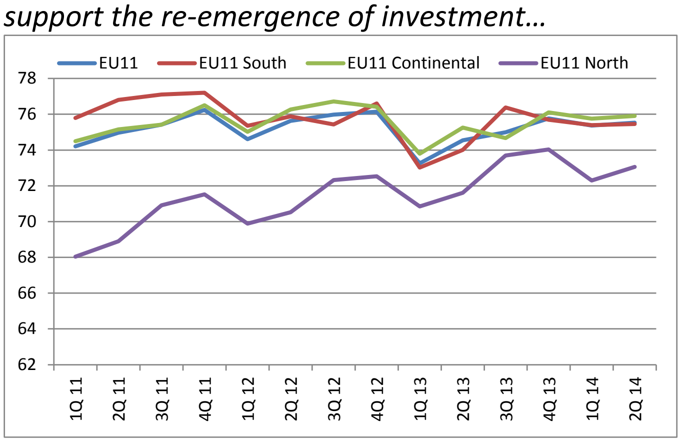
Growing consumer confidence supported retail sales…



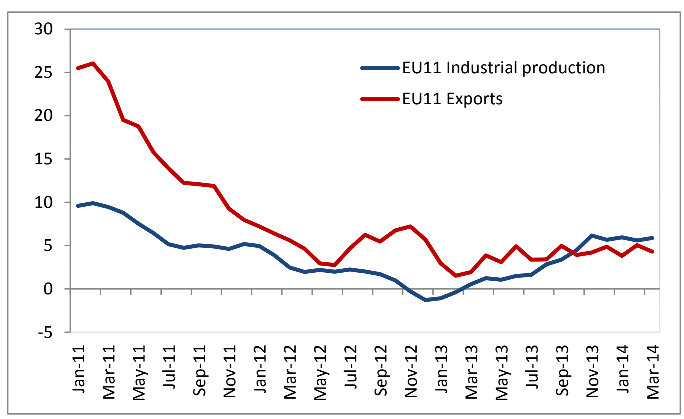
…amid rising real wages.



High capacity utilization rates should begin to support the re-emergence of investment…

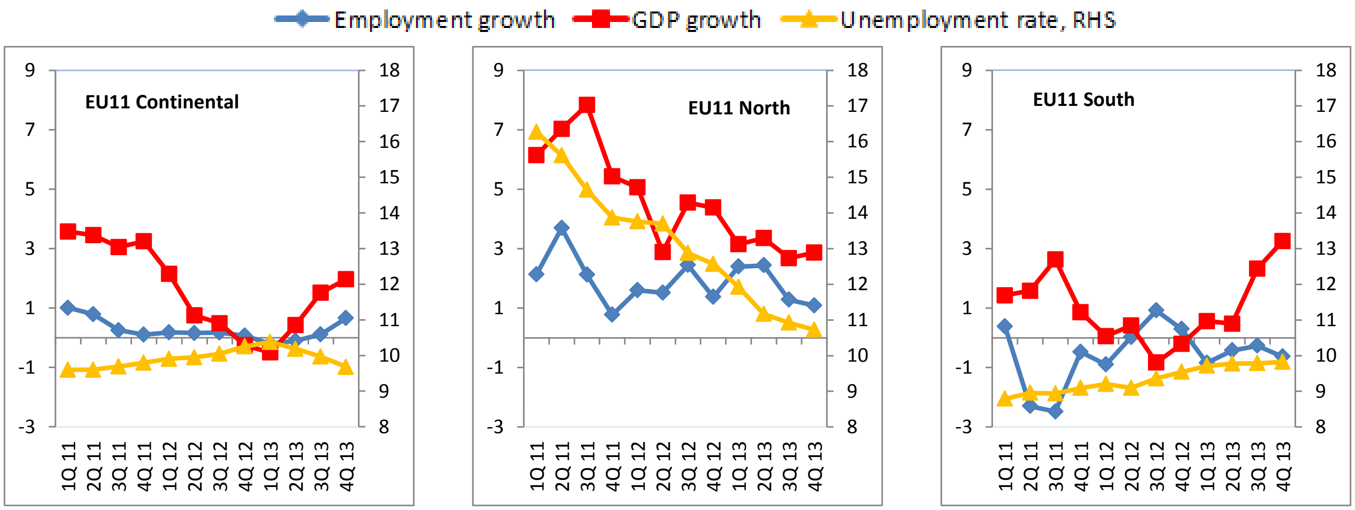


… while export activities continue to be strong.

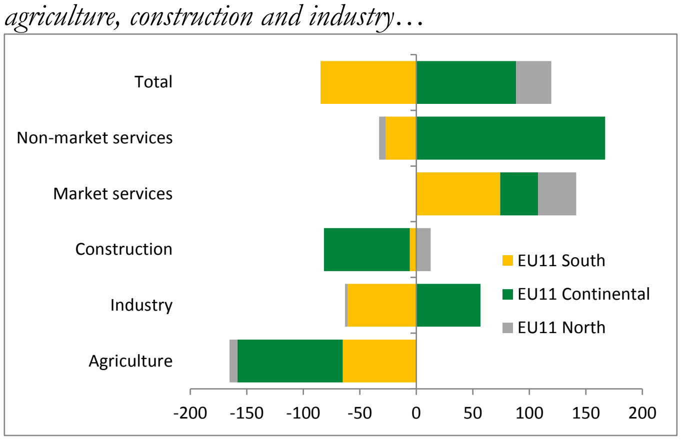


Labor markets are slowly improving, but unemployment remains high and entrenched

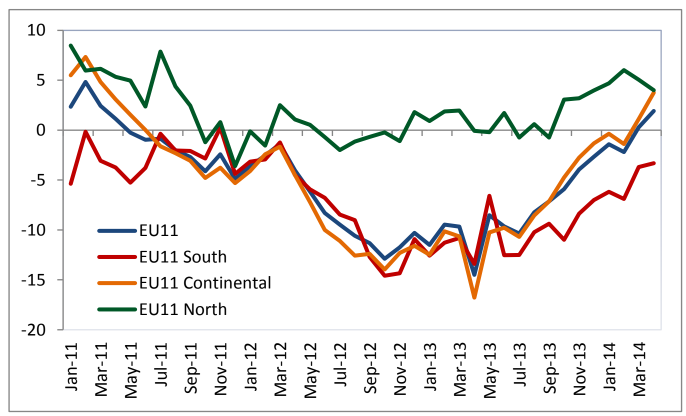
Labor market conditions are improving, especially in EU11 Continental, as unemployment rates start to decline and employment growth picks up…



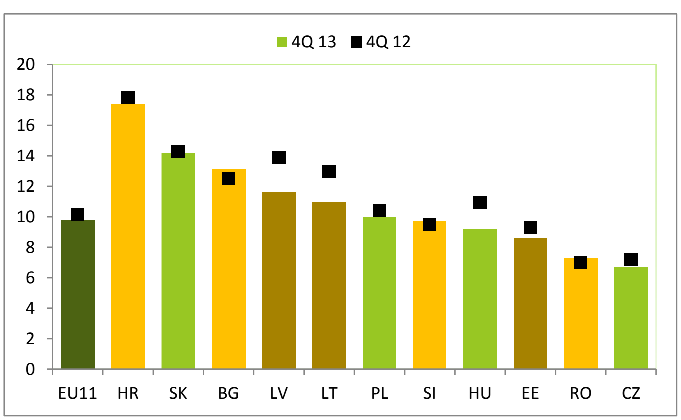
New jobs created in services sector outweigh job losses in agriculture, construction and industry…



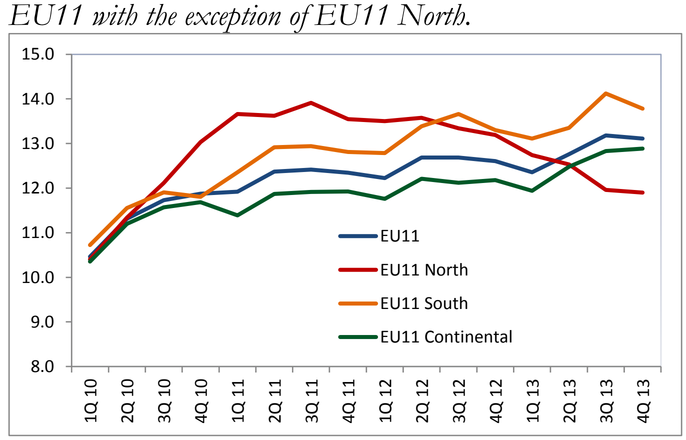
…supported by favorable employment outlook across the region.



Unemployment rates are still high in many EU11 countries…



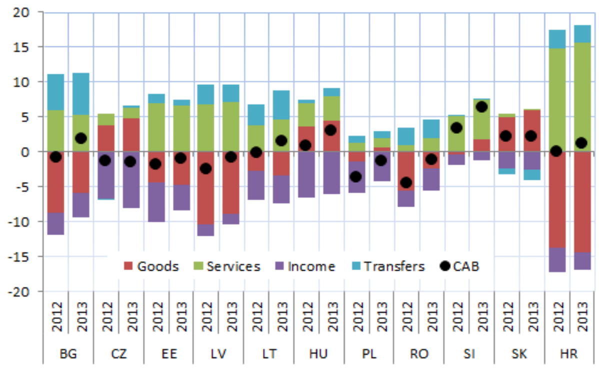
…and average duration of unemployment remains on rise across EU11 with the exception of EU11 North.



External imbalances continued to narrow, as exports continued to grow and imports declined

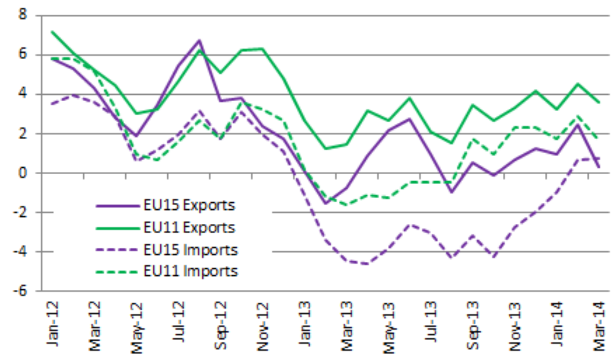
Significant rebalance of the current account…

Current account, in % of GDP



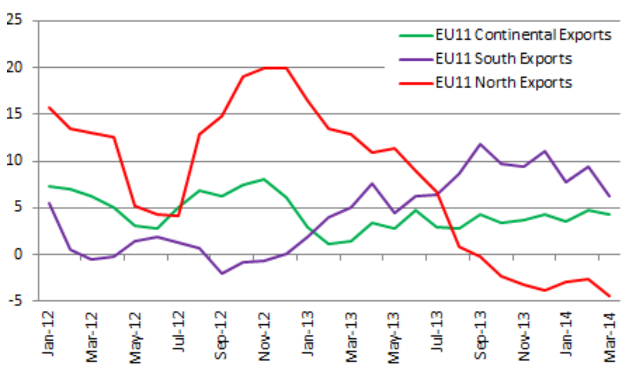
…supported by modest imports and steady growth of exports...

Export of goods, y/y, growth rate (3m average)



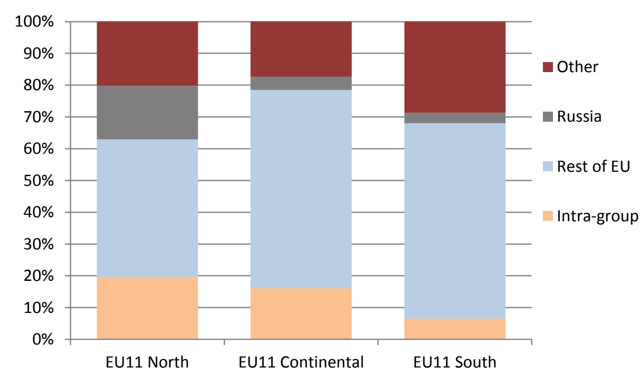
…driven by EU11-Continental and South links to EU15...

Export of goods, y/y, growth rate (3m average)



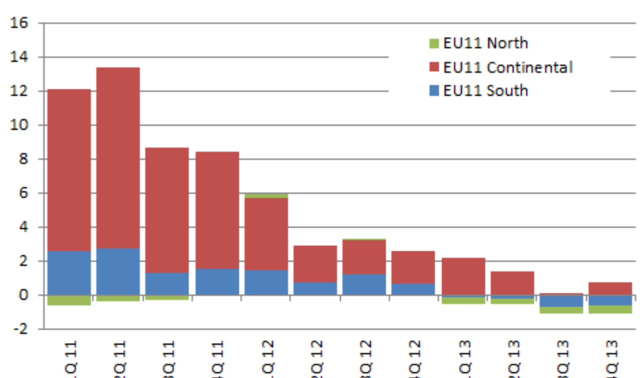
…while EU11-North has a high exposure to trade within the sub-region, EU15-North and Russia.

Structure of exports, in %



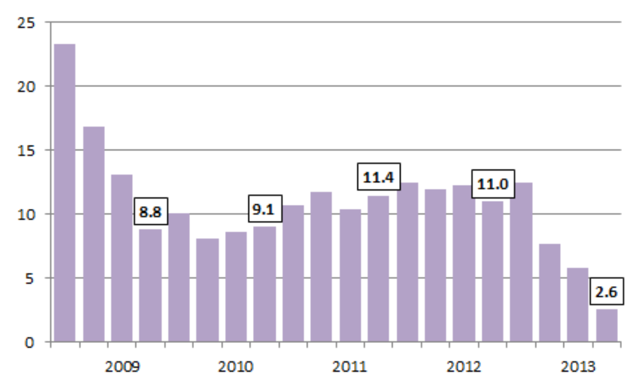
Regional external deleveraging continues…

Capital inflows, in % of GDP (rolling)



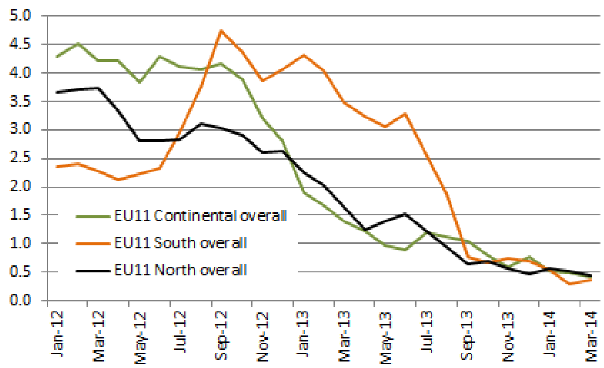
…driven by low inflow of FDI.

EU11 inward FDI, in % of GDP (rolling)



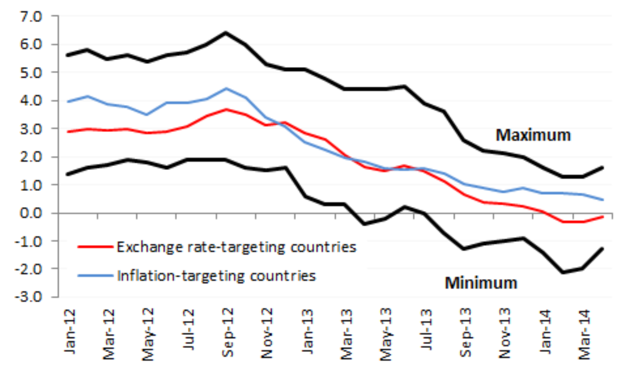
Annual headline inflation has fallen to the record low of 0.3 percent in EU11…

y/y, in percent



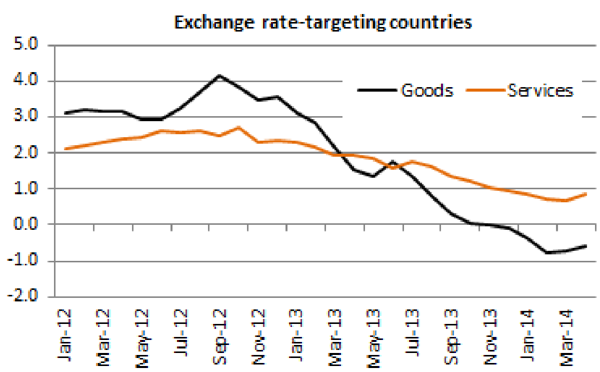
… but there is a wide variation across the region, with four countries experiencing deflation.

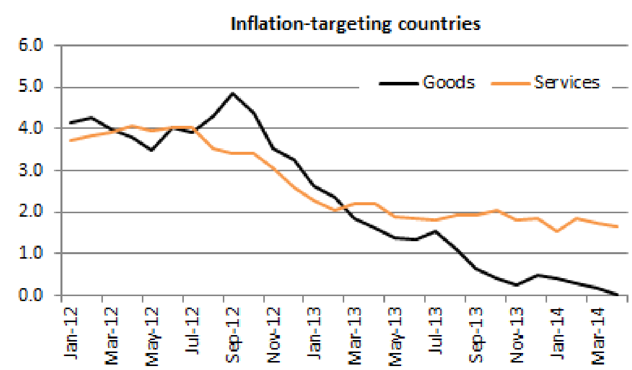
y/y, in percent



Energy and food prices have been the main driver of falling inflation

EU11 Harmonized Consumer Price Index (HICP), Overall and Core, (Percent, Year-on-Year)



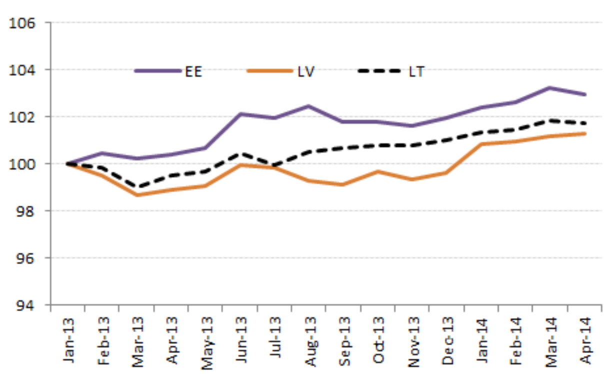


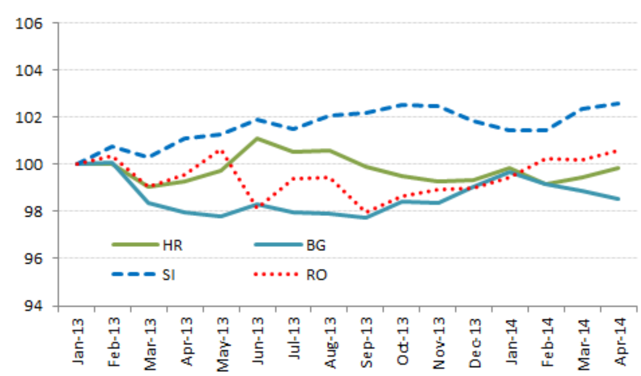
Source: Eurostat; World Bank staff calculations

Appreciation pressures continued in EU11 North…

…with most of the EU11 South countries following a similarly gradual path.

Real Effective Exchange Rate, CPI Deflated, Jan-2013=100

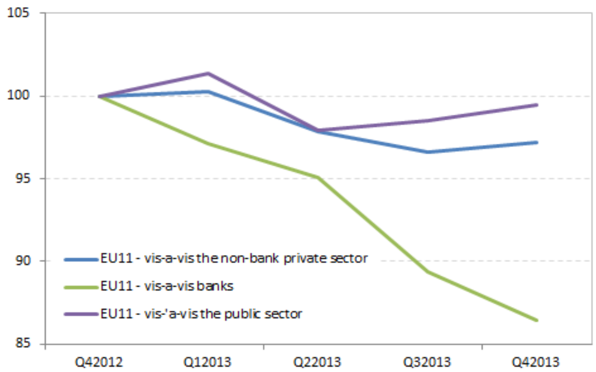




Credit growth remains muted by weak demand, while lending conditions continue to tighten

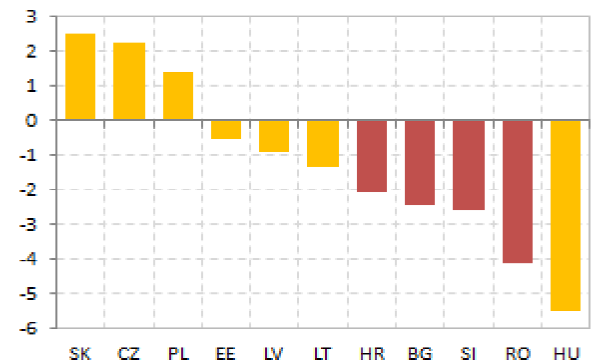
Increased market volatility contributed to continued deleveraging…

Total international claims by sector, 2012=100



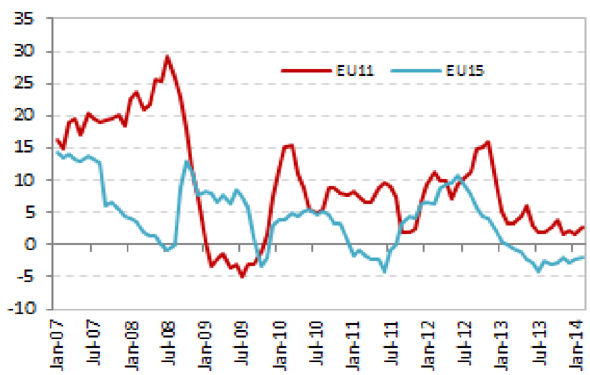
…in particular by EU11 South and Hungary.

2013 change in international claims by by country, EUR billion



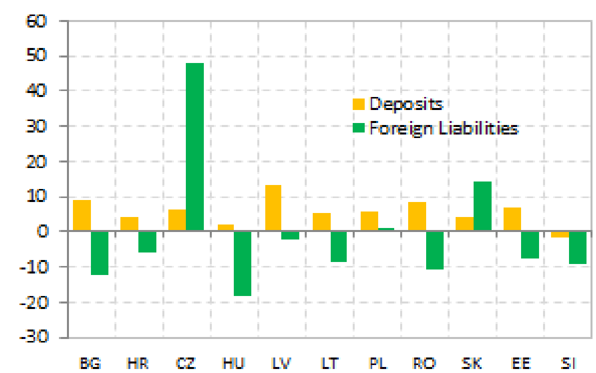
Deposit mobilization started slowing...

Deposits growth, in % (2013)



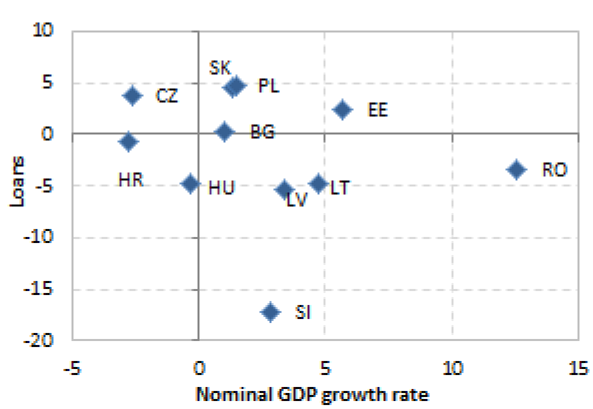
…coupled with continued contraction of foreign funding.

y/y (2013), in %



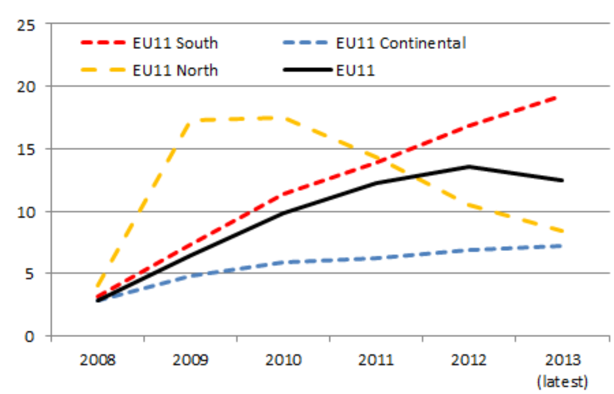
Credit growth remains muted, driven by still weak demand…

y/y, in % (2013)



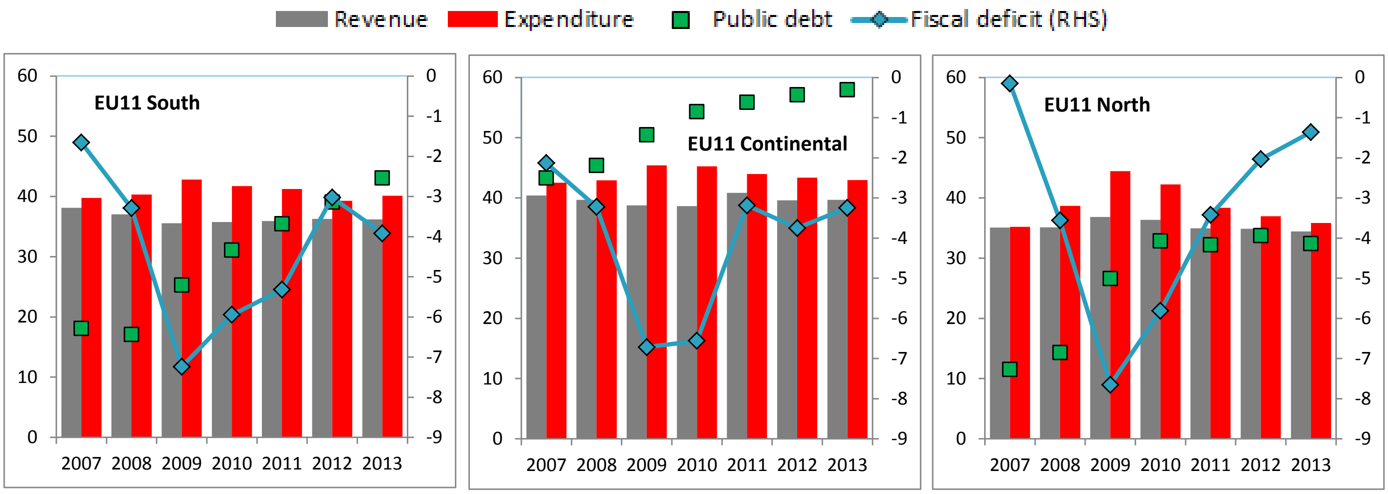
… but also tightened lending conditions.

Evolution of NPLs, in % (2013)

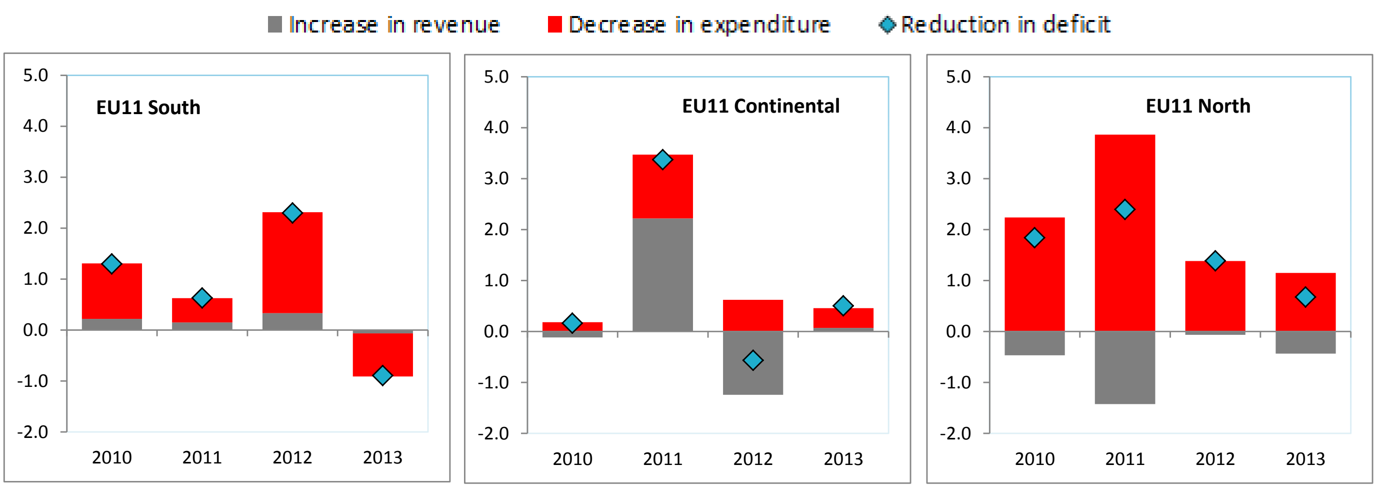


Fiscal balances have improved, but reforms continue in many countries

Fiscal balances have improved significantly since the crisis across each subregion, but is incomplete in many countries…



…as governments undertook largely expenditure-based fiscal consolidation…



… and focused on structural measures in EU11-South and Continental and favorable cycle in EU11-North.