Growth in the New EU Member States
Risks and Opportunities

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Background

- Strong (but volatile) growth since mid-1990s, but question whether this reflects bounce-back from initial transition recession and favorable external environment or reforms and real growth potential
- Growth driven by TFP and to a lesser extent investment. Labor shedding and jobless growth. Role of resource reallocation limited (mainly capital in the second half of 1990s)
- Relatively low employment and, in some countries, investment rates (compared to Asia)

Background continued

- EU accession further boost (exports).
- Per capita incomes (PPP terms) vary between 50-80% of EU average
- Modern export-oriented industry main engine of productivity growth in the larger countries
- Technology transfers and competition key (trade and FDI); less clear role for R&D spending and human capital hard to measure

Risks

Useful to distinguish between short-medium term and medium-long term risks:

- Short-term risks:
  - Political/policy reversal (Poland, Slovakia)—may affect investment (incl. FDI)
  - Euro adoption commitment and need to reduce inflation (Baltics/Slovakia) or fiscal deficit (Visegrad countries, notably Hungary) will require tighter policies
  - Large current account deficits (Baltics, Hungary, Slovakia) and fiscal deficit (Hungary) could lead to loss of market confidence and need to tighten policies sharply

Risks continued

- Medium-term risks:
  - Loss of competitiveness; increasing competition in labor intensive products
    - Failure to diversify production and move up value added/technology ladder
    - Failure to attract new needed investment, including FDI (K/L ratios low: 20-50% of euro area average)
    - Brain drain and inadequate education
    - Inflation and real effective exchange rate
  - Fiscal pressures from aging, migration, etc.

Opportunities

- EU membership and access to large regional aid funds
  - Trade-induced competition
  - Pressure for policy reform
  - Increased financial integration
  - Large infrastructure investment needs, but low absorption
- Unexploited comparative advantages? Liberalizing strategic sectors and reducing excessive bureaucracy
- Improving investment climate and raising employment rates (mostly below EM average)

In sum…risks+opportunities=challenges

- Sustaining rapid TFP growth (although likely to slow)—education, FDI, R&D
- Facilitate market-driven relocation of resources (from agriculture, mining, heavy industry, etc.) and enhance competition in regulated sectors
- Raising investment rates—improving investment climate (legal and regulatory reform etc.) and ensuring foreign savings are put to good use
- Raising employment rates (labor taxes, social benefits, mobility).
- More political and social consensus
- More rapid growth (higher return)=higher risk

Prospects

- Czech Republic and Hungary should be able to grow at about 4%; Poland and Slovakia at over 5%, and the Baltic States even faster