EU Regular Economic Report

MODEST RECOVERY, GLOBAL RISKS

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EU Regular Economic Report

MODEST RECOVERY, GLOBAL RISK

Europe and Central Asia Region
The World Bank

Final Report
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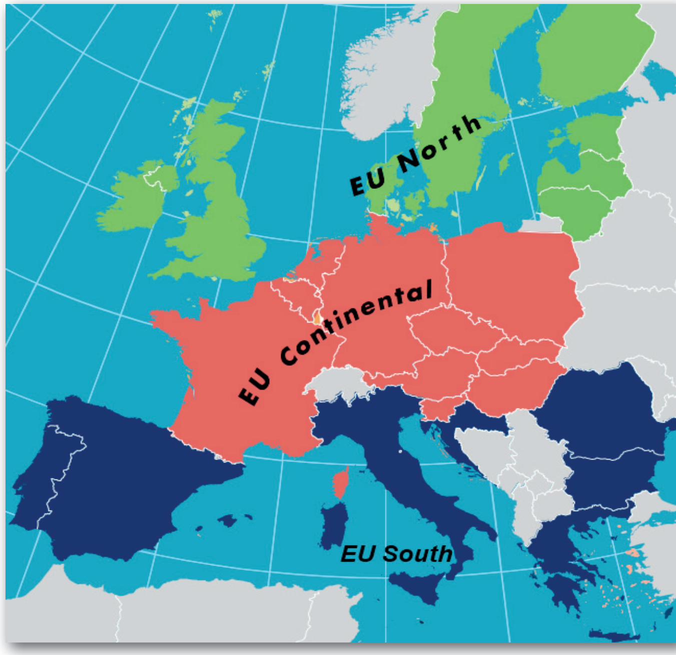
NOTES AND ACKNOWLEDGMENTS



This is the inaugural issue of the EU Regular Economic Report (RER), which is designed to be a semiannual publication of the World Bank. The objective of the RER is to present economic developments and prospects in the European Union (EU), with a special focus on countries most engaged with the World Bank in **EU Central and Eastern European countries (EU-CEE)**, and in particular **Bulgaria**, **Croatia**, **Poland**, and **Romania**.

The report allows the benchmarking of countries relative not only to neighbors, but also to EU subgroups. The subgroupings used in this Report are drawn from the World Bank report "Golden Growth: Restoring the Lustre of the European Economic Model" (2012). They provide a basis for clustering countries with similar economic characteristics and linkages (see map): **EU North** comprises Denmark, Estonia, Finland, Ireland, Latvia, Lithuania, Sweden, and the United Kingdom; **EU South** comprises Bulgaria, Croatia, Cyprus, Greece, Italy, Portugal, Malta, Romania, Slovenia, and Spain; and **EU Continental** comprises Austria, Belgium, the Czech Republic, France, Germany, Hungary, Luxembourg, the Netherlands, Poland, and the Slovak Republic. The RER also contains a Focus Note on an issue of economic policy interest in the EU.

The Report is co-authored by Ewa Korczyc, Matija Laco and Theo Thomas, with inputs from Doerte Doemeland, Paulina Hołda, Stella Ilieva, Leszek Kasek, Sanja Madzarevic-Sujster, Catalin Pauna, Suzana Petrovic, and Emilia Skrok.

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, and non-performing loans, are calculated as simple averages, (iv) aggregates for labor market indicators, employment and unemployment rates, are weighted by labor force in 2013; (v) aggregates for inflation are weighted by final consumption expenditure in 2013; (v) and aggregates of financial sector indicators (credit, deposits) are weighted by their shares in the total. The data appearing in the Regular Economic Report are compiled by the World Bank staff and reflect data available by end-May 2015.

The team would like to thank Ivailo Izvorski (Practice Manager) and Satu Kahkonen (Director), from the Macroeconomics and Fiscal Management Global Practice at the World Bank, Mamta Murthi (Director, Central/South Europe and Baltics) and other colleagues for their guidance in the preparation of this report. The team is grateful for the comments on earlier drafts received from colleagues in the World Bank, and Central Banks and Ministries of Finance.

SUMMARY

Growth is slowly picking up in Europe against a backdrop of diverging global trends. The EU economy expanded by 1.3 percent in 2014 after no growth in 2013, thanks to rising consumer confidence, which bolstered consumption, and a pick-up in investment. However, Europe's recovery has lagged behind other OECD economies over the past four years, with the exception of Japan, and real GDP levels are barely 3 percent higher than in 2010, compared to about 10 percent higher in the US.

EU North and Continental are leading the modest recovery. The pick-up was particularly strong in Germany, Hungary, Ireland, Poland and the UK. EU South finally returned to growth in 2014 following significant financial and economic restructuring, and despite growing concerns about financial strains in Greece and generally weak global trade. Confidence in the modest recovery reflects gradually improving labor markets—increasing employment, low inflation and growing real wages—combined with the boost from lower food and oil prices. The ECB's expanded Quantitative Easing (QE) program has also driven bond yields and the Euro lower, supporting exporters and, as bank balance sheets improve, the gradual pick up in credit. The drag from fiscal consolidation is also set to moderate while inflation bottoms out in 2015.

Most EU Central and Eastern European countries (EU-CEE) will continue to grow above the Euro area average. The Czech Republic, Hungary, Poland, Romania and the Slovak Republic are expected to be some of the fastest growing economies in the EU, with growth of over 2.4 percent, based on robust domestic demand, and continued export growth as the EU recovery gathers pace. Investment should also continue to pick up with overall activity, but high corporate debt, ongoing financial deleveraging and high non-performing loans continue to weigh on prospects for a swift recovery. In Croatia, economic activity is expected to recover at a very modest pace, based on exports and EU financed investments, after a six-year recession. In Bulgaria, the recovery is constrained by the need to tighten fiscal policy as fiscal deficit widened due to expenditure over-runs and weaker than expected revenues in 2014.

While the risks to the outlook are balanced, there are significant concerns. These include: (i) an upsurge in financial market volatility as the US, EU and Japan implement divergent monetary policies; (ii) a sustained period of low growth and subdued inflation will continue to put pressure on EU countries' public finances, as revenues remain subdued and debt levels high; (iii) low returns on investment and incomplete bank reforms would reduce the availability of new lending for investment; and (iv) regional risks emanating from ongoing financial strains in Greece, the planned EU-referendum in the UK, and ongoing tensions in Ukraine. On the upside, lower oil prices, the ECB's QE and firming labor markets should continue to support consumption in the short-term.

Exports have driven the growth recovery in several EU-CEE countries. Bulgaria, Poland, Romania, and to a lesser extent Croatia, have seen exports grow significantly faster than in most other EU countries. One of the key factors has been the role of FDI in helping countries integrate into global value chains and 'push' exports. However, FDI has declined significantly in recent years, which puts renewed emphasis on reforms to promote FDI and sustain export growth, through improving skills, reducing regulatory barriers to businesses, providing supportive infrastructure investment, encouraging innovation and efficient labor and capital markets.

Growth and structural policies have resulted in marked differences in EU-CEE trends in poverty and shared prosperity. In Poland poverty is continuing to decline as unemployment levels are back at levels not seen since 2008, real wages are growing and well targeted tax credits are helping low income families. In Romania, improving employment conditions and support to vulnerable categories have resulted in a steady decline in poverty rates. In Bulgaria, poverty remains above pre-crisis levels, as job losses have been most severe in low-skilled jobs and fiscal consolidation has reduced the scope for increases in social transfers. Croatia's recession and high unemployment has resulted in a steady rise in poverty despite efforts to target benefits to a guaranteed minimum income.

Real GDP growth, percent	2014	2015f	2016f
EU	1.3	1.8	2.0
of which			
Bulgaria	1.7	1.1	2.0
Croatia	-0.4	0.5	1.2
Poland	3.4	3.6	3.6
Romania	2.9	3.0	3.2

Source: Eurostat, EC and World Bank calculations

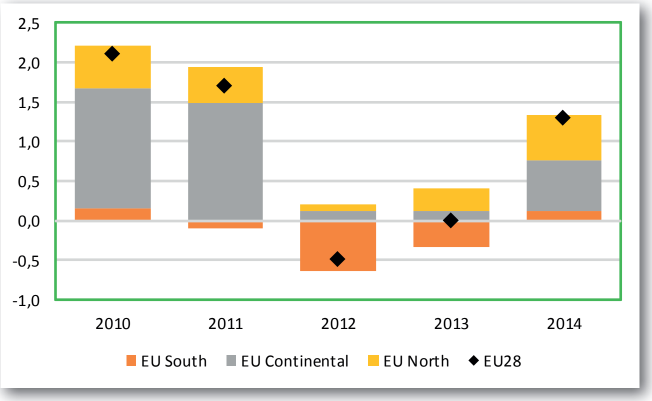
RECENT ECONOMIC DEVELOPMENTS

GROWTH IS SLOWLY PICKING UP IN EUROPE AGAINST A BACKDROP OF DIVERGING GLOBAL TRENDS AND POLICIES

Growth finally returned to Europe in 2014, and the pace has gradually strengthened, based on growing consumer confidence, which bolstered consumption, and a pick-up in investment. The EU economy expanded by 1.3 percent in 2014 as domestic demand rose, especially private consumption (Figures 1-2). This comes after zero growth in 2013, and recession in 2012. Europe's recovery after the initial financial crisis in 2008 and the second recession in 2012-13 has lagged behind developments in other OECD economies over the past four years, with real GDP levels in Europe less than 3 percent higher than in 2010, compared to an economic expansion of close to 10 percentage points in the US, around 15 percentage points in Korea and Mexico, and 20 percentage points in Turkey and Chile. Only in Japan, where growth has been subdued for over two decades, were levels similar to those of Europe. One of the reasons for the prolonged downturn and sluggish recovery in the EU resulted from the need to gradually unwind unsustainable credit and housing booms, which particularly impacted many EU South countries, as well as Ireland, the UK, and EU central and eastern countries (EU-CEE), and the emergence of structural imbalances that manifested in high current-account deficits, the loss of competitiveness and ultimately the rapid accumulation of both private and then public sector debt.

Figure 1. EU North and Continental countries are leading the recovery

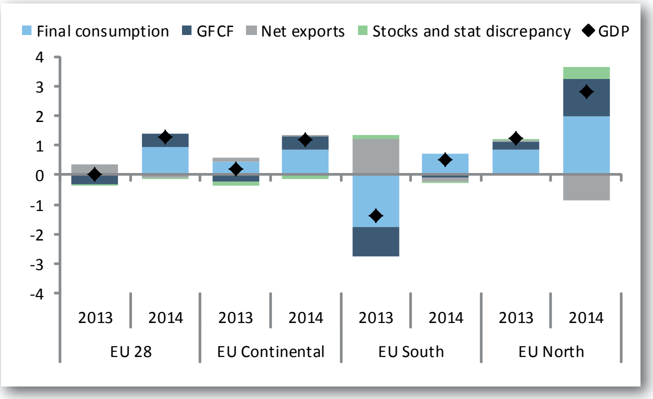
Contributions to GDP growth, 2010-14, percentage points



Source: Eurostat, World Bank staff calculations

Figure 2. As domestic consumption becomes the main driver of growth in most regions

Contributions to GDP growth, 2013-14, percentage points



Source: Eurostat, World Bank staff calculations

The EU's recovery is taking hold against a backdrop of diverging global trends and policies. Overall, global growth is estimated to have been 2.6 percent in 2014, only slightly higher than 2012 and 2013. Growth in the US was 2.4 percent, bolstered by robust private investment, a surge in consumption and easing fiscal consolidation. In Japan, a technical recession ended in the fourth quarter of 2014, with output remaining little changed, as both consumption and exports improved. China is also managing a gradual slowdown in growth, to a still impressive 7.4 percent, while overall growth in the BRICS[1] slowed from 5.4 to 5 percent. Low oil prices have led investors to reassess the growth prospects of oil-exporting countries and have contributed to capital outflows, reserve losses, sharp depreciations, or rising sovereign spreads, including in Russia, Venezuela, Colombia, Nigeria, and Angola. These financial strains could imply adverse spillover effects for partner economies, through trade and financial linkages, including remittance flows. Conversely, oil-importing regions like the EU have gained additional fiscal and monetary space to support activity. Nonetheless, global trade remains surprisingly weak, even though financing conditions are benign, growing by less than 4 percent in 2013 and 2014—well below the pre-crisis average of 7 percent a year. The slowdown is due partly to a drop in demand and partly because world trade seems less sensitive to changes in global activity. The diverging growth trend, between the US and Europe, has led to speculation that the US Federal reserve may start to gradually raise monetary policy rates no earlier than late 2015, while the ECB and Japan are committed to a sustained period of Quantitative Easing and low policy rates.

1 Brazil, Russia, India, China and South Africa.

Growth rates have picked up most strongly in EU Continental and EU North[2]. The impact of the euro-crisis looks to be finally starting to abate, with progress having been made to strengthen bank balance sheets, and ongoing moves toward the banking union that should improve supervision and regulation, while the downward spiral of fiscal adjustment and weakening growth appears to be easing. As concerns over the impact of the crisis, particularly in EU South, have gradually declined, companies and households are becoming more willing to invest and spend. All three sub-regions of the EU posted positive growth in 2014, for the first time since 2010. There has been strong economic expansion in EU North, of 2.5 percent, largely driven by consumption in the UK and Ireland, while the Baltic countries witnessed some of the fastest growth rates in the EU, all above 2 percent. The solid growth in EU Continental, in particular the German and Polish economies, was more balanced between consumption and investment. Following three years of recession, EU South, which was worst affected by the financial crisis, finally returned to growth after several years of financial and economic restructuring, registering a 0.5 percent increase in aggregate output, driven by domestic demand, despite growing concerns about financial strains in Greece.

Growth was well above average in Central and Eastern EU countries, as strengthening domestic demand helped to rebalance growth. Hungary and Poland were amongst the fastest growing economies in the EU in 2014, with growth of 3.6 percent and 3.4 percent respectively, with only Ireland growing faster, at 4.8 percent. Growth in the Baltic countries[3], the Czech Republic, Slovakia and Slovenia all exceeded 2 percent in 2014, as domestic demand picked up across the region to reduce the previous reliance on net exports. Growth remained robust in the Baltics, despite the slowdown in some of their major trading partners, with Finland's economy contracting by 0.1 percent (the third year of recession) and Russia's growth slowing to 0.6 percent. In Poland, strong domestic demand became the main driver of growth, including a notable rebound in fixed investment, reducing the previous reliance on net exports. In Bulgaria, GDP expanded by 1.7 percent in 2014, compared to 1.1 percent in 2013, boosted by the gradual improvements in labor markets, falling prices and a recovery in investment by EU funded projects. In Romania, economic growth reached 2.9 percent in 2014, compared to 3.5 percent in 2013, supported by strong private consumption—up 4.7 percent—based on robust wage growth despite investment remaining subdued by the modest rate of absorption of EU funds. Croatia's recovery is lagging behind other neighbors, relying mainly on a rebound in exports, which was more than offset by the continued contraction in all components of domestic demand, as GDP declined by 0.4 percent in 2014, the sixth year of negative growth that has seen the economy shrink by some 13 percent.

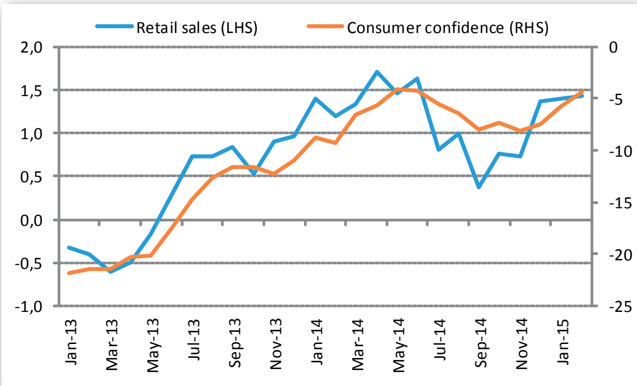
Flash estimates of GDP, as well as high-frequency leading indicators, suggest that economic activity in the EU continued its gradual recovery in early 2015. In the first quarter of 2015 EU GDP is expected to have expanded by 1.4 percent, while Euro Area registered growth of 1 percent, compared to a year before. The seasonally adjusted, quarter on quarter, growth of 0.4 percent for both the EU and Euro area was the highest in two years, and exceeded growth rates in both the UK and US. In particular, the performance of both Italy and France boosted Euro Area growth, despite somewhat disappointing growth in Germany. Retail sales continued to grow at a reasonable pace of around 1.5 percent while industrial production expanded close to 2 percent in the first quarter 2015. The Euro area PMI has been well above 50 points (reflecting continued expansion), as economic sentiment indicators rose. The EU-CEE countries are benefiting most from revitalized EU growth, with the Czech Republic, Hungary and Poland witnessing the highest Manufacturing PMI levels in the EU. Flash estimates of GDP in the first quarter confirm strong rebound in both Romania and Poland, registering growth 4.3 and 3.5 percent year-on-year respectively, some of the strongest in the EU, while growth in Bulgaria accelerated to 2 percent.

2 EU North comprises—Denmark, Estonia, Finland, Ireland, Latvia, Lithuania, Sweden, and the United Kingdom; EU South comprises—Bulgaria, Croatia, Cyprus, Greece, Italy, Portugal, Malta, Romania, Slovenia, and Spain; and EU Continental comprises—Austria, Belgium, the Czech Republic, France, Germany, Hungary, Luxembourg, the Netherlands, Poland, and the Slovak Republic.

3 Estonia, Latvia and Lithuania.

Figure 3. Strengthening consumer confidence has boosted retail sales, percent change

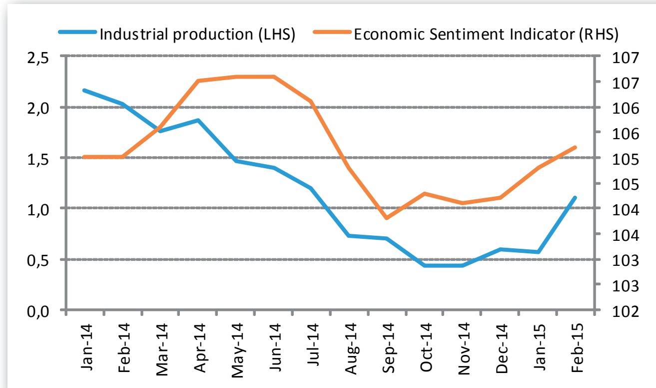
Growth in retail sales, percent change and Consumer Confidence Indicator, index



Source: Eurostat, World Bank staff calculations

Figure 4. As economic sentiment and industrial production also improve, percent change

Growth in industrial production, percent change and Economic Sentiment Indicator, index



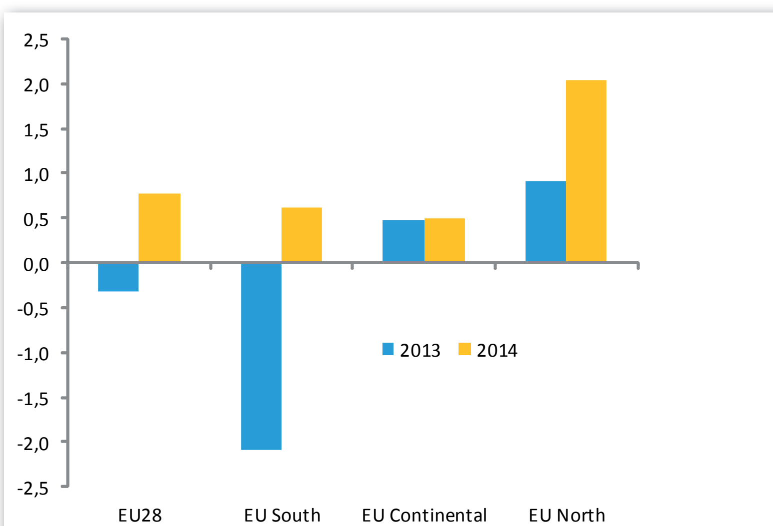
Source: Eurostat, World Bank staff calculations

EMPLOYMENT CONTINUED TO GROW ACROSS MOST OF THE REGION, BUT SLOWLY

The modest economic recovery of the last two years has prompted a steady rise in employment. In 2014, employment grew by 0.8 percent in the EU, with growth in all the regions and sectors, except in agriculture and construction. More than half of those employed were full-time workers, representing an additional 1.3 million new jobs. Although EU employment remains 2 percent lower than the peak in 2008, it has recovered 2.7 million jobs since the trough (the low point of the cycle) in the first quarter of 2013. As a result, the EU employment rate for 20-64 year-olds reached nearly 70 percent at the end of 2014, the highest rate since the end of 2008, with rates above 75 percent in Sweden, Germany, the UK, the Netherlands and Denmark.

Figure 5. Jobs are being created across the EU

Employment growth, percent change, annualized



Source: Eurostat, World Bank staff calculations.

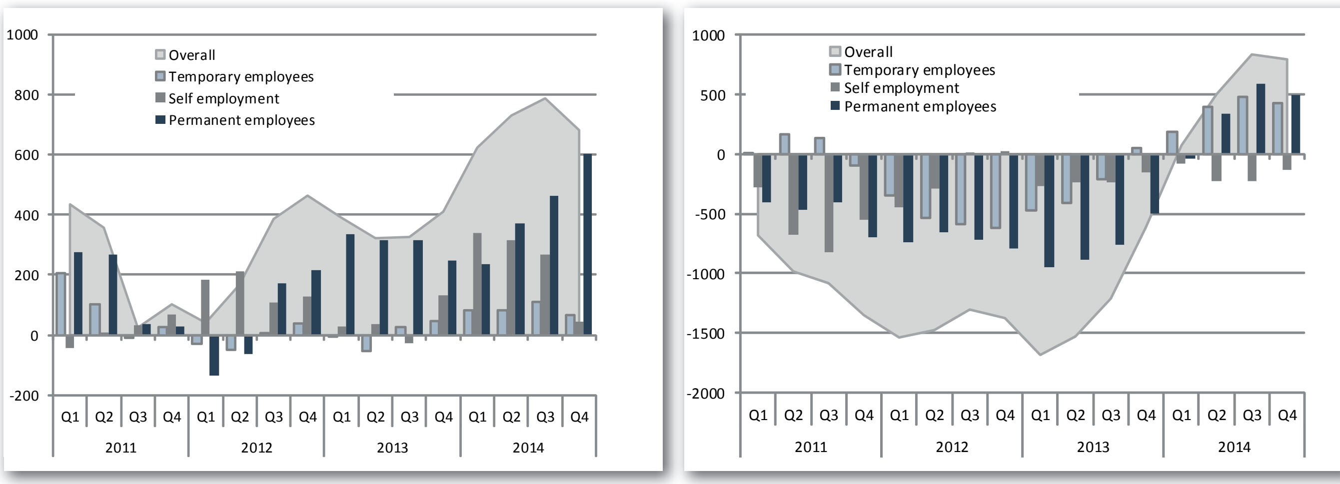
However, significant differences in employment remain between sub-regions, with extremely high rates of youth unemployment in EU South. Employment growth remained solid in EU Continental and picked up strongly in EU North. The pick-up in EU North mostly reflects the growth of full-time jobs, particularly in the UK, but was also robust in other countries, with the exception of Finland where job losses continued as the economy contracted. EU South employment finally began to grow, having declined significantly over the last few years, with growth in all countries including those with very high unemployment rates such as Greece and Spain. However, employment rates remain below 60 percent in Greece, Croatia, Spain and Italy, and unemployment still affects around 50 percent of young active people (aged 15 to 24) in Greece and Spain, and more than 30 percent in Cyprus, Croatia, Italy and Portugal.

Figure 6. Full-time jobs are now being created across the EU as the recovery becomes more solid

Annual Employment Changes by Type, in 000s

EU North

EU South

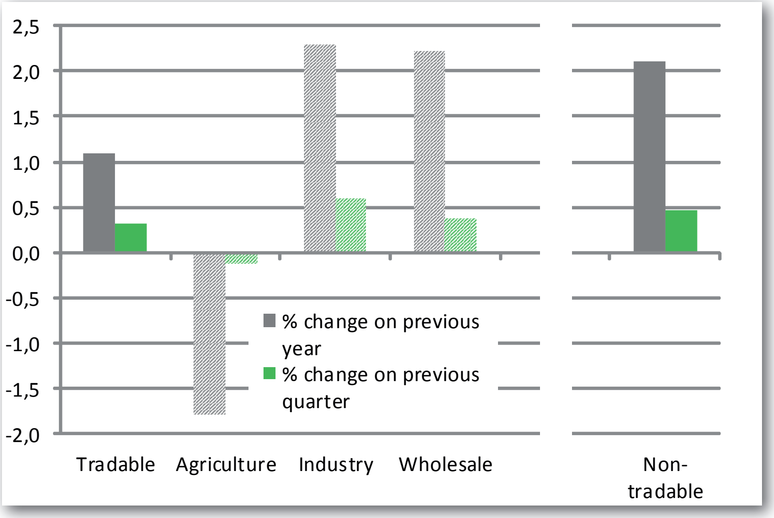


Source: Eurostat, World Bank staff estimates and calculations

Employment has grown in EU-CEE. Employment has improved in Bulgaria, Croatia, Poland and Romania across the large majority of sectors, growing on average by 1.6 percent in 2014, though more in non-tradable than tradable sectors. Employment is growing in manufacturing, and wholesale and retail sectors, while labor shedding is concentrated in the agriculture and financial industries. Bulgaria was an exception, where the increase in employment occurred in agriculture sector, while declines in employment were recorded in the wholesale and retail sectors, as well as public administration. Unemployment rates have also declined, except in Croatia, where the unemployment rate stood at 18.5 percent at the end of 2014, the third highest in the EU, after Greece and Spain.

Figure 7. Employment is growing in key sectors

Employment changes in 2014, by sector, in Bulgaria, Croatia, Poland and Romania, annualized



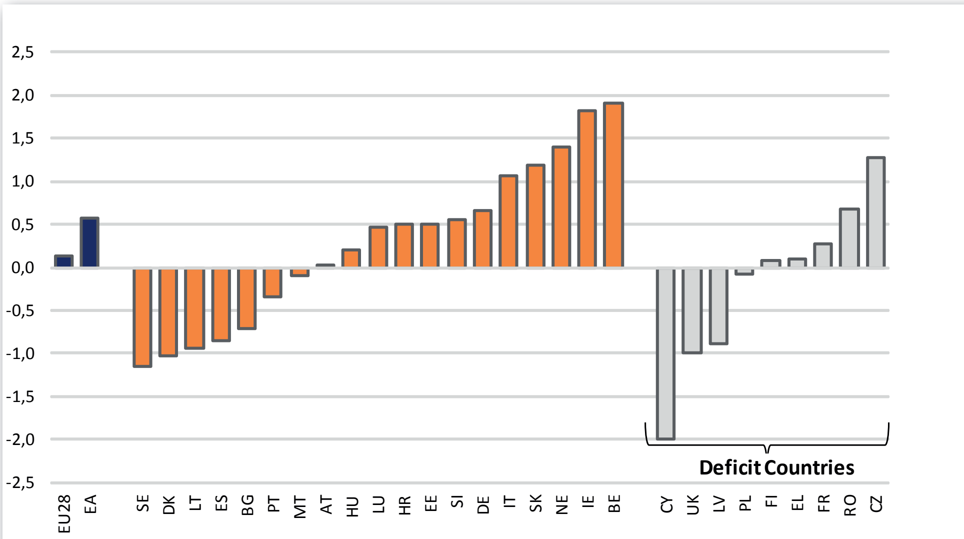
Source: Eurostat, NACE classification, World Bank staff calculations

CURRENT ACCOUNT BALANCES CONTINUED TO IMPROVE ACROSS THE EU, THOUGH TRENDS HAVE DIVERGED

The EU current account surplus improved modestly to 1.6 percent of GDP in 2014. The improvement is more pronounced in the Euro area, with the current account surplus increasing by 0.5 percentage points to 3 percent of GDP in 2014. Sizeable current account surpluses in net creditor economies—particularly Germany, Italy and the Netherlands—contributed most of the overall improvement in the euro area current account surplus. Current accounts in a majority of Euro area countries are now close to balance or in surplus. Member States running current account deficits exceeding 1 percent of GDP in 2014 were Greece, France, Cyprus Latvia, Poland, Finland and the UK. While exchange rate developments and oil price declines supported the rebalancing in countries that needed to strengthen their external positions, existing surpluses also widened already. In some countries, cyclical factors also played a role, for example Ireland, the Baltics and Malta exhibit bigger current account surpluses if adjusted for the cyclical component, while the opposite holds for Greece, Spain, Cyprus and Slovakia.

Figure 8. Countries have witnessed significant changes in their current account balances

Change in 2014, compared to 2013



Source: Ameco and the World Bank staff calculations

Note: The Figure above refers to the balance on current transactions with the rest of the world. Data may differ from the standard Balance of Payments statistics.

Exports between EU countries are growing more strongly, although global conditions remain challenging for countries exporting to the rest of the world. EU exports grew by 1.2 percent in 2014 (including exports between EU members and to the rest of the world), and have continued to accelerate in the first two months of 2015. While growth remains subdued, the structure has altered considerably as intra-EU exports (i.e. exports between EU countries) have rebounded due, in part, to rising domestic demand and, notably, investment within the EU. At the start of 2014, trade outside the EU's borders turned negative, although it started to recover in the last half of 2014, and is now contributing to the overall growth of exports.

The aggregate trade numbers mask divergent trends across sub-regions in both exports and imports. In the second half of 2014 and the beginning of 2015, the growth in merchandise exports and imports accelerated in EU Continental countries. Imports by EU South countries started to show signs of growth, after falling for almost two years, while exports have grown at a rate of around 5 percent year-on-year. Practically all countries in EU North, except Ireland and Denmark, saw their exports decline—in the UK this may be partially attributed to the appreciation of the currency, while the deteriorating economic situation in Finland and Russia weighed on exports from the Baltic States. The rapid growth in EU North imports is driven by the recovery in the UK, and to some extent Ireland and Denmark, while all other countries in the sub-region saw their imports decline (in the Baltics this may be due to the decline in re-exports).

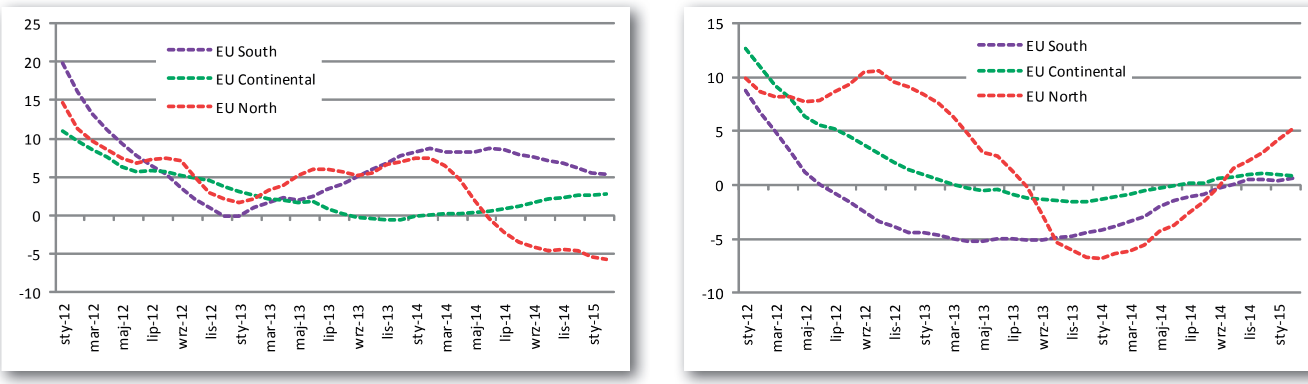
Exports and imports have continued to pick up in most of the EU-CEE, reflecting the rebalancing of the recovery. In the Czech Republic and Hungary exports grew at robust rates, but were outpaced by imports, as demand for investment goods like machinery and transport equipment increased. The largest exports growth in the second half of 2014 and beginning of 2015 was seen in Croatia, accompanied by a slowdown in imports that reflects the continued weakness of the domestic economy. Robust export growth continued in Poland and Romania, but with slower growth than in the first half of 2014. In contrast, annualized imports growth remained relatively stable in both countries, although notably, Polish imports started to decline in 2015 despite the economy's relatively strong growth. Bulgaria's trade dynamics continued to be driven to a large degree by decreases in the international prices of goods important for foreign trade turnover. By February 2015, exports started to pick up on an annual basis, reflecting mainly stronger performance in exports to EU countries, but also lately growth in exports towards non-EU countries.

Figure 9. Trade has picked up, but remains subdued by slowing global growth

Foreign trade in EU28 by sub-regions, annualized growth rates, seasonally adjusted data

Exports

Imports



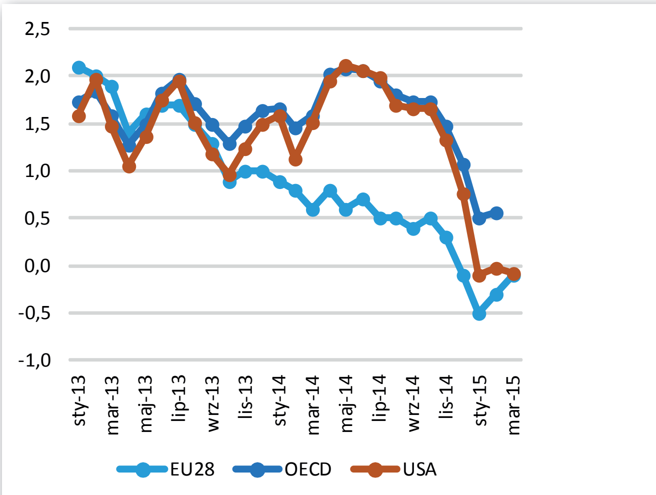
Source: Eurostat, World Bank staff calculations

INFLATION FELL IN 2014 BECAUSE OF LOWER ENERGY AND FOOD PRICES AND SUSTAINED OUTPUT GAPS

Declining food and global fuel prices, combined with still significant output gaps, led to falling, and sometimes negative, inflation in the EU members. In the EU on average, prices fell 0.1 percent from a year earlier in December 2014. The sharp decline in food prices in Europe reflects a combination of regional developments, such as a good harvest in Romania and the introduction of embargoes and countersanctions on European food exports to Russia, as well as global price declines. The drop in energy prices is largely driven by global developments. In addition, the slow recovery in the EU, undermined by increased geopolitical tensions, suppressed 12-month core inflation, which fell to 0.6 percent in March 2015, compared to around 1.5 percent in the US and other OECD countries. While in the first months of 2015 12-month headline inflation stayed negative, the pace of price declines diminished, as a result of the ECB's expanded QE program and associated depreciation of the Euro against other major currencies (see Box 2).

Figure 10. EU inflation rates have fallen rapidly

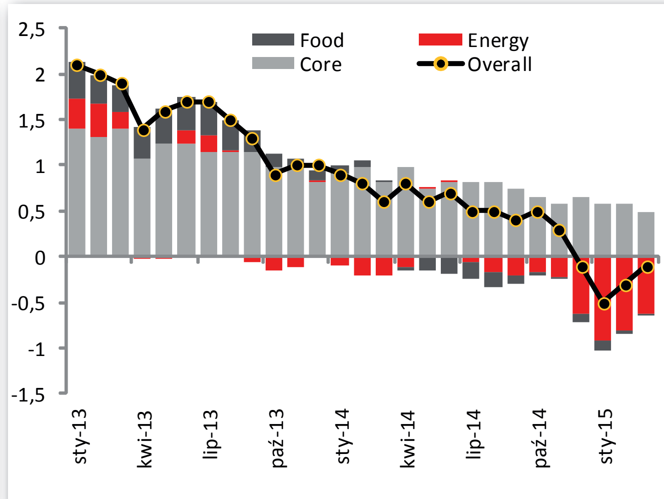
Consumer inflation, 2013-15, percent change year-on-year



Source: Eurostat, World Bank staff calculations

Figure 11...driven by energy and food prices

Contributions to headline inflation in EU, 2013-15, percentage points

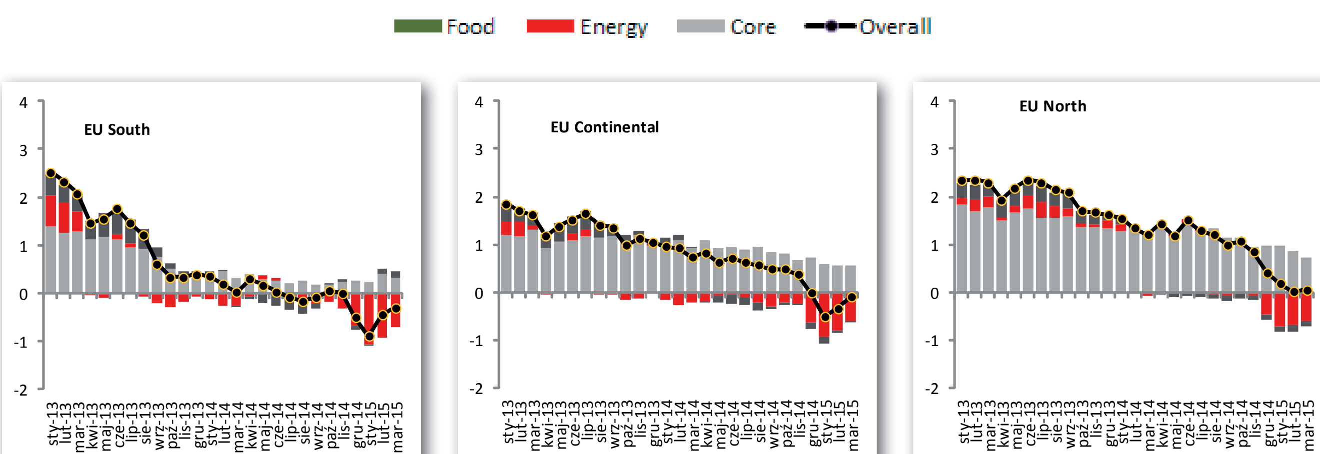


Source: Eurostat, World Bank staff calculations

Inflation rates turned negative first in EU South in 2014, with EU Continental following in 2015. Negative output gaps, low core inflation in EU South, accompanied by falling food and oil prices pushed the consumer price index to negative territory in mid-2014. Declining food and energy prices have been common for all three sub-regions of the EU, although decreasing price pressures have started to ease as international oil prices may have stabilized. Despite strengthening growth performance, core inflation in EU Continental has also continued to trend downwards, consistent with the large output gaps and high unemployment still faced by many EU countries, leading to overall price declines in early 2015. In EU North core inflation has been highest, reflecting stronger economic growth and employment, and headline inflation remains positive.

Figure 12. Core inflation remains low but positive in most regions of the EU

Contribution to headline inflation rate, 2013-15, percentage points



Source: Eurostat, World Bank Staff calculations

THE ECB EXPANDED ITS STIMULUS PROGRAM IN RESPONSE TO LOW INFLATION AND LARGE OUTPUT GAPS

The euro exchange rate has depreciated strongly amid the expansion of the ECB's quantitative easing (QE) and the expectation that the US Fed will gradually adopt a less accommodative monetary policy stance. The ECB's QE was introduced to counter the very low levels of inflation and to bolster the recovery (see Box 1). Inflation expectations remain muted and output gaps elevated in the EU and Japan, particularly in comparison to the US and UK, which has led to the ECB introducing the 'Asset Purchase Program' (APP) in 2015. This comes after the US and UK ended their QE in late 2014, and are contemplating a gradual rise in policy rates, though no earlier than late 2015. The divergence in monetary policies between the ECB (and Japan) and the USA (and UK) – and a similar divergence in economic outlooks, modest as it may be – have become a key factor for foreign exchange rates and capital movements in the second half of 2014 and early 2015. The euro has experienced substantial fluctuations compared to some other major currencies since the beginning of this year. While the Euro has weakened substantially against the US Dollar and the Pound Sterling, it has experienced more limited movements against most other EU currencies in the context of accommodative monetary policy actions taken by several central banks in the EU. In contrast, the Euro appreciated strongly against the Russian Ruble, which came under pressure amid geopolitical tensions related to the situation in Ukraine.

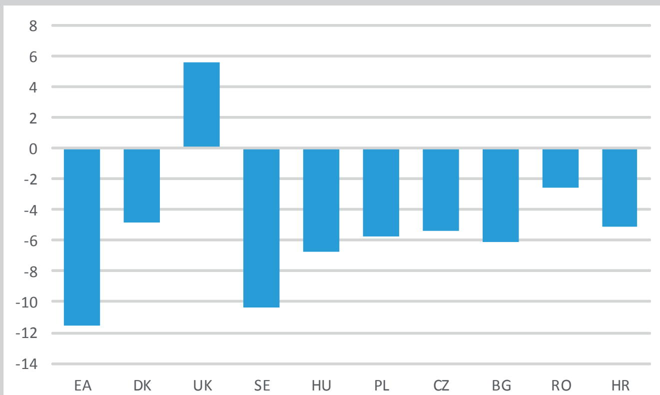
EU-CEE countries have experienced some of the highest rates of deflation across the EU, despite continuing to ease monetary policy. Bulgaria had the largest negative inflation rate for consumer prices in the EU in 2014, at an average of 1.6 percent over the year (compared to Greece who recorded a decline of 1.4 percent), as falling international prices combined with administrative cuts in electricity prices and in prices of some services (healthcare, telecommunications, and transport). Poland's inflation rate turned negative in the second half of the year as it experienced some of the strongest declines in food prices across the EU, owing to a good harvest and the impact of the sanctions and embargos with Russia. With little core inflation, Poland's Monetary Policy Council decided to reduce the key interest rate by 100 basis points in two steps in October 2014 and March 2015, bringing it to the historically low level of 1.5 percent. Prices also continued to fall in Croatia in 2014, at 0.2 percent over the year, as the economy continued in recession. Despite a downward trend, headline inflation in Romania was the highest in the EU (1.6 percent in 2014), as food and services prices rose, mainly as a result of the currency depreciation. Below target inflation also led the National Bank of Romania to lower the main policy rate from 5.25 percent in June 2013 to 2 percent by April 2015. Similar trends were witnessed elsewhere across the sub-region with prices declining in Slovakia and at zero in Hungary in 2014, before becoming negative in early 2015.

Box 1. ECB's QE aims to stimulate activity and bring inflation back to target

In early March, the ECB Council announced additional measures to ease monetary policy through an expansion of its Quantitative Easing (QE) program. Starting in April 2015, the ECB commenced monthly purchases of public and private sector securities amounting to EUR 60bn, under the APP, which incorporated the more limited Targeted Long Term Refinancing Operation (TLTRO). AAP is intended to last until September 2016, adding around EUR 1.1 trillion to the markets. It aims to set EU inflation on a sustained adjustment path consistent with achieving the target of below, but close to, 2 percent over the medium term. There will be no primary market purchases under the QE (i.e. direct purchases from issuers such as governments), regardless of the type of security. However, there is flexibility for national central banks to purchase their shares within the universe of eligible instruments.

Figure 13. The Euro has fallen significantly

Percent change in real effective exchange rate, Jan. 2014-Mar. 2015



Source: BIS

The QE program has begun to feed through to the economy via a number of channels. Firstly, it provides a signal that interest rates in the EU should remain low for a sustained period, informing the asset placement decisions of both investors and portfolio managers. It is also impacting sovereign bond yields directly—particularly as new issuance has fallen in line with lower government deficits in many countries—and yields on short-term government debt have turned negative in some countries (see below). As liquidity has increased, equity markets have also surged across Europe, mirroring the experience of QE in the US and UK. In addition, the Euro exchange rate has fallen against most major currencies, providing a boost for exporters as well as raising import prices, which should directly boost inflation. The real effective exchange rate of the Euro area (i.e. the exchange rate adjusted for trade and inflation) has depreciated by almost 10 percent since the start of the year. However, the impact has been much less pronounced outside the Euro area, in countries like Hungary, Poland, Romania and the Czech Republic, where real effective exchange rates have diverged. The UK and Switzerland have witnessed significant currency appreciation, partly as capital has flowed in to these well-performing economies.

THERE ARE WELCOME SIGNS THAT CREDIT IS PICKING UP AND STARTING TO SUPPORT INVESTMENT

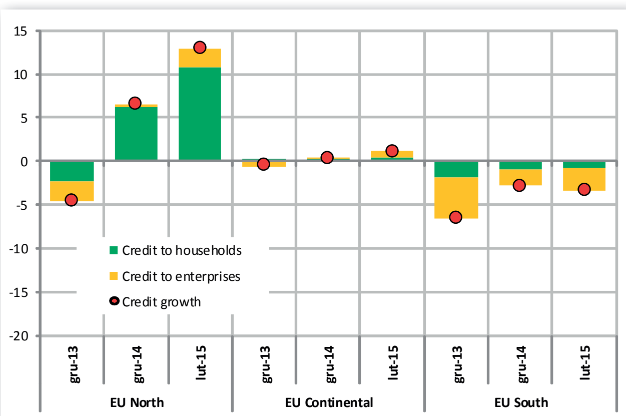
Financing conditions improved substantially as 2014 drew to a close, thanks to improving bank balance sheets and market expectations that the ECB would expand its QE program. Yields on long-term government bonds declined, with short-term yields in several countries turning negative (i.e. in Austria, Belgium, Germany, Finland, France and the Netherlands, while Poland issued a bond in Swiss Francs with a negative yield), with some volatility linked to the uncertainty surrounding Greece's continued access to financial assistance. Corporate bond spreads–both financial and non-financial issuers–also declined to levels close to those observed prior to the onset of the financial crisis. This was probably fuelled by expectations that the ECB's APP would result in portfolio-rebalancing effects and an increasingly difficult search for higher yields, and possibly reflects more positive market sentiment with regard to the ongoing effort to raise the capitalization of financial institutions across the EU. In an environment where lending rates have also fallen to very low levels, both the supply of and demand for bank credit have started to improve. The annual growth of credit to the private sector continued to recover as a result of the slower pace of the decline in loans to companies, while the growth of loans to households has stabilized.

Lower bank lending rates have supported credit growth. Although the subdued economic climate and historically tight lending conditions still weigh on loan provision, recent editions of the Euro area bank lending survey confirm credit supply tensions are gradually easing and point to rising demand for loans. The April 2015 Euro area bank lending survey points to further improvements in lending conditions as banks continued to ease credit standards for loans to the corporate sector in the first quarter of 2015, while for loans to households the picture was mixed. The easing for the corporate sector was attributed to the decline in the cost of bank funds and improved balance sheet conditions, as well as stronger competitive pressures among banks. The survey also shows that additional liquidity from the APP is being used by banks for granting loans. The survey points to a pick-up in demand for loans from non-financial corporations, for housing loans to households and for consumer credit. In this context, the low general level of interest rates has been an important driver of demand for loans to both firms and households.

Compared with mid-2014, credit conditions are slowly improving, but remain challenging in several countries. The strongest credit growth was recorded in EU North, driven solely by the strong performance of the UK. In other countries in the sub-region, the picture was mixed; credit grew over the year in Estonia, Denmark and Finland, while it continued to contract in the rest of the countries. The annual rate of change in loans to the private sector in EU Continental increased by an annual 1.2 percent in February 2015 as all countries recorded positive growth rates, including those countries where credit growth was still contracting during 2014 (i.e. Hungary, the Czech Republic, the Netherlands, Austria and France). In contrast, in EU South, the contraction in bank lending to the private sector moderated. Despite these positive trends, the consolidation of bank balance sheets and further deleveraging needs in some economic sectors and banking jurisdictions continues to curtail credit growth in most countries.

Figure 14. Credit is slowly picking up

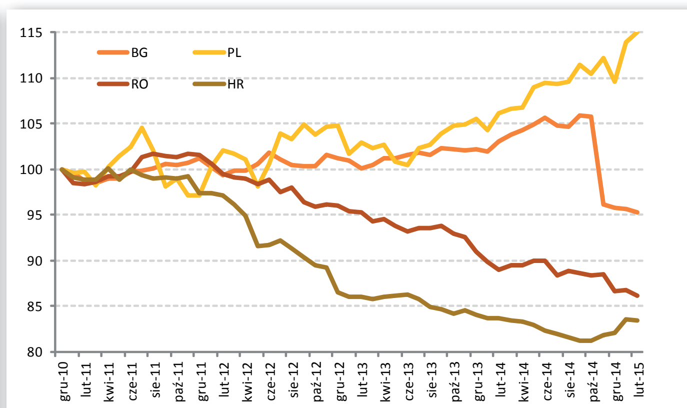
Private credit growth in real terms and contribution, percentage points



Source: ECB, World Bank staff estimates and calculations

Figure 15. Real credit trends continue to diverge

Index of real credit growth, Dec 2010=100



Source: ECB, World Bank staff estimates and calculations
Note: The real credit developments are not adjusted for statistical one-time effects.

Credit growth dynamics differed greatly among countries in Central and Eastern Europe (EU-CEE). Although bank lending has started a new recovery period driven by credit growth in a handful of countries, Croatia and Romania continue to record declines in credit to businesses. In contrast, Poland witnessed the restoration of corporate sector lending at the beginning of 2015, leading to sustained corporate credit growth as the economy has strengthened. Credit growth in Bulgaria contracted in November 2014, with a double-digit decline in corporate lending. The decline in corporate lending reflects the exposure of Corporate Commercial Bank (the fourth largest bank in Bulgaria), whose banking license was revoked in November on the basis of international auditors' assessments on the quality of assets and financial performance and consequently the bank has been excluded from monetary statistics since November 2014. Reassuringly, in the last three months of 2014, the average value of newly extended loans to the corporate sector continued to match that of early 2014. As of December 2014 claims on the household sector recorded a 1.6 percent decline on an annual basis.

Some encouraging signs can be seen in the resolution of Non-Performing Loans (NPLs) among EU-CEE. The resolution of NPLs continues to be one of the major priorities to bolster credit growth, and a concerted effort by regulators and banks is needed to speed up write-offs and facilitate loan restructuring, as it is already happening in some countries. NPLs in Croatia decreased to 17.1 percent at end-2014, from 17.2 percent in September 2014, but are still significantly higher than in 2013 (15.7 percent). Corporate sector NPLs reached 30.8 percent, while household NPLs amounted to 12 percent. In Romania and Bulgaria, banks continued with their efforts to reduce NPLs, but they continue to remain at an elevated level above 15 percent. On the other hand, NPLs in Poland remained below 5 percent.

Figure 16. Credit demand is increasing in Emerging Europe

IIF EM Bank Lending Conditions by Category, diffusion index, 50=neutral

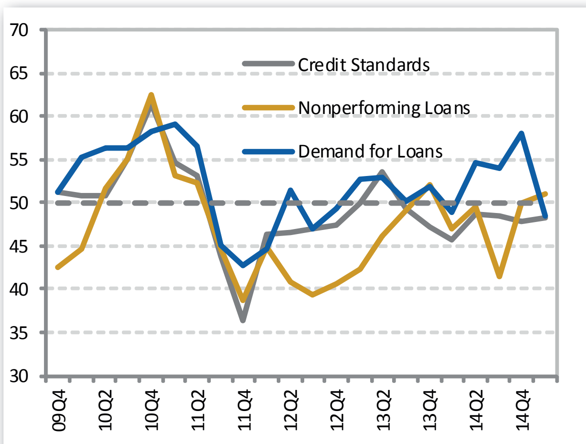
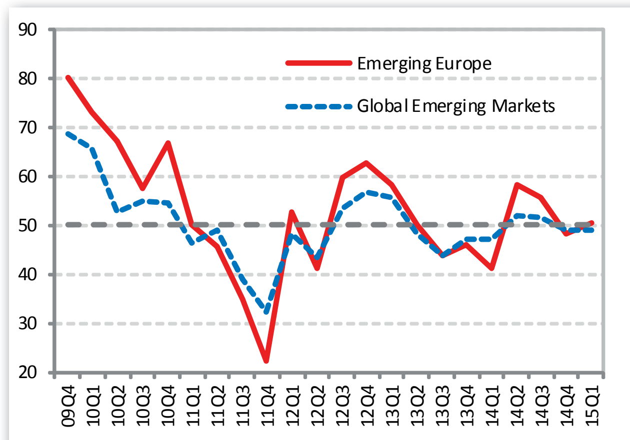


Figure 17. Funding Conditions are easing

IIF EM Funding Conditions, diffusion index 50=neutral



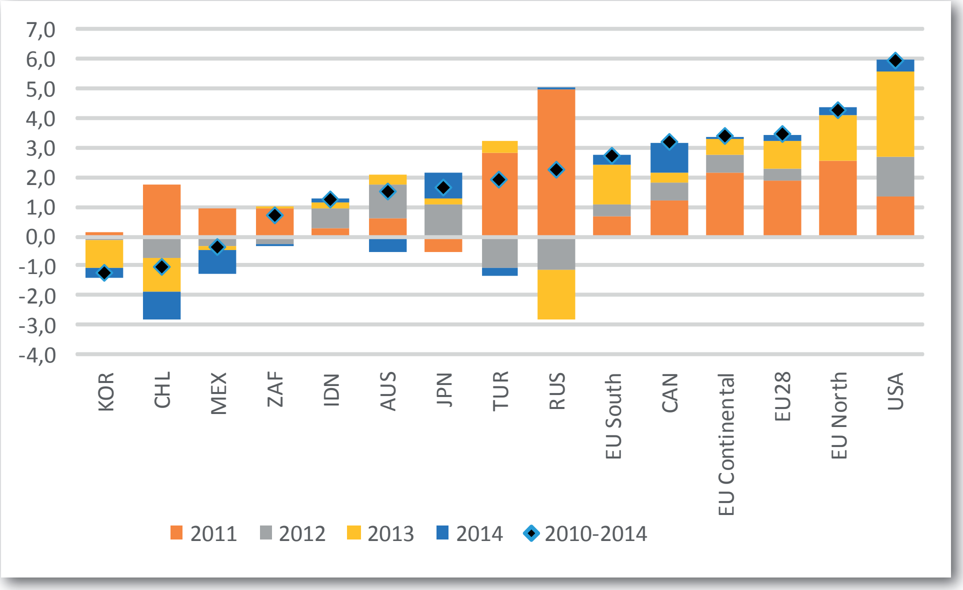
Source: IIF, World Bank staff calculations.

FISCAL CONSOLIDATION CONTINUED, BUT THE PACE IS EASING

Fiscal consolidation has helped bring down deficit levels and rebuilt some fiscal space. The European Union has achieved significant fiscal consolidation, which has helped reduce fiscal deficit levels to below 3 percent of GDP in many countries. These deficit levels were last seen before the outbreak of the global financial crisis. Most of the fiscal effort in Europe was frontloaded in 2011, while in the US, the biggest fiscal adjustment took place in 2013. The fiscal effort in 2014 was much lower, reflecting less urgent need for further adjustment and the aim of supporting the nascent recovery, although many countries are still aiming to reach lower medium-term deficit targets and reduce still high public debt levels.

Figure 18. Fiscal consolidation has been significant

Reduction in fiscal deficit by year, percentage points of GDP



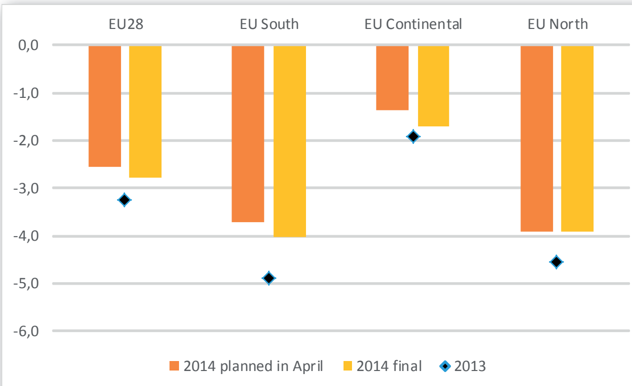
Source: Eurostat, OECD, World Bank staff calculations

Fiscal deficits declined across Europe in 2014, with the aggregate level below the Stability and Growth Pact threshold. The EU-wide fiscal deficit declined from 3.2 percent of GDP in 2013 to 2.8 percent of GDP in 2014, driven largely by improvements in revenue collection as stronger domestic demand boosted VAT and income tax receipts. The already low, and declining, fiscal deficit in EU Continental, at 1.7 percent of GDP in 2014, is the main driver of the EU-wide outcome. In terms of deficit reduction in 2014, the majority of the fiscal adjustment came from EU South, where the fiscal deficit declined from 4.9 percent of GDP in 2013 to 4 percent of GDP in 2014, reflecting significant deficit reductions in Greece, Spain and Slovenia. In EU North the fiscal deficit declined by 0.6 percent of GDP due to strong improvements in the fiscal positions of Denmark, Lithuania, Ireland, and the UK. Reflecting the improved fiscal performance, in 2014 the European Council closed excessive deficit procedures (EDP) for Belgium, the Czech Republic, Denmark, the Netherlands, Austria and Slovakia, leaving 11 countries subject to the EDP, down from 24 during 2010-11[4].

4 The EDP applies to countries having breached or being in risk of breaching the deficit threshold of 3 percent of GDP or having violated the debt rule by having a government debt level above 60 percent of GDP, which is not diminishing at a satisfactory pace. The 11 countries still under the EDP in 2015 include: Croatia, Malta, Cyprus, Portugal, Poland, the UK, Slovenia, France, Ireland, Greece and Spain. In May 2015 the European Commission recommended to the European Council to close the EDP for Malta and Poland.

Figure 19. The fiscal consolidation effort continues…

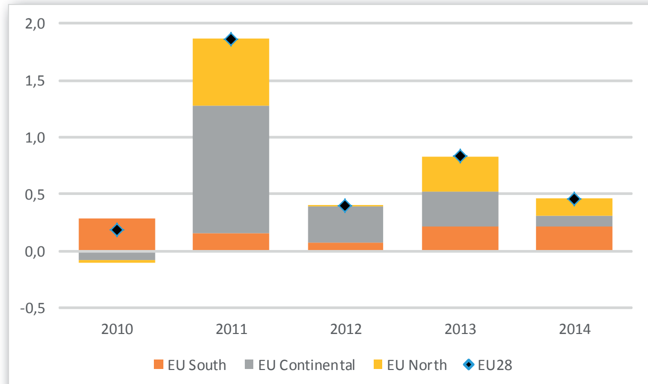
Fiscal balances in 2013-14, percent of GDP



Source: Eurostat, World Bank staff calculations

Figure 20. …across all regions of the EU

Reduction in fiscal deficit by sub-region, percentage points of GDP

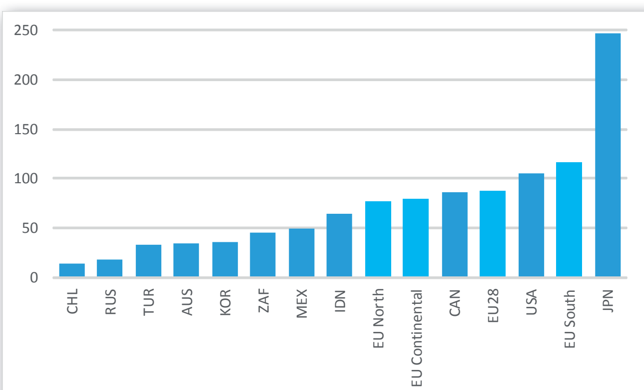


Source: Eurostat, World Bank staff calculations

Public debt levels remain elevated and are among the highest in the OECD, reflecting large debt accumulation in the post-crisis years. While the overall increase in indebtedness in 2010-2014 in Europe was very similar to the US, there is a significant variation within the EU. In particular, public debt in EU South increased by more than 25 percent of GDP and its level is now well above 100 percent of GDP. The pace of debt accumulation in Europe slowed markedly in 2014, reflecting better fiscal positions of many countries and higher economic growth.

Figure 21. Public debt levels have increased

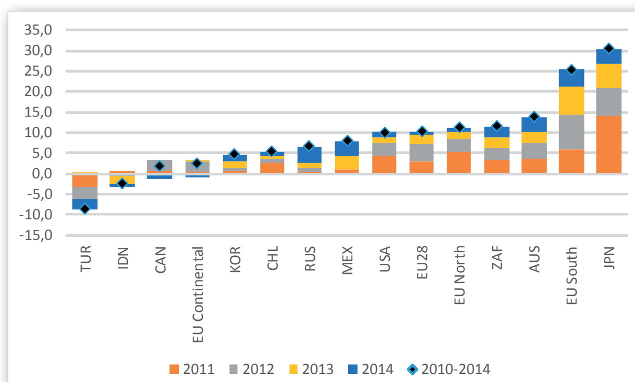
Public debt to GDP ratio, percent



Source: Eurostat, OECD, World Bank staff calculations, 2014

Figure 22. The rate of debt increase has slowed

Change in public debt to GDP ratio, percentage points of GDP



Source: Eurostat, OECD, World Bank staff calculations

Fiscal positions have improved across most countries in EU-CEE. While average debt levels in countries in EU-CEE are generally below the EU average, at just over 50 percent of GDP, they have risen above 75 percent in Cyprus, Hungary, Croatia and Slovenia. Of these, Hungary managed to keep its fiscal deficit below 3 percent of GDP, despite a stimulus in 2014 from increased investment spending that resulted in the deficit rising to 2.6 percent of GDP, (this was below budget expectations as tax revenues outperformed).

Fiscal consolidation continued in Poland. The fiscal deficit narrowed to 3.2 percent of GDP in 2014 from 4 percent in 2013, due to stronger-than-expected revenue collection as domestic demand pushed up VAT receipts. In addition, changes to second pillar pensions have reduced the government's social contributions. Expenditures are also expected to have turned out lower than in 2013 largely due to the continued freeze in public sector wage levels and lower interest payments. Given Poland's fiscal balance in 2014 and taking into account the cost of systemic pension reform of 0.4 percent of GDP, the European Commission recommended that the European Council abrogates the EDP for Poland in 2015, i.e. one year ahead of schedule. The public debt stock declined to 50.1 percent of GDP in 2014 from 55.7 percent in 2013, as the reform of the second pillar pension reduced the debt stock by some 7.6 percent of GDP (as government bonds were returned to the government balance sheet).

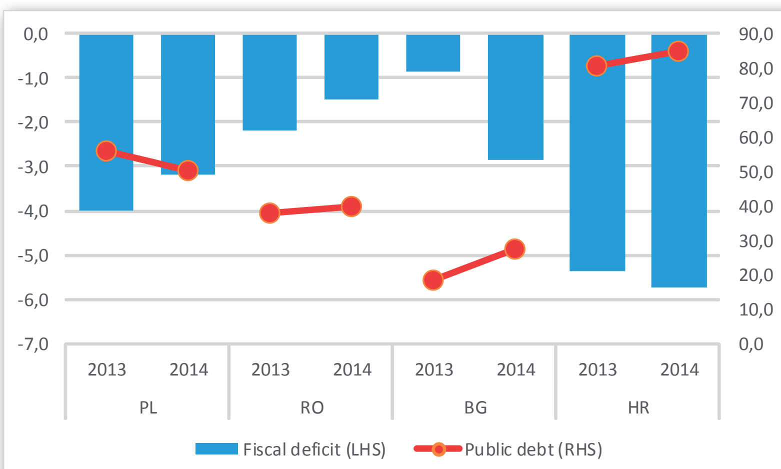
In Romania, the fiscal deficit reached 1.5 percent of GDP, down from 2.2 percent of GDP in 2013. The outturn masks the low absorption of EU funds and delays in implementing structural reforms, in particular the liberalization of gas prices for households and the restructuring of the state-controlled energy generation sector.

The fiscal deficit on accrual basis rose to 2.8 percent of GDP in Bulgaria, up from 0.9 percent of GDP in 2013 mainly as a result of expenditure slippages in healthcare sector and weaker than expected revenues. The Government provided support to the banking sector at the level of 2.4 bln BGN, equivalent to nearly 3 percent of GDP. The Government issued additional debt, pushing the debt stock up by 9.3 percentage points of GDP, compared to the end of 2013. Nevertheless, Bulgaria still has one of the lowest government debt-to-GDP ratios in the EU, at around 28 percent.

The fiscal deficit reached 5.7 percent of GDP in Croatia, and was significantly higher than the indicative target agreed under the EU Excessive Deficit Procedure (EDP). The target under the EDP was 4.6 percent of GDP. Revenues were underpinned by improved social security contributions due to increase in health insurance contribution rate, while expenditures rose, reflecting growing interest payments and transfers to the EU budget (while the absorption of EU funds for projects was conversely very low). This contributed to a further rise in public debt to 85 percent of GDP.

Figure 23. Fiscal deficits and debt in Poland, Romania, Bulgaria and Croatia

Fiscal deficit and public debt to GDP ratio, percent



Source: Eurostat, World Bank staff calculations

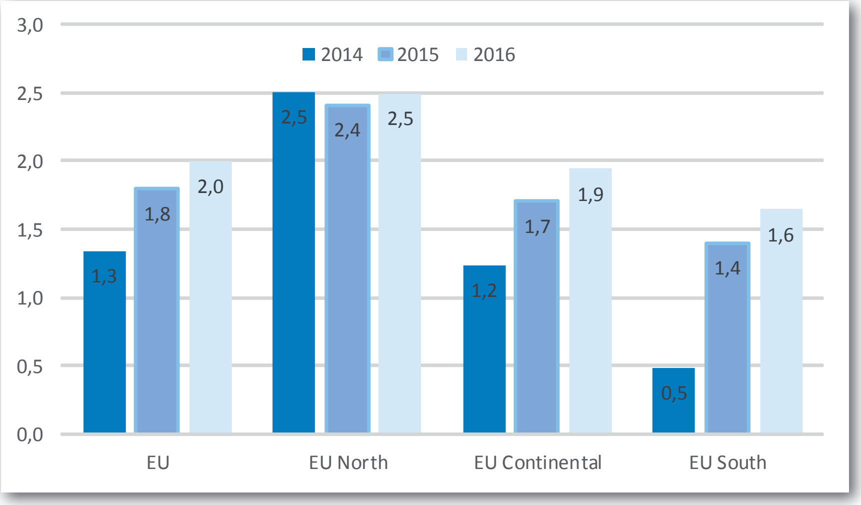
OUTLOOK

EU'S RECOVERY IS STRENGTHENING IN A DIVERGING WORLD

All the economies of the EU are expected to grow in 2015 and 2016, the first time this has happened since 2007. Domestic demand looks set to become the main engine of growth across the EU as confidence in the modest global recovery grows, bolstered by the heavy reliance on robust growth in the US, as above trend growth and job creation carry over into 2015. Meanwhile, activity in China and the other BRICS, except India, is expected to continue to moderate. While the decline in oil prices should support medium-term growth, the prospects for oil importers and oil-exporters will diverge in the short-term as the exporters face a tough adjustment process. The diverging global growth rates are also likely to be reflected in diverging monetary policy, with the US and UK expected to start to gradually raise interest rates, though not earlier than late 2015, while the EC, Japan and China amongst others continue an easing cycle.

Figure 24. Growth is set to strengthen

GDP growth 2014-16, percent

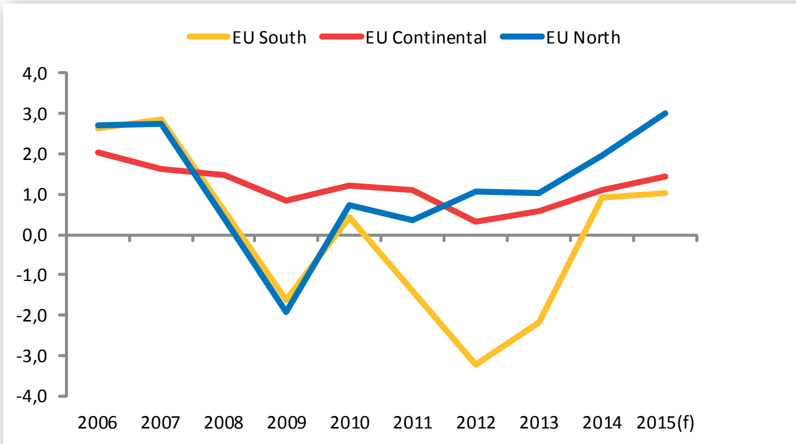


Source: Eurostat, World Bank staff estimates and calculations

Private consumption is set to continue growing in 2015, as the purchasing power of households increases. This reflects improved labor market conditions (i.e. increasing employment, low inflation and growing real wages), combined with the substantial decline in oil prices which is boosting real disposable income throughout the EU, a large oil importer. However, private consumption is not expected to return to pre-crisis levels for some time, given the tighter credit conditions and still high public and corporate debt levels in many parts of the EU. After two years of decline, investment also looks to 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.

Figure 25. Domestic consumption is expected to be the main driver of growth

Percent change, 2006-2015



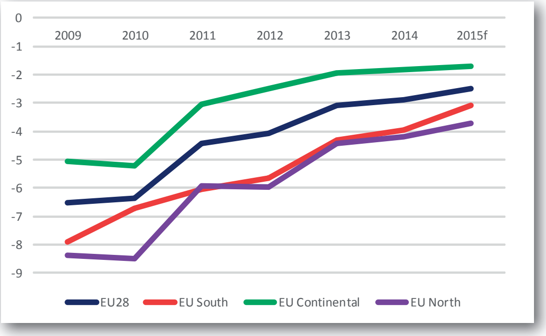
Source: Eurostat, World Bank staff estimates and calculations

Inflation across the EU is likely to bottom out in 2015, before gradually picking up. EU inflation is forecast to fall from 0.4 percent in 2014 to 0.1 percent in 2015, before rising to around 1.5 percent in 2016, as stronger domestic demand and base effects (from the fall in oil and food prices) gradually lift prices higher. This view is also supported by inflation expectations surveys conducted by the ECB, which show that professional forecasters expect prices will rise over the next 12 months, even in the countries that are experiencing outright deflation.

The drag from fiscal consolidation is also set to moderate. The adjustment in governments' fiscal deficits is projected to be more gradual than in previous years, as the fiscal situation across the EU has improved markedly and the need for urgent fiscal consolidation lessened. In addition, the much lower interest costs provide the opportunity to meet headline targets while easing the pressure to reduce other types of spending. The aggregate fiscal deficit is expected to drop from 2.9 percent of GDP in 2014, to 2.5 percent of GDP in 2015. After a rapid period of restructuring, the EU Continental countries are enjoying the best fiscal outcomes among the EU sub-regions, led by Germany whose deficit is expected to remain around 0.5 percent of GDP. While a number of countries are not expected to be able to comply with the EU threshold deficit levels of 3 percent of GDP in 2015—these include Croatia, France, Portugal, Spain, Slovenia, and the UK—significant progress is expected to continue to be made to achieve this in either 2016 or 2017. As the economic situation improves, the cyclical factors will increasingly support the consolidation effort, meaning that although the consolidation will continue, the pace and its drag on overall economic growth, is expected to moderate.

Figure 26. As the fiscal drag moderates

Fiscal balance, percent of GDP, 2009-2015



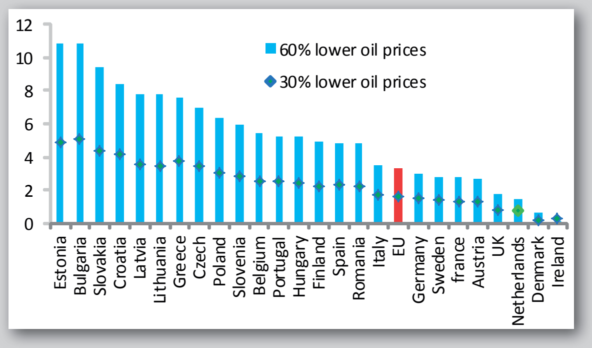
Source: Eurostat, World Bank staff estimates and calculations

Box 2. The impact of low oil prices for the EU

Global oil prices plunged by about 60 percent, from USD 115 per barrel in mid-June of 2014 to USD 48 at end-January 2015, while other fuel prices have continued the slow downward trend of recent years. Oil prices have begun to find some support in early 2015, but are expected to remain well below their 2013 levels during the next decade. Second-round effects of low oil prices on other commodities, together with robust supplies and soft demand, are expected to keep prices low for most other commodities in the medium-term.

The fall in oil price is expected to provide a positive boost to the global economy as a whole, but the effects will vary across countries. A 30 percent oil price decline, driven by a supply shock, would be associated with an increase in world GDP of about 0.5 percent in the medium-term (World Bank Global Economic Prospects, January, 2015). In the oil importing EU, the lower oil price leaves consumers more disposable income, which they can spend on various goods and services, and reduces production costs in energy-intensive sectors, which do not extract but use oil. The EU-CEE would benefit more than most countries because their economies are relatively oil intensive. The figure below shows the long-term impact of a 60 percent drop in oil prices on private consumption, where coal and gas prices also fall, by around 50 and 30 percent respectively.

Long-term impact of oil price changes on private consumption (percent change)

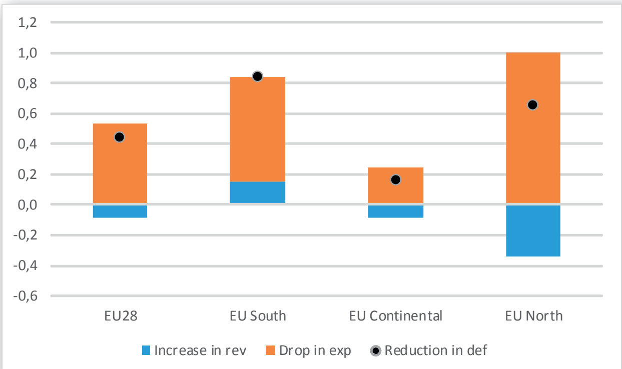


Cheap oil and other fossil fuels also create a challenge for alternative low-carbon technologies, which suddenly become less attractive. If fuel prices remain low, a further switch towards low- or zero-carbon technologies will depend largely on energy and climate policies and regulations, rather than market-driven prices of fossil fuels. The EU has the most ambitious climate policy targets for 2020 of any region of the world, and carbon emissions are controlled by the EU Emissions Trading Scheme (ETS) and national non-ETS emission limits. The carbon price in the EU helps control emissions by raising the relative price of carbon-intensive fuels—as a result, improvements in EU terms of trade due to falling world oil prices would provide less of a boost to welfare.

Source: World Bank, Low Oil prices: Long-term Economic Effects for the EU and other Global regions, Kasek and Boratynski, MFM Discussion paper No. 3, March 2015

Figure 27. The fiscal consolidation continues to rely on expenditure reduction

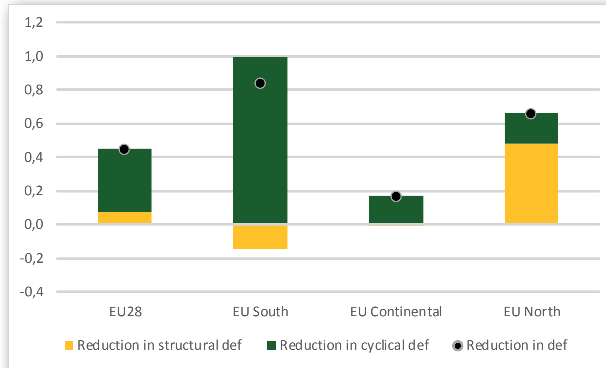
Reduction in fiscal deficits, percentage points of GDP



Source: EC, World Bank calculations

Figure 28. The economic cycle is helping to reduce fiscal deficits

Reduction in fiscal deficits, percentage points of GDP



Source: EC, World Bank calculations

There are divergent trends in the EU-CEE. Economic prospects for the Baltic countries are mixed. Geopolitical tensions, leading to a dearth of external demand, and particularly the massive depreciation of the Russian Ruble and slow growth in Finland, will continue to constrain exports, although domestic factors should continue to support economic growth of over 2 percent, with tightening labor markets and rising wages. In the Czech Republic, Hungary, and the Slovak Republic growth is expected to be supported by robust domestic demand in 2015 while the contribution of net exports is set to increase in 2016 and beyond, as the EU recovery continues to gather pace.

Resilient domestic demand will continue to support Poland's robust economic growth. GDP is forecast to grow around 3.6 percent in 2015 and in 2016. Domestic demand is expected to remain the main driver of growth backed by strong consumption and investment growth. Investment activity will benefit from the roll-out of new projects financed by EU structural funds and the ongoing recovery of credit growth to enterprises. Private consumption growth is forecast to reach 3.3 percent, as strong employment expansion reduces the unemployment rate to pre-crisis levels. This should put upward pressure on wages and raise disposable incomes. In addition, increased fiscal space from continued consolidation has allowed for a scaling up of some areas of social expenditure such as the child tax credit to families, and also more generous pensions indexation. This will further support the growth of real household incomes. Continued fiscal consolidation will allow Poland to gradually move towards the medium term objective of 1 percent of GDP in structural deficit, requireing an additional fiscal consolidation of 1 percentage point of GDP. The main fiscal adjustment continues to come from limiting aggregate expenditure for the general government in line with the recently introduced expenditure rule. The Government has also taken discretionary measures to adjust the structure of public expenditures by continuing the freeze of public sector wages, the abolition of early retirement schemes, increases in the retirement age, and the stream-lining of administration costs.

The economic outlook for Romania is positive, but risks remain. Real GDP growth is projected at around 3 percent, supported by further recovery in domestic demand. Private consumption will likely remain the main driver of growth on the back of an increase in real disposable income and positive labor market developments. An anticipated pick-up in the absorption of EU funds would support a recovery in investment. Current account deficit is expected to widen a little, driven by a rise in imports, but it would still remain at around 1 percent of GDP. For 2015, structural fiscal deficit will be around 1.0 percent of GDP (1.8 percent on a cash basis), bringing Romania in line with its Medium Term Objective (MTO) under the EU Fiscal Compact. However, in late March the Government proposed a package of tax reductions—in VAT, excises, construction tax, dividends, etc.—to be implemented from 2016. In the absence of compensatory measures, the adoption of the package would have an adverse impact on the fiscal deficit. With average inflation expected to remain around zero in the first half of 2015, the NBR may also be prompted to ease its policy rate in the coming months. However, the positive macroeconomic situation is partly overshadowed by delays in implementing structural reforms, in particular the calendar for the liberalization of gas prices for households and on the restructuring of the state-controlled energy generation sector. Renewed policy attention is needed to improve the efficiency of public spending, in particular in the area of public investment.

In Bulgaria, economic recovery is projected to be modest, with growth projected to slow to 1.1 percent in 2015, picking up to only 2 percent in 2016 and 2017. The recovery is constrained by tightening fiscal policy to reduce the deficit back to 3 percent of GDP in 2015, and to narrow it by 0.5 percentage points of GDP per year in 2016 and 2017, according to fiscal data on cash basis. Deficit reduction in 2015 relies on conservative revenue estimates, consolidation of wage spending and savings in health spending. Specific downside risks relate to the effectiveness of expenditure consolidation measures, weakening of VAT revenues as a result of lower oil prices, and uncertainty about the outlook in the EU. On the upside, changes to pension legislation might lead to an inflow of funds to the public pension fund from private pension funds. Furthermore, the government efforts to increase tax complience have already brought results in higher revenues in the first quarter of 2015.

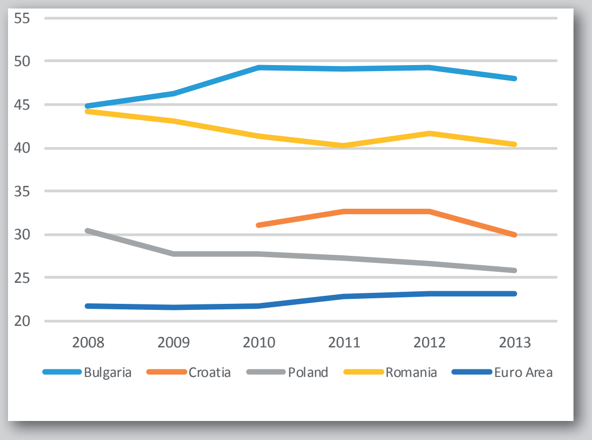
In Croatia, economic activity is expected to recover at a very modest pace. Real GDP growth is expected to strengthen gradually, from 0.5 in 2015 to 1.5 percent in 2017. Tourism and business services are expected to continue growing, with exports of pharmaceuticals, and the clothes and car industry supply chains to Italy and Germany supporting manufacturing growth. As the absorption of EU funds strengthens in 2015, investments into R&D and public infrastructure are expected to turn positive, generating jobs for the large pool of unemployed construction workers. In addition, negligible inflation, particularly in the energy and transport sectors, will boost real incomes, including among the poor, who spend over 10 percent of their total income on these items. However, household demand will pick up less robustly due to high unemployment and indebtedness, and tightening in credit standards. Private consumption is projected to grow by a modest 1.2 percent, while government consumption is projected to remain subdued due to the required fiscal consolidation under the Excessive Deficit Procedure (EDP) with the EU and large public sector borrowing requirements in 2015 at around 18 percent of GDP.

Box 2: Poverty trends and outlook in selected countries

Poverty rates have risen in many countries in the EU since 2008. The percentage of people at risk of poverty and social exclusion[1] in the Euro area rose from about 21.7 percent in 2008 to 23.1 percent in 2013. The increase has been felt most acutely in countries that underwent the largest economic contractions and where unemployment, particularly youth unemployment, remains high. However, as growth rates began to pick up in 2013 and 2014, countries have seen a gradual recovery in employment. We discuss below the experience and outlook for four countries, based on the US$ 5/day (purchasing power parity) measure of the poverty rate, which highlights the important role played by job growth and social policy in reducing poverty.

Figure 29. People at risk of poverty and social exclusion

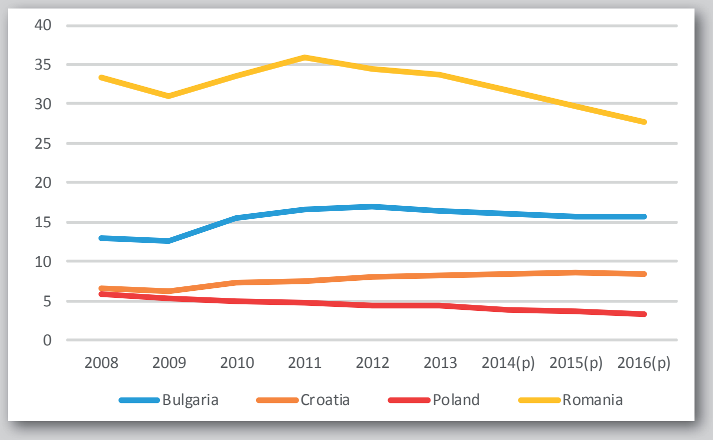
2008-2013, percent



Source: Eurostat

Figure 30. Actual and projected poverty rates

2008-16, US$ 5/day (PPP) percent



Source: Eurostat, EU-SILC, World Bank staff calculations

In Bulgaria, poverty remains above pre-crisis levels, as job losses have been the most severe in low-skilled jobs and fiscal consolidation has reduced the scope for social transfers. Poverty is expected to decline only gradually, based on the forecast for a modest economic recovery and gradual reduction in unemployment. The measures designed to tackle poverty include the newly adopted tax relief on taxpayers with children and existing child benefits (for a second child or twin and children with disabilities), financial support to cover heating costs for people with average monthly income for the previous six months below a defined threshold, an increase in the minimum wage, and the Youth Guarantee program to help youth back into employment or training.

Croatia has witnessed six years of recession and, despite support from active labor market policies, unemployment remains high, with about 60 percent of the unemployed having been jobless for more than a year, while youth unemployment exceeds 40 percent. While labor force participation rates started to improve in 2014, and declining prices have bolstered real wages, these developments were not sufficient to generate significant labor income growth among the poor and ultimately translate into poverty reduction. However, real pensions have grown as the Government abolished negative indexation, based on wage and price declines. It is estimated that the poverty rate continued to rise in 2014 and, going forward, social transfers and pensions will remain constrained under the fiscal consolidation pressure of the Excessive Deficit Procedure. Nonetheless, the Government has announced a debt relief scheme for the poorest households with monthly earnings below Kuna 1,250 (about Euro 165) and debts of less than Kuna 35,000 (around 4 percent of the population).

In Poland, the economic crisis in 2009, and subsequent slowdown in growth, moderated the sustained trend in poverty reduction. Faster growth in 2014 helped reduce unemployment markedly, to 8.2 percent in December 2014 from 10 percent the previous year. This is the lowest rate of unemployment since 2008, with the number of unemployed falling by 310,000 over the period. Job creation and strong real wage growth in the enterprise sector (despite an ongoing freeze in public sector pay) boosted private consumption and the poverty rate continued to decline. In 2015, the increased fiscal space has enabled a scaling up of some areas of social expenditure, such as the child tax credit to low-income families, and also more generous pension indexation, which should support further growth in real household incomes.

In Romania, economic recovery, improved labor market conditions and increased support to vulnerable categories have resulted in a steady decline in poverty rates. Increased allocations to the minimum guaranteed income, family benefit and heating benefit programs, as well as increases in the minimum wage, have contributed to the decline in poverty. Going forward, the recovery of domestic demand and improvements in the labor market, aided by low inflation, should boost real incomes and further reduce poverty in 2015 and 2016. However, progress is needed in tackling youth unemployment, which remains high, through active labor market policies and the EU-wide Youth Guarantee.

WHILE THE RISKS TO THE OUTLOOK ARE BALANCED, THE DOWNSIDE RISKS ARE SIGNIFICANT

The recovery is underway in the EU, with strengthening domestic demand that is based on both rising consumption and investment. Indicators suggest that the pace of growth remains firm in the first two quarters of 2015, albeit at relatively modest levels compared to pre-2009 growth rates. While there has been considerable divergence in economic performance within the EU since the crisis, import compression and improving competitiveness have generally reduced external vulnerabilities, as current account deficits have narrowed and in many cases become surpluses. Significant progress has also been made in restoring fiscal sustainability and rebuilding prudential fiscal buffers, as the drag from fiscal consolidation starts to diminish. There have also been significant measures to improve the resiliance of the financial sector, including the Asset Quality Review in 2014, along with more stringent stress testing of banks, and moves towards a more robust banking union—while many measures remain to be completed before the banking union is operational, the banking sector appears more robust and is gradually easing the deleveraging cycle to provide credit as buiness demand also starts to pick up. Activity could also be bolstered by the Euro 315 billion investment program ("Juncker Plan") that is intended to stimulate growth and create jobs—implementation will be coordinated through the European Investment Bank and leverage significant private investment, and is scheduled to commence in the second half of 2015.

While the risks to the outlook for the EU remain broadly balanced, the downside risks are significant. These risks include the following:

- An upsurge in financial market volatility as the US Fed and ECB implement divergent monetary policies, with the US expected to start tightening monetary policy, albeit gradually, towards the later part of 2015 at the earliest. This could trigger further instability associated with the Euro exchange rate, capital outflows and/or fluctuations in bond and other asset markets. There have been periods of heightened volitility in Euro area government bond markets in 2015, as investors seek to adjust their positions, and in exchange rates, notably when the Swiss decoupled from the Euro link in January 2015.

- The risk of a prolonged period of stagnation and negative inflation expectations becoming anchored in the EU appears to have receded following the commencement of the ECB's QE program. However, a sustained period of low growth and subdued inflation will continue to put pressure on countries' public finances, as revenues will remain subdued, and pose a challenge for the pace at which many countries can reduce their substantial debt overhang and therefore rebuild the fiscal buffers needed to respond to future volitility.

- The EU, and particularly countries in EU-CEE that are very open to trade and external capital flows, remain vulnerable to external debt deleveraging pressures through parent bank funding of local subsidiaries. In addition, while further reforms to the banking sector, notably the establishment of a more integrated EU-wide banking union and a reduction in the high level of NPLs, would support long-term growth, they could initially expose weaknesses that require banks to raise additional capital. The continued withdrawal of capital and equity would further increase the reliance of companies on internally-generated resources and banks on domestic deposits for providing loan funds for investment. This in turn would reduce the availability of new lending and tighten credit conditions, which could hamper lending for new investment and constrain growth.

- An orderly resolution to the situation in Greece is a priority for the EU: although the direct trade and financial flows from Greece to the EU may be reasonably small, and so far there has been little contagion reflected in the bond yields of neighboring countries, this does not preclude greater instability in the future. In addition, many of the countries in the south eastern parts of Europe, such as Bulgaria, and Romania, might be exposed to any instability in Greece from both trade and financial flows. The recent election in the UK also poses additional concerns, with a referendum on the UK's EU membership promised for 2017. This uncertainty may weigh on the confidence of both consumers and investors across the EU. The geopolitical tensions between Russia and Ukraine also pose economic risks for the EU, the most immediate through geopolitical channels and the impact on consumer and investor confidence, rather than direct economic costs.

- There are also risks emanating from the global economy, notably as China seeks to implement a cautious reform program that was planned in November 2013. The plan involves restructuring local government financing and maintaining domestic demand through policy stimulus measures, although investment slowed in 2014 and this could weigh on global growth despite the strengthening of other emerging countries such as India.

- On the upside for the EU, lower oil prices should continue to support an increase in consumption. Prices appear to have stabilized somewhat in the first few months of 2015, although commodity prices are unpredictable and fluctuations are likely to continue to be a source of uncertainty.

SIGNIFICANT STRUCTURAL CHALLENGES NEED TO BE ADDRESSED TO ENSURE THE RECOVERY IS SUSTAINED

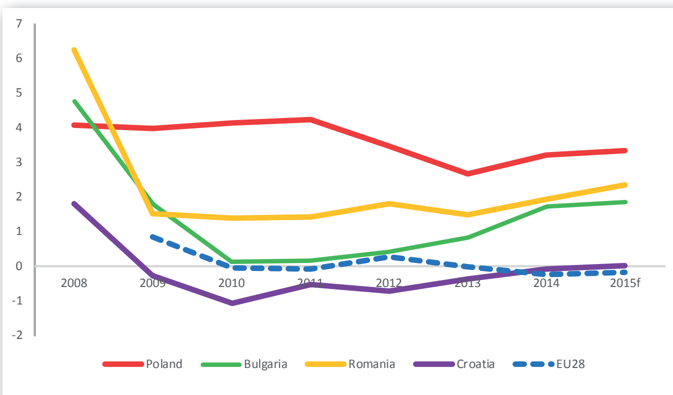
The major challenge for the EU is to ensure that the recovery—which is being fueled in part by the fall in oil prices and the ECB's stimulus—can be sustained over the long term as these factors become more benign. Of concern for the EU is the decline in potential growth rates in recent years: the current and projected decline in potential growth rates reflects both the impact of the rapidly aging societies in Europe, which have seen a falling supply of labor particularly in many EU-CEE countries[1], combined with falling rates of productivity and low levels of innovation[2].

1 See World Bank, 2015, Gray Areas: Aging and Public Policy Choices in Europe and Central Asia and East Asia Pacific.
2 See for example, World Bank, Poland Enterprise Innovation Support Review, 2013.

This suggests that the challenges in many countries may be shifting from fiscal and macroeconomic adjustment and towards structural measures to promote growth and competitiveness. The main macroeconomic balances have narrowed in the EU (e.g. fiscal deficits and current accounts) and indicators suggest impressive reform progress has been made, particularly at the periphery of the EU, for example in Greece, Portugal, Ireland, Spain, Poland, and Slovakia. As a consequence, many parts of the EU look to be emerging from a prolonged and painful adjustment period and are enjoying the rewards of reform with significant gains in growth dynamics and falls in unemployment. However, many of these countries need to continue the reform process to catch up with the most dynamic and resilient countries, both in Europe and then more globally (see Figure 32). The structural reforms include continuing to reduce labor market rigidities, enhancing the business environment[3], reducing barriers to trade (including in services within the EU), and promoting the skills needed for dynamic job creation and innovation[4]. This will need to be combined with affordable social policies that help to protect the most vulnerable, while promoting greater social and labor market inclusion[5].

Figure 31. Potential growth has been declining in the EU

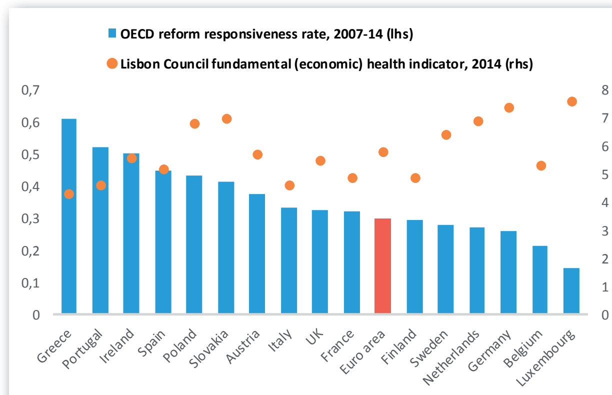
Rate of potential growth, percent



Sources: Eurostat, Ameco, World Bank.

Figure 32. Structural reforms remain incomplete in many countries

OECD and Lisbon Council structural reform indicators, indices



Sources: OECD indicator of policy actions taken versus prior OECD reform recommendation, one reflecting most action. Lisbon Council rank all indicators on a linear scale of 10 (best) to 0 (worst), based on trend growth, competitiveness, fiscal sustainability, and macroeconomic resilience. Data is not available for all EU countries.

3 See *Doing Business 2015: Going Beyond Efficiency*, World Bank.
4 See *Creating More and Better Jobs in Europe and Central Asia*, World Bank, 2013.
5 See Portraits of Labor Market Exclusion, World Bank, 2013.

Box 3: Further structural reforms are needed to promote a robust recovery:

EU Country Specific Recommendations for Bulgaria, Croatia, Poland and Romania

In May 2015, the EC released its annual country-specific recommendations (CSRs) for each member state[2]. The overarching aim this year is to make the recovery sustainable and prevent sluggish growth once the temporary tailwinds from low oil and food prices and the ECB QE fade. They focus on four key themes:

- Measures to boost investment: This entails the removal of barriers to financing, the launching of investment projects, as well as the implementation of the (Juncker) investment Plan for Europe.

- Continued structural reforms in product, service and labor markets are designed to increase productivity, competitiveness, investment and job creation. Financial market reforms aim to ease access to finance for investment and lessen the negative impact of deleveraging in the banking, private and public sectors.

- Striking a balance between short-term fiscal stabilization and long-term sustainability. Member States with high fiscal deficits or debt levels will need to make further efforts to achieve fiscal sustainability, while Member States with fiscal space are encouraged to take measures to support productive investment.

- Improving employment policy and social protection to activate, support and protect people and to ensure stronger social cohesion as key components of sustainable economic growth.

All Member States have taken some actions in addressing the issues identified in the previous country-specific CSRs. However, progress has been uneven and further reforms are required across the EU. In the case of Bulgaria, Croatia, Poland Romania, the EC highlighted the following priorities for reform:

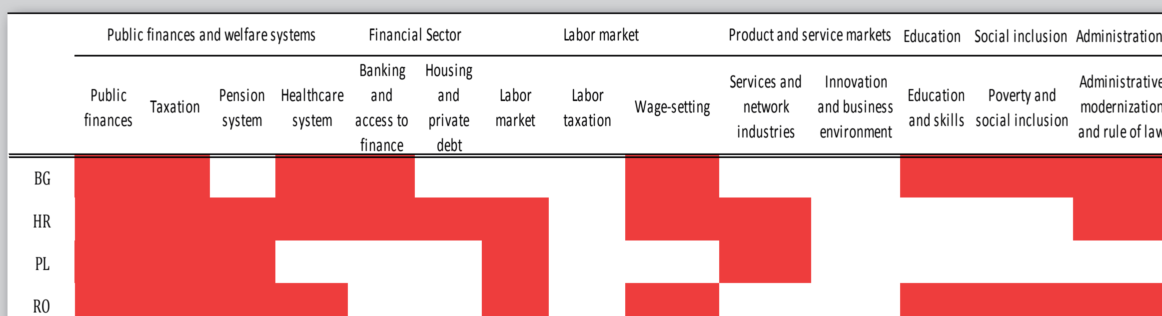
- Regarding the **removal of barriers to boost investment and support growth:** *Bulgaria* is urged to complete the asset-quality review and a bottom-up stress test of the banking sector while strengthening banking and non-banking financial sector supervision. In *Croatia,* the capacity of the financial sector to support the recovery would be bolstered by a resolution of corporate sector NPLs, reducing the exposure to foreign currency mortgage loans and strengthening governance practices in some state-owned institutions.

- **Improving the business environment and productivity are key to boost investment.** *Bulgaria* should reform its insolvency framework, to ease pre-insolvency and out-of-court restructuring for companies, while *Croatia* has initiated, but is yet to implement, a new insolvency framework while regulations continue to stifle competition. In *Romania,* some progress has been made in improving judicial system and fighting corruption, but the implementation of court decisions remains weak. Due to high track access charges and inadequate national financing in the *Polish* railway sector the EC stresses the need to remove obstacles to investment.

- **Adapting public finances to make them more supportive to growth.** *Bulgaria* needs to improve the cost-effectiveness of the health care system, including through implementation of the National Health Strategy (which currently lacks an implementation plan). The law equalizing the statutory retirement age for men and women in 2037, proposed by the government in December 2013, has been approved by the Cabinet, but not yet adopted by the Parliament. Both *Bulgaria* and *Croatia* have taken steps over the last year to improve tax compliance, including measures to address VAT fraud, but challenges remain. *Croatia* should introduce a new property tax (plans to introduce reforms in 2016 were recently shelved), improve control over expenditure at central and local level, strengthen the fiscal responsibility framework and the capacity and role of the State Audit Office, publish and implement the findings of the recent spending review, as well as reinforce public debt management. While Croatia has initiated measures to rationalize hospital funding, there are implementation risks and health arrears continue to pose fiscal risks. Regarding pension system, Croatia also needs to do more to discourage early retirement. In *Romania* an ongoing reorganization of the tax administration should reduce tax fraud and avoidance, while the national health strategy 2014-2020 needs to be pursued. *Poland* is urged to consider limiting the use of reduced VAT rates and to establish an independent fiscal council. It also needs to start to align pension arrangements for farmers and miners with those of other workers.

- **Improving employment policies and social protection.** In *Poland* the transition rate from temporary to permanent employment is low and the wage differential is among the highest in the EU due to rigid dismissal provisions, long judicial proceedings as well as other rigidities associated with open ended employment. In order to increase female labor market participation, Poland has increased the availability of pre-school education, but still ranks among the poorest performing countries in the EU for the availability of early childcare services. It also needs to put in place a system for assessing and recording farmers' incomes, because the social security privileges granted to farmers and miners continue to impose significant costs on public finances. *Bulgaria* amended the national education and training strategy and adopted a new strategy for higher education in 2014, which together with the reform of the School Education Act should help to improve the education attainment levels, increase participation of disadvantaged children, in particular Roma, and promote innovation and job creation, especially of older workers and young people. As regards social security systems, *Bulgaria* needs to establish a transparent mechanism for setting the minimum wage and minimum social security contributions in light of their impact on in-work poverty, job creation and competitiveness. *Romania* has started addressing challenges in education (the early school leaving rate, lifelong learning, Roma community, early childhood education and care services), but with little visible end-effect. Limited progress was made in introducing the minimum insertion income, which would simplify social assistance, while a law designed to strengthen the link between social transfers and employment activation measures is still under debate in the Parliament. A revised strategy for the integration of Roma was adopted in January 2015, but implementation is behind schedule as is implementation of the 2011 social assistance reform and the adoption of the strategy for social inclusion and combating poverty. In *Croatia* the consolidation of social benefits has started, but further reform efforts are needed to improve the coverage and adequacy of benefits.

EC Country-Specific Recommendations for 2015-2016



Note: EC's recommendations presented on May 13, 2015 for 2015-2016.
Source: http://ec.europa.eu/europe2020/index_en.htm

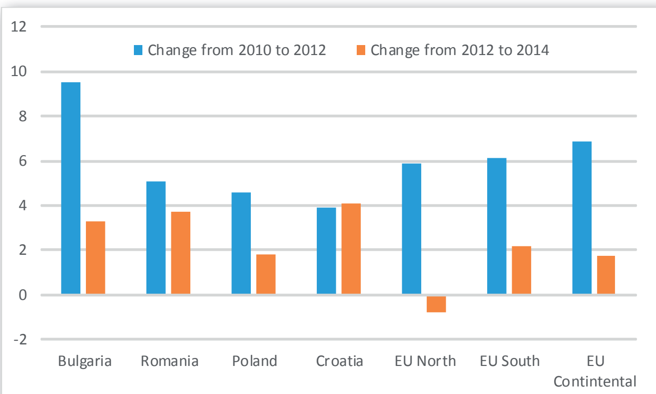
FOCUS NOTE: EXPORTS AND GROWTH RECOVERY

EXPORT PERFORMANCE OF BULGARIA, ROMANIA AND POLAND HAS BEEN STRONG …

Exports have become a driver of the growth recovery in several of the poorest EU member states. Between 2010 and 2014, exports in terms of GDP increased from 55.1 percent in 2010 to 67.9 percent in Bulgaria, from 32.3 percent to 41.1 percent in Romania, from 37.7 percent to 45.7 percent in Croatia, and from 40.5 percent to 46.9 percent in Poland. During the same period, the EU-wide export share in terms of growth remained broadly constant. Most of the gains in the export-to-GDP ratio took place between 2010 and 2012. Yet, Bulgaria's, Romania's and Poland's export growth in terms of GDP and volumes exceeded that of its regional peers between 2012 and 2014.

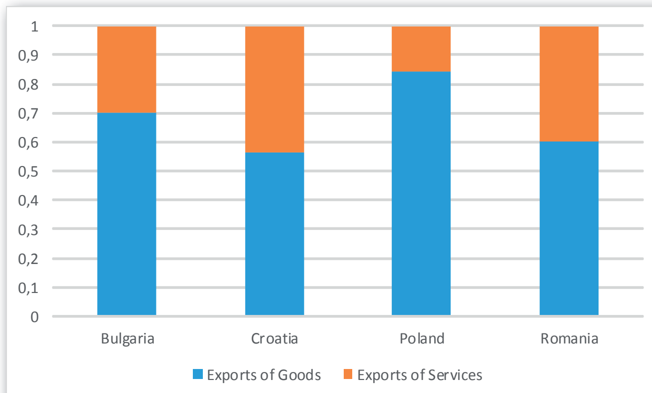
Figure 33. Exports have been an important growth driver in several EU member states…

Share of exports to GDP, percent



… driven by growth in goods and services exports in Bulgaria, Croatia and Romania.

Change in export volume and export unit value index, 2010-2014

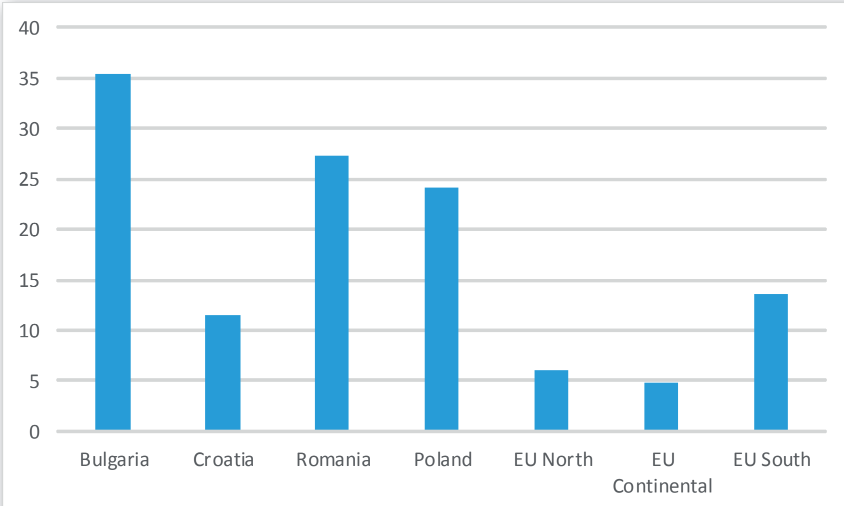


Source: WB Staff calculations based on Eurostat.

The contribution of services to overall export growth was particularly pronounced in Bulgaria, Croatia and Romania. In 2014, Bulgaria's services exports amounted to 17.8 percent of GDP, Croatia's to 23.3 percent of GDP, Poland's to 8.8 percent and Romania's to 10.0 percent. This compares to a services export-to-GDP ratio of 7.6 percent in Germany, 9.4 percent in Spain and 13.2 percent in Sweden. In Bulgaria and Croatia most exports are from traditional services, such as travel and transportation, which require face-to-face interaction between buyer and seller. Modern services, which can be traded across borders remotely, are a relatively small part of their total services exports. As countries develop, traditional service exports tend to stabilize as a share of GDP, while modern service exports tend to increase. In fact, modern service exports have been increasing in recent years in the most EU-CEE. Bulgaria's modern service exports increased as a share of total services from 23 percent in 2000 to 28 percent by 2011-2013. During the same time period, Poland's share of modern services climbed from 24 percent to 42 percent, while Romania's share of modern services rose from 43 percent to 63 percent–twice Bulgaria's share. In Romania and Bulgaria, ICT related service exports are quite large and both countries have a revealed comparative advantage (RCA) in this category . Meanwhile, exports of services, such as research and development, management consulting and professional services, technical and trade-related services and operational leasing have also grown significantly in Bulgaria, Poland and Romania. (World Bank 2015)

Bulgaria's, Poland's and Romania's goods exports grew significantly more than in other EU countries. Between 2010 and 2014, Bulgaria's, Romania's and Poland's export volume grew by more than 35.3 percent, 27.3 percent and 24.2 percent, respectively. This was significantly above the average export volume growth in EU Continental and EU South. Croatia's export volume grew by only 11.5 percent, which was below the EU South average of 13.6 percent.

Figure 34. Export volume growth* was strong in Bulgaria, Romania and Poland between 2010 and 2014.



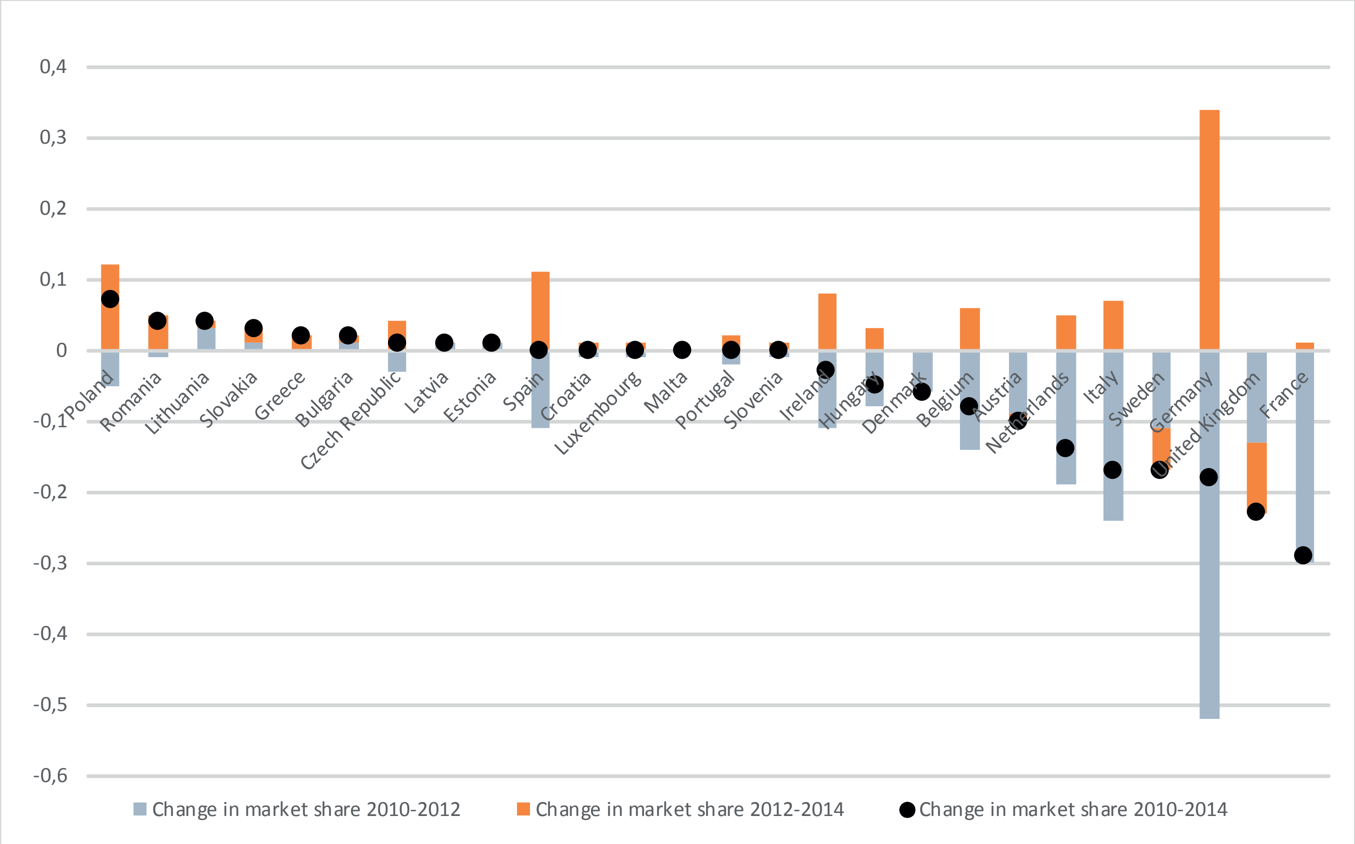
*Source: Eurostat. *Of goods exports.*

Bulgaria, Romania and Poland were among the EU countries with the largest gains in market share between 2010 and 2014. Goods exports growth has exceeded world export growth in several EU member countries, enabling them to increase their market share. Yet, Poland and Romania were the two EU countries with the largest gains in market share. In fact, their increase in the market share exceeded that of other dynamic emerging market countries like Brazil or Malaysia. Bulgaria ranked 6th among EU member states, while Croatia's increase in market share was close to the EU median. All four countries had the highest gains between 2012 and 2014.

The increase in market share was largely driven by shipments of existing products to established markets. Most of the gains in market share can be attributed to the intensive margin, i.e. the intensification of existing trade flows as Bulgaria, Croatia, Poland and Romania increased their market share largely based on existing products in already established markets. All four countries also managed to diversify their exports in established markets, which means that they started to increase the number of export destinations for existing products within their group of established markets. Contrary to Bulgaria, Romania and Poland, Croatia faced a significant decline of exports to existing markets, which significantly depressed its trade performance.

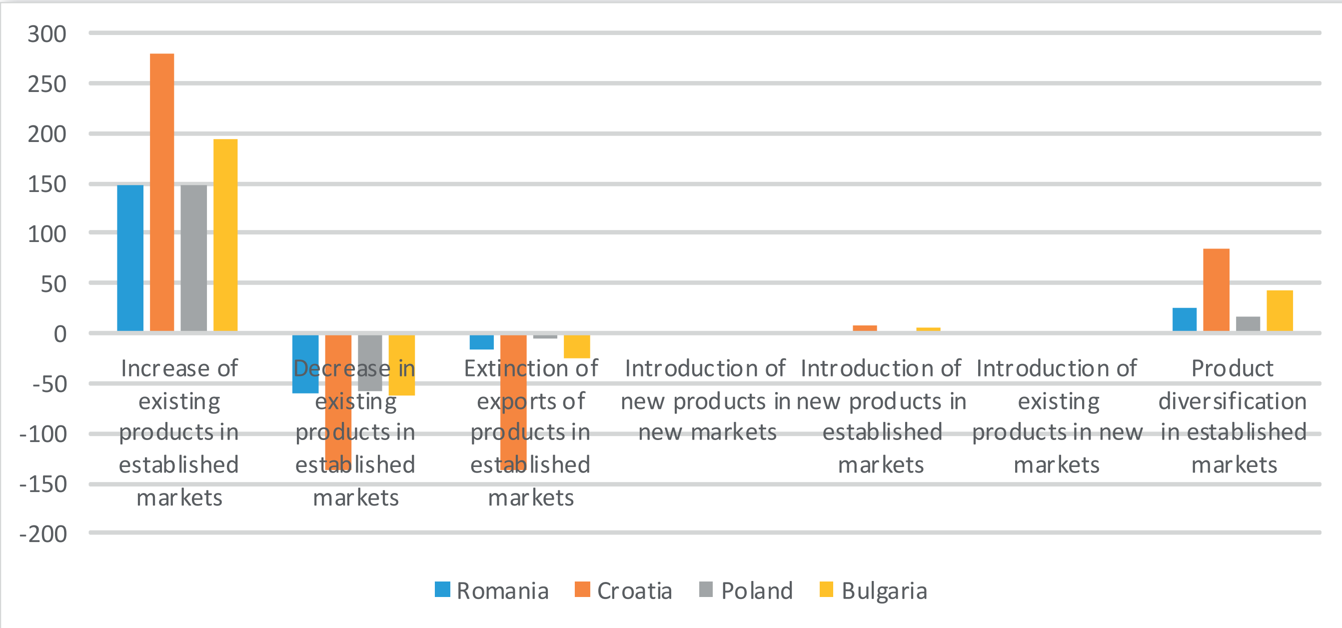
Figure 35. Poland, Romania, and Bulgaria were among the EU member states that obtained the highest gains in world market share between 2010 and 2014.

Contribution of goods and services to change in exports to GDP ratio, percentage points



Source: Eurostat.

Figure 36. Export growth between 2010 and 2014 was largely driven by shipments of goods to established markets



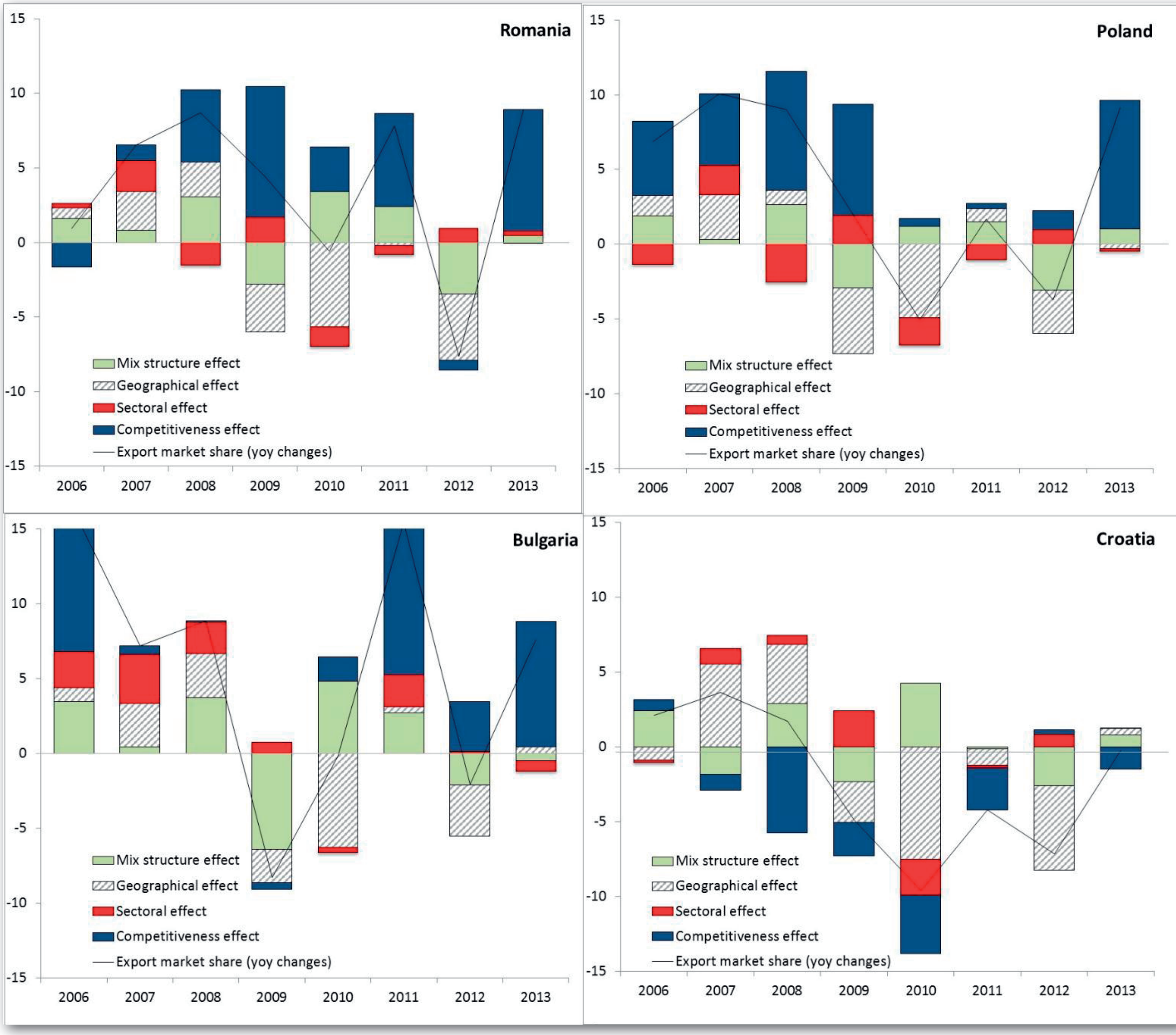
Source: WITS.

NON-PRICE RELATED IMPROVEMENTS IN COMPETITIVENESS SEEM TO HAVE BEEN AN IMPORTANT DRIVER OF EXPORT GROWTH.

To understand better the determinants of the change in the market share, we decompose export growth using a constant market-share analysis. The key idea behind this analysis is that a country's export growth is shaped by many different factors, such as the growth of world trade itself, the country's mix of trading partners and the bundle of goods it exports. If all these factors remain unchanged then a country's export market share should also remain constant. If the market share, however, increases then exports are overperforming or, put differently, the country's competitiveness has improved. Following Brenton and Newfarmer (2007) and Cheptea, Fontagne and Zignago (2014), we use a constant market share analysis to assess the different drivers in market share. More precisely, the analysis decomposes the change in market share into four key components: i) world trade growth (structural effect); ii) growth in exports of individual products (sector effect); iii) growth in imports in specific markets (geographical effect); and iv) the residual which is usually interpreted as an indicator of a country's competiveness which can capture price and non-price related aspects of competitiveness. The latter may capture aspects, such as a country's ability to tap into Global Value Chains, the ability of exporting firms and domestic suppliers to adapt to a changing external environment, the capacity to innovate, and the supply of workers with the right skills.

According to this decomposition, the competiveness effect has been a key driver of export growth in Bulgaria, Romania and Poland since 2006. Europe's weak growth performance has significantly depressed export growth in all four countries since 2009 (geographical effect). The contribution of the sector effect has also remained weak since 2009, suggesting that the global demand for the type of goods these countries export has suffered. The decomposition also shows that Croatia's comparably weak export performance between 2010 and 2014 can be explained by a relatively strong negative geographic effect and a negative competiveness, which means that its change in market share was actually weaker than what would have been predicted by its mix of trading partners and composition of export goods. Croatia's two largest trading partners are Italy and Bosnia and Herzegovina, whose import demand has declined. Moreover, exports of transport goods, such as ships, to Italy have been particularly sensitive to the falling demand.

Figure 37. Improvements in competitiveness have been a key driver of export growth in Bulgaria, Poland and Romania.



Source: WITS; World Bank staff calculations.

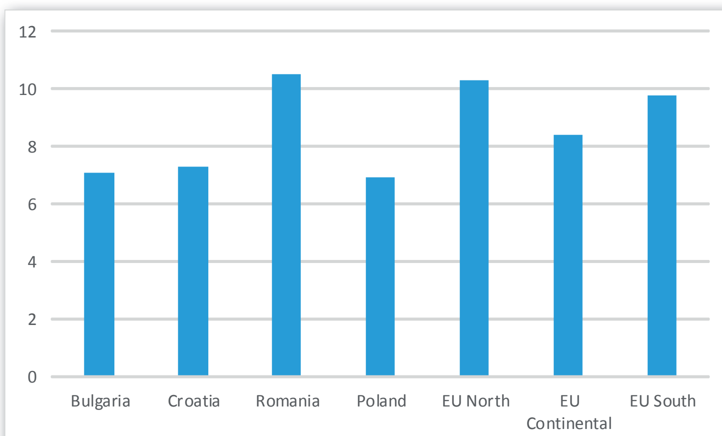
Price-based competitiveness measures are unlikely to explain the competitiveness effect. Since 2010, real effective exchange rate trends across the four countries have been mixed. Both CPI-based and ULC-based REERs have depreciated moderately vis-à-vis their trading partners in Croatia and Poland. In Bulgaria, the CPI-based REER remained fairly stable between 2010 and 2012 and depreciated slightly after 2012. Whereas the ULC-based REER appreciated steeply until 2013 as unit labor costs increased by 10 percent between 2010 and 2013 alone. Romania's CPI and ULC-based REERs depreciated between 2010 and 2012 but have, in contrast to the other countries in the region, appreciated since then.

Figure 38. Real effective exchange rate trends have been mixed.

a) CPI–based　　　　b) ULC-based

Source: Eurostat. Based on 28 trading partners.

Figure 39. Export unit value growth has - with the exception of Romania - been broadly average 2010 and 2014.



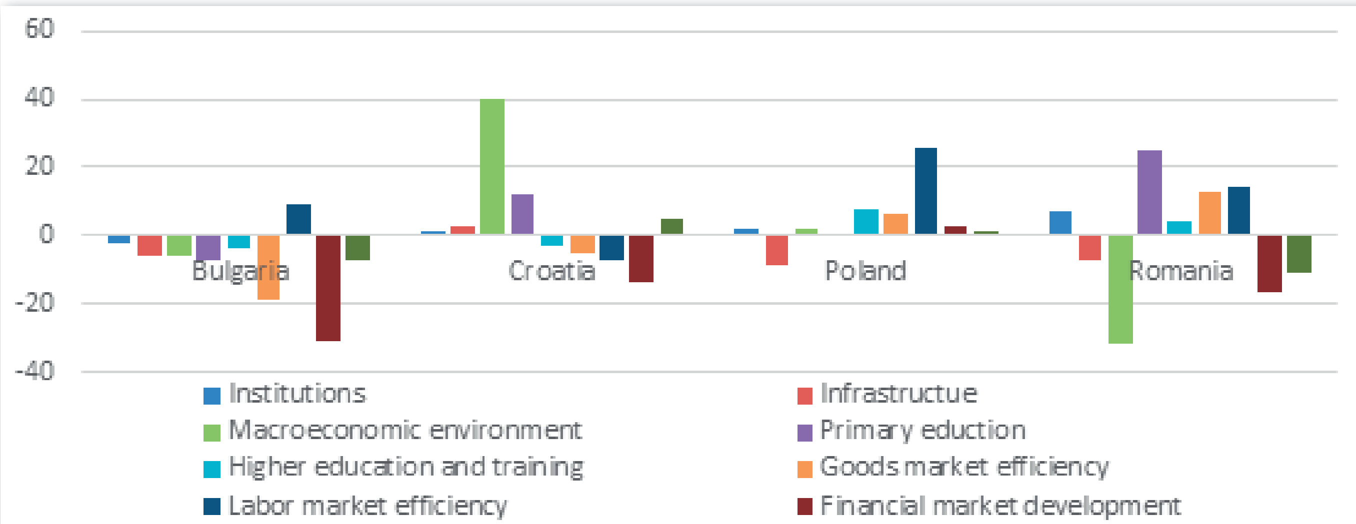
Source. Eurostat.

One possible measure of relative non-price competitiveness is the export unit value, which can be used as a proxy for changes in the quality of export goods. All four countries upgraded the quality of their export products, but Romania has been most successful in improving the quality of its exports as proxied by a significant increase in its export unit values, while the increase in the export unit value of Bulgaria, Croatia and Poland remained significantly below the average increase in EU Continental and EU South. This suggests that the relatively strong export performance of Bulgaria and Poland is unlikely to be the result of quality upgrading.

Key structural reforms can help export performance. According to the World Economic Forum's Global Competitiveness Report, Poland has been most successful in improving its ranking with respect to a variety of dimensions that are relevant for a country's competiveness. Between 2010 and 2014, Poland's ranking improved, in particular, with respect to labor market efficiency, goods market efficiency and higher education. Croatia and Romania's progress was mixed. According to the WEF indicator, Bulgaria fell back in its ranking among most reform dimensions, as political uncertainty lead to a significant slow-down in reform. According to the 2014 ranking, improvements in infrastructure, higher education, and business sophistication and innovation seem to be key reform areas for strengthening competitiveness in Bulgaria, Croatia, Romania and Poland.

Empirical evidence confirms that structural constraints hamper trade in services. Trade in services tends to increase when trading partners are near to one another, have large service markets, share a common language, and have less restrictive service-trade regulations. Estimates from a gravity model1 show that service trade increases significantly with the proximity of trading partners, market size in terms of GDP, fewer regulatory restrictions as measured by the World Bank's Services Trade Restriction Index (STRI)2 and the use of a common language. Controlling for fixed effects, i.e. constant unobserved country-specific characteristics, corroborates these findings and increases the explanatory power of the model. This suggests that country-specific structural factors or policy barriers beyond what can be measured by the STRI are the key to explaining bilateral services trade. This is particularly true for Bulgaria, in which structural factors appear to play a major role. These factors may include labor-force skills, ICT infrastructure, domestic regulatory barriers not captured in the STRI, and other trade-related issues.

Figure 40. With the exception of Poland, progress with structural reforms has been limited.



Source: Global Competitiveness Report.

FDI in export sectors is likely to have helped countries to further integrate into global value chains and "push" exports. Most exporting firms in Bulgaria, Croatia, Poland and Romania are foreign-owned. The share of foreign-owned, exporting firms is particularly high in Bulgaria and Poland. Most of Poland's so-called 'superstars', which are a key driver of export growth, are foreign owned. FDI not only helps to boost the exporting capacity of countries, but is also an important conduit for knowledge, technology and innovation. In Bulgaria, one in four innovating firms that are exporting goods have significant FDI, compared to one in fifteen firms in the non-exporting innovative group[3]. Strategies to boost exports, therefore, would need to rely on removing constraints to competiveness of domestically-owned firms and attracting FDI. FDI has declined significantly since the 2008 global

1 Anderson and van Wincoop (2003), Feenstra (2004), and Baldwin and Taglioni (2006), among others, offer extensive literature reviews on the use of gravity equations in the empirical literature on trade.

2 The World Bank's Services Trade Restrictions Database covers 103 countries, 19 subsectors and 34 country-subsector mode combinations. It assess policy regimes for each subsector-mode and groups these policies into five categories with associated scores: completely open (0); virtually open but with minor restrictions (25); major restrictions (50); and virtually closed with limited opportunities to enter and operate (75). The categories are then aggregated by mode, sector and country. The model here uses the country indices for importers and exporters. It is available at http://iresearch.worldbank.org/servicetrade/aboutData.htm

3 Patent activity in Bulgaria is now also on the rise, driven by the creation of new R&D facilities by multinationals in the IT industry focused on cloud computing and other cutting-edge software development. In fact, collaboration between foreign researchers and firms, mostly from Belgium, Germany, Japan, Sweden and the USA, have picked up in the late 1990s and co-inventions account for more than half of Bulgaria's patents at the USPTO (World Bank 2013).

financial crisis, though a higher share of FDI is now destined for sectors with export potential, such as manufacturing and services, rather than construction and financial services.

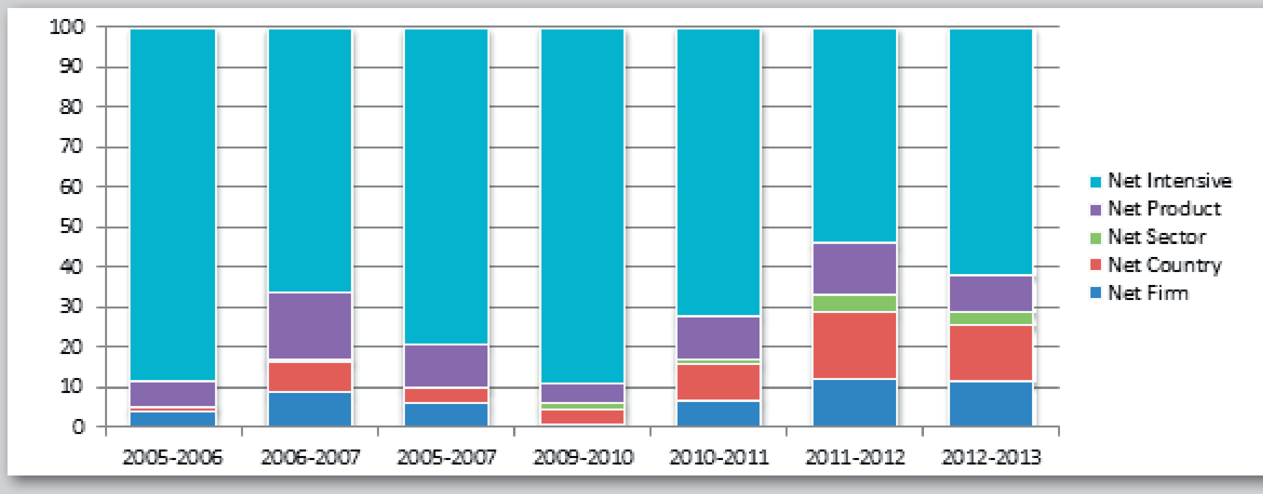
Poland's export performance – A firm-level perspective

Poland's export growth has been underpinned by significant changes at the firm level. Though overall exports have been growing, the number of exporters has been declining in most sectors. The only exception is the machinery and transport sector where the number of exporters has actually increased. Despite the overall decline in the number of exporters, competition in Poland's export sector has increased as the share of top 5 exporters has been decreasing over time, reducing the dominance of big exporters.

Polish exporters are very diversified. Polish firms export on average 8 products, which is well above the average of 5 for a sample of 44 middle-income and high-income countries. For a sub-sample of high-income countries the figure is 6.7. Polish exporters have also increased their number of export destinations and now reach between 3 and 4 destinations which is in line with high-income countries. Diversification along products and destinations is more pronounced for larger firms. In 2013, the group of exporters at the top quartile of the distribution value reached 10 markets and sold 18 products on average.

Diversification among products, markets and firms has become an increasingly important driver of export growth. Between 2012 and 2013, net market diversification contributed 14 percent to total export growth, net product diversification 9.5 percent and net firm entry 11.4 percent to total export growth. This compares to 1 percent, 6.3 percent and 4 percent, respectively in 2005-06. Still, the largest contribution comes from increases in exports volume among existing firm-product-destination relations (net intensive), see figure. Firms that are able to export new products and reach new destinations are significantly above the average size of exporting firms. Firms that are able to export a new product tend to be 3 times larger than the median exporter. Firms that are able to reach new markets tend to be even larger – about 4 times the size of the median exporter. About 33 percent of exporting firms that started exporting a product that they have never exported before are also able to reach a new markets. Small firms, however, tend to stick to the same products and same destinations.

Figure 41. Decomposition of Export Growth into Extensive and Intensive Margins



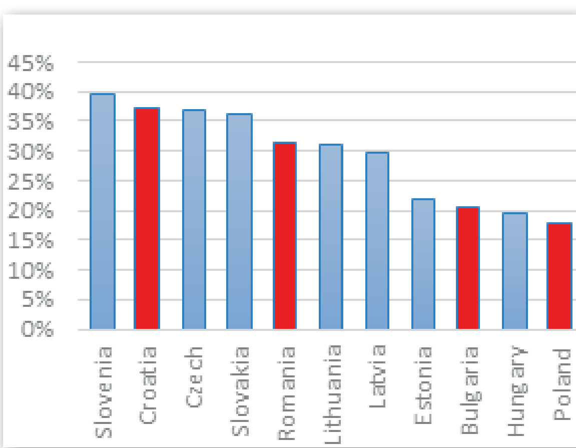
Source: WB' calculations based on Polish Customs Data

"**Superstars" which are the top 1 percent exporters account for 70 percent of total exports and are the key drivers of export growth**. Before 2011, these superstars contributed to more than 70 percent of export growth. In 2012 and 2013, their contribution to export growth has been around 50 percent. The average size of a super star is about 80 times that of an average export firm. As entry costs are substantial, the 'large firms' or 'export superstars' have been contributing less to export growth over time.

Accumulated experience, competition and diversification increase the survival rate of Polish exporters. Accumulated experience, proxied by the number of exports to a destination, increases the probability of surviving. To a lesser extent this also holds for accumulated experience related to products. While a more competitive market for a given product reduces survival, the opposite is observed among firms exporting to the same destination. Firms in sectors that have a greater revealed competitive advantage are more likely to survive. Firms that survive longer tend to become larger and more diversified.

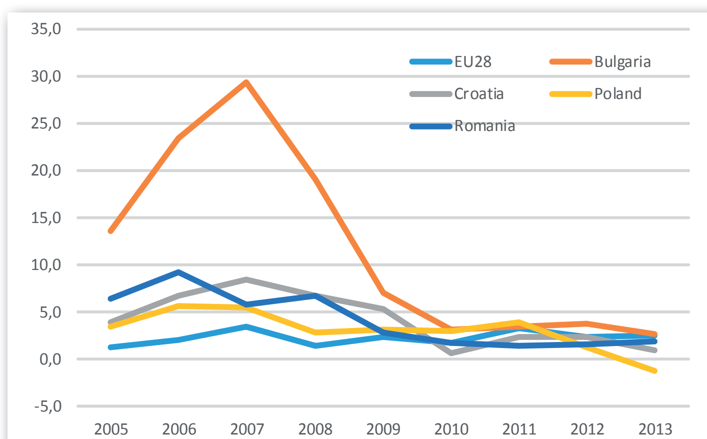
Figure 42. Despite high FDI prior to the crisis, the share of domestically owned, exporting firms remains low in several new EU member states.

a) Share of domestically owned, exporting firms, percent



Source: BEEPS; WB staff calculations.

b) Inward FDI-to-GDP ratio, percent



Source: Eurostat.

A renewed structural reform push will be needed to sustain FDI and export growth. Empirical studies for Bulgaria have found that market potential, low labor costs, a well-trained and motived workforce, proximity to the EU and improvements in the economic and business environment were key determinants of FDI in the early 2000s. However, the lack of educational improvement of the labor force and of efficient institutions seem to have become increasingly important constraints to FDI in recent years (Sakali, 2013). For Poland, key drivers include market size and the maintenance of macroeconomic growth, competitive labor costs and productivity, trade openness, currency stability, access to the third markets, and ongoing subsidies and tax incentives (Leven, 2012). Also critical for FDI inflows in Poland were the relative stability of the financial sector and housing market. Moreover, improvements in the business climate will be important for increasing the number of domestically-owned exporting companies.

However, the educational attainment and skills of the labor force and well-functioning institutions, such as the judiciary and public services, along with conducive business and labor market regulations, seem to have become increasingly important constraints to FDI in recent years across the EU-CEE. Therefore, reforms that continue to attract FDI are likely to include those that help create an equal playing field among firms, remove constraints to firm entry and exit, encourage innovation and provide firms with access to an appropriately skilled work force, good infrastructure and efficient capital markets. These measures will be important to sustain export growth, and thus overall growth to ensure countries continue to converge within the EU.

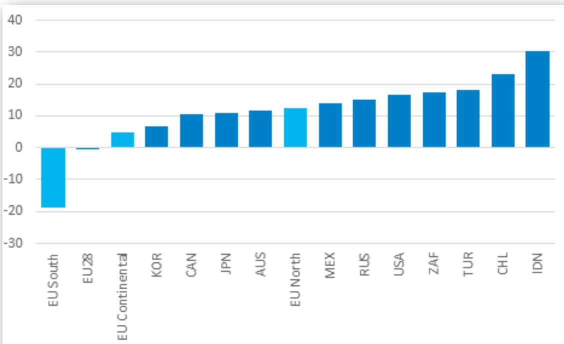
ANNEX 1. KEY CHARTS

ANNEX 1. KEY CHARTS

GROWTH CONTINUES TO STRENGTHEN IN EUROPE, BUT FROM A LOW BASE

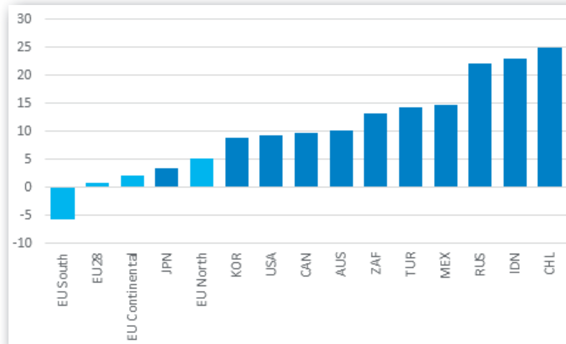
Since 2010, Europe's overall growth has been hampered by weak investment…

Investment growth in selected countries since 2010



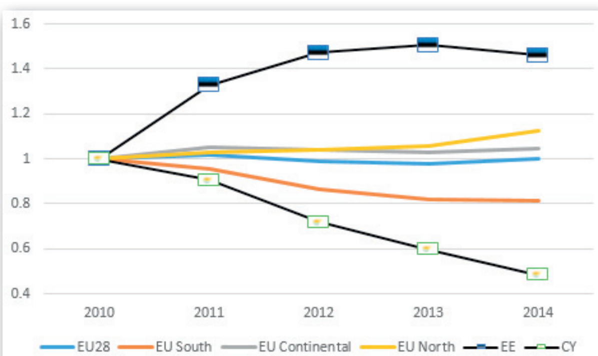
…and sluggish private consumption as consumer confidence remained low

Private consumption growth in selected countries since 2010



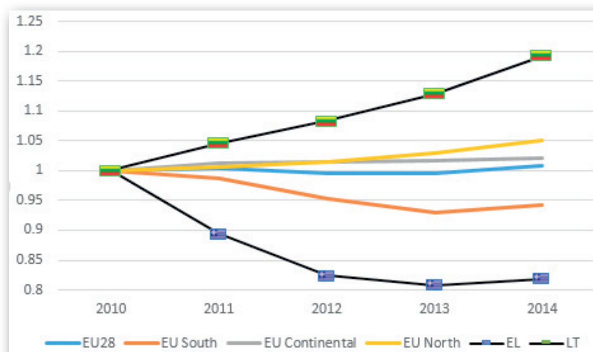
Investment in Cyprus declined by 50 percent since 2010, while in Estonia they have risen by 40 percent

Investment levels in selected countries, index, 2010=1



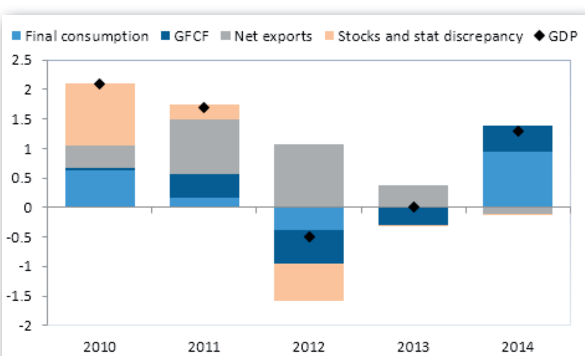
Private consumption declined most in Greece and rose most in Lithuania

Private consumption levels in selected countries, index, 2010=1



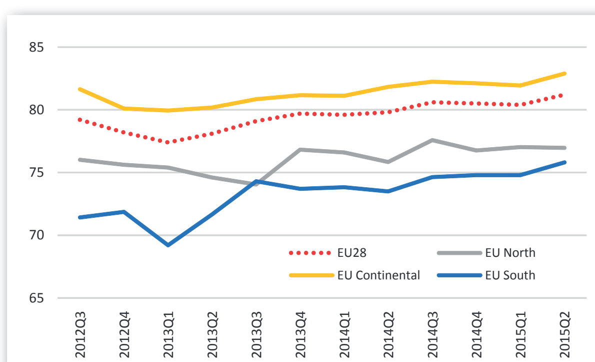
Growth has gradually become more balanced, as private consumption strengthens and investment slowly returns

Contributions to GDP growth, percentage point



High capacity utilization rates should encourage investment

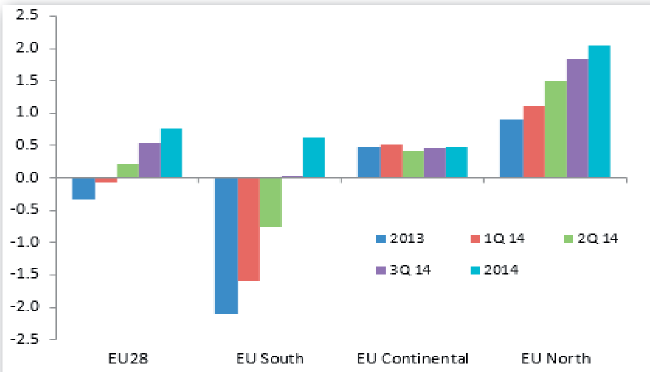
Capacity utilization in manufacturing industry, percent



LABOR MARKETS ARE IMPROVING BUT PROGRESS REMAINS SUBDUED ACROSS COUNTRIES

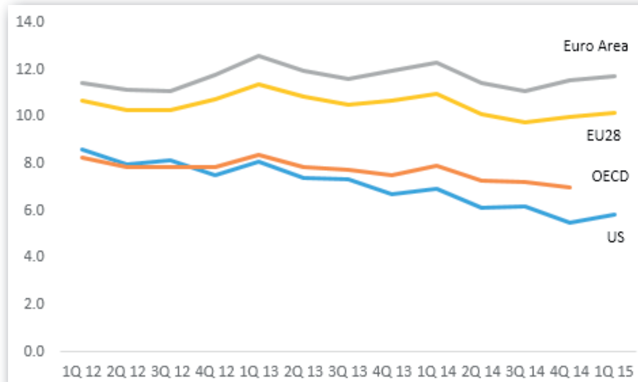
The labor market is slowly recovering in the EU

Employment growth, annualized, y/y



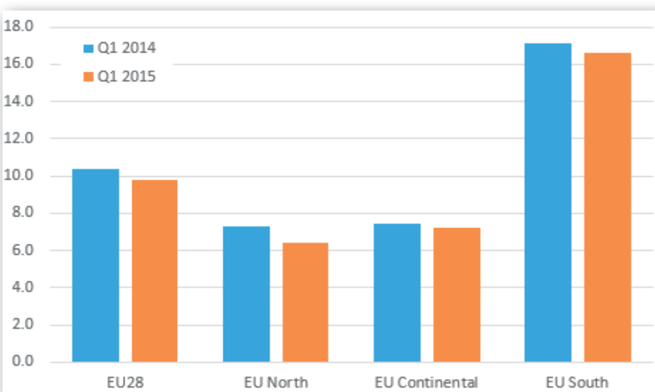
…though unemployment rates remain high compared to other regions

Unemployment rates, percent y/y



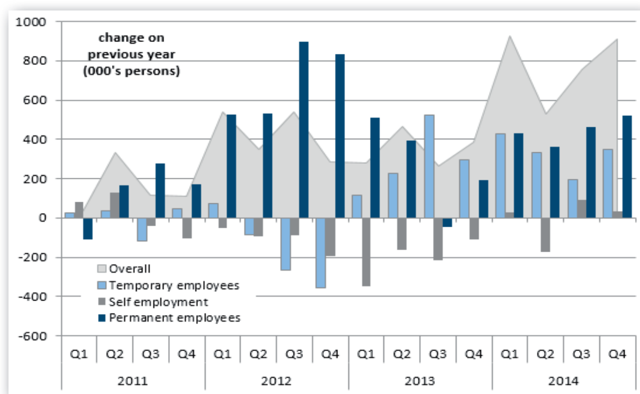
Job growth is driven to a large extent by improvements in countries with relatively high unemployment rates…

Unemployment rates, seasonally adjusted, in %



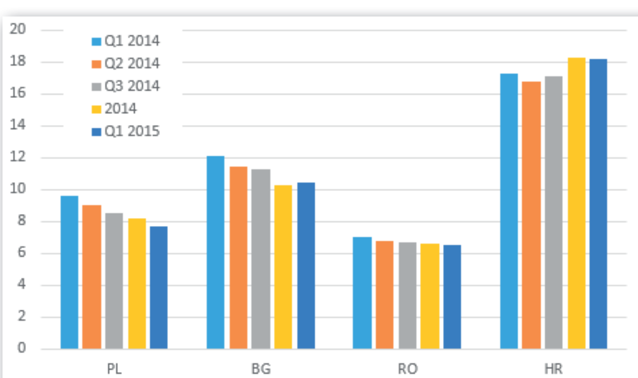
...and robust employment gains in EU Continental

Annual Employment Changes by Type



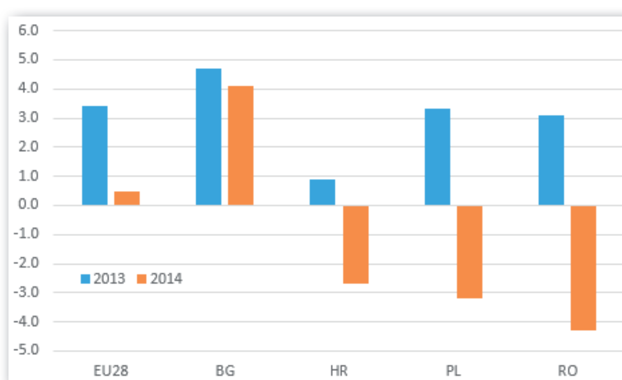
The unemployment rate in Croatia remains the third highest in the EU

Unemployment rates, seasonally adjusted, in %



Long-term unemployment starts to fall in some countries

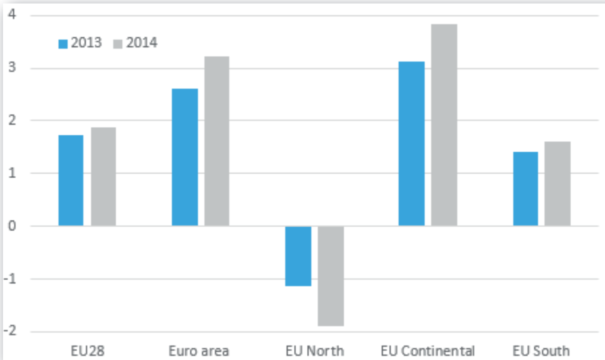
Annual changes of long-term unemployment in % of unemployment



CURRENT ACCOUNT BALANCE IMPROVED FURTHER, AS EXPORTS CONTINUED TO GROW AND IMPORTS DECLINED

Current and capital account surplus increased…

Current and Capital account balance, in percent of GDP

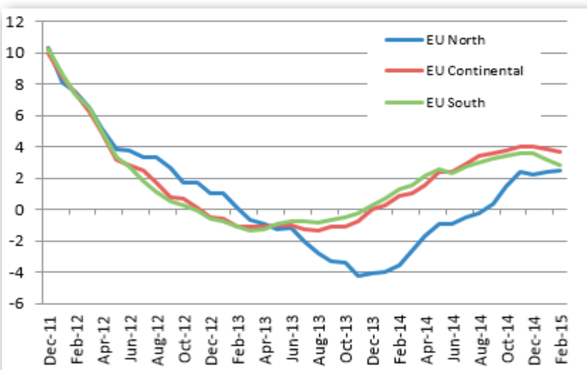


…largely due to an increasing surplus in the overall trade balance…

Trade in goods, year-on-year, growth rate (12m average)

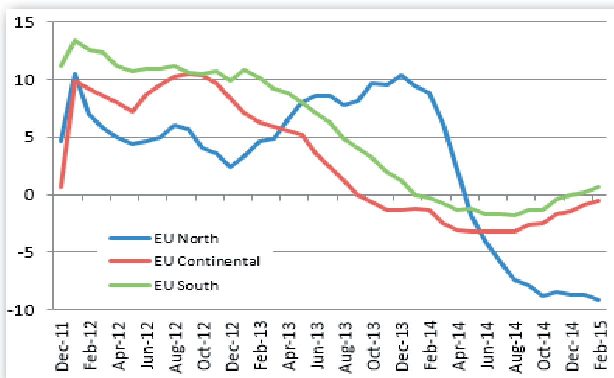
…driven by intra-EU28 exports...

Export of goods, year-on-year, growth rate (12m average)



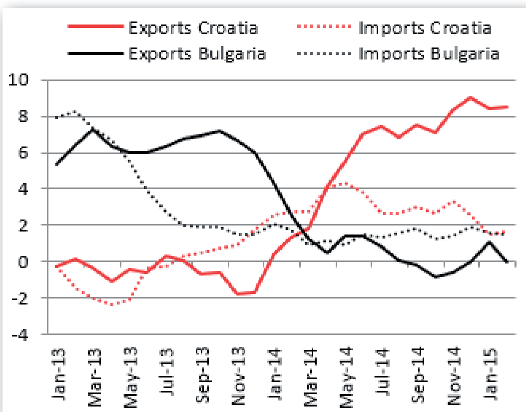
…and somewhat better exports to outside the EU28

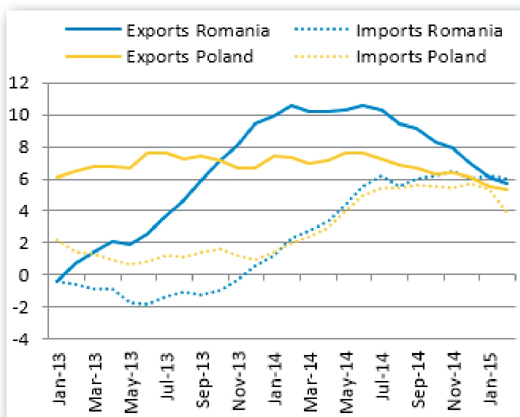
Export of goods, year-on-year, growth rate (12m average)



Trade in goods continues to be strong in Romania and Poland, though growth rates have slowed

Export and imports of goods, year-on-year, growth rate (12m average)

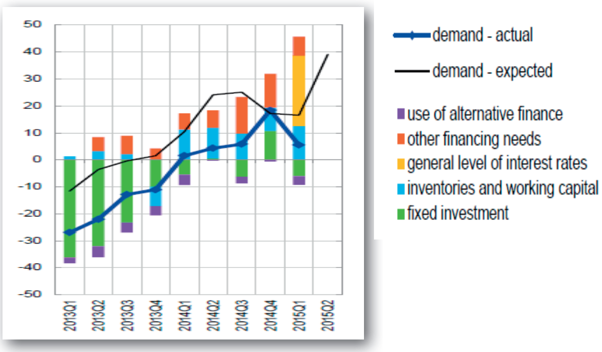




EASIER FINANCING CONDITIONS SHOULD SUPPORT LENDING, CONFIDENCE, AND ULTIMATELY ECONOMIC GROWTH

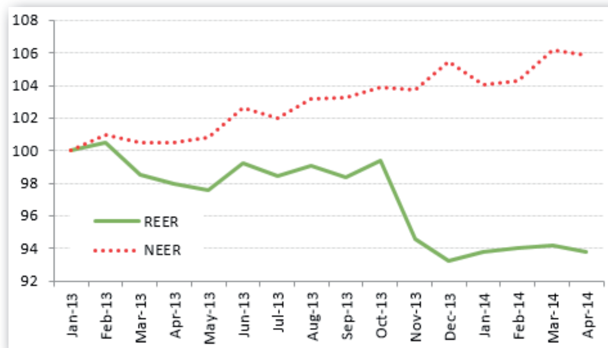
The impact of both the announcement and implementation of QE improved confidence…

April 2015 ECB Survey—Changes in demand for loans or credit lines to enterprises



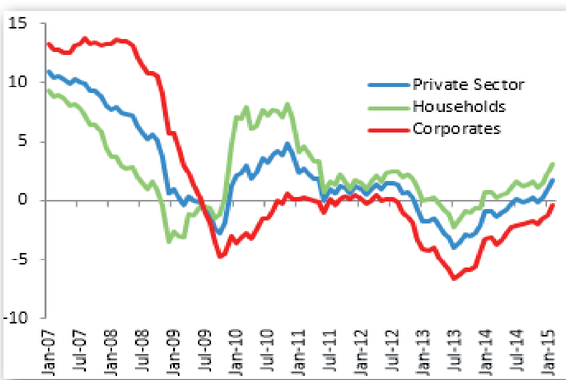
... and supported the depreciation of the Euro

Euro Area NEER and REER, Jan 2013=100



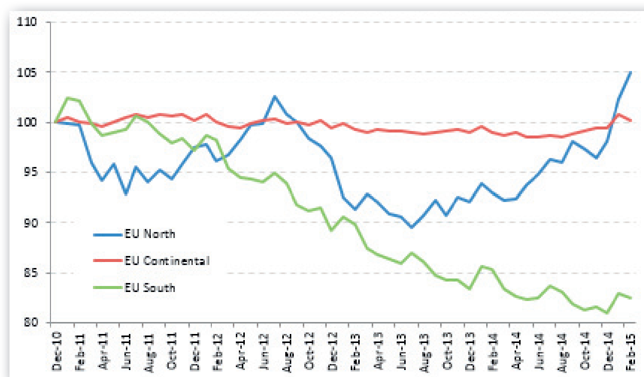
Private credit is modestly recovering…

EU 28 Private sectors annual growth, in %



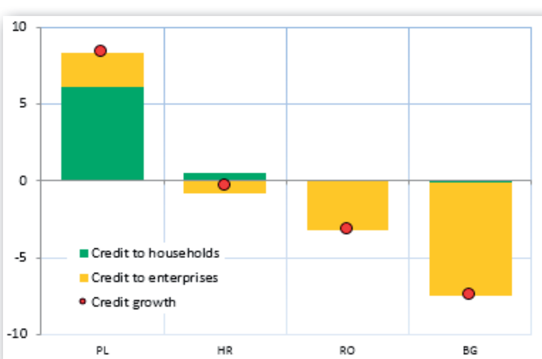
…with notable differences throughout the sub-regions

Private sector lending (Dec 2013=100)



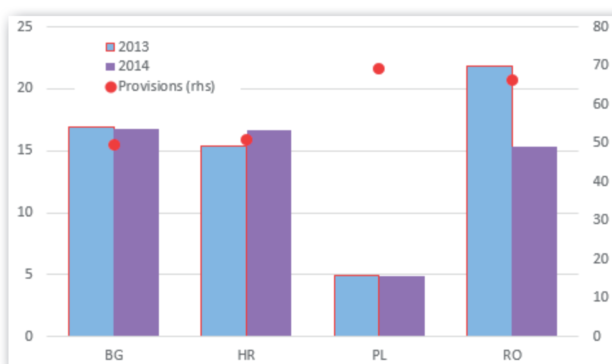
Credit growth is still negative in Bulgaria, Romania, and Croatia…

Real credit growth and contribution, in %



… reflecting high levels of NPLs

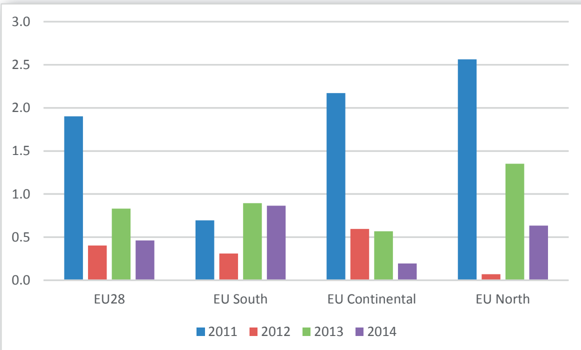
Evolution of NPLs (2013-14) and Provisioning (2014), in %



FISCAL CONSOLIDATION CONTINUES, ALBEIT AT MUCH SLOWER PACE, AS PUBLIC DEBT LEVELS OFF

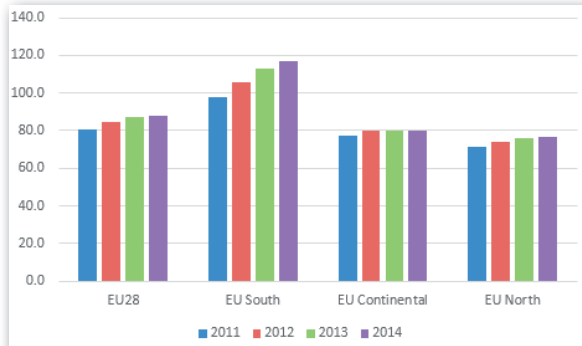
In 2014 the pace of fiscal consolidation in Europe was significantly slower than a year before…

Fiscal deficit reduction, percentage points of GDP



… as public debt to GDP ratios leveled off

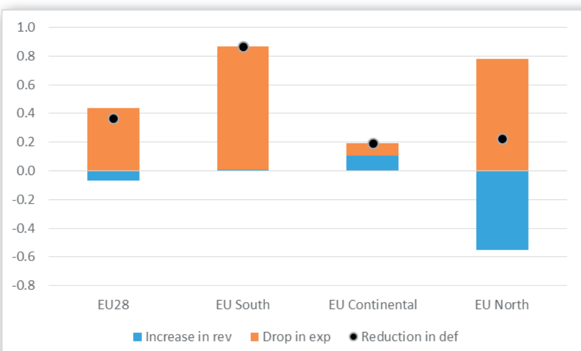
Public debt, percent of GDP

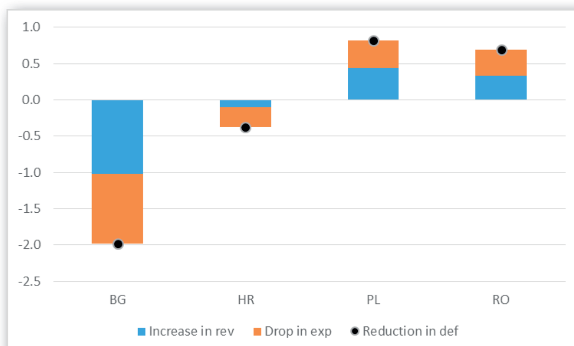


The decline in expenditure was a key contributor to the EU deficit reduction in 2014 …

… while in Central and Eastern Europe the adjustment was both due to the revenue and expenditure sides

Contributions to deficit reduction from expenditure and revenue sides in 2014





The economic cycle was conducive to fiscal adjustment in 2014 especially in EU South and North…

…while in Central and Eastern Europe fiscal developments were almost entirely driven by structural measures

Contributions to deficit reduction from structural and cyclical components in 2014