EU11

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Promoting Shared Prosperity during a Weak Recovery in Central and Eastern Europe

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EU11 Regular Economic Report

Promoting Shared Prosperity during a Weak Recovery in Central and Eastern Europe
Notes and acknowledgments

This Regular Economic Report (RER) is a semiannual publication of the Europe and Central Asia Region, Poverty Reduction and Economic Management Department (ECA PREM), The World Bank. It covers economic developments, prospects, and policies in 11 European Union (EU) member states—Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic, and Slovenia. Throughout the RER, for simplicity, we refer to this group of eleven countries as the EU11.

The RER comprises two parts: a Macroeconomic Report, and a Special Topic on an issue of economic policy interest in EU11. The Macroeconomic Report is co-authored by Ewa Korczyć, Matija Laco, and Theo Thomas (team lead), with inputs from: Sanja Madzarevic-Sujster, Stella Ilieva, Catalin Pauna, Paulina Holda and Emilia Skrok. The Spotlight on “EU Cohesion Policy Funds” is authored by Matija Laco. Contributions were also received from Allen Dennis, Ekaterine Vashakmadze, Mizuho Kida and Raquel Alejandra Letelier. The Special Topic on “Shared prosperity in EU11” is co-authored by Kenneth Simler, Lidia Ceriani, Nistha Sinha and Carolina Sanchez.

EU11 and EU15 aggregates are calculated as either weighted averages, sums, or simple averages. The following conventions apply: (i) aggregates for data relating to the domestic economy, growth rates and ratios, contributions to gross domestic product growth or value added growth, external trade indicators, as well as fiscal accounts—deficit and debt—are weighted by GDP valued at purchasing power parities (PPPs) in 2010 as a share of total GDP, (ii) aggregates for short-term high frequency indicators, retail sales and industrial production, are weighted by applying Eurostat’s turnover and production weightings for total retail trade and total industry; (iii) aggregates of economic sentiment indicators, Doing Business indicators, non-performing loans, are calculated as simple averages, (iv) aggregates for labor market indicators, employment and unemployment rates, are weighted by labor force in 2010; (v) aggregates for inflation are weighted by final consumption expenditure in 2010; (v) and aggregates of financial sector indicators (credit, deposits) are weighted by their shares in the total.


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MACROECONOMIC REPORT:

A WEAK ECONOMIC RECOVERY
SUMMARY

Economic prospects for the 11 European Union member states that joined after 2004 started to improve during 2013, as the situation in the Euro Area stabilized and domestic policies bolstered growth. The upturn initially relied on net export growth, notably in Romania, Slovakia and Poland, to offset falling investment and muted domestic consumption.

Economic growth across the EU11 is expected to continue to pick up in 2014 and to become more balanced, with rising domestic demand. Notably investment is expected to grow, having declined for the last two years, as external demand, particularly from the Euro Area, boosts business confidence and industry.

However, the recovery is expected to be protracted, with growth not reaching pre-crisis rates for some time. Despite the continued easing of monetary policy both the demand and supply of credit appear subdued in many countries. The recent ‘Doing Business’ survey highlights the need for reforms, such as improving insolvency practices or the issuance of construction permits (e.g. in Croatia and Romania), that would promote private investment. Countries also need to tackle the high levels of nonperforming loans and strengthen banking supervision in line with European reforms—these factors could temporarily reduce credit to EU11 firms if banks require more capital.

Fiscal adjustment will resume in 2014, with domestic demand helping to rebuild revenue, but at a relatively gradual pace in order to support economic growth. However, there is a need for larger adjustments in Croatia and Slovenia to achieve sustainable deficit and debt levels.

The nascent recovery has enabled unemployment rates to stabilize, albeit at record highs in many of the EU11. Around 4.9 million people in the EU11 are jobless, with particularly high unemployment amongst the young and low skilled.

Although the inflation outlook remains benign, the eventual transition to higher global interest rates poses risks for the EU11 recovery. Rising global interest rates coupled with volatile capital markets, could slow the Euro Area recovery and hamper domestic demand, particularly investment, in EU11.

Focusing on the welfare of the less well off as a measure of real societal progress is the fundamental principle underlying the World Bank’s indicator of “shared prosperity”, namely—bolstering the incomes of the bottom forty percent of the population.

The bottom forty percent in the EU11 tends to be concentrated in low skilled, young or older unemployed and minority groups. While incomes grew rapidly before the crisis, the current challenge is to promote shared prosperity in what may be a prolonged period of weak growth. Countries will need to accelerate economic growth and job creation, in an environment in which fiscal and credit constraints are more binding and household coping mechanisms have been weakened by the crisis. Achieving such inclusive and sustainable growth requires policies that build skills and opportunities, ensure labor mobility, and encourage private sector competitiveness. Strengthening social contracts, with more targeted social protection mechanisms and greater opportunities, can protect vulnerable groups while limiting barriers to work.

<table>
<thead>
<tr>
<th>Real GDP growth (percent)</th>
<th>2012</th>
<th>2013(p)</th>
<th>2014f</th>
</tr>
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<td><strong>EU11</strong></td>
<td>0.8</td>
<td>1.0</td>
<td>2.3</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>0.8</td>
<td>0.6</td>
<td>1.7</td>
</tr>
<tr>
<td>Croatia</td>
<td>-2.0</td>
<td>-0.8</td>
<td>0.8</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>-1.0</td>
<td>-1.0</td>
<td>1.8</td>
</tr>
<tr>
<td>Estonia</td>
<td>3.9</td>
<td>1.3</td>
<td>3.0</td>
</tr>
<tr>
<td>Latvia</td>
<td>5.5</td>
<td>3.9</td>
<td>4.2</td>
</tr>
<tr>
<td>Lithuania</td>
<td>3.7</td>
<td>3.0</td>
<td>3.5</td>
</tr>
<tr>
<td>Hungary</td>
<td>-1.7</td>
<td>0.9</td>
<td>1.9</td>
</tr>
<tr>
<td>Poland</td>
<td>1.9</td>
<td>1.5</td>
<td>2.8</td>
</tr>
<tr>
<td>Romania</td>
<td>0.7</td>
<td>2.2</td>
<td>2.2</td>
</tr>
<tr>
<td>Slovenia</td>
<td>-2.3</td>
<td>-2.7</td>
<td>-1.0</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>2.0</td>
<td>0.9</td>
<td>2.1</td>
</tr>
<tr>
<td><strong>memo:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Euro Area</strong></td>
<td>-0.6</td>
<td>-0.5</td>
<td>1.1</td>
</tr>
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1 Throughout this Regular Economic Report (RER) EU11 refers to the 11 European Union (EU) member states—Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic, and Slovenia.

Source: Eurostat, EC and World Bank
EU11 Recent Economic Developments

Growth rates are starting to pick up

Growth in the EU11 countries was close to zero in the beginning of the year amid shrinking domestic demand, with declining investment and muted consumption. Nonetheless, economic prospects improved during the year, as the situation in the Euro Area stabilized and domestic policies have bolstered growth.

Economic growth in the EU11 has been gradually increasing since the first quarter of 2013. While the EU11 region barely grew in the first quarter of 2013, registering annual GDP growth of 0.2 percent, output in the EU15 shrunk by 1.5 percent (Figure 1). Economic activity subsequently strengthened, with growth rising to almost 2 percent in the third quarter, amid improving confidence triggered by signs of a recovery in the Euro Area, which exited from recession in the second quarter, following six quarters of GDP declines (seasonally adjusted). Overall, seasonally adjusted GDP increased by 0.8 percent in the EU11 in the first nine months of 2013. Retail sales, production and sentiment indicators also suggest that the modest economic recovery will continue (Figure 2).

Figure 1. GDP rate of change in EU15 and EU11 Countries (percent)
Not seasonally adjusted, year-over-year
Seasonally adjusted, quarter-over-quarter

![GDP Rate of Change](image1)

Source: Eurostat; World Bank staff calculations.

Figure 2. Retail sales and industrial production growth (percent)

![Retail Sales and Industrial Production](image2)

Source: Eurostat; World Bank staff calculations.

Figure 3. Economic Sentiment Indicator (index)

![Economic Sentiment Indicator](image3)

Source: Eurostat; World Bank staff calculations.

2 EU15 countries refer to the pre-2004 EU Member States: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, and the United Kingdom.
**Box 1: External Developments**

Following several years of weakness, growth in high-income countries is firming, including in the Euro Area (Figure 3). High-income countries’ growth accelerated in Q2 2013, led by the United States, recovery of the Euro Area, and robust growth in Japan. In the US, growth led by the private sector doubled to 2.5 percent from the previous quarter, despite rising interest rates and the effects of fiscal sequestration. The Euro Area returned to positive growth with annualized growth in Q2 at 1.2 percent—across a range of economies—and forward-looking PMI surveys suggesting stronger consumer and import demand. Germany and France also showed solid growth. Recession was easing in Italy and Spain, while Portugal’s real GDP grew by 4.4 percent, the first increase in three years. Progress has also been made on reducing external and fiscal imbalances with improved competitiveness driving exports in high-spread Euro Area economies. Growth also accelerated in Q2 in several major emerging market economies, including China, where quarterly GDP growth picked up to 7.5 percent from 6.3 percent. However, growth across other major developing countries remained mixed.

Capital flows to developing countries began to rebound and pressures on asset prices and currencies eased since late-August. In mid-year, concern over the tapering of the US Federal Reserve’s (Fed) monetary stimulus raised borrowing costs and weakened capital flows to developing countries, but flows began to rebound in late August surging to $60.3 billion in September, mostly reflecting bond issuance ($43 billion). Pressure eased on asset prices and currencies of several large middle-income countries. Also, borrowing costs for high-spread European countries have not worsened noticeably. However, despite the Fed announcement on delayed tapering, the average cost of bond financing for emerging markets is up nearly 70 basis points since the low in May and the US 10-year bond yields also remain 100 basis points higher. This, along with policy uncertainty and fiscal retrenchment are expected to provide a drag on the US growth and consequently constitutes a significant risk to the global outlook.

GDP growth in the EU11 region was driven by external demand in 2013, with domestic demand starting to pick up in the second quarter. As demand from the EU11’s main trading partners, especially within the Euro Area, supported export growth (see section on trade developments), weak domestic demand subdued imports thereby increasing net trade’s contribution to growth (Figure 4). The reliance on net export growth was reflected in the tradable sector, especially manufacturing, being the main contributor to value added growth (Figure 5). In the second quarter, domestic consumption started to contribute positively to growth, following four quarters of either contraction or stagnation. The rebound in private consumption was supported by increased consumer confidence and rising real disposable income in the absence of inflationary pressures. Public consumption also grew in 2013 as fiscal consolidation was put on hold amid weak economic growth (see the fiscal section).

---

3 High spread EA economies are Ireland, Portugal, Spain and Italy.
Growth rates varied between countries, but in general net exports grew and declining investment was a drag on growth during the first nine months of 2013. Latvia and Lithuania recorded highest growth rates not only in the EU11, but also in the entire EU28 region\(^4\) (Figure 6). This good performance was supported by consistently strong levels of domestic consumption, in contrast to most other EU11 countries, although overall growth was lower than 2012, due to a decline in private investment in Latvia and a slowdown in exports from Lithuania. Poland’s growth slowed to the lowest rate since 2001 in the first quarter of the year, due to falls in investment and consumption. Romania’s growth was mainly driven by robust export performance on account of the automotive industry, despite weak domestic demand with flat consumption and investment contracting. The Czech Republic, Slovenia and Croatia, all experienced declines in domestic demand during most of the first three quarters of 2013. More generally, investment was weak across the region due in part to tight credit conditions, low confidence levels and weak external conditions (see external imbalances and credit sections).

\(^4\) EU28 refers to all the member countries of the European Union.
Figure 6. GDP rate of change in the first 9 months of 2013 (percent, year-on-year)

Source: Eurostat; World Bank staff calculations.

Figure 7. Contribution to GDP growth by country, by quarter in 2013 (percentage points)

Source: Eurostat; World Bank staff calculations.
Unemployment rates in the EU11 remain at their highest level since early 2007, with especially high rates for the youth and low-skilled, but employment levels have stabilized. Stronger growth and labor market reforms will be needed to reduce unemployment rates.

The labor market has yet to benefit greatly from the nascent recovery. While current employment levels in both the EU11 and EU15 have risen above the minimum of the last four years, they nevertheless remain below pre-crisis peaks. Despite higher overall growth rates in the EU11 region, employment during the crisis suffered more than in EU15, as employers in EU11 were more prone to cutting employment than working hours. In none of the EU11 countries the employment level has reached the pre-crisis peak, but the performance of individual countries differs greatly. In the case of the Czech Republic and Poland, current employment levels are close to the pre-crisis peak, as labor hoarding continues in the former, while stronger growth helped protect jobs in the latter. In Latvia and Lithuania the current employment level is still around 20 percent lower than the pre-crisis rate, reflecting large economic adjustment in 2008-09 as well as significant migration. Estonia has improved most considerably over the past two years driven by strong economic rebound, which led to large job creation in manufacturing, construction and transportation.

Positive economic developments of the past few months have resulted in the stabilization of employment levels. The number of employed people in the EU11 in the second quarter 2013 stopped falling and stabilized at around 44.7 million. By contrast, employment in the EU15 region has continued to decline due to the lagged effect of growth on employment (this effect also applied to the EU11, although the contraction in the EU15 has been deeper). Nonetheless, employment expectations in both the EU11 and EU15 have started to improve, albeit from low levels.

\[\text{Figure 8. Current level of employment (pre-crisis employment} \times 100)\]

Source: Eurostat; World Bank staff calculations.
Notes: Pre-crisis peak of employment represents maximum employment level in 2007-2008, Crisis employment level represents the minimum employment level in 2009-2013, and Current employment level represents the second quarter of 2013. Data based on employment domestic concept from national accounts auxiliary indicators.
Unemployment rates continue to be at a record high both in the EU11 and EU15. Currently around 4.9 million people in the EU11 are jobless, representing an increase of 1.8 million from the historic low recorded in August 2008. Following a short-lived improvement in unemployment rates in mid-2011, the labor market situation worsened in late 2012 and early 2013 with unemployment rates close to the peak of the 2008-09. Over the past few months unemployment rates have stabilized in the EU11, while in the EU15 they continued to increase. Unemployment rates have fallen significantly from their peaks only in the Baltic countries. In Croatia and Slovenia they continued to increase as growth contracted.

Vulnerable groups are most affected by the poor labor market situation. While low levels of growth over the past couple of years was detrimental to overall labor market outcomes, the greatest burden has fallen on the youth and the low-skilled. These groups are also most likely to be in the bottom 40 percent of population in terms of income (see the Special Topic section). Across these groups unemployment rates increased much more markedly than for the overall population. The youth unemployment rate in Croatia is the third highest in the EU after Greece and Spain—close to 50 percent. This follows five years of negative economic growth in Croatia and significant obstacles to effective youth employment, such as barriers to entry in some professions,
the mismatch between education outcomes and market needs, and a reduction in the country’s industrial potential. Large increases in unemployment among the low-skilled in Lithuania reflect job losses in the construction, manufacturing and wholesale sectors. However, in both the EU11 and EU15 the unemployment rates for older workers did not increase more than the overall unemployment rates, reflecting the higher redundancy costs and more rigid labor market regulations associated with older workers (including pre-retirement protection periods).

**Figure 13. Increase in unemployment rates by groups (percentage points)**

Source: Eurostat; World Bank staff calculations.
Notes: Increase relates to the period 2007/2008 minimum to the current level (2Q 2013)
External imbalances have narrowed, as exports continued to grow and imports declined

The modest growth of exports, accompanied by shrinking imports, led to a narrowing of current account imbalances. Foreign capital inflows to the EU11 continued to weaken throughout 2013.

Export growth slowed to below two percent in the first three quarters of 2013, while imports declined by over one percent. The growth rate of exports to countries outside the EU28 declined over the period as global economic conditions became more challenging. Exports from Bulgaria and Romania grew strongly in the third quarter of 2013, driven by robust demand for food, transport and machinery, and equipment. In Estonia, Latvia, the Czech Republic and Slovenia, exports were either stagnant or decreased. Lithuania was the only country to experience strong import growth throughout the year, while imports declined significantly in Slovenia and more moderately in Poland, the Czech Republic and Croatia due to weak domestic demand.

Current account balances continued to improve thanks to broadly favorable trade balances. Half of the countries in the region were in surplus, thanks to improved foreign trade balances. Additional improvements came from a reduction in the factor income deficit and gains from higher EU fund transfers (see Spotlight on Cohesion Policy), in particular to Bulgaria and Lithuania. In Croatia, trade patterns were affected by accession to the EU as exports to CEFTA countries, notably of food products, were brought forward into the second quarter—before Croatia’s membership of the CEFTA ended in July—while both imports and exports declined in the third quarter.

Portfolio investments, stemming from acquisitions of government bonds by non-residents, remained the main source of foreign capital in most countries. Net FDI inflows to the region remained on a downward trend in 2013, with above average investment being recorded only in the Czech Republic mainly as a

6 The Central European Free Trade Agreement (CEFTA) is a trade agreement between non-EU countries in Southeast Europe. CEFTA membership ended for Croatia when it joined the European Union (EU) in 2013.
result of increased equity capital and reinvested earnings. Intercompany lending continued to be the main source of FDI in EU11, with reinvested earnings remaining stable, while equity capital was withdrawn from the region as a whole (in particular from Poland\(^7\)).

The deleveraging of the corporate and banking sectors continued. The reduction in risk aversion and favorable levels of liquidity did not translate into improved bank-related debt flows to the EU11. Both enterprises and banks continued to reduce their debt, albeit at a slower pace, and relied more on domestic sources of funding. All other countries continued to reduce their bank-related borrowing from abroad, with pronounced outflows recorded in Hungary and Slovenia.

Foreign bank exposures to EU11 countries continued to decrease in the first half of 2013. With the overall decline of capital inflows to emerging markets, EU11 countries were not an exception. In the second quarter of 2013, foreign bank claims dropped across the board as parent banks continued to reduce their presence in the region\(^8\). Compared to a year ago, claims to the non-bank private sector declined by an additional ten percent to €237 billion, while those to banks decreased by 16.6 percent to €34 billion. In addition, after five quarters of moderate growth, claims on the public sector also contracted in the second quarter, except in the Slovak Republic. Croatia, Latvia and Hungary experienced the largest reductions in bank exposure to their private sectors.

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\(^7\) In the case of Poland the FDI outflow resulted from one-off transactions of special-purpose vehicles.

\(^8\) Note that cross-border institutions such as EBRD and EIB as well as institutional investors are not factored in these cross-border flows, although they are significant creditors of EU11 countries.
Foreign banks remained selective about where they allocated funds within the EU11. Compared to June 2012, international claims from European banks decreased further by 3.2 percentage points to 22.8 percent of GDP, but with notable variations. Spain increased its exposure by as much as 47 percent or €9 billion, through the acquisition of a Polish bank that had been partly owned by a Belgian bank. Austrian banks were the most active in rebalancing exposures in the region, withdrawing from Hungary, Slovenia, Poland and Romania, while increasing resources to the Czech Republic, and to a lesser extent, Slovakia and Croatia. Overall, European banks continued to withdraw funds from Hungary and Slovenia.

Santander acquired Bank Zachodni WBK SA in 2012 and merged it with Kredyt Bank SA in January 2013 to create Poland’s third largest bank by assets.
Subdued Inflation and Further Monetary Easing

Monetary policy remained accommodative in the EU11 throughout 2013, with policy interest rates further reduced. Inflation has subsided due to weak domestic demand, a significant decline in the rate of global food price rises and a fall in energy prices.

The European Central Bank (ECB) has continued to ease monetary policy in the Euro area. The ECB lowered its main policy interest rate in May 2013 and again in November, both times by 25 basis points, as the underlying rate of inflation declined to just over one percent, and economic growth and credit growth remained subdued. The ECB’s main policy interest rate at end-November was 0.25 percent, while the rate on the ECB’s deposit facility was unchanged at zero. The ECB also confirmed its forward guidance (see Box) that interest rates are expected to remain at present levels, or lower, for an extended period until the recovery appears more sustainable. In contrast to the US, where 10-year government bond yields rose by around 80 basis points over the year, to around 2.8 percent, the yield on similar German bonds remained stable at around 1.75 percent, suggesting that markets expect a much more modest economic recovery in the Euro area.

Central banks in the EU11 also lowered interest rates to support economic activity. During 2013, the central bank of Hungary gradually reduced its policy rate to a new record low of 3.2 percent in November, while the Romanian central bank reduced its policy rate in four steps, by 125 basis points, after more than a year of keeping the policy rate on hold because of persistently high inflation. Poland’s policy rate was reduced a number of times up until July 2013, after which time the central bank indicated that interest rates will remain unchanged until at least mid-2014.

Inflation has been on a downward trend in

Box 2: Central Banks “forward guidance”

As policy interest rates have hit record lows around the world, central banks have introduced less conventional policy measures to support economic activity, such as the purchase of government bonds (“Quantitative Easing, QE”). This has raised uncertainty about the future path of monetary policy, and in response central banks, such as the US Federal Reserve and the Bank of Japan, have introduced more “forward guidance” to provide a clearer signal to financial markets and the public about the future direction of monetary policy. For example, a central bank may indicate that it expects to reduce bond purchases or raise the policy interest rate when the unemployment rate falls to a more reasonable level, or they may indicate a time when action is likely to be taken, or simply assure the markets that policies will, for example, support growth for as long as necessary.

The ECB and the Bank of England started to provide more forward guidance over the summer of 2013. The former has adopted a more open-ended strategy, to support growth as long as necessary, while the latter has linked the consideration of rate rises to the unemployment rate. However, as global markets’ reaction to the US Fed’s announcement in May 2013 about a possible tapering of QE toward the end of the year demonstrated, uncertainty can still be disruptive, particularly for emerging markets, despite greater forward guidance.

![Figure 22. Policy Interest Rates in Selected EU Countries (Percent)](image)

Source: Central banks; World Bank staff calculations.
the EU11 during 2013, as a result of falling energy prices and lower food price increases. As energy prices have fallen from their elevated levels in 2011-12, the overall inflation rate in the EU11 has steadily declined during 2013, with an average rate of 0.8 percent in October 2013. In recent months, the faster than expected reduction in food price inflation has also contributed to reduced overall inflation. EU11 countries experienced inflation in the range of -1.1 to 2.2 percent—with deflation in Bulgaria and the highest rate of inflation in Estonia. Reflecting the weakness of domestic demand, the EU11 core inflation (i.e. excluding energy and unprocessed food) remained low and stable, reaching 1.2 percent in October 2013. The overall and core rates of inflation in the EU11 are both lower than in the EU15 for the first time.

**Figure 23. Harmonized Consumer Price Index (HICP), Overall and Core, EU15 and EU11 (Percent, Year-on-Year)**

**Figure 24. Average HICP, EU15 and EU11 (Percent, Year-on-Year)**

*Note: Core inflation is defined as overall index excluding energy and unprocessed food*

*Source: Eurostat; World Bank staff calculations.*
Credit remains subdued, limiting support for economic recovery

As credit demand has shown some signs of recovery, consistent with the observed turnaround in the business cycle, supply-side constraints continue to limit the pace of new credit growth.

The gradual shift in funding sources toward local deposits has continued in 2013, partially offsetting the decline in foreign funding. Since 2008, local deposits have gained importance in the funding structure of banks, accounting for more than two thirds of funding sources for most EU11 countries. Loan-to-deposit (LTD) ratios are still adjusting downward. In most EU11 countries, deposit growth rather than a decline in loans is behind the drop in LTD ratios, with the notable exception of Slovenia, and to a lesser extent, Hungary and Latvia. However, foreign funding remains relevant in the Baltic countries, Hungary and Romania. Except in Slovenia, the growth in local deposits has only partially offset the decline in foreign funding over the last 12 months.

Given the incipient recovery in economic activity, the question arises as to whether the banking sector will be able to provide enough funds to the private sector. As highlighted above, foreign-owned banks have continued deleveraging in most of the EU11, with the exception of Poland, Slovakia, and Bulgaria while equity capital has also been withdrawn from some countries.

![Figure 25. Annual Growth in deposits, loans, and loan-to-deposit ratios, Q2 2013 (percentage points)](chart1)

![Figure 26. Annual Growth in Deposits and Foreign Liabilities, 2nd Quarter of 2013 (percent)](chart2)

Source: IMF International Financial Statistics; central banks; World Bank staff calculations.

Note: Foreign liabilities of Euro area countries are liabilities to non-Euro area residents.

Bank lending began to slowly increase in the third quarter of 2013, after reaching the lowest point in June 2013. Real credit grew in Slovakia due to lending to households that was partially offset by a contraction in credit to enterprises. In Bulgaria, after contracting in 2012, credit to households increased at the end of the third quarter of 2013, which combined with an increase in lending to enterprises, led to an overall real growth rate of about 2 percent as of September 2013. In contrast, Slovenia and Latvia experienced the largest decreases in credit, followed by Hungary and Croatia. The latest bank lending survey suggests that overall lending conditions in EU11 deteriorated, due to tighter funding conditions. Although the demand for loans grew in the

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10 Real credit growth rate is computed using CPI as a deflator.
11 Conducted by the Institute for International Finance (IIF); [www.iif.com](http://www.iif.com)
third quarter of 2013, albeit at a slower pace than in the first part of the year, credit standards tightened, after easing in the previous two quarters, particularly on commercial real estate loans and consumer loans.

While resolving the high level of non-performing loans (NPLs) and addressing regulatory uncertainty are key for alleviating constraints, credit conditions will remain difficult in the near-term. In June 2013 NPLs accounted for over one fifth of total loans in Romania, and remained above 15 percent in Bulgaria, Slovenia and Hungary, although Bulgarian, Latvian, Romanian and Polish banks have made relatively high provisions for their NPLs. Such high levels of NPLs reduced banks’ profitability and in some cases impaired the ability to make new loans. To bolster credit growth, a concerted effort by regulators and banks is needed and an important step would be the adoption of the draft harmonized definitions of NPLs and regulatory forbearance that was published by the European Banking Authority (EBA) in October 2013. As the implementation of a single set of harmonized prudential rules for banks progresses (the “European Single Rulebook”, see Box in the outlook section), banks will likely need to reflect losses and adjust their provisions for NPLs, which may negatively affect profitability, capital adequacy and thus lending levels in the near-term.

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12 Given the differences in NPL definitions across countries comparisons are currently difficult.
Fiscal Consolidation delayed in a Challenging Environment

Fiscal adjustment was put on hold in the EU11 in 2013, as weak domestic demand undermined revenues and increased spending pressure to bolster economic growth. Consequently public debt-to-GDP ratios increased further in 2013.

The weaker macroeconomic situation in 2013 partially reversed recent fiscal consolidation efforts in the EU11. Fiscal consolidation generally started in 2010 and intensified in 2011 and 2012, leading to significant improvements in public finances in both the EU11 and EU15. The fiscal deficit dropped by almost 4 percentage points of GDP in the case of the EU11 and 3 percentage points for the EU15, and the growth of public debt ratios started to moderate. The EU15 continued to narrow their fiscal deficits in 2013 despite the economic contraction, albeit at a slowing pace. However, in 2013 the EU11 fiscal deficit is expected to increase slightly to 3.6 percent of GDP from 3.4 percent of GDP in 2012. This contrasts to a planned reduction in fiscal deficits, by 0.4 percent of GDP, outlined in the EU Stability and Convergence Programs in April 2013.

Figure 30. Fiscal deficit in EU11 and EU15, 2012-2013, percent of GDP

The Czech Republic, Slovakia, Romania and Lithuania managed to continue their fiscal consolidation efforts. Fiscal deficits declined in the Czech Republic13, Slovakia, Romania and Lithuania, compared to 2012, although in all these countries the deficits were higher than expected in mid-2013. The Czech relied predominantly on revenue measures to support fiscal consolidation efforts—including an increase in VAT rates. More modest improvements in fiscal balances in Romania and Lithuania came from reduced public investment in the former (related also to challenges in absorbing EU funds) and further expenditure compression in the later.

Fiscal balances in other EU11 countries either deteriorated or stayed at 2012 levels. Slovenia recorded the largest increase in the fiscal deficit in 2013 among the EU11 countries, albeit much lower than anticipated in the summer, as the bulk of bank recapitalizations were shifted from 2013 to 2014; in Bulgaria the fiscal deficit is expected to widen from 0.8 percent of GDP in 2012 to 2 percent of GDP in 2013 as a result of weak growth and a fiscal stimulus that includes an increase in pensions and social assistance. According to the European Commission Autumn Forecast, the fiscal deficit in Hungary is on course to increase by about 1 percentage point of GDP in 2013, reaching almost 3 percent of GDP, reflecting a combination of revenue shortfall—despite mid-year increases in taxes on bank transactions, a bank levy, treasury transactions and selected sector

13 The nominal deficit for the Czech Republic would have been 2.6% of GDP if adjusted for the large one-off payments (mainly church restitutions) that amounted to 1.8% of GDP.
taxes as well as elimination of the cap on employee pension contribution and new expenditure increases—a hike in the minimum wage, healthcare and teachers’ salaries and an increase in pension benefits. The fiscal deficit in Poland is expected to widen to around 4.6 percent of GDP in 2013, from 3.9 percent of GDP in 2012, due to revenue shortfalls mainly from VAT, excise duties and CIT, and despite expenditure cuts embedded in a budget amendment from September.

**Figure 31. Fiscal adjustment, composition in 2013 (percent of GDP)**

From the perspective of the EU fiscal rules, roughly half of EU11 countries are expected to have fiscal deficits below or equal to 3 percent of GDP in 2013. Countries which exited the EU Excessive Deficit Procedure (EDP) based on their fiscal outcomes in 2011 and 2012 (Bulgaria, Hungary, Latvia, Romania, Lithuania) have their fiscal deficits below the reference value and are now mandated by the Stability and Growth Pact to maintain or progress towards their country-specific Medium-Term Budgetary Objectives (MTOs). Poland, which missed the EDP target set for 2012 was given additional time—to 2015—to lower the fiscal deficit to below 3 percent. Slovenia is also set to exit the EDP in 2015. The Czech Republic and Slovakia are both on track toward exiting the EDP in 2014, as they are likely to reduce their fiscal deficits to below 3 percent in 2013. In December 2013 the European Commission’s recommended that Croatia enter the EDP in 2014, due to an expected fiscal deficit of 5.4 percent of GDP in 2013 and debt rising to over 60 percent of GDP. The Council set a deadline for EDP correction for Croatia in 2016.

The reversal in the fiscal consolidation effort resulted in further increases in public debt to GDP ratios. In 2013 public debt ratios in the EU11 region ranged from 10 percent of GDP in Estonia to around 80 percent of GDP in Hungary. Over the last couple of years, public debt-to-GDP ratios have been increasing across the region, except in Hungary and Latvia. Poland’s debt ratio decreased in 2012 while Lithuania’s declined in 2013. In 2013, increases in the public debt-to-GDP ratio from 2012 were particularly marked in Slovenia and Croatia: Slovenia’s debt increase, of close to 9 percentage points of GDP, resulted from payments for bank recapitalization, economic recession and increasing debt service costs. In the case of Croatia, the increase in debt is projected to be around 4 percentage points of GDP, driven by similar factors: the government will accept sizeable debts from some public and state owned enterprises, as well as the ongoing economic contraction.

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14 In December 2013, the European Council assessed that Poland had not taken effective action to reduce the fiscal deficit to below 3 percent of GDP by 2014 and asked the authorities to specify additional fiscal measures by April 2014 and extended the deadline for EDP correction until 2015.
While the perception of sovereign risk has generally declined across EU11 countries, the levels remain high. There is a clear differentiation across the region, with most of EU11 countries registering credit default swap (CDS) spreads below 150 basis points. However, countries such as Slovenia, Hungary, Croatia and Romania continue to be perceived as riskier due to weak fiscal positions and/or challenging economic conditions. CDS spreads in Hungary rose to levels near 400bp during 2013, returning to below 300 basis points toward the end of the year as markets took some comfort in the ongoing fiscal consolidation effort, current account surplus, and low inflation. CDS spreads of EU11 countries are in line with their respective sovereign ratings, with the exception of Slovenia, which shows the highest CDS spreads despite being rated A- by S&P, reflecting the continuing deterioration of its economic outlook and recapitalization needs of the banking sector. However, emerging markets with the highest spreads may be more at risk from tightening global credit conditions should financial markets in the US, amongst others, start to reduce quantitative easing and raise interest rates in 2014.

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15 Croatia and Romania are rated BB+ by S&P, while Hungary is rated BB.
16 On November 8, Fitch raised its estimate of how much Slovenia would have to pay to recapitalize its mostly state-owned banking system to €4.6 billion (from €2.8 billion), driven by an increase in NPLs and the continued contraction of the economy.
Figure 33. 5Y CDS, EU11 Countries (Basis points)

Figure 34. Sovereign credit ratings and 5Y CDS spreads

Source: Reuters; Bloomberg; S&P sovereign rating; World Bank staff calculations.

Note: Data as of November 11, 2013. Sovereign ratings were converted into points, with a lower value indicating a higher sovereign rating. The ratings range from 4=AA- to 12=BB.
EU11 Near-Term Outlook

A Weak Economic Recovery, but growth looks set to become more balanced

Amid a gradually improving external environment and supportive domestic developments, EU11 growth is expected to increase in 2014 to over two percent, from one percent in 2013. Although relatively weak, the recovery will be based on more balanced growth, with both domestic demand and net exports supporting economic activity. Notably, investment is expected to start adding to growth for the first time since 2011. However, downside risks are significant both from weaker external demand and tighter credit conditions.

EU11 growth is expected to double in 2014 and the region will retain its growth advantage over the EU15. With the improvement in the external environment, especially the Euro Area emerging from recession in 2014 (see Box 3), the prospects for the EU11 region have improved as well. The EU11 region is expected to grow 2.3 percent in 2014, which is double the rate of growth from 2013. By comparison, after a small contraction of output by 0.1 percent in 2013, the EU15 region should turn to positive growth of around 1.3 percent in 2014, driven by improvements in Southern Euro zone economies.

All countries in EU11 will grow faster in 2014 than in 2013, with Croatia and Czech Republic turning to positive growth rates. Among the EU11 countries only Slovenia will stay in recession in 2014, reflecting the large ongoing bank deleveraging. Baltic countries will continue to expand at the fastest rates in the region—all above 3 percent—while in the majority of EU11 countries growth will be around 2 percent. Sweden, which is expected to be the fastest growing EU15 country, will expand by around 2.8 percent in 2014.

Economic growth in 2014 is expected to become more broad-based. Growth in 2013 was predominantly based on net exports, while in 2014 domestic demand will continue to improve based on the trends seen in the latter part of 2013. All components of domestic demand are projected pick up: private consumption will be boosted on the back of growing real wages as employment prospects continue to improve in an environment of subdued inflationary pressures and strengthening consumer confidence; public consumption will improve, but only modestly, constrained by the need for further, albeit gradual, fiscal consolidation; investment growth is finally expected to turn positive after two years of contraction, as external demand continues to bolster producers’ sentiment and manufacturing, while supportive lending conditions will critically depend on both the continuation of accommodative monetary policy and firm action to address non-performing loans in many countries (that does not lead to significant requirements for additional capital). Moving further forward, investment in EU11 should also be bolstered by the new 2014-2020 round of EU structural funds (see Spotlight section).
**Figure 36. Contribution to GDP growth (percent)**

Source: Ameco, European Commission, Autumn 2013; World Bank staff estimates

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**Euro Area recovery should bolster growth in the EU11**

**EU11 exports are projected to gain momentum in 2014.** Export order books have improved markedly toward the end of 2013, signaling that exports are likely to grow in 2014. This is based on stronger demand from advanced economies—particularly the Euro Area, which looks set to grow after two consecutive years of contraction (see Box 3)—while demand from emerging economies for EU11 products appears to have lost some momentum despite their continued robust growth forecasts. The short-term prospects for imports into the EU11 continue to be restrained by still weak domestic demand, although with increasing growth momentum, stronger domestic demand, and a pickup in investment, import volumes are also set to grow, which may gradually push current account balances back toward historical levels.

**Figure 37. Annual export growth and expectations, (percent)**

Source: Eurostat, World Bank staff

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**Box 3: Near-Term Global Outlook and Risks**

High-income countries’ growth will remain a relatively modest 2.2 percent in 2014, but projected to firm to 2.4 percent in the following two years. Concerns about fiscal policy gridlock in the US may continue with the government shutdown and debt-ceiling debate likely cut into annualized growth in the fourth quarter of 2013 by around 0.5 percentage points of GDP. However, the drag on growth from fiscal cuts in 2014 is expected to be 1 percent of GDP smaller than this year, which should be a strong impetus to growth in 2014. Overall, US GDP is expected to grow around 1.7 percent in 2013 and by 2.6 percent in 2014.

In the Euro Area, the reduced drag from ongoing fiscal consolidation is expected to push growth into positive territory in 2014 and strengthen it further to around 1.5 percent in 2015. However, unemployment

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17 Based on latest World Bank Global Economic Prospects.
remains high: 12 percent for the Euro Area and over 26 percent in Greece and Spain. Euro Area GDP is about 2 percent and several periphery countries nearly 10 percent below pre-crisis levels. Furthermore, still weak banking sectors and rising political uncertainty, notably in Greece and Italy, add to downside risks to growth against a backdrop of rising global financial uncertainty.

**Growth in developing countries is projected to firm in 2014 to 5.4 percent, from 4.9 percent in 2013, slightly slower than potential growth.** Growth in developing countries excluding China is projected to firm in 2014 to 4.3 percent (from 3.5 percent in 2013) broadly in line with potential growth.

**Table 1: Global Growth Assumptions – Real GDP Growth (in percent)**

<table>
<thead>
<tr>
<th></th>
<th>2011</th>
<th>2012</th>
<th>2013f</th>
<th>2014f</th>
<th>2015f</th>
<th>2016f</th>
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<td>2.5</td>
<td>2.4</td>
<td>3.2</td>
<td>3.4</td>
<td>3.5</td>
</tr>
<tr>
<td>High Income</td>
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<td>1.5</td>
<td>1.3</td>
<td>2.2</td>
<td>2.4</td>
<td>2.4</td>
</tr>
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<td>4.9</td>
<td>5.4</td>
<td>5.6</td>
<td>5.7</td>
</tr>
<tr>
<td><strong>Memo Item</strong></td>
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<td>-0.6</td>
<td>-0.5</td>
<td>1.1</td>
<td>1.5</td>
<td>1.5</td>
</tr>
</tbody>
</table>


**Downside risks and uncertainty related to the eventual timing of tapering and its impacts on developing countries remain.** Global capital flows remain volatile, as evidenced by the sharp drop in gross capital flows to developing countries in October that fully reversed the rebound in September. Markets also appear to be discriminating between developing countries on the basis of domestic policy frameworks and risks. The eventual transition to higher interest rates poses risks of a disorderly adjustment if rates rise too rapidly or a sudden stop in capital flows exposes vulnerabilities. Although some adjustment has taken place (the average long-term cost of bond financing for developing countries has risen 50 basis points since May), U.S. yields likely have a further 200-300 basis points to rise, with developing country yields likely to rise by 300-450 basis points over the medium term. The decision to maintain QE at current levels simply delays the day of reckoning for developing countries with external financing difficulties. Countries with large external imbalances and deep financial markets are most at risk.

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**Shared prosperity requires further reforms to promote jobs and competitiveness**

**Labor market conditions are not expected to improve by the end of 2014.** Enterprise surveys indicate some hiring plans in the coming months, but the initial effect on unemployment rates will be limited. Economic growth is likely to remain too sluggish, i.e. well below potential in most countries, to create enough jobs to reduce unemployment rates18. Instead, better economic conditions and employer sentiment is likely to first result in employers increasing working hours to utilize surplus capacity rather than headcount. New hiring may initially be limited to people with specific skills and the low-skilled, as entrepreneurs make use of existing government programs (i.e. various labor subsidies) and flexible contract arrangements. Only when the sustainability of the economic recovery is more certain will unemployment rates be likely to fall significantly.

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18 The European Commission defines potential growth as the level of GDP that is consistent with a stable rate of inflation. If actual output rises above potential, then constraints on capacity begin to bind and inflationary pressures can materialize. Potential growth rates are published in the European Economic Forecasts: [http://ec.europa.eu/economy_finance/publications/](http://ec.europa.eu/economy_finance/publications/).
The EU11 countries have continued to reform their business environments to remove regulatory obstacles to businesses. However, more can be done to improve competitiveness, promote entrepreneurship and create jobs, as unnecessarily complex business environment breaks the virtuous cycle linking productivity, enterprise growth, and trade with shared prosperity (see the Special Topic). Even though legal frameworks and their implementation may not be the main drivers of foreign investment decisions, they can tip the balance in favor of one economy over another. The average Doing Business 2014 ranking for the EU11 countries was 49th among 189 economies in the world, with the Baltic countries in the top thirty globally. The Baltic countries are also in the top ten within Europe, while Slovenia and Poland perform well compared to EU11 average. However, the rest of the region is in the bottom third of the European Doing Business rankings.

![Figure 38. Global Ease of Doing Business Ranking for the EU11, 2014](image1)

![Figure 39. Ease of Doing Business Ranking for the EU11 within the EU28, 2014](image2)

Source: Doing Business database

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19 Based on the Doing Business methodology ([www.doingbusiness.org)](http://www.doingbusiness.org). Rankings measure regulatory performance relative to other countries. Other areas important to a business, such as a country's proximity to markets, the quality of infrastructure services, the transparency of government procurement, macroeconomics conditions or the underlying strength of institutions etc. are not measured directly.
A number of EU11 countries are on the frontier for particular reforms—for example, Slovenia has the lowest costs of starting a business, Poland is one of 26 countries that presents the best information on credit, while it takes only six days to export goods from Estonia. Business regulations are a significant part of the puzzle. Countries whose enterprises successfully operate in the single market are on the front line. If barriers to entry are low and transaction costs cut, countries with industrial structures with larger and more outward-oriented enterprises seem to perform better.

While large improvements have been made in the EU11, the reform agenda remains unfinished. Table 2 highlights areas where the EU11 are performing comparatively well with Europe, and where reforms might help to boost a country’s competitiveness. For example, courts in the EU11 are affordable, but the average time to enforce contracts is still long—about 580 days, compared to a low in Europe of around 300 days in Lithuania and Sweden. This means that a company that is disputing a commercial case has to wait for more than a year-and-a-half to resolve its case. It also takes an average of 2.5 years to resolve an insolvency procedure and over 180 days to deal with construction permits, rising to over 280 days in Romania and Slovenia. Companies are also spending a significant time to compile their taxes in many countries—over 400 hours in Bulgaria and the Czech Republic, compared to around 80 in Estonia and Ireland.

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20 The frontier is derived from the most efficient practice or highest score achieved on each of the component indicators by any economy in the world. The distance to frontier is reflected on a scale from 0 to 100, where 0 is the lowest.
Financial sector reforms are under way, but will take time to ease credit constraints

Inflation rates are expected to remain low during 2014, even though activity is set to rise. A broadly based and protracted period of low inflation is expected to continue throughout 2014. Core inflation is expected to remain stable, as unemployment levels and unutilized productive capacity remain high. The risks to the inflation outlook are broadly balanced. On one hand, the ongoing weakness in domestic demand, particularly investment, both within the EU11 and the Euro Area, could result in a slowdown in the growth of non-food and non-energy consumer prices. Conversely, inflation could rise due to increases in administered prices in the EU11, as governments look to continue fiscal consolidations, or growth in world raw material prices, especially crude oil and foodstuffs, or through adverse weather conditions boosting domestic agricultural prices.

Monetary policy will remain accommodative to support more sustainable Euro Area growth, but weak credit growth in the EU11 reflects ongoing credit risks and the likelihood of further adjustments of financial and non-financial sector balance sheets. The improvement suggested by survey data looks set to be gradual, as the corporate sector continues to rely on internal funding and credit conditions remain tight. As firms rebuild their balance sheets, credit supply side constraints may become more binding once firms start to expand investment at a faster pace. As growth accelerates, domestic deposit growth may well prove insufficient to support a meaningful revival of credit growth. Bank balance-sheet repair remains a precondition for the normalization of credit growth. It remains urgent to tackle persistently high NPLs in several countries in the region, thereby improving conditions for new lending. In the short run, however, banks’ efforts to shrink their balance sheets to resolve NPLs may constrain new credit growth and result in an effective tightening of credit conditions.

Table 2. Ease of Doing Business Rankings: EU11 and Selected EU15 Countries

<table>
<thead>
<tr>
<th></th>
<th>Starting a Business</th>
<th>Construction Permits</th>
<th>Getting Electricity</th>
<th>Registering Property</th>
<th>Getting Credit</th>
<th>Protecting Investors</th>
<th>Paying Taxes</th>
<th>Trading Across Borders</th>
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Note: The color reflects the rank (out of 28) of a country for an indicator. The lower the number, the better the performance for a specific indicator—colors range from green (strong performance and a high ranking), to yellow (average performance) and red (low performance).
If the upcoming asset quality review (AQR), to be undertaken by the ECB and EBA on the banks, identifies significant balance sheet weaknesses in parent banks, this could significantly reduce credit in the EU11. The AQR will be an assessment of all Euro area banks’ asset classes, as of 31 December 2013, including on- and off-balance sheet positions. It will be conducted on the basis of the new harmonized definitions and the results will feed into a new round of stress tests, with banks required to adopt corrective measures if necessary (see Box 4). While designed to restore confidence in the banking sector over the long term, this could create short-term volatility in the markets, and the EU11 subsidiaries of affected banks could be subject to new rounds of deleveraging, as parent banks seek to shrink assets to reduce their capital needs.
Box 4: Building Blocks of a European Banking Union

As a response to the weaknesses identified after the onset of the global financial crisis, and the sovereign debt crisis in some Euro area countries, the European Union is in the process of strengthening its regulatory and supervisory framework. The goal is to create an integrated architecture for financial stability, that is, a ‘European Banking Union’. Some building blocks are already in place or are in the process of being implemented, while others are still under discussion. Some elements are applicable only in the Euro area (with non-Euro area members having the option to participate), while others are EU-wide. The EU11 countries are therefore facing regulatory uncertainty, and national authorities will need to adjust their supervisory practices while non-Euro area countries must consider if it is in their interest to adopt certain provisions. The new framework is summarized below:

1. **Liquidity Provisions** performed by the ECB for all Euro area banks.

2. **Macropudential Regulatory and Supervisory Functions**: will be performed by the new European Systemic Risk Board (ESRB), and are applicable to all EU Member States (who must create their own Systemic Risk Board).

3. **Microprudential Regulatory and Supervisory Functions**:
   a. Regulatory Framework: the new Basel III capital requirements have been adopted into EU laws (i.e. the Capital Requirement Directive IV/Cash Reserve Ratio package). It entered into force in July 2013, with implementation phased in gradually until 2019.
   b. Supervisory Functions: will be performed by i) the European Banking Authority (EBA), ensuring effective and consistent prudential regulation and supervision across the EU, including the creation of a single set of harmonized prudential rules for banks (the “European Single Rulebook”) and promoting the convergence of supervisory practices; and ii) the Single Supervisory Mechanism (SSM), transferring supervisory functions to the ECB for banks in the Euro area with over €30 billion in assets or 20 percent of national GDP, and those considered systemically relevant. The ECB will assume its supervisory tasks on November 2014.

4. **Bank Resolution**:
   b. The Single Resolution Mechanism (SRM): creates a resolution authority to manage the failure of any bank in the Euro Area. Following notification from the ECB or national supervisor a Single Resolution Board (SRB) would assess if there is a systemic threat or private resolution, and the European Commission would decide to trigger a resolution process for the national resolution authority to implement, under the supervision of the SRB.
   c. Funding: a proposed Single Resolution Fund would be capitalized with contributions from the banking sector, but would not be large, at one percent of covered deposits, and would be built up gradually. The exact funding structure of the Single Resolution Fund is yet to be finalized.

5. **Deposit Insurance**:
   a. Regulatory Framework: the Deposit Guarantee Schemes (DGS) Directive would harmonize national deposit guarantee schemes, including their funding and allowing mutual borrowing. The Directive has been under discussion since 2010, and a decision is pending the adoption of the BRR Directive.
   b. Common Deposit Insurance: preliminary discussions have raised concerns regarding the amount of risk-sharing involved and to date, no proposal has been formally tabled.
Fiscal consolidation will resume in 2014, but the adjustment will be relatively gradual in order to support economic growth. Overall, the EU11 fiscal deficit is expected to decline from 3.6 percent in 2013 to about 3.2 percent in 2014, driven by a combination of expenditure and revenue measures. Fiscal consolidation will also continue in the EU15 with the fiscal deficit dropping to 3 percent of GDP, from 3.7 percent in 2013, as governments mainly cut expenditures. The nascent economic recovery is supporting fiscal adjustment, with the cyclical component, particularly the rebound in revenues, contributing to the reduction in fiscal deficits in the majority of EU11 countries.

The majority of EU11 countries are moving ahead with fiscal adjustment. Budget deficits above the EU requirement of 3 percent of GDP are classified as ‘excessive’ and procedures are in place to ensure a reasonable adjustment trajectory to below this level. The rebalancing of growth, with improving domestic consumption, should help to bolster consumption and income-based tax revenues across the EU11. Poland’s fiscal deficit in 2014 is expected to shrink by around 1 percentage point of GDP, also reflecting large savings from changes in the pension system and the continuation of spending controls introduced in 2011—including a freeze in public sector wages and personal income tax thresholds as well as maintaining a higher VAT rate. Lithuania will continue to constrain expenditure growth in line with the Law of Fiscal Discipline and deficits of Latvia and Estonia will also improve—in Latvia the government postponed the lowering of labor taxes, but increased non-taxable income thresholds thereby lowering the tax burden on low wage earners; in Estonia sizeable revenue measures include raising excise duties, a rescheduling of dividend payments from state-owned enterprises, limiting VAT deductibility for corporate cars, and measures to improve tax collection and combat shadow economy, although this will be partially offset by higher discretionary expenditure, including wage increases and compensation schemes for pensions.
Despite the upturn in growth, fiscal consolidation will remain challenging. The fiscal deficit in Slovenia is expected to increase further in 2014, reflecting the need for large bank recapitalizations that will more than offset fiscal consolidation measures on both the revenue and expenditure side. Croatia’s fiscal deficit is expected to widen in 2013 on the back of the rise in interest payments, clearance of the health sector arrears, as well as decline in revenue collection after the introduction of the middle VAT rate for tourism and catering services, and the CIT tax relief for reinvested profit. Both Hungary and Slovakia will also face challenges in continuing their fiscal consolidation efforts, due to public wage pressures (Hungary) and the expiration of one-off revenue measures (Slovakia).

The public debt to GDP ratio is set to decline in the EU11 for the first time since the crisis, but this is largely the result of pension changes in Poland. The public debt to GDP ratio in 2014 is expected to be around 50 percent, i.e. 2 percentage points less than in 2013, as debt is set to decrease in Poland, Latvia, Hungary and Estonia. In Poland, the debt to GDP ratio will decrease on the back of a sizable transfer of sovereign debt (8.5 percent of GDP) from the open pension funds to the state pension pillar. In Latvia public debt will drop by some 3 percentage points, following large repayments of crisis support loans, while Croatia’s public debt is set to rise above the EU threshold of 60 percent of GDP.
Economic growth forecasts in the EU11 are subject to multiple risks, mainly on the downside, as the global financial situation remains fragile. There are significant external risks that are no longer dominated by the prospects of the Euro Area economies. As the immediate risk of contagion from the Euro Area sovereign debt crisis and recession have subsided the growth prospects for emerging markets, whose growth rates slowed in 2013, are more uncertain and a slowdown could impact European exports and growth. Another factor affecting the economic prospects of the EU11 is the volatility in international financial markets, triggered by announcements of future tapering of US bond purchases and over the US budget and debt ceiling and uncertainty related to the path of monetary and fiscal policy in the US. Shocks in the US could lead to larger spillovers through financial markets, confidence and links to the real economy, particularly if long-term interest rates continue to rise.

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

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

While the gradual pace of fiscal consolidation is appropriate to support long-term growth, public finances will remain fragile across the EU11. If domestic demand does not pick up as expected, revenues from income and consumption taxes could continue to underperform, and further measures may be required to ensure that fiscal deficits and debt levels resume their move toward more sustainable levels (consistent with the EU thresholds). It could also take time to program and commence implementation of the new EU Cohesion Policy funding (see Spotlight), which constitute a large share of public investment funds. Both these effects could dampen domestic demand and growth in the short term.
**Spotlight: The New EU 2014-2020 Cohesion Policy—boosting investment in the EU11**

EU11 countries are the main beneficiaries of EU structural funds, which often support the majority of public investment. The new round of funding, from 2014-2020, is consequently critical for stimulating growth and shared prosperity within Europe.

The objective of the EU Cohesion Policy in 2014-2020 is to deliver the Europe 2020 objectives of smart, sustainable and inclusive growth. Accounting for over a third of the EU budget for 2014-2020 (amounting to €325.1 billion), the main goal of the European Structural and Investment Funds (ESIF) is to promote job creation and boost economic growth, with a focus on less developed regions across the Member States—defined as regions with GDP per capita less than 75 percent of the European average. Twenty percent of the overall envelope is allocated to the Cohesion Fund, which supports Member States with GNI per capita less than 90 of EU average.

Spending on Cohesion Policy is channeled through three funds, namely:

a) *The European Regional Development Fund* (ERDF), which provides direct aid for investment in companies, infrastructure, financial instruments, and technical assistance measures. The ERDF is allocated on a regional basis;

b) *The European Social Fund* (ESF), which finances projects in the labor market that improve skills, social integration, and access to employment opportunities. The ESF is also allocated on a regional basis; and

c) *The Cohesion Fund*, which finances developments in transport networks, environmental projects, and energy and transport projects that offer environmental benefits. The Cohesion Fund is allocated at national level.

The EU11 countries will receive just over half of the overall Cohesion Policy resources. In absolute terms, the majority of the resources (€115 billion) are earmarked for less developed regions. In the EU11 region, Bulgaria, Croatia, Estonia, Latvia, Lithuania, as well as the majority of the territories in the Czech Republic, Hungary, Poland, Romania, Slovakia, Hungary and Slovenia are considered less developed regions.

These funds, along with domestic co-financing, constitute a significant share of public investment in the EU11, and will therefore have a major impact on growth. Poland is allocated around 40 percent of the total EU11 allocation, through both the Cohesion Fund and for less developed regions, which is equivalent to around 2.6 percent of GDP per year while Hungary’s allocation is equivalent to 2.8 percent of GDP annually.

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21 In addition, the Cohesion policy funds are earmarked for (i) transition regions (defined as regions with income of 75-90 percent of EU average)—€31.7 billion; (ii) more developed regions (over 90 percent of EU average)—€49.5 billion; (iv) Territorial cooperation—€8.9 billion; (iii) An extra allocation is made to outermost islands and sparsely populated regions—€1.4 billion; and (iv) To a youth employment initiative—€3 billion.
over 7 years. Annual allocation for the EU11 countries averages around 2.3 percent of GDP over 7 years\textsuperscript{22}. In most countries the total amount will decline or remain flat in nominal terms, although increases are envisaged for Poland, Romania, Bulgaria and the Slovak Republic. Croatia, as a new member state, is allocated to receive around 2.6 percent of GDP per year. During 2009-11 under the previous funding round, Cohesion funding (including national co-financing) represented over seventy percent of public investment in Hungary, Slovakia, Bulgaria, Lithuania and Estonia, and over 50 percent on Poland and the Czech Republic, and as such it was a major contributor to growth and employment.

Changes have been introduced for the 2014-202 period to boost the impact of the funds. The funds must be aligned with the Europe 2020 Strategy, to better focus resources on a limited number of key priorities. The Commission identified four priority areas with high growth potential: Research and Innovation, Small and Medium Enterprises (SMEs), Information and Communication technologies, and the low-carbon economy. An increased focus on results is designed to show whether public investments are achieving their desired effect through enhanced transparency, accountability and performance measurement. Integration and coordination between the Cohesion Policy and other Union policies is being strengthened through a common set of rules to combine different funds and instruments towards achieving objectives.

Countries are also required to fulfill a range of specific pre-conditions to access the funds. All Member States will have to fulfill pre-conditions linked to the effective and efficient use of EU funds. For example, by producing a “smart specialization” strategy that identifies particular strengths and opportunities, or taking measures to improve public procurement systems and demonstrating compliance with environmental laws. Strategies to fight youth employment or to promote gender equality and non-discrimination are also necessary preconditions. If conditionalities are not fulfilled, countries will need to present the European Commission with an action plan and a timetable for implementation to be completed no later than end-2016.

Cohesion Policy is also set to be linked to the EU’s economic governance framework through macroeconomic conditionality. The areas supported by the Cohesion policy will have to be consistent with

\textsuperscript{22} The Common Provisions Regulation for the Structural Funds defines the maximum level of transfer (capping) from the Funds to each individual Member State at 2.35% of the GDP of the Member State. This capping will be applied on an annual basis. For Member States which acceded to the Union before 2013 and whose average real GDP growth 2008-2010 was lower than -1%, the maximum level of transfer will be 2.59%.
National Reform Programs that address reforms identified through that EC’s annual country-specific recommendations in the process known as the European Semester23. The Commission can now ask Member States to modify programs to support key structural reforms, which should be consistent with Cohesion Policy investments. In addition, the Commission has the authority to suspend funds if macroeconomic problems are not satisfactorily addressed.

23 For a description see: http://ec.europa.eu/europe2020/making-it-happen/
SPECIAL TOPIC:

Poverty Reduction and Shared Prosperity in the EU11
Introduction

While economic growth is fundamental to enhance the well-being of the population, the pattern of growth, job creation and the social contract also matter. Focusing on the welfare of the less well off as a measure of real societal progress is the fundamental principle underlying the World Bank’s two institutional goals: to reduce extreme poverty and to promote shared prosperity. For poverty, the goal is to reduce the percentage of people living on less than $1.25 a day globally to 9 percent by 2020 and to 3 percent by 2030. For shared prosperity, the goal is to foster income growth of the bottom 40 percent of the population in every country. The indicator itself is a simple monitoring device, while the policy agenda underpinning the idea of shared prosperity is more complex than simply raising incomes, taking account of both the monetary and nonmonetary dimensions of welfare over time. Achieving shared prosperity requires linking lower income people to the economic growth process in an environmentally, socially, and fiscally sustainable manner, such that the gains will be secured for generations to come. This requires jobs and a well-functioning labor market in addition to a social contract that generates a structure of taxation and social spending, and social protection programs that enable societal investments in institutions that improve the opportunities for all and provide safety nets to protect the vulnerable against extreme deprivation and shocks.

The emphasis on reducing extreme poverty is in line with the commitment to halve extreme poverty enshrined in the first target of the Millennium Development Goals (MDGs). As less than 0.2 percent of the EU11’s population lives on less than $1.25 per day, this chapter focuses on how well the countries have fared in reducing relative poverty, looking at both the EU relative monetary poverty measure and through the lens of shared prosperity. Through these two indicators this paper looks at the extent to which all, particularly relatively poor members of society in the EU11, share the benefits of economic growth. Understanding better the characteristics of the bottom 40 percent highlights that while economic growth is necessary, unless the benefits are shared widely and reach the poorer members of the population, for example through promoting skills and access to labor markets (particularly for the young and women), reducing business constraints as well as well targeted social protection, it is not sufficient to promote a sustainable and inclusive development process. Improving the efficiency and effectiveness of such policies is particular important in an environment of historically weak economic growth and in the EU11, and where further fiscal consolidation is necessary in many countries.

This special topic chapter is organized as follows: Section 2 presents relative poverty trends in the EU11 countries, covering the period from 2006 to 2010 (see Box 5 for information on the availability and limitations of household income data in the EU11); Section 3 explores the available evidence on shared prosperity in the EU11 countries, examining the extent to which economic growth has benefitted the poorest 40 percent and discussing the likely driving forces behind these changes; Section 4 looks at the key characteristics of the poorest 40 percent; and Section 5 considers policies that are likely to have the greatest bearing on shared prosperity in the EU11.

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Box 5: Data availability and data quality in the EU11

The EU11 is one of the most data-rich sub-regions in which the Bank works. All EU11 countries participate in the European Union Statistics on Income and Living Conditions project (EU-SILC). The EU-SILC is the main source of data on income, poverty, social exclusion, and living conditions in the EU. The EU-SILC provides two types of annual data: (i) cross-sectional data and (ii) longitudinal data. Cross-sectional data refers to a snapshot of individuals and households at a particular point in time, whereas longitudinal data contains repeated observations on the same individuals over a four-year period. EU-SILC surveys have been conducted annually since at least 2007 in all EU11 countries except for Croatia. Although Croatia conducted its first EU-SILC survey in 2010, 2011 is the first year for which Eurostat provides EU-SILC data on Croatia.

The EU-SILC framework maximizes the comparability of the information produced and allows comparable estimates over time and across countries. Survey questionnaires vary across countries, but all EU-SILC surveys use lists of harmonized target variables to be transmitted to Eurostat and all countries follow common guidelines and procedures, common concepts (for example, household and income definitions) and classifications.

The main drawback of EU-SILC is the considerable time lag before the data become available. Data collected in a particular year are not transmitted to Eurostat until November of the subsequent year, and Eurostat makes the micro data available to researchers the year after that, releasing cross-sectional data in March and longitudinal data in August. Moreover, income variables refer to the calendar year before the interview. As a consequence, at the end of 2013 the most recent EU-SILC data available was collected in 2011, with income variables that correspond to the year 2010.

In this chapter, the years refer to the income reference year, and not the year in which the EU-SILC survey was carried out. For example, the trends reported for 2006 to 2010 use the EU-SILC surveys from 2007 to 2011. In EU11 countries household budget surveys are still implemented, but in several cases the micro data from their household budget surveys are not readily available.

Policy makers could use more timely and readily available measures of poverty and shared prosperity. While the data in the EU11 is of a high quality, evidence based policy making may sometimes require more recent information to demonstrate if policy changes are having an impact on the incomes of certain groups. This suggests that some leading or ‘flash indicators’ could usefully be developed to help refine policies and inform debate about the distributional effects of countries’ reforms, particularly with regard to poorer and vulnerable groups that may have less ability to cope with unintended negative changes in their circumstances.
Section 2: The European Union’s Poverty and Exclusion Measures in EU11

The EU’s monetary poverty indicator is based on a relative poverty concept. Relative poverty is more closely related to inequality measures than to extreme poverty measure. An individual is defined as being at risk of monetary poverty if her/his income is less than 60 percent of the median income in that country. Under this definition, the relative poverty line varies considerably from one EU member state to another (Figure 46). Within the EU11, in 2010 the risk of poverty threshold for a household comprising two adults and two children ranged from €2,667 per year in Romania to €15,119 in Slovenia (or €7.31 and €41.42 per day, respectively).

Based on these thresholds, the percentage of the population living below the relative poverty line in the EU11 countries ranged from 10 percent in the Czech Republic to 22 percent in Bulgaria and Romania. Other EU11 countries with high rates of relative poverty are: Croatia (21 percent), Lithuania (19 percent), and Hungary (19 percent). These are followed by Estonia and Poland, both with 18 percent of their populations below the relative poverty line. Latvia, Slovakia, and Slovenia have relatively low risk of relative poverty, with incidences of around 13 to 14 percent. For comparison, the average relative poverty rates in the EU15 and the EU28 are 17 percent.

Within EU11 countries there is large intra-country variation in relative poverty rates, and all have sub-national areas and regions with elevated relative poverty rates. At the sub-national level—from small municipalities to large regions of a country—the relative poverty rate may be up to three times the national average. Devising policies to address concentrations of relative poverty is an essential element for reducing poverty and promoting shared prosperity. A World Bank and European Commission initiative will identify the poorest sub-national areas, and will be completed in 2014.

25 Income refers to adult equivalized total household disposable income. The total disposable income of a household is calculated by adding together the personal income received by all of household members plus income received at household level. It includes all income from work, income from investments and property, transfers between households and all total transfers received in cash, including old-age pensions. It excludes rent and non-monetary income components. To take into account the impact of differences in household size and composition, the total disposable household income is then divided by the equivalization factor which assigns a value of 1 to the first person aged 14 or more, a weight of 0.5 to other persons aged 14 or more and a weight of 0.3 to persons aged 0-13.
A second EU indicator, Severe Material Deprivation, captures aspects of absolute poverty. Severe material deprivation is one of the indicators contained in the European Union’s ten-year growth strategy, Europe 2020. It is a measure of poverty and social exclusion that reflects a household’s inability to afford items considered necessary to lead an adequate life in the European Union setting. The indicator has a strong negative correlation with median household incomes (Figure 47). The percentage of severely materially deprived persons is less than ten percent in the higher income EU11 countries, such as Slovenia, the Czech Republic, Slovakia, and Estonia, which also implies smaller absolute differences in material deprivation across the income distribution in those countries. At the other end of the scale, severe material deprivation rates are over 20 percent in lower income countries such as Hungary, Latvia, Romania, and Bulgaria.

Section 3: Shared Prosperity in the EU11

Shared prosperity means robust income gains for poorer groups

The World Bank’s shared prosperity indicator—based on income growth of the bottom 40 percent of the income distribution—measures whether growth is reaching the less well-off. It has much in common with the EU’s relative monetary poverty indicator. Both are inherently relative notions. Unlike the US$1.25 per day extreme poverty line that is fixed in real terms over time and space, the “goalposts” for the relative poverty and shared prosperity indicators shift over time. Equally important, the reference points (60 percent of median income and the 40th percentile, respectively) are self-referential within a country, and therefore may be at very different income levels and standards of living in neighboring countries. As seen earlier, in the EU11 countries between 10 and 22 percent of population lives below the relative monetary poverty line so the shared prosperity indicator includes this group that is below the risk of poverty threshold. It also enlarges it to include vulnerable and aspiring middle-class households that are above the poverty line, but may be at risk of falling into poverty.

26 A third EU indicator of poverty and social exclusion is Low Work Intensity, which measures the prevalence of persons living in households in which no one works, or works only very limited hours. This indicator is discussed later.
27 Severely materially deprived households are those that state they cannot afford at least four of the following nine items: (i) mortgage payments, rent, or utility bills; (ii) adequate heating; (iii) unexpected expenses; (iv) meat, fish, or a protein equivalent every second day; (v) a week-long holiday away from home; (vi) a car; (vii) a washing machine; (viii) a color television set; or (ix) a telephone. The indicator thus attempts to capture a household’s economic capacity, albeit subjective, to acquire basic material goods and services regardless of whether or not they actually acquire them. As a Europe 2020 indicator, it lends an element of absolute poverty to complement the relative monetary poverty indicator.
Nevertheless, the shared prosperity indicator is fundamentally different from the EU relative poverty indicator in that shared prosperity is intimately tied to income growth, whereas the EU relative poverty indicator is concerned only with income distribution. The EU relative monetary poverty measure is “strongly relative,” meaning that changes in the indicator arise exclusively from changes in the shape of the income distribution, and not from changes in the overall level of incomes. The shared prosperity indicator is affected by changes in both the shape and in the overall level of the income distribution. For example, if income growth is distribution neutral (that is, all households experience the same income growth rate as the national average) there is no change in the EU relative monetary poverty measure, even if absolute income levels increase rapidly across the entire income distribution. In contrast, the Bank’s shared prosperity indicator would improve, because the incomes of the poorest 40 percent would have improved. Put differently, the objective of the shared prosperity goal (as reflected in the indicator) is to increase the real income of the bottom 40 percent in absolute terms, and how this increase compares to the rest of the income distribution is not specified.

Before the crisis, the incomes of the bottom 40 percent grew rapidly

Between 2006 and 2010,28 average household incomes grew in most EU11 countries, with the incomes of the bottom 40 percent growing at about the same rate as the overall average. The difference in the growth rate of the bottom 40 percent with respect to the average growth rate was less than one percentage point in all countries except Romania, where the income of the bottom 40 percent experienced two percentage points annual growth as opposed to a one percent decrease in average income (Figure 48). Bulgaria and Slovakia, in particular, experienced high annual growth rates, respectively 12 and 10 percent. In contrast, average incomes fell overall and for the bottom 40 percent in Hungary, Latvia and Lithuania, where the 2008 crisis reversed the gains made from 2006 to 2008.

During the pre-crisis period (2006–2008) there was economy-wide growth, and in most of the EU11 the income growth rate of the bottom 40 percent was faster than that of the population as a whole. In only three countries (Latvia, Lithuania and the Slovak Republic) did the first two quintiles grow slower than the average from 2006 to 2008, and only in Latvia was the difference substantial (4 percentage points), although in all cases incomes were growing, often strongly. In the 2008–2010 crisis period average household incomes fell in all EU11 countries except for the Slovak Republic, and so did the average incomes of the bottom 40 percent in these countries. It is noteworthy that in most EU11 countries income growth of the bottom 40 percent outpaced the national averages in the pre-crisis period, but contracted more sharply than the national averages in the crisis years. The reasons behind this are not clear, but could be related to weaker labor market attachment, especially in sectors such as construction, in which the boom and bust was most pronounced. Compared to EU15, the bottom 40 percent in the new member states fared better from 2006 to 2010.

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28 As noted in Box 5, these years are chosen because they are the most recent years for which household-level income data are available for most of the EU11 countries.
As the EU11 recovers from the crisis, it should not be assumed that prosperity will be shared as successfully as it was from 2000 to 2008. First, it is expected that overall growth rates will be slower for the next few years, and this is likely to mean slower income growth for poorer households, even if they do manage to keep pace with overall income growth rates. Second, in the wake of the crisis the patterns, or incidence, of growth are likely to be different, especially as employment growth is expected to lag behind GDP growth. Third, the crisis has affected public finances severely, and fiscal consolidation significantly constrains non-labor income sources of the bottom 40 percent (particularly pensions and social transfers) for the near future.

Despite similarities in the broad patterns of growth before and after the crisis, there are also notable differences in the incidence of economic growth across EU11 countries. As examples, growth incidence curves—which display the annual income growth rates for each percentile of the income distribution—are shown for the Czech Republic, Hungary, Poland, and Romania in Figure 49. In the pre-crisis period, overall household income growth was strong in all four countries, with the highest growth rates occurring in low-to-middle portion of the income distribution, particularly in the Czech Republic, Poland and Romania. From 2008 to 2010, mean household incomes fell in Hungary, Poland and Romania. The contraction was more or less evenly spread across the income distributions in Poland and Romania, but in the Czech Republic and Hungary it was the poorer part of the income distribution that was most adversely affected. Taken together, for the 2006–2010 period as a whole these four countries exhibit vastly different patterns of income growth and

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29 Growth incidence curves for the other EU11 countries are shown in the annex.
incidence: strong and nearly distribution-neutral growth in the Czech Republic, recession with increased inequality in Hungary, strong and inequality-reducing growth in Poland, and modest income growth in Romania that tended to benefit poorer households.

**Figure 49. Income growth incidence curves for selected countries, 2006-2010**

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Labor earnings and social insurance are the main sources of income growth among poorer persons

From 2006 to 2010, poverty reduction in the EU11 was driven primarily by increases in average labor earnings and increases in social insurance (public pensions and unemployment benefits). This is especially the case in those countries that experienced the largest reductions in poverty, such as Bulgaria, Poland, Romania and Slovakia. The blue diamonds in Figure 50 show the overall changes in the risk of poverty headcount from 2006 to 2010 using the EU’s relative monetary poverty indicator. The colored bars decompose the change in poverty, showing how much of the change is attributable to changes in eight different income sources. In four countries (the Czech Republic, Hungary, Poland and Slovakia), increased average labor earnings were the largest contributor to poverty reduction. Increased average labor earnings also accounted for more than five percentage points of poverty reduction in Bulgaria and Romania. The importance of employment earnings is also seen in Latvia, where most of the increase in poverty was attributable to decreased average employment earnings. The decomposition analysis takes into account changes in the number of working adults in a household, so increases in average wages have two components: increases in the hourly wage and increases in the number of hours worked by those who are already employed. Compared to increases in average earnings, increases in the share of adults who were employed were a very small contributor to reducing poverty, accounting for no more than 1.5 percentage points in any of the EU11 countries.

Increased income from social insurance was also a major contributor to poverty reduction from 2006 to 2010. Increased income from social insurance, which includes public pensions and unemployment benefits, was the largest contributor to poverty reduction in Bulgaria, Estonia, Latvia, Romania, and Slovenia (Figure 50). Changes in social insurance also accounted for three percentage points of poverty reduction in Poland and Slovakia. Social assistance transfers played a much smaller role across the EU11 countries, with the exception of Lithuania, while changes in taxes had an adverse impact in all countries, except the Czech Republic.
Section 4: Who is in the bottom 40 percent?\textsuperscript{30}

This section presents a profile of those who are in the bottom 40 percent of the income distribution in each of the EU11 countries, examining demographic, educational, and labor market characteristics. In the analysis that follows, separate figures are presented for the bottom 20 percent of the income distribution (which is roughly equivalent to those below the monetary risk of poverty lines in the EU11 countries), the bottom 40 percent, and the top 60 percent. The analysis highlights not only the differences between the bottom 40 percent and the top 60 percent, but also the differences between those below the poverty line and the rest of the bottom 40 percent.

\textsuperscript{30} This section uses the most recently available EU-SILC to profile the characteristics of the population by income group. It should be noted that there is natural upwards and downwards relative income mobility over time, such that the composition and profiles of the bottom 40 percent and other groups change over time.
Households in the bottom 40 percent have more dependents, especially elderly

There is no clear relationship between household size and whether or not a household is in the bottom 40 percent. In eight countries large households (defined as those with four or more members) are more likely to be in the top 60 percent of the income distribution, while the opposite is true in Hungary, Poland, and Romania (Figure 51).

However, in all EU11 countries households in the bottom 40 percent have higher dependency ratios. As Figure 52 depicts, this is driven by the greater prevalence of elderly persons in lower income households. In all EU11 countries, households in the bottom 40 percent have a higher—often much higher—share of elderly dependents than the top 60 percent. Even though the top 60 percent has a higher child dependency ratio in eight of the eleven countries, the differences across income groups are small and more than counteracted by the differences in the elderly dependency ratio.

Figure 52. Dependency ratio, children and elderly, 2010

Source: World Bank staff estimates using EU-SILC data
The elderly dependency ratio in the bottom 40 percent is higher than that in the bottom 20 percent in all EU11 countries except Croatia and Slovenia. The large proportion of pensioners distinguishes the second quintile both from those below the poverty line and those in the top 60 percent. On average, pensions are sufficient to keep the elderly out of the bottom quintile, which, as will be shown in the next section, is dominated by working-age persons who are unemployed or out of the labor force. By the same measure, pensions are lower than the prevailing wages earned by the top 60 percent of the income distribution. As seen in Figure 53, between 9 and 33 percent of persons in the bottom 40 percent live in households in which all members are 65 years or older. Any strategies that aim to increase the incomes of the bottom 40 percent must therefore consider how to raise participation rates or sustainably support this older cohort in the EU11.

Individuals in the bottom 40 percent, and particularly those in the first quintile, have lower levels of education on average (Figure 54, Figure 55). By very wide margins, those in the bottom 40 percent are more likely to have completed only primary education and less likely to have tertiary education. The differences are most pronounced in Bulgaria and Romania, where the average educational attainment in the top 60 percent is similar to that of the top 60 percent in the other EU11 countries, whereas the figures for the bottom 40 percent are considerably lower than that observed in the other EU11 countries.
Higher income households make much fuller use of their potential labor power than lower income households. Increased labor income has been the largest contributor to reducing absolute poverty in the EU11, and it is also essential to increasing the incomes of the bottom 40 percent. This section examines labor market participation and outcomes, disaggregated by the bottom 20 percent, the bottom 40 percent, and the top 60 percent in each of the EU11 countries.

Being in the bottom 40 percent of the income distribution is closely linked to low rates of employment. The Europe 2020 indicator for “low work intensity” defines a household as having low work intensity if the total number of months its working-age members were employed is less than 20 percent of the months they could have been employed. As seen in Figure 56, 15 to 57 percent of those in the poorest quintile live in low work intensity households, with ranges of 11 to 38 percent among the bottom 40 percent, and only 1 to 7 percent among the top 60 percent. The low work intensity indicator in Romania is remarkably low across all income groups relative to other EU11 countries. As incomes in Romania are among the lowest in the EU11, this suggests that low income groups in Romania tend to work in low-return and mostly informal jobs.

The crisis further weakened labor market attachment of those in the bottom 40 percent. For most EU11 countries—notably Estonia, Hungary, Latvia, Lithuania, Slovenia and Slovakia—the low work intensity indicator among the poorest 40 percent was higher in 2010 than it was in 2006, meaning that the prevalence of “jobless” households is worse than it was before the crisis (Figure 57). From 2008 to 2010 the low work intensity indicator among the bottom 40 percent also increased in Bulgaria and the Czech Republic, although not to the levels that prevailed in 2006.

For the low work intensity indicator working-age persons are defined as those 18 to 59 years old (inclusive), and excludes students aged 18 to 24 years. Households composed of (i) only children, (ii) only students aged less than 25, or (iii) only people aged 60 or more are completely excluded from the indicator calculation.
In all of the EU11 countries, labor force participation rates are lower in the bottom 40 percent of the income distribution than they are in the top 60 percent. Figure 58 shows that 25 to 38 percent of the working age population in the bottom 40 percent is not employed or actively seeking employment, with almost identical percentages for the bottom 20 percent. Inactivity rates are 7 to 19 percentage points lower (or conversely, participation rates are 7 to 19 percentage points higher) in the top 60 percent of the income distribution. This suggests that one key to increasing the incomes of the bottom 40 percent is increased labor market participation. This, however, is not a sufficient condition because once activated, it will also be necessary to find employment that provides a good income.

The unemployment rate is three to four times higher in the bottom 40 percent than it is among the top 60 percent. In addition to having lower labor force participation, working-age individuals in the bottom 40 percent of the income distribution are more likely to be unemployed than their counterparts in the top 60 percent. Figure 59 presents the unemployment rate by income category. For those in the bottom 40 percent, the combination of lower labor force participation and higher unemployment rates among those who are in the

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32 The unemployed are those aged 20–64 who are not working, have been actively looking for work in the four weeks preceding the interview, and are available to start work within the next two weeks.
labor market adds up to significantly lower employment rates than those occurring for the top 60 percent. In most EU11 countries the employment rate in the bottom 40 percent of the income distribution is approximately 30 percentage points lower than that in the top 60 percent (Figure 60). Gender differences in labor market status exist in all EU11 countries and across all income groups, but they are much more pronounced in the bottom 40 and bottom 20 percent of the distribution. In the bottom 40 percent the share of women who are not in the labor force is generally 10 to 36 percentage points higher than that for men, with the exception of Estonia where the gap is only two percentage points. In the Baltic countries, the employment rates in the bottom 40 percent are almost equal for men and women, but in the rest of the EU11 women trail men by 9 to 30 percentage points.

In addition to having lower employment rates, those in the bottom 40 percent who are employed have less job security. Workers in the bottom 40 percent are two to three times more likely to work in jobs under temporary employment contracts than workers in the top 60 percent (Figure 61). The percentage in the bottom 40 percent on temporary contracts ranges widely, from a low of four percent in Romania to a high of 43 percent in Poland.

Workers in the bottom 40 percent are also more likely to work in low skilled and low paying occupations. As seen in Figure 62, from 9 to 27 percent of workers in the bottom 40 of the income distribution work in elementary occupations, whereas the corresponding figures in the top 60 percent are only four to nine percent. Furthermore, those in the bottom 40 percent are much more likely to be
employed in agriculture (ISCO-08 category 6), most of which is relatively low productivity. The share of workers in the bottom 40 percent who work in agriculture are particularly high in Romania (44 percent) and Poland (25 percent). Similarly, workers in the bottom 40 percent are much less likely to be in professional occupations (Figure 63).

![Figure 62. Share of employed individuals in elementary occupations (ISCO - 08: category 9)](image1)

![Figure 63. Share of employed individuals in professional occupations (ISCO - 08: category 2)](image2)

Source: World Bank staff estimates using EU-SILC data

The crisis has increased the vulnerability of the poor

Although the bottom 40 percent experienced income growth before the crisis, they are still vulnerable to economic shocks. One of the components of the severe material deprivation indicator asks if households are able to afford to pay for “an unexpected required expense” from its own resources. As seen in Figure 64, in all of the EU11 countries a majority of the bottom 40 percent report that they cannot afford such an expense, with Bulgaria, Hungary and Latvia being the most extreme cases, where only 11 percent or less can afford such an expense. Across EU11 countries, the share of those in the bottom 40 percent who can afford the expense is 20 to 40 percentage points lower than that observed in the top 60 percent.

The financial crisis exacerbated low income households’ vulnerability. The left panel of Figure 65 shows that among the poorest 40 percent, the capacity

![Figure 64. Capacity to face unexpected financial expenses, 2010, percent](image3)

Source: World Bank staff estimates using EU-SILC data

Note: EU-SILC question: “Can your household afford an unexpected required expense and pay through its own resources?”

33 The amount of the unexpected expense is equal to the monthly risk of poverty threshold for a single person household, and in 2010 varied from €106 in Romania to €600 in Slovenia. The definition of what is a “required” expense is also allowed to vary somewhat from country to country.
to meet unexpected expenditures declined between 2008 and 2010 in all countries except Bulgaria, where this capacity is extremely low to begin with. More significantly, for all but three countries (Bulgaria, Poland and Slovakia) the capacity to meet unexpected expenditures in 2010 was even lower than it was in 2006. Although more recent data are not yet available, it is likely that this vulnerability has continued, or even been heightened, by the slow growth, fiscal consolidation, and economic uncertainty in the years since.

Figure 65. Capacity to face unexpected financial expenses, evolution over time, 2006, 2008, 2010

[Graph showing capacity to meet unexpected expenditures over time for bottom 40 percent and top 60 percent of the population in different countries, 2006-2010.]

Source: World Bank staff estimates using EU-SILC data

Section 5: Pathways for boosting shared prosperity

Despite the use of relatively simple monetary indicators the goals of eradicating poverty and promoting shared prosperity are multidimensional. The goals of raising the incomes of the bottom forty percent and eradicating absolute poverty are concerned with people’s ability to obtain basic goods and services critical for welfare as well as having access to education, health, clean water, sanitation and electricity, which a pure monetary indicator may not capture. Moreover, these goals are concerned with people’s welfare over time, to ensure that welfare gains are sustainable, while protecting future generations in terms of human and natural endowments and financial sustainability.

Given its multi-dimensional nature, shared prosperity is consistent with the EU’s Europe 2020 strategy for smart, sustainable and inclusive growth. As highlighted above, some of the main characteristics of the bottom forty percent include: high rates of unemployment and low labor force participation; low skills; and higher dependency ratios. Three of the headline targets of the Europe 2020 strategy address similar topics, namely: (i) a 75 percent employment rate for women and men aged 20-64; (ii) better educational attainment with at least 40 percent of 30-34-year-olds completing third level education and reducing dropout rates to below 10 percent; and (iii) 20 million fewer people in or at risk of poverty and social exclusion.

Economic growth is fundamental for shared prosperity

The immediate challenge for EU11 countries is to try to accelerate economic growth in a very difficult environment. For lower income groups to prosper it is necessary for the overall economy to prosper. However, as the outlook section highlights, the current outlook is for a weak economic recovery in the EU11 over the medium term as fiscal and credit constraints remain potentially binding. The risks to the outlook are significant on the downside, particularly as the reaction to global monetary tightening is uncertain and
potentially destabilizing for emerging market capital markets. The move toward a fuller banking union in the Euro Area also presents some short-term risks to credit availability to the EU11 (see the outlook section for a discussion of the risks). As indicated above, household coping mechanisms have already been weakened by the 2008 crisis, which may constitute a drag on domestic demand if employment growth remains subdued.

While reinvigorating and maintaining growth will be led by the private sector, the state plays a crucial role in promoting competitiveness, improving the business and investment climate, and encouraging innovation. This includes providing a regulatory and macroeconomic environment that provides stability and the right incentives to the private sector. Fiscal consolidation is necessary in many countries across the EU11 in order to maintain macroeconomic and fiscal stability, while there is also considerable scope for EU11 governments to continue to reform their business environments and regulations to encourage private investment (see the outlook section on the relative fiscal and Doing Business performance of the EU11). Governments also invest in public goods such as physical infrastructure and education to build a modern workforce, and in this regard EU11 countries can raise investment spending through the utilization of the EU Cohesion funds that make up a significant share of public investment—see the Spotlight on the new round of EU Cohesion funds and investment in the EU11.

A key to increasing the incomes of the bottom 40 percent is increased labor market participation

Achieving inclusive and sustainable growth requires policies that encourage broad participation in the growth process. At the core are policies to improve the functioning and accessibility of markets, especially labor markets, as inclusive growth depends first and foremost on creating more and better jobs. Employment income is the most important source of income for most people in the EU11, including low income households, and there is considerable underutilized potential. As seen in the profiles in the preceding section, poorer households have much higher rates of inactivity and unemployment than those who live in better-off households, such that the employment rate among the bottom 40 percent is less than 50 percent in almost all EU11 countries. Greater private sector job creation, better equipped workers, and access to fluid labor markets are needed to tap this unused potential.

On the demand side, continued strengthening of the business environment is important to support faster private sector and employment growth. More accessible credit markets will encourage entrepreneurship and job creation. Measures to ease both the entry into and exit from new businesses (i.e. including efficient insolvency and restructuring regimes), such as easier access to inputs, bankruptcy law reform, and shaping social attitudes to encourage more risky entrepreneurship and innovation can stimulate employment creation, including self-employment.

Supply side interventions are also needed to increase labor force participation rates and the probability that a low income worker will find a job. Education levels are much lower among the bottom 40 percent, so education and training opportunities that are relevant to the market needs will be essential to better equip these workers for employment. Strengthening generic skills (including “soft skills”) and market-driven tertiary and adult education that responds to the labor needs of employers are especially important, as is greater opportunity to develop skills for innovation (e.g., generic problem-solving skills, adoption and adaptation skills, and “soft” skills such as communication and teamwork).
The design of labor taxes and social protection systems also need to create better incentives for the bottom 40 percent to move into employment. In many EU11 countries the cost of moving out of social assistance or unemployment benefits is high, especially for low wage earners and part-time workers. This tax or benefit wedge can be a significant barrier to entry into the labor market for employees as well as discouraging employers from hiring more workers. Reform of social protection systems to remove work disincentives, for example, by allowing income disregards for low-wage earners, may help improve participation rates.

Figure 66. The costs of moving out of social assistance or unemployment benefits can be high in the EU11
Average effective tax rates (income tax plus benefit loss as a percent of gross labor income), 2010

Similarly, removal of other barriers to employment—such as inflexible work schedules, lack of child and elder care services, and lack of information about job opportunities—will also serve to increase participation rates. The fluidity of labor markets can be enhanced by removing barriers to physical mobility, both within the EU and within member states. For example, many are deterred from relocating to high labor demand areas because thin real estate markets make it difficult to sell their homes. In the EU11, a significant share of pensioners is in the bottom 40 percent because of the relatively low retirement age in many countries and options available for early retirement. As pensions are unlikely to increase in the current fiscal environment, flexibility to allow older persons to extend their working lives will be the primary means of increasing incomes among this segment of the bottom 40 percent. This requires attention on the demand side as well, in terms of bending business and social attitudes toward greater acceptance of older workers.

**Strengthening the social contract in important, particularly promoting equality of opportunity**

A social contract for promoting shared prosperity would include investments and building of institutions that improve opportunities for all citizens, and protect the vulnerable against extreme deprivation and shocks.\(^34\) It would include mechanisms to raise resources to support these policies through a

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\(^34\) The term “social contract” refers to some degree of societal consensus over the basic principles of the operation and role of the state vis-à-vis the private sector and citizens. Key elements that can be used to characterize the nature of a social contract are the structure of taxation and social expenditures, the performance of the state in using revenues to deliver and
tax system that promotes fairness through progressivity and creates incentives for economic growth. Strong social safety nets and social insurance are needed to protect the poor and reduce vulnerability to shocks—including unemployment insurance and pensions—for easing labor market transitions and helping households manage risks. This is not just about transferring income from one segment of the society to another at a point of time, but more about investing in improving the capabilities of people over time and across generations. An effective social contract is about creating a virtuous, self-sustaining cycle—leveraging economic growth to improve human capabilities, which in turn feeds back to growth, and so on.

**Beyond the usual labor market supply and demand considerations, greater equality of opportunities is needed to achieve and sustain inclusive growth in the EU11.** For many in the EU11 access to jobs is constrained by factors outside the individual’s control, such as gender, ethnicity, and parental or geographic circumstances. Recent evidence\(^\text{35}\) shows that, even though education plays an important role in having access to the labor market, inequality in the access to employment is explained by attributes beyond the control of the individual for a large part of the population (from 36 percent in Romania to 78 percent in Hungary, Figure 67). The contribution of each circumstance (e.g., gender, father’s education, minority status such as the Roma communicates in many parts of the EU11) varies considerably across the EU11 countries (Figure 68). In all countries, labor market outcomes are heavily influenced by the educational attainment of one’s father, underlying the importance of education also in an inter-generational perspective. In Latvia and Croatia, gender seems to be the main discriminant in determining the access to employment. In all countries—and particularly in Lithuania, Romania and Bulgaria—belonging to a minority group such as the Roma reduces the possibility to access to employment.

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An agenda for shared prosperity

In 2014, the World Bank and its EU11 partners will continue to deepen our understanding of the key policy choices for promoting shared prosperity. One line of the work program will build on the diagnostic information presented here to gain new insights on the interrelationship of growth, inequality, economic mobility, and shared prosperity. The main drivers of changes in income (for example, earnings, demographics, transfers, taxes, social protection) will be examined for both the bottom 40 percent and the population as a whole. Economic mobility—such as the extent to which people move in and out of the bottom 40 percent over time—and the determinants of that mobility will be explored. The spatial aspects of incidence of past and potential future growth will be investigated, taking advantage of the new information from small area poverty maps that will be available in 2014. The roles of intergenerational mobility and equality of opportunities in promoting shared prosperity will also be investigated.

The diagnostic work will serve as a springboard for country case studies that will examine the potential for specific policies to promote shared prosperity in more detail. In particular, studies will focus on income mobility in and out of the bottom 40 percent, and on the fiscal and labor market policies that can increase the incomes of the bottom 40 percent. Fiscal policy analysis will examine the potential to promote shared prosperity, through its growth-enhancing and distributional effects. It will also analyze the incidence of taxes and social spending, paying particular attention to reforming policies that may be discouraging firms from creating jobs or deterring potential workers from entering the labor market.
Appendix 1: Income growth incidence curves for EU11


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