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Thibault Mercier

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The eastern members of the EU: catching up fast

This article analyses the recent economic performances of the eastern countries of the European Union, specifically focusing on the so called Visegrad-6 group, comprising Poland, Hungary, the Czech Republic, Slovakia, Bulgaria and Romania. Long considered as the EU's "junior partners", their very strong macroeconomic performances in recent years suggest that they will soon catch up with their western EU counterparts. Are we about to witness the culmination of more than 10 years of convergence? Only if we ignore the structural challenges these economies are still facing.

Anna Dorbec

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France: What to expect from labour code reform?

Thibault Mercier

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Labour market reform, one of Macron's key campaign promises, is set to be the first large-scale economic reform of his administration. The reform builds on the measures introduced in the El Khomri law adopted in summer 2016. According to the policy guidelines spelled out in the Prime Minister's *lettre de cadrage*, the goal is "to converge social and economic performances by further advancing our labour laws to take into account the diversity of employee expectations and corporate needs." The idea is to give companies greater flexibility in dealing with cyclical trends, technological transformations and the challenges arising from globalisation. The reform will focus on two key vectors: providing companies with greater flexibility to manage their headcount, and placing greater emphasis on company-level negotiations when establishing labour standards.

The government points to a key observation to justify its labour reform: in terms of unemployment rate and, above all, employment rate, France underperforms many of its neighbouring countries. This shortfall is attributed to the poor functioning of the labour market.

This article has two objectives: to assess the job market situation in early 2017, by focusing on the high level of unemployment and its causes; and to describe the potential impact of labour market reform on the economy, by distinguishing between the short and medium-term effects.

The current situation

The labour market deteriorated during the crisis

Unemployment rose...

Ten years ago, the French unemployment rate (metropolitan France and the overseas *départements*) was about 8% of the labour force and trending downwards. Unemployment continued to slip to a low of 7.2% in first-quarter 2008. France was then hit by two major crises: the global financial crisis of 2008-2009, commonly called the Great Recession, and the eurozone debt crisis, from 2010 through summer 2012. This period of virtual stagnation, with average economic growth of only 0.1% q/q between mid-2008 and mid-2016 (vs. 0.5% between 2000 and mid-2008), triggered a sharp rise in unemployment. Using the International Labour Office (ILO) definition¹, the number of unemployed in

metropolitan France rose from 1.9 million in Q1 2008 to 2.9 million in mid-2015, before declining somewhat thereafter, to 2.6 million in Q1 2017.

The unemployment rate – the number of unemployed as a share of the active population – also rose sharply, from about 7% in early 2008 to 10.5% at year-end 2015. It then eased slightly to 9.6% in Q1 2017, which is still nearly 2.5 points higher than the pre-crisis low point.

...due to sluggish employment

Over the past ten years, the labour market situation has deteriorated sharply. Yet unlike Italy and Spain, which were hit much harder by the crisis, France shows no net job destructions compared to 2008 and employment has even increased slightly² (chart 1). Consequently, the rise in unemployment rate is due essentially to sluggish job creations with regard to demographics.

Employment's resilience to the crisis was not strong enough to prevent unemployment from rising. Moreover, the situation must be kept in perspective. First, it is due in part to the increase in fixed-term government-subsidised contracts in the non-market sectors. Recent studies show that these contracts are not very effective in terms of lasting professional rehabilitation³. If we look solely at non-farm payroll employment in the market sectors, the situation is still one of net job destructions, despite the rebound underway since Q2 2015 (+0.3% q/q on average). In Q1 2017, non-farm payroll employment in the trade sectors was still 1.3% below the early 2008 level (chart 2).

Second, the quality of new jobs has deteriorated. The number of self-employed workers and entrepreneurs has increased as a share of total employment, as has part-time work. Over the past decade, part-time employment has increased by a point and a half, notably due to the increase among men⁴.

month); and to be actively seeking work or to have found a job that begins within the next three months. Actively seeking work means conducting at least one job-hunting procedure (contacting a temporary employment agency, prospecting an employer, searching for a workplace, etc.) over the relevant period.

² The initial decline in French employment was completely absorbed by mid-2012, and employment has been growing moderately ever since. Measured by the number of persons employed, the overall volume of employment in Q1 2017 was 2.2% above the pre-crisis level.

³ Bernard S., Rey M. (2017), *Les contrats aidés: quels objectifs, quel bilan?* DARES, March

⁴ Although this figure has increased for men, many more women hold part-time jobs. But for women, part-time work as a share of total employment has remained basically stable, at about 30%, while for men it has increased from 5.7% in early 2007 to 8.1% in Q1 2017.

¹ Under the ILO definition, three conditions must be met to be considered as unemployed: to be out of work, without having worked for even an hour during the reference week; to be available to work within the next two weeks (except in cases of illness of less than a



Expressed in full-time equivalent, the level of employment in early 2017 was only 0.8% higher than the pre-crisis peak. As to atypical forms of job contracts (fixed-term contracts, temporary employment and apprenticeships), their share of total employment increased by one point, from 11.9% in 2007 to 12.9% in 2016. There was a particularly big increase in fixed-term contracts for youth (18-24 age group), which rose from 25.8% of employment in this age group in 2007 to 31.3% in 2016.

Uncertainty about structural unemployment

In its most recent set of forecasts (Spring 2017), the European Commission (EC) estimates France's structural rate of unemployment (NAWRU) at 9.4% in 2017, a level very close to the effective unemployment rate of 9.6% observed in Q1 2017⁵. In other words, according to the European Commission, demand only plays a marginal role in the high level of French unemployment: cyclical unemployment is virtually inexistent. This is close to the OECD's estimate, which calculates France's structural unemployment rate at 9.2% in 2017.

In both cases, structural unemployment is on the rise, albeit for different reasons. For the OECD, the increase in structural unemployment during the crisis is due to a hysteresis effect arising from the persistence of long-term unemployment.⁶ For the European Commission, structural unemployment has been more stable over time, but has held close to an average that has been constantly revised upwards (chart 3).

However, if we line up the European Commission NAWRU estimates for year *n* made in year *n* (2009 estimates made in 2009, 2010 estimates made in 2010, etc.), we can see both the high volatility and the gradual upward trend in the equilibrium rate of unemployment, which follows the increase in observed unemployment. Yet this option implies that the French economy was overheating (positive output gap) between 2000 and 2008, which does not seem to have been the case: inflation held close to 2%, there was no distortion in the sharing of value added, and the current account deficit was small, even though it deteriorated (the current account deficit was 1% of GDP in 2007).

From a theoretical perspective, how can we justify the estimated increase in structural unemployment during the crisis? Hysteresis explains how a protracted period of unemployment can turn into a permanent increase: the skills of the long-term unemployed gradually erode, which eventually makes them unemployable. Yet this does not mean that hysteresis explains all of the *estimated* increase in structural unemployment. Beyond that effect, there can be an estimation issue: indeed, we know that in crisis periods, methods based on unit labour costs can exaggerate the increase in structural unemployment⁷. Besides, if we admit that persistently weak demand can affect supply,

⁵ The most common estimate of the structural unemployment rate is NAIURU, the Non-Accelerating Inflation Rate of Unemployment. The European Commission uses a concept close to NAIURU called NAWRU (Non-accelerating wage rate of unemployment), the unemployment rate that does not accelerate wage growth.

⁶ Long-term unemployment (i.e. more than 12 months) rose from 40% to 45% of total unemployment between 2007 and 2017.

⁷ See for example, Sterdyniak H. (2015), *Should we still use the concept of potential growth?*, OFCE review, N°142

then we must also consider the opposite case: that an extended period of stimulated demand could increase the potential supply and lower structural unemployment. In a recovery phase, the rebound in investment increases the capital stock, which has a favourable impact on potential growth.

Employment

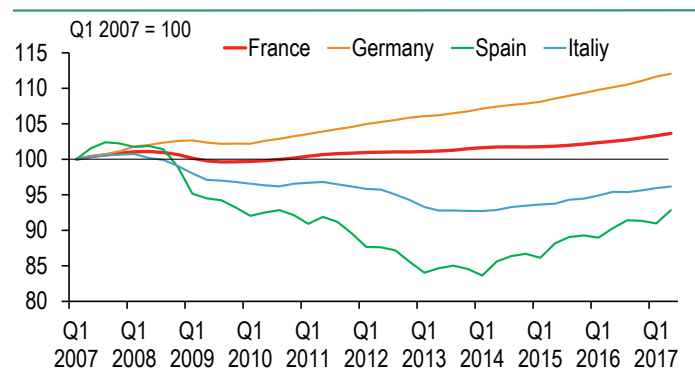


Chart 1

Source: Eurostat

Payroll employment

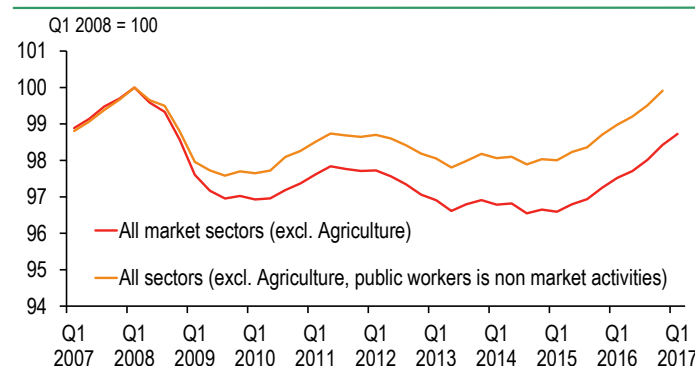


Chart 2

Source: INSEE

Structural unemployment rate estimates

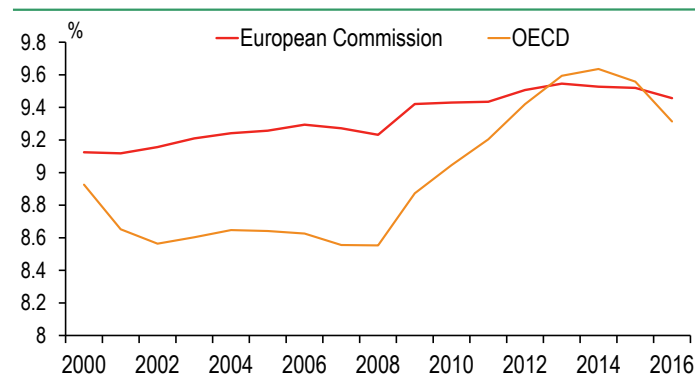


Chart 3

Sources: AMECO, OECD



Similarly, in a persistently stimulated economy, companies would be more inclined to hire the long-term unemployed and to redevelop their skills, making them employable again, which would not have been the case in a cyclical downturn.

The question of the correct level of structural unemployment is open: While a consequence of higher structural unemployment is precisely the formation of inflationary pressures at a higher level of unemployment than in the past (since some of the long-term unemployed are no longer employable, and no longer strain wage formation) the French economy is not showing any signs of price or wage pressures (chart 4).

Underemployment and the unemployment halo

Several explanations have been put forward to justify this situation. One of the most common consists of saying that the slope of the Phillips curve is not constant, but that it varies according to the cycle. In a period of high unemployment, wages and prices would not be very responsive (the curve would flatten) but its responsiveness would increase (the curve would steepen again) as the economic cycle improves. Once the structural unemployment rate has been reached or surpassed, wages would begin accelerating again⁸.

Another argument says that the unemployment rate gives only a partial image of the labour market situation. Broader indicators that take into account underemployment (involuntary part-time work) and the unemployment halo (persons available to work but who are not actively seeking employment, and those actively seeking employment but who are temporarily unavailable to begin work) better explain the inertia of prices (charts 5 and 6). This broader measure of labour underutilisation, which corresponds to the American U6 unemployment rate, shows an underutilisation of labour of 18.5% in early 2017, compared to 15.4% in 2008. It indicates rather clearly that production constraints are not about to hamper the current cyclical upturn.

Above all, the crisis has had an impact on the quality of new jobs, as illustrated by the increase in the number of involuntary part-time workers and temporary job contracts. Yet *a priori*, nothing suggests that this increase is irreversible. The hypothesis that France's rigorous labour legislation may have accentuated this phenomenon (in an uncertain cyclical environment, companies resort more readily to short-term and/or part-time job contracts when faced with rigid redundancy regulations) is countered by comparisons with other countries that adopted greater job market flexibility during the crisis. Spain and Italy have shown even sharper trends (chart 7)⁹. In Germany, the U6-type unemployment rate has declined over the past decade, as has the headline unemployment rate, but the gap between the two measures has increased. This tends to limit the role played by labour market institutions.

⁸ "The slope of the Phillips curve may steepen again when the economy reaches and surpasses full potential" (Draghi)

⁹ In Italy, the number of involuntary part-time workers rose by nearly 60% between 2010 and 2016. In Spain, the increase was 40%. In France, the trend was also strong, although relatively less so, at 35%. Note that Spain and Italy were hit much harder by the crisis.

The upturn in demand observed over the past three quarters should lead to a decline in underemployment. The pace of net job creations has already accelerated significantly, to 259,000 jobs a year in Q1 2017, from an average of 103,000 jobs between mid-2013 and mid-2016.

Price indices

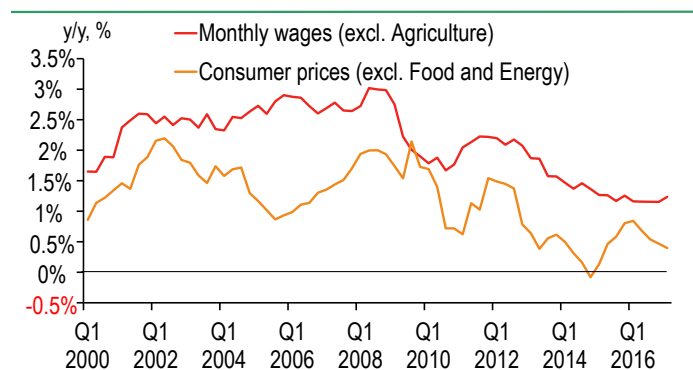


Chart 4

Sources: IMEE, DARES

Broader estimate of labour underutilisation

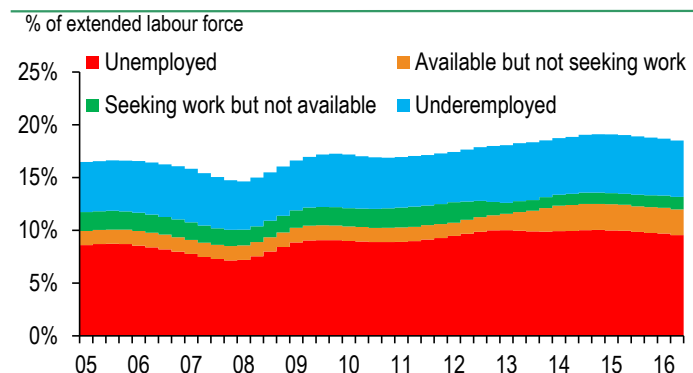


Chart 5

Source: Eurostat

Phillips curve with U6-type unemployment rate

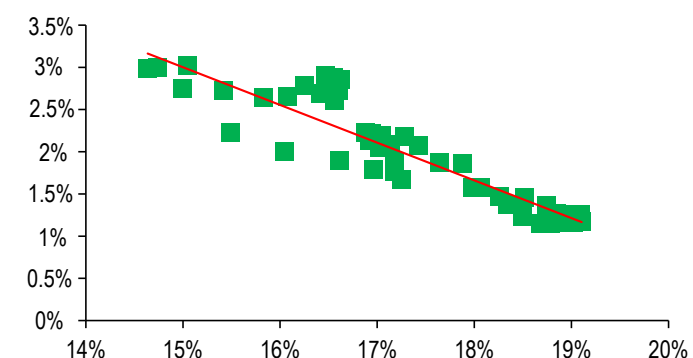


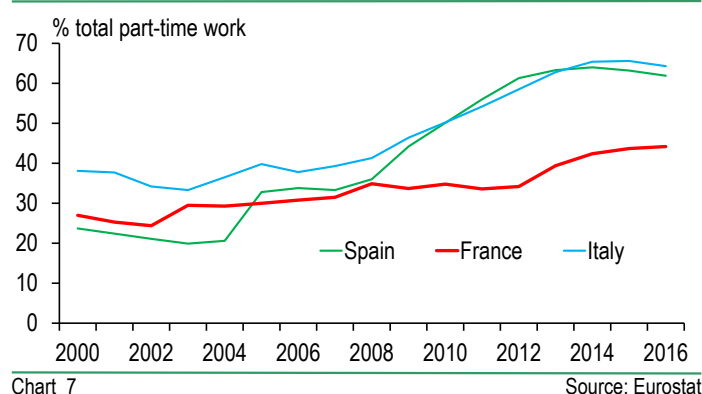
Chart 6

Source: Eurostat, DARES



Yet it could take some time before wages accelerate, since the cyclical improvement first reduces the “intensive margin” (the spread between unemployment and overall underemployment): the number of hours worked increases, temporary job contracts are transformed into open-ended job contracts, and discouraged job seekers return to the job market.¹⁰

Involuntary part-time work



The basis for the reform

In the previous section we underscored the difficulties of estimating the equilibrium rate of unemployment. Our analysis also invites to keep in perspective the pertinence of this indicator, which is less and less good at capturing the reality of underemployment in France.

Even so, for the past thirty years, France has suffered from a high unemployment rate on average. Since the second half of the 1980s, this average has never fallen below 8% for very long (chart 8). The employment rate is historically low for youth and seniors, who also hold the most precarious jobs. It is this observation, more than the surge in unemployment during the crisis that serves as the basis for the overhaul of France's labour code. Labour reform should have a positive impact in the medium term. In the short term, however, the question is harder to answer: economic literature indicates that the starting point matters most when evaluating the short-term impact of structural reforms.

Dissatisfying performances

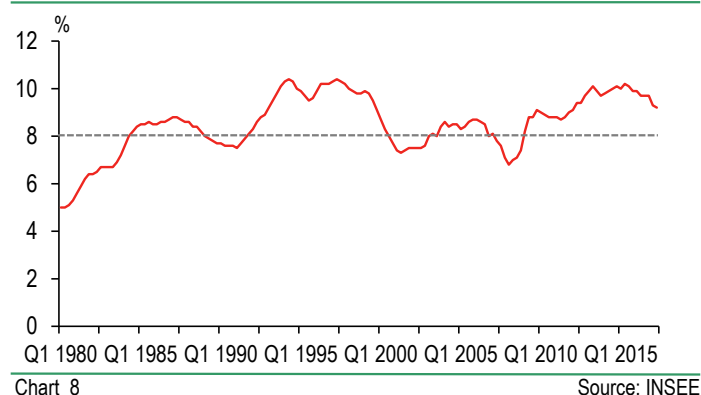
France's employment problems can be looked at by comparing its performances to those of similar countries (in the OECD, and eurozone member countries) as well as to countries achieving better results. Yet it will never be possible to perfectly determine which share is attributable to labour market institutions, the economic cycle, differences in economic structures or social choices. For example, France has a deficit of industrial jobs compared to Germany, but this is not due solely

to differences in the cost of labour or the quality/price trade off. Germany's productive structure is more concentrated on industry for historical and geographic reasons that go beyond the question of labour costs. Differences in specialisation may have been accentuated by the adoption of the euro and the industrialisation of the emerging countries. Similarly, comparing level of unemployment rates hardly makes sense when the countries involved have very different social models (such as the US or the UK). Keeping these remarks in mind, it is nonetheless possible to make the following observations.

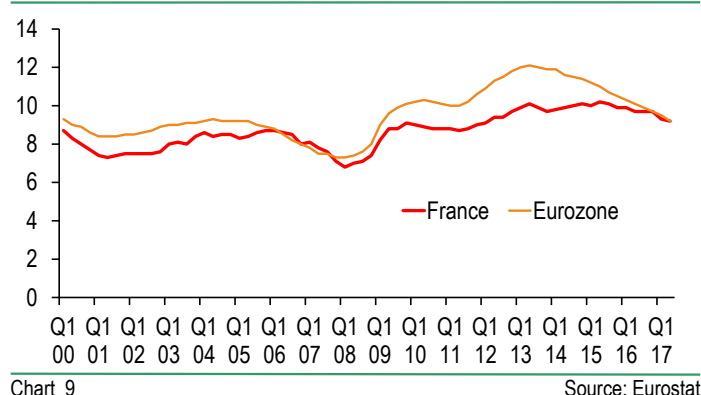
The average unemployment rate is high, notably among unskilled youth

Since the second half of the 1980s, France has reported a high unemployment rate, significantly higher on average than in the United States or the UK, but much less volatile, too. Relative to the eurozone, France's unemployment rate was close to but slightly lower than the Eurozone average between 2000 and 2008. The gap began to widen in 2009 and peaked at nearly two points at year-end 2013. Since then the gap has narrowed constantly, and by Q1 2017, the French unemployment rate was equivalent to the eurozone average (chart 9).

France : unemployment rate



Unemployment rate



¹⁰ For more information on this and the other points raised in this section, see the speech by B.Coeuré (2017), *Scars or scratches? Hysteresis in the euro area*, ECB, May



Within the Economic and Monetary Union (EMU), three countries do significantly better than France in terms of unemployment: Germany, the Netherlands, and Austria.¹¹ Moreover, job quality, as measured by the European Trade Union Institute's Job Quality Index, is generally higher as well.¹²

The difference in unemployment rates with these countries can be seen across all age groups, although it is particularly pronounced among youth (15-24 age group). Since 2000, the youth unemployment rate in France has been more than twice as high as in Germany, the Netherlands or Austria. France also has the highest unemployment rate among the least educated population¹³ (ISCED 0-2: Lower secondary education). Once again, youth are hit hardest: the unemployment rate for uneducated youth has averaged 33% since 2000, compared to 13% in Germany, 11% in the Netherlands, and 13% in Austria. Moreover, it has risen sharply in France since the beginning of the crisis, whereas it remained stable in the other countries under consideration (chart 10).

The high unemployment rate for youth is coupled with a low participation rate. Since 2000, the average participation rate of the 15-24 age group has been singularly lower in France (38%) than in Germany (50%), the Netherlands (71%) or Austria (58%). This can be partially explained by the length of schooling. In a Eurostat survey, more than 90% of the inactive population in the 15-24 age group in France said they were inactive due to schooling or professional training. This is slightly higher than the percentage for the three countries cited above. In France, however, the participation rate of the least qualified is relatively lower¹⁴, and this cannot be blamed on the length of studies. In the end, although France has the highest unemployment rate for unqualified youth, their share of total youth unemployment is lower than in Germany, the Netherlands, and Austria. Yet this is due solely to differences in the participation rates.

The employment rate is relatively low at the two extremities of working life

After looking at the jobless rate, we will now turn to the employment rate (i.e. the number of persons employed as a share of a given age group). In 2016, the employment rate for the 15-64 age group was 64% in France, 75% in Germany and the Netherlands, and 72% in Austria. Whereas the employment rate has stagnated in France since 2003, it has increased by 10 points in Germany, 3 points in Austria and 1 point in the Netherlands, where it is historically high (chart 11).

France's relatively low employment rate can also be seen across all age groups. Unsurprisingly, the gap is particularly high for youth (15-24 age group).

¹¹ Belgium and Finland also report better performances, especially since 2009, but the spread is much smaller. Luxembourg also reported better performances than France, but the structure of their economies is hardly comparable.

¹² This does not settle the question of low-wage jobs, which account for 22% of employment in Germany, 18% in the Netherlands and 15% in Austria, compared to only 9% in France.

¹³ We use Eurostat's 2011 international standard classification for the level of education

¹⁴ In all of the countries under review, the participation rate increases with the level of education. For each level of education, France reports a lower participation rate, but the gap is biggest for the least educated.

France's employment rate for youth has averaged only 30% since 2000, compared to 45% in Germany, 65% in the Netherlands, and 52% in Austria. For seniors (60-64 age group), France's employment rate is also low, and significantly lower than in Germany and the Netherlands (but comparable to Austria).

Youth unemployment rate - no qualifications (ISCED 0-2)

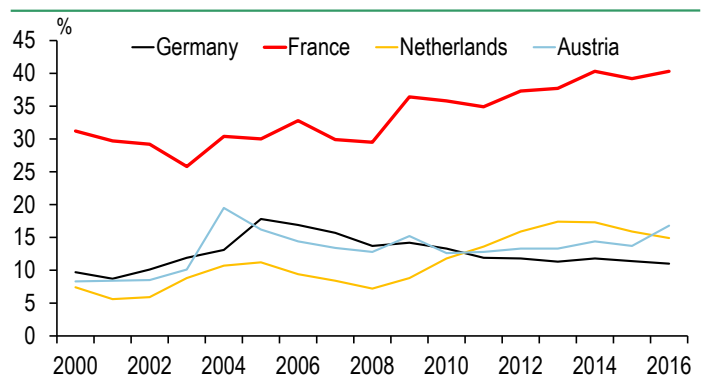


Chart 10

Source: Eurostat

Employment rate (15-64)

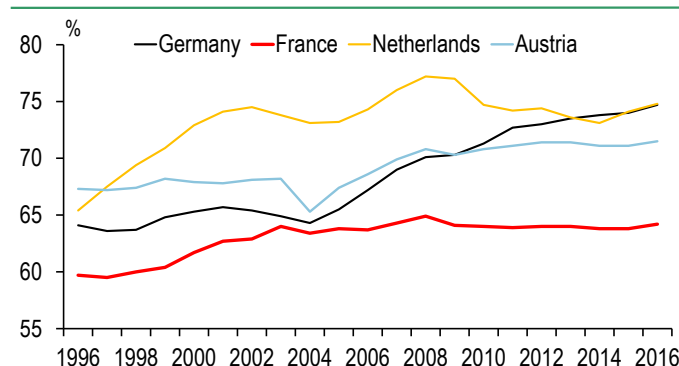


Chart 11

Source: Eurostat

Employment rate

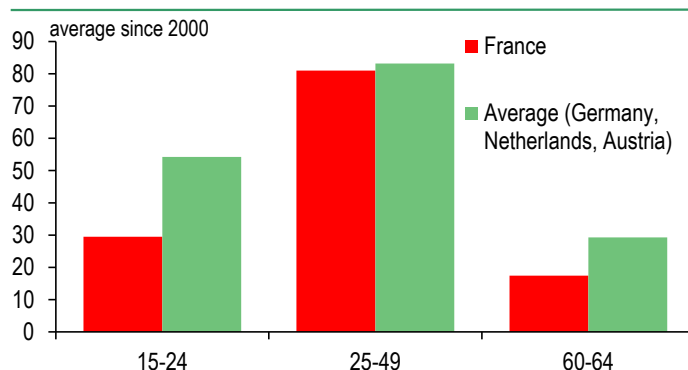


Chart 12

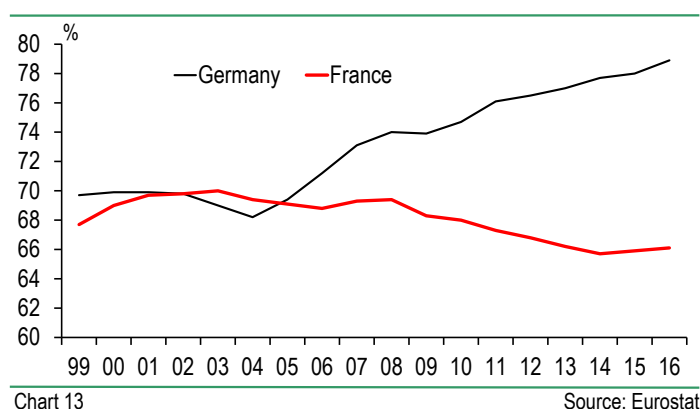
Source: Eurostat



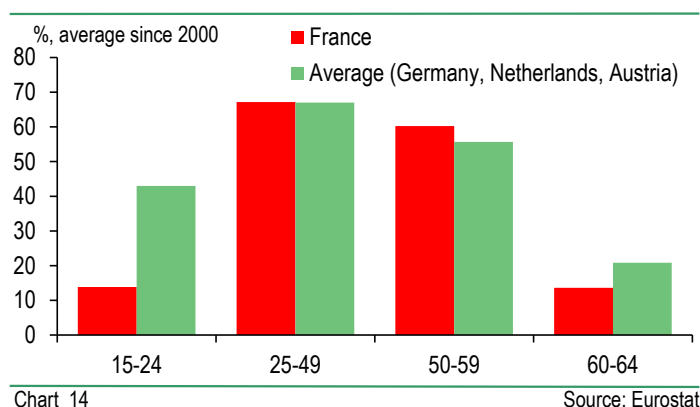
For the 25-49 age group, in contrast, France has a high employment rate, which is very close to the average for the other countries (chart 12).

An analysis of the employment rate by level of education attained shows that France has a shortfall for all levels of education, although the gap with other countries is largest for those with the least education, in particular those with an upper secondary education and a post-secondary non-tertiary education (ISCED 3-4). The employment rate in this category has averaged 68% since 2000, compared to 73% in Germany, 78% in the Netherlands, and 74% in Austria. A comparison between France and Germany for this segment of the population reveals two opposing trends over the past 15 years: starting from the same employment rate of 70% in 2002, Germany has gained ten points while France has lost four (chart 13).

Employment rate (CITE 3-4)



Employment rate among the least educated population (ISCE 0-2) by age



By crossing the data by age group and education level, we can see that the low employment rate for the least qualified concerns essentially youth and seniors. Although France's employment rate for the least qualified (ISCED 0-2) has shown an average shortfall of about 6 points since 2000 compared to the average for the highest performing countries, the gap is concentrated in the 15-24 age group (-30 points) and the 60-64 age groups (-7 points). In contrast, it is non-existent for the 25-49 age group and even plays in France's favour in the 50-59 age

group (chart 14). The same distribution can be found for the gap in the employment rate for those with a tertiary education, although in this case, the relatively low employment rate for youth can be attributed more to the organisation of studies.

Although for a given age group, the employment rate always increases with the level of education, this effect tends not to be as strong in France compared to the average for the other countries. The big exception is in the 15-24 age group: despite the low employment rate for those with a tertiary education, there is still a very big gap with those with the least education. It indicates that it is extremely difficult for unqualified youth to enter the job market: only 9.5% had a job in 2016 (vs. 15% in 2006), compared to 30% in Germany, 52% in the Netherlands, and 35% in Austria.

All in all, France is essentially hit by low employment rates at the two extremities of active life, namely in the 15-24 and 60-64 age groups. The difficulties are particularly high for the least educated: compared to the highest performing countries, the lower the level of education, the bigger the gap in the employment rate, notably among youth. Moreover, French youth, and the least educated in particular, generally hold precarious jobs (short-term contracts, involuntary part-time work). More than one out of two workers have temporary job contracts, and 55% of those with part-time jobs would prefer full-time work.

In contrast, if we focus on the 25-59 age group, France's results have been slightly lower but nonetheless comparable to the average for the other countries since 2000, regardless of the level of education. Note, however, that the crisis has accentuated France's gap relative to the others, particularly among the least educated.

France's weak performance is more pronounced for men

Labour market performances can also be looked at by gender. In France, like in Germany and Austria, the female unemployment rate was slightly lower than for men in 2016. Although this observation has been confirmed since the early 2000s in Germany, and to a lesser extent in Austria, it has only been true in France since 2012. It can be attributed to the crisis' impact on the unemployment rate. Between 2008 and 2016, the male unemployment rate rose from 6.7% to 10.3%, while the rate for women rose from 7.4% to 9.9%.

In France, like in the other countries under review, the female participation rate is lower than for men, but the spread has narrowed by 5 points over the past fifteen years, reflecting an increase in the participation rate for women and a slight decrease for men.

Turning to the employment rate, we can see that France's relatively low rate is slightly less pronounced for women. The employment rate for working age women (15-64 age group) was 60.9% in France in 2016, compared to an average of 69.5% in Germany, the Netherlands, and Austria. For men, the employment rate in France was 67.6%, compared to an average of 77.8% for the others.

In general, in the categories where France underperforms the highest performing countries, the distinction is not as sharp for women as for men. This is true for the gap in the employment rates for youth and seniors, but also for the least educated youth and seniors. In contrast,

job quality is comparatively lower for women in France than in the other countries under review.

The reform measures and their effects

The labour code reform (see box 1) aims to improve the functioning of the labour market, notably by reducing duality and allowing a better adjustment of wages and working conditions to cyclical trends and/or technological developments. The reform is expected to have an impact not only on the overall volume of employment but also on its composition. Another goal is to improve firms' competitiveness.

Employment protections

One of the key challenges of the reform concerns employment protections, i.e. the legislation regulating the termination of job contracts¹⁵. The Combexelle report, which inspired the 2016 El Khomri law, recalls the following point: *"labour laws were built around an observation: the job contract concluded between the employer and the employee is an unequal contract that by nature favours the employer. A series of legislative measures forming the labour code were gradually adopted to offset this inequality and to protect the employee".* The labour code stipulates that any dismissals must be motivated by *"a real and serious justification"*. The prime objective is to respect the fundamental rights of the individual, which rules out, for example, any justifications based on nationality, gender, religion or way of life.

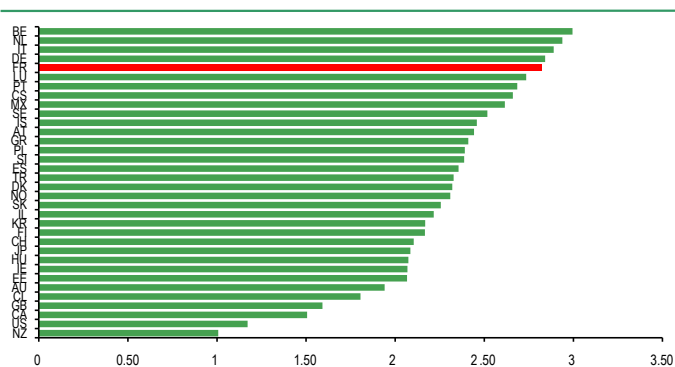
In addition to respecting fundamental rights, the labour code also regulates dismissals for *economic* reasons. In cases of dispute, the judge evaluates the pertinence of the reasons for terminating the job contract. Here the focus is no longer on the individual but on the economic difficulties or technological transformations confronting the company. For unfair dismissals – ones without real and serious justification – companies must pay damages and interest to the employee, in addition to the normal severance pay, which is proportional to seniority.

Economic dismissals must also follow pre-established procedures. The procedure is more demanding in the case of collective layoffs (i.e. when at least two employees are dismissed within a 30-day period). To dismiss 10 or more employees, companies with more than 50 employees must elaborate a redundancy plan, called an Employment Preservation Plan, which includes the obligation to reclassify, train and support employees, who have the right to legally contest the redundancy plan.

The OECD has constructed indicators gauging the degree of restriction of employment projections against individual and collective dismissals. They integrate notification and consultation requirements, advance notice periods, severance pay, the implications of unfair dismissals, and the extra costs associated with collective layoffs. The scores range between 0 and 6, with the higher number indicating stronger employment protections. France ranks among the countries with the most restrictive labour legislation, alongside the other countries of

continental Europe, including Germany and the Netherlands, which are traditionally more protective of workers than the Common Law countries (New Zealand, the United States, Canada, the UK, Australia and Ireland). French law stands out in particular for its strong protection of individual dismissals (charts 15, 16 and 17).

Employment Protection Indicator: against individual and collective dismissals



- Employment protection, employment and unemployment

Speaking about employment protections today essentially refer to a worker's capacity to preserve employment throughout cyclical fluctuations. At first sight, a rigorous legislation would seem to help limit unemployment, by curbing job destructions during cyclical downturns. Yet this is not so obvious: rigorous protection can be a source of rigidity for companies, making them more reticent to hire, even during cyclical upturns.

Companies know that when there is a negative shock on demand, they will have to bear the high cost of layoffs, as well as the legal insecurity of economic layoffs, and the delays and uncertainty surrounding legal

procedures. From a macroeconomic perspective, strong employment protections mean that employment is less sensitive to fluctuations in GDP, which can be verified by comparing the situation in France with that in the United States and the UK.

Theoretically speaking, employment protections have an ambiguous effect on unemployment. Under protective legislation, companies hire fewer employees during cyclical upturns, but they fire less when the economy slumps. Under flexible legislation, they hire more to cope with a rebound in activity, but they also fire more during cyclical downturns.

Box 1: Key measures of the future law

The decrees concerning the labour code reform, which are to take effect at the end of September, were released on 31 August. The key points are highlighted below.

A new breakdown between company and branch-level agreements

The areas of jurisdiction between branch and company-level agreements will be divided into three blocks. The first block corresponds to themes handled exclusively at the branch level. Five themes are maintained: minimum wages, job classifications, training, supplementary social protection and equal opportunity. Two new themes will be added to this block: the rules for resorting to fixed-term and temporary job contracts, previously set by law (duration, renewals, and waiting periods), and those for "project" or "operations" CDI open-ended contracts, which terminate at the end of the employee's mission. The second block covers themes in which the branch will be empowered to introduce lock-in clauses: arduous work, occupational risk prevention, workers with disabilities, and the conditions for exercising a union mandate. The third block encompasses all themes in which company-level agreements take precedence over branch agreements, excluding those specified in blocks 1 and 2. As of 1 May 2018, company-level agreements must be approved by representative bodies accounting for 50% of the vote, up from 30% today.

New procedures for social dialogue

For companies with more than 50 employees, works councils, health & safety commissions and employee representatives will merge into a single representative body: the social and economic committee. This committee will be able to seek expertise and file lawsuits, although it must pay 20% of the cost. Henceforth, even in the absence of union representation, the management of companies with fewer than 50 employees may negotiate directly on all subjects with an elected employee representative. Previously, to negotiate and sign agreements, the management of SME had to deal with an employee representative mandated by a union.

The decrees expand the possibility for employers to call referendums on agreements. For companies with fewer than 20 employees and without an elected employee representative, management may negotiate directly with employees before submitting the agreements to a vote on all subjects negotiated: remuneration, working hours and organisation, etc. Currently, this is only possible for certain subjects (employee profit-sharing, Sunday work). The agreement must be ratified by two thirds of employees.

Moreover, under the El Khomri law, a company-level agreement was adopted if it was signed by unions representing at least 50% of the votes in professional elections, or by minority representations (at least 30% of the votes) after validation by a referendum. Until now, only the unions had the power to call a referendum. The decrees expand this option to include employers. Unions representing the majority would still maintain the option of opposing the move.

Modification of dismissal regulations

The decrees call for the introduction of a table for damages and interest, based on seniority. This would mainly cover unfair dismissals for economic reasons (without real and serious justification), as the mandatory table would not apply to cases of harassment, discrimination and the infringement of a worker's basic rights. The table would impose a floor and ceiling level, and would be progressive based on the employee's seniority. With 2 years of seniority and beyond, the floor is set at 3 months of gross salary. As for the ceiling, with 2 years of seniority, it will reach three months, increased by a month per year of seniority up to ten years, and then increased by half a month per year, to a maximum of 20 months for 30 years of seniority within the same company. A different table will apply for companies with less than 11 employees but only for the floor: it will range between 0.5 and 2.5 months of wages depending on seniority. In exchange, mandatory severance pay (for all companies) will be raised to a quarter of a month of wages per year of seniority (up from a fifth currently).

The period for contesting layoffs before a labour court will be reduced to 1 year from 2 years at present, regardless of the justification for terminating the job contract. Moreover, for international groups laying off workers in France, the scope used for assessing their economic difficulties will also be revised. In case of a dispute, the court currently evaluates the economic difficulties of the group as a whole. The reform will restrict this scope to France.

Lastly, the government will create a collective termination agreement. Currently, friendly termination agreements can only be negotiated individually, between an employee and his employer. The reform will authorise agreements to define a single framework for collective voluntary redundancies.



From the numerous empirical studies on the subject¹⁶, it is hard to conclude that there is a significant link between redundancy legislation and the unemployment rate. However, they do show that the duration of unemployment generally increases with the degree of employment protection. Actually it is the employment rate that is most affected by rigorous legislation: strong job protections tend to diminish the employment rate, particularly for youth and seniors. The differences in the impact on employment and unemployment rates can be attributed to the decline in the participation rate associated with the duration of unemployment: it tends to last longer in countries with stricter job protections, resulting in more discouraged jobseekers.

Loosening employment protection legislation would seem to address the main problems in the French labour market, namely the low employment rates of youth and seniors. Yet according to the OECD, Germany and the Netherlands also have high degrees of employment protection (including for individual dismissals), and they both report better performances in this segment than France.

This means that other variables must be taken into consideration. Several studies¹⁷ show that above a certain level, an overly rapid increase in the minimum wage relative to the median wage can have a negative impact on employment for the least qualified workers. For the same minimum wage, or slightly higher, companies tend to opt for qualified workers to the detriment of less qualified ones.

- Employment protection and labour market segmentation

Employment protection has an impact not only on the volume of employment, but also on its composition. We can observe that rigorous redundancy legislation – which essentially protects permanent open-ended job contracts – is generally accompanied by a high proportion of temporary contracts, only a small share of which give access to permanent employment (currently about 10% in France). The labour market is segmented between workers benefiting from a stable job and those alternating between temporary contracts and periods of unemployment. This job insecurity is concentrated in the most fragile social categories, especially unqualified youth. The consequences of this situation extend well beyond the labour market: temporary employment also makes it harder to gain access to housing and loans.

Labour market segmentation tends to intensify during cyclical downturns, when employers resort more frequently to temporary contracts.

In France, although temporary contracts as a share of total payroll employment rose by only 1 point during the crisis this trend masks the growing duality of employment. Out of 100 workers hired between 2012 and 2015¹⁸, 83 were employed under fixed-term job contracts (vs 71 between 2000 and 2006) with an increasingly large share of these contracts for very short periods (70 ended after a month), despite the

surcharge on short fixed-term contracts introduced in 2013. The labour turnover rate increased sharply, but primarily for a minority of workers, who bore the brunt of the cyclical risks (chart 18).

Loosening redundancy regulations is a way to redistribute the uncertainty over a greater number of workers, and to reduce the relative cost of hiring associated with open-ended contracts. *A priori*, this should encourage companies to resort more readily to this type of permanent job contract.

Share of fixed-term contracts in hires

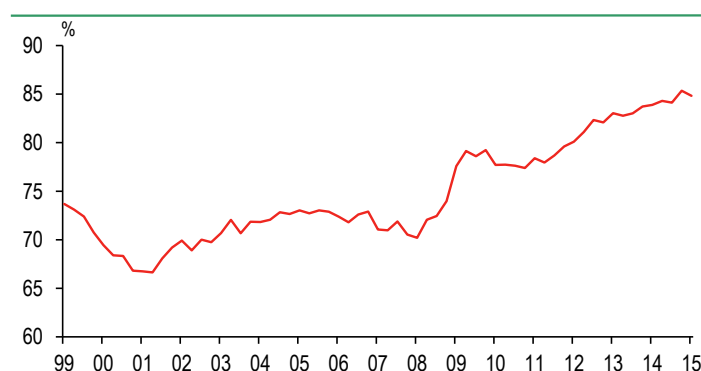


Chart 18

Source : DARES

Box 2: Why protect employment?

From a macroeconomic perspective, employment protections are justified by the distinction between the private and social value of employment.

The private value of employment represents the production realised by a person employed by a company. It is broken down into wages and profits. But employment also has social value: its value for the community. This corresponds to the sum of the private value and externalities, namely the repercussions of employment decisions that go beyond the employer's and the employee's interests.

Destroying a job thus implies a social cost that must be added to the private cost. This is due to the fact that the majority of fiscal revenues are levied on employed persons. For dismissals, the difference between the social and private value of employment equals the loss of fiscal revenues as well as the amount of social transfers. The differential is even greater if we take into account the financing of social protection. In the end, the total cost for the community can be very high. Yet companies only take into account the private value of their decision, which is why employment protections are necessary (looking beyond respect for an individual's fundamental rights).

Employment protection can create distortions though. That is why some authors prefer other measures to align the private and social value of employment. Blanchard and Tirole (2003) propose internalising the social costs linked to the loss of employment by introducing a redundancy tax, based on the experiences in North America: in the United States and Canada, each company must contribute to unemployment insurance in keeping with the severance pay that was paid to employees laid off in the past.

¹⁶ See notably Blanchard O., Tirole J. (2003), "Employment protection", CAE, October.

For a summary of empirical research, see also Addison J. Teixeira P. (2003), *The Economics of Employment Protection*, Journal of Labor Research, vol.24

¹⁷ See notably Laroque G. and Salanié B. (2004), *Salaire minimum et emploi et présence de négociations salariales*, Annales d'économie et de statistique, N°73

¹⁸ These are the most recently available statistics, since DARES temporarily stopped releasing labour movement statistics after this date.



- Employment protection and productivity

High employment protections can also have harmful effects on productivity by hampering the process of creative destruction, a key source of productivity gains. According to Bouis et al (2011),¹⁹ an employment protection reform facilitating the reallocation of labour in response to changes in demand can boost productivity by 0.25% to 0.75% depending on the country. An increase in productivity helps reduce structural unemployment by allowing real wages to increase without generating inflation.

Moreover, high job segmentation probably strains the level of labour productivity by fostering less vocational training and a smaller accumulation of company-specific human capital.

Collective bargaining

Loosening legislation on economic dismissals is a way of giving companies greater flexibility to manage their headcount in keeping with the strength of demand. This is known as external flexibility. Another source of flexibility, called internal flexibility, consists of adjusting the volume of working hours and wages. For a given level of employment protection, greater internal flexibility theoretically increases the incentive for companies to offer open-ended job contracts.

Numerous factors can influence internal flexibility, including the presence and bargaining power of unions, right-to-strike legislation, and the amount of replacement revenues. A key factor is the degree of centralisation of collective bargaining.

In labour law, there are three sources of employment standards: labour legislation, the job contract and collective bargaining agreements. Collective bargaining agreements can be negotiated at three basic levels: the company level, the branch level (the scope of which is defined by the social partners), and finally, the national and inter-professional level. These three sources of labour standards are governed by two key principles: 1) a hierarchical structure in which legal standards and regulations take precedence over collective bargaining agreements negotiated by social partners, and within collective bargaining, branch-level agreements take precedence over company-level agreements; and 2) a favourable treatment principle that stipulates that a lower ranking labour standard cannot override a higher ranking one, unless it is more favourable for employees.

The theory²⁰ distinguishes between three types of collective bargaining: completely centralised negotiations at the national level, completely decentralised negotiations at the company level, and those carried out at an intermediate level, the branch. In the first case, negotiations on wages and working time internalise the effects on employment, while in the second, each company negotiates according to the prevailing conditions: wage increases can be adjusted better to keep pace with productivity gains in each company.

¹⁹ Bouis R. Duval R (2011), *Raising potential growth after the crisis: Quantitative assessment*, OECD WP 835

²⁰ See Calmfors L. and Driffill J. (1998), *Bargaining Structure, Corporatism and Macroeconomic Performance*, Economic Policy, n°6

Box 3: Fifteen years of decentralising the collective bargaining process in France

The prevailing idea that workplace regulations in France are determined essentially by labour laws is increasingly less true. Numerous themes are negotiated through collective bargaining (minimum wage by branch, training, qualifications, prevention, etc.). Historically, the branch is the privileged level for social dialogue (more than 95% of employees are covered by a branch-level agreement, notably due to extension procedures), but company-level agreements have gained importance since the early 1980s.

The annual obligation for companies to negotiate effective wages and the effective duration and organisation of working hours dates back to the Auroux laws of 1982. This obligation only concerns companies with one or more union sections. The 1982 legislation also provided for the creation of company level derogations concerning overtime work.

The Fillon law of 2004 reinforces company-level agreements by empowering them with regard to branch-level agreements. Company-level agreements signed after this date could override an agreement at a branch level on condition that the themes were not excluded by the branch agreement. This waiver option is open to all subjects of negotiation, with the exception of minimum wages, job classifications, the mutualisation of vocational training funds and the mutualisation of supplementary social protection funds, which are protected by law (i.e. the branch's minimum set of guarantees).

The Bertrand law of August 2008 introduced the primacy of company-level agreements in certain areas for the organisation of working hours: overtime work allowance, distribution and organisation of working hours. The branch-level agreement applies only if there is not a company-level agreement, and the labour code applies in the absence of a collective bargaining agreement.

The Job Security Act of June 2013 allows companies to negotiate employment preservation plans, which were previously a unilateral procedure conducted by the employer (in consultation with the works council). These employment preservation agreements (AME) allow companies undergoing "severe economic difficulties" to sign temporary collective bargaining agreements to reorganise working hours and/or wages, in exchange for preserving employment.

The El Khomri law of August 2016 expands the primacy of company-level agreements to include 37 subjects pertaining to working hours, holidays and rest days; the definition of non-working days; the terms for carrying over holidays; increased pay for overtime work, etc. In addition to these themes, and as part of the framework defined by the Fillon law of 2004, the El Khomri law of 2016 introduced a measure for branches to define the themes for which less favourable company-level agreements cannot be signed.

Two themes were added to the set of minimum branch guarantees: prevention of arduous work and gender equality in the workplace. Lastly, the law introduces the possibility of signing "offensive" agreements (as opposed to the defensive employment preservation agreements-AME) which regulate working hours for companies seeking to improve their competitiveness. In this case, collective bargaining agreements prevail over measures in individual job contracts. Any changes must be approved by a company majority agreement, i.e. signed by the employer and union representatives that have received more than 50% of votes (as opposed to 30% normally).



Negotiations at the intermediate level would tend to produce the worst results, because the negotiated terms would be too costly for some companies, while the negotiating bodies would not internalise the negative impact on employment: differences in market power mean that wages could be too high for some companies, who would be forced to reduce their headcount. This phenomenon would be aggravated by extension procedures, whereby a ministerial decree makes a collective bargaining agreement applicable to all companies within its scope of application, including those without representation by one of the unions that signed the agreement. As a result, in terms of the employment/wage trade-off, only highly centralised or decentralised systems would produce Pareto optimality (i.e. improving the situation for some without harming that of others).

A series of French labour law reforms over the past 30 years have largely modified the hierarchical structure of labour standards, by expanding the scope of collective bargaining with regard to labour law, by lending greater autonomy to the different levels of negotiation (see box 3) and by introducing exceptions to the favourable treatment principle.

Consequently, although the branch level still dominates in terms of the bargaining structure, a significant number of themes on labour relations are now negotiated at the company level. This is notably the case for the management of working hours, for which company-level negotiations now override branch-level agreements.²¹ The upcoming labour code reform intends to pursue the decentralisation of collective bargaining by expanding the areas in which company-level agreements override branch agreements (for example when determining seniority bonuses or 13th month pay).

In principle, greater internal flexibility offers an alternative to layoffs during cyclical downturns²². It also allows companies to modulate working conditions better (compensation, working hours, internal organisation) according to their specific situations, reducing the distortion of competition between big and small companies: wage differentiation is a way to compensate for differences in productivity within a branch. At the aggregate level, this should result in a slower increase in unit labour costs, which boils down to an improvement in cost competitiveness; all other factors being the same.

Yet it does not totally resolve the question of competition between and within branches. First, a certain degree of competition between firms is needed for improved cost-competitiveness to translate into better price-competitiveness. According to a CAE note (2015)²³, the problem of French competitiveness is due less to unit labour costs in the manufacturing industry than to intermediate consumption costs. These have increased sharply over the past ten years, due notably to

insufficient competition in the sheltered sectors. Blanchard and Giavazzi (2003)²⁴ also underscore the importance of taking a comprehensive approach to deregulation. Opening up product markets before deregulating the job market would make wage moderation easier to accept by limiting the decline in real wages in the short term.

This also leaves open the question of competitive conditions between firms in the same branch: excessive deregulation increases the risk of “social dumping”, i.e. the widespread propagation of the least socially-favourable company-level agreements. This shows the pertinence of a strong enough branch’s minimum set of guarantees.

Lastly, the decentralisation of collective bargaining raises the question of whether companies have the capacity to reach agreements, since most of France’s small and medium-sized enterprises (SME) lack union representation. The possibility of negotiating in the absence of unions in firms of less than 50 employees might overcome this problem, on condition that it does not undermine the social climate. Although the low level of union representation (less than 10% of employees are union members) can partly be attributed to extension procedures, it is also due to public opinion’s deteriorated image of the unions and the lack of confidence between social players.

Short-term effects

So far, we have examined the effects that can be expected from the reform in the *medium-term* that is to say by implicitly assuming that economic output equalled potential. To be more specific, this means that the economy does not experience a shortage of demand: the decline in unemployment only runs up against supply-side constraints, which the reform is precisely designed to alleviate. Yet as we saw in part one, the crisis has left major scars on the French labour market. A significant part of underemployment can be attributed to insufficient demand. Although demand is picking up, it is still lower than supply, creating a negative output gap.

The debate on the effect of structural reforms on activity occupies a significant place in the economic literature. Although there is something of a consensus about the positive effects over the medium to long term, opinion is more divided as to their short-term effects. Often the negative impact on employment and consumption is felt before the positive effects kick in (Cacciatore et al. (2016)). Yet they can have an immediately positive impact when expectations of future revenue increases – due to the expected increase in potential GDP – acts as a wealth effect, stimulating both consumption and investment in the short term. Yet a positive reaction from demand assumes that economic agents form rational expectations²⁵, and that they are not liquidity-constrained. The credibility of the first assumption is open to debate while the second hypothesis is less credible in a fragile – albeit improving – economic situation (negative output gap). In contrast, several negative effects are more likely to emerge.

²¹ Negotiations do not cover the legal workweek, which is set at 35 hours per week. This does not limit the number of working hours per week, but marks the threshold above which overtime rates apply.

²² The Job Security Act of 2013 already made it possible for distressed companies to sign employment preservation agreements (AME), whose terms were less favourable than job contracts. According to a 2015 assessment by the Labour Ministry, companies did not make much use of AME. Among the reasons cited to explain the poor success, the maximum duration of 2 years was said to be too short.

²³ See Bas M., Fontagné L., Martin P., Mayer T. (2015), *In search of lost market share*, CAE Notes, n°23 May

²⁴ See Blanchard O. Giavazzi F. (2003), *The Macroeconomic Effects of Regulation in Goods and Labour Markets*, *The Quarterly Journal of Economics*, vol.118

²⁵ This assumes that economic agents make perfect use of all available information to form expectations, and that on average they are not wrong.



Rebuilding margins and precautionary savings

We have seen that restrictive legislation on economic dismissals helps curb the increase in unemployment during cyclical downturns. Although this reduces the loss of household revenues, from a corporate perspective, it puts downward pressure on profitability. A decline in demand at a constant headcount implies a slowdown in the growth of labour productivity. In France, labour productivity increased at an average rate of around 1.1% between 2000 and 2007, but has fallen to 0.4% since 2012, which suggests overstaffing (chart 19). Under these conditions, loosening dismissal legislation risks triggering net job destructions in the very short term, although the risk is smaller if the recovery is firmly anchored, which now seems to be the case.

The impact on growth can also be negative if the labour market reform triggers an increase in household savings. As we have seen, one of the objectives of the labour code reform is to spread the distribution of economic uncertainty. In essence the reform consists of shifting part of the cost of uncertainty from companies and outsiders to the insiders. If the insiders respond by increasing their savings, the impact on demand will be negative.

Labour productivity growth

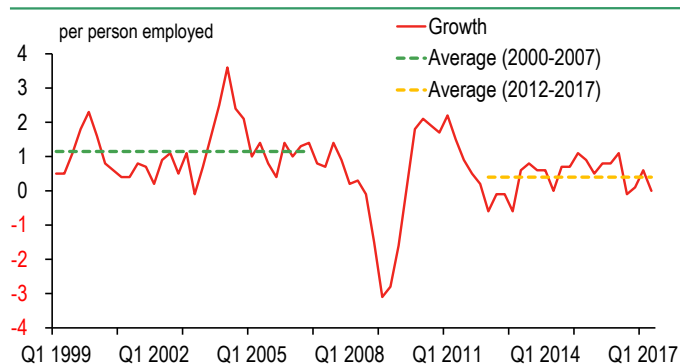


Chart 19

Source : Eurostat

Slower wage growth and real rates

The decentralisation of collective bargaining should slow down the growth of real unit labour costs. The impact can be positive from a microeconomic perspective (by stimulating hiring by some companies), but negative at the macroeconomic level when the output gap is already negative (the slowdown in wages accentuates the demand deficit). This is a typical example of the fallacy of composition: under certain circumstances, a specific trend can produce the opposite effect when it is applied to all economic agents²⁶.

Wage moderation can also have a negative effect by raising real interest rates, when monetary policy has hit the lower zero bound, and even more so when it has also engaged in monetary tightening.

²⁶ The textbook case is the "savings paradox" popularised by Keynes: if all economic agents try to increase their savings simultaneously, the resulting weakening of demand will trigger a decline in aggregate savings.

The IMF recently rounded out these theoretical considerations with an empirical assessment of the impact of supply-side policies, distinguishing between favorable and unfavorable (negative output gap) cyclical conditions.²⁷ The results tend to support the theoretical models. Labour market deregulation policies introduced when the output gap is negative tend to have a negative impact on activity in the short term, especially when the reform involves loosening dismissal legislation.

Impact on competitiveness

So far, we have only looked at the effects of the reform on domestic demand. But as we have pointed out, wage moderation can have a positive impact on competitiveness, making it possible to capture a bigger share of world demand. Stronger exports can at least partially offset the erosion of domestic demand, as was the case for Spain.

Note, however, that the improvement in price-competitiveness can result solely from the decline in the *relative* prices of a country's goods and services with regard to its competitors. In other words, in an integrated trade zone like the Eurozone, the simultaneous introduction of supply-side policies tends to reduce their effects. The gains are bigger when the reforms are implemented in isolation. Inversely, maintaining the *status quo* can be a risky strategy if other countries embark on the path of wage moderation. Recent reforms in Italy and Spain have increased the risk for other countries, including France, which have steered away from such policies.

Gaulier (2016)²⁸ analyses the un-coordinated introduction of supply-side policies in a monetary union as a kind of prisoner's dilemma, starting with the assumption that these reforms have a positive impact on domestic demand when the macroeconomic environment is favourable and a negative impact when it is unfavourable.

He considers two countries that can choose whether or not to deregulate their labour markets. In a favourable macroeconomic environment, it is in the interest of both countries to launch reforms, because they will gain in terms of GDP. But when the reforms are introduced in both countries simultaneously, the gains are limited and generated essentially by domestic demand (the impact on foreign demand is cancelled out). The maximum gain is obtained when a country deregulates on its own: it also benefits from a greater share of foreign demand. Symmetrically, the country that does not deregulate suffers a loss of market share. From a collective point of view, it is better to reform than to maintain the *status quo*.

The situation is different when the macroeconomic environment is unfavourable. The reform has a negative impact on domestic demand, so if the reforms are carried out simultaneously, the overall impact is negative. From a collective point of view, it is better to maintain the *status quo* than to reform. This is a configuration similar to a "prisoner's dilemma": it is not in the interest of country 1 to reform, but if it does not reform it risks losing market share to country 2 if the latter opts to reform. Yet, it is more advantageous to reform alone: the gains in terms of foreign demand exceed the cost in terms of domestic demand. As a

²⁷ <http://www.imf.org/external/pubs/ft/weo/2016/01/pdf/c3.pdf>.

²⁸ Gaulier G. (2016), *Politique d'offre en économie ouverte: un dilemme du prisonnier quand la politique monétaire est contrainte?*, France Stratégie



result, both countries opt to reform, which is not the optimal solution from a collective perspective.

Conclusion

The upcoming labour code reform is likely to have positive effects on the French labour market: greater flexibility should boost the employment rate, notably for youth and seniors, and reduce market segmentation. The decentralisation of collective bargaining should help reduce the distortion of competition between firms and boost cost competitiveness. All in all, the structural unemployment rate should decline. As is generally the case with structural reforms, however, it is likely to take some time before their effects are felt. In the short term, the impact is likely to be mixed. *All other factors being the same*, there is greater risk on demand when the output gap is negative, which seems to be the case. Of course, nothing ever happens *all other factors being the same*. Short-term growth and employment prospects are more likely to be determined by changes in the policy mix (monetary and fiscal policies) than by structural changes induced by the reform.

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The eastern members of the EU: catching up fast

Anna Dorbec

This article analyses the recent economic performances of the eastern countries of the European Union, specifically focusing on the so called Visegrad-6 group, comprising Poland, Hungary, the Czech Republic, Slovakia, Bulgaria and Romania. Long considered as the EU's "junior partners", their very strong macroeconomic performances in recent years suggest that they will soon catch up with their western EU counterparts. Are we about to witness the culmination of more than 10 years of convergence? Only if we ignore the structural challenges these economies are still facing.

This article examines the economic performances of the Visegrad-6 (V-6), which comprises the original Visegrad-4 (Poland, Hungary, the Czech Republic and Slovakia) which joined the EU in 2004 as well as Bulgaria and Romania, which joined in 2007. Together, these six countries account for 61% of the GDP of central and Eastern Europe¹, and 86% of the region's population. Of these countries, only Slovakia is a member of Eurozone.

Part one will examine the real economy, including growth and competitiveness. Part two will look at macro-financial convergence, including inflation, interest rates and macroeconomic imbalances. Part three will analyse the structural aspects such as demographics and innovation capacity. By examining these three vectors, we will try to define the region's future short and medium to long-term trajectories and risks.

Performance of the real economy

Eastern Europe's economic performances have caught the world's attention. The region reports the most dynamic GDP growth in the EU. Since year-end 2016, the region seems to benefit of the rebound in world growth, the upturn in international trade and the improvement in investor confidence. Since they joined the EU, the V-6 countries have consistently outperformed the averages of both the EU and the Eurozone (table 1).

Average growth (geometric mean)

	V-6	European Union	Eurozone
2010-16	2.3%	1.3%	1.1%
2008-09	0.1%	-2.0%	-2.1%
2004-07	6.1%	2.7%	2.6%

Table 1

Sources: Eurostat, BNP Paribas

¹ The region of Central and Eastern Europe (CEE) includes the old «eastern Bloc» countries (Bulgaria, Hungary, Poland, Romania, Albania), the countries issued from the dissolution of Yugoslavia (Croatia, Slovenia, Serbia, Bosnia-Herzegovina, Macedonia, Montenegro and Kosovo...), and of Czechoslovakia (Czech republic and Slovakia) as well as the Baltic states (Lithuania, Latvia and Estonia, old soviet republics).

Although growth has slowed sharply since 2010, the V-6 continue to grow at significantly faster rates than the EU and eurozone averages. With the exception of Poland, which avoided recession, the others all passed through recessionary periods. For the region as a whole, growth rebounded in 2010-2011, except Hungary and the Czech Republic, where GDP continued to contract in 2012 (2012 and 2013 for the Czech Republic). Since 2014, however, these troubles have been a thing of the past, and real GDP exceeded its 2008 peak, except in Bulgaria (chart 1). The catching-up movement has resumed again, buoyed by very strong industrial performances (chart 2).

Real GDP growth above the EU average

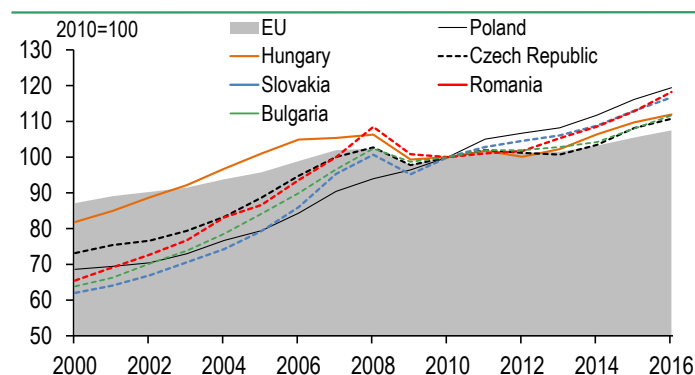


Chart 1

Sources: IMF, Eurostat, European Commission, BNP Paribas

Industrial boom

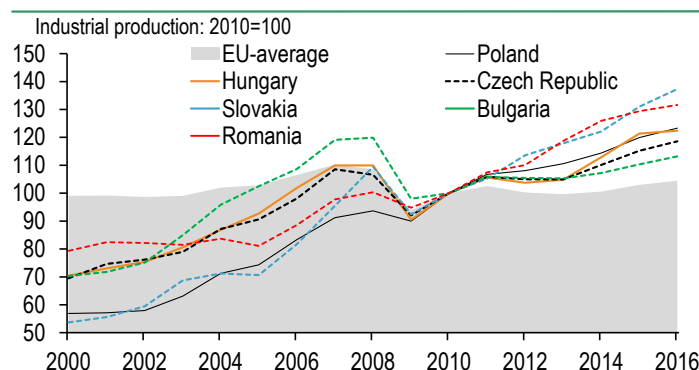


Chart 2

Sources: IMF, Eurostat, European Commission, BNP Paribas



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world

Acceleration in industrial activity and gains in market shares

Eastern European industrial performances have surpassed the EU average since 2001. The only exception is 2009, when industrial activity in four of the six countries contracted by more than for the EU as a whole, which reflects the importance of sub-contracting activities linked to the European industrial giants, who sharply reduced their orders in response to the uncertainty of the financial crisis. But the industrial sectors of the V-6 quickly swung back into growth. The year 2012 was also tough, undermined by fears about the sovereign debt crisis. Once again, Eastern European industries adapted very quickly and managed to pull through the crisis. Although European industry as a whole has grown only 2.5% since 2004, the V-6 countries have staged an impressive industrial performance: over the same period, industrial production rose 18% in Bulgaria and 93% in Slovakia, respectively the region's weakest and strongest industrial performances (chart 2).

The V-6 countries gained market shares within the EU thanks to a skilled but low-cost labour force, an institutional environment rapidly catching up with European standards, and the absence of customs barriers. This created a propitious environment for international groups to set up new production units and to develop outsourcing, notably in the automobile sector, where Germany remains the main player in this new industrial fabric.

The wage gap is narrowing at an accelerated pace, buoyed by a spectacular improvement in the labour market

The V-6 economies still benefit from the advantages of low-cost labour (chart 3). Slovakia pays the highest wages of the group, at EUR7.8 per hour in 2016, but wage costs there are only 30% of the EU average. Bulgaria pays the lowest wages, with average hourly wages of EUR 3.7, which is only 14% of the European average (EUR 25.9 in 2016). Nonetheless, the wage gap has been narrowing over the years and this catching-up movement has even accelerated since 2014. In the first half of 2017 nominal wages soared by 15% year-on-year in Romania, by 10% in Bulgaria and by 9% in Hungary, compared with the average growth of less than 2% in the EU as a whole.

With the notable exception of the Czech Republic, wage increases are once again exceeding productivity gains, although the situation still has not returned to 2007 levels. If the gap between wage increases and productivity holds at current levels, we are likely to see the competitiveness of these countries gradually erode. This makes it even more vital for the V-6 to make the "qualitative leap", i.e. to switch from outsourcing for European industrial groups to the development of integrated national industrial groups and more innovative activities.

Recent labour market trends point towards the continuation in wage acceleration. After a long period of severe underemployment (notably in Poland, Slovakia and Hungary), unemployment rates have been declining since 2013. Today unemployment rates are at their all-time lows, and below the European average (chart 6).

Labour demand is also on the rise. Companies complain of a lack of skilled labour. The surplus labour demand is mainly due to vigorous growth, but it also reflects the aggravation of demographic trends over the past twenty years (declining birth rates and aging populations).

These trends are straining the active population, which declines in Poland, Bulgaria and Romania, and increases very mildly in Czech republic and Slovakia (chart 7). Only Hungary seems to have bucked this trend, with an ongoing increase in the active population since 2010.

Wage gap with the EU average is still high

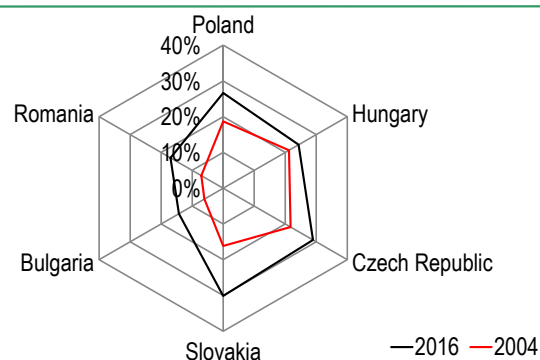


Chart 3

Sources: Eurostat, BNP Paribas

Nominal wage growth: another acceleration

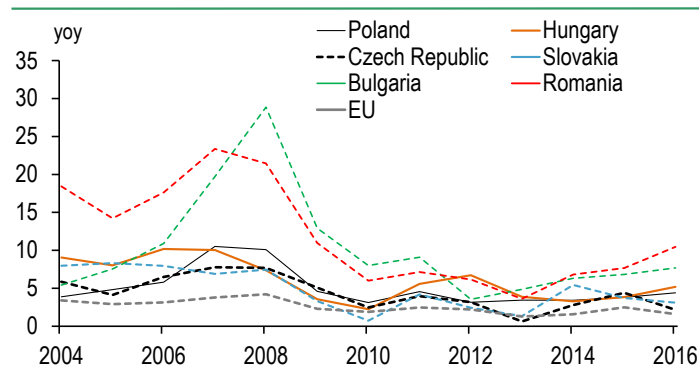


Chart 4

Sources: National statistics, Eurostat, BNP Paribas

Real wage - productivity gap

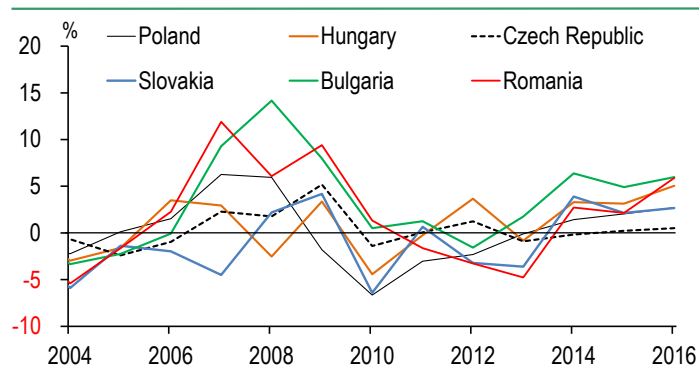


Chart 5

Sources: IMF, Eurostat, European Commission, BNP Paribas

This can be attributed to government measures both to reduce unemployment and to increase the active population, notably by setting up large-scale public works programmes to create jobs and to attract discouraged workers who had given up on the labour market after long and unsuccessful job searches.

Historic decline in unemployment...

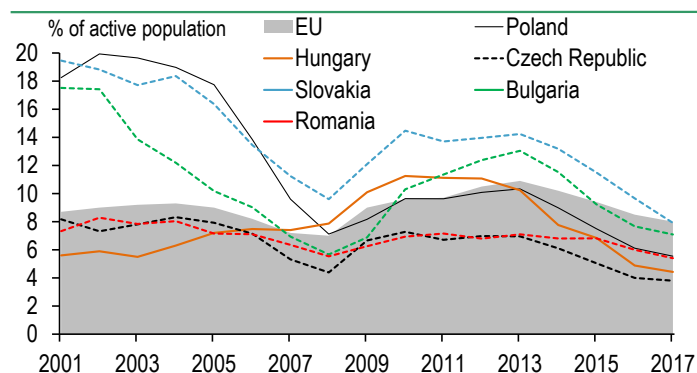


Chart 6

Sources: Eurostat, BNP Paribas

...facilitated by an alarming decline in the active population

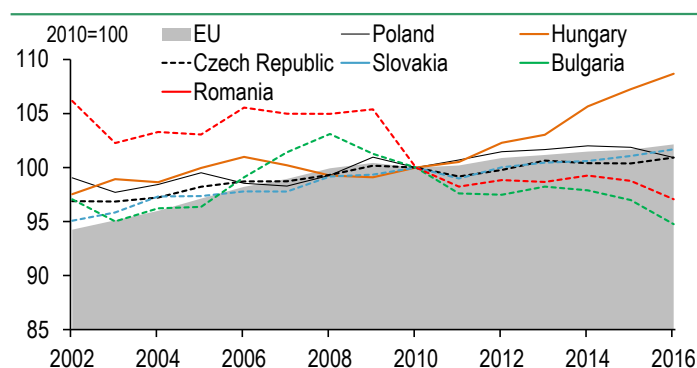


Chart 7

Sources: Eurostat, BNP Paribas

Buoyant export growth

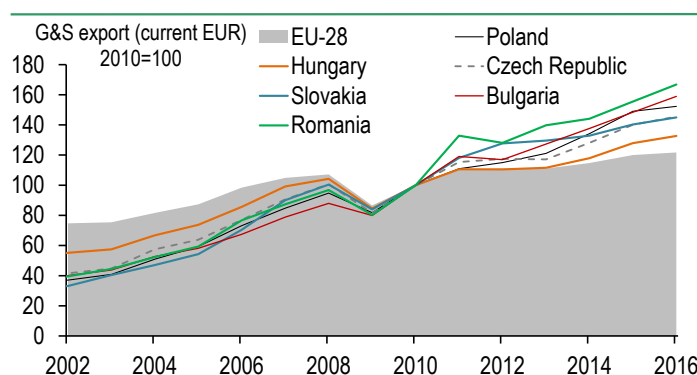


Chart 8

Sources: Eurostat, BNP Paribas

Under these conditions, posted workers only aggravate tensions in the short term. The V-6 countries are net suppliers of posted workers: in 2015 (the most recently available figures), posted workers accounted for 2% of the active population in Poland, 3% in Slovakia, and 1% in Hungary and Romania. The most recent estimates point to the amplification of this trend. Efforts to reform the European directive on posted workers are still highly controversial. The defensive positions of the countries that are net suppliers of posted workers (from the East and South of the Union) are encountering growing reticence from the countries that are net receivers of such workers fearing social dumping. Although the posted workers reform has been announced, the negotiations promise to be long and complicated. Consequently, the departure of workers towards other EU countries offering higher wages will continue to drain labour in the V-6 countries.

All of these factors support the idea of ongoing wage acceleration. The shortage of skilled labour will continue, and will require specific policies, notably in terms of vocational training and the development of child care facilities. The latter is needed to increase the female participation rate, which is lower than the EU average despite equal access to education.

Relations with the EU: seeking a new balance of power

While the recent trends in trade integration and the stock of foreign direct investment point to stabilization, the impact of European structural funds as a vector of integration and development of the eastern European countries gained power. The EU budget of 2014-2020 envisages a substantial increase in structural funds' flows to V-6 countries, fuelling large-scale infrastructure projects. In contrast, political relations between Brussels and the new member states have soured. Several thorny issues have emerged, notably concerning posted workers and migration quota policy. Political reforms introduced in some countries have also created tension, further complicating the negotiations even more complicated.

Stabilisation of foreign trade and FDI

Exports remain a major axis for convergence and regional development, although its importance seems to be levelling off. V-6 exports' growth exceeds the EU average (chart 8). The European Union still plays a preponderant role in the foreign trade of the V-6 countries, accounting for 79% of total exports of goods and services and for 75% of imports in 2016. Paradoxically, the EU's share of total V-6 exports has remained basically flat since 2000 (chart 9). It even contracted in the period 2005-2013. In terms of imports, it was not until 2010 (2012 for Poland) that the EU weighed more as a supplier of goods and services. Averaging 75% in 2016, it's share in imports now exceeds the 2004 peak in all the V-6 countries except Poland, which seems to be lagging behind this trend by about two years (chart 10). On the whole, even though the weight of imports is expected to increase, the original Visegrad 4 (V-4) countries seem to have largely completed their integration within the European market, while trade with Romania and Bulgaria should continue to intensify.

The V-6 countries managed to seize the opportunities offered by the single European market to develop trade with other EU countries, as well as to integrate within supply chains at the European level.

The development of exports has relied heavily on foreign direct investment, another key vector of integration. After an accelerated accumulation during 2000-2008, the stock of FDI has tended to stabilise as a share of GDP (chart 11), at levels ranging from 40% of GDP for Romania to 90% of GDP for Hungary. This levelling off confirms the end of an era in which the massive inflow of FDI served as a vital source of growth for these countries (notably for investment). It also means that other sources of financing will need to be found to fund future growth.

EU funds: a cornucopia through 2020...

Structural funds have played a growing role among the new sources of financing growth in recent years. Starting from less than 1% of GDP in the first years following EU membership, net transfers of structural funds reached an average of 4% of GDP in 2015. The 2014-2020 budget is also generous, with gross transfers (i.e. excluding contributions) planned at 3% of countries' GDP on average. The substantial growth of EU structural funds flows towards the end of the 2000s helped to offset the recessionary impact of the credit crunch and the reduction in fiscal capacities following the 2008-2009 recession.

In 2016, the slowdown in financing due to the particularities of the European fiscal cycle² strained investment growth in the V-6 countries. Yet this was temporary and flows resumed in 2017. In the remainder of the fiscal period that lasts to 2020, the absorption of funds should grow further thus supporting new investment and growth³.

Will this policy be continued beyond 2020? A priori, the region will continue to receive structural funds, but we can reasonably expect that the EU will be less generous. First, after Brexit (the UK's exit from the EU), officially set for Q1 2019, the EU's financial capacity will be reduced. The UK currently makes a net contribution of about 20% to the European budget. Financial conditions will therefore be fundamentally different in the 2021-2027 cycle, which means the priorities of structural policies will have to be reviewed. Second, some countries, notably those of southern Europe, are currently hit by insufficient potential growth and high unemployment rates, accompanied by the erosion of the private sector's financing capacities, notably in terms of access to credit (due to ailing banking sectors), and the need to restore fiscal sustainability. Therefore the rebalancing of the funds flows to these countries may be put on the agenda of the negotiations on the funds' allocation for the next budget period.

² The 7-year budget cycle is based on investment projects in which the EU is not the sole investor. Projects must be co-financed. The new fiscal cycle began in 2014, but the funds for projects approved during the previous cycle (2007-2013) could still be used through 2016. The funds are organised on a project basis, which means they are not released in equal parts each year, but according to project advancement. The budget cycle reflects the time necessary to prepare investment projects: fund transfers are small at the beginning of the cycle and accelerate towards the end (with the possibility of absorbing funds 2 years after the budget period).

³ Knowing the gearing effect these projects can have on short and medium-term growth, certain governments, like Hungary, have made special efforts to accelerate the absorption of funds available for the period 2014-2020, thereby hoping to smooth the variations in the budget cycle. For domestic political reasons, they also hope to stimulate short-term growth.

Lastly, numerous controversies are arising with the EU, which threatens to retaliate through financial sanctions, which could take the form of cutbacks in European funding.

Exports to EU as a share of total goods & services exports

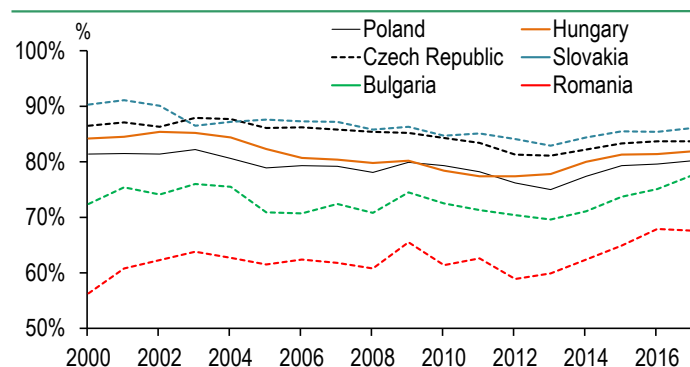


Chart 9 Sources: European Commission, BNP Paribas

Imports from EU as a share of total goods & services imports

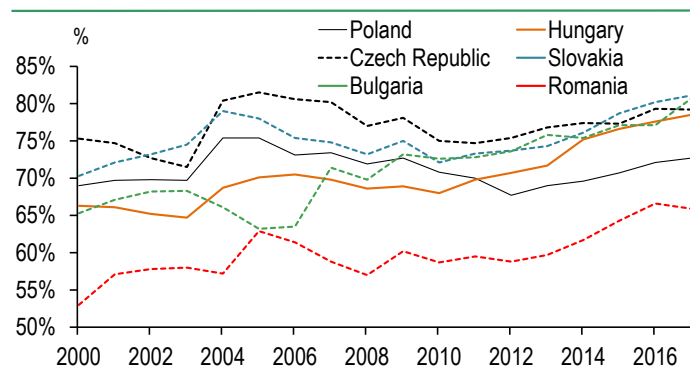


Chart 10 Sources: European Commission, BNP Paribas

Cumulative stock of FDI

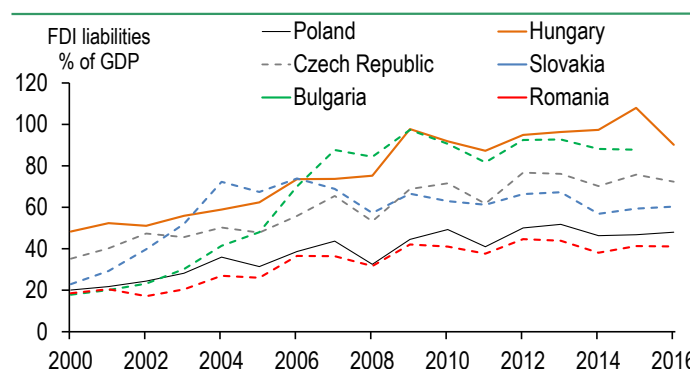


Chart 11 Sources: European Commission, BNP Paribas

Political relations: controversies emerge

Several controversies have sprung up recently between the eastern European countries and Brussels, notably over migrant quotas. Backed by public opinion, the governments have refused to comply with EU demands⁴. In June 2017, the EU opened procedures that aim to sanction Hungary and Poland for not respecting Brussels' decision on the reallocation of refugees.

Another thorny issue souring east-west relations is the reform of the posted workers directive. This directive allows European residents to work temporarily in another EU country without being subject to local social contributions. As a result, the western and southern countries of the EU, which have higher wage and social contribution rates, are attracting substantial flows of (cheaper) posted workers. Yet many of these countries also have high unemployment rates. Eastern European countries, which pay relatively lower wages, are net suppliers of posted workers. The reform, aiming at combating social dumping, looks to subject posted workers to the same conditions as the local labour force. The reduction of the maximum period to which the worker may be sent to another country without paying local social contributions (which is of 36 months currently) to 12 months over a period of 2 years, which should oblige all workers willing to work for longer to comply with the regulations of the receiver country is notably among the possibilities. Despite very low unemployment rates and the need to retain skilled workers (see below), the eastern European countries do not welcome this reform. Negotiations promise to be long and complicated, and for the moment, there are no signs of a consensus emerging.

In addition, the political reforms implemented in Hungary in 2013 and in Poland in 2015-2017 angered Brussels that perceived it as endangering the balance of power necessary for the smooth functioning of a democracy. European institutions do not really have the capacity to change the decisions of the national authorities, despite several threats of sanctions. European leaders are frustrated with the uncooperative positions taken by new member states, which largely benefit from the transfer of structural funds, but are reluctant to embrace decisions made collectively, despite the benefits for the EU as a whole. It is in the interest of all parties to reach a compromise position (and then to implement it), which will be vital if they are to avoid cumbersome warning procedures and sanctions. But we cannot rule out the possibility that more conflictual choices will prevail, lasting tensions and ending in a loss of confidence in the convergence process.

Macro-financial convergence

An analysis of financial indicators shows that the V-6 countries have made notable progress towards macro-financial convergence, and some have even completed the process. Starting from very disparate levels and dynamics, inflation and interest rates are now evolving within a very narrow band. The convergence of inflation rates determines the

convergence of monetary policies, notwithstanding the Eurozone's membership.

Inflation and interest rates

Looking retrospectively at inflation dynamics since 2000, we can see that the inflation rates have moved sharply closer, despite very different initial situations and independently of foreign exchange policies. Poland, Hungary and Romania use floating exchange rates, Slovakia adopted the euro in 2009, Bulgaria uses a fixed exchange rate as part of a currency board, and the Czech National Bank introduced a floor rate between November 2013 and April 2017 to limit the koruna's appreciation.

In the early 2000s, the countries of the region reported very disparate inflation rates, exceeding the EU average. In 2000, annual inflation neared 50% in Romania but was only 2% in the Czech Republic (chart 12). The 2008-2009 shock marked the beginning of synchronisation, and this movement intensified after 2012. By 2017, inflation rates in the eastern EU countries were bunched closely together, and differed little from the EU average. Today, they are just slightly below the ECB's price stability target (annual rate of 2%).

Yet despite the convergence of inflationary trends that is obvious, there are still significant price level differentials when compared with the old Eurozone member countries (EU-15). The spread is even wider for the non-tradable sectors, those in which goods cannot be traded internationally. According to European Commission estimates, in 2014 the prices of tradable consumption and investment goods in the new member countries amounted to 80% and 85%, respectively, of average prices for the EU-15, while prices of non-tradable goods were only 50% of the EU-15 average, with high disparities between countries. The convergence of price levels makes the central banks' task even harder, because it needs letting exchange rates appreciate, hampering the competitiveness of tradable sectors and increasing risks of bubble formation, in particular for the real estate.

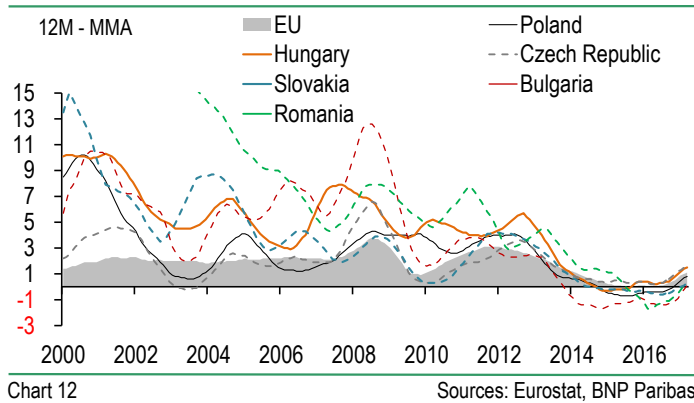
The convergence and decline in inflation rates have paved the way for a significant improvement in financing conditions in domestic currencies for governments and the private sectors.

The alignment of interest rates is very visible for government bonds (see chart 13 for 10-year government bonds): after the two shocks of 2009 and 2012, which correspond to periods of financial markets' stress, government bond yields dropped to very low levels, very close to those of German Bund. Except the recent widening of spreads for Poland and Hungary which is due to political tensions with Brussels (see supra) and should be temporary, general trend points to narrowing spreads and declining rates. Although interest rates could become more volatile again in the eastern European countries, the current decline significantly improves the financing conditions for their governments. Some, like Hungary, quickly took advantage of this situation by launching a programme to favour domestic financing in the local currency over foreign currency financing on international markets. As a result, it has reduced both currency risk and the debt servicing costs (see chart 14). Other countries have also benefited from this rate effect.

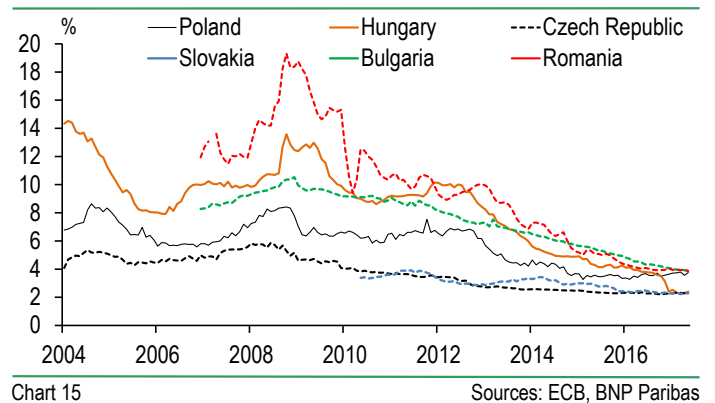
⁴ Hungary and Slovakia filed a complaint with the European Court of Justice in 2015. Although the Court ruled against them in July 2017, the two countries, along with the Czech Republic, continue to refuse to comply with the migrant quotas.



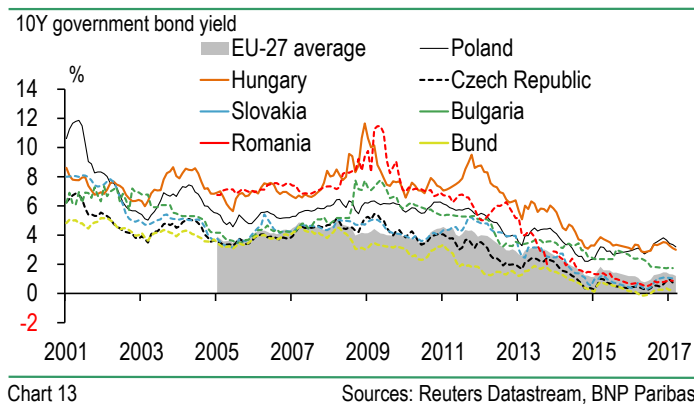
Inflation: spectacular convergence



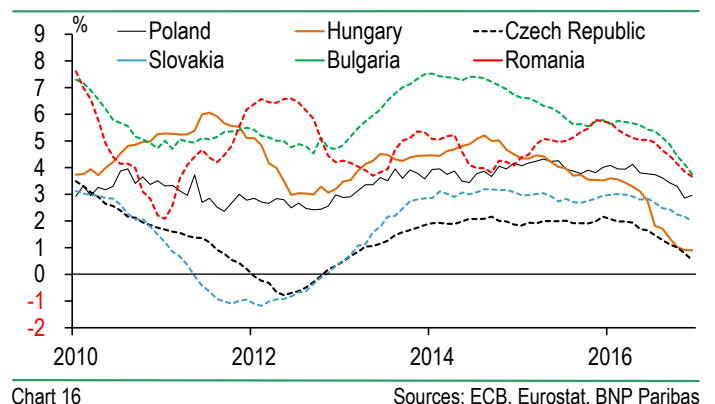
Corporate lending rates



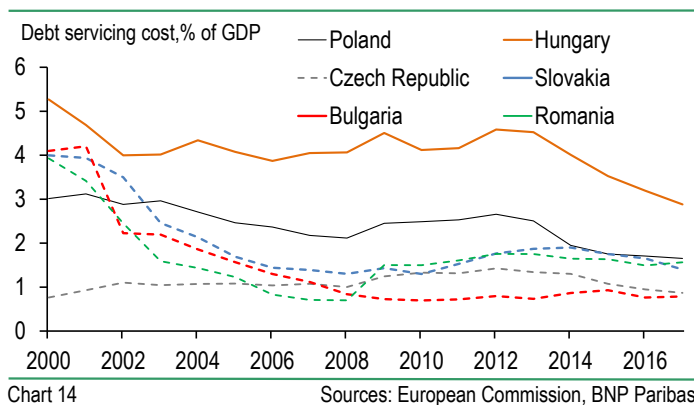
Government lending rates: convergence resumes after a double shock



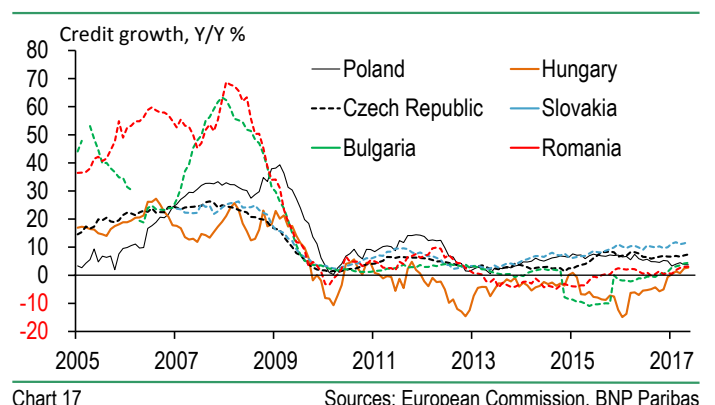
Real interest rates (adjusted for the consumer price index)



Debt service cost



Credit growth: slow start-up after prosperous years



Private sector lending rates have followed similar trajectories, leading to better credit conditions. However, the decline in interest rates alone was not enough to pull these countries out of the credit crunch that struck after the bursting of credit bubbles in 2009. The Czech Republic, Slovakia and Poland were only hit by a sharp slowdown in lending to the private sector, but Bulgaria, Romania and Hungary entered a long period without any new bank financing. It was not until 2016 that lending to the private sector finally swung back into growth (chart 17). During this period, the V-6 banks managed to restore their external positions, and deposits became their main source of balance sheet financing again.

Although the resulting credit growth is milder than before the crisis, bank loans are now contributing to financing growth. With historically low nominal interest rates, and the decline in real interest rates since 2013 (a trend reinforced in 2016, chart 16), the environment is increasingly favourable for long-term financing in the local currency. The loan-to-GDP ratio averages 50% for the V-6 countries (with a range from 28% of GDP for Romania to 57% of GDP for Slovakia at year-end 2016), which is still much lower than the European average of 97% of GDP. This highlights the development potential for lending. The conditions have come together for the banking sector to begin growing again, assuming it avoids the excesses of 2004-2008.

Fewer macroeconomic imbalances

The 2009 financial crisis has left its mark. Public finance metrics deteriorated sharply and most of the countries under review suddenly found themselves facing excessive deficit procedures, launched by the European Commission in 2009-2010, and completed between 2013 and 2015. Poland, the only V-6 country to avoid recession in 2009, was the last to exit the excessive deficit procedure in 2015. Public debt increased by 15 points of GDP on average between 2007 (the last year before the crisis) and 2016. Even so, public debt was still lower than the averages for the EU (chart 18) and the Eurozone. With the exception of Hungary, the other countries all have public debt ratios of less than 60% of GDP, which means they still respect the EU's convergence criteria. Hungary has reduced its debt since 2011, bringing the debt ratio to 74% of GDP in 2016. According to the latest IMF estimates, its debt should continue to contract to 70% of GDP in 2020 and remain below the EU average.

Hungary and Romania had to request international assistance to cope with the financial crisis' balance-of-payments shock. Hungary benefited from a stand-by arrangement with the IMF for SDR10.5bn in place between November 2008 and October 2010, of which SDR7.6bn was effectively drawn. Romania also called on IMF funding between 2009 and 2011, with a stand-by arrangement of SDR11bn that it used almost completely, as well as stand-by facilities through 2015 (the last lines of which were not used). Poland still benefits from a precautionary line: opened for the first time in 2009, but never used, it was renewed for another 2 years in January 2017 (albeit for a smaller amount of SDR6.5bn).

Exchange rates have remained stable since 2010, after two decades of high volatility and the shock of the financial crisis in late 2008. Slovakia

definitively adopted the euro in 2009, and Bulgaria has maintained its fixed exchange rate policy (via a currency board set up in 1997). External liquidity has improved: the foreign reserves of the V-6 countries have generally increased since 2010, with the exception of Hungary. Reserves are now sufficiently high to absorb a moderate global liquidity shock. Current accounts have turned around since 2009, and most of the countries generate either a current account surplus or a very small deficit (Poland). The big exception is Romania, where vigorous domestic demand maintains the deficit above 2% of GDP, which is a far cry from the 15% of GDP reported in 2007. External debt has also tended to decline since 2012, although it is still high at an average of 76% of GDP. Intra-group loans account for about a quarter of this debt (between 21% for Slovakia and 51% for Hungary at year-end 2016), mitigating external liquidity risk. All in all, balance-of-payments risks have been reduced, and the V-6 countries seem to be better armed to handle global liquidity shocks.

Public debt

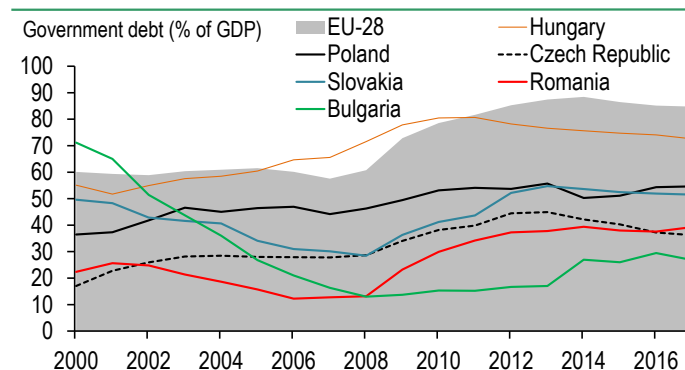


Chart 18

Sources: Eurostat, BNP Paribas

Structural challenges

Although macroeconomic convergence has progressed well, the V-6 countries still face numerous medium and long-term challenges. The time is ripe to tackle these challenges: with renewed growth, healthier banks and abundant EU funding, the countries have the necessary resources to deal with them. First, there are the demographic problems arising from the drop-off in birth rates and massive emigration. A key objective for structural policy is to shift the value chain upmarket, and to redirect production facilities towards goods with higher innovation content. Industrial sectors that are already well integrated in global supply chains must participate more actively in world technical progress.

Demographics: declining birth rates and massive emigration

Birth rates in the V-6 countries have collapsed since 1990. The situation improved slightly in the 2000s, but this proved to be short-lived as birth rates began contracting again with the 2009-2010 crisis. In all of the countries under review, birth rates are below the EU average, and well below the population replacement rate of 2.1 children per woman (chart 20).



Exchange rates

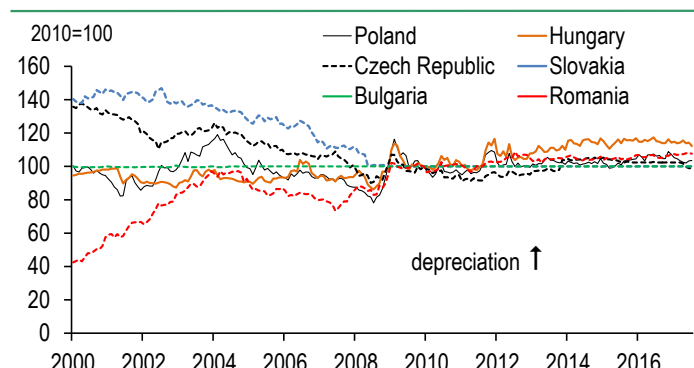


Chart 19 Sources: Reuters Datastream, BNP Paribas

Birth rate

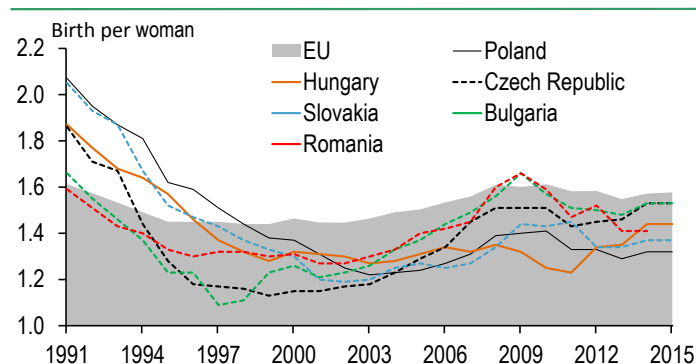


Chart 20 Sources: World Bank, BNP Paribas

Demographic forecast for 2040

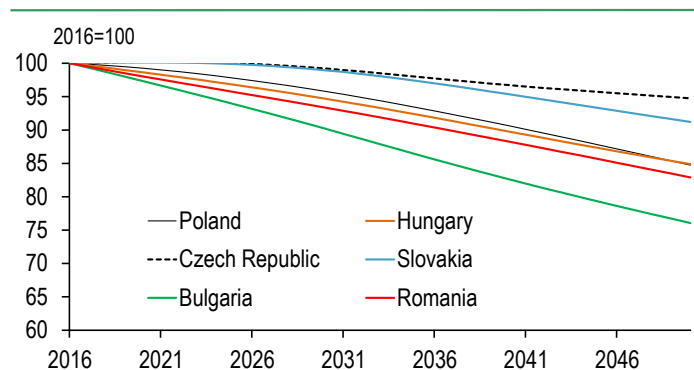


Chart 21 Source: United Nations

The problem of declining birth rates is exacerbated by emigration. According to IMF estimates (2016)⁵, between 2009 and 2012 the

original V-4 countries lost about 9% of their population due to emigration towards other countries with higher revenues. The decline is closer to 15% in Bulgaria and Romania. Emigration mainly affects young and skilled (and even highly skilled workers). The overall impact on growth in the “source” countries is negative, despite the boost to consumption and investment in construction from remittances. The brain drain is reducing potential growth rates, thereby slowing their convergence and negatively impacting competitiveness of the private sector. The impact on public finances is also negative because governments are obliged to maintain a high level of social spending on the remaining inactive population, which leaves little manoeuvring room for other spending, notably on investment and development.

According to Coface estimates (2017)⁶ for the recent period (2010-2014) emigration flows amounted to 19% of the total population in Romania, 14% in Bulgaria, 9% in Poland and Slovakia, 7% in Hungary and 2% in the Czech Republic. In addition, the authorities and public opinion in these countries are still highly opposed to the massive inflow of immigrants, which could offset the labour shortage in the short term. The only interest that has been shown is for Ukrainian immigrants, notably in Poland, for reasons of cultural and linguistic proximity. Net migratory flow in Poland switched to positive in 2016, after several years in negative territory. For the moment, overall migratory flows are slightly positive in the Czech Republic and Slovakia. Yet Bulgaria and Romania still seem to be finding it difficult to limit emigration and/or to attract foreign labour to compensate for it (chart 22).

Yet even if Brexit may reduce emigration somewhat, the persistence of negative migratory flows, despite higher revenues and the decline in unemployment, calls for government action, notably by creating attractive conditions to encourage skilled workers to return home and more generally improving the institutional framework. All of the region's governments have announced pro-family policies. Poland, which has the lowest birth rate of the V-6 countries (1.31 children per woman), and one of the lowest in the world, has launched 500+, its first family allowance programme: families with two or more children will receive a monthly allowance of 500 zlotys (EUR 117).

Hungary intends to raise the average birth rate from the present level of 1.5 children per woman to a target of 2.1 by 2030. To achieve this, the government intends to adjust student loan reimbursements (which will be cut in half for women with two children, and totally cancelled with the birth of a third child). It also plans to grant home loan subsidies of up to HUF 1 mn (EUR 3200) per child. The government will launch programmes to develop childcare centres and nurseries, in order to increase the female participation rate. Tax reductions for families with two or more children are also being studied: the total budget for families could account for as much as 5% of GDP. The other countries are also showing their political determination to combat depopulation, although they are committing fewer financial resources. Since a massive inflow of immigrants to replace declining active populations does not seem to be a politically feasible option, efforts will have to focus on increasing the total participation rate (notably by supporting female participation

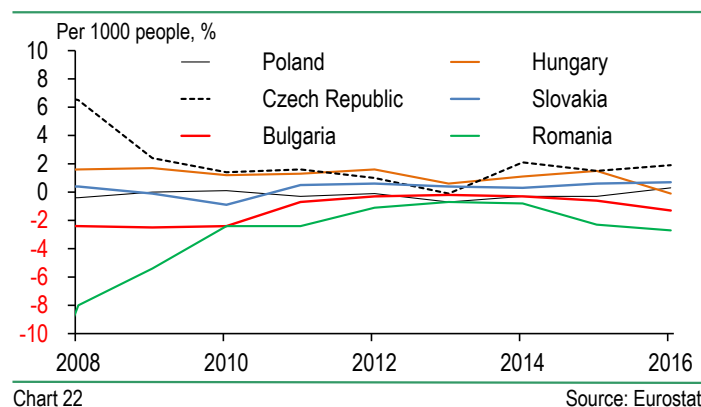
⁵ Atoyan et al. (2016) *Emigration and its Economic Impact on Eastern Europe*, IMF Staff Discussion Note, July, SDN/16/07

⁶ Fruchter D. Selewicz G. (2017) *Labour Shortages in Central and Eastern Europe Countries: a growing concern for businesses*, Coface Economic Publications, May



through the development of childcare facilities, which have disappeared since the 1990s) and raising productivity.

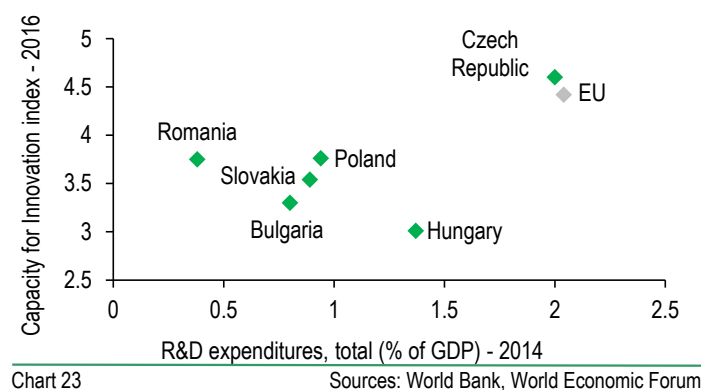
Net migration rates



Innovation, the key to development

For the V-4 countries (Poland, Hungary, Czech Republic and Slovakia), integration in the European supply chain seems to be very advanced, while Bulgaria and Romania, which accessed the single market much later, have made substantial progress. Yet furthering convergence and maintaining revenue growth will run up against competition from other countries with even lower wages. The V-4 countries seem to be approaching the limit beyond which pursuing wage and revenue growth will undermine competitiveness.

Innovation capacity



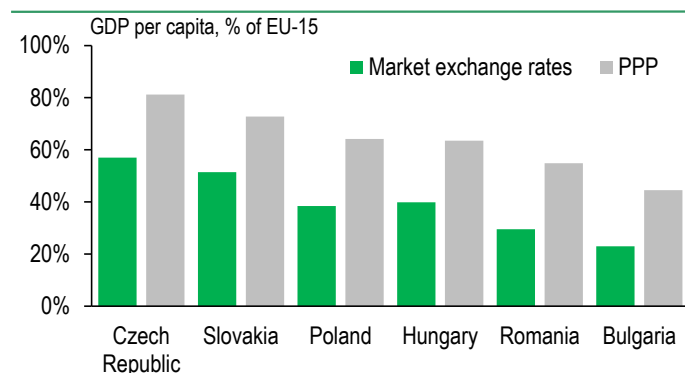
To extract themselves from this situation, called a “middle income trap”, they must shift production upmarket and develop more innovative, higher value added products. It is vital to accelerate investment in innovation, research and development as part of their development strategy.

Yet with the exception of the Czech Republic, the V-6 countries have fallen behind the EU average in terms of R&D investment and their

capacity to innovate (chart 23). Innovation policies require long-term investments that are often risky, and need government participation (to organise or provide financing, or to ensure against risks). Given today's very favourable conditions, the situation must be tackled without delay. Public finances are in better health, the institutional environment has improved tremendously over the past decade, and financial stabilisation now makes long-term financing possible.

The Polish authorities have clearly grasped the challenge at hand. The government adopted the Morawiecki plan to pull the country out of a middle income trap and a mid-range producer trap, while supporting balanced growth. The plan calls for major investment efforts, notably by calling on European funds, to boost the investment rate to 25% of GDP from 18% presently, while encouraging investment in new technologies and boosting exports.

Still a long way to go



Hungary took advantage of the European Union's expertise and advice: as part of its 2016 Policy Support Facility, the EU conducted an in depth review of Hungary's research and innovation system and made 33 specific recommendations⁷. The report recognises the country's innovative potential, but insists on the need for a coordinated policy with precise targets. Hungary has already set up a national office for research, development and innovation that is responsible for coordinating policies. The government intends to promote products “invented in Hungary” (as opposed to “made in Hungary”), notably via tax incentives. According to the OECD, of the V-6 countries, the Czech Republic spends the most on innovation, with an expenditure rate slightly above the EU average. It is counting heavily on private investment. These countries are also working to make investments more effective and to better coordinate the efforts of the various institutions participating in their innovation policies. Slovakia has long bet on technology imports via multinational subsidiaries. It is strengthening its arsenal of support for innovation by defining priority sectors; expanding guaranteed loan mechanisms and risk sharing; favouring venture capital programmes; and introducing tax incentives.

⁷ EU Commission (2016) *Peer Review of the Hungarian Research and Innovation System*, Horizon 2020 Policy Support Facility



According to the European Commission⁸, Bulgaria is suffering from the excessive segmentation of players in its innovation policy and needs to better coordinate research and the corporate world. All the V-6 countries have set up programmes to improve the effectiveness of public research and to reinforce the link between the academic and corporate worlds.

All in all, the region's authorities now seem to fully understand the interest of innovation⁹. Of course, these programmes have substantial implementation risks. Yet their capacity to take advantage of the today's strong economic momentum will be decisive for ensuring the "qualitative leap" necessary to complete the convergence process first launched in 2004.

Conclusion

The countries of Eastern Europe are in the midst of a buoyant recovery that is bound to continue. Macroeconomic conditions are favourable for consumption to accelerate, bolstered by wage acceleration and strong investment, thanks notably to the inflow of European structural funds. Macroeconomic imbalances have diminished over the past four-five years, improving financial stability.

The emergence of controversies in their relations with the EU suggests that the political honeymoon has come to an end. National political forces are more mixed about the need to pursue and deepen relations with Brussels. Moreover, the lack of political will to provide solidarity efforts raises doubts among the older EU member countries about the need to continue massively supporting development in these countries. A new phase is beginning in which it will be vital to seek compromise at the political level.

The manna of European structural funds will likely diminish after 2020. These funds will no longer play the same role of driving growth. The countries will have to find other sources of financing for growth, and will have to rely more on domestic savings. Challenges remain: orchestrating a demographic revival while investing massively in innovative industries. The governments' capacity to meet these challenges will have a decisive impact on convergence.

Completed on 12 September 2017

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⁸ EU Commission (2015) *Peer Review of Bulgaria's Research and Innovation System*, Horizon 2020 Policy Support Facility

⁹ For further information on the policies set up on a country basis, see for example, <https://www.innovationpolicyplatform.org>



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