showCASE
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CASE – Center for Social and Economic Research

Overview: Amidst the heated Madrid-Barcelona debate, our experts tackle the question just how viable the Catalonian secession would be from the economic point of view. Our experts also describe the so-called "convergence trap," a tool to measure a country's progression along the continuum of economic development, and discuss it in the context of Central and Eastern Europe and the Commonwealth of Independent States.

Catalonia and the Economics of Secession

By: *Krzysztof Głowacki, Economist*

The popular support for the secession movement in Catalonia notwithstanding, a serious question must be asked about the underlying rationale: is it economic utopianism that keeps the movement alive, or could the secession really be an opportunity for the region? The answer to this question is crucial, as the reality of secession may come to resemble both the 2016 Brexit campaign and the 2015 Greek bailout referendum, when populist nationalism left both economies significantly worse-off.

Catalonia, which accounts for 16% of the Spanish population but 20% of its GDP, is a net contributor to the Spanish central budget. In 2014, it contributed EUR 9.9 billion net, much more that the next biggest payer (Valencian Country) with EUR 1.7 billion net. However, Catalonia contributes only about half as much as biggest payer overall, the Community of Madrid, which paid-in EUR 19.7 billion net to the Spanish budget. If Catalonia could detach itself from the redistributive, bloated fiscal system run by the Spanish central government, it could save those billions as well as fine-tune its economy by coming up with its own, hopefully more efficient, fiscal system. But the need to cover fixed costs of running its own state, such as those related to foreign policy and the military, would not make such an effort any easier.

Photo: Reuters

At present, Catalonia is Spain's economic powerhouse, with Barcelona being home to a buzzing industrial zone and one of the fastest growing ports in Europe. Despite this reality, the Spanish connection seems indispensable to the region. In the wake of Catalan independence, a natural migration path of economic activity away from Barcelona can be expected unless a concurrent deal is struck with the European Union. This is because the core trading partners of the region are EU member states, which account for approx. 65.8% exports, with Spain alone accounting for 35.5% of

exports. All of these partners are members of the European Single Market, to which Catalonia will lose access once it opts for independence. And the Single Market is not just about goods being traded; it is also about people getting work, capital changing hands, and services being delivered – all of which will be curtailed for Catalonia should a new border be added to Europe. This could be avoided if a separate Catalonia-EU deal is struck, but this appears unlikely, not due to the Catalonian inability to meet the Copenhagen criteria, but mainly due to the veto powers of existing Member States. In particular, countries that face secession movements, such as Belgium, not to mention Spain itself, have strong incentives to block the accession of Catalonia to the Single Market.

Recently, the Catalonian leaders received a glimpse of how its future outside Spain will appear, following the introduction of a decree that enables firms to relocate their legal seat within Spain and outside of Catalonia. Within only a few days, there was a cascade of firms gushing out of Catalonia, with Caixa Bank, Banco Sabadell, Gas Natural Fenosa, Dogi International Fabrics, and Oryzon Geonomics only some of the recent departures.

Catalan nationalism appears to be of a similar nature as the recent outbursts of protectionism in the United Kingdom and Greece, in that it erroneously links political independence with economic prosperity. In reality, the economics of secession simply do not add up at this moment for Catalonia. It appears that the smart, if stubborn, donkey should consider maintaining its uneasy friendship with the big bull, at least for the short-term.

Is the "Convergence Trap" the New Risk for the CEE and CIS?

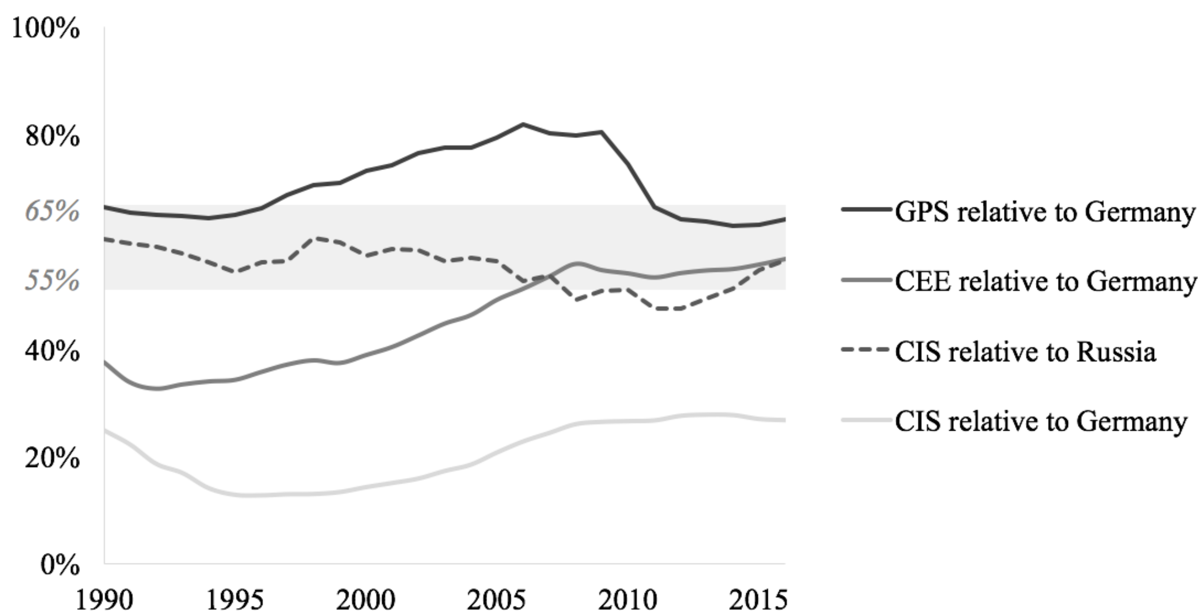
By: *Kamil Pruchnik*, *Jakub Zowczak*

On September 29th, the global equity index provider FTSE Russell announced plans to upgrade Poland from an "Advanced Emerging" to a "Developed" market, making it the first country from Central and Eastern Europe (CEE) to join the ranks of the twenty-four most advanced economies. The upgrade provides fresh evidence of the "success story" of the Polish transformation and carries important practical implications, as foreign investors may now compare Polish companies to German or American equities, as opposed to Russian or Turkish stocks. It is likely that this upgrade will also encourage investors to increase their allocation in the Polish market.

Despite Poland's advances, other countries of the CEE region still have a way to go before achieving "Developed market" status according to the index, while many of the countries from the Commonwealth of Independent States (CIS) are yet to even be classified in the lowest "Frontier" category. In a recent article published by CASE, we have discussed these differences and analyzed how different models of transformation affected the long-term prospects of the CEE and CIS countries. In particular, we focused on the risk of the CEE and CIS countries falling into the middle-income trap (MIT), a concept which describes when middle-income economies are squeezed between low-income economies competing with cheap labor and high-income economies competing in innovative industries. The study revealed that, while the CEE countries may be affected by the risk of the MIT in their struggle to join the advanced economies, the CIS remains a poorer region and is not near the lower MIT thresholds.

Another way to analyze the situation of the CEE and CIS countries is through the lens of the convergence trap which is not constrained to middle-income countries but is defined relatively to a regional benchmark economy. Countries stuck in the convergence trap remain at intermediate levels of the regional value chain dominated by the benchmark economy, due to similar challenges as in the case of the MIT, i.e. productivity slowdown and insufficient competitiveness. However, compared to the MIT, the convergence trap puts more emphasis on regional trade clusters and may be a better tool to examine country groups at different levels of income, such as the CEE and CIS.

Unweighted average of GDP per capita PPP (int'l USD) relative to benchmark economy



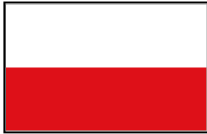
Source: [World Bank (2017)](). The CEE is defined as Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia. The CIS is defined as Armenia, Azerbaijan, Belarus, Kazakhstan, Kyrgyzstan, Russia, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan. The GPS is defined as Greece, Portugal, and Spain.

The convergence trap can be illustrated by the example of Greece, Portugal and Spain (GPS), which import heavily from Germany while lagging behind it in global competitiveness rankings. The average income per capita (PPP) of the GPS countries converged from 63% of the German income in the 1990s to 80% before the financial crisis, but has since decreased back to its earlier level. The inability of the GPS countries to converge to Germany in the long-run indicates that these countries may be stuck in the convergence trap.

We can repeat a similar analysis for the CEE and the CIS countries to illustrate this point. For the former group, we chose Germany as the benchmark economy due to its strong economic ties with the region and high competitiveness. The analysis revealed that despite rapid growth in the 1990s and 2000s, the CEE countries have already experienced a convergence slowdown. The CEE reached 55% of the German income in 2009 and has remained at this level as of 2016.

In case of the CIS countries, relative GDP per capita PPP to Germany has been stuck at below 27% for the past decade, close to where it was in 1990. However, a better reference economy for the CIS region could be Russia, as it has stronger economic and financial links with the CIS region. The relative income per capita of the CIS region to Russia has also not surpassed 60% since 1990.

The above analysis indicates that both the CEE and the CIS have experienced convergence slowdowns once they reached 55%-65% of their benchmark economy's income per capita level, similar to the GPS countries. The above analysis has its drawbacks, mainly that there are considerable differences between countries within the regional groups, and that the choice of the regional benchmark economy is not unambiguous. Nonetheless, it serves as a reminder that long-term economic convergence should not be taken for granted, especially once a country uses up its basic growth engines, such as low wages and capital accumulation. These challenges are well described by the qualitative framework of the MIT, even though the convergence trap may offer a better tool to analyze them at different levels of income and taking into account regional differences.



This week: The Government Legislature Center published a draft bill that expands the Prime Minister's competencies with respect to state-owned companies. In January 2017, oversight over 432 state companies was removed from the Treasury (due to its liquidation) and divided between different governmental departments. If the new bill comes into force, Beata Szydło will become the first Prime Minister in Poland's history to be granted supervision over all companies with state treasury holdings.

GDP (Q2 2017, est.)

4.4% y/y

Up from 4.2% in Q1

Inflation (Sep 2017, est.)

2.2% y/y

Up from 1.8% in Aug

Unemployment (Aug 2017)

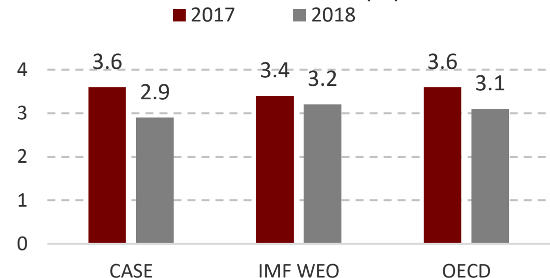
7.0%

Down from 7.1% in July

NBP Base rate

1.5%

From 2% Mar 2015



This week: The Central Bank's First Deputy Governor Sergei Shvetsov, making reference to "protect Russian investors," criminalized the use of bitcoins in the country, calling the crypto-currency "dubious." This statement was backed by President Putin, who denounced bitcoins as a possible tool for unlawful activities. The statements mark a change of heart from the side of the Russian authorities following last month's declaration by Shvetsov, where he said it is better to regulate bitcoins rather than forbid them.

GDP (Q2 2017)

2.5% y/y

Up from 0.5% in Q1

Inflation (Sep 2017)

3.0% y/y

Down from 3.3% in Aug

Unemployment (Aug 2017)

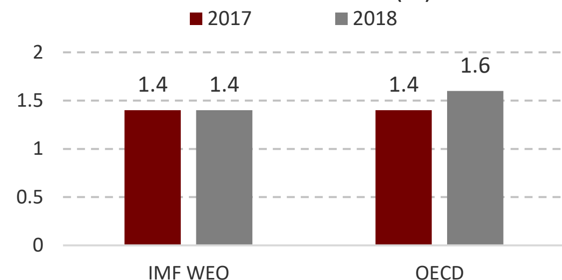
4.9%

Down from 5.1% in July 2017

CBR Base rate

8.5 %

From 9%



This week: The German division of internet retailer Amazon plans to significantly augment its manpower in anticipation of the Christmas period by recruiting 13,000 temporary workers, a move that will double the company headcount. The temporary workers will be compensated on the same conditions as their colleagues with permanent contracts, guaranteed a minimum EUR 10.52 gross per hour.

GDP (Q2 2017)

2.1% y/y

Up from 2.0% in Q1

Inflation (Sep 2017)

1.8% y/y (est.)

Up from 1.8% in Aug

Unemployment (Aug 2017)

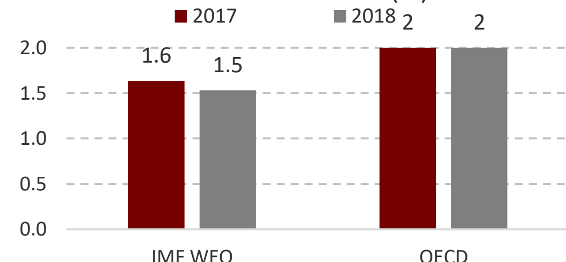
3.7%

Up from 3.6% in July

ECB Deposit rate

-0.4%

From -0.3% Dec 2015

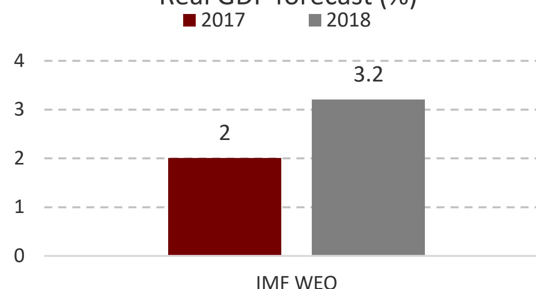


Countries at a glance

Center for Social and Economic Research

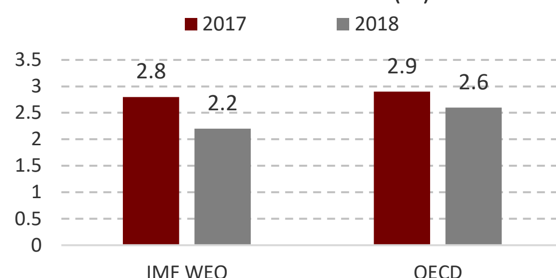
This week: On October 3rd, the Ukrainian Parliament adopted Bill number 6614, implementing a pension reform as of October 11th. The law increases the requirements for work insurance period (with some observers calling it a “hidden raising of the retirement age”), introduces automatic pension indexing based on inflation and the growth of average wage, and removes the pension taxation for working pensioners.

GDP (Q2 2017)	**Inflation (Sep 2017)**
↓ **2.3% y/y**	↑ **16.4% y/y**
From 2.5% in Q1	Up from 16.2% in Aug
Unemployment (Q2 2017)	**NBU Base rate**
↓ **9.1%**	**12.5%**
Down from 10.5% in Q1 2017	From 13.0% in May



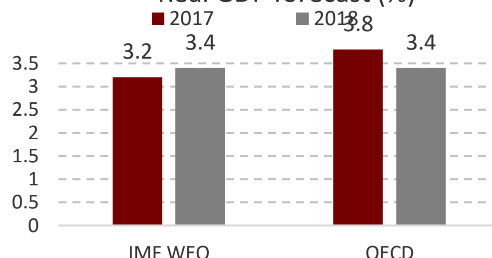
This week: Around 250,000 players have registered in the receipt lottery since its inception on October 1st. The lottery is used by the government to combat tax evasion by providing additional incentives for consumers to collect receipts for the purchases of goods and services. CASE recently released a report on the methods of reducing tax gaps in the Visegrad Group countries and Ukraine, which describes a similar lottery scheme in the Slovak Republic.

GDP (Q2 2017)	**Inflation (Sep 2017)**
↑ **4.7% y/y**	↑ **2.7% y/y**
Up from 3.0% in Q1 2017	Up from 2.5% in July
Unemployment (Q2 2017)	**CNB Base rate**
↓ **3.0%**	**0.25%**
Down from 3.4% in Q1	From 0.05% (4 August 2017)



This Week The 17th edition of the World Export Development Forum (WEDF) will take place in Budapest on October 24th-26th. According to the Budapest Business Journal, around 160 companies from 31 countries will attend the WEDF. The participants will be discussing innovative types of business partnerships, evolution of start-ups into international businesses and the role of new technologies in economic development, among others.

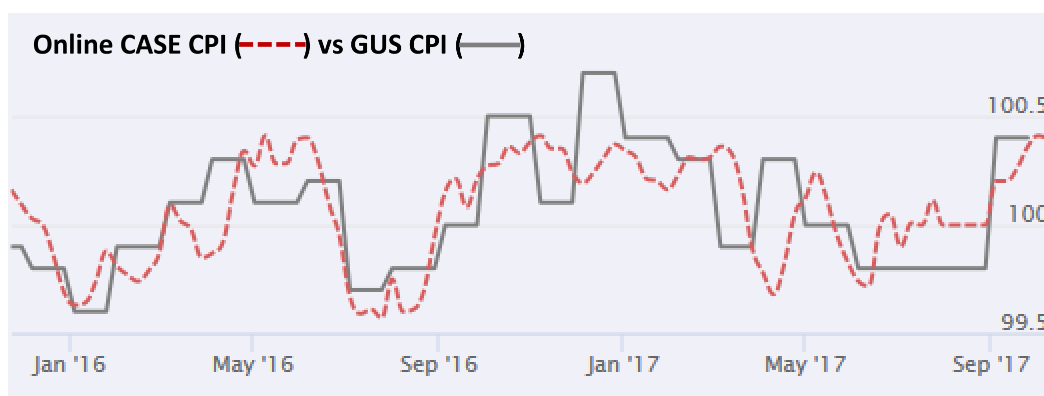
GDP (Q2 2017)	**Inflation (Sep 2017)**
↓ **3.2% y/y**	↑ **2.5% y/y**
Down from 4.2% in Q1	Up from 2.1% in July
Unemployment (Q2 2017)	**MNB Base rate**
↓ **4.2%**	**0.9%**
Down from 4.3% in Q1	From 1.05% May 2016



The weekly online CASE CPI

The online CASE CPI is an innovative measurement of price dynamics in the Polish economy, which is entirely based on online data. The index is constructed by averaging prices of commodities from the last four weeks and comparing them to average prices of the same commodities from four weeks prior. The index is updated weekly.

Our weekly online CASE CPI



Monthly CASE forecasts for the Polish economy

Every month, CASE experts estimate a range of variables for the Polish economy, including future growth, private consumption, and foreign trade, current account balance, and the CPI.

CASE economic forecasts for the Polish economy
(average % change on previous calendar year, unless otherwise indicated)

	GDP	Private consumption	Gross fixed investment	Industrial production	Consumer prices
2017	3.8	4.3	2.7	4.3	1.9
2018	3.3	3.3	3.1	3.7	2.1
	Nominal monthly wages	**Merchandise exports (USD, bn)**	**Merchandise imports (USD, bn)**	**Merchandise trade balance (USD, bn)**	**CA balance (USD, bn)**
2017	5.1	201.6	201.8	-0.2	-4.7
2018	3.5	211.3	213.1	-1.8	-5.9

For more information on our weekly online CASE CPI, please visit: http://case-research.eu/en/online-case-cpi
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Contributions: Stanislav Bieliei, Krzysztof Głowacki, Katarzyna Mirecka, Marian Mraz, Aleksandra Polak, Katarzyna Sidło, Klaudia Wolniewicz-Słomka **Editor:** Krzysztof Głowacki **Editor-in-chief:** Christopher Hartwell
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