Renaissance Capital

Thoughts from a Renaissance man
Economics & Strategy

29 June 2017

Charles Robertson
+44 (207) 005-7835
CRobertson@rencap.com

Mobile +44 7747 118 756
@RenCapMan

Vikram Lopez
+44 (207) 005-7974
VLopez@rencap.com

Thoughts from a Renaissance man
CE3 demographics to create MENA jobs

Half of the EU has not seen employment this high since at least 2006. Wage growth should pick up in CE3. We see Morocco, Tunisia, Egypt, Turkey and perhaps Ukraine as unintended beneficiaries.

We flagged the impact of demographics in 2014; we revisit the theme a year earlier than expected

European bulls may have noticed that 13 EU member states have reached "peak" employment rates. Central Europe is leading the charge, and this is now driving wages growth. Hungarian wages rose 15% YoY in April. Kia gave its highest ever pay increase in March, but only to Slovak workers. Faced with labour unrest, VW has given a double-digit wage increase in CE3. Unemployment rates have roughly halved from Estonia to Poland over the past five years. This is partly due to Germany, which is also at "peak" employment of 79%. Its industrial health tends to lift its Central European supply chain. But another driver is the demographic pressures we flagged in 2014. We said then that wages could become an inflation problem, but not for a few years. First, demographics would help cut unemployment and we would see a rise in the participation rate. We promised to revisit this issue in 2018-2020, but pressures are building earlier than we expected. A host of questions are raised by these trends.

CE3 rate hikes, higher domestic demand and still being cheap vs Spain

First, will the boom in Central European wages force aggressive interest rate hikes? Probably not in the near term. So far, CE3 has looked more like Japan. Despite 3-5% unemployment, and a workforce shrinking by 1% a year, overall wage inflation has been relatively modest (this is true in the US too). But the latest wave of automotive industry pay hikes suggest inflation should pick up; especially when labour participation rates are as high as 77% in the Czech Republic. We and the market expect the first 25-bpt hike here, followed by Poland and Hungary. Romania should have further to run than these three, given labour costs are two-thirds of Hungary's levels and the employment rate has far more room to rise. Second, how will growth change? Domestic demand should become a key driver in Central Europe, rather than investment; as recognised in the quadrupling of some retail stocks since 2014. Never again is Central Europe likely to offer what it did in the 1990s: the best combination globally of high education, low cost and high labour supply. The next wave of investment into industrial sectors may have to go a little farther afield.

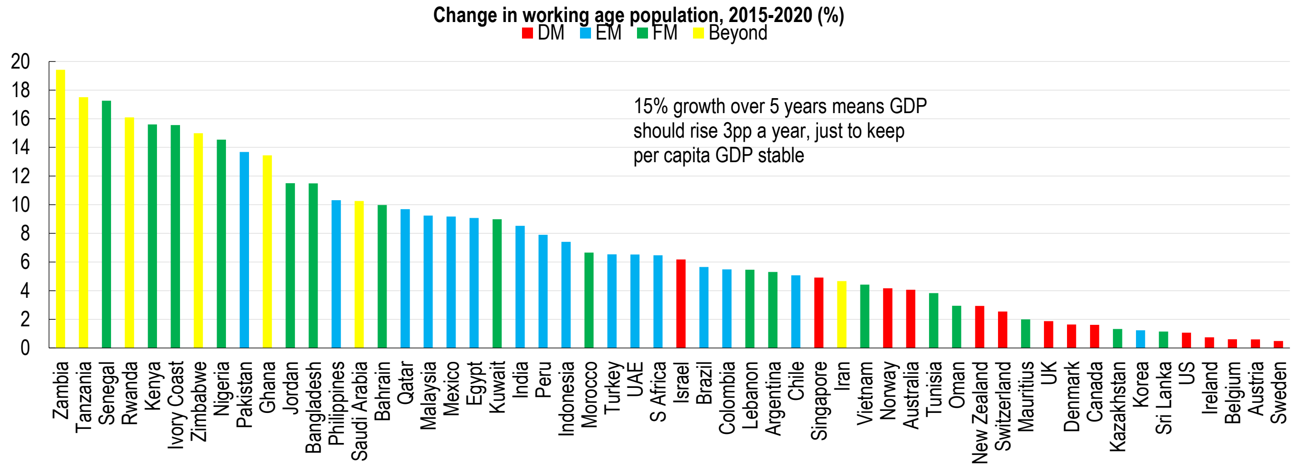
North Africa, Turkey and Ukraine may replace CE3 as favoured industrial FDI destinations

We think rising Central European costs can benefit Morocco, Tunisia, Egypt, Turkey and potentially Ukraine or Iran. We have already been positively surprised by the extent to which Morocco now rivals CE3 as an investment choice for French firms. Wages seem to be much lower and should not face the same upward pressure. Even though demographic trends are not that different to CE3 (only Egypt and Turkey have rising numbers of 15-24 year olds over 2015-2020), the total employment rate in MENA countries we focus on is around 40-50% compared with 60-80% in Europe. There is much more potential supply of labour on the EU's doorstep – and this untapped resource is largely female. Educational access, particularly for females aged 11-17, has expanded dramatically in the past 20 years. In Turkey, despite a government that offers inducements to women to remain at home, the consequence has been a rise in the female employment rate from one in four women to one in three over the past decade, which is responsible for over fourth-fifths of the rise in the overall employment rate to 54%. We suspect similar change is coming in North Africa over the coming decade. Cheap wages and better human capital means MENA should become more attractive to FDI. This can answer the "where will the jobs come from" question about MENA.

We think the convergence theme is back in Central Europe, but this time with a focus on wages not private sector debt ratios or bond convergence. We do not expect FDI to leave Central Europe; rather their workers will move up the value-added curve. But when European business confidence is high again, we think the next wave of investment expansion will lap the shores of Turkey and the southern Mediterranean. MENA governments should prepare for this by prioritising political stability and pro-FDI reforms.

The numbers on the front page (cited in the FT article of 27 June 2017 *Labour shortage threatens growth in central Europe*) are pretty eye-catching. Wage pressures have arrived in Central Europe a good two-to-three years earlier than central bankers expected when we raised this very issue back in 2014 (see *Thoughts from a Renaissance Man: Who can cope with a shrinking workforce?*, 23 September 2014). Our 2014 report was triggered when we looked at strong demographic growth in frontier markets and were a little surprised to see how poor the demographic numbers were for European markets.

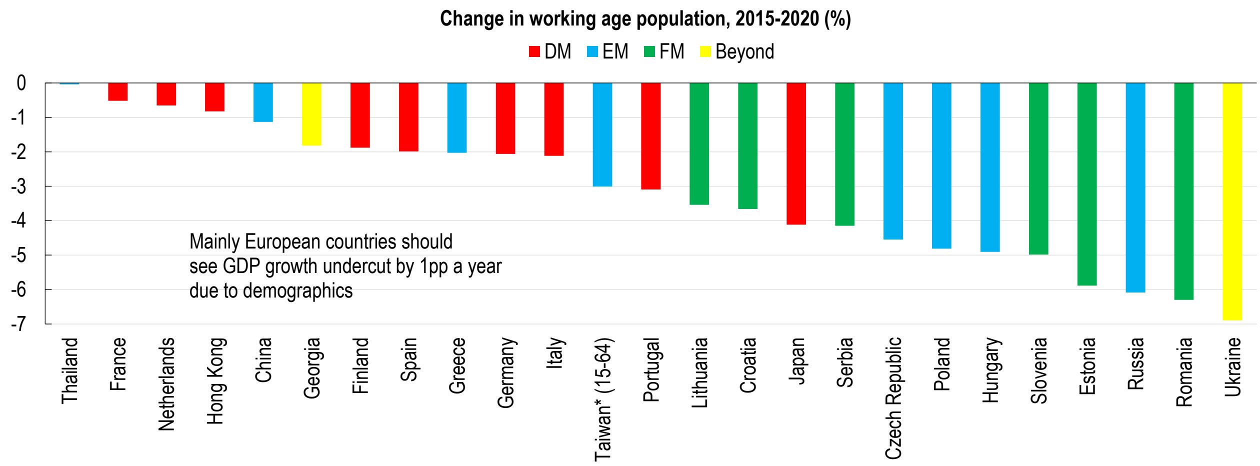
Figure 1: Many frontier and African countries should see GDP rise by 3-4% a year purely due to demographics



Source: UN

Central bank officials told us to relax. Yes, the workforce was shrinking, but this would initially be helpful in reducing high rates of unemployment. In addition, the labour force participation rate was relatively low in most of Central and Eastern Europe, so higher participation rates could offset the shrinking in the labour force. Also immigration could always be a solution for some. Already in 2014, officials pointed to Ukrainians fleeing the conflict with Russia, and adding to the labour force in Poland.

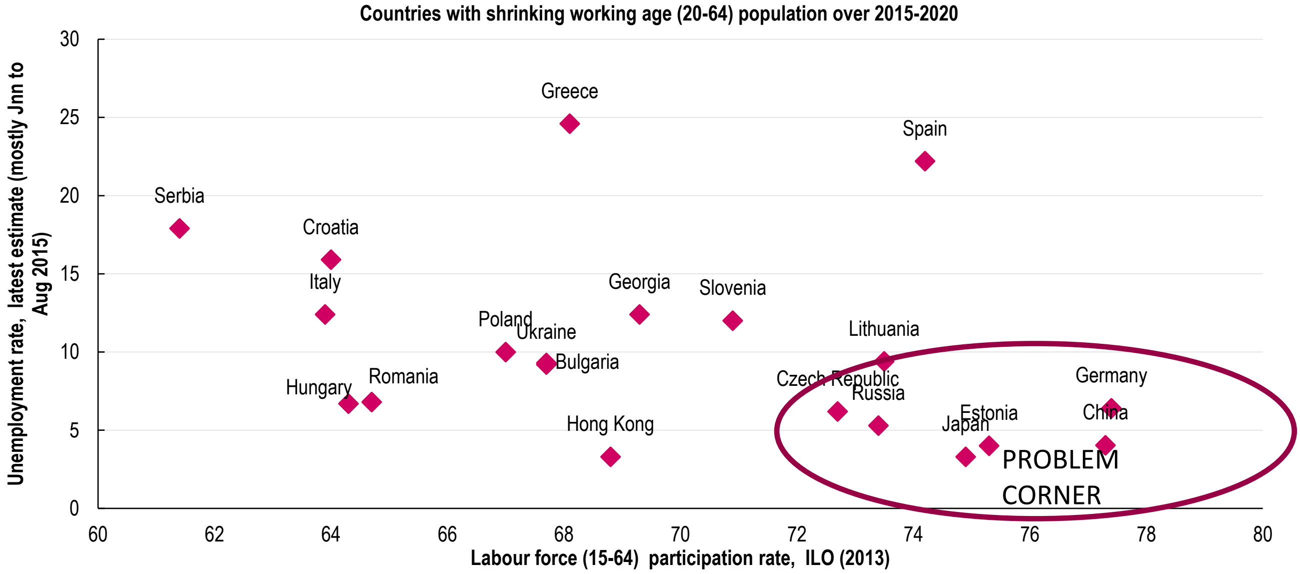
Figure 2: A number of European countries have worse demographics than Japan



Source: UN

We produced the following graph and agreed that the Central European central bankers had a point. Greece and Spain might see unemployment fall, while countries such as Hungary or Romania might see participation rates rise. None of them (bar perhaps Estonia or the Czech Republic) should have an inflation problem within a few years. Note the chart below still uses ILO data we collected in 2014, and unemployment rate data we updated in late 2015. We argued then that even countries that might have a problem, such as Germany, could address this by encouraging immigration (we saw this in 2016 Syrian refugees). It turned out Russia did not have a problem because plunging oil prices send the economy into recession, but demographic pressures did mean that unemployment never rose above 6% even as GDP shrank by 4%. Meanwhile Poland attracted perhaps a million Ukrainians to ease its labour market shortages (on 28 June, a Czech official told us that their automotive industry is now also seeking 150,000 workers from Ukraine).

Figure 3: This 2014 chart (updated in 2015) showed wage/inflation pressure was unlikely for most countries in the medium-term



Source: ILO, Bloomberg, Renaissance Capital

ILO data don't come out frequently enough to update this graph. So to illustrate where we are now, we look at Eurostat employment participation rates (not quite the same measure, but it serves a similar purpose).

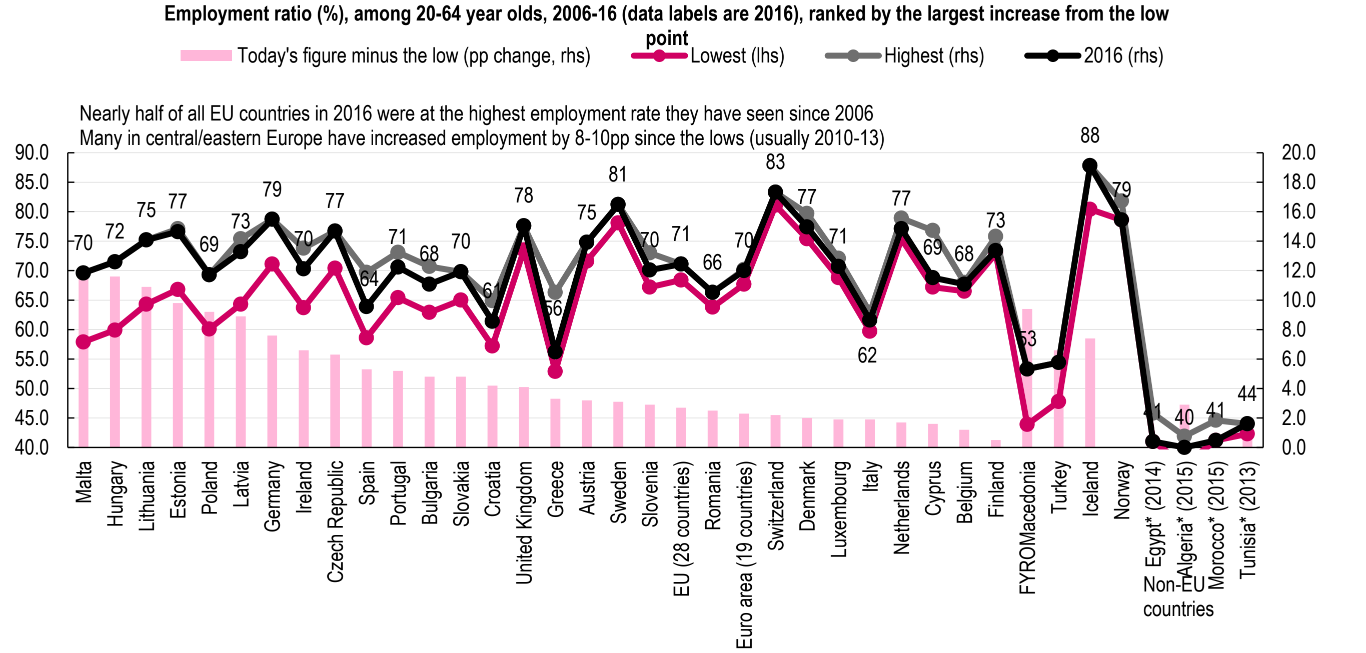
Below is the most surprising graph in this report.

First, it shows that 13 of 27 EU countries at the end of 2016 had reached the highest employment rate in any year since 2006. Germany has seen the largest increase of any major economy. Both Germany and the UK are at record highs. We excluded France as we only have three years of data, but the latest figure was also the highest at 70%, so we could say 14 of 28 countries have reached record highs.

This is supportive of the European equity bulls.

Second, it shows the success that Spain and Greece are having in increasing the employment ratio, helped by a working age population decline of 0.4% annually. We left Iceland in the chart too, to highlight its success. Curiously it is often overlooked countries such as Belgium and Finland that have seen the lowest increase in the employment rate over the past 10 years.

Figure 4: Nearly half of the EU countries have not seen the employment ratio this high since at least 2006



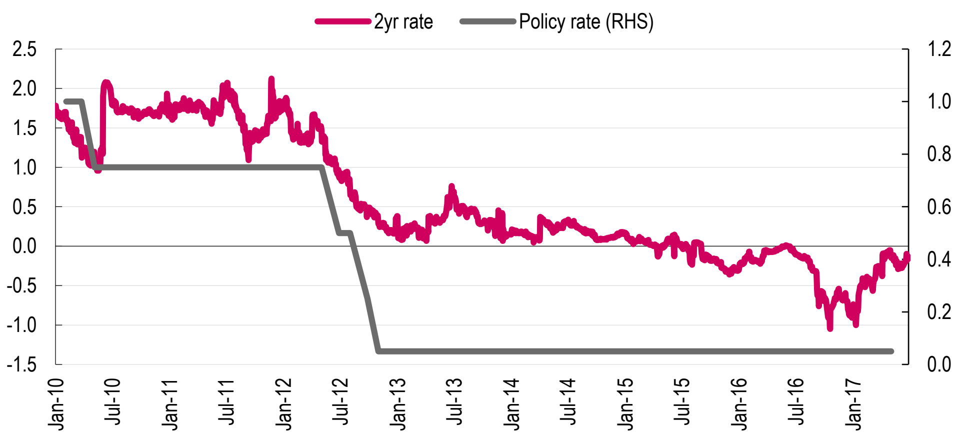
*Non-EU countries

Source: Eurostat

Third, we can see the Central European central bankers were right. Participation rates have risen significantly, helped in Hungary's case by government schemes to reward those in work while cutting benefits to those out of work.

This raises the question of how much further these participation rates can go. Romania's rate of 66%, Poland's of 69%, or Hungary's of 72% remain low relative to Germany at 79% or the UK at 78%. But the Czech Republic or Estonia at 77% look closer to peak employment. **This ratio suggests the Czechs will hike interest rates before Hungary or Poland.** This would appear to be recognised by the markets. Two-year yields are already 30 bpts above the Czech National Bank (CNB) policy rate. The main scope to raise the participation rate further comes via increases in the retirement age and bringing in more women to the labour force, but it is hard to imagine the overall rate increasing much further. For more on these issues, see page 48 of the latest CNB inflation report.

Figure 5: The market is looking for a CNB rate hike

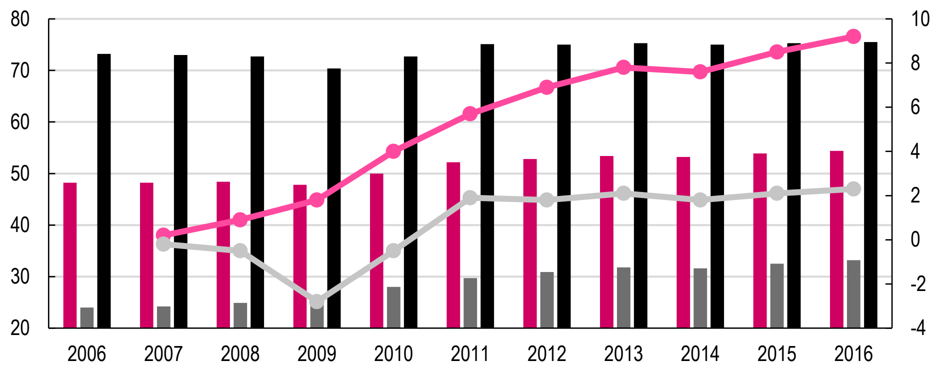


Source: Bloomberg

Fourth, this chart rammed home just how low the employment participation rates are in the MENA region. The latest Eurostat data for Tunisia (2013) puts the figure at 44%, while it is 41% for Morocco (2015) and Egypt (2014), and just 40% in Algeria. Also interesting was the rise in Turkey, from 48% in 2006 to (a still low by European standards) 54% in 2016. We see Turkey as a leading indicator for what may be coming in North Africa. **The implication is that perhaps 20 ppts of the workforce in Turkey could join the ranks of the employed over the long term, and 30 ppts of the workforce in North Africa.**

Women are the solution. In Turkey, less than one in four were formally employed in 2006, while now the figure is one in three. Why? A former economist colleague, Mert Yildiz, says it is because it is becoming harder for families to manage on just one (male) income.

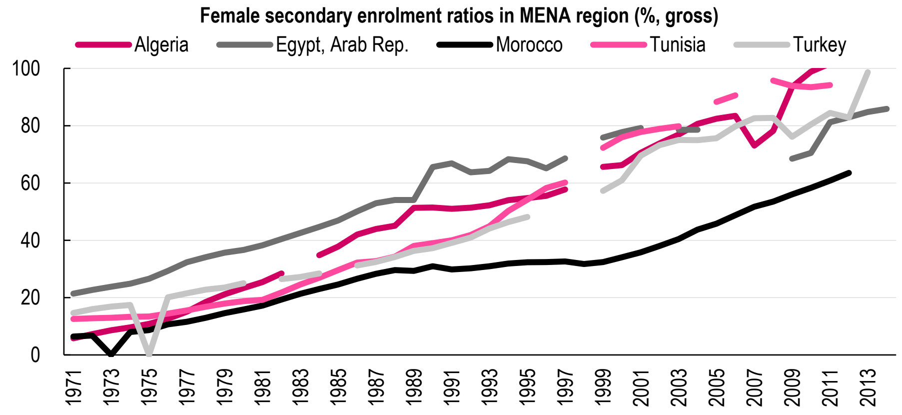
Figure 6: Female employment ratio has risen by 9 ppts over 2006-2016, male employment by just 2 ppts



Source: Eurostat

In addition, this is the dividend of women getting more access to education a generation ago. Roughly half of Turkish girls aged 11-17 attended secondary school in the mid-1990s. This means that even today, less than half of women aged 40 or higher have an education level required to do much more than low-productivity work in agriculture. By 2003, 75% of Turkish girls aged 11-17 attended secondary school, which makes them far more likely to be counted in the employment rate. The latest figures for Turkey are even more encouraging, at nearly 100% enrolment in 2013. Morocco is roughly a decade behind Turkey, but Tunisia, Egypt and Algeria all have similar ratios to Turkey.

Figure 7: North Africa now educated most of its 11-17 year old girls; which is good news for employment in the coming decades

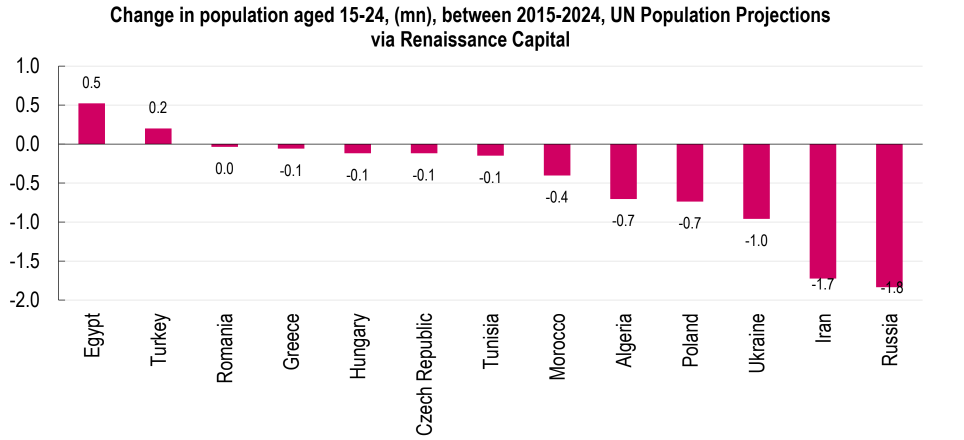


Source: World Bank

This is important, because curiously North African demographics are not that different from Central European demographics, if we look at the supply of young people. Algeria's population of 15-24 year olds is expected to shrink by 700,000 between 2015 and 2020, the same as Poland. Tunisia will lose about 100,000, similar to Hungary and the Czech

Republic. Only Egypt (up by 500,000) and Turkey (up by 200,000) will see an increase in our sample of countries.

Figure 8: Many countries we follow will have less young people by 2020 than they do today

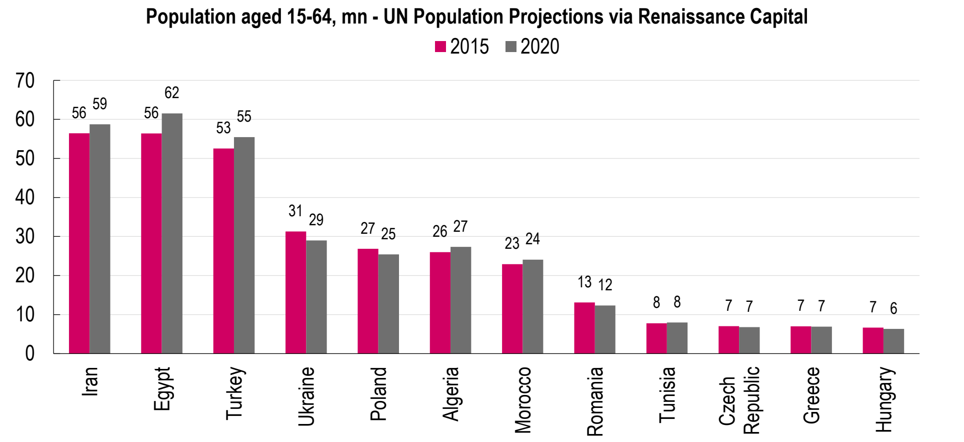


Source: UN

So what is important is that more of the existing total workforce becomes employable, due to the lagged effect of educating women in the 1990s or because it is becoming more culturally acceptable for women to work. And the overall working age population is still rising in MENA even if it is falling in Emerging Europe.

Note that the rise of female employment in Turkey or Poland for that matter, is despite government measures aimed at encouraging women to stay at home to produce more children.

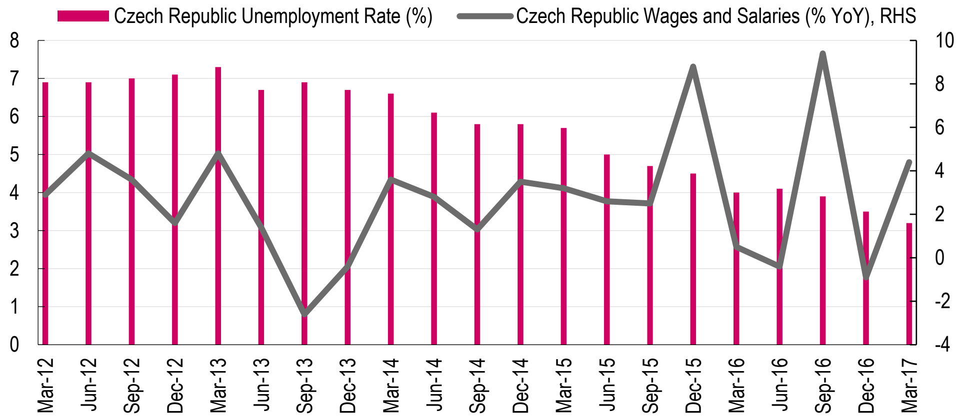
Figure 9: The size of the total workforce in central/eastern Europe and MENA



Source: UN

Our base line assumption is that falling unemployment will drive up wages in Central Europe. The examples cited at the beginning of this piece suggest this is now happening. But overall data suggest wage growth is not aggressive just yet. One official in the Czech Republic suggests this could be due to fears of outsourcing. Czech Skoda workers are fully aware that Skoda's production in China is already higher than it is in the domestic market, and a factory has been established in Russia too. While workers may want German wages, they see the threat of losing their jobs to cheaper countries.

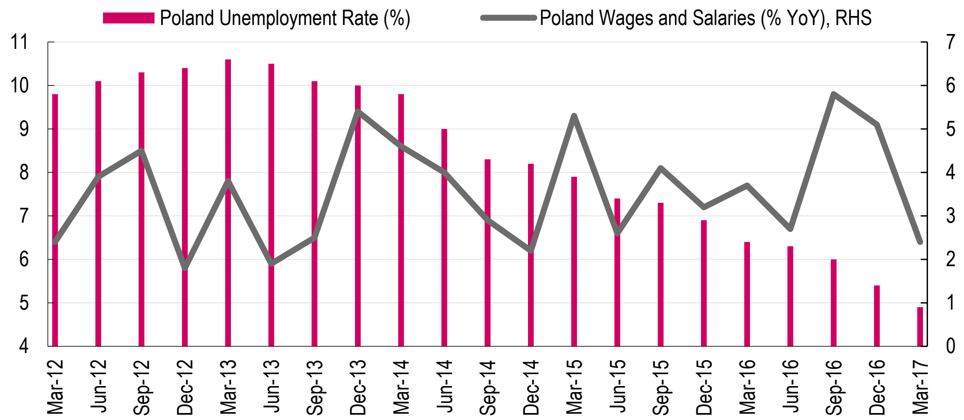
Figure 10: Wage growth has sat consistently at 4% even as unemployment has halved in the Czech Republic



Source: Bloomberg

We were given another explanation for relatively low wages growth in Poland by a market participant who recently visited businesses in Wroclaw. Companies there suggest there is no point in hiking wages, as all it will do is suck workers from neighbouring factories, who will then raise wages themselves to get their workers back again. After a round of two of this, all companies will be employing the same number of workers, but pay will have gone up and profitability will go down. It sounds much like investment banking near the market peak – where employees end up capturing outsized gains while doing the same job.

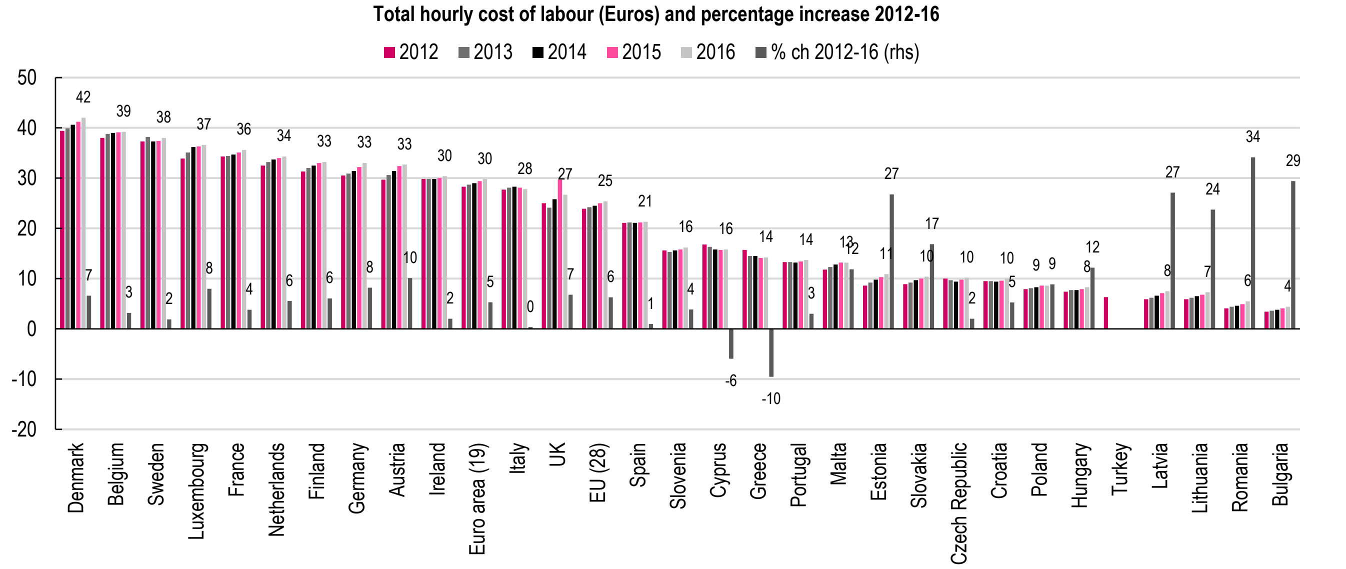
Figure 11: Poland's wage growth has also averaged about 4% even as unemployment has halved



Source: Bloomberg

The relatively modest wage growth until this point is one reason why Central Europe still looks competitive relative to Western Europe. Czech labour costs were 47% of Spanish levels in 2012 and rose to just 48% in 2016.

Figure 12: So far, wages growth in CEE has not greatly changed their relative level vs Spain



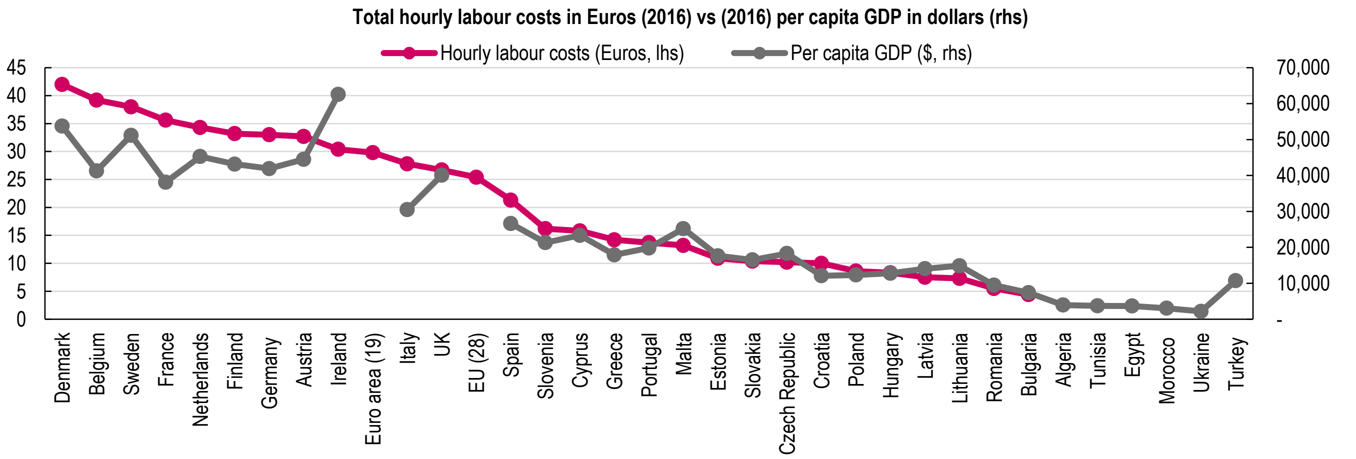
Source: Eurostat

We are not therefore concerned in the next year or two that Central Europeans are pricing themselves out of jobs relative to Western Europe. More obvious is that Greeks and Portuguese are pricing themselves back into jobs. Polish labour costs were 50% of Greek levels in 2012 but 60% by 2016. Hungarian labour costs were 55% of Portuguese levels in 2012, but 60% in 2016.

But we do assume that with limited room for further labour market participation, and an ever tighter labour market, wage pressure will build. If this does not show up in wage inflation, it may instead show up via currency appreciation. Either way, Central Europe will no longer be the low cost, plentiful labour source of the future.

Sadly we do not have comparable labour cost data for MENA. The best proxy we can use is to compare hourly labour costs from Eurostat with per capita GDP figures (in dollars) from the IMF. The implication is that wages in Algeria, Tunisia, Morocco, Egypt and Ukraine are roughly half that of Bulgaria, which itself has the cheapest wage costs in Europe. Turkey may be closer to Poland or Hungary.

Figure 13: GDP comparisons imply north Africa has labour costs half that of the poorest EU members



Source: Eurostat, IMF

Conclusion

We think convergence is back on as a theme for Central Europe, but in contrast to the 2000s, it will be focused more on wages and less on convergence of private sector debt ratios or bond yields. Estonia is at the forefront of this, and we suspect Czech Republic and Lithuania may be next to follow. Hungary and Poland still have room to increase labour force participation rates, which may help delay high wage inflation. But each are likely to experience stronger wage growth or currency appreciation over the next few years.

With shrinking demographics, it is hard to see Central Europe ever returning to the low cost, high labour supply, destination of choice for new waves of industrial investment. These countries will have to move up the value-added supply chain.

The question then is, which countries will attract the sort of industrial investors who sought out central Europe in the 1990s?

Despite poor demographics, we suspect Romania and Bulgaria still have scope to do so. Even Greece and Portugal may be pricing themselves back into the market for such jobs.

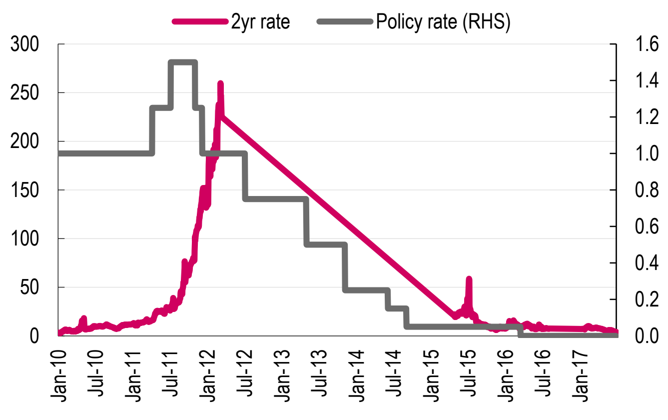
But we think Morocco, Tunisia, Egypt and Turkey and potentially Ukraine are likely to become more attractive to foreign direct investors over the next decade. A combination of improving education levels especially among women, better demographics than Central Europe, and relatively low wages, will all help. Each also has an industrial base, with plenty of room to expand.

We suspect the Eurozone needs to experience stronger growth for a year or two before global investors will seek to add industrial capacity around the EU-periphery. This is time which governments could use to improve problematic security situations and make pro-business reforms. We do not expect the wave of investment will be as great as it was into Central Europe, when German car manufacturers and other seized the opportunity to invest in countries an hour's flight away with a manufacturing base and an excellent level of education. But we do see FDI picking up significantly, helping improve per capita GDP and in turn helping improve political stability. So we welcome every new pay demand out of Central Europe.

Czech Republic: Demographics are shrinking the workforce by around 1% annually. With 3% unemployment, and a high employment rate of 77%, we expect wages growth of around 4% will pick up, and prompt CBN rate hikes and/or CZK appreciation. Wages are already high by CEE standards, but remain cheap relative to Spain. We expect growth to be increasingly driven by household consumption.

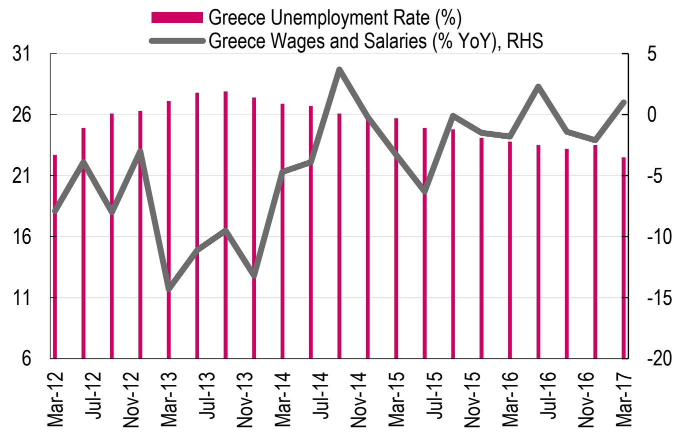
Greece: Demographics are shrinking the workforce by 0.4% annually, which is helping cut the unemployment rate. The employment rate has risen 3 ppts off its lows, but at 56% it remains 10 ppts below its highs. We see no reason to expect meaningful wages growth in the medium term. We expect more convergence of Greek wages to Central European levels (via Central European wages rising).

Figure 14: Two-year yields and policy rates – Greece



Source: Bloomberg

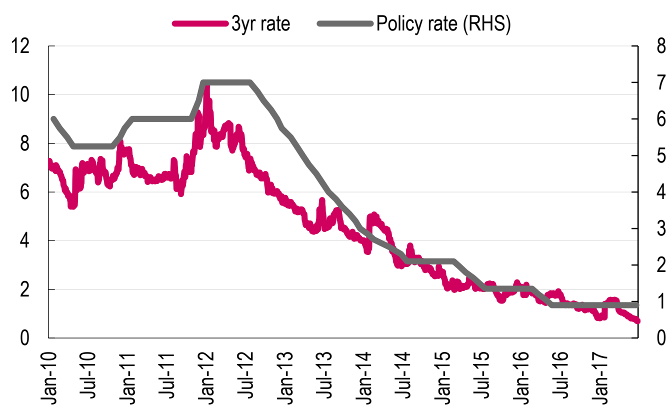
Figure 15: Unemployment and wage growth – Greece



Source: Eurostat

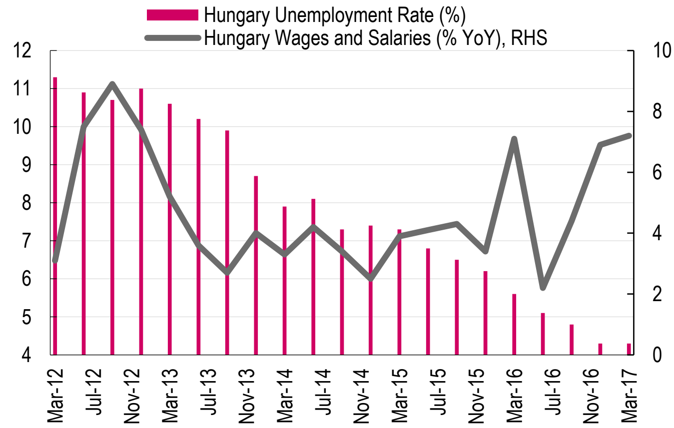
Hungary: Government job creation schemes and wage hikes have turbocharged the demographically inspired trends (1% workforce shrinkage annually). The government can step back and let the private sector take over, and there is still room to increase the employment rate from 72% towards Czech levels of 77%. Hungarian labour costs in 2016 were just 81% of Czech levels. We expect growth to be increasingly driven by household consumption.

Figure 16: Three-year yields and policy rates – Hungary



Source: Bloomberg

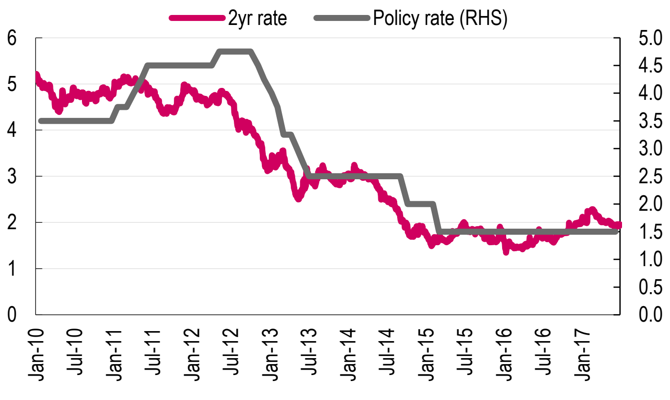
Figure 17: Unemployment and wage growth – Hungary



Source: Eurostat

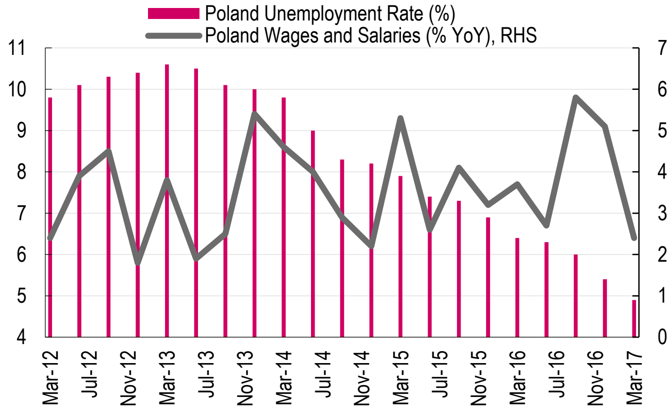
Poland: With the lowest employment rate of the CE3, at 69% (likely to rise as the workforce shrinks 1% annually), and a million or more Ukrainians in the country, we suspect wage inflation will remain subdued for a little longer than in the Czech Republic or Hungary. We expect growth to be increasingly driven by household consumption.

Figure 18: Two-year yields and policy rates – Poland



Source: Bloomberg

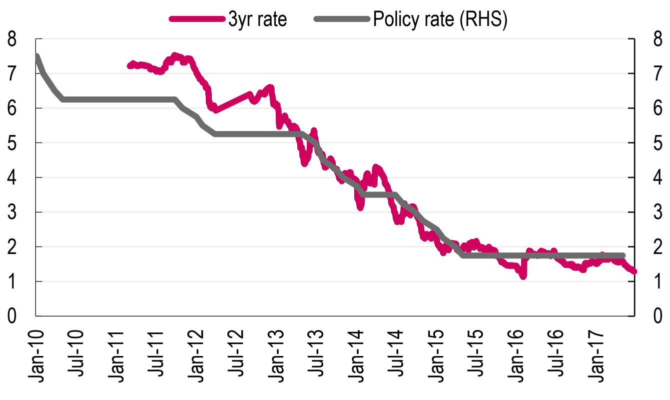
Figure 19: Unemployment and wage growth – Poland



Source: Eurostat

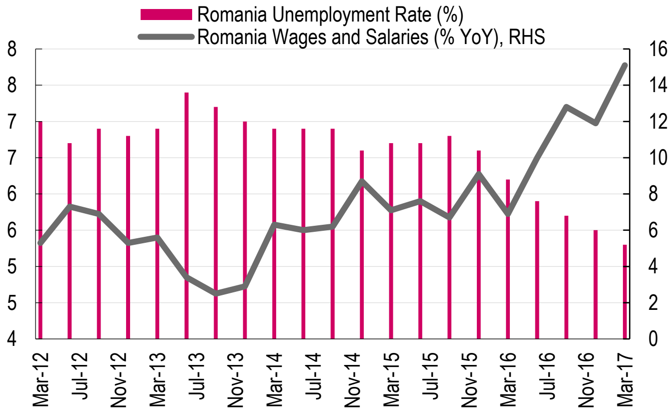
Romania: As in Hungary, politics is contributing to strong wages growth. The employment rate has risen only modestly from its lows to 66%, and another 11 ppts could theoretically be added before it reached Czech levels. Labour costs are up 34% over 2012-2016 (the highest rise in the EU), but they remain just two-thirds of Hungary's costs. We think Romania can still attract investment whilst also benefiting from rising domestic demand.

Figure 20: Three-year yields and policy rates – Romania



Source: Bloomberg

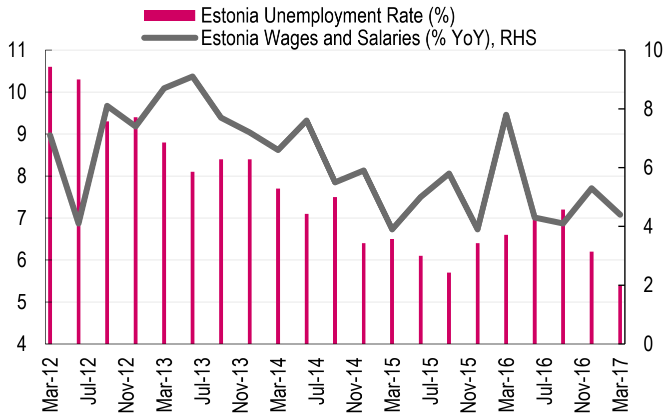
Figure 21: Unemployment and wage growth – Romania



Source: Eurostat

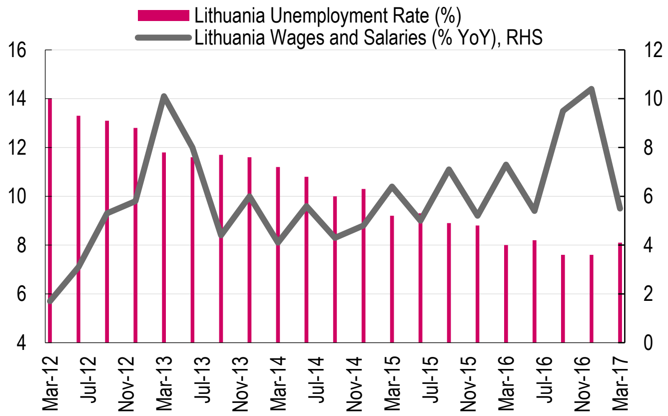
Estonia: Has already seen high labour cost increases of 27% off a high base (relative to Latvia or Lithuania). Unless the country can lift its employment rate to Swedish or Icelandic levels, wage pressure is likely to continue.

Figure 22: Unemployment and wage growth – Estonia



Source: Eurostat

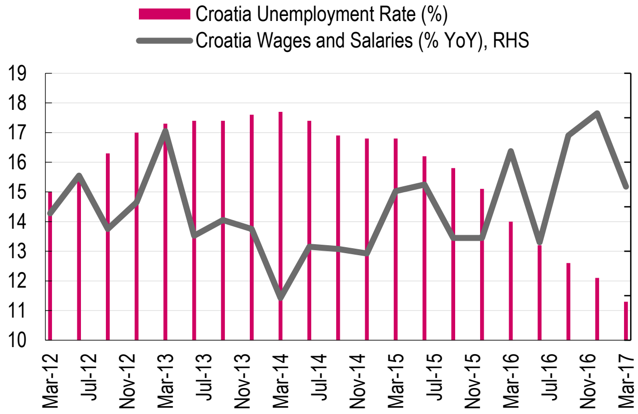
Figure 23: Unemployment and wage growth – Lithuania



Source: Eurostat

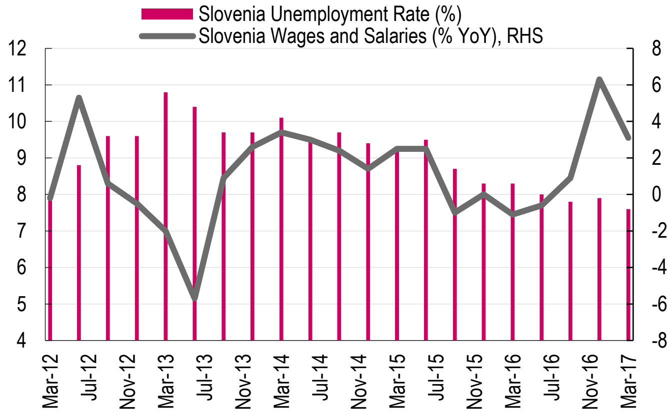
Lithuania/Croatia/Slovenia: None of these appear to have serious issues in the near term. Lithuania is probably leading the three in terms of domestic demand lifting inflation.

Figure 24: Unemployment and wage growth - Croatia



Source: Eurostat

Figure 25: Unemployment and wage growth - Slovenia



Source: Eurostat

Egypt: Given the late 2016 devaluation, we see Egypt as one of the most plausible long-term beneficiaries of Central European wage inflation. We suspect labour costs are half that of Romania. The workforce is still growing, and with an employment rate of 41% in 2014, there is scope for 30 ppts of increase in coming decades, which should keep a lid on labour pressures. This will require more women to enter the workforce, which is plausible given the improved educational access seen in the 1990s. Egypt looks ripe to pick up manufacturing and export orientated FDI in coming years. The government may need to engage more with Ease of Doing Business reforms and provide reassurance regarding political risk.

Morocco: The population is still on course to rise marginally by 2020, but the labour market opportunity for foreign investors also centres on women. The overall employment is still 31 ppts below Hungary and 25 ppts below Romania where the Renault Dacia was first built. Given we assume lower labour costs, it makes sense that Renault has already started manufacturing the Dacia in Morocco. That, and Peugeot's investment, and others, means there is already a challenger in place to take over from CE3 as the next investment destination. Morocco may be held back by the historically low proportion of educated women, the poor rank of the education that is offered (see education outcome data in Daniel Salter's *The Focal Point: Morocco, the non-frontier frontier*). But education access has improved, and the country has an enviable record of macro-economic stability. Politically, the stability of Morocco gives it an advantage over all others in the MENA region.

Tunisia: Like Morocco, this also has a developed industrial base, but a better education level, and is also cheap relative to central Europe. We suspect FDI should also be attracted here, but as in Egypt, politics and terrorism will be obstacles to attracting investors.

Turkey: We were positively surprised by the sustained rise in the employment rate. This can help fuel GDP growth for decades to come, as Turkey reaps the dividends of educated (now) nearly 100% of its girls. Turkey is the only country aside from Egypt to see its young population rise in numbers over 2015-2020. There is a developed industrial base, which adds to the attraction for industrial FDI. Turkey may not be as cheap as other alternatives.

Ukraine: We believe labour costs are low, given the per capita GDP comparisons, and as central European wages take off, we might assume this is finally Ukraine's decade to attract foreign direct investment. But demographic problems are more acute in Ukraine than any other country we cover. So the labour force is already shrinking. Mass emigration means foreign direct investors elsewhere in CEE may already be taking advantage of cheap Ukrainian labour by paying them to work in Polish factories. High profile corruption problems and the ongoing tension with Russia may also deter foreign investors.

Iran: We include Iran given it too has a manufacturing base, and a well educated workforce, and despite poor demographics. However, we see foreign direct investors coming to Iran to supply the domestic market, but not the European market.

See also the following publications

Morocco

Thoughts from a Renaissance Man: Morocco's 'first world' problems, 29 February 2016

The Focal Point: Morocco, the non-frontier frontier, 18 January 2017

Egypt

Thoughts from a Renaissance Man: Egypt – Still bullish, 30 January 2017

Ukraine

CIS and regional economies: Rising prospects, 27 April 2017

Turkey

Thoughts from a Renaissance Man: A bear market rally in Turkey?, 5 December 2016

Turkish Renaissance: The market was a right to yawn, 24 April 2017

Iran

The Focal Point: Iran's presidential election – What's Persian for glasnost and perestroika?, 22 May 2017

Frontier and Emerging Markets:

Populism Matters, 15 May 2017

The Fifth Element, 12 June 2017

The Fifth Element Data Book, 12 June 2017

Renaissance
Capital

Renaissance Capital Moscow T + 7 (495) 258-7777	**Renaissance Capital Ltd.** London T + 44 (203) 379-7777	**Renaissance Capital** Johannesburg T +27 (11) 750-1400	**Renaissance Securities (Cyprus) Ltd.** Nicosia T + 357 (22) 505-800
Renaissance Securities (Nigeria) Ltd. Lagos T +234 (1) 448-5300	**Renaissance Capital** Nairobi T +254 (20) 368-2000	**Renaissance Capital** Dubai T +971 (4) 409-2000	**Renaissance Capital** Cape Town T +27 (11) 750-1164