Re - establishing growth after the crisis

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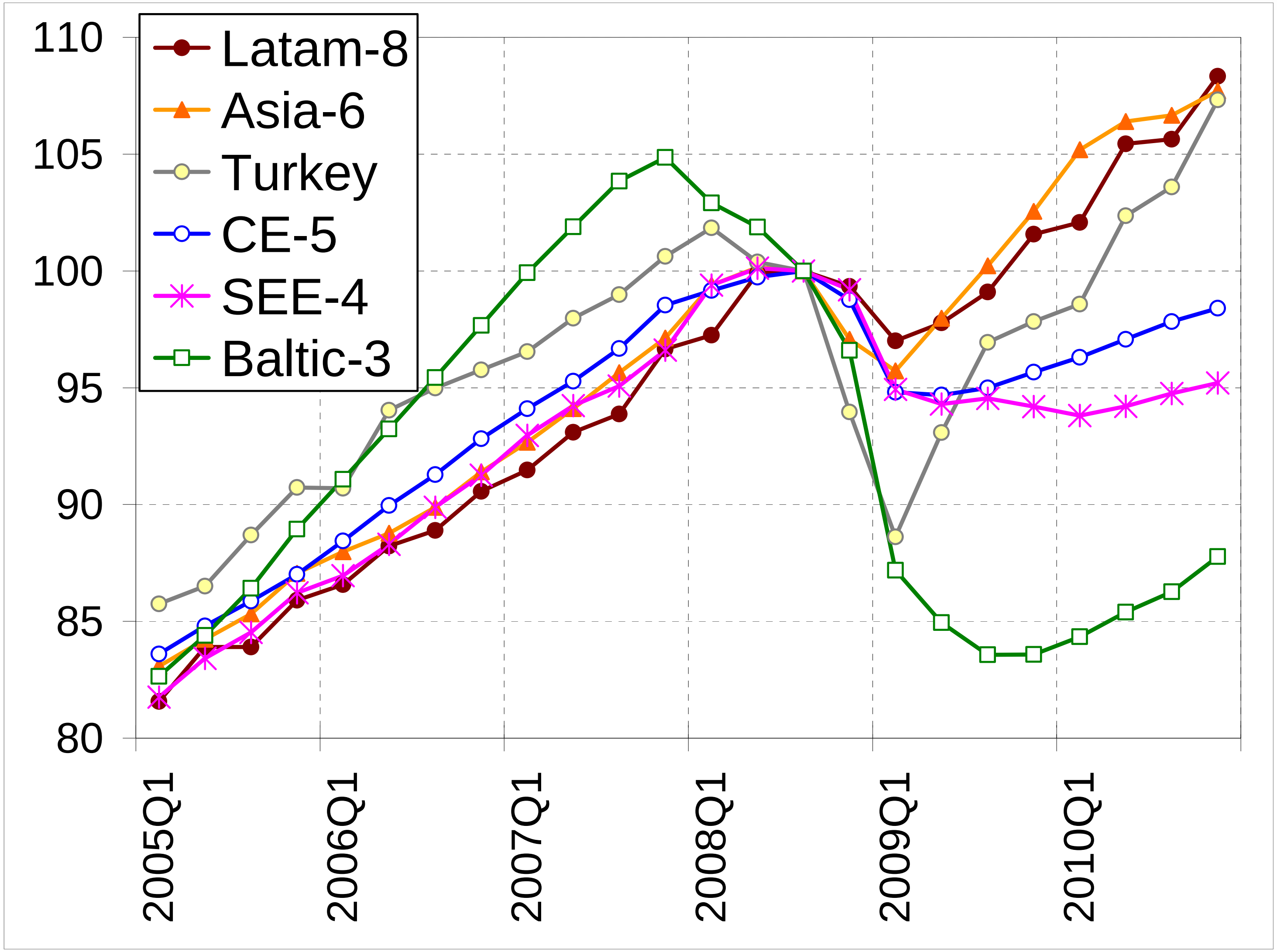
Starting point: CESEE - severe shock and weak recovery (vs Latam/Asia/Turkey)

GDP, 2008 Q3 = 100 (2005 Q1–2010 Q4)



Latam-8: Argentina, Brazil, Chile, Columbia, Ecuador, Mexico, Peru, Uruguay

Asia-6: Indonesia, Korea, Malaysia, Philippines, Taiwan, Thailand

CE-5: Czech Republic, Hungary, Poland, Slovakia, Slovenia

SEE-4: Bulgaria, Croatia, Romania, Serbia

Baltic-3: Estonia, Latvia, Lithuania

Questions

- Is Emerging Europe's growth model broken?
- How should growth strategies change to help the region embark on renewed catching-up?
- Fiscal and monetary policy issues

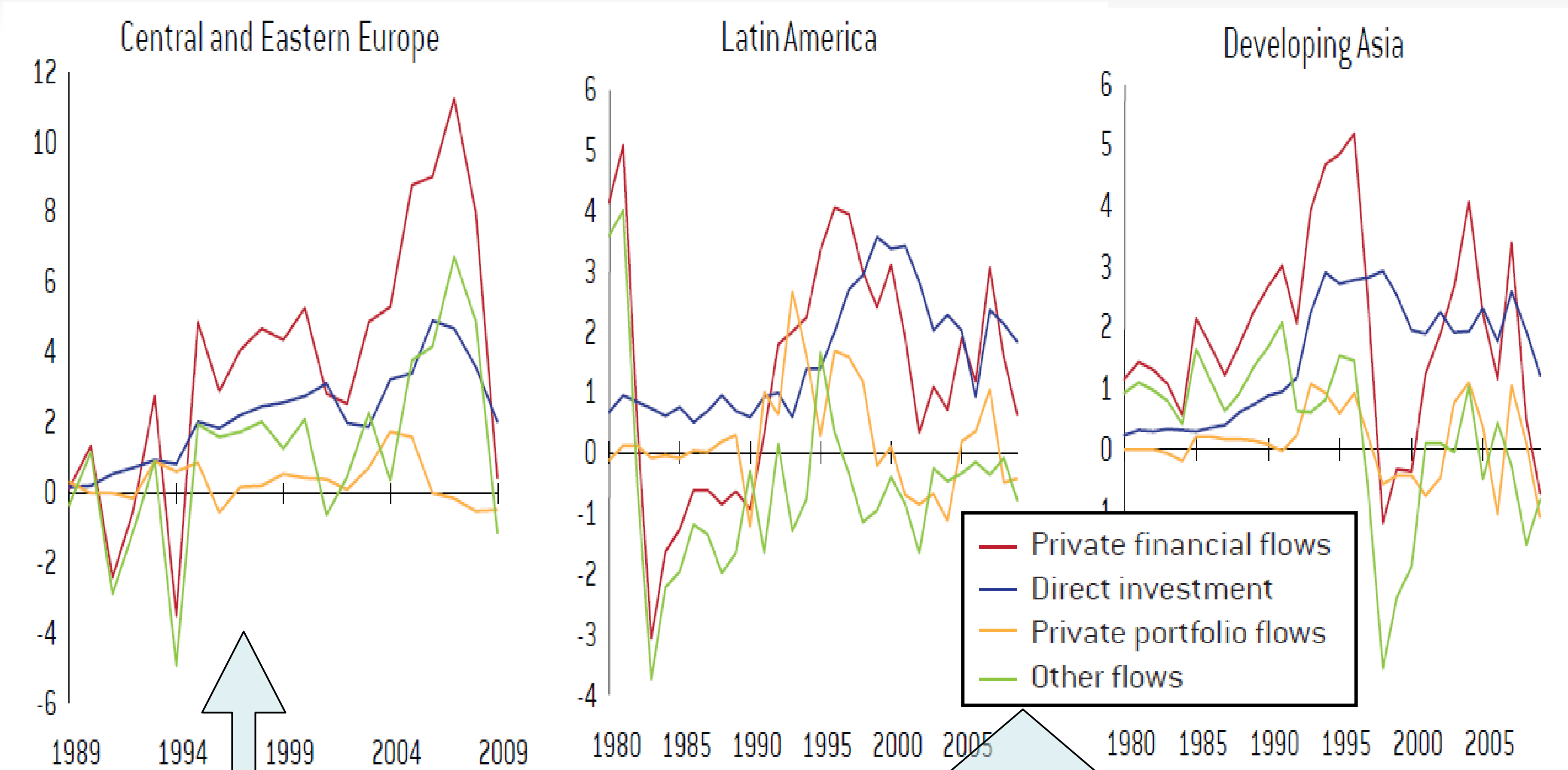
What ‘growth model’?

- **In the last decade the region experimented with unique model of growth through integration into the EU**
- **Key features**
  - Strong institutional anchoring (also in EU candidates)
  - Trade and FDI integration
  - Financial integration (downhill capital flows)
  - Labour mobility
- **Made considerable sense in view of initial conditions**
  - Foster institutional build-up
  - Substitute lack of domestic saving by foreign saving
  - Technology transfer
  - Make use of wealth of human capital

Is the growth model broken?

- Crisis resulted in much more severe slowdown, weaker recovery than in the rest of emerging world (Albania & Poland excepted)
- Elsewhere (Asia, Latin America) such crises led to major questioning and policy changes
- Questions here too:
  - Was Emerging Europe wrong to rely on foreign savings at a time other emerging economies were doing the opposite?
  - Has EU framework been a blessing or a curse?
  - Wrong model or policies inadequate to the model?
  - What needs to be changed?

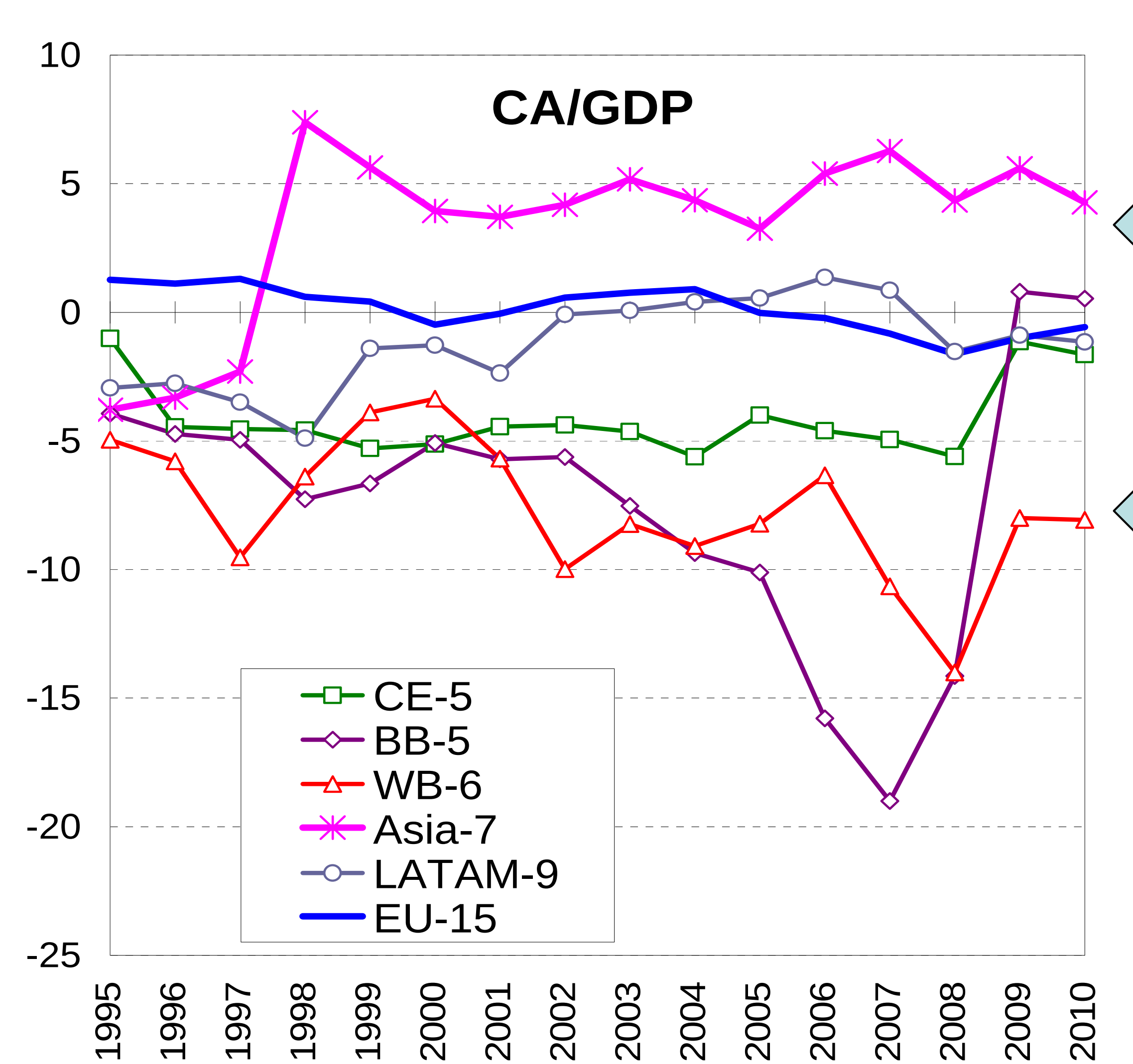
Common characteristics 1: Net private financial flows: larger than elsewhere



CEE: Reached 12% of GDP by 2007, then fell to zero

Latam & Asia: less inflows; capital outflows during previous crises

Common characteristics 2: Reliance on foreign savings



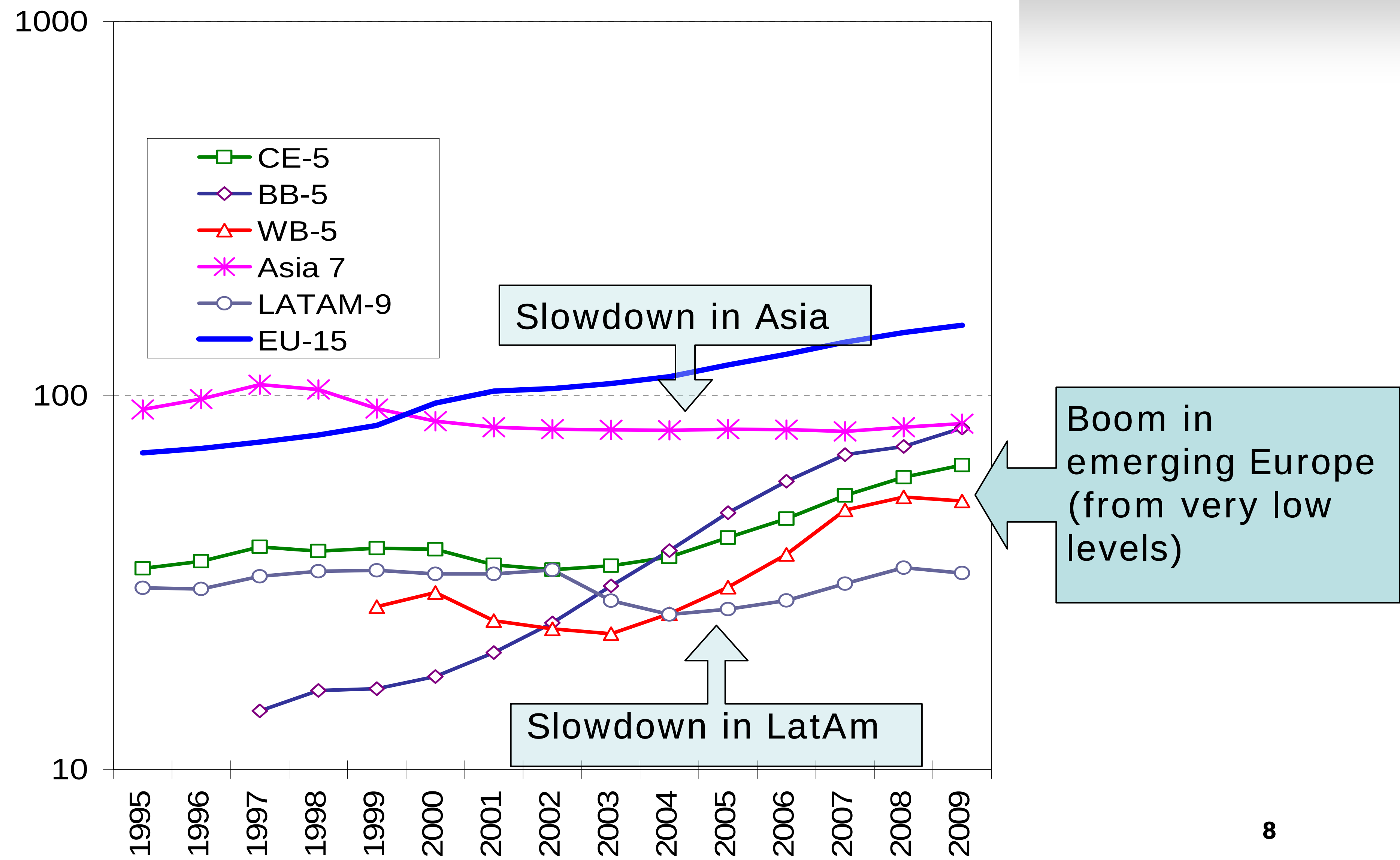
Post-1998, Asia and even Latin America go into surplus

Until 2007, most of emerging Europe goes into deficit

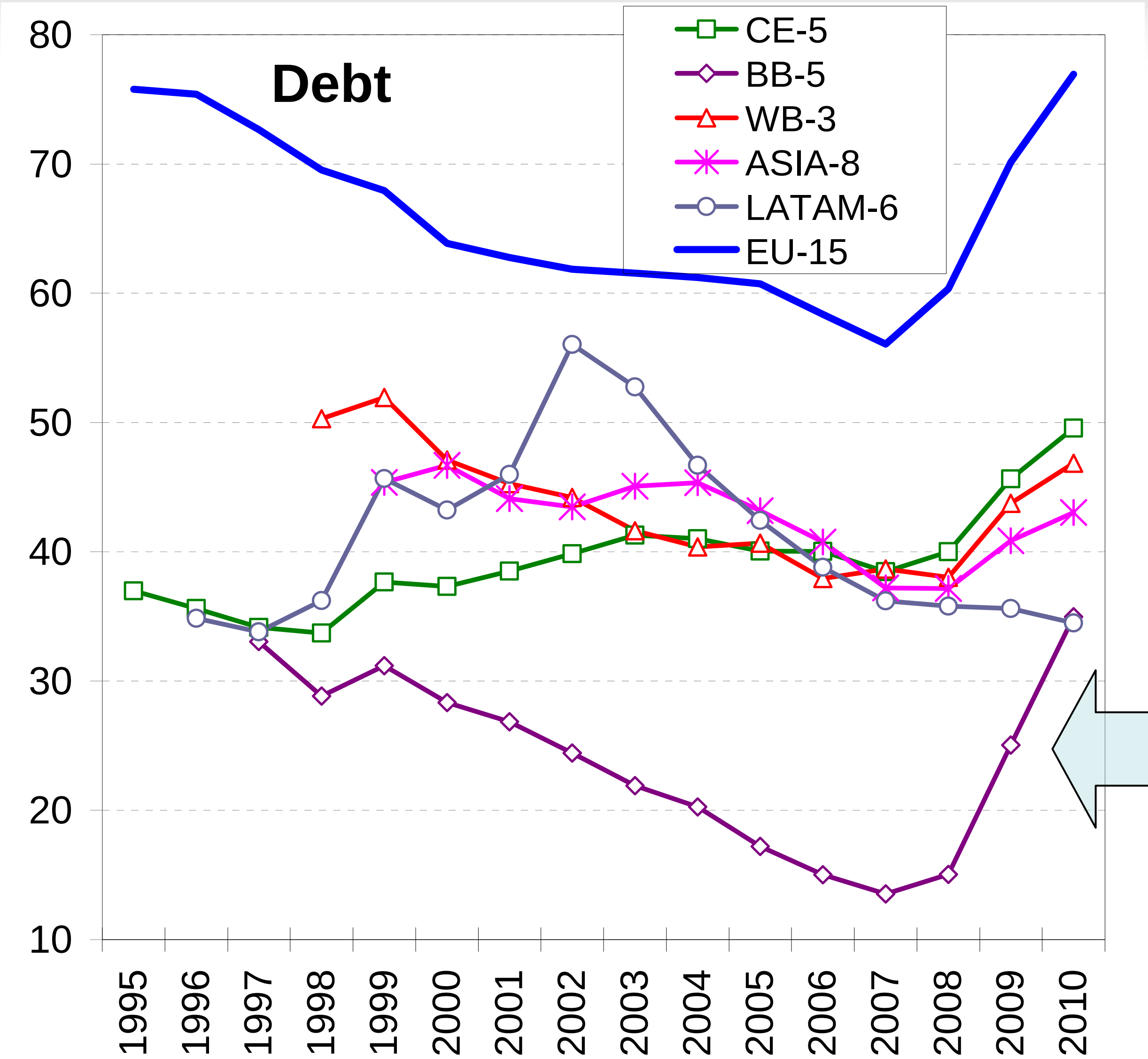
BB-5 = Baltic/Balkan members of the EU

WB-6=Western Balkan 6 = Albania, Bosnia/Herzegovina, Croatia, FYR Macedonia, Montenegro, Serbia

Common characteristics 3: Credit booms

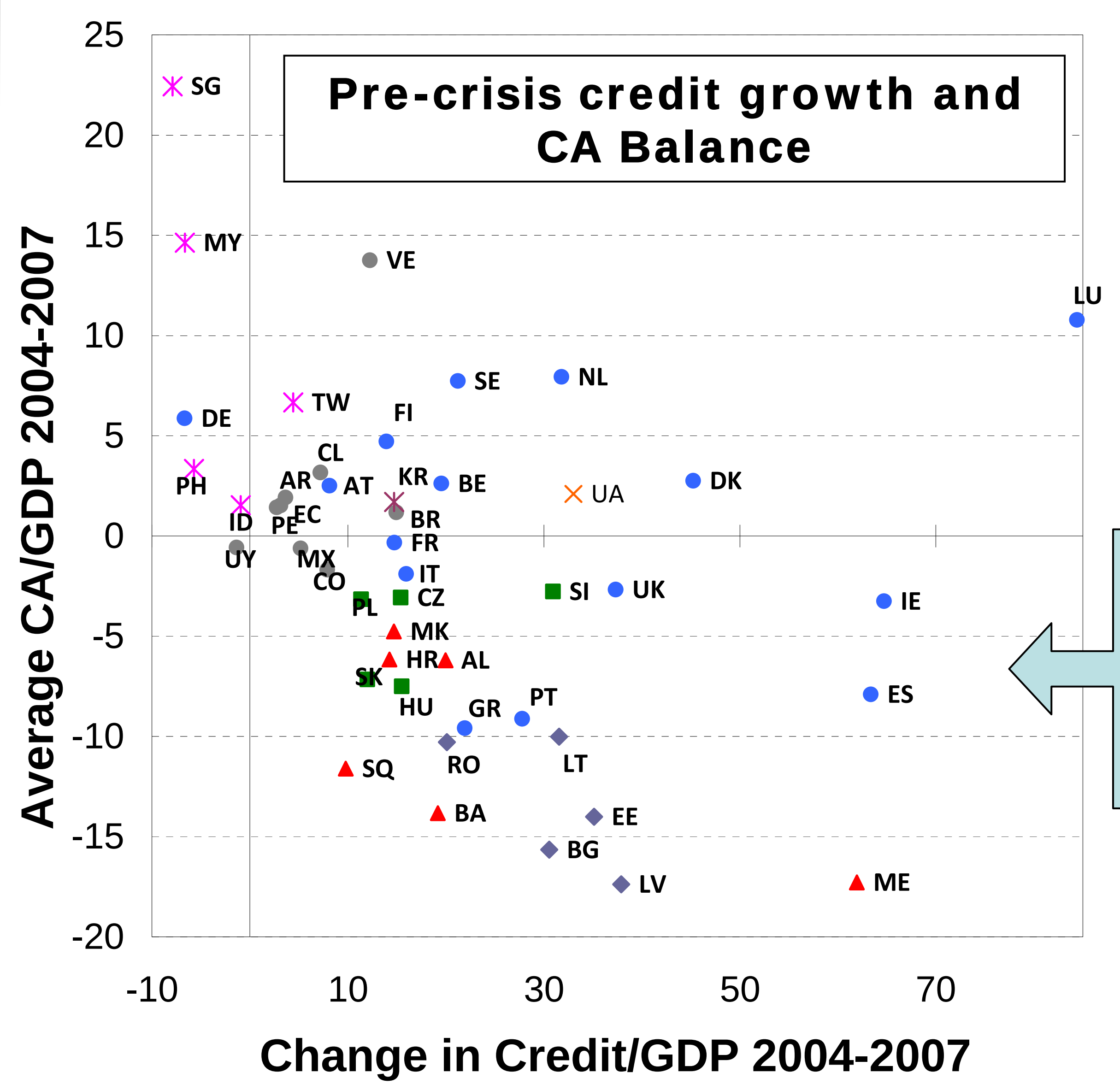


Common characteristics 4: It's not mostly fiscal!



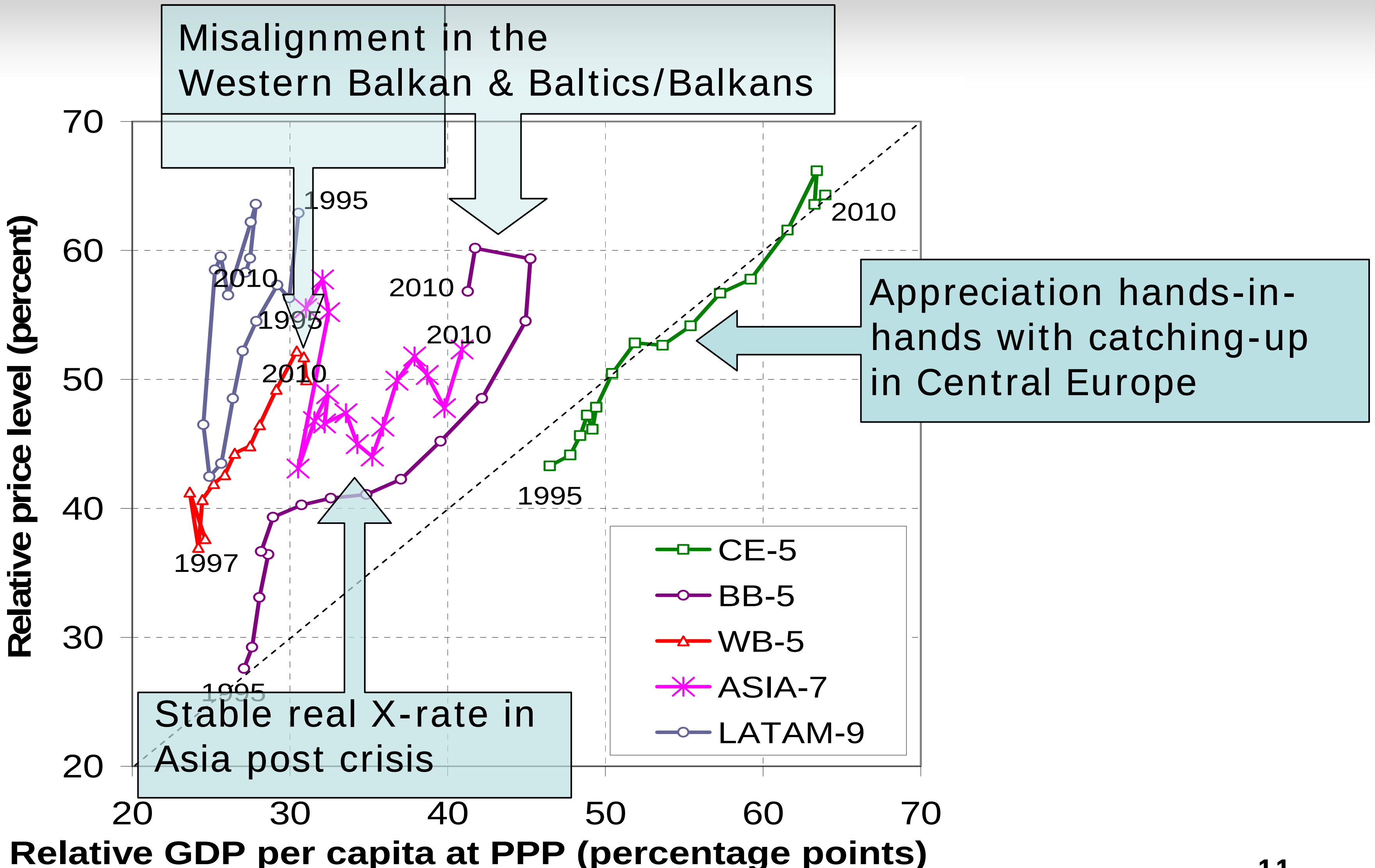
If anything, more favourable public debt developments until 2008, especially in Baltic/Balkan EU members

Differences: Degree

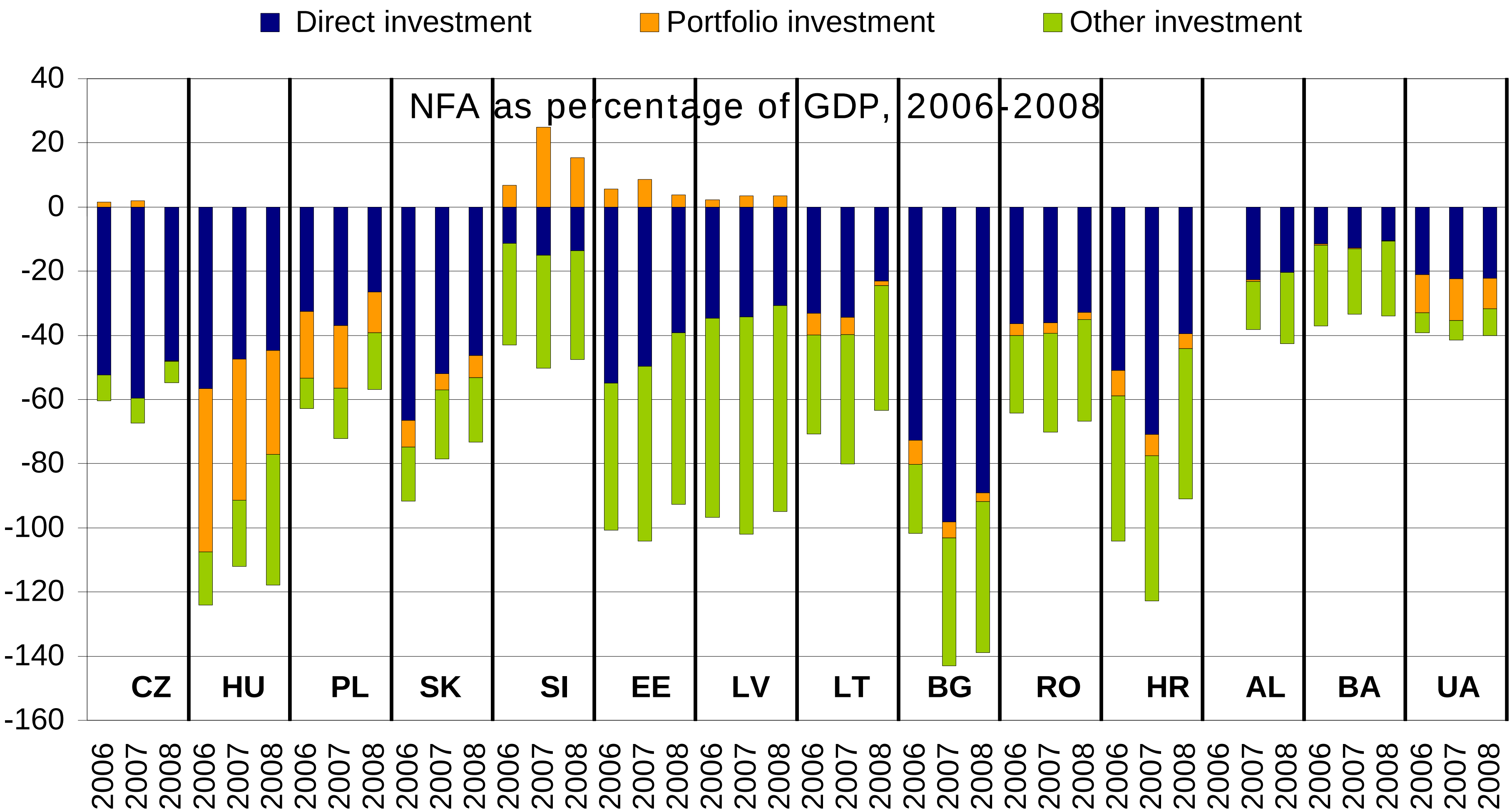


- Clear negative relationship that also applies to non-CEE
- Large diversity

Differences: Real exchange rate developments



Differences:
Composition of capital flows

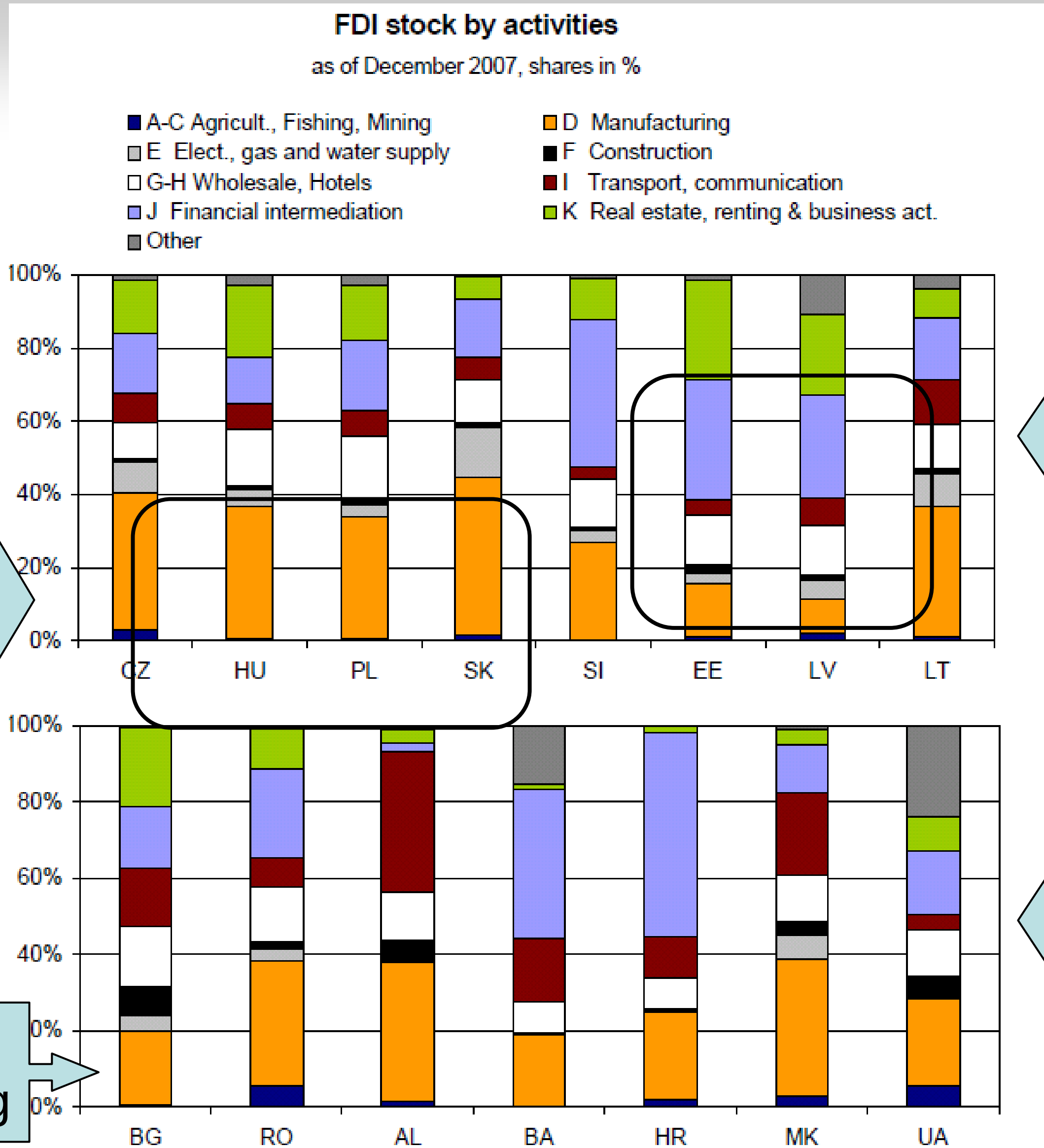


Mostly FDI in **Central Europe**

Mostly credit in **Baltic** countries

Credit important in **SEE** as well

Differences: Composition of FDI



Large part of manufacturing, infrastructure, trade in **Central Europe**

Large part of real estate, finance in **Baltic** region

Low manufacturing in **SEE** as well

Orange: manufacturing

Summing up

- Integration led emerging Europe to embark on uncommon path
  - Strong reliance on capital inflows
  - Credit booms
  - Mostly private debt
  - Catching-up and production upgrading
- But also major differences across countries: Central Europe differs from Baltic & SEE
  - Degree
  - Real exchange rate developments
  - Composition of capital flows
  - Allocation of FDI

Which were the important factors?

Some made better use of the model than other

– Overall policy mix: importance of macro stability

Other factors

– EU membership? (not really)

– Initial conditions (significant role of development level); geographic closeness; size

– Timing: wars and other domestic problems is SEE: started to reform/develop institutions later

– Exchange rate regimes (floaters more successful)

– Financial regulation

– Fiscal policy

EU institutional framework: not well designed for catching-up economies and for crisis management

Exchange rate policy

Polarisation of exchange-rate regimes:

- A couple of countries with similar circumstances opted for different regimes, e.g.
  - Czech Republic (float) and Slovakia (euro),
  - Romania (float) and Bulgaria (currency board),
  - Serbia and Albania (float) and the other four western Balkan countries (various kinds of fixed exchange rates)
- ‘No single currency regime is right for all countries or at all times’ (Frankel, 1999)
- ‘Hollowing-out of intermediate regimes’ (Fischer, 2001)

Differences between floaters and fixers (1)

	All CESEE		EU		non-EU	
	Float	**Fix**	**Float**	**Fix**	**Float**	**Fix**
Credit/GDP, change from 2004 to 2008 (percentage points)	**20.5**	**32.8**	20.7	37.4	20.0	34.8
Real interest rate, average of 2004-2008 (percent)	**1.6**	**-1.6**	1.4	-2.5	2.0	-1.0
Current account balance/GDP, 2007 (percent)	**-6.6**	**-11.8**	-6.7	-17.3	-13.0	-14.1
Inflation, average of 2004-2008 (percent)	**5.5**	**5.4**	4.7	6.2	7.3	5.6

More credit, less real interest, more CA deficit in fixers

Differences between floaters and fixers (2)

	All CESEE		EU		non-EU	
	Float	Fix	Float	Fix	Float	Fix
FDI to finance and real estate sectors, 2007 (percent of total FDI stock)	**26.5**	**40.2**	30.6	44.8	5.7	34.4
Gross external debt, 2009 (percent of GDP)	**78.8**	**95.6**	86.8	123.6	39.0	80.8
GDP growth, 2009 (percent)	**-2.9**	**-8.2**	-4.1	-11.9	0.2	-6.1
Change in unemployment rate from 2007 to 2010, (percentage point)	**1.5**	**3.9**	2.5	8.9	-0.8	-0.4

More FDI in Finace/real estate sectors, more external debt, larger crisis response in fixers

Legacy in Baltic/Balkan countries

- *(Capacity to adjust fiscal policy; social peace)*
- Severe weakness of tradable sector
- Overvalued exchange rates
- Slow adjustment in private sector wages
  - ➢ wages are still low in absolute terms, but have risen compared to competitors in Central Europe
- Distorted FDI
- High private debt
- High unemployment

\+ External environment: slower growth in EU-15; deleveraging; more differentiation; financial regulation

$\Rightarrow$ Other dimensions of competitiveness must be improved

Financial integration & stability

- Financial integration: **major channel** for shocks
- Issue in the **short run** is to manage deleveraging cycle under way in large part of the region
  - Lending prospects?
- **Medium term** issues remain however as capital inflows may resume soon
  - Should Emerging Europe build-up reserves?
  - Strength of financial infrastructures
  - Home/host relationship and responsibilities for financial stability
  - Crisis resolution
  - Manage liquidity and solvency risks
  - Combat boom and bust created by lending

Fiscal sustainability

Fiscal policy reaction: huge adjustment in CESEE

Average annual changes in total general government expenditures, 2008-2010

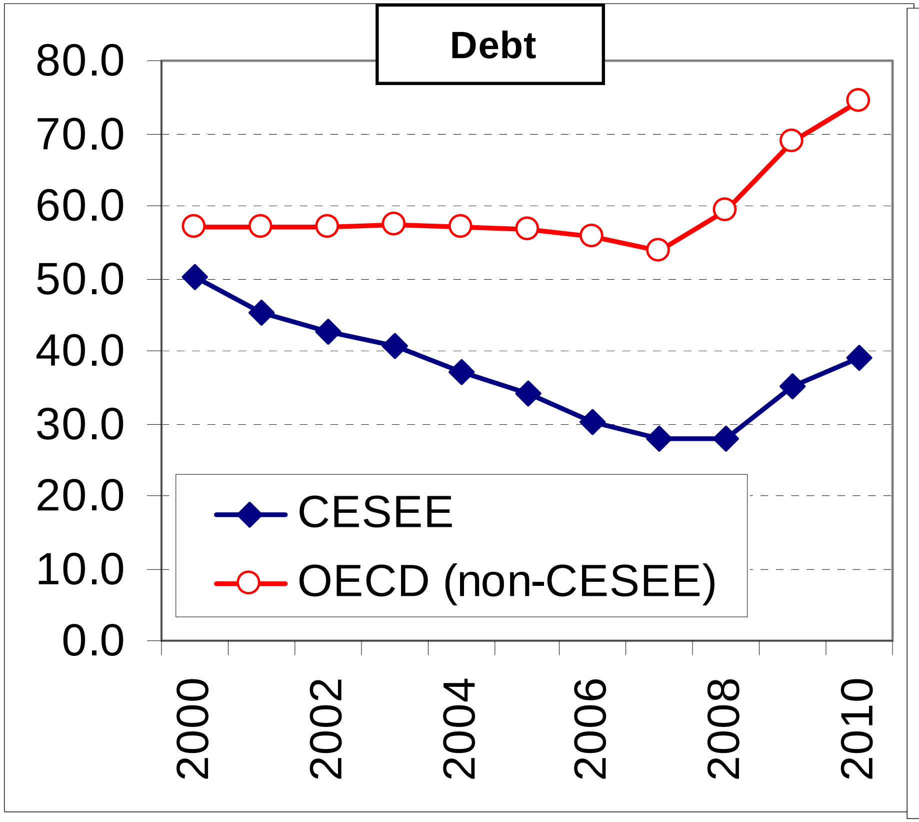
	Nominal percent change			Real percent change		
	2008	2009	2010	2008	2009	2010
CESEE-17	**19.2**	**0.5**	**3.9**	**9.2**	**-2.6**	**1.8**
EU-15	**6.3**	**5.4**	**1.8**	**2.8**	**4.8**	**0.6**
Asia-6	**14.2**	**6.9**	**4.7**	**7.3**	**5.3**	**1.4**
Latam-8	**20.8**	**13.0**	**10.1**	**12.7**	**8.0**	**5.2**

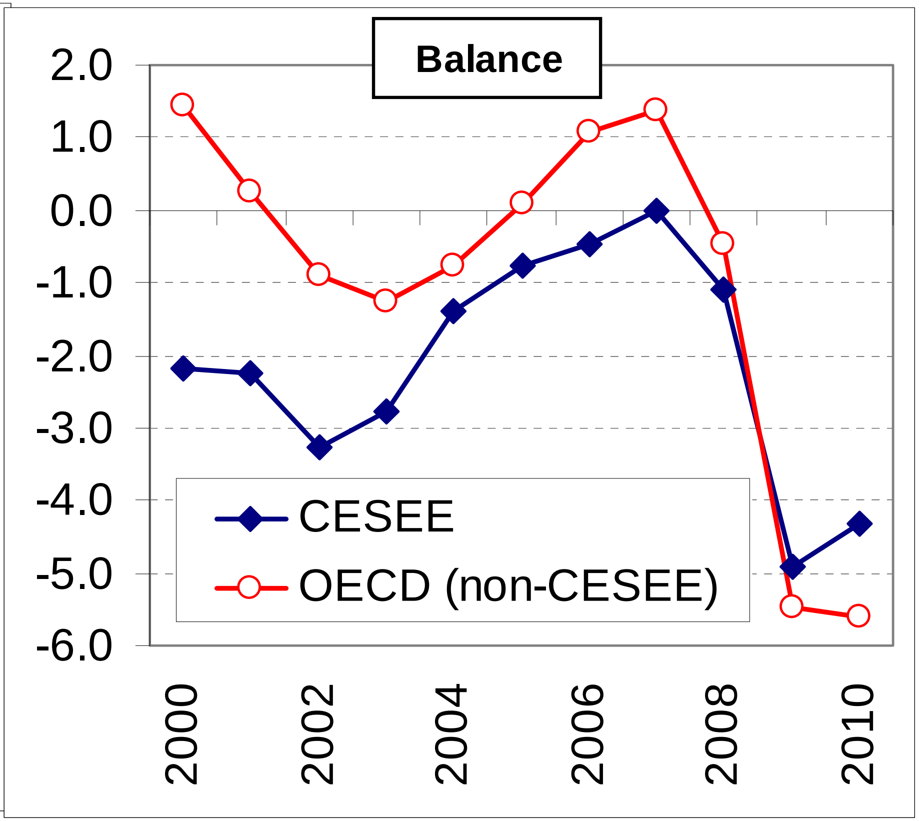
EU-15: increase in real expenditures in 2009

Asia and Latam: little adjustment

CESEE: favourable debt developments

General government balance and gross debt (% GDP), 2000-2010

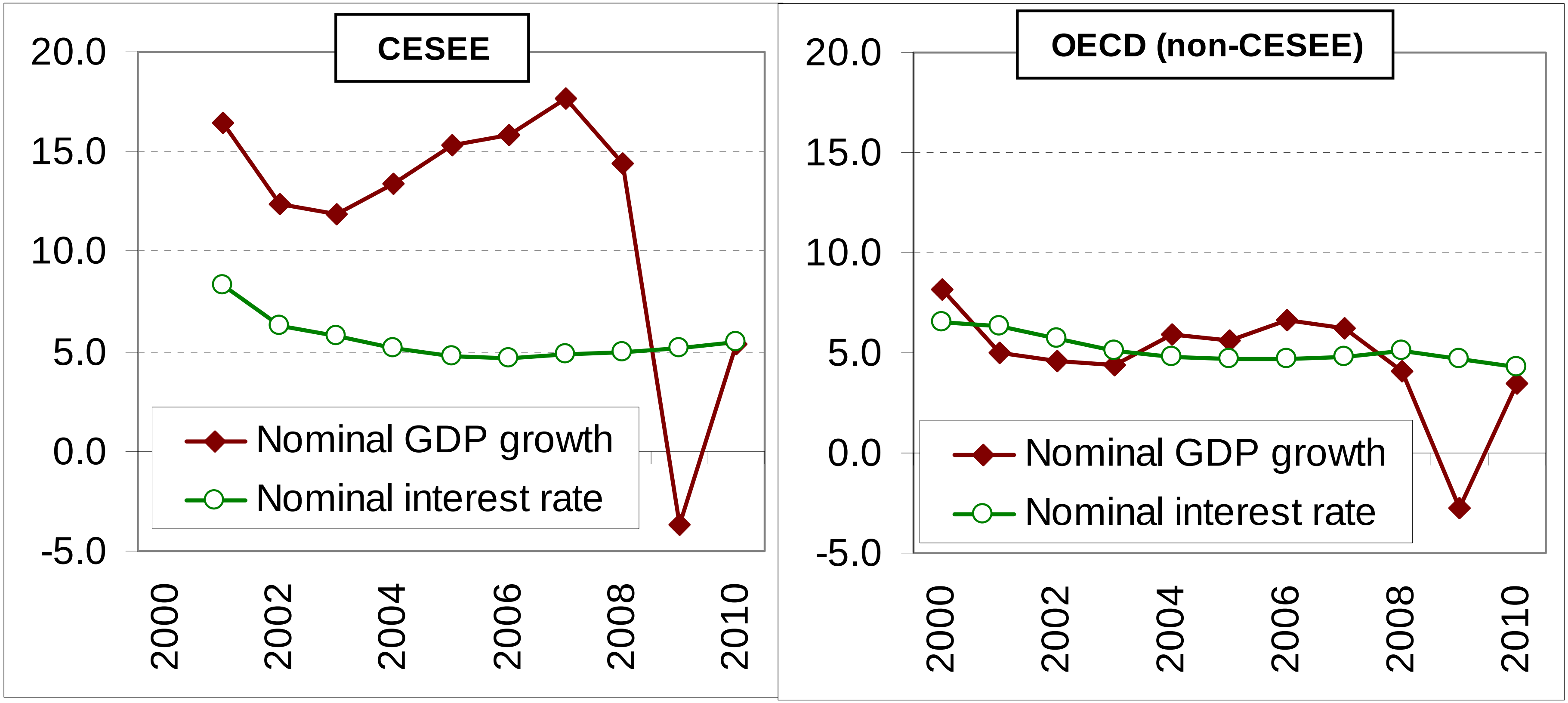




CESEE: low debt (on average), even after the crisis

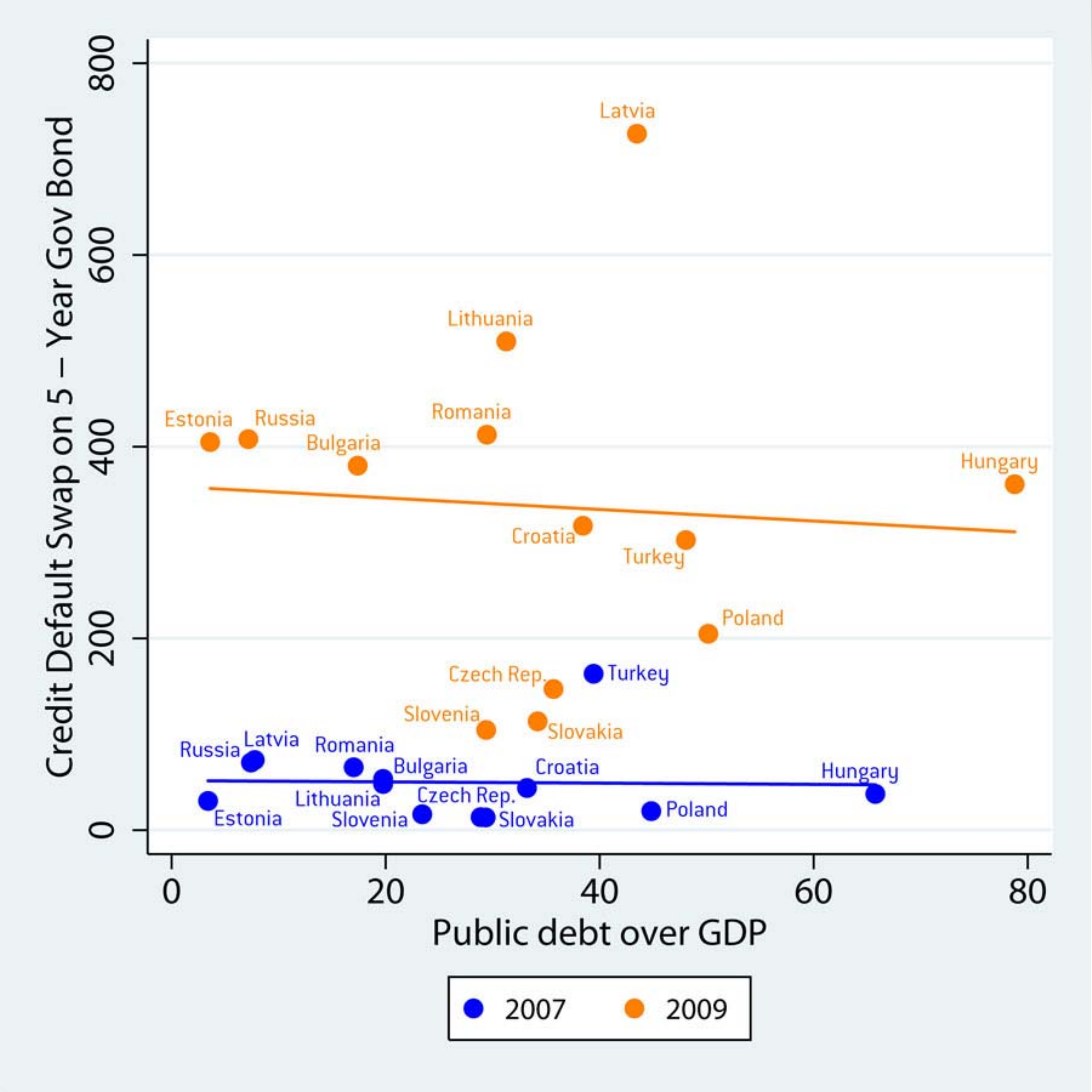
CESEE: GDP growth was well above the interest before the crisis

Nominal interest rate on government debt and nominal GDP growth (%), 2000-2010

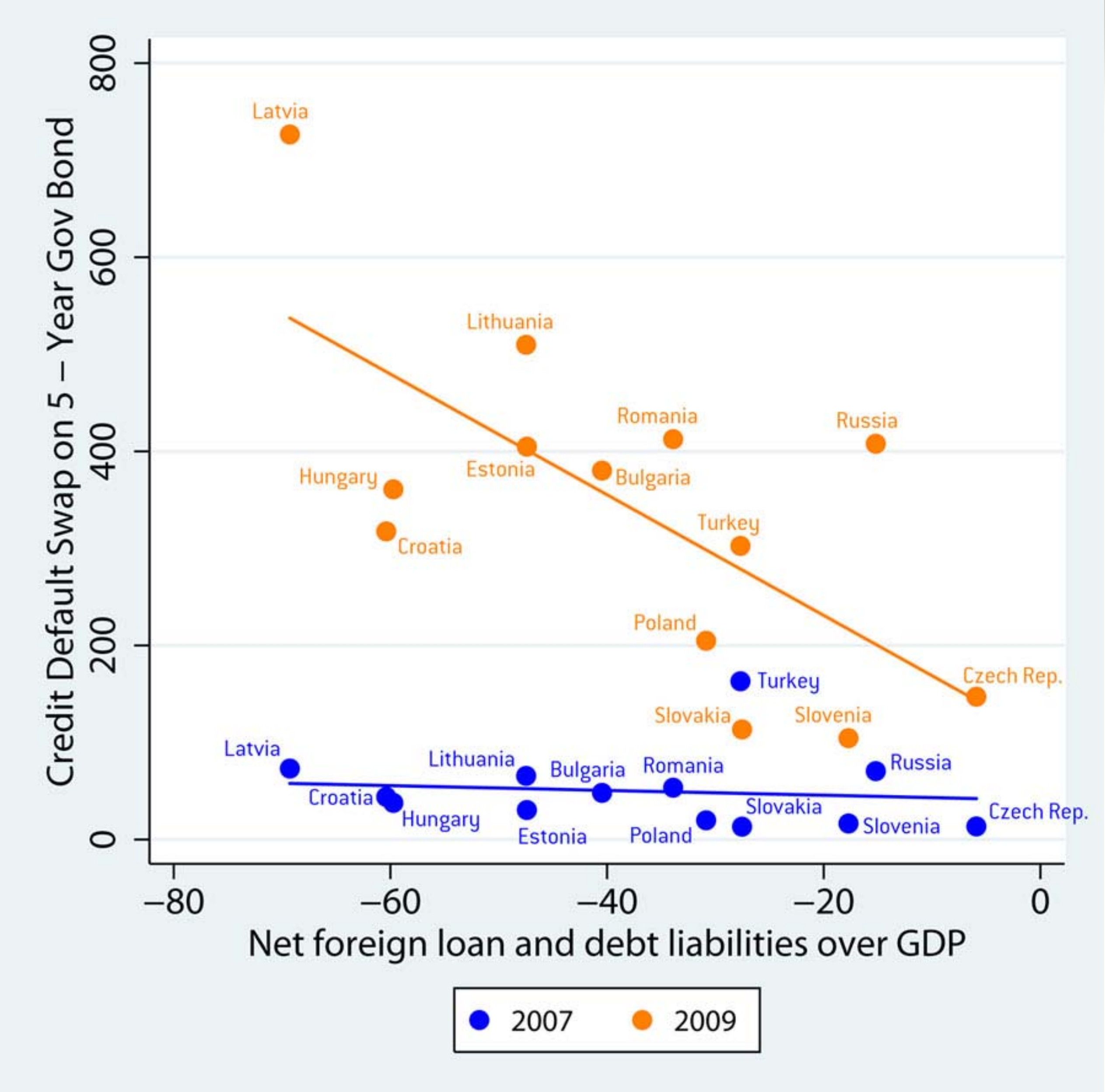


Note. Interest rate=government interest expenditures/previous year gross debt

Risk of government default was not related to government debt



Risk of government default was related to external debt in 2009



What is the alarming level of government debt?

Government debt/GDP levels in 2007 in CESEE countries that turned to IMF in 2008/09

Armenia	16
Bosnia and Herzegovina	19
Georgia	22
Hungary	66
Latvia	9
Romania	13
Serbia	34
Ukraine	13

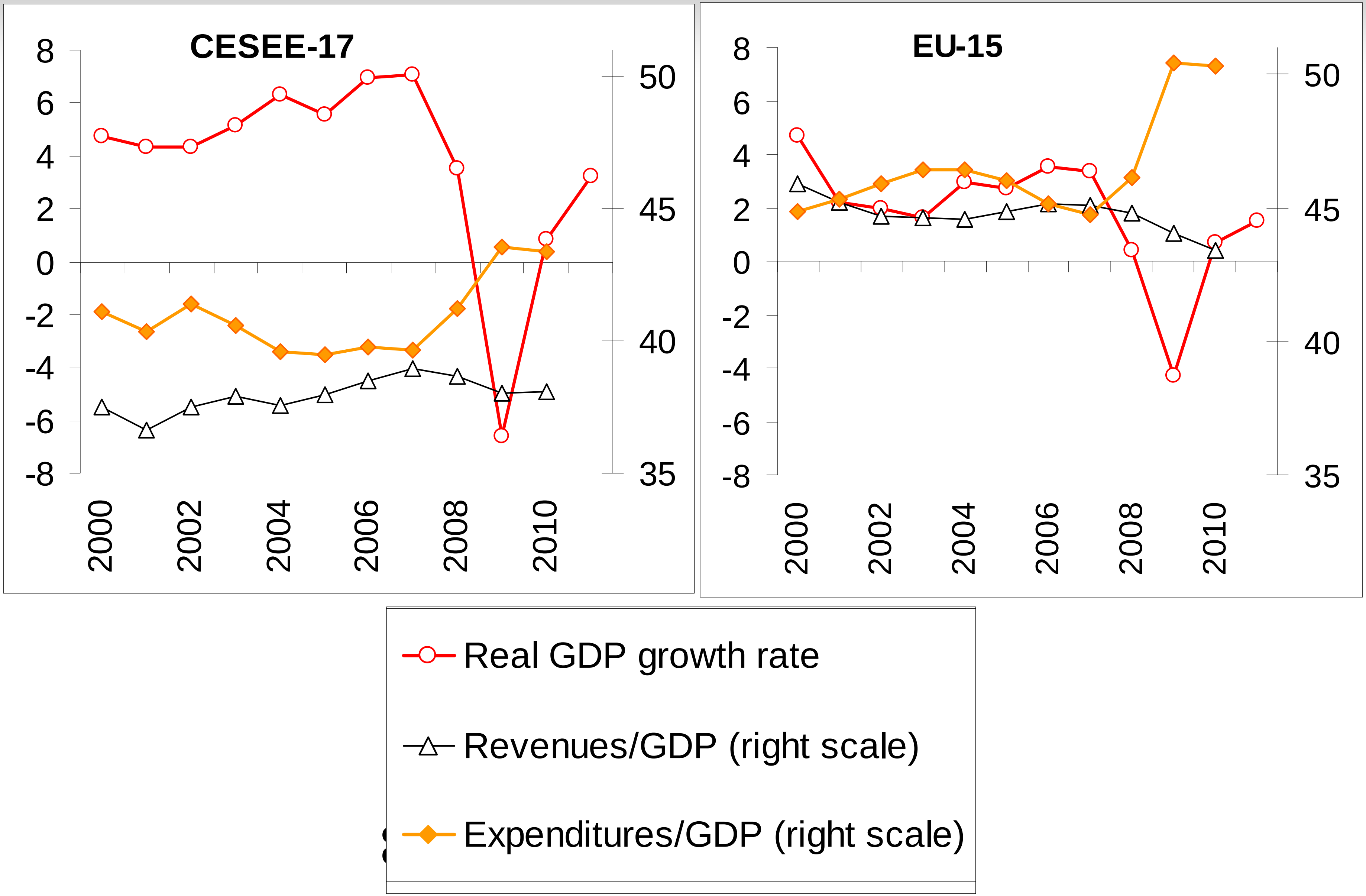
What is the alarming level of government debt? (2)

Government debt/GDP levels in the year before some recent government defaults

Argentina 2002	45
Russia 1998	54
Ukraine 1998	37

Source: Sturzenegger and Zettelmeyer, 2006

Expenditure and revenue ratios, GDP growth



Implications of the crisis

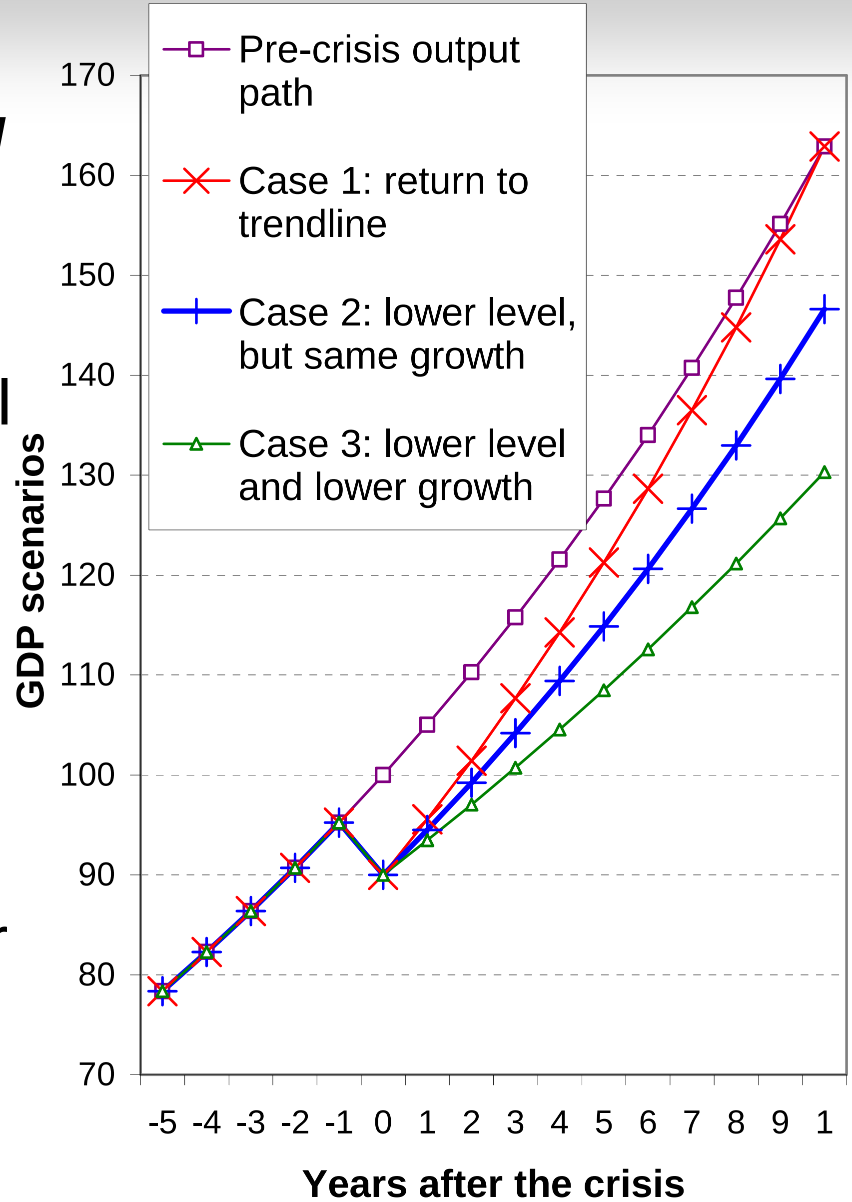
- GDP fell:
  - Part of this fall is likely a permanent output loss
  - Part is a negative output gap that will correct
- GDP growth: will be less than before the crisis
- Interest rates: may be higher
- Expenditure/GDP ratio: increased is most countries (even in the event of significant consolidation) $\rightarrow$ when output fall is permanent, this creates a structural deficit
- Revenues fell, but revenue/GDP ratio is broadly stable
- Markets became more sensitive

Crucial question: output prospects

Three options:

1. downturn in ***purely cyclical*** and GDP will return to the pre-crisis trendline
2. part of the downturn in permanent, but the potential ***growth rate*** is unaffected
3. part of the downturn in permanent **and** the potential growth rate is also reduced

⇒ 1 may characterise Asia, CESEE will likely follow 2 or 3



Illustrative scenarios for CESEE 1.

Common to all scenarios:

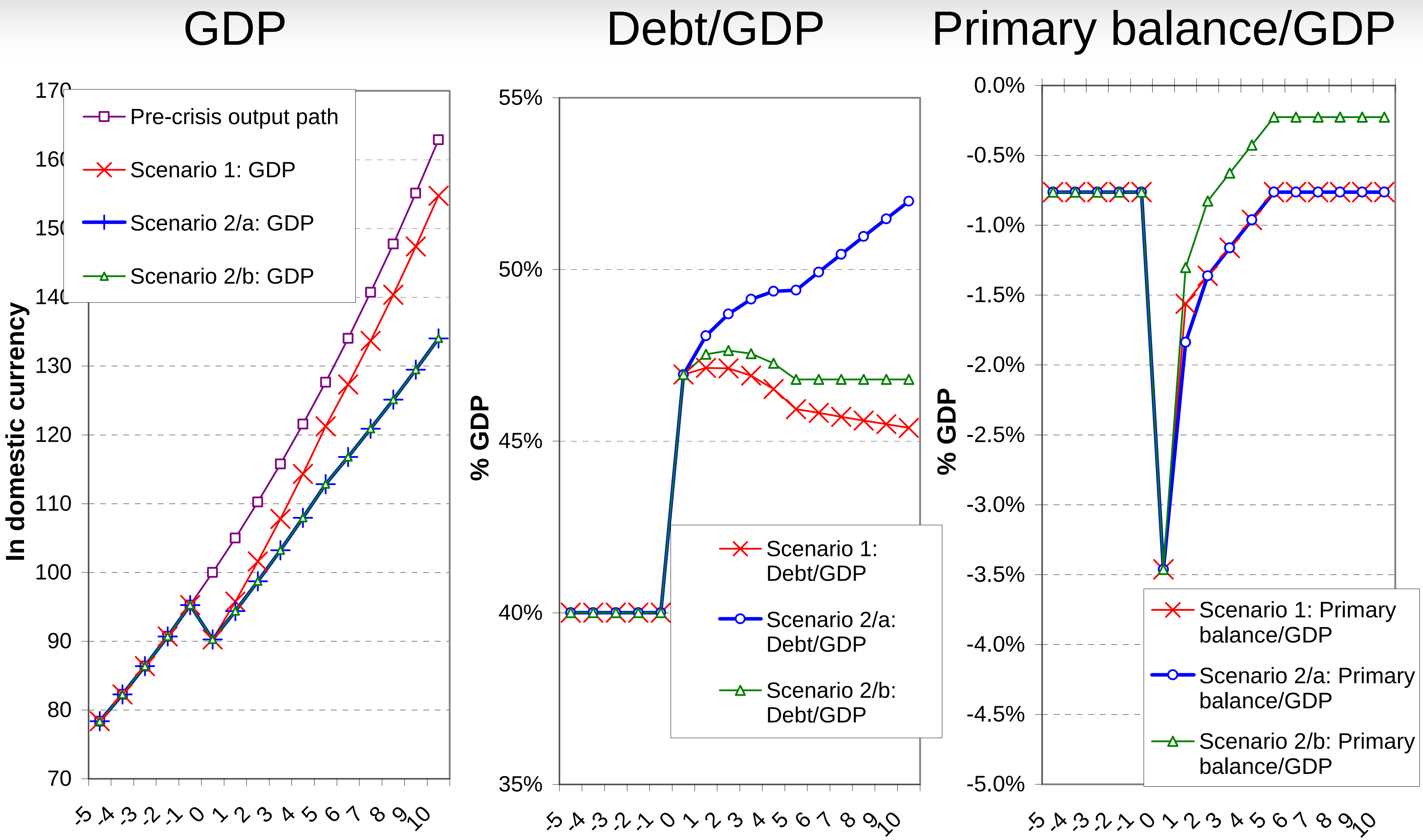
- Expenditures are frozen till the expenditure/GDP ratio is restored to its pre-crisis level
- Revenue/GDP is constant
- 5% permanent GDP fall
- 5% output gap that corrects in 5 years
- Cyclical spending is related to output gap

Scenario 1: i-g = -2%; no further fiscal adjustment (in addition to restoring the expenditure/GDP ratio)

Scenario 2a: i-g = -0.5%, no further fiscal adjustment (in addition to restoring the expenditure/GDP ratio)

Scenario 2b: i-g = -0.5%, and further fiscal adjustment (in addition to restoring the expenditure/GDP ratio)

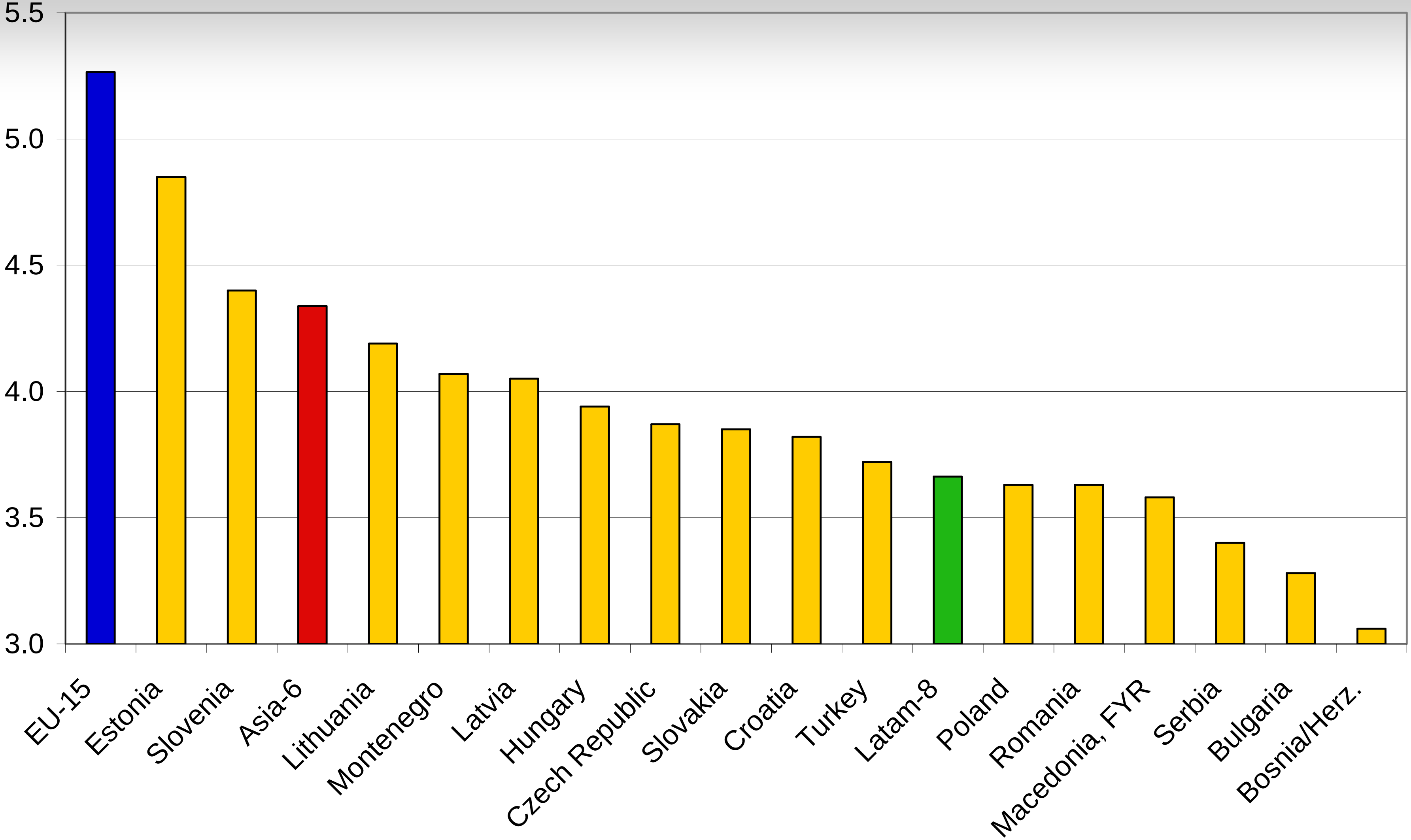
Illustrative scenarios for CESEE 2.



Fiscal policy implications

- Fiscal sustainability was not the problem prior to the crisis (interest rate well below growth)
- ... but pro-cyclical and little demand management to contain pre-crisis credit growth
- Whether the recent increase in expenditure/GDP ratio will become structural depends on GDP developments
- Key to public-debt: consolidation of private debt
- In case of risk to sustainability: prudent policies based on conservative growth and interest rate assumptions
- But in order cases: premature fiscal consolidation while private sector deleveraging should be avoided
- Fiscal institutions (Darvas & Kostyleva 2011)
- Role of the EU: should support counter-cyclical fiscal policy

Quality of institutions



The index of Institutions is composed of public institutions (75%) (property rights, ethics, undue influence, government inefficiency, security) and private institutes (25%) (corporate ethics, accountability)

Lessons to learn

- Preserve, but reform integration model of growth
- More emphasis on supply-side conditions
  - direct policies toward the tradable sector (structural policies, macro stability, FDI promotion, use EU funds)
  - labour markets (employment, education, immigration)
  - foster competition (product/labour markets)
  - controlled real exchange rate appreciation
  - Institutions, business climate
- Foster domestic savings (yet not to the Asian level)
- Need for counter-cyclical fiscal policy (and EU support for this)
- Conditions for successful financial integration; importance of financial regulation & supervision
- Design better crisis resolution mechanism
- Non-EU SEE: EU should continue to be the anchor

Conclusion

Growth model is not broken,

but it needs to be fixed