Whither Growth in Central and Eastern Europe? Policy Lessons for an integrated Europe

Bruegel-wiwi Report

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Zsolt Darvas
Sofia, December 6, 2010
Questions

• Is Emerging Europe’s growth model broken?

• How should growth strategies change to help the region embark on renewed catching-up?

• Policy implications at EU and national level
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
  – Trade and FDI integration
  – Financial integration (downhill capital flows)
  – (Labour mobility)

• Made considerable sense in view of initial conditions
  – Foster institutional build-up after transition
  – Substitute lack of domestic saving by foreign saving
  – Make use of wealth of human capital
• Crisis resulted in much more severe slowdown, weaker recovery than in the rest of emerging world (Poland & Albania 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?
Stylised facts

GDP, 2008 Q3 = 100 (2005 Q1–2010 Q2)

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

Baltic/Balkan-5: Bulgaria, Estonia, Latvia, Lithuania and Romania

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

Latam-7: Argentina, Brazil, Chile, Columbia, Ecuador, Mexico and Uruguay

Starting point: severe shock and weak recovery
IMF Outlook till 2015

IMF Oct 2010 WEO projections

GDP, 2008=100

- **CE-5**: Czech Republic, Hungary, Poland, Slovakia and Slovenia
- **Baltic/Balkan-5**: Bulgaria, Estonia, Latvia, Lithuania and Romania
- **Asia-6**: Indonesia, Korea, Malaysia, Philippines, Taiwan and Thailand
- **Latam-8**: Argentina, Brazil, Chile, Columbia, Ecuador, Mexico, Peru and Uruguay
Common characteristics 1: Net private financial flows: larger than elsewhere

- **Central and Eastern Europe**: Reached 12% of GDP by 2007, then fell to zero.
- **Latin America**: Less inflows; capital outflows during previous crises.
- **Developing Asia**
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
Common characteristics 3: Credit booms

- **Slowdown in Asia**
- **Boom in emerging Europe (from very low levels)**

Graph showing trends from 1995 to 2009 with different color lines representing different regions.

Legend:
- CE-5
- BB-5
- WB-5
- Asia 7
- LATAM-9
- EU-15
Common characteristics 4: It’s not mostly fiscal!

If anything, more favourable public debt developments until 2008, especially in BB countries.
Differences:
Degree 1.

GDP growth and the current account, 2003-2007

More prudent behaviour in Central Europe
Differences:
Degree 2.

Pre-crisis credit growth and CA Balance

- Clear negative relationship that also apply to non-CEE
- Large diversity
Differences: Real exchange rate developments

Misalignment in the Baltics/Balkans

Appreciation hands-in-hands with catching-up in Central Europe

Stable real X-rate in Asia post crisis

Relative GDP per capita at PPP (percentage points)
Differences: Composition of capital flows

NFA as percentage of GDP, 2006-2008

- Direct investment
- Portfolio investment
- Other investment

Mostly FDI in central Europe
Mostly credit in Baltic countries
Differences: Composition of FDI

Large part of manufacturing, infrastructure, trade in central Europe

Bulgaria: little manufacturing

Large part of real estate, finance in Baltic region
Summing up

- Integration led emerging Europe to embark on an uncommon path
  - Downhill capital flows
  - Credit booms
- But also major differences across countries
  - 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
  – Initial conditions (significant role of development level)
  – Exchange rate regimes (floaters more successful)
  – Financial regulation
  – Structural policies e.g. infrastructure investment, competition (entry) play important role in shaping allocation of capital
  – Fiscal policy
Which were the important factors? (2)

- **Exchange rate policy**: crucial role, both before and after the crisis
- **Financial stability**: financial integration is a major channel for transmitting shocks; domestic financial regulation and supervision have delicate trade-offs and little room in a financially integrated environment; lending prospects?
- **Fiscal policy**: generally adequate, but pro-cyclical and little demand management to contain pre-crisis credit growth; future pro-cyclicality should be avoided
- **Overall policy mix**: importance of macro stability
- **EU institutional framework**: not well designed for catching-up economies and for crisis management
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)

<table>
<thead>
<tr>
<th></th>
<th>All CESEE</th>
<th>EU</th>
<th>non-EU</th>
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<tbody>
<tr>
<td></td>
<td>Float</td>
<td>Fix</td>
<td>Float</td>
</tr>
<tr>
<td>Credit/GDP, change from 2004 to 2008 (percentage points)</td>
<td>20.5</td>
<td>32.8</td>
<td>20.7</td>
</tr>
<tr>
<td>Real interest rate, average of 2004-2008 (percent)</td>
<td>1.6</td>
<td>-1.6</td>
<td>1.4</td>
</tr>
<tr>
<td>Current account balance/GDP, 2007 (percent)</td>
<td>-6.6</td>
<td>-11.8</td>
<td>-6.7</td>
</tr>
<tr>
<td>Inflation, average of 2004-2008 (percent)</td>
<td>5.5</td>
<td>5.4</td>
<td>4.7</td>
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More credit, less real interest, more CA deficit, more inflation in fixers
## Differences between floaters and fixers (2)

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

More FDI in FIRE sectors, more external debt, larger crisis response in fixers
Will internal adjustment work in currency board countries? (1)

Unit labor costs: Latvia vs Czech Republic (1999Q1=100)
Will internal adjustment work in currency board countries? (2)

Average nominal monthly wages, 2001 Q1 – 2010 Q3; sa

- **Estonia**
  - State
  - Private Estonian

- **Latvia**
  - Public sector
  - Private sector

- **Lithuania**
  - Public sector
  - Private sector

- **Bulgaria**
  - Public sector
  - Private sector
Will internal adjustment work in currency board countries? (3)

How to evaluate recent current account surpluses?

1. Disappearance of unsustainable consumption and investment booms
2. Financing constraints
3. Negative output gap
Legacies in currency board countries

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

+ External environment: slower growth in EU-15; deleveraging; more differentiation; financial regulation
Implications of euro-area crisis

Policy issues (long been known, but not well addressed):

• Public finance: sustainability, contingent liabilities; pricing of default; crisis resolution;
• Excessive imbalances; competitiveness crises; lack of sufficiently binding mechanisms for economic policy coordination;
• Asset price divergences and private sector debt accumulation;
• Discrepancy between banking sector integration and the weaknesses of the EU framework for regulation, supervision, and crisis resolution
Will the euro-area break-up?

Seeming anomaly: break-up predictions and high interest rate spreads in periphery countries versus strong euro

Exchange rate of the euro against the US dollar and the purchasing power parity (PPP) conversion rate, 4 January 1999 – 29 November 2010
Exchange rate policy implications

- Maastricht criteria vs Optimum Currency Area criteria
- National exchange rate policies
- Crisis management
- EU Surveillance
Exchange rates and euro membership

- **Case for dual-track approach**
  - Stronger case for floating exchange rates along catching-up (emerges from both non-euro and euro experience)
  - Membership strategy for countries with strong fixing track record
- **Revisit criteria for euro accession**
  - Inflation criterion less and less sensible (adopt better definition of “three best performers”: three countries whose performance is closest to euro-area average)
  - Emphasise sustainability condition/OCA
- **Strengthen surveillance within and outside the euro area**
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
Relevant facts

- Opening of the capital account: a rule of the game in the EU; deep financial integration
- Reliance on massive imports of capital (only 4 countries could avoid skyrocketing external (private) debt)
- Bank credit: the overwhelming source of external funding
- Financial integration: major channel for transmitting shocks (CESEE region hardest hit by the crisis)
- But no meltdown of financial systems
Financial integration, but:
• Restricted access to liquidity when markets froze…
• ECB collateral and swap policy: one-sided
• Contagion fears
• National choices remain important, in spite of a ‘single market’
• Cross-border banking resolution issues
Why no meltdown?

- The pre-crisis state of banking system
- Multilateral responses (conditional lending; frontloading of EU funds)
- The “Vienna Initiative”
- The rescue packages for parent banks and EU’s political commitment that parent bank rescue should benefit subsidiaries as well
Cross-border bank ownership and financial stability

• Exposure to CESEE region
• Inconsistencies of the EU framework: cross border operations while regulation & supervision (R&S) and fiscal choices are national
• Tense home- and host country regulators/supervisors relationship (distribution of tasks; limited ability of host authorities to protect national markets; the balance of power in Colleges)
• Inadequate burden-sharing arrangements
• ESRC and the three Authorities: move in the right direction; as well as EMU/EU governance
• But the content of R&S is essential as is dealing with the burden-sharing arrangements issue
Policy options: 4 core issues

- Lending prospects and economic recovery (effects of deleveraging)
- Crisis resolution
- Manage liquidity and solvency risks
- Combat boom and bust creating lending
Credit to the private sector (in fixed exchange rate CESEE), September 2008 = 100
Fiscal sustainability

Fiscal policy reaction: huge adjustment in CESEE

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

<table>
<thead>
<tr>
<th></th>
<th>Nominal percent change</th>
<th>Real percent change</th>
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<tbody>
<tr>
<td></td>
<td>2008</td>
<td>2009</td>
</tr>
<tr>
<td>CESEE-17</td>
<td>19.2</td>
<td>0.5</td>
</tr>
<tr>
<td>EU-15</td>
<td>6.3</td>
<td>5.4</td>
</tr>
<tr>
<td>Asia-6</td>
<td>14.2</td>
<td>6.9</td>
</tr>
<tr>
<td>Latam-8</td>
<td>20.8</td>
<td>13.0</td>
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</table>

*EU-15: increase in real expenditures in 2009*

*Asia and Latam: little adjustment*
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
Cost of insurance against government default was not related to government debt.
Cost of insurance against government default was related to external debt in 2009.
Government debt/GDP levels in 2007 in CESEE countries that turned to IMF in 2008/09

<table>
<thead>
<tr>
<th>Country</th>
<th>Debt/GDP</th>
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<tbody>
<tr>
<td>Armenia</td>
<td>16</td>
</tr>
<tr>
<td>Bosnia and Herzegovina</td>
<td>19</td>
</tr>
<tr>
<td>Georgia</td>
<td>22</td>
</tr>
<tr>
<td>Hungary</td>
<td>66</td>
</tr>
<tr>
<td>Latvia</td>
<td>9</td>
</tr>
<tr>
<td>Romania</td>
<td>13</td>
</tr>
<tr>
<td>Serbia</td>
<td>34</td>
</tr>
<tr>
<td>Ukraine</td>
<td>13</td>
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</tbody>
</table>
Government debt/GDP levels in the year before some recent government defaults

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<thead>
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<tbody>
<tr>
<td>Argentina</td>
<td>45</td>
</tr>
<tr>
<td>Russia</td>
<td>54</td>
</tr>
<tr>
<td>Ukraine</td>
<td>37</td>
</tr>
</tbody>
</table>

Source: Sturzenegger and Zettelmeyer, 2006
Expenditure and revenue ratios, GDP growth

CESEE-17

EU-15

- Real GDP growth rate
- Revenues/GDP (right scale)
- Expenditures/GDP (right scale)
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) → 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.

GDP

Pre-crisis output path
Scenario 1: GDP
Scenario 2/a: GDP
Scenario 2/b: GDP

Debt/GDP

Scenario 1: Debt/GDP
Scenario 2/a: Debt/GDP
Scenario 2/b: Debt/GDP

Primary balance/GDP

Scenario 1: Primary balance/GDP
Scenario 2/a: Primary balance/GDP
Scenario 2/b: Primary balance/GDP
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
- Ability to tax is not affected; 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
- Role of the EU: should support counter-cyclical fiscal policy
• Benefits of integration model conditional on national policies
• But EU responsibility: incentivise good national policies, help focus the policymakers’ attention on the important
• Positives
  – Single market: market access, mobility of technology, capital and labour
  – EU transfers
  – Institutional and policy anchoring (avoidance of costly first-order policy mistakes)
  – Crisis management initiatives (Vienna initiative, financial assistance) – but no ECB support
The negatives

- **No coherent growth strategy**
  - Instruments (structural funds), but growth policy (Lisbon) often ill-suited to emerging economies, and ineffective

- **Fiscal focus**
  - Too often, implicit assumption that all what you need is only to keep your fiscal house in order

- **Too benign view of capital market integration**
  - Micro: risks of misallocation of capital underestimated
  - Macro: destabilising capital flows and foreign currency borrowing not considered an issue

- **Fatal attraction of monetary union**
  - Euro membership as holy grail, rather than case-by-case approach to exchange-rate regime choice
Lessons to learn

• Preserve integration model of growth
  – Cost of ditching it would be significant
• But reform it
  – More emphasis on supply-side conditions
  – More economic (less legalistic) approach of integration
  – Get the framework right: proper incentives & surveillance
• Emphasise conditions for successful financial integration
• Review conditions for euro membership
• Design better crisis resolution mechanism
Growth model is not broken, but it needs to be fixed
Thank you for your attention

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