Growth Patterns and Challenges in the Eastern Member States (EMS) of the European Union

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Introduction

The framework of presentation:

1. Sharply changing external environment for EMS
2. Rapid but country specific convergence to EU27 averages
3. Short-term growth performance driven by long-term competitiveness changes, policy adjustments and external conditions

The questions to answer:

1. What are the similarities and differences in short-term growth outlook of EMS?
2. What are the main risks to growth?
3. What are the policy implications?

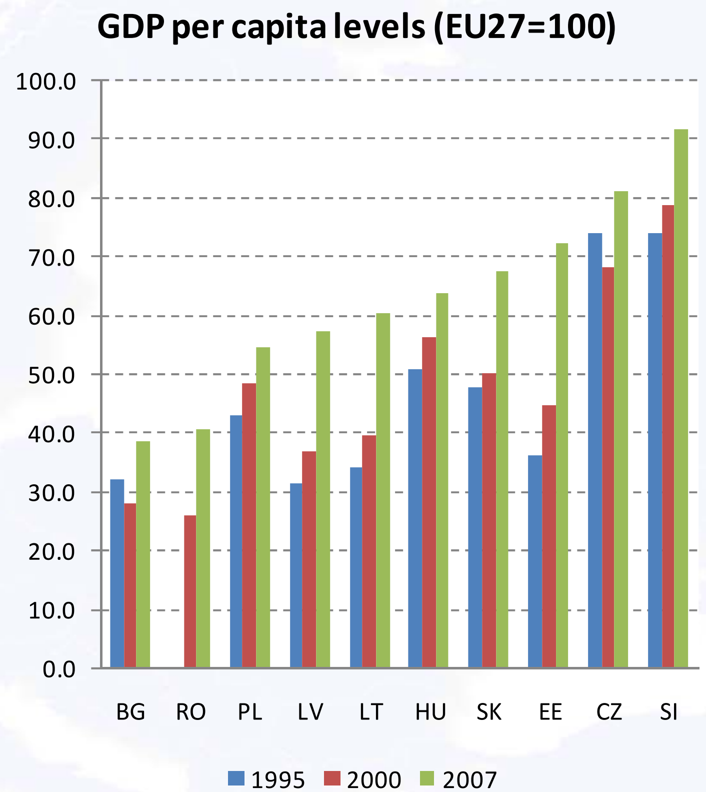
The structure of presentation

1. Long-term patterns of growth in the EMS
2. The short-term growth patterns: 2007-2008
3. The main risks to growth
4. The common and country group specific policy issues

I. Long-term patterns of growth in the EMS

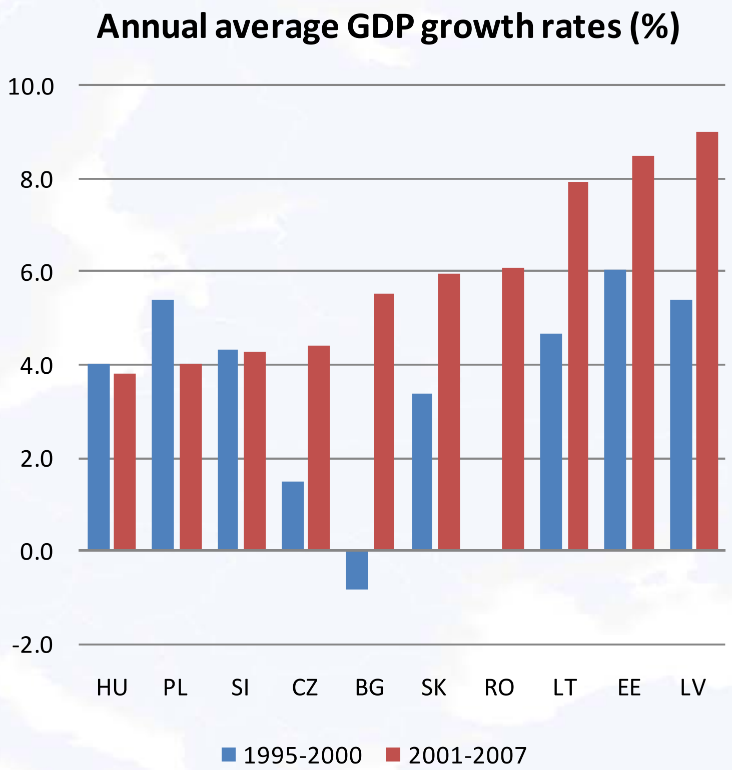
Economic growth (1)

- Eastern EU Member states converged to EU average since mid 1990s
- Average convergence amounted to 15 pp between 2000 and 2007 but the gap in most countries remained significant
- The speed and timing of convergence has strong country specific features
- Most EMS countries need 20-30 yrs to reach EU average



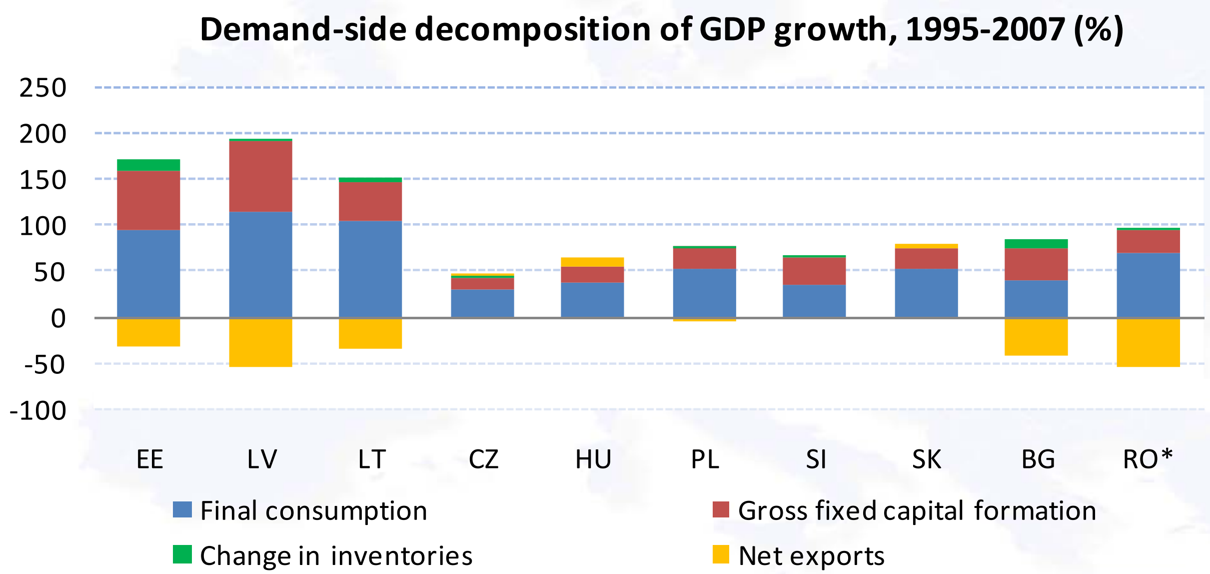
Economic growth (2)

- Economic growth accelerated in 2000-2007 in many countries (vs 1995-2000)
- Average growth was higher in the Baltic States than in CEE-5
- Bulgaria and Romania were between the two groups
- Speed of convergence and initial income levels in appropriate relationship



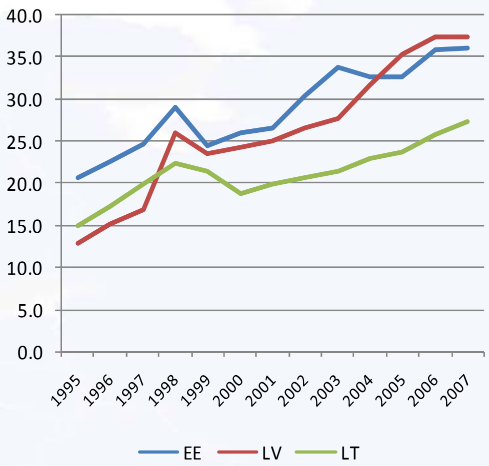
Demand side

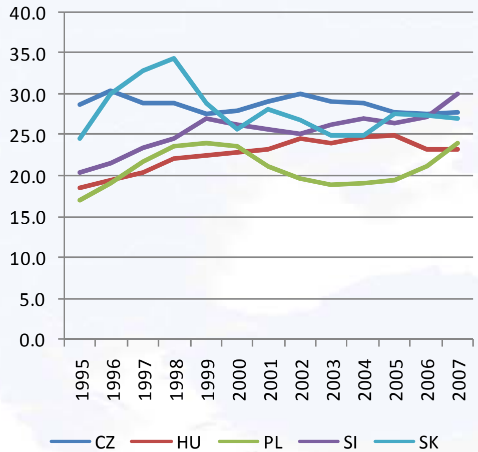
- Different factors explain growth on the demand side
- Baltic States: significant negative impact of net exports; higher growth rate of private consumption and investments
- CEE-5: net exports in balance; lower growth rate of domestic demand
- Bulgaria and Romania: rising domestic demand accompanied by negative net exports



Investment/GDP

- GFCF/GDP ratio increased to relatively high level in the Baltic States
- CEE-5: 20-30% (low)
- In other emerging coutries (in Asia) investment ratios were higher
- Capital played small role in growth (in CEE-5)
- Bulgaria+Romania: growing high (~30%) from low level



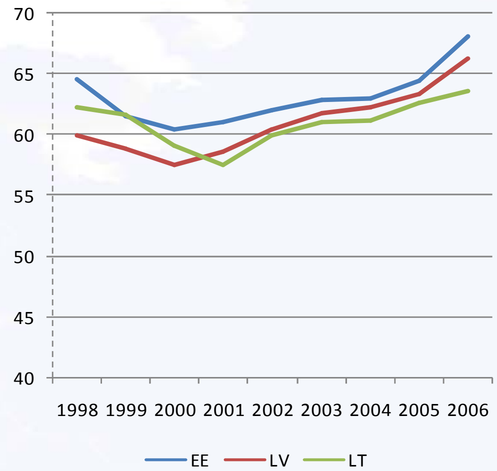


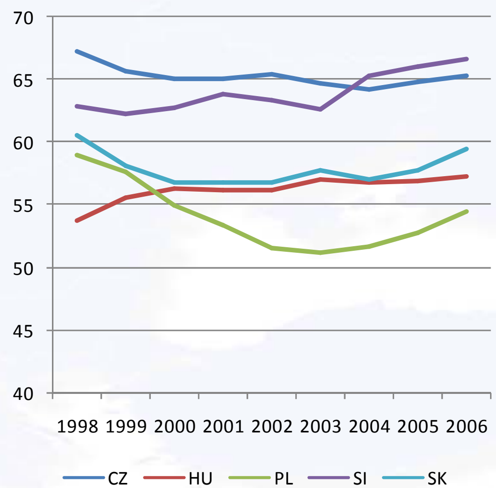
Employment

- Emploment rate increased in Baltic states since 01/02 employment growth contributed to economic growth

- In CEE-5 countries employment stagnated (jobless growth)

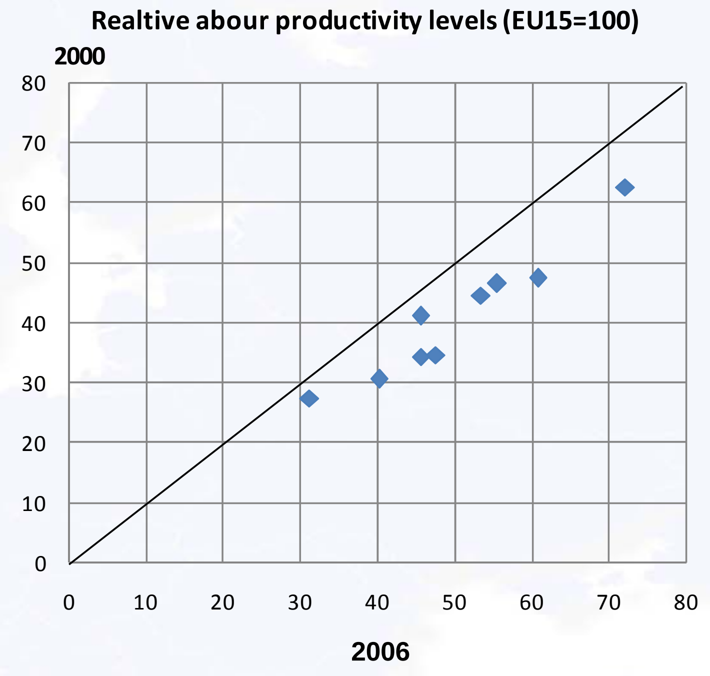
- Besides, empoyment rates are generally lower
- Bularia+Romania: low employment rate, but improving





Productivity

- Labour productivity improved
- Total factor productivity played key role in economic growth
- Transition caused that type of growth – what happens when transition is over? (is this growth sustainable?)



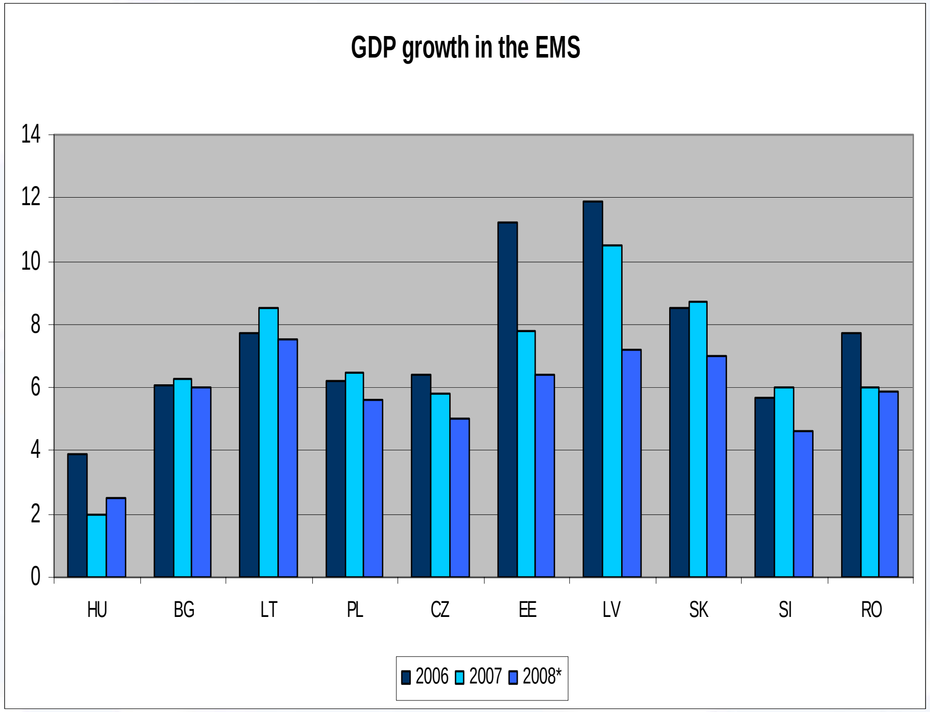
II. The short-term growth patterns: 2007-2008

Mixed growth performance in EMS

Country differences in long-term convergence also appear in the short-term growth

The EMS can be divided to three main country groups:

- GROUP I (RO, SI, SK and EE, LV): decelerating but still high growth and smaller overheating
- GROUP II (BG, CZ, PL, LT) fast and almost unaffected growth
- GROUP III (HU): Gradual recovery from stabilisation driven recession



Trends in growth performance

While rates differ, composition of growth reveals similarities accross countries :

- growth in 2007 and most likely in 2008 is almost exclusively driven by **domestic demand** except HU after stabilisation, SK where earlier export oriented investments mature and increase net exports
- net exports have been declining due to slowdown in export growth: slower growth in foreign demand, competitiveness problems due to wage increases (B-3) though productivity rise is still fast
- private consumption moderates: worsening consumer sentiment, increasing private sector debt and debt service, worsening net worth of households, but real employee compensation and nominal wages on rise
- public consumption either declines (HU) or remains moderate (B-3) due to fiscal constraints
- private investment started to reflect worsening external demand conditions and tighter financing conditions

III. The main risks to growth

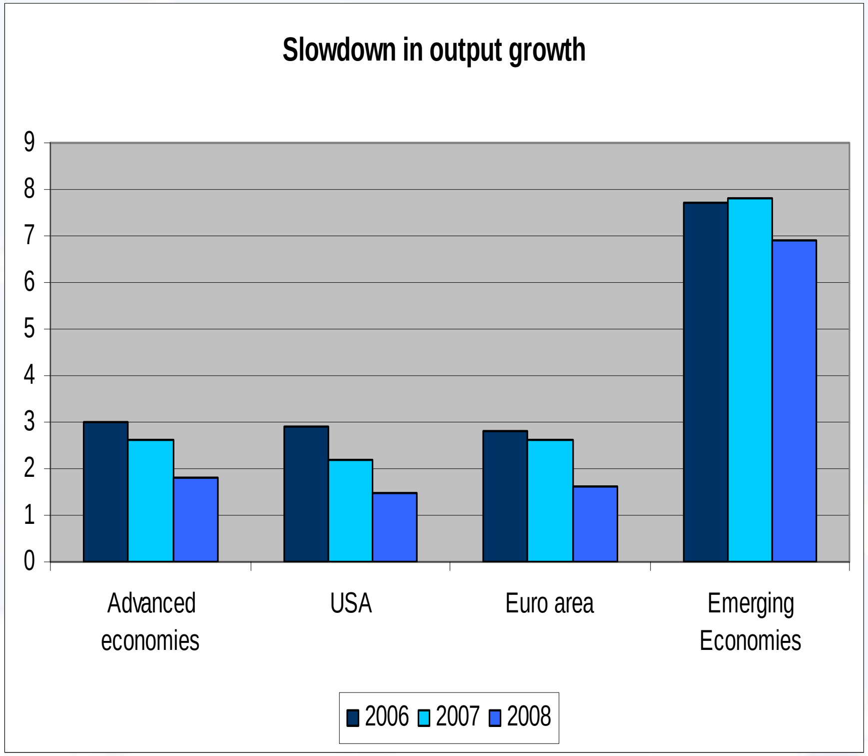
1. Exposure to external shocks

The good news:

- overall less credit growth
- lower exposure to US markets and financial shocks
- stable banking sector

The difficulties:

- some countries exposed to changing investor sentiment
- rise in risk premium
- enhanced exchange rate and asset price volatility
- some EMS are stronger integrated with the Euro-zone, which is expected to slowdown above the slowdown in advanced economies, with its negative effect on export dynamics



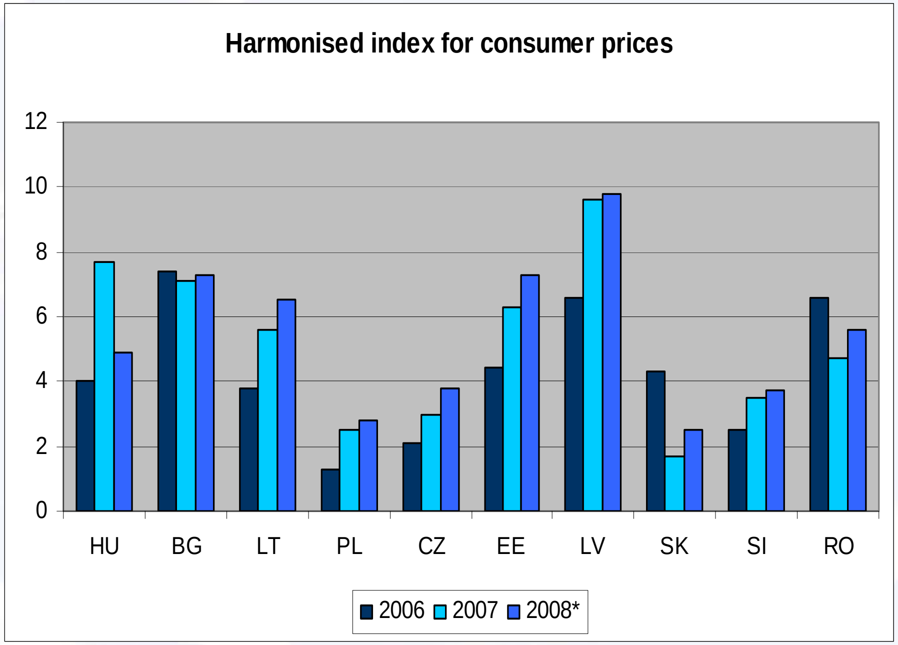
2. Accelerating Inflation

Inflation is peaking:

- rise in oil and food prices, part of which is permanent
- credit growth and rise in domestic demand
- labour market shortages and rise in employee compensation, real wages and ULC
- adjustment in several countries of administrative prices as a part of price liberalisation or fiscal adjustment related subsidy reduction

Problem for growth:

- rise in inflationary expectations, which fuels back to wage, exchange rate developments
- difficult monetary arrangements: interest rate hike but slowdown and financial vulnerability, plus uncertain policy of FED and ECB
- Monetary policy inefficient in most of exchange rate arrangements to curb inflation alone, but fiscal and incomes policies are insufficiently flexible



3. Current Account Deficits

External vulnerability high :

- due to persistently high CA deficit in SEE-2 and B-3, and rising foreign debt in several countries (including HU with low CAD)
- In pegged exchange rate regimes (LV, EE, BG) CA deficit is caused by private sector dissaving, while in flexible ones the public sector contributes too
- CA deficit is financed by capital inflows, but contrary to the past only in BG, PL, CZ is FDI covering 100% the CAD, HU FPI, B-3 and SI foreign bank lending is the main driver
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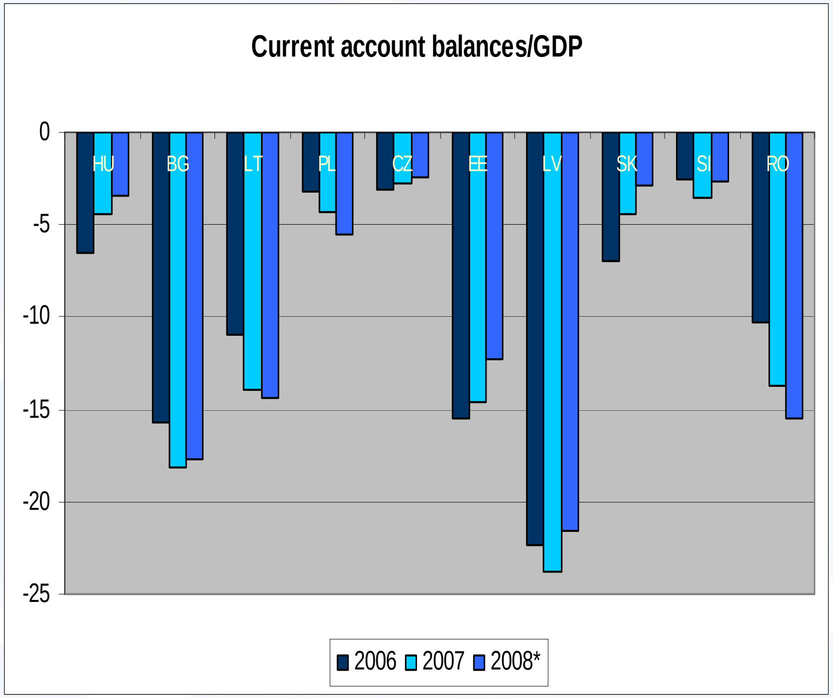
- foreign debt on rise though at different levels : 38% RO, 90% BG, HU, SI and over 100% EE, LV



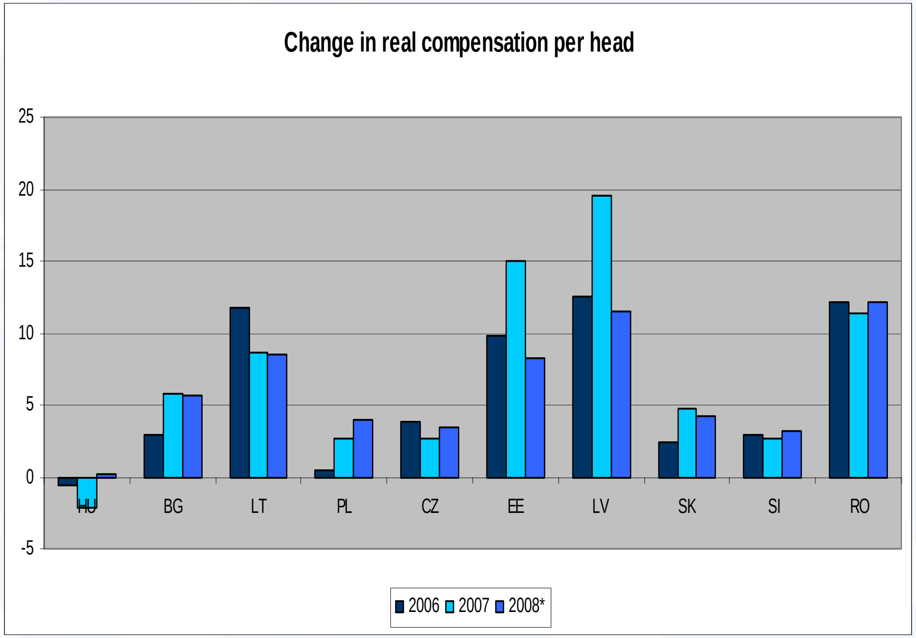
Problem for growth:

- Net FDI inflows worsen due to increased OFDI, profit repatriation and negative effect of relocation to BRIC
- Rising gross and net external foreign debt may lead to sustainability concerns, excessive exchange arte turbulence, constraint on foreign capital inflows

4. Wage pressure and labour market problems

Labour market trends:

- strong nominal wage increase, which moderated to smaller real wage increase due to higher inflation
- but ULC grows fast as productivity growth slows down
- migration, supply side shortages related to skill mismatch, lack of appropriate human skills and labour market rigidities (minimum wages, in some countries high degree of employment protection levels, etc.) maintain the wage pressure



Problem for growth:

- Rising ULC
- Competitiveness of tradable sector
- Accelerating inflation in non-tradables sector
- The hands of monetary authorities are tied small room for manouvre in incomes policy

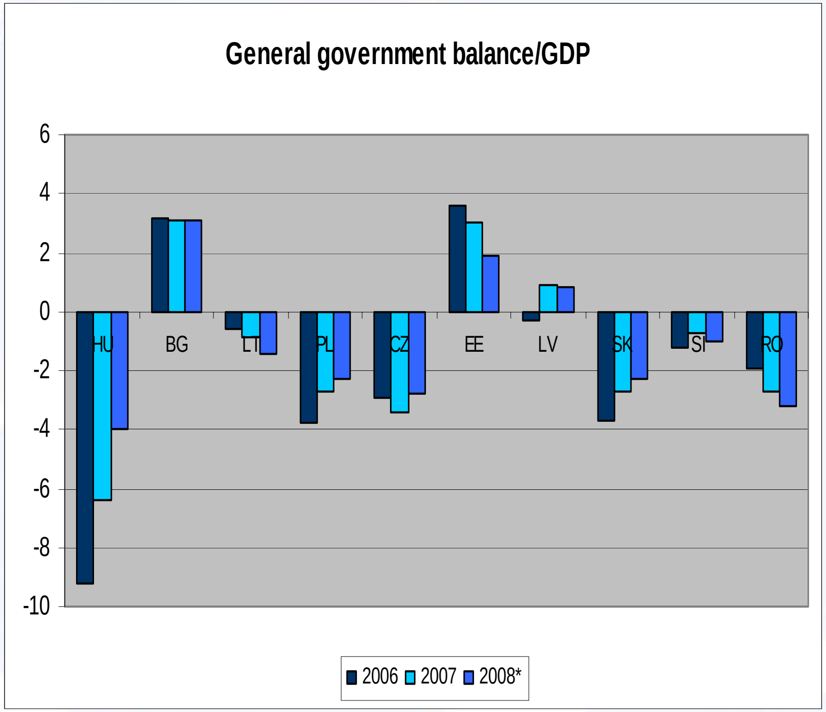
5. Fiscal stance

Fiscal trends:

- in 2007 better than expected performance due to higher revenues (income growth, higher inflation, improved tax discipline and better tax collection)
- in 2007 only HU, PL, LV, SK and SI reduced their structural deficits, while others increased it or loosened somewhat
- in 2008 fiscal balances worsen in CZ, LV, RO, LT, EE (in the latter surplus declines)
- declining debt/GDP ratios especially due to faster growth and higher revenues
- expenditures are in line only in HU, RO, CZ decline due to lower interest expenditures, or lower Ig (RO)

Problem for growth:

- EE, LV, LT, RO worsening balances amidst increasing and high CA deficits
- Expenditure reduction difficult: entitlements, wages in public sector amidst wage pressures, national contribution to SF financing high
- At the same time tax reductions: corporate income tax rate is reduced in the Czech Republic, social contribution rates go down in Poland and Romania, personal income tax rates are cut in Bulgaria, the Czech Republic, Estonia, and Hungary plans to reduce tax burden by 1,5% of GDP



IV. The common and country specific policy issues

Common policy issues

- Fiscal stance: fiscal policy altogether should be tightened in countries with unsustainable CA deficits and soaring inflation (B-3, SEE-2)
- Market reforms: deregulation, liberalisation, easing market entry in network industries to increase productivity and reduce inflationary pressures
- Labour market reforms: increased labour market flexibility, education and training sector reforms to reduce labour market mismatches and wage pressures
- Financial sector: tighter surveillance on banking sector lending to reduce excessive and unsustainable rise in private sector borrowing and exposure

Country specific policy issues

GROUP I:

- Tighten fiscal and incomes policies
- Much stronger banking sector supervision
- Monetary tightening in countries with flexible exchange rate arrangements

GROUP II:

- Supply side reforms to increase competitiveness of the tradables sector
- Curbing private sector consumption spending

GROUP III:

- Structural reforms to enhance supply and quality of labour and capital
- Firm monetary-fiscal policy mix to stabilise expectations and avoid slippages

Thank you for your attention!

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