Emerging Europe and the EU: Is the growth model broken?

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(Based on forthcoming report by Torbjörn Becker, Daniel Daianu, Zsolt Darvas, Vladimir Gligorov, Michael Landesmann, Pavle Petrović, Jean Pisani-Ferry, Dariusz Rosati, André Sapir, Beatrice Weder di Mauro)

Outline

- Questions
- Stylised facts
- Policy issues

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

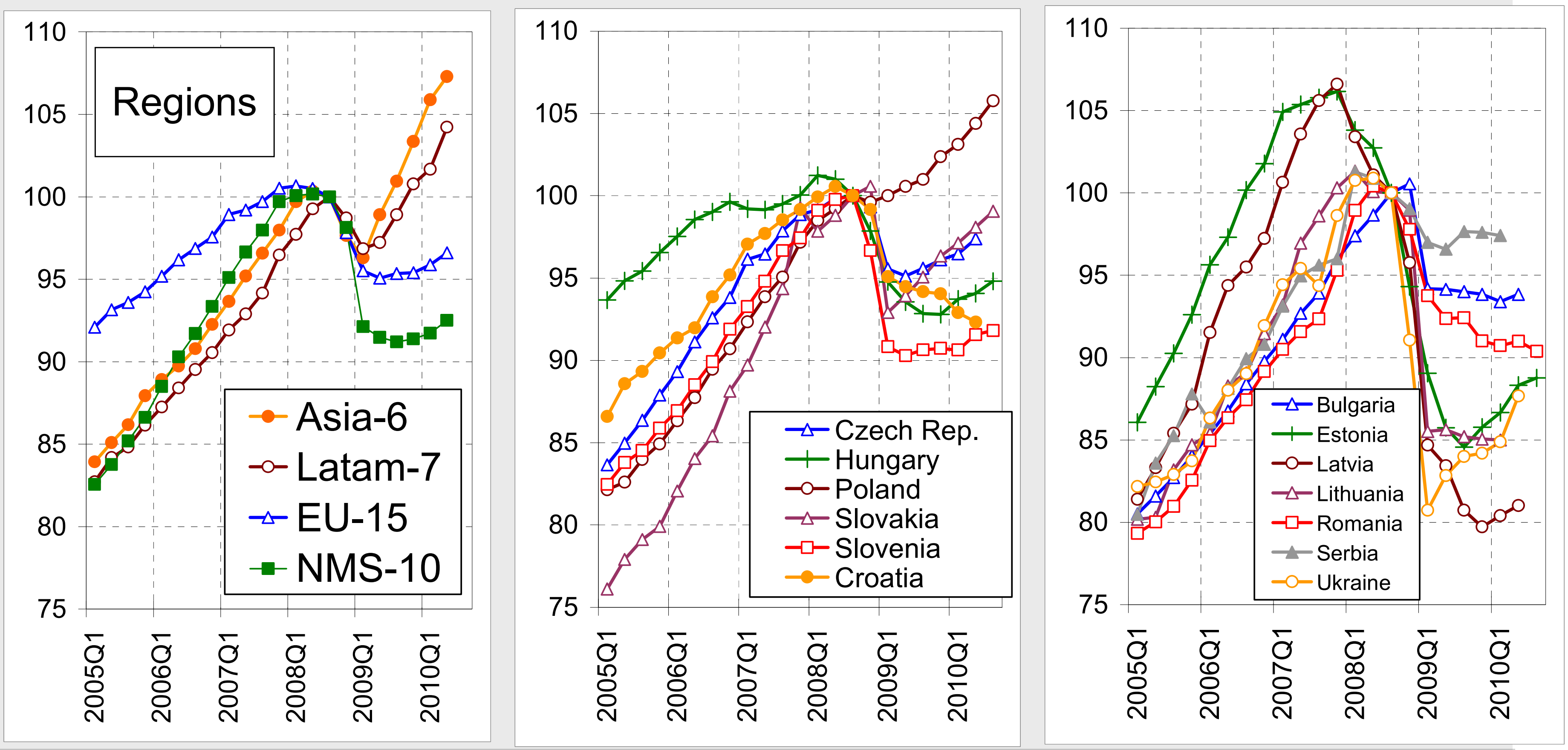
Broken?

- Crisis resulted in much more severe slowdown, weaker recovery than in the rest of emerging world (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?

Stylised facts

Starting point: severe shock and weak recovery

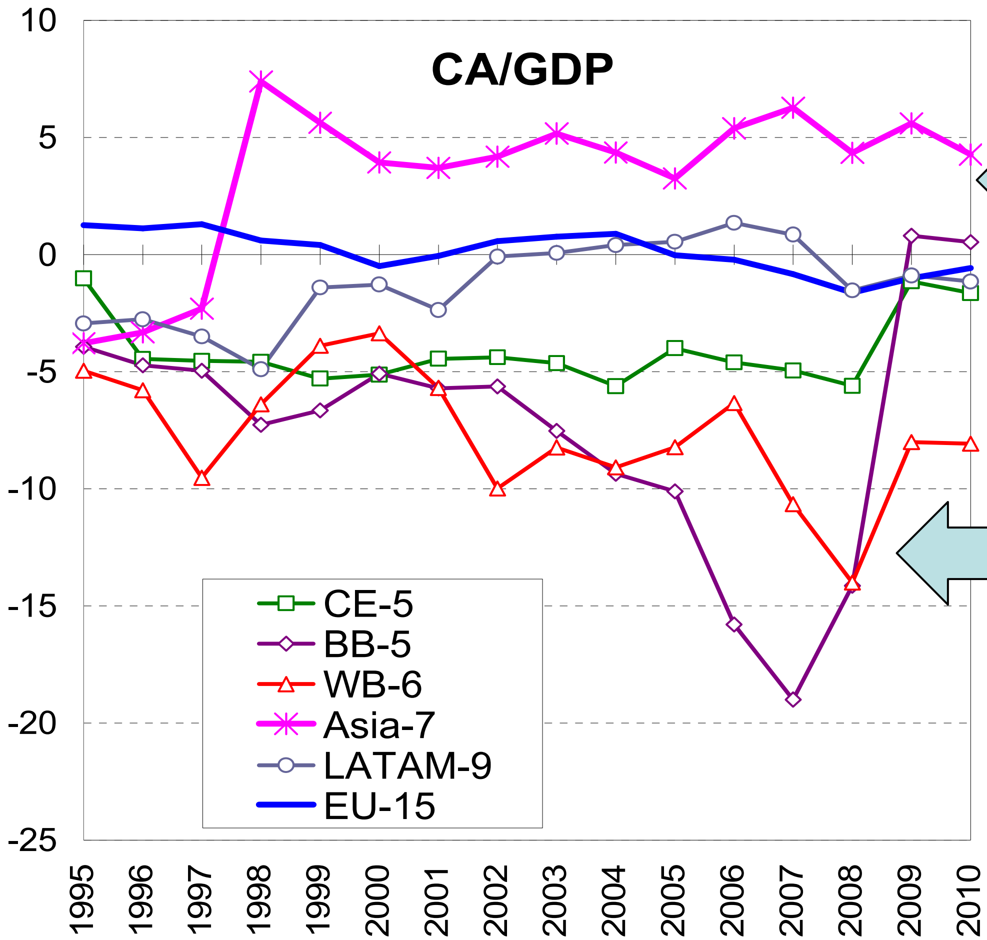
Real output, 2005-2010



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

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

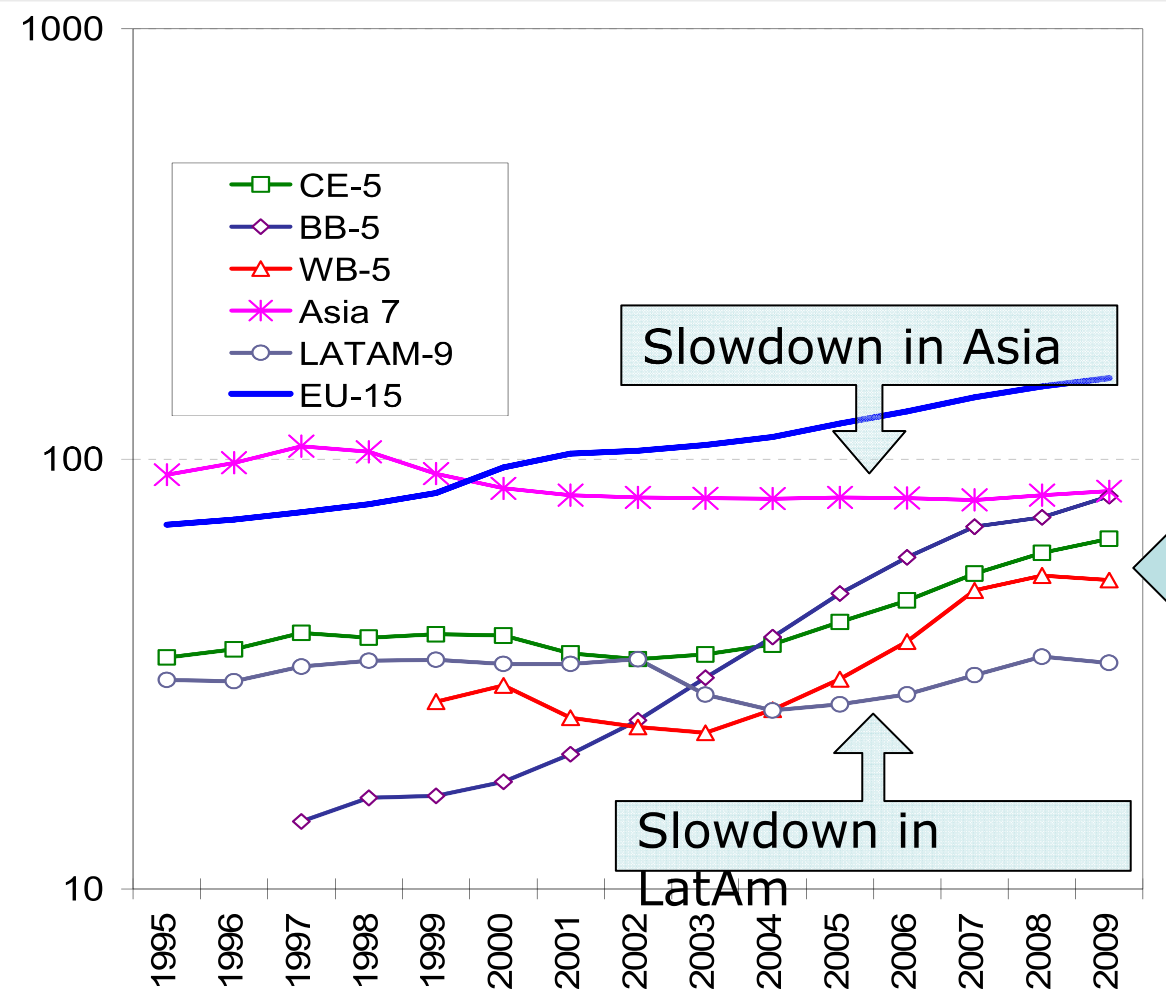
Common characteristics 1
Reliance on foreign savings



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

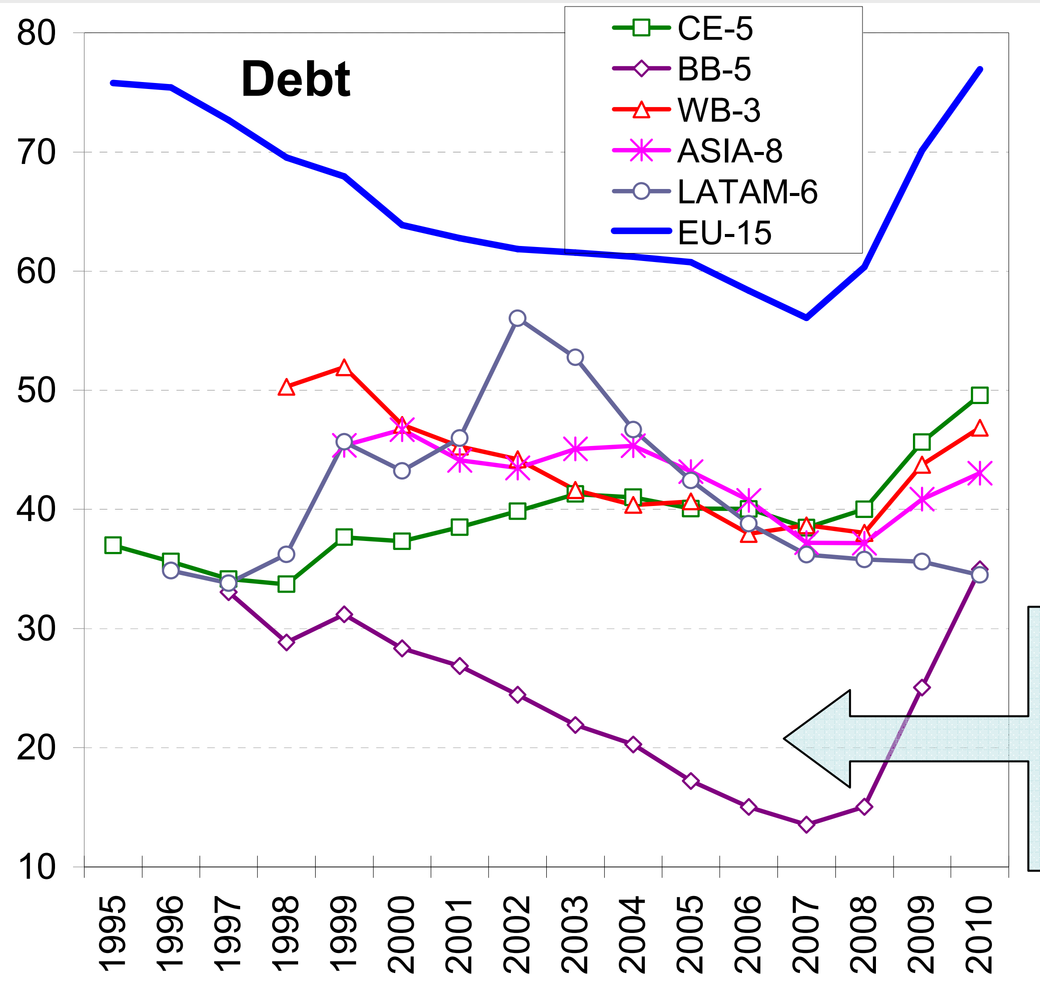
Until 2007, most of emerging Europe goes into deficit

Commont characteristics 2
Credit booms



Boom in emerging Europe (from very low levels)

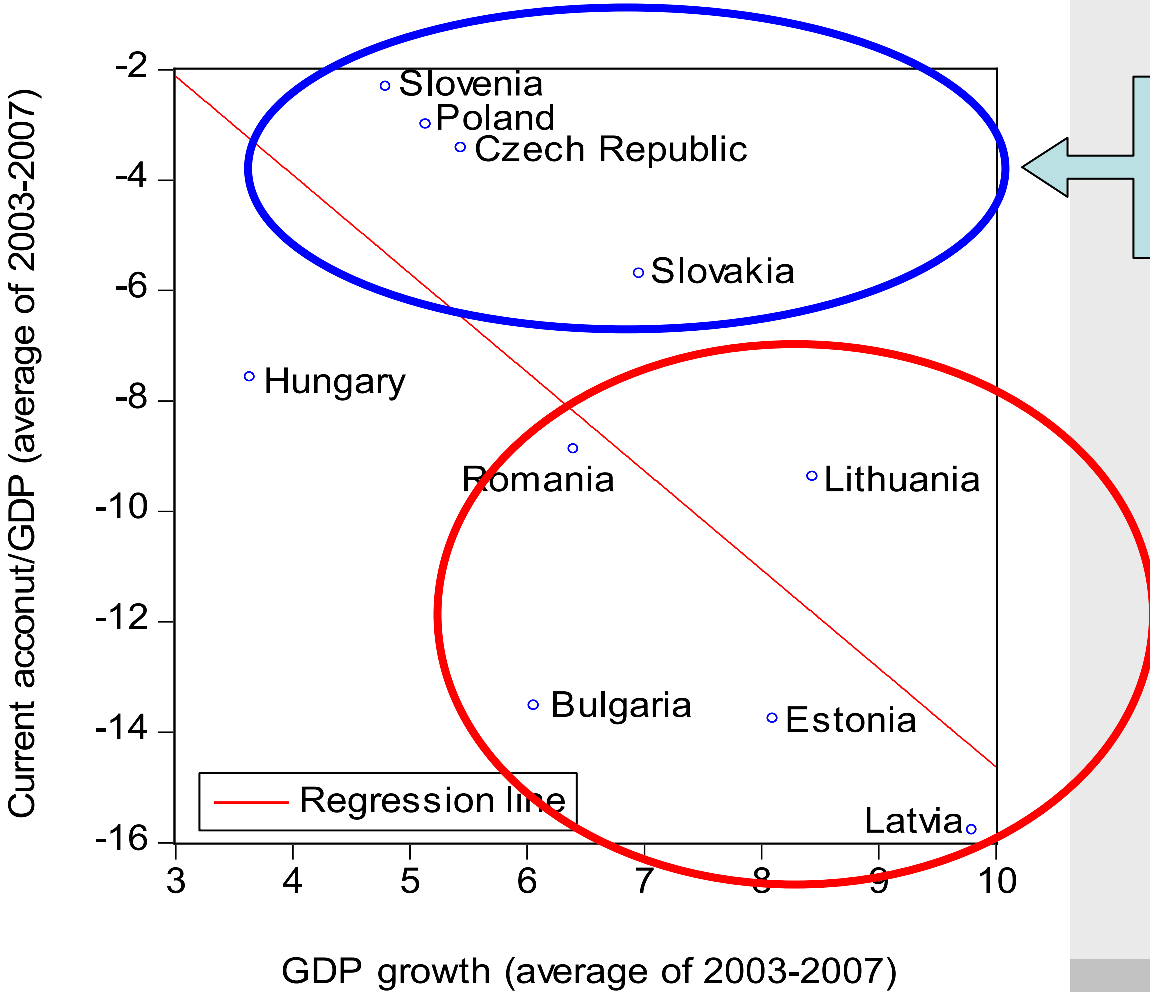
Common characteristics 3
It's not mostly fiscal!



If anything, more favourable public debt developments until 2008, especially in BB countries

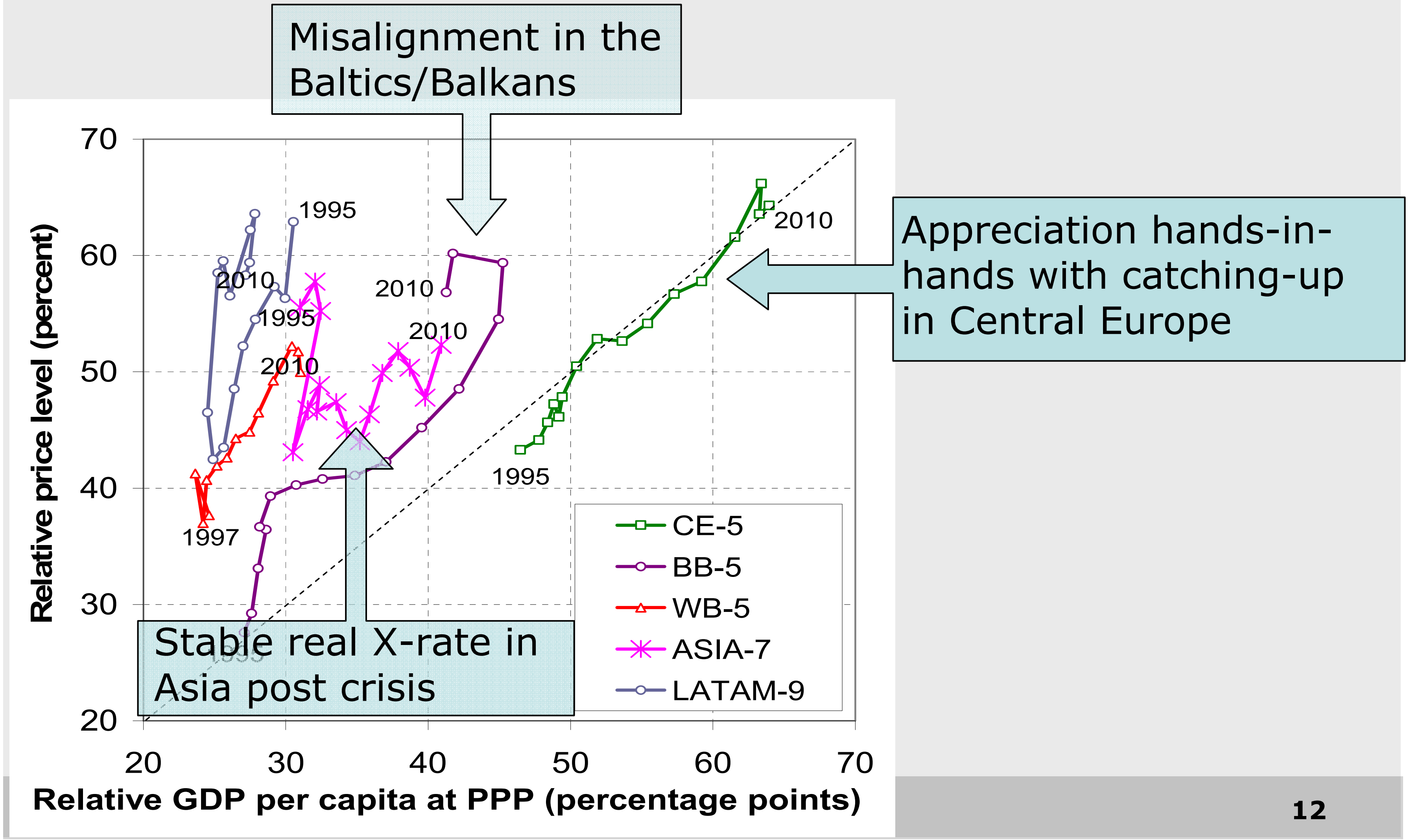
Differences 1
Degree

GDP growth and the current account, 2003-2007



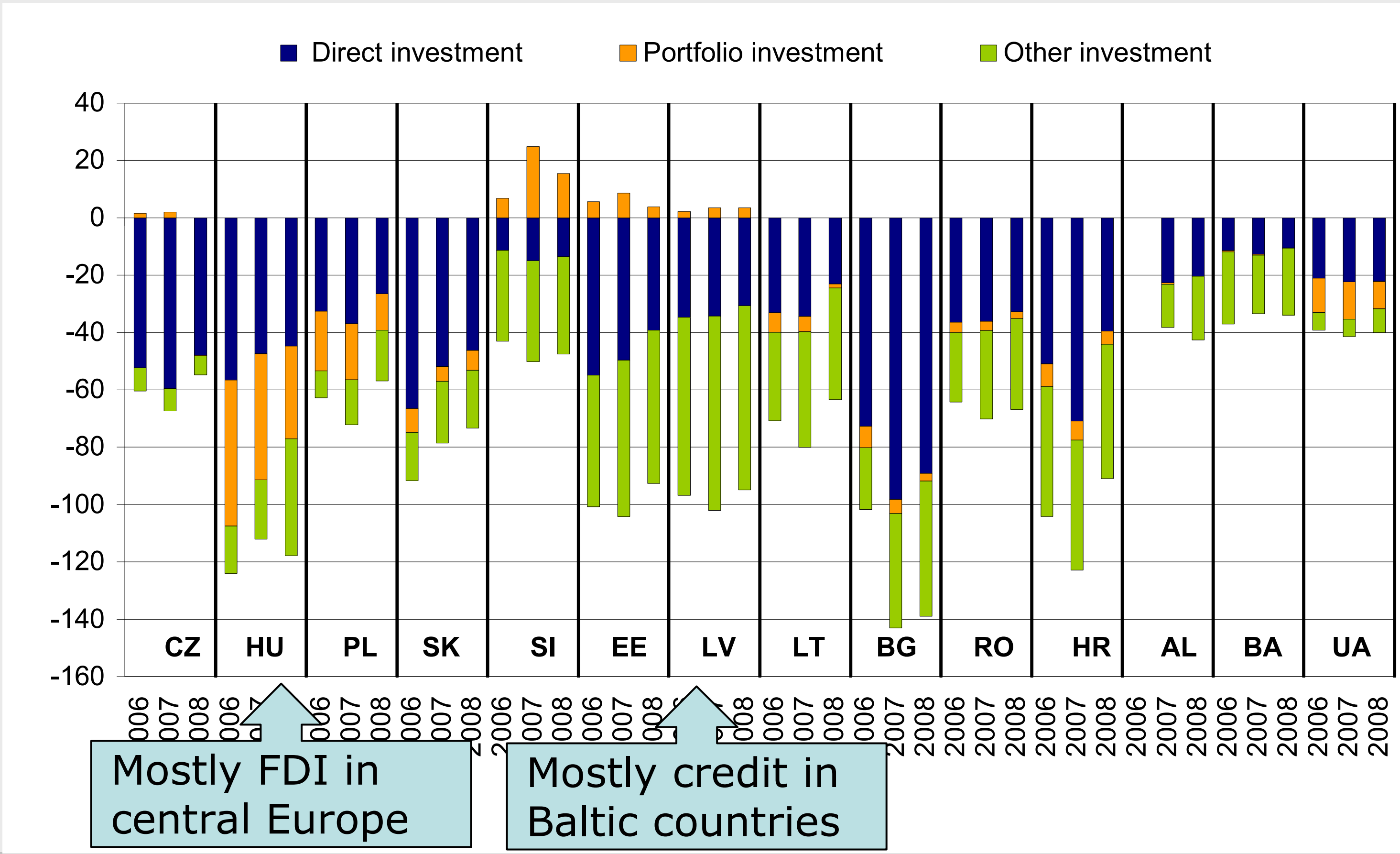
More prudent behaviour in Central Europe

Differences 2
Real exchange rate developments

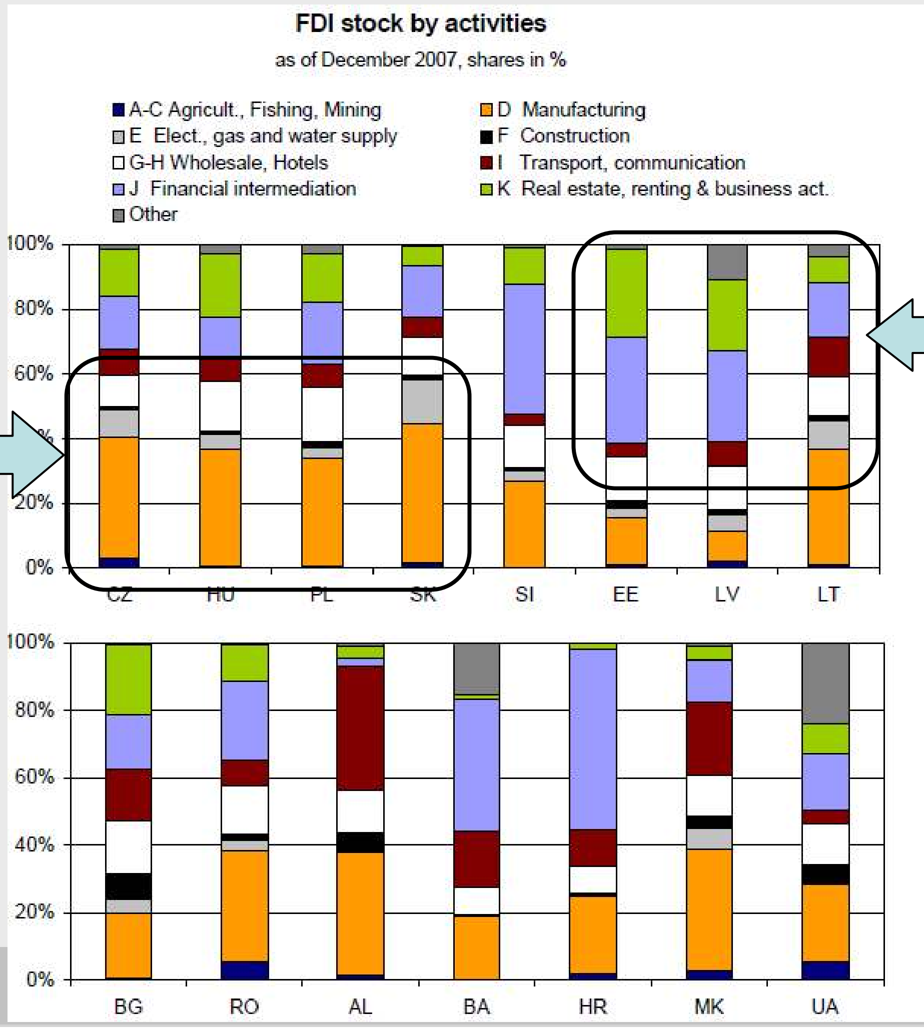


Differences 3:
Composition of capital flows

NFA as percentage of GDP, 2006-2008



Differences 4
Composition of FDI



Large part of manufacturing, infrastructure, trade in central Europe

Large part of real estate, finance in Baltic region

Summing up

- **Integration led emerging Europe to embark on 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
  - Only in part a matter of macro policy
- Other factors
  - Initial conditions (significant role of development level)
  - Exchange rate regimes (floaters more successful)
  - Financial supervision
  - Structural policies e.g. infrastructure investment, competition (entry) play important role in shaping allocation of capital
  - Taxation

The role of exchange rate policies

	CA/GDP (%) 2007	Inflation (%) average of 2004-2008	Credit/GDP (%-point) Change from 2004 to 2008	FDI to FIRE Sector (% of total FDI), 2007
EU floaters	-6.7	4.7	20.7	30.6
non-EU floaters	-13.0	7.3	20.0	5.7
EU fixers	-17.3	6.2	37.4	44.8
non-EU fixers	-14.1	5.6	34.8	34.4

More external deficits, more credit, more FDI in FIRE sectors among fixers

Policies
How good the EU framework?

- Benefits of integration model conditional on <u>national</u> 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 for swap agreements

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: principles/assessment/incentives rather than rules/criteria/sanctions
- Emphasise conditions for successful financial integration
- Review conditions for euro membership

Financial integration

- Issue in the short run is to manage deleveraging cycle under way in large part of the region
- 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
  - Borrowing in foreign currency

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. Rather, adopt better definition of “three best performers” (three countries whose performance is closest to euro-area average)
  - Emphasise sustainability condition
- Strengthen surveillance within euro area

Conclusions

It’s not broken, but it needs to be fixed

Appendix

The country groups

- **CE-5:** Czech Republic, Hungary, Poland, Slovakia and Slovenia
- **BB-5:** Bulgaria, Estonia, Latvia, Lithuania and Romania
- **WB-6:** Albania, Bosnia and Herzegovina, Croatia, Former Yugoslav Republic of Macedonia, Montenegro and Serbia
- **EU-15**
- **Asia-6:** Indonesia, Korea, Malaysia, Philippines, Taiwan and Thailand
- **Latam-8:** Argentina, Brazil, Chile, Columbia, Ecuador, Mexico, Peru and Uruguay