Adjusting Exit Strategies to the Needs of New Member States

Zsolt Darvas

Workshop
‘The Impact of the Crisis on the New Member States - Non-Eurozone New Member States‘
EPP Group, CRIS Committee
9 December 2010
Countries in Central and Eastern Europe (including new EU Member States) have been hit the hardest by the crisis among all regions of the world and recovery is weak.

Yet the “worst problems from past crises”, such as currency overshooting, bank runs and banking system collapse, have been avoided.

Although huge affect on average, but substantial variation across countries.

Less benign external environment: slower growth in EU-15; deleveraging; more differentiation; financial regulation; euro-area crisis.
Starting point: severe shock and weak recovery in NMS

GDP, 2008 Q3 = 100 (2005 Q1–2010 Q3)

Asia-6: Indonesia, Korea, Malaysia, Philippines, Taiwan and Thailand
Latam-7: Argentina, Brazil, Chile, Columbia, Ecuador, Mexico and Uruguay
Growth before the crisis

• 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
Has the growth model broken?

• Elsewhere (Asia, Latin America) such crises in the past decades led to major questioning and policy changes

• Questions:
  – 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?
  – Exit from the crisis and invigorating growth
Two different clusters within NMS

1. Central Europe: Czech Republic, Hungary, Poland, Slovakia and Slovenia
2. Baltics/Balkans: Bulgaria, Estonia Latvia, Lithuania, and Romania

• Differences across countries
  – Same overall developments, but different degree
  – External imbalances & indebtedness; domestic credit booms; housing booms
  – Composition of capital flows & composition of FDI
  – Unit labour costs/real exchange rates
  – Export performance
Composition of the stock of FDI  
2007, percent of total stock

<table>
<thead>
<tr>
<th>Sector</th>
<th>Latvia</th>
<th>CZ, HU, PL, SK, SI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manufacturing</td>
<td>9</td>
<td>38</td>
</tr>
<tr>
<td>Finance + Real estate</td>
<td>47</td>
<td>32</td>
</tr>
<tr>
<td>Other sectors</td>
<td>45</td>
<td>30</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>
Unit labour costs: Latvia vs Czech Republic (1999Q1=100)

- Total economy
- Manufacturing (D)
- Construction (F)
- Trade, transport and communication (G_I)
- Financial and business services (J_K)
‘Internal devaluation’: will it work?

Average nominal monthly wages, 2001 Q1 – 2010 Q3; s.a.
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); geographic closeness; size
  – 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

**EU institutional framework:** not well designed for catching-up economies and for crisis management
### Fiscal and monetary policies during the crisis

<table>
<thead>
<tr>
<th>Country</th>
<th>Fiscal policy</th>
<th>Monetary policy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>consolidation</td>
<td>currency board</td>
</tr>
<tr>
<td>Estonia</td>
<td>consolidation</td>
<td>currency board</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>stimulus</td>
<td>loosening</td>
</tr>
<tr>
<td>Hungary</td>
<td>consolidation</td>
<td>tightening</td>
</tr>
<tr>
<td>Latvia</td>
<td>consolidation</td>
<td>quasi currency board</td>
</tr>
<tr>
<td>Lithuania</td>
<td>consolidation</td>
<td>currency board</td>
</tr>
<tr>
<td>Poland</td>
<td>stimulus</td>
<td>loosening</td>
</tr>
<tr>
<td>Slovakia</td>
<td>automatic stabilisers</td>
<td>euro</td>
</tr>
<tr>
<td>Slovenia</td>
<td>stimulus</td>
<td>euro</td>
</tr>
<tr>
<td>Romania</td>
<td>consolidation</td>
<td>tightening</td>
</tr>
</tbody>
</table>
General government gross debt (% 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
- 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: support counter-cyclical fiscal policy and assess fiscal sustainability, instead of focusing on the 3% target
Policies: How good the EU framework?

• 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) were there, but growth policy (Lisbon) often ill-suited to emerging economies, and ineffective
  - Unused structural funds

- **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
### Some structural characteristics of NMS

<table>
<thead>
<tr>
<th></th>
<th>Quality of institutions</th>
<th>Corruption perception</th>
<th>Ease of doing business (rank)</th>
<th>Infrastructure</th>
<th>Markets</th>
<th>Employment rate (%)</th>
<th>Quality of the educational system</th>
<th>Technology access</th>
<th>Absorptive capacity</th>
<th>Creative capacity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>3.3</td>
<td>3.8</td>
<td>44</td>
<td>2.8</td>
<td>4.4</td>
<td>62.6</td>
<td>3.3</td>
<td>3.8</td>
<td>3.6</td>
<td>3.1</td>
</tr>
<tr>
<td>Czech R.</td>
<td>3.9</td>
<td>4.9</td>
<td>74</td>
<td>4.1</td>
<td>5.2</td>
<td>65.4</td>
<td>4.7</td>
<td>5.0</td>
<td>4.5</td>
<td>4.2</td>
</tr>
<tr>
<td>Estonia</td>
<td>4.9</td>
<td>6.6</td>
<td>24</td>
<td>4.4</td>
<td>5.1</td>
<td>63.5</td>
<td>4.5</td>
<td>5.5</td>
<td>4.7</td>
<td>4.4</td>
</tr>
<tr>
<td>Hungary</td>
<td>3.9</td>
<td>5.1</td>
<td>47</td>
<td>3.9</td>
<td>5.0</td>
<td>55.4</td>
<td>3.2</td>
<td>4.8</td>
<td>4.4</td>
<td>4.1</td>
</tr>
<tr>
<td>Latvia</td>
<td>4.5</td>
<td>4.5</td>
<td>27</td>
<td>3.8</td>
<td>4.9</td>
<td>60.9</td>
<td>3.7</td>
<td>4.5</td>
<td>4.5</td>
<td>3.7</td>
</tr>
<tr>
<td>Lithuania</td>
<td>4.2</td>
<td>4.9</td>
<td>26</td>
<td>4.2</td>
<td>4.8</td>
<td>60.1</td>
<td>3.7</td>
<td>4.7</td>
<td>4.5</td>
<td>4.0</td>
</tr>
<tr>
<td>Poland</td>
<td>3.6</td>
<td>5.0</td>
<td>72</td>
<td>2.8</td>
<td>4.8</td>
<td>59.3</td>
<td>3.8</td>
<td>4.4</td>
<td>4.2</td>
<td>3.6</td>
</tr>
<tr>
<td>Romania</td>
<td>3.6</td>
<td>3.8</td>
<td>55</td>
<td>2.6</td>
<td>4.7</td>
<td>58.6</td>
<td>3.6</td>
<td>4.2</td>
<td>3.8</td>
<td>3.4</td>
</tr>
<tr>
<td>Slovakia</td>
<td>3.9</td>
<td>4.5</td>
<td>42</td>
<td>3.6</td>
<td>5.2</td>
<td>60.2</td>
<td>3.4</td>
<td>5.0</td>
<td>3.9</td>
<td>3.6</td>
</tr>
<tr>
<td>Slovenia</td>
<td>4.4</td>
<td>6.6</td>
<td>53</td>
<td>4.5</td>
<td>4.5</td>
<td>67.5</td>
<td>4.4</td>
<td>4.6</td>
<td>4.9</td>
<td>4.4</td>
</tr>
<tr>
<td>NMS</td>
<td>4.0</td>
<td>5.0</td>
<td>46.4</td>
<td>3.7</td>
<td>4.9</td>
<td>61.4</td>
<td>3.8</td>
<td>4.6</td>
<td>4.3</td>
<td>3.8</td>
</tr>
<tr>
<td>EU-15</td>
<td>5.1</td>
<td>7.1</td>
<td>34.6</td>
<td>5.7</td>
<td>5.4</td>
<td>64.8</td>
<td>4.6</td>
<td>5.4</td>
<td>5.1</td>
<td>4.8</td>
</tr>
<tr>
<td>USA</td>
<td>4.9</td>
<td>7.5</td>
<td>4</td>
<td>6.1</td>
<td>6.0</td>
<td>70.9*</td>
<td>5.0</td>
<td>5.8</td>
<td>5.6</td>
<td>5.8</td>
</tr>
</tbody>
</table>
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 EU framework right: proper incentives & surveillance
- Conditions for successful financial integration
- EU should support counter-cyclical fiscal policy
- Review conditions for euro membership
- Design better crisis resolution mechanism