Adjusting Exit Strategies to the Needs of New Member States

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Workshop
'The Impact of the Crisis on the New Member States - Non-Eurozone New Member States'
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Impact of the crisis on New Member States

- 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

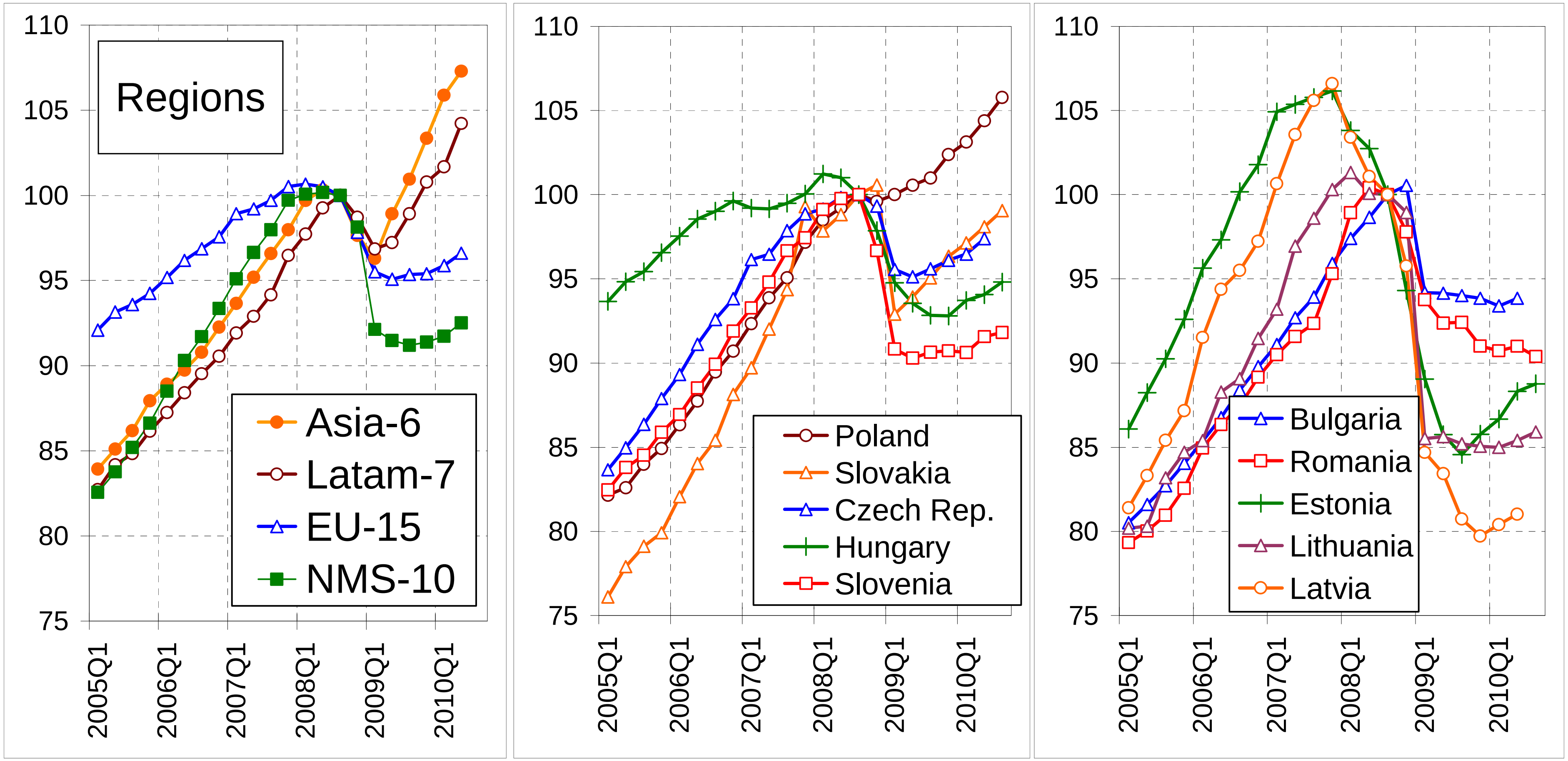
- Yet the “worst problems from past crises”, such as currency overshooting, bank runs and banking system collapse, have been avoided

- 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

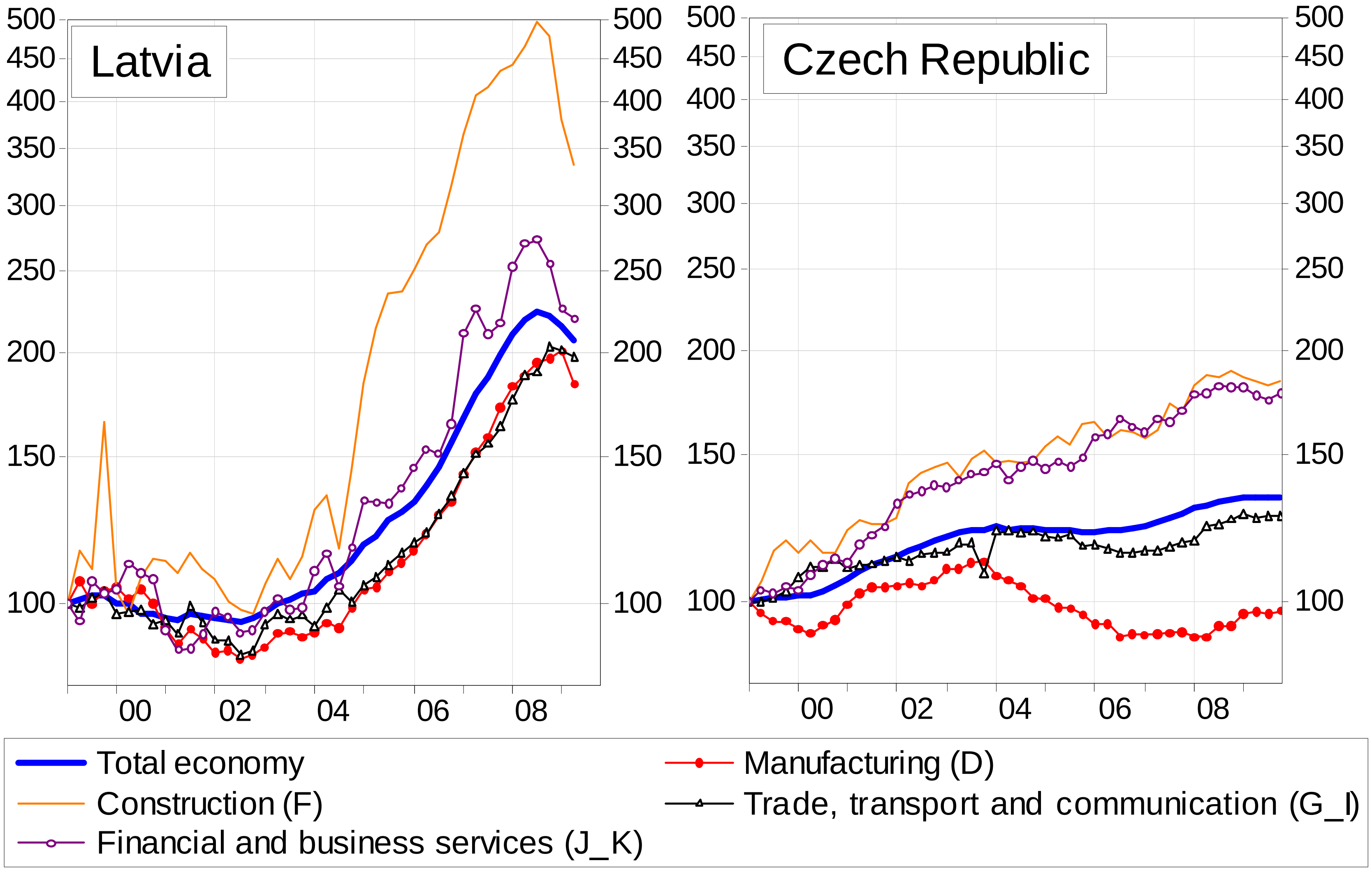
Composition of FDI

Composition of the stock of FDI

2007, percent of total stock

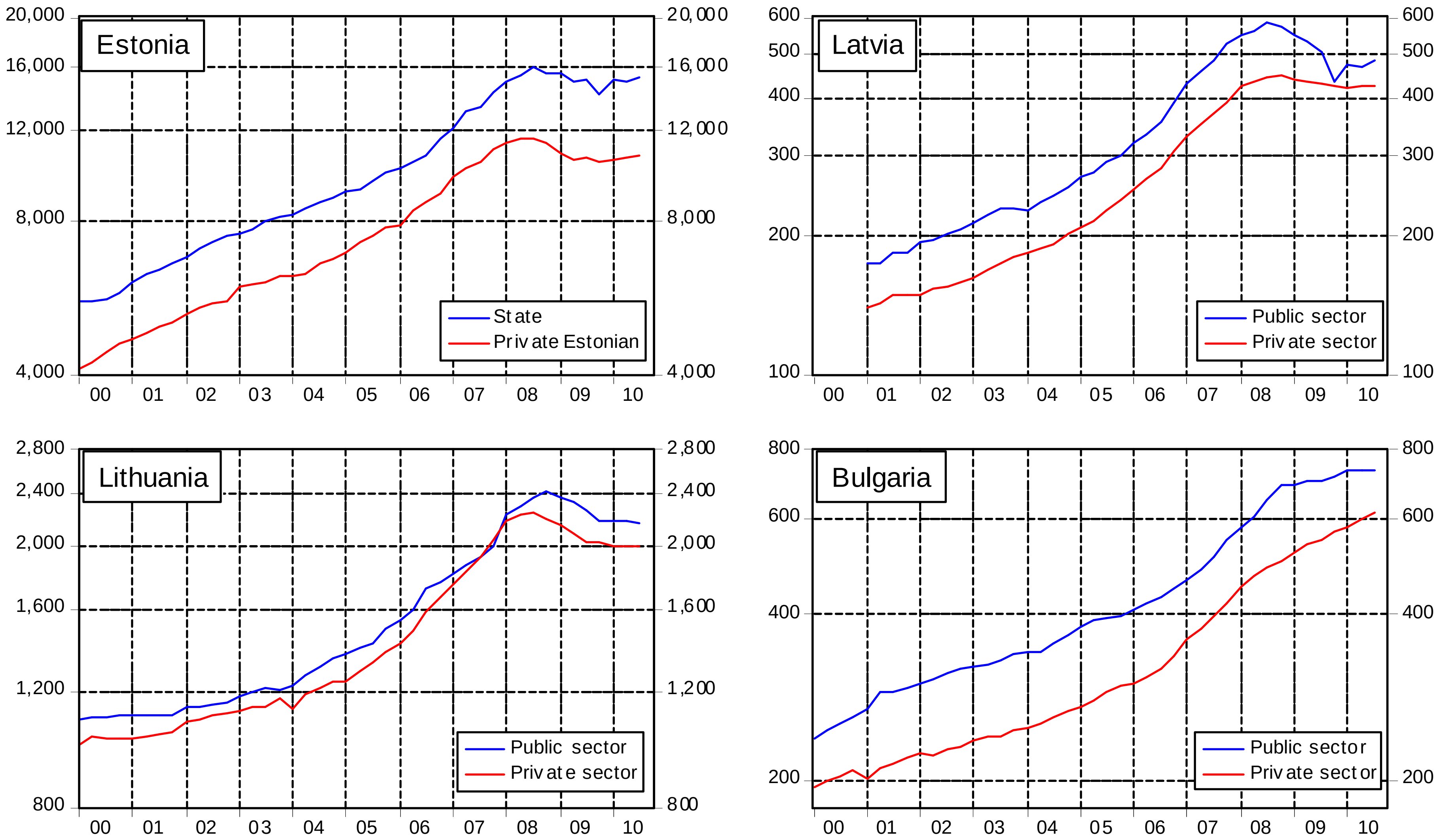
	Latvia	CZ, HU, PL, SK, SI
Manufacturing	9	38
Finance + Real estate	47	32
Other sectors	45	30
	100	**100**

Unit labour costs: Latvia vs Czech Republic (1999Q1=100)



‘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

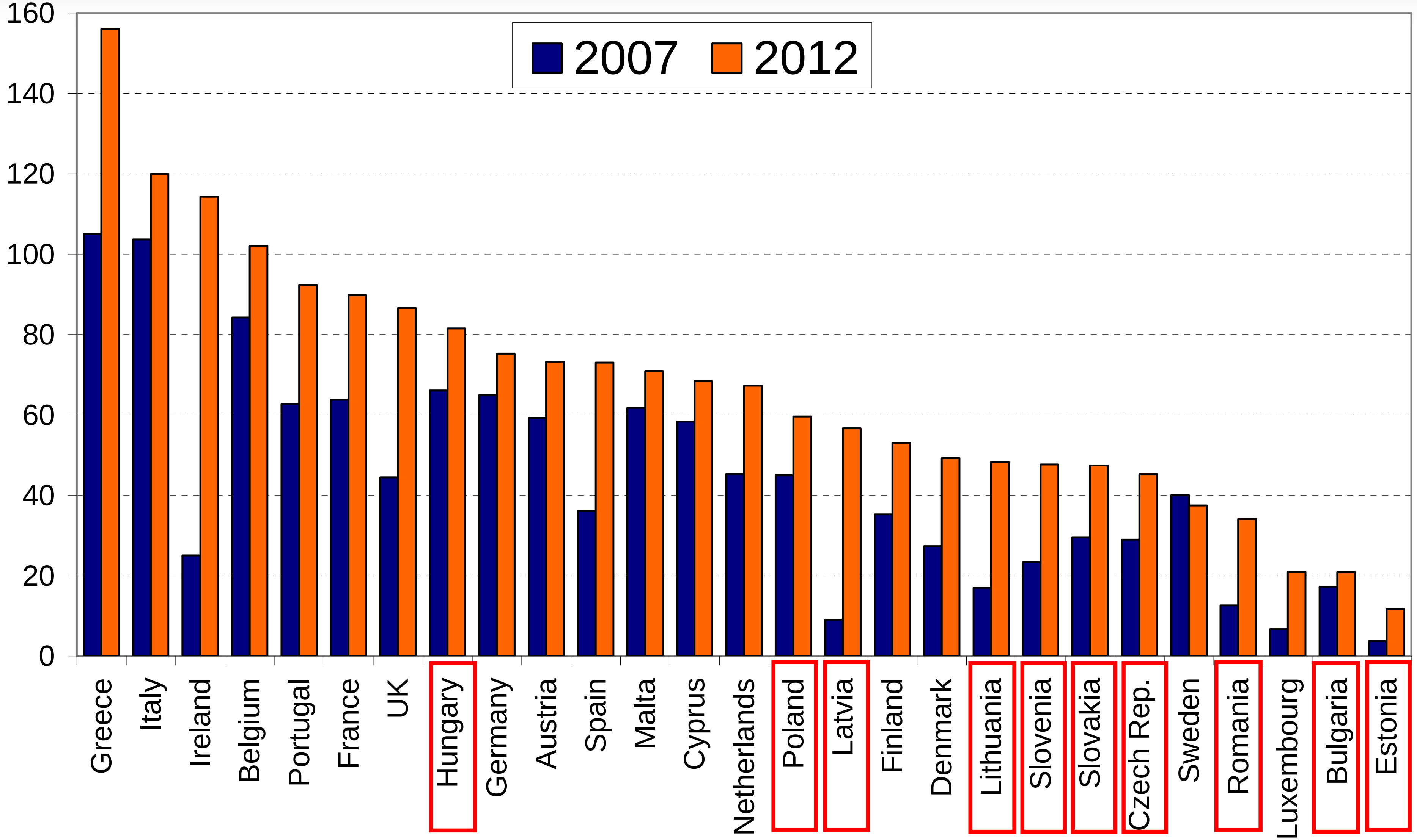
EU institutional framework: not well designed for catching-up economies and for crisis management

Exit? From what?

Fiscal and monetary policies during the crisis

	Fiscal policy	Monetary policy
Bulgaria	consolidation	currency board
Estonia	consolidation	currency board
Czech Republic	stimulus	loosening
Hungary	consolidation	tightening
Latvia	consolidation	quasi currency board
Lithuania	consolidation	currency board
Poland	stimulus	loosening
Slovakia	automatic stabilisers	euro
Slovenia	stimulus	euro
Romania	consolidation	tightening

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

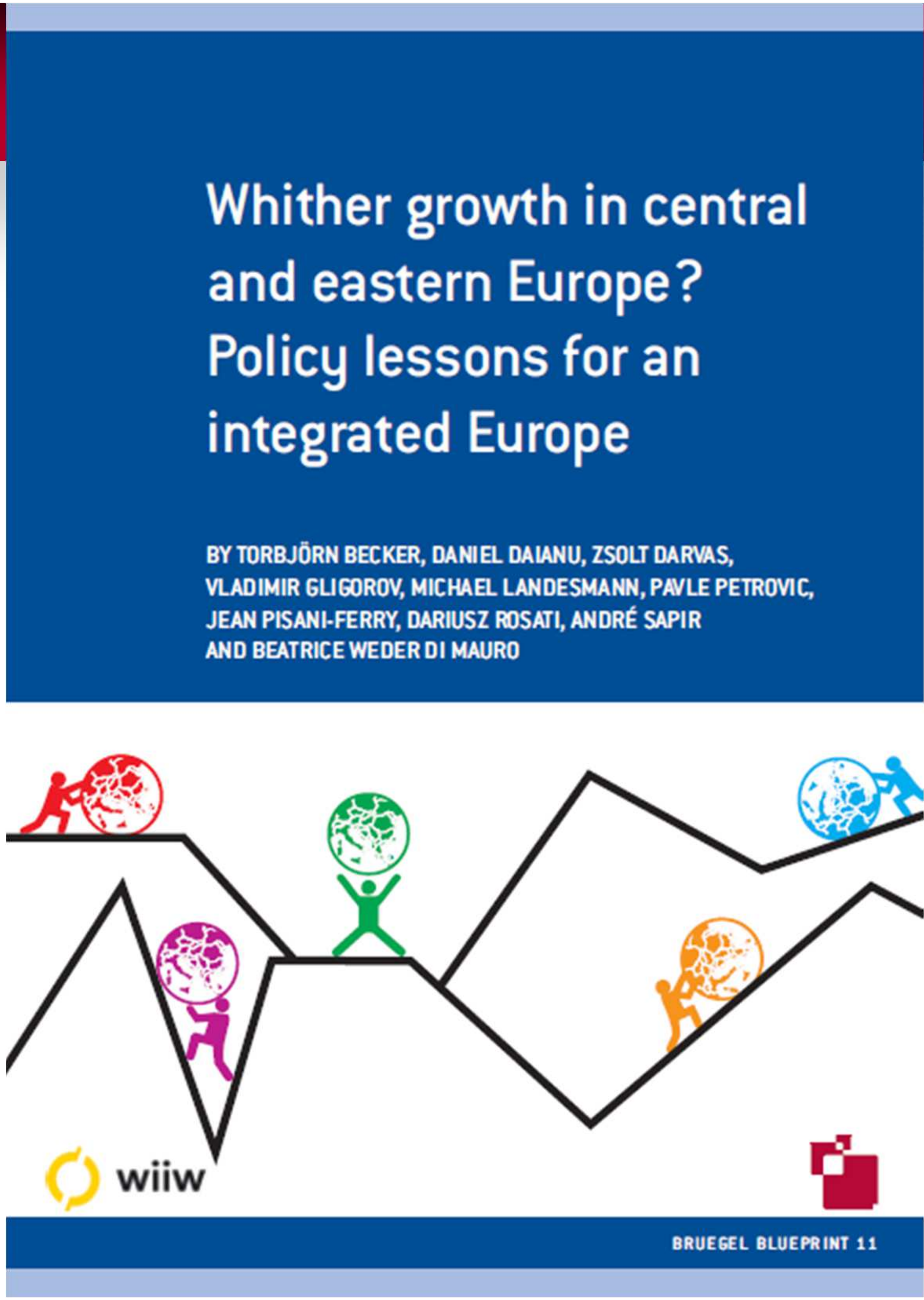
- **No coherent growth strategy**
  - Instruments (structural funds) were there, but growth policy (Lisbon) often ill-suited to emerging economies, and ineffective
  - Unused structural funds
- **Fiscal focus**
  - Too often, implicit assumption that all what you need is only to keep your fiscal house 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

scale: from 1 to 7 in most cases	Quality of institutions	Corruption perception	Ease of doing business (rank)	Infrastructure	Markets	Employment rate (%)	Quality of the educational system	Technology access	Absorptive capacity	Creative capacity
Bulgaria	3.3	3.8	44	2.8	4.4	62.6	3.3	3.8	3.6	3.1
Czech R.	3.9	4.9	74	4.1	5.2	65.4	4.7	5.0	4.5	4.2
Estonia	4.9	6.6	24	4.4	5.1	63.5	4.5	5.5	4.7	4.4
Hungary	3.9	5.1	47	3.9	5.0	55.4	3.2	4.8	4.4	4.1
Latvia	4.5	4.5	27	3.8	4.9	60.9	3.7	4.5	4.5	3.7
Lithuania	4.2	4.9	26	4.2	4.8	60.1	3.7	4.7	4.5	4.0
Poland	3.6	5.0	72	2.8	4.8	59.3	3.8	4.4	4.2	3.6
Romania	3.6	3.8	55	2.6	4.7	58.6	3.6	4.2	3.8	3.4
Slovakia	3.9	4.5	42	3.6	5.2	60.2	3.4	5.0	3.9	3.6
Slovenia	4.4	6.6	53	4.5	4.5	67.5	4.4	4.6	4.9	4.4
NMS	**4.0**	**5.0**	**46.4**	**3.7**	**4.9**	**61.4**	**3.8**	**4.6**	**4.3**	**3.8**
EU-15	**5.1**	**7.1**	**34.6**	**5.7**	**5.4**	**64.8**	**4.6**	**5.4**	**5.1**	**4.8**
USA	**4.9**	**7.5**	**4**	**6.1**	**6.0**	**70.9***	**5.0**	**5.8**	**5.6**	**5.8**

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**



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