

A map of Europe with the 11 EU member states highlighted in a light tan color against a dark blue background. The highlighted countries are Estonia, Latvia, Lithuania, Poland, Czech Rep., Slovakia, Hungary, Romania, Bulgaria, Greece, and Ireland. The text 'EU11 REGULAR ECONOMIC REPORT' is written in yellow, and 'COPING WITH EXTERNAL HEADWINDS' is written in dark blue over the map.

EU11 REGULAR ECONOMIC REPORT

COPING WITH EXTERNAL HEADWINDS

July 2012

Brussels

THE EU11 REGULAR ECONOMIC REPORT

A map of Europe with the 11 countries covered by the EU11 Regular Economic Report highlighted in orange. These countries are Estonia, Lithuania, Poland, Latvia, Hungary, Romania, Bulgaria, Slovenia, Croatia, and Cyprus. The rest of Europe is shown in a darker blue.

The RER: a semiannual publication which covers economic developments and prospects in 10 European Union member states (Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic, Slovenia) and

Croatia: 1st time in the RER series, because of its expected EU entry in July 2013



EU11 REGULAR ECONOMIC REPORT: JUNE 2012 ISSUE

- Reviews Recent Economic Developments and Trends
- Provides the Near-term Outlook
- Discusses “Drivers of Convergence in EU11” (Special topic)

TREACHEROUS TIMES IN THE GLOBAL ECONOMY

A map of Europe with several countries highlighted in a light tan color. The highlighted countries are Estonia, Latvia, Lithuania, Ireland, Czech Republic, Hungary, Romania, and Bulgaria. The rest of the map is in a dark blue color. The title 'TREACHEROUS TIMES IN THE GLOBAL ECONOMY' is written in yellow text at the top of the map.

- Increased market jitters,
 - reduced capital inflows, and
 - high-income fiscal and financial-sector consolidation
- => have and are expected to keep growth weak



EU11 Recent Developments

MAIN MESSAGES

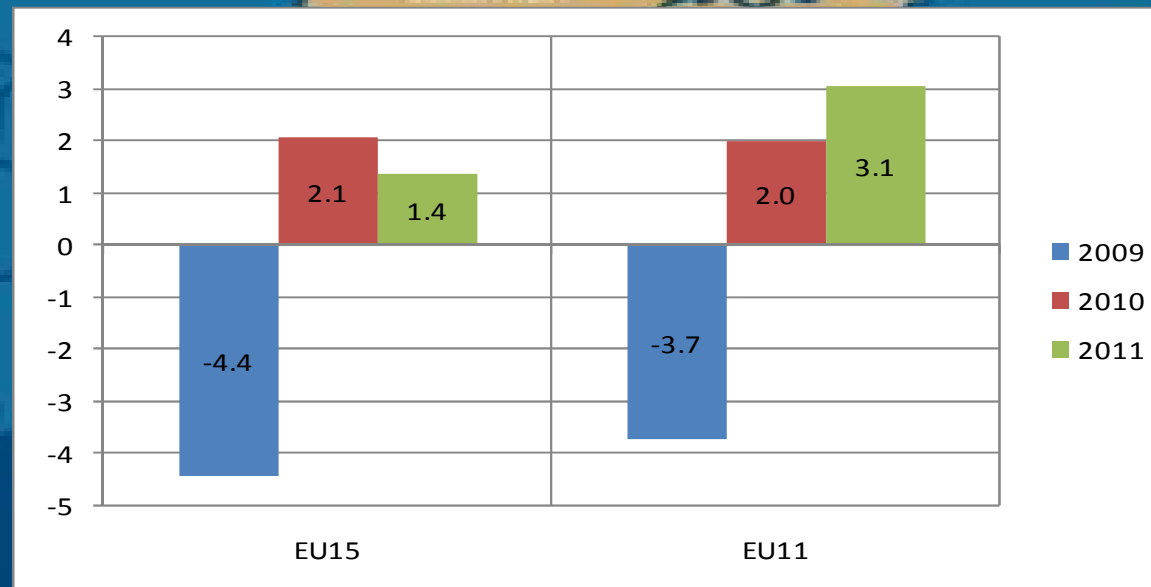
DESPITE CHALLENGING EXTERNAL ENVIRONMENT, EU11 WEATHERED THE STORM IN 2011

- Relatively **strong economic growth**, but large differences across countries
- **Bold fiscal consolidation** measures, but further strengthening of public finances remains a top priority
- Orderly **deleveraging** in the EU11 financial sector thus far, but funding pressures
- **Employment growth**, but unemployment affecting the most vulnerable
- **Elevated inflation** due to increases in indirect taxes and commodity prices

ECONOMIC SLOWDOWN THROUGHOUT EUROPE, YET STRONG GROWTH IN EU11

- EU11 grew by 3.1% in 2011, resuming the convergence process with EU15
- Sufficient to recover EU11 output losses from the global financial crisis (but not for each country)

GDP Growth in EU11 and EU15, percent

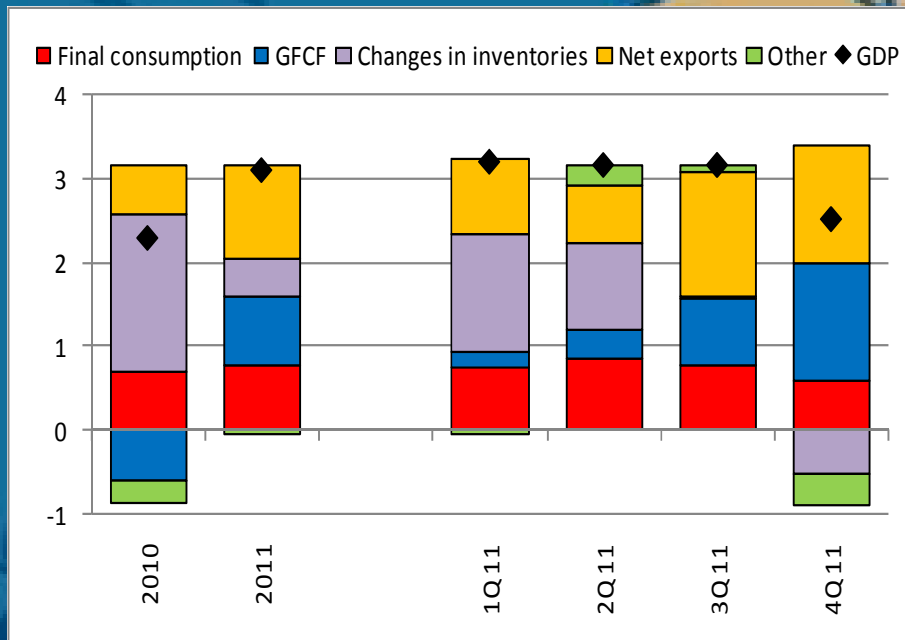


Source: Eurostat, World Bank staff calculations

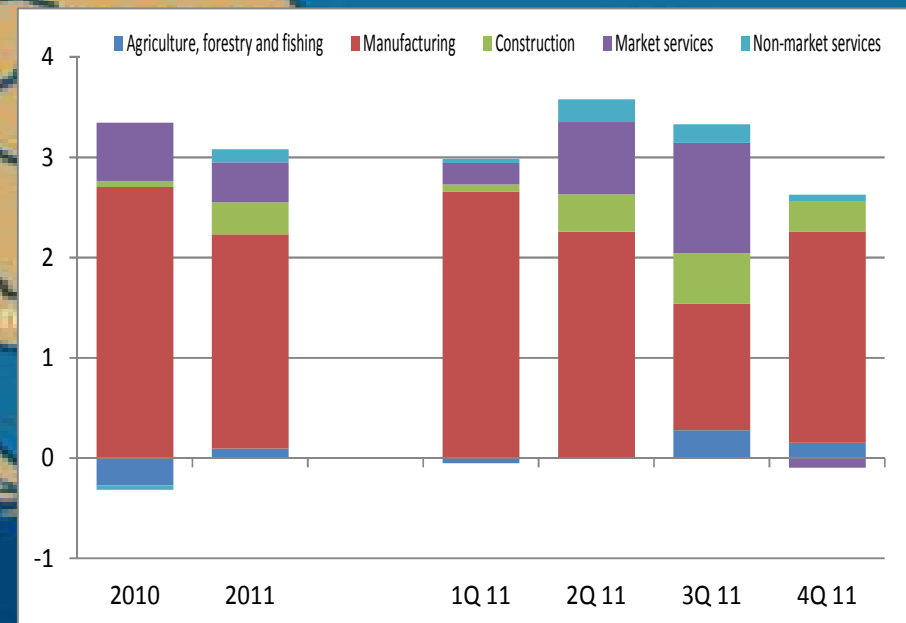
BALANCED ECONOMIC GROWTH IN EU11

- Relatively broad-based
- Driven by manufacturing and construction

Contributors to GDP Growth in EU11



Contributions to Value-Added Growth in EU11

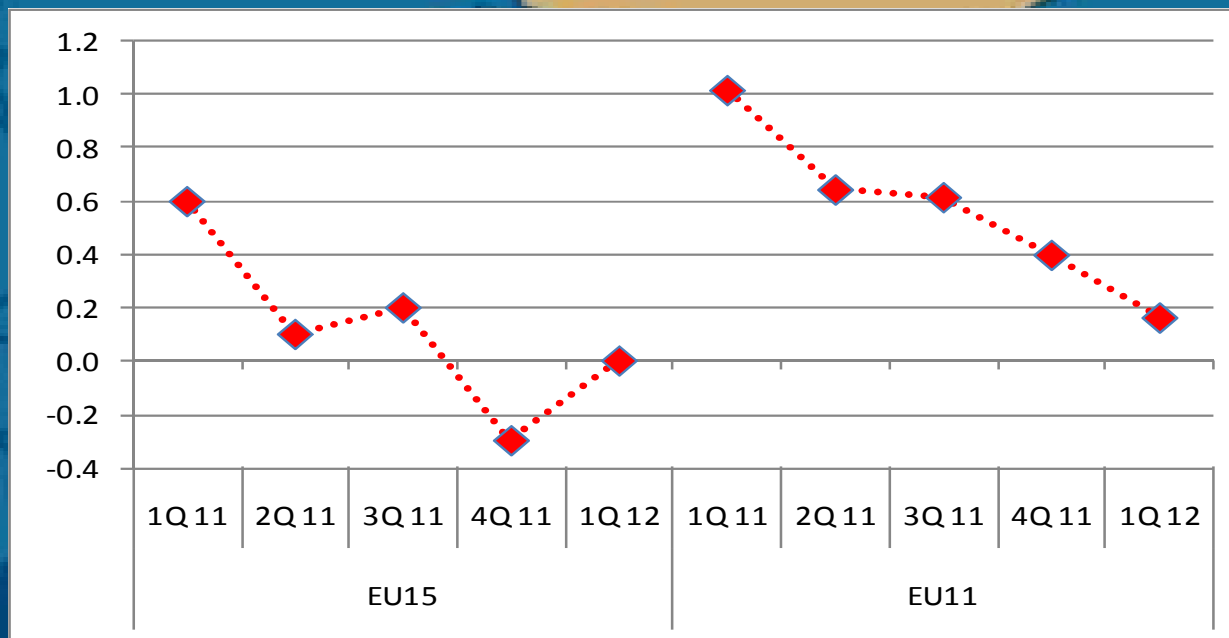


Source: Eurostat, World Bank staff calculations

ECONOMIC PERFORMANCE ON A WEAKENING PATH

- With the mild recession in the euro area, growth in EU11 decelerated in each quarter of 2011 and first quarter of 2012

GDP Growth in EU11 and EU15, percent, q-o-q sa 1Q 11–1Q 12

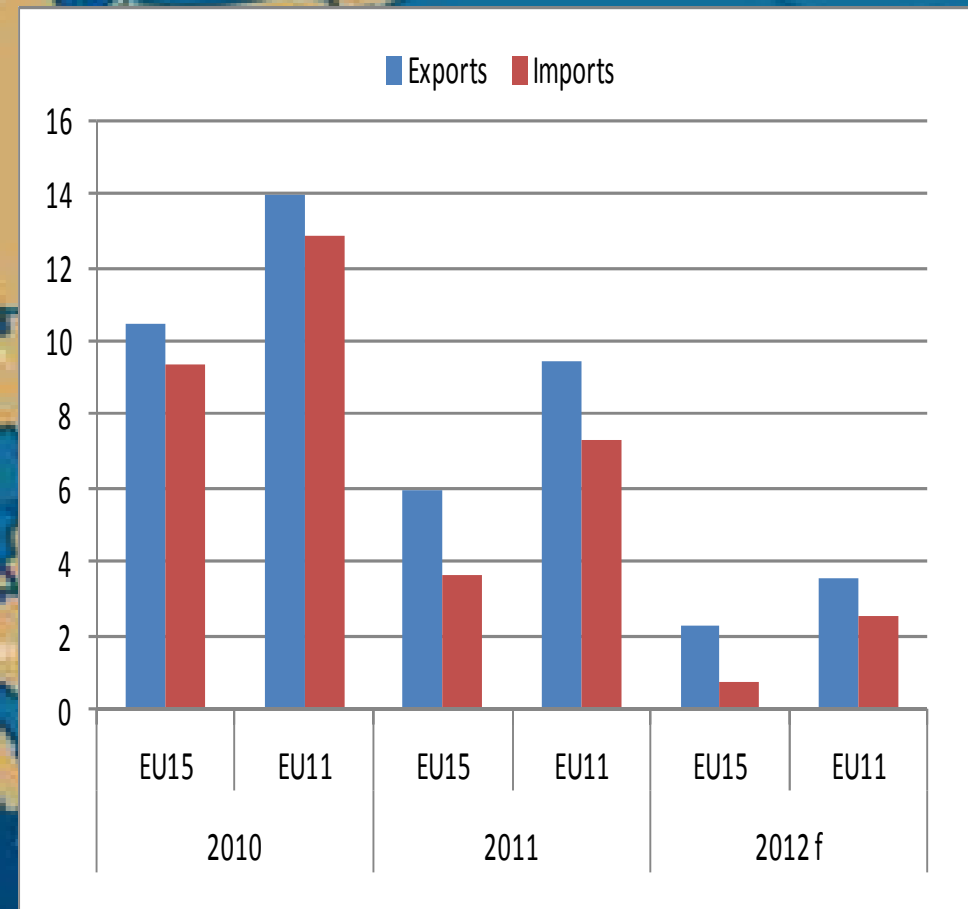


Source: Eurostat, World Bank staff calculations;

NET EXPORTS CONTINUED CONTRIBUTING TO GROWTH IN 2011

Growth in Exports and Imports

- External economic activity abated in key trading partners (EU15)
- EU11 exports and imports weakened, but their growth rates remained positive
- Consequently, EU11 current account balances improved

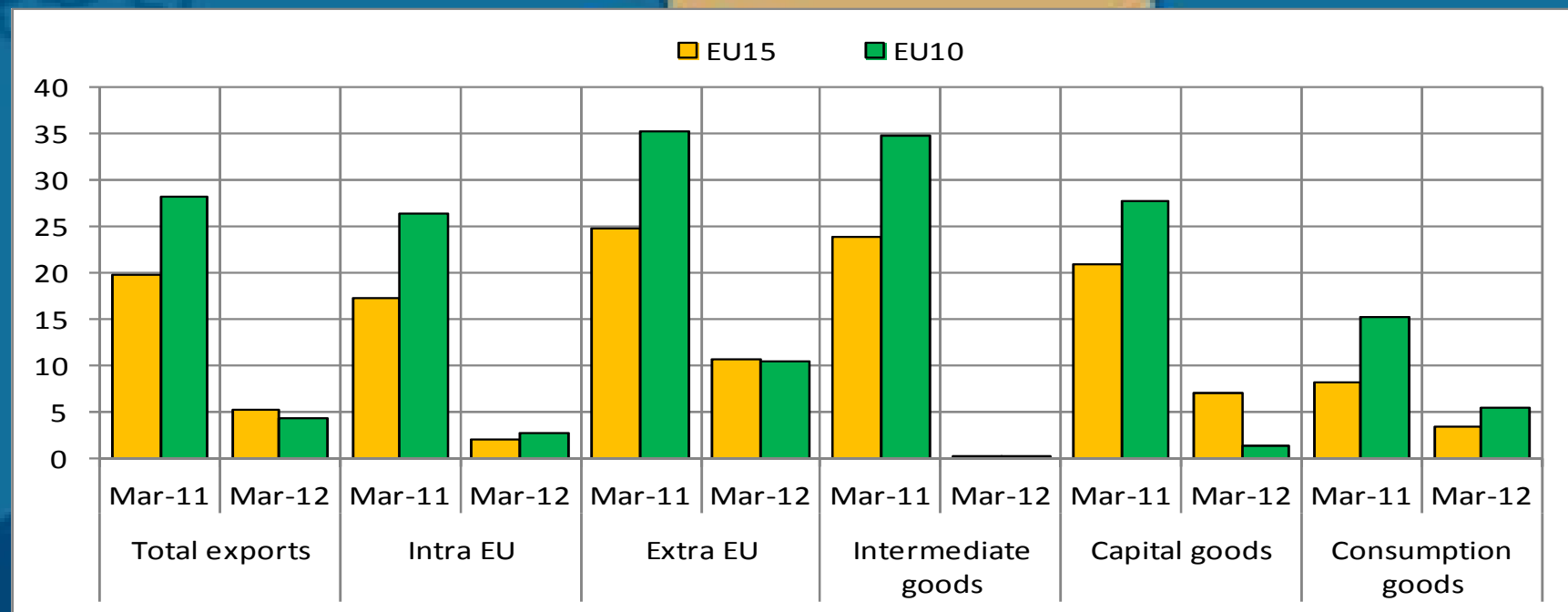


Source: Eurostat, World Bank staff calculations

CHANGING TRADE PATTERNS IN EU11

- Notable export deceleration over the past year, especially in intermediate goods and in intra-EU trade
 - In contrast, trade outside the EU grew notably

Growth in Exports by Trade Partner and Goods Category, EUR (%)



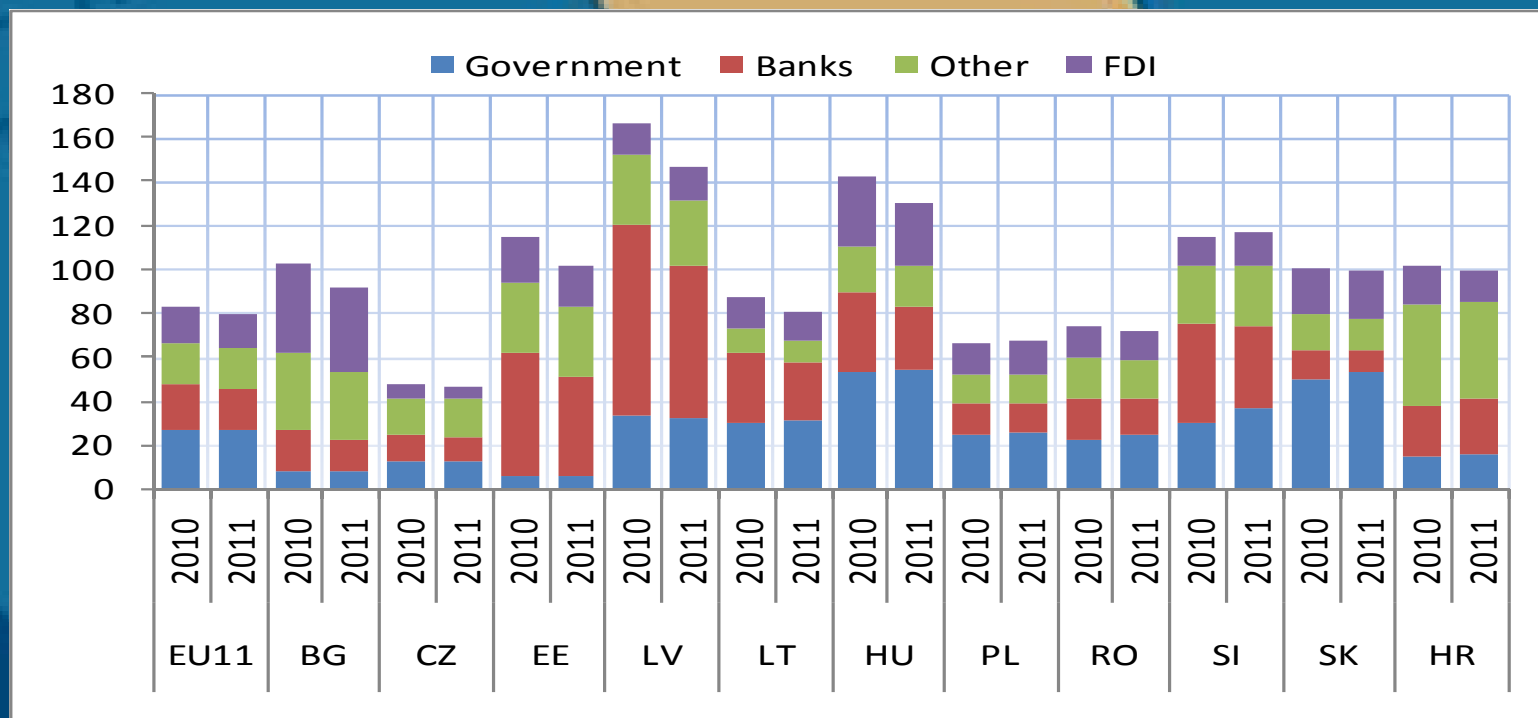
Source: Eurostat, World Bank staff calculations.

Notes: Data for Croatia are not available. 3M moving average.

EXTERNAL DEBT LEVELS STABILIZED

- Overall, EU11 external debt to GDP remained almost unchanged
 - But large current account adjustments in some countries brought debt levels down

External Debt to GDP in EU11

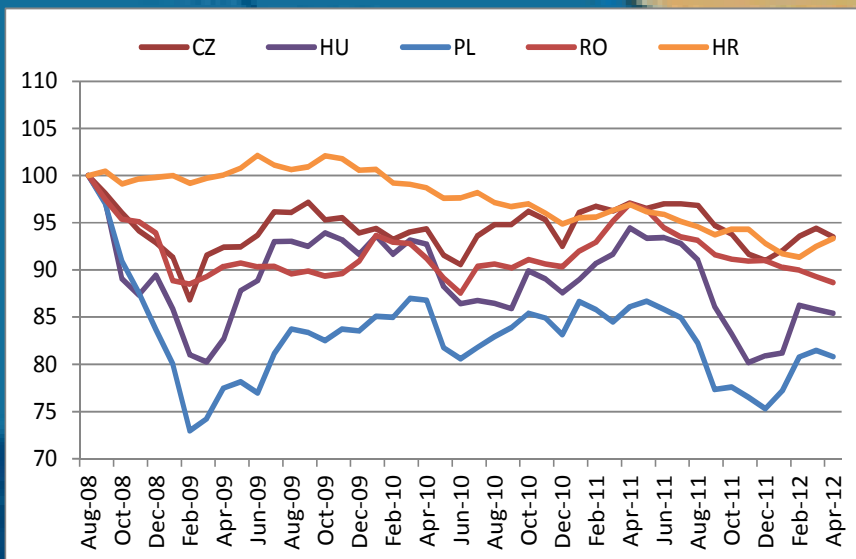


Source: Central banks, World Bank staff calculations

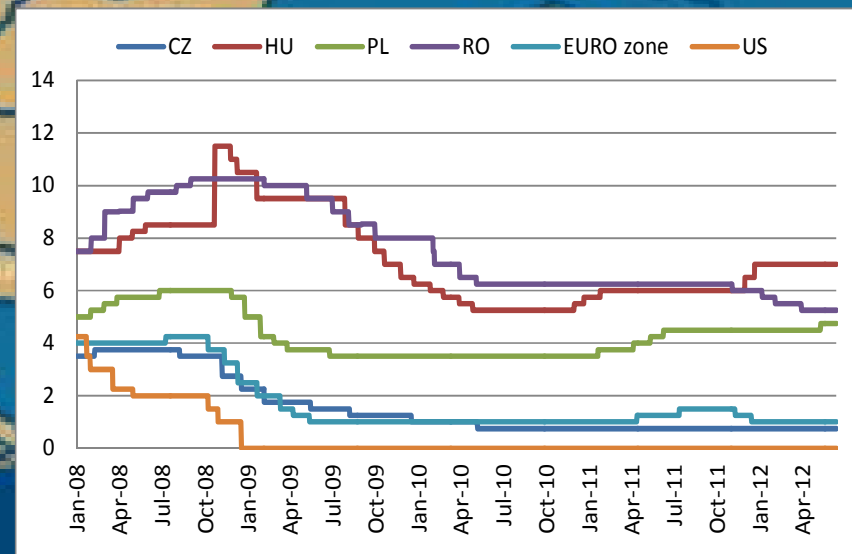
MONETARY POLICY STAYED ACCOMMODATIVE

- Monetary policy instruments used against external shocks
- Flexible exchange rates in some EU11 countries helped boost competitiveness
 - Interest rates stayed low

Real Effective Exchange Rates, CPI Deflated
(Index: Aug 2008=100)



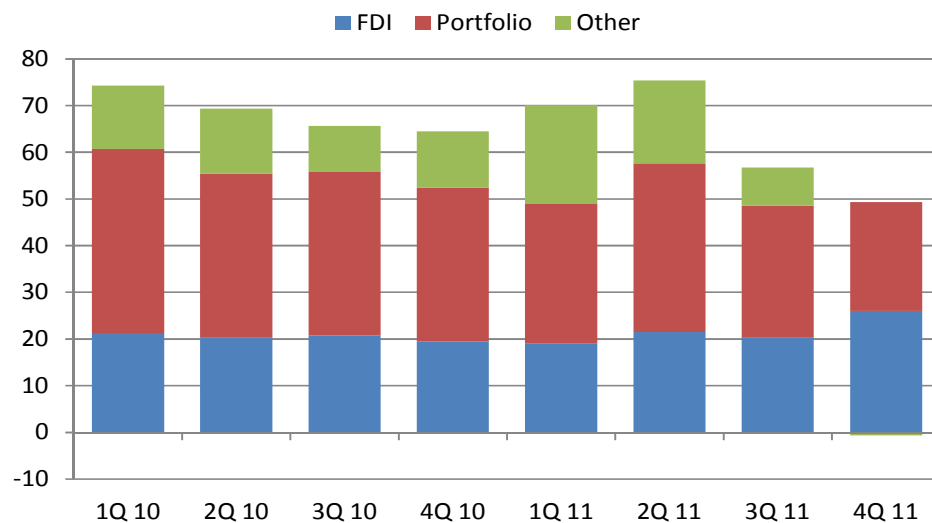
Policy Interest Rates , %



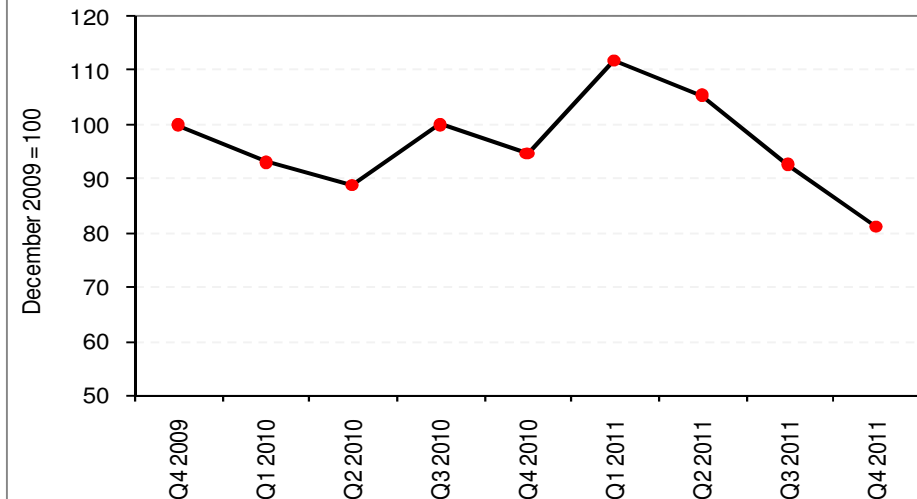
Source: Central banks, World Bank staff calculations

ORDERLY DELEVERAGING

Cumulative Gross Capital Inflows, EU11 (€ billions)



Foreign Bank Claims in EU11



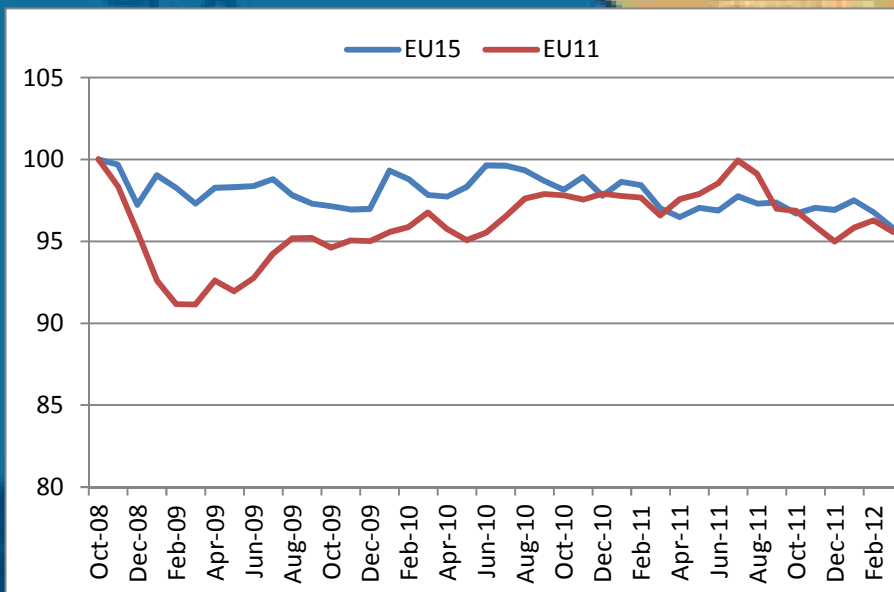
Source: Eurostat, BIS, World Bank staff calculations.

- Capital flows to EU11 contracted by almost 25% since 2010
- Cross-border claims by foreign banks dropped in all EU11 countries in second half of 2011
- Funding pressures on EU11 banks intensified

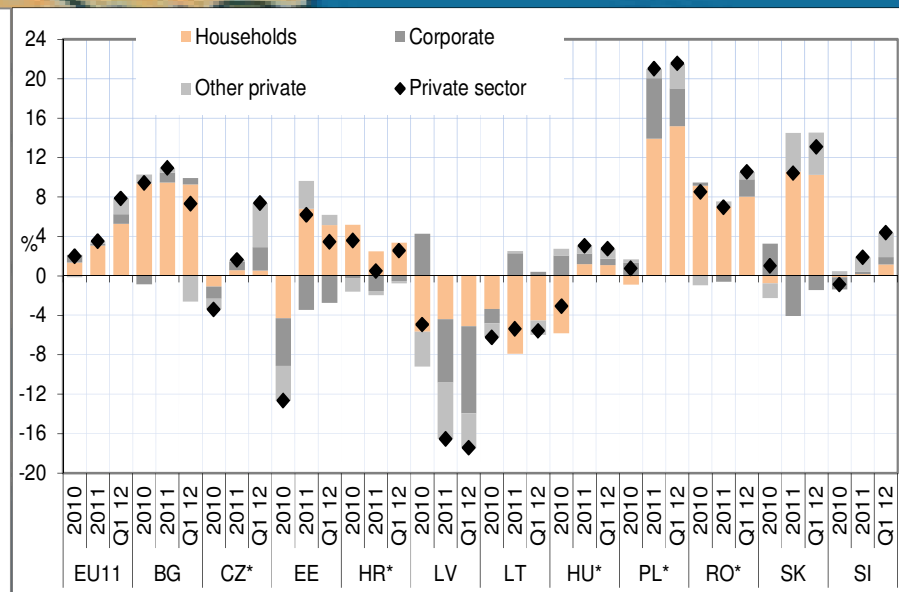
FINANCIAL SECTOR REMAINED RESILIENT

- Credit remained constrained by both demand and supply factors
- Local private sector deposits became the dominant source of EU11 funding

Real Credit Growth in EU11 and EU15



Private Sector Deposits Growth and Contributions

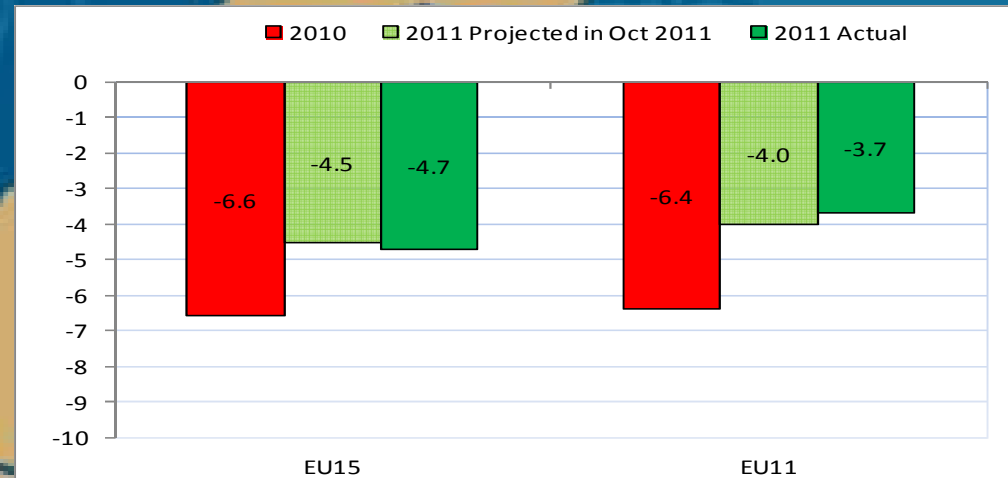


Source: ECB, EU11 Central Banks, World Bank staff calculations

EU11 FISCAL CONSOLIDATION CONTINUED

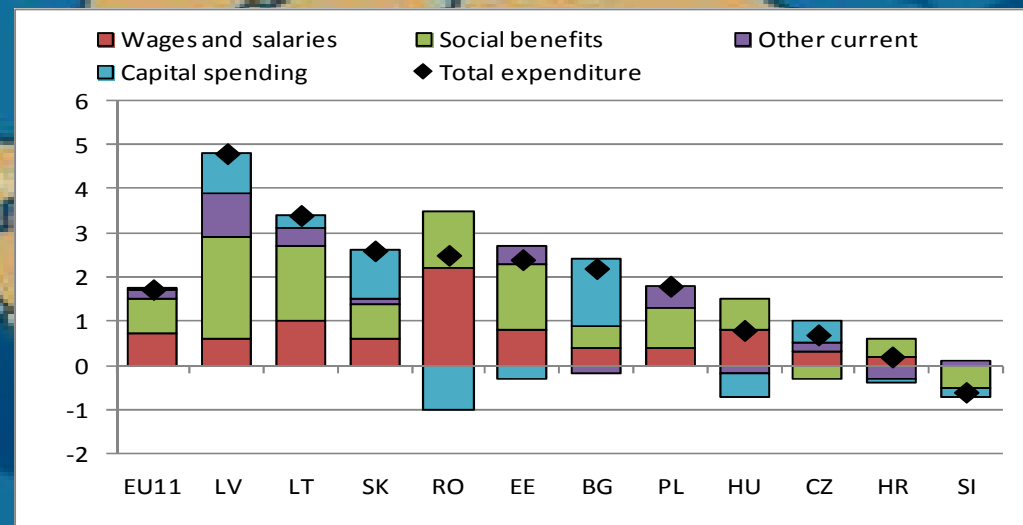
- Fiscal consolidation measures improved EU11 public finance position
- Consolidation was largely expenditure-based, but spared public investment
- Public debt-to-GDP increases continued, but less in EU11 (48.2 in 2011 from 46.4 in 2010) than EU15 (86.3 in 2011 from 82.8 in 2010)

General Government Fiscal Deficits



Source: Eurostat, April 2012 EDP notifications, World Bank staff

Expenditure Reductions, 2010 to 2011, % GDP

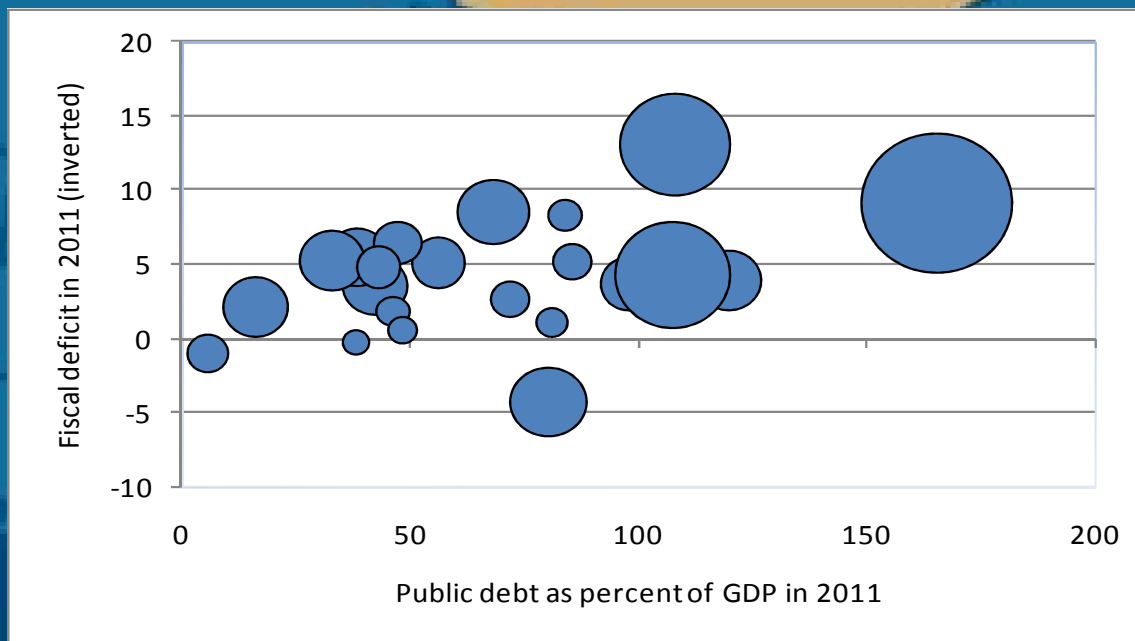


Source: Eurostat Ameco, World Bank staff calculations

MARKETS RESPOND TO FISCAL EFFORTS

- Currently, sovereign CDS spreads are much higher for countries with high deficits and significant debt

EU27 Public Debt, Deficits, and CDS Spreads,



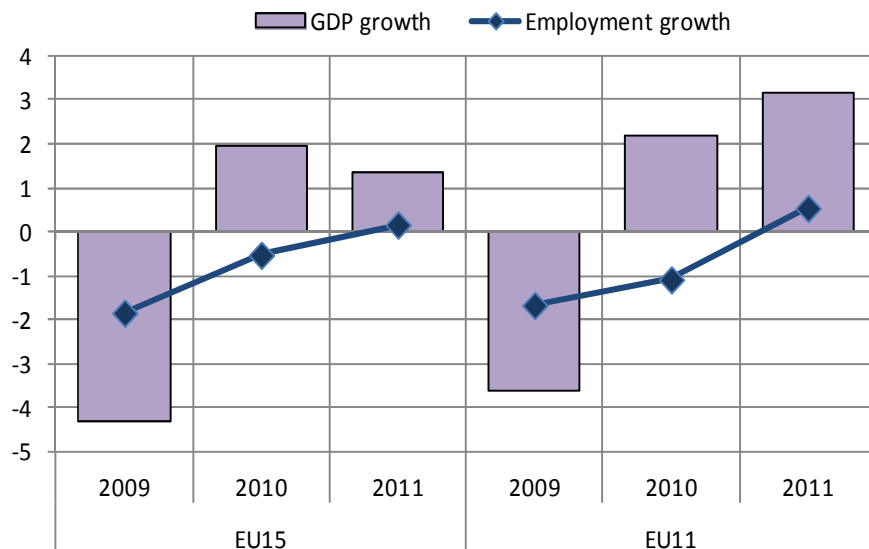
Source: Eurostat, Bloomberg, World Bank staff calculations

Note: The size of the bubbles represents 5Y CDS spreads.

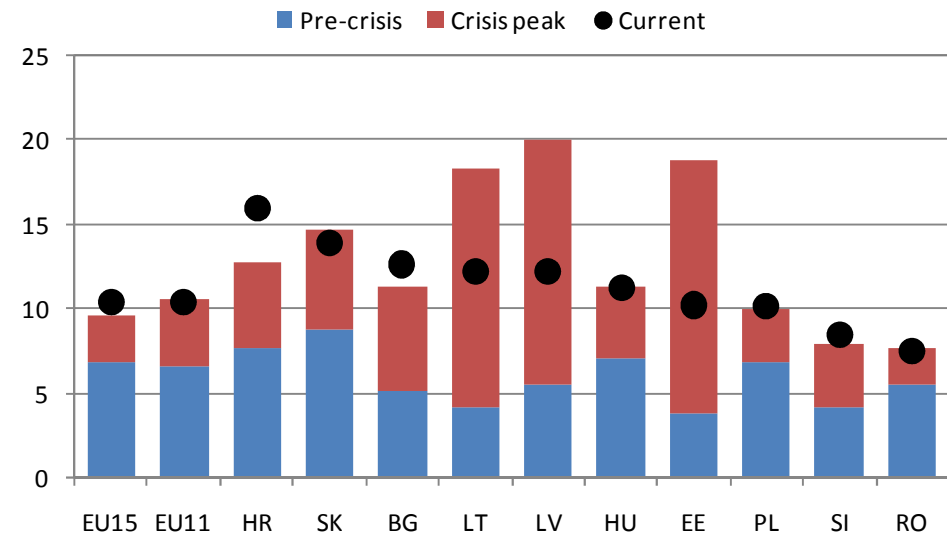
GROWTH WAS LARGELY JOBLESS

- Positive employment growth for the first time since 2008
- Modest employment creation mainly from part-time and temporary jobs
 - Employment gains lagged the recovery of output
 - Unemployment is as high as at the peak of the crisis

GDP and Employment Growth



Unemployment Rates

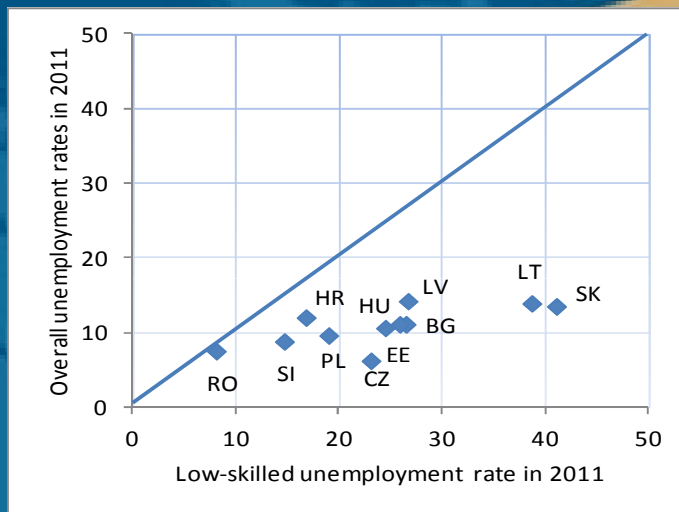


Source: Eurostat, World Bank staff calculations.

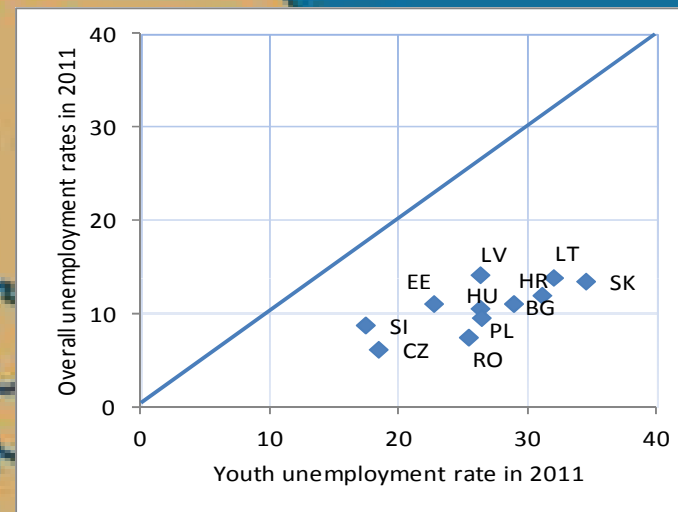
UNEMPLOYMENT AFFECTED THE MOST VULNERABLE

- High jobless rate among the youth and the unskilled

**Unemployment Rates:
Low-skilled vs. Total**



**Unemployment Rates:
Youth vs. Total**



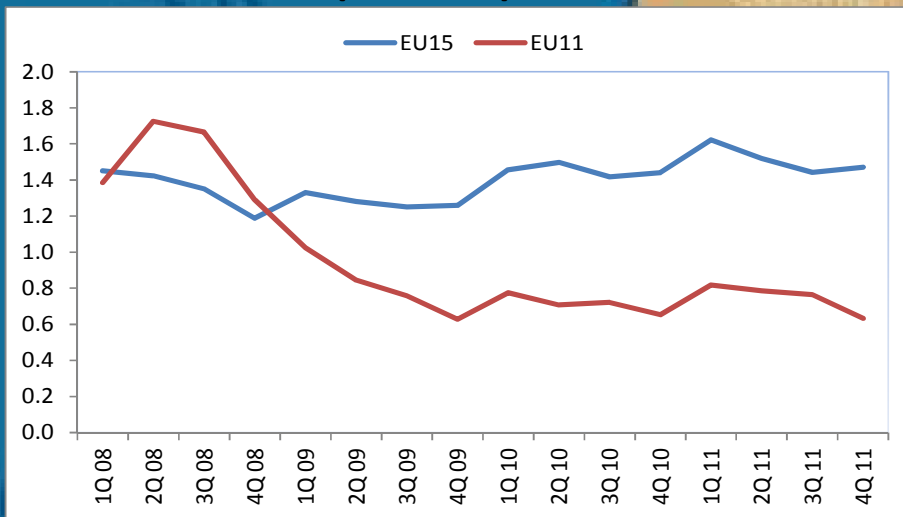
Source: Eurostat, World Bank staff calculations.

- Long-term unemployed in total unemployed rose from 44% percent before the crisis to almost 50% in 2011

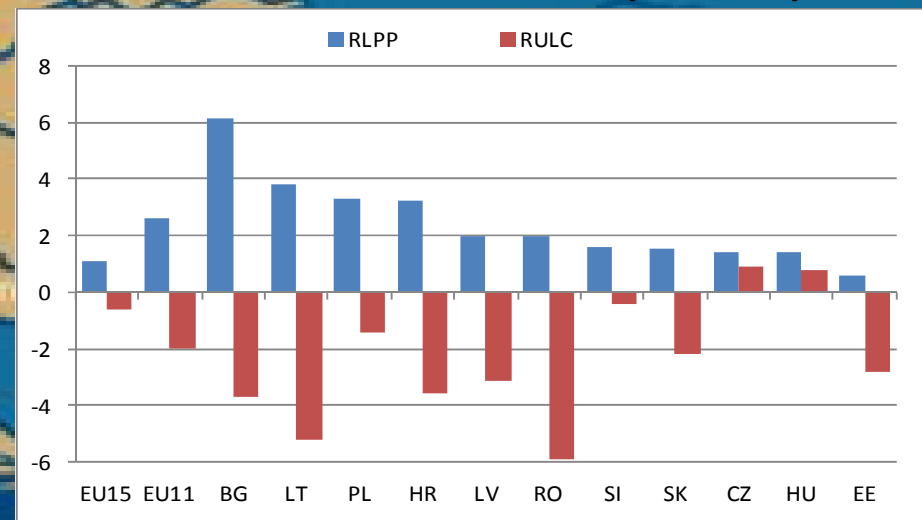
REAL WAGES UNDER DOWNWARD PRESSURE

- High unemployment rates and steadily declining vacancy rates in EU11 (lowest since 2008) put downward pressure on wages
 - Productivity outpaced real wages

**Vacancy Rate, EU11 and EU15
(Percent)**



Growth in Real Labor Productivity and Real Unit Labor Cost, 2011 (Percent)

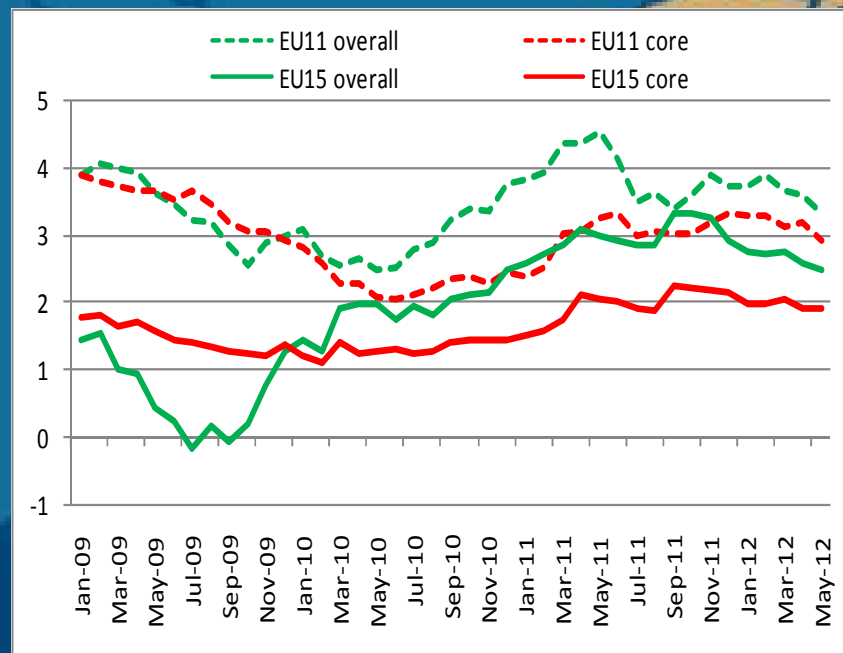


Source: Eurostat, World Bank staff calculations.

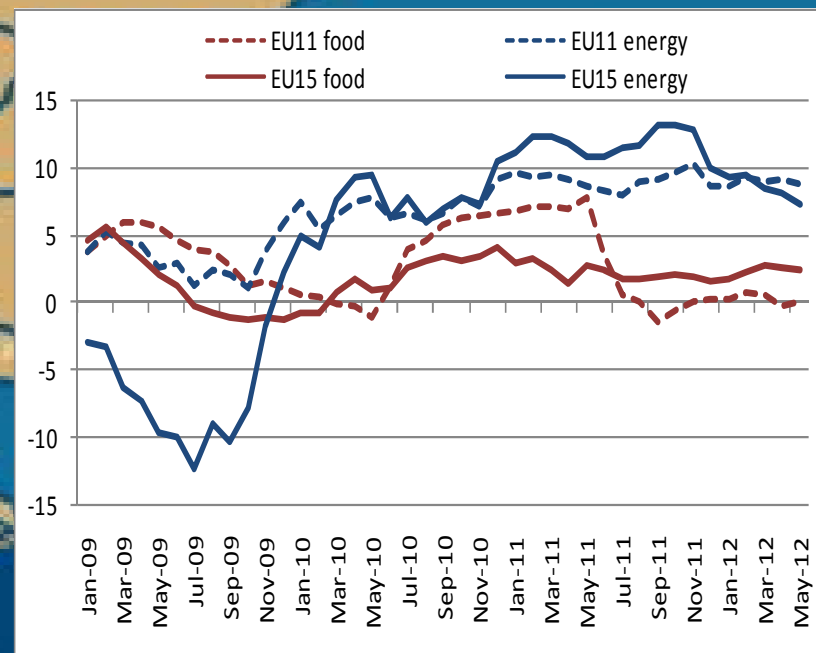
INFLATION STAYED ELEVATED

- Headline inflation in the EU11 was high in 2011 due to increases in indirect taxes and global commodity prices

HICP, Overall and Core, EU15 and EU11



Energy and Food HICP, EU15 and EU11



Source: Eurostat, World Bank staff calculations.



EU11 Near-term Outlook

MAIN MESSAGES

RENEWED FINANCIAL TURMOIL ADDS TO HEADWINDS AND CHALLENGES FACING EU11

- Economic activity strengthened through the first 4 ½ months of 2012
- Renewed financial turmoil in May added to pre-existing headwinds
- In volatile environment, EU11 must keep focus on the medium-term
- Risk of a crisis persists, with potentially serious consequences for high-income and developing countries (including EU11)

ECONOMIC GROWTH IN ALL EU11 COUNTRIES WILL SLOW DOWN IN 2012

Even this projected modest growth assumes that appropriate policies will be adopted in the Euro area to successfully avoid a serious deterioration in international financial market conditions

	2011	2012	2013
EU11	3.1	1.5	2.5
Bulgaria	1.7	0.6	2.5
Czech Republic	1.7	0.0	1.0
Estonia	7.6	1.7	3.0
Latvia	5.5	2.3	2.9
Lithuania	5.9	2.3	3.5
Hungary	1.7	-0.4	1.5
Poland	4.3	2.9	3.2
Romania	2.5	1.2	2.8
Slovenia	-0.2	-1.2	0.6
Slovak Republic	3.3	2.1	3.1
Croatia	0.0	-1.0	1.5
<i>Memo:</i>			
EU15	1.5	-0.1	1.2

Source: World Bank staff.

SIGNIFICANT DOWNSIDE RISKS TO THE OUTLOOK

A map of Europe with the EU11 countries highlighted in orange. The highlighted countries are Estonia, Latvia, Lithuania, Poland, Slovakia, Hungary, Czechia, Slovenia, Croatia, Romania, and Bulgaria. The rest of Europe is shown in a darker blue color.

- Further **escalation of the euro area sovereign debt crisis** would exert pressure on EU11 financial markets across asset classes
 - EU11 banking system is susceptible to **deleveraging** by euro area banks
 - **Protracted recession in the euro area** would spill over to EU11, especially for those with close trade links with troubled euro area countries
- ➔ A major deterioration in conditions in the euro area could reduce GDP growth in EU11 by about 2 percent compared to the baseline



EU11 Policies for Growth

MAIN MESSAGES

A THREE-PRONGED POLICY TO BOOST GROWTH

A map of Europe with the 11 Eurozone countries (EU11) highlighted in orange. The highlighted countries are Estonia, Latvia, Lithuania, Poland, Slovakia, Czechia, Hungary, Malta, Cyprus, Romania, and Bulgaria. The rest of Europe and the surrounding oceans are shown in shades of blue.

- 1) Central banks and financial supervisory authorities across the EU have to shore up confidence of financial markets:
 - **Monetary policy** should continue to be accommodative to buffer EU11 against external shocks and help defend against euro area volatility.
 - **Financial sector polices** should be in place to ensure access to credit for viable borrowers despite banks' balance sheet pressures and ongoing deleveraging.

A THREE-PRONGED POLICY TO BOOST GROWTH

A map of Europe with the 11 countries of the Eurozone (EU11) highlighted in orange. The countries shown are Estonia, Latvia, Lithuania, Slovakia, Czech Republic, Hungary, Malta, Slovenia, Greece, and Ireland. The rest of Europe and the surrounding oceans are in shades of blue.

2) Calibrate **fiscal consolidation** to support growth:

- With heightened uncertainty and market pressures and decelerating economic growth, EU11 governments must decide how much, how fast, and in what ways to consolidate public finances, so that fiscal positions do not become a source for financial market volatility.
- In designing the composition of fiscal consolidation, governments should take into account the fragility of the economic outlook and try to limit the negative impact of fiscal consolidation on growth.

A THREE-PRONGED POLICY TO BOOST GROWTH

A map of Europe with the 11 countries of the Eastern European group (EU11) highlighted in orange. These countries are Estonia, Latvia, Lithuania, Poland, Czech Republic, Slovakia, Hungary, Slovenia, Malta, Cyprus, and Bulgaria. The rest of Europe is shown in a darker blue color.

- 3) **Structural policies** can help overcome financial, labor and fiscal challenges and support growth
- By removing barriers to growth in product and labor markets, the EU11 countries can increase their potential economic gains in the medium term.
 - Closing the existing institutional and structural gaps with the rest of the EU will soften the constraints imposed by demographic trends and facilitate income convergence with EU15.

THANK YOU!



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