Revisiting the Growth Model in Central and East Europe

Michael Landesmann
Vladimir Gligorov

Topics covered:

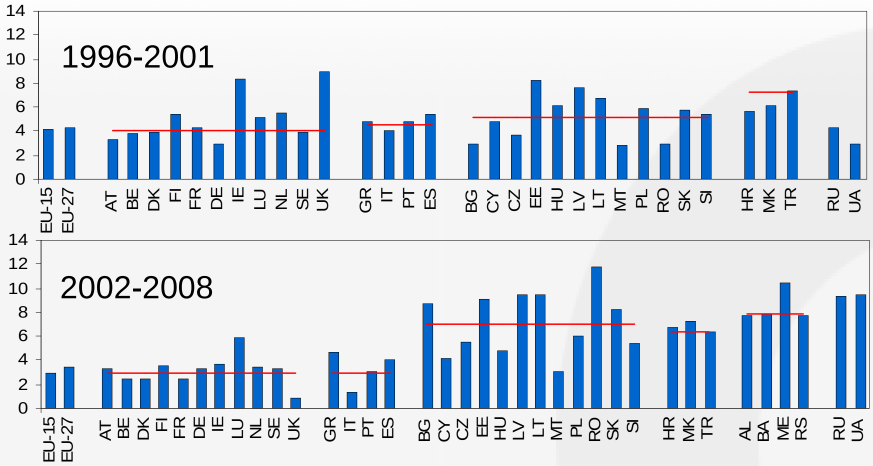
- ‘Revisiting the growth model’?
- Differentiation across country groups
- Structural imbalances: which ones and where?
- External and internal (constraining) factors
- Policy issues:
  - short-run vs. medium- and long-run
  - fiscal, exchange rates, financial market reform
  - EU and national policy agendas

The ‘old’ growth model:

- targeted at **integration with the EU area** (not in the case of all countries, e.g. CIS; started at different points in time, e.g. Western Balkans)
- was associated with significant internal and **external liberalization** (trade, capital transactions, financial market integration)
- the model worked - ‘convergence process’ (sometimes with interruptions) **- but**
  - (a) **differentiation** by countries and regions
  - (b) emergence of **structural imbalances**

Growth – GDP per capita

Average annual growth rates, 1996-2001 and 2002-2008, in %



Source: wiiw Annual Database incorporating national statistics, Eurostat.

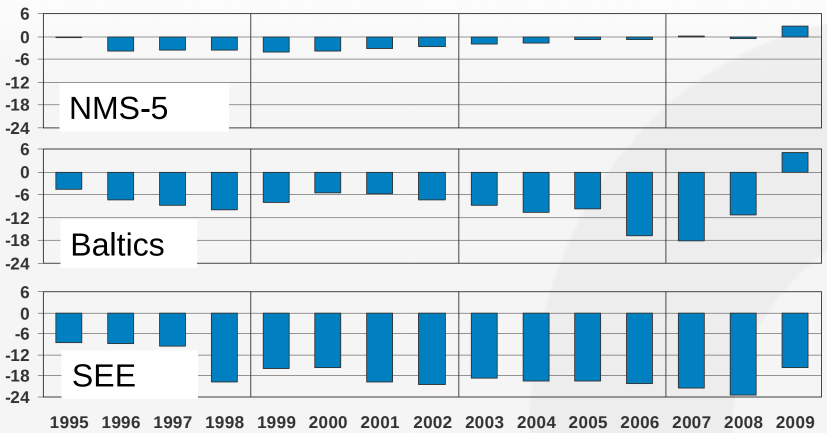
Redirecting the growth model:

1. **The legacy of structural imbalances**

2. **New constraints following the crisis**

Trade balance of goods and services (BOP)

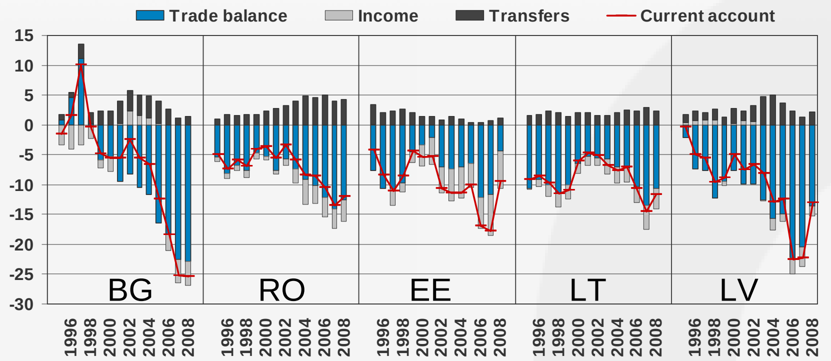
in % of GDP



NMS-5: CZ, HU, PL, SK, SI. Baltics: EE, LV, LT. SEE: BG, RO, HR, MK, BA (from 1998), RS (from 1999), ME (from 2001).
Source: wiiw Annual Database incorporating national statistics, Eurostat.

Trade balances of goods and services and income balances, 1995-2008

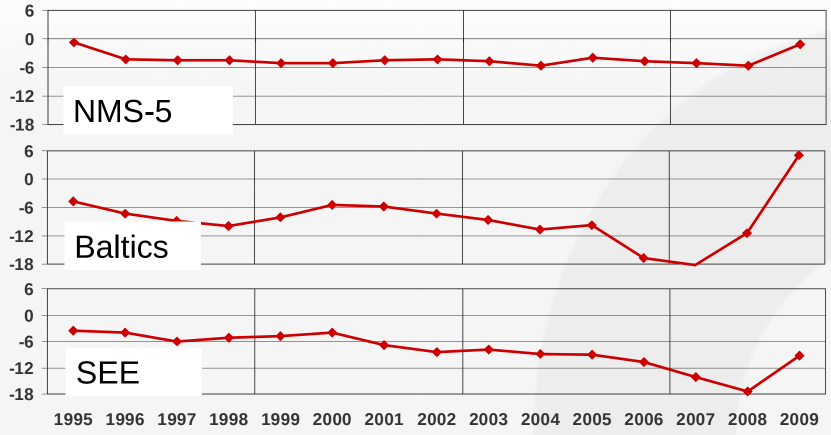
in % of GDP



Source: Eurostat, wiiw calculations.

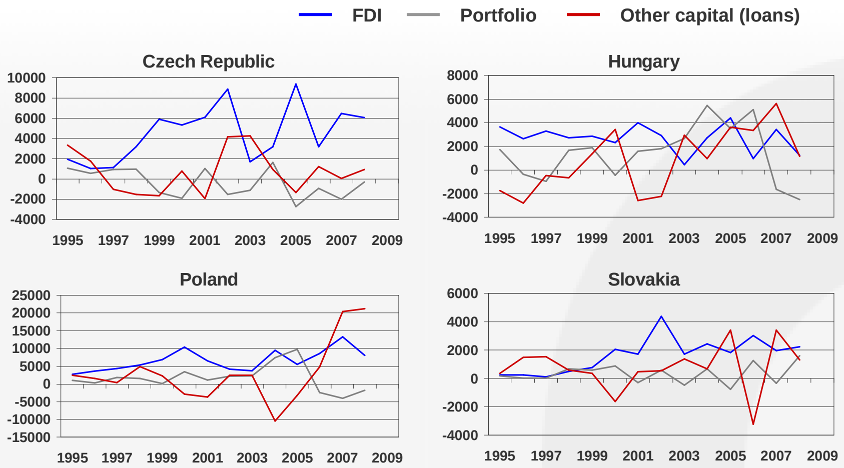
Current account

in % of GDP



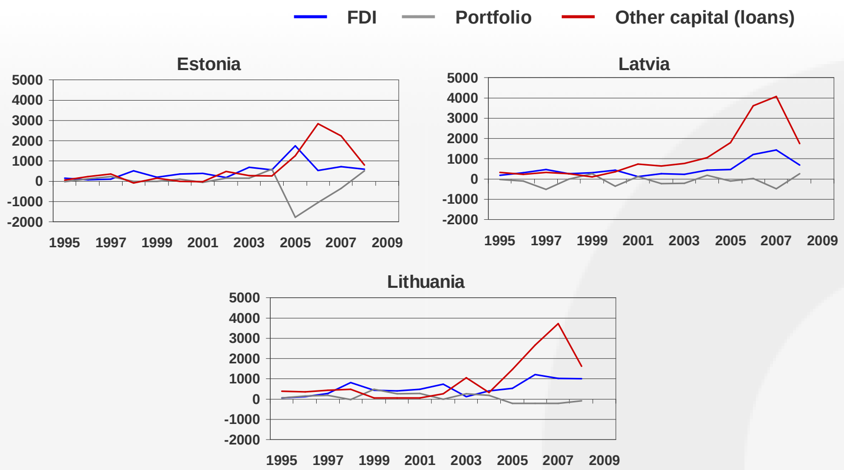
NMS-5: CZ, HU, PL, SK, SI. Baltics: EE, LV, LT. SEE: BG, RO, HR, MK, BA (from 1998), RS (from 1999), ME (from 2001).
Source: wiiw Annual Database incorporating national statistics, Eurostat.

Net capital flows, EUR million, 1995-2008



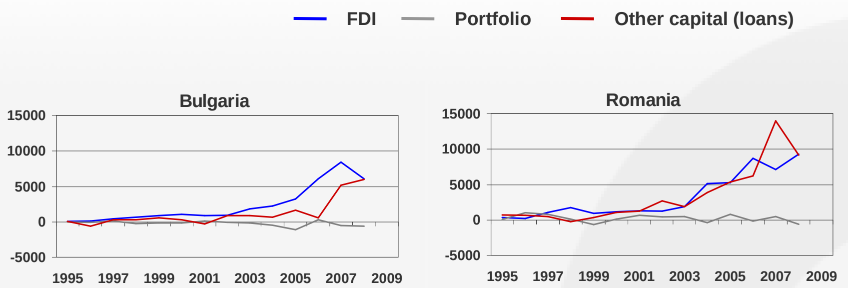
Source: wiiw Annual Database incorporating Eurostat statistics.

Net capital flows, EUR million, 1995-2008



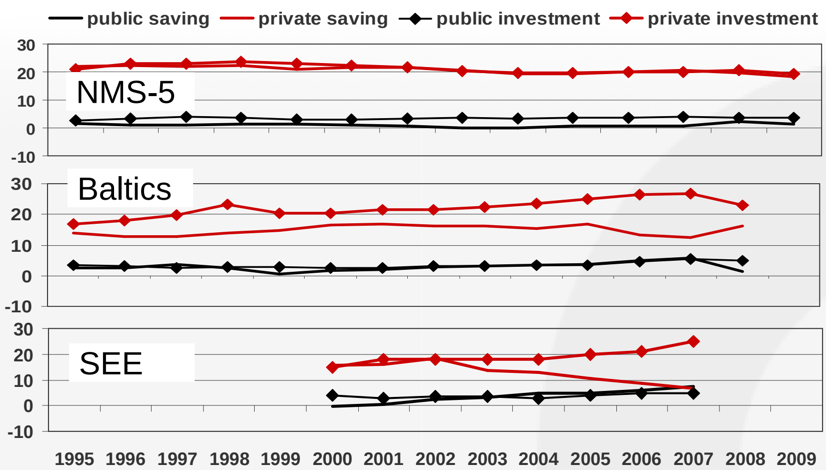
Source: wiiw Annual Database incorporating Eurostat statistics.

Net capital flows, EUR million, 1995-2008



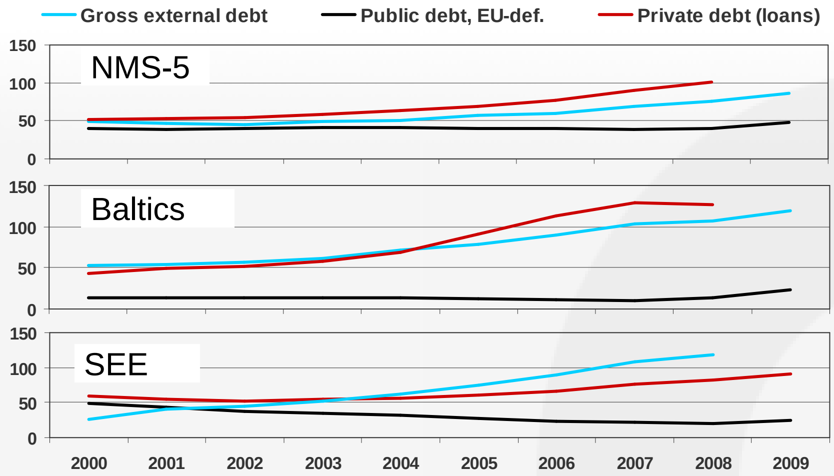
Source: wiiw Annual Database incorporating Eurostat statistics.

Savings and investment in % of GDP



NMS-5: CZ, HU, PL, SK, SI (from 2000-2007). SEE: BG (2000-2006) and RO (from 2004-2007).
Source: Eurostat, wiiw calculations.

Debt in % of GDP



NMS-5: CZ, HU, PL, SK, SI. Baltics: EE, LV, LT. SEE: BG, RO, HR.
Source: wiiw Annual Database incorporating national statistics, Eurostat.

The new situation after the crisis:

Strong differentiation by countries and country groups but also certain common constraints:

- **External factors:** new risk assessment of the region; more difficult internal and external financing; reduced growth expectations for the most important export markets; much tougher to join the eurozone
- **Internal factors:** reducing private sector debt leads to increased propensity to save (‘deleveraging’); more limited room to manoeuvre for fiscal policy; tightened financial market regulation (at the national and European level)

Policy challenges for the

short and medium term:
- getting credit going again
- pursue active fiscal policy in countries with room to manoeuvre
- real exchange rate adjustment vital in some countries
- labour market policy

medium and long term:
- paying much closer attention to external disequilibria
- flexible exchange rate regimes have proven to be more successful
- sustainability of private and public debt development (cross-border financial market regulation, increased EU monitoring)
- programme to promote the tradable sector (also involving **EU transfers**)
- deepening of EU fiscal and monetary policy coordination – also with candidate and (willing) neighbouring countries

Summary of the argument on ‘revisiting the growth model’

***1.* Adjusting to new external constraints and internal behavioural responses following the crisis:**
- External: export markets, more difficult financing conditions, tougher effective EMU membership conditions; financial market regulation
- Internal: weaker financial sector, deleveraging – higher domestic saving rates, less space for fiscal policy but more pressure on streamlining

2. Dealing with sustained structural imbalances:
- Differentiation across country groups (e.g. fix- and flex-exchr. economies)

3. Policy challenges:
- For the short run and the medium and longer run
- At national and at EU levels

Redirecting 'the integration model of growth'

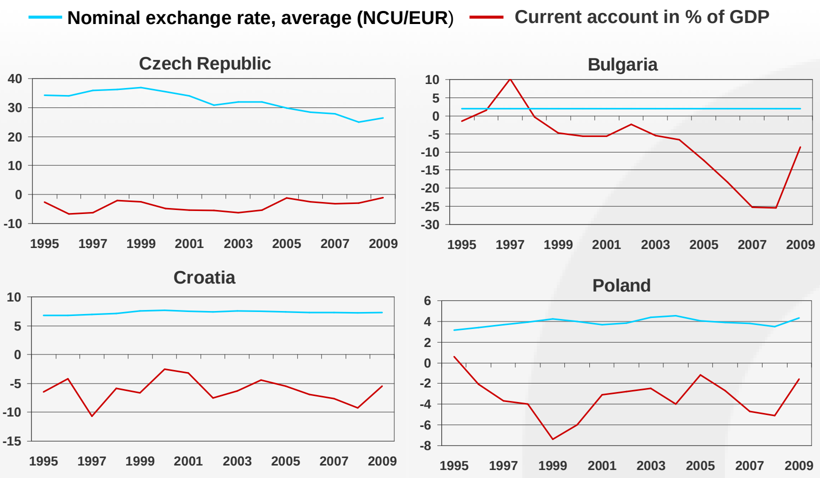
The policy choices:

- Fixed vs. flexible rates
- Fiscal consolidation vs. fiscal stimuli
- Free flow vs. sand in the wheels

Exchange rates

- Flexible exchange rates have supported sustainable current account deficits
- Countries with flexible exchange rate regimes may have had a less costly adjustment to the crisis
- To the extent that real exchange rates have improved with nominal depreciation, improved competitiveness should support growth once external demand recovers
- Fixed exchange rates tend to mandate procyclical fiscal policies during the crisis and in the medium run
- EMU membership may not protect against real exchange rate misalignments

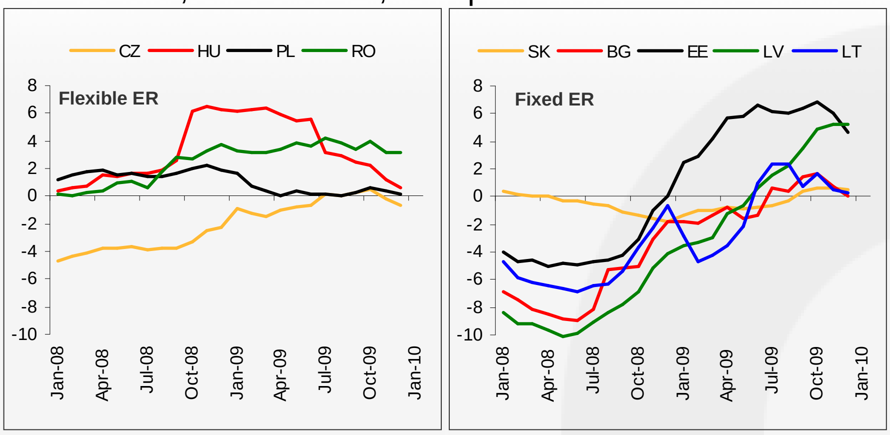
Exchange rate and current account



Source: wiiw Annual Database incorporating Eurostat statistics.

Real National Bank/ECB interest rates,

2008-2010, CPI-deflated, in % p.a.

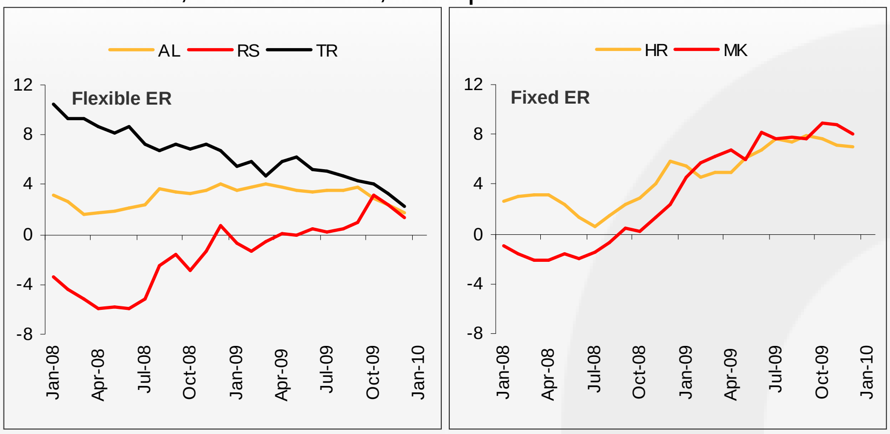


Note: For Estonia: 1-month interbank lending rate (Talibor); for Lithuania: 1-month interbank lending rate (Vilibor).

Source: wiiw Annual Database incorporating Eurostat statistics.

Real National Bank/ECB interest rates,

2008-2010, CPI-deflated, in % p.a.



Source: wiiw Database incorporating national statistics and Eurostat.

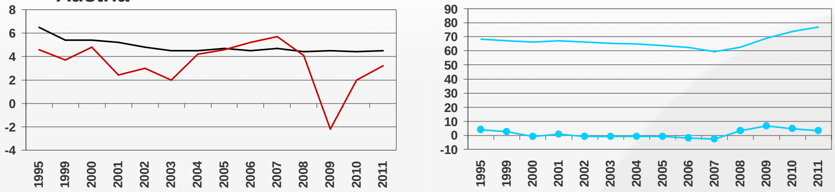
Fiscal issues

- In catching-up economies, as a rule, the interest rate on public debt is below the growth rate. Therefore the sustainability of public debt is not an issue, except if primary deficits are permanently higher than those that stabilize public debt to GDP ratios.
- In the current crisis, it does not seem that in most, not necessarily all countries, the structural primary deficit has changed permanently so that fiscal balances are not sustainable.
- Some of the hikes in fiscal deficits are the consequence of the deleveraging of private debts and thus fiscal consolidation is not the first best policy in those cases.

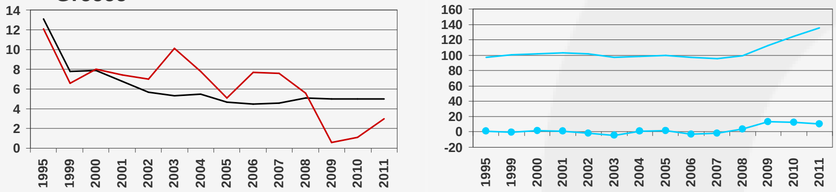
Public debt

Interest rate — GDP growth — Gross public debt to GDP — Change

Austria



Greece



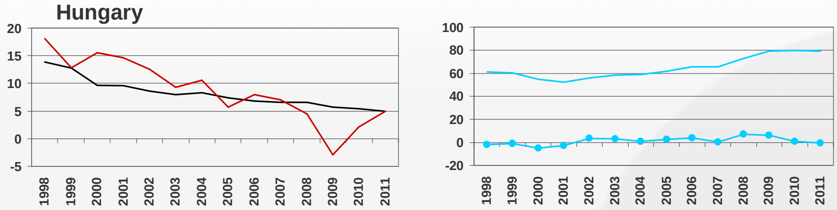
Note: Implicit interest rate and nominal GDP growth rate (sustainability); gross public debt and change in debt (measure of revealed fiscal risk).

Source: Eurostat, forecast according to Autumn Report 2009.

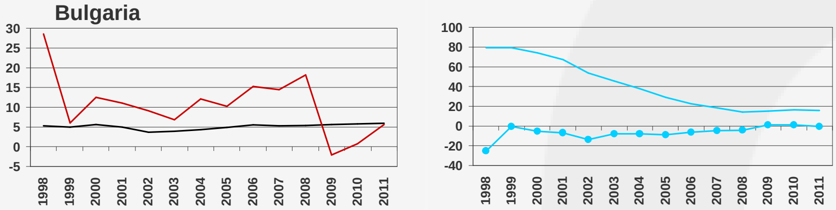
Public debt

Interest rate — GDP growth — Gross public debt to GDP — Change

Hungary



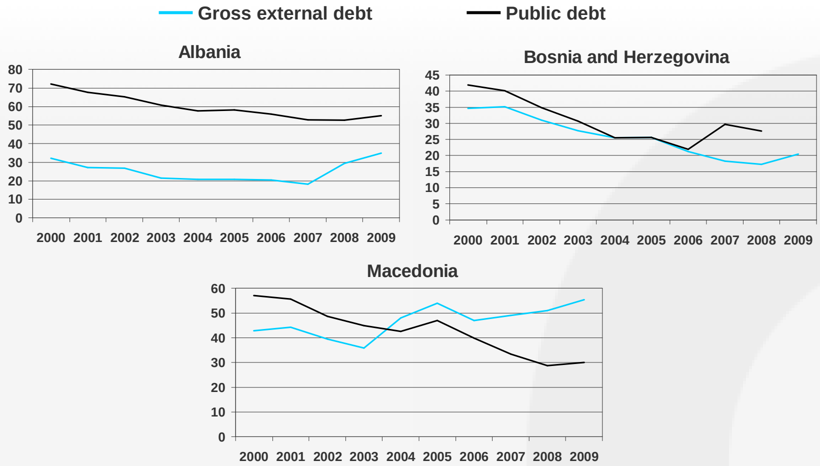
Bulgaria



Note: Implicit interest rate and nominal GDP growth rate (sustainability); gross public debt and change in debt (measure of revealed fiscal risk).

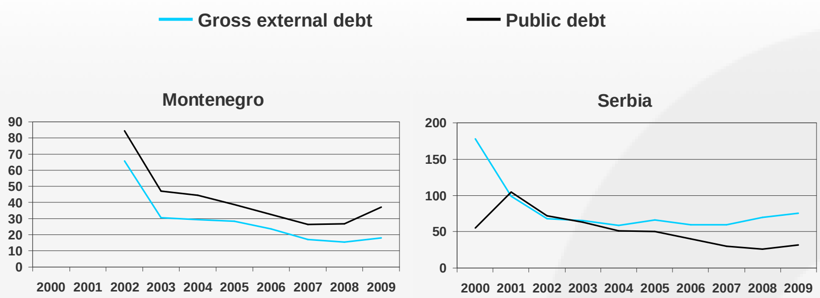
Source: Eurostat, forecast according to Autumn Report 2009.

Debt in SEE in % of GDP



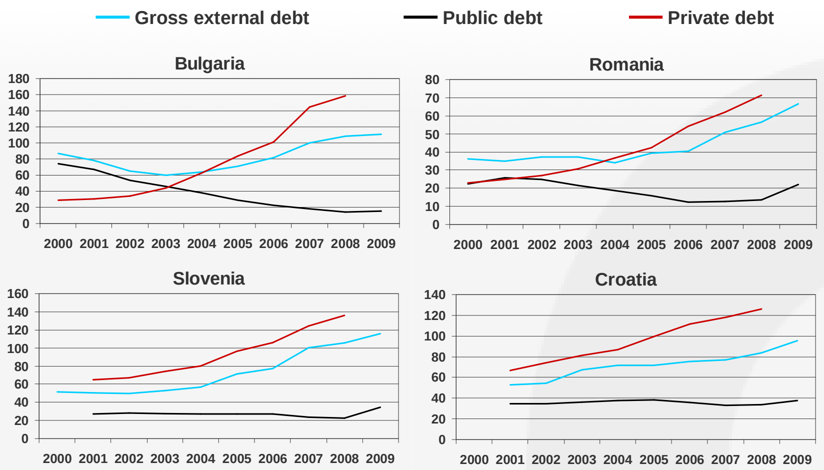
Source: wiiw Database incorporating national statistics.

Debt in SEE in % of GDP



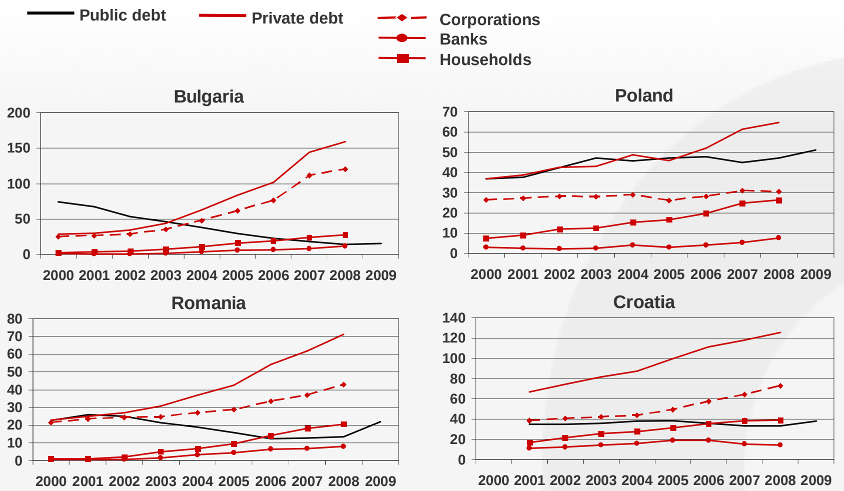
Source: wiiw Database incorporating national statistics.

Debt in % of GDP



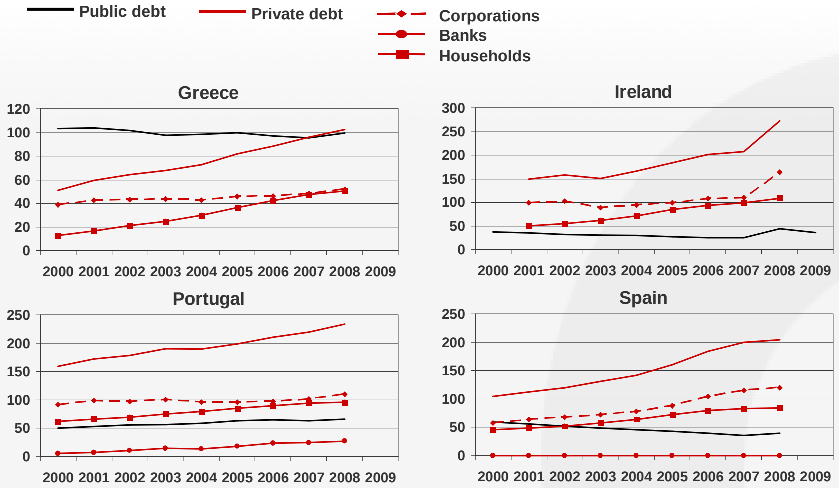
Source: wiiw Annual Database incorporating Eurostat statistics.

Public and private debt in % of GDP



Source: wiiw Annual Database incorporating Eurostat statistics.

Public and private debt in % of GDP



Source: wiiw Annual Database incorporating Eurostat statistics.

Financial regulation

Financial integration requires regulation at the EU level because there are EU-wide

- systemic risks,
- effective capital requirements, and the need for
- transparent supervision.

Policy recommendations for the improvement or the redirection of 'the integration model of growth':

EU agenda

- EU: Copenhagen and Maastricht criteria should ensure that accession to the EMU leads to sustainable currency union ex ante
- EU: Reinterpretation and enrichment of the Stability and Growth Pact with short-term crisis management facility (support for fiscal adjustments with conditions and mechanisms to implement these conditions which should not be procyclical)
- EU: Strengthening financial regulation for systemic risks

Policy recommendations for the improvement or the redirection of 'the integration model of growth':

National agenda

- Countries: exchange rate flexibility wherever that is feasible (countries that already use the euro or have committed to currency boards would have to make sure that the euro is an optimal currency union for them)
- Countries: Countercyclical fiscal policy with sustainable fiscal deficits and public debt to GDP levels
- Countries: Use of taxation or insurance to prevent bubbles in financial markets (sand in the wheels taxes on various types of investments)

Conclusions

- EU and national policy structures should be reformed in order to:
  - continue to benefit from trade and financial integration
  - with increased policy flexibility to deal with external and domestic imbalances.
- Depending on the types and severity of imbalances, countries should calibrate the speed to full integration.
- That is, they should redirect or even postpone the adoption of 'the integration model of growth'.