

New Divide(s) in Europe? Convergence in Europe Derailed?

Medium-Term Economic Prospects for CESEE

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Convergence in Europe Derailed?

- Pre-crisis: strong belief in the 'European integration model of convergence'; under-estimation of the impact of financial markets integration
- International financial markets integration and EU/Eurozone set-up strongly accentuate the possibility of external and internal imbalances
- Catching-up processes can be seriously derailed due to the build-up of imbalances
- Medium-term effects of the crisis: Debt overhang – especially in the private sector in many CESEEs; deleveraging processes hamper recovery; reduced fiscal space
- Development of EU policy framework affects recovery and convergence prospects

The European integration model of catching-up

- targeted at '**deep integration**' with the EU/Euro area
- associated with very far-reaching internal and **external liberalization** (trade, capital transactions, financial market integration, labour mobility)
- **benefits**: 'downhill' capital inflows; trade integration – encourages cross-border production networks; 'technology' transfer; institutional convergence; monetary policy anchor
- EU integration model affects **not only EU members** but also economies in the 'waiting room' (e.g. Balkans)
- the model worked - 'convergence process' – **but** emergence of severe **structural imbalances** in important groups of European EMEs; **heterogeneity** of pre- and post-crisis experience of European EMEs

Post crisis - the predicament of Europe's 'periphery'

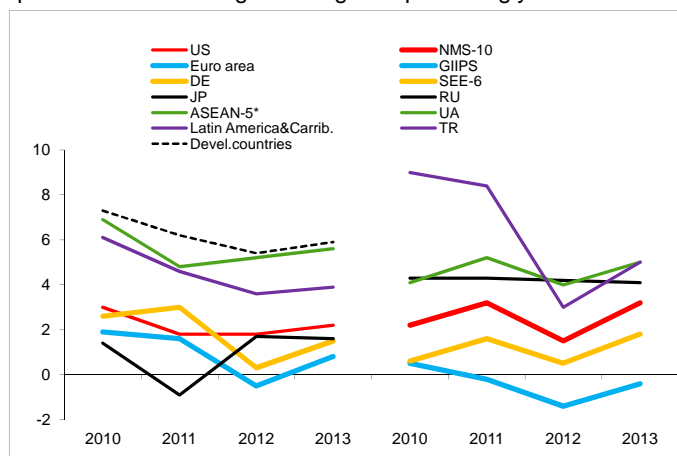
- In many countries (Southern and Eastern periphery) **high debt levels of private sectors** (corporate and household sectors) – **deleveraging processes**; public sector debt has significantly increased
- **Foreign banks in retrenchment** – credit constraints severe; cross-border banking goes through a process of re-nationalisation
- **Current accounts adjust strongly** – mechanisms different in fix- and flex-exchange rate countries; in a range of economies strong legacy of **distorted tradable/non-tradable sector structures**
- FDI and **inward capital flows sharply down**

wiiw Forecast (2012-2014) – main issues

- **External environment:** global growth slows, but mostly eurozone experiences another slump in 2012; oil price risk
- **'Divide(s) in Europe?':** country groups in CESEE (CE-3, HU, SI; Baltics; SEE; TR, UA, RU, KZ) and GIIPS
- Most important **differences across countries:**
 - Debt build-up prior to the crisis (mainly of the private sector)
 - Longer-term weaknesses of the export sector
 - Different responses in terms of economic policy (in particular fiscal policy)
- Expected impact of the **economic policy (re)orientation of the eurozone**

External environment: growth and growth forecasts

Development of GDP change in % against preceding year



GIIPS: Greece, Italy, Ireland, Portugal, Spain, ASEAN-5: Indonesia, Malaysia, Philippines, Thailand and Vietnam.
Source: IMF, WEO, Jan. 2012. European Commission, Interim Forecast, Feb. 2012. wiiw forecast.

GDP growth 2012

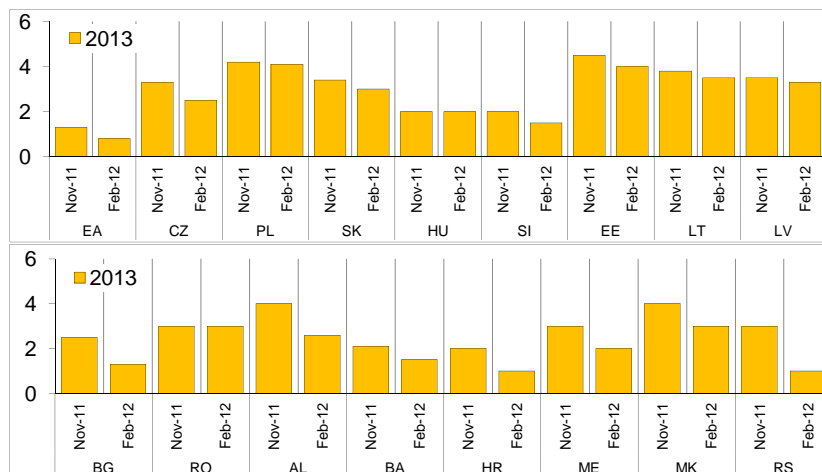
Revisions of forecasts (November 2011, February 2012)



Source: wiiw forecast. European Commission, Autumn and Interim Forecast, Feb. 2012.

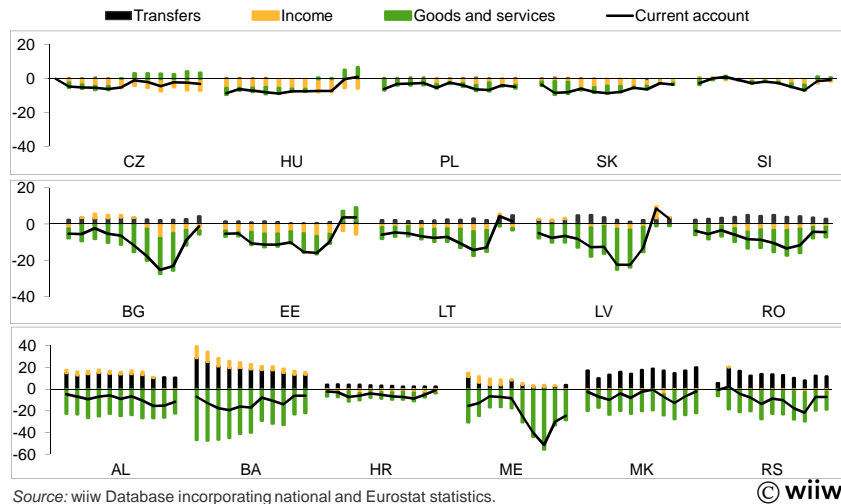
GDP growth 2013

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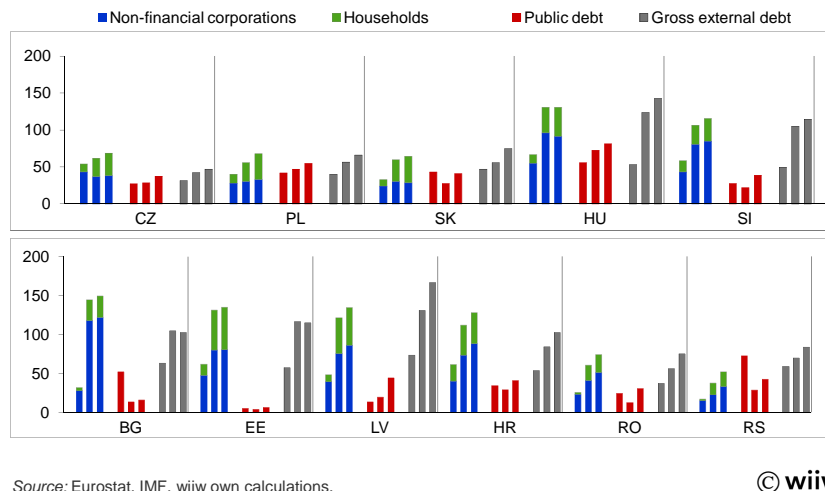


Source: wiiw forecast. IMF, WEO, Jan. 2012. European Commission, Autumn and Interim Forecast, Feb. 2012 © wiiw

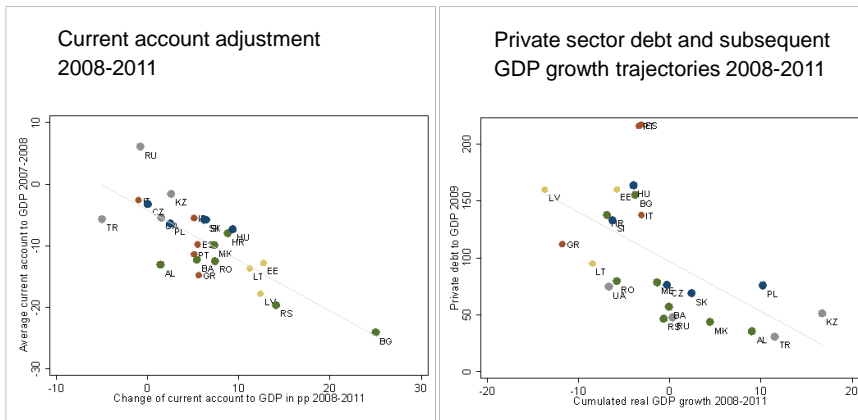
External imbalances: composition of the current account of the balance of payments, 2000-2010, in % of GDP



Debt level: private, public and external debt in % of GDP, 2002, 2008 and 2010

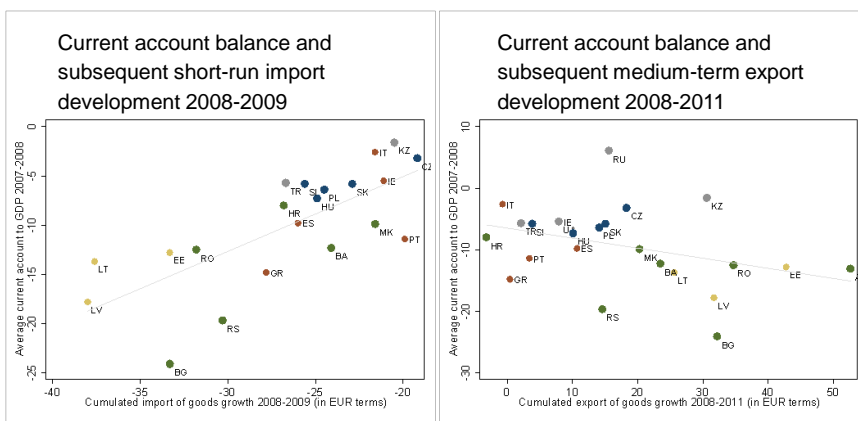


Debt level and adjustment of external imbalances determine growth 2008-2011



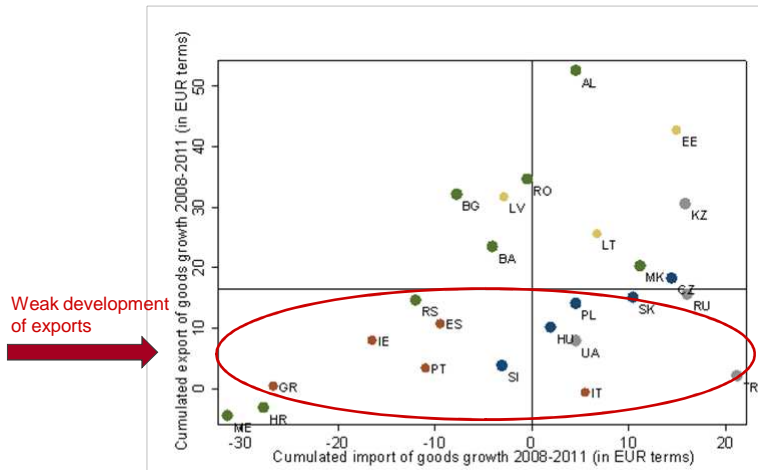
Source: wiiw Database incorporating national and Eurostat statistics, own calculations.

Current account goods adjustment first through imports, then through exports



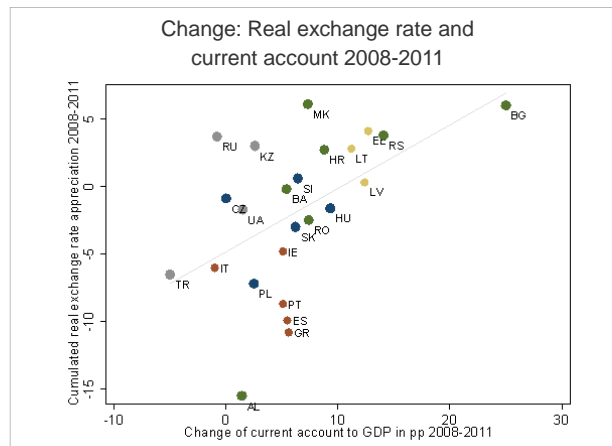
Source: wiiw Database incorporating national and Eurostat statistics, own calculations.

But:
Different development of exports and imports 2008-2011



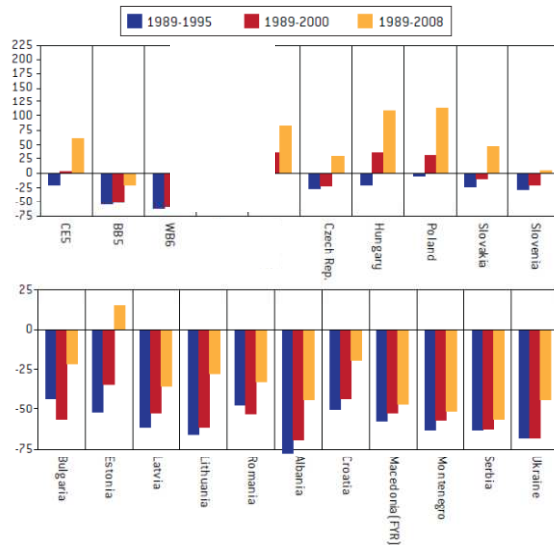
Source: wiiw Database incorporating national and Eurostat statistics, own calculations.

Real exchange rate developments have hardly contributed to current account adjustments

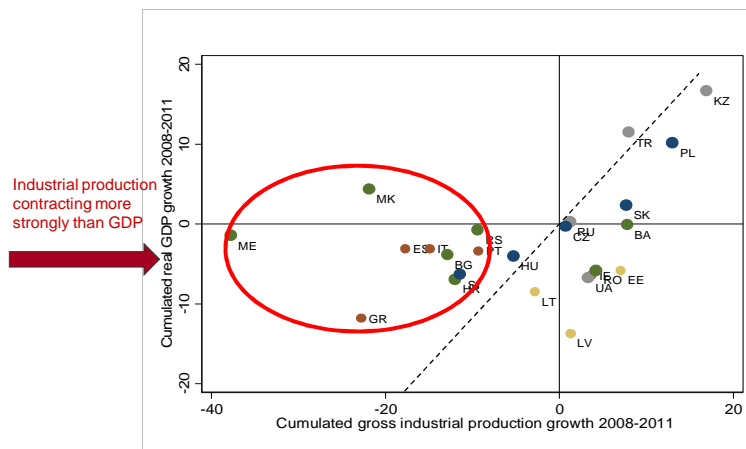


Source: wiiw Database incorporating national and Eurostat statistics, own calculations.

De- and re-industrialization processes continue to play an important role
(Industrial production – level relative to 1989: 1995, 2000, 2008)



Development of GDP and gross industrial production,
2008-2011

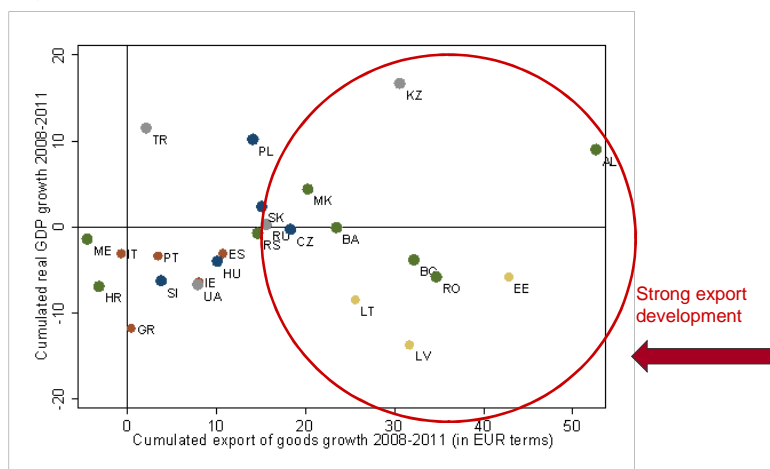


Source: wiiw Database incorporating national and Eurostat statistics, own calculations.

Forecast 2012-2014

- Future growth can rely less on the contribution of the external sector
- Thus, greater dependence on domestic demand
- But:
 - Consumption and investment demand characterized by difficult financing conditions and deleveraging processes
 - Fiscal policy in most countries restrictive
- Dampened recovery processes that will extend over 2013, 2014
- Implications for the labour market

Growth determined by exports in 2010, 2011; but strong differentiation by country



Source: wiiw Database, national statistics and Eurostat, wiiw calculations.

Changing contributions to GDP growth

positive and negative contributions to GDP growth

		2009	2010	2011	2012	2013
Household final consumption	+	3	8	13	12	15
	-	14	9	4	5	2
Government final consumption	+	9	9	6	6	10
	-	8	8	11	11	7
Gross fixed capital formation	+	1	5	12	12	16
	-	16	12	5	5	1
Trade balance	+	16	11	9	5	6
	-	1	6	8	12	11

Note: A figure in a + row indicates the number of countries that had a positive contribution. A figure in a - row indicates the number of countries that had a negative or stagnant contribution.

Source: wiiw estimates incorporating national and Eurostat statistics.

External demand: Differing growth developments of the most important trading partners

Trade-weighted GDP growth in %

	2008	2009	2010	2011
CE-5	1.6	-3.6	2.4	2.2
Baltics	1.4	-6.6	3.4	3.8
BG+RO	1.8	-3.8	2.9	2.5
SEE-6	2.0	-4.0	2.0	1.8
RU+UA	3.2	-2.4	4.3	3.7

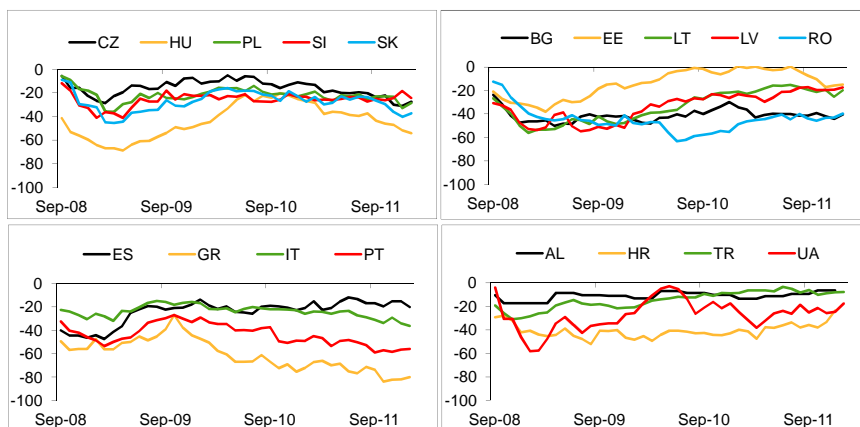
Source: wiiw Database incorporating national and Eurostat statistics, own calculations.

Growth rates of consumption and investment remain low; lack of strong impulse from domestic demand

		2011	2012	2013
Czech and Slovak Republics and Poland	Real GDP	3.1	1.7	3.2
	Household consumption	0.9	0.7	2.3
	Gross fixed capital formation	4.3	2.2	4.3
Hungary and Slovenia	Real GDP	1.1	-1.0	1.8
	Household consumption	0.0	-1.0	-0.2
	Gross fixed capital formation	-8.2	-3.0	1.0
Baltic countries	Real GDP	6.2	2.0	3.6
	Household consumption	4.8	2.3	2.7
	Gross fixed capital formation	-2.0	1.5	4.5
Bulgaria and Romania	Real GDP	2.1	0.5	2.2
	Household consumption	1.2	1.0	1.8
	Gross fixed capital formation	18.8	5.7	7.3
Western Balkan countries	Real GDP	2.0	0.8	1.9
	Household consumption	1.7	1.1	1.9
	Gross fixed capital formation	0.9	1.5	3.6

Source: wiiw estimates incorporating national and Eurostat statistics.

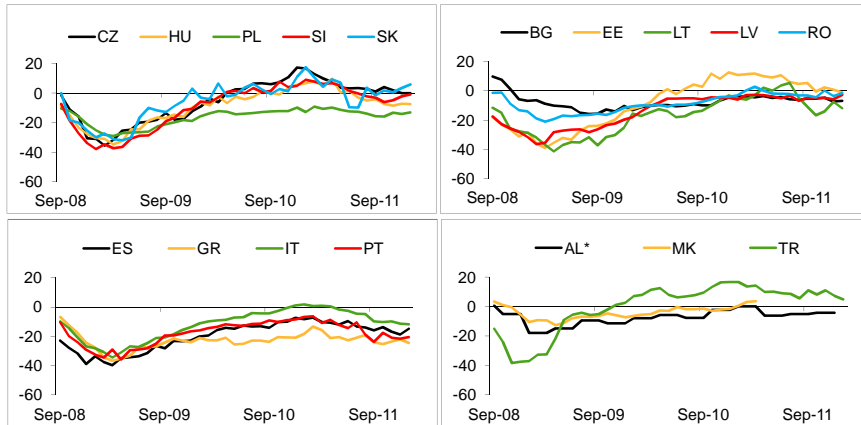
Recent consumer surveys indicate mainly negative tendencies



Remark: * AL: quarterly data.

Source: Eurostat, Consumer Confidence Indicator, national statistics.

The same holds for industry surveys



Remark: * AL: quarterly data.

Source: Eurostat, Industry Confidence Indicator, national statistics.

Assessment of recovery/growth prospects

- External demand will be low due to downturn in Eurozone
- Deleveraging and financing problems suppress domestic demand
- Restrictive fiscal policy approach in many countries
- Labour market problems are aggravating
- Longer-term impact of the economic policy course of the eurozone

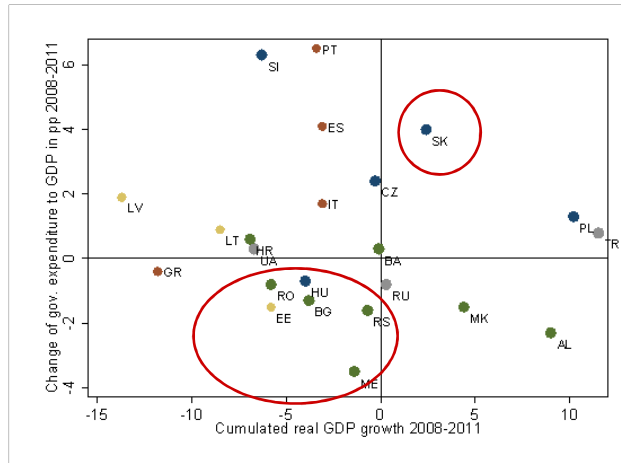
EU Policy Framework

- Fiscal compact
- ECB intervention
- Stabilisation and other funds
- Indicators of disequilibria and competitiveness
- General policy stance

Public and Private Debt Sustainability

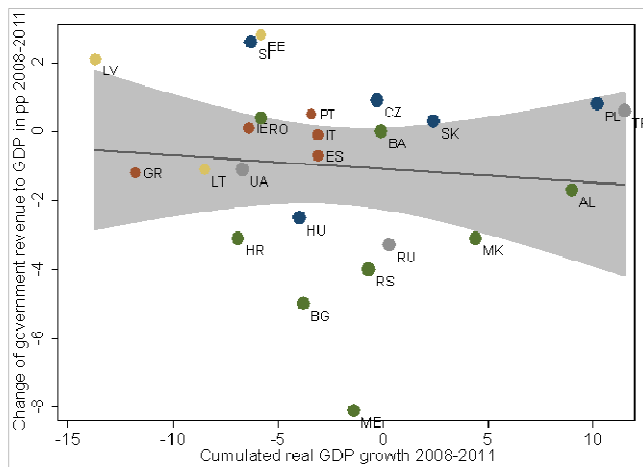
- EU indicators look mostly on debt levels which are not informative of sustainability
- Interest rates and growth rates mostly indicate that debt levels, even if comparatively low, are not sustainable
- Corporate sector balance sheets are the key, but more information is needed

Groups of CESEE countries pursue a pro-cyclical fiscal policy



Source: wiiw Database incorporating national and Eurostat statistics, own calculations.

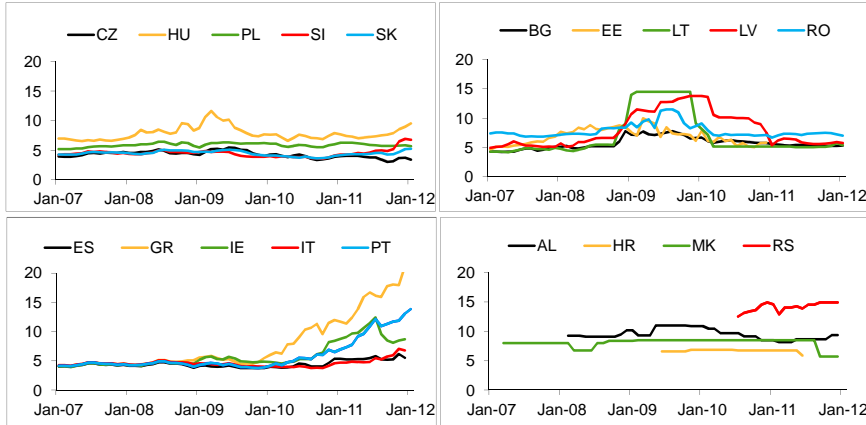
Change of general government revenues and GDP growth 2008-2011



Source: wiiw Database incorporating national and Eurostat statistics, own calculations. Shaded area shows the 95% confidence interval around the correlation.

Yields on government bonds

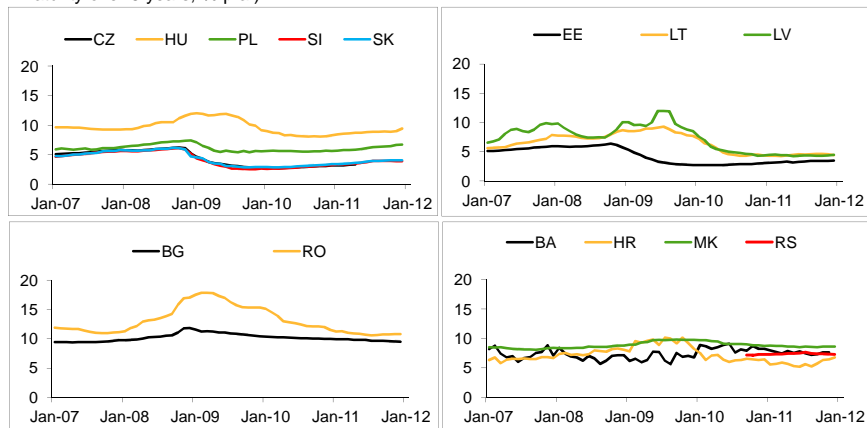
maturity 10 years, % p.a.



Source: Eurostat, National Bank statistics.

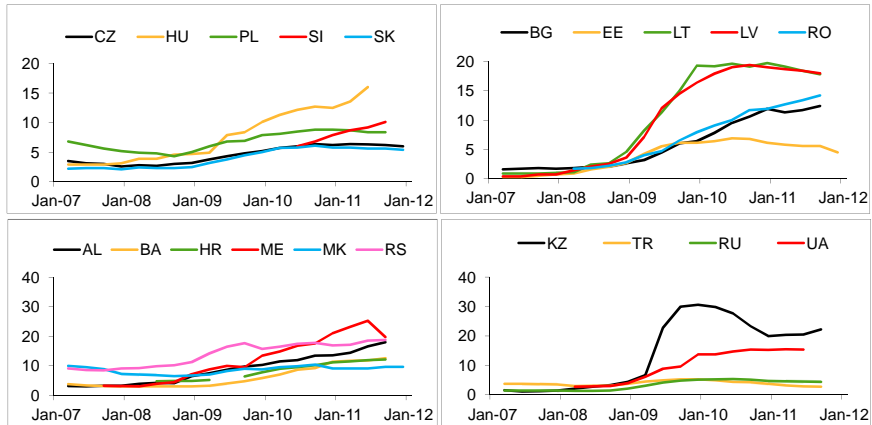
Interest rate spreads indicate the varying assessment of the credit risk in the individual countries

Interest rates - loans to non-financial corporations (domestic currency, amount outstanding maturity over 5 years, % p.a.)



Source: Eurostat, National Bank statistics.

Tight financial sector: Non-performing loans in % of total



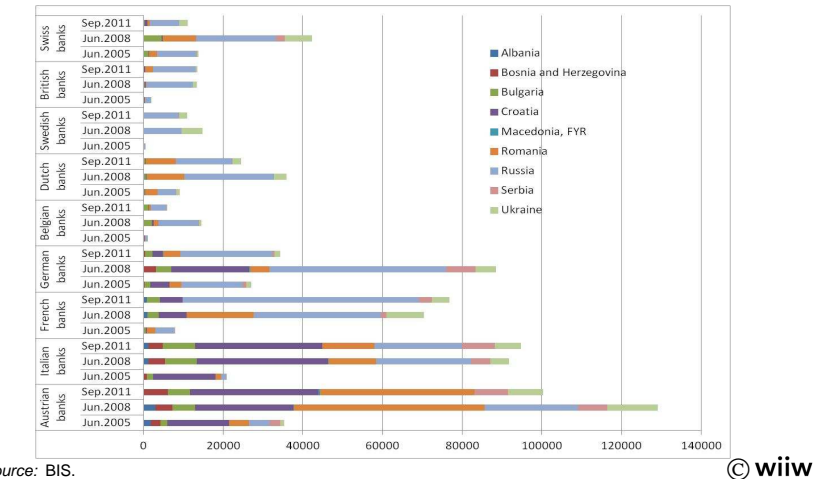
Remark: * AL: quarterly data.
Source: Eurostat, national statistics.

Cross-Border Deleveraging

- Significant retrenchment by banks
- Differentiated by countries of origin
- And by regions

Foreign banks reduce their balance sheets in Southeast Europe, Russia and Ukraine

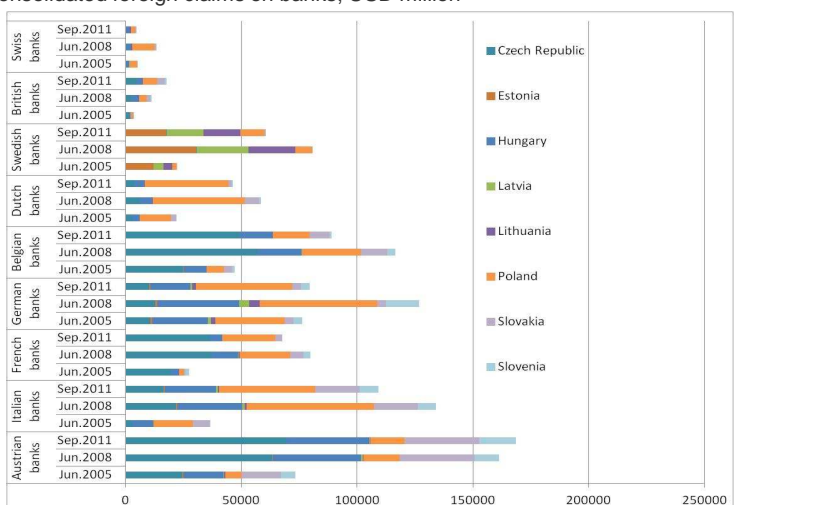
Consolidated foreign claims on banks, USD million



Source: BIS.

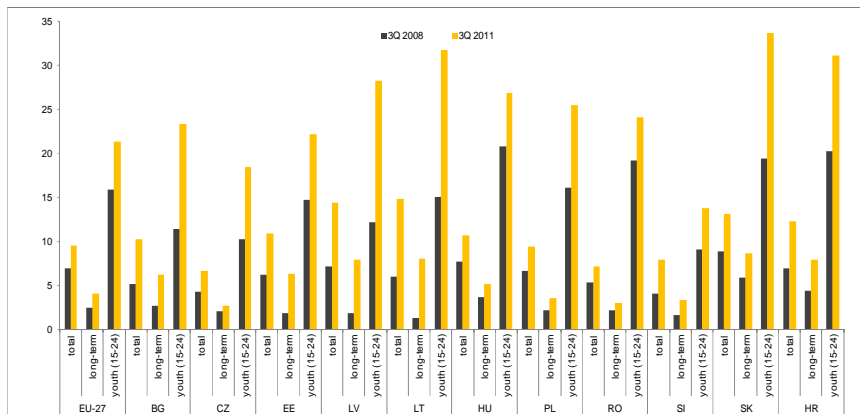
Less so in Central Europe

Consolidated foreign claims on banks, USD million



Source: BIS.

Youth unemployment (15-24) and long-term unemployment (more than 12 months) have increased strongly



Source: Eurostat.

Conclusions (I)

- Differentiated development of country groups
- Negative growth prospects: external demand; deleveraging and financing problems suppress domestic demand; restrictive fiscal policy approach
- Longer-term growth paths will be affected as well
- Labour market problems are aggravating
- Strong impact of the economic policy course of the eurozone

Conclusions (II)

- The overall policy framework depends on the revival of investments and the more balanced inter-EU trade flows
- Institutionally, EU and the Euro Zone in particular still have no instruments for countercyclical stabilization policies
- There is a risk that it will be some time before convergence between various European regions may continue