Redefining growth models for Eastern Europe after the crisis: Can Eastern Europe grow faster again than Western Europe?

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Issues to be addressed

◆ There are two main issues to be addressed in this presentation:
   – *First*, can the EE grow faster again than the WE and thus continue the convergence trend?
   – And *second*, can the return of the region to higher growth be achieved with the growth model that has been applied in the pre-crisis period. If not, what should be the components of the revised or even entirely new growth model?

◆ The presentation focusses on the 12 NMS and on EU candidate countries
Structure of the presentation

- Growth performance and economic convergence before the crisis
- During the crisis developments
- Economic growth and convergence perspectives over the medium-term period
- A new growth model for the region?
A. Growth and economic convergence before the crisis

- After the initial shock, the transition process facilitated strong economic growth of EE
- Between 1994 and 2008, the region has registered average annual growth rates of over 4%, and even higher than 5% in the final years of that period
- Growth rates were high also in comparison with other emerging market regions
- General picture masks significant differences between individual countries
A. Growth and economic convergence before the crisis (II)

- Strong economic convergence to the EU average achieved as well

- Many NMS already achieved levels between 60 and 80% of the EU-27 average

- For EU candidate countries the level is much lower - between 30 and 50% of the EU-27 average

Source: Economic Commission
A. Growth and economic convergence before the crisis (III)

Growth in EE fueled mainly by high domestic demand (private consumption and inward-oriented investment)

Source: Economic Commission
A. Growth and economic convergence before the crisis (IV)

- High growth was made possible with a distinctive growth model based on large capital flows

Source: IMF
A. Growth and economic convergence before the crisis (V)

- Main reasons for large capital flows into EE (largely intermediated by subsidiaries of commercial banks from WE) ...
  - Formal and economic integration with the EU and prospects for EU membership
  - Low interest rates in the euro area
  - Macroeconomic stabilisation and structural reforms of EE countries
  - Low credit penetration offered good business opportunities
  - Reduced country risk has resulted in an improved access to capital markets at very low price
A. Growth and economic convergence before the crisis (VI)

- ... and most important negative consequences of these inflows
  - Credit booms associated with overheating

Source: IMF
A. Growth and economic convergence before the crisis (VI)

- ... and most important negative consequences of these inflows
  - Increasing external vulnerabilities

Source: European Commission and IMF
A. Growth and economic convergence before the crisis (VII)

- ... and most important negative consequences of these inflows
  - Very high proportion of foreign denominated debt
A. Growth and economic convergence before the crisis (VIII)

- Comparison of EE and Emerging Asia
  - Both regions achieved high growth performance, but EA’s growth model after the 1997 crisis contrasted sharply with the one of EE
  - Key elements of the EA’s growth model
    - Export-led growth supported by rather restrictive fiscal policy and more cautious integration of domestic financial markets
    - Countries of EA have significantly increased domestic savings with investments mainly in tradable sector
A. Growth and economic convergence before the crisis (IX)

As a consequence, EA entered into the crisis with current account surpluses and high foreign exchange reserves .........

Source: IMF
A. Growth and economic convergence before the crisis (X)

...... and smaller reliance on global financial markets

Source: IMF
B. During the crisis development

- In the last quarter of 2008 EE entered into a deep crisis with substantial growth contraction in 2009 and only marginal growth in 2010.

Source: World Bank
B. During the crisis development (II)

- In comparison with other emerging market regions, economic growth in EE was hit the most drastically by the crisis.

Source: IMF
B. During the crisis development (III)

- Poor performance of the region during the crisis could be attributed to the fact that overall vulnerability of the region’s growth model was much higher than in other regions.

- Growth performance has varied widely among individual EE countries; it collapsed most in:
  - Countries with a combination of, first, high external vulnerability causing a sudden stop of capital inflows, and second, high dependence on domestic demand causing its sharp reduction.
  - In some of the more advanced EE countries due to the falling demand for their exports in WE.
B. During the crisis development (IV)

- Dramatic decline of economic growth in EE interrupted the region’s more than a decade long period of strong real economic convergence towards the average EU-27 level

- In 2009, per capita GDP in PPP terms as percentage of EU-27
  - Declined in 5 out 12 NMS (the 3 Baltic states, Hungary and Slovenia)
  - Stagnated in another 2 NMS (Czech republic and Malta)
C. Medium-term growth and convergence perspectives

- The crisis has affected dramatically potential and actual growth of EE as well as the output gap as the relationship between the two.

- In the pre-crisis period, EE had highly positive output gap.

- During the crisis, the output gap turned into strongly negative territory as the actual growth felt dramatically (to around -4 per cent in 2009 and below +1 per cent in 2010).
C. Medium-term growth and convergence perspectives (II)

- Potential growth rate of EE before crisis was at an annual level of between 4 to 5 per cent.

- High potential growth was a reflection of the region’s good economic fundamentals for strong economic growth.

- The main driver of the region’s economic growth at that time was TFP growth, i.e., a part of total output growth not explained by capital and labor and is a fact a reflection of increased productivity achieved reforms.
C. Medium-term growth and convergence perspectives (III)

- Contribution of TFP to the EE’s growth
- TFP growth in EE faster than in any other region

Source: IMF
During the crisis the region’s potential growth declined significantly; for NMS, for example, it roughly halved between 2007 and 2013.
C. Medium-term growth and convergence perspectives (V)

- The decline of potential growth is especially dramatic for Baltic states; from an annual rate of around 6 per cent in the period 1999 – 2008 to below 2 per cent in the period 2009 – 2013.
C. Medium-term growth and convergence perspectives (VII)

- Factors contributing to the potential growth decline of EE countries
  - Changed international environment is less growth supporting (crisis of confidence; access to capital more difficult and expensive; lower growth in WE; regulatory changes requiring from banks higher capital requirements)
  - On internal side, growth will be negatively affected by lower private demand (household credit growth already declined) as well as public demand (significantly worsened fiscal position requires strong fiscal consolidation)
C. Medium-term growth and convergence perspectives (VIII)

- The crisis affected negatively all components of potential growth
  - **Investments**: Investment opportunities were reduced as demand for products decreased and availability of capital declined and its costs increased; investment levels have gone down
  - **Labour**: Significant increase of unemployment which may turn into a structural one; on a longer run the ageing of the population is a key factor
  - **TFP**: The dynamics of structural reforms may be slowed down in the medium-term
C. Medium-term growth and convergence perspectives (IX)

- Comparison of downward potential growth revisions for NMS and OMS by the EC
  - OMS: after falling from around 2% in 2007 to below 1% in 2009 and 2010, potential growth is expected to recover to around 1.5% in 2013
  - NMS: the potential growth is forecasted to have a continuously downward trend in the 2007 – 2013 period as contributions of investment and TFP will fail to recover from their low 2009 or 2010 levels and as negative trends with respect to the labor component will deteriorate even further due to slower growth rate of the working age population.
C. Medium-term growth and convergence perspectives (X)

- In contrast to the pre-crisis period, real economic convergence of EE towards WE average is expected to be significantly slower over the next medium-term period with some countries of the region probably growing even slower than their counterparts in WE.

- On a longer run, however, it is expected that developments will turn back to the normal “catching up process” with less developed EE growing again faster than WE.
D. A new growth model for the region

- As the pre-crisis growth model of relying heavily on domestic demand and massive capital inflows has proven to be unsustainable for EE, the question arises whether
  - an entirely new growth model may be needed for the region or
  - the existing model should be revised in a way that it will be less exposed to external shocks.

- Whatever the form, there are basically three main building blocks on which the reform of the existing EE growth model should be based
D. A new growth model for the region (II)

- **Building block No.1:** increase of domestic savings (private and public) and consequently a reduction of the reliance on foreign savings
  - *Private savings;* An improved business environment should increase potential returns and thus savings ratio and stimulate the shift of investments towards tradable sector and exports
  - *Public savings;* significantly deteriorated fiscal position of many countries needs to be corrected through a process of fiscal consolidation
D. A new growth model for the region (II)

- **Building block No.2:** adjustments in macro-economic and financial policy. These policies
  - will have to be more proactive in managing capital inflows including stimulating these flows to be channeled into tradable sector and exports
  - should stimulate greater reliance on domestic sources of credit funding and discourage excessive leveraging what would contribute to mitigation of external vulnerabilities and make domestic financial system more resistant to external shocks
D. A new growth model for the region (III)

- **Building block No. 3**: structural reforms aimed at increasing productivity
  - *Institutional changes*: The status of these reforms is far from consistent among sectors and countries.
  - *Human resource development*: it includes reforms in the areas of education, R&D development as well as innovation absorption and creation.
  - *Labour sector reforms*: they are even more needed in the context of rapidly ageing population of many countries in the region.
D. A new growth model for the region (IV)

- These reforms of the EE growth model are not without controversies/questions; for example
  - Structural reforms may increase productivity and economic growth, but at same time attractiveness for capital inflows what implies macroeconomic problems associated with possible appreciation pressures and consequently pressures on international competitiveness
  - EU integration means full integration of acceding countries including liberalization of their capital flows; if these countries are economically successful they will be attractive for capital inflows
D. A new growth model for the region (V)

- Due to structural characteristics of EE countries (small economies fully integrated into the EU) there seems to be no room for application of a completely new growth model.

- What, however, is realistic and also necessary for EE is to revise the existing growth model in order to be less vulnerable to external shocks:
  - On a medium term, reduced reliance on foreign savings will have a price in lower economic growth.
  - On a longer-term, growth perspectives depend largely on the interplay of all the three components determining potential growth rate of the region.