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Redefining growth models for Eastern European countries after the crisis: Can Eastern Europe grow again at a faster rate than Western Europe?

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I. Introduction

High economic growth of Eastern Europe (EE) throughout more than a decade and consequently its strong real economic convergence path with Western Europe (WE) has been brutally interrupted with the current economic crisis. The two main questions I will address in this presentation are the following: *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? Even though the title of the presentation implies that I will talk about the region as a whole, I will focus on the 12 NMS and on EU candidate countries.

II. Growth performance and economic convergence before the crisis

Let me start with the region's growth performance and convergence in the period prior to the crisis. After the initial shock in early 1990s, the process of transition towards market economies has facilitated strong economic growth of EE that has lasted in majority of countries in the region for well over a decade. 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 (between 2004 and 2008). These high growth rates that were high also in comparison with other emerging market regions have been accompanied with significant increase of per capita income, expressed in PPP terms, for the region as a whole. Of course, this general picture masks significant differences between individual countries or groups of countries. While many of NMS reached already the level of between 60 and 80% of the EU-27 average in the final year before the crisis, candidate countries were generally at a much lower level – between 30 to 50% of that average.

The region's engine of growth fueled mainly by high domestic demand, both in the form of private consumption as well as inward-oriented investment, was made possible with a distinctive model of economic growth. Formal and economic integration of EE into the EU has been instrumental for putting in place a legal and institutional framework conducive for transforming

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countries of the region into market economies while low interest rates in the euro area as well as the prospects of the region for accession to the EU have set the stage for large net capital inflows. These inflows were further stimulated by significantly improved macroeconomic performance and intensified structural reforms in the region. An improved business climate with highly educated work force and rather low wages on the one hand and low credit penetration on the other offered many new business opportunities primarily to partners from WE. And finally, a reduced country risk has resulted in an improved access of the EE to foreign financial markets as well as in significant tightening of funding costs, sometimes even below the levels justified by the economic fundamentals. Important negative consequences of these massive capital inflows largely intermediated by subsidiaries of commercial banks from WE and fostering primarily domestic demand have been credit booms associated with overheating of the economies as well as increasing external vulnerabilities in the form of rising current account deficits and growing external debt, very often in foreign currency denominations.

EE is not the only emerging market region that has achieved high economic growth and convergence with the EU as its economic gravity center. Another region with similar growth performance was Emerging Asia (EA) but its growth model contrasted sharply with the one applied by EE. After the 1997 crisis, EA opted for an export-led growth based on rather restrictive fiscal policy and accompanied by more cautious international integration of domestic financial markets. In contrast to EE, countries in EA have significantly increased domestic savings rates while investments were largely oriented towards the tradable sectors. As a consequence, economies of EA entered into the current economic crisis with current account surpluses and with relatively high foreign exchange reserves. Further on, the reliance of EA on global financial markets was at that time and in relative terms significantly smaller than in the case of EE.

III. During the crisis developments

In the last quarter of 2008 and after a long period of high economic growth EE entered into a deep crisis with substantial growth contraction in 2009 and only marginally positive growth in 2010. In comparison with other emerging market regions, economic growth in EE was hit the most drastically by the crisis. This could be attributed to the fact that overall vulnerability of the region’s growth model was much higher than in other regions and that consequently the region’s growth performance was affected much more negatively by the crisis than elsewhere.

Even though economic growth was drastically reduced throughout the region during the last two years, the growth performance differed widely among individual 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. Significant growth contractions have been registered also by some of the more advanced countries of the region due to the falling demand for their exports in WE. In contrast, better or less bad growth performance has been achieved by some commodity exporting countries, especially in the period prior to the fall of commodity prices, and also countries that have been less financial developed and integrated with international financial markets.

Dramatic decline of economic growth in EE in 2009 and 2010, in many countries of the region sharper than in WE, 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 has declined in 5 out 12 NMS (the 3 Baltic states, Hungary and Slovenia) and stagnated in another 2 NMS (Czech republic and Malta) what indicates that in a significant number of countries in the region real convergence was not only interrupted at least temporarily but even reversed.

IV. Economic growth and convergence perspectives over the medium-term period

Let me now turn to the prospects for economic growth of EE in the medium-term period. The current economic crisis has affected dramatically both, potential and actual growth of EE as well as the output gap as the relationship between the two. In contrast to the pre-crisis period characterized by highly positive output gap indicating that actual economic growth was well above the countries' macroeconomic potential during the crisis years the actual growth felt dramatically to a level of around -4 per cent in 2009 and below +1 per cent in 2010. Consequently the output gap for the region turned into strongly negative territory.

Empirical studies are rather consistent in estimating the region's potential growth rate in the pre-crisis period at an annual level of between 4 to 5 per cent. This high potential growth was a reflection of the region's good economic fundamentals for strong economic growth. The main driver of economic growth throughout the region at that time was TFP growth which is a part of total output growth that is not explained by capital and labor and is a fact reflection of increased productivity achieved through growth enhancing reforms.

In the pre-crisis period, TFP growth in EE was faster than in any other region of the world, except in China and CIS. There were, however, significant differences between NMS and pre-accession countries with respect to the TFP's participation in the potential growth. In the latter group, the participation of this component in overall potential growth was much higher because the overall transition process was slower than in NMS. Investment and overall capital deepening was another important factor contributing to the region's high potential growth in that period. On the other hand, participation of the third growth component – labor – was marginally positive and in some EE countries it was even negative due mainly to continuation of rigidities on the labor market and still large unemployment in many countries of the region.

During the crisis the region's potential growth dropped sharply. The European Commission, for example, estimates that potential growth of NMS roughly halved between 2007 and 2013; from around 4 to 2 per cent. Its decline 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. The assessment of reduced potential growth of NMS over the next medium-term is being shared by some academic studies. One of these studies, for example, estimates that in the 2011 – 2015 period potential growth of NMS will be for between 1 to 1.5 percentage points lower than in the 2001 – 2005 period with again Baltic states being on the top of the range.

Factors causing potential growth rates of the region to be lower for the forthcoming medium-term period than they were for the pre-crisis period are of two origins. On the one hand, significantly changed international environment is expected to be less supportive for high economic growth of the region than it was in the past. The financial crisis has namely triggered a general collapse of confidence. As a consequence, access of the region to external financing has become not only more difficult but also significantly more expensive. Further on, lower growth in WE as main trading partners for the region does not bode well for export demand from products from EE. And finally, external environment might change also due to expected regulatory adjustments requiring from banks higher capital requirement and thus influencing their credit generating capacity.

On internal domestic side, potential growth will be affected negatively both by private as well as well as public sector demand. On the private sector's side, major adjustments have already been made. Households, for example, have significantly increased savings as their credit growth decreased while in the corporate sector strong deleveraging process is underway. As far as public sector demand is concerned, it will be affected by significantly worsened fiscal position of most of the countries of the region that will require their strict fiscal consolidation in the forthcoming period.

The post-crisis reduction of the potential growth of EE *vis-à-vis* its pre-crisis performance can be assessed also through implications of the crisis on each of the three components of the potential growth. Financial crisis has reduced investment opportunities as demand for products and services has gone down and as availability of capital has been reduced and its real costs have increased. As a consequence, investment levels rates have gone down what in combination with an acceleration of the rate of obsolescence of some capital stocks due to a wave of bankruptcies and economic restructuring leads to a reduction of capital stock and lowering of potential growth in a short and medium run. In the long run, negative implications of the crisis on investment may continue in case that the cost of capital remains permanently increased due to changed risk perception of creditors and investors.

The crisis has affected negatively the potential growth's labor component as well. Practically all countries in the region have registered a significant increase of unemployment during the last two years. Due to rigidities on the labor market and long adjustment period at least one part of this actual unemployment it may prove to be structural. Continuation of the crisis over longer period of time may distort incentives to seek jobs and may also discourage immigration what may all contribute to a permanent destruction of human capital and thus further losses to the level of potential growth. On a longer run, contribution of the labor to potential growth of individual countries of the region will depend strongly on their structure of the population, more precisely on their exposure to the ageing of the population problem.

And finally, it is expected that performance of TPF as the most important component of the pre-crisis potential growth in EE will suffer as well as a consequence of the financial crisis. Over the medium-term, the main reason for sub-optimal TFP performance may be slower pace of productivity-enhancing structural reforms caused by financial constraints and by other rigidities in the economies. In the longer run, TFP performance may also suffer because of the drop of innovative activities as R&D the typical driver of innovation may often found to behave pro-cyclically. As a consequence, a prolonged crisis may considerably slow down the accumulation and diffusion of knowledge and thus an important source of productivity enhancement. It should be underlined here again that forecasting TFP performance is extremely complex and unreliable especially for emerging economies characterized by strong structural changes.

Post-crisis potential growth has not been reduced for NMS only but downward revisions have been made for old member states as well. There is, however, one significant difference in potential growth trend of the two groups of countries over the next medium term. In contrast to old member states for which the European Commission estimates that potential growth, after falling from around 2% in 2007 to below 1% in 2009 and 2010, will recover to around 1.5% in 2013, the potential growth of NMS is forecasted to have a continuously downward trend in the 2007 – 2013 period with only 2% growth estimated for the final year of the period. The Commission argues that contributions of investment and TFP for this group of countries will fail to recover from their low 2009 or 2010 levels and that negative trends with respect to the labor component will deteriorate even further due to slowed down growth rate of the working age population.

There is no doubt that drastically reduced potential growth of NMS over the next medium-term period will have important consequences for their real economic convergence to the EU average. In contrast to the pre-crisis period when the convergence process was strong and shared by all the countries of the region, in the next medium-term period this process will be significantly slower and with some countries in EE probably growing even slower than their counterparts in WE. On a longer run, it is realistically to expect that developments will turn back to normal “catching up process” with less developed EE countries growing again faster than their WE partners.

V. 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 current account deficit countries and therefore for majority of countries in 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 in order to create conditions for dynamic economic growth and sustainable real convergence of the region.

The first one is the increase of domestic savings and consequently a reduction of the reliance on foreign savings. Both components of domestic savings need to be addressed. An improved business environment and other measures enhancing international competitiveness could not only increase potential returns and the savings ratio of the private sector, but they could stimulate the shift in the structure of investments in the direction of the tradable sector and exports. Fiscal policy can also make a substantial contribution to higher domestic savings. Significantly deteriorated fiscal position of many countries of the region reflected in large fiscal deficits as well as in unsustainable structural deficits and public debt dynamics need to be corrected through a process of fiscal consolidation.

The second building block that is required for a return of the region to high and sustainable economic growth in are adjustements in macroeconomic and financial policy. These policies will have to be more proactive in managing capital inflows including stimulating these flows to be channeled into tradable, export oriented activities. On the one hand, they 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 shocks coming from the international environment.

And finally, radical structural reforms aimed at increasing productivity are the third component that is needed to restart a dynamic and sustainable economic growth in EE. One key component of these reforms are institutional changes. While this may be less critical issue for most NMS that have made significant advancement in this area during their pre-accession period, transition process, especially those segments related to institutional reforms, are in a much less advanced stage in pre-accession and other countries of the region. The level of reforms is far from consistent among the sectors and countries. Another broad segment of structural reforms where significant advancements are needed may be encompased under the term human resource development. It includes reforms in the areas of education, R&D development as well as innovation absorption and creation. And finally, there is a reform of the labour sector that seems to be of particular importance for practically all countries in EE and will strongly influence their economic performance in the forthcoming period. Reforms of the labour sector are even more needed in the context of rapidly ageing population of some countries as it will affect negatively labour productivity and consequently long-term economic growth.

It should be underlined that the reforms of the existing EE growth model are not without controversies / questions that will have to be addressed / answered appropriately and on country-by-country basis. For example, structural reforms may increase productivity and through them domestic savings and economic growth. But at the same time, successful structural reforms in a country will increase further its attractiveness for capital inflows what implies the already known macroeconomic problems associated with possible appreciation pressures and consequently pressures on international competitiveness. Or, an integral part of the EU integration is full economic and financial integration of acceding countries meaning full liberalization of their capital flows. If these countries are successful in transforming their economies then they will also be attractive for capital inflows. How to reconcile this fact with empirical findings of some academics arguing that less developed countries, and this is a characteristic of EE countries, relying strongly on foreign capital have not grown faster on a long run? The explanation is that they are more prone to financial crisis as their capacity to channel these inflows into productive uses is rather low due to still inadequately developed market systems, weak market institutions and appreciation pressures.

Based on what has been outlined above, and especially taking into account structural characteristics of EE countries as small economies fully integrated into the EU, there seem to be no room for application of a completely new growth model. What, however, is realistic and also necessary for countries in this region is to revise their existing growth model in a way that their small and open economies will be less vulnerable to external shocks. On a short run, reduced reliance on foreign savings will have a price in terms of economic growth while long-term growth perspectives of the region depend largely on the interplay of all the components determining potential growth rate of the region.