ICEG EUROPEAN CENTER

Growth Challenges in the Eastern Member States

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Background and Questions

The background of presentation:

1. Worsening external environment for the EMS affecting directly and indirectly the EMS growth performance

2. Significant differences among the EMS both in long-term growth performance and short-term prospects

3. Short-term growth performance driven by long-term changes in competitiveness, policy adjustments and spill-over effects of external conditions

The questions to answer:

1. What are the similarities and differences in short-term growth outlook of EMS?

2. What are the main risks to growth?

3. What are the policy implications?

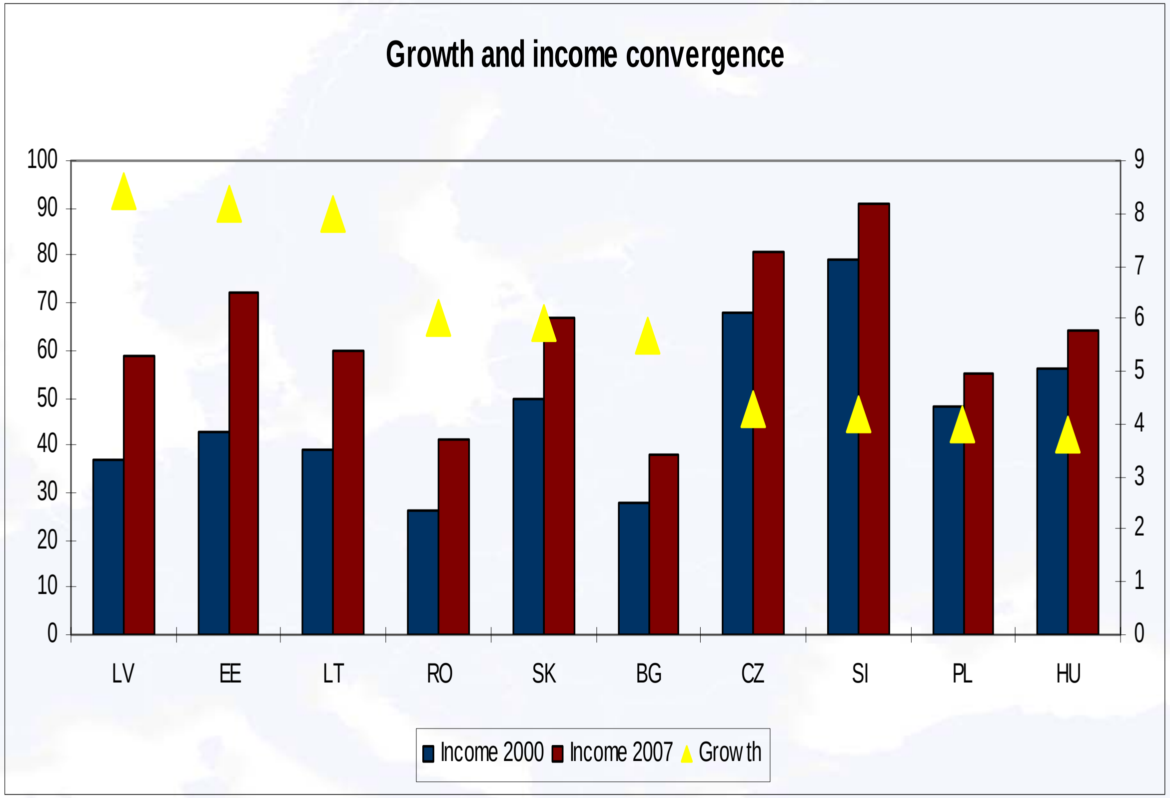
The presentation

1. Growth patterns of EMS in 2001-2007
2. The short-term growth outlook: 2007-2009
3. The main risks to economic growth in the EMS
4. The policy issues stemming from these risks

I. Growth patterns of EMS in 2001-2007

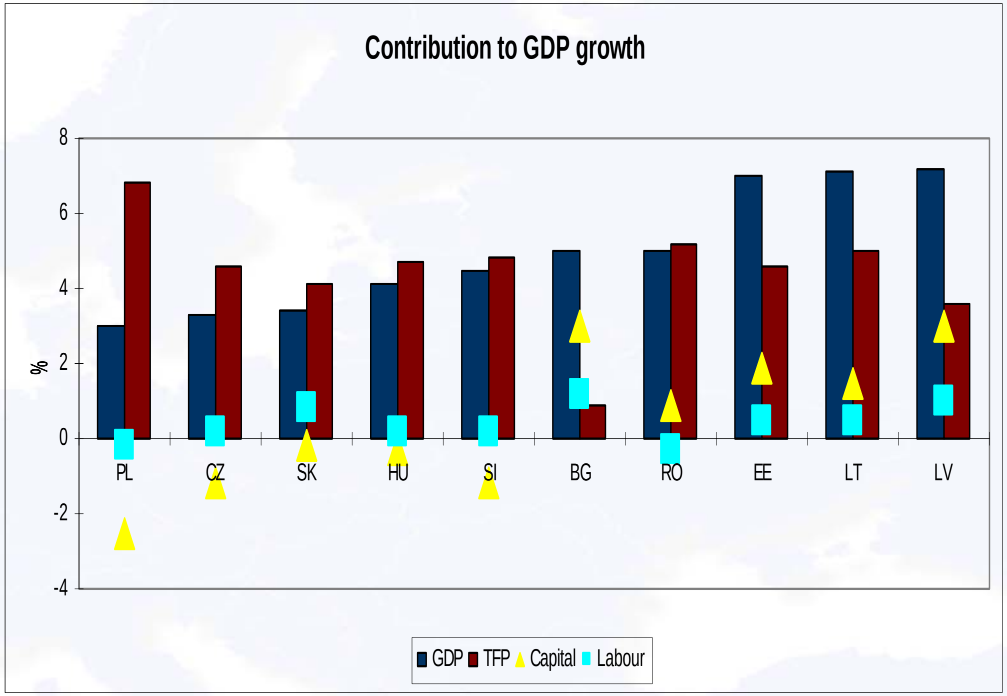
Growth and convergence

- GDP growth averaged 5,9% between 2001-2007 for the EMS
- Expected relationship between initial income and income growth with Baltic States and Romania, Bulgaria growing fastest
- Average convergence in income levels is 15 percentage points between 2000 and 2007
- The speed and evolution of convergence is strongly country specific



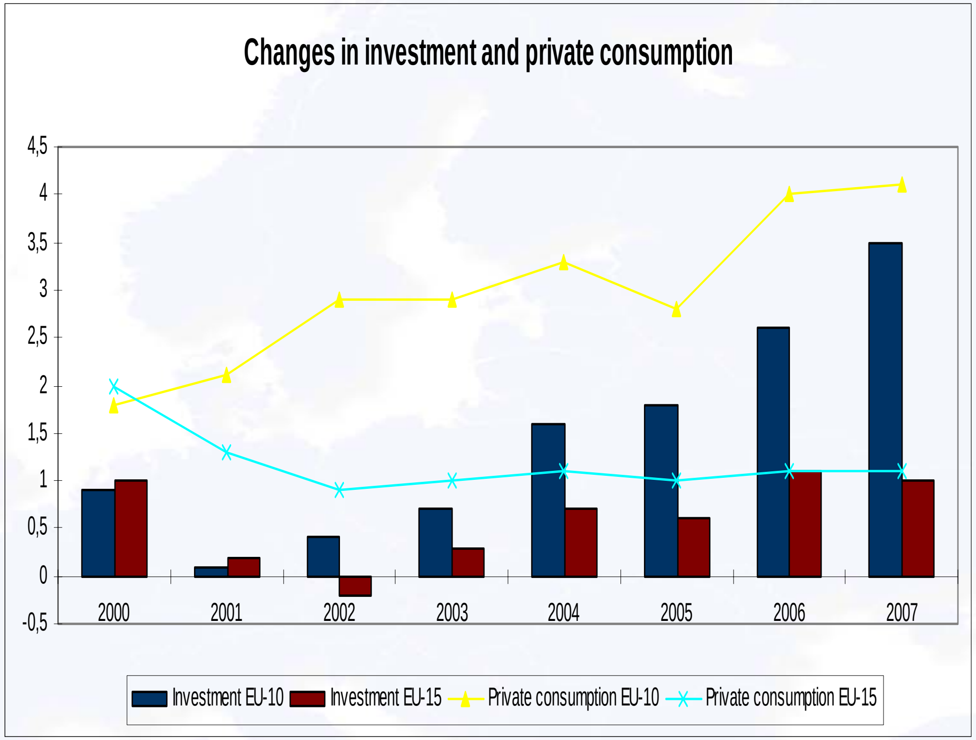
Supply side factors of growth

- Economic growth was almost exclusively driven by the rise in TFP
- Contribution of capital to growth was negative in the more advanced Central European countries, while positive in others with Bulgaria and Latvia having high values
- Investment rates are appropriate in most of the EMS (Baltics, Czech Republic), but are low in some others (Hungary)
- Labour contribution was negative in Poland and Romania, while elsewhere positive but only to small extent except Latvia and Slovakia
- Employment rates are low and below the EU-15



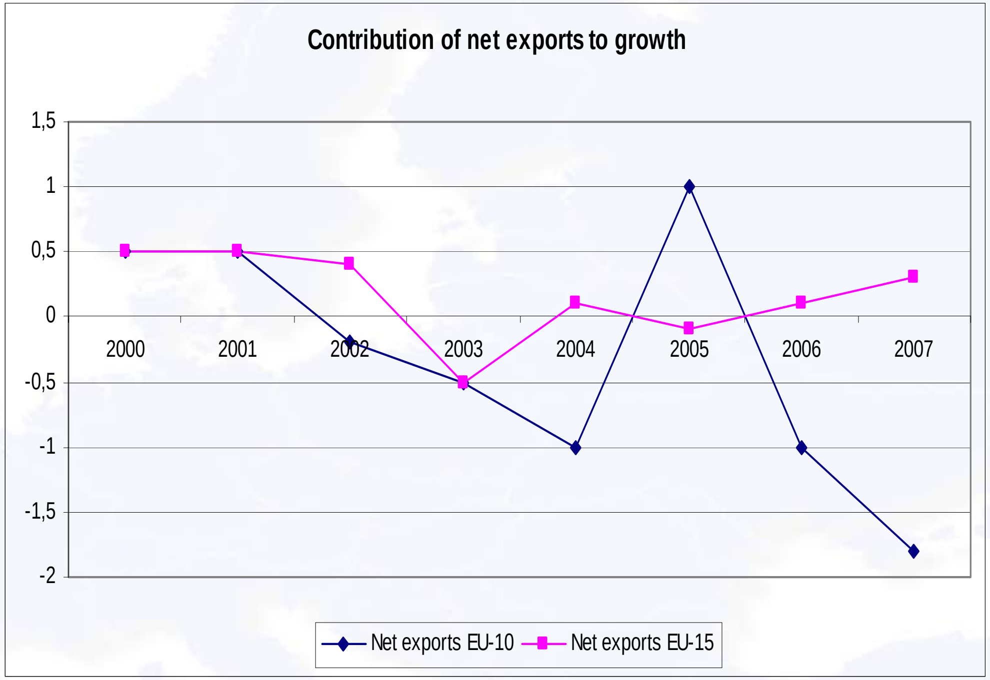
Demand side factors of growth

- Investments and private consumption were the engines of growth both evolving in a stable manner except private consumption in 2005
- Investments driven by higher returns than in advanced countries, steady inflow of FDI, rise in domestic public sector capital formation
- Private consumption increased sometimes very fast due to easing liquidity constraint, financial deepening, rise in income levels, increasing consumption propensity



Country features

- There are differences in the contribution of demand factors to growth
- In the Baltic States and Southeast Europe net exports were negative and growth was exclusively driven by private consumption and investments. This growth has been longer, more buoyant and volatile in the Baltic States
- In Central Europe net exports were in balance (except Hungary and Slovakia where they had a positive contribution to growth) and growth was driven by the expansion of domestic demand. Domestic demand with notable country differences expanded more moderately than in the former group of countries



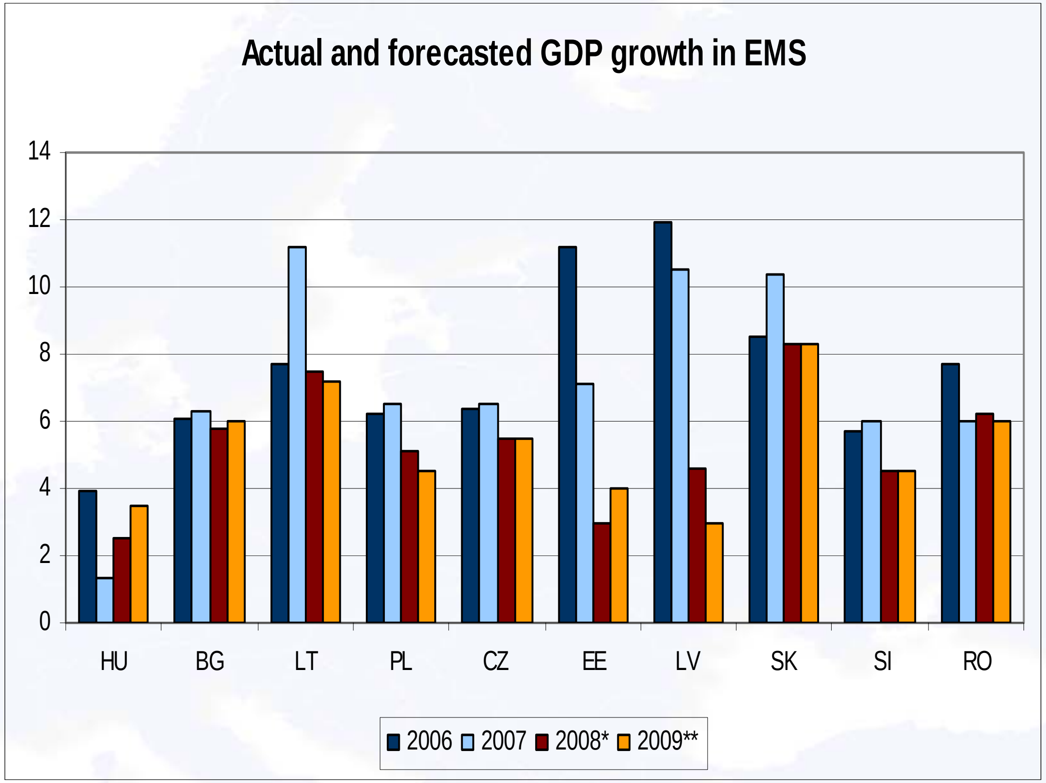
II. The short-term growth outlook: 2007-2009*

Mixed growth performance in EMS

With worsening external conditions GDP growth averaged 7,2% in 2007 compared to 7,5% in 2006 accelerating in LV and SK

When comparing 2008/2009 with 2006/2007 sharp slowdown in EE, LV where growth was unsustainable, some slowdown and return to 2005-2006 growth dynamics in SI, SK, LT, PL, CZ, while almost no change in Romania and Bulgaria and slight acceleration in Hungary

Growth in 2007 and most likely in 2008/2009 is almost exclusively driven by domestic demand except HU after stabilisation, SK where earlier export oriented investments mature and increase net exports



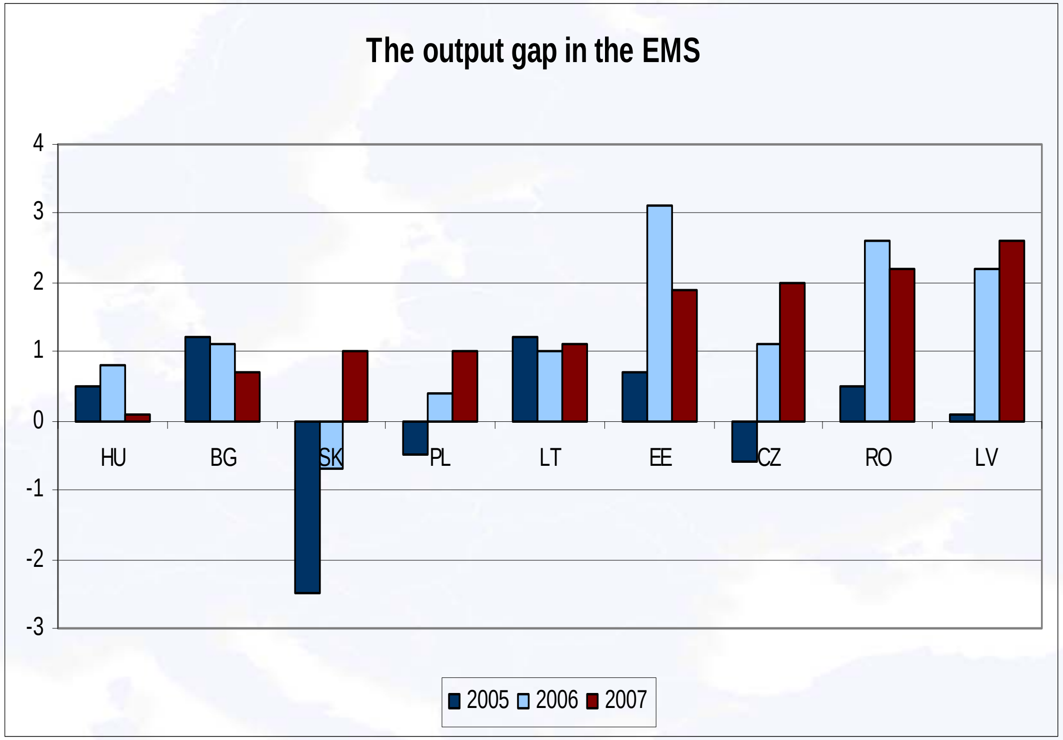
Output gaps are still positive

Net exports have been declining due to slowdown in export growth: slower growth in foreign demand, competitiveness problems due to wage increases (B-3) though productivity rise is still fast

Private consumption moderates: worsening consumer sentiment, increasing private sector debt and debt service, worsening net worth of households, but real employee compensation and nominal wages on rise

Public consumption either declines (HU) or remains moderate (B-3) due to fiscal constraints

Private investment started to reflect worsening external demand and tighter financing conditions



III. The main risks to economic growth in the EMS

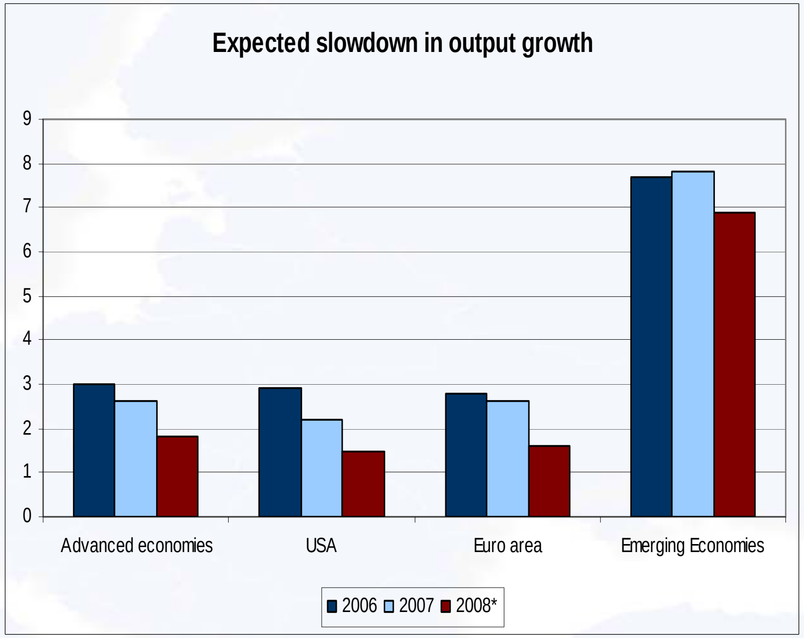
1. Exposure to external shocks

Overall exposure to global financial turmoil and slowdown is low

- Less credit growth and smaller levels
- Lower exposure to US markets and financial shocks than other catching up regions
- More stable and well regulated banking sector

However:

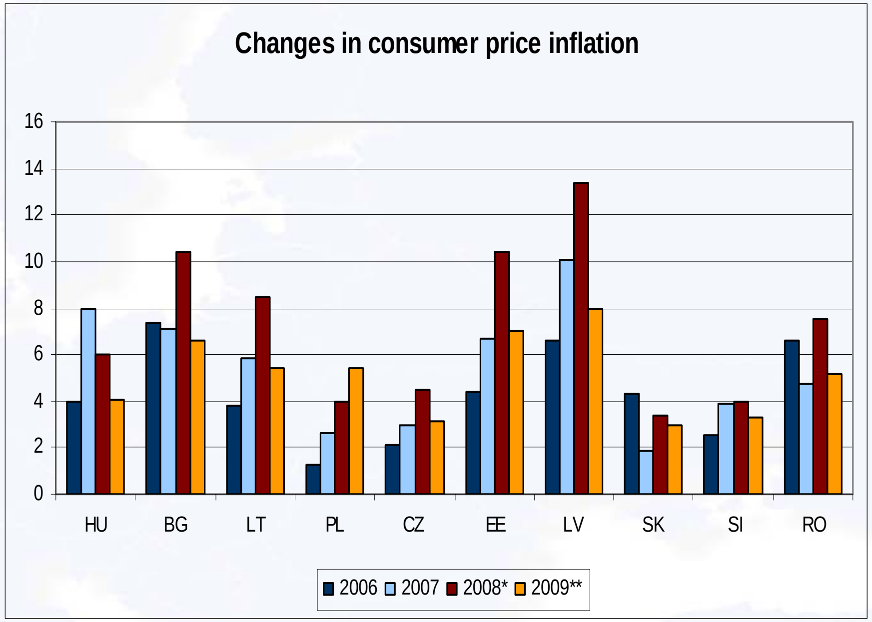
- countries with high external and internal imbalances exposed to changing investor sentiment
- rise in risk premium
- enhanced exchange rate and asset price volatility, while debt is linked to foreign currency
- Second round effects of rising global inflation may have some difficulties for monetary policies
- some EMS are stronger integrated with the Euro-zone, which is expected to slowdown above the slowdown in advanced economies, with its negative effect on export dynamics



2. Accelerating Inflation

Inflation is peaking:

- rise in oil and food prices, with their first and second-round effects
- credit growth and rise in domestic demand still high in many countries
- labour market shortages and rise in employee compensation, real wages and ULC
- in several countries adjustment of administrative prices as a part of price liberalisation or fiscal stabilisation



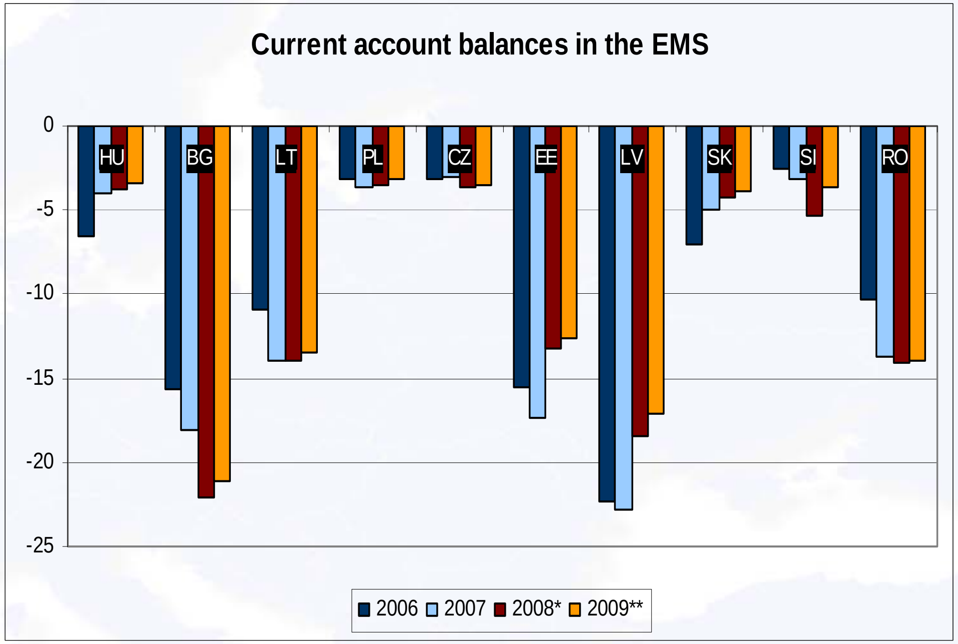
Risks for growth:

- inflationary expectations, which fuels back to wage, exchange rate developments
- Difficulty for monetary arrangements: interest rate hike but slowdown and financial vulnerability
- Monetary policy inefficient in most of exchange rate arrangements to curb inflation alone, but fiscal and incomes policies are still insufficiently flexible

3. Current Account Deficits

External vulnerability high :

- due to persistently high CA deficit in SEE-2 and B-3, and rising foreign debt in several countries (including HU with low CAD)
- In pegged exchange rate regimes (LV, EE, BG) CA deficit is caused by private sector dissaving, while in flexible ones the public sector contributes too
- CA deficit is financed by capital inflows, but contrary to the past only in BG, PL, CZ is FDI covering 100% the CAD, HU FPI, B-3 and SI foreign bank lending is the main driver
- foreign debt on rise though at different levels : 38% RO, 90% BG, HU, SI and over 100% EE, LV



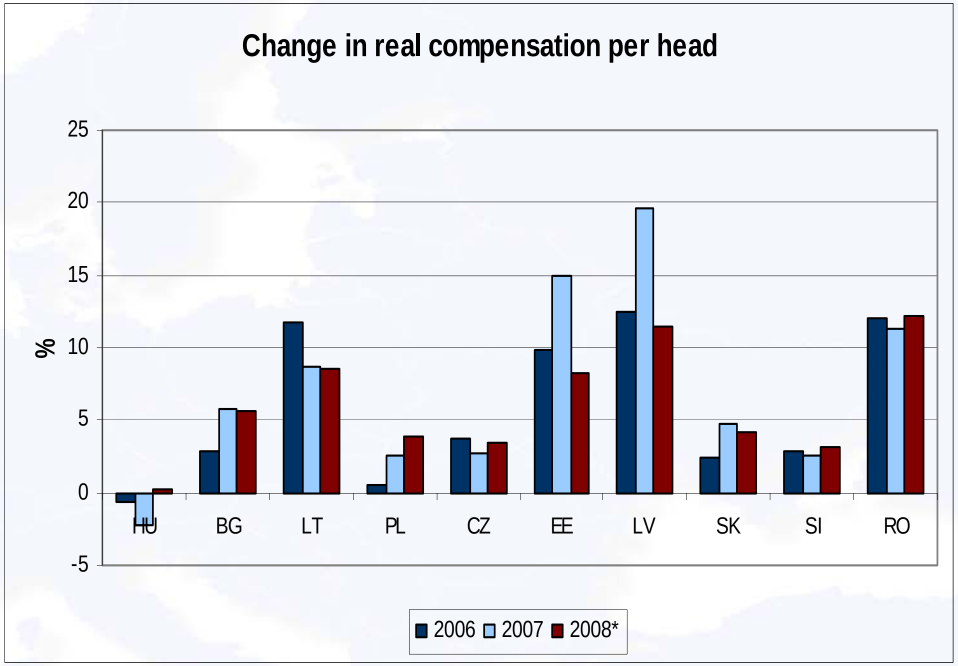
Risks for growth:

- Net FDI inflows worsen due to increased OFDI, profit repatriation and negative effect of relocation to BRIC
- Rising gross and net external foreign debt may lead to sustainability concerns, excessive exchange arte turbulence, constraint on foreign capital inflows

4. Wage and labour market pressures

Persistent labour market pressures:

- strong nominal wage increase, which moderated to smaller real wage increase due to higher inflation
- but ULC grows fast as productivity growth slows down
- migration, supply side shortages related to skill mismatch, lack of appropriate human capital and labour market rigidities (minimum wages, in some countries high degree of employment protection levels, etc.) maintain the wage pressure



Risks for growth:

- Rising ULC
- Competitiveness of tradable sector
- Accelerating inflation in non-tradables sector
- The hands of monetary authorities are tied small room for manouvre in incomes policy

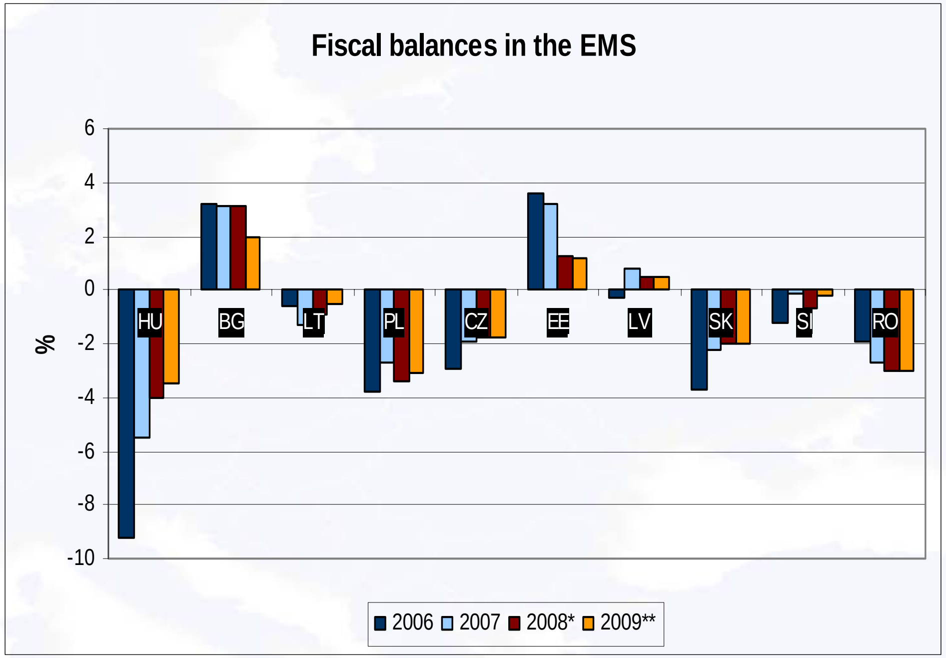
5. Fiscal stance

Fiscal trends:

- in 2007 better than expected performance due to higher revenues (income growth, higher inflation, improved tax discipline and better tax collection)
- in 2007 only HU, PL, LV, SK and SI reduced their structural deficits, while others increased it or loosened somewhat
- in 2008 fiscal balances worsen in CZ, LV, RO, LT, EE (in the latter surplus declines)
- declining debt/GDP ratios especially due to faster growth and higher revenues
- expenditures are in line only in HU, RO, CZ decline due to lower interest expenditures, or lower Ig (RO)

Risks for growth:

- EE, LV, LT, RO worsening balances amidst increasing and high CA deficits
- Expenditure reduction difficult: entitlements, wages in public sector amidst wage pressures, national contribution to SF financing high
- At the same time tax reductions: corporate income tax rate is reduced in the Czech Republic, social contribution rates go down in Poland and Romania, personal income tax rates are cut in Bulgaria, the Czech Republic, Estonia, and Hungary plans to reduce tax burden by 1,5% of GDP



IV. The policy issues

Policy issues I

Fiscal policy

- There is need for fiscal tightening in countries with unsustainable CA deficits and high inflation (B-3, SEE-2)
- While debt and debt service levels are low, private debt is on rise, and besides incomes policies and banking sector regulation fiscal tightening could reduce the extent of imbalances
- Difficult to tighten amidst tax competition and reduction of tax rates, while expenditures are more persistent

Financial sector regulation

- In most countries there is a need for a tighter surveillance of banking sector lending to reduce excessive and unsustainable rise in private sector borrowing and exposure,
- While the banking sectors are stable, regulation is in line with European standards, exposure to foreign debt and borrowing, evolution of the quality of lending portfolio, prevention of real estate and other financial bubbles is a priority for policy makers

Policy issues II

Monetary policy:

- Monetary policies should remain cautious as there is much less room for manuouvre than earlier
- Central banks should remain cautious in rate reduction and should be biased towards tightening

Labour market reforms:

- Employment and activity rates are overall low and this hinders economic growth
- Labour market reforms are needed to raise labour’s contribution to growth
- Labour market reforms would include increased labour market flexibility, more active ALMP instead of currently prevailing ones, education and training reforms to reduce labour market mismatches and wage pressures

Thank you for your attention!

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