

New Member States: how to drive in the fast lane?

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Introduction

Central and Eastern Europe is currently one of the fastest-growing areas in the world. By virtue of actual or prospective membership of the European Union and of EMU all countries in this area attracted large capital inflows, which took advantage of the high rate of return on capital, high levels of human capital and the catching-up process. However, signals of overheating have started to raise concern about sustainability, especially for those countries with fixed or strictly pegged exchange rate regimes.

I shall distinguish between Fixers (Latvia, Estonia, Lithuania, Bulgaria) and Floaters (Poland, Czech Republic, Hungary, Slovak Republic). This classification, although not always suitable for rather differentiated economies, can provide some insights into recent developments and help devise appropriate policies to sustain the growth process.

The consequences of a sudden downturn of these economies would be very painful within the area. To avoid that, policymakers ought to reduce vulnerabilities thus providing a safety margin against sudden shifts in market sentiment.

An equally important, yet often-overlooked, aspect is that in the medium term it will entail a fundamental reorientation of the economies involved. Protracted current account imbalances will have to change course, and resources will need to shift to productive investments, particularly in the tradables sector; else, an abrupt correction or a painful period of slow growth may follow. In this regard, flexible factor markets and strong financial systems will be most important.

Current macroeconomic developments

Growth in Central and Eastern Europe has continued briskly in 2006 and 2007, especially in the Baltic States (see figure 1). The main contribution to GDP growth came from domestic demand, supported by rising disposable incomes and abundant credit. Among Floaters, a contribution came also from net exports, thanks to a strong rebound of economic activity in Western Europe.

Buoyant domestic demand, rising oil and food prices, increases in administered prices and, in many countries, tightening labour markets contributed to a surge in inflation in 2006 (see Table 1).

Causes of concern and challenges

There is growing concern that the rapid growth of domestic demand, not matched by the expansion of productive capacity, is forcing some economies in the area, especially those with pegged exchange rates, on an unsustainable path. Signs that these economies are overheating are visible in the sharp increase in inflation rates over the last couple of years and in widening current account deficits.

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The buoyancy of domestic demand is also the result of exceptionally fast growth of credit to the private sector. In part, the latter reflects the low starting level of bank intermediation in these countries and the entry of foreign banks into the domestic markets. On the other hand, especially in countries with fixed exchange rates, the rapid expansion of credit is driven by expansionary monetary conditions.

In 2006 current account deficits widened in all countries, and are estimated to further worsen this year. Countries with fixed exchange rates, but also Romania, recorded double-digit deficits and experienced the most significant worsening (see figure 3). In addition, while the deficits of countries with floating exchange rates were largely financed by FDIs, this was not the case for Fixers, where the bulk of the financial account was made of loans and other banking system operations (see table 2, col. 4).

On the domestic side, signs of growing imbalances are observable in the widespread increase of inflation rates. To some extent, higher inflation rates in transition economies may be considered as an equilibrium phenomenon, associated with the process of real convergence. Owing to the Balassa-Samuelson effect, higher productivity growth in the tradable relative to the nontradable sector should lead to a real appreciation of currencies. Such real appreciation may be accomplished either by nominal appreciation or by higher inflation relative to trade partners if nominal exchange rate flexibility is limited. However, the relevance of this effect should not be overestimated. Rather, inflationary pressures have intensified in the last couple of years because of excess demand growth, output above potential, and tightening labour markets. This is true especially of countries with pegged exchange rates. While up to 2004, inflation in these countries was considerably lower than in floating-rate ones, since then the situation has reversed (see figure 2): strong exchange rate appreciation in the latter stemming from solid fundamentals and capital inflows helped to relieve price pressures via cheaper imports; in addition, as is the case of Poland and Czech Republic, monetary policy could be used independently to curb inflation.

Among the causes of hikes in inflation are the tightening conditions of labour markets. Although employment increased with strong economic growth and greater responsiveness of labour supply, during the last 2-3 years most of these countries experienced a fundamental shift from a shortage of jobs to shortages of skills and workers. Just after EU accession, migration from Poland, Slovakia, and the Baltic states and, more recently, Romania and Bulgaria helped lower unemployment, but is now causing labour shortages especially in such fast-expanding sectors as construction and financial intermediation. These conditions are pushing up real wages which are now growing faster than labour productivity.

The booming demand is outpacing supply expansion and all the economies are running into capacity constraints, despite high domestic investment and FDIs inflows. As shown in table 3, growth over potential is stronger in Fixers, although they record a higher level of fixed investment than the Floaters (except for Bosnia & Herzegovina) and on average a higher FDI stock as a percentage of GDP.

Policy options

Let me now turn to some tentative recommendations concerning economic policies.

On the structural front, one thinks obviously of labour market policies aiming at reducing mismatches that presently push up wages and labour costs; similarly, of policies aimed at improving the accumulation of human capital to overcome skill mismatches. Appropriate measures should also be adopted to prevent wages from increasing beyond productivity improvements and to ensure that the wage formation mechanisms, in both the private and public sector, are better designed to anchor inflationary expectations.

Investment is also important for potential growth. Increasing the capital stock helps to enhance productivity through innovation and the adoption of new technologies. Policies should thus make further effort to improve the attractiveness of the domestic business environment in order to promote a steady accumulation of productive capital, including FDI.

In the shorter term, important policy challenges are related to the management of domestic demand, especially by countries with pegged exchange rate regimes. In the face of surging capital inflows and rapid credit growth, monetary policy would be the ideal instrument, but it is not available. Actually, monetary policy makes things even worse for Fixers, because it is set by ECB with a view to ensuring price stability in Euro Area. Given the convergence process and the required higher rate of growth of productivity and income in CEE, as compared with the Euro Area, the monetary policy set by ECB is too expansionary for these countries. As an illustration, a 4% interest rate might be appropriate for an economy growing at a steady state rate of 2% and with 2% inflation, but is certainly not appropriate for an economy growing in real terms at 6% or more, as required by the catching-up process. In addition, to make things worse, the inflationary pressures make monetary policy pro-cyclical, via low or even negative interest rates (as it's the case in Baltics), so further destabilising the economy and making the adjustment more abrupt later on².

Many emerging countries experimented with rigid exchange rate regimes over the last decades, but in the aftermath of crises a consensus has emerged that the only fixed regime that is fully credible is one in which the national authority gives up the domestic currency, and adopts a third currency, unilaterally or within a monetary union. Even an extreme arrangement such as the currency board is best viewed as a temporary arrangement, which has to provide for an exit strategy, whose conditions in many cases may sound rather restrictive³. At present, the lack of a plausible date for euro adoption (see table 4), together with the growing imbalances and the associated difficulties in meeting the convergence criteria, may become a threat to the currency boards, but more generally to all exchange rate pegs in the region. Signs that the markets are becoming increasingly uncomfortable have shown up earlier this year in Latvia, where the exchange rate has been forced close to the lower end of the symmetric 1 per cent band around the central parity, and the 1-year forward premium has since risen from below 1 per cent to almost 8 per cent. The 1-year forward premium has also risen, although to a lesser extent, on the Estonian krona from 0.13 per cent at the end of March 2004 to 0.51 per cent, this June.

It has been suggested that countries should move to a more flexible exchange rate regime in order to cool their economies off and redirect the objective of their policy towards the stability of prices. Is this a feasible option? What are the risks? The exit must be engineered at benign times, in particular when capital flows are abundant and the external conditions favourable, and domestic fundamentals, especially the fiscal situation, are sound. This is, for instance, the IMF's view.⁴ At the current juncture capital flows into CEE countries are certainly abundant, but would they be sustained if the peg was abandoned? The above mentioned difficulties recorded by the Latvian lat last February, and the persistent higher forward premium on the Latvian and Estonian exchange rates *vis à vis* the euro suggest that it is depreciation forces which may

² Bini Smaghi L. (2007) "Real and Nominal Convergence: policy challenges", speech at the Conference on European Economic Integration, Vienna, 20 nov.

³ First, an exit must be planned not too distant in the future. Second, there must be no foreseeable need for intervention by a lender of last resort, as domestic credit expansion by the monetary authority is ruled out; this implies that the banking system (and the financial system more generally) must be (super)solvent and strong. Third, the regime must be accompanied by a sound budgetary framework. Fourth, the peg must be defined with respect to the major trade partners, appropriately weighted on the basis of their relative importance in trade.

⁴ Eichengreen B. et al (1998), "Exit strategies: policy options for countries seeking exchange rate flexibility", IMF Occasional Paper N. 168

eventually dominate, not appreciation. Add to this the fact that a substantial fraction of loans to the private sector are denominated in foreign currency (Table 2). Under such circumstances, a move towards more flexibility might occur in a disorderly way, with the possibility of exchange rate overshooting and a full blown financial crisis.

With monetary policy unavailable, fiscal policy becomes the only effective way to slow down domestic demand. As far as its effectiveness is concerned, there is little doubt that fiscal restraint is a valid instrument. There is evidence that in Southern European countries, including Italy, at different times in the 1980s and early 90s, fiscal discipline has limited the negative impact of large capital inflows on labour costs and, thus, competitiveness⁵. So far, consolidation efforts are not sufficiently ambitious in some of the CEE countries, where rapid DGP growth has been used to increase public spending. Hence, there is room for fiscal measures to alleviate inflationary pressures

Finally, it is crucial to keep banking and financial systems resilient. While curbing domestic credit growth may be important to rein in domestic demand, it is possibly even more important to prevent growing microeconomic imbalances that may threaten the stability of banking systems. The currency denomination of domestic loans appears a critical issue, especially if one considers the possibility of a depreciation of the exchange rate; hence there may be scope for measures aimed at limiting the building up of currency mismatches. More generally, since the expansion of domestic credit is feeding a boom in real estate prices, it is crucial to closely monitor the banking system exposure to that market. The risk of a correction in housing markets could materialize dramatically in the event of a switch to a more flexible regime followed by currency depreciation, with downward pressure on house prices eventually stemming from both lower demand and increasing defaults by financially strained debtors.

Conclusions

Central and Eastern European countries have entered a difficult phase in which ensuring sustainable growth, while pursuing structural reforms aimed at loosening existing supply constraints, requires slowing down domestic demand. This is especially critical for Fixers, where imbalances have grown larger and policy options are more limited. While switching to a more flexible exchange rate regime could restore their monetary policy autonomy, one should carefully weigh the risks that this option currently entails and the associated benefits, given the uncertainties surrounding the effectiveness of the monetary transmission mechanism in those economies. Although their budgetary and debt position is sound and budgetary restraint may prove politically difficult to carry out, it probably remains the main option. This could certainly be reinforced by measures acting on the tax benefit system, public sector wages, and the composition of government expenditure towards more productive uses. Fiscal restraint is also a primary goal for Floaters, which are experiencing smaller external imbalances but have less prudent budgetary positions.

⁵ Begg et al. (2002) "Sustainable regimes of capital movements in accession countries", CEPR Policy Paper No. 10, Dec.

Table 1. Main economic indicators in 2006

| Countries | Real GDP growth | Inflation | General government balance (1) | FDI inflows (1) | Current account balance (1) |
|-----------------|--------------------|------------|--------------------------------------|--------------------|-----------------------------------|
| Fixers | 9.2 | 5.6 | 1.8 | 10.4 | -15.7 |
| Bulgaria | 6.1 | 7.4 | 3.3 | 17.2 | -15.8 |
| Estonia | 11.2 | 4.5 | 3.8 | 10.1 | -14.8 |
| Latvia | 11.9 | 6.6 | 0.4 | 8.1 | -21.1 |
| Lithuania | 7.5 | 3.8 | -0.3 | 6.1 | -10.8 |
| Floaters | 6.5 | 4.1 | -4.3 | 6.3 | -6.2 |
| Poland | 6.1 | 3.6 | -3.9 | 4.3 | -2.9 |
| Czech Republic | 6.4 | 2.1 | -2.9 | 4.2 | -4.2 |
| Romania | 7.7 | 6.6 | -1.9 | 9.3 | -10.4 |
| Slovakia | 8.3 | 4.3 | -3.4 | 7.6 | -7.8 |
| Hungary | 3.9 | 4.0 | -9.2 | 6.3 | -5.6 |
| Memo: | | | | | |
| Slovenia | 5.7 | 2.5 | -1.4 | 1.0 | -2.5 |

Source: Eurostat, European Commission, IMF

(1) As a percentage of GDP

Table 2. Domestic and foreign financing in 2006

| Countries | Credit to the private sector | | Real interest rates (3) | Banking capital: net flows (1) | External debt (1) |
|-----------------|------------------------------|-------------------------|-------------------------|--------------------------------|-------------------|
| | Percentage Change | in foreign currency (2) | | | |
| Fixers | 43.5 | 63.3 | -2.0 | 14.7 | 87.9 |
| Bulgaria | 23.6 | 45.1 | -3.7 | 3.8 | 73.6 |
| Estonia | 34.0 | 78.1 | -1.3 | 21.3 | 96.6 |
| Latvia | 61.1 | 74.4 | -2.2 | 22.4 | 117.9 |
| Lithuania | 55.2 | 55.6 | -0.7 | 11.2 | 63.5 |
| Floaters | 28.3 | 31.2 | 1.1 | 0.4 | 56.7 |
| Poland | 20.5 | 27.3 | 0.6 | 1.7 | 49.3 |
| Czech Republic | 19.4 | 10.3 | 0.2 | -0.1 | 40.9 |
| Romania | 55.0 | 46.9 | 1.5 | 7.0 | 42.4 |
| Slovakia | 21.9 | 19.6 | 0.0 | -7.5 | 58.9 |
| Ungheria | 24.8 | 51.9 | 3.2 | 1.1 | 92.2 |
| Memo: | | | | | |
| Slovenia | 26.6 | 57.4 | 1.1 | 5.4 | 76.5 |

Source: Eurostat, European Commission, IMF

(1) As a percentage of GDP

(2) Foreign currency and indexed loans as a percentage of total

(3) Three-month interest rates adjusted for CPI inflation

Table 3. Output gap, unit labour costs and FDI stock

| Countries | Output gap (1) | | Unit labour costs (2) | | Inward FDI (3) |
|-----------------|----------------|------------|-----------------------|-------------|----------------|
| | 2005 | 2006 | 2005 | 2006 | 2006 |
| Fixers | 0.7 | 1.6 | 0.0 | 0.8 | 54.3 |
| Bulgaria | 0.5 | 0.1 | -1.3 | -3.4 | 65.8 |
| Estonia | 0.2 | 2.0 | -3.4 | 1.7 | 77.2 |
| Latvia | 0.0 | 1.8 | 4.6 | 2.7 | 37.5 |
| Lithuania | 1.9 | 2.4 | 0.2 | 2.1 | 36.7 |
| Floaters | -1.2 | 0.3 | -0.6 | -1.9 | 49.4 |
| Poland | -0.4 | 0.5 | -2.3 | -2.7 | 30.6 |
| Czech Republic | -0.8 | -0.1 | -0.4 | 0.1 | 54.8 |
| Romania | 0.2 | 2.1 | 0.5 | | 33.6 |
| Slovakia | -2.2 | 0.9 | -1.8 | -0.9 | 55.0 |
| Ungheria | -2.8 | -2.1 | 0.8 | -3.9 | 73.0 |
| Memo: | | | | | |
| Slovenia | | | -0.3 | -1.0 | 20.0 |

Source: European Commission, World Investment Report 2007

(1) As a percentage of potential GDP

(2) Percentage changes

(3) As a percentage of GDP

Table. 4 When do they join the EMU?

| COUNTRY | EXCHANGE RATE REGIMES AND MONETARY FRAMEWORKS | TARGET DATE OF EURO ADOPTION |
|-----------------|--|--|
| Fixers | | |
| Bulgaria | In the ERM II since May 2005 Currency board to the Euro | No target date |
| Lithuania | In the ERM II since June 2004 Currency board to the Euro | No target date, originally 1 Jan 2007 |
| Estonia | In the ERM II since June 2004 Currency board to the Euro | No target date, originally 1 Jan 2007 |
| Latvia | In the ERM II since May 2005, with exchange rate fluctuation band $\pm 1\%$ | No target date, originally 1 Jan 2008 |
| Floaters | | |
| Poland | Freely Floating Inflation Targeting | To be defined |
| Hungary | Freely Floating Inflation Targeting | No target date, originally 1 Jan 2010 |
| Czech Republic | Freely Floating Inflation Targeting | No target date, originally 1 Jan 2010 |
| Slovakia | In the ERM II since Nov 2005 Inflation Targeting | 1 Jan 2009 |
| Romania | In the ERM II since Nov 2005 Inflation Targeting | 2014 |

Figure. 1 GDP growth
(percentage annual rates)

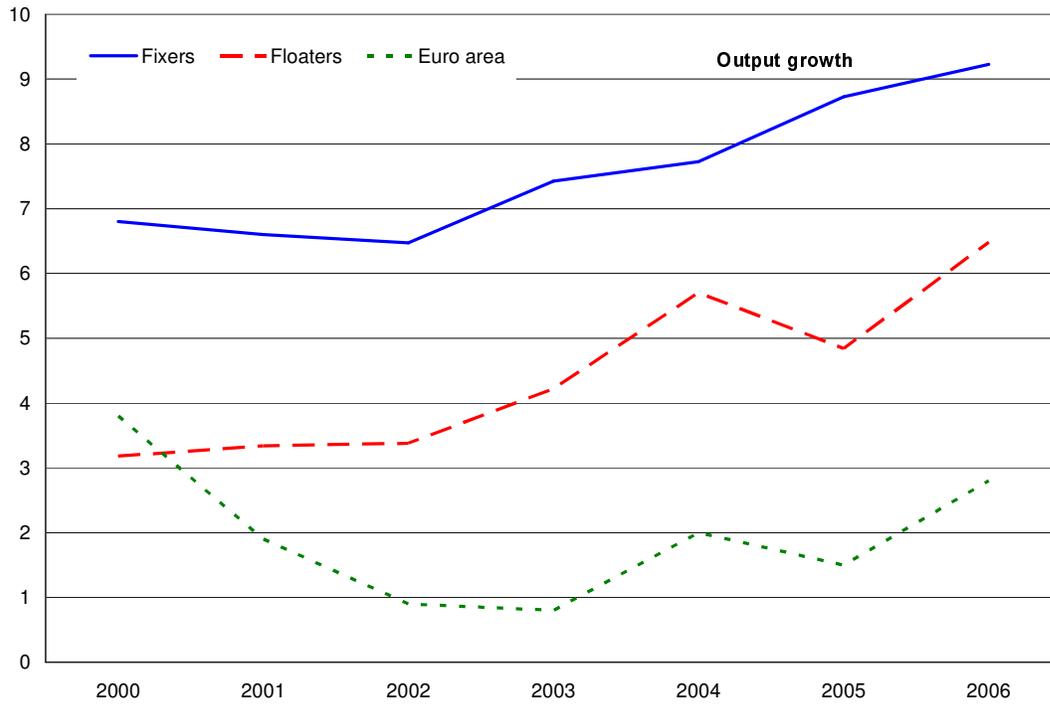


Figure. 2 Inflation

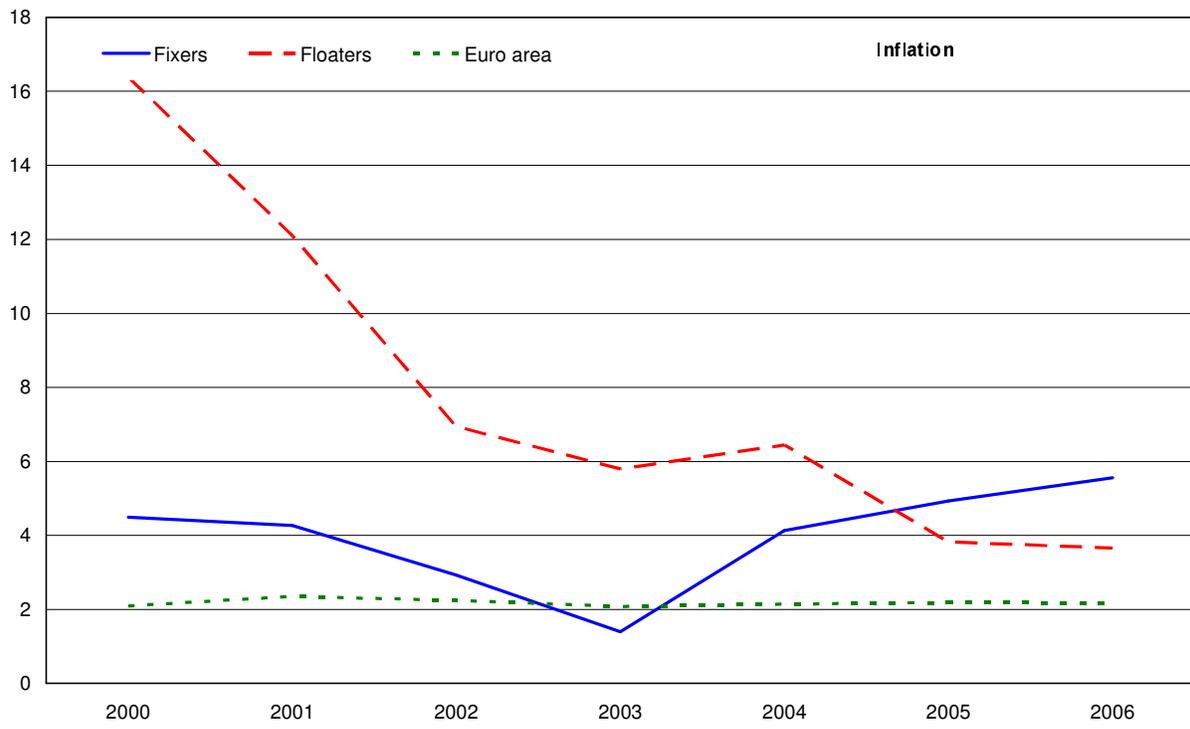


Figure. 3 Current account balance
(as a percentage of GDP)

