

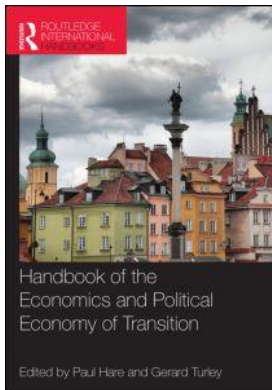
This article was downloaded by: 10.2.97.136

On: 21 Mar 2023

Access details: *subscription number*

Publisher: *Routledge*

Informa Ltd Registered in England and Wales Registered Number: 1072954 Registered office: 5 Howick Place, London SW1P 1WG, UK



## **Handbook of the Economics and Political Economy of Transition**

Paul Hare, Gerard Turley

### **Towards a New Growth Model in Eastern Europe**

Publication details

<https://test.routledgehandbooks.com/doi/10.4324/9780203067901.ch20>

Paul Marer

**Published online on: 25 Apr 2013**

**How to cite :-** Paul Marer. 25 Apr 2013, *Towards a New Growth Model in Eastern Europe from:* Handbook of the Economics and Political Economy of Transition Routledge

Accessed on: 21 Mar 2023

<https://test.routledgehandbooks.com/doi/10.4324/9780203067901.ch20>

**PLEASE SCROLL DOWN FOR DOCUMENT**

Full terms and conditions of use: <https://test.routledgehandbooks.com/legal-notices/terms>

This Document PDF may be used for research, teaching and private study purposes. Any substantial or systematic reproductions, re-distribution, re-selling, loan or sub-licensing, systematic supply or distribution in any form to anyone is expressly forbidden.

The publisher does not give any warranty express or implied or make any representation that the contents will be complete or accurate or up to date. The publisher shall not be liable for an loss, actions, claims, proceedings, demand or costs or damages whatsoever or howsoever caused arising directly or indirectly in connection with or arising out of the use of this material.

# TOWARDS A NEW GROWTH MODEL IN EASTERN EUROPE

*Paul Marer*

## **Why economic growth is important**

Economic growth matters not just because it leads to rising prosperity. People living in countries with growing economies tend to be happier and more optimistic. Material improvement leads to general satisfaction; stagnation or decline leads to misery and pessimism. Economic growth matters because its absence causes long-term unemployment and falling living standards for many. Growth is also the only realistic way to generate the tax revenues needed to service the outsized sovereign debts that so many countries have accumulated today, and to fund the obligations of ageing societies.

The growth prospects of a country depend not only on its past, current and future economic policies but also on the kinds of investment that its governments, companies and households have made and will make – or not make – in their economic future. Growth depends also on the economic and political health of a country's neighbourhood, as well as that of the world at large. The external environment is especially important for assessing the growth performance and prospects of the small and medium-sized open economies of Central and Eastern Europe (CEE).

However, generating growth is not easy. It consumes finite resources. It is cyclical and often has adverse environmental impacts. Growth is spurred by innovation and improved productivity, which not only creates jobs but also destroys old ones. Therefore, individuals, organizations and countries must constantly adapt, or face stagnation and decline.

This chapter focuses on the CEE countries – the 10 countries from the region that joined the EU in the 2000s – a group sometimes referred to as the EU-10.<sup>1</sup> The central thesis of this chapter is that the CEE countries must speedily adapt the growth model that had served them well for about a dozen years – from the mid-1990s through to 2007 – until the great global recession of 2008–09 and the eurozone crises that became evident in 2010 and 2011.

The first part of this chapter summarizes the common features of the 'old' growth model that characterized the development paths of the CEE countries up to the Great Recession. Focusing on the EU-10, it also contrasts the CEE model with those pursued by the countries of Latin America and East Asia. The next part calls attention to the vulnerabilities engendered by the CEE growth model. It then suggests that the nature and extent of country-specific vulnerabilities offer plausible explanations for differences in the ten countries' growth performance and prospects. The last part discusses the reasons why the 'old' CEE model needs to be modified, outlines the essential features of the proposed 'new' model, and concludes with policy recommendations.

## The 'old' growth model

The CEE 'growth model' story starts around 1995, when the turmoil from the post-Communist 'transformation recessions' was largely over and most CEE countries had reached or passed beyond their lowest output levels following the collapse of the centrally planned system. The classic phase of the model, when its features became the most pronounced, was the 2000–07 period, coinciding with a global economic boom and with the anticipation and then the realization of all ten CEE countries becoming full EU members.

The six distinct features of the CEE growth model were: (1) the fast-paced expansion of domestic demand; (2) this was facilitated by the rapid growth of credit; (3) financed in large part by capital inflows; (4) these allowed the countries to run sustained current-account deficits; (5) made possible by the region's speedy integration into the global economy; (6) while experiencing significant appreciation of their real exchange rates. The application of this model facilitated the *real economic convergence* of the CEE countries with Western Europe through to 2007.

The following paragraphs comment briefly on each aspect. Only summary evidence is given, with detail provided later or in the references. The evidence presented focuses on the EU-10 during 2000–07. However, certain of the reproduced figures (from the IMF, the World Bank, the EBRD, the ECB and other sources) may have country coverage larger or smaller than the EU-10, and periods somewhat longer or shorter than 2000–07.

### *Fast-paced expansion of domestic demand*

Pent-up consumer demand that resulted from perennial shortages under central planning, grossly under-developed service sectors, and under-valued property prices prompted rapid demand growth for consumer goods as well as for retail and financial services, and a boom in construction. Those, in turn, led to surges in investment-to-GDP ratios for a decade. Domestic demand during 2000–08 grew at double-digit rates in the Baltic states, Romania and Bulgaria, while *net* exports were negative for them (as well as for several other CEE countries, as shown on Figure 20.1<sup>2</sup>).

### *Rapid credit expansion*

The granting of credit was facilitated both by the pent-up demand for credit, for the reasons just stated, as well as by the abundant availability and the low cost of credit, largely from foreign sources. The period 2003–06 was one of historically high global liquidity, with fierce competition in international banking and abundant supplies of credit to emerging economies, such as CEE.

### *Large capital inflows*

The inflows were relatively larger in emerging Europe than in other emerging economies. At its peak in 2007, the average inflow in emerging Europe as a share of GDP (20 per cent) was double that in Latin America. Most of the difference was attributable to cross-border loans and deposits from West European parent banks to their affiliates in the East. The relative importance of other types of inflows, like foreign direct investment (FDI) and portfolio debt and equity accumulation, were broadly similar to those in other regions.<sup>3</sup>

### *Sustained current-account deficits*

Each CEE country ran current-account deficits each and every year between 2000 and 2007, ranging between 2 per cent and 22 per cent of GDP annually, depending on country and year.<sup>4</sup>

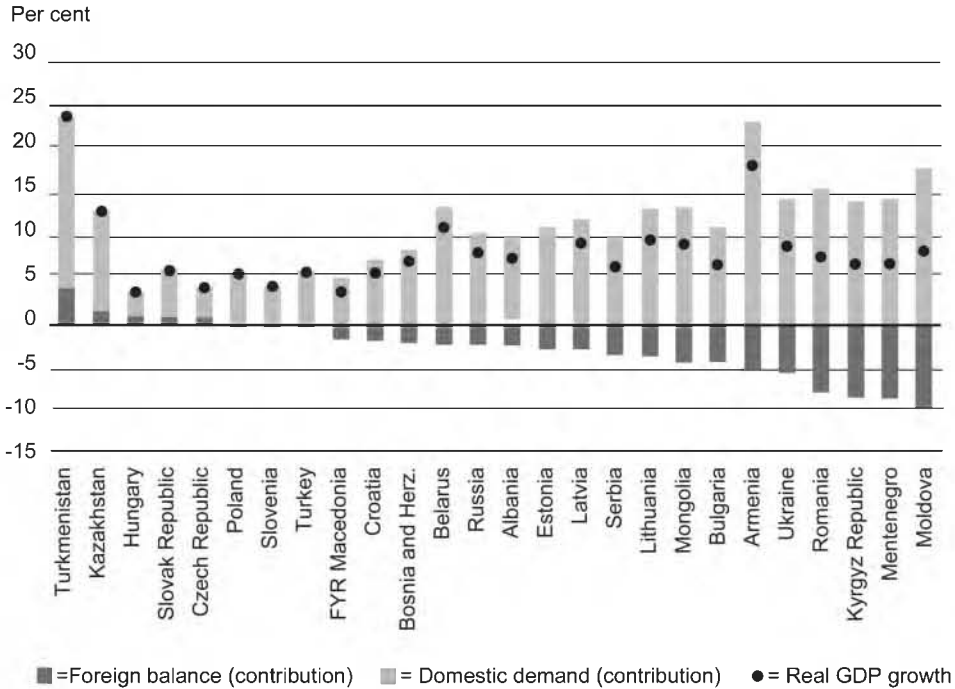


Figure 20.1 Contribution of net exports and domestic demand to average annual real GDP growth, 2000–08  
 Source: EBRD (2010), Chart 4.1, p. 68, with permission.

Independently of the size of the current-account deficit, it matters a great deal how the deficits are financed. The larger the portion covered by FDI – considered to be a less volatile source of capital inflows than cross-border borrowing by banks and non-financial institutions or portfolio investment – the lower is the vulnerability factor.

### *Speedy integration into the global economy*

The standard way to measure the level and trend of a country’s globalization is through its trade participation ratio (TPR): the sum of exports plus imports as a percentage of GDP. Between 1996 and 2007, the average TPR of the EU-15 (Western Europe) rose from about 60 per cent to about 80 per cent. However, during the same period, the TPRs of nine of the 10 CEE countries grew by more than 20 percentage points.<sup>5</sup> Parallel to – and even more dramatic than – trade integration was the CEE’s financial integration with Western Europe. The financial participation ratio (FPR) can be calculated analogously to the TPR: the sum of external financial assets and liabilities to GDP. In just over a decade, the ratios had increased in all CEE countries, in several to above 200 per cent. Both the level and the rate of increase of their FPRs were much faster than those of other emerging regions.<sup>6</sup>

One factor greatly facilitating the EU-10’s trade and financial integration (mainly) with Western Europe was the effect of political integration between Europe’s two regions. Membership in the EU probably encouraged foreign investors, including banks, to pursue long-term investment strategies in the East that otherwise might have been considered too risky.<sup>7</sup>

### **Real exchange rate appreciation**

All CEE countries had experienced appreciations of their 'real effective exchange rates' (REER) between the late 1990s (Latvia after 2004) and the Great Recession.<sup>8</sup> The appreciation took place while the CEE countries had different exchange rate regimes: the Baltic countries and Bulgaria had pegged rates; the rest, managed floating rates (Slovenia, Slovakia and Estonia only until they joined the eurozone in 2007, 2009 and 2011, respectively). In countries with *pegged exchange rates*, REER appreciation was due to domestic inflation (caused in part by capital inflows, which supported a rapid expansion of credit). In countries with *flexible exchange rates*, their rising REERs were due to a combination of appreciating nominal exchange rates and inflation. The rising REERs of these countries also reflected the substantial undervaluation of their currencies during the early stages of transformation.

*Real-income convergence.* The purchasing-power parity-based real per capita GDPs of the CEE countries, expressed as a percentage of the average per capita GDP of the EU-15, had increased at impressive rates until the Great Recession.<sup>9</sup> Growth theory identifies two factors that drive the convergence of the less-developed towards the more developed countries – provided that the two country groups are reasonably homogeneous, such as East and West Europe are: (1) diminishing returns in the accumulation of capital, giving capital higher marginal productivity in the poorer countries that have much lower capital/labour ratios; and (2) the adoption or adaptation of the wealthier countries' technology, knowledge and institutions, which increases total factor productivity in the less advanced countries.<sup>10</sup> Both factors had apparently supported the convergence of the CEEs toward the more developed West, as evidenced and supported by large net capital flows from West to East Europe. However, growth differentials in favour of the countries of CEE have been more varied than 'normal' convergence alone can explain. For certain CEE countries, there remain unexplained positive and negative 'growth differentials' between 'adjusted' per capita real growth rates – the difference between each country's actual growth tempo and the 'catch-up' growth rates that would have been expected, given initial per capita GDP levels.<sup>11</sup> Hungary was the only country among the EU-10 that during 2000–10 had an average negative growth differential of 0.5 per cent per annum. Each of the other nine countries had positive growth differentials, with Slovakia leading the pack with an average of 2 per cent per annum.<sup>12</sup> Later on, we identify some of the factors that were most likely responsible for such differentials.

*Price-level convergence.* Real income convergence inevitably means rising average prices towards the price levels of the more advanced countries. This is so because initial price levels in the lesser developed countries are always lower than in the more advanced countries. The logic is as follows. Wages in the tradeable (T) and non-tradeable (NT) sectors are approximately the same *within* any country. Competition for labour makes it so, even though productivity differences between the higher- and lower-income countries' T sectors are much smaller than in their NT sectors. Owing to the much higher level of productivity in the high-income country's T sector, wages – and thus the price level – will also be higher.

Fast-growing emerging economies will typically experience rapid productivity growth in their T sectors, so wage and price levels in the T sectors will increase. Wages in the NT sectors will follow, even though there will *not* be equally rapid increases in productivity in the NT sectors. This will result in inflation (or at least inflationary pressure) since increases in wages in the NT sector are not supported by corresponding increases in productivity. In conclusion, the catching up process will typically involve some extra inflation, adding to whatever other inflationary pressures the economy may be experiencing, so price levels will also be converging toward those in the higher-income countries. This is known as the Balassa-Samuelson effect;

evidence for it has been found in the CEEs, too.<sup>13</sup> Estimating how much of a price-level convergence is due to the Balassa-Samuelson effect as compared to other causes has been extensively debated.<sup>14</sup>

*The CEE growth model in global perspective.* Three key features of the CEE model – growth driven by domestic demand, supported by the rapid expansion of credit and FDI; large current account deficits; and the real appreciation of the exchange rates – had also characterized the old growth models of Latin America and East Asia (except that East Asia’s rapid growth was driven by exports rather than domestic demand). This growth model, whose central feature is persistent current-account deficits, was largely discredited by the collapse of the Latin American economies in the mid-1980s and by the East Asian crisis of 1997–98. Since then, both groups of countries have switched to policies ensuring current account balance or even surplus, reinforced by high savings (thereby accumulating international reserves), and to exchange rate policies supporting *net exports* as the key sources of growth.<sup>15</sup>

As long as the CEE countries could continue to match or exceed the real income convergence records of Latin America (*vis-à-vis* the USA) and East Asia (*vis-à-vis* Japan), as emerging Europe has been able to do until recently (*vis-à-vis* Western Europe), one could not be too critical of the CEE growth model.<sup>16</sup> However, this model will be unable to support further real-income convergence, for reasons discussed below. Let us note that Latin America and East Asia did indeed adjust their similar models, also as a result of the crises they faced.

### Model implementation and vulnerability

The CEE growth model helped to engender growth but also created vulnerabilities. Perhaps the most important vulnerability of the model has been to any sudden stop or reversal of capital inflows. To the extent that the flow of domestic credit and the servicing of foreign debt (resulting from cumulative current account deficits) rely on foreign financing, a sudden stop of capital inflows, even a significant slowdown, will cause growth to plummet.

Another vulnerability engendered by the model is the impairment over time of international competitiveness. This is a probable outcome of growth being driven mainly by domestic demand, especially if demand originates disproportionately in the NT sectors. Satisfying such demand will suck in imports and generate inflationary pressures, with adverse consequences for the competitiveness of countries whose main exports are *not* energy and other primary products, as is the case for the EU-10. The appreciation of REERs also has adverse impacts on competitiveness.

The author considers that the degree to which the individual CEE countries had allowed their economies to become vulnerable is the key to explaining differences in their growth performances (including growth volatility) as well as growth prospects.<sup>17</sup> Vulnerability means that an economy will be forced by an external shock to make a sudden, sharp and painful adjustment, or that it will be consigned to a low-growth trap, or both.

The literature identifies a large number of factors likely to shape economic growth; their importance varies across countries. To highlight some of the differences among the CEEs, *six interdependent economic policies* are identified that – in view of the growth model relied upon – had increased or dampened a country’s vulnerability to: (a) capital inflow disruptions; and (b) deteriorating international competitiveness. High vulnerability sooner or later adversely affects a country’s growth, while low vulnerability is neutral or favourable for growth performance and prospects, other things being equal. The six factors are:

- 1 The contribution of net exports to growth.
- 2 The pace and source of credit expansion.

- 3 Inflation, as measured by comparative trends in unit labour costs.
- 4 Choice of exchange rate regime.
- 5 The level and structure of external debt.
- 6 Fiscal balance and the relative size of the public sector.

The following paragraphs comment briefly on each aspect. Some statistical evidence is presented; fuller details are in the references.

### 1. The contribution of net exports to growth

Countries that during the boom years of 2000–07 had, on average, substantial import surpluses – so that net exports had made a negative contribution to growth – became especially vulnerable because net imports can become increasingly difficult to finance if the financing sources – be they capital inflows or remittances from migrant workers abroad – dry up, as they had, for several years, after the Great Recession. Sustained net imports are also an indication that a disproportionate share of foreign and domestic capital has gone into the NT sectors, which, over time, weakens international competitiveness. The extent of vulnerability depends on such factors as the country's export dynamics and composition (the more dynamic and high value the exports, the lower the vulnerability), inflation relative to the cost- and price-level changes of competitors, and the relative size and composition of foreign debt (the lower the debt/GDP ratio and the smaller the share in foreign currency, the lower the vulnerability).

Figure 20.1 shows the contribution of net exports and that of domestic demand to average annual GDP growth during 2000–08 for 26 transforming economies, including the EU-10.<sup>18</sup>

The contribution of net exports to real GDP growth is defined as the average change in real net exports between 2000 and 2008, divided by real GDP in 2000. The contribution of domestic demand to real GDP growth is calculated as the difference between the average annual real GDP growth and the contribution of real net exports.

Focusing on the 10 CEE countries, the figure reveals that Hungary, Poland, the Czech Republic and Slovenia had tiny positive or only small negative net export contributions to growth, whereas the three Baltic states plus Bulgaria and Romania had large negative contributions. Thus, this factor appears, *ceteris paribus*, to place the last five countries into relatively vulnerable positions on their post-2008 growth prospects, because it suggests inadequate international competitiveness.

### 2. The pace and source of credit expansion

While the growth of credit is essential for innovation, investment and economic growth, whether it engenders vulnerability – and if it does, the extent of it – depends on two factors: the pace of credit growth and its sources of funding. The pace of credit growth can be *excessive* (defined by a World Bank study as a tempo much faster than that of the average of all comparable developing nations outside emerging Europe, adjusted for the initial underdevelopment of the financial sectors in CEE) or *convergent* (credit growth rates similar to comparable nations outside the region).<sup>19</sup> Between 2000 and 2008, the three Baltic states and Romania had experienced excessive credit growth (Bulgaria to a lesser extent), while the other five countries had normal (convergent) credit expansion.<sup>20</sup> Excessive credit expansion accelerates GDP growth for a time, but it generates bubbles that eventually burst, creating a GDP slump.

The three main sources of credit are *wholesale funding* (short-term borrowing by domestically owned banks from other banks and financial institutions abroad); local subsidiaries,

predominantly funded by their *foreign parent banks*; and *resident deposits*. Wholesale funding has the highest risk because the availability and the cost of such funds are highly sensitive to changing international credit conditions. Foreign parent funding is less risky, at least as long as the parents are reasonably healthy and are willing to support their daughters. Resident deposits entail the least risk because central banks are usually ready to defend the domestic banking system in case of panicky withdrawals.

The three Baltic states, Hungary and Bulgaria had funded their credit growth mainly through the parents of their foreign-owned subsidiaries, making their economies medium-vulnerable. However, the Czech Republic, Slovakia, Poland and Romania had relied largely on resident deposits, making them relatively less vulnerable.

Considering credit vulnerability on both counts (excessive growth of lending and the ultimate sources of those funds), the three Baltic states were clearly the most vulnerable at the onset of the Great Recession.

It is important to stress that the source of the vulnerability has not been the predominant foreign ownership of the banking sectors in CEE. To illustrate, during 2000–06 the share of loans extended by foreign-owned banks in total credits was higher in the Czech Republic (85 per cent) than in Latvia (65 per cent).<sup>21</sup> At the same time, the loan-to-deposit ratio was 280 per cent in Latvia and only 80 per cent in the Czech Republic, implying that an extraordinarily large proportion of loan growth in Latvia was funded from abroad. While Prague's prudent monetary and fiscal policies kept Czech crown interest rates roughly on a par with those in the eurozone, hence providing no incentive to borrow in foreign currency, the combination of Latvia's relatively high inflation and Euro-pegged exchange rate made foreign-currency loans especially attractive.<sup>22</sup> Latvia's excessive credit growth, financed largely from abroad, made the country doubly vulnerable, similarly to those of the other Baltic states.

### 3. Unit labour costs and inflation

The lower is a country's unit labour cost relative to those of its competitors and the smaller its rate of inflation, the more favourable is its international competitive position, other things being equal. This is a matter of great importance for the open economies of CEE; certainly a key factor in their growth prospects.

Figure 20.2 shows the 2001 unit labour costs of four CEE countries – the Czech Republic, Hungary, Poland and Slovakia – relative to those of 16 competitor countries from around the world. A decade ago the four CEE countries' unit labour costs were at comparable levels; those of the others in the region were, plausibly, at similar levels or lower. Figure 20.2 shows that the CEE countries were quite competitive vis-à-vis the Latin American and Southeast Asian countries, especially if one takes into account the relatively high education and skill levels of the CEE workforces. This was certainly one factor in the EU-10's dynamic export performance, even though it was overshadowed by the even faster import growth in many countries.<sup>23</sup>

Changes in unit labour costs are the outcome of the tempo of productivity improvements (which reduce it) and the rate of increase of nominal wages and wage-related taxes and charges (which raise it). Figure 20.3 reveals that between 2001 and 2008 unit labour costs rose especially fast in the Baltic states and Romania (five to 10 times faster than in the USA), whereas unit labour costs had remained under impressive control in Poland. Therefore, considering this factor in isolation, Poland appears to have secured a sizeable advantage over the other CEE countries in terms of international competitiveness (thus also in terms of growth prospects), while the Baltic states and Romania found their situation increasingly difficult. Loss of competitiveness surely impairs growth prospects at some stage, unless remedial actions are successfully taken to



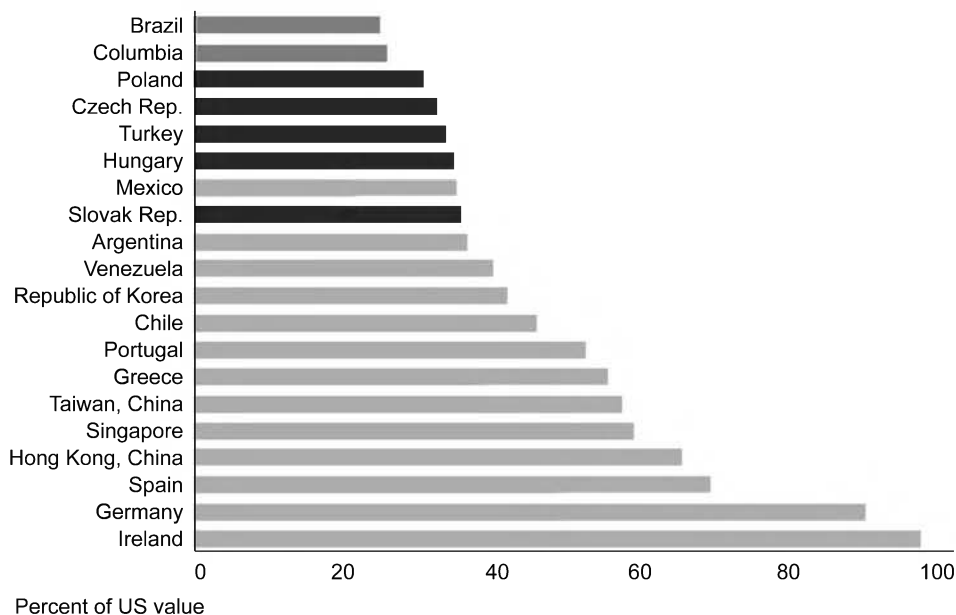


Figure 20.2 Unit Labour Costs of Poland, Czech Republic, Hungary and Slovakia versus 16 Competitor Economies

Source: EBRD (2010), Chart 4.4a, p. 70, with permission.

regain competitiveness. The other five CEE countries are in the middle of the pack, suggesting that changes in their relative unit labour costs neither enhanced nor constrained their growth prospects in a major way.

#### **4. Choice of exchange rate regime**

There is no ideal exchange rate regime, especially for small, open economies. The two basic types are pegged and flexible regimes (each with variants). Both types have economic and political advantages and problems. For example, if pegging to another currency or currency basket is credible, such a regime can stop high inflation in its tracks, as was the situation in the Baltic states and Bulgaria. Furthermore, pegging to the Euro has been a powerful political signal by the Baltic states of their strong determination to join the eurozone, an aspect of their further integration with Europe.

At the same time, pegged exchange rates can increase economic vulnerability through several channels. As a signal of eventual entry into the eurozone (at earlier times, before there was even a hint of the eurozone crises to come), pegging encouraged capital inflows, and thus credit expansion. Pegging encouraged capital inflows because it eliminates (or at least reduces) the currency-risk premium and thus lowers the effective rate of interest. However, when a currency is pegged, the central bank is unable fully to ‘sterilize’ the inflow of capital and to rein in the growth of credit.<sup>24</sup> As inflation accelerates, as the exchange rate remains credibly pegged, and as there is free movement of capital (full convertibility), domestic interest rates will rise much above interest rates on comparable assets in foreign currency. That encourages borrowing in foreign currency, which further promotes capital inflows and excessive credit growth.

A pegged currency can also make a country vulnerable if the exchange rates of its direct competitors have more flexible regimes (e.g. Poland, Hungary, Romania and the Czech

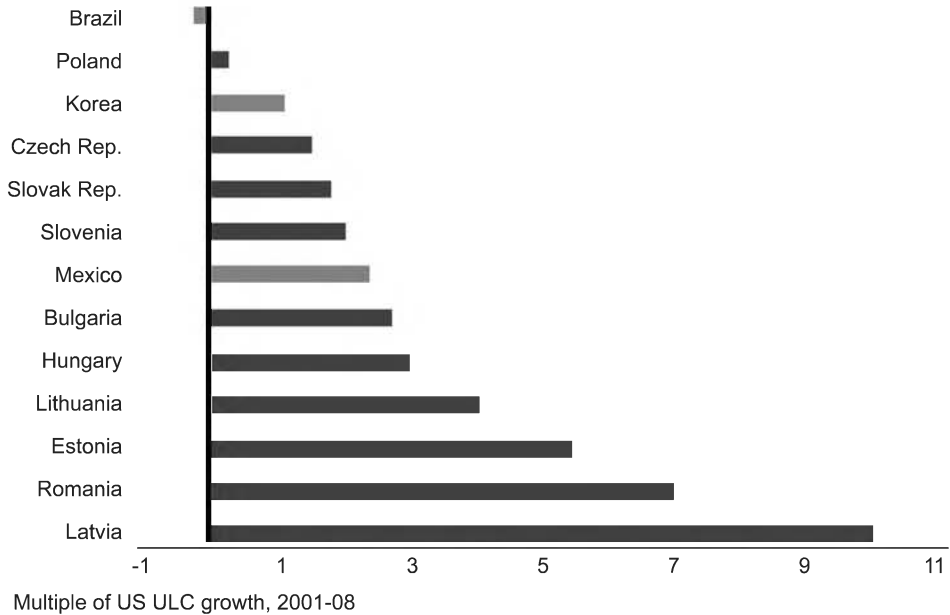


Figure 20.3 Unit labour cost growth of 10 CEE Countries, Mexico, Korea and Brazil, 2001–2008  
Source: EBRD (2010), Chart 4.4b, p. 70, with permission.

Republic) whose depreciation further impairs the competitiveness of the former group of countries, as happened early on during the Great Recession.

Because pegging the exchange rate also has significant benefits and because it is not the basic source of inflation – it only makes it more difficult to remedy its causes – this factor has tended to reinforce the already noted high vulnerability of the Baltic states and Bulgaria.

To regain competitiveness, the alternative to currency devaluation is ‘internal devaluation’, that is, substantial lowering of money wages and prices in the economy. This is exceedingly difficult to do economically, socially, and politically. None the less, large internal devaluations were engineered in the Baltic states as well as in Romania (and to some extent in Bulgaria) during 2009–11.

### 5. The level and structure of external debt

It is important to make a distinction between *public debt* (sovereign or government) and *external debt*. Public debt can be held by domestic and external lenders while external debt can be owed by governments and by the private sector (i.e. financial and non-financial institutions and households). Therefore, public and external debt sustainability need to be addressed as separate though interdependent issues. One source of interdependence is that large-scale defaults by the private sector tend to increase government debt through lower tax receipts and higher unemployment and other social benefit payments. Public debt also rises if systemically important financial and non-financial firms are bailed out. Another source of interdependence is that a high level of public debt, which needs to be continuously rolled over, displaces credit to the private sector, which after all is the sector that drives an economy forward. And a decline in the sovereign’s creditworthiness raises not only its cost of foreign borrowing but also that of the private sector.

No theoretical model can specify what levels of government debt to GDP or private external debt to GDP ratios are 'safe' because sustainability depends on a host of future domestic policies and on unpredictable external environmental variables. However, what has been established, based on the accumulated historical experiences of many countries, are the ranges at which debt burdens clearly become too onerous, significantly reducing GDP growth. And at still higher levels of debt (in some cases even at lower levels), default can be threatened or triggered. Reinhart and Rogoff identified a *sovereign-debt-to-GDP ratio* of 90 per cent as such a threshold.<sup>25</sup> The Maastricht criteria set 60 per cent as the maximum 'safe' sustainable limit for eurozone members. According to Reinhart and Rogoff, emerging markets face even lower thresholds for total external debt (public plus private) – which is usually denominated in foreign currencies. When *total external debt* reaches 60 per cent of GDP, growth declines, on average, by 2 per cent per annum; at much higher ratios, the decline becomes larger and debt sustainability increasingly problematic.<sup>26</sup> Debt sustainability is defined as the ability of a country to permanently cap its debt-to-GDP ratios at current levels or, if they are higher than the threshold, the ability to bring the debt to or below the threshold.<sup>27</sup>

Figures 20.4 and 20.5 show the sovereign debts and the total external debts, respectively, of the CEE countries as a percentage of their GDP in recent years, with regional and international comparisons. Our focus is not so much on sustainability but on the comparative vulnerabilities of the countries on account of differences in their debt levels and structures.

The first thing to note is that sovereign debt levels to GDPs are, on average, much lower in the EU-10 than in Western Europe's EU-17. This is no great comfort, however, to the CEE region, given the severe sovereign debt problems several eurozone countries are currently facing, and considering that most Western European countries can better afford to service larger public debts than the economically and financially weaker countries of CEE.

Also notable is that in every EU country (except in Sweden), debt ratios had risen dramatically between 2007 and 2011. However, most relevant for us are the exceptionally large differences in the sovereign debt levels among the EU-10. Hungary has by far the largest ratio at 80 per cent of GDP. At the other end of the spectrum we find Estonia (with debt levels below 10 per cent) and Bulgaria (20 per cent). The sovereign debt levels of each of the seven other countries lie roughly in the 40–60 per cent range. But external debt-to-GDP ratios are different!

Estonia and Bulgaria – the two CEE countries with the lowest sovereign debt ratios in Figure 20.4 – were among those with the highest external debt ratios in 2008 – indicating that it was excessive foreign borrowing by their private sectors, for the reasons already indicated, that caused their debt explosions. Latvia had the highest external debt ratio, at almost 180 per cent of GDP. By refusing to sever its currency's peg to the Euro, its government was forced to borrow large amounts from the IMF and from other sources to defend the peg. That, in turn, dramatically increased Latvia's sovereign debt from 10 per cent to 60 per cent of GDP in just four years (Figure 20.4), an excellent example of the interconnectedness of private external and public debt.

The level of sovereign debt matters. But for the small, open economies of CEE, the level of external debt matters even more, especially for those with weak domestic financial systems (including capital markets), which means that their main sources of funding have to be external. This makes them highly vulnerable to changes in external credit conditions.

On the eve of the Great Recession, we find the Czech Republic in the most advantageous debt position: It was one of only two EU-10 countries whose 50 per cent external debt ratio had remained substantially below the Reinhart-Rogoff threshold of 60 per cent, as did Poland's at 55 per cent. At the other extreme – clearly in the danger zone – were/are Latvia, Estonia and Hungary, with external debt ratios twice to three times higher than that of the Czech Republic.

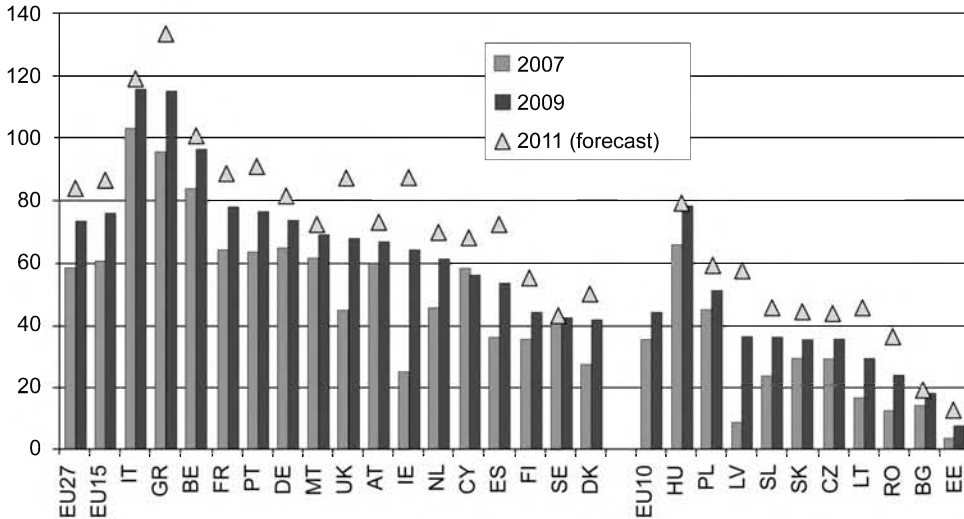


Figure 20.4 Public Debt Level in per cent of GDP in the EU-27 before and after the crisis  
Source: Eurostat (2011) and Eurostat forecast.

### 6. Fiscal balance and the relative size of the public sector

Figure 20.4, which shows sovereign debt as a percentage of GDP, says a lot – but not everything – about the comparative cumulative fiscal balances of the countries. A high ratio indicates large cumulative budget deficits. However, the Figure 20.4 does not reveal when the deficits were accumulated and how difficult it will be for the authorities to bring their budgets under control. Were the deficits accumulated mainly during the down phases of the business cycle or during boom times? If during the latter, then deficits will be more difficult to bring under control, other things being equal. Another important factor is the relative size of the public sector in the economy. The higher is the share of budget expenditures in GDP and the higher is the level of public debt, the more difficult it will be to achieve a *primary balance* in the budget (that is, balance before interest payments on outstanding debt), which is a precondition for debt stabilization.

The cumulative government budget surpluses (+) or deficits (-) of the EU-10 during 2001–07, as a percentage of GDP, were<sup>28</sup> Estonia +10.0 per cent; Bulgaria +5.3 per cent; Latvia -8.0 per cent; Lithuania -10.2 per cent; Romania -14.2 per cent; Slovenia -14.5 per cent; Slovakia -27.7 per cent; Czech Republic -8.9 per cent; Poland -31.5 per cent; and Hungary -48.9 per cent. The numbers show that the outlier in the group, Hungary, had unusually large fiscal deficits during the boom years preceding the Great Recession, making it highly vulnerable to the global liquidity crisis in the fall of 2008, following the collapse of Lehman Brothers. This forced Hungary to be the first to turn to the IMF and the EU for a 20 billion Euro emergency aid package, and to undertake a painful retrenchment early on. (Subsequently, Latvia and Romania among the EU-10 also received IMF assistance). Hungary is also a regional outlier on the relative size of its public sector (Figure 20.6).

Figure 20.6 shows individually for 27 EU countries the size of public expenditures in 2007 as a percentage of each country's GDP (vertical axis) against per capita GDP levels (horizontal axis). As the regression line shows, the share of public expenditure in GDP tends to rise as income levels rise. For example, the shares are the highest (just above 50 per cent) in some of the richest EU countries: France, Sweden, and Denmark. The shares tend to be much lower in

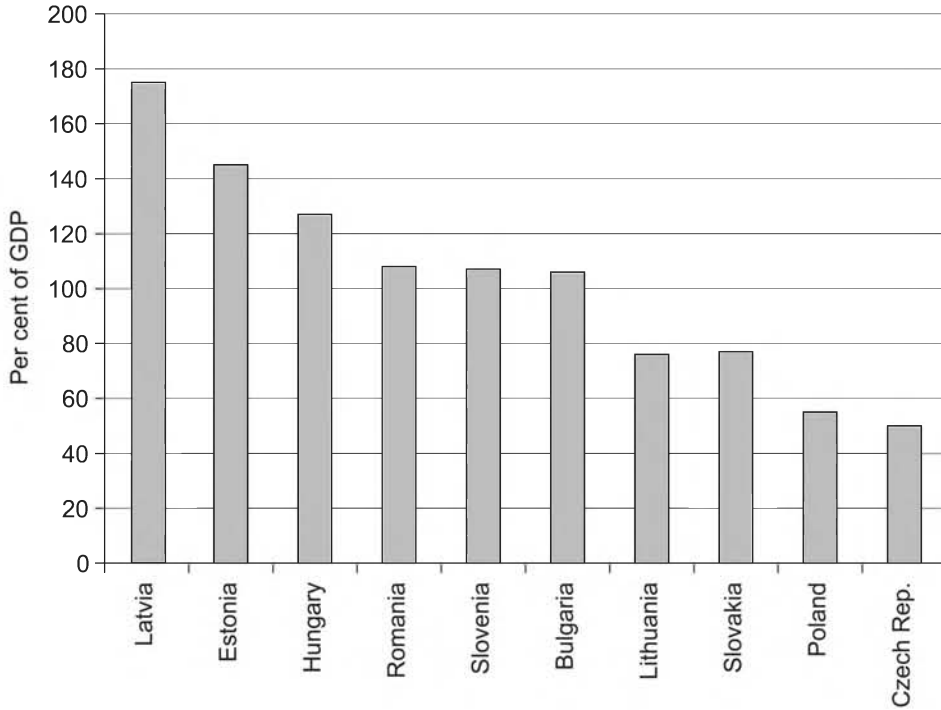


Figure 20.5 External Debt-to-GDP Ratios of the EU-10 Countries in 2007

Source: Calculated by the author, based on USD external debt and GDPs (at current exchange rates), as reported in the *CLA Fact Book*, 2007 or 2008, country pages.

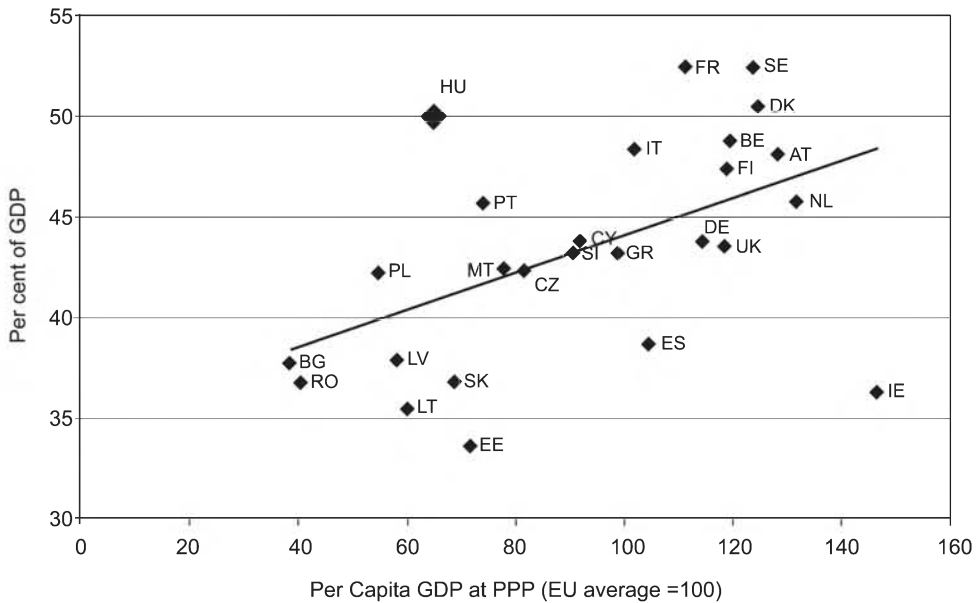


Figure 20.6 Public Expenditure in the EU Countries in 2007 as per cent of GDP

Source: Forthun, C. and R. P. Hagemann (2010), 'Sustaining the Momentum of Fiscal Reform in Hungary', *OECD Economics Department Working Papers*, No. 802, OECD Publishing.

CEE: under 35 per cent in Estonia and between 35 and 40 per cent in Lithuania, Latvia, Slovakia, Bulgaria and Romania.

Hungary is an outlier: at 50 per cent of GDP, its government expenditure level is comparable to those of some of the Western European welfare states and higher than those of Austria, Finland, Italy, Germany and the Netherlands. Hungary is thus what János Kornai called a 'premature welfare state' – premature in the sense that it has a level of government expenditures, spent disproportionately on transfer payments, that the country simply cannot afford. Therefore, taxes are high, which has pushed many individuals and SMEs into the grey economy to avoid taxes, prompting successive governments to raise taxes on those who cannot escape them. That, in turn, has been pushing more people into the grey economy and the authorities into deficit spending, financed at high real rates of interest. Large public expenditures and high local-currency real interest rates crowd out credit that would otherwise be available for the private sector, pushing businesses and households to borrow in foreign currency (which was available before the Great Recession at much lower interest rates than those charged on domestic-currency loans).

The above facts and reasoning suggest, first, that Hungary has not only a short-term but also a longer-term vulnerability to worsening credit conditions in Europe (and globally) and, second, that it will be difficult for the country to find sources of adequate and sustained economic growth.

### Summing up

It is the author's contention that the degree to which an individual CEE country had allowed its economy, through policy choices, to become vulnerable prior to the Great Recession, that is, through 2007 – under the growth model outlined earlier – is the key to explaining differences in growth performances (including growth volatility) during the Great Recession as well as differences in medium-term growth prospects from 2011 on. Two types of interdependent vulnerabilities are emphasized: harm to the economy that would be triggered by a sudden stop or reversal of capital inflows and those resulting from a substantial loss of international competitiveness. The two vulnerabilities can reinforce each other: persistent loss of competitiveness hurts the current account whose growing deficits will be increasingly difficult to finance if capital inflows were to decline, stop or be reversed, and/or the cost of foreign financing were to rise significantly.

Table 20.1 summarizes the country-specific vulnerabilities that were induced or avoided by the domestic policy factors discussed: If *net export contribution is negative* and large for an extended period, that makes an economy vulnerable, as does a *credit bubble*, a comparatively high rate of *inflation*, an *inflexible exchange rate regime*, *high public and/or external debt*, or a *high share of government expenditure* in GDP.

A 'V' symbol indicates vulnerability relative to those of the other countries in the group. A 'P' sign suggests that the country had 'protected' itself comparatively well with respect to the given policy variable against potential adverse impacts. Although the placing of the symbols is evidence based, judgement is also involved.

The patterns shown in Table 20.1 indicate vulnerability to external shocks not just in the absolute sense but (perhaps mainly) the vulnerabilities of the countries relative to each other. The pattern shows that the Baltic states, Bulgaria and Romania became vulnerable owing to several domestic policies having contributed to unsustainable credit bubbles and substantial loss of external competitiveness. These factors had enabled the countries to achieve impressive rates of growth through 2007. However, at the onset of the Great Recession the vulnerabilities came

Table 20.1 Vulnerability of the EU-10 during 2009–10 due to domestic policy choices

Country	Vulnerability factors							
	Type of external shock	Exp. contr.	Cr. bubble	High infl.	ER. regime	High debt		High G/GDP
						Sov.	Ext.	
Estonia								
Δ K inflows		V				P	V	
↓ Competitiveness	V	V	V	V				
Latvia								
Δ K inflows		V					V	
↓ Competitiveness	V	V	V	V				
Lithuania								
Δ K inflows	V						V	
↓ Competitiveness	V	V	V	V				
Bulgaria								
Δ K inflows			V			P	V	
↓ Competitiveness	V	V	V	V				
Romania								
Δ K inflows		V						
↓ Competitiveness	V	V	V					
Hungary								
Δ K inflows						V	V	V
↓ Competitiveness								
Poland								
Δ K inflows								
↓ Competitiveness			P					
Czech Republic								
Δ K inflows							P	
↓ Competitiveness								
Slovakia								
Δ K inflows								
↓ Competitiveness								
Slovenia								
Δ K inflows								
↓ Competitiveness								

Source: Author's construction.

V, highly vulnerable; P, protected well.

big problems for the small, highly open economies (which the Baltic states and Bulgaria certainly are). Their high levels of external indebtedness, mainly by their private sectors, created further vulnerabilities.<sup>29</sup> The high and multiple vulnerabilities of the five countries thus contributed to their rather extreme see-saw pattern of growth: impressive tempo on the way up; followed by painful plunge on the way down.

Responding to the crisis, especially to the loss of competitiveness, each of the five countries had, in fact, taken drastic actions – internal devaluation (a substantial lowering of wages and prices during 2009–10) – which set the stage for their subsequent growth recovery (Table 20.2). Most of the other countries in the EU-10 group also had impressive pre-crisis growth rates and they were also hurt by the crisis. However, in most cases their GDP declines were not as severe as those countries with comparatively greater vulnerabilities.

Table 20.2 Real GDP growth in the EU-10, 2007–11 and estimates for 2012 (in per cent)

	2007	2008	2009	2010	2011	2012*
Bulgaria	6.4	6.2	-5.5	0.4	1.7	0.8
Czech Rep.	5.7	2.5	-4.7	2.7	1.7	0.1
Estonia	7.5	-3.7	-14.3	2.3	7.6	2.0
Hungary	0.1**	0.9	-6.8	1.3	1.7	0.0
Latvia	9.6	-3.3	-17.7	-0.3	5.5	2.0
Lithuania	9.8	2.9	-14.8	1.4	5.9	2.0
Poland	6.8	5.1	1.6	3.9	4.3	2.6
Romania	6.3	7.3	-6.6	-1.6	2.5	1.5
Slovakia	10.5	5.8	-4.9	4.2	3.3	2.4
Slovenia	6.9	3.6	-8.0	1.4	-0.2	-1.0
Ave (not weighted)	7.0	2.8	-8.2	1.6	3.4	1.2

Source: IMF, *World Economic Outlook Europe*, April 2012, Table A-4, p. 194.

Notes: \* Forecast. \*\* Owing to its unsustainable external debt, Hungary was forced to adjust early.

Hungary is the only other country in the group with multiple ‘Vs’, indicating excessive levels of public and external debt and a grossly oversized public sector. These three vulnerabilities were (and remain) mutually reinforcing. Because Hungary apparently did not experience a big loss of competitiveness, its large GDP decline during the Great Recession was not among the worst in the region (Table 20.2). The main consequences of Hungary’s multiple vulnerabilities would seem to be the danger of economic stagnation, of being stuck in a low-growth trap.

The remaining four EU-10 countries – Poland, the Czech Republic, Slovakia and Slovenia – had no glaring vulnerabilities relative to the other six. In fact, Poland has a ‘P’ in one column, indicating that it appears to have maintained its external competitiveness better than its neighbours. This was probably one of several factors helping Poland to be the only country not only in CEE but in the EU able to sustain growth during the Great Recession (Table 20.2). The Czech Republic also gets a ‘P’ in one column for having its economy relatively well protected against sudden stops in capital inflows by accumulating only a relatively modest level of external debt.

### Adjusting the growth model

Let us recall the main features of the region’s pre-crisis growth model: fast-paced expansion of domestic demand, facilitated by rapid credit growth, financed by large capital inflows covering the resulting current-account deficits, made possible by the region’s rapid political, trade and financial integration with Western Europe, accompanied by real exchange rate appreciation. This growth model has made the EU-10 economies highly vulnerable to external shocks, especially those emanating from Western Europe. High vulnerability was the inevitable consequence of the model. The only question about it was whether the individual CEE countries’ domestic economic policies and institutional choices had increased or dampened their vulnerability; this issue was analysed above and summarized in Table 20.1.

Given recent past and prospective future developments in Western Europe – the linked sovereign debt and banking crises, threatening the very existence of the eurozone as it was constituted more than a decade ago – why East Europe’s growth model must now be adjusted is quite evident. So how can and should the model be modified?

The proposed ‘new’ model should have two strategic priorities. One is to find new domestic sources of growth. The other is to reduce their vulnerability to external shocks, especially



those that will continue to be generated by the medium- and long-term economic, financial and political problems in Western Europe. This dual development strategy should rest on three interdependent pillars: macro-stabilization, export promotion so that net exports become a driver of growth and reducing obstacles to sustained domestic productivity improvements.

### ***Macro-stabilization***

The experiences of many countries over extensive periods have shown that a stable macro-economic framework is a necessary though not sufficient condition for sustained growth. A stable macro-framework means smoothing macroeconomic volatility, which discourages long-term investment. This includes preventing excessive, credit-driven domestic demand booms, since these encourage the transfer of resources from the generally more productive and productivity-enhancing tradeable to the generally less productive and less innovation-focused non-tradeable sectors.

A stable macro-framework includes prudent fiscal policies, a commitment to which can be strengthened by parliaments adopting fiscal rules that set limits on expenditure growth and deficits, as Bulgaria, Poland and some of the Baltic states have recently done. High public and external debt ratios that are growth limiting, such as those of Hungary, need to be gradually and prudently reduced. This should be facilitated by caps on the size of the public sector relative to GDP agreed upon by the main political parties. When tax burdens on labour and entrepreneurship are excessive, they should be reduced, with the resulting gaps in revenues closed by an equitable widening of the tax base.

### ***Increased trade participation and net exports should be enhanced sources of growth***

Among countries of comparable size, those with relatively high and growing TPRs tend to have higher growth rates, *ceteris paribus*, than those where such indicators are lower and growing more slowly. This is because productivity tends to be higher in the tradeable than in the non-tradeable sectors. Relying on net exports as a source of growth promotes this. To be sure, the EU-10 faces a much more difficult environment for achieving this than did the Asian and Latin American countries in past decades. Therefore, geographic and product diversification should be emphasized; both could be helped, for example, by strengthening intra-CEE co-operation and specialization – based on market potential, not on administrative edicts.

### ***Reducing obstacles to productivity growth***

Usually enumerated under the label of structural reforms, they include certain standard as well as country-specific measures designed to eliminate obvious domestic bottlenecks to growth. Standard measures include designing, implementing and enforcing industry- and branch-specific competition rules (neither too lax nor excessive); assuring labour-market flexibility, including rules of wage determination that safeguard competitiveness; and improving those many aspects of the business environment where a country suffers competitive disadvantages.<sup>30</sup>

Strengthening institutions can also remove growth bottlenecks. For example, most CEE countries need to establish – and others to improve – well-functioning domestic money and capital markets (which has many aspects) to pool domestic savings and to make available additional sources of finance to the private sector, thereby reducing excessive dependence on the (foreign and domestic) bank-centric nature of their financial systems.

A great deal can be done everywhere in the region to improve the educational systems at all levels, using as models the experiences of countries where improved education and industry-academia co-operation have been major long-term contributors to accelerated economic growth.<sup>31</sup>

\* \* \*

Sustained economic growth is essential for the reasons stated in the introduction of this contribution. The pace of sustainable growth is the outcome of a huge number of interacting variables; there is no single magic bullet that can be fired to achieve it. The growth prospects of a country will of course always be influenced by developments in the external environment. Nevertheless, the immense complexity of sustainable growth can be reduced to two sets of domestic variables. First, policymakers in CEE must achieve a consensus on new growth strategies and policies, along the lines sketched above. Second, a country must have a reasonably stable central power structure to implement the agreed economic strategies and policies, while securing a sustained ‘buy-in’ for them from the general public.<sup>32</sup>

### Notes

- 1 The Baltic states of Estonia, Latvia and Lithuania, plus the Czech Republic, Hungary, Poland, Slovakia and Slovenia joined in 2004; Bulgaria and Romania in 2007.
- 2 EBRD (2010), Chart 4.1.
- 3 IMF-REO, May 2010, p. 28. The IMF definition of ‘emerging Europe’ excludes two of the most developed CEE countries (the Czech Republic and Slovenia) while it includes Turkey, Russia, Ukraine and the non-EU-member South European countries. However, in this context, the statement about the relative size and composition of capital inflows is valid for the EU-10 group, too.
- 4 ECB (2009), p. 10.
- 5 Fabrizio *et al.* (2009, p. 7). Only Estonia, already highly open in 1995, registered a smaller TPR increase.
- 6 *Op. cit.*, p. 10 and Figure 7 on p. 15. See also IMF-REO, October 2011, Section 4.
- 7 EBRD (2010), Chapter 4.
- 8 Jimborean (2011), Figures 4, 5 and 6 (pp. 34–35). The REER is the weighted average of a country’s currency relative to an index or basket of other major currencies, adjusted for the effects of inflation. The weights of the different currencies are usually their countries’ trade shares. The measure of inflation used – consumer prices, wholesale prices, unit labour costs, or export unit values – will influence the results, although in the case of CEEs, the results were not dissimilar. Comparing the REER trends of several countries will show which have gained or lost international competitiveness. Another source, charting data since 2005, shows that all CEE currencies appreciated until late 2008, declined significantly in the following year, and by and large stabilized during 2010 (Gardo and Martin 2010, Chart 31, p. 37).
- 9 Fabrizio *et al.* (2009, Figures 1(a) and 1(b), pp. 3–4); Jimborean (2011, Figure 1, p. 6) (in the latter study, the base line is the average per capita GDP of the EU 27). See also *Turmoil at Twenty*, Figure 1.1., p. 26.
- 10 Institutional adaptation could involve, for example, privatization, the central bank, tax and accounting systems, and commercial law.
- 11 IMF-REO, October 2011. Estimates of the growth differentials are sensitive to the shape of the calculated convergence line.
- 12 *Ibid.*, Fig.3.7 (p. 52)
- 13 Jimborean (2011, Figure 2, p. 7). Bela Balassa and Paul Samuelson developed their quite similar theories, independently, in 1964. The Balassa-Samuelson inflation effect originates in the supply side (cost push). Real income convergence will also generate inflationary pressures from the other side (demand pull) as capital inflows and the resulting expansion of credit lower the real rate of interest and raise asset prices as well as the CPI.
- 14 BIS (2008).
- 15 Fabrizio *et al.* (2009, p. 5).
- 16 *Ibid.*, p. 10.
- 17 The link between vulnerabilities and performance is not straightforward because the tempo of GDP growth in any period is the net outcome of a complex set of interdependent variables. For an excellent study defining, quantifying and applying a large number of vulnerability indicators to nine CEE countries individually as well as a group, see Gardo and Martin (2010).
- 18 EBRD (2010), Chapter 4, p. 68.

- 19 World Bank (2010) *Turmoil at Twenty*, p. 10.
- 20 For the growth and composition of credit growth to the private sector in each country, see *Turmoil at Twenty*, Table 1.3, p. 50. For comparisons of trends in credit levels relative to GDP, see Gardo and Martin (2010), Chart 7, p. 14. The chart shows that while credit-to-GDP levels in CEE are still modest as compared with averages in the eurozone, per cent changes in the CEE countries since 2002 were dramatically higher than in Western Europe.
- 21 *Ibid.*, Box Figure 2, p. 67. A different set of data, for different years, can be found in Gardo and Martin (2010), Chart 3, p. 8.
- 22 *Turmoil at Twenty*, pp. 6–7.
- 23 EBRD (2010), *Transition Report*, Chapter 4, offers detailed data and analysis.
- 24 A peg means that the central bank's primary responsibility is to maintain the exchange rate. Since large capital inflows would appreciate the rate, the central bank must 'sterilize' the inflow by selling its own currency for foreign currency-denominated assets, thereby building up its foreign exchange reserves. Since the central bank is releasing more of its currency into circulation, this will expand the money supply, creating inflationary pressures that will erode a nation's export competitiveness just as much as currency appreciation would.
- 25 Carmen M Reinhart and Kenneth Rogoff, 'Debt and Growth Revisited', VOX, August 2010. [www.voxeu.org/index.php?q=node/5395](http://www.voxeu.org/index.php?q=node/5395) (accessed November 1, 2011).
- 26 *Ibid.* A more recent BIS study identifies the threshold at around 85% of GDP, noting that governments should keep debt levels well below the threshold to have fiscal buffers to deal with extraordinary adverse events (Cecchetti *et al.*, 2010).
- 27 The conditions for capping debt-to-GDP ratios are the following (Akyüz, 2007, pp. 1 and 5):  
A *public debt ratio* stops increasing when the growth rate of the GDP is at least as high as the real effective interest rate on government debt. If the growth rate is lower, then there must be a corresponding primary budget surplus. If the growth rate is higher, the debt ratio can be stable or declining even when there is a primary budget deficit.  
An *external debt ratio* stops increasing when there is a sufficient current-account surplus (net transfer of resources abroad) to cover the difference between net capital inflows and interest payment on the debt. The amount of surplus increases with the external debt ratio and the growth-adjusted real interest rate on debt.
- 28 European Commission, ECOFIN, *General Government Data* (Spring 2011), Table 53b.
- 29 A partial offset in Estonia and Bulgaria has been their surprisingly low levels of sovereign debt, giving their authorities some room to manoeuvre.
- 30 The annual *Global Competitiveness Report* and the World Bank's *Doing Business* reports are goldmines for identifying such bottlenecks.
- 31 The OECD's annual, multi-country Programme for International Student Assessment (PISA) survey results show that an intelligently improved educational system is the greatest contributor to improved economic growth performance.
- 32 The overwhelming importance of these factors has been documented in the recent cross-country study, *Why Nations Fail*, Robinson and Acemoglu (2012)

## Bibliography

- Akyüz, Y. (2007), 'Debt Sustainability in Emerging Markets: A Critical Appraisal', *DESA Working Paper* No. 61
- Cecchetti, S., Madhusudan, M. and Zampolli, F. (2010), 'The Future of Public Debt: Prospects and Implications', *BIS Working Paper* No. 300
- Checherita, C. and Rother, P. (2010), 'The Impact of High and Growing Government Debt on Economic Growth: An Empirical Investigation for the Euro Area', *ECB Working Paper* No. 1237.
- Coricelli, F., Driffield, N., Pal. S. and Roland, I. (2010), 'Microeconomic Implications of Credit Booms: Evidence from Emerging Europe', *EBRD Working Paper* No. 119.
- EBRD (2010), *Transition Report*, London: EBRD.
- Fabrizio, S., Leigh, D. and Mody, A. (2009), 'The Second Transition: Eastern Europe in Perspective', *IMF Working Paper* No. 09/43, Washington, DC: International Monetary Fund.
- Forthun, C. and Hagemann, R.P. (2010), 'Sustaining the Momentum of Fiscal Reform in Hungary', *OECD Economics Department Working Papers*, No. 802, OECD Publishing.

- Gardo, S. and Martin, P. (2010), 'The Impact of the Global Economic and Financial Crisis on Central and Eastern Europe and Southeastern Europe and Latin America', *Bank of Spain Occasional Paper* No. 1002.
- IMF (2010), *Regional Economic Outlook: Europe Fostering Sustainability*, Washington, DC: IMF (May)
- (2011a, b), *Regional Economic Outlook*, Washington, DC: IMF (April and October).
- Jimborean, R. (2011), 'The Exchange Rate Pass-Through in the New EU Member States', *Banque de France*, Document No. 341.
- Mihaljek, D. and Klau, M. (2008), 'Catching Up and Inflation in Transition Economies: The Balassa-Samuelson Effect Revisited', *BIS Working Paper* No. 270.
- Reinhart, C. and Rogoff, K. (2010), 'Debt and Growth Revisited', VOX-EU. [www.voxeu.org/index.php?q=node/5395](http://www.voxeu.org/index.php?q=node/5395) (accessed November 1, 2011).
- Robinson, J. and Acemoglu, D. (2012), *Why Nations Fail*, New York: Crown Publishers.
- World Bank (2010), *Turmoil at Twenty: Recession, Recovery and Reform in Central and Eastern Europe and the former Soviet Union*, Washington, DC: World Bank
- Zorzi, M., Chudik, A. and Dieppe, A. (2009), 'Current Account Benchmarks for Central and Eastern Europe', *ECB Working Paper* No. 995.