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Regional Competitiveness Initiative

RCI Budapest

Emerging Europe Out of the Crises?
RCI-Focus v EU Member Countries

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Outline

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- Country-groups compared
- Revisiting my key points in Kiev & Sarajevo
- Main issues today
- Comparative data
- Conclusions and looking ahead
- Implications for USAID

Emerging Europe Defined

The RCI focuses on 11 countries:

- 8 "less developed" emerging Europe (the Balkans & Ukraine)
- 3 in the Caucuses ("almost Europe")

An appropriate comparator group for the 8 (perhaps for all 11) would be the 10 (soon to be 11) EU members from CEE

<u>Emerging Europe</u>: the RCI group of 8 (11) + the EU group of 10 (11) from CEE

Six Key Points I Made in Kiev and Sarajevo

1. During the last decade, the affiliates of W. European banks had come to dominate emerging Europe's banking sectors.

2. Most of emerging Europe's impressive growth before the Great Recession had depended, significantly, on large, net foreign K inflows.

Key Points (cont'd)

3. Net K-inflows should be partitioned into:

"Beneficial" flows: those that help the host country to improve its international competitiveness.

"Dysfunctional" flows: too large a share of K inflows are channeled into such non-tradable sectors as real estate, construction, and domestic services. This overheats the economy, raising costs and prices, leading to loss of international competitiveness and heightened vulnerability to K-flow reversals.

Key Points (cont'd)

4. In emerging Europe, the extent of GDP declines during the Great Recession was closely linked to

- the prior rate of growth of credit expansion,
- the share of loans in foreign currency, and
- the size of the persistent current account deficits relative to GDP. (The larger the deficit, the greater is the country's excess consumption, which can be maintained only through continued large net K inflows).

Key Points (cont'd)

5. Since net K inflows, especially their dysfunctional components, will slow and are unlikely to recover to pre-crisis levels, emerging Europe will need to rely <u>relatively more</u> on internally-generated sources of Δ productivity, international competitiveness, and growth. This means a continuation of needed reforms, restructuring (e.g., moving resources from the non-tradable to the tradable sectors), and improving the business climate. These conclusions,recommendations remain valid today.

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Key Points (cont'd)

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6. West Europe's recovery & medium-term growth will be sluggish. This does not bode well for emerging Europe. The conclusion holds still. To be sure, I did not foresee the impressive pace of German recovery, which has been a boon to emerging Europe. At the same time, the Eurozone's sovereign debt crisis has been getting worse, clouding the future economic prospects of <u>all of Europe</u>.

Issues Addressed Today

- Is emerging Europe out of the crisis?
- Are countries getting back to their impr-essive pre-crisis growth trajectories?
- Are there signs that their growth models are being adjusted? That is, reorienting K & L from the non-tradable to the tradable sectors and significantly improving their business environments?

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Issues Today (cont'd)

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- Are there new economic threats on the horizon; if yes, what are they and what can be done to mitigate them?
- What new or unexploited economic opportunities are there and how can USAID programs promote and leverage them?

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Country Groups Compared In This Presentation

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RCI focuses on 11 emerging countries:

- 8 in less developed emerging Europe: Albania, Bosnia-Herzegovina, Kosovo, Macedonia, Moldova, Montenegro, Serbia, Ukraine
- 3 in the Caucasus: Armenia, Azerbaijan, Georgia

Will compare these two groups with the

- 10 CEE members of the EU: Bulgaria, Czech R, Estonia, Latvia, Lithuania, Hungary, Poland Romania, Slovakia, Slovenia

Juxtaposing the “less-” & the “more” developed country groups of **emerging Europe**

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1. Real GDP Growth, 2007-2012:*
Less Developed Emerging Europe 8

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	2007	2008	2009	2010	2011	2012
Albania	5.9	7.7	3.3	3.5	3.4	3.6
Bosnia/H	6.1	5.7	-3.1	0.8	2.2	4.0
Kosovo	4.0	5.4	2.9	4.0	5.5	5.2
Macedonia	6.1	5.0	-0.9	0.7	3.0	3.7
Moldova	3.0	7.8	-6.0	6.9	4.5	4.8
Montenegro	10.7	6.9	-5.7	1.1	2.0	3.5
Serbia	6.9	5.5	-3.1	1.8	3.0	5.0
Ukraine	7.9	2.1	-14.8	4.2	4.5	4.9
Average	**6.3**	**5.8**	**-3.4**	**2.9**	**3.5**	**4.3**

* 2010: preliminary; 2011-12: IMF projections.

Sources. IMF, *Regional Economic Outlook: Europe,* Oct 2010 and May 2011.

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2. Real GDP Growth, 2007-2012:* "The Caucasus 3"

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	2007	2008	2009	2010	2011	2012
Armenia	13.7	6.9	-14.2	2.6	4.6	n.a.
Azerbaijan	25.0	10.8	9.3	5.0	2.8	n.a.
Georgia	12.3	2.4	-3.8	6.4	5.5	n.a.
Ave	**17.0**	**6.7**	**-3.0**	**4.7**	**4.3**	**-**

* 2010: preliminary; 2011: IMF projections

Source: IMF, *Caucasus and Central Asia* (April 2011)

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3. Real GDP Growth, 2007- 2012*
Ten CEE Members of the EU

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	2007	2008	2009	2010	2011	2012
Bulgaria	6.2	6.0	-5.5	0.2	3.0	3.5
Czech Rep.	6.1	2.5	-4.1	2.3	1.7	2.9
Estonia	6.9	-5.1	-13.9	3.1	3.3	3.7
Hungary	1.0	0.6	-6.7	1.2	2.8	2.8
Latvia	10.0	4.2	-18.0	-.3	3.3	4.0
Lithuania	9.8	2.8	-14.7	1.3	4.6	3.8
Poland	6.8	5.0	1.7	3.8	3.8	3.6
Romania	6.3	7.3	-7.1	-1.3	1.5	4.4
Slovakia	10.6	6.2	-4.8	4.0	3.8	4.2
Slovenia	6.8	3.5	-8.1	1.2	2.0	2.4
Average	**7.1**	**3.3**	**-8.1**	**1.5**	**3.0**	**3.6**

* Sources and notes the same as Table 1. Croatia may join the EU in 2012

The Evidence Shows …

1. Taken as a group, emerging Europe's average pre-crisis growth rate was impressive, exceeded only by India and China among the emerging economy groups.
2. However, in quite a few countries in our region, the exceptionally high tempos of growth were not sustainable, mainly because they were rooted in excessive growths of credit, supported by large net K inflows.

The Evidence Shows … (cont'd)

3. Of the 21 countries in Tables 1, 2 and 3, only three could avoid GDP declines in 2009: Kosovo and Albania (recovering from the civil-war) and Azerbaijan (oil &gas).
4. The **<u>average decline</u>** in the 21 countries of Central & Southern Europe & the Caucasus was about the same as that in W. Europe. But deviations from the average were much greater in our region than in W. Europe.

The Evidence Shows … (cont'd)

5. The 8 less developed (mainly Balkan) countries and the 3 nations of the Caucasus have returned to growth last year. Their performances varied widely, reflecting the country-specific legacies of the pre-crisis boom periods and special circumstances, such as the post-civil-war recoveries of Kosovo and Albania.

The Evidence Shows… (cont'd)

6. The more developed (EU members) of CEE also returned to growth in 2010 (except Romania and Latvia).
7. However, the fact that growth rates in 2010 were modest – the rebound in all cases being less than the declines in the previous year – suggests that the recession was largely (or to certain extent) a correction of excessive growth in the pre-crisis period.

The Evidence Shows … (cont'd)

8. This year, and also in 2012, growth is projected by the IMF to be somewhat higher in the less-developed than in the more-developed emerging economies in the region. This is perhaps encouraging for the group of countries that RCI has been trying to support. However, there do not seem to be good medium-term prospects that the region will get back onto its pre-crisis growth trajectory.

Are There Signs …

… that the growth models of emerging Europe are being adjusted, which would mean reorienting K & L from the non-tradable to the tradable sectors?

An IMF publication issued last week states: "Although the recession of 2009 has mostly corrected the large external [current account] imbalances built up in the boom years, many resources have been idled …."

Are There Signs … (cont'd)

… and there are only tentative signs that the required reallocation across sectors has started. And the signs of K reallocation from the non-tradable to the tradable sector are also still scant."

Source. IMF, *Regional Economic Outlook: Europe* (May 2011), pp. 48-49.

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Are There Significant …

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improvements in the business environments of the countries of emerging Europe? The World Bank's Business Environment index is based on the ease or difficulty of:

- starting a business
- dealing with construction permits
- registering property
- getting credit
- protecting investors
- paying taxes
- trading across borders
- enforcing contracts and
- closing a business

Business Environment

- The good news: globally, Georgia's index had improved the most during the past five years. Today it ranks 12th among 183 countries in the ease of doing business. A real accomplishment!
- Also impressive are the rankings of the Baltic states (17th to the low 20s) and of Macedonia (38th).

- Georgia and Estonia are not shown on Chart 4.

Business Environment (cont'd)

- The disappointing news is the continued very low rankings of several RCI countries, such as Ukraine (145th), Kosovo (119th), & Bosnia-Herzegovina (110th).
- Chart 4 shows visually the very large differences in the business environs of the countries of emerging Europe (not all countries are shown):

4. Business Environments

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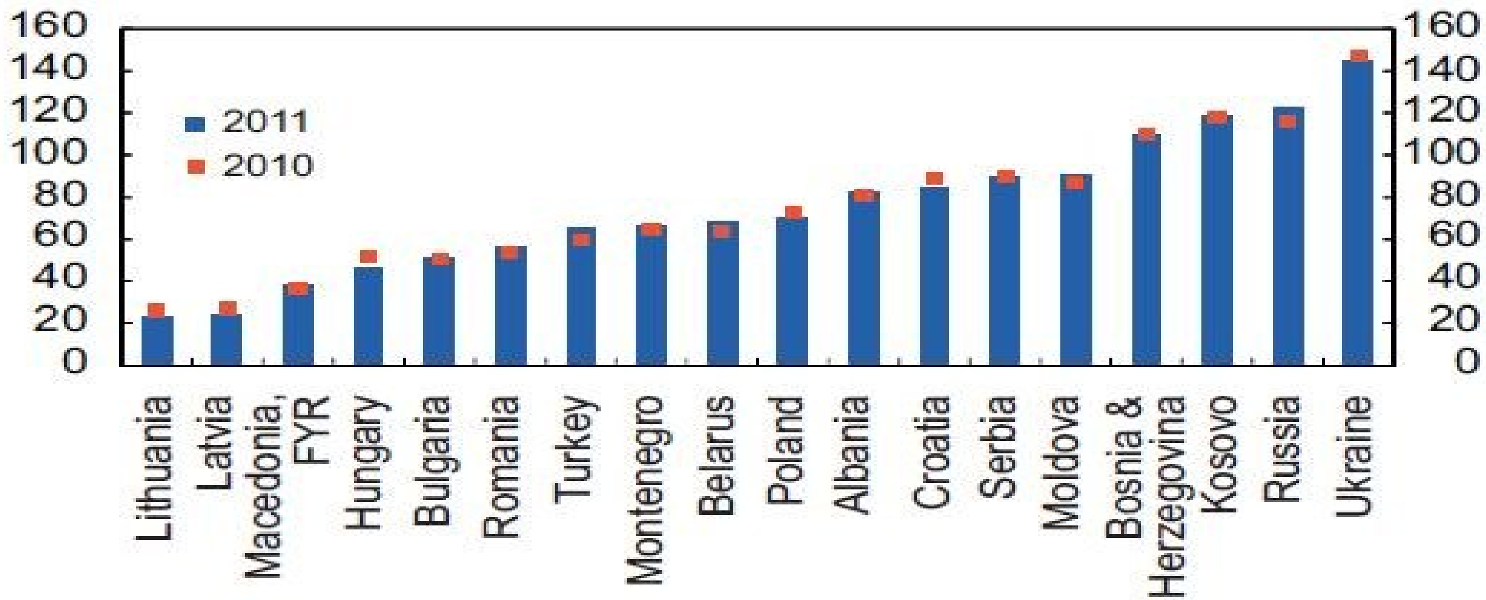
Emerging Europe: Ease of Doing Business Rank, 2010–11



Source: World Bank, Ease of Doing Business database, 2011.
Note: Countriesare ranked from best to worst out of a group of 183 countries.

Are There New Economic Threats?

Two are of particular concern in many of these countries:

- the rise in the share of non-performing to total loans in their banking systems (for country data, *op. cit*., p. 45); and
- the sovereign debt problems of the euro area, which can have serious negative repercussions for emerging Europe because …

Are There Opportunities To Improve?

Yes. For example:

- the necessary sectoral reallocation of labor calls for training programs to address skill mismatches and, in many cases, for further labor-market reforms.
- improvements in the bus. environment are badly needed in Ukraine and in the western Balkans, where announced reform plans still await implementation. As the IMF notes, such improvements would be particularly effective in stemming the emigration of skilled L and in making return migration more attractive.

Can USAID Programs Help & Leverage Improvements?

- I'd rather comment on this during the 3rd day of the conference.
- Let me now suggest only that two likely areas are those just mentioned:
  - Labor training to address skill mismatches and
  - Improving selected aspects of the business environments, making use, for example, of the experiences of Georgia and Macedonia

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May 2011, Budapest

Business Networking break next: Mission Presentations and E&E summary

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