Catching-up and Economic Integration: Unresolved Problems in the Light of the Recent Crisis

Michael Landesmann

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Economic Integration and Competitiveness: Challenges created by the Global Crisis
Economic Integration and Emerging Economies: Pitfalls revealed in Repeated Crises

- The role of (deep) financial market integration
- The nature of external and internal imbalances
- The crucial role of exchange rate regimes
- European and other emerging economies – do they differ?
- The E(U)ropean integration model of catching-up
- Constrained policy choices in different environments
- Have we found solutions?
Comparing emerging market economies (EMEs)

- **CE-5**: Czech Republic, Hungary, Poland, Slovakia, Slovenia
- **B-3**: Estonia, Latvia, Lithuania
- **SEE-2**: Bulgaria, Romania
- **WB-6**: Albania, Bosnia and Herzegovina, Croatia, Former Yugoslav Republic of Macedonia, Montenegro, Serbia
- **B-SEE**: B-3 + SEE-2 + WB-6
- **EU-COH**: Greece, Portugal, Spain, Ireland
- **Turkey**

- **ASIA-6**: Indonesia, Korea, Malaysia, Philippines, Taiwan, Thailand
- **LATAM-8**: Argentina, Brazil, Chile, Columbia, Ecuador, Mexico, Peru, Uruguay
- **MENA-6**: Egypt, Jordan, Lebanon, Morocco, Syria, Tunisia
Comparing emerging market economies (EMEs)

- **European EMEs:**
  CE-5; B-SEE (B-3, SEE-2; WB-6); EU-COH; Turkey

- **Non-European EMEs:**
  ASIA-6 (w/o China, India); LATAM-8; MENA-6 (non-oil)

- **Focus areas:** specific characteristics of European integration; European vs. global capital market integration; evolution of disequilibria; policy environment and policy choices
The European integration model of catching-up

- targeted at integration with the EU/Euro area
- associated with very far-reaching internal and external liberalization (trade, capital transactions, financial market integration, labour mobility)
- benefits: ‘downhill’ capital inflows, trade integration, ‘technology’ transfer; institutional convergence
- the model worked - ‘convergence process’ – but emergence of severe structural imbalances in important groups of European EMEs; heterogeneity of pre- and post-crisis experience of European EMEs
‘Growth models’ in emerging economies

- The question of ‘downhill’ vs. ‘uphill’ capital flows in the global economy (see e.g. Prasad/Rajan/Subramanian, 2006; Gourinchas/Jeanne, 2009; Abiad/Leigh/Mody, 2009)
- The issue of financial and monetary integration and catching-up economies (‘threshold’ effects, ‘institutional anchoring’)
- The nature of external disequilibria and the composition of capital (in)flows; role of exchange rate regimes
- Which disequilibria are ‘sustainable’ and under which external circumstances?
- The available spaces for policy choices
Growth performance and characteristics of the different EMEs before and during the crisis
Growth - GDP at constant prices
Average annual growth rates, 1995-2010, in %

Source: IMF World Economic Outlook, October 2010.
EBRD and wiiw Annual Database incorporating national statistics, Eurostat.
Differentiating features of EMEs

- Degree of openness:
  - trade integration; financial market integration
- Private sector borrowing and debt
- External disequilibria: current accounts, composition of capital flows; real exchange rate developments
- Sectoral ‘distortions’ (tradable/non-tradable sectors); FDI allocation
- Fiscal policy during the crisis
- Recovery from the crisis
Openness indicators: trade and financial integration, 2007
in % of GDP

Note: Assets and liabilities: EU-COH: 618.1%; ASIA-6 excl. Taiwan, MENA-6 excl. Lebanon.

Financial integration - Changes in: (i) assets plus liabilities; (ii) credit to private sector in % of GDP (percentage point change), 2001-2007

Note: Assets and liabilities: EU-COH: 265.82%; WB-6: 212.14%.
Foreign bank ownership, 1998-2005
(assets owned by foreign banks as % of banking system assets)

Note: ASIA-6 excl. Taiwan, MENA-6 excl. Syria.
Summarizing some of the features of European EMEs compared to other EMEs

- High growth prior to the crisis
- High indicators for openness: trade and particularly strong growth in international financial integration
- Much greater role of foreign banks in European EMEs compared to other EMEs
- Fast growth of credit to private sector in European EMEs
- The build-up of significant disequilibria before the crisis
Composition of the current account of the balance of payments, 1995-2009

Note: ASIA-6 excl. Taiwan.
Net private financial flows
in % of GDP, 1993-2009

Source: IMF Balance of Payments Statistics. ASIA-6 excl. Taiwan.
Credit to the private sector, 2000-2008 in % of GDP

Credit to the private sector, 1995-2008 in % of GDP

Credit to the private sector (%GDP, 1995-2009)
Relationship between pre-crisis credit growth and current account balances
Relationship between pre-crisis credit growth and current account balances

Source: IMF World Economic Outlook.
Real lending NB/ECB interest rates, 2003-2010
CPI-deflated, in % p.a.

Gross private and public debt in % of GDP, 2008

External debt: public and private (% of GDP), 2008

Note: ASIA-4 excl. PH, TW. MENA-4 excl. LB, SY. B-3 excl. FYROM, BA, RS.

External debt: public and private (% of GDP), 2008

Note: ASIA-4 excl. PH, TW. MENA-4 excl. LB, SY. B-3 excl. FYROM, BA, RS.

Real exchange rate developments, 1995 to 2010

- Appreciation hand-in-hand with catching-up in Central Europe
- Misalignment in the Baltics/Balkans
- Stable real X-rate in Asia post crisis
## Structural features: European and other EMEs

<table>
<thead>
<tr>
<th></th>
<th>LATAM-8</th>
<th>ASIA-6</th>
<th>MENA-6</th>
<th>CE-5</th>
<th>EU-COH</th>
<th>B-SEE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit/GDP, change from 2004 to 2008 (percentage points)</td>
<td>15.85</td>
<td>-8.97</td>
<td>7.02</td>
<td>6.68</td>
<td>56.88</td>
<td>39.21</td>
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<tr>
<td>Real interest rate average, 2005-2007</td>
<td>4.33</td>
<td>3.17</td>
<td>-0.09</td>
<td>1.10</td>
<td>-3.10</td>
<td>-0.26</td>
</tr>
<tr>
<td>Current account balance/GDP, 2007 (%)</td>
<td>0.14</td>
<td>3.35</td>
<td>-1.42</td>
<td>-4.88</td>
<td>-10.09</td>
<td>-15.21</td>
</tr>
<tr>
<td>Gross external debt, 2009 (% of GDP)</td>
<td>20.8</td>
<td>34.8</td>
<td>20.9</td>
<td>62.7</td>
<td>229.6</td>
<td>80.4</td>
</tr>
<tr>
<td>GDP growth, 2008-2010</td>
<td>3.82</td>
<td>3.47</td>
<td>5.38</td>
<td>0.50</td>
<td>-1.67</td>
<td>-1.55</td>
</tr>
</tbody>
</table>

*Source: wiwiw calculations.*
Summarizing the build-up to the crisis – differentiated patterns in the EMEs

- Sharp deterioration in some European EME’s current accounts; strong real exchange rate appreciation
- Fast credit growth to the private sector; low (partly negative) real interest rates
- Public debt situation not that different between European EMEs and other EMEs
- Clear link between private credit growth and current account deterioration
Summarizing the build-up to the crisis – differentiated patterns in the EMEs (Part 2)

- Different developments amongst European EMEs EU-Coh, CE-5, B-SEE and compared to other EMEs
- Current account developments; real exchange rate appreciation
- Composition of net capital inflows
- Credit growth to the private sector; low (partly negative) real interest rates
- Public debt situation not that different between European EMEs and other EMEs
- Clear link between private credit growth and current account deterioration
The impact of the crisis and patterns of recovery
Pre-crisis credit growth and GDP growth in 2009
Pre-crisis credit growth and GDP growth in 2009

Source: IMF World Economic Outlook.
Pre-crisis credit growth and GDP growth in 2010

Source: IMF World Economic Outlook.
### Structural features: the role of exchange rate regimes 'Fixers' and 'floaters' amongst the CESEEs

<table>
<thead>
<tr>
<th>Metric</th>
<th>CESEE float</th>
<th>CESEE fix</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit/GDP, change from 2004 to 2008 (percentage points)</td>
<td>20.5</td>
<td>32.8</td>
</tr>
<tr>
<td>Real interest rate average, 2005-2007</td>
<td>1.6</td>
<td>-1.6</td>
</tr>
<tr>
<td>Current account balance/GDP, 2007 (%)</td>
<td>-6.6</td>
<td>-11.8</td>
</tr>
<tr>
<td>Gross external debt, 2009 (% of GDP)</td>
<td>78.8</td>
<td>95.6</td>
</tr>
<tr>
<td>GDP-growth, 2008-2010</td>
<td>1.18</td>
<td>-1.78</td>
</tr>
<tr>
<td>FDI to finance and real estate sectors, 2007 (per cent of total FDI stock)</td>
<td>26.5</td>
<td>40.2</td>
</tr>
<tr>
<td>Change in unemployment rate from 2007 to 2010 (percentage points)</td>
<td>1.5</td>
<td>3.9</td>
</tr>
</tbody>
</table>

**Source:** wiwiw calculations.
Fiscal policy reaction: huge adjustment in CESEE

Average annual changes in total general government expenditures, 2008-2010

<table>
<thead>
<tr>
<th>Region</th>
<th>Nominal per cent change</th>
<th>Real per cent change</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2008</td>
<td>2009</td>
</tr>
<tr>
<td>CE-5</td>
<td>3.7</td>
<td>1.4</td>
</tr>
<tr>
<td>B-3</td>
<td>20.5</td>
<td>-4.4</td>
</tr>
<tr>
<td>SEE-2</td>
<td>27.7</td>
<td>2.9</td>
</tr>
<tr>
<td>WB-6</td>
<td>16.8</td>
<td>4.5</td>
</tr>
<tr>
<td>EU-15</td>
<td>6.3</td>
<td>5.4</td>
</tr>
<tr>
<td>ASIA-6</td>
<td>14.2</td>
<td>6.9</td>
</tr>
<tr>
<td>LATAM-8</td>
<td>20.8</td>
<td>13.0</td>
</tr>
</tbody>
</table>

Note: Nominal from data in EUR.
Source: IMF World Economic Outlook, wiwiw Database and Eurostat.
Summarizing the crisis impact

- Stronger impact of the crisis on European EMEs than on other EMEs
- Countries with high current account deficits and high credit growth prior to the crisis have stronger downturn
- Significant differences between ‘fixers’ and ‘floaters’ amongst European EMEs
- Substantial pro-cyclical contraction of real government spending in European EMEs during the downturn
The aftermath of the crisis
Crucial question: output prospects

Three options:

1. downturn is **purely cyclical** and GDP will return to the pre-crisis trendline

2. part of the downturn is permanent, but the potential *growth rate* is unaffected

3. part of the downturn is permanent and the potential growth rate is also reduced

⇒ 1 may characterize Asia, CESEE will likely follow 2 or 3
GDP development, 2005-2012
2008=100

Source: wiiw forecast and IMF World Economic Outlook, October 2010.
Quarterly GDP developments
3rd quarter 2008 = 100

Source: Eurostat, wiwiw calculations.
General government gross debt (% of GDP), 1995-2010

Source: IMF World Economic Outlook.
General government balance and gross debt (% GDP), 2000-2010

CESEE: low debt (on average), even after the crisis
CESEE: GDP growth was well above the interest rate before the crisis

Nominal interest rate on government debt and nominal GDP growth (%), 2000-2010

Note: Interest rate = government interest expenditures / previous year gross debt.
Unemployment at high levels
registered unemployment rates in %

Source: wiiw Monthly Database.
The outlook on recovery after the crisis

- Which pattern of recovery after the crisis? European EMEs show level and (likely) trend effect of crisis impact
- Fiscal policy: less room for manoeuvre because of reduced growth expectations and higher interest rates
- Household deleveraging process and fragile banks
- Unemployment: previous gains lost
Summary: Specific features of European EMEs

- Opening of the capital account: a rule of the game in the EU; deep financial integration
- Reliance on massive imports of capital; only 4 CESEE-countries could avoid skyrocketing external (private) debt
- Bank credit: the overwhelming source of external funding
- Financial integration: major channel for transmitting shocks (EU-Coh, B-SEE regions hit hardest by the crisis)
- In general no meltdown of financial systems (advantage of the presence of foreign banks? Implies also less socialization of private debt in CESEE – i.e. lower public debt effects); difference to EU-Coh
Principal policy lessons:

- In national and EU policy frameworks: neglect of private sector debt build-up relative to public sector
- Financial market regulation severely underdeveloped; but very high degree of financial market integration; specific issue in CESEE region: high level of cross-border banking
- Fixed exchange rate regimes bear high risks; but what are the options of highly euroized EU members and candidates?
- Scope for counter-cyclical fiscal policy was used much less in European CE-EMEs during crisis; post-crisis: task to restructure public finance in growth-enhancing manner
- Impact of evolving eurozone support systems on European EMEs; implications of current reforms
<table>
<thead>
<tr>
<th>Country Group</th>
<th>Population, total (mn)</th>
<th>GDP (USD bn)</th>
<th>GDP, PPP (USD bn)</th>
<th>GDP per capita (USD)</th>
<th>GDP, PPP per capita (USD)</th>
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<tbody>
<tr>
<td>LATAM-8</td>
<td>445.673</td>
<td>3682.786</td>
<td>5253.562</td>
<td>8263</td>
<td>11788</td>
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<td>ASIA-6</td>
<td>460.701</td>
<td>2102.759</td>
<td>3478.175</td>
<td>4564</td>
<td>7550</td>
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<td>MENA-6</td>
<td>154.048</td>
<td>399.710</td>
<td>844.183</td>
<td>2595</td>
<td>5480</td>
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<td>EU-COH</td>
<td>71.841</td>
<td>2462.928</td>
<td>2304.365</td>
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<td>CE-5</td>
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<td>SEE-2</td>
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<td>B-3</td>
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<td>WB-6</td>
<td>21.364</td>
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<td>12335</td>
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<td>Turkey</td>
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<tr>
<td>B-SEE</td>
<td>57.466</td>
<td>520.098</td>
<td>830.676</td>
<td>9050</td>
<td>14455</td>
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Indicators: Pop, GDP, GDP (per capita) averages per country in group, 2008

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GDP, PPP and Exports plus Imports in % of GDP, 2007

GDP, PPP and Assets plus liabilities in % of GDP, 2007