

Sustaining Convergence: Policy Challenges for the New Member States

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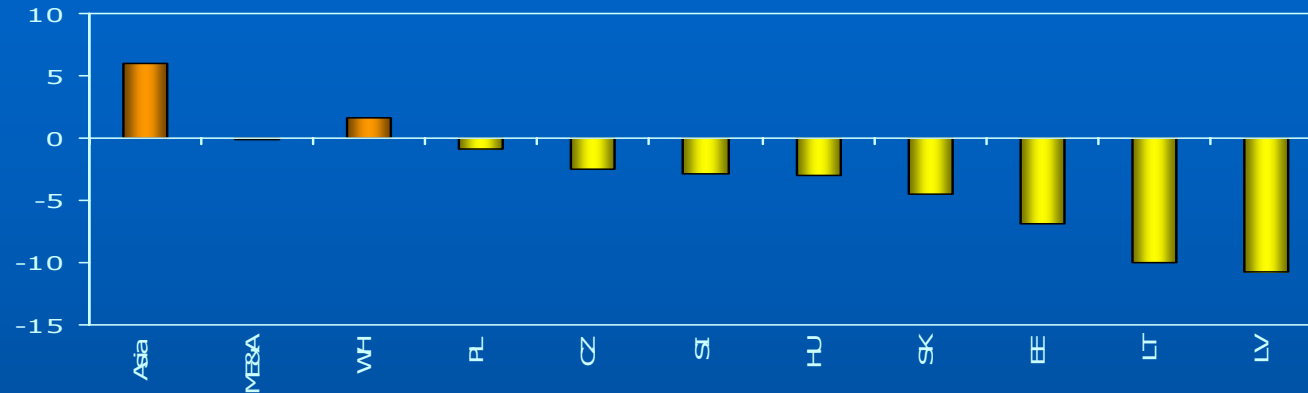
Sustaining Convergence:
Policy Challenges for
the New Member States

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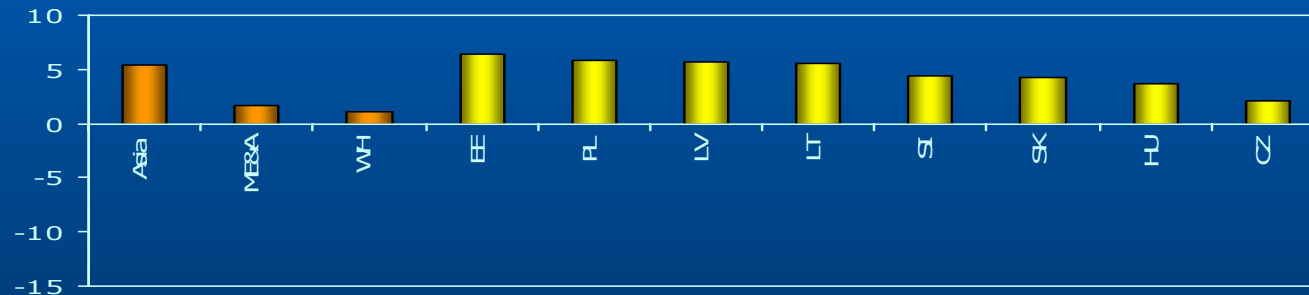
EU8 countries are catching up rapidly

Real GDP per capita growth (period average, in percent)

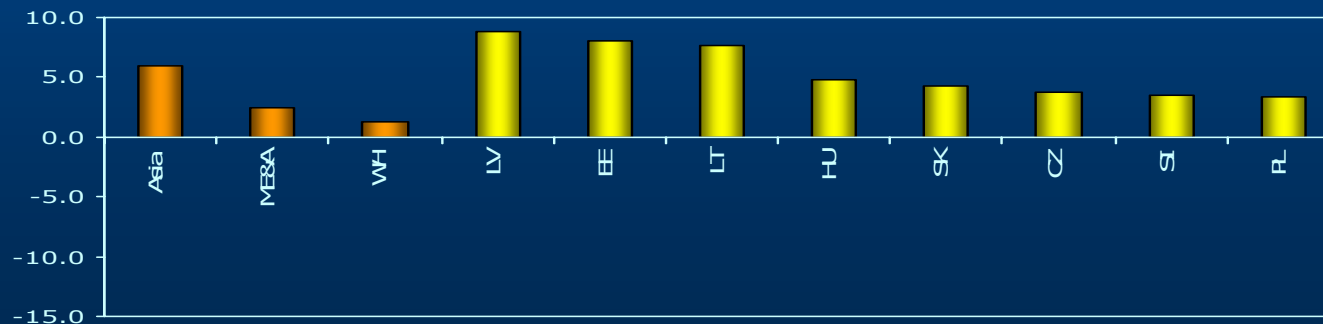
90-94



95-99



00-05



Source: IMF.

*ME&A – Middle East & Africa, ** WH – Western Hemisphere

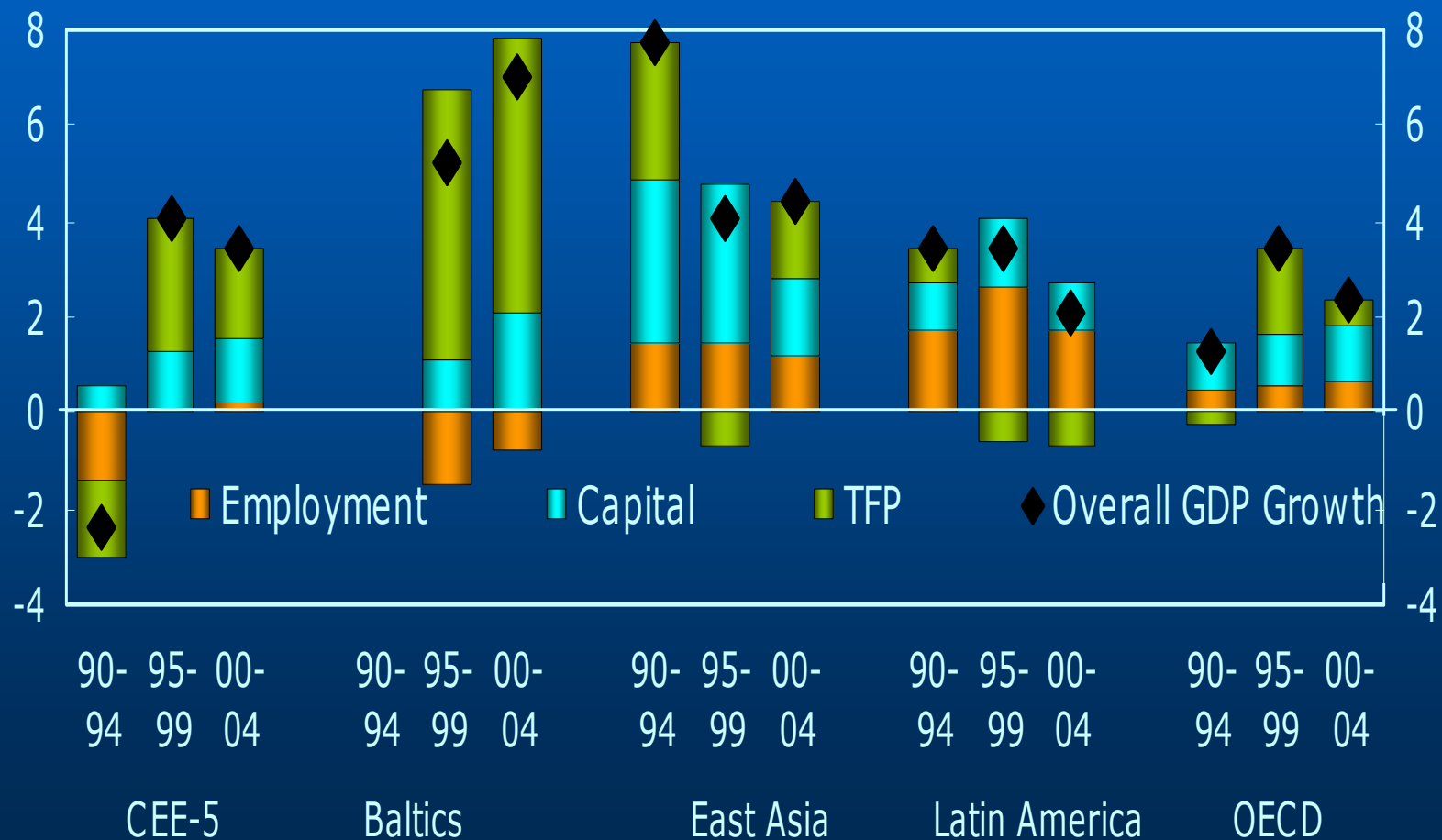
Factors supporting per capita growth in the EU8

Results from a large - scale regression analysis
(Schadler, Mody, Abiad and Leigh, 2006)

- Low initial per capita income (esp. Baltics)
- Slow population growth
- Growth in export markets (esp. Baltics)
- Good institutional development indices
(but governments are larger and
educational standards lower than in Asia)
- European integration

Increasing labor utilization and maintaining productivity growth are key to sustaining convergence

EMs: Contributions to GDP growth

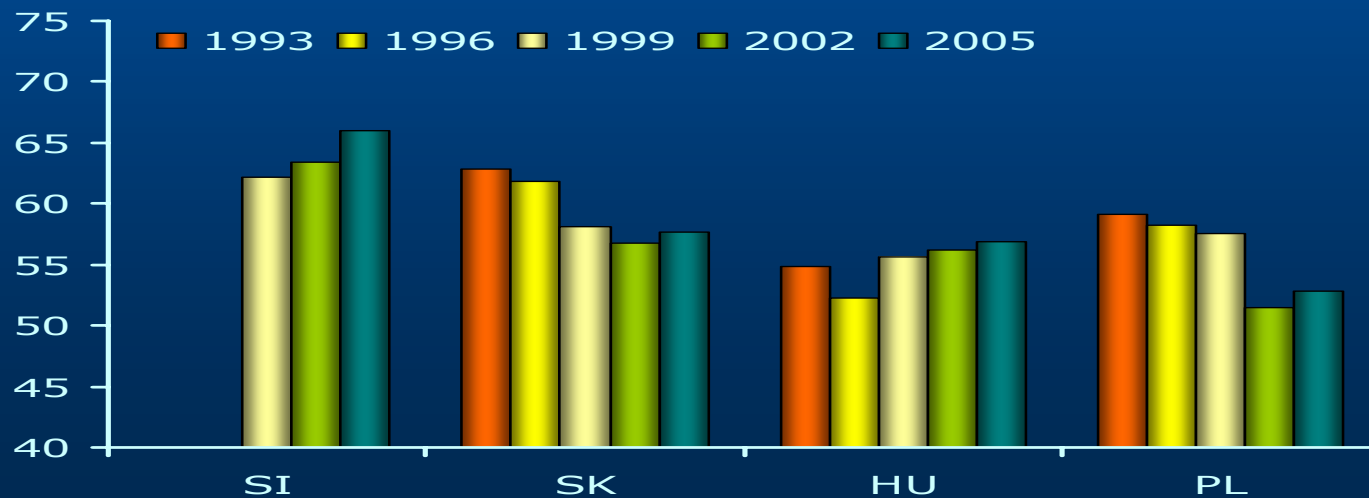
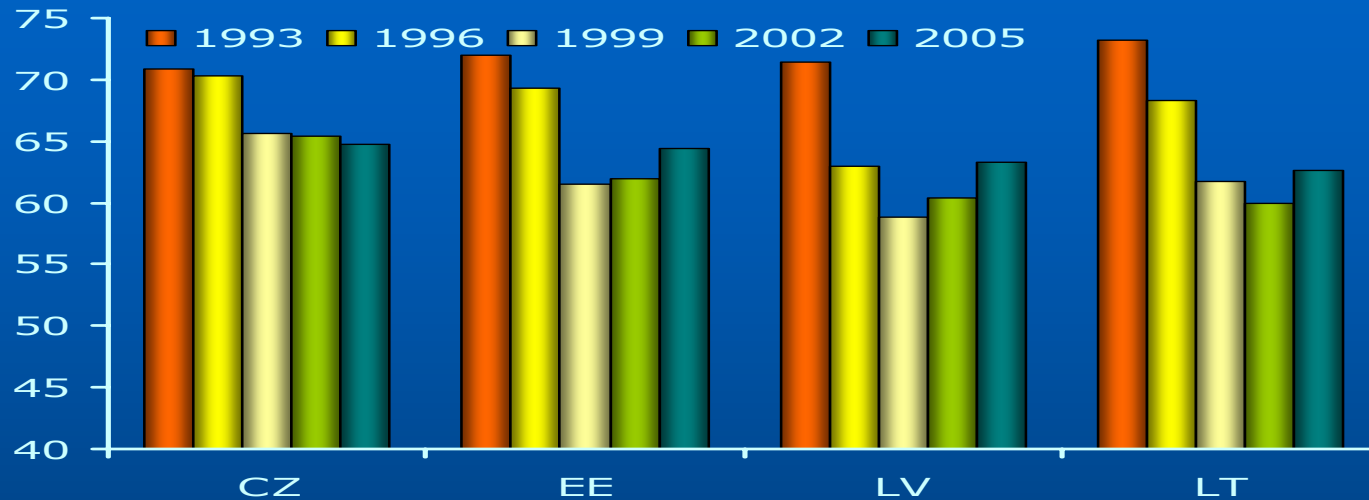


Specific challenges:

1. Increasing employment
2. Providing a flexible business environment
3. Efficient use of foreign savings, while keeping vulnerabilities in check
4. Adjusting fiscal policies to support growth, including efficient use of EU funds
5. Euro adoption

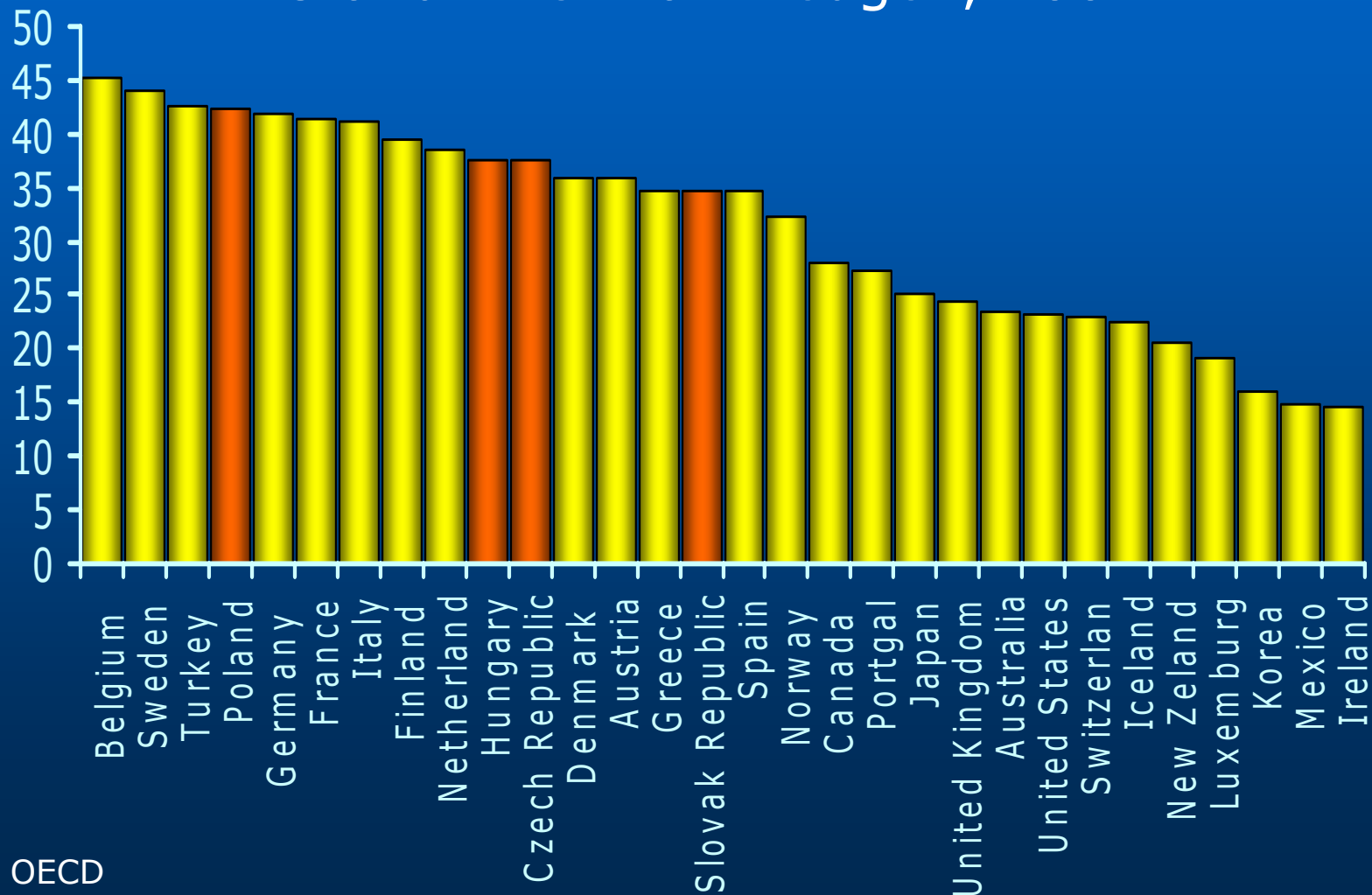
Employment rates are recovering only slowly.

Employment rates in EU8



Tax wedges are one of several disincentives to employment

EU and EMs: Tax wedge*, 2004



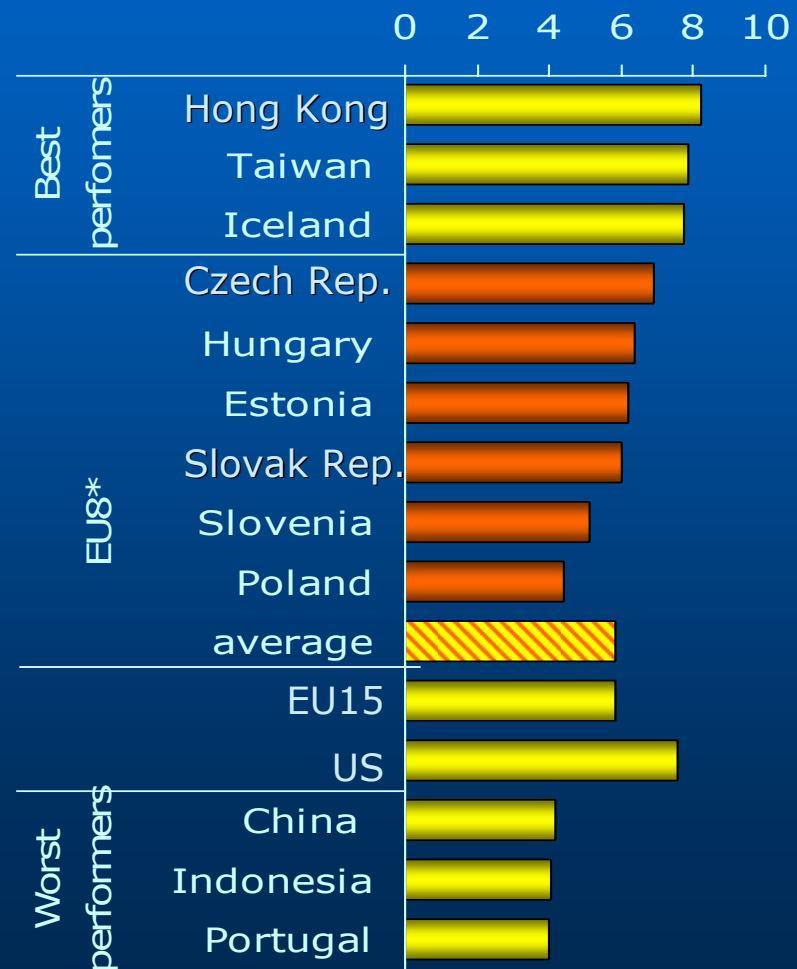
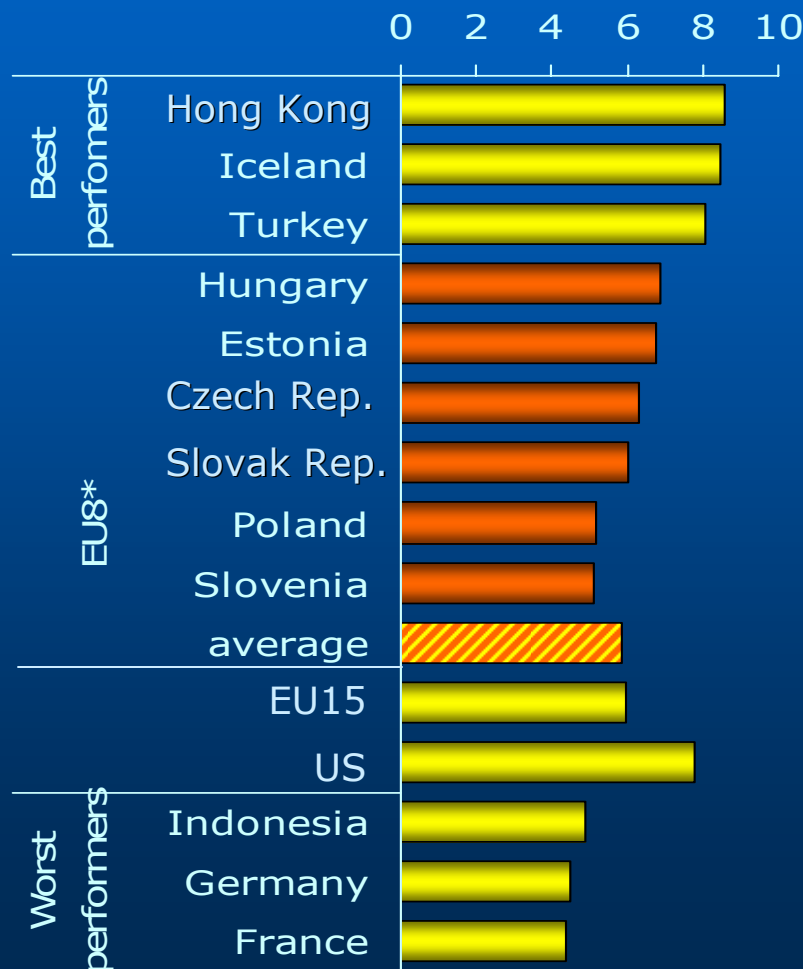
Source: OECD

* labor cost/ take-home pay

A flexible business environment is essential for sustaining convergence

Flexibility and adaptability (0-10)

Adaptability of companies (0-10)



Source: IMD World Competitiveness
 * Excluding Lithuania and Latvia

Structural policies need to focus on improving the business environment

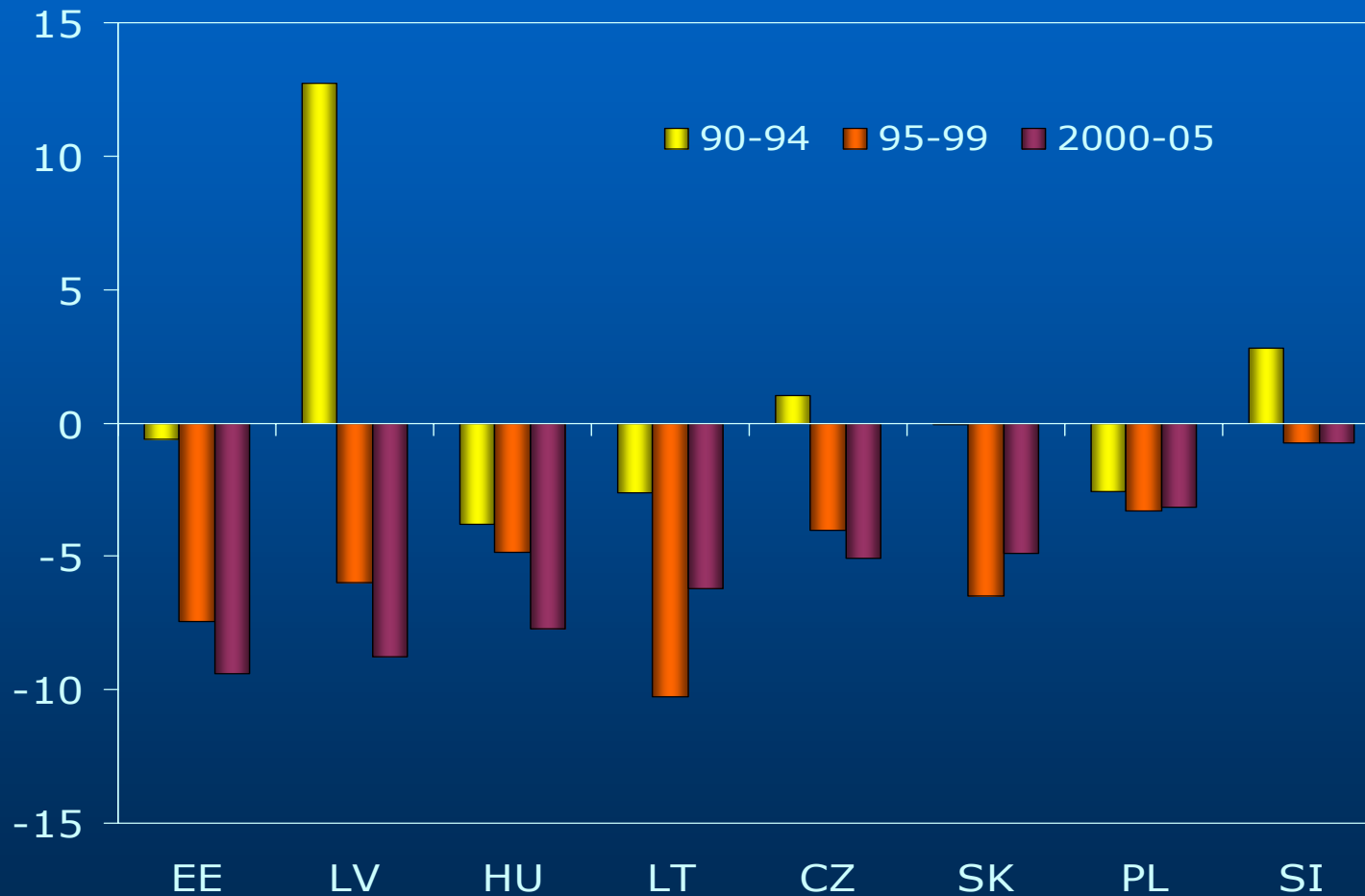
OECD and EU Countries: Country Ranking According to Business Climate Indicators

World Bank		WEF		WEF		IMD		ICRG		Heritage Foundation	
Doing Business		Growth Competitiveness		Business Competitiveness		World Competitiveness		Institutional Quality		Economic Freedom	
New Zealand	1	Finland	1	United States	1	United States	1	Finland	1	Ireland	3
United States	3	United States	2	Finland	2	Iceland	4	Australia	2	Luxembourg	4
Canada	4	Sweden	3	Germany	3	Canada	5	Luxembourg	3	Iceland	5
Norway	5	Denmark	4	Denmark	4	Finland	6	Denmark	4	United Kingdom	6
Australia	6	Iceland	7	United Kingdom	6	Denmark	7	Iceland	5	Estonia	7
Denmark	8	Switzerland	8	Switzerland	7	Switzerland	8	Germany	6	Denmark	8
United Kingdom	9	Norway	9	Japan	8	Australia	9	Netherlands	7	Australia	9
Japan	10	Australia	10	Netherlands	9	Luxembourg	10	Sweden	8	New Zealand	10
Ireland	11	Netherlands	11	Austria	10	Ireland	12	Ireland	9	United States	11
Iceland	12	Japan	12	France	11	Netherlands	13	Norway	10	Canada	12
Finland	13	United Kingdom	13	Sweden	12	Sweden	14	Switzerland	11	Finland	13
Sweden	14	Canada	14	Canada	13	Norway	15	United States	12	Switzerland	15
Lithuania	15	Germany	15	Australia	15	New Zealand	16	Cyprus	13	Cyprus	16
Estonia	16	New Zealand	16	Belgium	16	Austria	17	New Zealand	14	Netherlands	17
Switzerland	17	Korea	17	Iceland	17	Japan	21	United Kingdom	15	Austria	18
Belgium	18	Estonia	20	New Zealand	18	United Kingdom	22	Austria	16	Germany	19
Germany	19	Austria	21	Ireland	19	Germany	23	Belgium	18	Sweden	20
Netherlands	24	Portugal	22	Norway	21	Belgium	24	Canada	19	Czech Republic	21
Latvia	26	Luxembourg	25	Korea	24	Estonia	26	Japan	20	Belgium	22
Korea	27	Ireland	26	Spain	25	Korea	29	Portugal	21	Lithuania	23
Spain	30	Spain	29	Estonia	26	France	30	France	24	Malta	24
Austria	32	France	30	Czech Republic	27	Czech Republic	36	Spain	25	Japan	29
Slovak Republic	37	Belgium	31	Portugal	30	Hungary	37	Malta	26	Norway	31
Czech Republic	41	Slovenia	32	Slovenia	32	Spain	38	Slovenia	27	Portugal	32
Portugal	42	Cyprus	34	Hungary	34	Slovak Republic	40	Greece	30	Spain	33
France	44	Malta	35	Cyprus	36	Portugal	45	Turkey	32	Slovak Republic	35
Hungary	52	Czech Republic	38	Italy	38	Turkey	48	Latvia	36	Slovenia	38
Poland	54	Hungary	39	Slovak Republic	39	Greece	50	Poland	38	Latvia	39
Slovenia	63	Slovak Republic	41	Greece	40	Slovenia	52	Czech Republic	39	Hungary	40
Italy	70	Lithuania	43	Lithuania	41	Italy	53	Estonia	40	Poland	41
Mexico	73	Latvia	44	Poland	42	Mexico	56	Hungary	41	Italy	42
Greece	80	Greece	46	Malta	46	Poland	57	Korea	42	France	44
Turkey	93	Italy	47	Latvia	48	Cyprus	--	Lithuania	49	Korea	45
Cyprus	--	Poland	51	Turkey	51	Latvia	--	Slovak Republic	55	Greece	57
Luxembourg	--	Mexico	55	Mexico	60	Lithuania	--	Italy	60	Mexico	60
Malta	--	Turkey	66	Luxembourg	--	Malta	--	Mexico	80	Turkey	87
OECD average	28	OECD average	25	OECD average	23	OECD average	25	OECD average	23	OECD average	25
EU average	32	EU average	25	EU average	23	EU average	28	EU average	25	EU average	28
<i>Memo:</i>											
<i>sample size</i>	<i>155</i>	<i>117</i>	<i>116</i>	<i>60</i>	<i>140</i>	<i>157</i>					

Sources: The World Bank, World Economic Forum, IMD, International Country Risk Guide, and Heritage Foundation.

The NMSs have increased the use of foreign savings

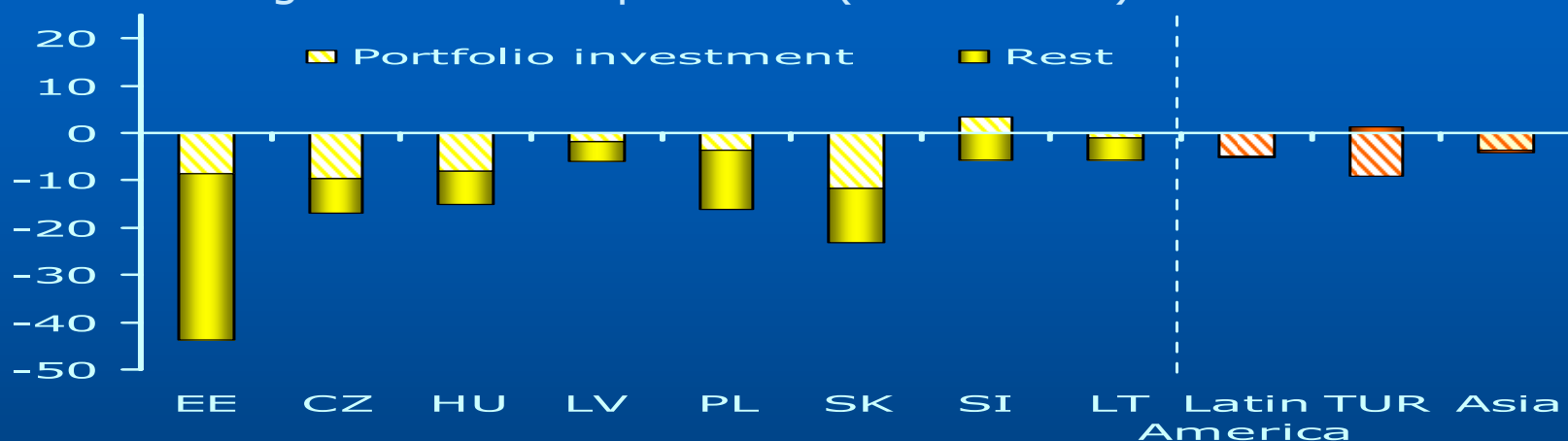
Current account deficit (period average, in percent of GDP)



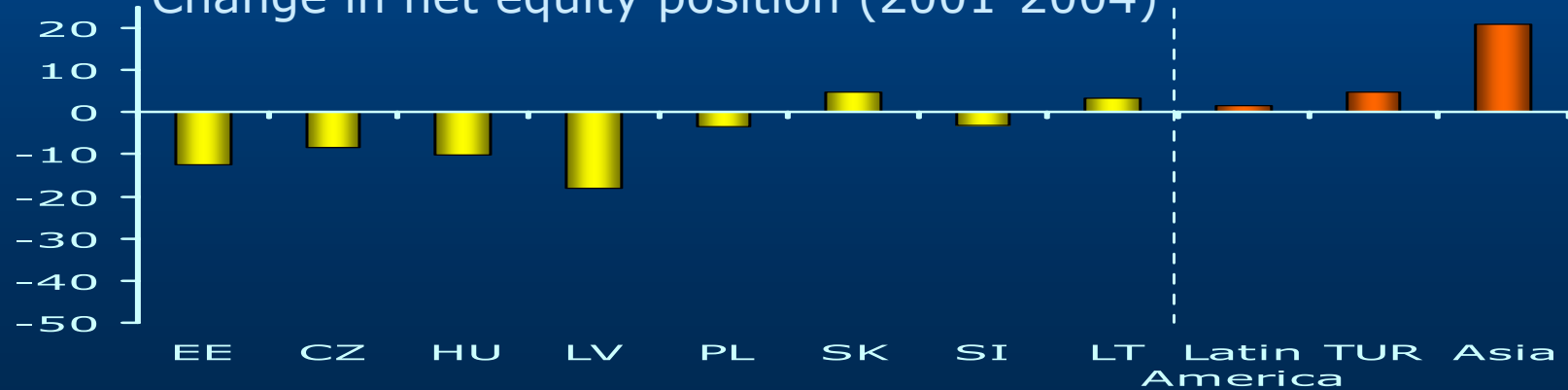
Equity inflows dominate IIPs, but debt inflows have contributed in some countries

EU8 and EMs: International Debt and Equity Position

Change in net debt position (2001-2004)

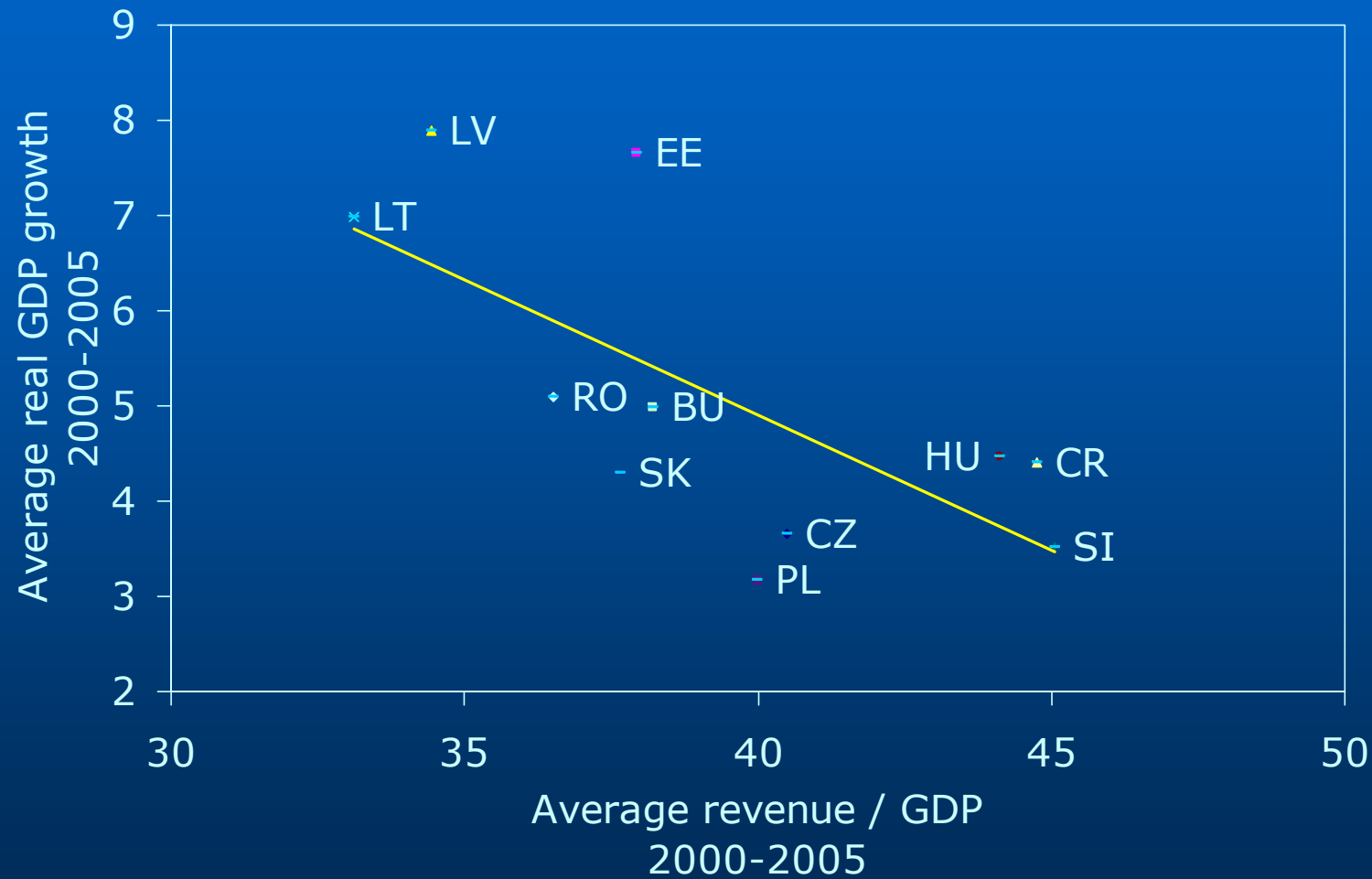


Change in net equity position (2001-2004)



Source: Milesi-Ferretti and Lane, "External Wealth of Nations" database

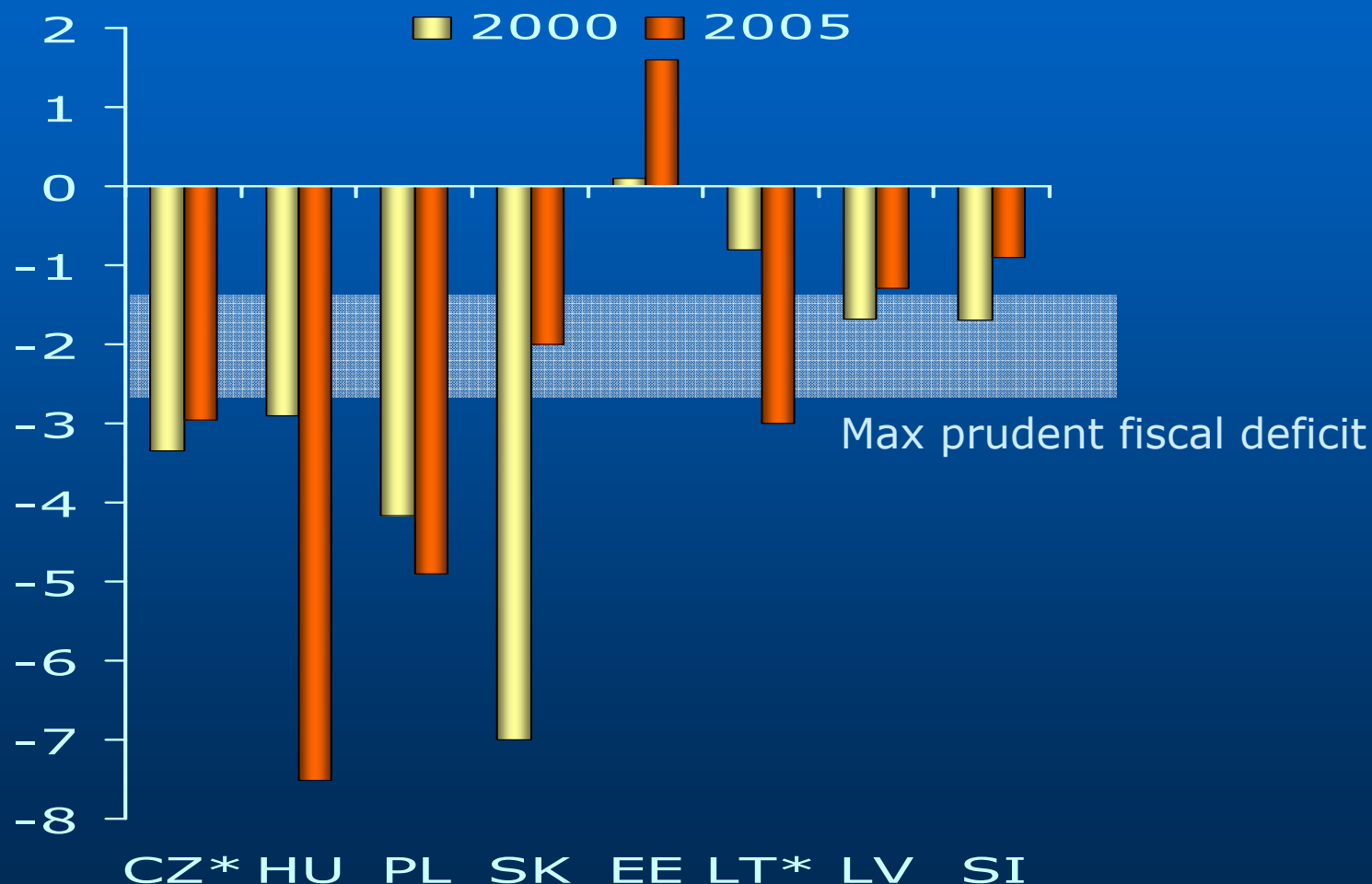
The size of government has some effect on growth



Source: Eurostat.

Few countries have used the benign global environment to undertake fiscal adjustments

EU8: Structural Fiscal Balances (in percent of GDP)

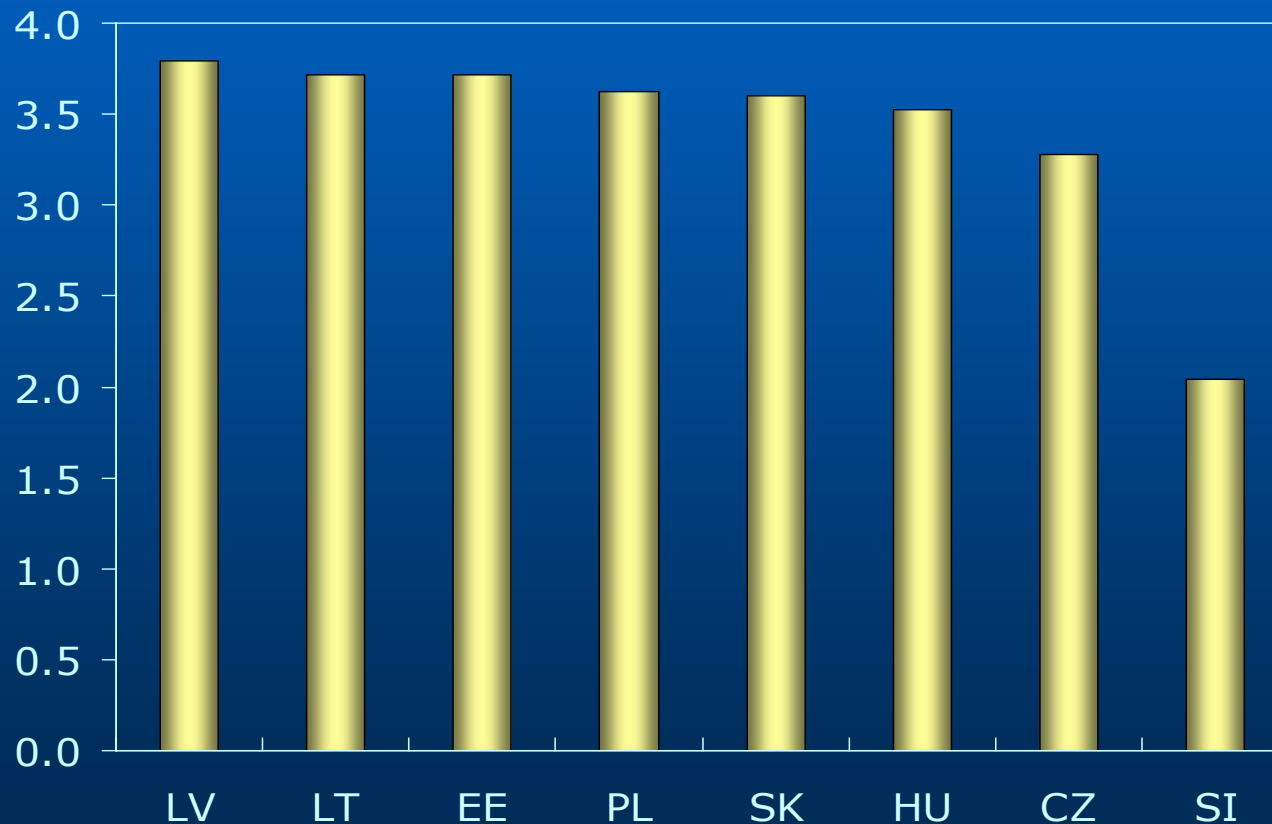


Source: IMF staff estimates

* data for 2004

EU funds present a huge growth opportunity, if efficiently used

Average annual commitments for 2007-2013
(in percent of GDP)



Euro Adoption

- Increased trade
- Greater policy discipline
- Reduction of risk premia, investment
- Elimination of currency-related vulnerabilities

But: Conditions need to be right, especially sound fiscal policies and a flexible economy

Conclusions

Huge growth opportunities

- EU membership (including EU funds of up to 4% of GDP p.a.)
- Outsourcing from Western Europe with attendant capital inflows and productivity improvements

But:

- Competition from the East
- Momentum for structural reform is petering out
- Need to contain vulnerabilities



Central Europe