POLICY MEASURES FOR THE ECONOMIC RECOVERY OF THE EUROPEAN COUNTRIES

MĂSURI DE POLITICĂ PENTRU REVENIREA ECONOMICĂ A ȚĂRILOR EUROPENE

MAGDALENA RĂDULESCU[1]

[1]***University of Pitesti, Romania; magdalenaradulescu@yahoo.com***

Abstract: *Resolute domestic policy responses to the crisis—as well as large official financing packages from multilateral institutions—helped prevent a cascade of bank and currency crises. Still, these policies themselves, and the deep economic downturns, have had some side effects that policymakers in the region will now have to deal with.*

Key words**:** *fiscal consolidation, private credit growth, external trade competitiveness, FDI.*

1. INTRODUCTION

Several emerging European (EE) countries need to rein in large public sector deficits to secure debt sustainability and avoid negative market reactions as experienced earlier in 2010-2011. The timing and pace of the consolidation will ultimately need to be tailored to individual country circumstances, and countries at high risk of market concerns about sovereign debt sustainability may need to proceed with fiscal consolidation at a faster rate. Beyond the short term, most of the EE region will need to find new growth engines. In a number of countries, the growth model of the boom years—driven by capital inflows, rapid credit growth, and domestic demand booms—will need to shift toward a model more reliant on the tradable sector as an engine of growth. While this shift will in large part be the result of private sector decisions, government policies, in particular structural reforms and prudent wage policies, can also help.

2. HEALTH OF THE PUBLIC FINANCES

In 2007, emerging Europe as a group recorded a fiscal surplus of about 2 percent of GDP. Moreover, debt levels—at roughly 23 percent of GDP for EE countries—were low compared with other emerging market economies, with the important exception of Hungary (Table 1).

Table no.1. Emerging Europe: Evolution of Public Debt and General Government Overall Balance, 2007–2011 (% of GDP)

	General Government Overall Balance					Public Debt				
	2007	2008	2009	2010	2011	2007	2008	2009	2010	2011
Baltics[2]	0.3	-4.3	-7.1	-7.5	-6.4	11.2	13.8	25.7	33.5	36.7
Estonia	2.9	-2.3	-2.1	-1.1	-1.7	3.7	4.6	7.1	8.1	7.8
Latvia[3,4]	0.6	-7.5	-7.8	-11.9	-7.6	7.8	17.1	32.8	42.2	49.0
Lithuania	-1.0	-3.3	-8.9	-7.7	-7.7	16.9	15.6	29.5	39.5	42.3
Central Europe[2]	-2.6	-3.7	-6.5	-6.8	-6.2	49.9	52.9	56.7	60.0	61.8
Hungary[5]	-5.0	-3.7	-4.1	-4.2	-4.5	65.8	72.9	78.3	78.4	78.8
Poland	-1.9	-3.7	-7.1	-7.4	-6.7	45.0	47.1	50.9	55.2	57.4
Southeastern Europe-EU[2]	-1.4	-2.8	-5.7	-6.3	-4.3	19.8	20.0	26.3	30.9	33.3
Bulgaria[3]	3.5	3.0	-0.9	-4.9	-4.2	19.8	16.1	16.1	18.2	21.1
Romania	-3.1	-4.8	-7.4	-6.8	-4.4	19.8	21.3	29.9	35.5	37.7
Southeastern Europe-non-EU[2]	-1.5	-2.3	-4.5	-4.7	-4.2	34.7	32.5	36.9	41.0	43.0
Albania[3]	-3.6	-5.1	-7.4	-4.1	-5.0	53.8	55.2	59.5	60.6	61.9
Bosnia and Herzegovina	-0.3	-3.6	-5.7	-4.5	-3.0	32.9	30.8	35.4	39.1	43.0
Croatia[3]	-2.4	-1.3	-4.1	-5.3	-4.7	33.2	29.3	35.4	40.0	42.6
Kosovo[3]	4.9	-0.2	-0.8	-3.4	-5.5	...	...	...	...	...
Macedonia, FYR	0.6	-0.9	-2.6	-2.5	-2.5	22.8	20.8	23.5	24.9	25.4
Montenegro, Republic of[3]	6.3	1.5	-4.4	-7.1	-7.7	27.5	29.0	38.2	43.5	49.4
Serbia, Republic of[3]	-1.9	-2.6	-4.1	-4.8	-4.0	35.2	33.4	35.6	40.5	41.6
European CIS Countries[2]	5.4	3.2	-6.0	-4.8	-3.6	15.3	15.5	14.3	15.3	17.1
Belarus[3]	0.4	1.3	-0.7	-3.4	-3.5	11.5	11.5	25.1	29.3	33.4
Moldova[3]	-0.2	-1.0	-6.4	-5.4	-3.4	26.9	21.3	30.7	33.8	35.1
Russia[3]	6.8	4.3	-6.2	-4.8	-3.6	8.5	7.8	10.9	11.1	12.9
Ukraine[3]	-2.0	-3.2	-6.2	-5.5	-3.5	12.3	20.0	34.6	39.5	40.6
Turkey[3,6]	-2.1	-2.9	-6.2	-4.0	-3.1	39.4	39.5	45.5	43.4	42.4
Emerging Europe[2,7]	1.8	0.2	-6.0	-5.2	-4.1	23.3	23.8	29.4	30.8	32.1
New EU Member States[2,8]	-1.7	-3.2	-6.3	-6.6	-5.6	35.7	37.4	43.4	47.9	50.4
Memorandum										
Czech Republic	-0.7	-2.7	-5.9	-5.4	-5.6	29.0	30.0	35.3	40.1	44.4
Slovak Republic	-1.9	-2.3	-6.8	-8.0	-4.7	29.3	27.7	35.7	41.8	44.0
Slovenia[3]	0.2	-0.3	-6.1	-5.8	-4.4	23.3	22.5	29.4	34.5	37.2

Source: IMF, World Economic Outlook database.

However, these seemingly healthy fiscal balances were inflated by high temporary revenues related to domestic demand booms; the underlying fiscal positions had actually deteriorated as a result of rapidly growing expenditures. The rapid growth of expenditures during the boom years had set the stage for large deficits when revenues collapsed with the implosion of credit and domestic demand.

As a result of the crisis, public sector deficits and debt levels shot up in 2009. EE countries' average headline balance deteriorated from about zero in 2008 to a deficit of 6 percent of GDP in 2009, with a wide range—from a low of 0.7 percent in Belarus to a high of nearly 9 percent in Lithuania (Table 1). Average public debt levels rose from about 24 percent

of GDP in 2008 to nearly 30 percent of GDP in 2009, again, with substantial intraregional variation. Those countries that had allowed their expenditures to grow more rapidly during the boom years tended to experience a larger fiscal deterioration. Thus, in hindsight, fiscal policy was too loose in most EE countries, reducing the scope for countercyclical fiscal policy during the crisis.

Deficits remain high in 2010—with only a modest reduction—while debt levels continue to rise (Table 1). EE countries' average headline deficit is projected to fall to 5¼ percent of GDP in 2010-2011, but there is considerable intraregional variation.

While deficits in some countries, notably Bulgaria, but also in Belarus, Kosovo, Montenegro, and Serbia, are projected to widen significantly, in several others, particularly those facing binding financing constraints, large fiscal adjustments are taking place in 2010-2011. In Latvia, the widening headline deficit masks substantial fiscal effort: Latvia is on track to take another 4 percent of GDP in fiscal consolidation measures in 2010, following measures of approximately 8 percent of GDP in 2009.

Deficits and debt levels in EE countries are generally not as high as in euro area countries, but deficit levels are high by emerging market standards. Moreover, several countries in the region face difficult medium-term debt dynamics, reflecting an aging population, while medium-term growth prospects for most EE countries have worsened significantly after the crisis. Even though fiscal consolidation is likely to be beneficial over the long term, fiscal retrenchments tend to have contraction effects on output in the short term. At the same time, recent events have shown how weak public finances can destabilize financial markets.

3. STIMULATING PRIVATE SECTOR CREDIT

The credit boom in many EE countries came to an abrupt end after the Lehman Brothers collapse. Credit growth in 2009 was very low, and in many countries even turned negative. Private sector credit levels continue to decline in 2010 in the Baltics, and have remained flat at end-2009 levels in Bulgaria.

Credit growth stopped when banks in advanced countries, confronted with liquidity and capital shortages, advised their subsidiaries and branches in the EE region that new credit would henceforth need to be

financed from an increase in local deposits. This effect was compounded by the freezing of the international syndicated loans market and the halt in the growth of direct cross-border loans.

With the recession and exchange rate depreciations, the supply of credit was further affected by increases in banks' provisioning needs. The increase in provisions was particularly high for countries with double-digit percentage drops in real GDP in 2009, but even for countries with less severe recessions, such as Hungary, Moldova, and Russia, provisioning has more than doubled since 2007. Higher loan loss reserves in 2007 are associated with a lower drop in (nominal) credit growth in 2009. Part of the reason is that there was less of a need for banks with higher reserves to form extra provisions during the crisis (Table 2).

In the first half of 2010, the effect of both supply and demand factors on private sector credit continued to be felt: bank deleveraging continues, increasing net credit to the public sector likely reflects some rebalancing of banks' portfolios towards safer assets, and lending rates, particularly in those countries with weak credit growth, continue to fall.

As capital inflows are likely to remain weak, the funding of credit growth will have to rely more on domestic deposit growth, which could remain subdued due to the relatively high unemployment levels.

The higher cost of banking funds is likely to have been the result of the drop in cross-border funds, as domestic deposit growth was still positive. Disentangling demand and supply factors in 2010 is more difficult, as bank-by-bank data are not yet available. Weak demand is likely to have gained in importance, as lending rates, which had increased during the crisis, came down in a number of countries. On the supply side, aggregate banking system data show that bank deleveraging continued, especially in the Baltics and Bulgaria. Crowding out by the public sector could have played a role as well, as net credit to the public sector has increased in a number of countries, but it is difficult to disentangle potential crowding out effects from portfolio rebalancing toward safer assets. Higher capital and funding costs in Lithuania and a high non-performing loans ratio in Romania are contributing to tighter lending standards for corporate loans.

Countries that relied on domestic demand booms for growth, fed by rapid credit growth, were left without sufficient expansion of the economies' supply potential. Indeed, the average growth over the cycle in

these countries is no higher, and in some cases lower, than in countries with more restrained credit increases.

Table no. 2 Emerging Europe, Selected Financial Soundness Indicators, 2007-2009 (%)

Country	Capital Adequacy Ratio			Provisions to Nonperforming Loans			Nonperforming Loans to Total Loans		
	2007	2008	2009	2007	2008	2009	2007	2008	2009
Albania	17.1	17.2	16.2	47.2	42.8	51.3	3.4	6.6	10.5
Belarus	19.3	21.8	19.8	61.5	70.0	44.9	1.9	1.7	4.2
Bosnia and Herzegovina	17.1	16.3	16.1	37.2	37.9	34.4	3.0	3.1	5.9
Bulgaria	13.8	14.9	17.0	100.4	109.0	78.3	2.1	2.5	6.4
Croatia	16.9	15.4	16.6	54.4	48.7	42.5	4.8	4.9	7.8
Estonia	10.8	13.3	15.7	110.9	57.2	83.5	0.4	1.9	5.2
Hungary	10.4	11.2	12.9	64.8	58.9	53.2	2.3	3.0	6.7
Kosovo	17.4	16.5	17.9	...	...	...	4.1	3.3	4.3
Latvia	11.1	11.8	14.6	129.8	61.3	57.4	0.8	3.6	16.4
Lithuania	10.9	12.9	14.2	...	...	...	1.0	4.6	19.3
Macedonia, FYR	17.0	16.2	16.4	117.0	120.3	101.4	7.5	6.8	8.9
Moldova	29.1	32.2	32.7	113.8	94.2	59.2	3.7	5.2	16.3
Montenegro	17.1	15.0	15.7	73.6	55.6	46.3	3.2	7.2	13.5
Poland	12.0	11.2	13.3	68.8	61.3	50.2	5.2	4.5	7.6
Romania	13.8	13.8	14.7	61.6	60.3	50.6	4.0	6.5	15.3
Russia	15.5	16.8	20.9	144.0	118.4	94.8	2.5	3.8	9.7
Serbia	27.9	21.9	21.3	...	187.8	168.1	...	11.3	15.5
Turkey	18.9	18.0	20.6	86.8	79.8	83.6	3.6	3.8	5.6
Ukraine[2]	13.9	14.0	18.1	...	132.4	65.1	13.2	17.4	40.2

Source: IMF, *Global Financial Stability Report* (October 2010).

4. GROWTH OF THE TRADABLE SECTOR

During the boom years, a capital inflows-fueled domestic demand boom resulted in strong GDP growth, particularly in the non-tradable sector, a growth pattern that contributed to rising current account deficits, increasing imbalances, and significant vulnerabilities.

Capital inflows are unlikely to return to pre-crisis levels, and domestic demand is likely to remain depressed. Future growth must rely more on the tradable sector and less on the non-tradable sector—especially in countries that had built up large imbalances during the boom. Restructuring should be helped by market signals that will change as profits in the non-tradable sector shrink and investments seek more promising venues in the tradable sector. But the process may be difficult. Even in the tradable sector, new projects may have to compete for much scarcer financing. Inflows will remain subdued as banks in advanced Europe struggle to rebuild their balance sheets and risk-adjusted returns in emerging Europe seem less attractive.

Fiscal policy in particular could play a much more active role—saving money when revenues are growing instead of increasing spending and boosting public wages. This may mean that during boom times small fiscal surpluses are not sufficient—that large surpluses are needed.

Policymakers may prefer to spend in boom times, but the payoff from savings that a large fiscal buffer will reduce the need to cut expenditure sharply during a recession—as several countries had to do during this crisis. Structural reforms could take advantage of the export-led recovery currently under way. This is the time to urgently undertake labor market reforms to address skill mismatches between workers in the non-tradable sector looking for jobs and the jobs in the tradable sector waiting to be filled.

Such investment would support growth, transfer technology, and help contribute to an improvement of labor force skills. Recent research shows that for emerging Europe, increases in the share of FDI going to the tradable sector corresponds to an increase in the export-to-GDP ratio. Improvements in infrastructure and an educated labor force should help attract FDI to the tradable sector.

5. POLICY IMPLICATIONS REGARDING FDI

EU countries have continued to honor their pledge not to retreat into investment protectionism. On the contrary, the majority of investment measures taken during the review period carry on the trend towards investment liberalization and facilitation.

However, these findings provide no grounds for complacency. Recent measures by some emerging markets attest to these countries‘ concerns about the impacts of global macroeconomic imbalances on their economies. If these imbalances and related risks for other countries are not dealt with in a credible manner, the resulting policy tensions could degenerate into a protectionist spiral. In non-financial sectors, risks of discrimination against foreign investors are still real as well. EU countries will want to continue their vigilance in this area. Managing the investment impacts of emergency measures taken in response to the crisis still constitutes a great challenge for EU governments. These measures could be applied in a discriminatory way toward foreign investors. In addition, they pose serious threats to market competition in general and to competition operating through international investment in particular.

There are also grounds for concern that support policies are becoming an entrenched feature of the policy landscape in some countries. The fact that many emergency schemes are still operating two years after the crisis points to the political dilemmas facing governments. Although there may be a few cases where concerns about systemic stability persist,

there is now a growing risk that governments are being captured by a logic for subsidization from which it is difficult to escape. Internationally, government subsidies in one country create pressure on governments elsewhere to subsidize or shoulder the structural adjustment shifted on to them by other subsidizing governments. EI should also be mindful of the risks for international investment resulting from global macroeconomic imbalances. These pose two types of problems for international investment policy makers. First, in a general way, global macroeconomic imbalances and related policy tensions detract from investor confidence and therefore dampen investment, both domestic and international.

Second, countries have begun adopting policies (capital controls and financial regulations with similar effects) aimed at buffering their economies from volatility of foreign exchange markets and capital flows induced by these imbalances. Such policies will, if they become entrenched, lead to fragmentation of international capital markets along national lines and may be difficult to dismantle once in place. Progress by EU in credibly addressing global macroeconomic imbalances will help create an environment in which international investment can make its full contribution to global prosperity and sustainable growth.

6. CONCLUSIONS

The consensus view of the literature is that foreign direct investment in general has a favorable impact on productivity and exports. FDI can be resource-seeking or market-seeking and the former type boosts exports directly. But both types of FDI also have indirect impacts through positive externalities and spillover effects: they may bring capital and know-how to domestic industries, have positive externalities on domestic companies through competition and reduced costs of inputs, and help host country exporters to gain access to foreign market. Although FDI could adversely affect domestic producers by competing for markets and skilled employees, empirical evidence tends to support that the benefits of FDI significantly outweigh its costs for host countries.

With the exception, FDI patterns of European countries cast doubts on whether FDI has played as significant a role as it could be in boosting external performance. Although FDI inflows have been rising, the patterns were different among the European countries.

They are likely to have had only limited externalities on productivity and trade. Some European countries, although being able to attract larger inflows, did not seem to have a sector distribution conducive to future growth and also had lower manufacturing FDI than the rest. Furthermore, scope exists in improving the policy environment for FDI, to improve their competitiveness.

European financial markets are increasingly focusing on fiscal vulnerabilities. In emerging Europe, in the early stages of the crisis, investors were more focused on external imbalances and private sector credit growth and the nature of its funding, and sovereign credit default swaps spreads were not associated with the level of fiscal vulnerability at that time. To prevent the emergence of market concerns, countries with high fiscal vulnerabilities may need to proceed with fiscal consolidation at a faster rate. Indeed, EE countries faced with relatively high deficits are generally projected to make larger fiscal adjustments, and in Bulgaria, Romania, and Ukraine the consolidation is front-loaded.

Credible fiscal consolidation plans should reduce sovereign debt concerns and put less pressure on both capitalization and liquidity in banks. Credible macroeconomic policies would also make it possible to keep policy interest rates low, which would not only stimulate demand for credit but would also encourage bank funding through domestic sources and support lending in local rather than foreign currency.

REFERENCES

1. **BLANCHARD, OLIVIER,** (2006) "*A Macroeconomic Survey of Europe*," MIT, pp. 1–26.
2. **BLONIGEN, BRUCE,** (2005) "*A review of the empirical literature on FDI determinants*," National Bureau of Economic Research Working Paper No. 11299, pp. 1–37.
3. **LIM, ELAINE**, (2001) "*Determinants of, and the Relation Between, Foreign Direct Investment and Growth: A Summary of the Recent Literature*," IMF Working Paper No. 01/175, pp. 38-51.
4. **NEARY, PETER,** (2006) "*Measuring Competitiveness*," IMF Working Paper No. 06/2009, pp. 1–21.