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EU11: Coping With External Headwinds

Ladies and Gentlemen, it is a privilege for me to address you today. I would like to thank Deputy Governor Vujcic and Vice Governor Preseca for organizing this conference and for the kind invitation.

A. Context of Global and European Economic Outlook: Risks for the EU11

This is a difficult and treacherous time for the countries of the EU11. Global growth is expected to slow down and renewed tensions in the Euro Area will add to pre-existing headwinds. Current estimates put global growth at 2.5% in 2012 as documented in the World Bank's *2012 Global Economic Prospects* report published last week. Increased market jitters, reduced capital inflows, high-income country fiscal and banking-sector consolidation are all expected to keep growth weak in 2012.

Turning to the region, Europe and Central Asia grew by an estimated 5.6 percent in 2011, despite the renewed financial turmoil and weakening Euro Area demand in late 2011. The growth in 2011 was supported by the robust domestic demand and good harvests in countries such as Russia, Romania and Turkey. However, bad weather earlier this year, renewed tensions in the Euro-area, capacity constraints in some

countries, and deleveraging by European banks are projected to slow regional GDP growth to 3.3 percent in 2012. Domestic demand is expected to remain robust in most resource-rich economies benefiting from still high commodity prices, but capacity constraints will hold growth back in Russia over the medium-term. Among regional oil importers, high commodity prices will contribute to slower growth, deteriorating current accounts and fuel inflation. Monetary policies are likely to remain loose given still ample spare capacity in most economies.

Unfortunately, developments in the Euro area and its spillover effects on emerging Europe, and developing countries more generally, come at an inopportune time, as the fiscal buffers that existed before the 2008/2009 crisis are largely exhausted. Developing countries are thus more vulnerable to additional external shocks than previously. If conditions in the Euro Area deteriorate significantly, growth in developing countries will be severely affected and will not bounce back as quickly as it did from the 2008/2009 crisis, as countries have less room for counter-cyclical policies. On average, government deficits are 2.5 percent of GDP higher than they were in 2007, suggesting less room for fiscal stimulus. In addition their external vulnerabilities have also increased, as current account balances have deteriorated on average by 2.8 percent of GDP, with oil-importing countries registering some of the largest deteriorations. International reserves remain at relatively comfortable levels, suggesting that most countries would be able to deal with short-term fluctuations in capital flows. GDP in developing countries is projected to expand 5.3 percent in 2012.

Nonetheless, weak high-income demand, weak capital flows, rising capital costs, and capacity constraints in several large middle-income countries will conspire to keep developing countries' growth from exceeding 6 percent in each of 2013 and 2014.

A sharp deterioration in financial market tensions cannot be ruled out. And while the precise nature of such a scenario is unknowable in advance, developing countries could be expected to take a large hit. Simulations suggest that their GDP could decline relative to baseline by more than 4 percent in some regions, with commodity prices, remittances, tourism, trade, finance and international business confidence all mechanisms by which the tribulations of the high-income world would be transmitted to developing countries. Despite renewed optimism in financial markets in early June, investors continue to reduce their exposure to emerging markets equity and bond funds.

In fact, deleveraging by European banks is already cutting into developing country capital flows. European banks started to reduce their loan books in the second half of 2011 as they were faced with rising borrowing costs, increased country-party risk assessments, deteriorating bank-asset-quality, and concerns over the adequacy of capitalization. Indeed, the quantity of cross-border syndicated bank lending to developing countries organized and led by European banks fell by almost 40% during the 6 month period October 2011-March 2012 compared with a year earlier. Nearly all developing regions were affected, with the sharpest percentage declines among projects in South Asia (down 72%), partly reflecting deteriorating investment conditions in India. Lending by European banks to Russia and Turkey also dropped by 50 and 56 percent, respectively. [So overall, the global outlook remains gloomy.]

B. Weathering 2011 and Current Risks

Despite the challenging external environment, new EU Member States and prospective member Croatia did well in 2011, as discussed in our June EU11 Regular Economic Report. First, economic growth strengthened to above 3 percent (from around 2 percent in 2010) and the region fully recovered its output losses from the

global financial crisis. **Second,** fiscal measures delivered reduction of around 3 percent of GDP in the EU11 average fiscal deficit. **Third,** the financial sector remained resilient to renewed concerns about negative feedback loops between insecure sovereign debtors and fragile financial markets.

However, the good performance conceals important shifts in economic sentiment that occurred during the year. While the growth momentum was still strong in the first half of 2011, it slowed toward the end of the year, as the region started to feel the impact of lingering concerns about European sovereign-debt markets, creeping oil prices, and the global slowdown. With the downward trend in economic activity, labor markets remained slack. Unemployment rates hovered around those recorded in the midst of financial crisis with sluggish employment growth.

In mid-2012, three and a half years after the global financial crisis occurred, EU11 counties are once again faced with serious external shocks. With the economic slowdown in Europe, the prospects for EU11 countries now look weaker than six months ago. Since then a number of downside risks have materialized:

- **First,** the slowdown in economic activity in EU15 has been worse than expected and raised doubts about the prospects for economic recovery in Europe;
- **Second,** the impact of bold economic policy interventions in late 2011 and early 2012 was short-lived and financial markets have remained fragile;
- **Third,** the uncertainty and volatility in financial markets has further undermined the confidence of both investors and households.

In this volatile environment, the economic growth in EU11 countries is set to decline from 2011 levels to 1.5 percent in 2012, with all EU11 countries growing slower than

a year before and three countries slipping into recession, including Croatia. However, given the heightened uncertainty, even this modest growth projected assumes that policies will be adopted in the Euro area to successfully avoid a serious deterioration in international financial market conditions. The near-term labor market outlook also remains unfavorable with unemployment at stubbornly high rates. With the weakening of economic activity and real wage growth below productivity growth, price pressures are expected to subside. Deliberate exchange rate flexibility and accommodative monetary policy in some EU11 countries are likely to continue to help the economies respond to the Euro area volatility. Banks' funding pressures may intensify if the deleveraging process advances further.

C. Coping with Headwinds: the Structural Reform Agenda

A weak and uncertain economic outlook necessitates strong policy action along three fronts:

- **First,** governments, central banks and financial supervisory authorities across the EU have to shore up financial markets' confidence by addressing the structural weaknesses in financial regulation and supervision that were exposed by the crisis. Building on recent policy measures, priorities include prudent risk assessments, following up plans for recapitalization and restructuring of banks as needed, and bolstering the resilience and stability of the financial system through macro-prudential regulations.
- **Second,** with heightened uncertainty and market pressures on the one hand and growth decelerating on the other, the EU11 governments must decide how much, how fast, and in what ways they wish to consolidate public finances, so that their

fiscal positions do not become the source for financial market volatility. While the EU11 countries have specified numerical fiscal targets, they still need to specify the measures to achieve the envisioned adjustments. In designing the composition of fiscal consolidation, governments should take into account the fragility of the economic outlook and try to limit the negative impact of fiscal consolidation on growth.

- **Third,** structural policies in support of growth can help to overcome the financial, labor and fiscal challenges. Europe 2020 -- the EU strategy for jobs and growth -- sets ambitious targets to tackle not only the ongoing financial and macroeconomic challenges, but also the structural obstacles to sustainable growth in Europe. By removing barriers to growth in product and labor markets, the EU11 countries can increase their potential economic gains in the medium term. Closing the existing institutional and structural gaps with the rest of the EU will soften the constraints imposed by demographic threats and produce sizable returns in income convergence with the EU15. Providing incentives for labor mobility, making public finances more sustainable, adapting social security systems to demographic developments and harmonizing regulation across borders are key reform priorities for EU11.

In conclusion, while many EU11 countries have started tackling the issues of competitiveness and the structural dimensions of fiscal adjustment, achieving significant post-crisis growth in a more challenging global environment will require these reforms to be intensified. The alternative is the danger of being caught in a middle-income trap.

Thank you for your time.