May 8, 2006

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Seminar 06/2

11:15 a.m., February 27, 2006

1. Seminar on Growth in Central and Eastern European Countries of the European Union: A Regional Review

Document: SM/06/46

Staff: Schadler, Mody, EUR

Length: 1 hour, 41 minutes

Executive Board Attendance

A. Carstens, Acting Chair

Executive Directors	Alternate Executive Directors
	A. Al Nassar (SA), Temporary
	C. Brinkmann (GR), Temporary
	O. Cuny (FF)
	M. Lundsager (UA)
	N. Yamasaki (JA), Temporary
W. Kiekens (BE)	
	Y. Yakusha (NE)
	L. Croitoru (NE), Temporary
	M. Kruger (CO), Temporary
	S. Rouai (MD), Temporary
	V. Srinivas (IN), Temporary
	A. Tolstikov (RU), Temporary
	J. Steytler (AE), Temporary
	A. Blazey (AU), Temporary
	E. Menye (AF), Temporary
	M. Xafa (IT)
	H. Mori (BR), Temporary
	A. Hauser (UK)
	M. Martínez (CE), Temporary
A.S. Shaalan (MI)	
T. Saarenheimo (NO)	
	C. Todesca-Bocco (AG), Temporary
X. Wang (CC)	
	A. Raczko (SZ)
	H. Ng (ST), Temporary

L. Hubloue, Acting Secretary
T. Orav, Assistant

Also Present

ECB: R. Ritter, O. Wijnholds. European Department: A. Abiad, A. Chopra, M. Deppler, S. Fabrizio, J.J. Fernandez-Ansola, A. Mody, F. Ohnsorge, S. Schadler, R. van Elkan. Policy Development and Review Department: A. Mazarei, A. Stuart, I. Vladkova-Hollar. Secretary's Department: A. Blazejewski, P. Gotur. Senior Advisors to Executive Directors: I. Ábel (BE), O. Hollensen (NO), S. Polak (BE). Advisors to Executive Directors: H. Caracalla (MI), J. Chen (CC), M. Donovan (UA), M. Lanz (SZ), J. Leichter (UA), B. Marchitto (IT), J. Minkevicius (NO), M. Piatkowski (SZ), P. Williams (UK).

1. SEMINAR ON GROWTH IN CENTRAL AND EASTERN EUROPEAN COUNTRIES OF THE EUROPEAN UNION: A REGIONAL REVIEW

Mr. Charleton and Mr. Kruger submitted the following statement:

Key Points

- The impact of policy advice, which is based on statistical analysis, could be strengthened by case studies. We believe that there is a lot in the Irish experience that reinforces the staff's messages.
- While, as the staff shows, foreign savings can increase growth, it is essential that they be used effectively or the increase in debt will constitute a vulnerability. The time path of the debt ratio is one check on this effectiveness.

We broadly agree with the conclusions of the staff paper that, in order to maintain high rates of growth and continue the convergence process, the Central and Eastern European countries (CEECs) need to raise employment rates, accelerate capital accumulation, and improve education.

The impact of policy advice, based on statistical analysis, could be strengthened by case studies.

We appreciate the staff's analysis of the sources of growth in CEECs and their assessment of the durability of prospects and trends. The staff's analysis rests, almost entirely, on econometrics. This approach is useful and we broadly support the conclusions it reaches. However, we believe that the staff's advice would have more impact if it combined such statistical analysis with case studies.

In paragraph 20, the staff notes that a number of Western European countries—Italy, Spain, Greece, Portugal and Ireland—have gone through spurts of above average productivity growth. In the spirit of sharing experience, we would like to offer an overview of Ireland's experience during the late 1980s and early 1990s.[1] Ireland joined the E.U. in 1973, but initially spent much effort in preserving traditional jobs rather than taking advantage of the new opportunities that access to this larger market could create. While corporate taxes were cut dramatically in the 1960s to attract foreign direct investment (FDI) and encourage exports, they remained relatively high for domestic production. These tax wedges created inefficiencies in capital allocation. Deficits spiraled out of control, particularly in the 1980s, and public debt rose to well over 100 percent of GDP. With the narrow tax base and rising deficits, personal and domestic corporate taxes were ratcheted up, depressing domestic demand and services. As a result of

[1] The section draws heavily from Dr. Kevin G. Lynch, "The Celtic Dynamo," a presentation to the Rotman School of Management, University of Toronto, January 26, 2006.

rising personal taxes and high inflation, workers drove wages to uncompetitive levels.

The Irish authorities realized that they needed a broad-based consensus from labor, business, and government on a "Social Partnership" with four basic elements:

- Globalization was embraced as an unparalleled opportunity.
- The Irish were among the earliest to grasp the inexorable links between investment and trade.
- Investment in capacity-building, both human and physical, had to take precedence over present consumption.
- Both the risks and returns should be shared equitably across Irish society.

Dramatic fiscal action was implemented after 1987. Within a few years, the Irish deficit was largely eliminated with a particular emphasis on expenditure cuts. At the same time, the government entered into a series of multi-year pay deals where, in return for relatively small wage increases, workers' high personal tax burden was progressively eased and the government tackled widespread tax evasion. The government also began to reduce the corporate income tax for the nonmanufacturing sector as Ireland's economy recovered and the fiscal situation improved.

The move to the Single Market encouraged more U.S. companies to establish a toe-hold in Europe and Ireland disproportionately attracted this U.S. FDI. Moreover, the rise in E.U. structural and cohesion funds provided some offset to the negative effects of the fiscal tightening.

Ireland's experience reinforces staff's analysis that openness and high levels of human capital are necessary for growth. It also points to the advantages of flexible labor and product markets as well as the benefits of high levels of FDI. Ireland is also one of the cases where a large fiscal contraction was expansionary. While the CEECs do not have the fiscal problems Ireland had, Ireland's experience points to the benefits of fiscal prudence and reinforces the staff's message that smaller government may improve growth prospects.

It would be interesting to know what lessons the other Western European countries noted in paragraph 20 offer for Central and Eastern Europe convergence. The staff's views (or those of other Chairs) are welcome.

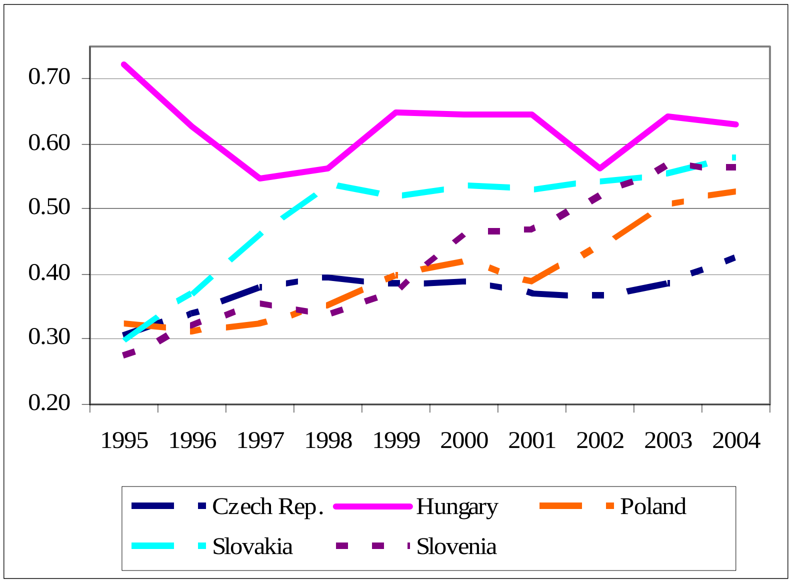
How Effectively Are Foreign Savings Being Used?

The staff states that "perhaps the largest benefit from European integration will come from the scope provided for easing the savings constraint on growth."[2] Indeed, sizable use of foreign savings is already being made, with large current account deficits in the Baltics, Hungary, and Slovakia. While the staff presents econometric evidence that opportunities to access foreign savings, either through FDI or through debt-creating flows, support growth, and allow for faster convergence, it also notes the associated increase in vulnerabilities is a key issue for Fund surveillance.

Ultimately, the extent of the risk posed by the accumulation of foreign liabilities rests on how well these savings are being used. If the savings are used efficiently, then they should promote relatively rapid GDP growth and the external debt-to-GDP ratio should fall.

Graph 1 shows that for most of the CE-5 countries, debt ratios are rising. Indeed, the debt ratios for Slovenia and Poland have even increased relatively sharply since 2001, suggesting that the investments funded by the foreign liabilities have not been especially productive.

Graph 1:
Debt Ratios in the CE-5



Graph 2 shows the debt ratios for the Baltic countries. Latvia's debt ratio has risen sharply over the last 10 years and its level of indebtedness is high. This suggests that the increase in vulnerability associated with further borrowing

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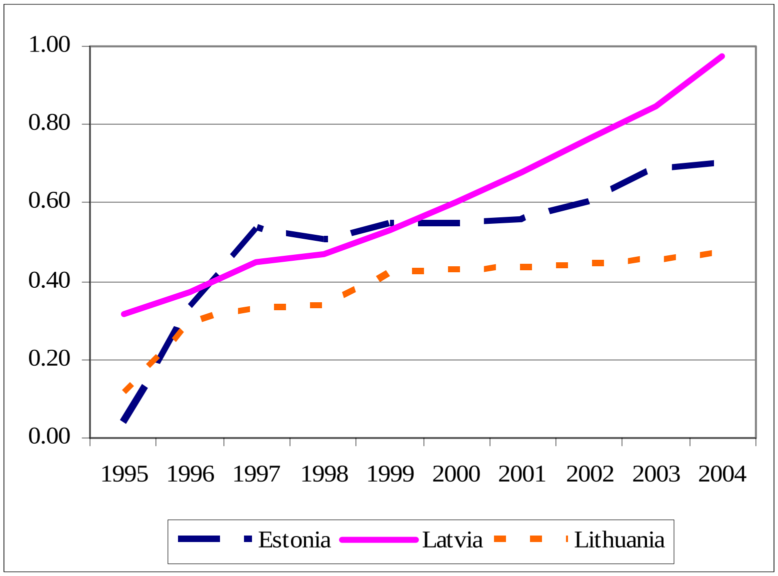
[2] See paragraph 43.

would outweigh any boost to growth. In contrast, Lithuania's debt ratio has essentially stabilized since 1999, suggesting that the use of debt has been relatively efficient. Estonia's experience is somewhere in between.

Graph 2:
Debt Ratios in the Baltic Countries



To some extent, external borrowing reflects operations of local banks with their foreign parents and markets anticipation of early euro entry. On the other hand, phenomena such as foreign currency lending for residential mortgages carries substantial risk, which is difficult to hedge, and may not be the most productive use of foreign savings.

The staff says that the adoption of the euro could "fundamentally reduce the domestic savings constraint for the CEECs" and lead to accelerated convergence.[3] In view of the rising debt levels in most CEEC countries, does the staff believe that the binding constraint on growth is truly one on domestic savings or is there a problem in ensuring that available domestic and foreign savings are used as effectively as possible?

Mr. Saarenheimo and Mr. Kravalis submitted the following statement:

Key Points

- The nature of economic developments in Central and Eastern European Countries (CEECs) has reflected the specific features of their ongoing

[3] See paragraph 43.

catch-up process. For the Baltic countries, having previously been part of the Soviet Union, the starting conditions were rather different from those in the CE-5, and hence cannot necessarily be captured by the same model.

- Going forward, growth dynamics in the Baltic states will be supported by EU funding as well as the prospective early adoption of the euro.

- Potential vulnerabilities in the Baltic states and other CEECs need to be taken seriously, but parallels to the East Asian pre-crisis situation should not be overblown. There are fundamental differences that overshadow the similarities.

We thank the staff for the well-written paper that ties together a considerable amount of work. We welcome this seminar as an opportunity to develop insights about the factors underlying the growth performance in the CEECs, and the factors and policy choices that could help to create the necessary preconditions for sustained growth in the future as well. We broadly share the staff’s analysis, and would like to offer some interpretations on the findings regarding past growth performance, as well as clarify what we see as the main factors that should ensure growth, in particular in the Baltic states.

Determinants of Growth Patterns in the Past

The authors have done considerable work modeling the growth rate of the per capita GDP of CEECs using a global sample model. At the same time, we believe that in order to correctly interpret the results and to draw more cogent conclusions and implications for trends and prospects, it is necessary to look beyond the rather narrow set of explanatory variables to some key differences between the Baltic states and the CE-5.

Most of all, it is important to recognize that the Baltic states, having previously been part of the Soviet Union, had starting conditions very different from the CE-5 in the beginning of their transition. At least three factors should be pointed out. First, under the Soviet rule, the Baltic states did not even have rudimentary elements of a market economy. Second, unlike the CE-5, the Baltic states inherited a few public institutions. With the Soviet rule, governmental and regulatory structures ceased to exist and had to be built from scratch. And third, with the collapse of the Soviet Union, the Baltic states also lost virtually their whole export market (as reflected in Table 6 of the paper).

These factors combined to accentuate the initial fall in production immediately after their independence. At the same time, the initial lack of institutions and economic structures meant that there were few vested interests to protect and made possible to build up a new system without much baggage from the past. The Baltic states were able, in a short span of time, to establish liberal market economies, with fully free capital flows and an attractive business environment. Hence, we believe that while the depth of the initial economic slump has undoubtedly contributed to the subsequent rapid rate of convergence in the Baltic states, the successful design of their economic structures has been the most important and durable factor explaining sustained growth. We believe that failure to fully capture this may account for the model's inability to explain growth in the Baltic states.

We agree with the staff that the different orientation of the Baltic states' export markets has contributed to their faster growth, but the benefits from exports to Russia should not be overstated. The share of exports to Russia has decreased considerably and stands currently at rather low levels: 6 percent in both Estonia and Latvia, and 9 percent in Lithuania. Moreover, the trade share with the Nordic countries is large only in Estonia. It seems that rather than just exports to the Nordic countries and Russia, the strength of the Baltic states has been the flexibility of the tradable sector to reorient itself geographically and the greater degree of diversification in trading partners compared with the CE-5, where Germany features heavily among export markets. Furthermore, the importance of growth in the trading partners as a determinant of GDP per capita growth has diminished in the Baltic states in 2004 compared to 1999 (see Table 6 p. 29).

Finally, we do not think that a bounce back from "the sharp effects of the Russian crisis in 1998" is an important contributor to the model's inability to fully explain growth in Estonia and Latvia in 2000-2004 is. The negative consequences were, in the first place, relatively limited in those two economies, and the bounce back was largely completed by 2001. However, the Russian crisis did act as a catalyst for the Baltic states to diversify their exports away from Russia, resulting in a less volatile export demand.

Growth Factors in the Future

The Baltic economies have grown at about 7 percent for the last six years. According to the forecasts of central banks of the Baltic states, economic growth will remain close to those levels, reflecting favorable developments in the external sector as well as in domestic demand. Some growth slowdown in the near-term could be expected, but that would reflect regular cyclical development rather than a fundamental slowdown of potential growth.

The staff's estimates of the potential growth in the Baltic states diverge downwards from the authorities' estimates by about 1.5–2 percentage points. While estimating the future trend growth is obviously subject to great uncertainties, and even more so for countries where economic structures evolve rapidly, we believe that there are good grounds for the authorities' more optimistic projections.

First, in the Baltic states, economic policies are aimed at improving the knowledge-based developments that should encourage reasonably high capital and labor productivity growth also in the future. In this regard the key aspect is whether the inflows of foreign capital and, in particular, of EU funding will be used productively.

Second, the weights of the production function used in the paper may tilt the results to underestimate future growth. For example, in Estonia the capital share in income is approximately 55 percent, not 35 percent as in the model, and hence the contribution of future capital accumulation to growth is likely underestimated.

The third critical factor that sets all of the CEECs apart from the other emerging markets used in the sample is, as staff recognizes, the European integration process. The economic developments of the Baltic states have been underpinned by the strong trade and financial integration toward the European Union. In order to support continuous productivity growth and convergence developments, an important part of the economic policy strategy of the Baltic states is to join the euro area as soon as possible. Small and economically open Baltic economies conform favorably to the criteria of optimal currency area. The Baltic states' economies will clearly benefit from the higher credibility, lower transaction costs, and even deeper integration arising from the euro area membership.

We agree with the staff's analysis that the projected path of rapid convergence is not without risks. Due to their high growth potential, the CEECs have been able to attract considerable inflows of foreign savings, which has resulted in high current account deficits and external indebtedness. However, while the Baltic authorities take possible vulnerabilities very seriously, we do not think drawing a parallel to the East Asian pre-crisis situation is helpful in understanding these risks. Fundamental differences exist. The foremost among these is the role played by the EU integration process which, in addition to its direct economic impact, has strongly influenced the institutional framework and governance and the structure of the financial sector, which turned out to be the core vulnerabilities in the Asian crisis. Furthermore, the Baltic states have not seen the inflows of speculative capital or competitiveness and profitability problems that contributed substantially to the emergence of the Asian crisis in 1998.

Mr. Meissner and Mr. Brinkmann submitted the following statement:

We thank the staff for an insightful and thought-provoking paper. After having overcome the initial transition shock, most of the Central and Eastern European countries (CEECs) that joined the European Union in 2004 have recorded remarkable economic growth in the past decade. Going forward, sustaining the CEECs' catch-up process and preparing for euro adoption requires maintaining macroeconomic stability, generating and preserving strong economic growth in the long term, and containing external vulnerability. The Fund should closely monitor economic developments in the CEECs within its surveillance framework, thereby concentrating on its core competencies.

Generating Strong Long-Term Growth

We support the staff's finding that the quality of institutions has a significant impact on countries' growth performance. In the case of the CEECs, reforms related to the preparation for EU accession have certainly played an important role in enhancing institutional quality. Yet, as the concept of institutional quality is rather vague, we encourage the staff to carry out further research on which types of institutions are particularly crucial for a strong growth performance. In this regard, it would be also helpful to segregate the contribution of financial development to economic growth from other institutional factors.

Based on high-quality institutions, the ability to engineer continuously high productivity gains will be critical for a rapid catch-up with the more advanced EU countries. While removing labor market frictions and disincentives to work will help to raise participation rates, increasing capital intensity, fostering human capital development and achieving or maintaining high total factor productivity will be key to enhancing potential growth. The staff paper (Table 2) illustrates that both, capital intensity and total factor productivity, are well below the euro area average in the CEECs, signaling room for improvement.

Containing External Vulnerability

While we acknowledge that large current account deficits in most CEECs are closely related to the catch-up process, we see a need for closely monitoring their impact on the development of external debt ratios. Beyond a certain level of external debt it could become increasingly difficult to finance further current account deficits, which in turn might have negative effects on economic growth. In this context, the staff's finding of a positive impact of current account deficits on growth (Box 3) needs to be interpreted with caution. The results are strongly influenced by the advanced EU member states. The relevant sample should rather have comprised similar emerging market economies. Staff comments are welcome.

We note that the staff identifies similarities in vulnerability indicators of some CEECs to those of selected pre-crisis Asian countries, which point to the need for close monitoring, in particular of financial sector developments by supervisory authorities. At the same time, vulnerabilities are contained by generally robust financial sectors and high transparency standards in the CEECs that help market participants to adequately assess investment risks.

Euro Adoption

We share the staff's assessment that adoption of the euro by the new EU member states should be predicated on a sound macroeconomic basis with strict fulfillment of the convergence criteria. Inflation rates which are clearly above the euro area average need to be reduced before euro adoption is possible. In this regard, it would be important to find out whether protracted price level increases are still due to Balassa-Samuelson effects or rather indicate an emerging problem with cost competitiveness. The economic tensions of a premature euro introduction, possibly at a misaligned conversion rate, would be substantial. Moreover, the eventual adoption of the euro requires CEECs with a formerly flexible exchange rate regime to have sufficiently flexible wages and prices in place in order to stabilize the real exchange rate. Otherwise, continued convergence of wages and prices to the EU average—if not matched by corresponding productivity gains—entails the risk of production being shifted to other locations outside the euro area offering even lower production costs.

The Fund's Role

The priorities for IMF surveillance mentioned in the staff report are reasonable. In particular, macroeconomic vulnerabilities associated with strong capital inflows and, more specifically, the shift toward portfolio capital inflows warrant close monitoring by the Fund since, as the staff rightly points out, there is the risk that foreign savings could be put to relatively unproductive uses, which are unlikely to generate the envisaged productivity gains and could rather lead to inflationary pressure.

Other areas with a need for reform, like education, but also labor legislation and general institutional development outside the economic sphere, while certainly important, are clearly outside the Fund's mandate and should not become part of IMF technical assistance. In this respect, the lead role of other international financial institutions should be maintained. The Fund does have a role to play in safeguarding macroeconomic and financial stability.

Mr. Silva-Ruete and Ms. Todesca-Bocco submitted the following statement:

We will focus on a few issues for emphasis.

First, given that the staff proposes publication of this review as an Occasional Paper, we are somewhat concerned by their assessment that conditions in the region "create a picture similar, for some countries, to that in East Asia prior to 1997." The potential impact of this remark should be carefully assessed before publication of this paper. Particularly considering that some of the "mitigating factors" underlined by the staff as "reassuring" for the region could be subject to future debate—e.g., strong fiscal positions, which were certainly in place in East Asian countries prior to the 1997 crisis, but that turned out to be an insufficient defense against a systemic crisis and/or large currency mismatches.

Second, we are concerned about the presence of large current account deficits, which according to the staff are already between 8 and 12 percent of GDP for some countries of the region. Indeed, the staff characterizes their situation as one where “rapid growth along with large-scale use of foreign savings inevitably produces conditions commonly associated with heightened vulnerabilities to financial shocks.” Moreover, the staff describes this situation as a “tension between the role of large inflows in supporting a rapid catch-up and their contribution to vulnerabilities stemming form rising external debt-to-GDP, strong appreciation, rapid credit growth, and balance sheet mismatches.” In this regard, we wonder if the large current account deficits these countries are experiencing are mainly related to growing imports associated with increasing production capacity or, on the contrary, if they are the consequence of both sluggish export growth and growing imports of consumption goods. The difference should not be overlooked, since in one case production capacity and resilience to future crises grow, whereas in the other debt-creating flows mainly finance consumption and therefore vulnerabilities become a greater concern.

Third, we find the references regarding exchange rate policy rather unclear. The ideas expressed in paragraphs 31 and 65 (“choosing a conversion rate compatible with strong export performance is crucial”) are broad. We would have expected a more robust set of recommendations in this field.

Fourth, in the same vein, we find the staff’s assessment of labor markets somewhat vague. Although the staff points out that “a stark characteristic of the CEECs’ performance since 1995 has been small, or even negative, contributions of labor input” and calls for “raising employment ratios to at least the EU average,” no hint is given regarding the reason for the differences among countries in the region (Figure 5 on page 10). In addition, the staff recognizes that “labor markets in the CEECs are not notably inflexible,” but their recommendation (based on a series of studies) comes down essentially to increasing labor market flexibility. At the same time, the crucial issues of labor’s skills and migration are only timidly mentioned, with no policy recommendations.

Fifth, policy recommendations for “closing the productivity gap” are too comprehensive and broad—raising capital-labor ratios, keeping inflation expectations low, achieving a government size “that supports growth,” guaranteeing fiscal sustainability, and nurturing institutions.

Finally, a good data appendix is missing.

Ms. Xafa and Ms. Marchitto submitted the following statement:

We would like to thank the staff for an excellent paper, which can serve as a model for future regional surveillance papers. It offers an in-depth evaluation of the growth performance, past and prospective, of the Central and Eastern European Countries (CEECs) of the EU, including an analysis of the forces driving it. The paper is especially relevant in that it highlights the main policy challenges facing the CEECs, and the responses required on the part of both national authorities and the Fund.

The analysis developed in the paper is also enlightening as it draws comparisons with other emerging economies, although the prospect of EU (and eventually European Monetary Union) membership has undoubtedly made a huge difference for the CEECs in terms of institutional development, macroeconomic stability, and incentive to carry out structural reforms. Economic and monetary unification has more benefits to deliver—provided the CEECs complete the convergence process and are sufficiently flexible to adjust to shocks after they give up monetary policy sovereignty—by further boosting trade and capital inflows, improving credit-worthiness, and promoting greater policy discipline.

Both the catching-up and the transition to full EMU participation may result in heightened vulnerability to financial shocks, and we fully agree with the staff that this is an area where the regional and multilateral surveillance exercises, by the Fund as well as within the EU, have a crucial role to play. Moreover, the paper correctly points out that as long as foreign savings are used for productive investment, they can contribute to securing a faster and stronger catch-up.

We understand that the paper introduces an element of novelty in growth regressions, by allowing for an interaction term between per-capita growth and institutional quality. It turns out that this was in fact a noteworthy extension of existing models as institutional development not only contributes to higher steady-state incomes, but also allows countries to achieve higher per-capita incomes faster. In this respect, the paper shows that there is ample scope for policymakers to accelerate economic growth by enhancing the quality of institutions. This in turn calls, among others, for measures aimed at: (a) fostering the development of financial markets while strengthening banking and financial regulation and supervision, thus taking full advantage of the increasing capital inflows; (b) promoting competition in product markets to improve competitiveness and consumer demand; (c) prioritizing and improving the efficiency of the public provision of goods and services to support investment and growth.

The single most important problem confronting policymakers in the CEECs remains stubbornly high unemployment. We agree with the staff that to fully exploit their growth potential, the CEECs need to "decisively turn around labor market performance." To this end, a combination of active labor market measures to lower job protection, enhance social safety nets, and reduce labor taxation are needed.

The paper also shows that education makes a significant contribution to per-capita income growth. For countries like the CEECs that already score high in terms of years of schooling, further improving the quality of education and training programs may represent a key element also in addressing critical skill mismatches. More generally, we share the staff’s conclusion that continued investment in human capital will be crucial to achieve sustained and long-lasting productivity growth.

Mr. Shaalan and Ms. Beidas submitted the following statement:

The paper raises interesting questions and useful material on the convergence of Central and Eastern European countries (CEECs) to EU growth and income levels. It also presents a good discussion of vulnerabilities associated with rapid growth and large recourse to foreign savings and draws important implications for the Fund’s future surveillance. We have a number of comments on the vulnerability discussion and other policy considerations in view of their impact on the speed of convergence and the role of future Fund surveillance.

The paper rightly highlights the significant vulnerabilities posed by the very high current account deficits, which deserve some decomposition. Current account deficits reflect the desire to smooth consumption when future income is expected to rise and new investment opportunities are attracted by relatively higher rates of return on capital. It would have been useful for the paper to examine more closely the composition of CEECs current account deficits and their impact on the quality of growth convergence and its sustainability. In particular, if imports of capital goods and intermediate inputs, rather than consumption goods, were dominant, then this might offer some comfort that the deficits are facilitating the income convergence process rather than posing undue vulnerabilities. As the paper stands, however, one cannot discern those current account deficits that are caused by fiscal or consumption profligacy and thus the role for focused surveillance is left untapped. In addition, it would have been useful for staff to shed light on the extent to which excessive consumption prevails today in CEECs and the extent to which public domestic savings have a role to play to ensure that productive spending (i.e., investment) is indeed sufficient enough to facilitate a speed up in convergence.

While the paper points to the challenge for surveillance of ensuring that catch-up does not breed excessive vulnerabilities, an examination of what constitutes excessive vulnerabilities would have been helpful. The paper highlights the success of CEECs in attracting large foreign savings in the forms of FDI and non-FDI, which appear to have both contributed to growth. However, a careful description of how foreign capital inflows have been channeled domestically would have been useful, since in aggregate one is left to believe that either FDI or non-FDI play have had an equally useful growth enhancing role. But whether debt levels are sustainable with the present current account deficits, and to what extent are current account deficits covered by irreversible FDI or other mitigating factors, is left unanswered. In addition, a summary of a sectoral analysis of balance sheet vulnerabilities in CEECs would have offered insights as to where the debt build up is occurring and allow for sharpening bilateral surveillance and its sectoral interlinkages. At this stage, the paper does not offer more than suggesting the existence of some currency mismatches. Vulnerabilities stemming from open CEECs' capital accounts and considerably easy access to EU savings would have been useful to examine, particularly in view of the differing capital conditions facing the Asian comparator group. Finally, in our view, while euro adoption will reduce currency risk and may further stimulate capital inflows to the CEECs, it will not remove countries' external constraint as they will have to repay the debt. Therefore, the use of additional foreign savings as a permanent source of boosting growth will remain subject to debt sustainability considerations. This puts the onus on the Fund to analyze the effects and sustainability of large current account deficits, to justify an eventual benign policy attitude.

Regional aspects of vulnerability particularly merit further consideration. The exposure of the region to common bank lenders, the perception that it is a safe haven for nonresident deposits, and the likelihood that troubles in one of the CEECs could quickly lead to a reevaluation of the fundamentals in the rest, creates yet another role for surveillance. Indeed, regional linkages, through which market pressure in one member could spillover into others would induce differing speeds of convergence, remain unexplored. In view of the relatively weak domestic financial sector in CEECs, the role that leading development agencies, such as the European Bank for Reconstruction and Development (EBRD) and the European Investment Bank (EIB) have played over the last decade in mitigating adverse regional spillovers could have usefully been elaborated. The risks of adverse regional spillovers could have usefully been quantified through a sample of sectoral balance sheet exercises, particularly those concerning the private sector over-borrowing. Finally, while the paper compares productivity convergence relative to the early experience of Greece, Ireland, Portugal, and Spain, it would have been useful to elaborate on the lessons learnt and parallel risks—including in particular the combination of high inflows with high unemployment rates, and persistently large current account deficits. This would appear relevant now in view of the stagnation in Portugal.

Important surveillance considerations concerning prevailing exchange rate regimes could be usefully explored. While this Chair has always been of the view that competitiveness owes a lot more to fundamentals than a particular exchange rate regime, these considerations are all the more pressing since euro adoption will eliminate the role of parity changes and bring about corrections to real exchange rates, thus ensuring that trade balances converge to levels consistent with stable net foreign liability positions. Rather than highlighting these inevitable corrections and the importance of containing net external indebtedness, the paper appears to suggest that differences in rates of return would induce even larger capital inflows. The paper also refrains from commenting on the role of currency boards prevailing in the Baltics on their relatively higher current account deficits and low reserve covers and whether a correction might put an end to their faster convergence process.

An analysis of recent developments in labor migration and competition in services could have usefully been included in the paper along with the respective effects on trade. The papers are awash with reports of skilled (shipping, construction, plumbing, etc.) and unskilled labor migrating from the CEECs westward (to Britain, Sweden, and Finland), but one is unable to determine their impact on growth convergence and changing capital-labor ratios. Specifically, to what extent will this migration change employment rates, and thus future capital-labor ratios; what has induced the recent improvement in employment rates in some of the Baltics, Hungary, and Slovenia shown in figure 5; have these led to shifts in productive sectors up or down the value chain and increase specialization; and will the EU service directive imply new markets for CEECs inducing stronger convergence?

Mr. Kremers and Mr. Croitoru submitted the following statement:

General

We welcome this interesting paper on growth in Central and Eastern European countries (CEECs) of the European Union and endorse its main conclusions. Findings in this paper are useful for policy making in both CEECs individually and the EU at large. The paper rightly concludes that CEECs face the challenge to: (i) increase employment; (ii) foster productivity growth; (iii) manage risks inherent in the use of foreign savings; and (iv) create the preconditions for successful euro adoption. Starting from these challenges, the paper provides some implications for Fund surveillance. Our understanding from section VI of the paper (Implications for Fund Surveillance) is that while remaining focused on the Fund's core domain, namely macroeconomic and financial sector policy issues, Fund advice should also contribute to addressing these challenges.

Growth Scenarios

We share the assessment that CEECs are in a unique position to reap the benefits of economic integration within the EU. We would, however, like to make some qualification on the real convergence scenarios presented in Table 1 on page 15. Neoclassical growth theory (on which the staff's calculations are based) predicts that growth slows down as countries approach their steady state per capita income level. For this reason, estimating the number of years needed to achieve convergence on the basis of past growth rates is a somewhat hazardous exercise and may well overstate the catch-up process. In addition, we somewhat question the working assumption that total factor productivity (TFP) growth is likely to slow down over the coming years. While acknowledging the relatively high unemployment, the countries under review are still significantly away from the technological frontier, which suggests that there is still scope for continued TFP growth.

Improving Labor Utilization

We concur that growth in CEECs is primarily driven by strong productivity gains and capital goods accumulation, while labor utilization has on aggregate played a very limited role. This implies that the growth process has been far less factor-intensive than that in emerging Asia, which relied heavily on capital goods and labor accumulation. Judging from their employment rates, labor utilization is especially low in Hungary, Poland, and the Slovak Republic. To a large extent, this originates from the start of the transition, when the restructuring of state-run enterprises resulted in mass-dismissals. These workers were granted relatively generous (and often permanent) benefits, which were deemed necessary to secure political support for reforms. Over time, the price of this policy in terms of labor participation has become increasingly clear: constraining supply (i.e., incentives) and demand (i.e., high labor taxation). The fact that these countries have recorded growth rates that are significantly below those of the Baltic states suggests that improving labor utilization is key to accelerating growth. Considering the long-term nature of unemployment, one should be relatively conservative in making assumptions on productivity. But even under such conservative assumptions, back-of-the-envelope calculations suggest that the welfare gains of enhancing the employment ratio to the EU 15 average could amount to 10 percent of GDP.

The Size of Government and the Fiscal Stance

The analysis reconfirms previous findings that only a small range of policy variables are consistently linked to growth. Thus, a smaller government (i.e., lower government consumption as a share of GDP) can contribute significantly to growth. This conclusion is important for countries that have entered the EU, but also for accession candidates. At the same time, to enter the EU, some of them had to, or have to increase government spending to meet requirements for accession. In doing so, authorities can, as suggested by staff in paragraph 55, contain current spending while making room for necessary investment. At the same time, some might need to increase revenues, for instance through higher tax rates, to properly deal with associated costs. However, they should limit this increase in revenue (as percent of GDP) to levels consistent with the goal of more rapid real convergence. Given that CEECs show a large range of revenue-to-GDP ratios, we would like to hear from staff what might be an "optimal" size of government that is consistent with the latter objective. Moreover, since the euro area has generally faced slow growth in recent years, should these countries be advised to revise their government size downward?

Starting from the role that the fiscal stance can play in closing the productivity gap, staff rightly underlines its larger role in restraining the pace of demand. This raises the question of political feasibility of fiscal balances stronger than prompted by consideration of debt sustainability. In some CEECs, in response to overheating pressures stemming from large capital inflows, currency appreciation, and rapid credit growth, fiscal balances have gone much beyond debt-related rationalities. Bulgaria and Romania are good examples. Does staff have a view to what extent further strengthening of fiscal positions is feasible and indeed effective and desirable in addressing overheating in some CEECs?

Growth and Vulnerabilities

We agree with the staff's view that, ultimately, strongly based growth reduces vulnerabilities, and therefore see merit in having a medium- to long-term perspective on growth complementing the short-term concerns prominent in surveillance. Although the paper does not focus on vulnerabilities of CEECs, it provides a good assessment of the existing vulnerabilities and risks. It is implicit from the paper that both a significant increase in interest rates and a significant slowdown in growth at a global level pose risks for CEECs. In this context, and given the many similarities mentioned in the paper between these countries and pre-crisis emerging Asia, we would like to hear staff's view on which of the two possible changes (a significant increase in interest rates or a significant slowdown in growth) has more potential for creating problems in the financial sectors of CEECs. And, if the latter is the most relevant, does staff see a need for Fund recommendations to move the emphasis from demand-side to supply-side oriented measures, e.g., for countries that show high current account deficits and relatively slow growth?

Reliance on Foreign Savings

We welcome the attention to the macroeconomic and financial stability implications of CEECs' reliance on foreign savings. In our view, two points deserve special attention. First, we agree that emerging markets have benefited from exceptionally favorable access to international financial markets over recent years. With spreads at the lower end of the emerging market segment, the scope for a further drop in risk premia is limited. Second, there are a number of striking similarities between pre-crisis emerging Asia on the one hand, and a number of CEECs on the other. The similarities seem to be especially striking for countries operating a currency board or fixed exchange rate arrangement. Similarities include (i) rapid economic growth, (ii) disciplined budgetary policies, (iii) strong credit growth, (iv) external imbalances that are primarily driven by the private sector, (v) fixed exchange rate regimes conducive to large-scale foreign currency borrowing, and in some cases, (vi) limited international reserves. Whether these similarities forestall a crisis is disputable, also taking into account institutional quality and foreign bank presence. But they do indicate that a scenario of sudden stops or capital flow reversals could have quite serious consequences.

In view of the finding that foreign savings have contributed to the strength of growth in lower-income, rapidly growing economies, we share and welcome staff's view that a rule of thumb regarding a "safe" maximum current account deficit should be avoided. At the same time, we agree with staff that, while large capital inflows support rapid catching-up, they also contribute to vulnerabilities stemming from strong appreciation, rapid credit growth, and balance sheet mismatches. Since it is difficult to identify when changes that accompany rapid catch-up involve excessive vulnerabilities, vigilance in doing such assessment is warranted, while being well-engrained in country-special circumstances and avoiding generalities. In addition, we want to emphasize the need to strengthen supervision. While CEECs have good prudential regulation for the financial sector, appropriate supervision implementation might be difficult during catching-up. Thus, the question arises if the Fund has an accurate assessment template of the quality of the effective supervision in these countries. Staff comments are welcome.

Mr. Ngumbullu and Mr. Steytler submitted the following statement:

Introduction

We thank the staff for the interesting paper on growth in the Central and Eastern European Countries (CEECs) of the European Union, and we welcome the opportunity to comment. Within a relatively short period, CEECs have made a remarkable and successful transition from centrally-planned economies to emerging market economies of the European Union. As a result of this successful transformation, CEECs have become among the top destinations of foreign capital, further enhancing their growth prospects. It is noted, however, that after a rather strong pickup, growth performance of these countries has started to slow down in recent years compared with other fast growing emerging markets. This raises issues of concern, as rightly identified in the staff paper, such as whether the relatively rapid growth rates since the mid-1990s have been the result of bounce back from large losses during the early transition period rather than enduring strength, and the role of policy in explaining the recent divergence of growth between the Baltics and the CE-5 countries. While the observation period is relatively short to draw firm conclusions, and the issue of causality not resolved, these questions are pertinent and worthy of reflection. Moreover, the paper also rightly reflects on new vulnerabilities that have emerged together with the rapid transformation of these countries and the challenge for Fund surveillance. We agree with the main observations and conclusions of the paper, but would like to comment on a few issues for emphasis.

Sources of Growth

The study notes that, following sharp output losses of the initial transition period, CEECs have been among the stronger performing emerging market economies. In terms of the sources of growth, the study shows that growth in the

CEECs has been driven mainly by capital accumulation and especially total factor productivity, while the contribution of labor input has been small and in some instances negative. A number of reasons reflecting a variety of transition effects are cited for the sharp fall in employment rates. It also notes that barriers to regional labor mobility and other labor market rigidities contributed to long-term structural unemployment. While the focus of the study is not on the labor market per se, we would have appreciated a more elaborate discussion on some of the factors that contributed to labor market rigidities in these economies and what is being done to make the labor market more flexible, since this is the one area that could potentially contribute more to improved growth performance of the CEECs in the future. We would also be interested to know more about the skills composition of the labor force in the CEECs and whether there has been a loss of skills from these countries to the more advanced EU member states, and how it has impacted on CEECs growth performance. Related to these would be the issue of remittances and how it influences growth.

With regard to the question of whether the low level of savings in the CEECs is holding back investment, our view is that it should not necessarily be the case, more so since these countries have access to foreign savings and the investment rates in most of them are higher than in the high savings emerging market economies. However, like Messrs Charlton and Krueger, we believe that it would be essential for foreign savings to be used effectively to avoid potential vulnerability from debt buildup. In this connection, we also think that the study could have benefited from a more detailed analysis on the composition of capital inflows, and whether there is a real danger that there might be an abrupt reversal of such capital flows with negative consequences for output and macroeconomic stability.

Policies and Long-Term Growth

With regard to the policies to support long-term growth, we would like to quote from a recently concluded study by the World Bank on “Economic Growth in the 1990s—Learning from a decade of reform,” which concludes that there are not too many policies that one can say with certainty deeply and positively affect growth. We note that the study relies more on cross country regression to draw lessons on long-term growth. The danger of this approach is that it might overlook country and institution-specific factors that are important for growth. We, therefore, share the observation of Messrs Charlton and Krueger, that the strength of policy advice could have been strengthened by case studies. We would caution against drawing too firm conclusions about the relationship between the various variables mentioned in the study and growth. It is also important to keep in mind that the success or failure of growth policies very much depend on the manner and sequencing in which policies are introduced, as well as the initial conditions and legacy of history, which is difficult to capture in econometric modeling. In addition, the issue of causality on many of these variables has not been addressed conclusively in the economic literature. For instance, does financial development lead to more growth or is it the reverse relationship that faster growth leads to financial deepening? The same goes for institutional quality and growth.

European Integration and Growth

It is true that the formal membership of CEECs members to the EU brought a lot of benefits, most notably and easily quantifiable, large transfers of up to 3 percent of GDP for some of the CEECs. Other more dynamic benefits, such as larger capital inflows, trade effects, technology transfer, etc, are more difficult to quantify, but could be more important. We agree with the observation that potentially one of the biggest benefits could be the easing of the savings constraint given the low savings rate of most of the CEECs. Another factor that the paper does not explore is that membership of these countries to the EU which also enhances the growth prospects of the EU, especially of some of those EU member states that are confronted with the population ageing problem. We appreciate the analyses done on selected vulnerability indicators. These indicators show that rapid growth has come with increased vulnerability that needs to be monitored more closely to avert crisis similar to the Asian crisis of 1997.

Implications for Fund Surveillance

Given the main findings of the paper, we agree that a more medium-term perspective on growth will be necessary to complement the short-term concerns prominent in surveillance. We also support the identified areas for such surveillance in the case of the CEECs, including increasing employment, productivity growth, and managing risk inherent in greater use of foreign savings, including through euro adoption. However, like Messrs Meissner and Brinkman, we would caution that while these areas are important from a surveillance perspective, they do not fall in the core mandate of the Fund, hence should not become part of Fund technical assistance program.

Mr. Steiner and Mr. Mori submitted the following statement:

We thank the staff for the informative and well-written paper on growth in the Central and Eastern European Countries (CEEC) of the European Union. The paper provides a comprehensive analysis of the macroeconomic implications of transition toward adoption of the euro. Surveillance in the case of the CEECs as a block is pertinent because all countries share the common ongoing process of becoming members of the euro area. As this Chair has stated in the past, regional surveillance should not be determined by geographical proximity considerations only, but rather by the commonality of economic structures and/or economic policy frameworks—including prominently, having or planning to adopt a common currency.

While the staff report provides detailed evidence supporting the claim that there are important differences among individual country experiences within the

CEEC, we will focus our comments on general issues applicable to all countries in the group. An important lesson of the process undergone by CEECs is that once the external financial constraint is lessened or removed, countries can generally enjoy higher economic growth. However, and as is generally the case, it is not easy to determine whether strong capital inflows are exogenous to economic policy or whether they are in fact the market response to improved fundamentals. In particular, the direction of causality—i.e., whether strong fundamentals are driving large capital inflows, or whether capital inflows are improving fundamentals—is a matter of debate. For instance, it could be the case that strong capital inflows reduce domestic interest rates lower and thus bolster output growth, with both low interest rates and higher GDP growth feeding positively into fiscal results.

The staff notes that CEECs could receive even more external capital flows than they have actually been receiving, and that this would eventually materialize in the absence of exchange rate risk once the euro is adopted. While this is a plausible line of reasoning, one could also argue that what appears to have been an unlimited access to external financing on the part of CEECs has actually been driven by the expectation that the euro will be adopted in the foreseeable future. Foreigners, therefore, may have been anticipating their investments, which would imply that the current flows are in part a result of bunching and not entirely sustainable in the longer run.

The prospects of euro adoption and the capital inflows that this has fostered makes large current account deficits in the CEECs less of a concern as compared to the situation in some Asian countries prior to the crisis of the 1990s. While there are some similarities between the two groups of countries—particularly easy credit conditions and weak domestic demand in key trading partner countries—for the Asian countries there was no presumption that exchange rate risk—and therefore currency mismatches—would eventually be eliminated. If no backtracking takes place concerning the project of incorporating the CEECs into the euro area, growth prospects before euro adoption should remain favorable, as these economies should continue to have ample access to inexpensive foreign financing.

The major challenge for the CEECs seems to be to join the euro area on a right footing, including prominently a strong macroeconomic framework. The latter seems to be a prerequisite for achieving the ultimate goal of raising living standards to Western European levels. It is of course possible that potential weaknesses in economic policy become masked by abundant external financing. Unless those problems are identified before adoption of the euro, the current healthy environment would not only be misleading, but, more importantly, could evolve into a situation of disequilibrium, and a correction would be much more difficult without recourse to exchange rate flexibility. In that regard, staff has already indicated that lack of labor market flexibility may be a potential source of future problems for CEECs.

The staff identifies three elements that need to be observed in order to better ensure that the benefits of euro adoption do in fact materialize: (a) to choose a conversion rate compatible with strong export performance; (b) to enter the euro area from a position of sound macroeconomic policies; and (c) to bolster mechanisms for economic flexibility. These elements are well defined in theory, but they seem to be difficult to determine in practice, especially in a situation where capital inflows could be distorting key economic variables. The evaluation of economic conditions becomes even more complex in a situation in which part of the capital inflows to CEECs may reflect easy monetary conditions and weak domestic demand in trading partners rather than strong fundamentals at home. The complex tradeoffs involved between the benefits of a rapid adoption of the euro and the carrying over of economic distortions into the monetary union therefore need to be carefully weighted.

Mr. Schwartz and Mr. Martínez submitted the following statement:

The Central and Eastern European countries (CEEC) have made substantial progress in the formidable task of transforming and modernizing their economies. This difficult process of change has required great resolution and steady efforts within the countries involved. Looking forward, the challenge is to achieve sustained strong growth which will allow CEECs to reach the overarching goal of raising living standards to Western European levels. European integration provides a unique opportunity in this task.

The paper presented by the staff, "Growth in the Central and Eastern European Countries of the European Union—A Regional Review," makes a useful and rigorous analysis of past growth in these countries, as well as of their economic outlook for the future. We concur with its general view that the economic perspective of growth of CEECs is good. We also find adequate the emphasis placed on the important current and future vulnerabilities that these countries face. These weaknesses are mainly related with the sustainability of the inflows of foreign capital, the current account deficits, and the risk of increased credit.

Since we are broadly in agreement with the staff's analysis and conclusions we will limit our comments to some specific issues.

It is mentioned in different parts of the paper that a two-speed catch-up may be emerging with a lower pace of growth in the Central European countries than in the Baltics. Certainly, growth in the Baltic countries has been faster in recent years; however, this experience is very difficult to project into the future. As also mentioned in the document, the fact that the Baltic countries started from lower levels of development could explain some part of the growth differential. A simpler classic model would forecast in this case a faster growth increase than in other countries with higher levels of per capita income. In addition, the Baltics could have benefited from a stronger dynamism in their export markets (Nordic countries and Russia). These factors are not necessarily permanent and as the countries go forward in their process of convergence, it is not unreasonable to expect a more moderate growth increase, perhaps similar to other countries in the region.

One aspect of study that is worth mentioning is the analysis in relation to the contribution to growth of the current account deficits (Box 3). While the results show that the high pace of growth has coexisted during these years with sizable current account deficits (which might have promoted strength in investment), we should not come to complacent conclusions based on this fact and bear always in mind the risks that high current accounts deficits can entail.

We note that the paper finds that some measures of vulnerability, especially in the Baltics and Hungary, are worrisome and that the situation in the CEECs bears a resemblance to that in East Asia prior to 1997. There are reasons for this comparison: for instance, high credit growth, especially in foreign currency, and large and persistent current account deficits. However, we think it is worth stressing that the mitigating factors are also important, particularly the strong fiscal position in the Baltics and the well-supervised and predominantly foreign-owned banks. CEECs are indeed not free of risks and this is a challenge for Fund surveillance. Also, as the staff states, these countries will be well advised to draw lessons from experiences elsewhere. However, the similarity with the crisis in the Asian countries in the late 1990s (which is becoming a somewhat fashionable topic) should not be exaggerated.

The implications for Fund surveillance that the staff mentions are reasonable. We share the view that rapid income convergence will be the context of surveillance for the foreseeable future. Within the background of this catching-up process, the Fund's surveillance job will be to analyze whether the policies of each country are appropriate, to identify possible policy changes, and, in the staff's words, to keep a sharp eye on vulnerabilities.

Mr. Al-Turki submitted the following statement:

I thank the staff for an informative paper on growth in the eight Central and Eastern European countries (CEECs) of the European Union. The accomplishments of these countries in restructuring and reforming their economies in recent years have been significant. Indeed, as the staff notes, following sharp output losses of the initial transition period, CEECs have been among the stronger-performing emerging market countries and have become attractive destinations for international capital.

Looking ahead, the challenge is to sustain strong growth and maintain macroeconomic stability in order to catch up to advanced EU income levels. This will require continued pursuit of prudent macroeconomic policies and ambitious structural reforms, while mitigating the risks inherent in a rapid convergence process. In this regard, I broadly concur with the staff that the progress will depend on various factors including a steady increase in the employment rates and large increases in investment and productivity. In addition, the risks arising from the large-scale use of foreign savings will need to be managed carefully. To this end, Fund surveillance has a key role to play in identifying vulnerabilities, especially prior to euro adoption. Here, it is important to stress that any Fund advice should be tailored to the different circumstances and institutional development in each country.

To enhance growth prospects in the CEECs, the focus should be on measures that can help achieve a steady increase in employment rates. To this end, priorities identified in the paper appear reasonable. Streamlining and tightening of the current benefit payments and reducing the high level of tax wedge should help stimulate labor supply. In addition, improving regional mobility and addressing skill mismatches by encouraging retraining are also needed to increase labor participation.

On raising CEEC productivity to EU levels, I agree that raising capital-labor ratios through higher investment and improving the efficiency of resource use will be needed. In this regard, the paper has identified several pertinent issues. The stress on adjusting monetary, fiscal, and wage policies to curtail any pickup in inflation is appropriate. Here, I welcome the record in the CEECs in achieving low inflation, but vigilance is needed, especially in countries undergoing a rapid convergence process. I also agree that fiscal sustainability must be at the core of a sound growth strategy, particularly in view of overheating pressures emerging in some countries due to large capital inflows, currency appreciation, and rapid bank credit growth. To this end, increasing domestic savings through fiscal surpluses and improving incentives for private savings will be important. I also support the emphasis on enhancing the quality of institutions relating to the conduct of economic and financial policies that should have a positive impact on growth performance.

While foreign savings have contributed significantly to growth in the CEECs, rising external debt ratios, rapid credit growth, and balance sheet mismatches in some countries underscore the need for a close monitoring of these risks.

Mr. Misra and Mr. Srinivas submitted the following statement:

Key Points

- Accession is raising hopes of better economic prospects. Speeding up income convergence will require structural reforms in the areas of job friendly policies, productivity growth, and, in the longer term, in the development of a knowledge economy.

- There remain large challenges for Fund surveillance in this region given the risk profiles in East Asia 1996 and Eastern Europe 2006 are very similar.

- Hopefully, no crisis will happen, but previous projections for a large decline in current account deficits have not materialized and concerns remain about debt sustainability.

- A two speed catch up has emerged as a distinct possibility.

- Euro membership is still some years away and it is far from certain if CE-5 countries will enter the euro area soon.

We support the thrust of staff appraisal. The Central and Eastern European countries (CEECs) have made significant progress toward macroeconomic stabilization and structural transformation in the past fifteen years, with growth in most countries above the emerging market average and the Baltic countries among the top 5 emerging market performers. The administrative challenges of EU accession have been successfully overcome and the import sector has responded positively to competition. The macroeconomic imbalances have been well contained and the CEECs have achieved inflation rates well below the thresholds identified as harmful for growth prospects.

External Vulnerabilities

While the economic outlook remains broadly favorable, continuing external vulnerabilities need to be viewed with concern. Large current account imbalances, which are unsustainable over the long term, high external debt ratios, much less healthy public finances, rapid credit growth, and low reserve coverage of short term debt in the Baltic countries make the vulnerability indicators in Eastern Europe rather worrisome. Hopefully, no crisis will happen, but past projections of large decline in current account deficits did not materialize and concerns remain about debt sustainability. Current account deficits in part are financed by FDI inflows, but the current account deficit net of FDI inflows is also increasing and a considerable part is debt creating. Credit growth is extremely rapid and raises questions about current assessment capability. In the absence of independent monetary policy to restrict credit growth, there is a need to underscore the importance of well developed management systems, tight prudential regulation, and high standards of transparency and supervision. Given the overheating concerns, macroeconomic policies should avoid adding to demand pressures, with fiscal restraint needed to restrict domestic demand, and measures to allow automatic stabilizers to operate and reduce external imbalances. There remain large challenges for Fund surveillance in this region, given that the risk profiles in East Asia 1996 and Eastern Europe 2006 are very similar. We are to see if the Fund’s surveillance and signaling is more effective so that it is not caught on the wrong foot as in case of Asian crisis.

Growth Scenarios

This review addresses the critical question whether CEECs stand a chance of catching up with the EU. Accession is raising hopes of better economic prospects. Speeding up income convergence will require structural reforms in the areas of job friendly policies, productivity growth and in the longer term in the development of a knowledge economy. Convergence also requires productivity and employment growth and the CEECs.

Formal membership of the EU and openness to trade has promoted large capital inflows. The impetus to growth from foreign savings and FDI flows inevitably produces conditions commonly associated with heightened vulnerabilities to financial shocks. It is therefore critical for the CEECs to avail themselves of the opportunities for institutional and financial integration with Western Europe to change the nature of risks.

A two-speed catch up has emerged as a distinct possibility. The speed at which the income gap closes with the euro area varies considerably across CEECs. High rates of investment will be necessary to achieve convergence and some CEECs will have to raise investment rates up to 40 percent of GDP. The challenges are considerable for a catch up but higher rates of productivity growth may indeed be possible. CEECs have improved policies in several dimensions that should contribute to growth potential.

Productivity growth could remain strong if large investments were made, which would require eliminating hindrances to FDI, upgrading public transportation infrastructure, enhancing competition, and removing barriers to reallocation of labor. In the longer run, catching up is helped by the building of a knowledge economy and a well functioning education system is important.

Fund Surveillance in CEECs

Fiscal sustainability must be at the core of a sound growth strategy. Improving fiscal performance requires strengthening of fiscal institutions and the budgetary processes. The importance of a medium-term fiscal framework, greater budgetary transparency, and further checks and balances on the expenditure management system should be emphasized. Arriving at a size of government that supports growth prospects represents a big challenge. To deflect the adverse effect that population aging is expected to have on public finances, ambitious expenditure reforms to avoid repeated bail outs of health insurance companies are needed. There is also a need to create incentives for containing costs and allow greater burden sharing of financial users.

Given that there is no nominal exchange rate flexibility, flexible labor and product markets are needed. Active labor market policies and increased competition in key sectors like electricity and telecommunications increases employment. Wages should keep in line with productivity increases.

Close monitoring of the expansion of foreign currency denominated borrowing—especially by households and small- and medium-sized enterprises that are not naturally hedged—is needed. This would require stronger disclosure requirements, appropriately formulated additional provisioning for foreign currency loans, and development of market-oriented risk hedging instruments.

Euro Membership

Euro membership is still some years away and it is far from certain if CE-5 countries will enter into European Monetary Union soon. While new EU members are obliged to adopt euro, there is no time path. A central question will be how euro adoption will affect growth prospects and specifically risks in large scale use of foreign savings. euro adoption would bring substantial benefits for trade and output growth, provided that the budget deficit remains below the Maastricht limit and the conversion rate affords strong competitiveness. There is also a risk that some of the CE-5 countries could use ad hoc accounting and expenditure reduction measures to meet the Maastricht criteria and would risk entering the euro area with a large underlying deficit. While there may no longer be risk of a currency crisis, they could undermine long-term growth prospects and could end up with rather protracted recession.

Mr. Raczko and Mr. Piatkowski submitted the following statement:

We thank the staff for the excellent paper. It rightly points out that over the last fifteen years the Central and Eastern European countries (CEECs) have made a remarkable progress in changing their economic structure. The accession to the EU symbolically marked the end of the transition period. Nonetheless, large income gaps remain relative to the EU average. The main challenge going forward is then how to speed up the catching up process while ensuring that imbalances remain in check.

Sustained convergence with developed countries will rely on the growth in inputs from capital, labor, and total factor productivity (TFP). We will discuss these inputs in turn and then proceed to analyze the corollary vulnerabilities. We will conclude by discussing the areas for future surveillance.

Given the large gap in capital-labor ratios, high rates and high efficiency of investment will be essential to drive convergence. As domestic savings are low in most CEECs, foreign financing—both FDI and non-FDI—will continue to play an important role in ensuring high investment rates. The increasing integration with the European Union and the prospect for eventual euro adoption are clearly beneficial in attracting foreign savings. In particular, the adoption of the euro could substantially add to faster investment growth rates by decreasing the costs of funds and eliminating foreign exchange risk premia. Improvements in the business climate, institutional framework, and the development of more sophisticated segments of financial markets will also be important to attract foreign savings.

Higher investment rates will also be crucial to drive the growth in employment. Given the transition from a centrally planned economy with full employment to a market economy with unemployment, it is not surprising that until recently the contribution of labor to growth was low in most CEECs. Going forward, however, the role of labor should be enhanced by increasing incentives to work, reducing skills mismatches, further liberalizing labor markets, enhancing regional mobility, and reforming pension systems to extend working lives will be imperative. In this perspective, it is encouraging that a large number of CEECs have already implemented far-reaching pension reforms, which are poised to bring large benefits in terms of raising employment and—no less importantly—improving long-term fiscal sustainability. Nonetheless, more needs to be done, also in terms of enhancing EU-wide labor mobility. This would not only directly benefit CEECs, but also—as shown in recent studies—the recipient countries in Western Europe.

As noted by the staff, TFP growth has so far been the main factor driving convergence. The key question going forward is whether these high productivity growth rates will be sustained. This will depend on the balance of two countervailing set of forces. On the one hand, productivity growth may slow due the fact that simple post-transition reserves have been largely exhausted, restructuring—mostly in manufacturing—has been largely completed, and basic institutional reforms have been implemented. Moreover, productivity growth may slow due to the projected rapid population ageing, which is likely to hamper innovation.

On the other hand, however, productivity growth can be sustained or even increased due to positive effects of the European integration on enhancing innovation (through increased trade and investment), continued improvement in institutional environment and business climate, and higher spending on research and development partially financed by the EU. Given the experience of the United States and a number of other developed countries, productivity growth can also accelerate thanks to the increased production and use of information and communication technologies (ICT), the dominant general purpose technology of our era. Given that it took more than twenty years for the United States to learn to use ICT productively, which then contributed to two-thirds of productivity acceleration starting in 1995 and the “new economy” boom, a similar productivity jump could also occur in CEECs sometime soon.

However, for this to happen, far-reaching structural reforms are needed. A number of industry-level studies argue that given the near completion of restructuring in the manufacturing sector, evidenced be slowing productivity growth rates from earlier double-digit rates, sustained convergence in CEECs will have to rely mainly on faster productivity growth in the service sector, where it has so far been relatively low in spite of the large catch-up potential. Faster growth in services, as opposed to basic fundamental reforms needed to increase productivity in manufacturing, seems to require a more sophisticated set of reforms focused on the deregulation of product markets, increased labor flexibility, enhanced access to EU-wide services market, developed ICT infrastructure, organizational innovations in enterprises, and investment in a broader palette of human capital and skills. These reforms are much harder to achieve than those required during the restructuring phase. They also require much stronger social consensus. Compared to the EU, CEECs may or may not develop an advantage in achieving this objective. Should these reforms not be fully implemented, the convergence process in CEECs may slow or even reverse, particularly relative to the United States and fast-growing East Asian countries.

Turning to vulnerabilities related to the catch-up process, we note that dealing with the tension stemming from high current account deficits, strong appreciation of national currencies, booming credit and balance sheet mismatches will be the main challenge for the Fund surveillance and for the policymakers.

External vulnerabilities in CEECs, particularly in the Baltic States and Hungary, may, *prima facie*, resemble the situation in East Asia before the crisis. Yet, a deeper analysis of these issues reveals that there are serious limits to the CEECs-East Asia comparison. This has to do with CEECs having much stronger banking sectors, better institutional environment, largely sound fiscal policies, particularly in the Baltic States, a strong anchor in EU institutions and regulations, and the prospect of joining the euro area. Also, the rapid credit growth, while worrisome, started from a very low level. Furthermore, and as opposed to East Asia, the sources of funding of the current account deficits are significantly different in CEECs—in the case of the Baltic States, for instance, they are mostly financed with FDI and long-term intra-company loans, namely in the banking sector. These are obviously much less risky than in East Asia, where large part of foreign borrowing was short term. Finally, the virtually nonexistent liquidity in the financial markets in the Baltic states limits the risks of foreign exchange shocks. That said, it would be extremely interesting to more deeply analyze these vulnerabilities in future papers. Such studies could also review the potential mechanism of regional contagion in case of a crisis. Again though, for the reasons enumerated above, the potential channels of contagion would likely be much different than in East Asia.

As regards surveillance, the staff's study confirmed the significant impact of the quality of institutions on growth. In this respect, the staff seems to stress the right areas for the focus for further reforms (financial supervision and prudential control; judicial institutions and efficient protection of property rights; corruption; costs of doing business, and product market competition). As suggested by the study results, reducing the size of government could also be a growth enhancing option for the countries with more sizable expenditure-to-GDP ratios, but in the end what matters is not the size of the government per se but rather the efficiency of public spending.

Helping the countries to prepare for euro adoption is a central element of Fund surveillance in CEECs. While euro adoption will clearly reduce the risks associated with foreign borrowing, countries should prepare themselves to fully take advantage from the monetary union. Their adaptability to asymmetric shocks after euro adoption will depend primarily on wage and price flexibility and the ability to use fiscal policy as an automatic stabilizer. Therefore, steps to increase economic flexibility and to establish a sound fiscal position are warranted. Finally, the conversion rate is an important element affecting competitiveness and needs to be chosen carefully, so as to ensure long-term competitiveness. In this light, the Fund should carefully monitor exchange rate developments in these countries and recommend in a timely and candid manner steps to be taken by the authorities. The Fund and the policymakers would be well advised to draw lessons from earlier entrants into the euro area, in particular the mixed experiences of Portugal, Italy, and Greece.

Given the wealth of lessons derived from the CEECs' experience, we believe that it would be useful for future papers to put more emphasis on discussing their implications for the entire Fund membership. Growth analysis as such, while important to the countries concerned, is less pertinent to other Fund members that often face a much more different domestic and external environment. This, in particular, concerns the unique and historical role that the EU played in supporting transformations of CEECs and providing a strong external reform anchor for other countries in Europe, including Turkey and Ukraine.

Mr. Lushin and Mr. Tolstikov submitted the following statement:

We thank the staff for a well-written paper prepared for this seminar. The cross-country study of growth in the Eastern European region provides additional information for better and deeper understanding of determinants of growth in individual Central and Eastern European countries (CEECs) and may help to draw conclusions about the benefits and risks of certain economic strategies. The study is thought-provoking in a sense that it raises more questions than provides answers and, as other Directors' statements show, there are different interpretations of some of the staff findings.

We broadly share the conclusion of the paper that the past CEEC growth experience was very specific. The unique starting conditions as well as the final goal of their transformation process—institutional and financial integration with the Western Europe—make their experience different from other emerging market economies. This limits the relevance of conclusions obtained from the world-wide sample of emerging market economies or even from the fast-growing

East Asian countries. At the same time, the initial conditions and external environment for each country within this group were relatively similar. Therefore, the causes of difference in growth performance between the CE-5 and the Baltics become even more interesting.

We do not fully agree with Mr. Saarenheimo and Mr. Kravalis that starting conditions in the Baltic states and the CE-5 were so dramatically different. However, we share their point that old governmental and regulatory structures were decisively destroyed and the new ones were built from scratch. The same happened with the production cooperation ties inherited from the centrally-planned economy. Unlike in the CE-5, the governments in the Baltic countries were less inclined to provide significant social support or protect any particular industry. As a result, the initial fall in production, employment and incomes was much deeper than in the CE-5 countries and entire industries ceased to exist, clearing space for a new, modern economic structure. The lack of domestic savings was compensated by a large-scale external borrowing and foreign direct investments, which brought modern equipment, management, and expertise. From this it follows that in 1990s the Baltics implemented a more liberal and outwardly-oriented transformation model than the CE-5 countries and thus laid a foundation for more rapid growth in 2000–05.

The growth model based on heavy reliance on foreign savings is typical for the entire CEE region, although the Baltics are the most striking example. Massive foreign capital inflows in the CEECs were associated with profound current account deficits and a high level of external debt. Rapid accumulation of external debt rises concerns about how productively foreign savings are used and poses a question about vulnerability of the CEECs to a financial shock. External vulnerability indicators in many CEECs (p. 37) are at the same level or even worse than in the South-East Asia prior to the 1997 crisis. However, until now substantial use of foreign savings has been consistent with high growth rates. Also, high standards of transparency, well-supervised financial systems, strong fiscal positions in the Baltics, and a high level of reserves in the CE-5 make the situation different. However, we agree with the staff that potential vulnerabilities should be closely monitored in the context of Fund’s surveillance.

Euro adoption is the next big challenge for the region. Those countries that will join the euro area will benefit from a reduction in the risk premia and even larger access to foreign savings. That will be an additional growth-enhancing and vulnerability reducing opportunity. Since the countries of the region will join the euro area at different times, this factor may become essential for deviations in their growth performance in the future.

Mr. Wang and Mr. Xu submitted the following statement:

We welcome the opportunity to discuss growth in the Central and Eastern European countries (CEECs), and thank staff for the constructive and interesting paper.

In order to narrow and eventually close income gaps within the euro area, sustaining growth momentum in the period ahead is the common task facing the CEECs. Supported by international comparisons, the paper presents a deep analysis of various growth determinants and their development trends, and makes clear the implications for Fund surveillance. Given the general character of growth for emerging countries and developing countries, we believe the discussion will not only provide benefits for the policymaking process from individual country's and regional perspectives, but also contribute to the study of growth on a broad basis.

The nature of growth in the CEECs is different from other regions, reflecting its unique nature in the economic development process during the last 15 years—and facing the challenges of regional integration after a difficult initial transitional period. Growth in the CEECs relies more on increases in total factor productivity (TFP) compared to the contributions of employment and capital. Over time, this feature, however, may change as a result of enhanced economic structures. The increase in TFP may slow after its dramatic improvement associated with the initial transition process, and the contribution of employment and capital could become more evident. With the low saving rate, the important challenge facing the CEECs is how to sustain investment and improve efficiency while containing vulnerabilities arising from large amounts of foreign savings. The efforts toward euro adoption could also help speed up major structural reforms, which would facilitate the improvement of employment.

We particularly welcome the in-depth analysis in this paper of the implications of the growth issue in the CEECs for Fund surveillance. The paper identifies a number of areas—relevant elements for medium- and long-term growth—that point to several directions for future surveillance. By doing so, well-targeted surveillance could strike a balance between the focus on short-term vulnerabilities and due attention given to medium- to long-term growth.

We broadly endorse the methodology used in this paper, and generally share staff's major conclusions. However, we also wish to point out the following aspects, which either need more careful interpretation or warrant further study.

First, while international comparisons could help deepen our understanding of the structure of growth in different regions, we should be mindful that full account must be taken of the region-specific factors when conducting such comparisons. The paper compares the contributing factors for growth in the CEECs with East Asian countries. According to Figure 4 of the paper, growth in the CEECs from 1990 to 2004 has been largely supported by TFP (measured as a residual), while the contribution of capital and employment is more evident in East Asian countries. The different growth patterns for the two regions mainly reflect the region-specific environment—high saving and investment rates in East Asian countries and low saving rates and weak labor markets in the CEECs. These differences could not be fully explained by pure economic theory. In fact, they should be examined within an historical context, including the tradition of saving in East Asian countries and the deterioration of employment performance in the CEECs during the initial transition period. In this regard, it is not realistic to expect a universal growth pattern to work for all countries. The optimal growth model for a country, if any, can only be justified when it is in line with the country-specific situation and when better resource allocation and higher efficiency can be achieved under this pattern.

Second, the role of institutional quality in growth deserves more careful and comprehensive analysis. While it is undeniable that good institutions can promote better growth, the question is how to define a good institution and how to quantify its impact on growth. Again, the assessment of institutional quality should involve a careful analysis of country-specific factors, as one institutional arrangement may work well for a country but probably not for others. In our view, the International Country Risk Guide (ICRG) composite index could be considered as a proxy for the quality of institutions, but a more detailed, case-by-case analysis is needed when moving to a comprehensive examination of institutional quality for a specific country. Another issue is the role of population growth. Although staff concludes that slow population growth has favored catch-up in the CEECs over East Asia, staff also admits that, over time, aging could shift this advantage—this is one element we must consider in forecasting growth trends.

Third, the important role of macroeconomic and structural policies in assessing growth prospects should be reflected in a more specific and systematic way. There is no doubt that policies are critical for sustained growth, through direct or indirect ways. The challenge now is how to get a more complete picture of the role of policies on growth. Staff indicates in the paper that several factors are influenced directly or indirectly by policies. We think that is useful but not enough, and we encourage staff to explore further ways to improve study of this issue.

Fourth, while euro adoption will certainly bring tremendous benefits to the CEECs, it is also desirable to be aware of the challenges brought by euro adoption and make an objective assessment on its potential impact on growth in the CEECs. The experience of a few countries suggests that economic developments may become more volatile after euro adoption. Therefore, managing euro adoption is an important challenge facing the CEECs.

Ms. Lundsager and Ms. Donovan submitted the following statement:

We thank the staff for a valuable contribution to regional surveillance and to transition literature more generally. As the paper makes clear, the Central and Eastern European countries (CEECs) have undergone not one, but in fact multiple transitions over the past 15 years. These ongoing and substantial structural and policy shifts place a premium on high quality policy advice. For this reason, and without prejudice to the excellent technical analysis, we found Section VI (Implications for Fund Surveillance) to be one of the more interesting components of the paper. How Fund engagement is structured and how policy advice can be sharpened in pursuit of sustainable growth and reduced vulnerabilities is an overarching question with relevance for all member countries.

With this in mind, we offer the following observations on the role of the Fund and the paper's findings more generally:

While the forward-looking evaluation of Fund surveillance was interesting, it might have been equally useful to provide a degree of backward looking analysis. For instance, the nature of Fund engagement is not apparent from the document and could have been highlighted if only through an annex. Is there any evidence that program countries performed better than those under only surveillance? Was conditionality focused on factors within the Fund's remit that the paper identifies as primary contributors to growth? How was technical assistance targeted? Without undertaking a full-scale Independent Evaluation Office (IEO) or ex post evaluation, even a superficial analysis of this dimension of the Fund's work and its impact on CEEC countries would have been useful. The Fund substantially increased staffing when transition countries became members and an examination of how resources were deployed and with what results would be welcome at some point in the future.

Like Messrs. Charleton and Kruger, we think the paper might also have benefited from the inclusion of more expansive case studies. Indeed, there is a flavor of this throughout with comparisons to other emerging markets, but we assume that much of the Fund's role in these countries has involved transmission of lessons learned, and, as Mr. Saarenheimo and Mr. Kravalis note, there is ample room to extend the paper's comparative analysis even within the CEEC. As a number of Directors note, studies could also usefully analyze potential contagion in case of a crisis.

While the paper rightly highlights the complexity of complementarities in growth determinants, and notes the difficulty of mapping to policies, we found the tentative conclusions quite reasonable. In particular, the discussion on size of government, extent of trade openness, quality of institutions, and level of financial development/quality of regulatory regimes was interesting. As the paper notes, only some of these influences lie within the remit of the Fund. We agree that sustaining low inflation, containing the size of government and development of appropriate institutions in these areas fit well within the IMF's mandate. Broad institutional development should, however, be in large part the work of the multilateral development banks (MDBs). Finally, the OECD has also undertaken extensive analysis across countries of various structural issues and is a useful source of policy and institutional best practices.

Like Mr. Silva Ruete and Ms. Todesca-Bocco and Mr. Shaalan and Ms. Beidas, we were somewhat disappointed at the limited discussion of exchange rate policy, given the clear responsibility of the Fund for surveillance in this area. Euro adoption has the potential to provide a boost to growth prospects, but it is essential that countries put in place sound macroeconomic policies to ensure sufficient flexibility to respond to asymmetric economic shocks in the absence of independent monetary policy. We remain concerned that countries have not taken advantage of favorable conditions to implement permanent fiscal reforms and will be tempted to rely on short-term fixes to meet the Maastricht criteria rather than fully addressing underlying rigidities.

We were surprised not to see any mention of remittances in the paper, given their potential impact on SME development which can help drive private sector-led growth. Like other Directors, we see openness to trade as a critical determinant and would highlight the ability of countries to reorient export markets geographically and by product as essential flexibilities. We also support comments by Directors on the need to decompose current account deficits and their underlying financing in order to evaluate whether or not they truly represent a vulnerability. The paper's conclusion that foreign inflows have generally contributed to much faster growth is encouraging, but this will merit continued observation, especially in the event of a shift from currently favorable market conditions. This is particularly true in the case of Hungary, which the paper cites as the only country in the region where actual growth performance diverges from what would be expected based on the size of the current account deficit.

While recognizing data constraints, these vulnerabilities lead us to suggest that many of these countries might benefit from application of the balance sheet or contingent claims approach, perhaps in the context of upcoming Article IV surveillance. Identification of key balance sheet indicators that might complement the more standard macro-indicators can improve analysis of crisis vulnerability.

We agree with the paper's conclusions on total factor productivity and its recommendations for closing the productivity gap. While we feel there is perhaps more scope for total factor productivity-induced growth than the paper would imply, it is also clear that improved utilization of labor can help, and we note the comments of Messrs. Kremers and Croitoru and Messrs. Raczko and Piatkowski in this regard. Labor force participation rates remain comparatively low throughout the region, highlighting fiscal disincentives, inflexible labor markets, and skill mismatches that contribute to high structural unemployment.

Mr. Kiekens and Mr. Ábel submitted the following statement:

The staff paper provides a useful analysis of the sources and prospects of growth in Central and Eastern European countries (CEECs). Equally useful is the analysis of vulnerabilities that may intensify as economic progress continues. The paper formulates relevant recommendations for both policymakers and Fund surveillance. We would like to suggest that the staff, in future, builds on the illustrative results of the vulnerability analysis included in today's paper to make a full-fledged vulnerability analysis. It would also be interesting to broaden the comparison with other countries by including not only emerging market economies from Asia but also European convergence countries like Ireland, Spain, and Portugal.

Reform and growth achievements in the CEECs have been a success. The EU accession and integration process played a decisive role in this performance. Compared to other countries at a similar stage of economic advancement, the CEECs have been in a privileged position as they have been able to embrace the institutional and legal framework of the Union (*acquis communautaire*)—helped by considerable EU support.

It is an important finding of the paper that the increase in total factor productivity (TFP) has been the more significant source of growth, rather than capital accumulation made possible by FDI and other sources of external financing. Indeed, TFP growth was almost double than that in other emerging market economies (Figure 4 on page 11 of the staff paper).

Whether TFP growth can be sustained during the convergence process and what other sources of growth could be essential to sustain a rapid catch up are critical issues to which the paper devotes useful considerations. We agree that increasing employment, domestic savings, and investment will all be important.

In the CEECs, we observe significant differences in labor productivity growth between tradable and nontradable sectors. This phenomenon is relevant for understanding, in particular, wage developments, the disinflation process, and differences among countries in the evolution of TFP. Differences in TFP are often attributed to differences in institutions and policies. True as this is, it remains an interesting question as to why these differences affect more the tradable than the nontradable sector. We presume that a closer examination of TFP differences among sectors may help clarify this issue.

We recognize that for making this analysis, complex measurement problems must be overcome. Capital inputs might be underestimated because of overestimates of depreciation. Unrecorded employment hides actual labor inputs. Both phenomena lead to an overestimation of TFP. Unmeasured differences in labor or capital inputs cause divergence between the actual and the observed cross-country differences in TFP, without reliable indicators about how much of these differences can be accounted for by labor or capital. We may assume that unmeasured differences in labor inputs should cause the largest TFP differences in the sectors that have the largest labor shares. Thus, analyzing observed differences in TFP on an aggregate basis may be misleading. Focusing more on productivity at sectoral levels could result in more reliable analysis.

Shifts in the composition of output toward high-productivity sectors increases growth without any implication for policy or surveillance. Box 1 in the staff paper is very informative in this respect. The Hungarian experience shows that “continued strong productivity growth will depend in part on ‘climbing the technology ladder’ and on rapid productivity growth in the information and communication technology sectors.”

Data show massive labor shedding and a decline in employment as the transition to market economy progressed. This was a correction of serious distortions during the command economy, when there was excess demand for labor and widespread labor hoarding to cope with the uncertainties in the delivery of inputs.

Bringing low-skilled workers into the workforce will indeed increase employment, but also lower labor productivity. Nonetheless, it may add to growth. However, it would hurt growth if incentives would encourage skilled workers to move to lower productivity sectors.

It is now widely accepted that the Solow (1956) growth model, and the recognition of productive factors other than capital and labor, explains well differences in per capita income growth.

There is considerable empirical research on the effects of fiscal policy on growth. Some research finds a significant negative correlation between the level of fiscal spending and output growth. This could prove that greater government intervention distorts incentives and lowers productivity, thus lowering growth.

However, the staff paper shows that this finding is not robust. There are certainly other factors that influence growth. Evaluating the role of the government is more complex than what is reflected by its size.

Most empirical studies on the relation between fiscal policy and growth are not based on an explicit theoretical framework. This research includes the size of the public sector to the standard convergence equation in an ad hoc manner. At this stage, such research has not produced innovative practical policy recommendations.

The macroeconomic situation of rapidly catching up countries will not be free of risks because of their reliance on foreign savings. The trade-offs between higher growth and a higher risk makes the job for IMF surveillance complex. The staff's perspective on several aspects of the vulnerabilities is noteworthy. Nevertheless, the current theoretical or empirical knowledge surveyed in the staff paper does not seem to provide a firm basis for a clear policy conclusion or surveillance prescription beyond what is already part of the common practice in the Fund.

The conclusion that high current account deficits in CEECs represent significant economic risk should be nuanced by a closer analysis of the underlying factors, the trade balance and other components of the current account. The recent developments of the current account in some CEECs e.g., the Czech Republic, Poland, and Slovakia, reflect a healthy "catching up" process based on an improving trade balance and on the deepening of the income account deficit. Despite a worsening in the situation in the main export markets and a strong appreciation of the exchange rate, the foreign trade balance of the CEECs has been improving substantially. The current account deficit is partly caused by an increase in revenues on foreign direct investment (FDI). These revenues consist of two key items: reinvested earnings and transferred dividends. Reinvested earnings warrant special attention. They do not affect the balance of the external account, as the outflow, recorded in the current account, is automatically financed by an inflow recorded in the capital account. Thus, large current account deficits because of large reinvested earnings related to FDI tend to overstate the risks associated to the current account deficits.

We have a few drafting suggestions, which we will send separately to the staff.

Extending his remarks, Mr. Saarenheimo commented on external debt, which was an issue raised in the staff report and subsequently by Messrs. Charleton and Kruger. He noted the staff's finding that the Baltic countries stand out as having relatively high external debt. He pointed out that the staff was citing measures of gross debt, and Latvia had the highest such level among the Central and Easter European countries at approximately 100 percent of GDP. By comparison, the same measure for Ireland was about 540 percent. That said, he considered it unlikely that Ireland would be characterized as at risk of a financial crisis. It was clear that there was no straightforward manner in which to interpret debt ratios. In the case of the Baltic countries, debt levels reflected the high degree of financial integration with European markets, particularly the strong presence of Nordic banks.

Extending his remarks, Mr. Kiekens considered that demographic developments would have an important impact on economic growth, employment, and productivity. A report issued by the European Commission on the impact of aging on public expenditures had concluded that potential output growth rates would decline dramatically in the EU accession countries, from an average of 4.3 percent this decade, to 3 percent over the next two decades, then sharply down to only 0.9 percent from 2030 to 2050. The decline over the final 20 year period was particularly dramatic, with Central Europe potential growth substantially below that in Western Europe; mainly from population aging in the former group (productivity was assumed to converge in newer and older EU member states). The report also found that over the next two decades, declines in European potential growth because of aging would be offset in part by employment growth. Without the projected increases in employment and productivity, the drop in potential growth rates could be even more dramatic. In that sense, from 2030 on there was the potential that convergence might in fact reverse, as potential growth in Central Europe lagged behind Western Europe. The Fund should therefore examine the consequences of demographic aging on medium-term growth in Central Europe.

Mr. Cuny made the following statement:

We have found this exercise very useful in the context of regional surveillance, which clearly describes the increase in the production factors that is needed for Central and Eastern European countries to raise their living standards to Western European levels, and helps to measure the challenges these countries are facing. The fact that the empirical literature does not provide clear conclusions regarding the economic policies that favor growth makes it difficult for the Fund to formulate policy recommendations. Nevertheless, listing the difficulties that the Central and Eastern European countries are likely to face, as well as focusing on the issues on which the Fund should concentrate its surveillance, is a useful initiative, and we thank the staff for their efforts.

I have three issues that I would like to discuss today. First, the lack of a distinction in the policy and surveillance recommendations between the two groups of countries identified in the report; second, issues related to the financing of capital accumulation; and third, the analysis of the impact of euro adoption on economic growth.

First, we have found the analysis of the potentially diverging growth paths between the CE-5 group and the Baltic countries to be very interesting. Nevertheless, we would have expected that this differentiation be kept in the recommendation section of the report. Even if the core of the advice is similar, some details could have been provided under specific recommendations for each of the groups, given that the different sizes of their economies create different kinds of challenges with some economic variables, such as the cost of capital being more exogenous in the Baltic countries.

Second, the emphasis put on the need to accumulate capital at a fast pace to sustain high economic growth is welcome. The report rightly points out that the relatively low level of domestic savings makes the use of foreign capital necessary. One may, however, wonder if the end of the privatization process may not limit the size of private capital inflows, and we would appreciate the staff's view on the channels capital inflows are likely to take in the coming years. Also, part of the financing will come from EU transfers that often require co-financing by the authorities. We therefore share Mr. Kremers' question on the optimal size of governments, given that in some countries revenue increases will be needed. Moreover, the tax competition that seems to arise between some of these countries may constitute a constraint to large public investment. We would welcome the staff's comments on the potential negative consequences of tax competition.

Third, the report analyzes the potential consequences of euro adoption on economic growth. We agree with the staff that the elimination of exchange rate risk and closer commercial integration will certainly play an important role in fostering growth. We also fully agree with the staff that the timing and conditions of euro adoption are likely to have major effects on growth prospects, and that a comprehensive cost-benefit analysis has to be made before euro adoption. At the same time, macroeconomic risks linked to the fixed exchange rate regime that must be maintained for the two years prior to euro adoption have to be carefully monitored. The staff has a key role to play in terms of policy recommendations to help these economies reach sufficient nominal and real convergence during this phase in order to reap all the fruits of the future euro adoption. As pointed out by Mr. Steiner and Mr. Mori, the major challenge for these economies will be to join the euro area on the right footing. We note that the staff report does not comment extensively on the ERM-II phase. We would therefore appreciate staff's views on the measures the authorities can take to mitigate the macroeconomic risks during the ERM-II phase and on the role that the IMF can play in terms of policy recommendations.

To conclude, we concur with Mr. Saarenheimo and Mr. Kravalis as well as with Mr. Raczko and Mr. Schwartz that potential vulnerabilities should be taken seriously, but that comparisons with pre-crisis East Asian countries are exaggerated. First, progressive financial integration with Western European countries has reduced risk, which has also been pointed out by the staff. Second, the experience of the Asian crisis is now well known and has drawn the attention of the authorities to the consequences of risky policies.

Mr. Hauser made the following statement:

We thought this was an excellent paper. I would liken it to a lavish Eastern European meal: enormously satisfying, but so rich that it left at least this reader feeling a little overfull and slow witted for a few hours after having finished. There was such an enormous amount of material here; it could easily sustain a whole month of discussion. We are very glad to see it will be published as an occasional paper. We have four points to make.

First, we agree with Mr. Saarenheimo and Mr. Kravalis and other Directors that the transition challenges in this region are quite unique; differences in initial conditions, economic structure, and external context and so forth do make it quite hard to draw simple comparisons with areas like East Asia. At the same time, we as a Board often encourage the staff to emerge from their silos and do more to draw out cross-country comparisons. We believe there is merit in this exercise. The challenge here, as elsewhere, is to continue to strive to identify relevant information from other countries and not provide overly simplistic comparisons.

Second, of the many differences between the region and Asia, one of the most striking we thought was the low savings rate, which the paper draws out very clearly. We would be grateful if the staff could say a bit more on why they think savings are so low. I know this is not a new issue in the region. Is it driven by poverty, by a relatively high degree of impatience, by relatively low rates of return, or perhaps linked to continued imperfections in the financial system? Does the staff believe that policy could make more concerted attempt to raise private savings rates in the future and if so how that best might be done?

Third, we recognize the main focus of this paper is not on vulnerabilities, but as the paper itself notes this is a major focus of individual country reports and is closely linked to the question of growth. Again, as the paper notes, countries seeking to speed up their catch-up process in the ways discussed in the report also run the risk of exceeding their own innate speed limit. When countries are growing rapidly on the back of large imports of capital, it is particularly hard to judge the extent to which macro developments, such as high current account deficits, credit growth, and indebtedness, reflect a normal transition process, and the extent to which they have been overshot, storing up problems for the future. While we agree with Mr. Kremers' warning against implicit rules of thumb, we join Mr. Shaalan and Ms. Beidas and Mr. Raczko and Mr. Piatkowski and others in encouraging the Fund to build on the work in this paper and elsewhere to develop a more consistent tool kit of techniques for addressing this difficult question in specific country reports. For example, the message from the growth model shown in figure 17 and paragraph 59 of the report is more reassuring than what we often hear in specific country discussions, but no doubt other metrics, such as comparisons with other countries at similar points in transition, assessments of financial system mismatches, the composition of trade and capital flows, and so forth, might give different messages. Beyond noting this is a critical issue for Fund surveillance, this paper is rather noncommittal about how an analysis of this kind might actually be applied in future bilateral surveillance reports. We would be very grateful if the staff here today in the seminar context could give their informal views on how easy it would be to develop such a tool kit.

Fourth and finally, we very much agree with the importance of appropriate preconditions for euro entry, including ensuring a competitive entry rate, sound macro policies, and flexible markets. Although this report notes euro membership may in principle provide a spur to further structural reform, the evidence on this has been somewhat mixed, which increases the premium on ensuring that reform is already well under way before giving up an independent exchange rate that can act as a further shock absorber. In this context, I noted on page 6 of the report it is stated that the Fund might do more to act as an advocate for policies that support early euro adoption. I am sure what that meant to say was that the Fund would

> advocate policies that allow for an appropriately timed and structured euro adoption. I know Ms. Schadler herself has written very extensively on this issue. Early entry *per se* does not seem to us to be quite the right message.

Mr. Rouai noted that several Directors commented on the comparison made by the staff between the Central and Eastern European countries and some East Asian countries prior to the regional crisis in 1997. While cross-country comparisons were always helpful, he felt care should be taken in drawing firm conclusions. As recent experience had shown, financial crises tended to be unique from one another, and there might be a temptation in the Fund to think about the next crisis using the previous crisis as a template. The Fund should focus its future work on country-specific factors, as noted by Mr. Kiekens.

The representative from the European Central Bank (Mr. Wijnholds) made the following statement:

> As you know, the European supranational institutions are intimately involved in the process of euro adoption by the new EU member states, and we therefore take a keen interest in the IMF's relations with these countries. I am fully convinced that the Fund has played a crucial role in helping these countries prepare for EU membership, and is again very helpful in preparing the new member states for further integration. The ECB agrees with most of the key passages and findings of this rich paper. I would like to comment on a few issues where we are perhaps not fully clear as regards the staff position or where we think that the emphasis should perhaps be somewhat different.
>
> First, we fully agree with the staff that sound macroeconomic policies and flexible product and labor markets are crucial for successful participation in the exchange rate mechanism, also known as ERM-II, and the subsequent adoption of the euro. However, we are not quite sure what the staff means when it states that the new member states should enter ERM-II and adopt the euro at a rate compatible with strong export performance.
>
> With regard to a country's central rate in ERM-II, it may be recalled that this is chosen on the basis of the best possible assessment of the equilibrium exchange rate at the time of entry into the mechanism. Decisions on central rates are taken on the basis of mutual agreement of the various parties to ERM-II, which include the supranational institutions. In passing, let me outline the present state of affairs as regards ERM-II. Of the ten new member states that joined the EU in May 2004, three entered the ERM-II in late June 2004, and another four countries joined the mechanism last year. The three remaining countries have come to the conclusion that they need more—and perhaps considerably more—time for taking this step.
>
> Second, successful participation in ERM-II is only one of the Maastricht convergence criteria that countries need to comply with before adopting the euro. The other criteria pertain to maintaining price stability, sound public finances, and

a low long-term interest rate. Like Mr. Meissner and Mr. Brinkmann, we would underline that fulfilling these criteria in a sustainable manner can safeguard against possible economic pitfalls that countries may face if they adopt the euro prematurely.

Finally, it is suggested in the executive summary that there may be a two-speed catch-up process, with the Baltic countries in the fast lane and the CE-5 countries in the slow lane. This is a fair description of the current situation, but perhaps could be nuanced a bit given that, firstly, the Baltic countries have also the greatest needs in terms of catching up and, secondly, there are a number of risks associated with the sustainability of the very high growth rates of the Baltic countries. In that regard, one can mention the very large current account deficits and, for instance, quite high inflation in Latvia.

The Deputy Director of the European Department (Ms. Schadler), in response to Directors' comments and questions, made the following statement:

I thought Mr. Hauser put it very nicely that this is a very rich paper, and I think that the comments from the Directors reflect the fact that there were many things that different people took away from the paper, both in terms of messages and in terms of areas with which they were less satisfied than they would like to have been. I would like to preface all my remarks by saying that this paper was aiming for a rather focused look at growth prospects in these countries. There are many questions that spring from such an analysis, and one could take many different possible steps to go beyond this study. I think what makes this discussion useful is that it identifies areas where more in-depth work is needed, but we intended to keep this paper focused on the growth question.

Why did we ask this question? We started with a sense that there had been in several countries a real spurt in growth in the early stages of transition that had petered out; while in other countries that spurt had been sustained or lasted longer. In the first instance, we wanted evaluate whether these countries were experiencing a good or disappointing growth performance, and a reasonable standard of comparison was with other emerging market countries. This leads to questions about the path that these countries were taking in their growth efforts and the related vulnerabilities. But the central question in this paper was whether these countries were turning in growth performances that appeared to be reasonable.

The growth question may not exactly fall under the IMF's core mandate, but there were two considerations that drove our work. First, we wanted to know whether there were countries that were losing out on significant growth possibilities, and advice on this would be central to our surveillance. There could be areas in which we needed to focus our efforts more strongly in order to ensure that these countries realize their potential. Second, a clear view on growth prospects and policies to enhance them is absolutely essential to assessing vulnerabilities that are at the center of our surveillance. I think Mr. Hauser picked this up very well when he was discussing what it is that we are really looking for in this paper. Surveillance has a very appropriate orientation toward examining short-term developments and vulnerabilities, often driven by cyclical developments. But to some degree this assessment takes place in a near-sighted framework, because we do tend to focus on the short to medium term. Essentially, we look at balance sheets of governments, banks, nonbank private sectors and extrapolate out only two to three years. This assessment is consistent with the IMF's mandate, but we have found, especially in the Central and Eastern European countries, that the most significant risks to the outlook stem from deviations from the staff projected growth trajectory rather than from other factors. In the case of Poland, last year's staff report identified clear risks should interest rates rise suddenly or exchange rates depreciate suddenly. However, if assessing the risks going forward in the context of the historical experience, then it is growth that matters most. Thus, it is absolutely essential in assessing vulnerabilities that we have a clear fix on whether very strong growth is likely to continue. This is particularly important for the Central European economies, which are drawing to almost unprecedented degrees on foreign savings. Given that longer-term growth scenarios are not a strength of the Fund staff—and I think this is understandable, because the literature in general has a lot of difficulty coming to terms with what exactly causes high growth over long periods of time—a paper like this is important for this set of countries.

In summary, the purpose of the paper is to have a first pass at drawing conclusions from a framework on assessing growth prospects. It would be wrong, however, to prepare such an analysis without also highlighting the fact that the very large use of foreign savings is pushing these countries in some respects toward more vulnerable positions. That said, the objective of this paper is not a vulnerability analysis *per se*; it is simply to raise as a supplement to the basic analysis on growth that there are vulnerabilities that are arising at the same time.

Directors have raised several other questions about areas the paper could have pursued issues in more depth. Before I comment on some of these issues, I would note that the cross-country work in the European Department is guided by the principle that we should not be reinventing the wheel. Where there are other studies that cover issues of interest, we will draw on those studies and move our work into issues where we feel there are real gaps that affect the quality of surveillance.

One question that was raised was whether we should have undertaken more of an ex post review about the strengths and weaknesses of conditionality during the period that these countries had arrangements with the Fund. Most of these countries had arrangements that ended in the mid-1990s, while one country never had an arrangement with the Fund, and a few others had arrangements that ended in 2002/03. We do not expect these countries will need to use Fund resources in the near future, thus we do not feel that drawing on those lessons is critical to our surveillance going ahead. What we want to do is focus on the things that in the next five years or so are going to be critical for our surveillance.

Often a question that is raised when we approach this sort of work is whether we should be going the case study route, or alternatively the more statistically comprehensive route, which is the direction the staff ultimately chose. There is quite a bit of work done on the lessons from Ireland, Portugal, and Greece, not least by Mr. Lynch, as cited by Mr. Charleton and Mr. Kruger in their preliminary statement. There are also studies that have been done by the staff, some of which are covered in the euro adoption paper. We thought a different path in this instance would break some new ground.

We also ran into problems of comparability in the case studies. The CEECs will undergo the catch-up process in an environment of completely open capital accounts. Most of the present EU members that have experienced catching up from relatively low income levels did so in a much more closed environment, and many of the options that are open to Central and Eastern European countries were not available to those countries. However, those options are open to other emerging markets right now, so this becomes a very important comparator group.

Several Directors asked about contagion, which is a very important issue for this region. I think it is recognized universally that this is a ripe setting for contagion should a serious shock occur in any one country. I believe there was a study on contagion between Poland, Hungary, Slovakia, and the Czech Republic in a selected issues paper for the Article IV Consultation on Poland in 2004. There has been some work done on this in the economics literature, but I would say this is a very important area for future vulnerability work.

Directors raised many questions about exchange rate policy and euro adoption more generally. Many of these were covered in some depth in the paper on euro adoption two years ago, which is still serving as a framework for our Article IV consultations. There were specific questions about euro adoption and the staff's position is that regard. I think generally the staff's position is understood, but I can summarize it very briefly. Euro adoption promises to reduce risks for these countries in important ways, and as a result could significantly increase the scope for these countries to use foreign savings in a safe manner. It is important that countries that join the euro have the right policies in place, and the euro adoption paper goes into some depth on those policies, which I will not repeat here today. The staff's message on the timing of euro adoption is to get the policies right so that countries can get into the euro area as quickly as possible. In that context, the message is not "get the policies right, but its okay if that may take 10 or 15 years." We want to press the countries to get the policies right quickly, because getting into the euro area will be a major plus for them.

Labor markets also elicited many comments and requests for further work. Increasing employment rates is important to the growth prospects in these countries, particularly for the two countries at the low end of the scale. Several countries have employment rates that are near EU averages, but that is not an impressive standard. We still think that all of these countries can do more to get employment rates up with huge benefits in terms of growth. There has been a considerable amount of work done in the European Department on this issue and an occasional paper was published last year, covering a regional review of labor market developments, influences on labor markets, and the policies that these countries should be following. We did not feel that in this review it was worth going over that ground again, although we drew on that study quite significantly.

There were some questions about migration. This is an important topic and one in which we are interested. I should note that, while preparing this report, Mr. Mody and I, together with the IMF Institute, the Joint Vienna Institute, and the National Bank of Poland, organized a conference on labor and capital flows following EU enlargement. This conference was held last January, and I believe was hugely successful and interesting. I think anyone who attended the conference would say the discussion was book-length-like in its depth. I would repeat a few of the conclusions from that conference for the benefit of those Directors who asked about labor mobility and its effects on growth.

Generally speaking, labor mobility will be beneficial to both the new and the old EU member states, but based on the experience of other regions outside Europe that have seen changes that could open the way to potentially large waves of mobility, then migration in Europe will probably not be huge. The stock of workers from new members that are likely to end up working in old members at any given time is likely to be about 3 percent of the new members' population, or less than 1 percent of the old members' population. This will not be enough to have a major effect on capital labor ratios in either the new or old members. Whether this will be transient labor—people who go to work for brief periods of time but then intend to move back to the new members—or whether it will be more permanent migration is very uncertain. I would say there is not much evidence to speak clearly to one outcome or another. The permanence of the migratory movement will determine the importance of workers' remittances in terms of factor flows.

Far larger mechanisms in the factor flow picture are likely to be outsourcing (where companies in old members import more and more intermediate inputs from the new members) and offshoring (where companies in old members actually move production facilities to new members). One of the significant conclusions of the conference was that outsourcing and offshoring are the way of the future. This result is consistent with what we are seeing right now, which is a huge shift of foreign savings from the old members to the new members.

Directors raised some questions about the effects of labor mobility on skills in the old members and, indeed, in the new members. There were a couple of participants at the conference who made a very strong case that we are headed toward "war for talent." They felt this competition had already started and would probably intensify. In this regard, the competition is more likely to come in the form of offshoring, certainly to the extent that old members are restricting inward migration. This will hasten the outflow of capital for the offshoring of production, but much depends on institutions in the new members. Once again, this conclusion is consistent with the staff's paper, as institutions have and are going to play a key role in the new members in terms of attracting capital and the use of foreign savings. With little institutional change, there will be more pressure for migration from the new members to the old members; with more institutional change, there will be more offshoring from old members to new members.

There were a number of questions on vulnerabilities and whether there was an appropriate amount of vulnerability analysis done in this paper. The aim of the paper was simply to ensure that the vulnerability question was on the map, but not to make conclusions about vulnerabilities in specific countries. As we know from the Article IV consultations, it is critical that these vulnerability analyses are very country specific. I think this is the concern that we are hearing around the table about the comparisons with East Asia in 1996. It is absolutely critical to look in detail at the underpinnings of the increase in indebtedness, the transfers of foreign direct investment, and the rapid growth of bank credit, so that the institutional framework in which these developments are occurring is clear. One problem, however, is that this vulnerability analysis, which is probably going to entail very detailed balance sheet analysis, faces data limitations. At this stage, it is rare to find disaggregated data on balance sheets, and we have to resort to aggregated sector-wide balance sheet analysis. This can be very useful to point to places where we should be paying more attention, but frequently we are not going to get the kind of hard conclusions that would allow us to be virtually certain that the balance sheets in this country indicate problems. At an aggregate level, there are always going to be questions about interlinkages and the extent of the exposure of individual entities to balance sheet risks. I think the challenge going ahead will be to come up with data that allow us to do the kind of analysis that will let us draw fairly hard conclusions.

A few Directors noted that the Central and Eastern European countries are generally low savers. We do not know why this is the case. The amount of data we have and the relatively short time series are not conducive to clear conclusions on this issue. There are two potential factors that I would point out with regard low savings. First, many of the conference participants in January pointed to the fact that these countries were under a very repressive Communist system in which it was impossible to obtain high-quality consumer goods for a half century, thus when things became more free there was a burst of consumption that naturally would result in low savings. This is not to say these countries have particularly high rates of consumption growth, but overall the savings rates are relatively low, and in part this could be a stock adjustment. The second factor is that growth prospects in these countries are relatively good; hence people should be smoothing their consumption streams. We have heard this factor mentioned in many countries that have subsequently had crises and have not had the strong growth, which is all the more reason to look at whether the growth prospects in these countries are as strong as current indicators might suggest.

I would like to just address a few other more general questions before turning the floor to Mr. Mody. One conclusion that elicited comment from a few Directors concerns the interaction between institutions and vulnerability. I would like to just say a few words on this because in many respects the emphasis on this needs to be increased, particularly in the Central and Eastern European countries. These countries are low savers, they have open capital accounts, and they have very high potential rates of return on investments. When combining these three elements together, it implies that the countries are going to absorb significant foreign savings. We can fret about this issue, given that there are vulnerabilities that are being created, but there are underlying economic influences that are going to mean the capital is going to move from high saving Western Europe to the low saving, highly profitable Central European countries. It is preferable when this takes the form of FDI, which is a little bit safer than debt, although in the paper we find that the difference between FDI flows and debt-creating flows is not very large in terms of the effect on growth. These are trends that are going to be with us for sometime and not just a year or two. There are some things that can be done in response to manage the vulnerabilities. Certainly, fiscal policy can be tightened, and these countries are going to have to get used to the notion that if they are going to have very rapid growth rates, they are going to have to start running fiscal surpluses. But when current account deficits are in double digits, we still have a big problem left over. The situation can be likened to being in a car going down a very steep hill with brakes that do not work perfectly. We need to recognize that we need to continue heading down the hill, so we better make sure that the passengers all have their seat belts on and that we are steering the car well. I think that is exactly the lesson that I would take away from this paper: what is going on in these countries is a long-term trend, and we are going to have to watch these vulnerabilities very carefully. However, at some point, we are also going to have to realize there is not too much we can do about the vulnerabilities when they develop—at least not until they reach a certain stage where we may need to attempt draconian measures as a last resort. We do need to make sure that the countries have institutions that will allow them to absorb shocks and weather disturbances that could develop in the event of crises. The paper does put a fair amount of emphasis on the importance of improving supervision, making sure that bankruptcy legislation in these countries is strong so that when companies go under there is a way to restart the productive facility as quickly as possible, making sure that labor markets are sufficiently flexible so that labor can move from one activity to another if necessary, and most especially ensuring that transparency is very strong so that people who are investing in these countries understand the risks. This is why we debated rather extensively about whether to include in the staff report the comparison to the East Asian countries. We decided in the end it was worth calling attention to the vulnerability and that people better understand those vulnerabilities if they are going to invest in this part of the world.

The last small question that was raised is whether the binding constraint on growth stems from low domestic savings or whether it is ensuring that the savings are used effectively. I would say that you cannot differentiate those two aspects. If savings are not being used effectively, they will stop coming. If we look at capital labor ratios and total factor productivity (TFP) in these countries relative to the old European Union members, it is true that both these measures reveal huge gaps. We need to be sure that TFP growth is there to ensure that savings are used effectively, but savings are also important because the capital-labor ratios are extremely low right now.

The staff representative from the European Department (Mr. Mody), in response to Directors' questions and comments, made the following statement:

I will address two sets of questions. First, a topic that Ms. Schadler just left off concerning the link between the current account and growth. Second, I will cover the issue of the size of government and perhaps some more short-term fiscal policy issues.

The link that is examined between current account and growth is in some sense a novel contribution of this paper, which has understandably drawn a number of questions, both with respect to the robustness of the finding, as well as its implications. In particular, there was a question on whether the results are strongly influenced by advanced EU member states being in the sample. This was an issue that we considered quite carefully. What is the right set of countries to which to compare these new member states? What we have tried to do in the paper is to be somewhat eclectic in this regard.

The Central and Eastern European countries (CEECs) are in a traditional sense emerging markets, given that their institutions, while having made a lot of progress, are still not yet fully mature. They also have issues relating to the business environment. On the other hand, the fact that these countries are geographically part of Europe has a very important bearing on their prospects. This is a factor for a couple of different reasons. First, for historical reasons that are not fully understood, Europe has been much more of a convergence club than other regions, and this finding is well documented. Second, Europe has a very high degree of financial integration. In other words, if you look at Europe, Asia, and Latin America, what you find is that the degree of financial integration within these regions is highest in Europe. What this paper seeks to determine is the likelihood that these new members of the EU will enjoy the benefits of deeper convergence and financial integration, as has been the case for earlier EU entrants. While it is technically correct that the econometric results are influenced by the presence of the more advanced European Union members, the substantive interest here is in whether that same benefit that has accrued to past members will accrue to the new members. In general, the finding seems to be that, yes, provided that the vulnerabilities are addressed, we can expect that these benefits will be quite substantial.

This conclusion raises a set of related questions about competitiveness and vulnerabilities. One Director asked whether these current account deficits are a reflection of sluggish exports and rapid import growth, particularly of consumption goods. I think we can say at least up until this point we find no evidence of sluggish export growth. The shares of exports from these countries, both in international markets as well as in European markets, have more or less been rising. There may be a tendency in some countries for export shares to flatten out over time, but as yet there is no sense that there is sluggishness in exports. In fact, in 2005 export growth has been particularly buoyant for some specific reasons.

This then leads to a question of a somewhat longer-term nature on how one assesses competitiveness in these countries, particularly because (i) some of them already have a currency board and therefore do not use the exchange rate instrument; and (ii) they are all likely to adopt the euro at some point in the near future. The staff agrees with the conclusion that competitiveness owes a lot more to a variety of fundamentals than only to a particular exchange rate regime. Indeed, the analysis in a number of recent surveillance efforts in the context of Article IV consultations have tried to move beyond just a look at equilibrium exchange rates by delving deeper into qualitative and technological advances in these countries. It is our understanding that this whole process of climbing the “quality ladder” will be central to ensuring long-term competitiveness. The emphasis on the Lisbon Agenda, the use of EU funds, and on labor market flexibility in the context of surveillance has been important in regard to this crucial issue of long-term competitiveness.

On savings rate, if I may offer my own spin, then it is not clear to me that we know why savings rates differ between regions. One possibility is that the savings rate we observe in Central and Eastern Europe is a legacy of suppressed consumption. That said, we do not know why savings rates in Asia are so high. The fact that savings rates in Asia are around 35 to 40 percent is also perhaps a reflection of their own historical and cultural legacies. Therefore, an assessment of what constitutes a low or high savings rate is difficult. The savings rates that we observe in CEECs are at least partly a reflection of their recent growth process, with consumption smoothing as a necessary outgrowth. Looking at the issue in a broader welfare context, which embraces both the increase in consumption and increase in investment, I am not yet willing to come to a conclusion that the prevailing savings rate is right or wrong. It might well be the right rate, but clearly it does increase vulnerabilities, and therefore our surveillance includes a number of suggestions toward increasing the domestic savings rate.

A final set of questions related to the size of government and, in particular, what might constitute an optimal size of government. This is again a question that is hard to answer, but simple charts do show that based on the current level of per capita income, especially Hungary and Poland have a size of government that is much larger than predicted from a cross-section of countries. In these cases, reducing the size of government is perhaps the right approach. On the other hand, if you look at the Baltic countries, the size of government is relatively modest at about one-third of GDP. In those cases, however, looking ahead there is reason to anticipate serious fiscal pressures. On the expenditure side, these could result from aging, migration, as well as an increased demand for public investment. At the same time, tax competition will put pressure on the revenue side. Thus, although the size of the government today may be about right, it does not necessarily mean that important fiscal issues do not have to be addressed. The advice that we have been proposing at this point is not necessarily a change in the size of government, rather to enhance the efficiency of government. There remains considerable scope for improving the efficiency of expenditures and for increasing the size of the tax base and structuring taxes in a way that is more efficient.

There was a technical question on whether we project sustained growth rates based on current performance or allow for the possibility that per capita income growth will slow down over the course of convergence. Indeed, we do allow for the latter possibility, so we do not have a naive projection of continuation of current growth rates.

There was a question on whether we have any advice on what countries should be doing while they are in ERM-II as distinct from preparations for the euro. I think these recommendations would be extremely country specific. The recent lessons we are learning from the countries that are approaching their assessment with respect to ERM-II is that caution, especially in terms of possible overheating, is extremely important. In this respect, a conservative fiscal policy that deals with overheating issues at an early stage might be important to ensure successful euro adoption.

Mr. Kiekens made the following statement:

I have not too much to add, but let me say that I very much appreciate this work by the staff. In my assessment, it is the Fund at its best. This work helps prepare for better surveillance in individual country cases and help toward understanding the interlinkages. To the extent that was not very clear in my written statement, let me say that I very much agree with the staff's views on the core points where surveillance must be attentive in ensuring that economies are functioning transparently while the use of foreign savings is high, which is very important in making sure that there are at least no disincentives for domestic saving. It is also important to ensure that, in the event of shocks, there is sufficient flexibility, including through efficient bankruptcy systems.

I also agree to the extent there is financial vulnerability linked to exchange rates and different currencies that, and I quote from the staff paper, "the euro is the growth-enhancing and vulnerability-reducing opportunity unique to these countries." In that regard, I sometimes have the impression that authorities in the region seem to challenge the importance of timely euro adoption for both good and bad reasons. The bad reason might be that the euro is not that important, and so there is no need to hurry policies in order to adopt the euro in a safe manner when conditions are right. But there is also a good reason to challenge rapid euro adoption, because the risks will not disappear with euro adoption. In reality, the risks become different, as the experience in the euro area shows. While the risk of an exchange rate or purely financial crisis lessens after euro adoption, the real exchange rate can still appreciate sharply leading to a growth crisis, as the Portuguese experience has shown, and Spain may show in the coming years. One of the most revealing charts that the Board has been shown of late was during the World Economic and Market Developments discussion, which illustrated that since euro adoption Spain and the Netherlands have seen their competitiveness decline by 10 percent, while Germany has gone the other way. If you compare those two sets of countries, Spain, Portugal, the Netherlands on one hand, and Germany on the other, there was a divergence of 20 percent based on unit labor costs in only five or six years time. The same could also happen in the Central European countries if following euro adoption there is more pressure on nominal wage increases in a natural process of wage bargaining to catch up with Western European levels, particularly if there are large productivity differences between sectors of the economy. Therefore, I would like to stress that I agree that the euro is a unique instrument for enhancing financial stability. At the same time, not only do the policies before euro adoption matter, they are also important after the euro is adopted in order to avoid another type of crisis that is specifically linked to key focus of this seminar, i.e., the drivers for growth.

Let me add another remark on the very interesting seminar in Warsaw last month on factor mobility in Europe. Any colleagues that are interested in the results of that seminar, all the papers are available through the web site of the Joint Vienna Institute.

Mr. Saarenheimo joined Mr. Kiekens in thanking the staff for the very good paper and comprehensive answers. He remarked that it was his understanding that the initiative to draw a parallel between the Central and Eastern European countries and pre-financial crisis East Asia originated from the Research Department. The Economic Counsellor had explained to him that the reference was intended to inspire discussion on the leading indicators of a financial crisis. In that regard, he considered that the Research Department was a bit more outspoken than the European Department. While he could appreciate the Economic Counsellor's views and the importance of keeping the issue on the radar screen, he felt that the argumentation needed to be further developed and deepened; otherwise, there was a risk that instead of usefully flagging the issue, future comments might risk rocking the boat. It was therefore necessary to work toward providing answers instead of raising additional questions.

The Deputy Director of the European Department (Ms. Schadler) responded that the initiative to draw the comparison between the Central and East European countries and pre-crisis East Asia came from the Policy Development and Review Department, which was appropriate given their role in the Fund. The chief benefit of the comparison was that it attracted attention, but the European Department had had strong misgivings about the comparison from the beginning. The European Department considered it a useful comparison at the level that it was being made, but agreed that it needed to give way to a more in-depth, country-by-country assessment of the vulnerabilities in the CEECs. A sweeping, regional analysis was insufficient in terms of a vulnerability analysis, because balance sheet exposures and policy contexts varied widely within the region.

Mr. Hauser noted the staff’s remark that the vulnerability assessment should be done on a country-specific basis. While he agreed with the rationale, he wondered whether it would be possible to make greater use of common analytical tools for countries in similar situations, which might help to minimize the past problem of countries in similar situations being given very different policy judgments for no obviously compelling reason. Recalling the staff’s analogy of a car speeding down the hill, he felt that country-specific studies risked a scenario by which everyone would be driving using a different set of rules. He also wondered how regional surveillance exercises fed back into bilateral surveillance; if regional reviews were merely a compilation of individual country cases, then they were of uncertain value. There needed to be some degree of feedback from the general conclusions about regions into bilateral surveillance, which was a topic for future discussion.

Mr. Raczko thanked the staff for a very interesting paper. He agreed that future growth in the European Union accession countries would continue to be highly dependent foreign capital inflows, because it would not be possible to rapidly increase domestic savings, as stated by the staff. Low savings rates were a legacy of central planning, and reflected the need to increase employment and sustain high labor productivity growth over a long period of time. With regard to the latter, he noted that the paper differentiated between the economic policies of the Baltic and the CE-5 countries, and wondered whether those differences had significantly impacted longer-term growth rates. Even if that was the case, he doubted whether it would be possible to implement specific elements of the Baltic countries’ policies, such as a currency board, in countries like Poland. For instance, there were important differences between the post-Communist countries; better growth rates in the Baltic countries partly reflected the fact they were relatively less dependent on heavy industries.

While vulnerabilities had emerged over the transition process, an important benefit of EU membership and eventual euro adoption was the encouragement those frameworks provided toward fiscal responsibility in the Central and Eastern European countries, Mr. Raczko continued. He felt the benefits of membership in the European Union and the euro area needed to be further explored. Noting the staff’s prognosis that it would take Poland approximately 70 years to catch up to the EU average per capita income level, he believed such forecasts needed to take into account the opportunities provided by EU membership to support faster catch up. For example, foreign capital inflows, access to European markets, and labor mobility could facilitate convergence and result in a more optimistic outlook.

Mr. Kiekens agreed that a vulnerability analysis needed to be done on an individual country basis, but also concurred with Mr. Hauser on the merits of employing a similar methodology in cases where the countries shared a great deal in common, as was the case with the Central and Eastern European countries (CEECs). He noted that comparisons, particularly between neighboring countries, could help to mobilize popular support for better policies, for instance to mitigate vulnerabilities. At the same time, he agreed with Directors who felt there were serious limits in the comparability of the CEECs with pre-crisis East Asia. He reiterated his view that it might be more helpful to understand what was behind the success of earlier EU accession countries, such as Spain and Ireland. The staff's argument that one could not readily compare the CEECs with previous EU entrants because the latter group started convergence with more restricted capital accounts was viewed with some skepticism, because foreign direct investment into those earlier accession countries was relatively unhindered from the start. The main difference between the CEECs and previous convergence countries seemed to be impact of aging. Returning to the earlier analogy, if the CEECs were a car headed downhill, then aggregate demand was most probably the brake. Given that private demand was being fueled by credit growth, public demand needed to be tempered. However, in light of the forecast for dramatic increases in aging-related expenditures going forward, particularly due to the cost of pensions in countries like Hungary and in the Czech Republic, the brake would not be able to work well and adjustments would be needed.

The Deputy Director of the European Department (Ms. Schadler) responded to Directors' comments on vulnerabilities. She agreed that cross-country analysis could be very useful to assess vulnerabilities. However, it was necessary to delve into the country-specific institutions and balance sheets in order to understand the differences between countries. On the tool kit suggested by Mr. Hauser, she pointed out there were already a large number of standard items that the staff looked at in connection with vulnerabilities. For example, there was a vulnerability table, and nearly all countries were conducting some form of balance sheet analysis. However, balance sheet analysis was very limited by the available data. If only sector-wide averages on corporates, households, banks, and governments were available, then the analysis was limited to only four variables. Although that was sufficient to detect the beginnings of problems and isolate what needed to be looked at more closely, it made it hard to draw a solid conclusion, e.g., that the Baltic countries were much less vulnerable than the pre-crisis East Asian countries. It was necessary to start looking at the situation in more depth to understand the linkages between the different abovementioned groups and to understand whether those groups were hedged. However, it would be some time before that data would be available.

Financial sector surveillance and more generally vulnerability assessments were also hampered by the fact that the criteria forming the basis for such assessments was not as clear as the criteria the staff typically worked with, the Deputy Director continued. There was a framework to analyze a country's fiscal position, such as debt sustainability, which could provide a relatively clear answer about the appropriateness of a country's fiscal policy. But very rarely was there a clear methodology for evaluating vulnerabilities. The staff would undertake cross-country papers on how to deal with those problems and individual country efforts to address vulnerabilities.

The Acting Chair (Mr. Carstens) made the following concluding remarks:

Today's Board seminar has been a welcome opportunity for Directors to discuss the challenges facing the Central and Eastern European countries (CEECs) of the European Union as they raise living standards to Western European levels. Directors welcomed the staff's comprehensive analysis of the CEECs' recent growth performance, the policies required to support rapid catch-up, and the vulnerabilities that will need to be monitored as convergence proceeds. They also made a number of useful suggestions on how the analysis of these issues can be deepened going forward, including with some case studies, and looked forward to similar regional surveillance reviews in the future.

Directors recognized the difficulty in disentangling the unique forces that shaped the CEECs' growth over the past 15 years, including the steep post-transition drop in output, the macroeconomic and institutional reforms related to European Union (EU) accession, and the benign global conditions in the more recent period. While the CEECs' per capita output growth in the past five years has put them in the upper half of the emerging market comparator group—with the Baltics among the top five performers—Directors cautioned that the continuation of these rapid growth rates cannot be taken for granted.

Directors noted important differences in the pattern of growth in the CEECs vis-à-vis other emerging markets, particularly the lack of employment growth, and the heavy contribution of total factor productivity (TFP) gains. They acknowledged that the convergence experience of other EU members, such as Greece, Ireland, Portugal, and Spain, demonstrates the viability of sustained periods of high productivity growth. Nevertheless, they pointed out that the CEECs' recent TFP growth may have been heavily influenced by the elimination of the inefficiencies of central planning—implying the possibility of some trailing off in the absence of strong efforts to improve the business environment.

Directors emphasized that prospects for the CEECs will depend on how well they do in establishing macroeconomic and structural conditions conducive to sustained growth, which is expected to be based on greater labor use and higher investment rates. They welcomed staff's use of empirical growth models to shed light on the key environmental and policy characteristics that will shape the CEECs' growth prospects. Directors noted that certain environmental features—including initial income gaps, population growth and aging, and historical trade relationships--as well as conditions more subject to policy influence play important roles in supporting growth. Among the latter, our discussion highlighted, in particular, the quality of legal and economic institutions, size of government, real cost of investment, educational attainment and labor market performance, openness to trade, and inflation. While Directors were encouraged that the CEECs do reasonably well in meeting these conditions, they also noted that differences tend to favor growth in the Baltics over the CE-5, reinforcing other indications that a two-speed catch-up—rapid for the Baltics, more moderate for the CE-5—may be emerging.

Directors agreed that the process of European integration will play a critical role in supporting a rapid catch-up in the CEECs. Substantial transfers from the European Union to the new member states are one obvious benefit, but potentially more important will be the benefits from closer institutional, trade, and financial integration with Western Europe. In this regard, Directors were encouraged by indications that thus far foreign savings have contributed significantly and appropriately to growth in most CEECs, and that the even large current account deficits of some countries have been in line with their growth rates.

Directors observed, however, that alongside the scope for accelerating the convergence process are the risks that increased reliance on foreign savings will generate significant vulnerabilities in the CEECs. They noted that large current account deficits are a potential source of increased indebtedness. The use of the foreign savings, therefore, needs to be watched closely, and the composition of current account deficits—including the extent to which they are caused by reinvested earnings on foreign direct investment—deserves careful assessment. The use of foreign savings has also stimulated rapid credit growth both for businesses and, especially for households that have had little access to credit, growing confidence in the future means sizable borrowing to smooth consumption. In this regard, Directors cautioned that, especially in the Baltics and Hungary, various combinations of high external debt ratios, rapid credit growth (with a sizable share in foreign currency), and, in the Baltics, low reserve coverage of short term debt need to be monitored carefully. For the immediate future, Directors were reassured that a number of factors—high reserves in the CE-5, strong fiscal positions in the Baltics, satisfactory competitiveness, relatively high standards of transparency, and well-supervised and predominantly foreign-owned banks—help mitigate these vulnerabilities.

Against this backdrop, our discussion identified a number of policy priorities for CEEC governments. Among them, the need to establish cushions against shocks; to contribute to domestic savings appropriately through sizable fiscal surpluses when catch-ups are rapid; to avoid disincentives to private saving; to support strong financial supervision; to ensure strong corporate governance and efficient bankruptcy procedures; and to increase transparency across the spectrum of economic activities. Directors also encouraged authorities to enact policies that will enable early euro adoption—the growth-enhancing and vulnerability-reducing opportunity unique to the CEECs. They considered that the adoption of the euro by the new EU member states should be predicated on a sound macroeconomic basis. This was seen as important especially to allow these countries sufficient flexibility to respond to asymmetric economic shocks in the absence of an independent monetary policy.

Directors considered that assessing the vulnerabilities associated with rapid catch-up—especially those related to strong capital inflows—will be the key challenge for Fund surveillance in the CEECs in the foreseeable future. Fund surveillance, Directors stressed, should encourage policies that are supportive of convergence, while closely monitoring accompanying vulnerabilities and helping to keep them contained. In this regard, several Directors noted that surveillance should focus on core issues related to macroeconomic and financial stability and its institutional underpinnings, while broad institutional development should remain the domain of development banks. Further, it was noted that Fund advice should continue to be sensitive to country-specific factors, while being mindful of the risk of potential adverse regional spillovers.

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