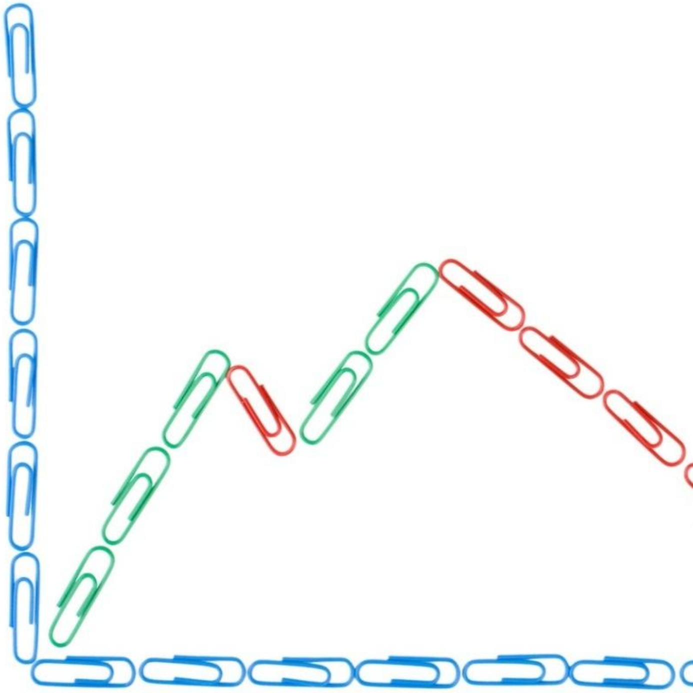
Deloitte.

4 or One?
28 x 1 or 1 for 28?

Changing Europe, Where are Visegrad countries heading?



Luděk Niedermayer

Krakow

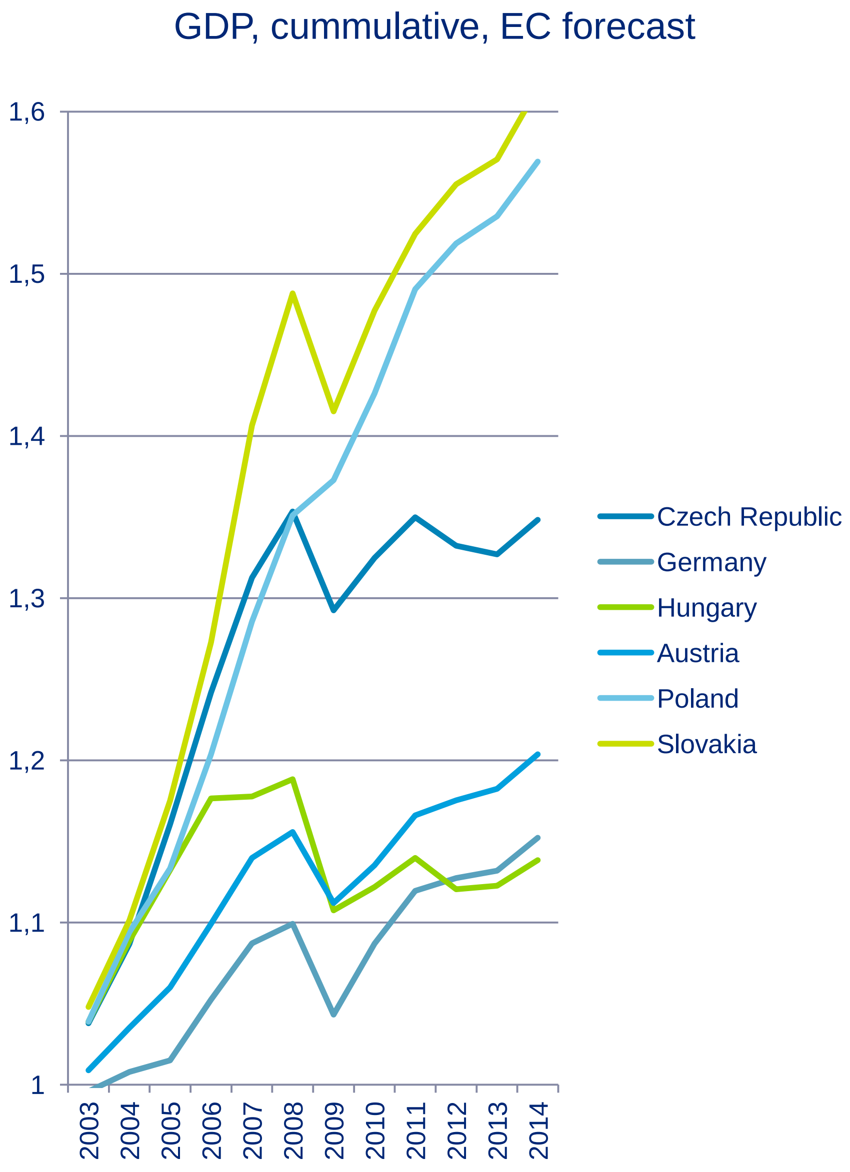
July 2013

V4 now
and in past years…

Who is „heavy weight“ in Europe?

Economy: Good years….

- Fast growing countries benefiting from EU accesion
- Very strong „catch up“ slowed down since crises for Czech and Hungary
- Increased differences in performace after the crises

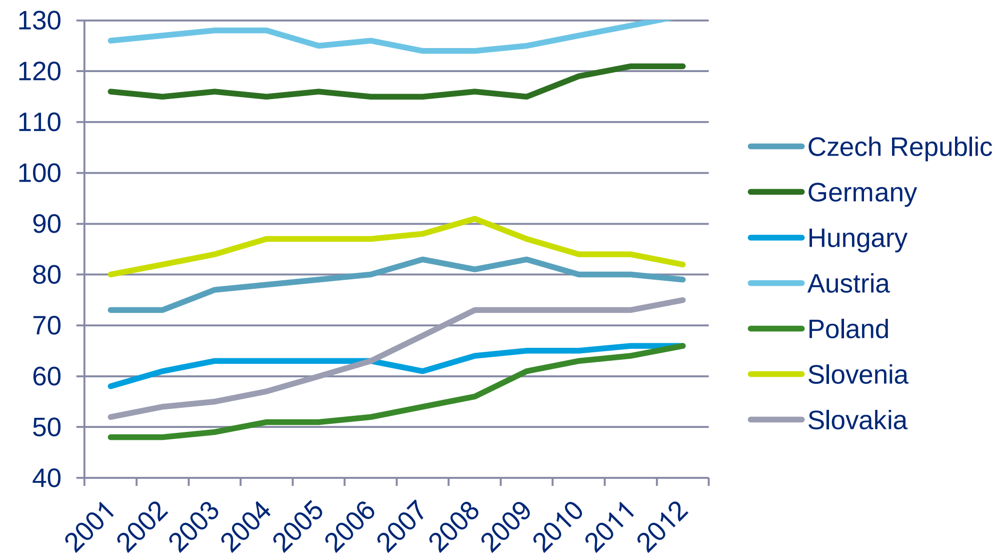


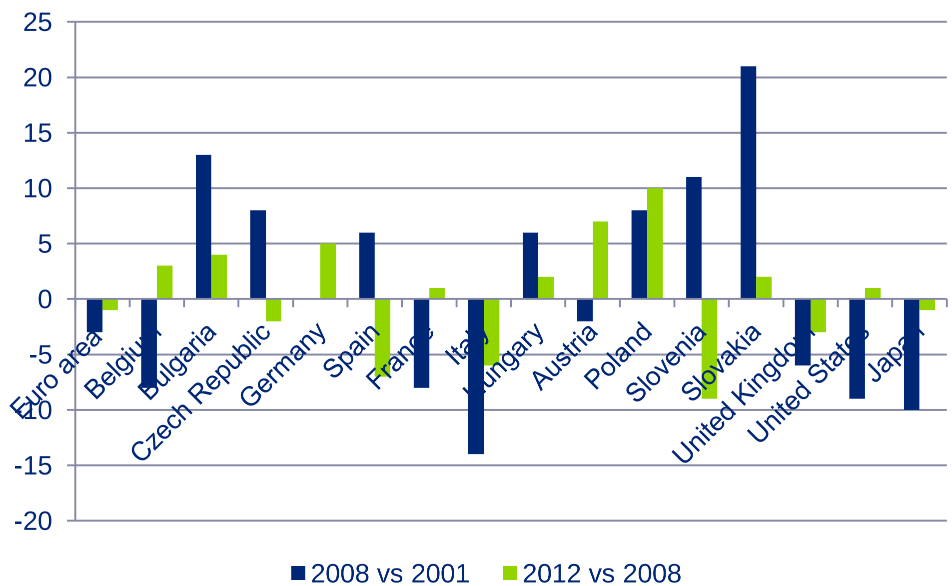
Closer look…

- V4 countries are less rich than „Old Europe“
- They are more rich than new commers (BG is around 45%)

- 2008 was breaking point in „catching up“ story. Group of „improvingů countries has significantly changed

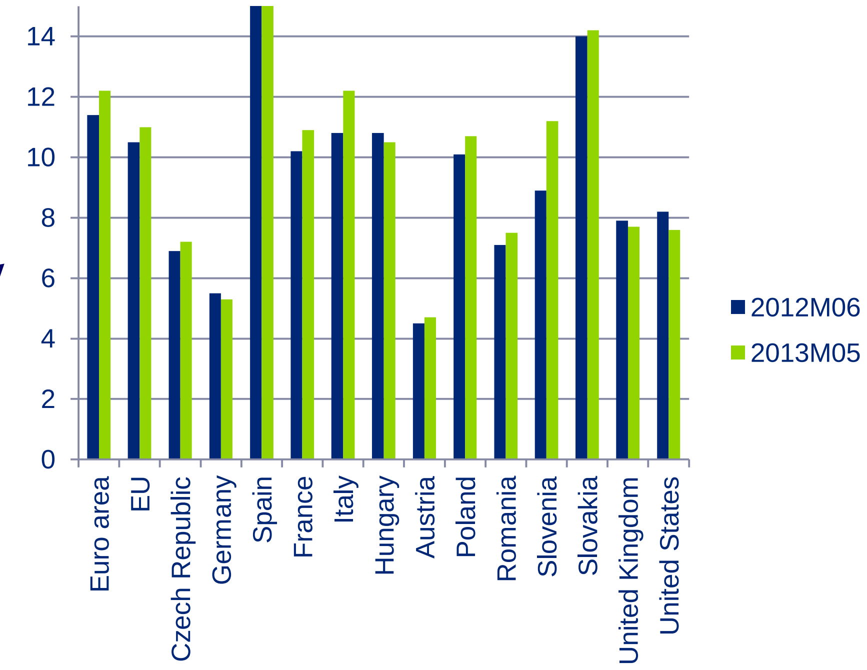
GDP per capita in PPP, against EU average



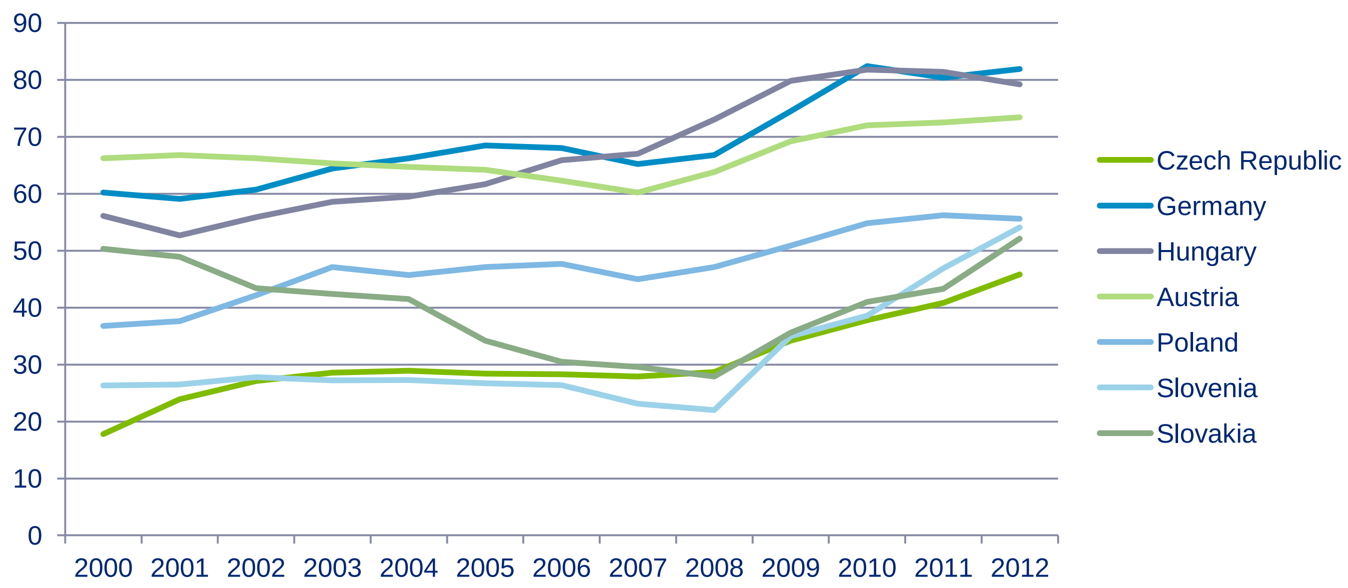


Similar but different

- Big differences in unemployment are showing differences in economics set up and development



- Apart from Hungary, low level of debt to GDP makes countries more stable than most of EU states….



Simplified snap shot….

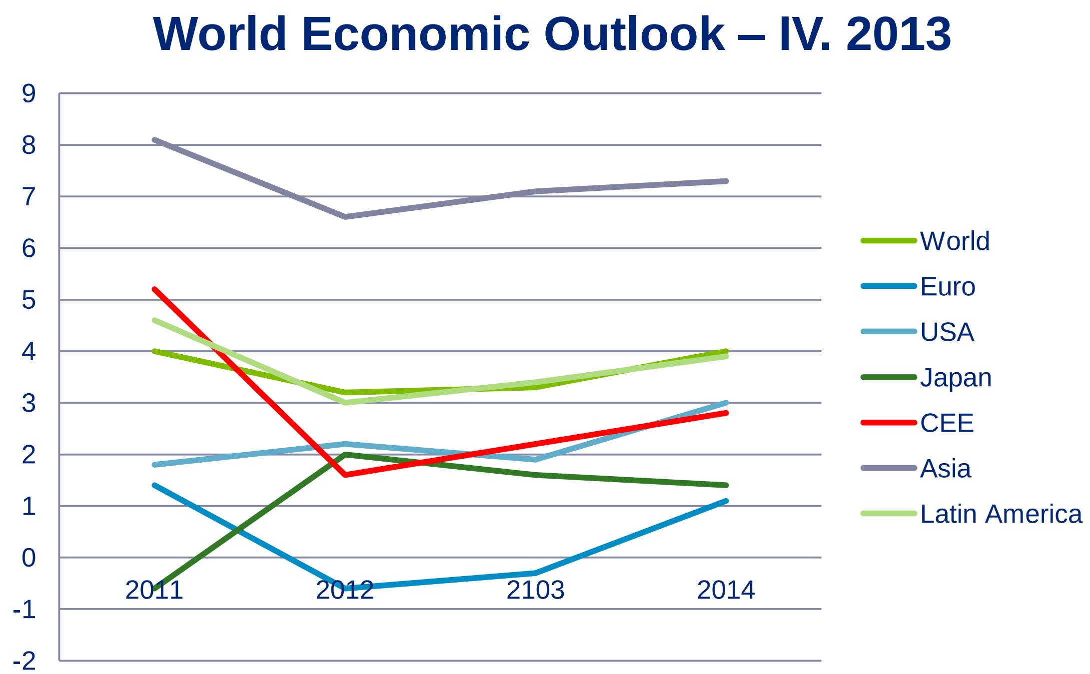
- Poland
  - Large market, political heavy weight
  - Star performer in growth during crises, but can be heading to „trouble waters“
  - Relatively good political situation
- Czech Republics
  - Very weak growth since crises
  - Good macro politics since 90s
  - Richest, very open, but facing problems in area of governance of the country
- Slovakia
  - After bad 90s, champion in growth, not in level of unemployment
  - Very good reforms years ago are still bringing benefits
  - Less advanced structure of economy and extensive growth – issue of sustainability
- Hungary
  - Too many crises in last decades
  - „Very special economical policy“, but performance better than expected
  - Future development is unclear

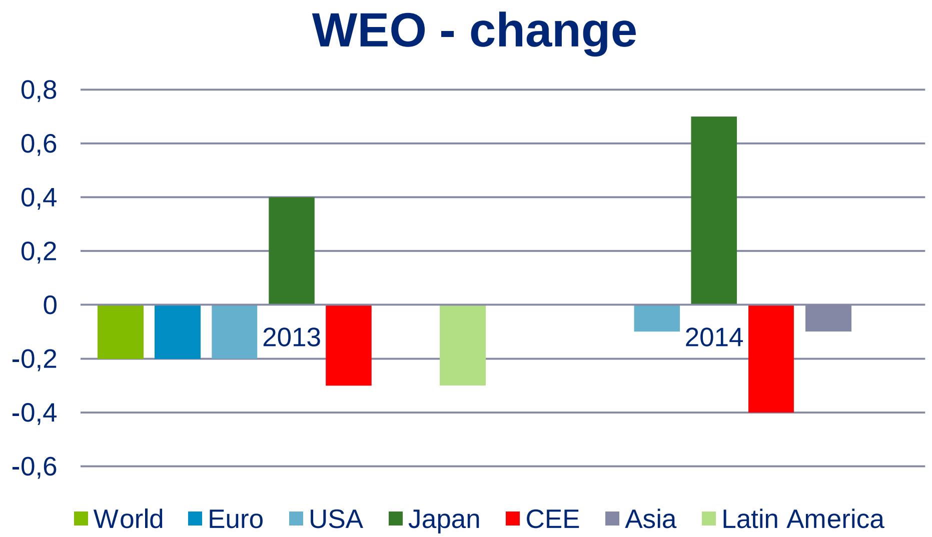
Global economy,
Post crises time….

Global economy
By IMF, WEO April 2013

- •Global economy will speed up in 2014
- •But most countries expect lower growth than 6 month ago
- •CEE countries are not high speed economies anymore

- •Economies are diverging:
    - •US economy will growt, challenge can be timing and extend of fiscal and monetary tightening
    - •EM will slow dow, causes are different
    - •EU is sick men of global economy





Future: fragile economy, but no crises….

- Risk, challenges and oportunities are different in different part of global economy:
  - Will US economy handle well more tight fiscal policy and switch off of monetary stimulation?
  - How will China deal with expected slow down, that will most likely take place (demography, if no other reason), what will be outcome of weaker growth on stability of the economy and society?
  - How will EM market deal with decline of prices of raw materials and possible normalistation of monetary policy?
  - Will Europe be able to handle debt crises (better than so far), and how fit are European banks?

  - *No special challenges for CEE, as there is not too much of similarity in their development. In the long run, chnage of „growth model“ from extensive, by low costs driven growth to more advanced, less extensive and more stable one can be challenge*

Economic policy now: Text book questions…

Consolidation or growth?

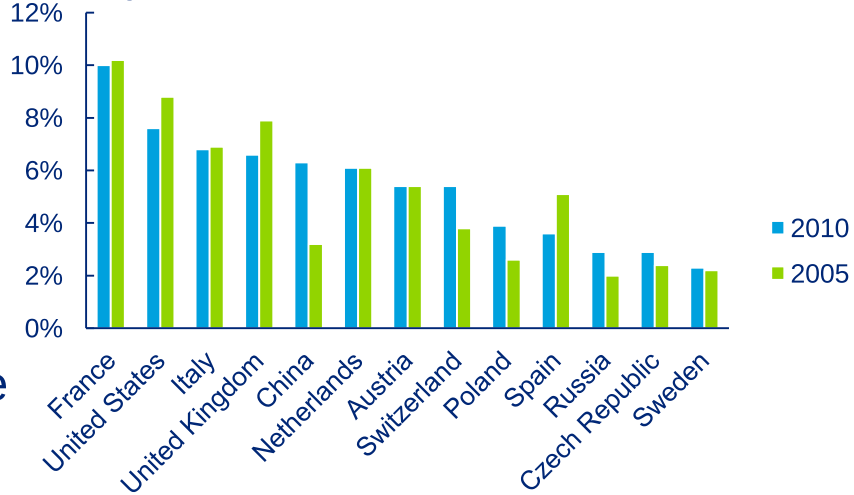
- Growth camp….
  - Growth of the economy makes fiscal consolidation easier and reduces risk of deflation trap
  - Stable economy and society makes reforms easier
  - Overdone consolidation can bring economy to „free fall“
- Friends of consolidation…..
  - Need to consolidate is known by agents in the economy, postphoned consolidation will just increase the uncertainty and after all costs
  - Government has very little tools how to support growth in the short run
- Size matters…..
  - Risk of waiting for too high growth
  - Risk of too much of stress on fast consolidation
  - Risk of market financing

So far, US economy is handling post crises situation better than EU..

Export: the best source of growth?

- Role of exports can be overestimated, structure of economy matters

- USA economy is closed, exports to GDP stands on 13%, imports are 16%
- Better net exports can help, but not drive recovery



- 59% of German exports went in 2011 to EU, 71% to Europe, 16% to Asie
- Export and imports to GDP in EU are 16 %
- Proportion of exports to non EU markets is expanding, but they can hardly substitute demand from EU markets
- In 2011 top 3 export markets for Germany (France, USA a Netherland) made 23% of exports, China was No 5 after UK

Common market of EU EU:

- **500+ milion population (7,3% of world)**
- **GDP of EU is 16 242 bil. USD (2010) - 20% global GDP in PPP**

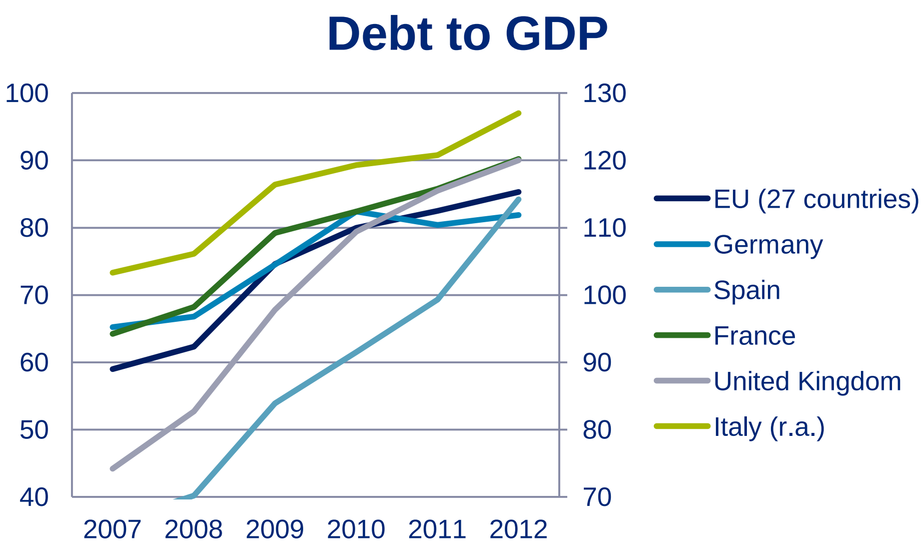
Europe and its debt crises

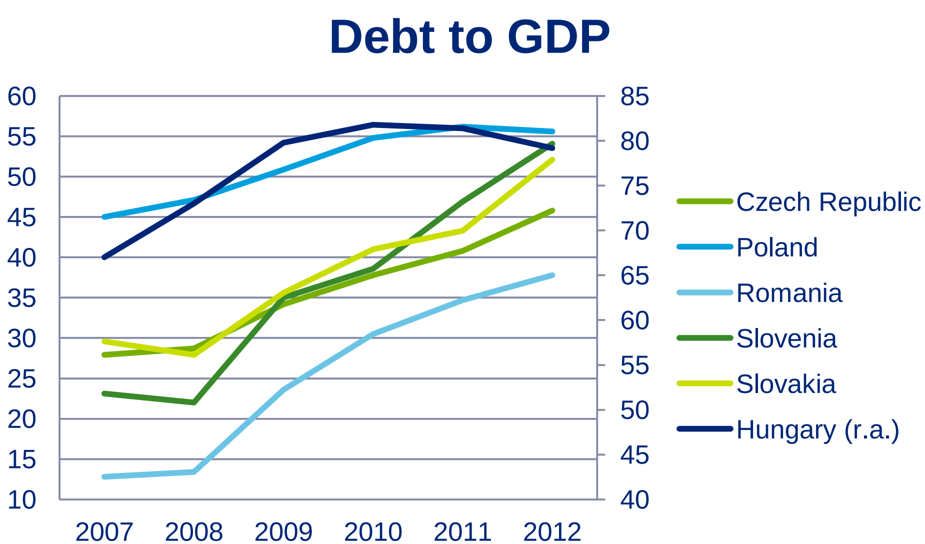
Good news, bad news…

- EU fiscal consolidation does not take place in a coordinated manner and is less predictable, its speed is relatively high (especially to the growth of the economy)
- „EU Crisis management" has elements of chaos and randomness
- Due to single market, countries are influencing each other
- So far, the development in countries under stress has brought different results:
  - Spain has reoriented sectors of the economy and macroeconomic indicators (not deficit or unemployment) improved a lot, so Spain can be well on way to stabilize the economy
  - In the case of Italy decrease of macro imbalances is caused by fall of demand, positive the impact of relatively good environment "core EU" is limited, but some reforms are under way
  - In the case of the Balkans, strong links of countries with each other)and less with core of EU) "help" them into a deeper recession and financial crisis (Slovenia, Croatia)

Without existence of single market and with possibility to implement protectionist policies, the situation would be much worse… Many economical mechanisms linked to Union do work quite well (mobility, conditionality, learning by examples etc.)

Way out of crises: debt stabilisation and sustainability…





- The level of debt to GDP since the crisis has increased considerably
- For most countries the growth of debt is gradually slowing
- Stabilization complicates weak growth economies

- The new EU countries are mostly (Hungary) less indebted than the EU average
- The growth of debt raises fears in Slovenia, Hungary budgetary improvement achieved by the work of "non-standard„ tools, to some extend

Dealing with debt crises in Europe…

- Fiscal consolidation was not planned but imposed by weak macro conditions in many countries, however, there is no alternative (funding requirements are high)
- Although Europe's economy is highly dependent on each other, „everyone is fighting for himself“. In addition rules – reqirements - goals are changing
- The risk of a significant drop in demand (restrictions and expectations) still exists, and would affect not only by the country in which it occurred. Greece is example

- The optimal model for each country for fiscal consolidation does not exist
  - If in the private sector deleverages massively, slower process of fiscal consolidation may be rational
  - Also the structure of consolidation plays important role, government often are able to implement mostly measures, that are more costly, and not good structural policies, benefitial for countries

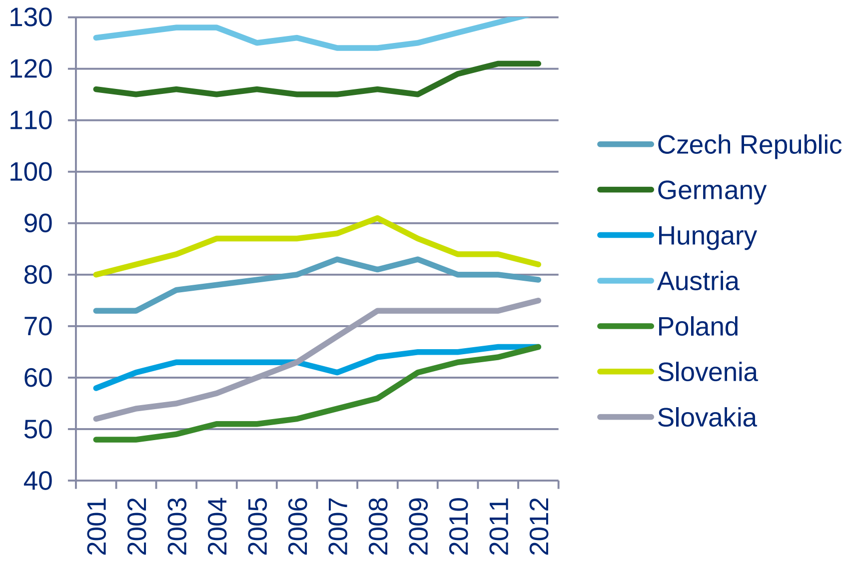
- Pre-crisis trend growth can be out of reach for most states, that can be important
- New EU rules define a comprehensive framework for economic coordination. Their effectiveness can not be assessed so far. Changes are under way

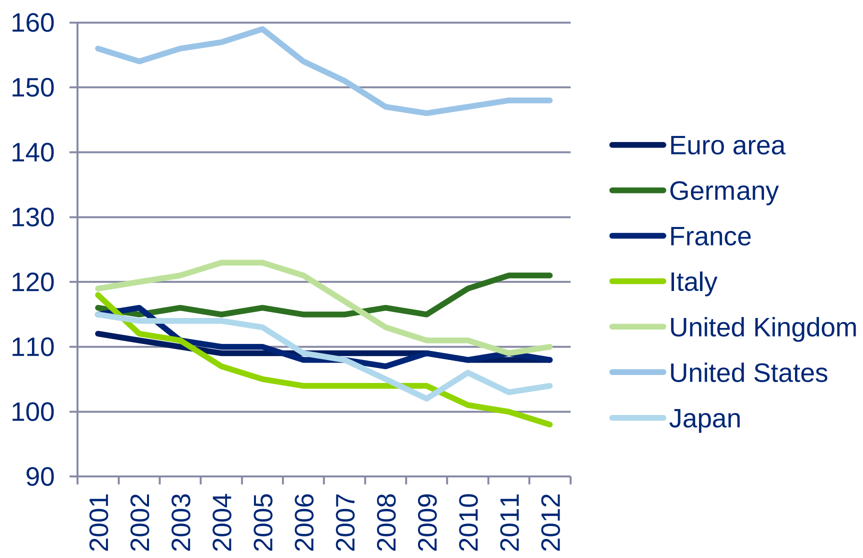
Visegrad and EU
Some basic facts…

What is similar…

- GDP in PPP (against EU average) is growing, mainly before crises
- Two richest „new member“ states – Czech and Slovenia – are in troubles

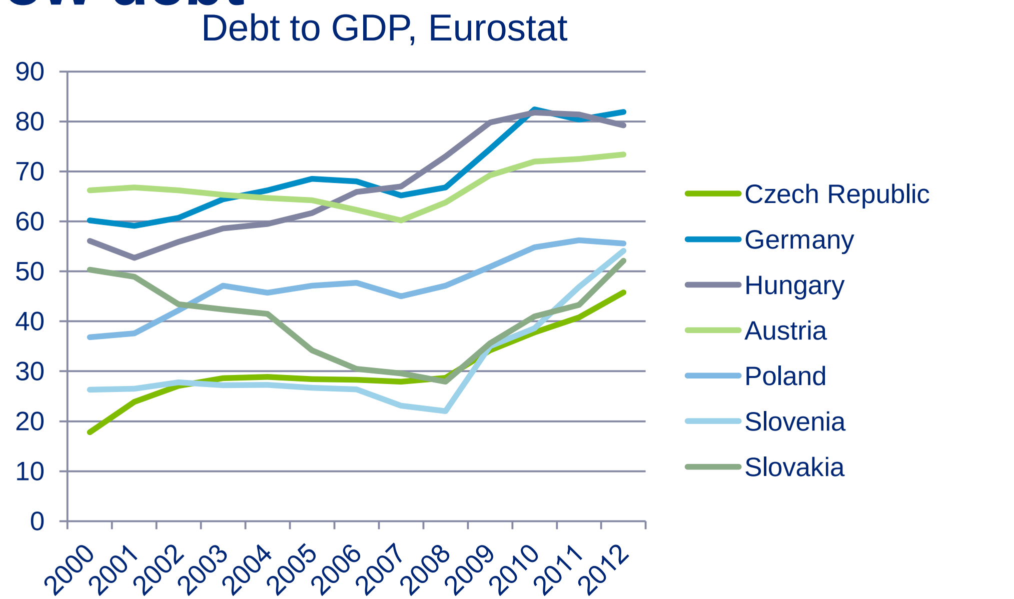
- Development in large old EU states, with exemption of Germany, is different
- Since crises, more divergence in both groups



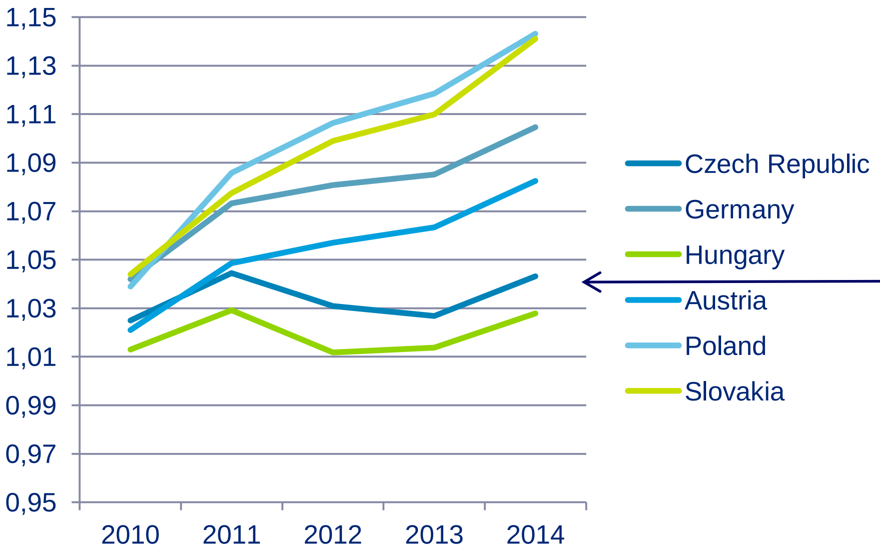


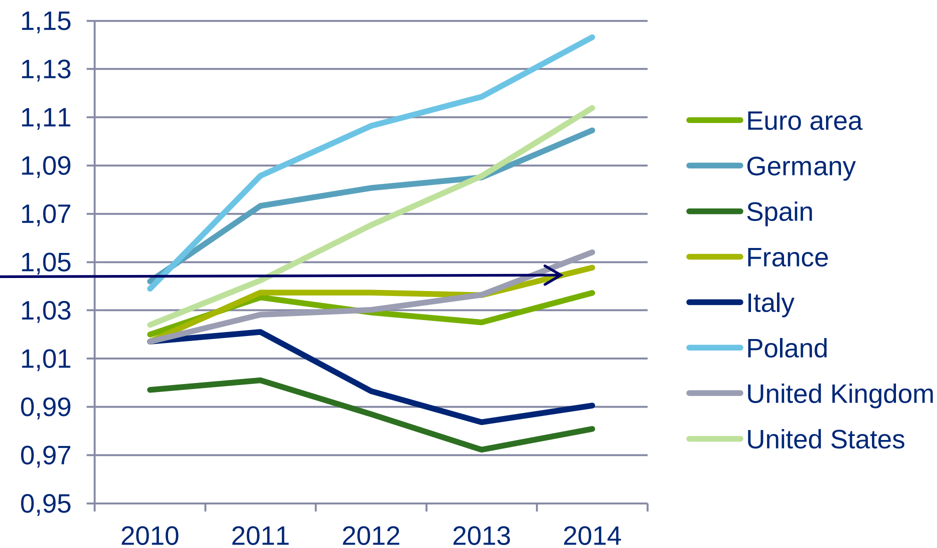
GDP since crises, mostly low debt

- Appart of Hungary, debt low or even very low and is not source of sustainability concerns
- GDP since crises shows divergence among V4, half of V4 growt similar to EU at best



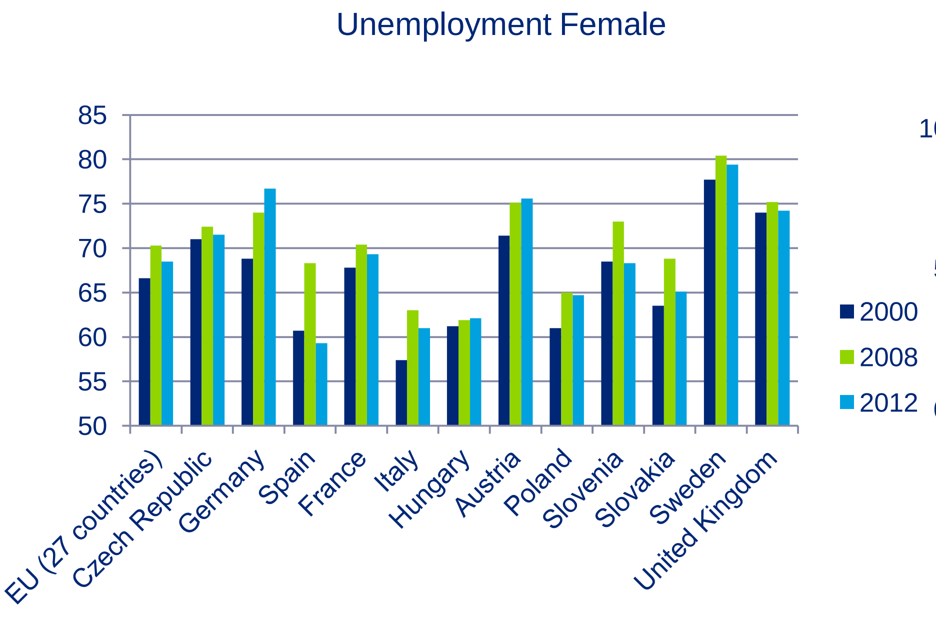
Cummulative GDP growth including forecast, EC

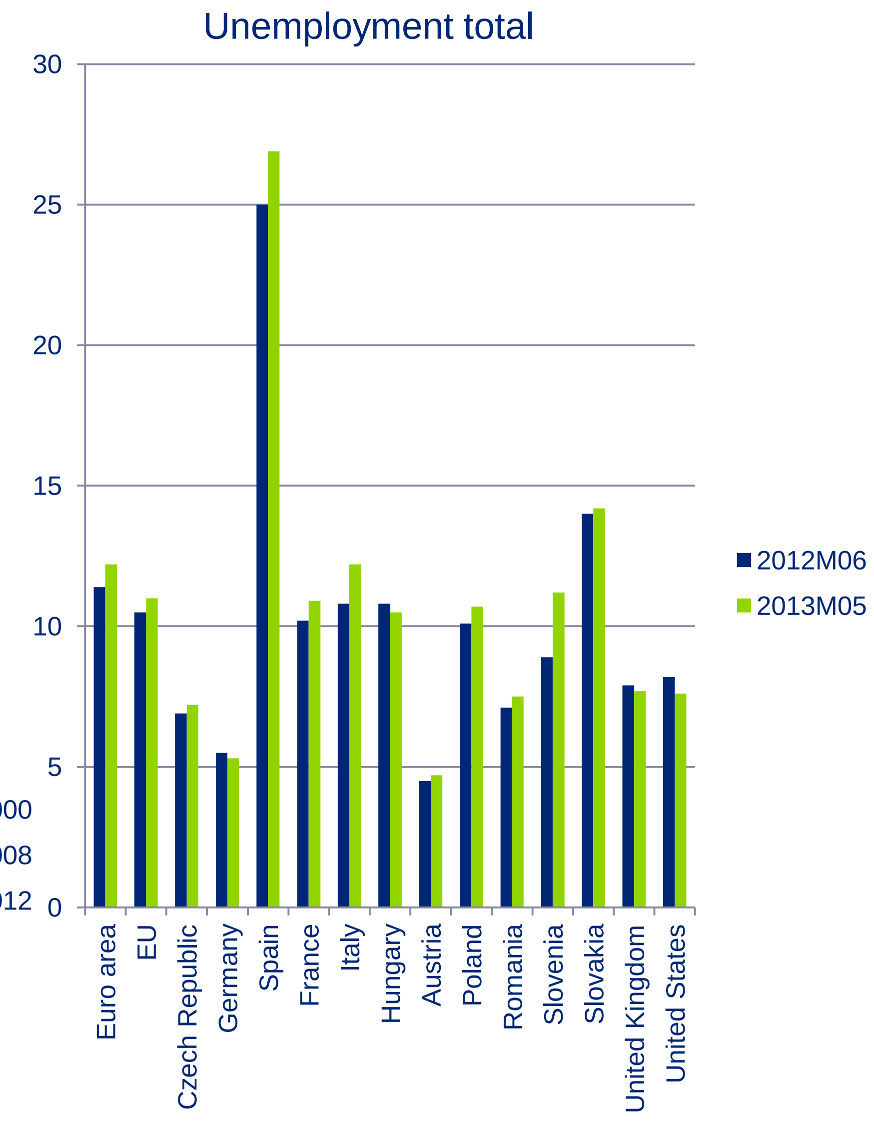




Different labour market…

- Czech unemployment low in EU standards, Polish and Hungarin average, Slovak very high
- Different structure of labour market and economy ilustrates also emploment of females

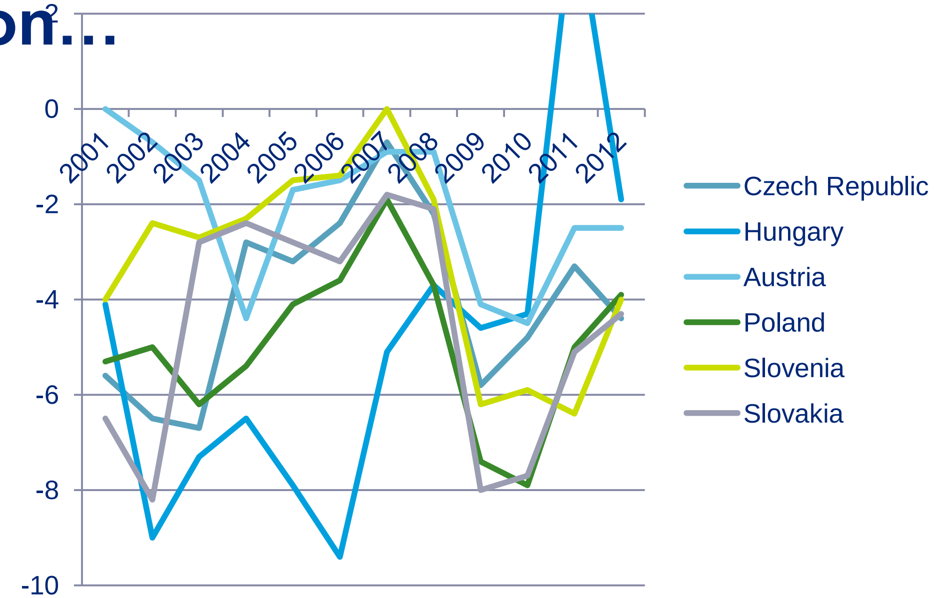


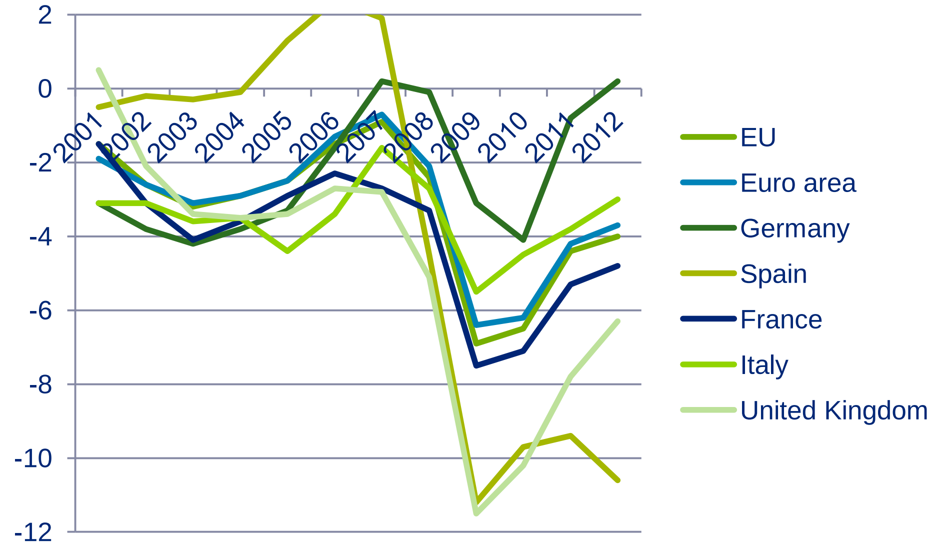


Fiscal policy – more variation…

- Different levels and trajectories of fiscal consolidation among V4 (lower respect for rules in V4 than in old EU?)

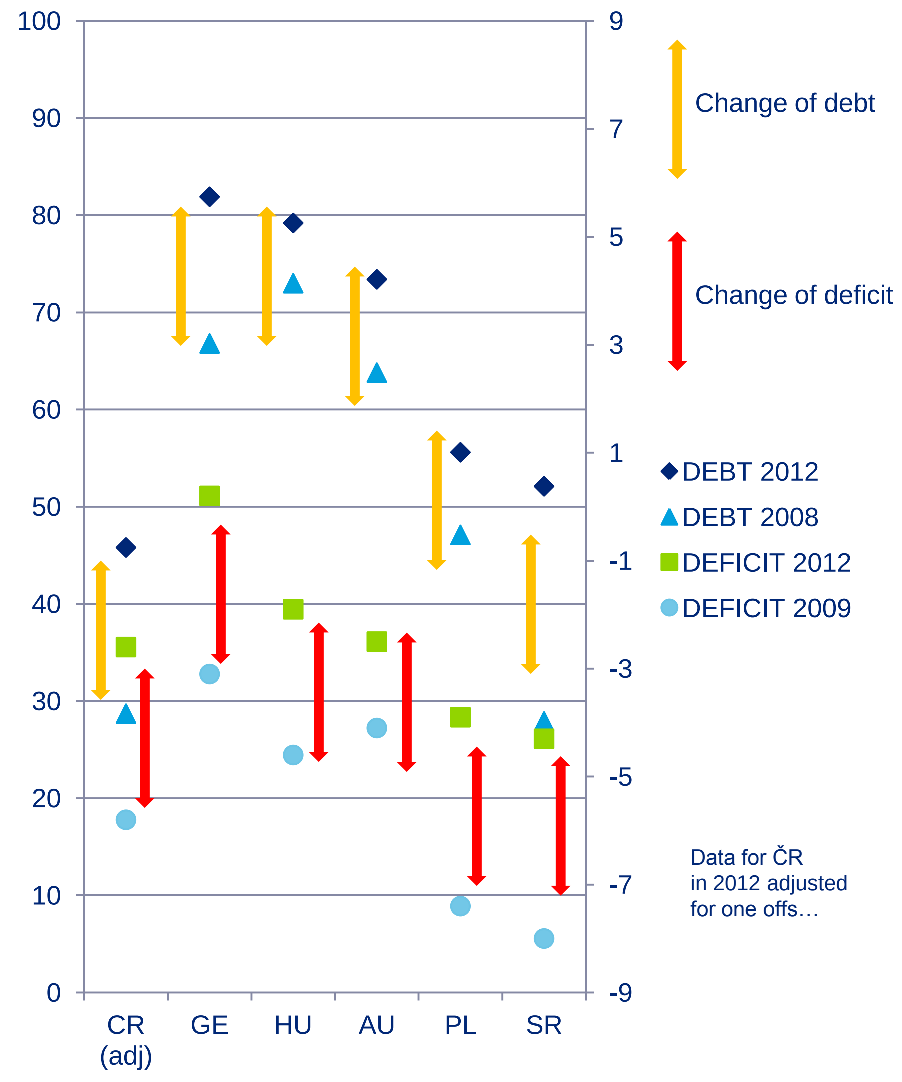
- Less divergence in „old EU“
- In „Old EU“:
  - UK and Spain are outliers on weak side
  - Germany on strong side





V4 Mid term consolidation report…

- **Poland and Slovakia improved fiscal situation, and kept rapid growth**
- **Improvement of deficit can be less structural, real test of progress will come with slow down of economy (on the way)**
- **Czech growth has suffered a lot, but even so, improvement is „average“**
- **Due to „unothodox“ policy in Hungary it is hard to say how robust is improvement**



Summary..

- V4 countries were performing very well, especially before LEHMAN crises
- Since crises, there is more divergence (half and half)
- Economic policies and political preferences are very different within group:
    - Poland has managed float, pragmatical economical policy and is relatively pro european. PLZ helped economy during crises
    - Czech has also managed float, CZK supported the economy (unlike before). Policy is rather conservative (mainly fiscal) and politicians are more or less anti euro – EU
    - Slovakia is member of eurozone, policy is pragmatic. Also EU policy is rather pragmatic, more or less main stream
    - Hungary has managed float, HUF is undermined by weaker fundamentals. Policy is „unorthodox“, results are hard to estimate. Same for EU policy

- Macro econom policy can hardly explain large differences in economic performance. Also, these days, sustainability of growth in some states could be an issue…

EU – dealing with crises…
V4 – is there role to play?

Why is dealing with crises difficult – 3 key channels

- **1. Risk of speed of fiscal consolidation. More is not always better, too lax policy can be bad either**:

Fiscal consolidation – slow growth – less revenues, need for stricter policy – even weaker growth

- **2. „infection“ from weake countries / Grexit. Does not help, make more troubles for all**:

Big troubles in weak country – more troubles for some other states – growing risk for most of countries – EU credibility falling

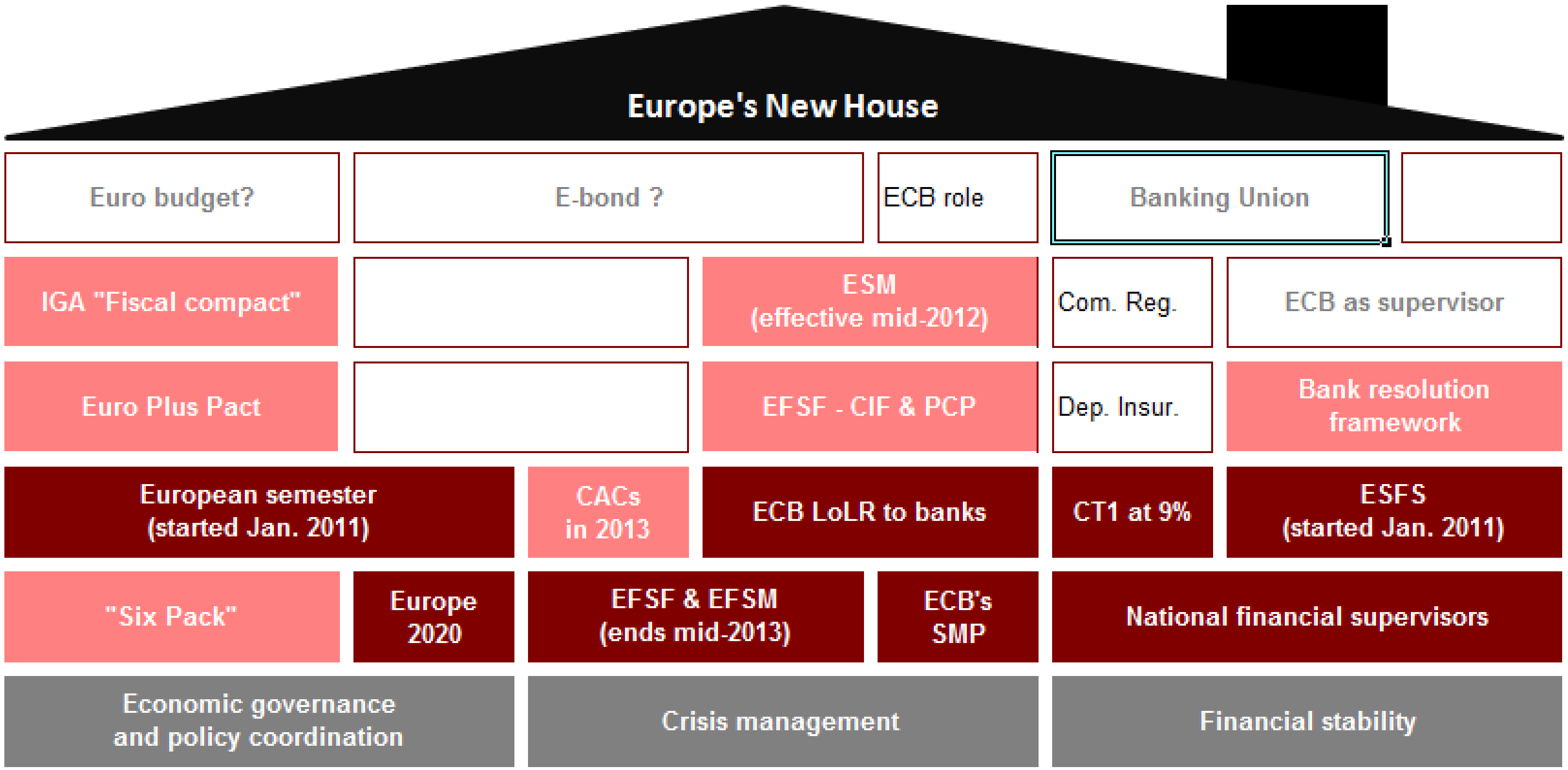
- **3. Fast track – fiscal/banking channel** – fall in price of government bolds is bad for everyone except some financial market players:

Increase in risk premium – losses of banks and fical costs – credibiliry of banks falling, credibility of state falling – banks in troubles – recesion

EU: heading forward? Or keep arguing?

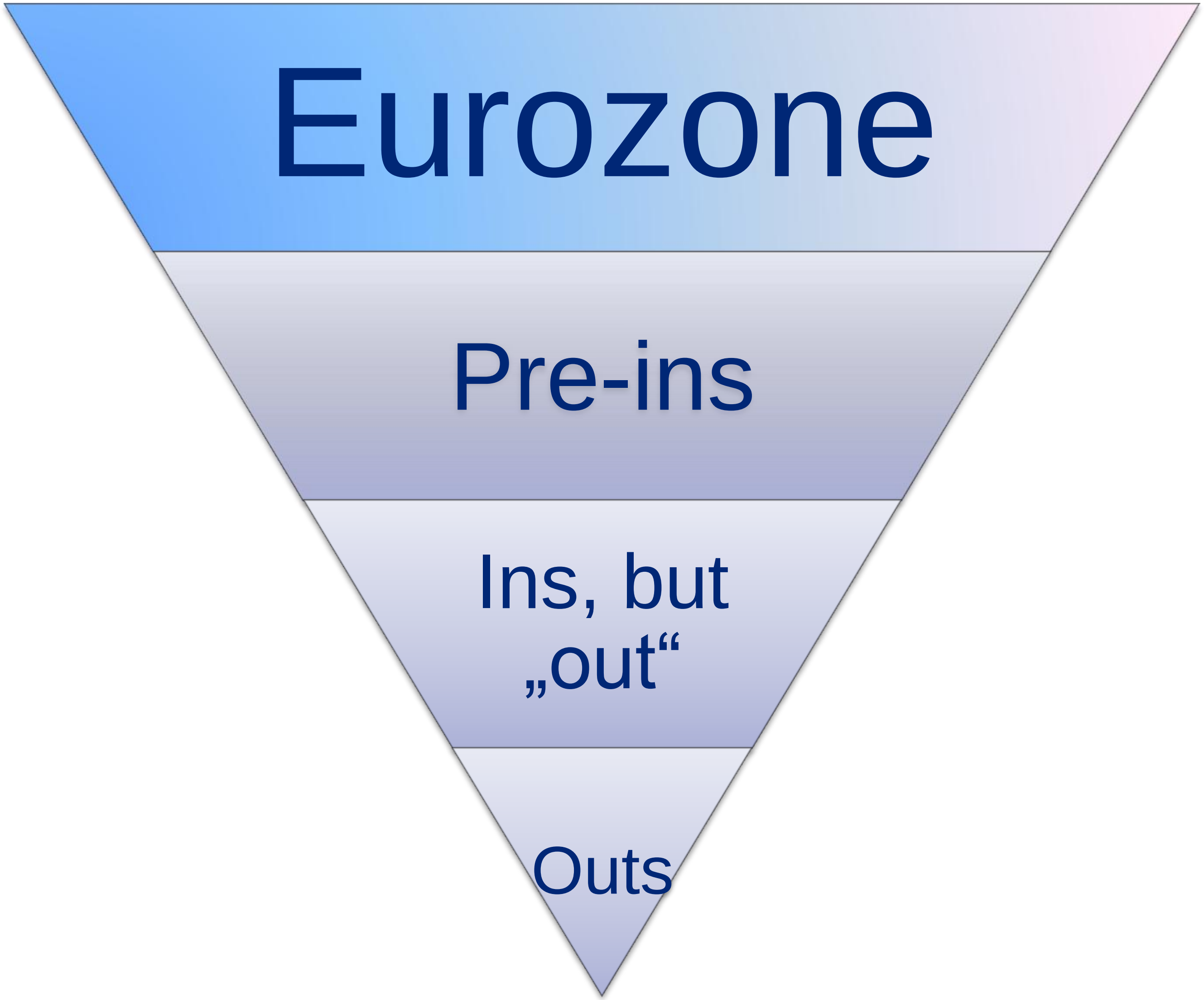
- Calmer the situation at the beginning of the year was replaced by Cyprus crises and Italian elections. Now, things are again better
- The political cycle in the EU (Germany) reduced the Union's capacity to act. In the event of crisis there is a considerable politicization of the issue and the conflict of two opposing legitimate requirements:
  - The need to quickly stop the rising interest costs and the risk of spill over
  - Inforce sufficient real economic reform first, help countries latter
- Moreover, the growing disparity in attitudes towards what constitutes the Union. But the core of the euro area so far is more unified…
- Since the crisis, there were significant changes in the economic architecture of the EU. These changes contributed to the stabilization of Europe, but their effectivness must be judged only after the time:
  - Significant adjustments are fiscal and macro-coordination (two and six pack),
  - Willingness ECB support government bonds of some countries (September 2012)
  - „Banking union"?

… progress yes … clarity no … elegance not great …



Europe is building a new framework based on three pillars; (1) economic governance and policy co-ordination, (2) crisis management and (3) financial stability. Dark red indicates the facility is operational, light red soon to be finalised, white elements not begun but we expect will come

Possible future of EU?



Baltics on the way
the euro area, Denmark
in fact rather "in".

Poland as a key country which is outside the euro area, but is building its influence. It is the main player in this group.

Czechs are there.
Strong "out position" of Britain, shift towards "out" in Sweden, the unclear position of Bulgaria and Romania. Hungary "completely out".

Countries like Switzerland have higher degree of independence,
but in some ways
EU policy has to be unconditionally accept there witout right to influence it.

Other options

- Flexible geometry
  - Reflection of British position – desire to move some responsibility from Brussels back to member states
  - Idea is to provide states with possibility permanently exist from some policies
  - None have more detailed idea (including Britan?)
  - It would for sure undermine the single market (priority of Brits) and likely it will make union less unstable during the time

- As it is
  - Eurozone will be more coordinated, sometime outside of legal framework of EU
  - Some countries outside will try to block process as they
    - Do not want deepening of integration
    - Will want to have its say in future shape of EU-eurozone
  - Solutions will be find on case by case bases
  - But general bias will be towards deeper integration

- Smaller EU
  - Possibility, but quite difficult to imagine all the consequences. Stability can be an issue

Where is EU heading? And what is future for V4 countries

Some of current risks of EU development…

- More risk areas for EU future, as seen now:
  - **Political dimension in the context of crisis management**
    More or less cooperative approach prevails in crises management after all, but it usually occurs as a difficult compromise reached „in last minute“. There is a risk that in some future case can such a approach fail and crises will grow into unmanageable extend (politically and economically)
  - **The risk of deepening of economic crisis in EU**
    Recession is relatively moderate in EU as whole, but economically weak countries can indeed lead Europe into a deep recession with unpredictable economic and political consequences
  - **The risk of new models of the Union**
    Concepts of "variable - flexible geometry" may be less stable than it seems, and may lead to the dissolution of the Union in areas in which are key of economic function of Union
  - **Risk of "business model" of Western economies**
    We can not exclude the situation that so far successfully continued deleverage of western economies is not sufficient for their sustainable development – for restoration of sustainable growth. This scenario would not be beneficial not just for western countries, but even for global economy. Ability to innovate or flexibility now be visible for example in the USA, are reducing this risk

What is in the EU do list?

- Key priorities that must be on the table
  - **Better coordination of fiscal and macro policies**
    Regulation approved, but not fully effective, future enforcement can be an issue
  - **Banking Union**
    Proposal in the approval process, final shape not clear. Weak EU banks can undermine the economy. BU de facto means some federalization of some costs now national. Politic dimension is there, and is not discussed a lot
  - **Competitiveness of EU and its member states**
    It is part of new economical coordination. Setting up goals or monitoring variables can be tricky and has political dimension. Also the ability of states to deliver the results is not convincing. On the top of that, there in no „one fits all“ in reform agenda
  - **Resist temptation „do more“**
    Clear issue for today is not increase regulation, but enforce one, that already exist (and make it better). Even some recent regulations have failed (fiscal area)

- Strategic issues
  - Deepening of single market, defense, foreign policy, environment inside and outside etc.…

V4 and EU challenges

- Like in all EU, „everyone has its own fight“
- Also, euro skepticism is on rise in most states (excl. South)

- Different state of economy makes top agenda for V4 states different
- Very different perception a strategy towards euro make things even more difficult
- In some concrete issues, the short term political agenda can also prevail

- As the consequence, for the time being, potential „joined agenda“ of V4 in most discussed strategic issues is very limited, in my opinion
- At given stage, countries not participating in the EMU are „out of game“ in many areas, despite of fair effort limit this situation

- Cooperation in concrete issues can be still possible
- Also debate about long term strategy of EU among V4 would be relevant, but is often prohibited by very political (ideological) stance of government
- Potential of V4 is not used and I do not see the change

Who could be „heavy weight“ in Europe?

Thank you

Ludek.niedermayer@email.cz