



Is the investment boom in Central and Eastern Europe sustainable?

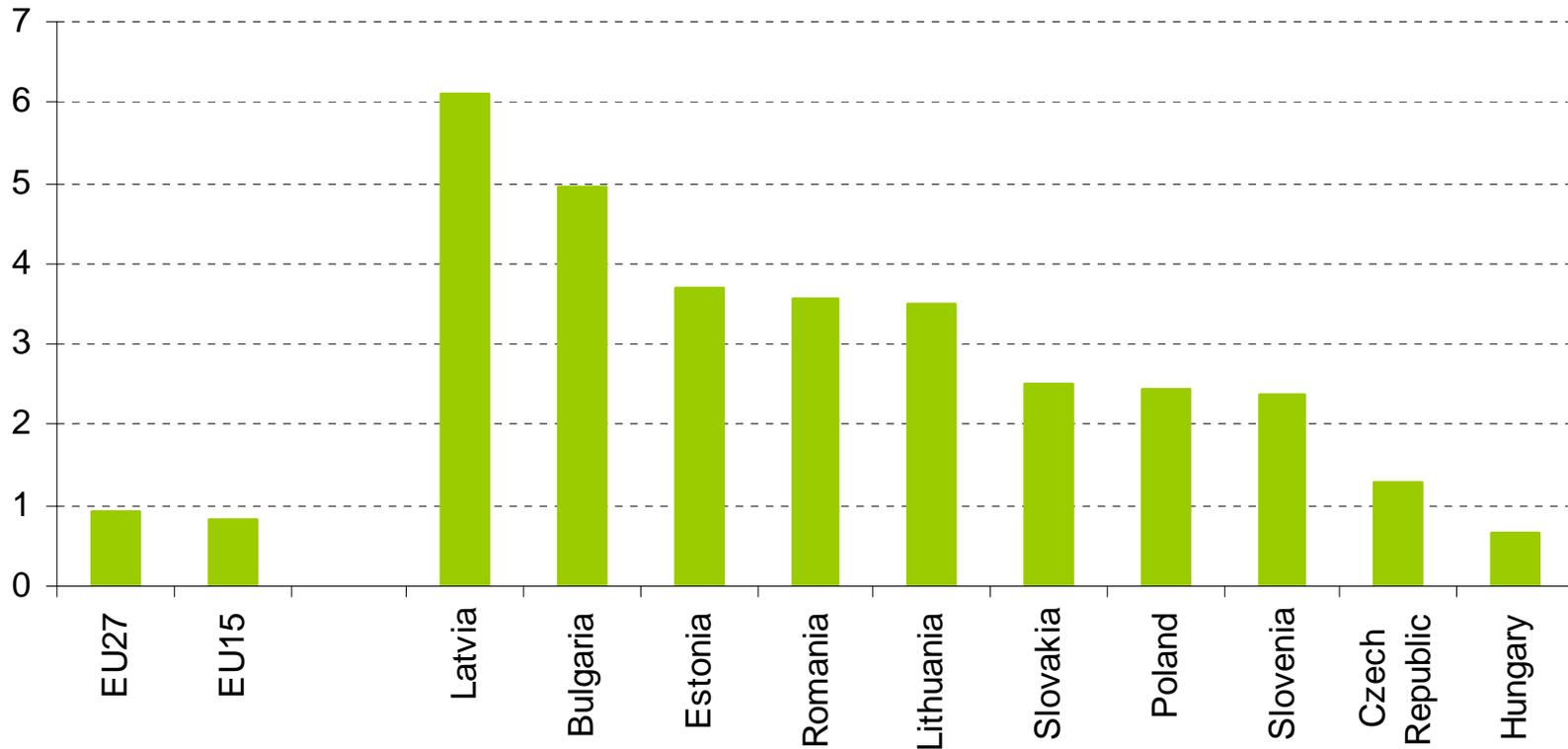
ICEG-EC Conference

Brussels – 14 May 2008

Marc Stocker – Economics Director

Capital deepening: a key driver of growth in Central and Eastern Europe (CEE)...

Contribution of fixed capital investment to annual GDP growth
(average 2004-2007, %)

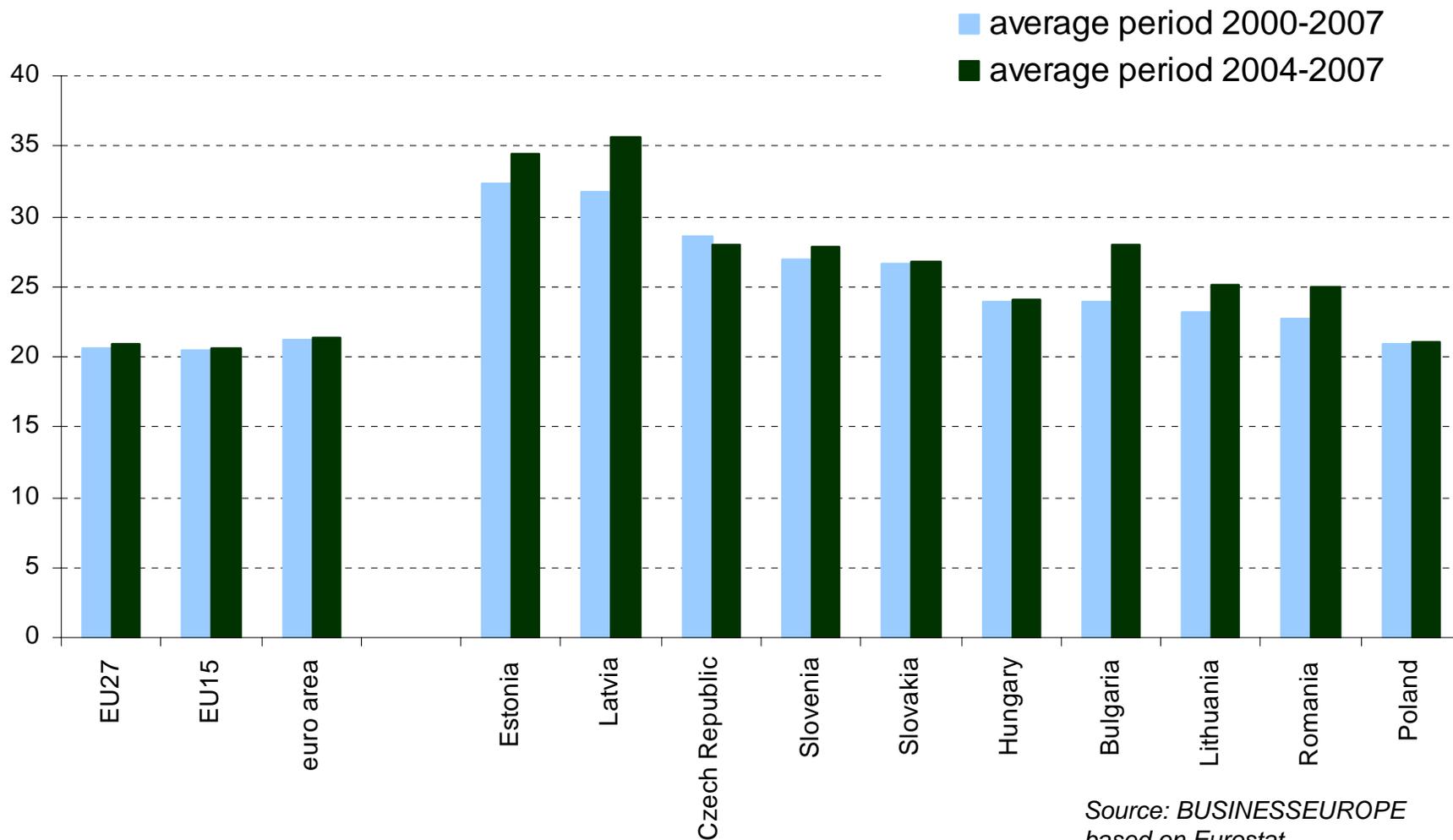


Source: BUSINESSEUROPE
based on Eurostat



Investment rates are higher and increasing faster than in the rest of the EU...

Share of fixed capital investment in GDP (%)



Source: *BUSINESSEUROPE*
based on Eurostat



EU Structural Funds will have a significant effect in the years ahead...

EU Cohesion Policy-related expenditures in percent of GDP 2007-13 programming period

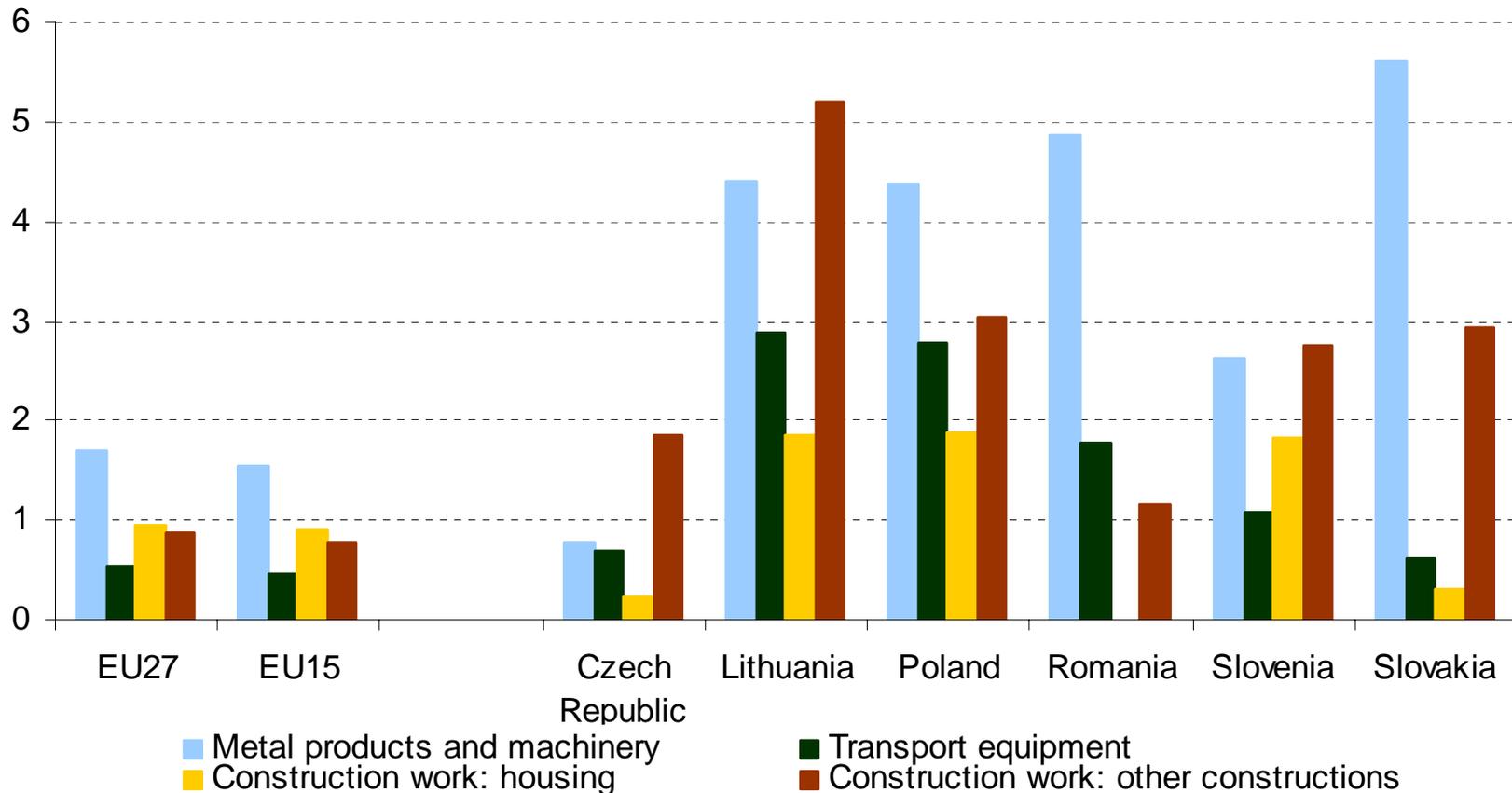
Average 2007-13	
Bulgaria	2,4
Czech Rep	2,4
Estonia	2,3
Latvia	2,3
Lithuania	2,5
Hungary	2,9
Poland	2,4
Romania	1,7
Slovakia	2,4
EU 9	2,4

Source: ECB



A marked contribution of machinery and construction investment...

Contribution to fixed capital formation (average 2004-2007, %)

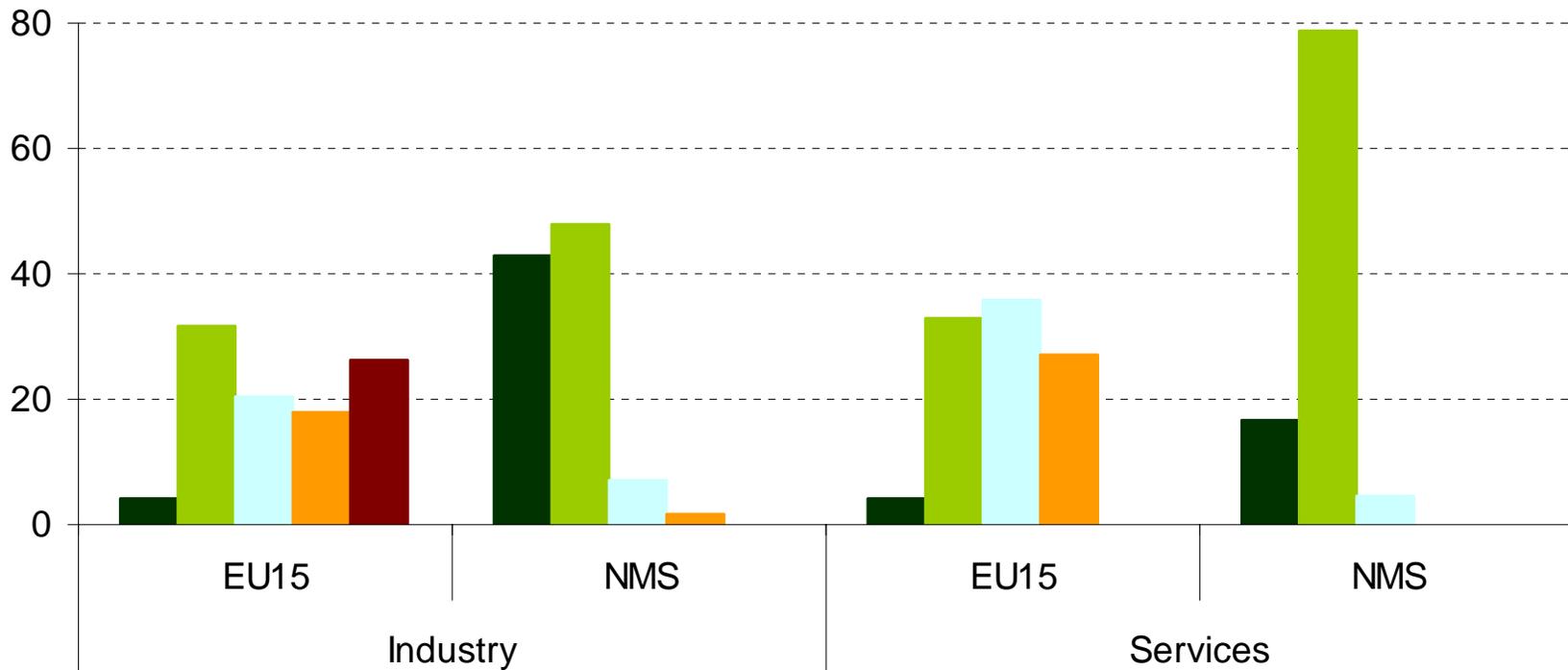


Source: BUSINESSEUROPE based on Eurostat



Investment trends continue to be positive in the short-term...

Investment intentions over next 6 months
(% of weighted replies)



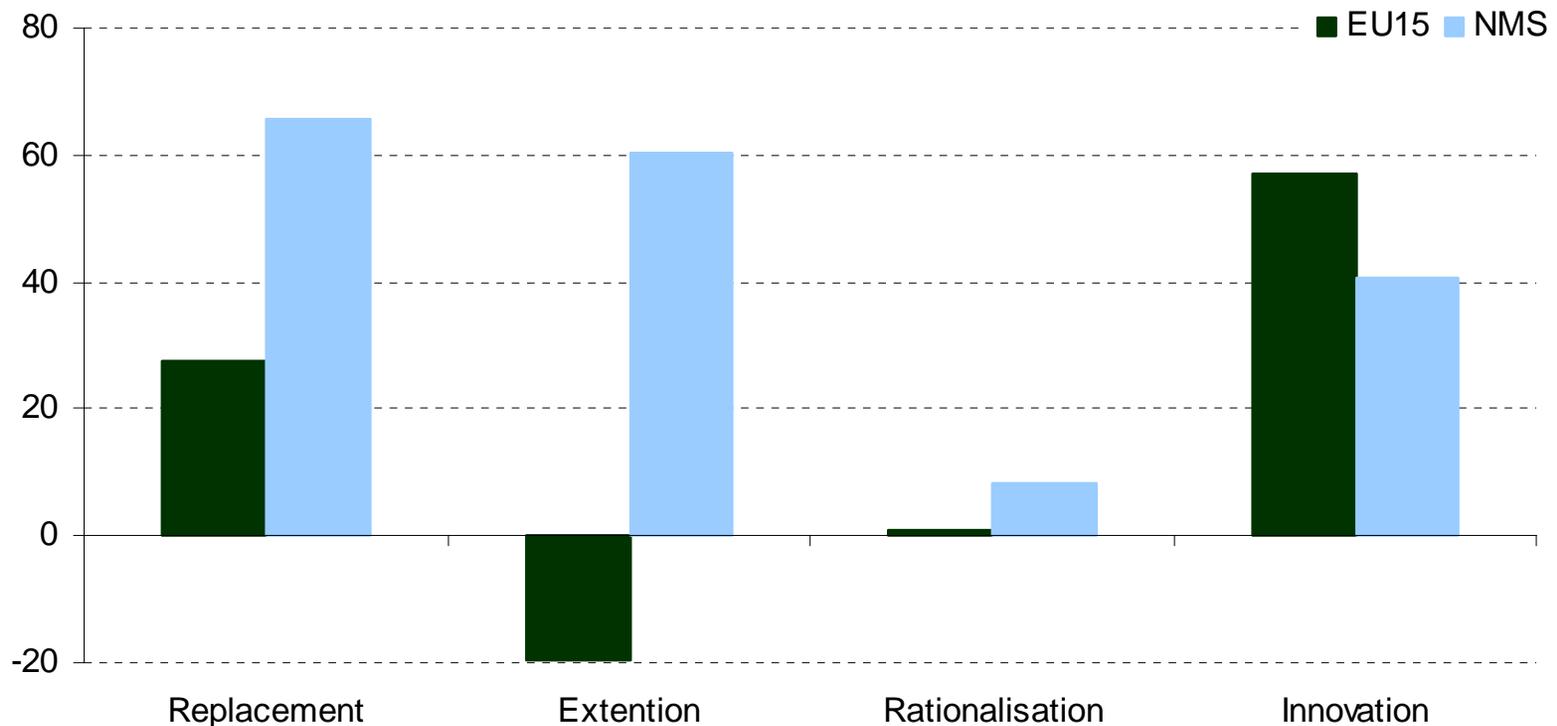
Increase (faster pace)
 Increase (lower pace)
 Unchanged
 Decrease (faster pace)
 Decrease (lower pace)

Source: *BUSINESSEUROPE Economic Outlook (Spring 2008)*



Extension and replacement of production capacity expected to continue...

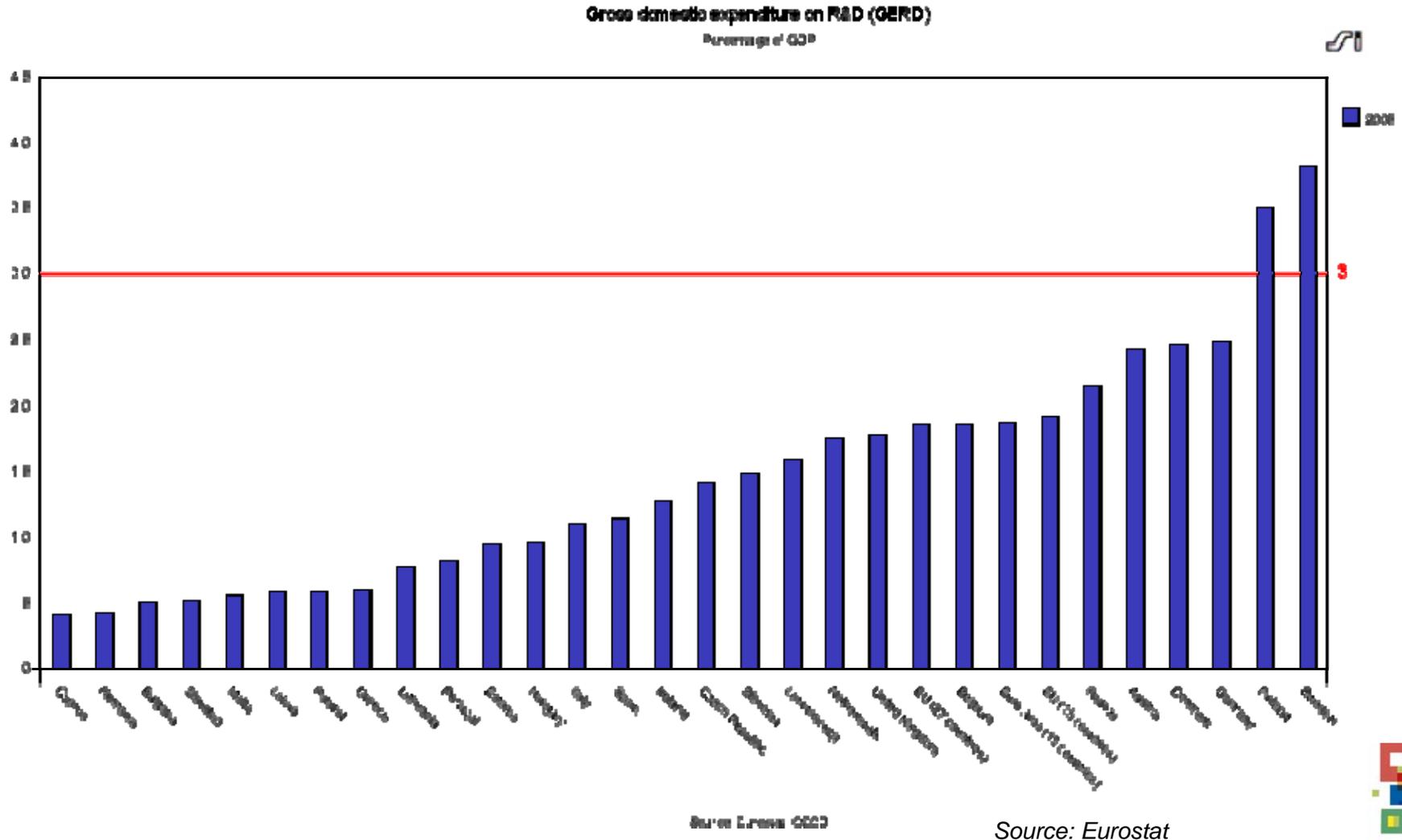
Driving forces behind investment spending over next 6 months
(balance of weighted replies, %)



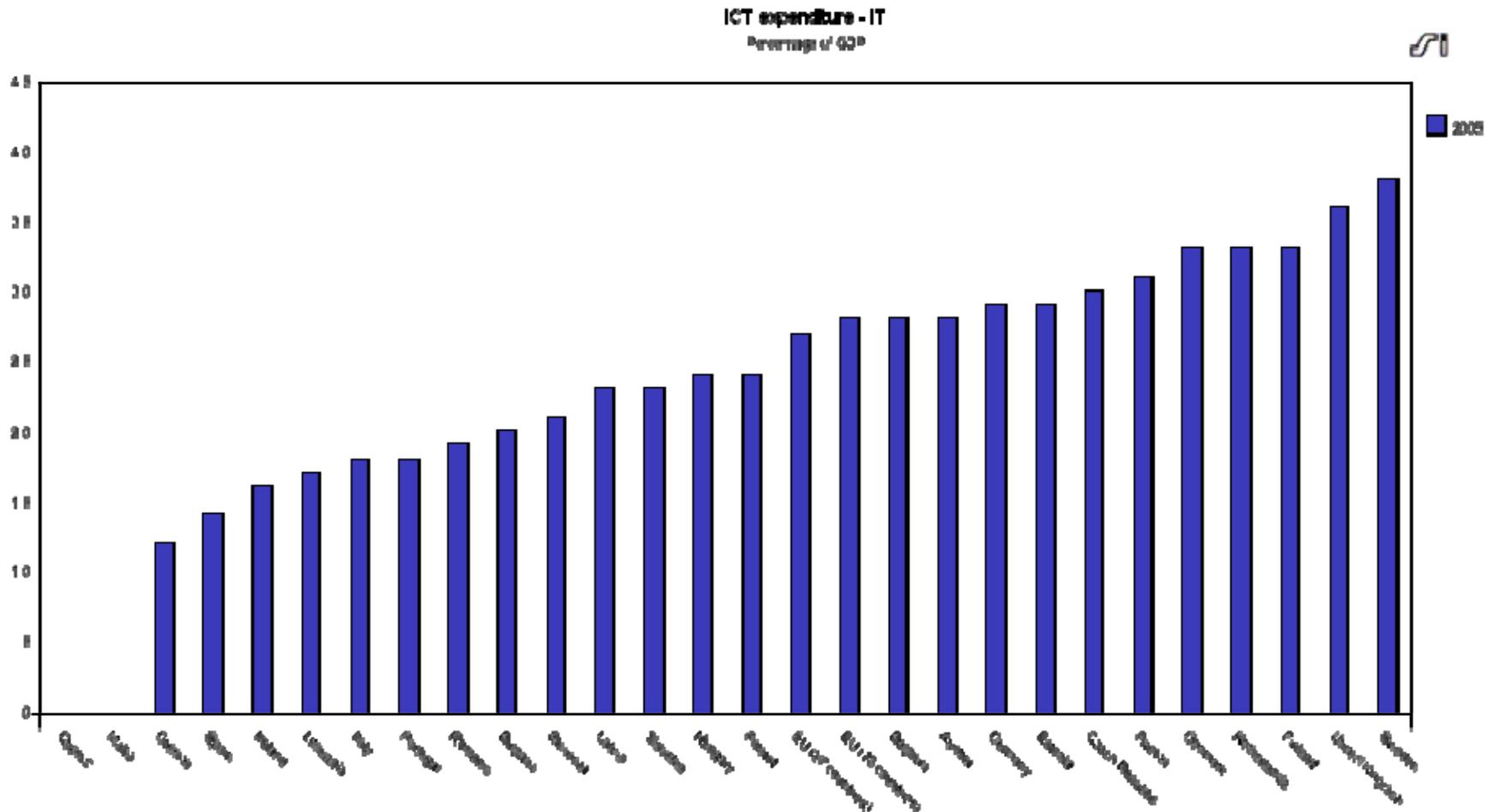
Source: BUSINESSEUROPE
Economic Outlook (Spring 2008)



R&D spending is low compared to EU15...



But ICT investment is closer to EU averages ...



Source: Eurostat

Source: Eurostat



Growth outlook remains favourable despite global economic headwinds...

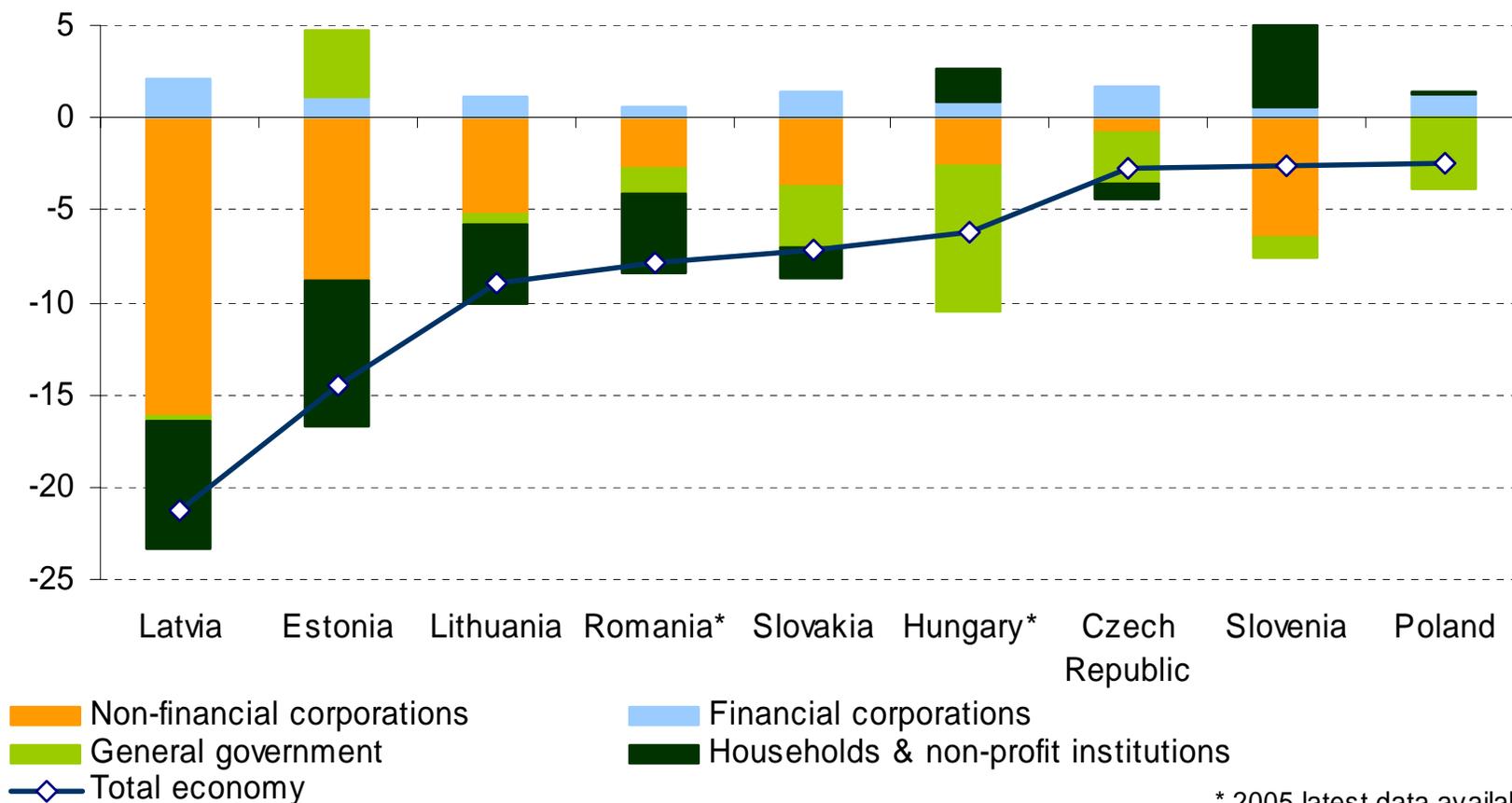
	2007	2008	2009
Bulgaria	6.5	6.5	6.0
Czech Republic	6.6	5.9	5.5
Estonia	7.1	4.2	5.0
Hungary	1.4	2.6	4.0
Latvia	10.2	6.0	6.5
Lithuania	8.0	6.5	6.0
Poland	6.5	5.3	5.6
Romania	6.0	5.4	4.7
Slovak Republic	10.4	6.6	5.6
Slovenia	5.9	4.5	4.2
EU27	2.9	2.0	2.1
Euro area	2.6	1.7	1.8
G7	2.2	0.9	0.9
USA	2.2	0.5	0.6
Japan	2.1	1.4	1.5
BRIC	9.6	8.0	8.0
Emerging economies	7.9	6.7	6.6
World	4.9	3.7	3.8

Source: *BUSINESSEUROPE Economic Outlook (Spring 2008)*, *IMF World Economic Outlook (Spring 2008)*



But current account imbalances raise questions of sustainability...

Net borrowing and net lending (2006, % of GDP)



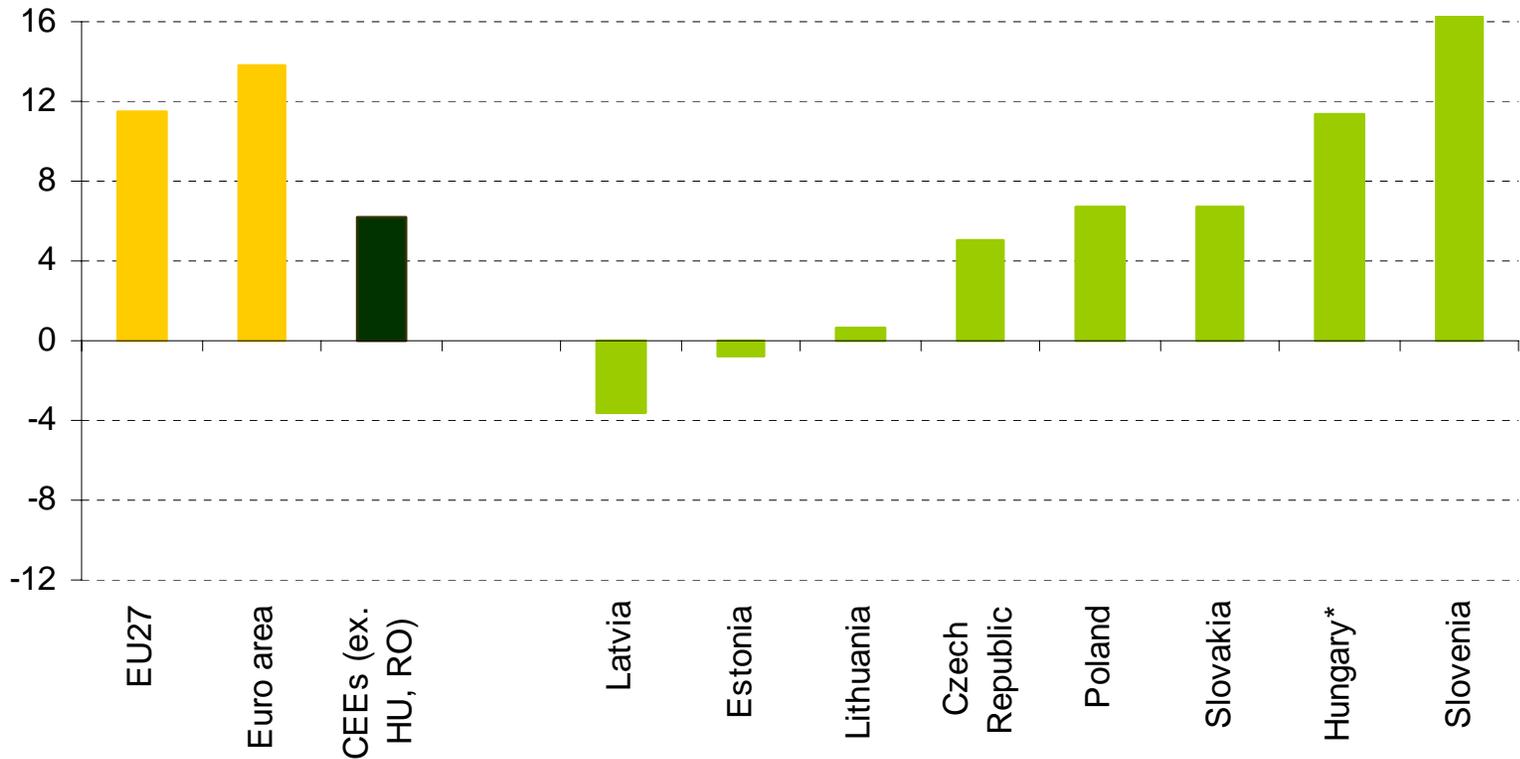
* 2005 latest data available

Source: *BUSINESSEUROPE*
based on Eurostat



Baltic states: over-investment and a lack of savings creates a dangerous combination...

Household savings rate (2006, % of disposable income)



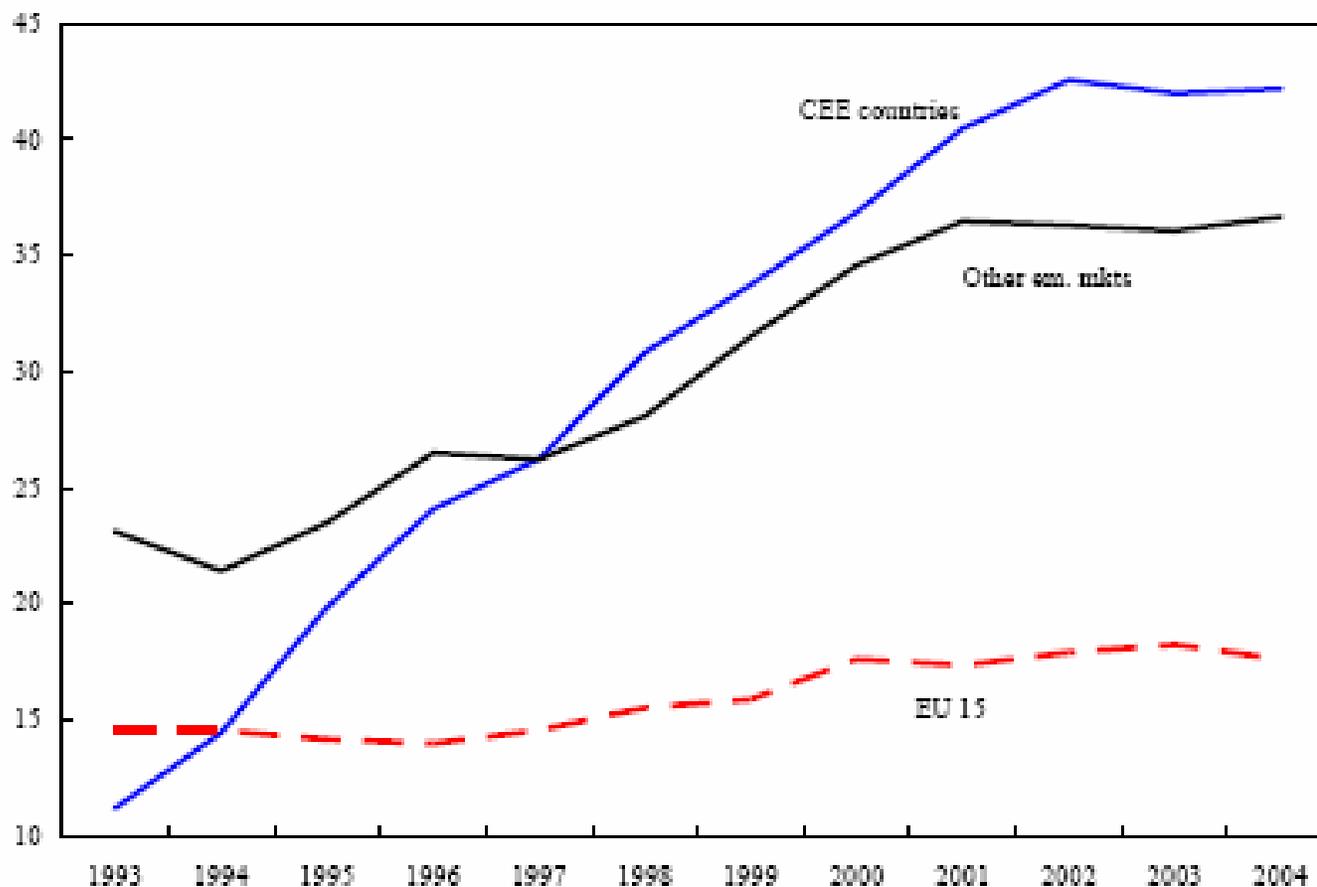
* 2005 latest data available

Source: *BUSINESSEUROPE*
based on Eurostat



CEE investment boom has relied on massive FDI inflows...

Composition of external liabilities:
share of FDI

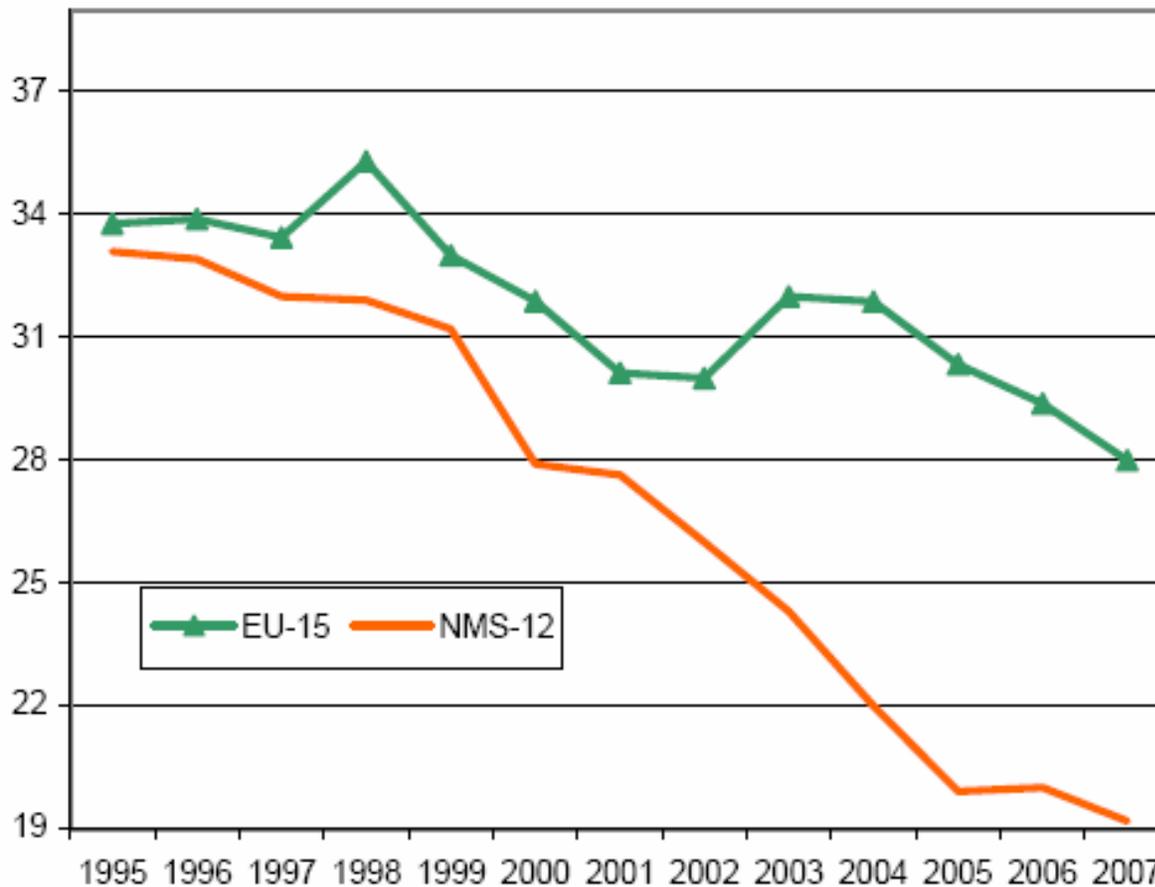


Source: Lane & Milesi-Ferreti (2006)



Fundamentals remain supportive for FDI inflows, tax competition being a relatively minor factor...

Average statutory tax rates on corporate income

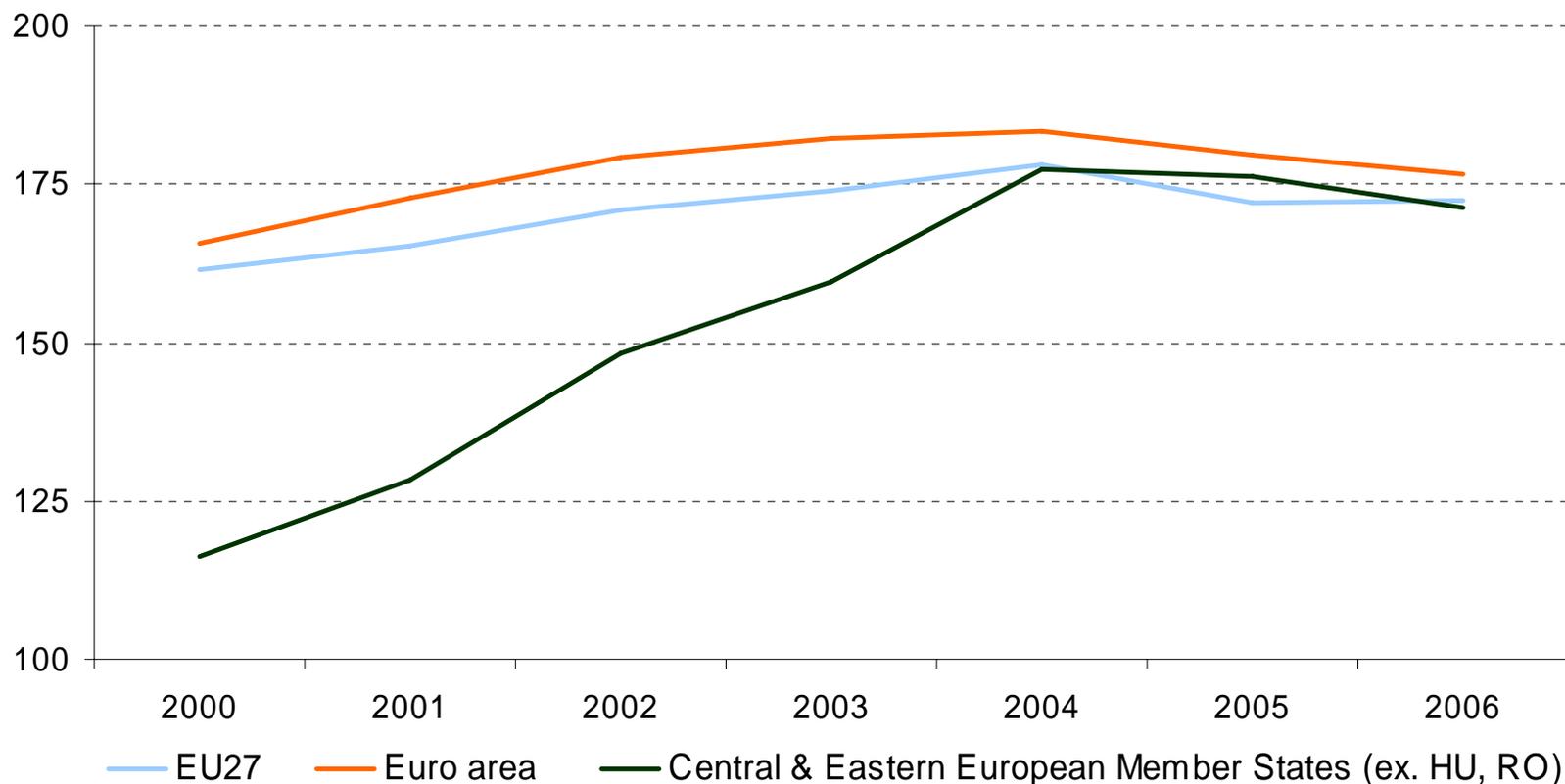


Source: Jakubiak & Markiewicz (2007)



But return on capital is levelling off after fast growth in the pre-accession period...

Gross operating surplus as share of gross fixed capital formation
(non-financial cooperations, %)

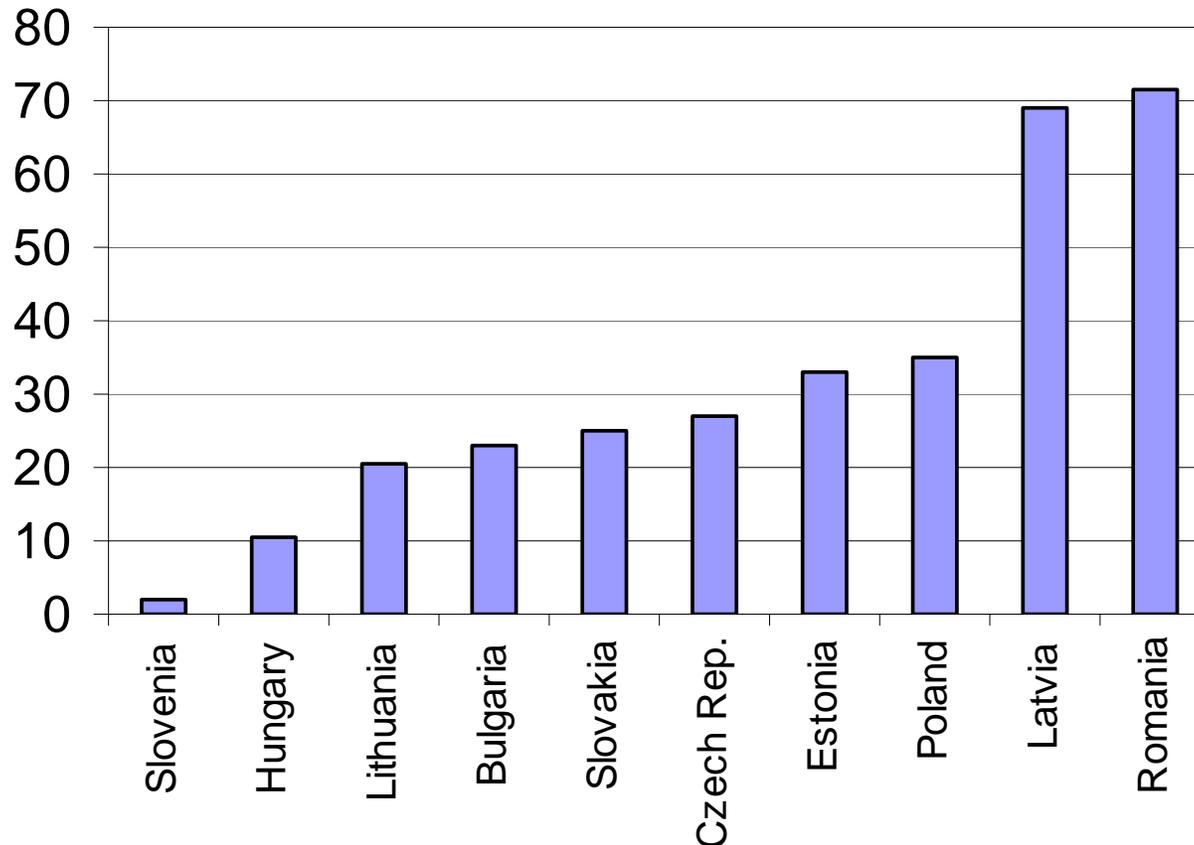


Source: BUSINESSEUROPE
based on Eurostat



And wage pressures are denting external competitiveness...

Unit labour costs evolution compared with 35 trading partners
Percentage change from 2004 to 2008

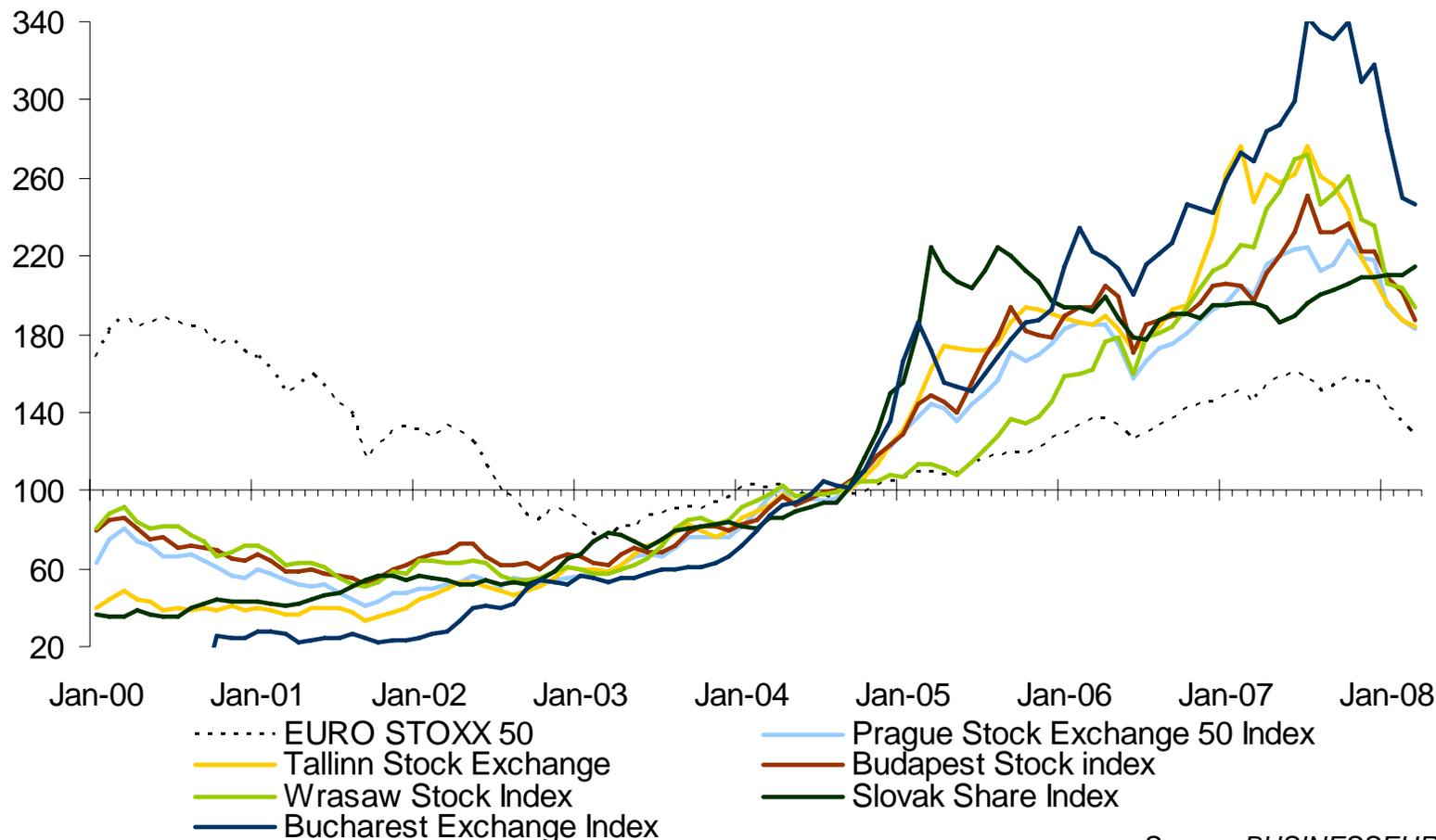


Source: BUSINESSEUROPE
based on AMECO



CEE countries are showing resilience to financial market turmoil, but are not immune...

Evolution of national stock markets (index, 2004 = 100)

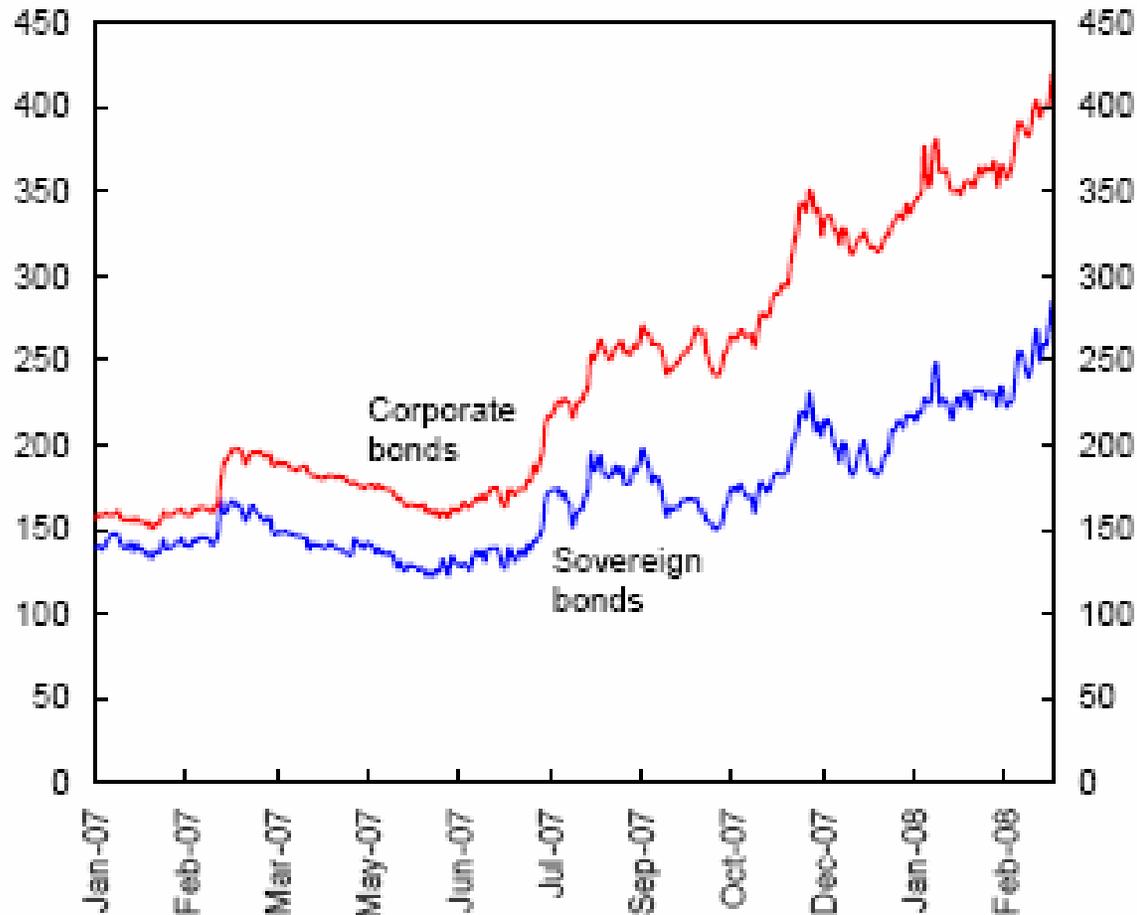


Source: *BUSINESSEUROPE*
based on Eurostat



Risk reappraisal will affect access to financing, both domestically and internationally...

Emerging Europe: Sovereign and Corporate Bond Spreads



Source : IMF, Regional Economic Outlook (April 2008)



Commission and **BUSINESSEUROPE** agree that reform progress is too slow...

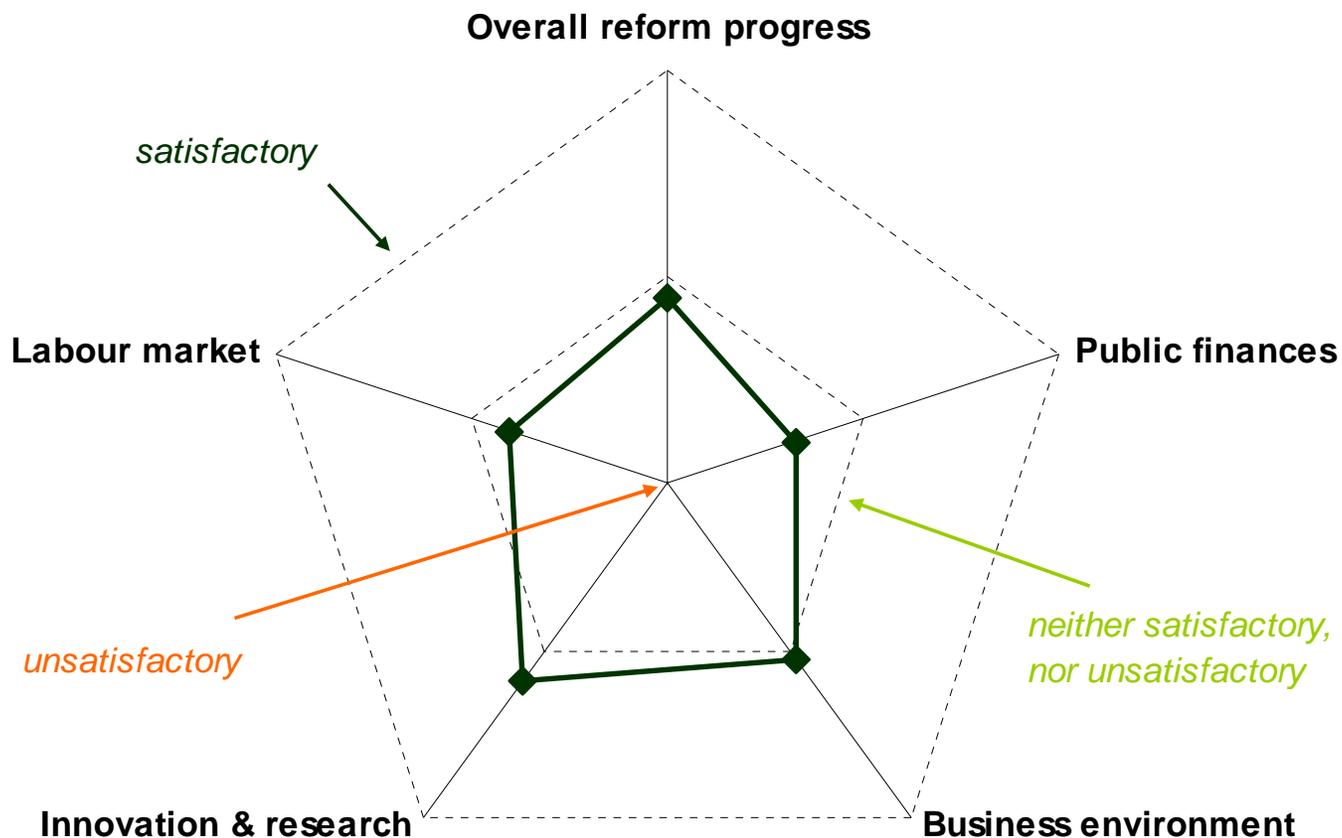
Comparison of reform progress assessments

Commission assessment of reform progress	very good		Estonia	Sweden Luxembourg Denmark Finland	Ireland	
	good	Italy	Spain Lithuania Germany	Slovenia Portugal Belgium	Malta Cyprus	
	significant			Austria United Kingdom	Netherlands	
	steady			Greece France		
	some		Slovakia Czech Republic	Latvia		
	limited		Poland	Hungary		
		← unsatisfactory		satisfactory →		
		<i>BUSINESSEUROPE assessment of reform progress in 2007</i>				

Source: *BUSINESSEUROPE Reform Barometer (Spring 2008 Update) and Commission*



Labour market and public finance reforms are a particular source of concern...



Source: BUSINESSEUROPE
Reform Barometer (Autumn 2007)



Conclusions

- Good economic prospects but equally large challenges
- Growth bottlenecks, financial market turmoil and FDI slowdown call to speed up domestic reforms
- Policy priorities have been well identified in the context of the Lisbon Strategy
- Governments must step up implementation or risk hampering convergence

