EU10 November 2010

Summary of Main Report

Half a year after Europe was shaken by a sovereign debt crisis, the recovery in the EU10 continued in 2010 and is set to strengthen in 2011. However, concerns over sovereign debt in some countries of the euro area persist and global growth could slow down somewhat from 2010 to 2011. Sustaining strong growth in the EU10 over the next years will depend on further difficult adjustments in financial markets, fiscal balances, and labor and product markets.

The rebound in global trade and industrial production and acceleration of EU15 growth lifted the EU10 economies, aided by close trade and production linkages within the EU, competitive production costs, a skilled workforce, and nimble entrepreneurs. The recovery in the real economy supported the return of financial market confidence, stabilized fiscal outcomes, and generated jobs.

- Yields on sovereign debt of EU10 countries have moderated, stock markets have risen, and interbank spreads have narrowed. Gross capital inflows to EU10 countries have picked up thanks to strong public bond inflows. External vulnerabilities are sharply reduced in view of the large improvements in current account balances.
- EU10 government bond spreads have come down noticeably since the peak of the crisis, and government interest payments on debt in 2010 are broadly in line with plans. Many EU10 countries have increased public investments to enhance growth prospects with the help of EU structural funds. These transfers have also played a crucial role in stabilizing local government finances and maintaining local public debt at low levels.
- Unemployment dropped from the first to the second quarter of 2010 in most EU10 countries.

However, with private demand remaining weak in many countries, the pace of the recovery in the EU10 is sluggish compared to the rebound in the early 2000s. Growth is set to continue to vary across the region, and is subject to a number of risks.

- Credit growth to enterprises remained negative in most EU10 countries. The recovery in credit growth could be derailed by a weak recovery in the EU15, as the phasing out of fiscal stimulus, the end of inventory accumulation and a strong euro could dampen economic activity. Renewed financial sector stress could spread to the EU10 through cross-border linkages, as parent banks could shrink the balance sheets of subsidiaries.
- Fiscal consolidation has slowed in a number of EU10 countries. Fiscal deficits are set to decline only moderately in 2010 in the EU10.
- Unemployment rates remain in double-digits for six of the EU10 countries. Job market conditions stay difficult for young and low-skilled workers and long-term job seekers.

Addressing these challenges through policies to strengthen financial markets, fiscal frameworks and structural reforms remains essential for sustained growth.

- Monetary policy is set to remain supportive of the recovery as inflation pressures continue to be moderate. Central banks and financial authorities should pursue efforts to reinforce the resilience of the financial sector at the national and European level.
- The implementation of credible medium term fiscal strategies is crucial in the light of volatile financial markets, rising public debt ratios and large structural fiscal deficits. While EU10 countries have gone a long way to spell out measures to bring about short-term fiscal adjustments, some countries still need to clarify long term targets for public debt, the size of government and structural reforms to meet these targets. Priorities include rationalizing benefit entitlements and stabilizing age-related spending, strengthening broad-based taxes and tax compliance, and enhancing fiscal institutions, including fiscal rules.
- Removing structural barriers can strengthen growth without bringing back unsustainable domestic demand booms fuelled by excessive credit expansion. The reform agenda includes easing regulations for doing business; increasing incentives for labor force participation and skill acquisition; and facilitating technology absorption and market integration.

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Summary of "In Focus" Notes

Focus Note # 1 Impact of the Global Financial Crisis on Local Government Finances

Local governments account for a large share of total government spending and revenues across the EU10 countries. They play an essential role in providing public services to citizens and facilitating investments of businesses. The crisis worsened fiscal positions of local governments, but less than of central governments and social security funds. The debt of local governments increased only moderately and was still less than 3 percent of GDP in the EU10 in 2009. The main reason for the limited impact of the crisis on local government deficits and debt is that they operate, to varying degrees, under borrowing rules that impose limits on the ability to borrow and own source revenues comprise only a minor part of their budgets. In addition, EU funds and central government transfers linked to mandated expenditures played an important role in stabilizing revenues at the local level. As fiscal consolidation has become the national priority in many countries, local governments will have to strengthen their fiscal positions through reforms of intergovernmental financial relations and improving cost and output efficiency in service delivery.

Focus Note # 2 Doing Business in EU10 countries

EU10 countries rank 43 out of 183 economies in terms of overall ease of doing business according to 2011 Doing Business report. This is around ten ranking positions behind the EU15 countries. The performance of the EU10 across indicators is uneven. While in the areas of registering property, getting credit and starting a business the EU10 tends to perform better than the EU15, there is significant room for improvement in regulations related to enforcing contracts, dealing with construction permits, paying taxes and closing a business. While Estonia, Latvia and Lithuania remain the most business friendly countries in the region, Hungary's reform progress last year was recognized and enabled Hungary to be in the group of top 10 Doing Business reformers in the world.