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Reflections on the resilience of Central, Eastern and Southeastern Europe (CESEE) Countries and future challenges

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* Overviewing The Resilience of Central, Eastern and Southeastern Europe (CESEE) Countries During ECB's Monetary Cycles

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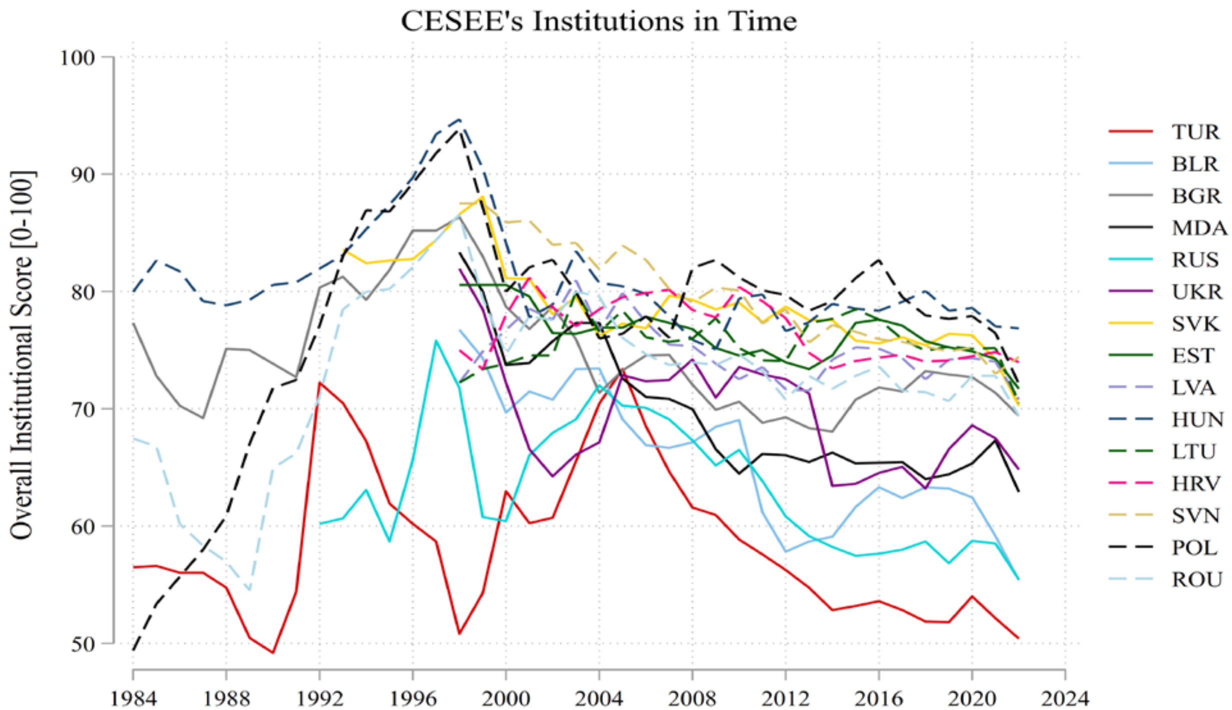
NBER WP 32957

- The CESEE countries experienced outstanding average growth during the 2000s.
- However, several obstacles appeared after the global financial crisis and the euro crisis.
- In many CESEE countries, the quality of institutions has stalled, or even worse, has known a deterioration.
- CESEE's high average growth during the 2000s does not guarantee future performance. The headwinds associated with growing geopolitical frictions and demographic challenges will challenge its growth.
- The high growth rates of CESEE countries were helped substantially by the generous European Union's Cohesion Policy. The successful convergence of most CESEE countries and the geo-political headwinds affecting the EU and the ECB may reduce future allocations to CESEE. The EU countries that have kept their currencies, and managed their monetary and exchange rate policies competently, frequently applying their version of Inflation Targeting, may face growing headwinds from the EU to converge towards adopting the Euro.

- The uneven trajectory of the institutional quality of CESEE countries, and the growing geo-challenges associated with the growing frictions between the EU and Russia, China, and their allies will test the cohesion of the EU and CESEE, imposing negative externalities on the future growth and stability of CESEES.



← ICRG overall institutional Score, normalized 0-100.

A portion of the countries experienced an overall stable trajectory (Slovakia, Slovenia & Estonia), while other countries experienced large volatility (Poland, Turkey, Hungary…).

Quality and Stability of Institutions is crucial for sustainable growth

This is especially the case in countries facing the risk of getting old before getting rich, overlooking the coming demographic challenges: the average live births per woman in CESEE dropped from 2.17 in 1980 to 1.5 in 2017:[1]

	2017	1980
Moldova,	**1.2**	**2.48**
Ukraine,	**1.37**	**1.95**
Bosnia and Herzegovina,	**1.38**	**2.1**
Poland	**1.39**	**2.28**
Slovakia	**1.48**	**2.32**
Hungary,	**1.53**	**1.91**
Bulgaria, Belarus, N. Macedonia,	**1.54**	**2.05, 2.03, 2.49 respectively**
Slovenia,	**1.58**	**2.32**
Estonia,	**1.6**	**2.02**
the Czech Republic,	**1.63**	**2.08**
Romania,	**1.64**	**2.43**
Lithuania,	**1.69**	**1.99**
AVERAGE: a drop of 0.67	**1.502**	**2.175**

[1]See Zgirski, Sebastian Dominic, "The Eastern European Fertility Crisis" (2020). *Anthropology Department Scholars*

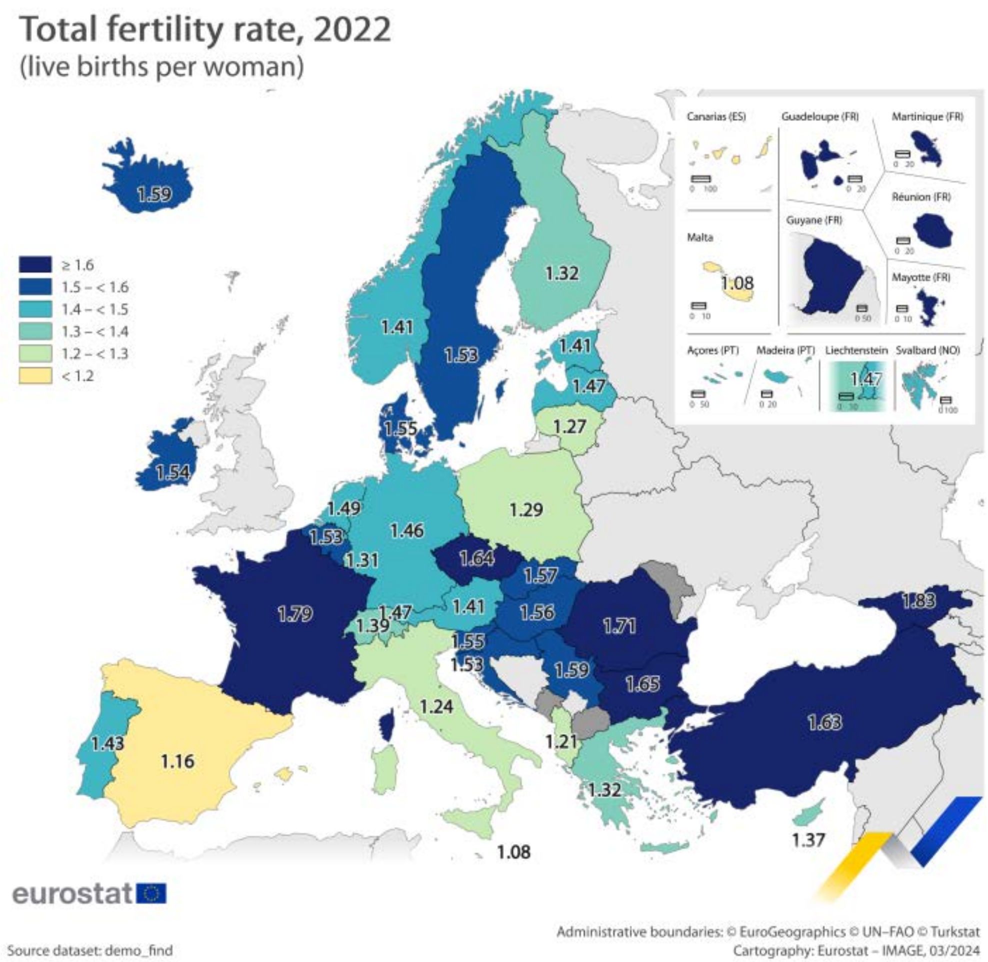
- Gary Becker: In the modern economy, with endogenous fertility, and kids' quantity/quality tradeoff, a sustainable growth equilibrium is characterized by low fertility, and high investment in human capital [see Becker, Murphy, and Tamura (1990)]. Growth rates are determined by the investment in human capital [Galor and Weil (2000) and Galor (2005)].
- Becker et al. insights are pertinent for the growth sustainability of CESEE countries:

1. Effective education is preparing the younger generations for the challenges of the modern economy, where more than 70% of the GDP are services. This requires quality stable institutions, and funding affordable education. The role of the quality of institutions in achieving this goal is highlighted by Chetty et al. (2014) Hanushek and Woessmann (2010), Prakash (2018).
2. Failure to deliver comprehensive quality education results in low and stagnating growth, inducing educated skilled workers to explore better opportunities in other EU countries.
3. An alternative mechanism is easing the skills gaps by encouraging selective immigration of skilled labor [medical doctors, scholars, IT etc.]. This policy requires quality institutions that welcome skilled labor immigration, and

societal support of these goals. The rise of anti-immigration parties will challenge this option.

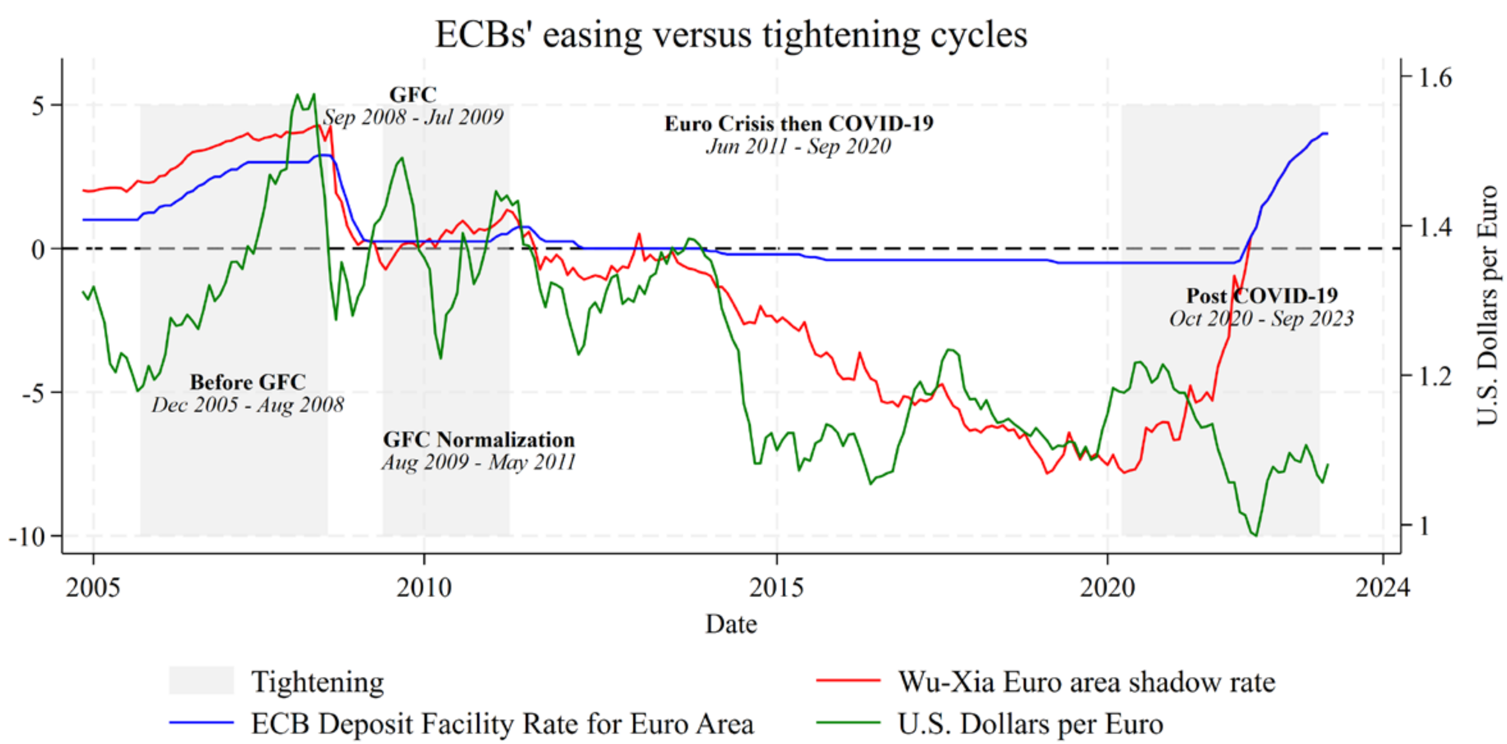
These issues are grappling most European countries:

Eurostat reports 1.46 live births per woman in the EU in 2022.



Yet, population aging challenges are much harder to deal with in poorer countries, with limited education capacities, nationalistic sentiments against immigration, and mobile skilled workers…

- The inability to adapt institutions to the challenges of getting old before getting rich may reflect the linear bias – the false presumption that most systems follow a linear path. After all, the collapse of net fertility implies an exponential decline in population (see Benartzi & Thaler for research dealing with linear biases).
- In "The Resilience of Central, Eastern and Southeastern Europe Countries During ECB's Monetary Cycles" (Aizenman and Saadaoui) we also examine how fundamental and institutional variables influence **CESEE resilience during the ECB tightening and easing cycles during 2005-2023:**



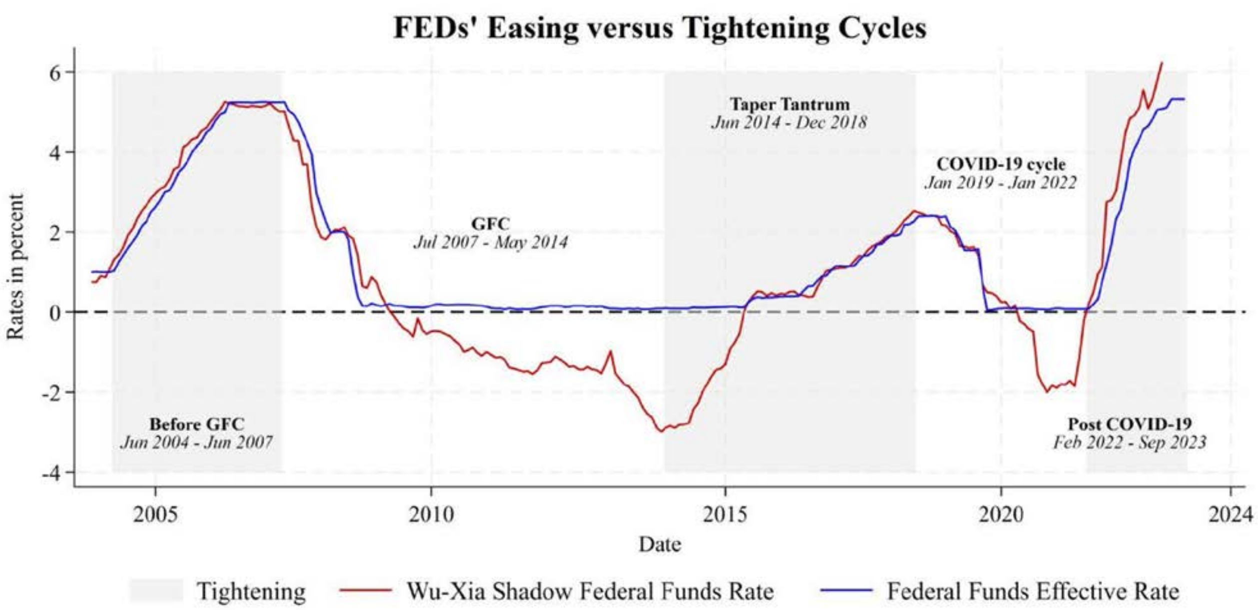
- We find that limiting inflation, active management of precautionary buffers of international reserves, smaller current account deficits, better financial development, and institution quality during a given cycle are important predictors of resilience in the next cycle.
- Overall, countries with better financial openness, more independent central banks, more developed financial systems, and better institution scores have experienced higher growth rates during these monetary cycles in the CESEE country group.
- We identify the main fundamental and institutional variables that enhance resilience; including efficient management of international reserves, current accounts, financial institutions, and other structural factors affecting the ability to deal with the spillover effects of the ECB's and FED's policies. We also validated that the US shadow Federal Funds rate strongly influences CESEE performance and resilience during ECB monetary cycles.
- Financial development & CB independence have asymmetrical effects between easing and tightening cycles: Greater central bank independence significantly limits depreciation during tightening cycles. Higher financial development is associated with a lower coefficient of variation for growth, and

helps to stabilize growth, especially when growth is highly dispersed during the next monetary cycles.

- Greater geopolitical tensions may reduce CESEE countries' opportunity to join the Global value chains. Yet, some of the CESEE countries may instead play the role of connector countries between different opposed geopolitical blocs, as may be the case of Turkey's alleged "ghost trade" with Russia, a trade that has strained Turkey's ties with its NATO allies.

Background Papers The performance of emerging markets during the Fed's easing and tightening cycles: A cross-country resilience analysis, JIMF 2024, Aizennman et al.

Monetary cycles in the US, June 2004 - September 2023



We investigate the determinants of emerging markets performance during five U.S. Federal Reserve monetary tightening and easing cycles during 2004–2023. We study how macroeconomic and institutional conditions of an Emerging Market (EM) at the beginning of a cycle explain EM resilience during each cycle. Our baseline cross-sectional regressions examine how those conditions affect three measures of resilience: bilateral exchange rate against the USD, exchange rate market pressure, and country-specific Morgan Stanley Capital International index (MSCI). We then stack the five cross-sections to build a panel database to investigate potential asymmetry between tightening versus easing cycles. Our evidence indicates that macroeconomic and institutional variables are associated with EM performance, determinants of resilience differ during tightening versus easing cycles, and institutions matter more during difficult times. We find that current account balance, international reserves, and inflation are all important determinants of EM resilience.

THE ECONOMIST Feb 23rd 2023, OVERVIEWING "On the effectiveness of foreign exchange reserves during the 2021-22 US monetary tightening cycle" R Ahmed, J Aizenman, J Saadaoui, GS Uddin - Economics Letters, 2023

- Battling currency markets used to be considered unwise by central bankers. Burning foreign-exchange reserves to take on the forces that push and pull a currency's value was foolish, so the thinking went, and almost certainly futile. Orthodoxy held that a country seeking to defend its currency should raise interest rates, not sell reserves.
- This was put through a real-world test last year as America raised rates and the dollar climbed in value. Officials in many emerging economies deployed their holdings to defend local currencies. According to the IMF, global foreign-exchange reserves fell by $1.1trn between the end of 2020 and the third quarter of 2022, with holdings of dollar-denominated assets accounting for half the decline.
- During the past few months, however, the process has begun to reverse, as the dollar has fallen and pressure on countries that intervene to defend their currencies has abated. The combined holdings of large Asian reserve holders—China, Japan, South Korea and Taiwan—have risen by $243bn since October, through a combination of revaluation and new purchases, to a total of $5.6trn. India's foreign-exchange reserves are up by $42bn since October, recovering more than a 1/3 of their decline in the preceding 12 months.

- A recent paper by Rashad Ahmed of America's Office of the Comptroller of the Currency and co-authors suggests that big reserve accumulators may, in fact, have reason to rebuild. Countries that entered 2021 with larger reserves and greater credibility in their capacity to intervene saw smaller depreciations in their currencies, all else equal. The authors calculate that additional reserves worth ten percentage points of national gdp were associated with 1.5% to 2% less depreciation in the domestic currency, relative to the dollar.
- Meanwhile, a number of countries which began this period with modest reserves have suffered deep depreciations. The Egyptian pound, which traded at 16 to the dollar at the start of 2020, now trades at 31.
- Healthy foreign-exchange reserves could have another benefit. Removing the need for interest rates to be used to defend the currency enables "domestic monetary policy to better target domestic objectives".
- The experience of large currency-reserve holders during the dollar's recent surge might give governments other ideas. Being able to resist the pressure to follow the Fed's interest-rate movements is a goal held by many developing economies—and the more reserves they hold, the more resistant they seem to become.

- “Monetary Policy Spillovers and the Trilemma in the New Normal: Periphery Country Sensitivity to Core Country Conditions.” **with Chinn and Ito JIMF 2016:** Unlike Rey’s (2013) “Dilemma not Trilemma” argument, we do find that the types of exchange rate regimes do affect the extent of sensitivity to changes in financial conditions or policies in the center economies. An economy that pursues greater exchange rate stability and financial openness faces a stronger link with the center economies through policy interest rates and real effective exchange rate (REER) movements. We also find that exchange market pressure (EMP) in peripheral economies is sensitive to the movements of the center economies' REER and EMP during and after the global financial crisis. Open macro policy arrangements, especially exchange rate regimes, also have indirect effects on the strength of financial linkages.
- Aizenman, Joshua, et al. (2024) Countries with a low development of their financial institutions may manage the international reserves as a shield to deal with the negative consequences of terms-of-trade shocks on the real exchange rate. We also find the buffer effect is stronger in countries with intermediate levels of financial openness.

- **A modern reincarnation of Mundell-Fleming's trilemma, Aizenman, Economic Modelling**, 2019, https://doi.org/10.1016/j.econmod.2018.03.008.

1. EMs converged to the trilemma's middle ground following financial crises.
2. Financial stability was added to the original trilemma policy goals.
3. New policy instruments were added to deal with financial stability.
4. The added instruments included macro-prudential, managing buffers, and swap lines.
5. Developed and emerging countries use a different mixture of policy instruments.

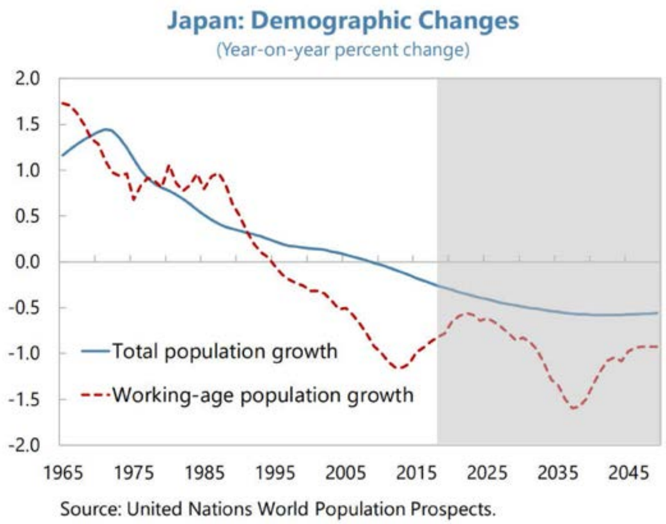
- **These results are in line with IMF recent overview Biljanovska, et al. (2023):** Evidence shows that in EMs a proper interaction of macroprudential measures, foreign exchange rate intervention, and monetary policies reinforce each other and applying these policies simultaneously can have a larger impact on credit, mitigating exposure to the global financial cycles.

Concluding Remarks

The mid-low-income CESEE countries will face growing challenges associated with getting old before getting rich. Investment in quality institutions, human capital, and upgrading their macro-policies is essential to prepare them for the rocky trajectory awaiting them. These challenges are universal but are greater for the poorer countries. A clear case study of the future challenges is the present adjustment of the most affluent 'hermit kingdom' in history, Japan. nippon.com reports "Japan's total fertility rate hit a new low of 1.20 in 2023, with the rate for Tokyo falling to 0.99 for the first time."

Bloomberg report overviewing Japan's painful adjustment in Feb 2024 noting:

'Record 2 Million Foreign Workers Are Changing the Face of Japan. As a labor shortage worsens, companies procure help from overseas' A year ago, Prime Minister Fumio Kishida warned that "the country now finds itself on the brink of being unable to maintain social functions" because of its low birthrate, Japan will need 6.74 million foreign workers in 2040 to meet its growth targets, according to a study by the Japan International Cooperation Agency. 'Japan is entering an era of mass foreign immigration,' said Junji Ikeda, president of a Hiroshima-based agency that sources and supervises foreign workers. "Incremental adjustments will not suffice." In Hiroshima prefecture the foreign workforce rose by 14% through October 2023 from a year earlier. The region has suffered the highest and fastest drain of locals among all prefectures. In response, authorities have sought imported labor for industries ranging from manufacturing and eldercare to oyster harvesting and processing. The prefecture produces about 60% of Japan's oysters.'



Japan's population shrinks each year by about 0.5%. Japan's affluence is smoothing the adjustment, as its cities remain a global attractor of skilled and manual labor.

The aging challenges facing the mid-income CESEE would be harder. The earlier these countries would wake up and upgrade their institutions and invest more in skilled labor, the less rocky will be their adjustment to the future challenges of depopulation trends. Failure to do so will imply that these countries are and will be growing sources of workers for the more affluent and better-managed countries.

Thank you for your attention

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