

New EU Member States—A Fifth BRIC?

- The collective size of the economies of the New EU Member States (NMS) is about the same as that of the smaller BRICs: Brazil or Russia.
- By 2050, NMS GDP could grow to \$5.3trn and average GDP per capita could be \$65,000, compared with \$1.2trn and \$11,400 today.
- We forecast potential growth in the NMS at around 4% per annum for the next ten years. It could be even higher with better economic policies.
- The NMS have largely adopted the EU's institutional capital, they have high human capital and will accumulate physical capital at a rapid pace.
- The NMS should improve their judicial systems, the transparency and quality of governments, and strengthen the private sector and competition.
- They need to focus on several macro policy areas, in particular maintaining low inflation and macro stability, counter-cyclical fiscal and regulatory policies, and the introduction of the Euro.
- Without this, policymaking may enter a more difficult phase as the inflation/growth trade-off worsens and current account deficits rise. The global slowdown will also act as a headwind in the near term.
- Nevertheless, we remain bullish about the long-term potential for equity markets and long maturity bonds in the NMS, and for currencies in the floating exchange rate regime countries.

Important disclosures appear at the back of this document

Thanks to Willem Buiters, Rory MacFarquhar, Jim O'Neill, Erik Nielsen, Dominic Wilson and Loretta Sunnucks for valuable comments, and to Raluca Dragusanu and Dominic Wilson for help with long-term projections.

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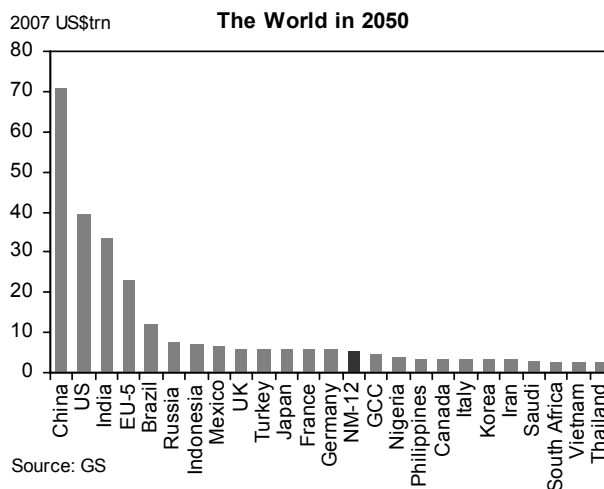
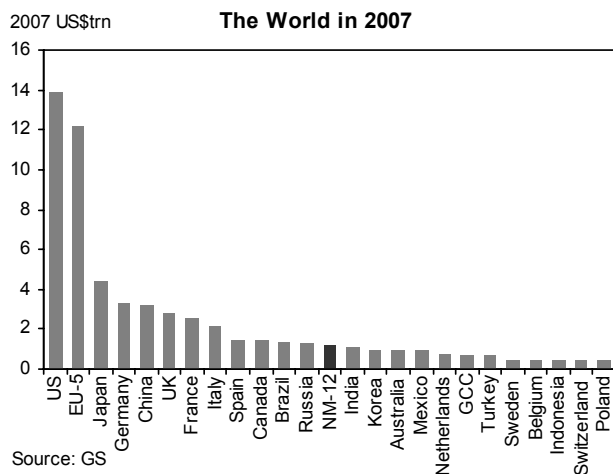
September 26, 2008

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Summary

- **The region represents a potential ‘Fifth BRIC’, situated on the doorstep of the ‘Old’ EU (the EU-15).** The size of the economies of the New EU Member States (Bulgaria, Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, Slovakia, Slovenia) taken together is about the same as that of the smaller BRIC economies (Brazil and Russia).
- **The growth potential of the New Member States (NMS) is also significant.** We expect real trend growth of at least 4% for the next 10 years (which is likely to be front-loaded) and continuing real appreciation. By 2050, NMS GDP could grow to \$5.3trn and average GDP per capita could be \$65,000, compared with \$1.2trn and \$11,400 today. To achieve this potential, the NMS need to concentrate on seven policy areas: maintaining low inflation and macroeconomic stability, anti-cyclical (and not just prudent) fiscal and regulatory policies, and the introduction of the Euro as soon as possible, on the macro side. On the structural side, the focus should be on improving the judicial system, the transparency and quality of governments, and strengthening the private sector and competition.
- **The NMS ‘imported’ the standard EU legal and institutional framework on entering the EU** (independent central banks, goods and capital market liberalisation, competition rules, etc.), although some question-marks remain regarding implementation. This created ‘institutional capital’ similar to that of the EU-15. At the same time, per capita GDP levels in the NMS are still on average around 60% of those in the EU-15 (in PPP terms), and around 30% in current terms, although these averages cover a considerable range. We expect these differences to continue to narrow rapidly.
- **The era of fast growth is far from over, although the global slowdown will act as a headwind in the near term.** Our Growth Environment Scores (GES) for the NMS are similar to the EU average but with greater variation. Other non-proprietary indicators suggest a similar performance. Human capital indicators place the NMS as a whole at around the EU average (better than the Mediterranean countries but somewhat worse than North-West Europe).
- **That said, the NMS are poised to enter a more difficult phase for policymaking.** So far labour markets have been loose, and this has papered over some of the policy-making dilemmas. As labour markets tighten, it is becoming more difficult to keep a lid on inflation, especially in the context of global shocks. A wage arbitrage exists between the ‘old’ and ‘new’ EU member states, both through migration and the relocation of production. This leads to rapid wage growth in the NMS (and restrains wage growth in the core EU). Inflation control will require more aggressive nominal exchange rate appreciation in inflation-targeting NMS.
- **Stronger currencies will result in widening current account deficits.** However, current account deficits are ‘natural’ for countries that accumulate physical capital to match their human/institutional capital. Nevertheless, there is a risk of overheating. On the structural side, the most significant issue seems to be more evidence of corruption and weaker governments in the NMS than in the EU-15.
- **We expect the NMS to make progress in most of the areas we have listed above, and we expect all of them to introduce the Euro in the next ten years.** A combination of strong growth, structural reforms and eventual Euro introduction should benefit all asset classes, including currencies (in the floating-regime countries), long yields, CDS spreads and especially equities, which currently look cheap.



New EU Member States—A Fifth BRIC?

1. Introduction: The ‘miracle’ decade of convergence and the challenges ahead

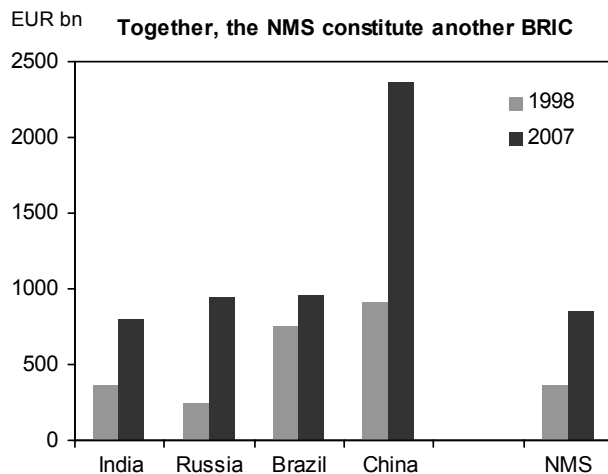
Ten years ago, the outlook for the countries now known as the New EU Member States (Bulgaria, Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, Slovakia, Slovenia) did not look very promising: they were sandwiched between Russia, which had just suffered economic collapse, and Western Europe, which was experiencing persistently weak growth, the so-called ‘Euro-sclerosis’. Inflation was still high (typically in double digits), and there was a risk it would increase further as investors’ confidence waned and currencies weakened. The political scene looked unsettled and many investors viewed the economic reforms instituted after the collapse of Communism as easily reversible. Potential EU membership could be glimpsed on the distant horizon, but whether and when it would materialise remained unclear. The Euro had not even come into being in Western Europe.

Ten years ago the outlook for NMS did not look very promising...

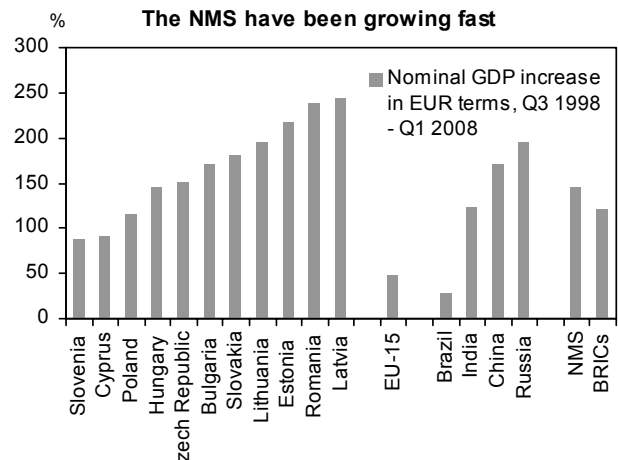
The temporary waning of confidence around 1998 proved to be the darkest hour just before dawn. Developments in the subsequent ten years have been remarkable. Institutional changes were cemented as these countries prepared for EU accession (in 2004 and 2007). The pull of the EU proved so strong that necessary reforms were implemented by right-wing and former-Communist politicians alike, with EU entrance becoming a key unifying item on the political agenda. Central banks have become independent, capital markets are fully liberalised, and inflation has been tamed¹. The New Member States have taken over the existing EU rules and regulations, and have enjoyed very rapid convergence with the EU-15 states over the past ten years.

...but that was the darkest hour before dawn

Between 1998Q3 and 2008Q1, the GDP of the 12 New Member States, or NMS, increased 145% to EUR886bn, making it comparable in size to that of Brazil, India or Russia. Over the past ten years, most NMS have enjoyed double-digit annual GDP per capita growth in foreign currency terms. Some of this was due to rapid real currency appreciation but, even in PPP terms, on average the NMS have reduced the gap in GDP per capita with the EU-15 by around 10 percentage points over this period. Rapid growth and disinflation have boosted domestic and foreign investors’ confidence in the NMS

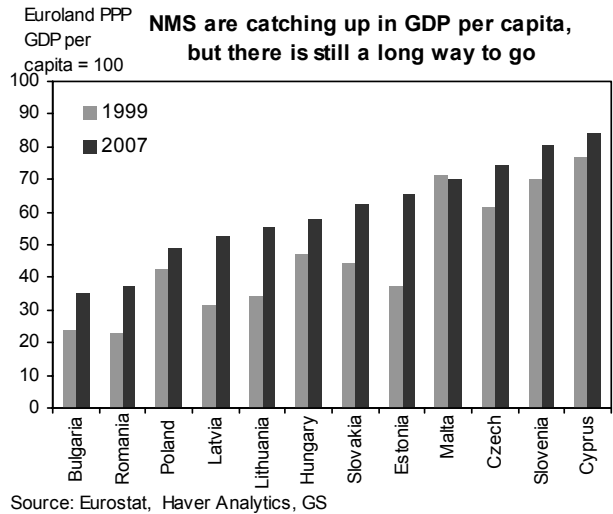
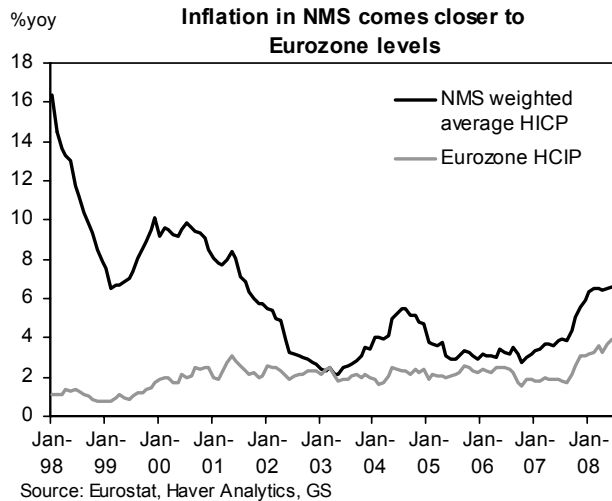


Source: Eurostat, IMF, Haver Analytics, GS



Source: Eurostat, IMF, Haver Analytics, GS

1. Inflation has become a problem again recently in some countries. We will return to this topic later in this report.

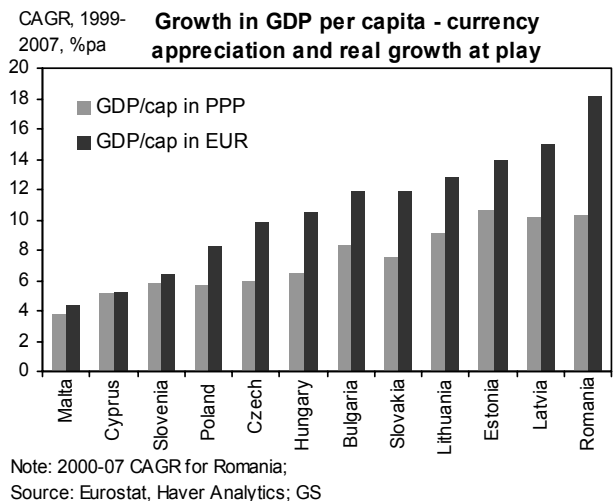
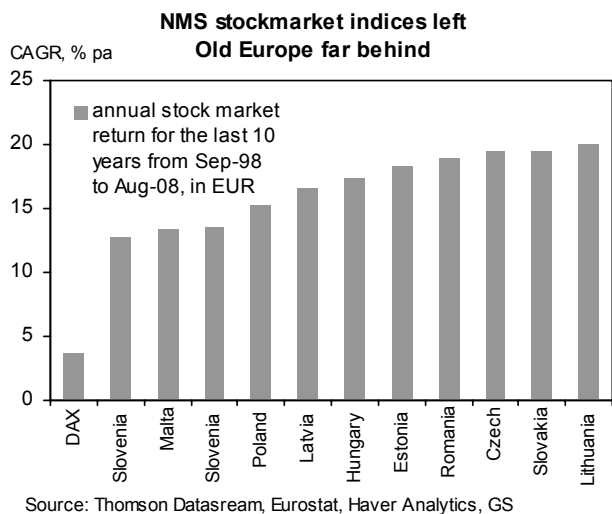


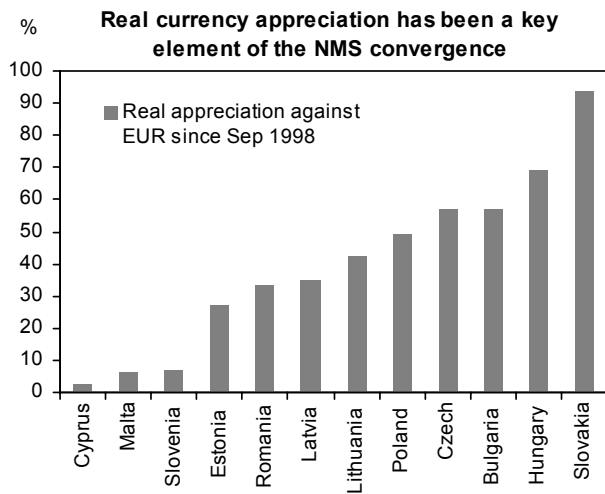
economies. Large amounts of capital have flowed in many different forms, and an investor in most of the local stockmarkets would have earned 15% or more a year in EUR terms.

This stellar performance raises the question of whether there is any juice left in the convergence process—and indeed whether expectations and pricing are already excessive. It also roughly coincided with the ‘NICE’ (No Inflation, Consistent Expansion) decade, when globalisation and macroeconomic stability made the task of policymakers easier everywhere. There are clear signs that policy choices are now becoming more difficult in many countries. The New Member States are no exception, and not just because of global factors.

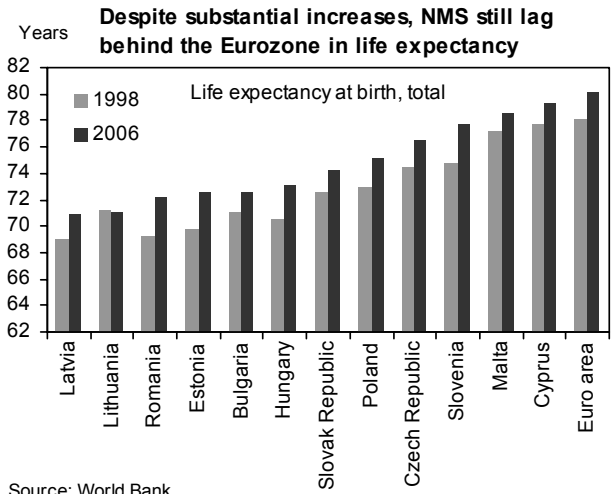
NMS performance has been stellar in many areas, and we think the period of rapid growth is not over

Nevertheless, we believe that the period of rapid growth for the NMS is far from over. Countries with similar levels of human, institutional and physical capital should have similar levels of economic development. The NMS still lag in terms of physical capital and to some extent institutional capital, but human capital indicators place the NMS as a whole at around the EU average (better than the Mediterranean countries but somewhat below North-West Europe)—although a good deal of variation exists within the group. Our Growth Environment Scores (GES) show a similar picture. Arguably, with EU accession, these countries have created institutional capital similar to that of the EU-15. In terms of labour market rigidity and corporate taxation, the NMS as a whole fare better than the EU-15.





Source: Eurostat, Haver Analytics, GS

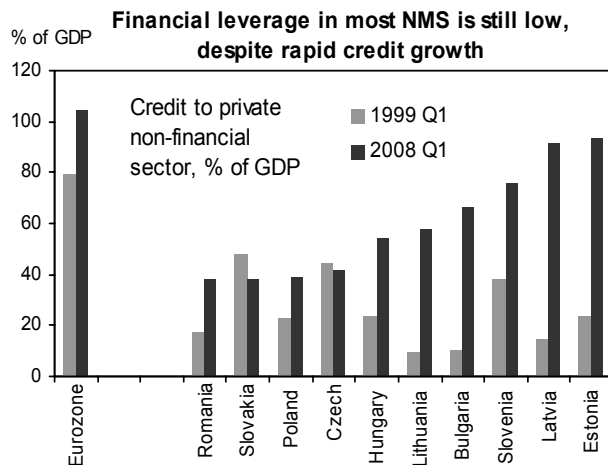


Source: World Bank

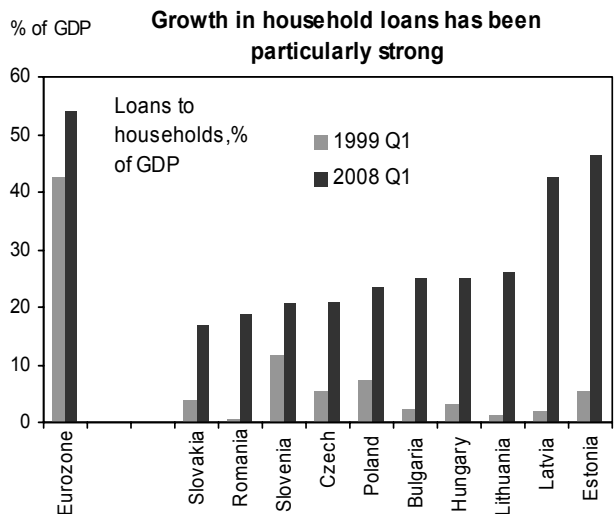
Despite the years of rapid growth, per capita GDP levels in the New Member States remain on average around just 60% (in PPP terms) of those in the EU-15, and this figure is around just 30% in current terms. This is mainly as a result of a lower level of capital endowment. Financial depth is also significantly lower, even as a percentage of GDP. A continued rapid inflow of capital, both from private sources and increasingly from EU funds, should sustain rapid GDP growth for many years to come. Even on relatively conservative estimates, NMS per capita GDP could increase more than twofold from 2007 levels by 2020. These countries could potentially largely catch up with the EU-15 countries by the 2030s (or possibly even earlier if the right policies are followed). Interestingly, the combined size of the NMS is similar to that of the smaller BRIC countries (Brazil and Russia), and in the next ten years we expect growth rates in the NMS broadly to keep pace with growth in these two countries. Indeed, the NMS could be considered the ‘Fifth BRIC’. Having their very own dynamic BRIC in their backyard is likely to continue to be beneficial for the EU-15.

The economic size of the NMS collectively is similar to that of the smaller BRICs

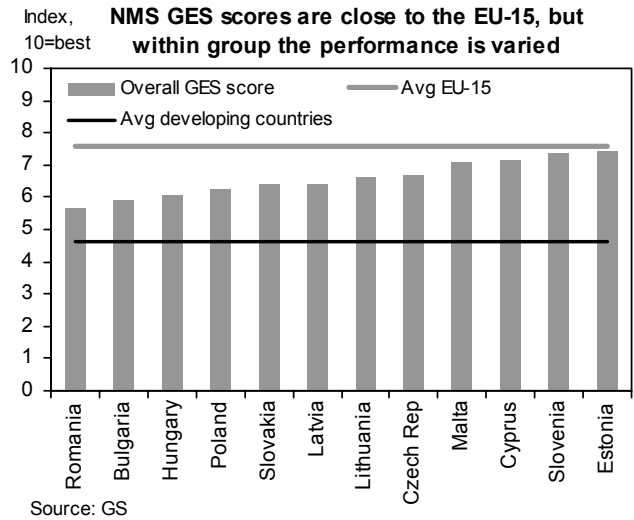
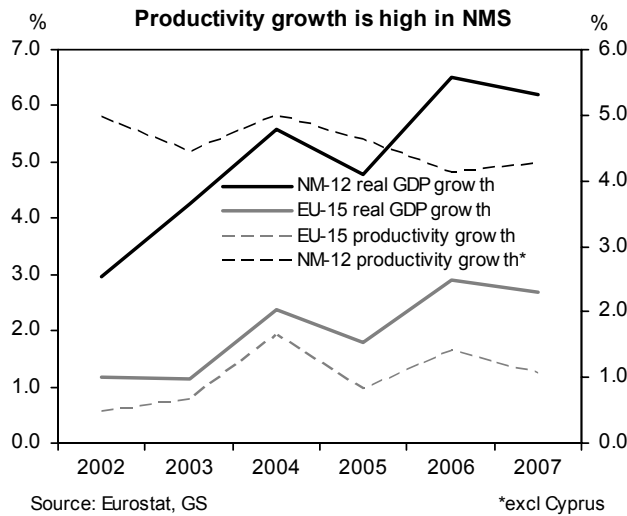
Nonetheless, managing the growth process in the NMS is likely to become more difficult than to date. At the risk of oversimplifying, we could say that until recently the NMS have followed a policy similar to that of China and other EM countries after the Asian/Russian crises: the NMS had low current



Note: 1999 data for Czech Rep, Slovakia, Romania, Estonia, Latvia includes loans to financial institutions
Source: National monetary authorities, GS



Source: National monetary authorities, GS



account deficits/undervalued exchange rates, FX reserve accumulation and rapid growth. Combined FX reserves for the NMS have risen from EUR52bn in September 1998 to EUR147bn in July 2008. The inflationary risks from this policy were held in check by high levels of domestic unemployment and the benign global environment. This policy greatly reduced the risk of another crisis occurring, but its success has meant that it is gradually becoming less sustainable. Rapid growth has all but eliminated cyclical unemployment, and a ‘wage arbitrage’ exists between the ‘old’ and ‘new’ EU member states both through migration and the relocation of production. This has led to rapid wage growth in the NMS (and holds back wage growth in the core EU countries).

Wage arbitrage now stronger between ‘old’ and ‘new’ EU member states

Inflation control will require more aggressive nominal exchange rate appreciation in inflation-targeting NMS. Stronger currencies should result in widening current account deficits (this is already the case in countries with fixed exchange rate regimes). Running current account deficits is ‘natural’ for countries that are accumulating physical capital to match their human/institutional capital. Nevertheless, there is a risk of overheating. The world as a whole is looking for ‘credible’ investment destinations where excess savings can be placed, and the NMS fit the bill. However, enthusiasm for these countries (and global risk appetite) can fluctuate wildly, and the volatility of capital flows is likely to result in volatile exchange rates. Despite the currency appreciation trend, the probability of an occasional disturbance has increased with a less benign global environment.

2. Adoption of EU rules works well for NMS

The countries that have recently become the EU's New Member States put considerable time and effort into adopting the EU's rules, regulations, legislation and institutions before joining and in the years immediately afterwards. We think this 'enhanced' structural reform process has been significantly more important than the EU funds (potentially) transferred to the NMS—even if the latter are more often the focus of everyday discussions about the advantages of EU membership. The NMS have already managed to achieve very strong growth rates and, so far, actual EU funds transferred to the NMS remain negligible from a macro perspective. The prospect of securing EU funds is a powerful disciplinary force for NMS governments—but that is mainly with regard to the future. So far, the importance of transfers from the EU budget has been dwarfed by rising private FDI and portfolio inflows.

In this section, we highlight the factors that point to a continuation of very rapid growth rates—possibly even faster growth than suggested by our standard 'BRIC-style' growth accounting framework. We have little reason to believe that the NMS as a group will not eventually reach the average per capita income levels of the EU-15. Indeed, we have reason to believe that at least some of them stand a good chance of overtaking average EU-15 income per capita levels. The convergence speed may even be faster than our estimates in the following section. But all of this will depend on whether the right policies are adopted.

EU accession: An accelerated structural reform process

On joining the EU, new countries have to adopt the existing regulations with very few exceptions. The term 'EU accession negotiations' is somewhat misleading, given that most of the negotiation is about whether the candidate countries have managed to adopt existing EU rules and regulations (and to a lesser extent about temporary concessions), rather than about what they need to adopt².

It is well beyond the scope of this paper to detail the EU legislation adopted by the New Member States: the so-called 'Acquis Communautaire', the body of existing legislation, runs to several tens of thousands of pages and is divided into 35 chapters. For illustrative purposes, we can divide these rules into three major groups:

Rules providing for macroeconomic stability: These include the requirement that NMS have independent central banks, run a budget deficit below 3% of GDP and eventually introduce the Euro.

Rules providing for 'micro'-level liberalisation: These include the free movement of capital, goods and people. They also include areas such as competition policy, restrictions on state aid, financial regulations, etc.

Other rules: Everything else, from harmonisation of certain taxation rules and statistics to environmental protection. Some of these are non-economic, such as regulations on the operation of justice systems, but they still make an important contribution to the overall framework.

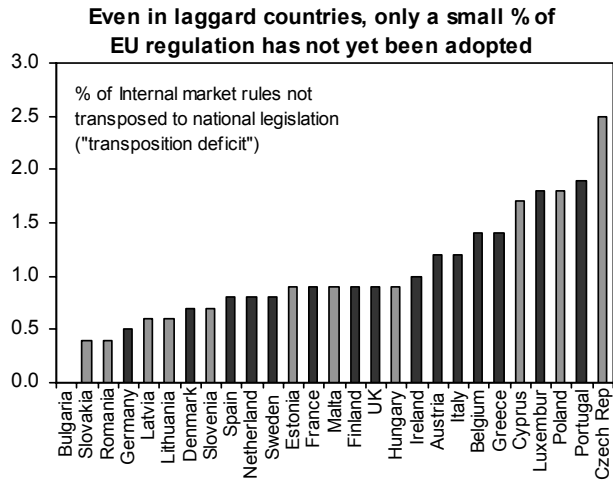
From the above examples, it is clear there is limited room for major discretionary economic policy choices in the NMS. They cannot, for example, easily introduce capital controls or increase tariffs (there is a common external tariff system). Governments cannot take over the management of central banks, without risking their full EU membership. In other words, a large part of

Adopting the EU rules has been more important than EU funds so far

We think the NMS will eventually reach average EU-15 income levels

EU rules limit the scope for populist policies

2. It seems that at least initially some candidate countries did not fully grasp this, and were hoping for more comprehensive/permanent concessions. This 'asymmetric' nature of EU negotiations also seems to have caused some misunderstanding among policymakers in Turkey, for example.



Source: European Commission, as of 13 May 2008



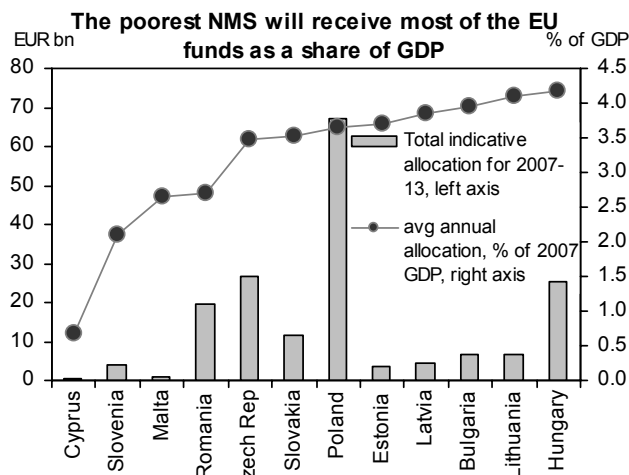
Source: European Commission

economic (and other) policymaking has been delegated to the EU, which means that the room for policy mistakes and for (localised) special interest groups to hijack regulation is limited. The hands of local politicians (who otherwise could be swayed by short-term gains from populist policies) are bound by EU rules.

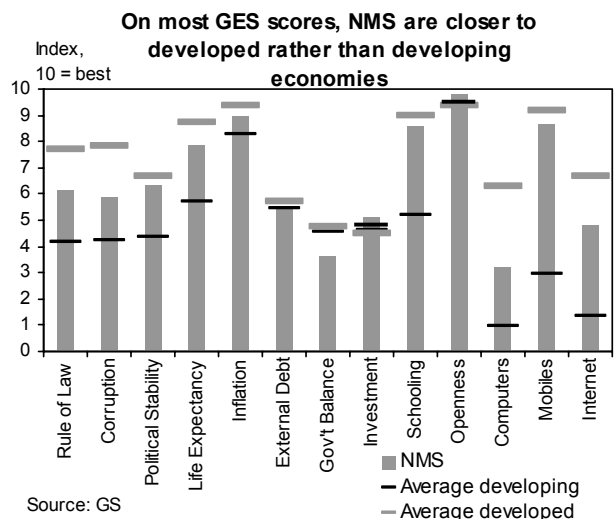
The EU acts as an umbrella or broad framework: it prevents (or at least makes costly) any large deviation from what is generally accepted as good practice in economic policymaking, and in important areas EU regulation actually leans in a market-friendly direction, despite its reputation for being 'statist'. EU rules are by no means perfect (for example, some interest groups are large enough to capture legislation even at the EU level, which is not in the interest of consumers). But they very likely result in a better overall outcome than the countries individually would achieve—and this appears to be true for both 'old' and 'new' member states.

EU regulation leans in a market-friendly direction

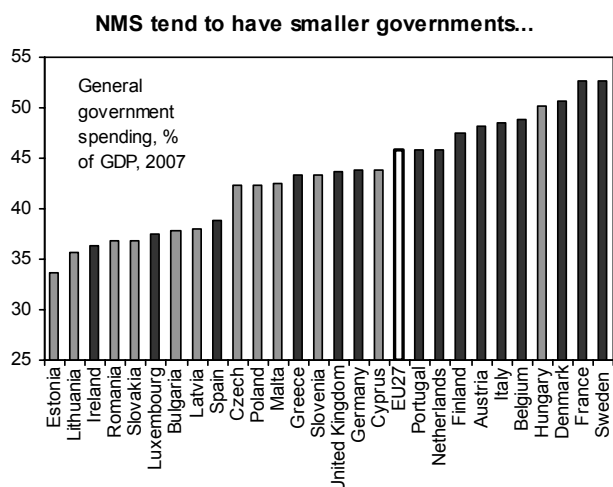
This 'regulatory umbrella' set-up is only successful to the extent that countries obey (and do not bend or change) the rules. It could be argued that the NMS should be better than some EU-15 states at implementing EU law. On the one hand, these countries are generally small and are rarely in a position to lobby successfully for the whole EU to change regulations. On the other hand, each NMS is a (potential) recipient of large amounts of structural funds. Governments risk losing access to these funds (and become politically unpopular at home) if they do not enact EU rules. Lastly, there is the issue of a



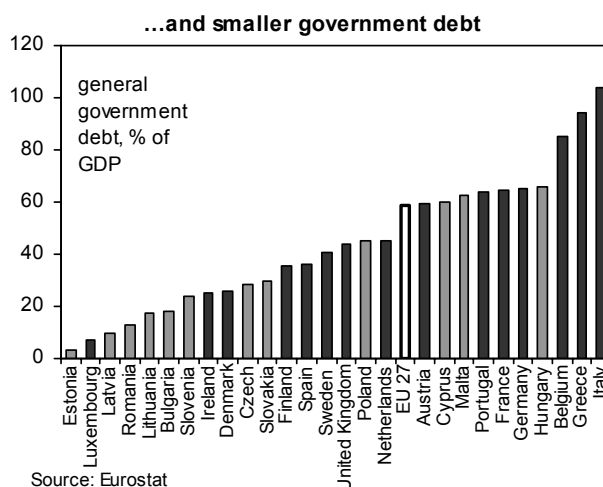
Source: European Commission, Cohesion Policy 2007-13: National Strategic Reference Frameworks



Source: GS



Source: Eurostat



Source: Eurostat

country’s ability to administer and enforce regulations and laws. Significant differences exist among the NMS, but on the whole they are behind the EU-15 in this area—we will return to this issue in our discussion of the risks in Section 4. The evidence also suggests that New Member States are diligent at adopting the rules of the internal market. They are, on average, better at embracing EU regulations, and fewer infringement proceedings have been taken out against them than against EU-15 members (see chart below).

Over just a few years, the NMS has ‘imported’ the existing EU regulatory/institutional capital to a large extent, and strong forces guarantee that the process is difficult to reverse³.

Not repeating old mistakes almost as important as adopting positives

While the New Member States imported many of the best practice regulatory capital from the EU-15, importantly—at least so far—they have largely managed to avoid the earlier economic policy mistakes of the EU-15. The NMS tend to have lower government debt ratios and government spending than the EU-15⁴, and some countries, such as the Baltic region, are exceptional in terms of managing to maintain a small state⁵ even by global standards. Also, on account of their faster trend growth rates (and the restrictions that already are or will be imposed on them by the Maastricht treaty), the NMS are less likely to run up large government debts in the future than the EU-15.

Importantly, the governing elites in the NMS are typically pro-capitalist and pragmatic, and have little ideological opposition to, for example, cutting profit taxes if that is required to attract capital. The result is that marginal corporate tax rates are lower in the NMS than in the EU-15. Also, many of the NMS have introduced flat tax systems for personal income (one tax rate for personal income above a certain tax exempt level). Typically, most of the exceptions that burden many older tax systems were eliminated at the introduction of the flat tax system. Often, a uniform tax rate is also applied to corporate incomes.

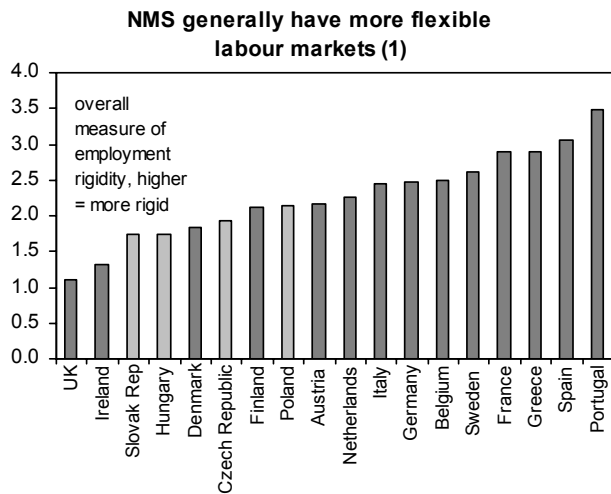
NMS governments tend to spend less...

...and have lower corporate tax rates

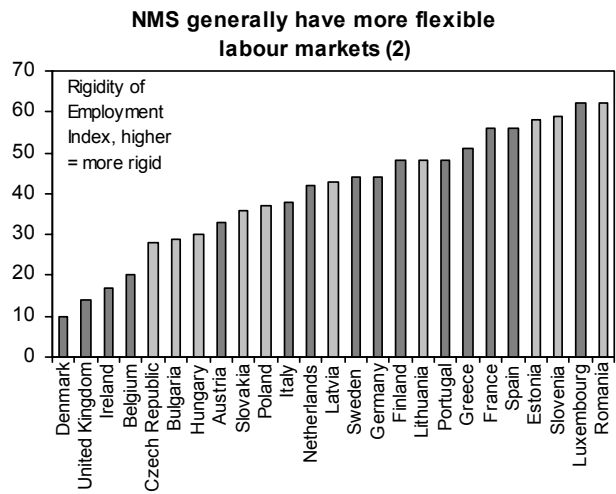
3. It is interesting to see how this rapid catch-up in regulatory/institutional capital was possible and how these countries were able to overcome the resistance of special interest groups, which were in a position to lose out. It appears that a mixture of the benefits of becoming EU members (including the financial resources that this implies) and a natural catch-up process after decades of statist economic policies did the trick. Identifying the dominant force will be useful for future potential members.

4. The main exception on the government spending side is Hungary, where the government spending to GDP ratio is among the four highest in the EU and still stands at 50%. But even there a consensus is building about the need to reduce government spending, or at least restrict its growth rate to below GDP growth.

5. It is not clear how decisive small government is for economic development, but recent successes in the EU either had low spending ratios (Ireland or Spain), or a relatively effective government sector and otherwise liberal policies (Scandinavia). For countries with lower administrative capacity than Scandinavia, the small government option is probably the safer option.



Source: OECD, 2003



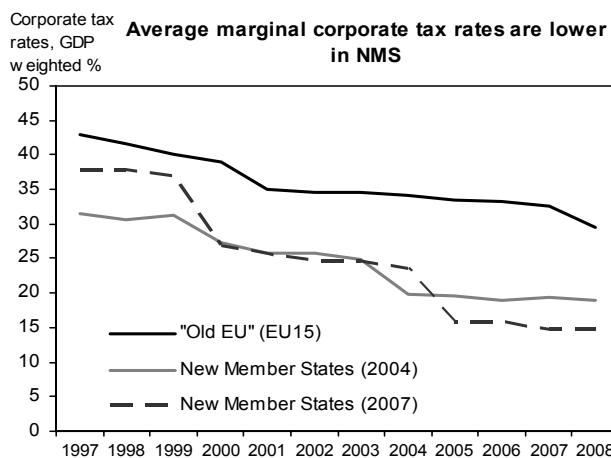
Source: World Bank, Doing Business 2009

Currently, seven out of the 12 NMS operate a flat tax system, and Poland will come close next year.

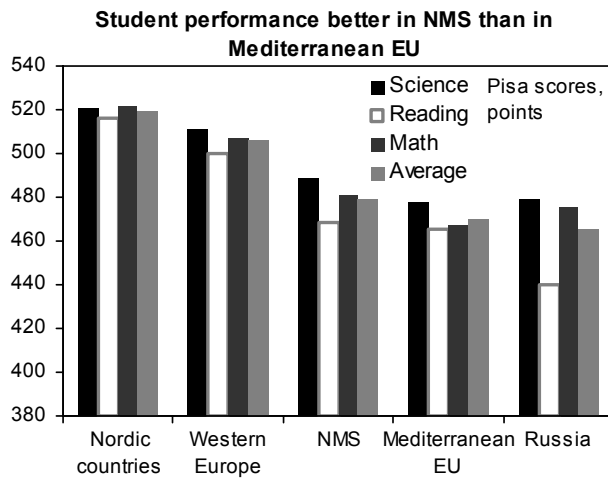
Labour markets also tend to be less rigid in the NMS than in those EU-15 countries with the most restrictive labour policies. But the advantage in this area is not as uniform as in the fiscal area and some of the labour market flexibility stems from the higher share of informal employment in the NMS. Importantly, though, the NMS have largely avoided the worst (past) excesses of some of the EU-15 countries in terms of trying to legislate against laying off employees. Competition from New Member States has helped the case for labour market reform in the EU-15. Some of the EU-15 have recently made their labour markets more flexible as well—partly as a reaction to the increasing migration of production to the NMS, and as NMS workers increasingly migrate to EU-15 countries. This has reduced (but, in the case of the Central European countries, not eliminated) the relative cost advantage of the NMS. Clearly, much remains to be done in terms of labour market reform in most of the EU, but most NMS start with an advantage, or at least from a position that is no worse than that of the older EU members.

NMS have largely avoided excessive labour market regulation

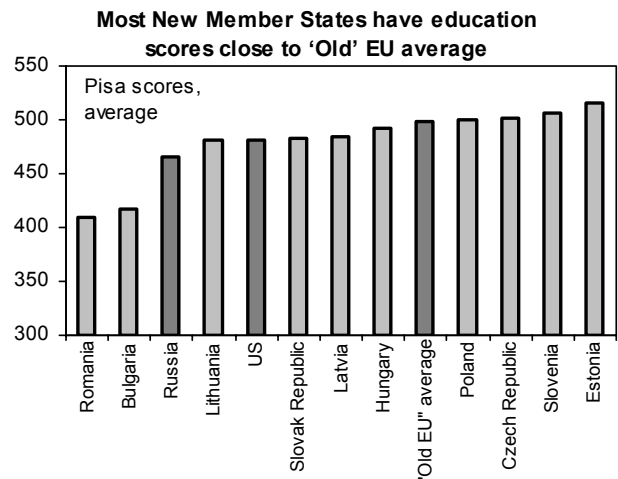
But how sustainable are these labour market advantages? We will return to this topic in the section about risks, but we are cautiously optimistic. Much of the labour market regulation in the EU-15, for example, was introduced with good intentions. The costs became obvious to politicians only later, when the creation of vested interests made it more difficult to reverse legislation. As long as policymakers and politicians can learn from earlier examples, some of the worst policy mistakes are likely to be avoided. It is becoming increasingly



Source: KPMG, Factiva and GS calculations



Source: OECD



Source: OECD

obvious that those countries with flexible labour markets are better-equipped to deal with the constant relocation of production and the relative price shocks that come with globalisation. The cost of misguided labour market policies probably becomes apparent earlier than in the past.

NMS are well endowed with human capital

Although the institutional capital in the New Member States is now similar, at least at the formal/legal level, to that in the EU-15 members, that in itself may not be enough to guarantee complete (and rapid) economic convergence. In many growth studies, human capital is an important part of the right mix that is needed to achieve rapid economic growth. In this respect, the NMS are relatively well positioned.

NMS score well on schooling variables

We incorporate into our GES scores a large number of variables that are likely to influence the speed of convergence to the highest income countries (see below). One of these is a schooling variable, based on enrolment in secondary education⁶. On this measure, the New Member States average 8.6, as opposed to 9.0 for the EU-15 (on a scale of 0 to 10). The difference is not significant and, in absolute terms, it is a fairly high value (the US, for example, scores 8.8 on this measure).

New Member States score even more favourably on education ‘output’ (attainment). The OECD conducts a survey that tests the performance of students in maths, science and reading. On this measure, the NMS average is above that for Mediterranean EU countries, and only slightly below the average for Western European countries. Several of the NMS, such as the Czech Republic and Estonia, score above the average for the EU-15.

We highlight this variable because traditional ‘input’ measures of education may not do full justice to the achievement of the NMS. Also, we believe that education is an important part of the mix needed for countries to grow rapidly and is probably harder to change in the short run than measures such as infrastructure endowments.

6. World Bank World Development Indicators database.

3. A 2050 scenario for the NMS

We use the same type of growth model that was used to develop GS BRICs projections⁷ to build longer-term projections for the potential of the New Member States to catch up with the rest of the EU. The model breaks GDP growth down into three components: employment growth, growth in capital stock and growth in productivity. For the NMS countries, the US Census Bureau population projections we used in the model show the labour force declining (although this is probably too pessimistic, given that the increasingly wealthy NMS are beginning to attract more migrants). Hence, the impetus to growth would come mainly from the catch-up with core Europe in levels of capital per worker and productivity.

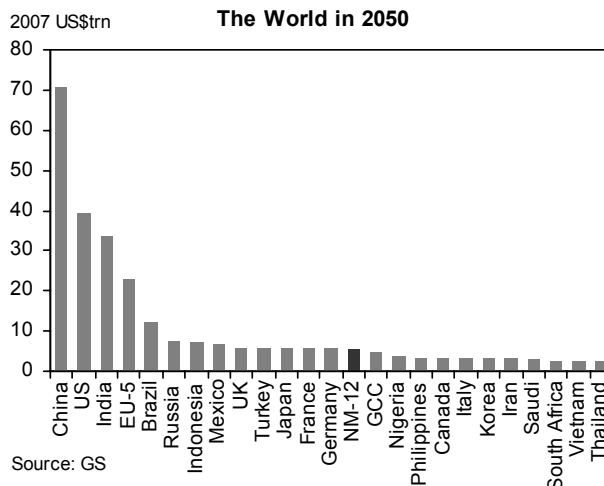
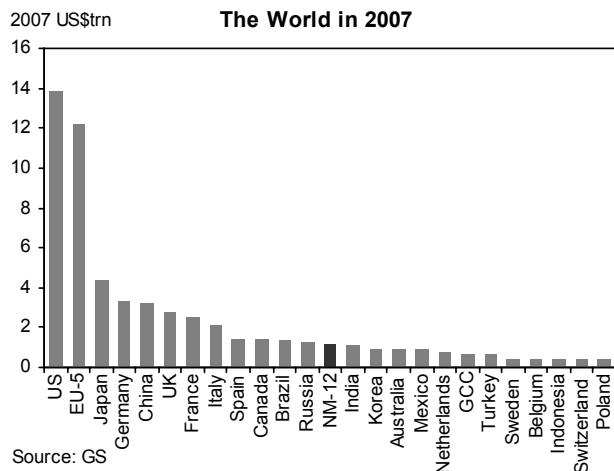
The combined GDP of the NMS could increase 4.5 times in real terms by 2050

The results, illustrated in the charts below, suggest that there is plenty of juice left in the convergence process, despite the progress already made. Real GDP growth rates for the NMS will generally converge to the EU-15 level of just below 2% by the end of the 2030s, and until then the NMS should grow by at least 2 percentage points per annum faster on average than core Europe. By 2050, the combined GDP of the 12 NMS would reach \$5.3trn in 2007 US\$ terms—4.5 times greater than the current \$1.2trn; over the same period, EU-15 GDP would only double to \$30trn.

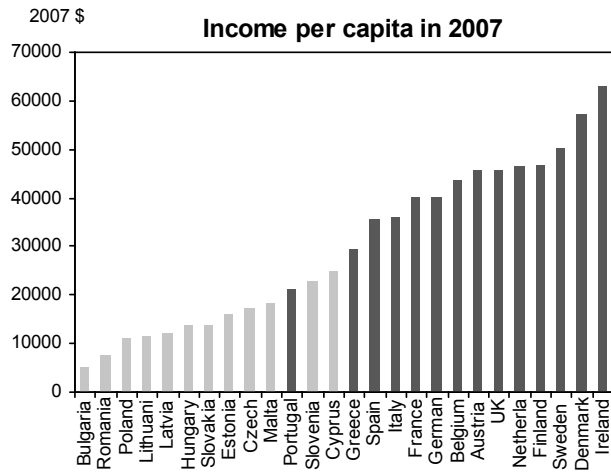
Rapid economic growth in the NMS would bring their per capita income levels very close to the core European states. In 2007, GDP per capita in Central Europe and the Baltic states was less than half of the levels in France and Germany. By 2050, the difference would be reduced to about 10%-15% on average. Most NMS would also overtake some of the ‘underperforming’ states of Southern Europe, while the more prosperous smaller countries have the potential to rival the wealthiest members of the EU.

NMS are likely to grow 2 percentage points faster than the EU-15

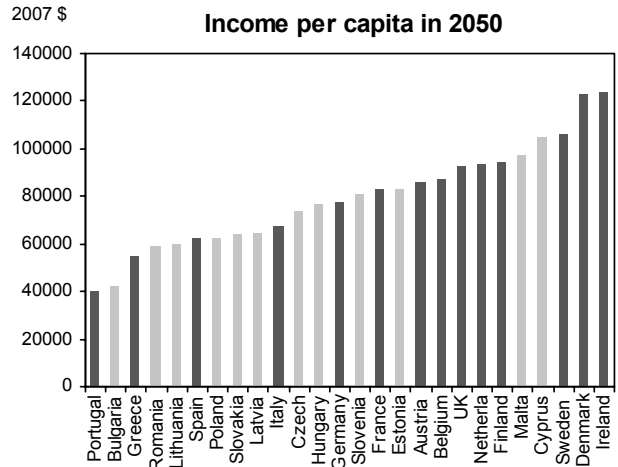
Our model projections may seem overly conservative, especially when compared to the recent stellar performance of the NMS. However, it is important to bear in mind that the model output reflects trend growth rates, implied by the three key fundamental inputs, whereas regional growth in the past 4-5 years has been clearly above trend. That said, the NMS do have room to grow faster than our projections suggest if they attain higher growth in total factor productivity, employment and capital accumulation.



7. The model projections were made by Dominic Wilson and Raluca Dragusanu. For a full description of the model and underlying assumptions, please see *Global Economics Paper* No 99 “Dreaming with the BRICs: The Path to 2050”.



Source: World Bank, GS

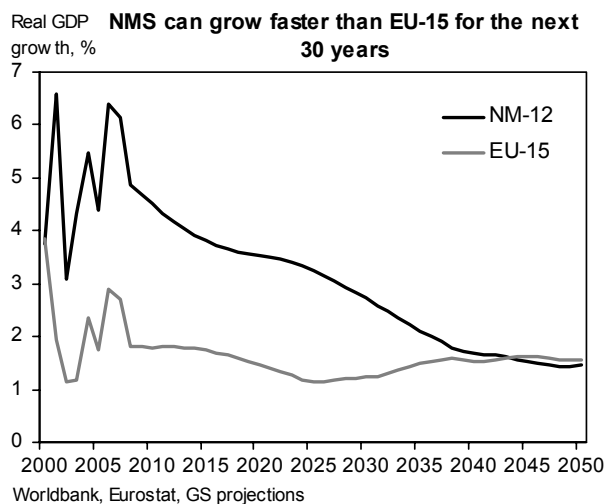


Source: GS

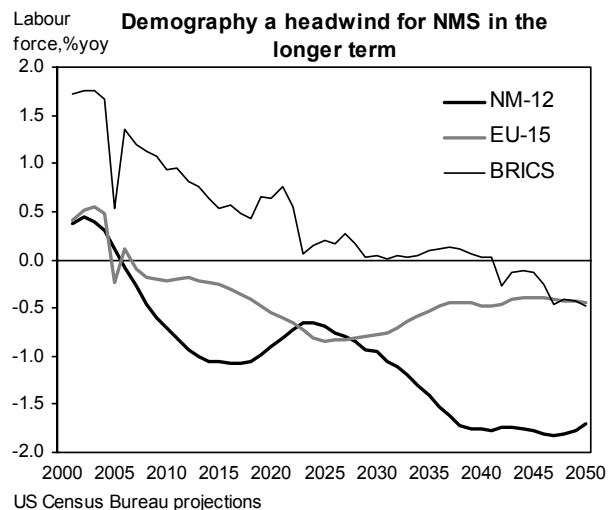
For the sake of simplicity, the model assumes constant investment-to-GDP ratios, based on ten-year historical averages for each country. With EU accession enhancing flows of private foreign investment into the NMS, supplemented with EU funds, investment rates in these states could plausibly be above average for the next few years, and then decline to levels closer to those of the core European countries. In this case, the convergence path for the NMS would be more front-loaded.

In addition, our model implicitly assumes constant employment rates (defined as persons in employment as a percentage of the population of the corresponding working age); so, as the population ages, employment growth declines. Rapid economic development in most NMS has gone hand-in-hand with gains in employment rates, but several Central European countries and Malta have lagged behind, including some big economies, such as Poland, Romania and Hungary, which means that an increase in employment rates would make a material contribution to growth in the region. Such an increase can come through greater labour participation rates for women, in line with trends in Western Europe. Another boost could come from older cohorts in the labour force; later retirement is also a Europe-wide phenomenon generally. But the NMS also benefit from the fact that the older cohorts that might have found it harder to adapt to changing economic realities during the 1990s and often fell out of employment are now being replaced by the next, better adapted, generations, who are more likely to remain employed further into older age.

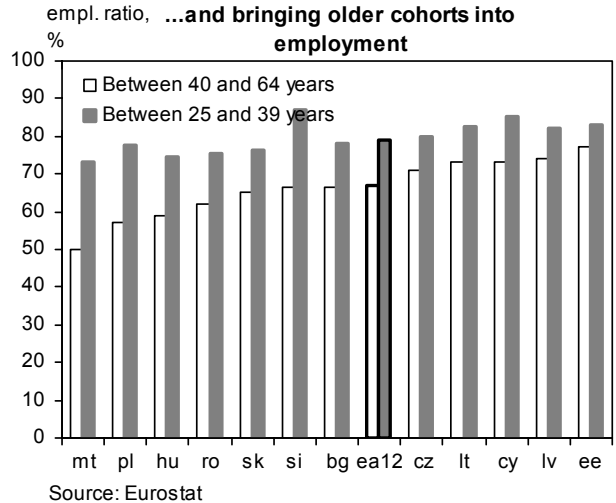
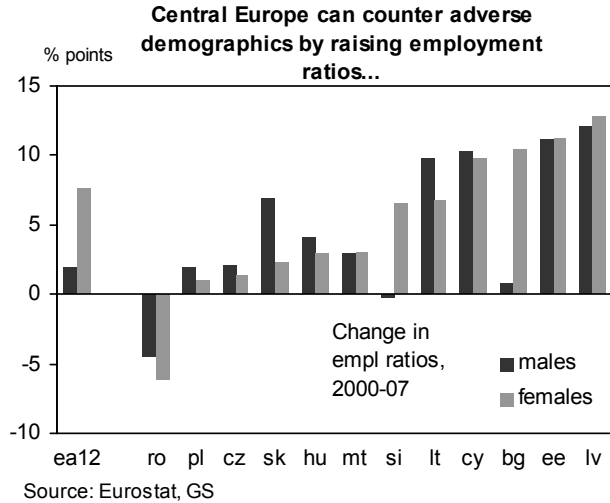
Our model projections may turn out to be conservative



Worldbank, Eurostat, GS projections

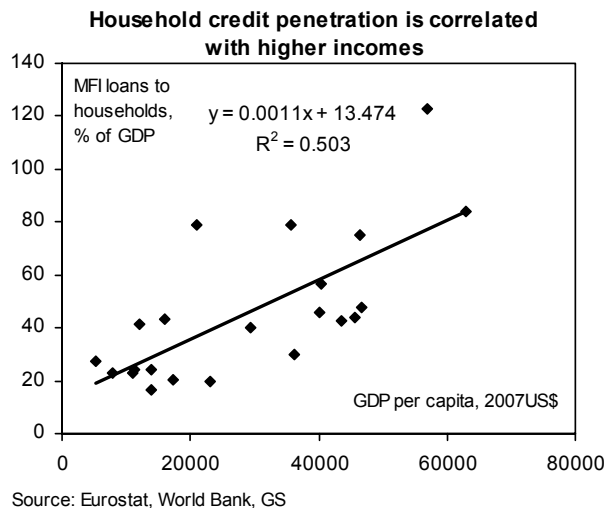


US Census Bureau projections



Growth in income per capita levels is also associated with the financial sector deepening. This is more easily traced for the household sector, since the mix of instruments for corporations' fund-raising is more complex and varies considerably across countries. Even after several years of high credit growth, loans to households are currently at about 25% of GDP in the NMS (not counting Cyprus and Malta). Based on our per capita GDP projections, one can expect household loans to GDP ratios in the NMS to reach today's core European levels of over 60% GDP by as soon as 2030. Recent history suggests that due to the rapid expansion of pan-European banks in the NMS, the convergence in financial penetration could happen even faster.

Financial deepening in NMS is likely to continue



4. The challenges ahead for the NMS

So far in this paper we have presented the case for the enormous potential for development in the New Member States. The emphasis, though, is on the potential. No country develops in a straight line, and in some cases potential is not fulfilled, often because of bad policies. In this section we look at the challenges that the NMS are likely to face, and some of the policies that can be employed to face these challenges and help these countries to fulfil their potential. We split the challenges into two broad groups: structural reforms and ‘macro’ challenges. The next ten years for these countries are likely to be more challenging than the past ten, partly because of the less supportive external environment, and also because some of the easy gains from convergence have been already achieved. Success, somewhat paradoxically, is leading to more difficult policy choices in many areas, and may, through complacency, undermine its own foundation.

The next ten years will be more challenging for policy than the past ten

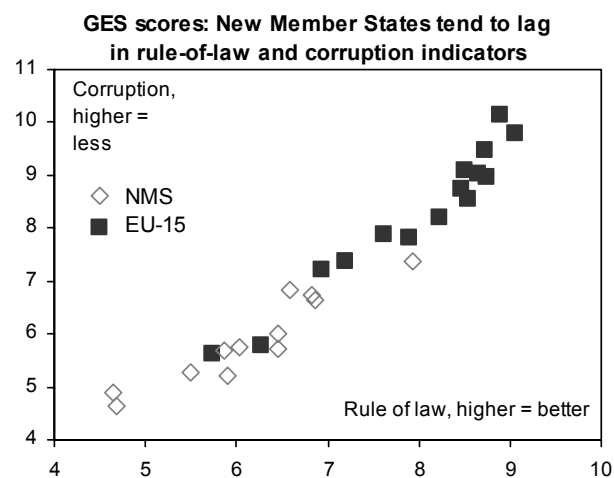
Structural challenges: Courts, corruption, complacency

Earlier we highlighted structural areas where the NMS have fared better than or equal to the EU-15, such as education, labour markets and generally business-friendly policies. We expect these areas to dominate economic development in the NMS. But the picture would not be complete without mentioning the structural areas where they fare worse than the EU-15—and that these areas present risks, especially if inadequate or no policy action is taken to remedy them. We see three broad areas of risks on the structural side: rule of law/corruption, administrative capacity and potential complacency.

Rule of Law/corruption. New Member States in general perform poorly in terms of corruption and ‘rule of law’ indicators, even compared with EU-15 laggards such as Italy and Greece. This is a problem in itself as they reduce the quality of life for the citizens of these countries, even if we disregard the likely implications for incomes. Relatively bad performance on ‘governance’ indicators is likely to be a heavier burden for small and medium-sized enterprises, as large ones (including, importantly, most foreign investors) have the resources and economies of scale to deal with governance problems. Large firms have legal experts and lobbyists, who partially compensate for these shortcomings, but this is a serious impediment to the development of a vibrant ‘Mittelstadt’ of (predominantly local) companies.

NMS perform relatively poorly on rule of law/corruption indices

New Member States have adopted the existing body of EU rules and regulations almost wholesale and, importantly, citizens in these countries have access to the European Court of Justice as a last resort. But legal cases typically take a long time to resolve and are costly. Corruption is partly related to the



weakness of legal systems, and also to the inefficiency of governments in the New Member States (see below). The rule-of-law and corruption indicators are well correlated (see chart on the opposite page).

Administrative capacity: NMS also tend to fare relatively badly on administrative capacity/quality of government measures (again, comparable to Italy). This is important, if for no other reason that governments in these countries will have to manage the channelling of large amounts of EU funds and the effective implementation of EU measures, not to mention managing EU presidencies from time to time. There are variations among countries, but government jobs tend to be underpaid in the NMS, while at the same time jobs are more ‘protected’ than in the private sector, with scant performance measurement. This combination does not help to attract and retain quality personnel. This is by no means unique to the NMS, but the inherited bureaucratic culture from Communist times in many countries exacerbates the shortcomings.

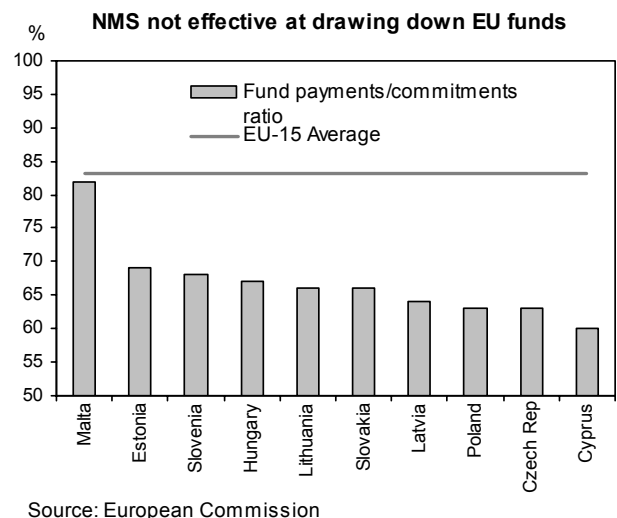
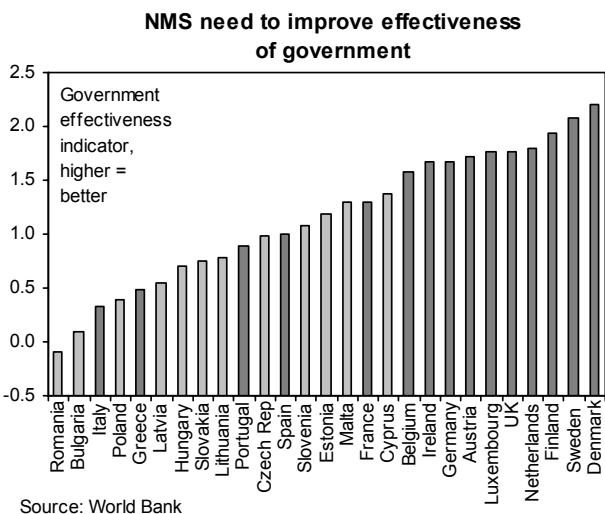
Governments’ administrative capacity is still weak in NMS

EU membership, perversely, tends to worsen the situation: the most talented public-sector employees in NMS often find that they earn several times their home salaries if they are employed by the EU institutions. This leads to adverse selection, and to a situation in which applicants take local state jobs as a temporary apprenticeship leading to better-paid EC jobs.

Ineffective governments sometimes result in badly-designed regulation and red tape; the EU regulatory framework is not encompassing enough to prevent this from happening, even if it rules out the worst market-restrictive measures. The NMS have mostly privatised their business sectors, but regulation is one area where governments often do too much, and where sometimes they fail to keep to the (often too long to begin with) deadlines. Administrative capacity has also led to relatively low levels of EU fund absorption ratios.

Complacency: Lastly, we should mention the risk that some of the ‘good’ policies may be reversed, possibly due to complacency on the part of policymakers and pressures from an ageing population. Policymakers in the NMS have so far assumed that they had to catch up with the most developed parts of Europe, and this has led to a technocratic, pragmatic policy consensus, despite the occasional noise and diversions. Often countries that were considered laggards have introduced the most radical pro-market policies, such as flat taxes, in an effort to leap-frog early reformers. Now that economic reforms are beginning to bear fruit, the urgency to catch up may wane, and political considerations may trump the technocratic consensus more easily. After years of continuous reform and very healthy macro balances, we may see

Complacency is a risk after a period of rapid reform



a temptation for NMS governments to spend a bit more, increase wages and pensions and ‘reap the benefits’ of EU accession.

Hungary is a recent case of how good policy consensus can in certain circumstances unravel. In the late 1990s Hungary’s economic reforms were considered to be among the more advanced of the EU applicants. But subsequently it has increased its budget deficits massively (at one point to 10% of GDP) and government spending has risen to more than 50% of GDP. The deficit reduction process is now hurting economic growth and large deficits have ruled out the introduction of the EUR, originally planned for 2008. However, Hungary is also an example of how responsible fiscal policies eventually need to be restored (even if the 3% Maastricht limit is not effective at preventing short-term overshoots). Now there is a political consensus that the deficit path needs to follow the Convergence Programme submitted to the EU. Hungary’s problems have very likely discouraged other countries that may have been tempted to follow its example.

Macro policy challenges: Learning to live with more inflation pressure and larger current account deficits

The most significant policy challenge for the New Member States will probably come from the macroeconomic side. To express this briefly, most NMS are now approaching full employment, which will mean that managing inflationary pressures will be a lot more challenging. This is occurring at exactly the same time as the global environment is turning less benign. Hence, NMS with a floating exchange rate/inflation targeting regimes will have to allow their currencies to appreciate in nominal terms, which could result in larger current account deficits and potentially more currency volatility.

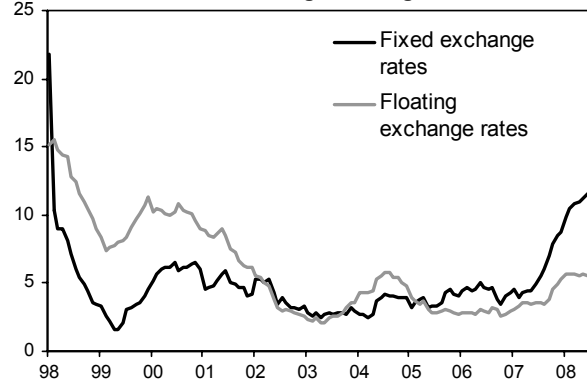
The most significant challenges will come from the macro side for NMS

Unemployment has helped keep inflation under control until recently

For a long time, repeated shocks kept unemployment rates high in the NMS, despite their relatively flexible labour markets. First, unemployment rates jumped and stayed at relatively high levels as economies restructured in the 1990s. The core-European and Russian-crisis-driven economic slowdowns in the late 1990s were an additional shock, as was the global economic slowdown in the early part of the 2000s. These forces helped to maintain unemployment at a relatively high level, and the history of high unemployment rates created the impression that the ‘natural’ rate of unemployment was high in the NMS.

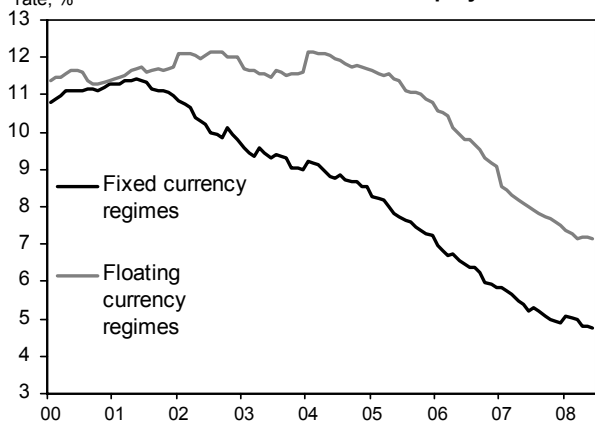
Loose labour markets, a generally supportive global environment and product market deregulation/development (the spread of more efficient retail outlets) created an ideal environment for disinflation in the early part of this decade.

Exchange rate fixers recently found it more difficult to fight inflation than countries with floating exchange rates



Source: Eurostat, Haver Analytics, GS

Fixed exchange rate regimes helped eliminate excess unemployment



Source: Haver Analytics, GS

Many NMS countries actually undershot their inflation targets in this period, and some managed to maintain inflation below developed country norms (for example, Euroland HICP inflation averaged 2.1% in 2003, while it was 0.7% in Poland and -0.1% in the Czech Republic). Importantly for policymakers, the trade-off between growth and inflation seemed very favourable: fast growth did not result in much of an increase in wages and inflation. EU accession in 2004 resulted in a temporary blip in inflation, but the low inflation, rapid growth situation was then resumed. If the decade leading up to circa 2007 was NICE (No Inflation, Consistent Expansion) for rich countries⁸, then it seemed that New Member States were on FIRE (Forget Inflation, Rampant Economies). Whether countries had fixed or floating exchange rates, inflation did not appear to be a problem (see chart).

NMS were on FIRE until recently

The NICE inflationary environment allowed countries to run relatively easy monetary policies and to some extent counteract the nominal appreciation pressure on their currencies. This occurred by default in countries with a fixed exchange rate regime, but even countries that had floating exchange rate regimes had accumulated FX reserves and kept interest rates low, which resulted in low carry and weaker exchange rates than would have been the case otherwise. Regimes with a ‘weak exchange rate policy’ ended up with low current account deficits.

Labour markets have been tightening everywhere...

Tightening labour markets and global shocks transform inflation outlook

This state of affairs has started to unravel recently at a rapid pace, and we expect the policy choices for the NMS to become a lot more difficult (even more so than in major economies). The low (wage) inflation/low external deficit environment began to change first in those countries with fixed exchange rates. But as far as the external balance side and labour markets are concerned, these countries are likely to be forerunners for the ‘floaters’ as well.

Extremely strong growth in NMS with fixed exchange rate regimes has practically eliminated any slack in their labour markets (see chart). The fixed exchange rate arrangement has resulted in low interest rates and a domestic consumption boom in many of these countries, helping to eliminate excess unemployment. The floaters could maintain tighter monetary conditions with higher interest rates/nominal currency appreciation, and the reduction of unemployment is taking longer—but these countries are heading in the direction of tighter labour markets as well. Many of the rapidly growing and

...and the growth/inflation trade-off has deteriorated



8. This formulation is from Mervyn King, the Governor of the Bank of England.

overheating fixed exchange rate regime countries have also developed large current account deficits as a by-product of their booms, financed by strong capital inflows.

Although some of the current labour market tightness in the NMS is likely to be cyclical, we do not expect the favourable inflation growth trade-offs of the past high unemployment era to return. Drastic reduction in unemployment rates is of course a good thing and one of the benefits of EU accession, but it complicates policymaking. The NMS still have relatively low wage levels and, at least at the FDI-financed manufacturing sites, practically the same productivity as the EU-15 members. This places constant upward pressure on wages. This tendency for wages to rise is exacerbated by the increasing ease of arbitrage in labour costs: manufacturing production has shifted to the NMS from the EU-15 member states and, increasingly, NMS workers can also move if there are large differences in the wages they can earn⁹.

The recent global inflation shock, transmitted through energy and food prices, came just as labour markets were tightening anyway. Inflation has increased everywhere in the NMS, although those with floating exchange rate regimes were better-positioned to limit the damage by allowing currency appreciation. We expect second-round effects through wage increases to be more difficult to contain in the NMS than in more mature markets, owing to the convergence pressures on wages described above. Wage growth has accelerated recently in the NMS (see chart), and it typically has a faster pace than is compatible with low inflation in the longer run.

Current account deficits to increase in the NMS with floating exchange rate regimes

To fight inflation, floating exchange rate/inflation-targeting countries will have to allow their currencies to appreciate, or increase their domestic interest rates to encourage this to occur. This has started to happen recently (and in the short run it may even have gone too far in some countries), but with tighter labour markets and a less supportive global environment, the inflation-targeting central banks in these countries will likely have to rely on nominal currency appreciation to a larger extent. Given that they are small open economies, this is the only effective way for these countries to fight inflation.

Put differently, the strong capital inflows into the NMS force current account deficits to increase eventually, one way or another. In recent years, in many of the floating currency countries (with the exception of Romania), FDI inflows have been large enough broadly to finance current account deficits, which tend to be relatively stable (see chart). But strong trend productivity growth in these countries is very likely to attract other types of capital inflows as well.

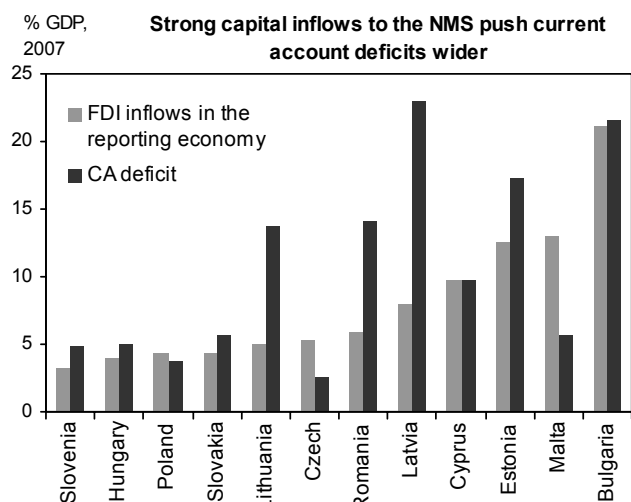
The world as a whole is still looking for ‘credible’ investment destinations where excess savings can be put to work, and these countries fit the bill, as we have argued above. The NMS have very good long-term growth potential, and at the moment the external balance side is still excellent in the Czech Republic, Hungary, Poland and Slovakia.

Strong capital inflows are likely to push the floating currencies in the NMS to a level where current account deficits will become sizeable (Romania’s current account deficit is already very large by historical standards). If central banks resist this by cutting interest rates to low levels, eventually they are likely to generate a domestic borrowing boom similar to that in countries with fixed exchange rate regimes, which in turn would push the current account deficits

Inflation-targeting countries are better equipped to deal with global price shocks

Current account deficits are likely to widen in floating currency countries

9. The mirror image of this process is that the bargaining power of workers in EU-15 has been eroded, contributing to wage discipline there, and possibly also eroding the political resistance to labour market reforms.



wider. We expect current account deficits in the Czech Republic, Hungary, Poland and Slovakia to increase several percentage points in the next few years from the current level of around 4% of GDP.

Strong capital inflows and large current account deficits are a ‘natural’ state of affairs for the NMS, in our view, and are beneficial, as these countries need to build up their capital stock. It also makes economic sense for households (which are becoming richer over time) to increase their very low financial leverage, which, by reducing the domestic savings rate, also pushes current accounts toward deficits. Large current account deficits are normally a vote of confidence from the market. But market confidence can change significantly; portfolio and other inflows tend to be more volatile than FDI, and a larger current account deficit, financed by these flows, is likely to result in more volatile currencies and interest rates. If there is a ‘sudden stop’ of capital flows, then countries with wider current account deficits are more likely to suffer.

Countries with a fixed exchange rate regime are at a more advanced stage in this process. Some of them, such as the Baltic states, already have very large current account deficits, have had domestic overheating during the period of strong capital inflows and are now feeling the impact of ebbing capital flows on the back of less forthcoming bank lending. This is pushing these countries towards recession right now. Floating currency countries are likely to have less volatility on the output side even in the future, but they will have to prepare for more volatility on the currency side. Given that they are small open economies, this will complicate inflation targeting and increases the risk of asset price bubbles.

Why we remain optimistic about structural issues

The above areas show that economic growth/convergence is not on ‘autopilot’ and is not without risks. But these issues are unlikely to be severe enough to wreck development, for two reasons. First, the laggards of the EU-15 have similar problems, and that has not prevented them from achieving reasonable convergence with core EU countries such as France and Germany. Greece has a PPP GDP per capita that is about 80% of the German level, and Italy has more than 90% of the German level. The NMS would still have some way to go before they hit these boundaries.

More optimistically, we think that if governments prioritise the important policy areas, they can achieve a great deal of improvement. The proliferation of governance indicators and league tables will make this concentration (and the tracking of improvements) easier than in the past. We can also hope that

Large current account deficits are ‘natural’ for NMS, but can still cause problems

increasing incomes and the developing civil society will also gradually help solve some of the structural shortcomings.

NMS need to concentrate on seven policy areas

The New Member States are in a relatively comfortable position, given their high potential growth rates. But, as we have shown above, to fulfil that potential, they will have to maintain the ‘good’ parts of their policy mix, and improve in some areas. So far, we have mainly compared the NMS to EU-15 members and found that in many areas they come out rather favourably, or at least no worse than EU-15 countries. This is enough to show that a further fast convergence to EU-15 income levels is likely. But in policy design, New Member States should remember that in many areas the majority of the EU-15 members are not following international best practice. In these areas (for example, labour market regulation) the NMS should strive to achieve more than just some kind of EU-15 average.

The EU is also part of the policymaking apparatus in NMS, and it will have an important role to play in the successful development of these countries. The EU’s role is not only that of shaping an important part of the policy mix; it will also dispense large amounts of money in the future (potentially around 3% of recipient country GDP per annum). This represents both an opportunity and a threat. These funds will help to build important infrastructure, and will give the EU leverage to promote further reform. On the other hand, pouring money into economies that could be more corrupt than most of the EU-15 members, and that have governments with weak administrative capacity, runs the risk of increasing corruption and waste. It is important that EU institutions apply very stringent rules for how these funds are spent.

It is also important to note that the differences within the NMS are as wide-ranging as those in the EU-15; therefore the optimal policy emphasis is different from country to country. But we think the following seven policy areas are the most important for the NMS as a group:

- **Maintain macroeconomic stability:** In inflation-targeting NMS, the temptation will increase to change the mandate of the central banks and to move towards ‘mixed’ mandates (maybe including elements of exchange rate stability and growth as dual targets) as current account deficits widen and global influences make inflation fighting more painful. We think it would be a mistake to try to dilute the inflation-targeting regimes in any way, and it is precisely during these periods when these regimes can anchor expectations and prevent inflation spiralling out of control.

The situation is more complicated in some of the currency board countries, such as Latvia. Here, maintaining the fixed regime may involve large output costs in the near term, due to the overheating in the past. But we believe that at this point abandoning currency pegs would be even more costly, as the likely weakening of the currencies would involve pushing many households and corporates into bankruptcy due to the prevalence of foreign currency denominated loans, and would also increase inflation from already high levels¹⁰. In any event (even if fixed exchange rate regimes are abandoned at some point), allowing inflation to get out of control would be a significant mistake.

- **Anti-cyclical fiscal and regulatory policies.** With monetary policy becoming less effective everywhere in the NMS, fiscal policy preferably should not just be prudent—it should be countercyclical. This would involve fiscal surpluses during good times, which is a tighter regime than the EU

Governments can help by concentrating on seven policy areas

EU has a role to play to improve policy in the NMS

It would be a mistake to dilute inflation-targeting regimes

10. However, running a currency board gives no guarantee that the fixed exchange rate is sustainable from a political/fiscal point of view, as the example of Argentina demonstrated.

requires of these countries. The NMS should consider establishing fiscal institutions and/or rules that would set the annual overall fiscal targets depending on some objective measure of the business cycle.

Regulation should also aim to be countercyclical: for example, it could include rules requiring banks to hold higher reserves during times when credit growth is faster—the NMS will have to incorporate the lessons of the current credit crunch to avoid a repeat performance as their financial systems grow rapidly.

Fiscal and regulatory policies should not just be prudent, but counter-cyclical

- **Introduce the Euro as soon as possible¹¹**, but until that happens preferably run one of the ‘corner solutions’—an inflation-targeting regime or a very strict currency board with plenty of fiscal and regulatory cushion (see previous point). The main reason for early Euro introduction is that this would make managing wider current accounts a lot easier, as monetary policy would not need to try to offset the ebbs and flows of the more volatile financing flows. The FX and fixed income markets of these countries would also become a lot more liquid.

We think that boom/bust risks cannot be avoided just by having an inflation targeting monetary policy, especially in small open economies¹², while as long as the NMS stay outside of the Eurozone, the risk of a self-perpetuating credit crunch/currency crisis is bigger. With the Euro introduction, these countries would eliminate the risk that in a financial crisis or economic slowdown, capital flight would bring down the currency with it, and would require pro-cyclical interest rate hikes.

Introduce the Euro as soon as possible...

- **Prepare for continuous structural change.** Policymakers in NMS may be tempted to believe that after so much structural change, they may be due a more stable period. On the contrary, they should prepare for a need to adapt continuously to the changing world (as does any other country). There are plenty of areas (pension systems among them) where the current status quo will have to change. The NMS should build and strengthen policy institutions that are removed from the everyday policymaking and evaluate longer-term policy initiatives. Policymakers will have to find a way to build political support for the necessary changes, and this may involve short-term fiscal costs as some of the losers are compensated.
- **Improve the judicial systems.** We take this as a separate point because of its importance and because it has a positive spill-over effect on other areas. This would also improve corruption and government efficiency. It is especially important to boost the timeliness and the efficiency of resolving business disputes, including those that involve the government. Boosting the efficiency of the judicial system will likely require more government spending in this area, and will also take several years to begin to bear fruit. But we believe that eventually it would pay for itself through increased economic efficiency and would also be politically easy to implement, as it would be popular with voters.
- **Strengthen governments.** NMS should concentrate on the administrative capacity and transparency of governments. This, again, would imply fiscal costs in the short run but more than likely would pay for itself in the longer term through, for example, a more efficient use of EU funds and less waste in general. Improving administration would have to involve a wide range of areas, including finding ways to pay for highly qualified individuals to enter (and stay in) public administration. The NMS should also strengthen their government disclosure rules—often, it is too easy to avoid publishing the

...and improve judicial systems

11. These countries are already committed to introduce the Euro at some point, so this is a point about the timing of entry.

12. Indeed, this was not enough to avoid credit cycles in other inflation targeting regimes, such as the UK.

details of, for example, government contracts. The EU should consider making it a requirement to publish in full all contracts that involve EU funding.

- **Strengthen the private sector and competition.** NMS have privatised important parts of their economies, but there are still some government-owned assets that could be sold. However, de- and re-regulation are even more important. Liberalising product markets and strengthening competition is an important way to mitigate inflation and overheating risks, and in the longer run would increase potential output. It is also important that the NMS should not let the relative size of government spending increase significantly in the future, at least not until the efforts to make the government more efficient bears fruit. We believe the fast trend GDP growth will provide enough room for manoeuvre to achieve that objective, even if demographic changes push NMS governments in the direction of higher pension spending.

5. Conclusions: We continue to see ways to profit from rapid convergence in NMS

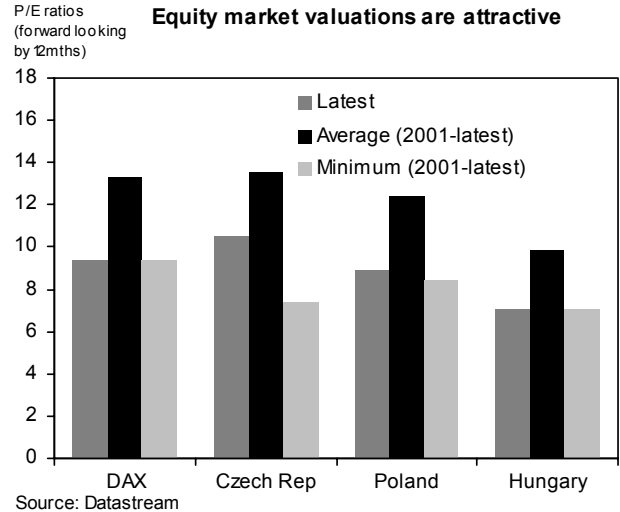
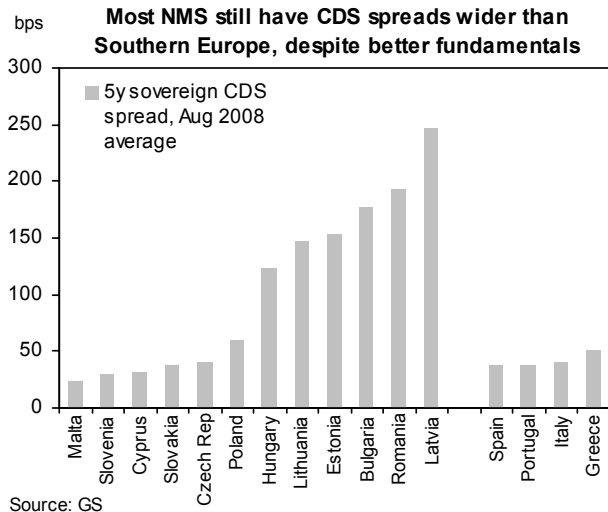
On the whole, we expect the New Member States to continue to improve their policy environment, and to make advances in most of the key areas we have listed above. This should open the way to continued strong growth in the next ten years and beyond. It looks likely that the New Member States of the EU will continue their rapid trend growth rates (around 4%)—substantially above the EU-15 average—for the next ten years. It also looks likely that their financial sectors will develop at an even faster rate. From a longer-term, structural perspective, we are far from the end of the convergence process. It is important to bear in mind, though, that this is a projection of the longer-term trends and for the region as a whole. In any particular time period or country, rapid growth is not guaranteed. Indeed, it is not guaranteed for the region as a whole either, if it does not follow the right policy mix. For example, the current global slowdown is likely to prove a headwind for the NMS, resulting in a slowdown and in some cases, such as the Baltic countries, an outright recession. That said, the region as a whole should still outperform the EU-15 by a comfortable margin.

The EU-15 have benefited from the dynamism of the NMS in many ways, and will continue to do so. It is as if the EU-15 effectively had another very dynamic BRIC country on its doorstep, with close cultural and (improving) transport links. To describe the process as convergence does not do it full justice, given that the EU-15 members have changed in the process as well, by expanding into new markets, by seeing the need for structural reforms more acutely because of the dynamism of the NMS, and by increasingly accepting their workers. To a large extent, for the EU-15 globalisation has meant the appearance of the NMS on the horizon, while for the NMS it has meant joining the EU. The accession of the New Member States to the EU has been a clear example of a hugely mutually beneficial development, despite the occasional frictions. We think this cooperation will continue to benefit both sides in the future, and will result in an EU that is more homogenous, a good deal richer overall and structurally more sound.

We expect all of the current NMS to introduce the Euro in the next ten years, and to make great advances in terms of infrastructure and capital stock in general. This should result in a significantly higher income per capita and consumption. In the meantime, the financial sector will grow significantly even compared to nominal GDP.

The current slowdown will be headwind, but the NMS as a whole will still outperform

The EU-15 will continue to benefit from the dynamism of the NMS



How should investors take advantage of this? On the currency side, the real exchange rate appreciation will continue, and in the case of the inflation-targeting countries, that means a long-term trend nominal appreciation. The need to rein in inflation in the face of the global shocks, as we described above, and the prospect of Euro introduction will reinforce this long-term trend. Euro introduction will also mean that nominal bond yields will converge to Eurozone levels. In most cases, this means a decline, but in the Czech Republic, for example, it means an increase in yields. Holding long maturity domestic currency bonds provides investors with exposure to both of these trends.

Currencies should stay on a nominal appreciation trend in inflation-targeting countries

We also expect Euro introduction to compress CDS spreads substantially from current levels: countries with similar fundamentals tend to have lower spreads inside the Eurozone than outside of it. The NMS still tend to have large premiums compared with even the weaker Southern European countries (see chart above). The introduction of the Euro and the gradual convergence of income levels should largely eliminate these. Based on fundamentals such as government debt to GDP, fiscal balances and growth potential, we think many of the NMS CDS spreads will be able to trade through the weaker Southern European spreads once inside the Euro-zone.

We also remain bullish about the long-term outlook for equity markets. Currently, equity valuations, on a P/E basis, are more favourable in NMS than in major markets. This means that investors do not have to pay any premium to obtain exposure to the higher growth rates of the NMS equity markets: on the contrary, in most NMS equities now trade at a discount to EU-15 comparables. In volatile times the timing of entry is crucial, but we believe that valuations are very attractive right now, and will eventually prevail. In the medium term, we would prefer the equity markets of the exchange rate floater countries versus the fixed ones, as the latter group is a lot more stretched on the current account side and the fixed exchange rate regime is likely to amplify the effects of the current economic slowdown.

CDS spreads and equities should also perform well

István Zsoldos and Anna Zadornova

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