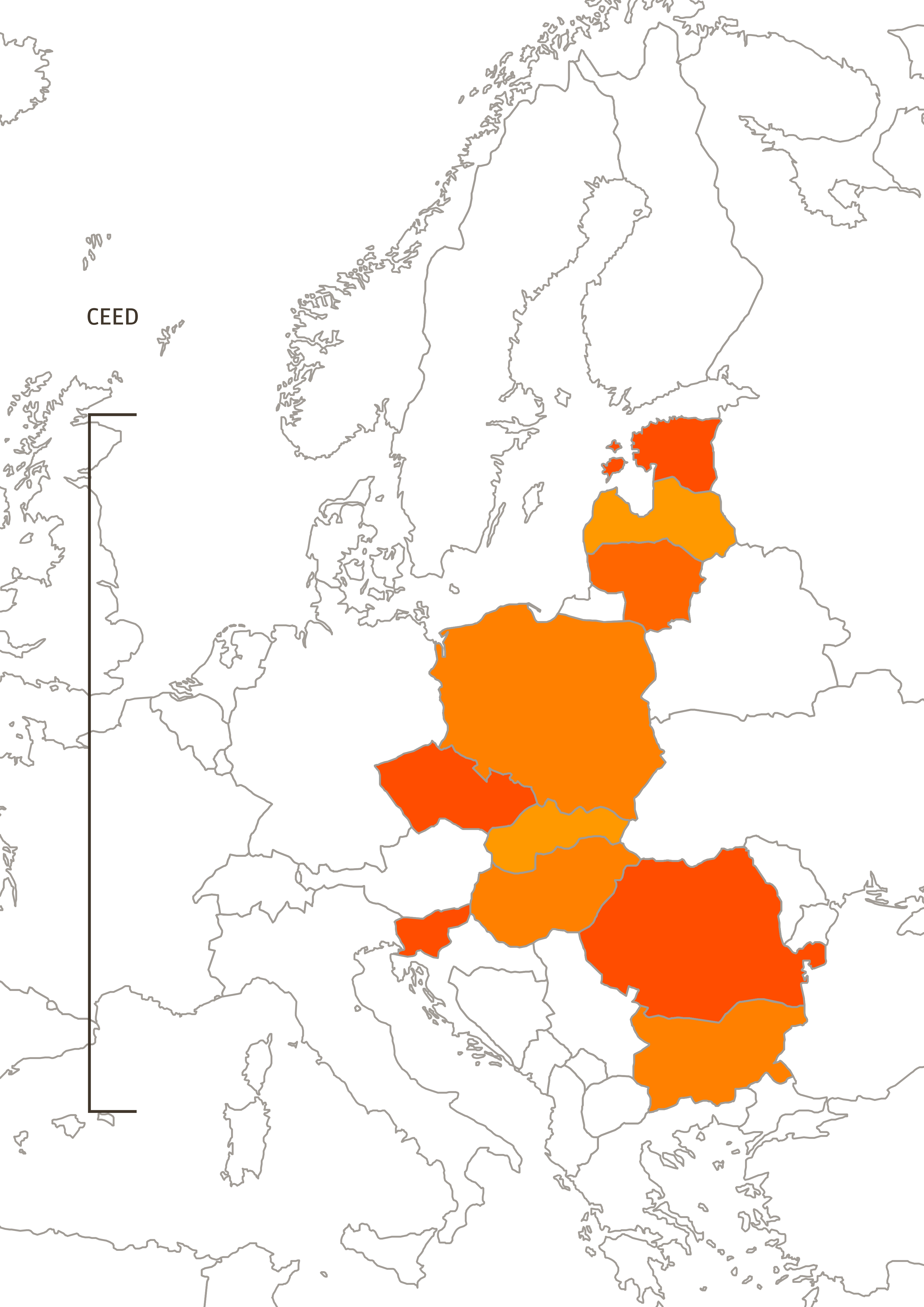
cee|d central & eastern europe development initiative

shared experience, common development

central and eastern europe development CEED

achievements, opportunities and challenges


CEED

CEED – shared experience, common development.

Dr Jan Kulczyk
CEED initiator, international entrepreneur and owner of Kulczyk Investments.

Ladies and Gentlemen,

I introduced the idea of a new alliance for Central and Eastern Europe Development – CEED – a year ago. Here the "D" represents not just economic and institutional development but also the social advancement of our citizens. It is a vital symbol and dimension for the further and future growth of our CEE economies and countries. I hope, that the CEED will become a model for renewal and resurgence, and the a great example of entrepreneurship on the global economic map. After all, the formulation and delivery of new ideas, new and different attitudes, approaches and directions, combining the best from each of us and our collective achievements, is also a legacy of Solidarity, and will become CEED's mantra for further and greater development.

Let me introduce the first CEED initiative report, which will allow us to advance our idea: **Central and Eastern Europe Development: Achievements, Opportunities and Challenges**. It proves, that the base for such a collective effort of CEED countries is more than solid. The report states clearly that this region is a great example of transition and integration success story. Between 1995 - 2008 all ten CEED states have managed to grow at much faster rates than the core of the EU, and in the period 2000–2008 they received the largest amount of FDI in per capita terms second only to East Asia as far as absolute FDI inflows.

Although hit hard by global financial crisis, the CEED coped better than most of the Euro area member states. Most importantly, the CEED will likely remain by far the fastest growing part of the EU, with predicted growth rates almost twice as high on average as growth rates foreseen for the EU15 and the euro zone. It is an absolutely unique feature, that the CEED currently combines the potential of emerging markets with the stability of developed economies. Worth to add, the engine for growth is in the hands of entrepreneurs!

The CEED initiative, should be a platform for market economy leaders to promote their achievements independently of their governments and bring about a new set of standards for regional cooperation. Let me warmly invite you to the CEED! I wish you an interesting reading.

Yours sincerely

The CEE should come out of the shade.

Solidarity – a word and value, which has changed the history of Europe and the world in XX century. Solidarity is about willingness of people for tackling the challenges together. The Central and Eastern Europe's revolution of 1989 was only possible because we had a courage to make our dreams come true and to think in a wider, strategic perspective. It has resulted in CEE's successful accession to the NATO and the EU.

The economic crisis has proved that there is a strong need for a common action on a global and European level. If Europe wants to be successful in this century of globalization, the narrow national interests cannot prevail anymore.
In this sense I appreciate those who could think creatively, who could identify the challenges and explore the opportunities in their best possible ways in order to make our world a better place to live. I am glad to support the initiatives encouraging the development of the region of Central and Eastern Europe, to be presented as a solid partner in a global market.

Therefore I have joined the CEED project undertaking. We should not only be proud of our successes which have already been achieved, but to promote this kind of attitude, which would ensure prosperous future for us all.

CEED initiative is a common effort of visionary entrepreneurs, who in a spirit of solidarity want to give our region a greater voice in global political economy. It definitely deservers it!

Lech Walesa
Historical leader of Solidarity movement (1980-1989),
Nobel Peace Laureate (1983)
and the President of Poland (1990-1995).

Anders Åslund
Author of The Last Shall be the First. The East European Financial Crisis (Washington, 2010); a senior fellow at the Peterson Institute for International Economics.

The last shall be the first – I have argued in my latest book on the East European financial crisis. The CEE-10 countries, rather than being the laggards, can be the leaders of economic policymaking. The political economy of crisis resolution has been equally striking and the public accepted significant hardship with minimal protest. It is remarkable how well these countries have steered out of crisis. The CEE economies have come out leaner and more efficient. Nothing is more easily taken for granted than such a success!

Janusz Reiter
Former Poland's Ambassador to Germany and the US.
President and founder of the Center for International Relations.

In the aftermath of 1989, the countries of CEE undertook far-reaching political, social and economic reforms. They achieved an absolutely tremendous success thanks to commonly shared values such as freedom, solidarity, belief in market economy and their struggle for modernization. But CEE's 2004-2007 entrance to the European Union – a symbol of continent's regained unity – did not mean that they reached a safe heaven. It appeared, that in the meantime the cherished EU has changed and now it must undertake even more challenging courses to remain competitive in a globalised world. I believe, that the CEE region has all the assets for reinvigorating Europe's prospects, thus we can call it CEED. This entrepreneurial initiative will surely help European and global decision-makers and investors to be more aware of CEED's - still unrecognized - potential.

Executive Summary

The CEE region is a great example of transition and integration success story. It should be rather called CEED, where "D" means Development. **CEE-10 states have managed to grow at much faster rates than the core of the EU, increasing their GDP levels by 40-120% over the 1995-2008 period.** Rapid economic growth has allowed these countries to substantially reduce per capita incomes gaps to the EU15 countries.

CEED enterprises benefitted from integration with the EU market, demonstrating their **flexibility, adaptability, productivity and ability to operate and expand in a very competitive environment.**
The pre-accession period together with EU enlargement forced these firms to undergo rapid, and costly restructuring and privatization processes. But growth of trade and investment flows between **CEE and the EU stimulated by unrestricted access to the Single Market, has been a powerful engine for CEE economic growth and development.**

Between 2000-2009, CEE was the one region in the world which received the largest amount of FDI in per capita terms second only to East Asia as far as absolute FDI inflows.

Although hit hard by global financial crisis, the CEED coped better than most of the Euro area member states.
The region was able to draw on and benefit from hard transition and accession lessons learnt during earlier transition and integration period. Without the kind of EU support envisaged for the Euro area members, the CEED countries were able to address and rapidly resolved their macroeconomic problems relying on self-imposed discipline, instead of easy solutions and external assistance.

CEE is likely to remain by far the fastest growing part of the EU, with predicted growth rates almost twice as high on average as growth rates foreseen for the EU15 and the euro area. This growth advantage will be key in maintaining the CEED position as the most attractive place to invest in Europe in the foreseeable future, competitively on par with other emerging markets as growth engines in the global economy.

Introduction

Although the central and eastern Europe region can geographically be defined broadly to include also non-EU member states in the Balkans and in the CIS region, we wish to acknowledge the crucial factor which distinguishes the 10 CEE states (CEE-10) from the other countries: successful integration and entry (2004-2007) to the European Union[1]. EU accession has framed the CEE-10 with a common set of standards, rules, benchmarks, institutions and policy-making processes. EU entry has provided a more coherent framework for outlining CEE-10's common history of transition, achievements and problems as well as opportunities and challenges.

In the aftermath of 1989 the countries of central and eastern Europe (CEE) undertook far-reaching economic, political and social reforms. Thanks to a common set of values linking freedom with solidarity, market economy with modernization, and democratic reform, the transformation process proved to be highly successful.
After having recovered from the fall of output and transition recession in the early 1990s, the CEE-10 have been growing fast, gradually reducing income gaps between them and the more affluent countries of western Europe. Rapid growth has been fuelled by trade, financial and institutional integration with the EU, including harmonization of laws and standards. But the global financial and economic crisis of 2008-2009 hit the CEE region particularly hard, with most countries suffering substantial falls in output levels, generally more severe than in western Europe. But CEE-10 have managed successfully and are recovering quickly. Their prospect are bright, although new challenges have arisen from a new global economic environment.

[1] These are: Bulgaria (BG), the Czech Republic (CZ), Estonia (EE), Latvia (LV), Lithuania (LT), Hungary (HU), Poland (PL), Romania (RO), Slovenia (SI) and Slovakia (SK).

The CEED as transformation and integration success story

The CEED as transformation and integration success story

The economic performance of CEE-10 after mid-1990s, and especially after the slowdown in 2001-2002 has been remarkable. All countries of the region registered consistently very high growth rates; several experiencing double digits.

All CEE-10 states managed to grow faster than the core of the EU, increasing their GDP levels by 40-120% over the 1995-2008 period.

When taking the average GDP growth rates for CEE-10 in two sub-periods: 1995-2000 and 2000-2008, the picture is diverse especially for the first sub-period, when some countries still registered negative growth rates (Bulgaria, Romania). But after 2000 the rapid growth settled in all countries concerned, which was caused by the fact, that the growth performance in 1990s was chiefly determined by transformational factors, such as policy regime changes and market reforms. By contrast, the growth performance in 2000s was mostly affected by integration with the EU, including factors such as accession to the EU-wide market, financial and trade integration, and institutional convergence, which have made the "integration decade" so successful and exceptional.

Table 1
Average annual GDP growth rates in CEE-10, EU15 and the euro area (EA), 1995-2000 and 2000-2008, %.

Source: Calculations based on Eurostat data

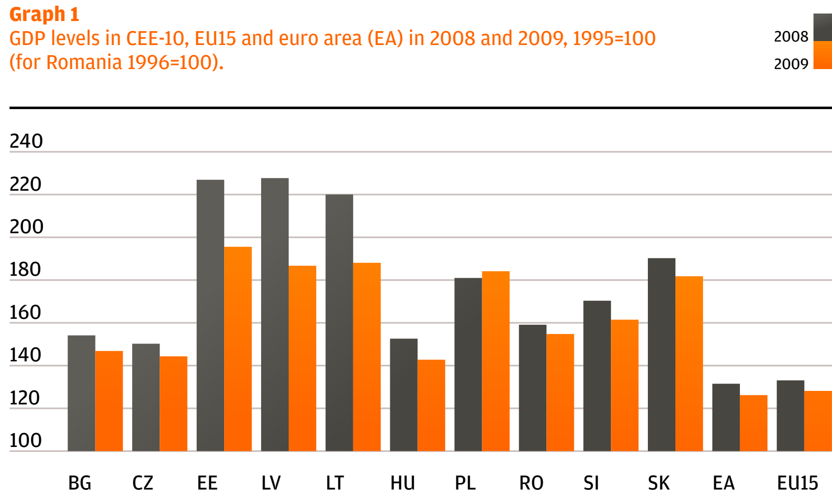
Country	1995-2000	2000-2008
Bulgaria	-0,4	5,8
Czech Republic	1,5	4,3
Estonia	6,7	6,4
Latvia	5,4	7,3
Lithuania	4,4	7,4
Hungary	3,6	3,1
Poland	5,4	4,2
Romania, a)	-1,3	6,3
Slovenia	4,4	4,4
Slovakia	3,4	6,2
EU15	2,9	1,8
EA	2,7	1,7

a) Romania since 1996.

See: Tables (1-4) and graphs (1-11), References & Sources

Although the crisis of 2009 wiped out some of the gains (with the exception of Poland), still the CEE-10 stayed at much higher levels than the corresponding GDP increases for EU15 and EA countries.

Graph 1
GDP levels in CEE-10, EU15 and euro area (EA) in 2008 and 2009, 1995=100 (for Romania 1996=100).



The performance of individual countries varied in reflection of the uneven pace of reforms, different policy patterns and different EU accession time paths across the region. Largest cumulative GDP increases were recorded in the Baltic countries, while the Czech Republic, Bulgaria and Hungary posted smallest gains. Graph 1 also shows that the impact of the 2009 crisis on output levels in CEE-10 was substantial in nearly all countries, again with the Baltic states registering deepest GDP falls.

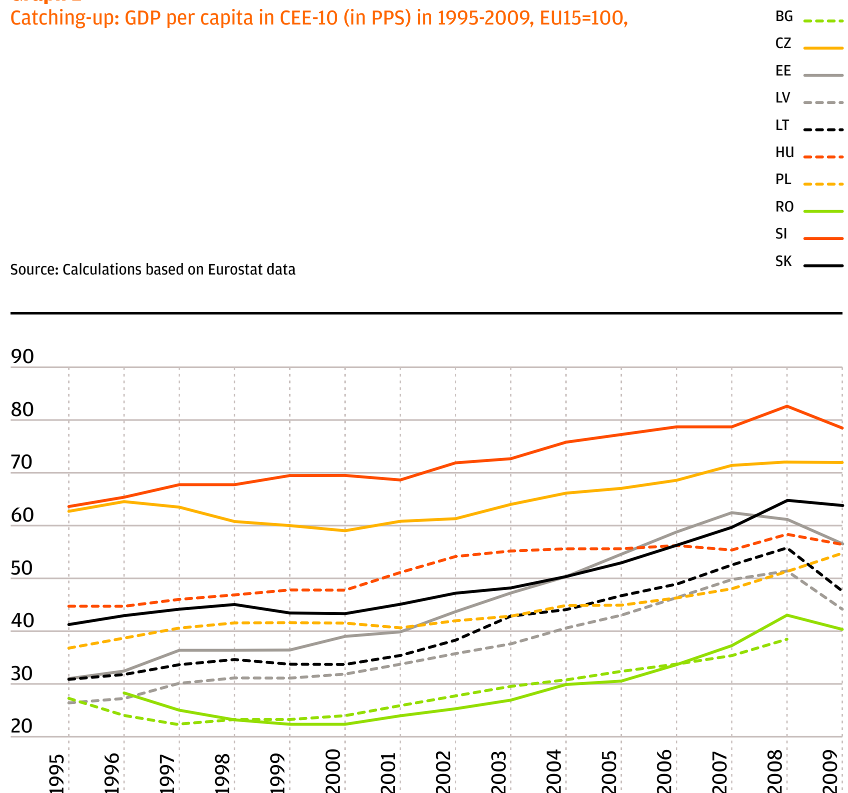
Also the GDP dynamics in CEE-10 was changing over time. In the early 1990s, the scope and speed of market reforms, the scope of international openness and the pace of privatization differed widely across the countries. In result, the time sequence of recovering from the transformational recession was also different in individual CEE-10 countries. Some countries managed to return to fast growth already in 1992-1993 (Poland, Slovenia, Slovakia), some others, however, struggled much longer before they eventually replaced old-type economic structures by functioning market structures. In fact, the second half of 1990s was still marked by occasional financial, banking and currency crises which caused temporary falls of output in almost all countries of the region (except for Poland).

The economic growth in CEE-10 actually accelerated before their formal accession to the EU in 2004 (2007 for Bulgaria and Romania) in spite of the global slowdown in 2000-2002 caused by the burst of the new technologies speculative bubble and the September 11 terrorist attack on the USA. This is because CEE-10 started to integrate with the EU much earlier, on the basis of the association agreements concluded in mid-1990s, and which opened up trade between the two groups of countries and initiated gradual harmonization of laws. In fact, the moment of formal accession in 2004 (2007) did not change much for CEE-10 enterprises (outside agriculture), as they were already exposed to full EU competition for several years. Accession proved that the challenge to the region’s industrial competitiveness was met with highest standards. Enterprises had achieved robustness and competitive advantages prior to entering the EU internal market.

Rapid economic growth in CEE-10 has allowed those countries to substantially reduce per capita incomes gaps to EU15 countries.

They reduced the incomes gaps by between 8-11 percentage points (BG, CZ) and 25-30 percentage points (EE, LV) from the initial levels over 1995-2008. This process accelerated after 2000, especially for countries such as BG, CZ, LV, HU, RO and SK. Only between 2000 and 2008 the countries concerned reduced the distance to EU15 by about a third. At the turn of the century the main drivers of growth in the region shifted from market transformation to integration with the EU.

Graph 2
Catching-up: GDP per capita in CEE-10 (in PPS) in 1995-2009, EU15=100,



Source: Calculations based on Eurostat data

While all CEE-10 converged to high incomes levels of EU15, the rate of convergence of poorer countries (BG, RO) was considerably higher – as could be expected - than that of more affluent countries (SI, CZ). Graph 2 shows that although CEE-10 are still diversified in terms of per capita GDP – in 2008 the incomes levels in the more advanced countries of the region were roughly twice as high as in the less advanced countries. By definition, and as a measure of this region's success, the speed of its convergence is expected to decline systematically with the gradual reduction of the distance in income levels between CEE-10 and EU15, so the convergence performance of 1999-2008 cannot continue in the same way.

Economic performance of all CEE-10 in the period 2000-2008, which can be called as "integration decade", displayed a number of striking similarities which made the growth path of these countries quite different from other groups of emerging economies. Apart from generally high growth rates, the new EU member states have run large current account deficits, financed with massive capital inflows in form of FDI, portfolio investment and bank credits. In fact, both the ratio of foreign capital inflows to GDP and the ratio of current account deficits to GDP were higher for CEE countries than for any other emerging economies group worldwide (IMF, 2010; Bruegel, 2010). These large capital inflows allowed CEE-10 countries to increase domestic credit, and finance rapidly expanding domestic expenditures. On the external trade side, the CEE-10 countries took advantage of the unrestricted access to the European single market and increased their exports considerably, albeit at lower rates than imports.

The key factor behind this remarkable foreign capital-financed growth between 2000 and 2008 has been economic integration with the EU (Bruegel, 2010; European Commission, 2009). Since the end of 1990s, CEE-10 have been already well integrated with the core EU in terms of trade, production links and investment flows. During the accession process in the run up to full EU membership further liberalization took place, including free movement of capital and, after the accession, increasingly free movement of people. In parallel, CEE-10 have harmonized their legal and institutional systems to the EU norms, standards and other regulations, completing this institutional integration process in the moment of accession. After accession, practically all remaining barriers to trade, investment and finance have been removed.

This integration process created a very unique environment for CEE-10. Their economies became an integral part of the EU Single Market, both as new sources of export expansion and a target for foreign imports and capital inflows. Higher GDP growth rates in this region were also associated with increasingly lower shares of agriculture and industry in their GDP, and correspondingly higher share of the service sector.

In particular, CEED enterprises benefitted from market integration, demonstrating their flexibility, adaptability and ability to operate and expand in a very competitive environment. They had to undergo massive restructuring, which was obviously costly. But as a prize, rapid growth of trade with EU partners, stimulated by unrestricted access to the Single Market, has been a powerful engine of economic growth.

Market integration has also been a factor of increased capital inflows to CEE-10. The free access to the huge European market (the largest in the world in terms of purchasing power) combined with relatively well educated and inexpensive labor force, geographical proximity and low domestic taxes, have all encouraged foreign companies to come and invest in CEE-10. Moreover, the institutional convergence and the adoption of the acquis communautaire contributed to strengthening macroeconomic stability and policy predictability in CEE-10, and resulted in reduced risk premiums included in market interest rates, that have made these economies even more attractive for investors.

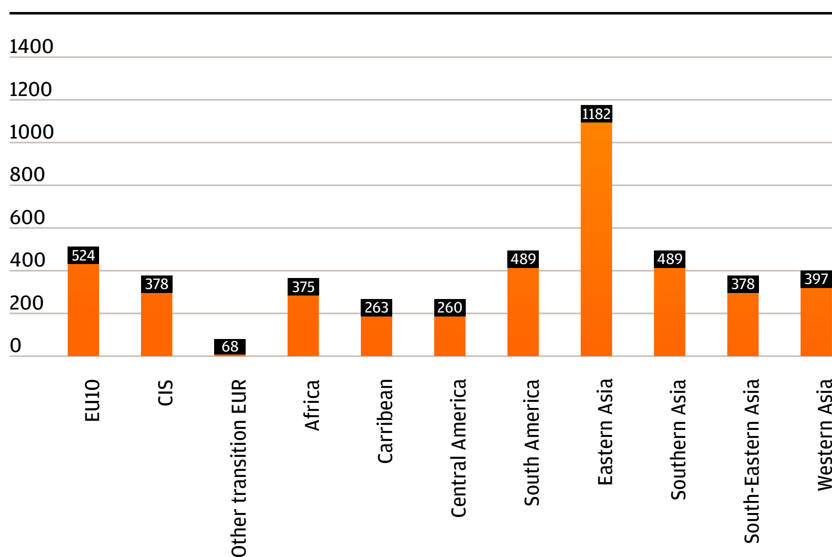
Table 2
The Integration Growth Model: a stylized representation

Area of integration	Mechanisms	Effects
Production and trade	Access to EU Single Market	Static and dynamic trade effects (better allocation of resources, more optimal specialization, economies of scale, lower production costs, higher investment)
Financial	Free cross-border capital mobility, integration of financial sectors through foreign acquisitions of domestic banks and other financial institutions	Fall of risk premiums, massive capital inflows, lower nominal and real interest rates, domestic credit expansion, higher investment
Institutional	Harmonization of laws and standards, adoption of the acquis communautaire, access to EU cohesion and regional policy	Increased macroeconomic stability, lower risk premiums, more capital inflows (including structural and cohesion funds) lower interest rates, higher investment

One particularly efficient form of capital inflows was foreign direct investment (FDI). High rates of returns on investment in CEE-10, resulting from relative capital scarcity and limited savings, attracted foreign capital into production and services sectors. During the “integration decade” **CEE-10 was the world region that received the largest amount of FDI in terms of per capita flows, and was second in terms of absolute FDI inflows after Eastern Asia** (China, South Korea, Hong-Kong, Taiwan) (see Graph 3).

The inflows in 2000-2009 were 5,5 times larger than inflows registered in the previous decade 1990-1999. These massive inflows of capital, technology and managerial expertise was a powerful stimulus of economic growth.

Graph 3
Cumulative FDI inflows, 2000-2009, USD bn, by groups of countries.
Source: UNCTAD



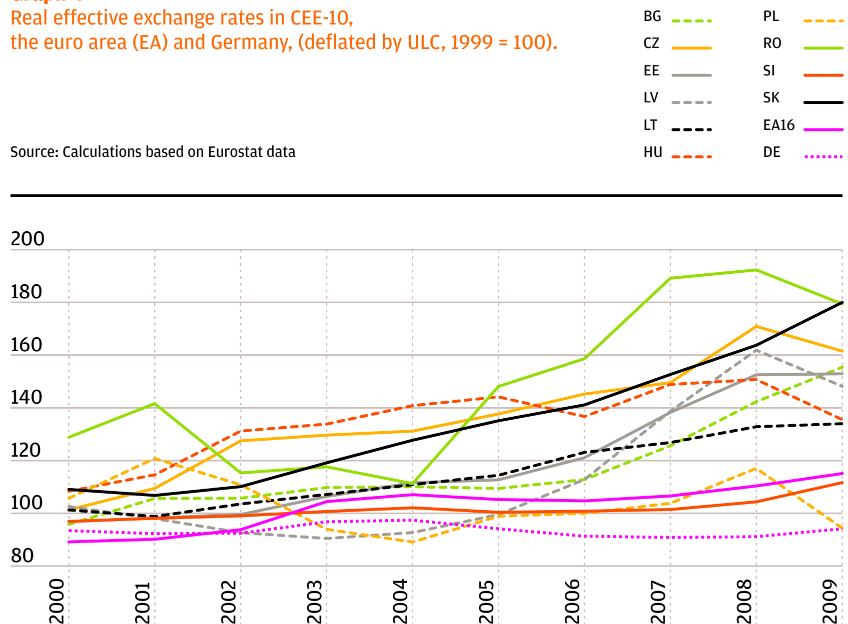
An additional source of investment financing for CEE-10 have been the EU structural and cohesion funds. Since the late 1990s the countries concerned benefitted from access to pre-accession funds (PHARE, ISPA, SAPARD), and after gaining full membership in the EU in 2004-2007 they were included within the framework of EU cohesion policy. Altogether, in 2000-2009 CEE-10 received from EU budget some € 70-75 bn in form of structural and cohesion funds, which clearly contributed to investment and growth.

This favorable economic environment had a number of important implications. Reduced macroeconomic and commercial risk helped to lower nominal market interest rates, driving down the real rates close to zero or even into negative territory. Financial integration was further strengthened with foreign banks taking over large chunks of domestic banking systems in CEE-10 and providing necessary liquidity to sustain rapid expansion of domestic credit. Lower cost of capital and abundant bank capital inflows have practically removed constraints on access to capital in these countries, contributing to credit booms.

This specific growth model, based on trade, financial and institutional integration with the EU and, through it, also with global markets, has been essential to ensure rapid growth and continuous catching-up in CEE-10. But on the other side it also contributed to building up growing imbalances in CEE-10 economies, making them more vulnerable to shocks, including capital flows reversals and sudden changes in market sentiment.

First, in most countries current account deficits widened sharply, reaching in some cases levels exceeding 10% of GDP (Graph 4). To the extent these deficits were financed by inflows of bank capital and debt investments, the CEE-10 economies became vulnerable to exogenous shocks and sudden capital flow reversals.
In 2004-2007 most of CEE-10 countries (except Poland, Slovakia and the Czech Republic), were in the state of deep and unsustainable external disequilibrium.
Second, the pace of domestic credit expansion was excessive. In 2004-2007 the annual rates of credit growth to the private sector in CEE-10 varied from 25-30% for Poland, Slovenia and the Czech Republic, up to 50-60% for Romania, Latvia and Lithuania. Even though the levels of private debt were still relatively low, the speed with which credits accumulated had a number of negative consequences.

Graph 4
Real effective exchange rates in CEE-10, the euro area (EA) and Germany, (deflated by ULC, 1999 = 100).



Source: Calculations based on Eurostat data

Third, the allocation of new capital was far from optimal. Domestic credits were mostly directed into financing real estate, construction and other service sectors, where real interest rates were low or negative. FDI have been also concentrated in specific domestic services (mostly trade and distribution, financial services, housing and real estate, and telecommunication), with only scant presence (especially in smaller economies) in export-oriented, manufacturing sectors.
Fourth, massive capital inflows and the fall in the risk premiums put upward pressure on domestic currencies, leading to sizeable real appreciation. The impact was very substantial practically in all countries irrespective of the foreign exchange regime adopted, except for Poland and Slovenia. This must have weakened the competitive position of export sectors in many CEE-10 countries, especially vis-à-vis their key export market (Germany) and the euro area as a whole.

Trade and financial openness, and the resulting high dependence on foreign capital inflows, were not accompanied by a sufficient increase of macroeconomic credibility, which resulted in increased vulnerability of CEE-10. Unfortunately, having been fully integrated financially with the rest of EU, the CEE-10 countries have not yet gained the same level of credibility enjoyed by the euro area member countries. Financial markets have not regarded them as belonging to the same risk category which was reflected by investment ratings generally lower by several notches than for the euro area countries, even though the **CEE-10 "fundamentals" (debt and deficit levels, growth rates) were generally much stronger that those of many euro area members**. As a result, not only government bond yields in CEE-10 were systematically higher than in the euro area, but also financial investors were much more sensitive to any change in market sentiment. While it was not a serious problem in "good times" (although it increased the cost of public and private borrowing), it has become a serious shortcoming when the crisis started.

This asymmetry was ignored at the EU level. While insisting that CEE-10 remove all restrictions on international capital movements and open up fully to the risks of global financial flows, the EU did not provide any sort of substitute protection mechanism, that would, at least partly, shield CEE-10 from the unwanted implications of sudden capital reversals. The result was that while being fully integrated with global financial markets, as were the euro area states, the CEE-10 countries have been much more exposed to the vagaries of international capital flows. The unwanted consequences of this status inequality have been felt painfully during the crisis.

The CEED and global financial crisis 2008-2009

The CEED and global financial crisis 2008-2009

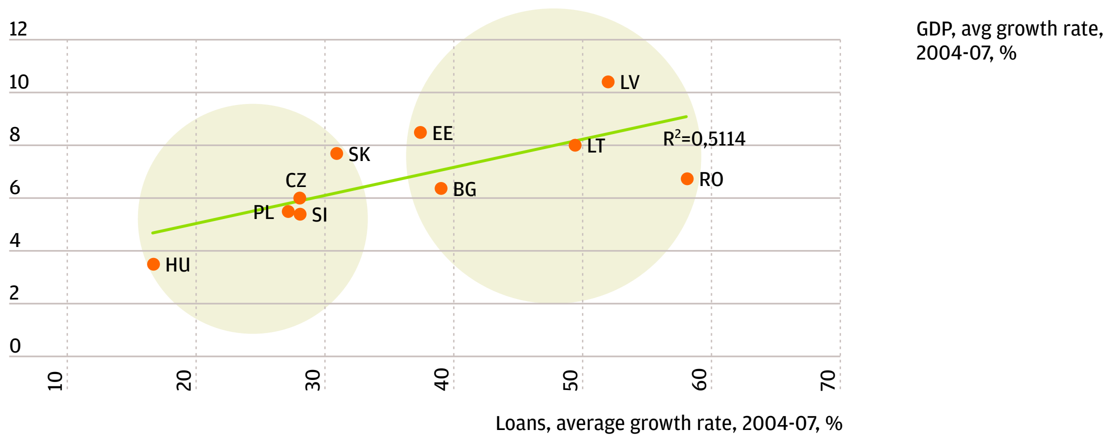
The crisis 2008-2009 has revealed those vulnerabilities of CEE-10. As Graph 1 shows, the impact of the 2009 crisis on CEE-10 was severe. In nearly all these countries the falls of per capita GDP were larger (with the exception of Poland) than in the EU15. The cumulative fall of output between the third quarter of 2008 and the second quarter of 2009 was between 13% and 18% for the Baltic states, and between 5% and 10% for the rest (except for Poland), well exceeding the cumulative fall for the euro area (4,4%) and for the EU27 as a whole (4,5%). Countries with floating exchange rates have also experienced substantial depreciations, sometimes raising concerns about overall sustainability of their currencies. A sudden stop of capital inflows (partly because of liquidity problems of mother banks, and partly because of an increase in overall uncertainty) blocked new credit emission and entailed a massive adjustment on the demand side.

The crisis showed, that while the CEE-10 countries share common history, have followed similar paths of integration with the EU and embraced a broadly similar growth model, but they differ in many aspects, such as the size of their economies and domestic markets, economic structure and economic policies pursued. The CEE-10 is not a homogeneous lot. The Baltic countries (EE, LT, LV) and the Balkan countries (BG, RO) have been clearly less stable economically, more vulnerable and, consequently, suffered deeper recessions. The Central European countries (CZ, HU, PL, SI, SK – the CE group) have been economically more stable, with much smaller imbalances. Export sectors were well developed and more robust, current account deficits limited, exchange rate regimes flexible (except for SI and SK after their accession to the euro in 2008 and 2009, respectively), and domestic credit growth more moderate. As a result, the necessary demand adjustments were smaller and the output recession in the CE group was milder during the crisis. The below graphs illustrate the differentiating impact of the crisis on CEE-10.

Graph 5

Average growth of credit to economy in 2004-2007 and average GDP growth in 2004-2007, %.

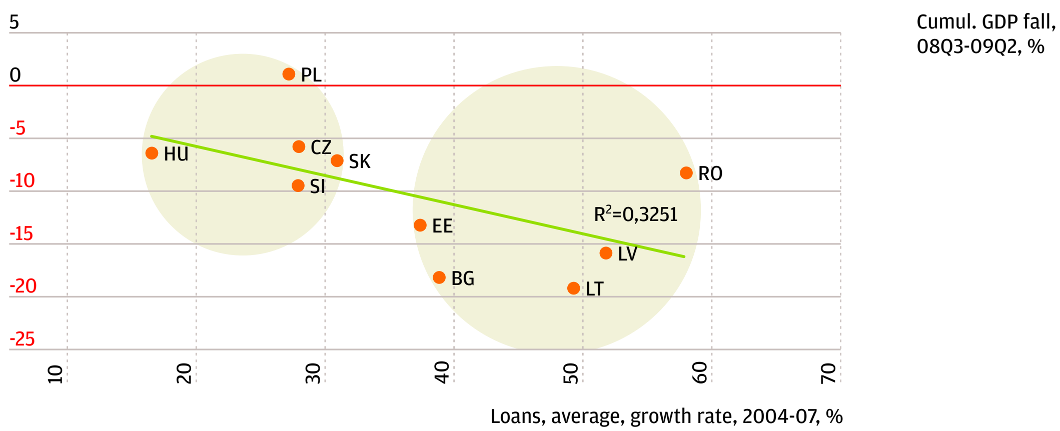
Source: Calculations based on Eurostat data



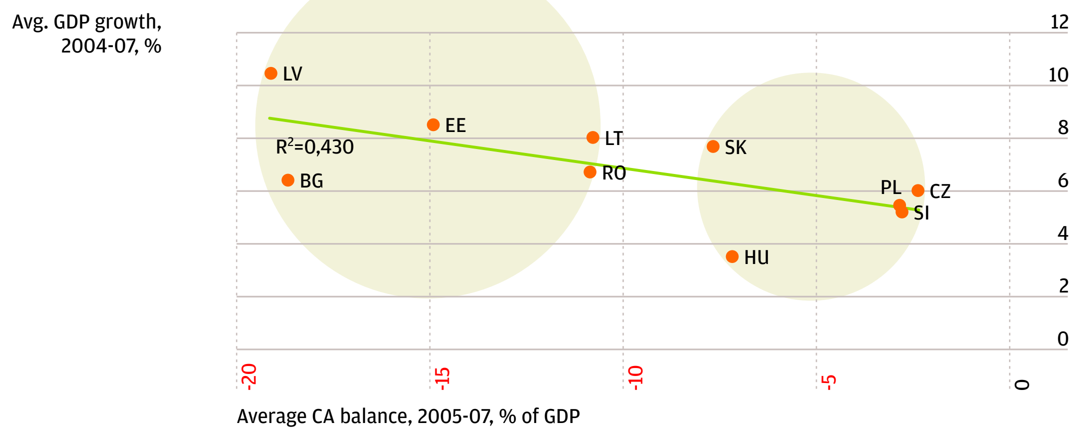
Graph 6

Average growth of credit to economy in 2004-2007 and cumulative GDP fall in recession, %.

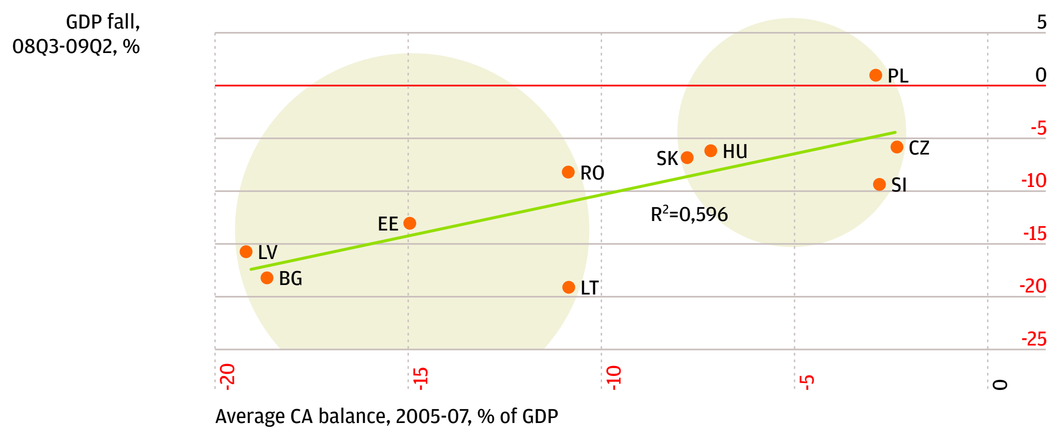
Source: Calculations based on Eurostat data



Graph 7
Average CA deficit in 2005-2007 and average GDP growth in 2004-2007, %.
Source: Calculations based on Eurostat data

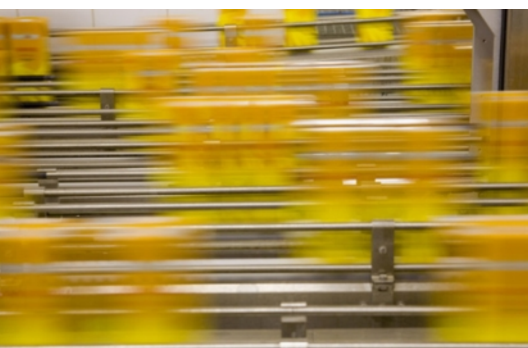


Graph 8
Average CA deficit in 2005-2007 and cumulative GDP fall in recession, %.
Source: Calculations based on Eurostat data

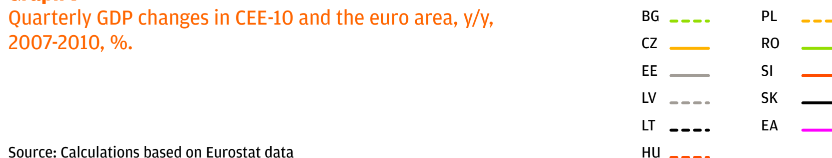


One important factor that had an impact on the depth of the recession has been also the foreign exchange regime. Countries with fixed exchange rates (Bulgaria, Estonia and Lithuania followed a currency board regime, Latvia had a fixed exchange rate) suffered much larger declines of output and have more difficulties in returning to a stable growth path. This is not surprising, as the initial imbalances simply grew much higher in those countries, partly because no adjustment was possible in the pre-crisis period and partly because under fixed exchange rates the currency risk was limited (or plainly non-existent), which attracted more capital inflows and allowed for faster expansion of domestic credit. Moreover, when the crisis hit, the "fixers" could not (or rather did not want to) devalue their currencies which of course entailed larger losses in output. By contrast, the "floaters" were able to cushion the impact of the fall of exports with currency depreciation which, even if unable to prevent export level declines, was effective in alleviating the financial position of exporters.

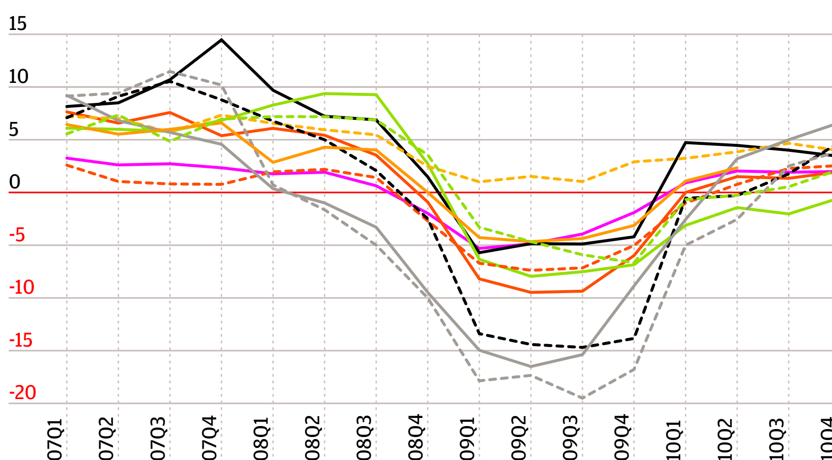
What is impressive, although hit hard by crisis, the CEE-10 were very effective in managing it. Only 3 (LV, R, H) of 10 CEE countries needed to ask for IMF standby programs. Problems were addressed and resolved instead of accumulated and neglected. They were relying on solid domestic policy responses and not external support. For example, despite the calls from recognized international economists against, Latvia, Lithuania and Estonia avoided currencies devaluations and drastically cut public wages and expenditures. This resulted in replacement of their vast current account deficits with surpluses and immense decrease in inflation figures.



Graph 9
Quarterly GDP changes in CEE-10 and the euro area, y/y, 2007-2010, %.



Source: Calculations based on Eurostat data



Poland proved to be Europe's best performing economy, labeled as a "green island" of economic growth. During the crisis, not a single case was noted among CEE-10 for changes to exchange rate policy. In general, the CEE governments cut public expenditures, wages, social transfers, and undertook painful austerity measures and policy reforms.

CEE-10 coped with crisis better than many of the peripheral members of the euro area. The private sector displayed astonishing robustness despite the unfavorable macroeconomic environment and credit squeeze, becoming more resilient and competitive.

As a result, at 3Q of 2010, 9 CEE countries were fulfilling the Maastricht public debt criterion, while from among euro area founders only 4 were doing so. It is worth mentioning, that for the CEE, there was a widely shared concern of collateral damage erupting from Greek financial crisis. But despite all the prophets of doom, not a single international (EU) bank withdrew from the CEE region. Relative to Euro area countries, the CEE-10 speed of post-crisis recovery has also proven the robustness of the region.

CEED: opportunities and challenges

CEE-10 as a group is likely to remain by far the fastest growing part of the EU, with the predicted growth rates almost twice as high on average than the growth rates foreseen for EU15 and the euro area. This growth advantage will be key in maintaining CEE-10 position as the most attractive place to invest in Europe in the foreseeable future.

Table 3
GDP growth rates in CEE-10, EU27, EU15 and euro area (EA) 2010-2012, %

Source: European Commission

Country	**2010**	**2011f**	**2012f**
Bulgaria	0,2	2,6	2,8
Czech Republic	2,4	2,3	3,1
Estonia	3,1	4,4	3,5
Latvia	-0,3	3,3	4,0
Lithuania	1,3	2,8	3,2
Hungary	1,2	2,8	3,2
Poland	3,8	3,9	4,2
Romania	-1,3	1,5	3,8
Slovenia	1,2	1,9	2,6
Slovakia	4,0	3,0	3,9
EU27	1,8	1,7	2,0
EU15	1,8	1,6	1,9
EA	1,8	1,5	1,8

f - forecast

However for obvious reasons, the return to very high growth rates similar to those observed in the "integration" decade (2000-2008) is not likely in the medium term. While the growth rates between 2006 and mid-2008 have been broadly between 5% and 10% annually, the growth rates in 2010 generally plateau around 5%. As such, in the new economic environment, economic growth in the CEE-10 countries will remain rather moderate. The recent forecast for 2011-2012 prepared by the European Commission (Table 3) suggests that GDP growth rates will generally stay in the range of 2% and 4% y/y (these figures are generally consistent with similar forecasts made by private institutions[1]).

The performance of individual CEE countries will differ, depending on their starting positions, inherited rigidities and, crucially, policy responses. Given the extent of the current imbalances and the existing scope for adjustment (flexible vs. fixed exchange rates, fiscal positions, wage adjustment), economic recovery will most probably be more evident in most of CEE countries and the Baltic States, whereas it may be more sluggish in Bulgaria, Romania and Slovenia.

In addition, the post-crisis economic environment is posing some new challenges for CEE-10. While still being the leader of growth and convergence with the EU15, the CEE-10 could be affected by spillover of other countries' troubles. The on-going crisis in the euro area, and especially the debt problems of peripheral euro countries, will reduce the scope for possible fiscal stimulation in the EU. This could adversely affect the pace of CEE-10 recovery. Faced with massive domestic deficits, the rigours of the excessive deficit procedure (imposed in 24 out of 27 EU states as of end Dec 2010) and the need to provide additional funding for rescue programs for currently ailing countries, the EU will be very reluctant to spend more. Potential growth rates will drop in EU15 and in the euro area, mainly because of the serious drop in investments in 2008-2010. Ample spare production capacity and low confidence levels will reduce the pace of investments in new technologies. This will translate into slower demand growth in EU15. Fiscal austerity applied across Europe will most probably translate into less resources in the EU budget, which is also an important source of funds for investment in CEE-10. Moreover, many banks in the EU is still struggling with inherited bad loans and are still short of capital. Their balance sheets are still loaded with some risky assets, such as government bonds of most indebted euro area countries. Additionally, the new wave of banking and financial markets regulations (chiefly the recommendations under Basel III and the measures proposed by Financial Stability Board) will put additional pressure on banks to consolidate their capital base and follow more prudent credit policies. This will reduce external resources available for enterprises and households in CEE-10 countries – while capital inflows start to recover, it will take long time before they can exceed the pre-crisis levels.

[1]See, e.g.,The Economist, April 9, 2011, p.93, or CEEMEA Outlook, April 2011, BNP Paribasfortis, p.4.

Interesting data (Table 4) on current account balances in CEE-10 in 2008-2010 demonstrates sharp improvement in their current accounts. While this is a return to macroeconomic equilibrium, the development also may be treated as one of the indicators of the scarcity of foreign funding. It can be seen that major adjustment took place in 2009 when the (arithmetic) average of CA balances for the group was reduced by more than 9% of GDP, but in some countries the adjustment was in the range of 20% of GDP (LV, LT). The adjustment reflected primarily an increase in net exports resulting from the fall in imports much larger that the fall of exports. Import volumes fell in 2009 by 10-14% in CZ, HU and PL, by 18-22% in BG, RO, SI and SR, and by 28-33% in the Baltic states.

Table 4
CA balances in EU10, 2008-2010, % of GDP.
Source: Calculations based on Eurostat data

Country	2008	2009	2010, a)
Bulgaria	-23,1	-9,9	0,7
Czech Republic	-0,6	-1,1	-3,3
Estonia	-9,7	4,5	3,1
Latvia	-13,1	8,6	5,2
Lithuania	-13,1	4,3	1,6
Hungary	-7,3	-0,4	2,3
Poland	-4,8	-2,2	-2,6
Romania	-11,6	-4,2	-5,6
Slovenia	-6,7	-1,5	-0,4
Slovakia	-6,6	-3,2	-3
EU10, b)	-9,66	-0,51	-0,20

a) estimates based on data for Q1-Q3 2010;
b) arithmetic average;

In these circumstances, slower export growth to EU markets can only partly be compensated by higher exports sales to third countries. Global competition is likely to get stronger – not only because emerging economies, such as China, India, Brazil, Korea, Turkey, will try to retain, or increase, their export shares, but one can also expect a shift towards more exports from developed countries, especially from the US (partly because of the depreciation of US dollar engineered by the Federal Reserve's policies).
In general, in the context of rebalancing the global economy, more (indebted) countries will have to sell more on export markets, and CEE-10 will have to adjust to this new situation. Given more restricted access to foreign sources of funds, CEE-10 economies will have to rely more on their own domestically stimulated export expansion. In 2009, the rebalancing in their external position came from imports falling deeper than exports. This time around, there is a need for exports to grow consistently if the economic recovery is to be sustained.

The engine for CEED growth is again in the hands of entrepreneurs. If firms adjusted to EU competition in transition phase they will most likely be able to adjust again to this new environment.
The transition and accession lessons have proven that flexibility, adaptability and productivity are their greatest assets.

There are positive signs, that at least in some CEE countries, unit labor cost trends have been reversed and competitiveness may gradually be improved. However, it may take some time to rebuild wage competitiveness, given the higher rate of increases in unit labor costs in the pre-crisis period. Graph 10 shows OECD data for quarterly changes in the unit labor costs (for the whole economy) for CEE-10 and Germany between 1Q2007 and 3Q2010. Until mid-2008 in most countries concerned real unit labor costs were increasing fast, at rates between 1% and 6% quarter-to-quarter. These rates declined substantially after the third quarter 2008 and remained low or even negative for most countries. While the largest fall was recorded in LV, in all CEE-10 unit labor costs declined relative to Germany (except for CZ).

But governments must also do their job in order to make CEE-10 economies more competitive internationally. Above all, the rankings of CEE-10 in terms of business regulations and business environment should be improved - a call for reforms aimed at establishing more conducive conditions for business activities, cutting red tape and promoting entrepreneurship. If CEE-10 are to rely on solid export expansion, they also need to spend more on research, development and innovations in order to stimulate knowledge-intensive production. Such reforms are especially important for **small and medium enterprises which are the largest job creators in CEE-10. There is a strong justification and need for government support for CEE enterprises, as fuels of economic growth throughout the region.**

A solid commercial policy on the side of the governments should also be of help. This includes export promotion and trade expansion to new markets, relying on tested models of economic diplomacy used world-wide. Increasing public diplomacy initiatives could similarly prove successful.

Graph 10
Changes in real unit labor costs in CEE-10, q/q, 2007-2010.

BG CZ EE LV LT HU PL RO SI SK DE

Source: Calculations based on OECD data

1,08
1,06
1,04
1,02
1,00
0,98
0,96

07Q1 07Q2 07Q3 07Q4 08Q1 08Q2 08Q3 08Q4 09Q1 09Q2 09Q3 09Q4 10Q1 10Q2 10Q3

Graph 11
Nominal exchange rates in the Czech Republic, Hungary, Poland and Romania, July 2008-March 2011, (July 2008 = 100, units of national currencies per euro, end of period)

Source: Calculations based on Eurostat data

CZ
HU
PL
RO

Challenges will be especially persistent for those CEE countries with fixed exchange rates. With no devaluation option at hand, and with low inflation levels likely to continue in the euro area, the countries concerned will have to go through a prolonged period of wage stagnation, combined with large-scale reallocation of resources from housing and financial services into more productive uses. Unless exports gathers momentum, imports will have to be cut. The balance of payments constraint will be somewhat less rigid for countries with flexible exchange rate regimes. When the crisis hit in 2008, their currencies depreciated substantially in nominal and real terms, cushioning the impact on the real sector. Although the currencies strengthened since then, in none of these countries have the exchange rates returned to the pre-crisis nominal levels. At the end of March 2011 the euro nominal exchange rates in Hungary, Poland and Romania were still 15-25% higher, and in the Czech Republic 3% higher, than in July 2008 (see Graph 11). This may be a factor supporting export growth and helping efforts to reduce current account deficits.

To conclude, the global economy is not yet fully in a sustainable recovery and persistent signs of the post-crisis difficulties are still evident. The CEE-10 will be the centre of growth in Europe in foreseeable future. However, this growth will be slower than previously (until 2008). This presents a good opportunity to get things right and to correct previous imbalances associated with the early integration period. Low labor costs have been one of the key advantages of CEE-10, which in combination with high educational levels, geographical proximity and institutional similarities, attracted foreign capital. If unit labor costs remain under control, with additional policy reform in labour markets to make them more flexible, and improvement to state public finances, the CEE-10 will maintain its international competitiveness even in slower phases of the economic and business cycle.

The question should be asked, whether the global economic environment can play a relatively constructive role in stimulating CEE-10 development. Will the international climate be favourable to CEE-10? Currently, **the CEED combines the potential of emerging markets with the stability of developed economies – an absolutely unique feature**.
Part of the response needed today to increase the competitiveness of CEE-10 can be delivered by factors of human nature, rather than by pure economic models. With the euro-periphery countries continuing to display instability and unpredictability, other EU members showing sluggish economic growth, and the events in North Africa and the Middle East unfolding into a newly dramatic situation, the CEE-10 picture looks quite positive after all.

It is undoubtedly the time for CEE to grow, develop and expand on its enormous potential as a fuel of future global trade and investment opportunities.

The post-1989 history of the region is so impressive that today many are wondering if the CEE-10 transformation model can be transposed to other EU neighbors undergoing reforms and transitions. Additionally, 2011 is a year of central European EU presidencies, Hungary and Poland, an opportunity not to be passed by as a showcase example of what the region has achieved.

Perhaps the perception of the CEE-10 is false? The clearest example of this was the sudden change of market sentiment at the beginning of 2010, away from the CEE “problem” and towards the so-called PIGS (Portugal, Italy, Greece, Spain) countries and their possible risk of sovereign default. It appeared, that despite many problems in the region, the CEE-10 were able to manage and resolve their difficulties by themselves - once again through domestic policy commitment to market reforms and enterprise adjustment to externally changing conditions. Perception can be changed.

The CEE-10 countries definitely deserve better off
- a stronger and more widely recognized position on the global economic map.
It is time for CEED – Central and Eastern Europe Development initiative!

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Tables (1-4) and graphs (1-11): all the tables and graphs in the text have been prepared for the Center for International Relations and under its auspices. They are appearing in: Rosati D. K. (2011b), which should be treated as a source.

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