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CEE Economies in the New Millennium: Their Strengths, Vulnerabilities and Forthcoming Challenges

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November 2014

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Abstract

After completing the painful transition of the 1990s, former communist countries enjoyed a period of rapid economic growth which was underpinned by three groups of factors: (i) benefits of market reforms and transition-related restructuring in the 1990s; (ii) increasing participation in the Single European Market (SEM) and other mechanisms of EU integration; (iii) global economic and financial boom of 2003–2007. However, the period of prosperity did not last long. Since 2008 the entire region has become hit by the global and European financial crises, the negative consequences of which have not yet been overcome.

While the size of negative shock and resulting macroeconomic performance differed between individual countries, the crisis revealed common vulnerabilities such as high dependence on economic developments in advanced economies of Western and Northern Europe, and changes in global capital flows determined, in turn, by changes in monetary policies of major central banks, limited room for manoeuvre in national macroeconomic policies, unfinished domestic economic reform agenda and others.

The after-crisis macroeconomic prospects look uncertain and challenging. The pace of economic growth is unlikely to come back to the high levels of the early and mid–2000s soon. That means CEE countries will have to live and conduct their macroeconomic policies in the environment of slower growth, which will have a considerable impact on their fiscal accounts. Another challenge is related to population aging, which will have serious consequences for sustainability of public pension systems (already in deep deficit), public healthcare systems, labour market, migration flows, etc. Rapid development of non-EU emerging-market economies and their closer trade relations with the EU will put increasing competitive pressure on several sectors and industries of CEE economies, including those which were considered to be their comparative advantage in the previous decade.

Countries most heavily hit by the crisis made some adjustment, but more concerted reform effort in the entire region is needed to increase growth potential. The future reform agenda should decrease implicit public pension and health liabilities, make domestic labour markets more flexible, improve business climate, and adjust education to the needs of contemporary labour markets. Countries which stay outside the Eurozone should join it soon.

Completing the Single European Market mechanism (especially in services), simplifying *acquis* wherever it is possible (pan-European deregulation), going ahead with the Banking Union project, strengthening fiscal surveillance rules, and more open migration policies, can contribute to improving future growth potential of all EU economies.

JEL: E63, F15, F21, F32, F34, F36, F43, F62, G01, G21, H53, P33

1. Introduction

The purpose of this paper is to analyse macroeconomic performance of CEE countries in the new millennium and single out major factors which have determined this performance and its change over time. While the focus of our analysis is on 10 former communist economies (FCEs) which joined the EU in 2004 and 2007, i.e. Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia, we also include, for comparative purposes, two other groups of CEE countries.[2] The first consists of the so-called Western Balkan countries (Albania, Bosnia & Herzegovina, Croatia, Kosovo, Macedonia, Montenegro, Serbia), and Turkey, which have been either actual or potential EU candidates through most of the analysed period[3] and as such shared a lot of common policy agenda with the new member states (NMS) of the EU. The second group includes eight East European countries of the former Soviet Union (FSU), i.e. Armenia, Azerbaijan, Belarus, Georgia, Moldova, Russia and Ukraine, which were not part of the EU integration process but had to deal with the similar communist-era legacy and post-communist transition agenda in the 1990s and early 2000s. Although their structural and institutional characteristics in the 2000s and early 2010s differed increasingly from both EU NMS and EU candidate groups, they faced similar global and regional challenges.

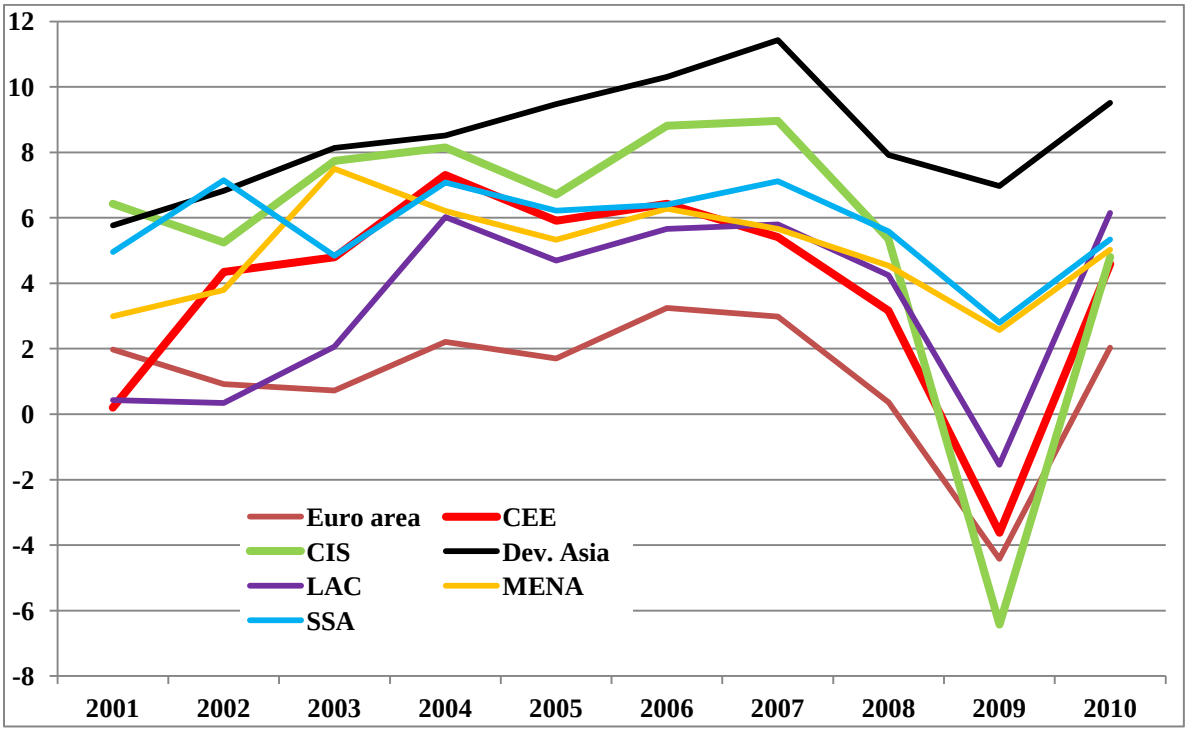
2. Macroeconomic situation in the early and mid–2000s: accomplishments, vulnerabilities and risks

From the beginning of the new millennium CEE economies experienced a period of rapid economic growth, much faster than their Western European peers belonging to the Eurozone, but similar to that of other emerging markets (Figure 2.1 and Table 2.1). It was hardly surprising after the decade of painful economic reforms and transformation-related output decline (in the 1990s).

[2] This is the slightly revised and updated version of the paper presented at the Conference on '*Ten Years of the New Europe*' organised by the European University Institute, San Domenico di Fiesole (Florence), May 29th–30th 2014. The usual disclaimer applies.

[3] Croatia eventually became the 28th EU member on 1st July 2013.

Figure 2.1. Annual real GDP growth, in %, 2001–2010, interregional comparison



Source: IMF World Economic Outlook database, October 2012

In the case of Central European and Baltic countries an additional boost was provided by the near perspective of EU accession which materialised in 2004 and 2007 respectively. In the case of Western Balkans the end of dramatic ethnic conflicts and perspective of the EU accession offered by the EU Summit in Thessaloniki in June 2003 facilitated fast recovery and encouraged more policy reforms (especially in the areas of trade policy, privatisation and financial sector restructuring).

However, it is worth remembering that the global environment was particularly supportive for all emerging-market and developing economies (EMDE) at that time. Global economic boom and relative calm on the financial markets (no major financial crisis!) in the early and mid–2000s resulted from a combination of several fundamental factors such as post-cold-war peace dividend, global trade liberalisation, ICT revolution and major policy reforms in emerging-market regions other than CEE and FSU, i.e. China, India and rest of Asia, Latin America and, to a lesser extent, MENA and Sub-Saharan Africa (Dabrowski, 2013b).

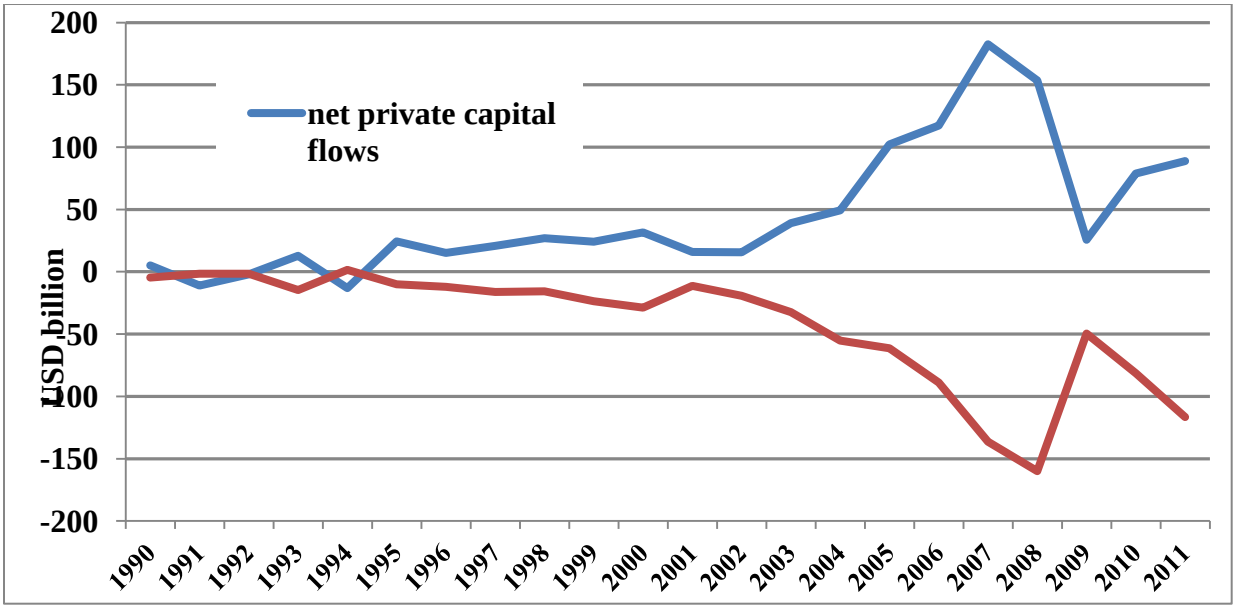
Table 2.1. CEE: Real GDP, annual change in %, 2001–2008

Group	Country	2001	2002	2003	2004	2005	2006	2007	2008
EU NMS	Bulgaria	4.2	4.7	5.5	6.7	6.4	6.5	6.4	6.2
	Czech Republic	3.1	2.1	3.8	4.7	6.8	7.0	5.7	3.1
	Estonia	7.5	7.9	7.8	6.3	8.9	10.1	7.5	-3.7
	Hungary	3.7	4.5	3.9	4.8	4.0	3.9	0.1	0.9
	Latvia	6.6	7.2	7.6	8.9	10.1	11.2	9.6	-3.3
	Lithuania	6.7	6.8	10.3	7.4	7.8	7.8	9.8	2.9
	Poland	1.2	1.4	3.9	5.3	3.6	6.2	6.8	5.1
	Romania	5.7	5.1	5.2	8.5	4.2	7.9	6.3	7.3
	Slovakia	3.5	4.6	4.8	5.1	6.7	8.3	10.5	5.8
	Slovenia	2.9	3.8	2.9	4.4	4.0	5.9	7.0	3.4
EU candidates	Albania	7.9	4.2	5.8	5.7	5.8	5.4	5.9	7.5
	Bosnia & Herzegovina	2.4	5.1	3.9	6.3	3.9	6.0	6.1	5.6
	Croatia	3.7	4.9	5.4	4.1	4.3	4.9	5.1	2.1
	Kosovo	27.0	-0.7	5.4	2.6	3.8	3.4	6.3	6.9
	Macedonia	-4.5	0.9	2.8	4.6	4.4	5.0	6.2	5.0
	Montenegro	1.1	1.9	2.5	4.4	4.2	8.6	10.7	6.9
	Serbia	5.3	4.3	2.5	9.3	5.4	3.6	5.4	3.8
	Turkey	-5.7	6.2	5.3	9.4	8.4	6.9	4.7	0.7
FSU	Armenia	9.5	14.8	14.1	10.5	14.1	13.2	13.7	6.9
	Azerbaijan	6.5	8.1	10.5	10.2	26.4	34.5	25.0	10.8
	Belarus	4.7	5.0	7.0	11.5	9.4	10.0	8.6	10.2
	Georgia	4.7	5.5	11.1	5.9	9.6	9.4	12.3	2.3
	Moldova	6.1	7.8	6.6	7.4	7.5	4.8	3.0	7.8
	Russia	5.1	4.7	7.3	7.2	6.4	8.2	8.5	5.2

	Ukraine	12.2	5.2	9.6	12.1	2.7	7.3	7.9	2.3

Source: IMF World Economic Outlook database, October 2012

Figure 2.2. Net private capital flows and current account balance in CEE countries, 1990–2011, in USD billion



Source: IMF, World Economic Outlook Database, October 2012

In addition, the lax monetary policy of major central banks (especially the US Fed) supplied the entire world economy with abundant liquidity, a substantial part of which flew as private investments to emerging markets, particularly to the CEE region (Figure 2.2). The latter was seen by financial markets as a relatively 'safe haven' (due to its EU membership/candidacy and expected fast-track accession to the Eurozone) which resulted in exceptionally low risk premia (Luengnaruemitchai & Schadler, 2007). On the other hand, global economic boom and abundant liquidity contributed to high commodity prices, especially of oil, natural gas, metals and food products, which boosted growth in the natural resource-based FSU region.

Table 2.2. CEE: annual inflation, end of period, in %, 2001–2008

Group	Country	2001	2002	2003	2004	2005	2006	2007	2008
EU NMS	Bulgaria	4.8	3.8	5.6	4.0	7.4	6.1	11.6	7.2
	Czech Republic	4.1	0.6	1.1	2.7	2.2	1.7	5.5	3.6
	Estonia	4.2	2.7	1.1	5.0	3.6	5.1	9.6	7.0
	Hungary	6.8	4.8	5.7	5.5	3.3	6.5	7.4	3.5

	Latvia	3.2	1.5	3.5	7.4	7.1	6.8	14.0	10.4
	Lithuania	2.1	-0.9	-1.3	2.8	3.0	4.5	8.2	8.5
	Poland	3.6	0.8	1.7	4.4	0.7	1.4	4.0	3.3
	Romania	29.6	17.6	14.1	9.2	8.8	4.9	6.6	6.3
	Slovakia	6.7	3.1	9.2	5.7	3.7	3.5	2.4	3.5
	Slovenia	7.0	7.2	4.6	3.2	2.3	2.8	5.6	2.1
EU candidates	Albania	3.5	1.7	3.3	2.2	2.0	2.5	3.1	2.2
	Bosnia & Herzegovina	0.6	-0.4	0.5	0.6	4.3	4.5	4.9	3.8
	Croatia	2.3	1.8	1.7	2.7	3.7	2.1	5.8	2.8
	Kosovo	n/a	n/a	0.5	-3.7	0.7	1.1	10.5	0.5
	Macedonia	4.0	0.8	2.7	-2.2	1.6	3.1	6.7	4.1
	Montenegro	27.9	9.4	6.2	4.2	1.8	2.0	6.3	7.2
	Serbia	26.3	2.5	4.1	14.2	15.8	5.7	11.0	8.6
	Turkey	68.5	29.7	18.4	9.4	7.7	9.7	8.4	10.1
FSU	Armenia	2.9	2.0	8.6	2.0	-0.2	5.4	6.7	5.3
	Azerbaijan	1.4	3.3	3.6	10.4	5.5	11.4	19.5	15.4
	Belarus	46.1	34.8	25.4	14.4	7.9	6.6	12.1	13.3
	Georgia	3.4	5.4	7.0	7.5	6.2	8.8	11.0	5.5
	Moldova	6.4	4.4	15.7	12.5	10.0	14.1	13.1	7.3
	Russia	18.6	15.1	12.0	11.7	10.9	9.0	11.9	13.3
	Ukraine	6.1	-0.6	8.2	12.3	10.3	11.6	16.6	22.3

Source: IMF World Economic Outlook database, October 2012

However, the same abundant liquidity contributed to building up, through various channels (capital flows, increase of commodity prices) inflation pressure in EMDE, which became quite visible from 2005. This unfavourable trend did not bypass CEE and FSU (Table 2.2). Signs of overheating included rapidly deteriorating current account balances, (Table 2.3) and credit booms in a number of these countries. To be fair, they were generated, to a large extent, by external push factors such as rapidly-growing capital flows which, in turn, resulted in a mirror adjustment of current account (Figure 2.2). More generally, this experience reflected the diminishing control of national authorities on several macro variables such as

money supply, current account, inflation and real exchange rate in the world of unrestricted capital movement (Dabrowski, 2013a).

Nevertheless national macroeconomic policies still mattered a lot and they were not prudent enough in the years of economic boom. As happens quite often, policymakers believe in indefinite continuation of good trends and do not hurry with policy tightening and building up reserves for rainy days. This exact situation could be observed in most regions in the early and mid–2000s, including CEE. As seen in Table 2.4, general government balances improved only slightly in boom years (except a few countries such as Estonia, Bulgaria and Russia). The same concerned public debt to GDP ratio (Table 2.5). Ex-post estimations of cyclically adjusted fiscal balances (where available – see Table 2.6) indicate deterioration rather than improvement in the run up to the crisis.

Table 2.3. CEE: current account balance, as % of GDP, 2001–2008

Group	Country	2001	2002	2003	2004	2005	2006	2007	2008
EU NMS	Bulgaria	-5.5	-2.4	-5.3	-6.4	-11.6	-17.6	-25.2	-23.0
	Czech Republic	-5.1	-5.4	-6.1	-5.0	-0.9	-2.1	-4.4	-2.1
	Estonia	-5.2	-10.6	-11.3	-11.3	-10.0	-15.3	-15.9	-9.1
	Hungary	-6.1	-7.0	-8.0	-8.4	-7.5	-7.4	-7.3	-7.4
	Latvia	-7.6	-6.7	-8.2	-12.9	-12.6	-22.6	-22.4	-13.2
	Lithuania	-4.7	-5.2	-6.8	-7.6	-7.0	-10.6	-14.5	-13.3
	Poland	-3.1	-2.8	-2.5	-5.2	-2.4	-3.8	-6.2	-6.6
	Romania	-4.4	-3.3	-5.8	-8.4	-8.6	-10.4	-13.4	-11.6
	Slovakia	-8.3	-7.9	-5.9	-7.8	-8.5	-7.8	-5.3	-6.6
	Slovenia	0.2	1.1	-0.8	-2.6	-1.7	-2.5	-4.8	-6.2
EU candidates	Albania	-3.1	-7.2	-5.0	-4.0	-6.1	-5.6	-10.4	-15.1
	Bosnia & Herzegovina	-12.9	-17.6	-19.2	-16.2	-17.1	-7.9	-10.7	-14.1
	Croatia	-3.0	-7.2	-6.0	-4.1	-5.3	-6.7	-7.3	-9.0
	Kosovo	-5.8	-6.7	-8.1	-8.4	-7.4	-6.7	-8.3	-15.3
	Macedonia	-7.2	-9.5	-4.0	-8.1	-2.5	-0.4	-7.1	-12.8
	Montenegro	n/a	n/a	-6.8	-7.2	-16.6	-31.3	-39.5	-50.6

	Serbia	-2.5	-8.2	-7.3	-12.2	-8.8	-10.2	-16.1	-21.5
	Turkey	1.9	-0.3	-2.5	-3.7	-4.6	-6.1	-5.9	-5.7
FSU	Armenia	-9.5	-6.2	-6.8	-0.5	-1.1	-1.8	-6.4	-11.8
	Azerbaijan	-0.9	-12.3	-27.8	-29.8	1.3	17.6	27.3	35.5
	Belarus	-3.2	-2.3	-2.4	-5.3	1.4	-3.9	-6.7	-8.2
	Georgia	-6.4	-6.4	-9.6	-6.9	-11.1	-15.1	-19.7	-21.9
	Moldova	-1.8	-1.2	-6.6	-1.8	-7.6	-11.3	-15.2	-16.2
	Russia	11.1	8.4	8.2	10.1	11.1	9.5	5.9	6.2
	Ukraine	3.7	7.5	5.8	10.6	2.9	-1.5	-3.7	-7.1

Source: IMF World Economic Outlook database, October 2012

In addition to external and fiscal accounts, vulnerabilities were also built in the financial and real estate sectors. The rapid credit growth led, in many instances, to the deterioration of credit portfolios, even if the latter became fully visible only in 2008–2009 (i.e. when the crisis hit the region and previously optimistic growth prospects had to be revised). As seen in Figure 2.3, it also led to substantial growth in real estate prices in Russia, the Baltic countries, Bulgaria and, to a lesser extent, Poland (Bakker, Klingen et al., 2012, p. 7). The potential risks associated with credit expansion were not fully recognised in boom years. Some analysts interpreted this expansion as legitimate catching up in the financial intermediation sphere in the region with previously underdeveloped and shallow financial markets (e.g. Backe et al., 2007).

Furthermore, expansion of long-term mortgage lending dramatically increased maturity mismatches, especially in the case of banks other than Western bank subsidiaries, which were totally dependent on short-term funding on the wholesale market. Those which belonged to the transnational banking groups were in a better position in terms of access to funding but became ultimately dependent on the fortunes of their parent companies in time of crisis (the risk which was not fully realised before the collapse of Lehman Brothers).

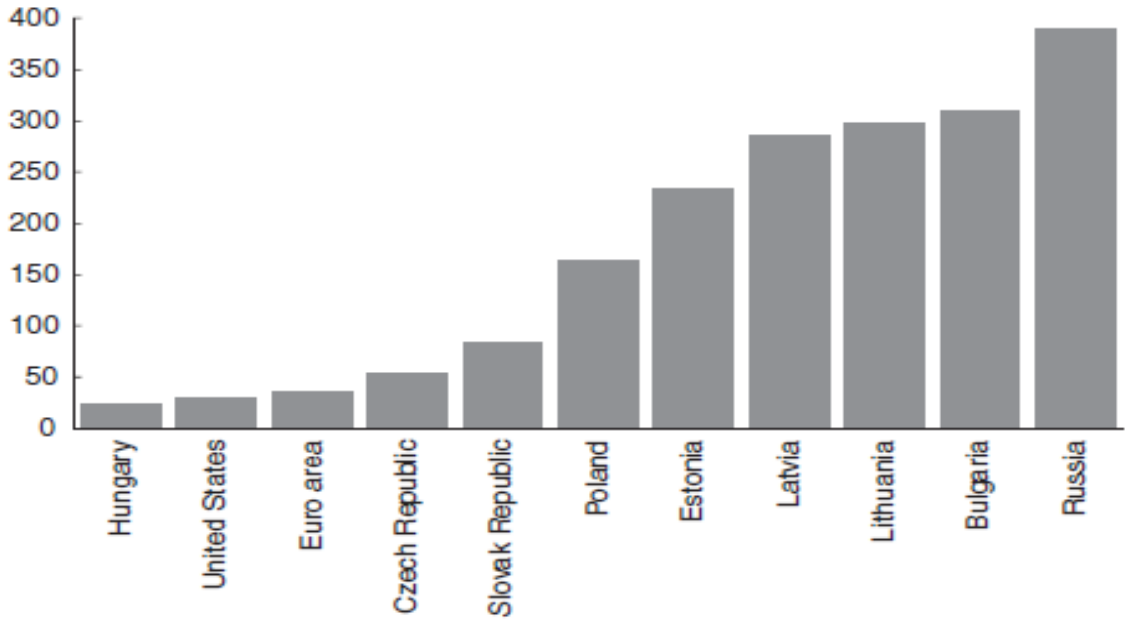
Table 2.4: CEE: general government net lending/borrowing, as % of GDP, 2001–2008

Group	Country	2001	2002	2003	2004	2005	2006	2007	2008
EU NMS	Bulgaria	-0.6	-0.6	0.0	1.6	2.3	3.3	3.3	2.9
	Czech Republic	-5.6	-6.5	-6.7	-2.8	-3.2	-2.4	-0.7	-2.2
	Estonia	0.3	0.9	2.2	1.6	1.6	3.2	2.8	-2.3
	Hungary	-3.9	-8.8	-7.2	-6.4	-7.8	-9.4	-5.1	-3.7

	Latvia	-2.0	-2.6	-1.7	-1.3	-1.3	-0.6	0.6	-7.5
	Lithuania	-3.6	-1.8	-1.3	-1.5	-0.5	-0.4	-1.0	-3.3
	Poland	-5.3	-5.0	-6.2	-5.4	-4.1	-3.6	-1.9	-3.7
	Romania	-3.2	-2.6	-2.2	-3.4	-0.7	-1.4	-3.1	-4.8
	Slovakia	-6.5	-8.2	-2.8	-2.4	-2.8	-3.2	-1.8	-2.1
	Slovenia	-1.3	-1.4	-1.3	-1.3	-1.0	-0.8	0.3	-0.3
EU candidates	Albania	-8.0	-6.1	-4.6	-5.0	-3.4	-3.3	-3.3	-5.1
	Bosnia & Herzegovina	-4.3	-3.0	-0.4	-0.2	0.8	2.2	0.2	-3.7
	Croatia	n/a	-5.2	-4.7	-3.4	-2.8	-2.6	-2.1	-1.3
	Kosovo	4.3	3.8	1.6	-4.6	-3.1	2.7	7.2	-0.2
	Macedonia	-6.3	-5.6	-0.1	0.4	0.2	-0.5	0.6	-0.9
	Montenegro	n/a	-3.4	-5.0	-2.9	-1.6	2.9	6.7	-3.3
	Serbia	0.4	-3.4	-2.9	0.1	1.1	-1.0	-1.4	-2.0
	Turkey	n/a	-13.9	-10.0	-3.9	-0.3	0.0	-1.7	-2.4
FSU	Armenia	n/a	n/a	n/a	n/a	-2.1	-2.0	-2.3	-1.8
	Azerbaijan	0.0	-0.4	-1.8	1.0	2.4	1.2	2.3	20.0
	Belarus	-0.7	1.3	-0.1	0.6	0.2	1.7	2.3	3.4
	Georgia	-0.7	-0.2	-0.6	3.7	2.2	3.4	0.8	-2.0
	Moldova	-0.3	-0.8	0.7	0.7	1.5	0.0	-0.2	-1.0
	Russia	3.2	0.7	1.4	4.9	8.2	8.3	6.8	4.9
	Ukraine	-3.0	-1.8	-0.9	-4.4	-2.3	-1.4	-2.0	-3.2

Source: IMF World Economic Outlook database, October 2012

Figure 2.3. CEE: change in real estate prices, 2003–2008, in %



Source: Bakker, Klingen et al., Figure 1.4, p. 7

Table 2.5. CEE: GG gross debt, as % of GDP, 2001–2008

Group	Country	2001	2002	2003	2004	2005	2006	2007	2008
EU NMS	Bulgaria	68.6	54.8	46.5	39.1	29.4	23.4	18.6	15.5
	Czech Republic	23.9	27.1	28.6	28.9	28.4	28.3	28.0	28.7
	Estonia	4.8	5.7	5.6	5.0	4.6	4.4	3.7	4.5
	Hungary	52.6	55.7	58.5	59.4	61.7	65.9	67.0	72.9
	Latvia	14.1	13.6	14.7	14.4	11.8	9.9	7.8	17.2
	Lithuania	22.7	22.1	21.0	19.3	18.4	17.9	16.8	15.5
	Poland	37.6	42.2	47.1	45.7	47.1	47.7	45.0	47.1
	Romania	27.3	27.4	24.2	21.1	17.6	12.6	12.7	13.6
	Slovakia	48.9	43.4	42.4	41.5	34.2	30.5	29.6	27.9
	Slovenia	29.1	28.9	27.6	27.3	26.8	26.4	23.1	22.0

EU candidates	Albania	65.9	65.5	60.7	57.4	57.8	56.7	53.4	54.7
	Bosnia & Herzegovina	35.2	31.2	27.6	25.6	25.5	21.4	32.8	31.1
	Croatia	n/a	34.8	35.4	37.6	38.2	35.4	32.9	29.3
	Macedonia	48.8	42.9	37.9	35.6	39.5	32.0	24.0	20.6
	Montenegro	n/a	75.7	40.3	45.3	38.6	32.6	27.5	31.9
	Serbia	114.5	81.2	77.8	65.4	56.3	43.0	35.6	34.2
	Turkey	77.9	74.0	67.7	59.6	52.7	46.5	39.9	40.0
FSU	Armenia	37.8	38.1	32.9	26.4	20.5	16.2	14.2	14.6
	Azerbaijan	24.2	22.9	21.7	20.2	13.3	10.2	8.6	7.3
	Belarus	n/a	n/a	n/a	9.7	8.4	13.4	18.3	21.7
	Georgia	n/a	n/a	n/a	43.6	34.1	27.3	21.5	27.6
	Moldova	84.0	67.2	54.6	42.8	34.8	30.0	24.0	18.8
	Russia	47.6	40.3	30.4	22.3	14.2	9.0	8.5	7.9
	Ukraine	36.5	33.5	29.4	24.7	17.7	14.8	12.3	20.5

Source: IMF World Economic Outlook database, October 2012

Table 2.6. CEE: GG structural balance, as % of potential GDP, 2001–2008

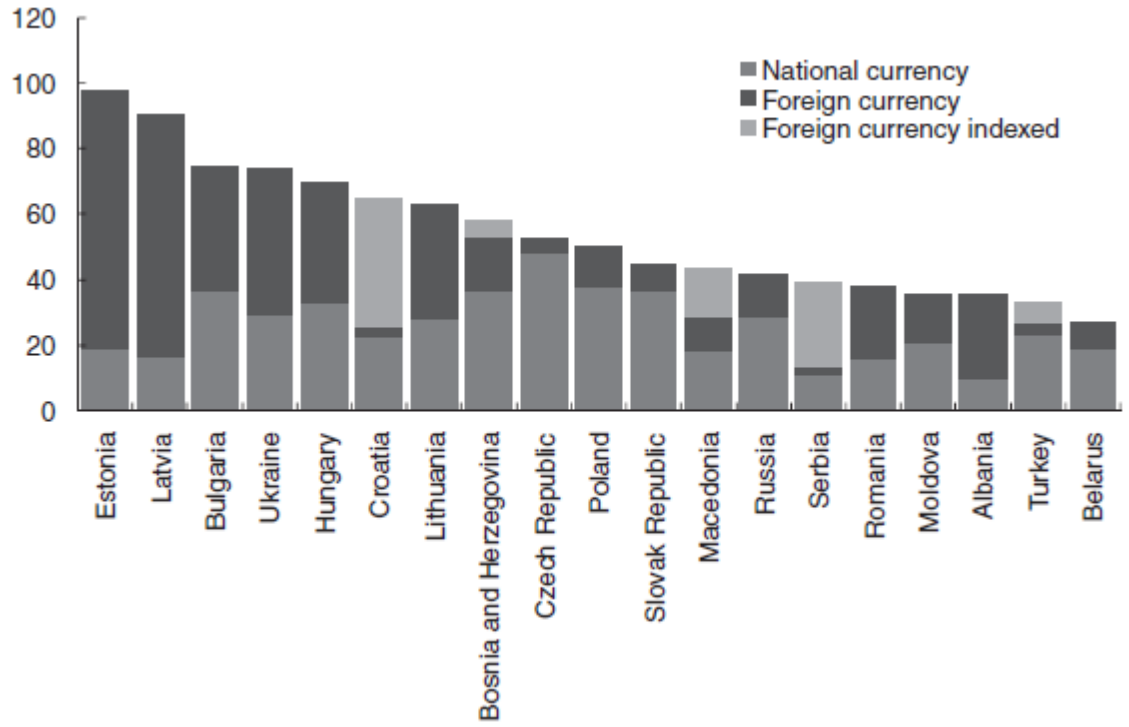
Group	Country	2001	2002	2003	2004	2005	2006	2007	2008
EU NMS	Bulgaria	-0.9	-1.4	-0.7	0.6	1.2	2.3	1.5	0.8
	Czech Republic	-5.3	-5.9	-6.3	-2.3	-3.1	-2.9	-1.8	-3.2
	Hungary	-4.1	-8.5	-7.1	-6.9	-9.3	-10.8	-5.7	-5.3
	Lithuania	-3.1	-1.5	-1.8	-2.1	-1.4	-1.9	-3.9	-6.3
	Poland	-3.2	-3.5	-5.3	-5.5	-3.9	-4.1	-2.8	-4.7
	Romania	n/a	n/a	n/a	-3.2	-0.2	-1.8	-4.3	-7.5
	Slovakia	-6.2	-8.3	-2.8	-2.3	-1.9	-3.1	-3.0	-3.1
	Slovenia	-0.6	-0.7	-0.3	-0.7	-0.8	-2.0	-2.8	-4.1

EU candidates	Croatia	n/a	-5.5	-5.1	-3.7	-3.2	-3.4	-3.7	-2.8
	Turkey	n/a	-11.8	-8.2	-3.8	-1.4	-3.3	-4.2	-4.0
FSU	Russia	2.5	0.5	1.1	4.6	8.1	8.2	6.1	3.9
	Ukraine	n/a	n/a	-1.5	-6.7	-2.8	-2.5	-3.9	-3.5

Source: IMF World Economic Outlook database, October 2012

Another vulnerability related to expansion of foreign exchange denominated mortgage lending (in EUR, CHF, sometimes in JPY) created an illusion of cheap borrowing (low nominal interest rates) for un-hedged households, largely unaware of a potential exchange rate risk (Figure 2.4). The nominal appreciation of several CEE currencies in the mid–2000s in addition increased customers' expectation of a one-way bet. However, lending in foreign currencies or indexed to foreign currencies played an equally major role in countries with hard or fixed but adjustable pegs (Baltics, Bulgaria, Bosnia & Herzegovina, Croatia, Macedonia, Ukraine), and in those with more flexible exchange rate regimes (Hungary, Romania, Serbia, Albania and Moldova). The regulatory intervention aimed at curbing this form of lending came too late and applied to only a few countries.

Figure 2.4. CEE: total private credit by currency, 2008, total stock in % of GDP



Source: Bakker, Klingen et al., 2010, Figure 1.16, p. 18

While some 'traditional' signs of vulnerability (e.g. current account imbalances, insufficient fiscal adjustment and credit boom) were noticed in advance in IMF country reports, and analytical studies of the European Commission, OECD, financial sector institutions and research centres, other problems such as foreign exchange denominated lending and maturity mismatches in the financial sector (in respect to un-hedged households and corporate borrowers) did not bring enough attention and were not remedied in time.

Most importantly, however, the degree of vulnerability of the financial sectors in advanced economies, particularly in the US and Western Europe, remained unnoticed for quite a long time, even after the so-called subprime mortgage crisis erupted in the US in summer 2007. As a consequence, the collapse of the Lehman Brothers in September 2008 and resulting worldwide contagion came as a big surprise to almost everybody, including the CEE region.

Underestimation of financial stability risks and macroeconomic vulnerabilities led to a widespread overestimation of potential growth in the medium to long term both globally and in the CEE region, even after the first signs of the forthcoming financial crisis became evident in the second half of 2007 and first half of 2008. Although growth forecasts of both the IMF and other institutions started to be revised downward, this was not enough to take full account of what actually happened at the end of 2008 and beginning of 2009. This in turn led to underestimation of fiscal sustainability risks. The dominant wishful thinking belief in a soft and reasonably painless 'landing' prevented contingency planning for the serious crisis to come.

In the CEE region two specific factors additionally contributed to such policy myopia. Firstly, there was a widespread feeling of economic success and an almost guaranteed catching-up scenario, especially in EU NMS and candidates. Secondly, there was equally widespread reform 'fatigue', which was understandable after the dramatic decade of the 1990s and the period of EU accession.

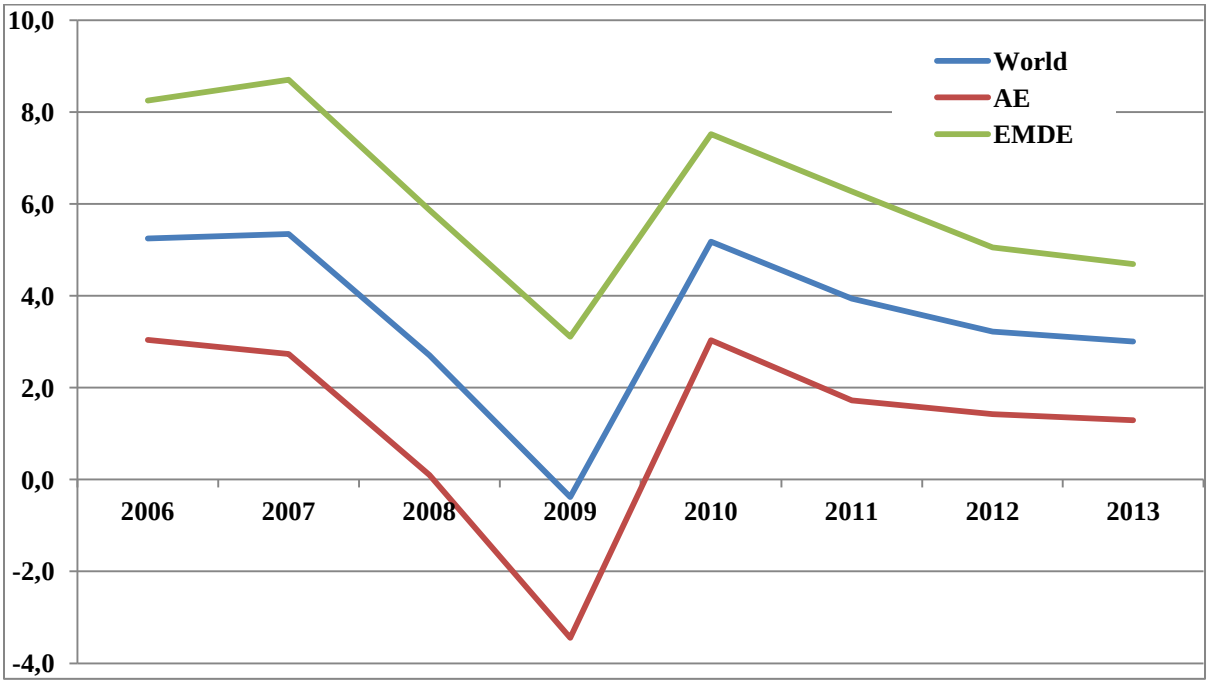
3. Impact of the financial crisis (2008–2013)

3.1 Financial crisis chronology

When considering the recent global financial crisis it is important to distinguish its major phases and the forces in play.

It began in the summer of 2007 with the so-called subprime mortgage crisis in the US non-banking mortgage lending sector. From the first half of 2008 its consequences started to be felt by major investment banks in the US and some lenders in Europe (especially in the UK). This new phase culminated with the Lehman Brothers bankruptcy in mid-September 2008 which triggered a global liquidity shock. Several financial institutions in the US, Europe and Japan became immediately affected. There were also severe consequences for real economic sector, i.e. a sharp decrease in global trade and global output in the second half of 2008 and the first half of 2009. The decline reached its lowest point in the second quarter of 2009 after which a rapid recovery started (Figure 3.1). Recovery was fuelled by an aggressive monetary and fiscal stimulus in major advanced economies.

Figure 3.1. Annual real GDP growth, in %, 2006–2013, advanced and emerging-market economies



Source: IMF World Economic Outlook database, April 2014

However, in 2010 the crisis entered a new phase, i.e. the sovereign debt crisis on the Eurozone periphery and rapidly increasing public debt level in most of the advanced economies, including the US, Japan and UK. This phase culminated in the second half of 2011 and 2012 when the future of the entire Eurozone as a single currency area was put under question by financial markets. In addition, fiscal solvency concerns in several EU/Eurozone countries negatively affected the quality of assets in European banks, and their rating.

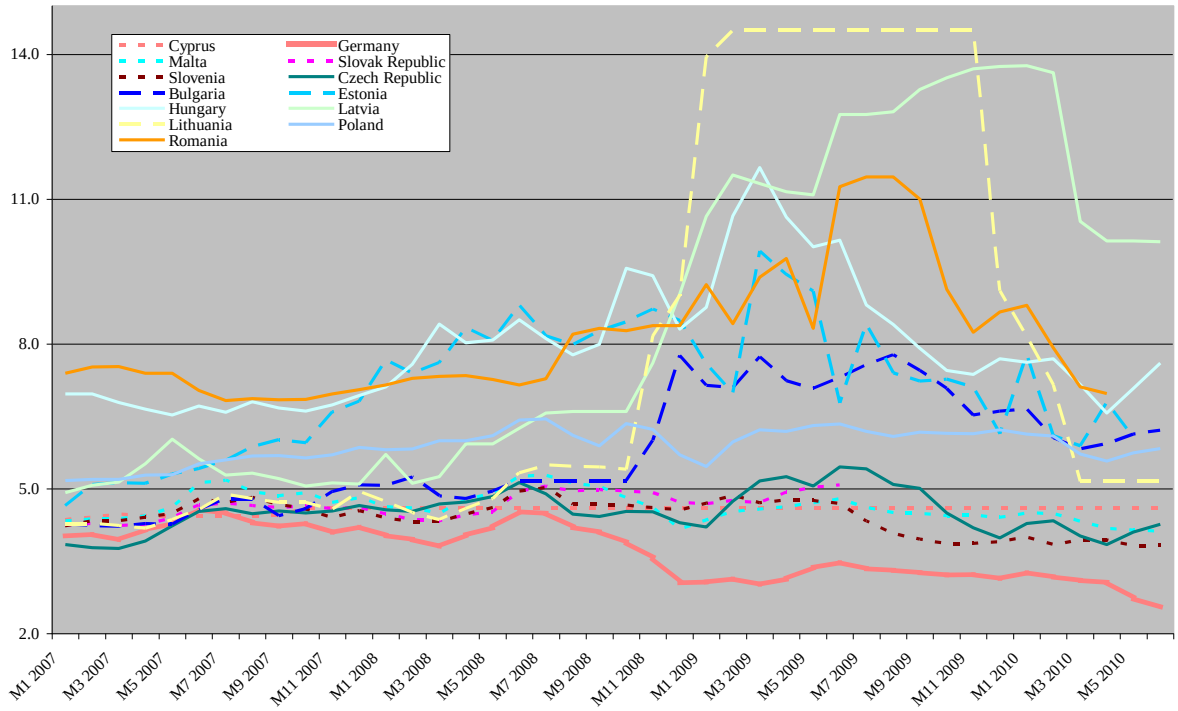
As in the case of the global phase, the European one also had an impact on real sector. It caused a shallow recession in the Eurozone in 2012–2013, with negative spillovers for EU members and candidates in the CEE.

As of the end of 2014 the prospects of the global and, even more, the European economy, remain uncertain due to various global and regional risk factors. The chance to return quickly to the pace of economic growth recorded prior to the 2008 crisis in the near future is not high (Dabrowski, 2013b), and this will have serious implications for economic policy. This will be considered further in Section 4.

3.2 The first shock: impact of the global financial crisis (2008–2009)

Once the financial crisis entered its global phase in the summer of 2008, it hit most of the EMDE regions (see Figure 2.1). However, the CEE region was the most seriously affected. Most of the favourable factors described in Section 2 disappeared or even started to have the opposite effect as compared with the pre-crisis period.

Figure 3.2. EU NMS: long-term government bond yields (annualised in %), 2007–2010



Source: IMF IFS database

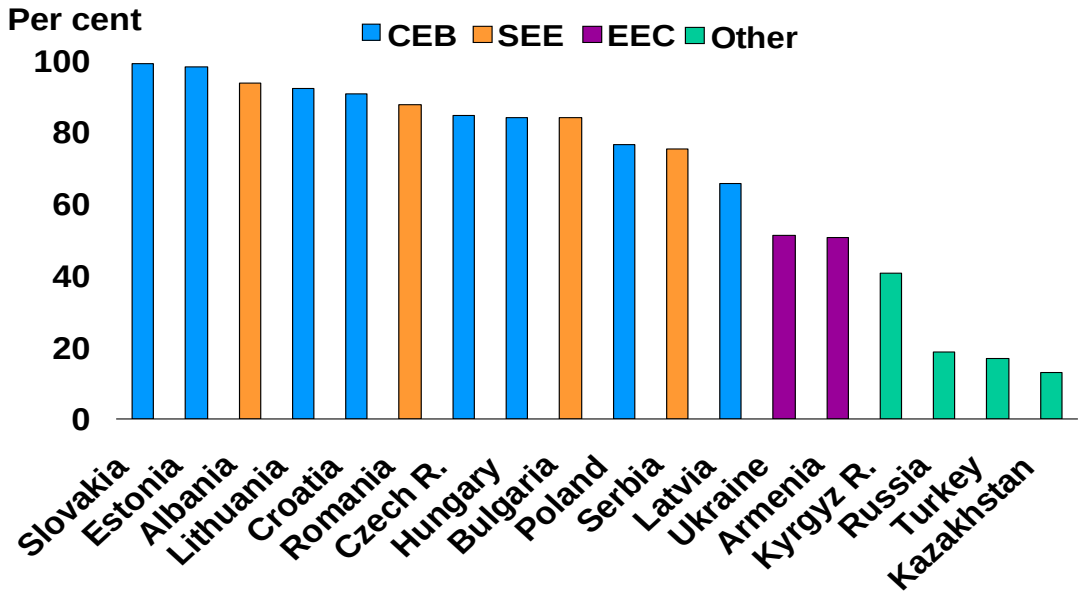
In the financial sphere, liquidity and credit dried up, capital started to return to the main financial centres, mostly the US (see Figure 2.2), stock markets and commodity prices declined (although there was almost a one-year time mismatch between the collapse of these two asset markets), risk premia for both sovereign and private borrowing grew dramatically (see Figure 3.2), and many national currencies depreciated (especially in countries which ran floating exchange rate regimes), threatening the massive insolvency of economic agents who had borrowed in foreign currencies. Some countries (Hungary, Latvia, Romania, Ukraine) experienced banking sector troubles. In the real sphere, external demand for exported goods and labour declined (the latter resulted in declining remittances of labour migrants).

Neither EU membership nor currency board regimes were considered by financial markets as effective insurance against balance-of-payment and fiscal crises any longer. Those EU NMS which managed to enter the EMU before the crisis (Slovenia, Cyprus, Malta and Slovakia) minimised nominal shocks (especially those related to currency risks) but were not able to use the exchange rate as a shock absorber. On the contrary, most CEE countries with floating exchange rates experienced much larger fluctuations of nominal variables but some of them (Poland, Albania) could accommodate declining external demand more rapidly.

The sharp fluctuations of nominal variables could have lead to a serious disruption of the banking and financial sectors. Fortunately, exchange rates and stock market indices started to rebound from spring

2009, which helped to avoid full-scale domestic financial crises. The rapidly-disbursed IMF loans (see below) provided additional backing to and sometimes rescued financial sectors in the troubled countries.

Figure 3.3. CEE and FSU: Share of assets owned by foreign banks subsidiaries, end–2008



Source: Berglof (2009)

However, the key factor which helped CEE banks to survive the crisis in relatively good shape was their ownership structure. Most of them were owned by their creditors from Western Europe (Figure 3.3), who were interested in their survival. As a result, the region avoided a systemic banking crisis and the Western European parents contributed enough resources (in the form of liquidity rollover and additional capitalisation when required) to help their CEE subsidiaries to survive the period of greatest market stress and continue their development. The cases of withdrawal (because of parents' serious troubles at home) were rare and carried out in an orderly manner. In fact, the biggest troubles were related to domestically-owned banks such as the OTP in Hungary, Parex Bank in Latvia and several domestically-owned (including state-owned) banks in Russia and Ukraine, rather than Western European subsidiaries.

The joint initiative of the IMF, EBRD, World Bank and the European Commission (the so-called Vienna Initiative) also helped to ensure the coordinated support to CEE banks provided by their parent banks, respective governments and international organisations (Berglof 2009; Berglof 2012; De Haas et al., 2012).

In macroeconomic policy terms, not surprisingly those countries which recorded the highest fiscal deficits / public debts (Hungary), highest current account deficits (Latvia, Serbia), or whose current account deficits rapidly grew in the run-up to the crisis (Belarus, Bosnia & Herzegovina, Ukraine), those

having fragile financial sectors (Hungary, Latvia, Romania, Serbia, Bosnia & Herzegovina, Ukraine and Moldova) or representing other vulnerabilities (like large-scale quasi fiscal operations – as in the case of Belarus) became its first victims and required emergency assistance from the IMF.

As a result, three EU NMS (Hungary, Latvia and Romania), one high-income country of the European Economic Area (Iceland), two EU candidates (Bosnia & Herzegovina, Serbia) and four East European FSU economies (Armenia, Belarus, Georgia, and Ukraine) had to resort to IMF assistance in the second half of 2008 and the beginning of 2009 to secure their international liquidity and avoid both sovereign default and an uncontrolled run on their currencies. In addition, Poland benefited from the IMF Flexible Credit Line, and Macedonia from the Precautionary Credit Line.

In the aftermath of the crisis IMF lending resources became substantially augmented, the size of individual stand-by arrangements increased (in some cases, above 10 times of country's quota), and the loan approval and disbursement process shortened. In most of the discussed cases IMF programmes were backed by EU resources in the form of either Balance-of-Payment Support (in the case of non-Eurozone EU members) or Macro-Financial Assistance (other countries).

3.3 The second shock: impact of the European debt crisis (2010–2013)

The European phase of the financial crisis started with Greece's sovereign debt crisis at the beginning of 2010 which then spread to Ireland (second half of 2010), Portugal (2011), Spain and Italy (2011–2012), Cyprus (2013) and Slovenia (2013). Almost everywhere the rapidly increasing costs of public debt servicing and/or difficulty in rolling over existing debt stock have signalled financial markets' concerns related to long-term fiscal sustainability of the countries in question. However, in Ireland, Spain, Cyprus and Slovenia the risks to sovereign solvency originated at least partly from the banking crises. On the other hand, the sovereign debt crisis has led to deterioration of banks' assets, often outside the country in trouble (e.g. Cyprus, where the two biggest banks held large portfolios of Greek government bonds).[4]

As mentioned in Section 3.1, the phenomenon of excessive sovereign debt burden has not been limited to countries in the Eurozone periphery. It also affected other Eurozone members (Belgium, France, Netherlands, Germany, Austria) often considered as representing the 'prudent' North, other EU members (UK, Hungary) and other major advanced economies (US, Japan).

The impact of this phase of the crisis on the CEE region has been felt in the real sector (trade channel) rather than the financial one. Slovenia is the exception but its banking problems are rather home-grown and originate from insufficient reforms of this sector in the two previous decades, and excessive public ownership. Similarly continued macroeconomic disequilibria in Belarus and Ukraine had roots in populist domestic policies (both countries) and political instability and military conflict (Ukraine). However, all CEE countries experienced much slower credit and financial intermediation growth (if compared to the pre–2008 period) as the consequence of global financial deleveraging.

[4] Balcerowicz (2014) makes the distinction between fiscal-to-financial and financial-to-fiscal crises.

3.4 Macroeconomic performance since 2008

As illustrated by Table 3.1, in 2008–2009 the CEE region experienced dramatic reversal of the previous boom.

Table 3.1. CEE: Real GDP, annual change in %, 2008–2013

Group	Country	2008	2009	2010	2011	2012	2013
EU NMS	Bulgaria	6.2	-5.5	0.4	1.8	0.6	0.9
	Czech Republic	3.1	-4.5	2.5	1.8	-1.0	-0.9
	Estonia	-4.2	-14.1	2.6	9.6	3.9	0.8
	Hungary	0.9	-6.8	1.1	1.6	-1.7	1.1
	Latvia	-2.8	-17.7	-1.3	5.3	5.2	4.1
	Lithuania	2.9	-14.8	1.6	6.0	3.7	3.3
	Poland	5.1	1.6	3.9	4.5	1.9	1.6
	Romania	7.3	-6.6	-1.1	2.2	0.7	3.5
	Slovakia	5.8	-4.9	4.4	3.0	1.8	0.9
	Slovenia	3.4	-7.9	1.3	0.7	-2.5	-1.1
EU	EU27	0.6	-4.4	2.0	1.7	-0.3	0.2
	Eurozone	0.4	-4.4	2.0	1.6	-0.7	-0.5
EU candidates	Albania	7.5	3.3	3.8	3.1	1.3	0.7
	Bosnia & Herzegovina	5.6	-2.7	0.8	1.0	-1.2	1.2
	Croatia	2.1	-6.9	-2.3	-0.2	-1.9	-1.0
	Kosovo	7.2	3.5	3.2	4.4	2.5	2.5
	Macedonia	5.0	-0.9	2.9	2.8	-0.4	3.1
	Montenegro	6.9	-5.7	2.5	3.2	-2.5	3.4
	Serbia	3.8	-3.5	1.0	1.6	-1.5	2.5
	Turkey	0.7	-4.8	9.2	8.8	2.2	4.3
FSU	Armenia	6.9	-14.2	2.2	4.7	7.1	3.2
	Azerbaijan	10.8	9.3	5.0	0.1	2.2	5.8

	Belarus	10.3	0.1	7.7	5.5	1.7	0.9
	Georgia	2.3	-3.8	6.3	7.2	6.2	3.2
	Moldova	7.8	-6.0	7.1	6.8	-0.7	8.9
	Russia	5.2	-7.8	4.5	4.3	3.4	1.3
	Ukraine	2.3	-14.8	4.1	5.2	0.2	0.1

Note: yellow colour indicates IMF estimate

Source: IMF World Economic Outlook database, April 2014

In 2009 all EU NMS but Poland recorded output decline deeper than the EU27 and Eurozone averages. In the case of Baltic countries (which grew rapidly before 2008 on the back of the credit and real estate boom) the contraction was particularly strong and started earlier as compared to other CEE economies.

Among the EU candidates, Croatia, Montenegro and Turkey recorded higher GDP decline as compared with the EU-27 average. On the other hand, contraction in Macedonia, Bosnia & Herzegovina and Serbia was less dramatic, while Albania and Kosovo managed to continue their growth path (similarly to Poland in the EU NMS group).

The Eastern European FSU economies also experienced dramatic decline, especially Armenia, Ukraine and Russia. Only Azerbaijan (due to its oil boom) recorded high positive growth in this period. The years 2010–2011 brought a slow-to-modest recovery in the region with only a few countries recording higher growth rates (Turkey, Estonia, Georgia, Moldova and Belarus). Croatia continued in recession.

However, in the next two years (2012–2013) the European phase of the crisis undermined even that modest and uneven recovery, with several countries experiencing negative growth in both or one of those years (Czech Republic, Hungary, Slovenia, Croatia, Bosnia & Herzegovina, Montenegro, Serbia) and others experiencing serious slowdown or stagnation.

Table 3.2. CEE: current account balance, as % of GDP, 2008–2013

Group	Country	2008	2009	2010	2011	2012	2013
EU NMS	Bulgaria	-23.0	-8.9	-1.5	0.1	-0.9	2.1
	Czech Republic	-2.1	-2.5	-3.8	-2.9	-2.4	-1.0
	Estonia	-9.2	2.7	2.8	1.8	-1.8	-1.0
	Hungary	-7.4	-0.2	0.2	0.5	1.0	3.1
	Latvia	-13.2	8.7	2.9	-2.1	-2.5	-0.8
	Lithuania	-13.3	3.9	0.0	-3.7	-0.2	0.8

	Poland	-6.6	-4.0	-5.1	-4.9	-3.5	-1.8
	Romania	-11.6	-4.1	-4.4	-4.5	-4.4	-1.1
	Slovakia	-6.6	-2.6	-3.7	-3.8	2.2	2.4
	Slovenia	-5.4	-0.5	-0.1	0.4	3.3	6.5
EU candidates	Albania	-15.2	-14.1	-10.0	-9.6	-9.3	-9.1
	Bosnia & Herzegovina	-14.1	-6.6	-6.2	-9.8	-9.7	-5.6
	Croatia	-9.0	-5.2	-1.2	-0.9	0.0	1.2
	Kosovo	-16.0	-9.4	-12.0	-13.8	-7.7	-6.8
	Macedonia	-12.8	-6.8	-2.0	-2.5	-3.0	-1.8
	Montenegro	-49.8	-27.9	-22.9	-17.7	-18.7	-15.0
	Serbia	-21.7	-6.6	-6.8	-9.1	-10.7	-5.0
	Turkey	-5.5	-2.0	-6.2	-9.7	-6.2	-7.9
FSU	Armenia	-11.8	-15.8	-14.8	-10.9	-11.2	-8.4
	Azerbaijan	35.5	23.0	28.0	26.5	21.8	19.7
	Belarus	-8.2	-12.6	-15.0	-8.5	-2.7	-9.8
	Georgia	-22.0	-10.5	-10.2	-12.7	-11.7	-6.1
	Moldova	-16.1	-6.9	-7.0	-11.3	-6.0	-4.8
	Russia	6.3	4.1	4.4	5.1	3.6	1.6
	Ukraine	-7.1	-1.5	-2.2	-6.3	-8.1	-9.2

Note: yellow colour indicates IMF estimate

Source: IMF World Economic Outlook database, April 2014

Analysis of capital flows and balance of payments help us to understand macroeconomic factors which contributed to the end of the CEE growth miracle and its unlikely comeback in the near future. As mentioned in Section 3.2, the first global phase of financial crisis in 2008 had already caused a sudden halt to capital flows to the region, which have been rebuilt only partly in subsequent years (Figure 2.2). As a consequence, CEE economies have had to adjust their current accounts to the new situation and many of them have done so in an impressive way (Table 3.2). This includes, for example, Bulgaria, Baltic countries, Romania, Slovenia, Montenegro, Serbia, Georgia and Moldova, which improved their current account balances by more than 10 percentage points of GDP. However, such a dramatic shift was

accomplished at the cost of lower investment rates, while national saving rates remained largely unchanged or even decreased (in FSU).

Fiscal policies in most CEE countries were not tight enough to stop growth in general government gross debt-to-GDP ratios (Table 2.5). This was the effect of both continuing fiscal deficits leading to further building-up of public debt stock (numerator of the equation) and a poor growth record (denominator). As result CEE countries, which before the 2008 crisis recorded, on average, modest or low levels of public debts as compared to their Western and Southern European peers, after 2008 'caught up' rapidly in this respect. Between 2008 and 2013 the highest growth in debt-to-GDP ratio was recorded in Slovenia (51 percentage points of GDP), Serbia (32.4), Croatia (30.5), Armenia (27.3), Montenegro (27.8), Slovakia (27), Romania (25.7), Lithuania (23.8) and Ukraine (20.5).

Table 3.3. CEE: GG gross debt, as % of GDP, 2008–2013

Group	Country	2008	2009	2010	2011	2012	2013
EU NMS	Bulgaria	15.5	15.6	14.9	15.4	17.5	17.6
	Czech Republic	28.7	34.2	37.9	41.0	45.7	47.9
	Estonia	4.5	7.1	6.7	6.1	9.8	11.3
	Hungary	73.0	79.8	82.1	82.1	79.8	79.2
	Latvia	17.2	32.9	39.7	37.5	36.4	32.1
	Lithuania	15.5	29.5	38.3	39.2	41.0	39.3
	Poland	47.1	50.9	54.8	56.2	55.6	57.5
	Slovakia	27.9	35.6	41.0	43.4	52.4	54.9
	Slovenia	22.0	35.1	38.7	46.9	54.3	73.0
	Romania	13.6	23.8	31.1	34.3	38.2	39.3
EU candidates	Albania	54.7	59.5	58.5	60.3	62.4	70.5
	Bosnia & Herzegovina	30.9	35.8	39.1	40.8	44.6	42.7
	Croatia	29.3	35.8	42.6	47.4	54.0	59.8
	Macedonia	20.6	23.8	24.2	27.9	34.1	35.8
	Montenegro	29.0	38.2	40.9	46.0	54.0	56.8
	Serbia	33.4	38.1	46.5	49.5	62.4	65.8
	Turkey	40.0	46.1	42.3	39.1	36.2	35.8

FSU	Armenia	14.6	34.1	33.7	35.7	38.9	41.9
	Azerbaijan	7.3	11.8	11.1	10.1	11.6	13.8
	Belarus	21.5	34.7	39.5	45.9	38.5	36.7
	Georgia	27.6	37.3	39.2	33.8	32.3	31.8
	Moldova	19.3	29.1	26.9	24.1	24.5	24.4
	Russia	7.9	11.0	11.0	11.7	12.7	13.4
	Ukraine	20.5	35.4	40.5	36.8	37.4	41.0

Note: yellow colour indicates IMF estimate

Source: IMF World Economic Outlook database, April 2014

The public debt of Hungary, Slovenia, Albania and Serbia exceeds the Maastricht threshold of 60% of GDP while in Croatia, Poland and Montenegro it is close to this level (over 55% of GDP). As the financial markets' debt 'tolerance' in respect to emerging-market economies is, on average, much lower than in advanced economies, the increasing number of CEE economies becomes fiscally vulnerable especially in the case of major exogenous shocks.

In addition, the increase in public sector borrowing requirements means lower national saving rates (other things being equal) and crowding out credit to the private sector, which will have negative consequences, via investment channels, for the future growth rate in the region.

4. Challenges ahead

As we discussed in Sections 2 and 3, the end of global financial boom of the early and mid–2000s, and subsequent financial crisis, put under question the dominant CEE growth model based on the large-scale import of savings from outside the region. Also, other growth factors such as the positive consequences of systemic transformation and structural reforms in the 1990s and early 2000s, or joining the SEM in the first half of the 2000s, have been largely consumed.

In structural terms, most of EU NMS and candidates tried to build their comparative advantages in the manufacturing (mostly in intermediate stages of global production chains) and service sectors. They competed with lower wages and salaries (as compared to Western Europe) for the relatively well-educated labour force. This was enough to encourage several transnational corporations to create their production and service centres in the region. However, as labour costs in CEE gradually increase and competition from lower-cost emerging-market producers (for example, in Asia) becomes stronger, those comparative advantages may soon disappear. Excessive social spending, being partly the legacy of the communist regime and centrally-planned economies, and partly the effect of the premature import of Western European welfare state institutions, adds to labour costs and further decreases the region's competitiveness.

Moving up a value chain and towards more knowledge-intensive sectors (the natural market niche for higher-wage economies) can be difficult given the weak innovativeness of CEE countries, low spending on research and their imperfect education systems.

The situation of FSU countries is even more difficult in this respect because of their large dependence on commodity production and exports (including fluctuation in commodity prices). Structural diversification of their economies is constrained by the same factors as in EU NMS and candidates and, in addition, by poor business climate and poor governance.

Analysis of long-term growth factors (according to the neo-classical growth theory) does not offer too much optimism either. Available labour resources in the region will systematically decrease as the consequence of deeply unfavourable demographic trends and continuing net outgoing migration.[5] Population aging will also create additional public liabilities, especially in public pension and healthcare systems.

Investment will be constrained by fairly low national saving rates and limited availability of external saving in an environment of continued financial deleveraging and high public sector borrowing requirements in Europe. Saving rates are unlikely to increase as long as large fiscal imbalances continue.

Thus the only remaining growth factor relates to improvement in total factor productivity. In turn, this will depend on political chances to return to the process of economic and institutional reforms which became stalled in most of the CEE region from the mid–2000s or even partly reversed in some countries (EBRD, 2013; Roaf et al., 2014).

In CEE countries the future reform agenda should lead, in the first instance, to containment and then the reduction of implicit public pension and health liabilities, and other social programmes. They also should increase flexibility of their national labour markets, improve business climate, and adjust education to the needs of contemporary labour markets. Countries which stay outside the Eurozone should join it soon to enjoy the full benefits of the SEM and eliminate volatility of their exchange rates.

The detail reform agenda in individual countries depends very much on their economic situation and characteristics. However, there are some common challenges shared by larger groups of countries. Firstly, the rapidly-growing public debt in most countries must be stopped as soon as possible. This will require a far-reaching fiscal adjustment and will be impossible, in most cases, without the revision of major expenditure programs, especially in the social welfare sphere. All European countries, including those in CEE, must neutralise the fiscal and other consequences of population aging and decline. Increasing both the formal and effective retirement age seems to be the best response. A greater openness to immigration (contrary to widespread populist fears in many countries) could be another good recipe.

[5] Turkey is an exception – decline in its productive-age population will start later as compared with other CEE countries.

A radical overhaul of the welfare systems and labour regulations is important not only for balancing government accounts but also for making labour markets more flexible, i.e. overcoming the serious obstacles to economic growth in continental Europe, including most of the EU NMS and EU candidate countries.

Several countries (especially those of FSU and Western Balkans) need to work hard on improving their business and investment climate, upgrading their legal and public administration systems and fighting corruption and organised crime, etc. to be able to attract more investment. However, the deregulation agenda is important for the whole of Europe, both on a national and EU level. Many countries should continue privatisation of their public enterprises and financial institutions.

There is also a large, perhaps even more complex and difficult reform agenda on the supranational level, as the crisis demonstrated a high degree of global interdependence and the limits of both national policies and regulations. First of all, this concerns global financial markets and institutions, where both close coordination of national regulations and the building of global standards, regulations and supervisory institutions is required. The same concerns some form of coordination of macroeconomic policies between the biggest players, which the G20 tried to do recently with mixed results. Finally, it is time to conclude global trade negotiations that began more than a decade ago under the Doha Development Round, even if the crisis and crisis-related recession have created the temptation for protectionist policies at national level.

The same concerns the regional agenda for Europe. The EU must complete the building of its SEM, especially in respect to the services and financial sectors (including completion of the Banking Union project). Some deregulation of product markets, especially for agriculture goods, would also be beneficial for the future growth of both EU member states and their trade partners. Accelerating EU enlargement (in respect to the Western Balkan countries and Turkey) would bring greater economic, financial and political stability to this part of Europe and make the SEM more vibrant and competitive. The same concerns EMU enlargement, which can offer more macroeconomic and financial stability to those NMS which are still outside the Euro area. Strengthening fiscal and macroeconomic surveillance rules can provide more stability to the entire European economy and reduce risks of repeating financial crises in future.

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