From Crisis to Recovery: Central Europe’s Winners and Losers

Report No. 28

Eva M. Blaszczynski

November 2009
<table>
<thead>
<tr>
<th>Acronym</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Baltic States</td>
<td>Reference to Estonia, Latvia and Lithuania</td>
</tr>
<tr>
<td>BIS</td>
<td>Bank for International Settlements</td>
</tr>
<tr>
<td>CE</td>
<td>Central Europe</td>
</tr>
<tr>
<td>CEE</td>
<td>Central and Eastern Europe</td>
</tr>
<tr>
<td>CIPA</td>
<td>China Investment Promotion Agency</td>
</tr>
<tr>
<td>EBRD</td>
<td>European Bank for Reconstruction and Development</td>
</tr>
<tr>
<td>ECB</td>
<td>European Central Bank</td>
</tr>
<tr>
<td>EMU</td>
<td>European Monetary Union</td>
</tr>
<tr>
<td>ERM II</td>
<td>Exchange Rate Mechanism Two</td>
</tr>
<tr>
<td>ESFS</td>
<td>European System of Financial Supervisors</td>
</tr>
<tr>
<td>ESRC</td>
<td>European Systemic Risk Council</td>
</tr>
<tr>
<td>EU</td>
<td>European Union</td>
</tr>
<tr>
<td>EU-15</td>
<td>Group of Original EU Member States, Non-Central European</td>
</tr>
<tr>
<td>EP</td>
<td>European Parliament</td>
</tr>
<tr>
<td>FDI</td>
<td>Foreign Direct Investment</td>
</tr>
<tr>
<td>GM</td>
<td>General Motors</td>
</tr>
<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
</tr>
<tr>
<td>ITD</td>
<td>Hungarian Investment and Trade Development Agency</td>
</tr>
<tr>
<td>R&amp;D</td>
<td>Research and Development</td>
</tr>
<tr>
<td>SME</td>
<td>Small and Medium Enterprise</td>
</tr>
<tr>
<td>SOE</td>
<td>State Owned Enterprises</td>
</tr>
</tbody>
</table>
Executive Summary

The days of enviable growth rates, large-scale capital flows and abundance of cheap foreign credit are over, leaving the countries of Central Europe (CE) to ponder how best to sustain their economic growth in light of the worst economic crisis since the Great Depression. Although the current global downturn has afflicted all of the countries in the region, the initial drivers, scale and severity of the crisis differ tremendously. As a result, Central Europe’s future economic sustainability and recovery will vary across countries and reflect the diverse economic and political paths that carried them into the crisis. Undoubtedly there will be winners and losers in the recovery. Three distinct groups will emerge 1) Winners: Poland, the Czech Republic and Slovakia; 2) Idlers: Bulgaria and Romania; and 3) Losers: the Baltic States and Hungary.

Introduction

As countries throughout Central Europe mark 20 years since the fall of communism, the sense of optimism and euphoria that once permeated their capitals has turned sour. The global financial crisis has prompted a wave of sobering, if not fatalistic, reports on the future of the region’s economic prospects and sustainability. Some regional analysts and policymakers even questioned the liberal economic model that promised to bring growth and stability to the countries of the former Soviet bloc. In May 2009 the European Bank for Reconstruction and Development (EBRD) confirmed anxieties by releasing forecasts that the economies of Central and Eastern Europe (CEE), on average, will contract by more than five percent in 2009.1 While the economic crisis has hit Europe’s post-communist countries particularly hard, not all of the region’s economies are doomed, share the same risk profile or threaten to spread financial contagion. In fact, some countries are emerging as harbors of relative stability amid the current financial storm. Therefore it is imperative to recognize and understand the key drivers that are setting various Central European countries apart, as they will also play a major role in the speed and scale of economic recovery.

Over the course of the last few months, Central Europeans watched their currencies plunge, credit default swaps rise, and foreign-capital and investment inflows diminish. European markets tumbled after Moody’s, a major credit-ratings agency, warned that banks in Western Europe faced credit downgrades due to hundreds of billions of dollars in outstanding loans to emerging Europe.2 The report named the Baltic States,

---

Hungary, Croatia and Romania as specific trouble spots. Instead of looking deeper into specific economic indicators, market analysts projected fears onto the entire region. A broad sell-off of Central Europe’s currencies and equities ensued.

In actuality, within the 10 new European Union (EU) member states, three very distinct economic profiles have emerged: winners, idlers and losers. These profiles can be linked to three types of economic transition models: the Baltic model, the embedded neoliberal model and the gradualist model. These differences not only reflect the severity of current economic risks but also the recovery options available to policymakers within national governments, international financial institutions and multilateral organizations. The three profiles include 1) winners: the Czech Republic, Poland and Slovakia (and Slovenia3); 2) idlers: Bulgaria and Romania; and 3) losers: the Baltic States (Estonia, Latvia and Lithuania) and Hungary.

3 Slovenia is not a focus of this report. It has “caught up” economically with the rest of the EU at a faster pace than most of its Central European neighbors and having joined eurozone in January 2007, well ahead of the economic crisis, its position entering the crisis is fairly different from that of the rest of the region. It has the highest credit rating in the region and is firmly in the winner category.
Three Economic Models

I. The Baltic Model

For most of this decade Estonia, Latvia and Lithuania reveled in their roles as “hot” emerging markets. The “Baltic tigers,” as they were cleverly dubbed, enjoyed some of emerging Europe’s highest growth rates and foreign-capital inflows. In spite of their small populations, large public sectors and lack of real durable industries, Western European financial institutions descended on the three former-Soviet republics bringing with them a plethora of cheap credit and a thirst for untapped consumers. Despite the lack of early warnings, a closer look at the economic model adopted by all three Baltic States reveals chinks in the armor and demonstrates a high degree of vulnerability to sudden financial shocks.

For the Baltic States, like most other post-communist economies, initial conditions and political choices all had a major influence over their preferred development path. Unlike neighboring Poland, the Baltic States did not have traditions of reform-socialism during communism. As a result, their transitions to market-based economies were swift and radical. Also, because the Baltic States did not gain independence from the Soviet Union until 1991, their reforms began later than other Central European economies and they had to start from scratch.⁴

Once the Baltic States became members of the EU, macroeconomic stability as well as credibility within global financial markets was the cornerstone of their economic growth model. That is why Estonia and Lithuania entered into currency boards by pegging their currencies to the euro in 1992 and 1994, respectively. While Latvia has not implemented an official currency board, it has linked the lat to the euro, which trades within a plus-or-minus one percent band of 0.7028 lats per euro. The goal was to adopt the EU’s “stability culture” as quickly as possible in order to meet the Maastricht Treaty’s convergence criteria for euro adoption. At the same time, independent central banks enabled the Baltic governments to depoliticize monetary policy (especially as inflation, wages and interest rates rose) thereby insulating key aspects of the economy away from political influence in lieu of internally and externally binding constraints.⁵

There were several problems with this development strategy. First, the Baltic States lacked diversification and became overly dependent on the services and construction sectors at the expense of more export-oriented sectors like agriculture and industry. Retail trade, transport and communications, business outsourcing, real estate and financial services all grew rapidly. In 2007 services accounted for nearly 70 percent of Estonia’s gross value added, while its share of manufacturing declined by half since 1989 to just over 16 percent. By 2006 Latvia’s service sector grew from 33 percent to 75

---

percent of GDP. In Lithuania the service sector’s share of GDP had grown from 40 percent in the early 1990s to roughly 60 percent by 2008. The sector’s growth was fueled by a large influx of foreign capital. Unlike foreign direct investment (FDI), which favors longer-term physical and/or capital investments, foreign-portfolio investments are less stable and move with changing market currents. They also react quickly to any signs of external vulnerability, resulting in capital flight, a scenario currently faced by the Baltic States. Large current-account deficits, consumption-driven growth and high levels of foreign-denominated debt caused panicked investors to flee.

Secondly, rapid credit expansion among all three Baltic States created an unsustainable economic environment, where consumer demand and investment outpaced real GDP output. For example, 85 percent of Estonia’s, 89 percent of Latvia’s and 64 percent of Lithuania’s total loans outstanding are denominated in foreign currencies, the highest in the region. Moreover, in the last five years the average rate of credit expansion in these small economies outpaced the rate of larger and more economically diverse countries such as the Czech Republic or Poland. The majority of credit went to fuel an overheating real-estate boom, while productivity, export capacity and overall competitiveness stagnated. Between 2004 and 2006 the average price of Latvian residential property rose by a remarkable 311 percent while housing loans increased by nearly 90 percent annually. Lithuania’s average housing prices rose from €927 in 2002 to €3,475 by 2006 – a 275 percent increase. In light of the current economic crisis, tighter lending conditions, coupled with overcapacity and drop in demand (especially from EU buyers), has caused the Baltic housing and construction market to collapse. If Baltic States fail to sustain their euro pegs, debt payments along with defaults will skyrocket causing additional shocks and a prolonged recession.

Credit Growth in Central Europe

<table>
<thead>
<tr>
<th>Country</th>
<th>External Debt Financing Needs (2009)*</th>
<th>Average Real Credit Growth in last 5 years**</th>
<th>Loan/Deposit Ratio</th>
<th>For/EX Share of Total Loans $</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>132</td>
<td>15.9</td>
<td>1.3</td>
<td>88.9</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>89</td>
<td>16</td>
<td>0.8</td>
<td>139.8</td>
</tr>
<tr>
<td>Estonia</td>
<td>346</td>
<td>27.3</td>
<td>2.1</td>
<td>95.3</td>
</tr>
<tr>
<td>Hungary</td>
<td>131</td>
<td>14.3</td>
<td>1.4</td>
<td>85.7</td>
</tr>
<tr>
<td>Latvia</td>
<td>331</td>
<td>36.4</td>
<td>2.8</td>
<td>89.3</td>
</tr>
<tr>
<td>Lithuania</td>
<td>204</td>
<td>43.2</td>
<td>2</td>
<td>64</td>
</tr>
<tr>
<td>Poland</td>
<td>141</td>
<td>14.7</td>
<td>1.1</td>
<td>32.5</td>
</tr>
<tr>
<td>Romania</td>
<td>127</td>
<td>47.1</td>
<td>1.3</td>
<td>55.5</td>
</tr>
</tbody>
</table>

| Source: IMF Global Financial Stability Report |
| * % of reserves |
| ** % year-on-year |
| $ % of Total Loans |

Finally, maintaining currency boards, or currency-board-like exchange-rate regimes, while concurrently maintaining an inflated public sector and external deficits, demonstrates the unsustainability of the Baltic model. In all three countries, the public

---

6 The Economist Intelligence Unit country profiles on Estonia, Latvia and Lithuania, 2008.
sector (health, education and government) employed between 20 to 30 percent of the workforce. Latvia and Lithuania desperately need massive fiscal adjustments if they are going to recover. According to the IMF’s European director, Marek Belka, the Latvian government must cut nominal wages and pensions.\(^8\) Given that in the last three years nominal pensions have increased by 90 percent, a 10 percent haircut increase is not devastating, but public sector employees and pensioners will feel its effects. In addition, the crisis exposed the Baltics’ mismatched tax systems, where low flat-tax rates (personal and corporate) provided insufficient revenues to pay for growing fiscal expenditures.

The Baltic States face a stark recession, making it increasingly difficult to satisfy Maastricht criteria and to enter into the eurozone. Fiscal deficits are high, with gross governmental debt in 2010 expected to reach 30 and 50 percent of GDP for Lithuania and Latvia. Fiscal deficits are projected to be especially high in Latvia and Lithuania, where unless preemptive measures are taken, the budget deficits may reach above 10 percent and eight percent, respectively, by 2010.\(^9\) Meanwhile gross government debt is expected to top 50 and 30 percent of GDP. Fiscal policy has been loose and Baltic governments have not responded quickly enough to growing inflation. Long-term interest rates will most likely increase and credit flows will subside. Policy options to alleviate the crisis are limited even if early euro adoption is accepted. Exchanging a hard peg for the euro would trigger devastating effects on both the financial and real-economy sectors.

**Estonia**

<table>
<thead>
<tr>
<th>Main economic indicators</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009(t)</th>
<th>2010(t)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP (annual % change)</td>
<td>9.2</td>
<td>10.4</td>
<td>6.3</td>
<td>-3.0</td>
<td>-10.8</td>
<td>-1.0</td>
</tr>
<tr>
<td>Inflation (annual % change)</td>
<td>4.1</td>
<td>4.4</td>
<td>6.9</td>
<td>10.4</td>
<td>6.8</td>
<td>-3.3</td>
</tr>
<tr>
<td>Unemployment (%)</td>
<td>7.9</td>
<td>5.9</td>
<td>4.7</td>
<td>5.5</td>
<td>11.3</td>
<td>14.1</td>
</tr>
<tr>
<td>Trade Balance (as % of GDP)</td>
<td>-13.9</td>
<td>-18.5</td>
<td>-17.6</td>
<td>-11.9</td>
<td>-8.4</td>
<td>8.0</td>
</tr>
<tr>
<td>Current Account Balance (as % of GDP)</td>
<td>-10.0</td>
<td>-16.7</td>
<td>-18.1</td>
<td>-8.2</td>
<td>4.5</td>
<td>-3.4</td>
</tr>
<tr>
<td>General Government Gross Debt (as % of GDP)</td>
<td>1.5</td>
<td>2.8</td>
<td>2.7</td>
<td>-3.0</td>
<td>-3.0</td>
<td>-3.8</td>
</tr>
</tbody>
</table>

Source: IMF World Economic Outlook 2009, European Commission (Eurostat Database)

Despite having a stronger financial position than its Baltic neighbors, Estonia will still experience one of Europe’s deepest recessions. In an effort to avoid devaluation and distance itself from Lithuania and Latvia, Estonia’s government is trying urgently to fulfill convergence criteria and adopt the euro in 2010 or 2011. Estonia has accumulated

---


fiscal reserves (5.5 percent of GDP) to cushion against further economic shocks. The
government has also instituted budget cuts in the hopes of keeping the budget deficit at
or below three percent in order to meet Maastricht criteria. To maintain competitiveness
and regain investor confidence, Estonia’s workforce needs to become more mobile,
wages and prices need to fall (to boost exports and compensate for loss of internal
demand) and the business climate needs to develop higher-value-added industries.10
The challenges facing Estonia’s recovery are substantial especially as other Central
European economies compete to attract knowledge- and high-tech-sector investments.

**Latvia**

<table>
<thead>
<tr>
<th>Main economic indicators</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Latvia (population 2.3 million)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Real GDP (annual % change)</td>
<td>10.6</td>
<td>12.2</td>
<td>10.0</td>
<td>4.8</td>
<td>12.0</td>
<td>2.0</td>
</tr>
<tr>
<td>Inflation (annual % change)</td>
<td>6.9</td>
<td>6.6</td>
<td>10.1</td>
<td>7.5</td>
<td>7.5</td>
<td>8.0</td>
</tr>
<tr>
<td>Unemployment (%)</td>
<td>5.5</td>
<td>6.8</td>
<td>6.0</td>
<td>7.5</td>
<td>7.5</td>
<td>10.0</td>
</tr>
<tr>
<td>Trade Balance (as % of GDP)</td>
<td>-15.8</td>
<td>-25.4</td>
<td>-22.9</td>
<td>-17.0</td>
<td>-19.5</td>
<td>-9.7</td>
</tr>
<tr>
<td>Current Account Balance (as % of GDP)</td>
<td>-12.5</td>
<td>-22.5</td>
<td>-22.6</td>
<td>-13.2</td>
<td>-6.7</td>
<td>-5.5</td>
</tr>
<tr>
<td>Government Budget Balance (as % of GDP)</td>
<td>-0.4</td>
<td>-0.5</td>
<td>-0.4</td>
<td>-0.5</td>
<td>-0.5</td>
<td>-0.5</td>
</tr>
<tr>
<td>General Government Gross Debt (as % of GDP)</td>
<td>12.4</td>
<td>16.7</td>
<td>20.0</td>
<td>19.5</td>
<td>31.4</td>
<td>50.7</td>
</tr>
</tbody>
</table>

The short- to medium-term outlook for Latvia is bleak as it seeks to survive Europe’s
worst recession. Although government officials insist they will not break the lat’s euro
peg, currency risk remains high as Latvia’s large external imbalances could force a
devaluation spreading contagion to other countries in the region and severely affecting
their ability to issue debt. The Latvian central bank has been burning through reserves
to prop up the lat; however a June auction of short-term treasury bills failed to raise the
desired $100.7 million. On June 16 the government announced $998 million in tax
increases and spending cuts (20 percent cut to public wages, 10 percent cut to pensions
and 70 percent cut on pension payments for working pensioners) designed to reduce
the budget deficit from 12 to seven percent. The budget also proposed setting new tax
measures that could make Latvia the first Baltic State to abandon its once-attractive flat
tax. Despite their severity, the cuts were enough to release €1.4 billion worth of
additional assistance from the IMF, EU and other bilateral donors. As a result of recent
negotiations focused on additional spending cuts, Latvia is set to receive €200 million
from the IMF.

Soon after, Latvian Health Minister Ivars Eglitis announced his resignation emphasizing
that the $176 million health-care cuts were too harsh on Latvia’s vulnerable citizens. His
resignation puts additional pressure on an already-weak coalition government and may
lead to further political and social unrest. Several thousand Latvians staged a rally in
Riga to protest rising unemployment, falling living standards and a budget which

radically hurts pensioners, health-care workers and teachers. Latvia’s road to recovery will be long and arduous. A devaluation would mean starting the Exchange Rate Mechanism Two (ERM II) process from scratch. However, if Latvia wants to be competitive it will have to impose sweeping adjustments including higher taxes, lower wages and a smaller public sector. In order to deflect the pain of IMF-imposed austerity measures on citizens, the EU and EBRD will need to provide additional financial and structural assistance including measures to recapitalize failed banks.

Lithuania

Lithuania will have the second-highest GDP contraction (15-18 percent) in Central Europe. The government is expected to approve a $401 million (€290 million) austerity package that will cut public-sector wages and increase taxes (abandoning its flat tax) causing continued social and political tension. On the other hand, unlike Latvia, Lithuania was able to successfully issue a $693 million (€500 million) Eurobond, signaling that a global-market appetite might be returning. Lithuania has ruled out devaluing the litas and is still keen on pushing towards speedy euro adoption. This sentiment was echoed by Prime Minister Andrius Kubilius when he stated, “It’s clear that we are suffering a bit more because of our currency board arrangement, but devaluation is not an option.”11 Many economists believe that Lithuania’s best chance of recovery is swift euro adoption; however, if other fixed exchange-rate regimes (e.g., Latvia or Bulgaria) devalue, it could spread contagion to Lithuania pushing euro adoption off even further. Lithuania barely missed euro entry in 2006 when its inflation rate was deemed slightly above the limit, providing sobering lessons for the EU. Had they eased convergence criteria and let Lithuania join the eurozone (whose small economy would not have affected EU-wide inflation) its economy would be in a better position to weather the crisis. Instead it is looking more likely that Lithuania will approach the IMF and EU for financial assistance.

II. Embedded Neoliberal Model

Just like the Baltic States, the economic development of the Visegrád countries (the Czech Republic, Hungary, Poland and Slovakia) has been shaped by prior legacies. This meant building open, export-oriented and foreign-capital-dependent economies. All four had a legacy of industrialization, reform and entrepreneurialism during communism and therefore attracted the majority of early investment.

Despite substantial amounts of capital and investment, Central Europe’s post-communist economies underwent substantial social and economic dislocations including increased unemployment, income inequality and early retirement. Although the Visegrád countries outpaced others in the region with regard to EU convergence, their development model exposed them to many macroeconomic vulnerabilities including currency volatility, overdependence on exports and unsustainable fiscal imbalances. When the global economy was strong these vulnerabilities were easily overlooked, but when the external shock of the crisis hit, it unmasked lingering structural and economic deficiencies that, if ignored, could result in long-term economic stagnation. In Hungary, those vulnerabilities have become even more acute due to a weak government and political infighting.

Currency Volatility

Unlike Slovakia, whose January 2009 eurozone entry provided immediate currency stability, deteriorating financial markets exposed the remaining Visegrád economies, all with flexible exchange-rate regimes, to wild currency fluctuations and widening bond spreads further eroding investor confidence. By late February 2009, the Polish zloty had slid 40 percent against the euro in just six months. Meanwhile the Hungarian forint slipped nearly 30 percent. For some, including exporters, retailers and tourism operators, the countries’ depreciating currencies were seen as short-term economic
gains. For others, including foreign-currency debt holders (private and corporate), they were seen as widening financial burdens. For the governments and central banks of Poland, the Czech Republic and Hungary, they were just another reminder of the necessity for swift euro adoption. Prior to the financial crisis, neither the Czech Republic nor Poland had the political will or popular support to usher in the reforms necessary to speed up euro entry. Despite the countries receiving assistance from the IMF – Poland via a $20.5 billion flexible credit line as it had strong macroeconomic fundamentals, and Hungary through a traditional $15.7 billion structured loan – international investors will remain risk averse, causing a sharp contraction in private-capital flows to the region over the coming years. This may result in growing rivalries and “bidding wars” amongst Central European countries over limited financial resources and investment opportunities.

This affects euro and non-euro economies in different ways. All four Visegrád states’ financial sectors are dominated by foreign banks and have thus far experienced substantial credit contraction. For Slovakia, euro adoption and its membership in a 16-nation monetary union have provided exchange-rate stability and a greater sense of collective financial security. However, loss of cost competitiveness and a rise of “retail tourism” to non-euro neighbors will delay Slovakia’s economic recovery. Meanwhile, currency depreciation in Poland and Hungary has increased the indebtedness of households as well as firms involved in foreign-exchange loans and options contracts. In Poland, more than 100 companies, mostly manufacturers, purchased foreign-currency options to hedge against the zloty’s rising value against the euro, the primary currency of payment among most Polish exporters. Since the currency’s fall last summer, Polish businesses’ debt obligations have soared, exceeding approximately 15 billion zloty ($4.6 billion, €3.3 billion), increasing operating costs and threatening the sustainability of many of the countries’ domestic firms.12

Despite these challenges, a smaller percentage of foreign-currency loans, lower public debt and immediate-term fiscal restraint will enable Poland and the Czech Republic to benefit from short-term currency depreciation while making the necessary long-term financial adjustments for euro entry, though euro targets will slip to 2013 or 2014. Meanwhile, for debt-burdened Hungary, setting a realistic euro target will depend on the government’s ability to sustain substantial spending cuts, avoid further social and political unrest, and spur economic recovery by 2011. If not, Hungary will fall further behind its CE neighbors, hindering future growth prospects and EU convergence.

Export-driven Economies

Since Slovenia and the Visegrád countries were the early front-runners in market reforms, they attracted FDI in traditional light industries including auto, machinery and electronics. By setting up export-oriented subsidiaries they took advantage of pre-existing technical expertise and highly skilled human capital. Out of all the former-communist countries, the Visegrád states advanced furthest at reducing entry barriers, allowing them to out-compete the Baltic States, Romania and Bulgaria. Through substantial FDI and access to the EU-15’s export markets, the Visegrád countries not only gained access to improved factors of production, but also developed the capabilities necessary to compete in the demanding single market. Moreover, clustering of complex industries brought tight cross-border integration between the Czech Republic, southwestern Poland, northwestern Slovakia and northwestern Hungary. Although this bolstered the Visegrád states’ reputation as a highly cost-competitive destination, it also made them overly reliant upon exports as their primary growth engine.

As the global financial crisis made its way to Central Europe, many local and multinational exporters were forced to curb production, close plants or institute layoffs due to falling demand in the EU-15. This hit Slovakia particularly hard, as export industries account for over 90 percent of its GDP, but the export sectors of the Czech Republic and Hungary also represent over 80 percent of GDP. Czech Ambassador to the United States Petr Kolář acknowledged, “If the current pessimistic forecasts are correct and the crisis has an even deeper impact on the global economy this year, I am afraid that the Czech automobile manufacturing industry will face more problems. ... The production of airplanes, IT, steel, textiles, glass, porcelain and so on might also be affected by the economic global downturn.” Only Poland, whose economy is less dependent on foreign trade and whose large internal market (of 38 million) has thus far propped up domestic demand, has been able to avoid deep recession. The structure and cost-competitiveness of the Polish export industry, specializing in mid-tech, relatively low-priced goods, should also prove to be an advantage.

Although wages had been rising over the last few years, the economic crisis along with returning migrants from the EU-15 will most likely keep wages stagnant in the immediate term, maintaining cost competitiveness. However, in order to sustain growth once the global economy recovers, the Visegrád countries need to diversify away from low-skill, low-cost production and build a more knowledge-based (higher-value-added) economy. Thus far, firms in Central Europe have adapted global knowledge to local needs rather than generating new solutions for global markets. Also, while local firms have engaged in strategic alliances as well as joint ventures with universities and research institutes or supply chain partners, this cooperation tends to

---

take place “on the margins” of the innovation process. In order to build domestic capabilities, local partners need to be integrated into actual product development. In addition, Central Europe needs to develop export markets and business partnerships beyond Western Europe to include the United States and other emerging players like China, Russia, India and Brazil. This will help Central Europe offset overdependence on the EU-15 before future economic downturns.

Fiscal Imbalances via Unsustainable Social Programs

These countries, especially Poland and Hungary, are maintaining generous social programs while undergoing major demographic shifts, including aging populations, falling birth rates and reduced contribution rates, creating large fiscal imbalances that will undermine economic recovery if left uncorrected. Both countries are constrained by large external debts accumulated in the 1980s. During their post-communist transitions Poland and Hungary initiated generous social packages to aid the losers of “shock therapy” along with other market reforms (mostly industrial workers and rural populations). As compensation, Poland introduced unemployment benefits, minimum-wage regulation and massive early-retirement (men at 60, women at 55) schemes for workers in jobs deemed difficult or dangerous, such as coal miners and truck drivers but also artists and journalists. Hungary’s social-welfare system, which extensively used disability and early-retirement schemes, became the most generous in the region.

For over a decade, Poland has pursued pension reform through privatization in order to avoid growing public deficits. However, recent reform efforts have proven difficult in light of the economic crisis and growing political friction between President Lech Kaczyński, who favors a stronger social safety net, and the more pro-business government of Prime Minister Donald Tusk. In December 2008 Polish lawmakers overturned the president’s veto of a law that would sharply reduce the number of recipients of early retirement benefits from one million to about 250,000 pensioners. Under current law, workers in some professions can retire and receive benefits after only 15 years of employment. To accomplish reforms, additional steps must be taken, including raising indirect taxes and reducing certain public-sector jobs. While challenging, Poland’s sound macroeconomic position, prudent crisis management and greater policy flexibility make a solution more attainable than in places like Hungary, Romania or the Baltic States, which are confined to strict IMF policy prescriptions.

In contrast, past economic mismanagement, ballooning social programs and unsuccessful governments make Hungary’s pension reforms quite difficult. For starters,

Hungary’s population, which numbers 10 million, has three million pensioners, many of whom took early retirement. Moreover, the average Hungarian retires at 58, and just 14 percent of citizens between the ages of 60 and 64 work, compared with more than half in the United States. Hungary has been running fiscal deficits for years, its annual costs for pensions currently surpass 10 percent of GDP. The number of pensioners swelled in the early 1990s as mass privatizations led to a significant rise in unemployment, making early retirement one of the few real guarantees of steady income.

The rationale for Hungary’s pension program was driven by politics and not sound economic judgment. Former-Prime Minister Ferenc Gyurcsány and his Socialist Party were especially reluctant to reform the pension system given that older pensioners made up a substantial portion of the Socialist Party’s voter base. Maintaining generous social programs while failing to admit the true extent of the fiscal burdens was a main reason for the liberal-socialist coalition’s reelection in 2006. Even though employers and employees paid into the state pension program, their contributions often failed to cover the total amount of benefits, leaving the government to make up the difference either through levying higher taxes or external borrowing. This growing tax burden drove up the cost of labor faster than in neighboring countries, hurting Hungary’s competitiveness. Not only did this impair the development of private enterprise, but it also burdened many of the country’s maturing small and medium enterprises (SMEs) with high income and payroll taxes. This “tax wedge,” the second highest in the Organisation for Economic Co-Operation and Development (OECD), undermines Hungary’s competitiveness and deters local business investment.

As part of Hungary’s IMF loan agreement, the government agreed to impose strict budget cuts including scrapping a bonus monthly payment made to all retirees, known as the “13th month.” Hungary’s new Prime Minister Gordon Bajnai has sought to reassure the Hungarian Socialist Party that once the economy recovers, some of the current sacrifices may be reversed. But in April the government revealed further spending cuts including a two-year freeze on wages, accelerated reform of the pension system, restrictions on family benefits and a discontinuation of subsidized mortgage loans. Although these policies make long-term social spending more sustainable, they will undoubtedly prolong the recession in the near-term as household consumption and economic confidence continues to deteriorate. Though Poland spends a greater portion of its GDP on pensions, it has begun working towards pulling the figure down sharply over the coming years. Meanwhile, the OECD estimates that Hungary’s pension outlays will be among Europe’s fastest growing in coming decades, thus putting additional strains on a government and economy that has hit rock bottom.

---

17 Ibid.
Like most countries in Central Europe, the Czech Republic’s economy contracted sharply in 2009. The country’s large export sector, comprising over 80 percent of the economy, has been the primary casualty. The recession will most likely last well into 2010 as domestic demand, tight credit conditions and growing external balances hinder growth despite the weakened koruna. Unemployment will rise but will not reach the double-digit levels of Poland or Slovakia. The Czech current-account deficit is moderate compared to that of its neighbors and its declining trade surplus will be counterbalanced to some extent by falling wages and dividend transfers in foreign-owned companies. The Czech banking sector, despite being dominated by Western banks, was spared the severity of the crisis, due to its low percentage of foreign-currency loans. In fact, the Czech Republic has been one of the few countries in the region not to require international loan assistance, instead becoming a contributor to Latvia’s €7.5 billion ($9.8 billion) bailout. Additionally, the country’s external debt refinancing needs are some of the lowest in Central Europe at 89 percent of total reserves (debt obligations resulting from lending by foreign banks to domestic subsidiaries).

The economy’s biggest challenge will be reining in the deficit, expected to near five percent by 2010, making it increasingly difficult to meet Maastricht criteria and speed up euro adoption. The government has introduced two fiscal-stimulus packages: the first a reduction in social-security contributions to support private consumption and boost infrastructure investment; the second, a €2.5 billion ($3.2 billion) package, included measures mainly targeted at aiding businesses such as through bank loans for entrepreneurs and public works programs (e.g., road construction). Despite these short-term measures, Prime Minister Jan Fischer said Czechs need to make painful long-term budget adjustments, including cutting generous social benefits, in order to jump-start economic recovery and meet a reasonable euro entry target (2014 at the earliest). Overall the Czech Republic’s healthier macroeconomic position, less volatile political environment and prudent reforms are not only differentiating them during the crisis, but are also making them one of the better positioned economies to experience early recovery as well as sustained long-term growth.

---

Among the Visegrád countries, long-term economic-growth prospects are most challenging in Hungary. With GDP expected to contract by as much as six percent this year and the implementation of an austere IMF fiscal-consolidation program, high-risk perceptions will continue to delay economic recovery beyond 2010. Like other countries in the region, Hungary’s financial and manufacturing sectors have been devastated by tightened credit markets and a drop in export demand. What differentiates Hungary from stronger performers like Poland, Slovakia and the Czech Republic is the accumulation of one of the region’s largest gross government-debt ratios (over 80 percent of GDP in 2009 compared to between 20 and 60 percent elsewhere in the region), the large volume of foreign-currency denominated loans (85 percent of consumer loans) gradual and incomplete economic reforms and the maintenance of an unsustainable social-welfare system. In 2007 while the rest of Central Europe’s economies were still growing between six and 10 percent, Hungary was already experiencing a sharp drop in GDP (1.1 percent) and domestic incomes, well before the global crisis began. This demonstrates that Hungary, compared to other CE economies, has been in decline for much longer. The crisis simply exacerbated long-existing economic problems.

One additional deficit hindering Hungary’s recovery prospects is the public’s lack of confidence in the government. By the spring of 2009 growing public resentment over the government’s response to the crisis, along with massive protests, led to the resignation of Socialist Prime Minister Ferenc Gyurcsány. Gordon Bajnai, himself an economist, has taken over, but double-digit unemployment, growth of inactive workers and reduction of social benefits will make justification of further austerity measures difficult. In fact, the rise and recent electoral success of Hungary’s far-right Jobbik party (the Movement for a Better Hungary) may delay further reforms or even result in fiscal easing, especially as political parties try to woo disaffected voters in Hungary’s upcoming parliamentary elections.

In the immediate term, Hungary will continue to be vulnerable to economic shocks, especially if other multinational aid recipients – including Latvia, Romania and Ukraine – default on their debt, causing additional weakening of the forint, contraction of Hungary’s financial markets and increased risk premiums. Despite ongoing threats, Hungary’s central-bank governor, Andras Simor, believes painful reforms to public
spending would improve the country’s long-term growth and recovery prospects: “Increasing the pension age, cutting back on child care and reducing the tax wedge for labour improves fiscal stability, not just for the current year deficit but for the growth path going forward.” Even though Hungary has averted total economic collapse, thanks to early IMF assistance as well as ongoing EU structural aid and standby loans for its ailing banking system, the scope and scale of Hungary’s economic shortcomings make its recovery one of the most difficult in the region.

Poland

Unlike the rest of Europe, Poland did not begin to feel the direct effects of the economic crisis until early 2009. Up until the end of 2008 strong domestic consumption, investment and rising wages all fueled economic growth. However, investment activity began to decelerate as regional business confidence began to dwindle and industrial output stalled due to falling Western demand. Market analysts encouraged a regional sell-off, unwilling to differentiate stable economies like Poland’s from those that posed higher risk of contagion including Hungary, Latvia and Ukraine. At the height of Eastern Europe’s market turmoil, Poland’s finance minister, Jacek Rostowski, tried to reassure global investors that Poland was an island of calm by claiming Poland will remain among the EU’s top performers because of actions “undertaken by successive governments and the clear commitment to financial discipline.”

Initial conditions and prudent policies, including a slower growth of consumer credit, less dependence on foreign trade and low inflation, have enabled Poland to have one of the mildest recessions in the EU. However, spurring economic recovery and sustaining growth will rest on the government’s ability to maintain future fiscal discipline. This is proving much easier said than done. In June the EU’s executive arm announced that it will give Poland until 2011 to bring its growing budget deficit under the three percent threshold or face disciplinary action, including a freeze on future EU aid funds. Poland’s inability to reform public finances during its boom years (especially between 2005 and 2007), along with growing unemployment caused by the global recession, will

---


widen the deficit to approximately seven percent of GDP over the next two years unless preemptive measures are taken. According to Leszek Balcerowicz, father of Poland’s “shock therapy” reforms, Poland, like other transition countries in the region, simply cannot afford to pursue excessive fiscal-stimulus policies. Not only would Poland have to pay extremely high interest rates to cover the costs of borrowing, but it would further delay euro entry.21 Instead, Poland should accelerate critical structural market reforms in order to gain a competitive edge once the global economy begins to recover.

Thus far, government spending and large cash transfers from the EU and EBRD are easing the effects of the crisis as well as enabling necessary reforms. In addition to qualifying for a $20.6 billion IMF flexible credit line, Poland is using its preferred lender status to negotiate a €1 billion World Bank loan to be used for social initiatives. Despite the economic crisis, a mixture of loans and EU funds are still set to expand the Krakow-Balice Airport, construct a major ring road in Warsaw, and improve highway linkages between Warsaw and the rest of Poland. In addition to social and infrastructure reforms, further economic liberalization efforts are planned to help stimulate investment. Specifically, Treasury Minister Alexsander Grad is leading a $3.5 billion privatization program to reduce state-run firms from 740 to just 16 by 2011. This year 200 firms will be up for bid including the Warsaw Stock Exchange.22 Poland would also be wise to reform its tax laws (deregulating business) and slash systemic red tape.

Despite Poland’s more favorable economic position, it still faces sizable challenges. Three major short-term challenges include retaining access to finance, further currency fluctuations and energy security. As in many other emerging markets, consumer and corporate lending in Poland has eased significantly. Although earlier threats of large-scale default have been largely averted, foreign lenders are still cautious to extend credit, especially to local borrowers. As a result, first-time “greenfield” investors and local SMEs may face financial setbacks as they are “crowded out” of access to finance. Secondly, even though the Polish zloty has been appreciating in recent weeks, any sign of heightened instability in Latvia or Hungary will weaken the currency, making long-term business planning difficult, especially for local businesses. Finally, although Poland has a lower dependence on Russian gas than other CE economies, growing pressure from the EU to meet global climate criteria by reducing coal usage while energy prices rise will make long-term growth more challenging.

Slovakia

Up until 1998, Slovakia steered a pro-Moscow line under the government of Vladimir Meciar, leaving the country and economy behind others in Central Europe. That changed with the election of Mikuláš Dzurinda, who began some of the region’s most far-reaching economic reforms, the most notable being the introduction of a 19 percent flat income, corporate and value-added tax in 2004. This turned Slovakia into a fast-growing magnet for foreign investment, while improving economic efficiency and labor flexibility. Unlike Hungary, the combination of tax and social-benefit reforms enhanced the incentives for the unemployed to seek work and by 2009 unemployment figures dipped below double digits. By mid-2008, decreasing global demand along with heavy reliance on exports to the EU-15 had put the brakes on Slovakia’s once-booming economy. Private consumption and investment have declined, causing real GDP growth to fall from a high of 10.4 percent in 2007 to a projected 2.1 percent contraction for 2009. Lower revenues and increased social spending will widen the budget deficit, but since Slovakia is anchored to the euro, it avoids the drastic currency and inflationary pressures that are being put on its non-eurozone neighbors.

On the positive side, Slovakia’s low budget deficits prior to the crisis and other sound macroeconomic policies have enabled the country to launch a host of public-private partnership initiatives (e.g., motorway construction) to ease the effects of the crisis and get a jump start on recovery. In January, the government announced a €332 million ($437 million) stimulus package to increase domestic demand and support exporters. The government increased credit lines to SMEs, pledged a more effective absorption of EU funds and supported interest-rate cuts. It also plans to increase subsidies for R&D activities and support programs aimed at improving energy efficiency.23 In addition, Slovakia will receive funds from a two-year European Commission-approved €500 million project to help EU businesses. Despite increased aid, Slovakia’s unemployment is on track to surpass 12 percent due to the slump in export industries as well as decline in demand for very low-skilled workers (taxes on labor remain high). Even though euro adoption has averted a collapse of Slovakia’s financial system, higher living and operational costs will weaken internal growth and consumption well into 2010. This has been demonstrated by growing numbers of Slovaks crossing the border into Poland and the Czech Republic in order to take advantage of cheaper goods and services.

---

Unlike many of its neighbors, Slovakia has avoided the need for massive foreign financial-rescue operations and as a result is well positioned to maintain one of the healthiest sovereign credit-risk ratings – currently at an A – as it heads into the recovery. This will ease Slovakia’s access to future credit and capital, especially as financial markets tighten and become more selective over their investment choices. “It will allow companies to stop focusing on the currency fluctuation only,” Ladislav Juza, a consultant with PricewaterhouseCoopers, told Financial Times. “The Czech Republic and Poland might gain a competitive advantage in the short term, provided local currencies decrease in strength, but, in the long term, euro adoption will bring [Slovakia] much more positive effects.” More importantly, the euro is a confirmation of the country’s status as a mainstream European economy, placing it among the few Central European economies that will come out of the crisis as winners.

**III. Gradualist Model**

Unlike the more rapid economic transitions of the Visegrád countries, Romania and Bulgaria underwent transition much later and at a much-slower pace. This resulted in a more moderate state of economic reform, even as it acceded into the EU in 2007. More importantly, Romania and Bulgaria’s gradualist development model enabled early economic imbalances, stalled further EU integration and facilitated the proliferation of systemic corruption. All of these factors deeply affected the scope and scale of the financial crisis on the two Balkan economies. Worst of all they are hindering their economic development and recovery. Unless these macroeconomic and structural hurdles are overcome, both Romania and Bulgaria will experience prolonged economic stagnation (idle) and fall further behind more stable economies in the region.

In addition to economic liberalization, successful economic-development models need to be anchored in strong legal and regulatory institutions that ensure the protection of private property, encourage competition and limit the government’s influence over the private sector. All are particularly weak in Romania and Bulgaria, due to incomplete reforms, lack of enforcement and the inability of both governments to depoliticize the economy from political elites early in the transition period. Both Romania and Bulgaria elected ex-Communists (turned Social Democrats) throughout the mid to late 1990s, when the majority of key economic reforms was taking place. Thus “gradual” reform policies continue to hold back necessary reforms and make Romania and Bulgaria’s growth model unsustainable over the long term.

---

Macroeconomic imbalances led to the banking and currency crisis of the 1990s

Although corruption, abuse of local power and the propping up of noncompetitive state firms existed throughout Central Europe, the degree to which they existed in Romania and Bulgaria is significant enough to affect its future progress and recovery. Both enacted only partial economic reforms between 1990 and 1996 (in contrast to rapid “shock therapy” in Poland) resulting in weak economic performance. At the expense of building competent local firms, each government focused on enhancing the wealth of former regime members and their associates. Even though medium- and large-scale privatization did take shape in the early 2000s, the tempo was slow and benefitted mostly insiders. By 2002 the EBRD’s Transition Report was still labeling Romania and Bulgaria as “slow liberalizers.” As a result, early economic mismanagement and slow institutional reform led to both a banking and a currency crisis.

Bulgaria’s macro imbalances led to a significant banking crisis in 1996. In order to regain international confidence the government introduced a currency board. Pegging the Bulgarian lev to the Deutsche mark (later the euro) eventually helped relieve economic turmoil and near-hyperinflation, but it did not go without controversy. Liquidity injections were used to support weak banks, finance the budget deficit and prevent falling confidence in the lev. The majority of state banks had negative capital, and over 50 percent of loan portfolios were nonperforming. Although the currency board was successful at regaining the lev’s credibility as well as bringing about low inflation and interest rates, the current economic environment puts limitations on its sustainability. Politically the central bank can no longer serve as a lender of last resort or enact interest-rate and exchange-rate adjustments to stimulate the economy. Instead it can devalue through wage and price adjustments which are often times more painful. Although Bulgaria has yet to break its peg, a devaluation or future IMF assistance are not completely off the table, especially as current budget-deficit forecasts look increasingly questionable.

In Romania, loss-making state-owned enterprises, large public and foreign debt, and an increase of nonperforming loans led to a major currency crisis in 1997. Plagued by bad loans, the Romanian Foreign Trade Bank (Bancorex) became insolvent forcing the government to devalue. The economy contracted by over six percent in 1997 and negative growth continued until 2000. With the economy in tatters and a large portion of the population living at or below the poverty line, many Romanians migrated abroad. Although privatization and large-scale foreign investment made its way to Romania in the 2000s – mostly in the run-up to EU membership – institutional and cultural changes necessary to build a thriving economy were slow. Up until 2002 the government helped loss making state owned enterprises (SOEs) with debt forgiveness

---

26 International Monetary Fund, “World Economic Outlook Database April 2009.”
and low energy prices. The government still plays an interventionist role, hindering its chances at a successful long-term recovery.

Gradualist EU integration

A second major factor that threatens to prolong economic stagnation in Romania and Bulgaria is the lack of progress on EU integration efforts. As the EU’s newest and poorest members, many within Brussels still question whether they were truly ready for EU membership as well as their long-term commitment to the European project. While both countries made significant strides to close economic and institutional gaps prior to accession, the truth is that the real race to catch up began once they became full-fledged EU members. Both governments are struggling to make the transition from steward of the EU accession process to that of guarantor of free markets, fair competition and property rights. Weak and incompetent governments, political infighting and rampant corruption have resulted in greater trust for EU institutions than for local governments among Romanian and Bulgarian citizens. According to a recent EU panel, unless “Bulgaria … build[s] a European agenda backed by the expertise and the active support of European institutions … it could undo the ties between the EU and Bulgaria, prompting a shift by Bulgaria towards Russian political and economic interests.”

Corruption

Confidence in Romania and Bulgaria has been severely undermined by the failure of the respective governments to eliminate rampant graft and organized crime. In 2008 the European Commission (EC) took the unprecedented step of freezing €800 million ($1.1 billion) in EU farm, regional and infrastructure aid to Bulgaria over concerns of corruption and fraud. As competition for investment, both public and private, increases, Bulgaria and Romania – both with deteriorating corruption perceptions – will find it increasingly difficult to access global financial markets, hurting their economic recovery prospects.

According to the 2008 Heritage Foundation/Wall Street Journal annual rankings of global economic freedom, its index placed Bulgaria 59th and Romania 68th out of 161 countries. Consequently, the findings demonstrated that high levels of corruption in both countries negatively interfere with economic progress and development.

According to the survey, Romania’s property rights, freedom from corruption and labor freedom are most likely to derail economic freedom and progress. Investors often cite unpredictable changes in legislation, weak enforcement of contracts and poor patents protection as their greatest challenges. In addition, corruption, tax evasion and money

28 Heritage Foundation/Wall Street Journal database.
laundering are widespread. In Bulgaria, enforcing property rights and corruption are seen as the biggest operational hazards. Bulgaria’s judicial system is considered ineffective and continues to suffer from corruption at all levels. As a consequence, in November 2008 the European Commission stripped Bulgaria of €220 million in EU funds for failing to tackle corruption. Finally, as recently as July 2009 the EC released a report that both Romania and Bulgaria have yet to adequately crack down on corruption and organized crime, instead needing to improve efforts at meeting EU standards on justice and the rule of law.

Bulgaria

<table>
<thead>
<tr>
<th>Main economic indicators</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009(t)</th>
<th>2010(t)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria (population 7.5 million)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Real GDP (annual % change)</td>
<td>6.2</td>
<td>6.3</td>
<td>6.2</td>
<td>6.0</td>
<td>-2.0</td>
<td>-1.0</td>
</tr>
<tr>
<td>Inflation (annual % change)</td>
<td>6.0</td>
<td>7.4</td>
<td>7.6</td>
<td>12.0</td>
<td>-3.7</td>
<td>1.3</td>
</tr>
<tr>
<td>Unemployment (%)</td>
<td>10.1</td>
<td>9.0</td>
<td>6.9</td>
<td>5.6</td>
<td>7.3</td>
<td>7.8</td>
</tr>
<tr>
<td>Trade Balance (as % of GDP)</td>
<td>-20.2</td>
<td>-22.0</td>
<td>25.5</td>
<td>-25.8</td>
<td>-19.9</td>
<td>-19.2</td>
</tr>
<tr>
<td>Current Account Balance (as % of GDP)</td>
<td>-12.4</td>
<td>-18.4</td>
<td>25.1</td>
<td>-24.4</td>
<td>12.3</td>
<td>-3.6</td>
</tr>
<tr>
<td>General Government Budget Balance (as a % of GDP)</td>
<td>1.9</td>
<td>3.0</td>
<td>0.1</td>
<td>1.5</td>
<td>-0.5</td>
<td>-0.3</td>
</tr>
<tr>
<td>General Government Gross Debt (as % of GDP)</td>
<td>29.2</td>
<td>27.1</td>
<td>18.2</td>
<td>14.1</td>
<td>16.0</td>
<td>17.3</td>
</tr>
</tbody>
</table>

Source: IMF World Economic Outlook 2009; European Commission (Eurostat)

Growth slowed in the final months of 2008 driven by a decline in domestic demand and exports. The economic crisis exposed many imbalances in the country including its staggering current-account deficit, which by 2008 reached over 25 percent of GDP, the largest among new EU member states. For the first time since 1997, GDP is expected to contract by at least two percent. Deceleration in wage growth and rising unemployment, estimated above seven percent (most likely higher due to underemployment and poor statistics), will add to further economic contraction. Mild improvement in the external deficit, together with higher projected capital transfers from the EU, could bring net borrowing down to 16 percent by 2010. However, uncertainty about short- to medium-term economic prospects is high, especially as domestic industries struggle to create a more balanced growth path based on a sustained export-based recovery.

Rapid credit growth (67 percent of consumer loans in foreign currency) and an overheated housing bubble created an unsustainable economic-growth model. Nominal wage growth was high at over 20 percent on average in 2008, reflecting tight labor market conditions. Up until 2008 Bulgaria had been running a budget surplus, but declining revenues and an increase in social and infrastructure spending over the next two years will increase the budget deficit. Even though official budget-deficit projections are low, high levels of corruption and unreliable government statistics increase the risk of higher-than-expected figures, which will make sustaining the euro peg without IMF or EU intervention difficult. In addition, rising social inequality and support for populist rhetoric may force newly elected Prime Minister Boiko Borrissov,
who campaigned on an anti-corruption platform, to bend towards greater public-spending initiatives despite chiding from Brussels.

On a more positive note, since this winter’s Russian-Ukrainian gas dispute, which shut off gas to many CE countries, most notably Bulgaria, the country has signed several deals that could end its near total dependence on Russian natural gas. In July, Greek, Italian and Bulgarian companies signed a deal to build a 160 km pipeline linking Bulgaria to the ITGI pipeline, which runs from Azerbaijan via Turkey and Greece. That same month Bulgaria, along with five other countries, including Romania and Hungary, signed on to join the Nabucco pipeline which will carry Azeri gas from Turkey to Austria. Although this is a promising step towards greater energy (and subsequently greater economic) independence for both Bulgaria and Central Europe, recently cozier diplomatic and business relations with Russia threaten to scale back such efforts.

Romania

<table>
<thead>
<tr>
<th>Main economic indicators</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009(l)</th>
<th>2010(l)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Romania (population 21.5 million)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Real GDP (annual % change)</td>
<td>-4.1</td>
<td>7.9</td>
<td>6.2</td>
<td>7.1</td>
<td>-4.1</td>
<td>0.0</td>
</tr>
<tr>
<td>Inflation (annual % change)</td>
<td>9.0</td>
<td>6.6</td>
<td>4.8</td>
<td>7.8</td>
<td>5.9</td>
<td>3.9</td>
</tr>
<tr>
<td>Unemployment (%)</td>
<td>7.2</td>
<td>7.3</td>
<td>6.4</td>
<td>5.8</td>
<td>8.0</td>
<td>7.7</td>
</tr>
<tr>
<td>Trade Balance (as % of GDP)</td>
<td>-9.8</td>
<td>-12.0</td>
<td>-14.4</td>
<td>-13.3</td>
<td>-9.1</td>
<td>-8.0</td>
</tr>
<tr>
<td>Current Account Balance (as a % of GDP)</td>
<td>-8.9</td>
<td>-10.4</td>
<td>-13.9</td>
<td>-12.6</td>
<td>-7.5</td>
<td>-8.5</td>
</tr>
<tr>
<td>Government Budget Balance (as a % of GDP)</td>
<td>-1.2</td>
<td>-2.2</td>
<td>-2.5</td>
<td>-3.4</td>
<td>-5.1</td>
<td>-5.6</td>
</tr>
<tr>
<td>General Government Gross Debt (as a % of GDP)</td>
<td>15.8</td>
<td>12.4</td>
<td>12.7</td>
<td>13.6</td>
<td>18.2</td>
<td>22.7</td>
</tr>
</tbody>
</table>

Source: IMF World Economic Outlook 2009, European Commission (Eurostat)

Up until 2008 GDP had grown steadily by about seven percent. Most of Romania’s recent economic success was attributed to an influx of FDI in the manufacturing sector as well as strong wage growth and rapid credit expansion. The largely foreign-financed domestic-demand boom and overheating pressures came to a sudden end at the beginning of the fourth quarter, following significant tightening of international capital flows and increased risk aversion by investors. This was exemplified when Romania’s government bonds were downgraded to junk status in October 2008. Shortly thereafter, Romania’s currency – the leu – took a steep dive. According to the Economist Intelligence Unit, FDI to Romania is expected to fall from $12 billion in 2008 to $7.5 billion in 2009 – a decrease of 38 percent.29 Its economy is projected to contract by more than 4 percent in 2009, while economic recovery will most likely not return until 2011.

In light of Romania’s large domestic and external balances, authorities asked the EU for balance of payments help in March 2009. The financial assistance provided was conditional on implementing additional fiscal-, financial- and structural-reforms measures. Prior to the crisis, Romania was building unsustainable macroeconomic

---

imbalances, including a large trade deficit (21 percent of GDP). In addition, once it secured EU membership it was unable to rein in spending and the budget deficit grew immediately above five percent of GDP. Since it has a large portion of euro-denominated loans (55 percent of GDP), additional monetary easing is not a feasible policy option. Debt to GDP will rise because of an increase in interest rates on government debt.

Unemployment will rise from a record low of five percent in 2008 to eight percent for 2009. Rising unemployment (and increased underemployment especially among those under 30), increased poverty and social dislocation will play a major role in Romania’s upcoming presidential elections in 2009. Meanwhile returning migrants from the U.K. and Spain will lower pressures on wages. Even though exchange-rate depreciation continues to maintain Romania’s cost competitiveness, investors may opt for more stable countries in the region due to its IMF loan and increased corruption perception. In May, Romania received a $17.1 billion IMF loan – the largest of any CE country. The IMF loan is part of a wider €20 billion ($27 billion) international-aid package, with additional funding coming from the EU, World Bank and EBRD. Romania has announced a series of tax increases and a freezing of state wages and has cut other public expenses to meet its budget obligations. Despite these efforts, recovery will be slower than in other CE economies.

**Key Sectors**

*How will competitiveness in key sectors be affected by financial crisis?*

Over the last two decades, Central and Eastern Europe became synonymous with “hot” emerging-market destinations, attracting billions of dollars in foreign capital and investment. According to the Economist Intelligence Unit, in 2008 onward FDI flows reached $155.4 billion. Among the 10 newest EU member states, foreign direct investment reached $59.5 billion, or 38 percent of total FDI amounts invested throughout the transition economies of Central Europe and the former Soviet Union. Attracted by the relative “stability” that eventual EU accession would bring, strong capital inflows into Central Europe also came as a result of large-scale privatizations, a growing real-estate and property boom, and an influx of multinational firms wanting to take advantage of the region’s low labor and operational costs.

---


Despite slowing economic-growth forecasts and rising macroeconomic risks, investors are still committed to having a long-term business presence in the region. This is most evident among existing investors, many of whom have already made substantial financial commitments. In contrast, first-time investors are becoming more hesitant to invest and some have even decided to pull out. In March 2009 Japanese electronics firm Hitachi announced that it was closing a new flat-screen television factory in the Czech Republic due to the slump in global demand.32 That said, not everyone is ready to abandon Central Europe. The current economic downturn could provide short-term stability for less volatile economies like those of Poland, the Czech Republic and Slovakia or more cost-effective economies like Romania’s. Recently, American computer manufacturer Dell announced it was shifting production from Ireland to Poland solely to generate costs savings. Although Central Europe’s fears of losing its status as an investment hub are legitimate, the more likely scenario is that unlike the previous investment boom, where all of Central Europe was considered a high-yield investment, the post-recovery period will see investors become more discriminating and prioritize investments in countries with stronger macroeconomic fundamentals, healthier business climates and lower corruption. In the following section, the report looks at three key sectors and assesses how the global recession is affecting competitiveness and growth prospects.

The banking sector in Central Europe has been the most severely affected in the crisis. Over the last decade Western Europe’s major financial institutions lent more than €1.1 trillion ($1.4 trillion) to the region’s governments, businesses and consumers directly or through local subsidiaries. Among the most exposed are Austrian, Italian and Swedish banks, which account for approximately 70 percent of Central Europe’s local banking assets. In February 2009 fears began to spread that the financial crisis would bring an end to the credit boom, resulting in massive loan losses and defaults. Misinterpretation of Bank of International Settlement (BIS) banking figures and

---

incomplete IMF data on Central Europe’s total debt-financing needs fueled misleading reports that the region owed $400 billion in debt repayments.\textsuperscript{34}

However, closer analysis shows that gross external debt in Central Europe, as a percentage of GDP, is actually lower than in most other Western European countries. Even though Latvia, Hungary and Bulgaria’s external debt is at or above 100 percent of GDP, the real concerning issue facing Central Europe’s banking sector is the amount of debt that is held in foreign-currency-denominated loans. In countries such as the Czech Republic (over 13 percent) the percentage of euro- or Swiss franc-denominated loans is low, but for pegged currency regimes like those in the Baltic States (over 80 percent) and Bulgaria (over 65 percent) the number is quite high. Recent currency volatility in floating-exchange-rate regimes has also increased the risk of default. There is no doubt that the region will see substantial slowdown in capital flows, putting additional pressure on countries with high current-account deficits and high levels of short-term external public and/or corporate debt. The region will have to adjust sharply as painful public austerity measures further reduce domestic demand. One of the biggest risks still facing the banking sector is an abrupt devaluation by Latvia or Lithuania, which could spread regional contagion or aggravate further economic decline.

\textbf{Gross External Debt (% GDP)}

\begin{center}
\begin{subfigure}{.5\textwidth}
\includegraphics[width=\textwidth]{Gross_External_Debt.jpg}
\end{subfigure} \hspace{1cm}
\begin{subfigure}{.5\textwidth}
\includegraphics[width=\textwidth]{Source.png}
\end{subfigure}
\end{center}

Stabilizing Central Europe’s banking sector will be the key to ensuring recovery in the medium to long term. If foreign and domestic banks cut lending (to shore up balance sheets) this will have adverse effects on both consumption and investment, inhibiting the recovery process. Although many banks in Central Europe appeared to be well-capitalized and profitable they lacked sufficient reserves to respond to economic shocks. According to the IMF, although these banks were generally in compliance with basic microprudential regulations, they should have gone well above the required minimums.

to maintain sufficient capital during the financial crisis.\textsuperscript{35} This is especially important when operating in an environment of rapid credit expansion. Furthermore, most of Central Europe’s banking sector is dominated by foreign banks meaning that the majority of critical decisions surrounding country risk, capital flows and reserve requirements were made by parent-bank headquarters outside of the region.

\begin{figure}
\centering
\includegraphics[width=\textwidth]{percent_of_foreign-owned_banks.png}
\caption{Percent of Foreign-Owned Banks}
\end{figure}

Since the onset of the financial crisis, the EU has supported Central Europe’s ailing economies via stabilization packages and funding for multilateral financial institutions. However, prosperous members in the west of the continent have shown a significant aversion to broader EU-wide recovery measures, including intervention by the European Central Bank (ECB). During a March EU summit, former-Hungarian Prime Minister Ferenc Gyurcsány called on the European Union to provide €190 billion ($241 billion) in aid to Central Europe, including its banking sector, but his proposal was rejected.\textsuperscript{36}

On one hand, the ECB worries that an expansionist monetary policy may stoke inflation. After all, the ECB’s sole mandate is to ensure price stability in the eurozone – not to drive economic growth. With inflation rates below the two percent target, the ECB has room to further reduce interest rates, but that alone will not solve the banking sector’s liquidity problems. In fact, a recent IMF report revealed that European – not North American – banks hold more than half of the global banking system’s toxic

Meanwhile, net private-capital flows to Europe’s emerging markets are projected to fall from roughly $254 billion in 2008 to $30 billion in 2009.37 Since a large portion of these toxic assets are located in Central and Eastern Europe, it is imperative that the EU act to recapitalize its financial sector and restore investor confidence.

Unfortunately, recent attempts to shore up Central Europe’s banks on a case-by-case basis have been met with only limited success. This strengthens the case for a collective EU approach. The EU should first establish a European Investment Bank fund to provide credit and capital injections to Central European subsidiaries. By making the EIB the majority shareholder of Western Europe’s “bad banks” (and by extension their Eastern subsidiaries), this would lessen the risk of systemic failure for individual member states, thereby “Europeanizing” Central Europe’s banking crisis. The EIB is a formidable vehicle for such a plan. Unlike the ECB, the EIB board of governors is made up of finance ministers from all EU member states – not just members of the more exclusive eurozone. Plus, the EIB already has experience raising substantial funds through capital markets to finance EU policy objectives. A second recommendation is to advance the debate on Eurobond creation, particularly among wealthier, yet more reluctant, EU members like Germany. Initiating a Eurobond market would reduce the need to tap state budgets for bank bailouts, especially as widening bond spreads among eurozone members raise the risk of borrowing for those in weaker fiscal positions.

In addition to bank recapitalization the EU needs to continue to strengthen the supervisory and regulatory framework set out in the de Larosière report.38 In addition to the establishment of a European System of Financial Supervisors (ESFS) and the European Systemic Risk Council (ESRC), there needs to be stricter monitoring of capital flows into the region. This could entail imposing stricter capital requirements for weaker banks under Basel 2 Pillar II.39 Pillar II has a new supervisory review process that requires banks to have their own internal processes to assess capital needs and for supervisors to evaluate a bank’s overall risk profile to ensure that they hold adequate capital. However, given the large role that foreign banks play in Central Europe, stricter capital requirements will require stronger cross-border cooperation between parent and daughter banks, regulators, and national and EU-level officials.

Finally, the EU should make revisions to the Stability and Growth Pact and allow for longer periods of adjustment in times of severe crisis. If it fails to act, Central Europe’s recession will deepen, recovery will stall and society will undergo greater economic and

38 The de Larosière Group is a high-level independent group composed of leading economic experts commissioned by the European Union to review financial-supervision policies. For more information see: http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf (accessed June 1, 2009).
social divisions. This not only erodes Brussels’ reputation, but adds legitimacy to those CE politicians looking to discredit previous pro-EU and pro-market policies.

Automotive Sector

The majority of FDI came on the heels of European Union accession in 2004 and 2007. By the end of 2008, Central Europe accounted for over 18 percent of the EU’s total car manufacturing and more than 20 percent of its workforce. Declining global sales, market saturation and tightening credit have made it difficult for manufacturers and their SME suppliers to obtain critical loans for operations and consumer financing. Meanwhile depreciation of the Polish zloty and Hungarian forint, heightened the region’s macroeconomic risk and shook investor confidence.

Though the short-term outlook is bleak, automakers remain optimistic about their long-term presence in Central Europe. Renault-Nissan CEO Carlos Ghosn recently noted, “I don’t think we will see factory closures in Eastern Europe because usually they’re the most cost-competitive factories in Europe. Because it is going with the weakening of the currencies, it makes them even more competitive than before.” Despite its cost advantages, the sustainability of Central Europe’s auto sector is dependent on a host of other factors, most notably the rise of protectionism in Western Europe. Earlier this year, French President Nicolas Sarkozy sent shockwaves through Slovakia and the Czech Republic when he unveiled plans for a €6 billion state-aid package giving French automakers Renault and Peugeot preferential loans in return for promises to keep production in France. Meanwhile Germany’s selection of Canadian auto-supplier Magna International Inc. and Russia’s Sberbank to purchase Opel from General Motors (GM) included provisions that all four German Opel factories remain open, leaving workers in other facilities, including Poland’s Gliwice plant, vulnerable and suspicious of Brussels’ willingness to protect the tenets of the EU’s single market.

The crisis will change the structure and operation of the global automotive industry for years to come. Cost-cutting, industry consolidation, resetting global production levels and promoting fuel-efficient vehicles are all at the forefront of the industry’s restructuring plans. For Central Europe’s car manufacturers, four drivers will affect the sector’s sustainability and recovery: 1) fostering research and development (R&D), 2) maintaining cost competitiveness, 3) addressing institutional deficiencies and 4) specializing in niche products and markets.

Central Europe’s auto manufacturers have expanded advanced research and technological development. Delphi Automotive Systems and TRW Automotive were the first to create centers of excellence in Poland. A partnership between Renault and

Dacia has resulted in Renault Technology Romania, which focuses on R&D activities that will bring extra value to the production process. The development of these regional R&D centers not only benefits the manufacturers’ bottom line, but also establishes critical links throughout the entire global supply chain. Further integration among existing R&D facilities can help CE auto manufacturers retain long-term investor interest and confidence.

Secondly, Central Europe’s auto sector can maintain its global competitiveness by continuing to develop regional clusters. Clusters near multiple Central European border areas – especially Poland, Slovakia, the Czech Republic and Hungary – have increased cross-border trade, provided greater economies of scale and allowed greater flexibility during market shocks. As a result, cluster mapping has enabled the region to have some of Europe’s more profitable and cost-competitive manufacturing operations.

Since the 1990s, governments have made progress in streamlining regulatory frameworks through tax incentives, legal reform, infrastructure improvement and special economic zones. At the same time, automakers point out that the region’s changing regulations make long-term business planning difficult. In order to maintain competitiveness, Central Europe’s governments need to invest in reforming judicial and regulatory systems, minimize bureaucratic red tape and eliminate local corruption.

Finally, the sector’s sustainability rests on the production of small, low-cost and fuel-efficient vehicles. Foreign firms such as Fiat, GM and VW along with Central European brands like Skoda and Dacia produce successful low-cost cars. Initially the €7,600 Romanian-made Dacia Logan was destined for emerging markets, but soon found a surge in popularity throughout Western Europe. Dacia followed up this success with the Sandero, another no-frills car that is proving particularly popular with German consumers. The success of recent car-scrapping initiatives across Europe have not only resulted in increased sales but also demonstrated rising market opportunities. With the global economy sagging, auto companies are shifting production strategies from up-market models to lower-end economy cars. According to R.L. Polk, a market-research firm, sales of cars priced below $14,000 are expected to grow 70 percent over the next nine years, particularly in emerging markets like China, India, Russia and Brazil.41 This positions CE producers for continued growth, although competition is increasing. The greatest threat comes from India’s Tata motors, which plans to launch its European version of the Nano, currently the world’s cheapest car, in 2011. To sustain competitiveness CE-based manufacturers need to quickly adapt to the changing marketplace. Already, Dacia (Renault) is forming new partnerships with Bajaj (an Indian scooter/rickshaw maker) and AVTOVAZ (Russian manufacturer of Lada cars) in order to gain market share and benefit from global economies of scale. By continuing

to develop quality low-cost products CE-based auto manufacturers stand their best chance at surviving the economic crisis and remaining competitive.

**Housing and Real Estate Sector**

During the last decade Central Europe’s housing market was one of the fastest growing and most lucrative sectors for investment. Buyers across Central and Western Europe as well as Central European diasporas took part in the buying frenzy. By 2009 Central Europe’s capitals had some of the most expensive real estate in the EU. In fact, seven Central European cities were ranked in the top 50 most expensive real-estate markets in the world including Bucharest, Krakow, Prague and Riga. The last five years saw the average house price in Poland and Estonia increase by over 128 percent and 91 percent respectively. In contrast, since the onset of the economic crisis all three Baltics States have seen average housing prices fall dramatically between 20 and 30 percent year-on-year.42

### Top 50 Most Expensive Property Markets

<table>
<thead>
<tr>
<th>Rank</th>
<th>Country</th>
<th>City</th>
<th>Ave Price (US$/sq.m.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Monaco</td>
<td>Monte Carlo</td>
<td>47,578</td>
</tr>
<tr>
<td>2</td>
<td>Russia</td>
<td>Moscow</td>
<td>20,853</td>
</tr>
<tr>
<td>3</td>
<td>UK</td>
<td>London</td>
<td>20,756</td>
</tr>
<tr>
<td>6</td>
<td>USA</td>
<td>New York</td>
<td>14,898</td>
</tr>
<tr>
<td>7</td>
<td>France</td>
<td>Paris</td>
<td>12,122</td>
</tr>
<tr>
<td>9</td>
<td>Italy</td>
<td>Rome</td>
<td>9,166</td>
</tr>
<tr>
<td>11</td>
<td>Ireland</td>
<td>Dublin</td>
<td>8,069</td>
</tr>
<tr>
<td>16</td>
<td>Spain</td>
<td>Barcelona</td>
<td>6,523</td>
</tr>
<tr>
<td>22</td>
<td>Spain</td>
<td>Madrid</td>
<td>5,672</td>
</tr>
<tr>
<td>26</td>
<td>Romania</td>
<td>Bucharest</td>
<td>5,184</td>
</tr>
<tr>
<td>27</td>
<td>Slovakia</td>
<td>Bratislava</td>
<td>5,088</td>
</tr>
<tr>
<td>34</td>
<td>Czech Republic</td>
<td>Prague</td>
<td>4,559</td>
</tr>
<tr>
<td>38</td>
<td>Poland</td>
<td>Warsaw</td>
<td>4,301</td>
</tr>
<tr>
<td>45</td>
<td>Slovenia</td>
<td>Ljubljana</td>
<td>3,802</td>
</tr>
<tr>
<td>46</td>
<td>Latvia</td>
<td>Riga</td>
<td>3,716</td>
</tr>
<tr>
<td>47</td>
<td>Estonia</td>
<td>Tallinn</td>
<td>3,691</td>
</tr>
<tr>
<td>50</td>
<td>Poland</td>
<td>Krakow</td>
<td>3,557</td>
</tr>
</tbody>
</table>

*Source: Global Property Guide, Most Expensive Real Estate Markets in 2009*

The global credit crunch has burst the region’s property bubble and put tremendous pressure on both lenders and borrowers. Central Europe’s banks have tightened lending requirements, while most borrowers are worried that their euro- and Swiss franc-denominated mortgages will increase debt obligations as regional currencies depreciate. This problem is especially acute for the Baltic States and Bulgaria, which

have pegged their currencies to the euro. Central Europe’s individual housing markets are a good indicator of their overall economic health and recovery prospects. As a result, it will determine both the quality and quantity of future investments in the sector.

Bulgaria, the Baltic States and Hungary’s housing markets are suffering some of the worst crashes, eliminating the chance of recovery for the next three to five years. By January 2009 approximately five percent of the Bulgaria’s real-estate agencies had gone into bankruptcy. As the EU’s poorest country, Bulgaria’s impressive economic growth (averaging 6 percent since 2005) was fueled primarily by a housing and construction boom that had been initiated by British and Russian investors looking to develop vacation property along the Black Sea coast. FDI flows into the real-estate sector soared from €13.4 million in 2001 to €2.3 billion, or 35 percent of GDP, by 2007. Once the crisis made its way to the region, construction projects were stalled or simply eliminated. As the Bulgarian government attempts to maintain the lev’s euro peg, this will make mortgages increasingly vulnerable to interest-rate fluctuations. Currently, about 57 percent of the outstanding debts are denominated in lev, while 43 percent are denominated in euros.

The housing markets in Latvia, Lithuania and Estonia experienced some of the worst asset bubbles. Between 2004 and 2006 housing prices quadrupled, while housing loans increased by approximately 90 percent annually. The bubble began to burst when all three Baltic governments tried to curb inflation. By mid-2007 low interest rates combined with double-digit GDP growth rates caused the Baltic economies to overheat. Since 2005, annual inflation rates soared between two and four percent, and in the case of Latvia up to 15 percent. When all three adopted euro pegs, their central banks had to give up pursuing an independent monetary policy. This meant they could no longer fight inflation through raising interest rates. When the ECB started raising rates in 2005, inflation in the Baltics was already on the rise. By the end of 2008, in an effort to ease the crisis the ECB reduced rates, but by then the damage was already done. In addition to tighter credit restrictions, additional job losses and wage cuts will result in higher default rates and further contraction of Central Europe’s housing market. This will surely postpone euro entry for all three countries until 2013-2014 (unless the EU eases entry criteria). The irony is that in 2006 Lithuania missed its inflation target by only 0.1 percent, missing eurozone entry by the slightest of margins. Three years later all three Baltic States are dealing with substantial current-account deficits, rising unemployment and a high risk of currency devaluation that could wreak havoc on their economies for years to come.

---

Hungary’s housing market is projected to decline even further in 2009 and 2010. Despite receiving a €20 billion financial-assistance package from the IMF, World Bank and EU, the economy is still expected to contract by six percent in 2009 while housing prices have declined up to 30 percent just in Q1 2009 alone. Hungarian banks will continue to tighten lending to businesses and households especially since banks expect further defaults on commercial and personal mortgages. Since last summer the Hungarian forint has depreciated by 40 percent. Moreover, between 80 and 90 percent of housing loans granted over the last two years were denominated in Swiss francs. In order to weather the financial storm newly elected Prime Minister Gordon Bajnai has implemented several cost-cutting measures including eliminating energy subsidies for homeowners and the introduction of additional real-estate taxes. Previous housing subsidies granted by the center-right government (Fidesz) contributed to Hungary’s ballooning budget deficit (87 percent of housing related expenditures were financed by the government). Despite the implementation of strict austerity measures to meet Maastricht and euro-convergence criteria, confidence in Hungary’s economy is low. As a result Hungary’s housing market will most likely not rebound until 2011.

Challenges to eurozone enlargement in light of the financial crisis

_Growth of fringe, populist and other anti-EU parties_

Anxiety over the global economic crisis and general voter apathy not only caused low turnout in June’s European parliamentary elections but also (and more importantly) electoral gains for several of Central Europe’s far-right parties. At 31 percent, voter turnout in the region was measurably lower than in Western Europe, where 43 percent of constituents voted. Far-right politicians played on the discontent of local populations—many of whom face hopeless economic conditions and hold increasing contempt for their government’s handling of the crisis—in order to strengthen anti-minority platforms and legitimize hostility towards the EU and NATO.

In the case of Hungary, Latvia and Bulgaria – three countries where the economic crisis has been particularly noticeable and where expressions of xenophobic, nationalist and anti-EU sentiments are increasingly common – far-right parties fared less well than anticipated. Despite falling short of projections, Jobbik still managed to place third with 15 percent of the vote while Bulgaria’s nationalist Ataka party won 12 percent – enough for two European Parliament (EP) seats. The June elections could be a harbinger of further success in upcoming national ballots, especially if the crisis persists and Central 46 Global Property Guide: Hungary, available at: http://www.globalpropertyguide.com/Europe/Hungary (accessed May 27, 2009).
Europe’s voters feel increasingly alienated by allies in Europe and the United States. Most recently, the results of Bulgaria’s national elections have Ataka entering into a loose governing coalition with Boiko Borrissov’s center-right Citizens for European Development of Bulgaria. This was the first test of an incumbent government since the full onset of the global recession in Central Europe. If the reaction of Bulgarian voters is any indication, other governments in the region should take notice.

The continuing rise of far-right groups warrants close attention, particularly ahead of the upcoming 2010 national elections in Slovakia, Hungary and Poland. Following ratification of the Lisbon Treaty, the EP will have a greater say over policy and lawmaking in Europe. If extremist parties are able to firmly establish themselves in their respective national assemblies, they could disrupt or dilute legislation that impedes critical EU law targeted toward further economic, monetary and political integration.

Tougher adherence to Maastricht and euro adoption for CE applicants

Given the negative effects that the crisis had on Central Europe, some have been calling for immediate euro adoption as a way to stabilize the region, particularly for more vulnerable economies in the Baltics and Balkans. Accomplishing this would require the suspension of the Maastricht Treaty’s Stability and Growth Pact, which up until recently has anchored euro membership in strict fiscal discipline. Although technically possible, as non-EU members like Montenegro have unilaterally adopted the euro, the ECB has disagreed with ad hoc adoption strategies, preferring that remaining non-eurozone economies in Central Europe join through formal channels.

Central Europe’s economies are already quite diverse with different exchange-rate regimes as well as monetary-policy needs. In this instance, one size does not fit all, and in some cases early euro adoption may benefit some countries more than others. For example, smaller economies like the Baltics States with fixed exchange rates could join the eurozone without destabilizing the currency too much and would be more suitable candidates than larger, more economically complex floaters like Poland or the Czech Republic. The latter have not been as badly affected by the crisis and it would be in their economic interest to take advantage of their current exchange-rate favorability, take action on long overdue structural changes and join the eurozone on a short but favorable timeline. One must also not forget that there is little appetite among Western European members to embrace or bail out Eastern compatriots who join without meeting criteria or bring with them elevated risk.

Will crisis bring Europe closer together or move it further apart?

The crisis appears to be pushing Europe further apart. In a time of increased need for EU-wide solutions, many national governments have fallen back on prioritizing domestic agendas and national politics. The most obvious divide is between the EU-15
and the new members of Central Europe. For both groups to recover, free flows of capital and open trade are paramount. Because exports to the EU-15 constitute a significant portion of their GDPs, CE economies are particularly susceptible to protectionist trade practices coming from larger EU members. Recent statements and actions by France and Germany to protect their auto sector as well as calls by Western European leaders to retract lending from daughter banks in the East only build mistrust among local populations and feed conspiracy theories about neocolonial desires in the region. Even French President Nicolas Sarkozy’s expression of doubt as to whether the Czech Republic would be able to handle its turn at the rotating EU presidency illustrates a growing three-tier system developing among EU member states.

Germany has also fallen victim to domestic political pressure. Germany’s response to the crisis has been timid from the start, with harsh criticism by Angela Merkel towards EU-wide bank bailouts and other pan-European coordination efforts. In May 2009, the German government announced that it was keeping labor restrictions on workers from the eight CE countries that joined in 2004. The controls were meant to fall away in 2009, but Germany invoked a clause allowing two more years in case of “serious labor-market disturbances,” or the threat of them. The idea that free movement by Poles or Slovaks would threaten “serious” disruption does not have much credibility, as Germany still has shortages of skilled labor in some areas. The economy is forecasted to shrink by six percent this year, making the decision to keep labor controls in place appear purely political in the run up to Germany’s national elections this fall.48

Central Europe’s global competitiveness and its prospects for sustained growth

Effects on comparative advantage and economic relations vis-à-vis other emerging markets

Despite the economic uncertainty, Central Europe will remain an attractive investment destination not only for Western investors, but also increasingly for emerging non-Western nations. Prior to the economic crisis, a number of Central European governments sought to diversify their trading partners to offset overreliance on the EU-15, focusing on nurturing viable relationships with emerging economic powers in Asia. As a result, Chinese and Indian investment interests in the region have increased. For example, Chinese imports into Poland grew from €6.2 billion to €8.6 billion between 2006 and 2007, a 39.4 percent increase.49 In 2008, Polish delegations traveled to both

countries in an attempt to build foreign investment interest, stressing Poland’s competitive labor force, growing infrastructure and business law reforms.\(^{50}\)

Despite heightened risk aversion by Western investors earlier this year, China and India continue to aggressively seek out business opportunities in the region. In May 2009, the China Investment Promotion Agency (CIPA) of the Chinese Ministry of Commerce, responsible for the national development and implementation of foreign-investment strategies, revealed that it will open its first regional office in Hungary, despite the country’s recent reputation as an investment pariah. In response, the Hungarian Investment and Trade Development Agency (ITD), concluded that Hungary’s selection was driven by the country’s “central geographical position, direct flights between Budapest and Beijing, [its] skilled workforce and the fact that Hungary is the only country in the region where the Bank of China is present.”\(^{51}\) This announcement coincided with China’s Huawei Technologies, a communication and equipment manufacturer, declaring its intention to construct two factories in Hungary. The company projects that it will generate $800 million in sales within its first year of operation.\(^{52}\) Indian investment is also escalating, specifically in the IT sector. In March 2009, a joint venture was announced between PLAY, Poland’s first multimedia-mobile-phone operator, and India’s Tata Communications.\(^{53}\)

Although not as visible as its competitors, Russia has also taken advantage of lucrative investment opportunities in Central Europe. Beginning in May 2009, Canada’s Magna International and Russian backed Sberbank have proposed to pay $710 million to purchase General Motors’ Opel.\(^{54}\) Magna has already signaled the possibility of relocating Opel production centers from Germany to Austria and Hungary.\(^{55}\) Moreover, concerns that Opel’s two factories operating in Poland would close upon completion of


the acquisition have been ameliorated with rumors that Sberbank will expand its investment in the Polish car industry.\textsuperscript{56}

The mounting financial involvement of these new stakeholders in Central Europe’s development and recovery poses interesting questions as to future economic and political developments in the region. As evidenced by the EU’s overall lack of coordinated response to the crisis as well as increased instances of economic nationalism by some Western members, it is in the interest of Central Europe to diversify their pool of foreign investors and trading partners. However, this presents future challenges for Western Europe and the United States. As the region’s primary investors, both Western Europe and the United States can anticipate increased competition and even a weakening of future economic and political influence in the region, especially as cash-abundant economies like China continue to penetrate Central Europe’s markets with badly needed capital and business.

**Policy Recommendations**

Poland, the Czech Republic and Slovakia stand the best chance for early recovery. Poland is one of the few EU member states to project growth for 2009 and 2010. This has been possible due to manageable current-account deficits, low macroeconomic imbalances, less dependence on exports and a large internal market. The Czech Republic’s best practices include prudent public finances and low levels of private and public indebtedness. The recent adoption of the euro allowed Slovakia to avoid exchange-rate fluctuations and large-scale investor retraction, highlighting the stability that euro membership brings to small, open and export-driven economies. Although all three face near-term challenges, especially managing growing public deficits, the proportion of debt and financing accumulated fail to reach the same proportion as those in the Baltic States, Hungary and the Balkans (Romania and Bulgaria). For Poland and the Czech Republic the best path forward includes keeping public spending low, taking advantage of EU funds to push through major structural reforms (health care, education, infrastructure and business climate) and setting a pace for euro entry that is most beneficial to their economic development. For Slovakia, long-term sustainability means diversifying their export base beyond the EU-15 as well as focusing on building a higher-value-added economy. All three winners need to engage in greater cross-border collaboration, encourage investment and develop a top-notch knowledge economy that will be the engine of future regional growth for years to come.

Bulgaria and Romania, the idlers, face larger economic contractions, delayed recovery and limited public-policy options to ameliorate the effects of the crisis on citizens and the economy. As FDI inflows and availability of credit decline, private-sector

investment will see a substantial contraction beyond 2010, leaving the two Balkan states at a disadvantage once investor confidence and capital return to the region. For Romania and Bulgaria, their long-term economic sustainability is tied directly to the success of further EU integration. Both countries need to take bold action and quickly adopt the recommendations set out in the EU’s recent report assessing Romania and Bulgaria’s battle with corruption and organized crime. On the other hand, the EU needs to take a more active role in working with local and high-level officials in setting clear metrics for success, otherwise additional punitive actions should be taken or the EU alone should be in charge of administering funds. Overall, both Romania and Bulgaria need to improve economic freedom including providing greater transparency, enforcing contracts and personal-property rights, and improving labor flexibility.

Finally, Hungary and the Baltic States face the toughest recovery due to years of alarmingly high trade deficits, large foreign-debt exposure and ballooning public sectors. Despite current efforts to address fiscal and macroeconomic imbalances, investor risk tolerance and international credibility are low. For the Baltic States the best path towards recovery and sustainable development includes building a more diverse economic base (away from high boom/bust sectors like real estate), streamlining the public sector and making rapid euro adoption the number one policy focus. For Hungary the path to sustainable development will require a two-phase approach. In the short term Hungary has to focus on improving its fiscal health through reform of its archaic and inefficient pension and tax systems, which have undermined competitiveness for years. In the long term, Hungary needs to rehabilitate its weakened financial sector. Through greater EU convergence, particularly EU banking and regulatory regimes, Hungary will be better positioned to regain investor confidence and fast-track euro adoption.

Conclusion

As the dust begins to settle on the battered economies of Central Europe, winners and losers have clearly surfaced. Poland, the Czech Republic and Slovakia stand ahead of the pack, ready to emerge as the region’s main economic engines. Romania’s and Bulgaria’s growth prospects, while facing stiff competition from healthier CE economies, will continue to be burdened by deep political and economic deficiencies. Unless major initiatives, both at the local and EU levels, take effect to reform chronic structural and institutional asymmetries, the two Balkan countries are headed for long-term stagnation. Finally, the Baltic States and Hungary, saddled with debt and strict austerity programs, will have the toughest road and the least amount of flexibility regarding the speed and scale of their recovery programs. Despite their various predicaments, all of Central Europe has the opportunity to emerge stronger and more economically viable. The key for the region is to resist the burden of reform fatigue while continuing to converge with the EU-15. That responsibility, however, must not rest solely on Central Europe. The EU, and its wealthier members, must also ensure that
Central Europe continues to benefit and be deeply anchored in free-market principles and EU institutions. Most importantly, they must convince the region that they are not simply EU charity cases but critical players in Europe’s future economic prosperity.