THE ECONOMIC RECOVERY IN THE CENTRAL AND EASTERN EUROPEAN EU COUNTRIES

Elena GURGU, Lecturer Ph.D.
Faculty of Marketing and International Business
Spiru Haret University

Abstract

Following the recession in 2008-09, the economies of the eight EU countries in central and Eastern Europe outside the euro area (CEE) are recovering gradually, albeit with significant differences across countries. The expansion in economic activity is currently being driven primarily by exports as domestic demand remains subdued. Those countries that accumulated relatively more substantial internal and external imbalances before the financial crisis suffered more severe contractions in output during the crisis, and most of them face a more sluggish economic recovery.

Key-words: *economic recovery, recession, competitivity, value added, economic exchanges*

JEL Classification: D_{51}, E_2, F_{41}, F_{43}, G_{01}

Introduction

Global economic activity is continuing to recover, but the pace of the recovery remains uneven. At the same time it is slower than in the first six months of the year 2010, as the impact from some supportive factors, such as the inventory cycle and fiscal stimuli, is fading. In advanced economies, the pace of growth has been more modest, while in emerging economies it remains robust, despite moderating recently. Notwithstanding the slight pick-up seen in the last few months, inflationary pressures continue to be rather subdued in advanced economies. This contrasts with some emerging economies where stronger inflationary pressures persist.

The CEE countries are now edging out of the deepest recession they have experienced since the transition to market-oriented economies, with almost all countries having recorded on average positive quarter-on-quarter GDP growth rates since the second half of 2009.

The importance of this mondoeconomic observation consists in the steps that must be followed in order to realise an economic growth in the region and in the world.

In what follows I will play extensively the current state of the economy of this area based on information that was taken from studies that were conducted mainly by the European Central Bank, International Monetary Fund, OECD and

Eurostat. Also, documenting the article was done researching specialized international statistics, especially reports of institutions, organizations and specialized international bodies.

The external environment of the euro area – developments in the world economy

Global economic activity is continuing to recover. The pace of the recovery remains uneven and has lost momentum compared with the first six months of the year 2010, as the impact from some supportive factors, such as the inventory cycle and fiscal stimuli, is fading.

In advanced economies, weak labour market prospects, the need to repair balance sheets and low levels of consumer confidence have contributed to dampening the recovery. Growth in emerging economies remains dynamic, although it has moderated in recent months.

The latest survey-based evidence confirms that the global economic recovery has continued at a more moderate pace in the second half of 2010. The Purchasing Managers' Index (PMI) for global all-industry output declined steadily in the five months to October, when it increased to 54.8. This index remains above its long-term average, but below the average recorded for the first half of 2010 (see Chart 1).

Chart 1 Global Purchasing Managers' Index (PMI)

Source: Markit.

In advanced economies, inflationary pressures remain rather subdued, despite inflation rates picking up slightly in recent months. In some emerging economies stronger inflationary pressures persist. In the OECD countries, headline annual inflation increased by 1.9% in the year to October 2010, compared with 1.7% in the year to September (see Chart 2).

Higher food and energy prices contributed to this increase. Annual inflation excluding food and energy stood at 1.1% in October, down slightly from 1.2% in September. As indicated by the global PMI input price index, purchase prices have increased in recent months, but remain below pre-crisis levels.

Having made a strong recovery between the third quarter of 2009 and the second quarter of 2010, global trade growth is also showing signs of moderation. The most recent data indicate that global trade grew by 0.9 % quarter on quarter in the third quarter of 2010, down from 3.2% in the second quarter.

Economic situation of EU countries – EU members and other European countries

The economic situation in the other non-euro area EU countries continued to improve in the second quarter of 2010. Nevertheless, inflation has been increasing in recent months.

In the third quarter real GDP rose quarter on quarter by 2.1% in Sweden and by 0.7% in Denmark. In both countries, inflation has risen slightly in recent months, standing at 2.4% in Denmark and 1.6% in Sweden in October 2010.

The largest central and eastern European EU countries have continued to recover in recent quarters. The recovery continues to be supported by external demand and the rebuilding of inventories, although some differences across countries prevail. Domestic demand has remained rather subdued, owing to weak labour and credit market conditions, low capacity utilisation, as well as fiscal restraint in some countries.

Looking ahead, short-term indicators suggest a further improvement in the economic situation in all countries except Romania, where the preliminary estimate suggests negative growth for the third quarter of 2010.

In recent months inflation has been increasing in the EU countries in central and Eastern Europe. In October 2010 HICP inflation stood at 1.8% in the Czech Republic, 2.6% in Poland, 4.3% in Hungary and 7.9% in Romania. In most countries, the rise in inflation resulted from energy and food prices, partly reflecting a base effect from last year's strong declines. The relatively high level of inflation in Romania also reflects the impact of the VAT increase that was introduced in July 2010.

The economic situation has also stabilised in the smaller non-euro area EU countries, namely the Baltic States and Bulgaria. Inflation has also picked up in these countries from the very low, and for some time negative, inflation rates witnessed during the deep recession in 2009.

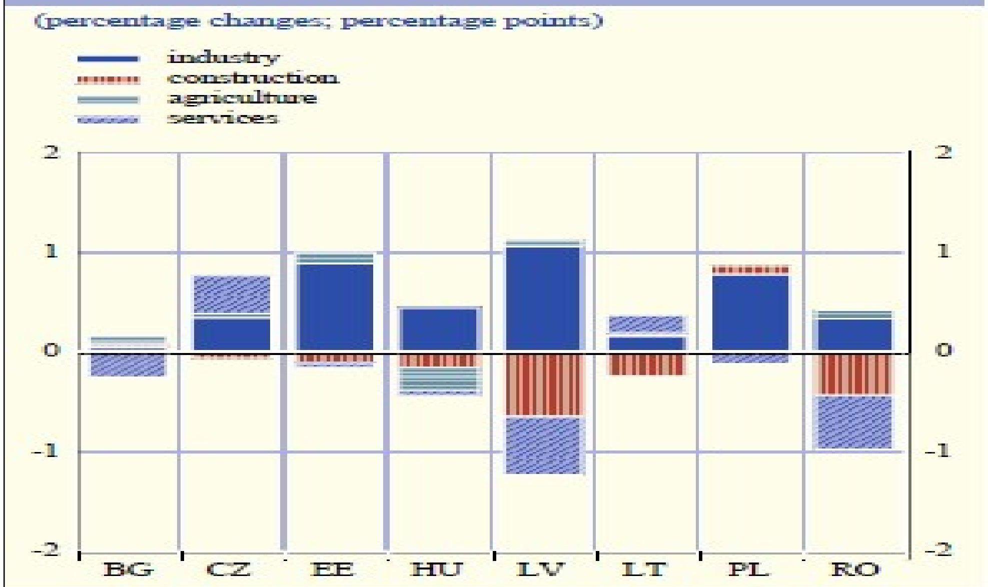
In Russia, the recovery in economic activity was interrupted in the third quarter of 2010 as a result of the adverse impact of the exceptional heat wave that engulfed the country. According to preliminary estimates, year-on-year real GDP growth moderated in the third quarter to 2.7%, down from 5.2% in the second quarter. However, owing to the temporary nature of this shock, growth is expected to pick up again by the end of the year, as also suggested by leading indicators.

Inflation started to edge up, reaching 7.5% year on year in October. This increase was driven largely by food price hikes on the back of the severe heat wave. Looking further ahead, the pace of the recovery is likely to be shaped by commodity price developments and domestic credit growth.

Recent recovery in economic activity in EU area

The timing and strength of the economic recovery have been heterogeneous across countries. While the upward trend in Poland, the Czech Republic and Estonia started earlier and has been stronger, the recovery in Hungary, Latvia and Lithuania, and in particular in Bulgaria and Romania, did not start until the first half of 2010 and has remained weaker. In terms of sectoral contributions, the recovery in most CEE countries has been driven by buoyant industrial activity (see Chart A).

Chart A Sectoral contributions to value added growth



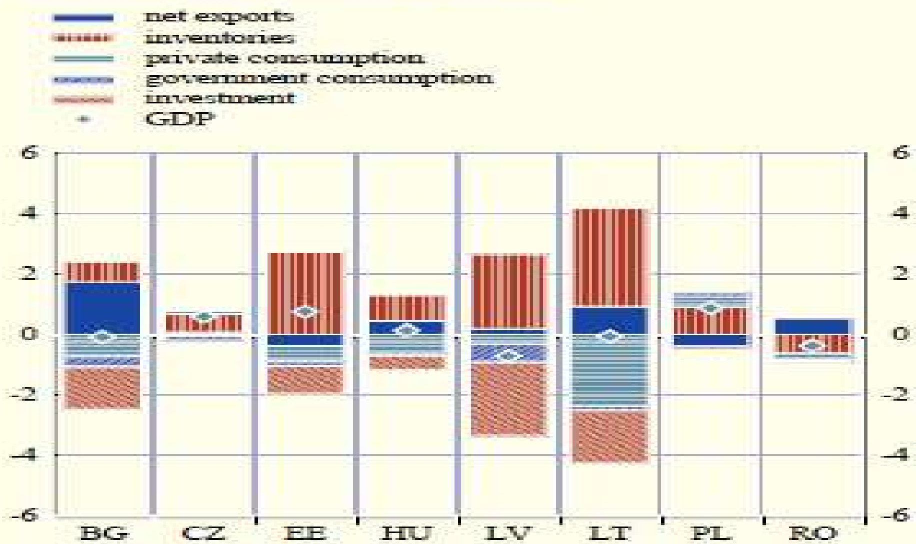
Source: Eurostat.
Notes: Average quarter-on-quarter growth rates over the period from the third quarter of 2009 to the second quarter of 2010. Data are working day and seasonally adjusted except for Romania (only seasonally adjusted).

Conversely, muted construction activity has constrained the recovery in nearly all CEE countries over the past year. This is particularly the case in the Baltic States, where the construction sector expanded at an unsustainable rate during the previous boom period. However, the positive contributions to growth from the construction sector in several countries in the second quarter of 2010 suggest that the downward trend has bottomed out.

Similarly, the services sector remained fairly weak at the beginning of the recovery, but, in many countries, it contributed to growth again in the first half of 2010. The pick-up in economic activity in most countries has been driven mainly by inventories and foreign demand on the back of a rebound in world trade since the second half of 2009 (see Chart B).

Chart B Contribution of expenditure to real GDP growth

(percentage changes; percentage points)



Source: Eurostat.
Notes: Average quarter-on-quarter growth rates over the period from the third quarter of 2009 to the second quarter of 2010. Data are working day and seasonally adjusted except for Romania (only seasonally adjusted).

Domestic demand has remained subdued in all countries except Poland. Private consumption has receded further in Bulgaria and Hungary, and especially in the Baltic States, where private consumption had risen considerably before the crisis and unemployment has reached high levels (around 18.5% in the second quarter of 2010).

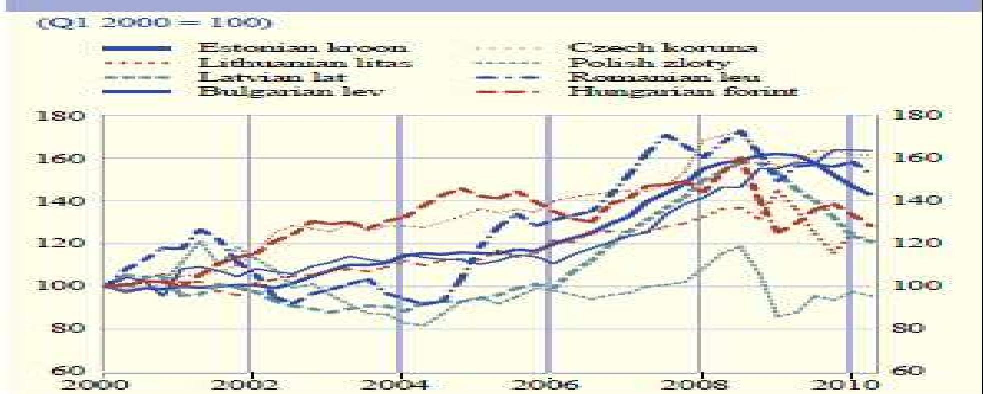
Investment has not yet started to recover since the end of the recession. In fact, it decreased further in all CEE countries in the first half of 2010. Government consumption has also made a negative contribution to economic growth in the region, reflecting already stretched public finances and fiscal consolidation efforts. Weighted average public deficits were around 6.7% of GDP in 2009 and are projected by the European Commission to remain broadly unchanged in 2010. Macroeconomic imbalances, which had been built up in some CEE countries prior to the crisis, are gradually being reduced. This process is necessary, but is currently constraining domestic demand. Credit growth to the private sector in the region has fallen gradually from the unsustainably high levels it reached in 2007-08, bottoming out at single-digit growth rates during the first half of 2010. The Baltic States and Hungary have even experienced negative credit growth rates since the second half of 2009, reflecting a reduced level of private sector indebtedness.

Although this is helping to repair households' balance sheets, it is hampering private consumption in the short term. In addition, the high ratio of nonperforming loans in some countries (between 17.5% and 19.2% in Lithuania, Latvia and Romania in the first quarter of 2010) is limiting banks' scope for further lending.

Alongside the slowdown in credit growth, financial account balances have deteriorated further since the onset of the recovery, compared with the levels seen during the crisis, and considerably more compared with the previous boom period. Turning to the individual types of capital flow, portfolio inflows, which tend to be a relatively volatile form of capital inflow, became negative in a number of CEE countries during the crisis. More recently, however, this downward trend has reversed in some countries (e.g. Lithuania and Poland). By contrast, most of the CEE countries continued to attract foreign direct investment (FDI) or recorded only small outflows during the crisis and the ongoing recovery period. These FDI inflows are likely to play an important role in supporting sustainable economic growth, especially if they are directed to the tradable sector.

Prior to the crisis, imbalances emerged in many CEE countries, among other things, as a result of unsustainable increases in employee compensation, which significantly exceeded productivity gains. During the crisis, however, some of the countries reduced nominal wages, in particular the Baltic States, where they have dropped by 26% on average since the middle of 2008. Although this drop in disposable income is an additional burden on households' ability to consume, the adjustments have helped these CEE countries to partly compensate for the earlier loss of price competitiveness vis-à-vis their main trading partners (see Chart C).

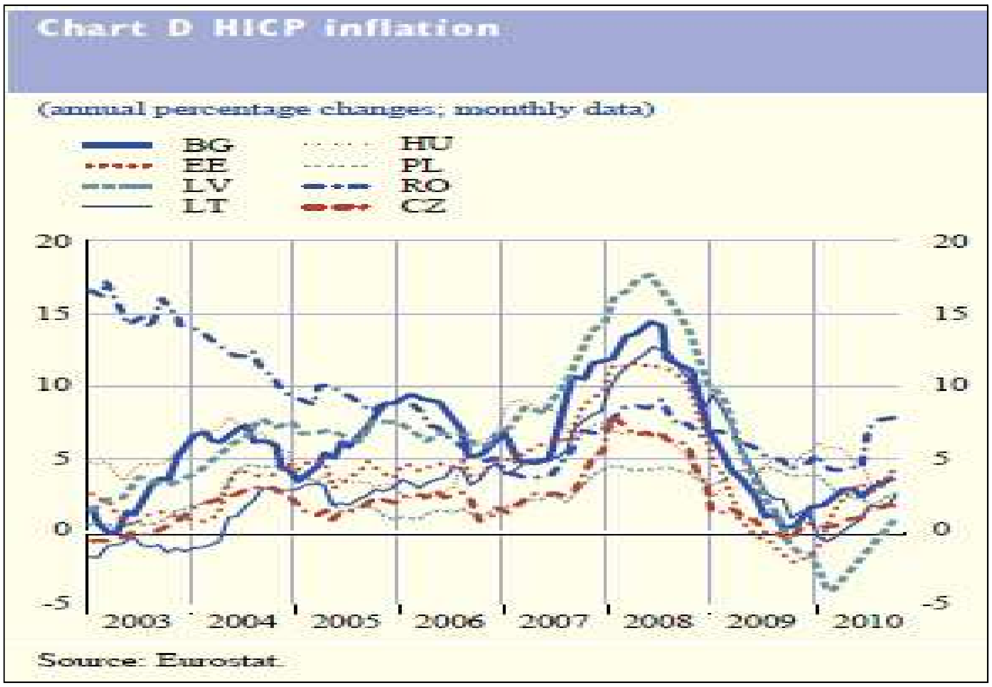
Chart C Real effective exchange rates based on unit labour costs



Source: ECB calculations.

The CEE countries with a flexible exchange rate regime (i.e. Hungary, the Czech Republic, Poland and Romania) enhanced their competitiveness mainly through a sizeable nominal depreciation of their currencies in 2008 and early 2009, although these developments were partly offset by appreciations at the end of 2009 and early 2010. Altogether, the rebound in foreign demand, greater competitiveness and subdued domestic demand have led to a sharp decline in current account deficits in the CEE countries. In the case of the Baltic States and Hungary, the deficits even turned into a surplus in the first half of 2010.

Following substantial disinflation (and partly deflation) during the crisis, HICP inflation in the CEE countries with a fixed exchange rate regime (i.e. the Baltic States and Bulgaria) has been rising again since spring 2010 (in Latvia only since September 2010). By contrast, the CEE countries with a flexible exchange rate regime did not experience such high inflation rates during the previous boom period and did not see an equally pronounced phase of disinflation during the crisis (see Chart D).



During most of the recovery period to date, inflation rates in these countries have remained positive and below 5%. In Romania, however, inflation has increased further in recent months.

Conclusion and outlook for economic activity in ECE area

Looking ahead, economic sentiment surveys signal a further strengthening of the recovery in all CEE countries, albeit to a lesser extent in Bulgaria and Romania. Domestic demand is expected to make a stronger contribution to growth in 2011, although exports are likely to remain a driver of economic activity in the region. With both domestic and foreign demand expected to gain momentum again next year, projections for real GDP growth in 2011 stand at around 3.5% for the Baltic States and Poland, 2.3% for the Czech Republic, Hungary and Bulgaria, and 1.5% for Romania (see the table).

GDP forecasts for 2011

(annual percentage changes)

	IMF	European Commission	Consensus Economics
BG	2.0	2.6	2.4
CZ	2.2	2.3	2.2
EE	3.5	4.4	3.8
HU	2.0	2.8	2.4
LV	3.3	3.3	2.9
LT	3.1	2.8	2.9
PL	3.7	3.9	3.8
RO	1.5	1.5	1.5

Sources: IMF World Economic Outlook (October 2010), European Commission autumn forecast (November 2010) and Consensus Economics Forecasts (November 2010).

Nevertheless, there are still risks to this outlook. Although the unemployment rate in all CEE countries (except Lithuania) has been decreasing gradually (or at least has stopped rising) since the beginning of 2010, the continued high level of unemployment is likely to dampen private consumption for a prolonged period. Similarly, should the deleveraging of the private sector continue, it will reduce growth in domestic demand. Moreover, additional uncertainties stem from the outlook for external demand as well as capital flows to the region.

REFERENCES

- Dabrowski, Marek. (2010). *The Global Financial Crisis and Its Impact on Emerging Market Economies in Europe and the CIS: Evidence from Mid* (October 5, 2010). CASE Network Studies and Analyses no. 411.
- Hegwood Natalie, Papell David (2007). *Are Real GDP Levels Trend, Difference, or Regime-Wise Trend Stationary?* Evidence from Panel Data Tets Incorporating Structural Change, Southern Economic Journal, vol. 74, issue 1, p. 104-113
- Hodgson, Geoffrey. (2006). I*nstitutions, Recessions and Recovery in Transitional Economies*. Revista de Economía Institucional, vol. 8, no. 15
- Pradeep Mitra, Ruslan Yemtsov. (2006). *Increasing Inequality in Transition Economies: Is There More to Come?* (September 1, 2006). World Bank Policy Research Working Paper No. 4007
- Ruben Atoyan. (April 2010). *Beyond the Crisis: Revisiting Emerging Europe's Growth Model*, International Monetary Fund Working Papers, p.1-31
- Rubinstein Mitchell H., (2009). *Obama's Big Deal: The 2009 Federal Stimulus – Labor and Employment Law at the Crossroads*. Rutgers Law Record, Vol. 33, No. 1, 2009; NYLS Legal Studies Research Paper No. 08
- Weber Enzo, (july 2010). *Foreign and Domestic Growth Drivers in Eastern Europe*, University of Regensburg, http://ssrn.com/abstract=1713706

- Zhang, Zhen. (2011). *Smart Grid in America and Europe: Past Accomplishments and Future Plans* (Part 2) (February 1, 2011). Public Utilities Fortnightly, vol. 149, no. 2
- Zhang, Zhen. (2011). *Smart Grid in America and Europe: Similar Desires, Different Approaches* (Part 1) (January 1, 2011). Public Utilities Fortnightly, vol. 149, no. 1
- http://www.economywatch.com/economy-business-and-finance-news/economic-forecast-2009-2010-imf-raises-gdp-growth-expectations-09-7.html
- OECD, *Annual Report 2009*
- The Markit Magazine – www.markit.com/en/
- Markit Economics
- Eurostat, *Eurostat Yearbook 2010*
- European Central Bank, *Annual Report 2009*
- ECB, *ECB Statistics: an overview2009*
- International Monetary Fund, *World Economic Outlook 2009*

II. **ADOPTING THE EURO – AN OSCILLATING TARGET**