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The new North-South Divide in Europe – can the European convergence model be resuscitated?

Abstract

The European Union has built up a track record for income and developmental convergence in the decades before the recent economic crisis. There was talk of a successful 'European integration model of growth and convergence' which included not only EU member economies but also a wider European region strongly integrated with the EU. This paper discusses the foundations of the integration model, its track record and the reasons why it was seriously derailed in the period prior to the crisis. A significant range of lower and middle income economies ('Europe's South') has experienced the build-up of unsustainable external imbalances, an accelerating rise in the debt positions (mostly of the private sectors) and strong distortions in their economic structures to the detriment of a sufficiently strong tradable sector. Other economies in EU's neighbourhood have become largely dependent on a small range of commodity exports and have suffered from a lack of diversification. With hindsight it is clear that the policy framework associated with EU integration (within the Eurozone, but also in relation to the wider European economic space) has to be reshaped to avoid a persistent 'North-South Divide' within the European Union and also with countries in its neighbourhood. The evolving policy framework within the Eurozone with its emphasis on stabilisation rather than loosening the growth constraints is likely to cement the Divide.

Introduction

Although global in character, the financial and economic crisis of 2008-2013 is on course to become a threshold event in the history of Europe's development and particularly with respect to its cross-country integration experience and policies. In this paper the focus is on the implications that the crisis bears for the low- and medium-income economies of Europe comprising: the countries of Central, Eastern and Southeast Europe (CESEE), the GIPS countries (Greece, Italy, Portugal and Spain)[1] as well as Turkey, the Ukraine, and Russia. In short, we shall refer to this group of economies as 'Europe's South' or 'Europe's Emerging Economies' (EMEs).

Over the years 2010 and 2011 it looked as if the European Union as a whole was recovering from the deep recession it experienced in 2009. Nonetheless, the recovery was relatively muted, although Germany and a few other 'Northern' economies (such as Austria, Finland and Sweden) recorded reasonably high growth rates in both 2010 and 2011. From the final quarter of 2011,

* Scientific Director, The Vienna Institute for International Economic Studies (wiiw); Rahlgasse 3; Vienna A-1060; Austria; landesmann@wiiw.ac.at; www.wiiw.ac.at.The paper draws on joint work, particularly with Vladimir Gligorov and also with Mario Holzner and Doris Hanzl; thanks go also to the wiiw statisticians, particularly to Beate Muck, Galina Vsaros and Monika Schwarzhappel.

1 The GIPS countries as defined above will at times also be referred to as Southern EU economies. At various times in the paper, we shall also refer to the GIIPS group of countries. In addition to the above economies, the latter group includes Ireland, a country that also suffered from severe external imbalances and debt build-up prior to the crisis but which cannot be counted among the low- and medium-income economies of Europe.

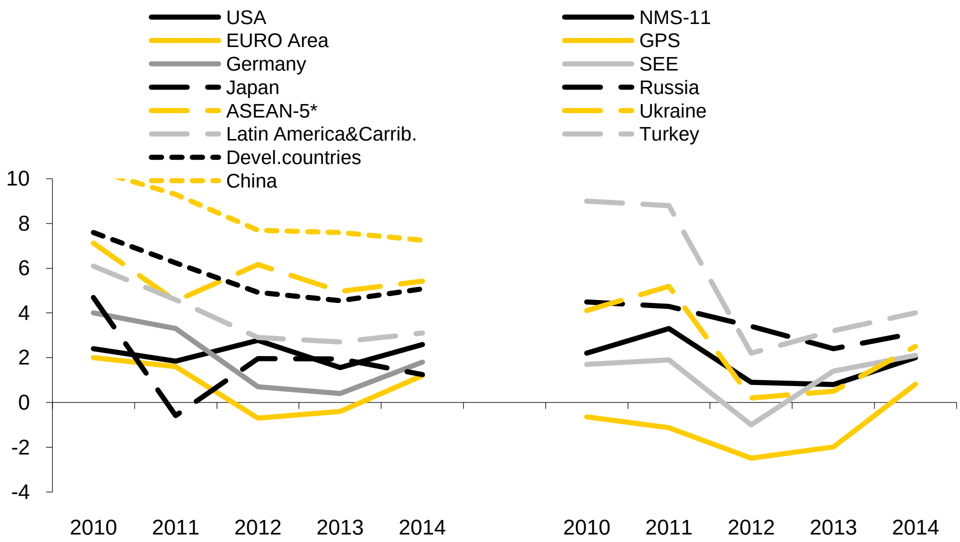
however, developments in the European economy showed a severe growth slowdown moving in large parts towards a ‘double-dip recession’ (see Fig. 1). This was the more remarkable as the other advanced economies, most notably the US and Japan did not experience such a double-dip (the US had been growing at 2.8 and 1.9% in 2012 and 2013 respectively, while the EU-27 grew at -0.7 and -0.4% in these years, Japan at 2.0 and 1.4%). This episode has been much discussed in the literature and the following factors have been put forward to account for the ‘divergence’ of European developments from developments in other advanced economies and global developments more generally in the course of the crisis:

- The lingering banking crisis in Europe, characterised by missing or much delayed consolidation and continued fragmentation along national lines while bank restructuring and bank consolidation has been tackled much earlier in the crisis in the US.
- The impact of built-up debt positions in the balance sheets of the household and corporate sectors combined with very cautious behaviour of European banks towards new lending and debt restructuring leads to protracted processes of deleveraging and thus reduced spending. In contrast, together with financial market stabilisation and that of the housing market, both investment and consumption expenditure has returned in the US having positive impacts on the labour market in turn.
- Fiscal policy conducted in the Euro area has proceeded quite differently from that in other advanced economies (see Table 1). Apart from the well-known austerity policy applied in the EU’s South, remarkable is also the very strong fiscal consolidation process in Germany (fiscal deficit of general government moved from -4.1% in 2010 to -0.8% in 2011 and then to +0.2% in 2012; the cyclically adjusted figures are -3.5%, -1.0% and +0.1%). This contrasts strongly with the development of fiscal balances in the US or Japan.
- The incomplete architecture of the Euro-system as well as complicated political processes and interest constellations amongst its main players have failed to unwind built-up external imbalances and debt positions of its ‘Southern periphery’ without inducing major and prolonged contractions of their economies and this now causes negative feed-back effects on ‘Northern’ economies through trade and continued weaknesses of the European banking system as a whole.

Figure 1

Development of GDP

real change in % against preceding year



- GPS: Greece, Portugal, Spain. ASEAN-5: Indonesia, Malaysia, Philippines, Thailand and Vietnam. NMS-11 incl. Croatia; SEE: non-NMS Balkans.
- *Source:* wiiw Database incorporating national and Eurostat statistics. IMF, World Economic Outlook, October 2013. wiiw and eurostat forecast.

Table 1

Fiscal balances, 2010-2014

Advanced economies	2010	2011	2012	Projections 2013	Projections 2014
United States	-11.1	-10.0	-8.5	-5.9*	-4.8*
Euro area	-6.2	-4.1	-3.6	-2.9	-2.6
Germany	-4.1	-0.8	0.2	-0.3	-0.1
Japan	-9.3	-9.9	-10.2	-9.8	-7.0
United Kingdom	-10.1	-7.9	-8.3	-7.0	-6.4

Source: World Economic and Financial Surveys, April 2013, Table 1. *The US figures for 2013 and 2014 are updated from IMF (2013b), June 2013.

IMF (2013b), Concluding Statement of the 2013 Article IV Mission to the United States of America, June.

The assessments of developments in Europe's EMEs have become much more gloomy not only for the short-term but also for the medium- and longer-term: Particularly strong were the economic contractions in the GIPS in 2012 and 2013 (Greece: -6.4% and -4.2%; Italy: -2.5 and -1.3%; Portugal: -3.2 and -2.3%; Spain: -1.6 and -1.5%); but there were also major downward revisions for most countries in the CESEE region, with quite a few countries having gone into recession (Czech Republic: -1.0 and -0.4% in 2012 and 2013; Croatia: -2.0 and -1.0; Slovenia: -2.5 and -2.0%) and many of the others slowing down to growth rates below or not much higher than 1%.[2]

[2] See e.g. the forecasts and analysis by the Vienna Institute for International Economic Studies (wiiw) in Podkaminer et al, July 2012 for the CESEE region which also includes forecasts for the years 2013 and 2014.

The crisis in the eurozone can thus be seen to have taken a heavy toll on Europe's EME region. We must emphasise, however, that the EME region is in itself far from homogenous and the adjustment processes initiated by the global financial and economic crisis proceeded along different trajectories in *different groups of low- and medium-income economies in Europe*.

The underlying driver of the 'New North-South Divide' in Europe is the build-up of external imbalances prior to the crisis within the EU and with the countries in Southeast Europe closely connected with the EU. The causes of this build-up will be discussed as will the inadequacy of the institutional and policy framework of the EU and the eurozone in particular. In the course of policy responses to the crisis, the EU is developing a new framework in which one of the main pillars is fiscal restraint. In addition, monetary policy has been relaxed and institutions have been set up to deal with the problem of stabilization support and debt resolution; most recently a move towards a 'banking union' has started. The contours and the outcome of this policy framework are however far from settled and subject to major political tensions across the EU.

As far as the policy framework has evolved in the course of the crisis it deals mainly with stability while growth is expected to be spurred by structural reforms, i.e. by supply-side policies. The risk is that these policies for stability and growth may deliver a prolonged period of stagnation with high unemployment in countries and regions that need to deleverage and build up their tradable sectors. With exchange rate rigidity and fiscal austerity, it may take considerable time for these countries to recover. That will severely test the weaker European economies, i.e. those in the GIPS group as well as the Balkan economies and in a different way also some of those in Central Europe and in the Baltics. This in turn can have severe repercussions on the EU set-up as a whole.

The analysis in the paper draws the following conclusions in the context of growth slowdown and the emerging policy framework:

- The most distinctive differentiating feature among the emerging European economies that the analysis singles out is the pre-crisis build-up of (structural) current account disequilibria, associated developments in external debt and the debt positions particularly in the private sector (households and corporations). The previous build-up of disequilibria and debt accounts for most of the differentiated impact of the crisis over the period 2008-2013.
- A sub-group of three Central European economies (Czech Republic, Poland and Slovakia) has been scarcely affected by the debt build-up. The countries concerned showed little sign of competitiveness problems in their tradable sectors (which is also the case with Hungary), while the GIPS (Ireland's problems were debt-, not competitiveness-related) and most of the countries in Southeast Europe and the Baltic states developed unsustainable disequilibria in both of these respects.
- Important groups of economies, such as the GIPS countries and most of the countries of Southeast Europe and some countries in Central Europe (Slovenia, Hungary), have

come up against a vicious circle: high initial debt levels and dim growth prospects translate into greater doubts about sustainability and hence into higher interest rates that impose a constraint on investment and encourage corporate and household deleveraging (further compounded by the weak state of the banking system). This dampens consumption expenditures, and leads to cutbacks in employment (and wages), which, in turn, lower household incomes and domestic sales prospects. The induced lower growth prospects, in turn, raise concerns over debt sustainability and the need to keep interest rates high.

- Prospects of offsetting factors such as a potential rise in competitiveness and hence export-led recovery are dim in the current context of low growth in the European economy as a whole.

The article thus points towards a sustained period in which the income convergence processes which characterized the decade prior to the current financial and economic crisis will either not proceed or proceed at a much reduced pace. Deleveraging processes, difficult moves to deal with the high debt positions of the private sector, the weak banking system and tendencies towards national fragmentation of financial markets in Europe, as well as the feedback effects on sovereign debt will characterize many of the lower-income economies in Europe. The driving force of foreign direct investment and the build-up of cross-border production networks will also show weaker momentum compared to before the crisis. Adjustment processes to deal with the pre-crisis neglect of building-up a viable tradable sector and sufficient and modernizing export capacities will have to gain priority and the use of different sets of policy instruments (particularly in the areas of training, labour market, industrial and regional policies) will have to be strengthened.

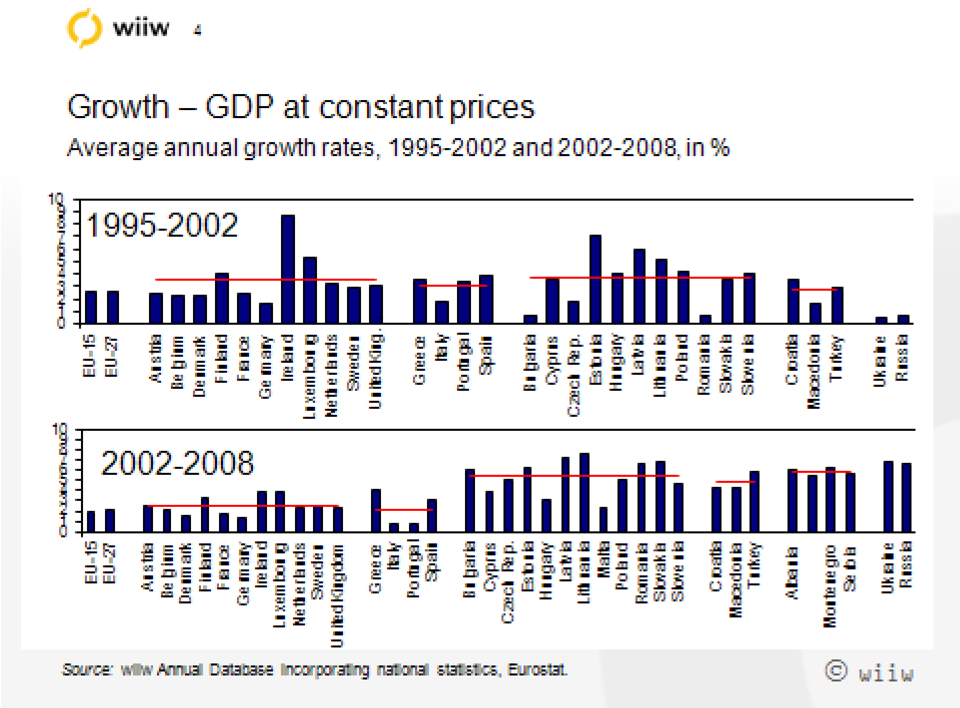
1. The European growth and convergence model prior to the crisis

The pre-crisis integration model in relation to Europe's Emerging Economy (EME) region was characterised by a very high degree of liberalisation of external economic relations. Trade relations were strongly liberalised (although in the services and utilities sectors non-tariff types of barriers persist) and there was a commitment to free international capital movements (in all its forms). In the CESEE region in particular, financial markets were fully opened up to foreign financial institutions and in most of these economies foreign banks attained a dominant market position.

As Fig. 2 shows, the period from the mid-1990s onwards coincided with a process of 'convergence' in many countries of the CESEE region, as these economies embarked (after a difficult first phase of 'transition') on a growth path with rates substantially above those of their western neighbours. For a number of these economies, the 'catching-up processes' were nonetheless interrupted at times by policy mistakes (such as the legacies of mistaken forms of privatisation programs, and often problematic steps taken in monetary and exchange rate policy, such as opting too early for a fixed exchange rate regime).The performance of the GIPS economies shows much less evidence of 'convergence' over this period, with Italy showing particularly low growth rates and both Greece and Portugal roughly maintaining their gaps in income levels relative to the EU as a whole while Spain experienced above average growth.

Underlying the growth performance of the CESEE economies was the opportunity which any lower income, lower productivity economy has to benefit from ‘technology’ transfer (the so-called Gerschenkron effect[3]); in the particular case of former transition economies, ‘technology’ should be interpreted rather broadly, including the importance of product design, in organisational structures, and behavioural practices, facilitated by changes in institutions and in legal frameworks. In the case of many of these economies the speed of ‘technology’ transfer was reinforced by the anchoring to EU pre-accession and then accession arrangements. This anchoring added to the attraction of the region to foreign direct investments, a major conduit for the type of technology transfer alluded to above. Low relative unit labour costs combined with relatively high human capital endowment (adjusting for relative income levels; however, this is not the case with the GIPS countries) made the region attractive to foreign investors. This in turn led to access to high-income markets and the possibility of integration into cross-border production networks.

Figure 2



As will be shown in the next section, only in some of the economies did this lead to a substantial recovery of industrial production capacities, i.e. a process of ‘reindustrialisation’ after the earlier period of – often massive – deindustrialisation which most countries experienced at the

[3] Named after Alexander Gerschenkron’s ‘advantage of backwardness’ thesis; see Gerschenkron A. (1962): *Economic Backwardness in Historical Perspective: A Book of Essays*. Cambridge, MA: Belknap Press of Harvard University Press, 1962.

beginning of the transition period. In many other economies, a longer period of political and economic turbulence such as in most countries of Southeast Europe and in the Baltics led to a situation in which pre-transition levels of industrial production were never attained; this in turn showed up in sustained gaps in trade balances. This had grave consequences in terms of vulnerability to external shocks to which we shall return below.

Furthermore, especially the economically weaker and vulnerable countries (in the Balkans and the Baltics) adopted various versions of fixed exchange rate regimes. The reason was often lack of trust in domestic monetary authorities and to avoid the large exchange rate fluctuations that can characterise shallow foreign exchange markets. By pegging the exchange rate, the countries also wanted to speed up financial and monetary integration with the euro area. In turn, the choice of exchange rate regime contributed strongly to sustaining and accentuating the problem of deteriorating trade balances.

In the next section we follow up the problem of external imbalances.

2. External imbalances and different groups of Europe's low- and medium-income countries

As discussed above, the pre-crisis European integration framework (with its monetary and financial markets dimension) was designed to encourage large inflows of foreign investment from the more developed to the less developed countries, with external imbalances expected to be temporarily widening, then narrowing and eventually closing as income levels converged mainly on account of export growth. The outcome in Central Europe (particularly, Czech Republic, Hungary, Slovakia, Poland) has been more or less as intended, but not in the countries of Southern Europe nor in the Baltic states or in Southeastern Europe. Once the financial crisis broke, it led to a dearth of foreign financial inflows and a sharp decline in foreign trade. In that context, however, export recovery has often proven stronger in those countries with lower pre-crisis trade deficits than in many of the countries with major trade imbalances (see below).

The development of external imbalances prior to the crisis led to an accumulation of foreign debts with clearly unsustainable growth dynamics. Since the start of the crisis they climbed at lower rates and, in some cases, the foreign debt to GDP ratios have declined: indicative of the onset of a deleveraging process. This again is more evident in Central Europe as well as in the Baltic states than in the countries of Southern Europe or in the Balkans. Uncertainties surrounding the future growth of exports of goods and services still point to a structural problem that may restrain the growth of those countries, given the somewhat unfavourable climate for foreign investments that is currently developing.

Groups amongst Europe's low- and medium-income countries

In the following discussion of economic developments in low- and medium-income countries in the European economy we shall group countries on the basis of certain commonalities and related features, the most important of which date back to pre-crisis developments. Particular emphasis is placed on the build-up of external and internal disequilibria prior to the financial crisis, which then led to different adjustment pressures following the onset of that crisis.

Figure 3a shows developments in the current account and its components. Figure 3b presents the pre- and post-crisis developments in various debt segments: external debt, public and private debt and the various components of private debt (all expressed as a percentage of GDP). The information contained in Figures 3a and 3b provides the main background to differences across countries in the build-up of external disequilibria, as well as in the debt positions of the economies on entering the crisis, which proved to be the main challenges in the adjustment processes following its onset. The evidence contained in the two figures also provides the main criteria for grouping countries in the following analysis.

Current account developments are taken first. The Central European economies (CE-5[4]) display a relatively positive performance in terms of their current account developments, which did not experience any substantial deterioration before the crisis. Furthermore, the trade accounts confirm the relative strength of those economies in terms of their export as against their import performance. A number of economies have been able to attain positive trade balances (Czech Republic and Slovakia) and others came close to balance. Given that evidence, it would thus seem that these economies encountered no competitiveness problems.[5]

Much more problematic were developments in the following groups of economies. All the Baltic economies as well as Romania and Bulgaria recorded strongly deteriorating current accounts before the crisis, which were predominantly associated with deteriorating trade balances. In part, those deteriorating trade balances reflected inordinately high growth rates in some of the economies prior to the crisis; however, there is clear evidence here of external balances 'moving out of gear'.

If we compare the above economies with the GIIPS countries[6], we can see competitiveness problems that came particularly to the fore in two countries with persistently high current account deficits: Greece and Portugal. Competitiveness problems featured less prominently in Spain and Italy, while Ireland recorded persistently high export surpluses (the current account deficit reflecting a high level of profits earned by foreign-owned companies as evidenced by the income accounts).

4 CE-5: Czech Republic, Hungary, Poland, Slovakia and Slovenia.

5 Of course, the trade accounts per se are insufficient to reflect fully competitive strengths and weaknesses as they can, for example, become sharply positive or negative when GDP growth exceeds or falls short of that of the main trading partners.

6 The GIIPS: Greece, Ireland, Italy, Portugal and Spain. See also footnote 1 above. While Ireland is not included in the range of low- or medium-income economies and therefore does not feature in other parts of our analysis (which refers to the GIPS without Ireland), it is included here as prior to the crisis, Ireland was also characterized by a build-up of very high external imbalances and high private sector debt growth.

The remaining countries in Southeast Europe (SE-6[7]) show very high trade deficits reflecting a very small export base upon which the economies can count. Current accounts displayed marked deterioration in the period prior to the crisis in two economies: Montenegro and Serbia. Most of the economies in the group rely on major transfers in the form of remittances from their nationals living and working abroad, thus partly offsetting the high trade deficit.

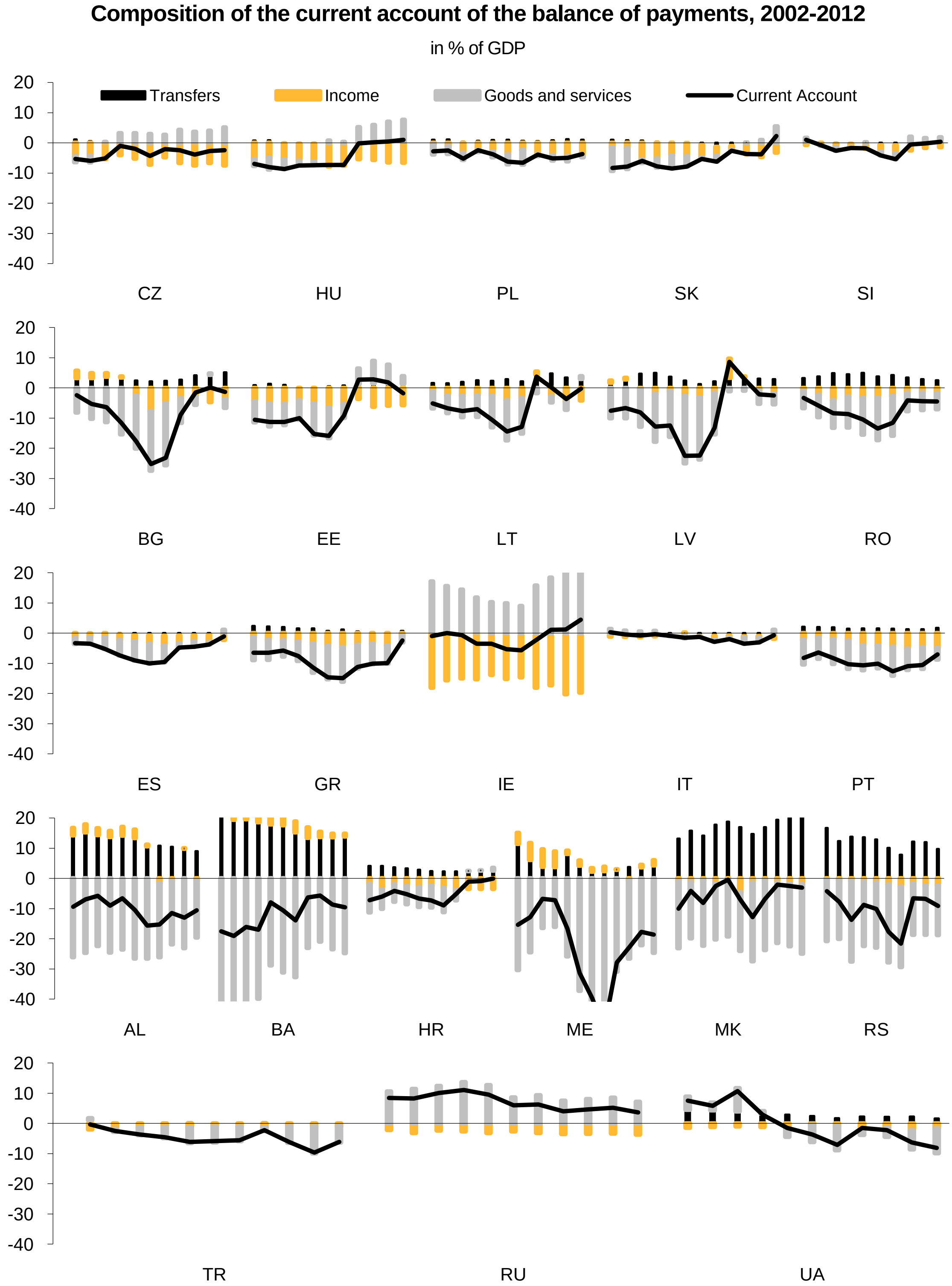
As to the other countries - *Kazakhstan, Russia, Turkey* and *Ukraine* -, they constitute a rather heterogeneous set. Two of them are major energy exporters (Kazakhstan and Russia) that registered highly positive trade balances before and after the crisis. The Ukraine struggled with high current account deficits and the build-up of high external debt, in addition to going through a major banking crisis and an attack on its exchange rate in the wake of the crisis. Turkey, on the other hand, after undergoing a crisis of its own in the late 1990s, embarked on a very successful phase, in the course of which it built up a thriving and more diversified industrial and export sector and drove down its public and external debt prior to the crisis. Admittedly, Turkey goes through bouts of high current-account deficits with every sign of over-heating, as was more recently the case in 2010 and 2011. This makes it necessary to adopt an appropriate policy response in order to achieve re-equilibration which also led to a sharp slow-down of its growth rate (from 9.0% and 8.8% growth in 2010 and 2011 respectively to 2.2% and 3.2% in 2012 and 2013).

As is well known, current account imbalances have to be financed and the capital inflows funding the same accumulate in the form of debt positions in different sectors of the economy. The accumulation of domestic and foreign debt positions is shown in Figure 3b. The information presented in the graphs shows further differences between and within country groupings.

Among the CE-5, relatively moderate or no increases are to be observed in the various debt levels of the Czech Republic and Poland, a somewhat higher increase of private debt in Slovakia (whereas public debt dropped as a percentage of GDP), and marked increases in private sector debt positions in Slovenia (mostly corporate debt) and Hungary. Furthermore, Hungary increased its public debt to 73 per cent of GDP in 2008, which is rather unique among the countries of Central and Eastern Europe, followed by Poland whose public debt rose to 50 per cent of GDP in 2008.

[7] SE-6: Albania, Bosnia and Herzegovina, Croatia, Macedonia, Montenegro, Serbia.

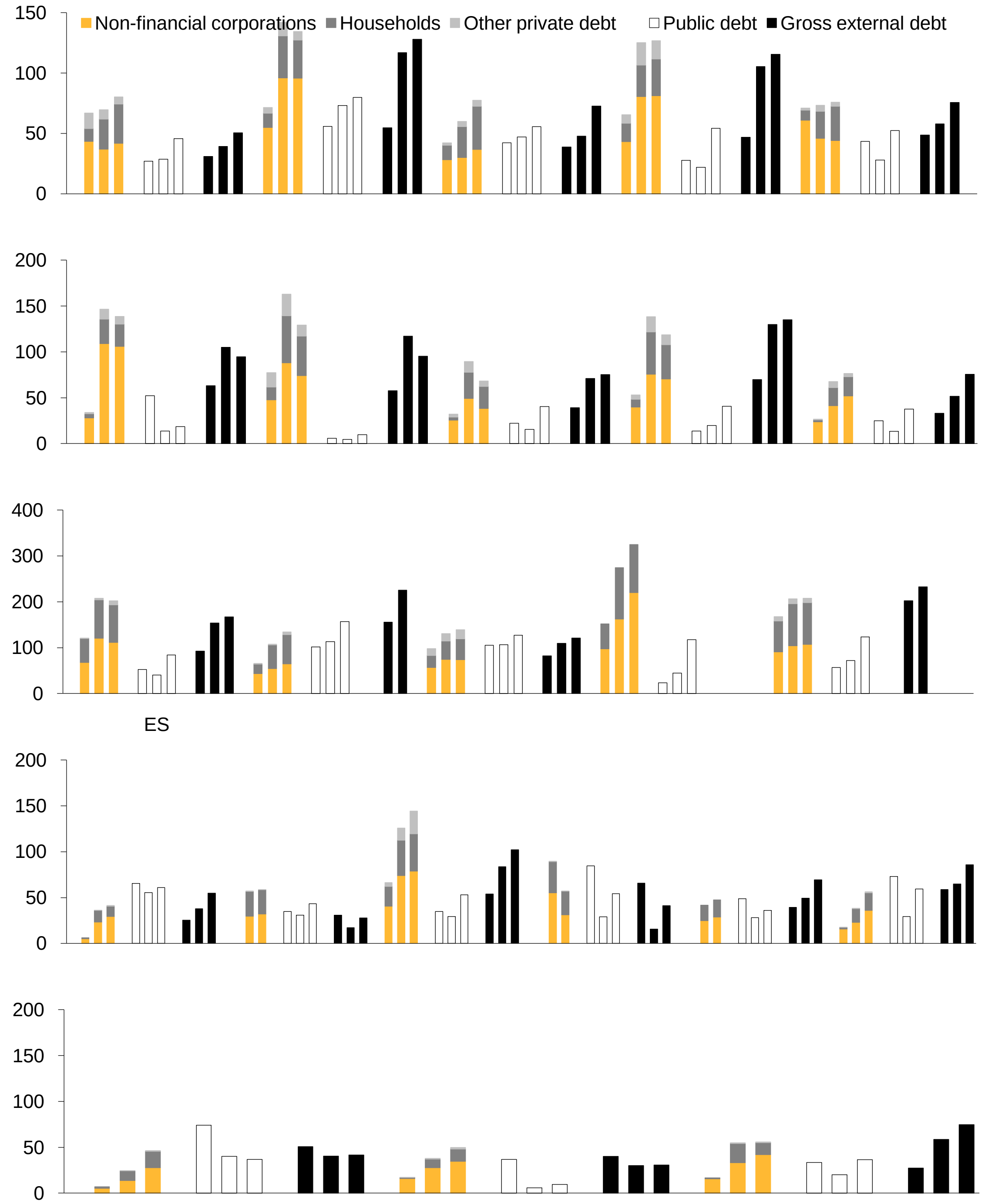
Figure 3a



Source: wiiw Database incorporating national and Eurostat statistics.

Figure 3b

Private and public debt in % of GDP, 2002, 2008 and 2012



IE: For a better readability other private debt and gross external debt is not shown (e.g. gross external debt 2012 would be 1002.3 % of GDP).

Source: Eurostat, IMF, wiiw own calculations.

The Baltic states as well as Bulgaria and Romania were characterized by a rapid development of private debt over the pre-crisis period, while public debt (as a percentage of GDP) was driven down, as it benefited from the high growth rates over that period and the associated tax revenue. Among the SE-6 countries, Croatia also displays a rapid rise in private sector debt, while Albania is characterized by a higher level of government debt, which, however, in common with most other economies, fell (as a percentage of GDP) in the period leading up to the crisis.

Summary

In the CESEE region prior to the crisis, one group of Central European economies (Czech Republic, Poland and Slovakia) encountered no evident problems related to the build-up of private and public debt. Many of the other CESEE economies experienced a major build-up of their private sector debt positions, with only Hungary (and to a lesser extent, Poland) amongst the CESEE economies displaying a high public debt to GDP ratio.

The situation was not all that much different to that prevailing in the GIIPS countries before the crisis, with the important exceptions of Greece and Italy, both of which maintained public debt levels of over 100 per cent of GDP prior to 2009. The other GIIPS countries (including Greece, but not Italy) experienced extremely rapid growth in private sector debt: the (in)famous ‘credit bubble’ in those economies prior to the crisis.

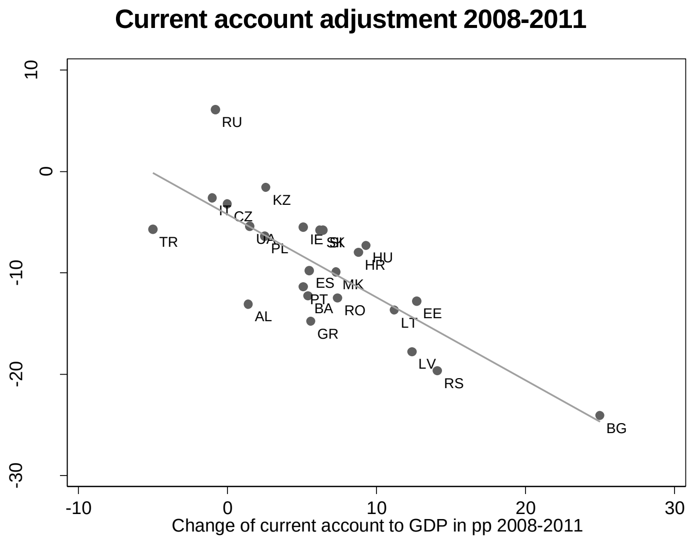
Hence prior to the impact of the financial crisis, the starting point was the major imbalances in the external accounts in a large number of low- and medium-income economies in Europe (the GIIPS group without Ireland and Italy, and a large number of CESEE economies with a sub-group of CE-5 being the exception). This went along with the build-up of debt positions, which in many economies were largely characterized by the swift build-up of private sector debt to very high levels, with only a small sub-group of economies (Hungary, Greece, Italy) showing high public debt levels prior to the crisis.

3. The impact of the crisis: external accounts adjustment

In the following, we shall discuss certain features of the adjustment processes that occurred in the wake of the financial and economic crisis, including both transitory features as well as the more permanent impact of the initial disequilibria on the patterns of recovery or lack thereof.

Figure 4 provides clear cross-country evidence, confirming that the extent of current account deficits prior to the crisis led to a major current account adjustment over the period 2008-2011. Furthermore, Figure 5a shows a similarly clear relationship between the other indicator of an extant disequilibrium prior to the crisis, the ratio of private sector debt to GDP, and the subsequent growth trajectories of the different economies. A similar relationship is shown in Figure 5b between the pre-crisis current account deficit and subsequent growth. We can conclude that, first, major current account adjustments took place that were determined by the previous extent of the disequilibria and, secondly, the extent of the previous build-up of private sector debt or pre-crisis current account disequilibria had a palpable negative impact on medium-term growth performance following the crisis.

Figure 4



Source: wiiw Database incorporating national and Eurostat statistics, own calculations.

Figure 5a

Private sector debt and subsequent GDP growth trajectories 2008-2011

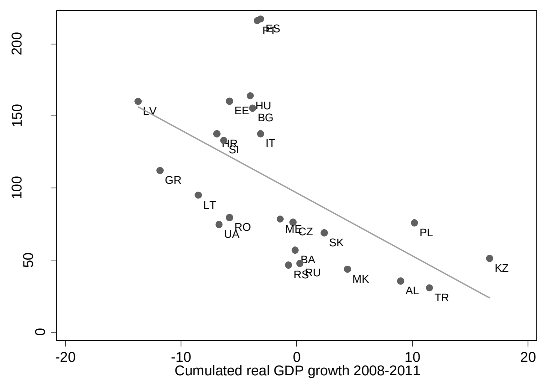
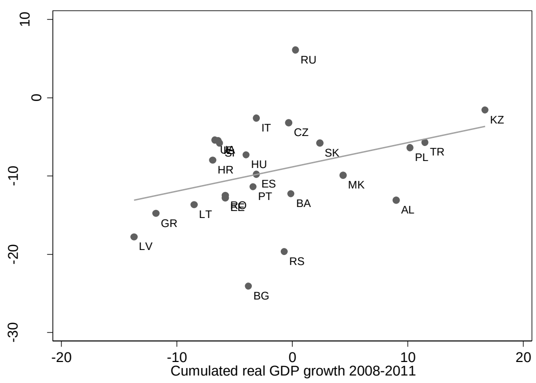


Figure 5b

Current account balance and subsequent GDP growth trajectories 2008-2011

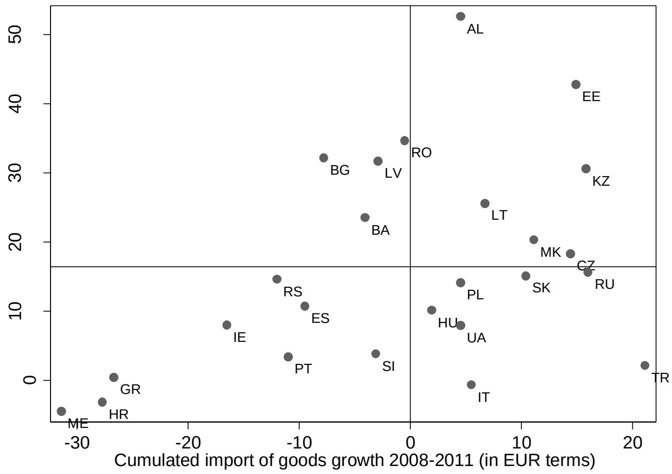


Source: wiiw Database incorporating national and Eurostat statistics, own calculations.

The degree of differentiation across economies is also apparent in Figure 6, in which both export and import growth rates are plotted over the period 2008-2011, thus allowing us to distinguish between various groups of economies: (i) those in the top two quadrants which experienced relatively high export growth; (ii) those which experienced comparatively pronounced import contractions, but relatively weak or even negative export growth (this group comprises most of the GIPS countries, as well as many of the SE-6 countries); and (iii) those with more balanced export and import growth that had no need for external accounts adjustment (this group comprises the CE-5 countries without Slovenia, but also includes Italy).

Figure 6

Export and import development 2008-2011



Source: wiiw Database incorporating national and Eurostat statistics, own calculations.

Summary

It is quite apparent that the crisis brought about a need to correct strong external imbalances and strong private sector debt build-up prior to the crisis. We have shown that the extent of adjustment was directly related to the size of the previous current account disequilibria and private sector debt build-up, and that those adjustments (and their severity) entailed clear medium-term costs in terms of GDP growth. Furthermore, patterns of adjustment across economies varied greatly, with some countries relying almost exclusively (even in the medium term) on import adjustments, while others were more successful in terms of export growth.

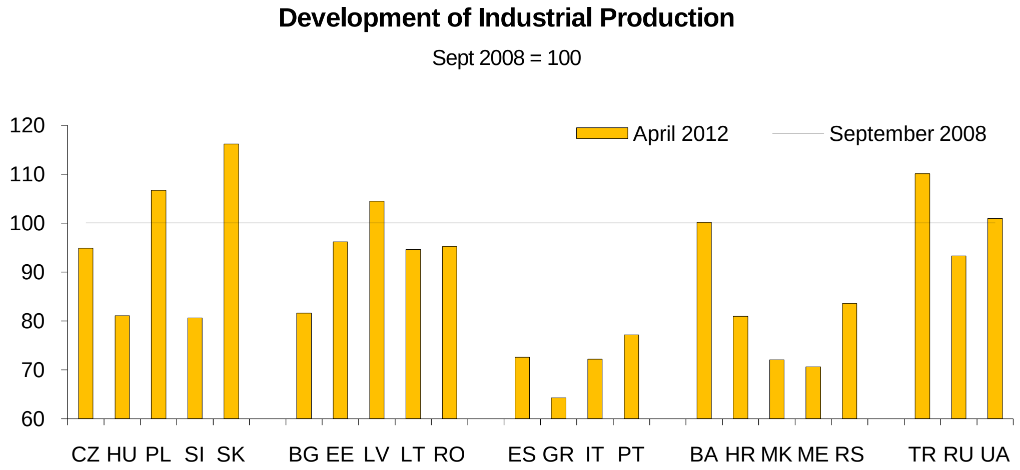
In the following section we the question of prospects for recovery and future growth prospects.

4. Continuation of the economic crisis and what can recovery rely on?

Sectoral distortions and levels of industrial production

In the previous section we discussed the issue of external imbalances and the need to rebalance in the face of stoppages of capital inflows and even their reversal specifically in those economies which built up large external imbalances in the pre-crisis period. Industrial production accounts in most economies for the bulk of the tradable sector and hence we are particularly interested in its development. Fig. 7 shows levels of industrial production in relation to the pre-crisis levels. The abysmal performance of industrial production in the course of the crisis comes across clearly for the GIPS economies, as well as in a rather wide range of Southeast European economies, and also in Hungary and Slovenia industrial production levels were strongly hit during the crisis.

Figure 7



Source: wiiw Database incorporating national and Eurostat statistics.

An additional piece of information is provided in Fig. 8 where the contributions of different sectors of the economy to overall GDP growth have been plotted.[8] Three different sub-periods are shown: the two-pre-crisis periods 2001-2004 and 2005-2008 and the period 2008-11 (2011 was the latest year for which disaggregated figures were available). The following sectors are identified in this figure[9]: manufacturing (C) as the classic tradable goods sector, construction (F) and wholesale and retail (G) sectors as important non-tradable sectors, and a range of 'other market services' activities (H-N) which include both tradable service activities (such as 'accommodation and food services' which would be particularly important for economies with a large tourism industry, or 'financial and insurance activities', all of which however still overwhelmingly cater for the domestic market) as well as non-tradable activities (such as real estate services).

From the figure we can detect the following patterns:

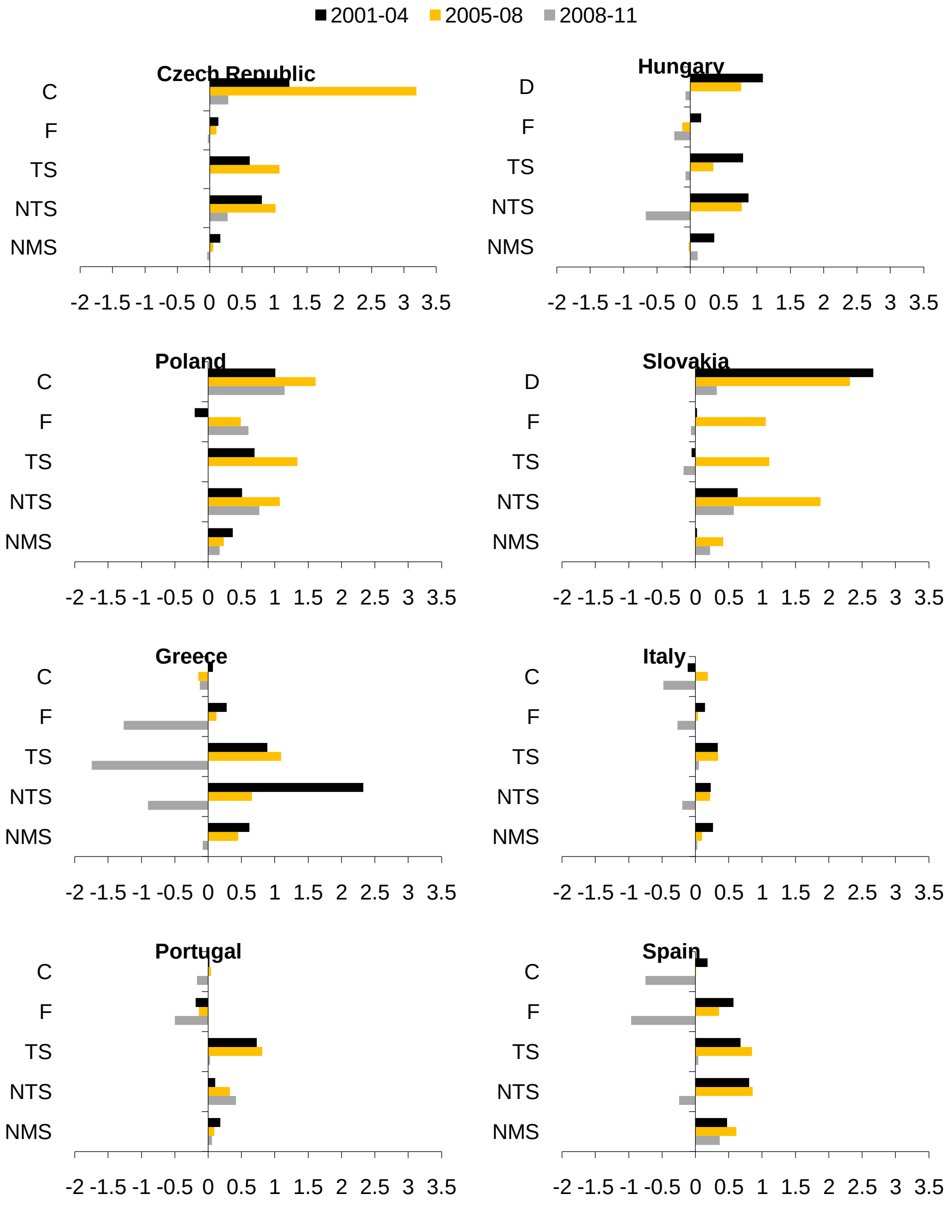
- It is clear that the manufacturing sector performed very badly in terms of its contribution to overall GDP growth in the GIPS countries in the pre-crisis period. GDP growth relied almost entirely on one or the other of the services sectors (G or H-N) or on construction (F).
- In contrast, in the CESEE economies we observe a more balanced picture with regards to the different sectors' contributions to GDP growth. Manufacturing played a particularly important role in the Czech Republic and Slovakia, but also in the other CESEE economies where services activities and construction dominated GDP growth, manufacturing still played an important role. However, as we look at the period immediately preceding the crisis break (2005-08), there is evidence for the contribution of manufacturing declining quite strongly in a range of CESEE economies (Estonia, Latvia, Lithuania, Hungary) while that of construction and market services increasing significantly (Baltics and also Slovenia).

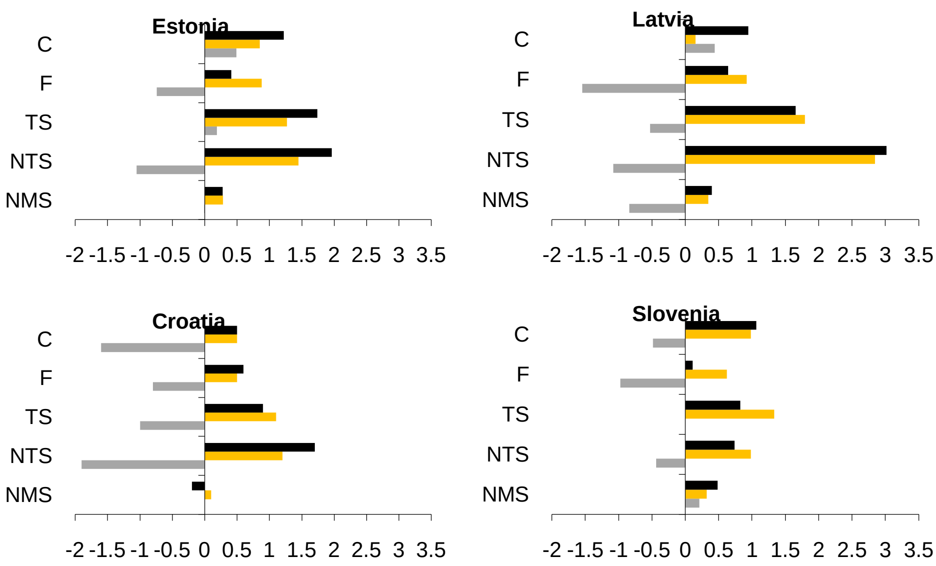
[8] Contributions are calculated by multiplying the share of the selected industry by its growth rate.

[9] Based on the NACE rev. 2 classification scheme.

- We also see that manufacturing was particularly negatively affected in the GIPS countries in the crisis period (2008-11) so that in this period there was no structural readjustment yet towards a strengthening of the tradable sector, rather the contrary.

Figure 8 **Sectoral contributions to GDP growth (from constant price data)**





Notes: Based on NACE rev. 2 classification scheme: C (Manufacturing), F (Construction), G (Wholesale and retail trade), H-N (Other market services).Contributions are calculated by multiplying the share in total GDP at current prices by real growth at preceding year prices.
Source: wiiw Database incorporating national and Eurostat statistics.

Summarising, one can say that there are distinct differences between GIPS and Eastern European economies[10] in the build-up of structural distortions before the crisis, in that the move away from manufacturing prior to the crisis was much more pronounced in the GIPS economies, while the growth pattern was more balanced in the NMS economies. Nonetheless, sub-groups of NMS economies (Baltics, Slovenia) experienced a strong shift away from manufacturing in the period just before the outbreak of the crisis. As to the adjustment in the wake of the crisis, we pointed out that manufacturing was also strongly negatively affected in many countries and hence a process of re-adjustment (favouring the tradable sector) has hardly started. This is particularly worrisome for those economies which entered the crisis with a very weak tradable sector, chronic current accounts problems and high external debt.

Private sector debt and deleveraging

The build-up of private sector debt in the period before the crisis in a wide range of Europe's low- and medium-income economies has already been discussed as a major source of the imbalances which have emerged in the European economy; this build-up exerted and still exerts a very significant strain on adjustment processes in the wake of the crisis (see Figs. 9a and 9b). It results from the fact that the flow problems of private sector debt build-up have now congealed in the form of substantial stock problems which require significant adjustment processes in the form of deleveraging with impacts upon banks' balance sheets, on access to and provision of credit (to households and enterprises) and upon spending levels and hence output recoveries.

The debt build-up, high interest costs and the deleveraging process have taken a heavy toll on investment while the decline in household consumption has been modest. This holds true for

[10] The analysis could only be done for EU member countries as comparable industry-level data are not available for a wider range of CESEE economies.

practically all of the countries reviewed. Some exceptions are to be found in Central Europe where investments have increased (Poland and Slovakia) or have not dipped as sharply as in other countries in Southern and Southeast Europe. Investments in Russia, Ukraine, Kazakhstan and Turkey are, for the most part, increasing. A similar development is to be observed in foreign investments, direct and otherwise. Foreign investments have slowed down significantly and there is significant evidence for cross-border deleveraging by the banks (see Hunya and Schwarzhappel, 2013). This, in part, reflects the fact that the corporate sector is burdened with debt that cannot be serviced, given the current state of the economy in most European countries.

In addition, the state of the banking sector in both the EU and most other countries is such that it does not support any rapid growth of credit. In fact, a few years after the onset of the crisis, credit growth still remains anaemic. To the extent that it relies on foreign credit, the prospects are not positive due to the stricter rules on capital requirements in the EU and globally. Thus, the prospect in countries with a strong presence of foreign banks is that they tend to decrease their cross-border exposure. Consequently, banks will increasingly depend on their domestic increase in deposits to finance their investments.

The question thus arises as to the consequences over the coming few years, given the prevailing policy framework in Europe. Household consumption cannot be expected to grow strongly owing to (at best) stagnant wages and the significant decrease in employment in a number of countries (see section 6 below). This shedding of labour is part and parcel of the corporate sector's restructuring strategy, which will take a while to unfold. In the medium term, the slow, if any, recovery of investments and stagnant consumption will translate into comparatively low rates of recovery.

Whether there is any likelihood of investments picking up is a further issue. Borrowing costs are a severe constraint in the GIPS economies and in many countries in South and Southeast Europe, and to a lesser extent in the countries of Central Europe. Problems associated with production costs are addressed by reducing wages and downsizing. However, given the depressed state of demand in the wake of stagnant private consumption and declining public expenditures, any marked increase in investments currently depends on the revival of external demand. In the countries of Central Europe, external demand may be spurred by the recovery of the German economy and indirectly by global demand. In the countries of South and Southeast Europe, the corporate sector faces balance-sheet problems, high financing costs and rising non-performing loans, investment-driven recovery is thus 'a long shot'.

Figure 9a

Corporate debt and subsequent gross fixed capital formation growth 2008-2011

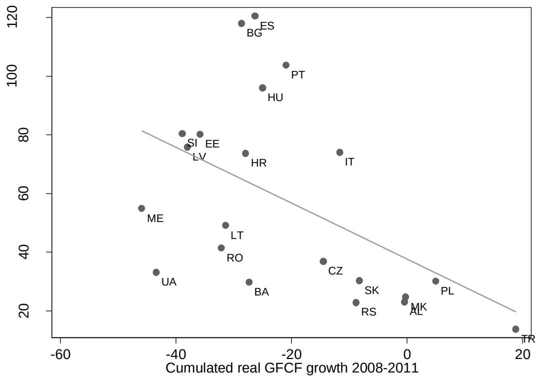
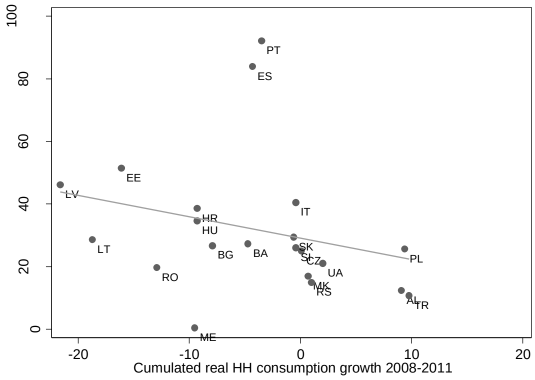


Figure 9b

Household debt and subsequent household consumption growth 2008-2011



Source: wiiw Database incorporating national and Eurostat statistics, own calculations.

Fiscal policy stance

Fiscal consolidation is seen as the key policy adjustment tool in both the EU and most of Europe (see also the discussion in the following section 5).

Depending on the policy mix adopted, almost every country has tended to introduce measures that increase revenues and lower expenditures. It is expected that this will ensue over a longer period of time, so fiscal support for growth should hardly be forthcoming in a prolonged period of fiscal consolidation. The recovery of the countries that will have to introduce more stringent fiscal austerity measures, many of them in Southern Europe, will have long-term negative effects on their growth performance, should it not be matched by a speedy recovery of their investments and exporting capacities.

Tax reform, an ingredient common to most fiscal adjustment programmes, increases reliance on indirect taxes and reduces the burden of direct taxes. Supply-side tax reform, which is often proposed and in some cases adopted, aims at increasing VAT rates and decreasing the rate of social contributions. Other proposals include increasing the progressivity of direct taxes and imposing more tax on property. The expectation is that increased indirect tax rates will yield more revenue, while lower rates of social contributions will reduce the tax burden on entrepreneurs. The added advantage is that lower consumption should limit import growth, while increased investments should be geared towards exports, since domestic consumption is not expected to recover swiftly. Given the experience to date, lower contributions will hardly be offset by the higher VAT rate and not much can be expected of the change in income tax rates. In fact, if it fails to boost investments, employment, growth and, thereby, public revenue, fiscal reform will lead to higher deficits.

5. EU policy framework

The EU policy stance is certainly a very important constraint on economic development in both the EU and eurozone member states, as well as in the Balkan countries whose economies are closely integrated with that of the EU. Given the manner in which EU policies have developed, the main characteristic is increasing pressure on fiscal consolidation supported by some monetary activism on the part of the European Central Bank (ECB). It is believed that fiscal commitment is essential to greater monetary support and to any further steps towards economic integration. This policy mix has been adopted following the sharp downturn in growth in mid-2011, and the escalation of the debt problem in a significant group of EU economies.

This mix of fiscal and monetary policy is geared towards stability, with growth to be reignited, it is expected, by supply-side policies. The latter are considered especially important for countries with significant external imbalances, i.e. practically all the countries in Southern and Southeast Europe. From the microeconomic point of view, the policy mix implies deregulation and increased competition which, in turn, should have some positive effect on growth and employment. In macroeconomic terms, however, it also implies that improvement in the corporate balance sheets is to be secured, in part at least, by shedding labour and thus improving productivity. Improved growth performance should be the consequence of increased competitiveness which, in turn, should lead to increased investment in exporting sectors.

This policy framework is basically a strategy for structural adjustment or restructuring. It assumes that the crisis has not led to a decline in aggregate demand or, if it has, the EU and euro frameworks are such that they do not allow for a general boost in demand, although individual countries that may have the fiscal space for such moves can engage in one or the other type of fiscal stimulus. In the final analysis, it is really the accumulated imbalances that need to be corrected by supply-side oriented restructuring and an appropriate change in relative prices.

The strategy is thus based on fiscal consolidation, with an expectation that household savings and corporate investments would be increasing, as well as a process of rebalancing of the tradable and non-tradable sectors being initiated. The risks are - and there is increasing evidence that these are materialising in quite a few of the EU economies - that the prerequisites for the strategy’s success are not met in which case stability, if achieved, will be coupled with stagnant or slow growing economies. It would also amount to a significant change in the growth model on which the common market and currency union are predicated. The original idea was that foreign investments would encourage converging growth, which would ultimately sustain the initially widening imbalances and eventually lead to their elimination. The new strategy, however, would require that the countries in Southern Europe shift towards adopting a mercantilist policy, i.e. aim to close the deficit on the external account and repay foreign debt. It is questionable whether a policy turnaround of that scope would support the existing or evolving overall institutional and policy framework in the EU, let alone being helped by the same.

Perhaps the most important observation is that this strategy of increased fiscal austerity and structural reforms does categorize EU member and candidate states less along the lines of a West-East divide, but more along a North-South divide. It is not a question of the old versus new member states or possibly both parties versus the candidate countries, but rather one of the industrialized North versus the non-competitive South. Moreover, it is not a split between developed and converging countries, but rather one between growing and diverging (or 'laggard') countries. The new EU and euro policy framework may well lead to a strengthening of this new divide.

Summary

- The 2008-2013 economic crisis bears all the familiar hallmarks of crises that are linked to the financial, debt-related and structural aspects of current accounts crises; they have lasting level effects and hence a proper recovery can be very protracted;
- The EU economic policy stance which the countries in EU South and in the CESEE region also follow to a large extent, is geared towards the revival of external demand. As regards internal demand, household consumption will only grow slowly, if at all, and public consumption is set to decline. Private investment will have a hard time picking up, if credit remains low and external demand subdued. If the expectation is that structural reforms will spur investments and exports, it may take some time before that actually happens, further to which it could well lead to an ever-widening divide between the various European regions. In all likelihood, the main effect of the financial crisis is that it saps private investment owing to the problems associated with settling liquidity and solvency problems in the corporate sector.
- The key observation on fiscal policy is that the fiscal stance adopted has been rather restrictive. This will be followed by even more fiscal austerity measures, as it proves increasingly costly to finance fiscal deficits and refinance public debts.

6. The 'manufacturing imperative for Europe's EME's

In the literature much has been written about the role of manufacturing at various stages of development and the process of tertiarisation in the course of development. Evidence has been found that the manufacturing share in an economy increases up to a certain level of income per head and then is expected to stabilise and subsequently to fall (see e.g. Syrquin, 2008). However, other factors than simply real income levels affect the share of the manufacturing sector in different economies such as specialisation in foreign trade, current account imbalances, etc.

Figure 10 depicts the share of manufacturing in GDP in comparison to the GDP per capita in the year 2005 for the EU member countries plus Southeast Europe (SEE). The general tendency of the share of manufacturing declining with rising real incomes in this group of economies is confirmed (see the downward sloping regression line). However, what we want to focus on is the segmentation amongst the groups of economies in Europe's 'periphery': we can see that the group of Central European economies (Czech Republic, Slovakia, Slovenia, Hungary) and also Bulgaria, Romania and Lithuania (in the case of the latter this is due to its important petroleum refining sector) lie above the regression line, the other Baltic states (Estonia, Latvia), Croatia, Poland, and all the Southern cohesion countries (Portugal, Greece, Spain, Cyprus) lie below the regression line. Also all SEE economies are located well below, with Albania and Montenegro having especially small manufacturing shares. Only Serbia is close to the regression line.

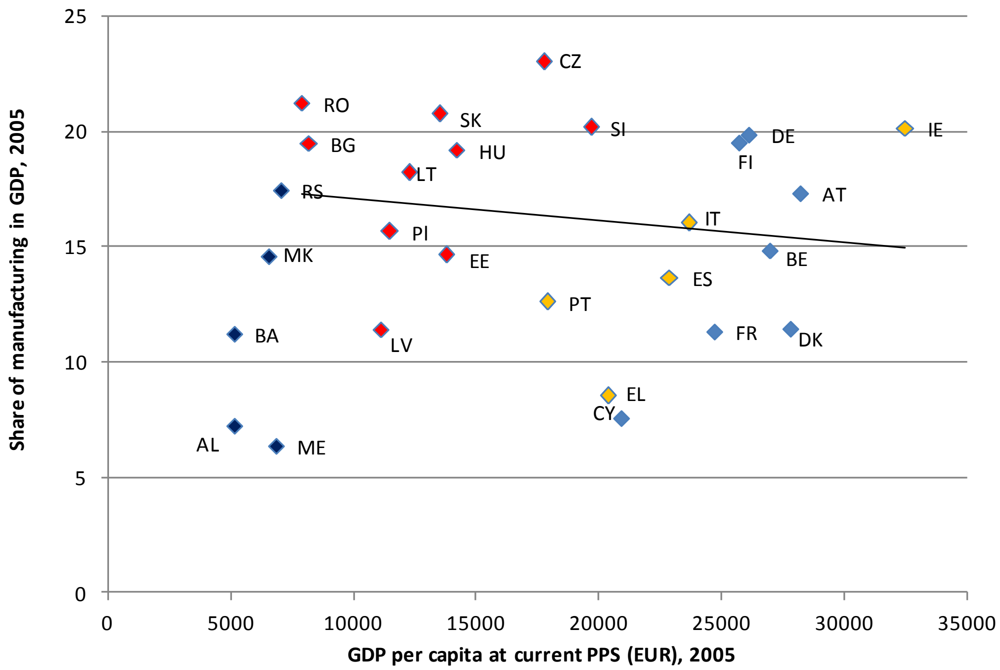
Furthermore, amongst the advanced European economies we can distinguish two groups of economies as well: Ireland, Germany, Austria, Finland and Sweden with a very strong position of the manufacturing sector and France, Denmark and the Netherlands with a weak manufacturing share; Italy and Belgium lie very close to the regression line.

The next issue we want to point out is the relationship between longer-term trade balances and share of the manufacturing sector. Figure 11 presents two regression lines, one showing the relationship between trade balances and the share of manufacturing for the lower- and medium-income economies, and another showing this relationship for the more advanced EU member countries. We can see that the regression line for the less advanced economies is shifted upwards compared to that for the more advanced economies; this means that lower income economies require a higher share of manufacturing to achieve the same balance in the trade accounts (something like a 5-7 percentage point higher share of the manufacturing sector). The reason is that more advanced economies can compensate more easily for a smaller manufacturing sector by exporting tradable services than lower- and medium-income economies can. The group of economies which had relatively persistent and high deficits (export/import ratios below 95%) in the trade accounts in the pre-crisis period amongst the lower income economies includes the Baltic economies, Bulgaria, Romania and all the Southern cohesion economies. On the other hand, we can also see the relatively good performance of the Central European economies (Czech Republic, Hungary, Slovakia, Slovenia).

Figure 10

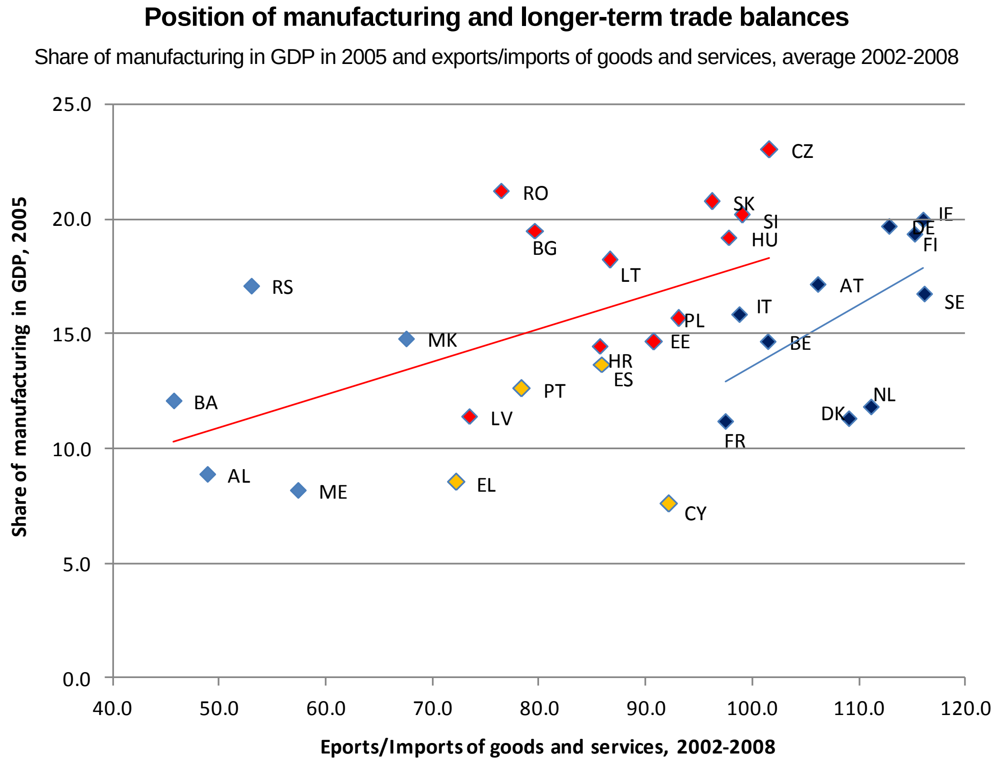
Importance of manufacturing in the economy

Share of manufacturing in GDP, 2005 and GDP per capita at current PPS (EUR), 2005



Source: Eurostat and wiiw own calculations.

Figure 11



Source: Eurostat and wiiw own calculations.

What has been established so far is the following:

Amongst the low- and medium-income economies of Europe ('Europe's periphery') quite distinct groups of economies can be distinguished: the group of Central European economies (Czech Republic, Hungary, Slovakia, Slovenia) as well as Bulgaria and Romania which show a high share of the manufacturing sector in GDP; and the rest of the low-/medium-income economies with shares which were rather below what one would expect at that level of income. Furthermore, in the pre-crisis period the Central European economies also showed a healthy longer-term trade balance, while Bulgaria, Romania, Croatia, the Baltics and the Southern cohesion countries (Greece, Portugal, Spain, Cyprus) showed rather high net import positions on the external trade accounts. With the exceptions of Bulgaria, Romania and Lithuania these economies also had a small share of manufacturing in GDP which we have shown to be correlated with weak trade accounts. This group of economies was thus particularly vulnerable to much more cautious capital inflows (or even capital flow reversals) which accompanied the onset of the financial crisis which took its starting point in the years 2008 and 2009.

Further evidence with regard to differentiated developments is given in Table 2 which shows changes in the shares of different EU member states in extra-EU exports (we make use here of recent research results using trade in value added figures derived from the WIOD database; see Stoellinger et al, 20013).

Table 2: Global market shares (in %) and changes in global market shares (in p.p.) in manufacturing value added exports of EU Member States, 1995-2011. Extra-EU exports only

	market share 1995	share in extra-EU exports 1995	change in market share 1995-2000	change in market share 2000-2005	change in market share 2005-2008	change in market share 2008-2011	market share 2011	share in extra-EU exports 2011	change in market share 1995-2011 (in p.p.)	change in market share 1995-2011 (in %)	change in share in extra-EU exports 1995-2011 (in p.p.)
Benelux	1.92	7.20	-0.47	0.01	-0.09	-0.10	1.28	6.17	-0.64	-33.57	-1.03
Germany & Austria	9.25	34.67	-2.04	1.26	0.14	-0.72	7.90	38.20	-1.35	-14.61	3.53
CEEC-5	0.58	2.18	0.01	0.54	0.29	-0.17	1.25	6.06	0.67	115.29	3.88
France & Italy	6.70	25.09	-1.09	-0.11	-0.13	-0.99	4.38	21.19	-2.31	-34.53	-3.90
Nordic Countries	2.45	9.20	-0.41	-0.03	-0.14	-0.35	1.52	7.36	-0.93	-37.99	-1.84
Baltic Countries	0.05	0.17	0.00	0.04	0.02	-0.02	0.09	0.42	0.04	90.95	0.25
Bulgaria & Romania	0.14	0.51	-0.04	0.08	0.08	-0.04	0.22	1.07	0.09	64.00	0.56
United Kingdom	3.99	14.95	-0.31	-0.78	-0.39	-0.35	2.16	10.44	-1.83	-45.84	-4.50
Ireland	0.39	1.47	0.31	-0.04	-0.10	0.06	0.63	3.03	0.24	60.37	1.57
Southern Europe	1.22	4.58	-0.07	0.17	0.08	-0.16	1.25	6.06	0.03	2.54	1.48
		0.00						0.00			
EU-27	**26.69**	**100.00**	**-4.09**	**1.14**	**-0.22**	**-2.84**	**20.68**	**100.00**	**-6.00**	**-22.50**	**0.00**

Note*:* Industry classification based on NACE Rev. 1.1. CEEC-5=Poland, Czech Republic, Slovakia, Slovenia, Hungary; Nordic Countries=Denmark, Finland, Sweden; Southern Europe=Greece, Spain, Portugal, Cyprus, Malta. Global market shares in value added exports and changes thereof exclude intra-EU value added exports

Source: WIOD, wiiw calculations.

Note: This table is from Stoellinger et al, 2013, Table 2.3, p.13.

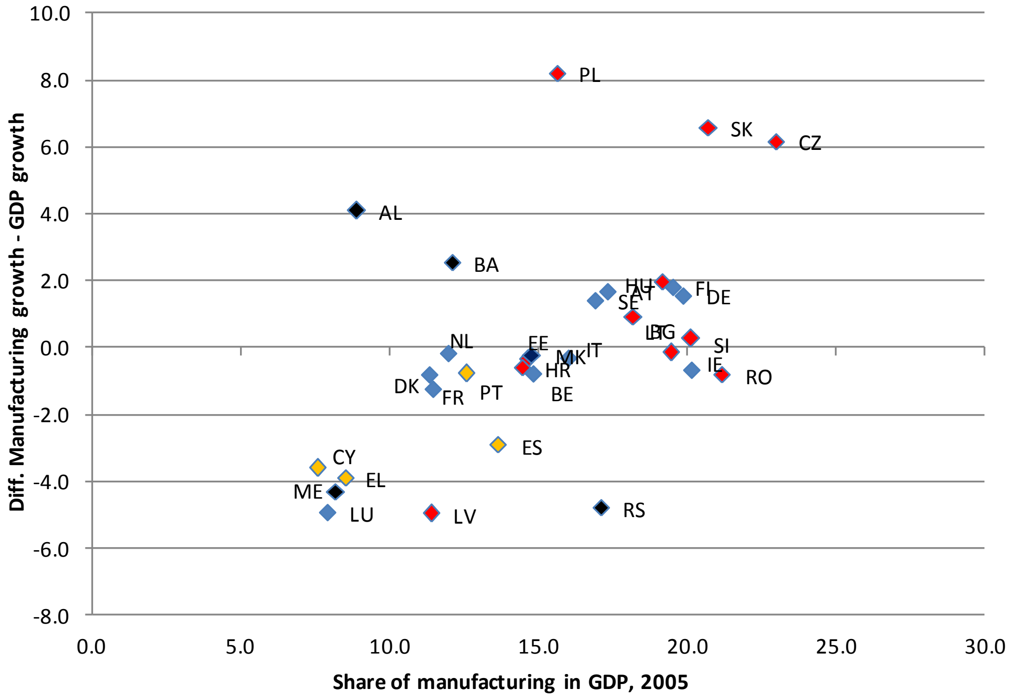
What we can see from Table 2 is a picture of differentiated development of manufacturing export capacities across the European economies. With regard to manufacturing we can observe a strong process of agglomeration of manufacturing export capacities in a Central European manufacturing belt which includes Germany, Austria on the one hand and Central Eastern Europe (the CE-5) on the other hand.

Figure 12 depicts, furthermore, developments in the share of manufacturing in the period prior to the crisis (2002-2008) and what we see is generally a picture of 'divergence', i.e. countries in Europe's periphery which already had a low share in manufacturing experienced lower growth rates in the manufacturing sector than in the economy as a whole, while countries with a strong manufacturing sector (the Central European economies) also experienced a positive growth differential of the manufacturing sector relative to the economy as a whole. Hence the relative weaknesses and strengths of the tradable sectors – here proxied by the manufacturing sector - in the two groups of economies became more pronounced. Bulgaria and Romania are somewhat different, in that they had a relatively strong share of manufacturing but experienced relatively weak manufacturing growth prior to the crisis (and also had quite strong deficits on the current account).

Figure 13 plots differential growth in manufacturing vs. the economy as a whole against pre-crisis export growth: again, we can see a picture of 'divergence', i.e. the economies with low export growth also experienced relatively low growth in manufacturing vs. the economy as a whole, which means that in these economies the economic structure turned further away from manufacturing which – as we argued – is for low- and medium- income economies the most essential part of the tradable sector and thus for potential export growth. On the other hand, the group of Central European economies which showed rather strong export growth prior to the crisis also experienced higher growth in manufacturing than in the economy as a whole, hence further strengthening the position of the tradable sector; for Slovenia growth is balanced and export growth rather moderate.

Figure 12

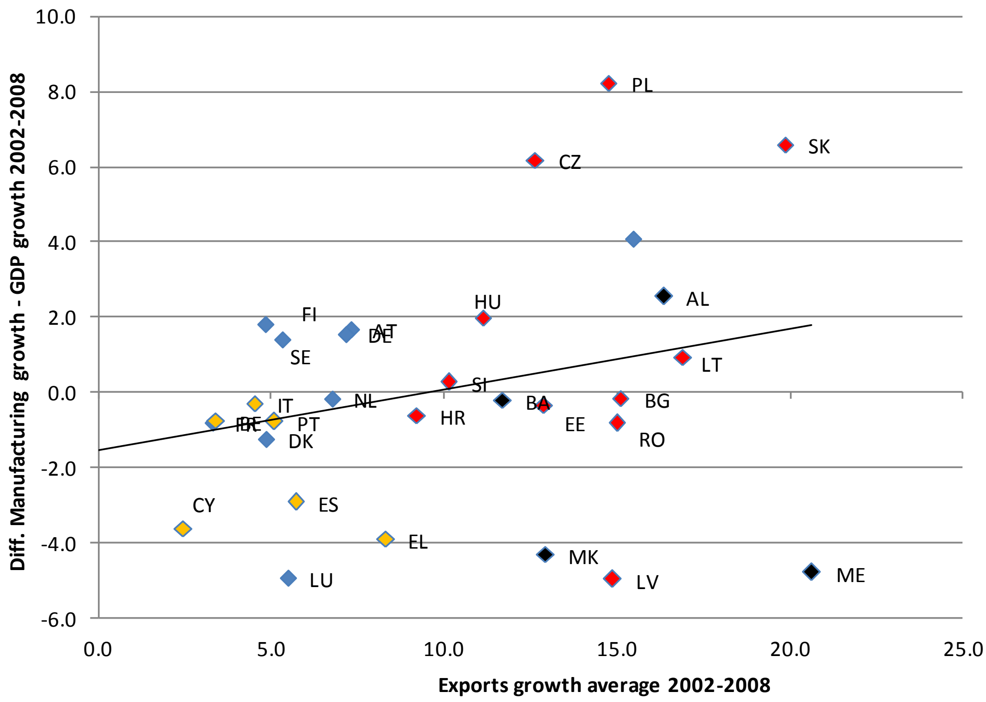
Differential growth manufacturing – total economy, 2002-2008 and share of manufacturing in GDP, 2005



Source: Eurostat and wiiw own calculations.

Figure 13

Differential growth manufacturing – total economy, 2002-2008 and export growth



Source: Eurostat and wiiw own calculations.

Summary

We have shown that amongst the lower- and medium-income economies which comprise the Southern cohesion countries (Cyprus, Greece, Portugal, Spain), the Central and East European new Member States (CE-NMS or NMS in short) and other Southeast European economies, different groups could be distinguished with regard to those which are characterised by a small share of the manufacturing sector pre-crisis and those economies (mostly the Central European NMS) which have built up a strong position in manufacturing. The manufacturing sector has been shown to be particularly important for lower- and medium-income countries (as compared to more advanced economies which can rely on a stronger contribution by the tradable services sector) to make sure an economy does not suffer from chronic longer-term trade imbalances. This provides a basis for a 'manufacturing imperative' for low- and medium-income countries in order to avoid a 'trade-balance constraint' on growth and catching-up in a post-crisis world when sustained current account disequilibria will no longer be financed as easily as prior to the recent crisis.

For the pre-crisis period we have also given evidence for 'structural divergence' in that countries which had a weak manufacturing sector were moving further away from manufacturing. This was not the case for the Central European countries which saw a strengthening - with the exception of Slovenia – of the position of the manufacturing sector. Hence we talked of 'vulnerability' (on the external accounts) and of 'distortions' in production structures getting entrenched in an important sub-group of ‘peripheral economies’. The overall economic geography of Europe is characterised by manufacturing capacities being concentrated in a Central European core (Germany, Austria, Switzerland on the one hand and CE-5 on the other hand) and – given the importance of manufacturing to avoid longer-term structural imbalances on the current account especially for lower- and medium-income economies – this creates a serious problem for a longer-term development perspective of large segments of ‘Europe’s periphery’.

7. Labour markets and political economy issues

In the countries of Southern and Eastern Europe, employment effects of the crisis have been very strong (see Fig. 14). Given that in most cases, employment rates, even in good times, tended to be low before the current crisis, the policy of internal devaluation, partly through labour lay-offs, is going to have significant social consequences. This comes on top of the direct effects of the policy of fiscal consolidation and the redistributive impacts of the burden of the crisis, which have significant social effects also in the better performing European countries as well. Furthermore, in an integrated Europe, distributional problems between countries can also come to a head that are hard to control.

This type of depressed labour market tends to have two social and political consequences. One is that in countries with stronger trade unions, it may prove difficult to implement an austerity policy in defiance of social resistance. However, in countries that are less organized along social lines, nationalist protection and disintegration policies may prove more influential. In both cases, structural adjustment policies relating to product and labour markets may prove unavailing.

The other effect is in the erosion of democracy. This can take on a number of forms that are all too familiar and well known from the history of democratic governments and their collapse both in Europe and elsewhere. This may well compound the problem in the EU context, given the additional issue of national sovereignty and the perception that decisions are being imposed from without.

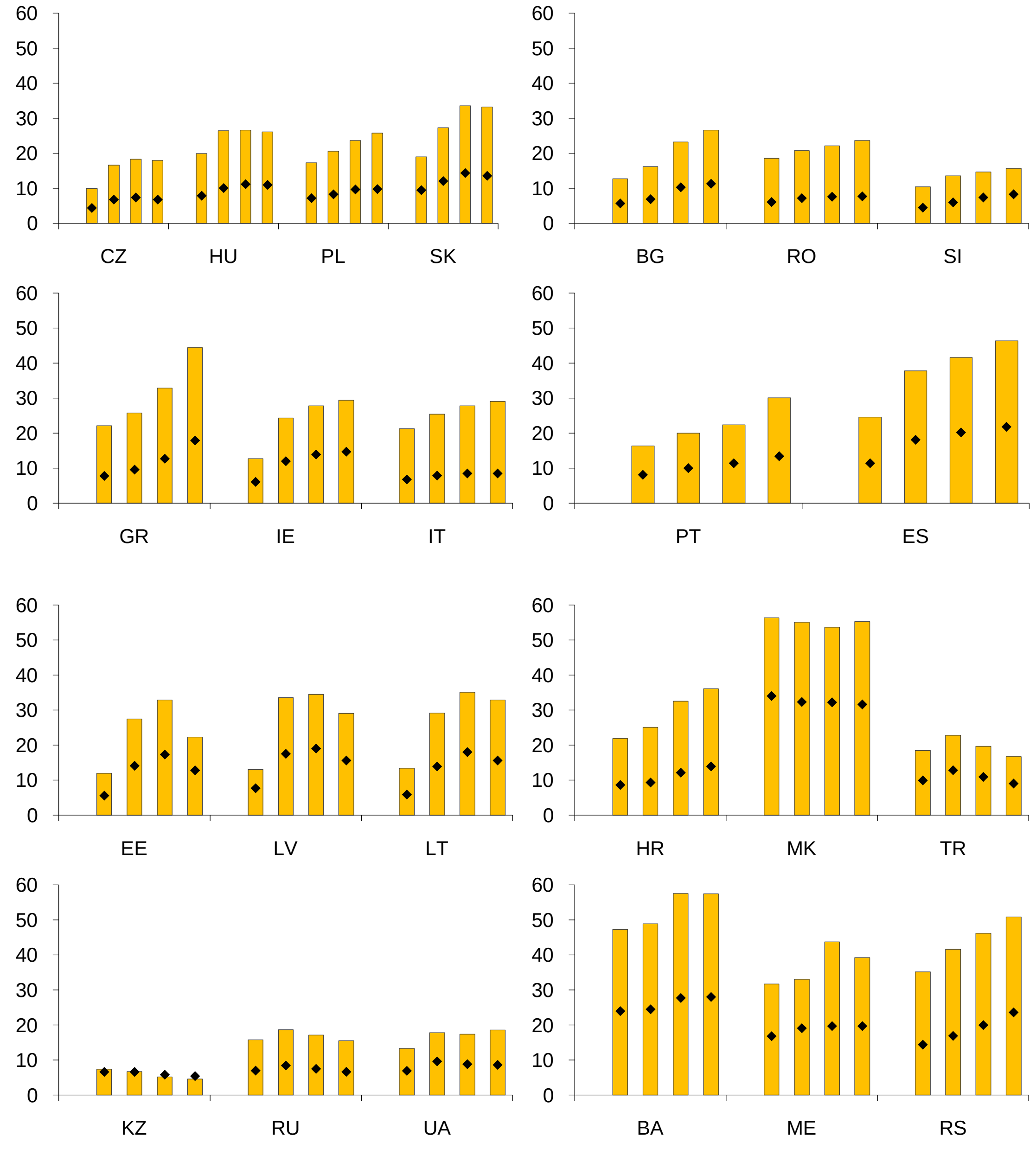
Both of these social and political developments may lead to repudiation of the EU and eurozone policy mix. For instance, they may lead to defaults and adverse political developments. In all likelihood, a prolonged period of stagnation or low growth will lead to significant social and political changes in the divergent countries and, in turn, to instability in the EU and the eurozone.

Figure 14

Total and youth unemployment rates

2008, 2009, 2010, 2011

15-24 years 15-64 years



Remark: Unemployment rate in KZ refers to 15+, in Russia 15-72.

Source: Eurostat, national statistics.

7. Summary and conclusions

The present paper analysed developments in the (rather wide) spectrum of lower- and medium-income economies in Europe in relation to; (i) recent developments in the EU, particularly the Union's evolving policy framework; (ii) the specific 'North-South' tensions which have been building up in the course of the current economic crisis.

We tried to identify differentiated groups of economies amongst the low- and medium income economies (comprising both CESEE and GIPS economies) with regard to their developments in the current context of the European economic and policy crisis. That comprehensive comparative perspective was chosen so as to focus the analysis on the theme of the *New South-North Divide in Europe*.

This stands in sharp contrast to the perspective widely subscribed to from the mid-1990s on. From that time, the conventional wisdom was that Europe displayed clear signs of 'convergence' at the inter-country level, with low-income economies growing at a faster rate than rich economies. Broadly convincing evidence was found of narrowing inter-country income gaps.

The impact of the financial and economic crisis, not only in its narrow economic dimension but also in its broad political and social dimension, as well as in the ways in which European policy frameworks are currently evolving, has since cast serious doubt on the *European integration model of convergence*. The convergence model was based on the enormous potential that transition and integration would provide to low-income and transition economies and the benefit they would gain from technology transfer, as well as organizational, institutional and behavioural emulation. If all that were properly applied, those economies would also benefit from a net inflow of capital and enjoy funding at relatively cheap rates.

Following the impact of the crisis, the differentiating features of the pre-crisis catching-up and integration processes have been subject to more critical scrutiny. Some of those features (such as the characteristics of capital inflows and the availability of cheap finance), it has transpired, are highly problematic. Furthermore, analysis of development processes prior and following the outbreak of the crisis leads to a closer consideration of segmentation processes with regard to the performance and prospects of different groups of 'emerging economies' in Europe. They also raise the question whether the crisis marks a watershed with regard to prospects of a continuing 'convergence' process for the integrating lower-income European economies - as a group or for sub-sets thereof - over the longer term.

In a nutshell, the analysis in this paper draws the following conclusions:

- Within the context of the global economy and in comparison with other world regions, Europe's economic prospects over the coming decade appear the most daunting. Despite the crisis having started in the United States, its negative impact seems to be most lasting and pronounced in Europe;

- The EU is continuously developing its policy framework in response to the crisis. This has had an impact on both policy formulation and current developments in the various groups of low- and medium-income economies in Europe.
- The most distinctive differentiating feature among the emerging European economies that the analysis singled out was the pre-crisis build-up of (structural) current account disequilibria, associated developments in external debt and the debt positions particularly in the private sector (households and corporations).
- A sub-group of three Central European economies (Czech Republic, Poland and Slovakia) was found to have been scarcely affected by the debt build-up. The countries concerned showed little sign of competitiveness problems in their tradable sectors (which also includes Hungary), while the GIPS and most of the countries in Southeast Europe and the Baltic states developed unsustainable disequilibria on both those fronts.
- The previous build-up of disequilibria and debt accounts for most of the differentiated impact when the crisis hit. This held particularly true for developments over the period 2008-2011.
- As to the medium-term prospects, the situation looks rather grim for emerging Europe. With growth having slowed down significantly in the advanced parts of Europe, pursuit of an 'export-led' strategy (as pursued over the biennium 2010 - 2011) will prove problematic, while the greater reliance on domestic demand factors that the situation demands will also face severe problems. The analysis assessed the likely recovery prospects of corporate investment activities and household consumption expenditures. For both items inherited debt levels and deleveraging processes, as well as income and sales prospects are seen to be major determinants (all of which, in turn, affect financing conditions). Country groups differ in those respects, just as they differ in the build-up of public debt in the course of the crisis.
- Important groups of economies, such as the GIPS countries and most of the countries of Southeast Europe, have come up against a vicious circle: high initial debt levels and dim growth prospects translate into greater doubts about sustainability and hence into higher interest rates that impose a constraint on investment and encourage corporate and household deleveraging (further compounded by the weak state of the banking system). This dampens consumption expenditures, and leads to cutbacks in employment (and wages) which, in turn, lower household incomes and domestic sales prospects. The induced lower growth prospects, in turn, raise concerns over debt sustainability and the need to keep interest rates high.
- Prospects of offsetting factors such as a potential rise in competitiveness and hence export-led recovery are dim in the current context of low growth in the European economy as a whole. One can also show that in the latter respect the countries of Southern and Southeastern Europe suffer further differentiating disadvantages as their main export markets are growing at lower rates than those of the other economies in Europe (hence differentiated inter-country trade multipliers between Europe's 'North' and 'South').

The paper thus points towards a sustained period in which the convergence processes which characterised the decade prior to the current financial and economic crisis will either not proceed or proceed at a much reduced pace. Deleveraging processes, difficult moves to deal with the high debt positions of the private sector, the weak banking system and the feedback effects on sovereign debt will characterise many of the lower-income economies in Europe. The driving force of foreign direct investment and the build-up of cross-border production networks will also show weaker momentum compared to before the crisis. Adjustment processes to deal with the pre-crisis neglect of building-up a viable tradable sector and sufficient and modernising export capacities will have to gain priority and the use of different sets of policy instruments (particularly in the areas of training, labour market, industrial and regional policies) will have to be strengthened.

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