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Center on Global Economic Governance

Europe in a post-crisis world

Consequences for Europe's Periphery and the European Neighborhood

Jan Švejnar

Columbia University & CERGE-EI

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GOVERNANCE

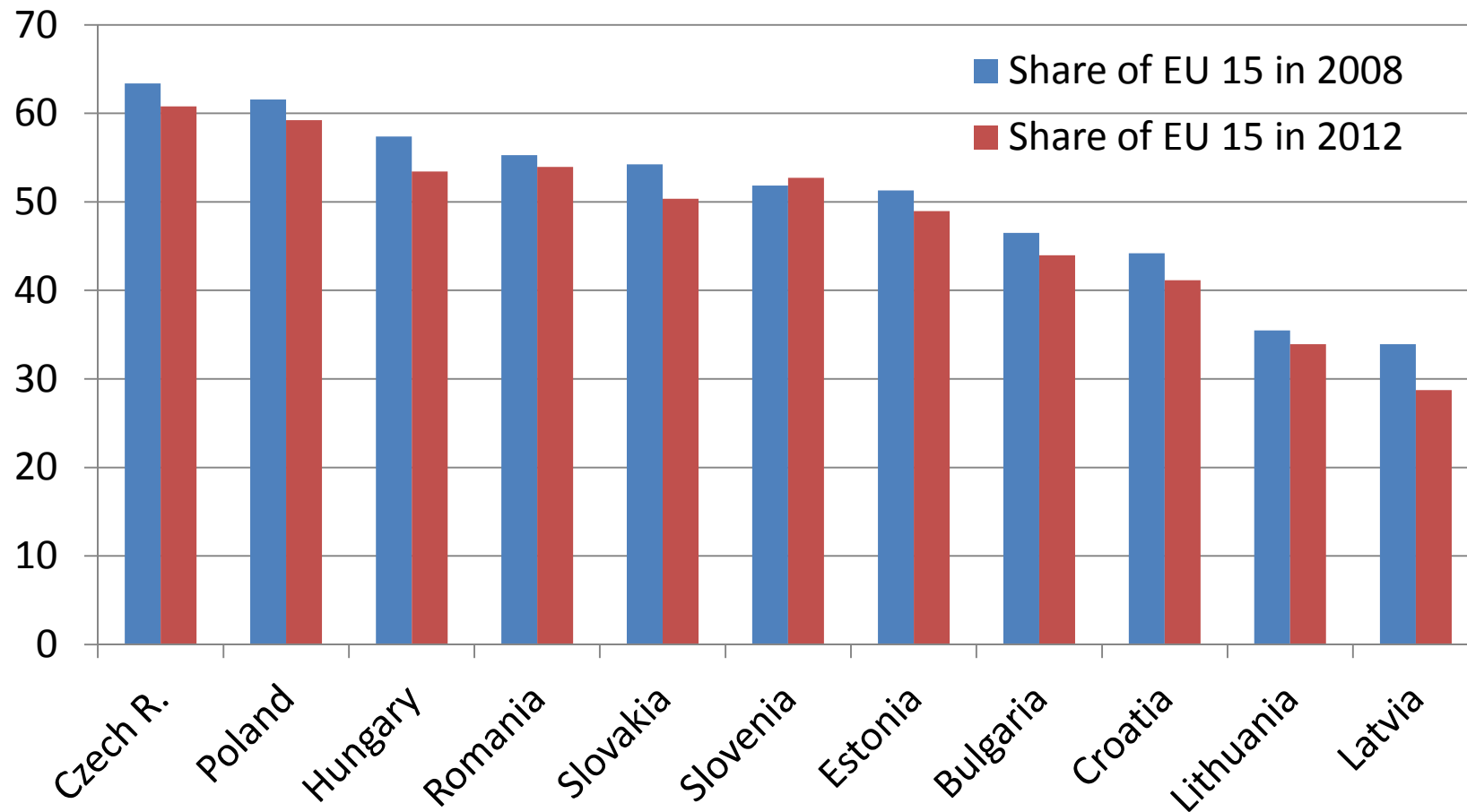
Key Issues

- Linkages to EU core and EU neighborhood
- Trade, Investment and Performance of CEECs
- Short-run v. Long-run Issues

EU and CEECs Linkages

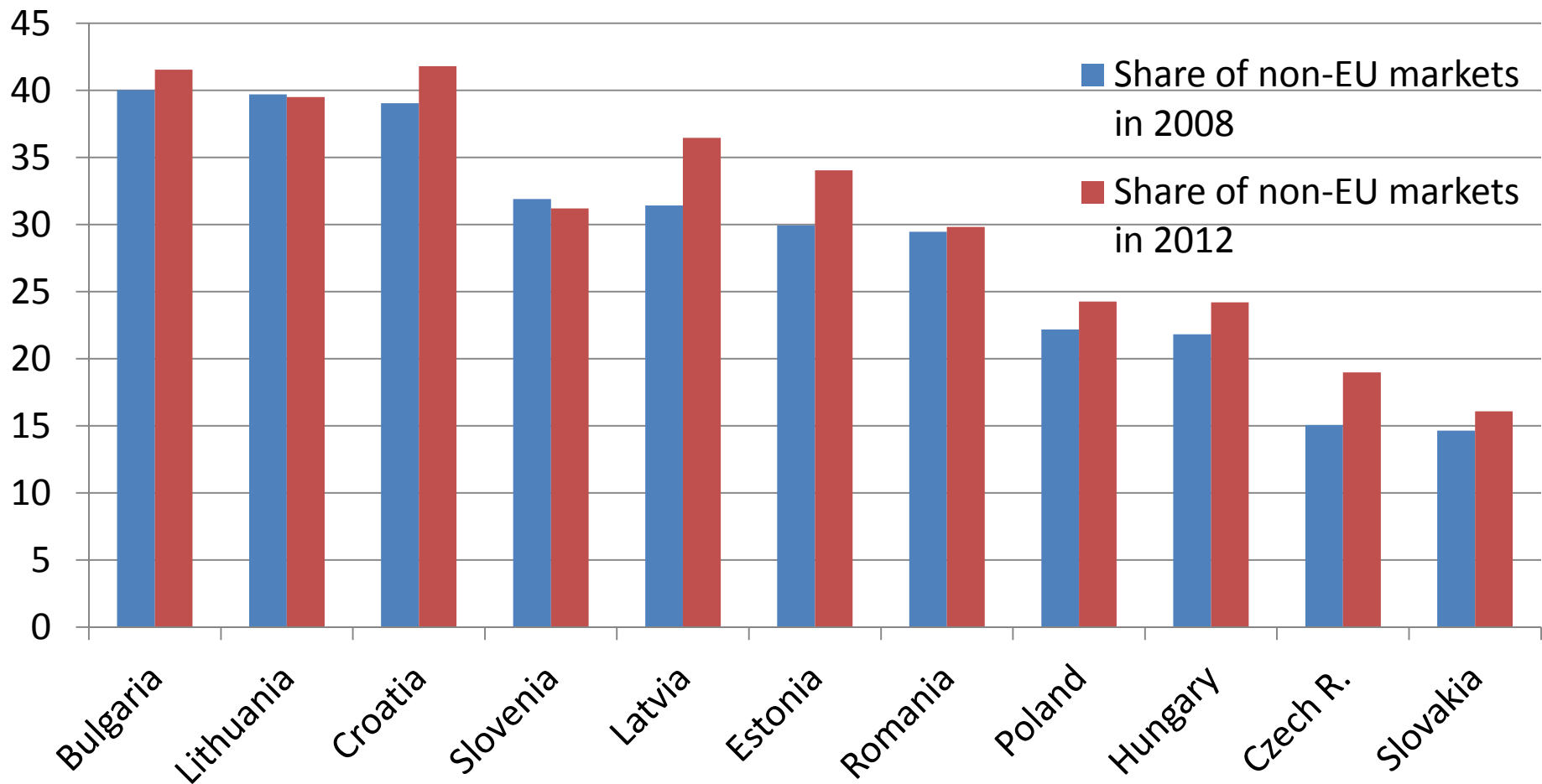
- Trade and Investment -- EU15/EMU main partner
- EU15/EMU plays role of a quasi-regulator
- EU perceived as counterweight to Russia

Economic Linkages with EU Core: Trade



Source: Eurostat, COMEXT

Trade with non-EU Markets



Source: Eurostat, COMEXT

Trade Linkage Trap: Effects of EU Woes

- Weak import demand in EU => problems for export oriented CEECs
 - Difficult to increase market share in EU countries
 - Hard to redirect trade to non-EU markets
 - Gradually takes place, but
 - Dependence on EU is natural (gravity relationship) and not easy to change

Changes in Financial Linkages

- 2008/2009: capital inflows to region dropped
- Capital inflow decline resumed in mid-2011
 - Market sentiment due to Euro crisis
 - Lackluster performance of many CEECs
 - Effects of regulation (Austria, 2011)
 - Changes in policies of parent companies
 - Domestic political instability in some CEECs

Depth of the Fall during the First Stage

Lowest quarterly GDP (s.a.) 2009-2011 in comparison with aver. quart GDP in 2008

Country	Max Decline (relative to average quarter in 2008)	Timing of Trough	Average rate of Recovery (2013q2/trough -annualized)
Poland	0.2	No decline	xxx
Czech Republic	-4.8	2009Q1	0.4%
Slovakia	-6.9	2009Q1	2.9%
Hungary	-7.3	2009Q3	0.5%
Bulgaria	-7.4	2009Q4	1.5%
Romania	-8.2	2010Q3	1.8%
Slovenia	-8.4	2009Q4	-0.6%
Lithuania	-15.3	2009Q4	4.4%
Estonia	-16.0	2009Q3	5.0%
Latvia	-20.9	2009Q3	4.4%
Croatia	More or less continuous decline		

Calculations based on Eurostat data

Unemployment during the Crisis

- Initially extreme differentiation (as with GDP)
 - Gradual and mild increase in Poland
 - Steep increase from 6.5% (early 2008) to 17.4% (April 2009) and eventually 21.3 (Jan 2010) in Latvia
- Baltic countries -- deepest initial drop in GDP and highest rise in unemployment, recently faster reduction of unemployment
 - Estonia reduced unemployment from 19.2% (April 2010) down to 7.9% (July 2013)

Hidden Risks in the Financial Sector?

Bank nonperforming loans to total gross loans (%)

	2006	2007	2008	2009	2010	2011	2012
Lithuania	1	1	4.6	19.3	19.7	16.3	18
Bulgaria	2.2	2.1	2.5	6.4	11.9	14.9	16.9
Romania	1.8	2.6	2.8	7.9	11.9	14.3	16.8
Hungary	2.6	2.3	3	6.7	9.8	13.4	15.8
Croatia	5.2	4.8	4.9	7.7	11.1	12.3	13.2
Slovenia	2.5	1.8	4.2	5.8	8.2	11.8	13.2
Latvia	0.5	0.8	2.1	14.3	15.9	13.9	11
Poland	7.4	5.2	4.4	7.9	8.8	8.2	8.4
Slovak Republic	3.2	2.5	3.2	5.3	5.8	5.6	5.3
Czech Republic	3.6	2.4	2.8	4.6	5.4	5.2	5.1
Estonia	0.2	0.5	1.9	5.2	5.4	4.1	3.7

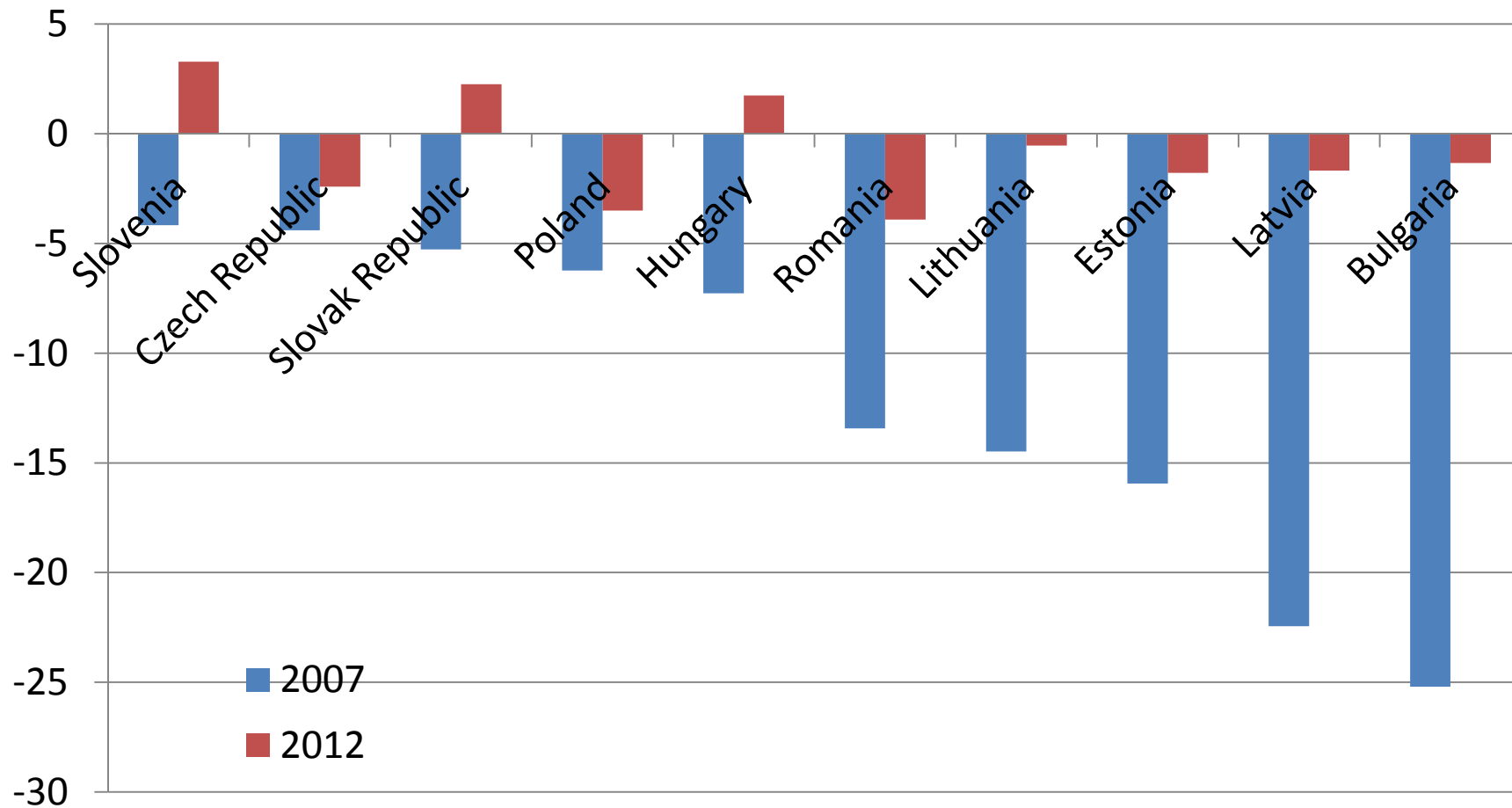
Source of data: World Bank

Financial Sector

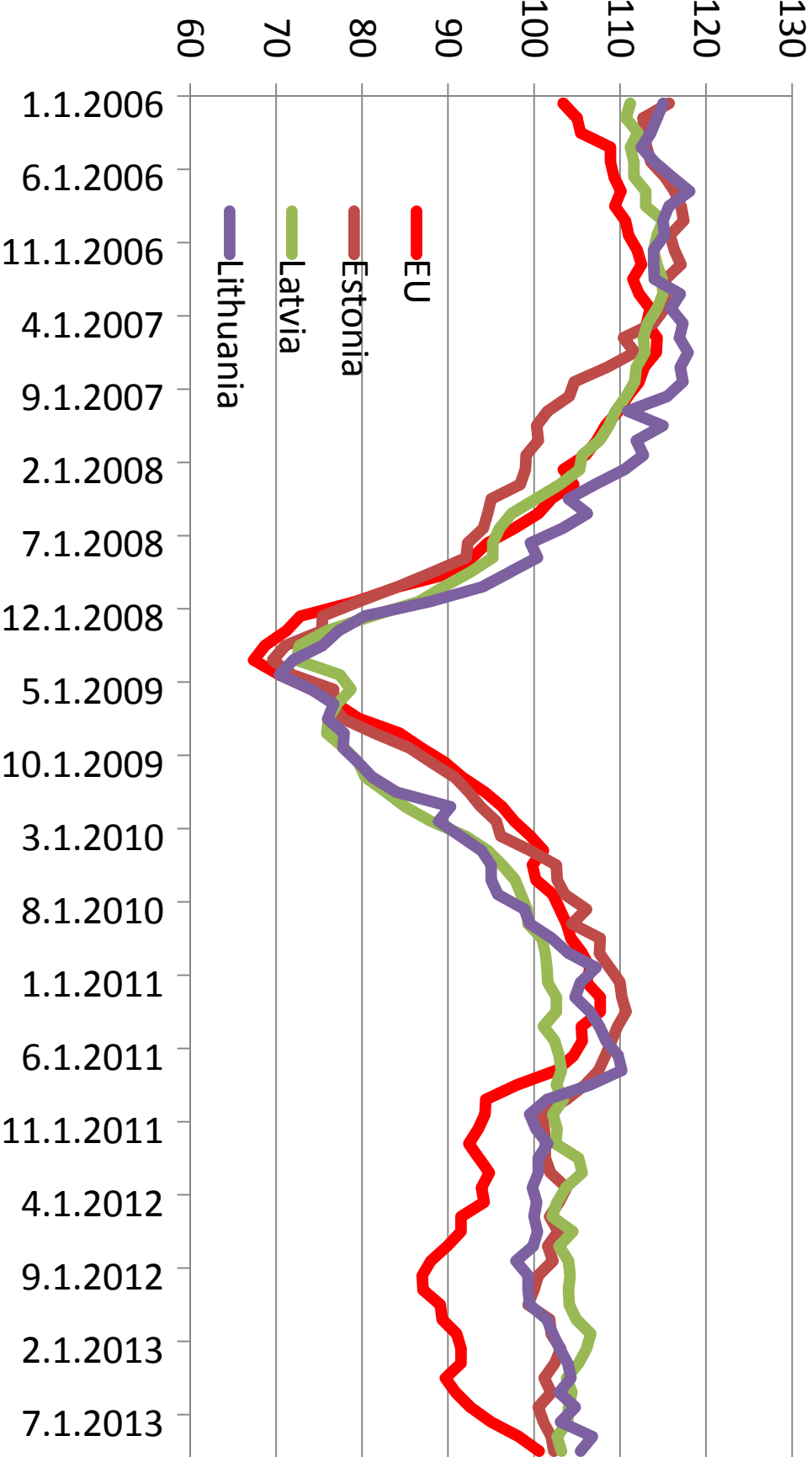
- Healthy in some countries (Czech Rep.)
- Concern in others – Lithuania, Slovenia

Shifts in External Financing Needs

Current Accounts in 2007 and 2012 (% of GDP)

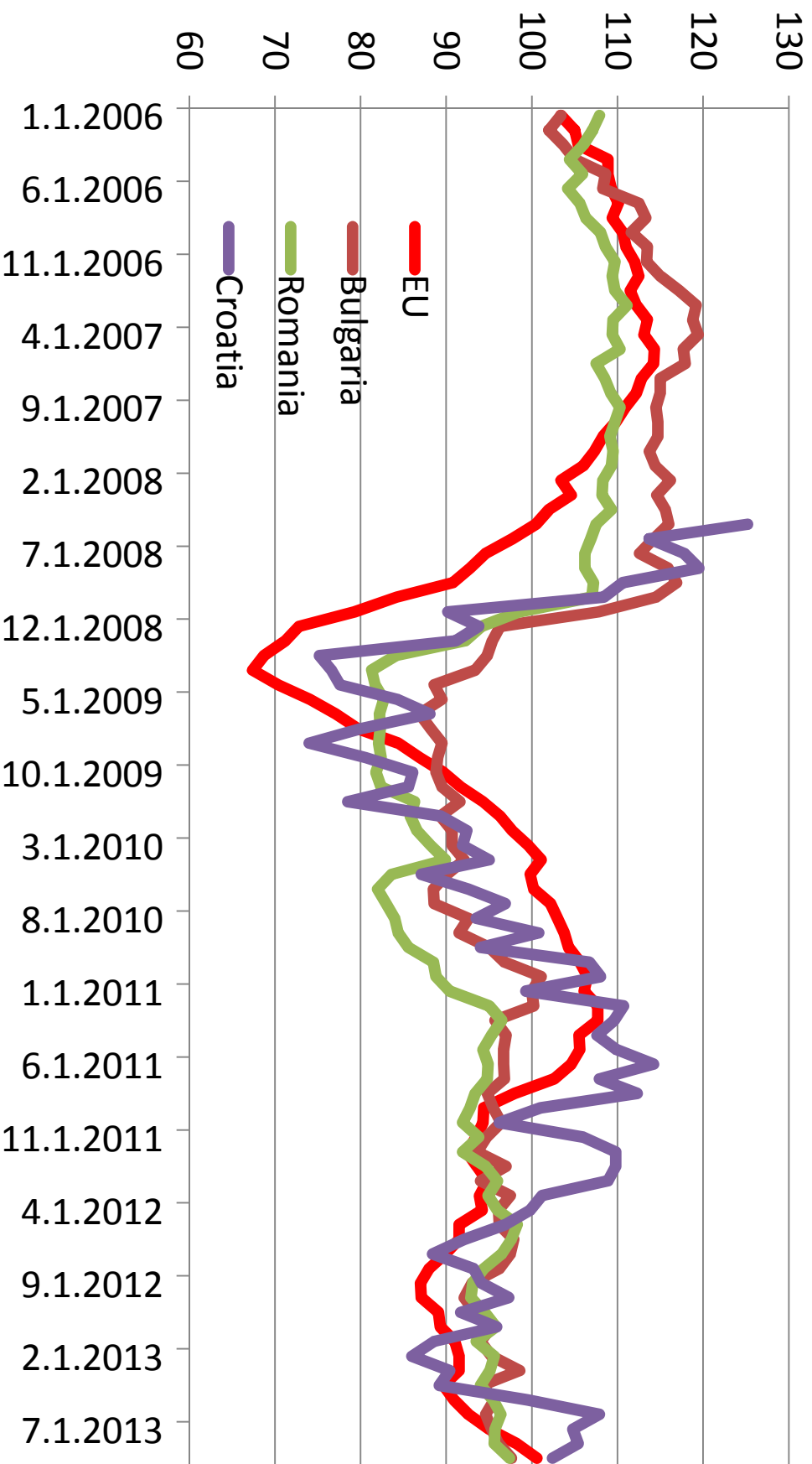


Economic Sentiment Indicator: Baltic Countries



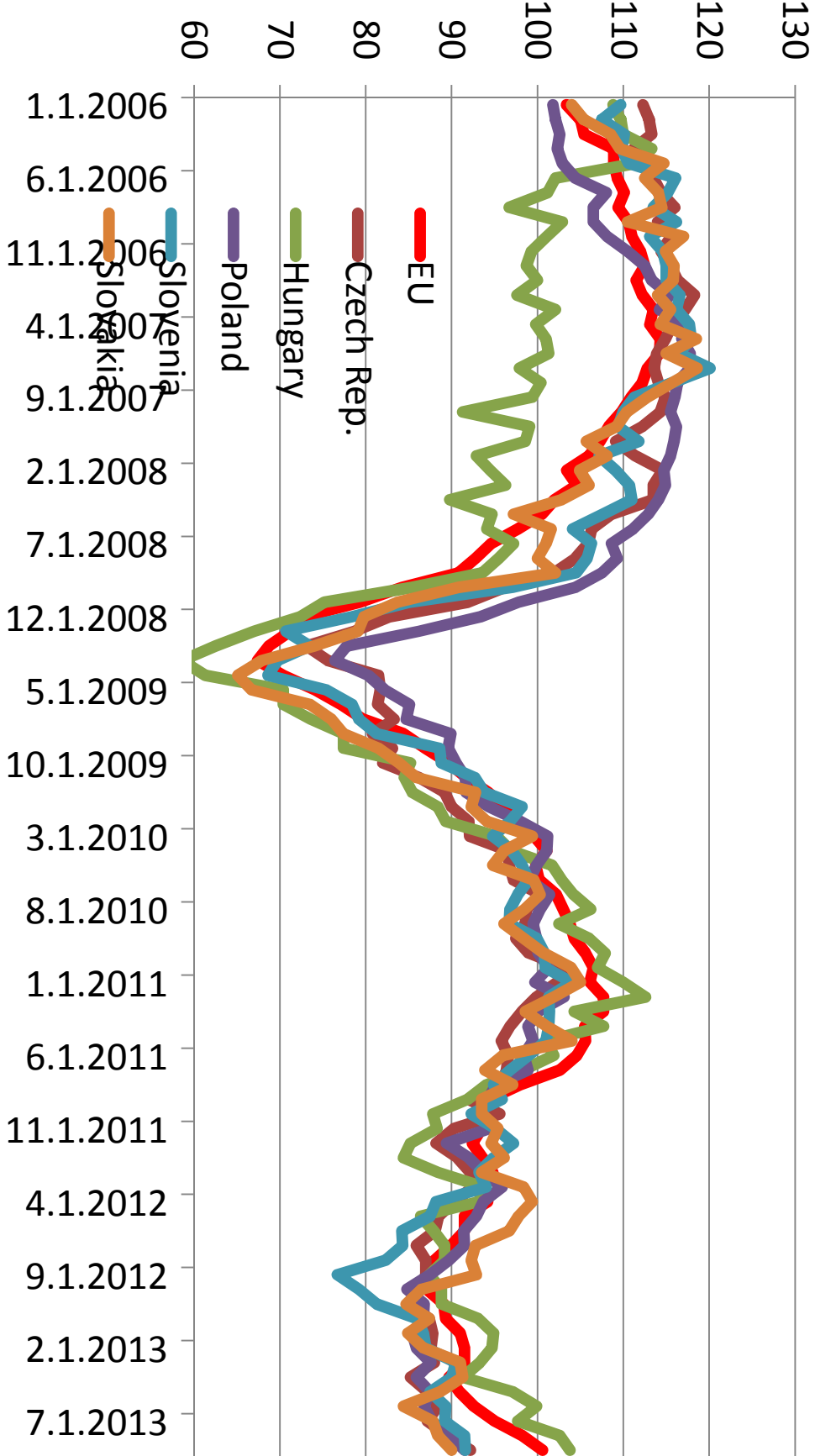
Source: Eurostat

Economic Sentiment Indicator: Poorest Members



Source: Eurostat

Economic Sentiment Indicator: Visegrad + Slovenia



Source: Eurostat

IMF Forecast for CEE Countries

	Real GDP		Inflation (period average)		Unemployment rate	
	2013	2014	2013	2014	2013	2014
Bulgaria	0.5	1.6	1.4	1.5	12.4	11.4
Czech R.	-0.4	1.5	1.8	1.8	7.4	7.5
Estonia	1.5	2.5	3.5	2.8	8.3	7.0
Hungary	0.2	1.3	2.3	3.0	11.3	11.1
Latvia	4.0	4.2	0.7	2.1	11.9	10.7
Lithuania	3.4	3.4	1.3	2.1	11.8	11.0
Poland	1.3	2.4	1.4	1.9	10.9	11.0
Romania	2.0	2.2	4.5	2.8	7.1	7.1
Slovenia	-2.6	-1.4	2.3	1.8	10.3	10.9
Slovakia	0.8	2.3	1.7	2.0	14.4	14.4

Source: IMF WEO Database (October 2013)

Growth and Stability

- CEECs need growth for stability and convergence, but
- their small size and export dependence on EU make this goal hard to reach
- => possibility of banking crises and political instability
- Reality is sobering:
 - Weak recoveries or second round of recessions
 - Not only cyclical effects but also lower growth of potential output (IMF, EREO)

Growth Accounting Perspective

- Differences in GDP per capita between EU-core and CEECs due to:
 - Lower per-capita stock
 - Need investment
 - Lower TFP
 - Need better institutions and incentives
 - Lower labor force participation rates + high structural unemployment
 - Need to deal with skills-mismatches and incentives

Growth Model of the CEE Countries?

- Original growth engine of CEECs
 - FDI combined with local labor => exports
 - Local R&D less important
 - Non-EU markets mainly accessed via parent-companies (or via esp. German trade partners)
 - Without this engine -- hard to achieve fast growth

Growth Model: Current Reality

- Comparative advantage of CEE countries
 - Location (location rent – esp. Czech economy)
 - EU membership
 - Lower cost of production than “old” EU
 - Reasonably skilled labor
- Questions:
 - Is this “growth engine” permanently weakened?
 - Is there an alternative model?

Outward/Export Model: How to Continue?

- Pressure for higher efficiency
 - Fight against corruption
 - Reforms of financial systems
- Insistence on multilateral (inter-regional) trade system?

Alternative Models of Growth?

1. Investment: Volume and sources

- Do CEECs need high inflow of FDI to sustain growth?
 - Czech R. used to have the highest inflow of FDI per capita but it was not the fastest growing country
 - Can one be more efficient and achieve higher K/L by relying on domestic savings?
- If need FDI, will CEE remain attractive for investors?
- Are there alternative sources of investment?
 - Russia (security and strategic issues), China, US, Japan?

2. External demand: Export markets

- Can CEE find markets in dynamic parts of the world
 - China, Russia,....?
 - What are the chances for success?

Future Role of CEECs: Scenarios

- **Stable developed members of EU**
 - EU/EMU survives and CEECs accelerate their convergence
- **Poor periphery of the EU**
 - EU/EMU survives but CEECs struggle with corruption and inefficiency
- **Successful development alongside “Germany”**
 - Combination of weak EU/disintegrated EU and relatively successful domestic economic development
 - Relevant for Western CEECs
- **Unstable country in the Russian “zone of interest” or “buffer zone” between Germany and Russia**
 - Weak Europe
 - CEECs plagued by corruption and organized crime

Thank you for Attention!

Jan Švejnar

js4085@columbia.edu