Central and Eastern Europe: Coping with external headwinds

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Speakers
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Following the publication of the EU11Regular Economic Report, Peter C. Harrold and Gallina Andronova Vincelette visited Bruegel to present the recent economic developments in the 11 EU member and accession member states and their near-term outlook. This 26th edition of the report also featured a special section on the drivers of convergence in the region. EU11 comprises all the member states that joined the European Union in 2004 and 2007 (excluding Malta and Cyprus) and Croatia, who is expected to join in 2013.

Despite the global turmoil and weak global growth (dropping from 4.1% in 2010 to 2.7% end 2011[1]), EU11 countries as a group performed well in 2011. Economic growth reached 3.1% compared to 2% in 2010 and it was mainly driven by manufacturing. The recovery was however uneven in between the eleven countries, and high output levels in Poland, Slovak and Czech Republic compensated for more moderate growth rates in the eight other countries. Bold fiscal consolidations led to reductions in the average fiscal deficits.

The volatile economic environment also affected capital flows and the access to credits, albeit there has not been a quick deleveraging by foreign banks similar to what was observed in times of financial crisis in other emerging markets. Local deposits are now growing faster than credits and they have become the main source of financing. Both lower demand and supply of credits have driven down credit growth rates in the region and they are currently below pre-crisis levels. The monetary policy has remained accommodative and is recommended to remain accommodative throughout next year as well. The inflation in the eleven countries remained at an elevated level of around 4% in 2011, high commodity prices being the main explanation. Both exports and imports weakened in 2011, but the net contribution remained positive due to a greater decrease in imports and a drop in domestic demand. Overall, trade balances narrowed and current accounts improved in almost all of the EU11 countries. Reinvested earnings lay behind the recovery of foreign direct investments to the region.

Unemployment remained high throughout the region although employment modestly increased for the first time since 2008, in particular due to a creation of temporary and part-time positions. The most hardly hit by unemployment are the younger population and low-skilled workers. Unemployment

[1] 2011 estimations

together with declining vacancy rates have led to a downward pressure on wages. Labour market reforms are hence needed in order to create work incentives and to prevent additional brain drains. While the regulatory environment has improved in many aspects, several obstacles remain; one of which is the lack of innovation. Enhanced innovation would lead to increased growth in the medium- and long term. Education is another crucial long-term determinant of growth and that would allow the conversion of EU11 towards EU15. Investments in human capital would allow EU11 countries to upgrade their skills, reduce mismatches, develop their tertiary education and hence their exports of services.

With their close links to the euro area and the rest of the EU, EU11 countries are particular exposed to the economic climate in EU15 countries. An escalation of the euro area sovereign debt crisis, a further deleveraging by foreign banks or an extended recession in the euro area countries are risks that would hamper the future growth and the implementation of structural reforms in Central and Eastern Europe.

Event notes by Li Savelin