

# Macroeconomic Impacts of the Crisis on Central and Eastern Europe<sup>1</sup>

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## **Introduction**

This paper does not deal with long-term Kondratieff waves. Instead, it analyzes the impacts of the 2008–2009 global crisis on emerging economies in Central and Eastern Europe (CESEE: Bulgaria, the Czech Republic, Hungary, Estonia, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia) at both the macroeconomic and sectoral levels. It focuses on growth and economic convergence patterns during the last two decades in the region, discusses briefly some broader structural effects of the global crisis, and dwells on future growth and convergence prospects in view of existing economic policies. Relying on extensive comparative studies and empirical analysis conducted regularly at the Vienna Institute for International Economic studies (wiiw), the author underlines the diverging growth experiences and responses to the crisis by individual CESEE economies. Finally, the paper attempts to outline some key features of the post-crisis “new growth model,” which could be more sustainable and more resilient to external shocks.

The paper focuses on the most recent crisis—sometimes dubbed the global or financial crisis of 2008–2009 (although many parts of the world, in particular China, were not affected by this crisis). CESEE emerging markets were severely hit, yet this particular crisis was already the third to hit the region during the previous 25 years. As compared to the transitional recession of the early 1990s, which hit the whole CESEE region, and the financial crisis in 1998, which affected mostly Russia, the crisis of 2008–2009 was more serious, with tremors

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<sup>1</sup> This paper represents an amended version of author’s contribution to the volume by Havlik, P. and Iwasaki, I. (eds), “Economics of European Crises and Emerging Markets”, Palgrave Macmillan, 2017 (forthcoming).

from the crisis still being felt. At that time, only Poland (as well as Albania) in Europe was spared by the recession. In addition, there was also a “double-dip” recession in 2011–2012 in Western Europe that affected CESEE as well. The recently established Eurasian Economic Union (comprised of Belarus, Kazakhstan, Russia, Armenia, and Kyrgyzstan) and Ukraine were hit by the new crisis in 2014–2016, largely due to the collapse of oil prices at the beginning of 2014 and repercussions from geopolitical conflicts.

It is also important to note that the crisis has had not only economic, but also social, and political impacts (here I focus mostly on economic aspects, yet will mention the others briefly as well). In addition, the external (again both economic and political) factors are still playing a crucial role in the responses to the crisis in the CESEE region, due to its high degree of integration with Western Europe. Among the main factors affecting CESEE post-crisis economic developments are the growth slowdown (resp., stagnation) in the Eurozone—the main export market for the region—which hampers their export-led growth; the East-West geopolitical conflict with Russia and Ukraine, economic sanctions and their spillovers via export losses, and rising overall uncertainty, which impairs investments. In addition, the Brexit vote in the UK referendum in June 2016 and the 2015 migration crisis (among others) currently pose serious threats to the sustainability of the whole EU and its institutions with serious repercussions on the CESEE.

These global developments and the related turmoil affect the European emerging markets. Needless to say, the ongoing instability in Middle East and North Africa (MENA), the migration flows and uncertainties related to Brexit, and the new US presidency add to the existing geopolitical and economic risks as well.<sup>2</sup>

### **CESEE Growth Performance**

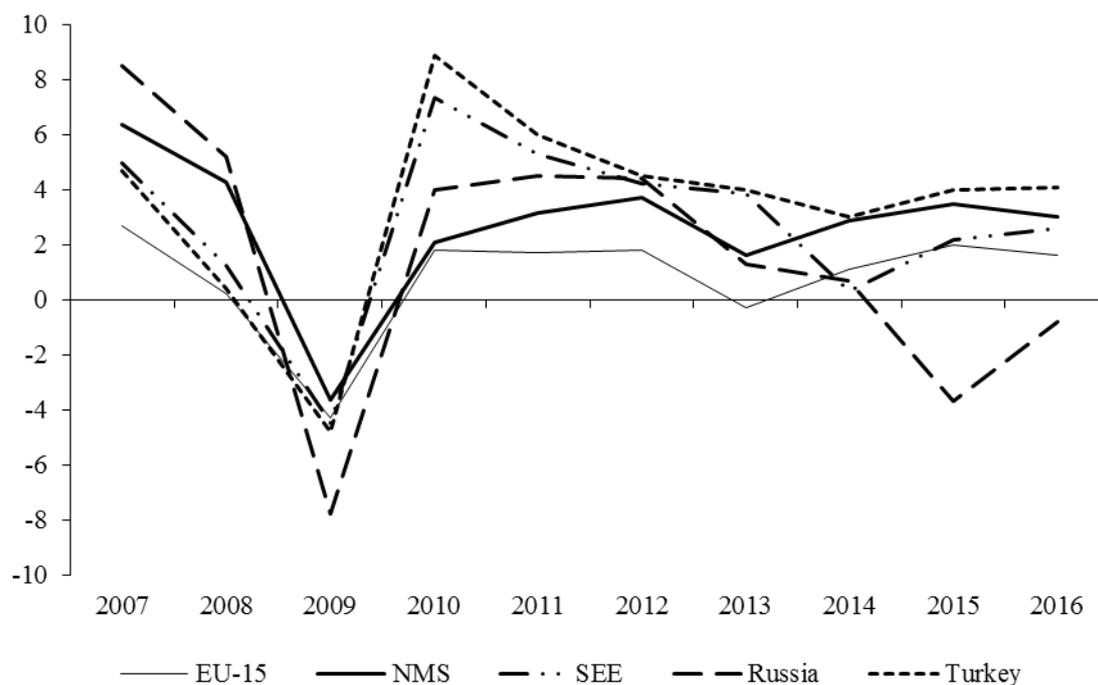
The slowdown in global economic growth has been the main characteristic of the crisis. **Figure 1** provides a growth overview of the major economies in Europe. Steep growth before the 2008–2009 crisis was followed by a deep recession in 2009 (strongest in Russia), whereas the recovery afterward has been rather weak in Western Europe (EU-15), the CESEE (EU new member states: NMS and Southeast Europe: SEE), and Turkey. A double-dip recession that hit Western Europe in 2013–2014 resulted in another growth deceleration in CESEE.

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<sup>2</sup> It is too early to say what impact Brexit and the Trump presidency will have on the EU, and the CESEE in particular; however, the expectation of more uncertainty and more protectionist policies is probably a safe bet (see Holzner et al., 2017, for some reflections on uncertainty regarding impacts on CESEE).

Post-crisis growth everywhere has generally been slower than before the crisis, and there are questions as to whether this growth slowdown now represents a new normal or whether it has just been temporary. We shall return to this issue later.

**Figure 1. GDP growth in Europe, annual changes in %**



Forecast: wiiw, European Commission (Economic Forecast, Autumn 2016) for EU-15.

Source: wiiw (Astrov et al., November 2016), Eurostat.

Russia slipped into a new recession in 2014-2016 (it had already been stuck in transition before—see EBRD, 2013, Havlik, 2015), mainly due to the oil price collapse of early 2014, the subsequent ruble devaluation, and geopolitical conflict with the West. Western European (EU-15) growth performance has been lackluster since the crisis, as there has been no real recovery after 2009. Low GDP growth, persistent high unemployment (especially of youth cohorts), a fragile banking sector that has not been sufficiently cleansed in the EU, and the European Central Bank (ECB) policy of quantitative easing so far have not been very successful in either stimulating investment or lifting inflation closer to the ECB target (close yet below 2%). The emerging consensus is that a lasting fiscal austerity represents the Achilles heel of sluggish growth (OECD, 2016). However, proposals by the European

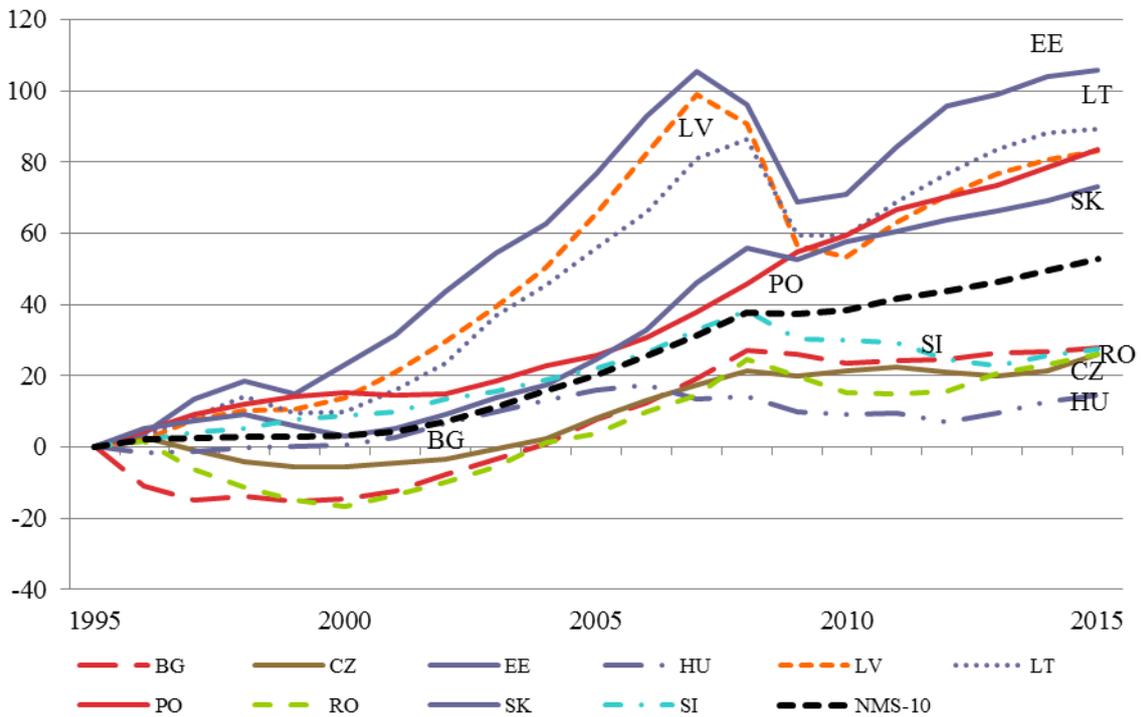
Commission to ease the restrictive fiscal policies and boost the economic recovery have not been accepted by the Eurogroup finance ministers, with Germany being the main advocate of lasting austerity.

As of mid-2017, and in even for the medium-term (during 2018–2019), the wiiw economic analyses and forecasts from November 2016 (Astrov et al., 2016) and March 2017 (Holzner et al., 2017) anticipate economic growth will stabilize at an average of approximately 3% per year in CESEE NMS (this is about 1 pp more than in EU-15), again with a large dispersion of growth performance across the region: Hungary, Poland, Romania, and Slovakia are performing better than the rest. At the same time, Russia, Belarus, Kazakhstan, and Ukraine will either stagnate or further disappoint with meagre growth (Belarus also will stay in recession in 2017). Diverging growth performance and current prospects of individual CESEE countries are discussed in more detail below.

Let us now turn to the growth performance of CESEE. A growth slowdown in Europe, particularly in CESEE, has been a general phenomenon observed after the 2008 global crisis. The previous rate of economic convergence of CESEE to the EU-15—about 2 pp per year observed during early 2000s—was reduced by about half, to some 1+ pp in the post-crisis period. The average CESEE speed of convergence may have accelerated recently, closer to the pattern observed before the crisis (Dobrinisky & Havlik, 2015; Holzner et al., 2017).

Different convergence paths of individual CESEE economies remain one of the key features of both early transition and post-crisis developments (**Figure 2**). Several observations are worth mentioning in this context: most CESEE experienced an accelerated catch-up since 2000 (note that their economic growth had already been faster prior to their EU accession in 2004, resp., 2007). This catching-up process followed a stagnation (resp., crisis) in the second half of the 1990s (dubbed a secondary transition recession owing to banking and balance of payments crises) e.g., in the Czech Republic, Romania, and Bulgaria. Subsequently, after 2005, there has been a rapid catching-up, especially in the Baltic States, but also in Poland and Slovakia in the immediate pre- and post-accession periods. A deep recession followed in 2009, and the catching-up process was interrupted, since the CESEE were hit hard by the crisis (especially in the Baltics), but not in Poland—the latter being the only country in Europe (bar Albania) that was able to avoid a recession in 2009, thanks largely to its flexible exchange rate and sizeable fiscal stimulus. Finally, a rather disappointing growth performance over the whole period in Hungary—the country which initially was the champion with respect to reforms and transition progress among the CESEE—is striking: in Hungary, hardly any catching-up (or just 10 pp) over two decades occurred between 1995 and 2015.

**Figure 2. GDP growth convergence, index 1995=100, differences from EU average in pp**



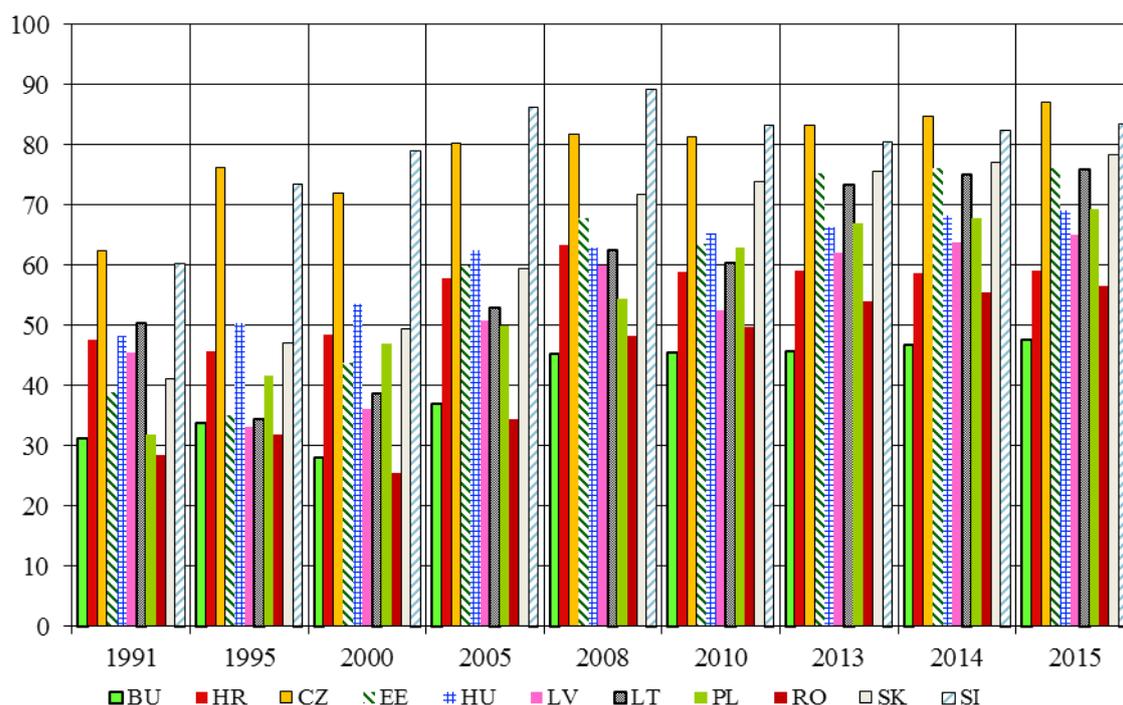
Source: The author's calculations based on the wiiw database and Eurostat.

Nevertheless, the overall CESEE catching-up/convergence progress has been quite impressive: on average, the NMS-10 region gained more than 50 pp in terms of GDP growth on the EU average over the period of 1995–2015. The diversity of growth performance within the CESEE region is remarkable and persistent: it ranges from about 10 pp reduction of the GDP growth gap in Hungary to more than 100 pp in Estonia (here, the development gap was reduced by half—see below). The average CESEE speed of convergence may recently have returned closer to the pattern observed before the crisis (Dobrinsky & Havlik, 2015) and estimated earlier for a larger sample of countries (Barro & Sala-i-Martin, 1995). Diverging growth performance is related to several factors, such as countries' starting development levels and past legacies, economic policies they pursued during transition, their integration in European and global markets, and their political stability.

Another perspective of convergence patterns provides the estimates of real per capita GDPs (at current PPPs) in relation to the EU average. **Figure 3** illustrates the closing of the development gap over the longer period since 1991 and after the 2008–2009 crisis, in particular. In the immediate crisis period, development levels (measured by real per capita GDP) fell sharply in Croatia, Estonia, Latvia, Lithuania, and Slovenia. Yet Poland (and partly

also Romania) managed to narrow the development gap even during that period. However, in the post-crisis period, the previously mentioned slowdown in convergence generally was visible again. Importantly, Slovenia lost its position as the most advanced CESEE (in terms of real per capita GDP) to the Czech Republic between 2008 and 2010; Slovakia had already surpassed Hungary in per capita development before the crisis. Thus, a substantial diversity in CESEE convergence patterns is visible again.

**Figure 3. Long-term income convergence in the CESEE: real per capita GDP levels, EU-28 average = 100, at current purchasing power parities (PPPs)**



Source: wiiw estimates based on Eurostat.

The above comparison has a one important caveat that is frequently ignored: in per capita terms, convergence patterns are affected by demography. This is highly relevant for CESEE, since the majority of countries have been suffering from substantial long-term population decline, due to the combination of low birth rates (a phenomenon common in most of Europe) and, especially, substantial outward migration. Migration has been particularly pronounced in the Baltic States, Romania, and Bulgaria—especially after their EU accession. These countries have lost more than 10% of their population during the last decade or so; their

process of economic convergence in GDP per capita terms would have been much slower without these demographic developments.

### **Diverse Drivers of Growth in CESEE**

The next section first investigates the key growth drivers in the post-crisis period, and then turns to a discussion of issues related to structural changes in the aftermath of the crisis and growth sustainability. Among the various factors that could possibly explain both the depth of the crisis and the speed of the subsequent recovery (such as the shares of industry and exports in GDP, various characteristics of the banking system, FDI penetration, and institutional factors)—all of which had been explored in the literature—were not very conclusive, due to statistical and other measurement problems (see, for example, The World Bank, 2012). The exchange rate policy, movements of the exchange rate, and the exchange rate regime seem to have played more prominent explanatory roles in both the depth of the CESEE slump and their post-crisis recovery. Indeed, there are some indications that transition countries with flexible exchange rate regimes tended to master the crisis better than those with a more rigid exchange rate regime, be it countries with a peg or currency board or those, such as Slovenia, that were already using the euro at that time. As a corollary, exports played a major role in CESEE countries' recovery from the crisis; in that sense, they did indeed prevail over austerity. Indeed, in countries such as Hungary, Poland, and Romania, exports to the eurozone were stimulated by exchange rate depreciation (see Box 1 by R. Stöllinger in Havlik et al., 2011). In addition, the depth of the recession also played a role in the scale of the growth reversal between 2009 and 2010. A recent analysis of factors underlying the weak economic growth in Europe is provided by Rzońca & Łaszek (2016). In contrast to a majority of other sources, the authors argue that the main causes of sluggish post-crisis growth in the EU (particularly in contrast to the USA) are supply side factors. In contrast, a recent IMF paper found that “the slowdown in potential growth has been associated with common external factors,” such as lower potential growth of trading partners and the evolution of global supply chains (IMF, 2017). For some countries, negative demographic developments have played a role as well.

Export-led growth has been an important characteristic of post-crisis developments in the majority of CESEE countries that are members of the EU. In contrast, the Western Balkan countries, as well as the “old” EU members in Southeast Europe (Greece, Portugal, and Spain), have been less open to exports, especially to the export of goods. The lack of export capacities in parts of Southeast Europe—for which there are many structural and institutional

reasons, such as lower FDI inflows to the manufacturing industry, labor market deficiencies, and a poor investment climate—represent serious bottleneck to a sustainable growth. Bruegel & WIIW (2010) analyzed this phenomenon in more detail in the immediate aftermath of the crisis. More recently, Landesmann & Hanzl-Weiss (2016) investigated factors behind correcting structural external imbalances and also identified, apart from the role played by the tradeable sector, real exchange rate developments, foreign direct investments, and industrial policy instruments. They concluded that the problem of structural external imbalances has not been resolved and that the heterogeneity among various groups of countries is large. Whereas the majority of CESEE economies have been recording trade and current account surpluses, or at least improving their external balances recently, other countries in the southern EU periphery still face serious structural imbalances and associated export weaknesses. These have been manifested in run-away deficits in Western Balkan countries in the pre-crisis period with large trade imbalances and sizeable capital inflows, the latter frequently of short-term, volatile, and speculative character. On average, current account deficits in the Western Balkans still amounted to 6–7% of GDP in 2015/2016 (compared to a roughly balanced position in the CESEE EU member states—see Astrov et al., 2016).

The Central European manufacturing core, established around Germany and including Austria, the Czech Republic, Hungary, Poland, Slovakia, and Slovenia, has been specializing in competitive export-oriented automotive, electrical, and chemical industries. This cluster of industries has been highly successful, thanks to FDI-led modernization and restructuring. It has been characterized by high productivity (especially of medium-skilled workers) and exploits outsourcing opportunities related to existing labor cost advantages in the CESEE (Stöllinger et al., 2013). The question is whether other countries in the region, especially the Western Balkan countries or Moldova and Ukraine, can follow this example, and, if yes, whether they should implement economic (industrial, structural) policies in order to foster a re-orientation toward manufacturing, e.g., via targeted FDI policies supporting specific sectors.

### **The Crisis and Structural Change**

Even before the crisis, and essentially since the beginning of transition, CESEE countries have experienced a process of economic restructuring away from industry and agriculture and toward services (Havlik, 2014a; Landesmann & Leitner, 2015). In the more advanced CESEE economies, however, the restructuring pattern has been partly reversed, and manufacturing industry shares of both GDP and employment have recently (between 2010 and 2015)

stabilized or even increased (e.g., in the Czech Republic and Slovakia, manufacturing employment shares reached about 25% in 2015—an unprecedented high level in the European context). This tendency toward re-industrialization has been associated with the CEE-German manufacturing cluster mentioned above. A closer look at more detailed patterns of structural change during and after the crisis reveals a rather differentiated picture.

**Figure 4a** and **Figure 4b** illustrate the diverse responses to the crisis using the examples of four CESEE countries that all belong to the CEE manufacturing core: the Czech Republic, Hungary, Poland, and Slovakia. **Figure 4a** shows structural changes in GDP in the period from 2008–2011. During that period, the shares of manufacturing value added in GDP dropped in the Czech Republic and Slovakia, whereas the same shares increased in Hungary and stayed constant in Poland. The crisis hit construction hard in Hungary and Slovakia, yet not in Poland (the latter suffered a financial services bust—in contrast to the Czech Republic, Hungary, and Slovakia). In terms of employment (**Figure 4b**), manufacturing suffered everywhere, yet the reactions in other sectors were much more diverse.<sup>3</sup> Looking at relative changes in shares of manufacturing value added and employment, we can see some evidence that labor productivity in manufacturing (C) increased during the crisis: in both Hungary and Poland, the shares of value added increased, while those of employment dropped between 2008 and 2011; in the Czech Republic and Slovakia, manufacturing employment shares dropped more than those of value added. As far as other economic sectors (and other CESEE countries) are concerned, the patterns of structural change during the crisis were much less clear, and the impact on productivity diverged significantly. As a rule, in the aftermath of the crisis, service employment increased (including financial services K), whereas employment in agriculture, manufacturing, and construction decreased.

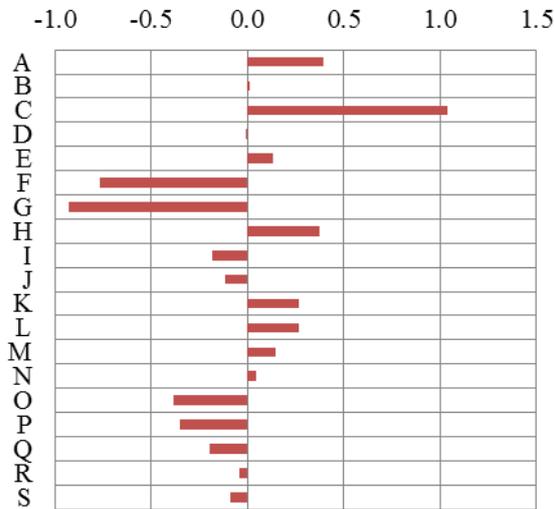
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<sup>3</sup> The Baltic States—Estonia, Latvia, and Lithuania—were hit harder by the crisis and experienced greater structural turbulence. Comparable data for Bulgaria and Romania were not available. A more detailed discussion, covering other CESEE and selected West European countries, can be found in Havlik (2014b): “Structural Change in Europe during the Crisis.” FIW Policy Brief Number 22, BMWFJ, January 2014. <http://www.fiw.ac.at/index.php?id=462#c12556>.

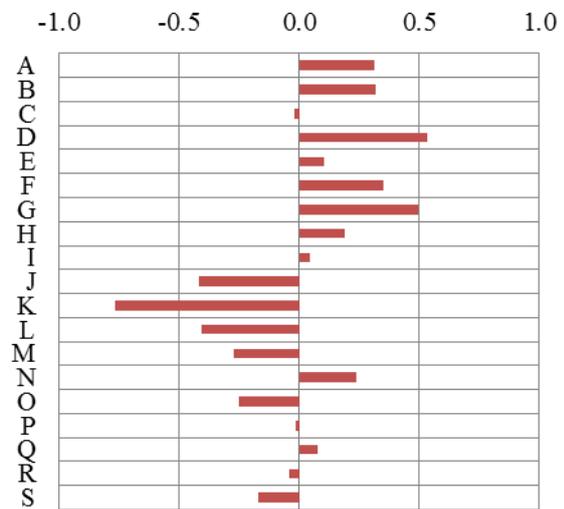
**Figure 4a. Structural change during the crisis—sectoral VA shares in GDP (in pp)**

NACE Rev. 2 (N2)

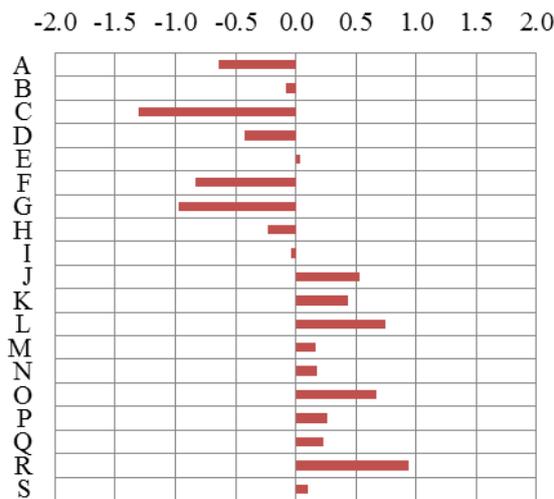
(a) Hungary, 2011–2008, N2



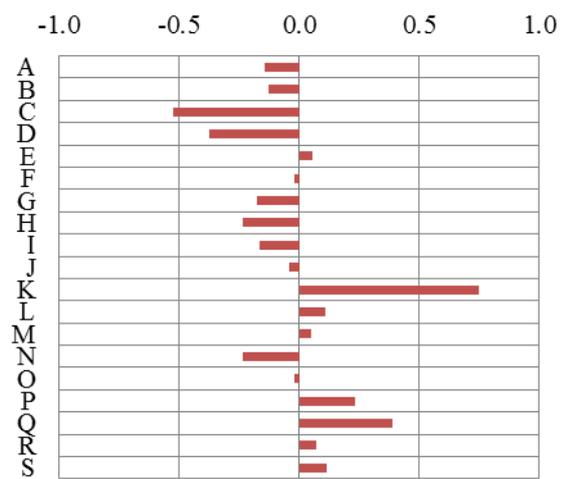
(b) Poland, 2011–2008, N2



(c) Slovakia, 2011–2008, N2



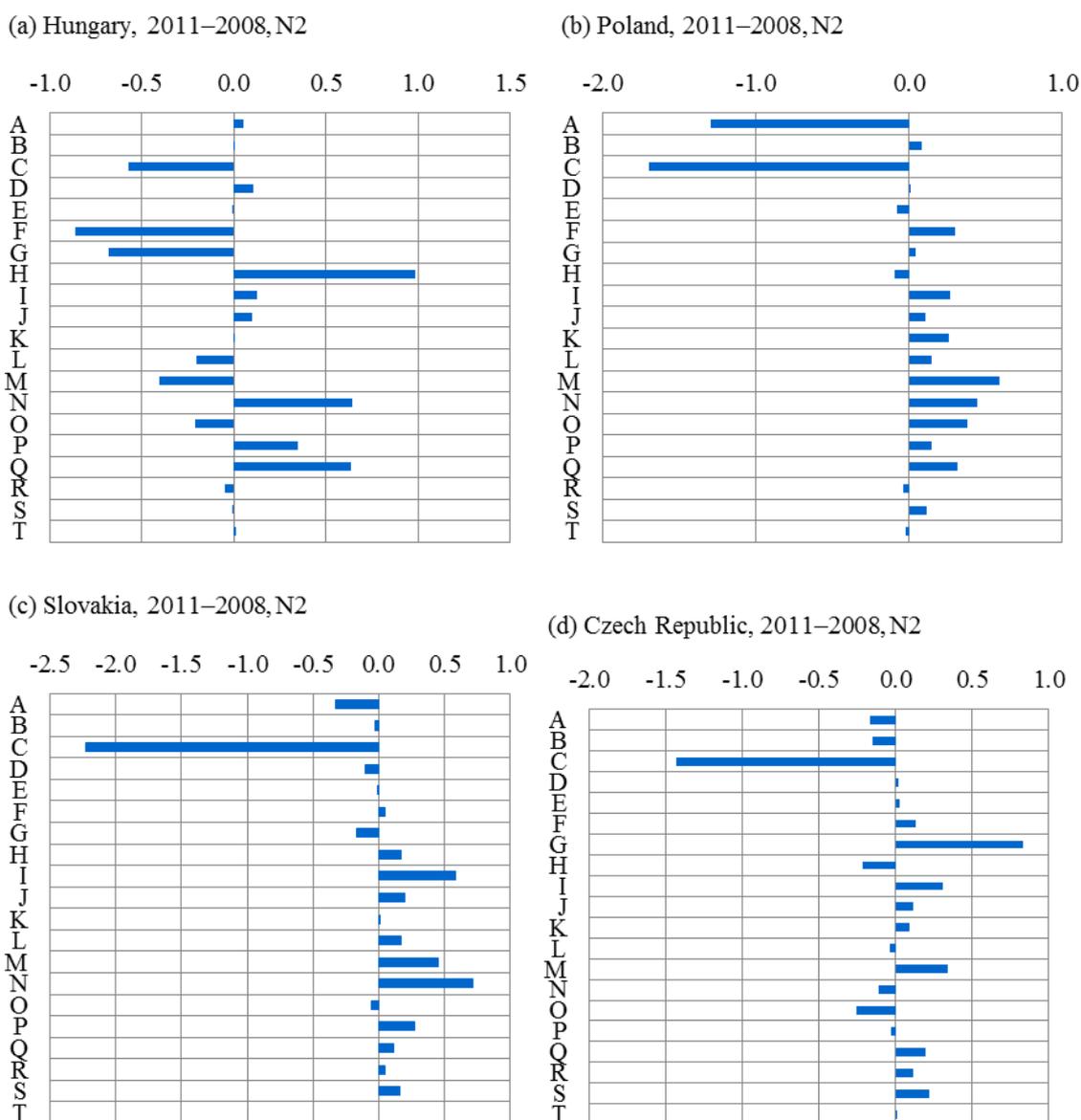
(d) Czech Republic, 2011–2008, N2



Source: wiiw calculations based on Eurostat

**Figure 4b. Structural change during the crisis—sectoral shares in employment (in pp)**

NACE Rev. 2 (N2)



Source: wiiw calculations based on Eurostat.

**Post-Crisis Convergence Slowdown: a New or an Adjusted Growth Model?**

I have illustrated above longer-term convergence patterns and the post crisis convergence slowdown. In the meantime, the growth slowdown has been empirically established as fact by the IMF, EBRD, World Bank, and others; it has already lasted for nearly a decade. With respect to CESEE, it has also been acknowledged that the previous convergence model—based on belief in the power of institutional convergence within the Washington Consensus or

EU *acquis communautaire*, free capital flows and the democracy agenda—had failed or was at least insufficient, as clearly evidenced by the crisis and post-crisis developments (Bruegel & wiiw, 2010; Dobrinsky & Havlik, 2014; EBRD, 2014; Podkaminer, 2013, etc.). Importantly, implications from the failure of the previous model extend beyond a purely economic agenda in terms of output losses, rising unemployment, and income inequality. These have also led to rising populism, a backlash in political stability, and eroding reform support coupled with declining support for the European integration project, which have brought to the fore weaknesses of EU-level governance structures that have been aggravated by the migration crisis and rising protectionist tendencies. All these disturbing tendencies have become evident in the post-crisis period everywhere, not just in the CESEE region.

The elements of the new growth model or post-transition agenda (a more detailed description of its individual features is beyond the scope of the present paper) may include the following general policy areas:

- More emphasis on the development of export-oriented sectors;
- Targeted FDI policies, focusing on the tradeable sector;
- Employing elements of industrial policy;
- Focusing on skills developments, especially in younger-aged cohorts;
- Preventing the emergence of excessive income and social disparities.

Obviously, due to the high diversity of individual CESEE countries, it is extremely difficult to devise a one-size-fits-all economic policy for the region. For example, it is questionable whether the above-mentioned successful German-CEE supply chain cluster in automotive, electrical, and chemical industries can be copied elsewhere in Southeast Europe, due to geographic, cultural, demographic, and other reasons. The evidence is again mixed: Romania—a transition latecomer that has been characterized for many years by stop-and-go economic policies—may have recently embarked on an FDI- and export-driven re-industrialization path that resembles the earlier experience of Hungary and Slovakia. However, elsewhere in Southeast Europe, particularly in Bosnia and Herzegovina, Serbia, Albania, and Kosovo, as well as in Ukraine, the challenges are much bigger—despite recent signs of economic stabilization or even recovery.

Turning now to the more recent period and growth prospects, wiiw analyses and forecasts from March 2017 suggest that household consumption has been the main driver of growth in CESEE. The average GDP growth was close to 4% in 2015 in the CEE manufacturing core (Czech Republic, Hungary, Poland, and Slovakia); the Baltic States and

Slovenia lagged slightly behind. The analysis identifies a virtuous circle of rising wages and consumption, accompanied by declining unemployment, triggered by emerging labor shortages. An additional recent growth driver has been investments, partly those financed by transfers from the EU, which have been particularly important for Hungary, Poland, Romania, and Slovakia, where it accounted for up to 3% of GDP in 2012–2014 (latest available Eurostat data).

The above-mentioned phenomenon of wage cum consumption-driven GDP growth is new for the CESEE (it was analyzed in more detail already by Astrov et al., 2016). In this respect, and apart from the generally higher GDP growth, CESEE also differs from Belarus, Kazakhstan, and Russia (which, together with Armenia and Kyrgyzstan, form the Eurasian Economic Union—EAEU) and Ukraine, which all had been plagued by recession from 2014–2015 and do not have particularly bright growth prospects, due to lasting structural and institutional deficiencies (Havlik, 2015; Dobrinsky et al., 2016; Astrov et al., 2016).

The latest economic developments in the CESEE region are, on the whole, encouraging: driven by robust domestic demand, especially by household consumption and investments, GDP growth in 2016 averaged 3% in the CEE region, and the outlook is fairly positive—despite increased geopolitical uncertainties and tensions after the migration crisis, Brexit, the US presidential elections, and the Greek crisis. The latest wiiw forecast from Spring 2017 reckons with a continuation of fairly robust GDP growth in the CESEE region (about 3% per year during 2017-2019)—about the same growth pace as in the Western Balkans—whereas a weaker and more gradual recovery is forecast in Belarus, Russia, Kazakhstan, and Ukraine (Holzner et al., 2017). Given that the latest European Commission forecasts for the eurozone expect GDP growth of less than 2% in 2016–2018, the CESEE pace of economic convergence will be maintained, albeit at a speed somewhat reduced from that observed prior to the crisis.

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